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PRI and the Use of Credit Derivatives

We invited Price Lowenstein, President of Sovereign Risk Insurance Ltd., to discuss the relationships between credit derivatives and PRI.

The fallout from the sub-prime crisis continues to generate turmoil in the banking and financial guarantee insurance industries. The depth and ultimate outcome of the current crisis, which arose primarily because complex derivative structures based on poor underlying credits were packaged and sold to investors, is difficult to predict. There is certainly the possibility that the entire market for derivative-type instruments could be dramatically different six months or a year from now. Still, there are synergies and relationships between PRI and credit derivatives that may be worth exploring.

What is a credit derivative?

While there is considerable complexity associated with it, a credit derivative is basically a security, like an option or futures contract, whose value depends on the performance of an underlying security or asset. In other words, a derivative is a financial contract whose value is based on, or derived from, a traditional security (such as a stock or bond) or an asset (such as a commodity).

The volume of credit derivatives has exploded in the past ten years, as investors have seized the opportunity to trade in (i.e., to assume or to lay off) the generic credit risk of an asset such as a loan or a bond without having to hold the actual credit asset itself. Because this "synthetic" market does not have the limitations of the "real" market for bonds or loans, credit derivatives have become an alternative, parallel trading vehicle for investors who seek to buy or sell credit protection in order to hedge exposure to corporate or government debt. The most common form of credit derivatives is a credit default swap (CDS), where one party sells credit default protection on an underlying asset to another party for a price.

Why is credit risk management so crucial to the global economy?

Our society lives on credit and depends on credit. Governments (both emerging and developed), corporations and individual consumers all increase their

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Political Risk Coverage of Regulatory Takings: A New Approach

Readers of the last edition of this Newsletter will recall our discussion of the importance and challenges of developing PRI wordings that are clear and appropriate. We invited Frederick Jenney and Thomas Eldert of Morrison & Foerster LLP to explore a problem of meaning and wordings of a particular interest: regulatory takings.

In the past, expropriation events tended to involve explicit government expropriatory acts, such as wholesale nationalizations in Cuba, Libya and Iran. For the political risk insurance business, those were the good old days -- at least with respect to clarity.

Today, outright nationalizations have become relatively uncommon, replaced instead with varying degrees of regulatory actions, ranging from the transparent, such as recent actions in Bolivia and Venezuela, to the more subtle, such as targeted environmental or consumer safety laws. In extreme cases, regulatory action can constitute a type of expropriation known as a "regulatory taking".

Until recently most political risk insurance policies have covered expropriations generically, without distinguishing outright expropriations from regulatory takings. Unfortunately, recent evolution of international law has made that approach nearly unworkable.

Scope of the Problem of Defining Wrongful Regulatory Takings

Limits of Traditional Expropriation Coverage

To an investor, any regulatory action that causes significant economic harm to its investment seems like an expropriation that should be covered by political risk insurance expropriation coverage.

However, expropriation coverage is not designed to protect against the effects of most regulatory actions. The reason is basic: when a political risk insurer pays an expropriation claim to an insured investor, the insurer needs to be in a position to make a claim back against the host government for its action.

A host government, however, is only liable for the consequences of its

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Political Risk Coverage of Regulatory Takings, cont'd.

actions if those actions are unjust (or "wrongful", as lawyers tend to say), as opposed to legitimate. Legitimate regulatory actions do not give rise to a right of recovery against the government. If they did, no government could afford to make changes to a regulatory regime.

But what actions are "legitimate" is a complex question. The host government's internal law regarding takings has long been rejected as a standard for legitimacy, in large part because the same government that takes the regulatory action in question can change the internal law (or the interpretation of it) as to the legitimacy of that action.

Need to Resort to International Law

Accordingly, a body of international law, not dependent on the law or interpretation of any one country, has developed as the standard for expropriation claims against a host government. In turn, most political risk insurance policies over the years have required that for there to be an expropriation, the government's actions must be in violation of this standard of international law.

Traditional international law regarding takings is complex, but generally has required that, to be legitimate, a taking must be (i) for a public purpose, (ii) nondiscriminatory, and (iii) accompanied by just compensation.

Application of the traditional standard to regulatory takings has proven to be difficult. Because of the "public purpose" test, normal regulation or change of law is not a wrongful action under international law -- and therefore is not an insurable event under political risk insurance expropriation coverage. On the other hand, it is easy to imagine a host government attempting to cloak a wrongful expropriation with the appearance of legitimate regulatory action.

Problems With International Law as a Standard

International law has some serious shortcomings, many of which are evident in regulatory takings cases. There is no system under international law, much of which is determined by arbitral tribunals, for assuring consistency of results, reasoning, or analysis. International tribunals have no *stare decisis* principle (*i.e.*, requiring consistency with previous decisions), there is no appeals process to review the rationale for decisions, and there is no World Supreme Court to sort out inconsistent results. As a result, current international law on the subject of regulatory takings can be fairly characterized as vague, inconsistent, evolving, political and (ultimately) unclear.

Problems for Political Risk Insurers in Defining Regulatory Takings

The prevalence of host government actions that clearly impair a foreign investor's position but are not clearly wrongful presents a big problem for a political risk insurer seeking to offer expropriation coverage. Put simply, the goal for an insurer is to write policy language that describes regulatory actions that are as likely as possible to be violations of international law, so that the insurer has a right of recovery against the host government. But given the confused state of international law, how can this be done? Recent discussions among political risk insurers have focused on the following questions:

Should a policy define expropriation by (a) attempting to define the difference between legitimate regulation and wrongful expropriation, or (b) referring to international law to draw that line? If a cross-reference to international law is impractical, how should specific policy language draw the line between legitimate regulation and wrongful regulatory taking?

> *Looking at recent arbitration cases to try to determine key elements of a workable standard for political risk insurance, we were able to ascertain some broad principles and common factors.*

Analysis of Regulatory Takings Cases

In recent years roughly twenty regulatory takings cases have been brought before international arbitral tribunals. In an attempt to find a consensus as to the key elements of what constitutes a regulatory taking, we reviewed eight of the leading international opinions and decisions involving alleged regulatory takings from the past seven years. Most of these were NAFTA and BIT cases, which collectively have developed new theories of regulatory takings under international law.

Not surprisingly, the arbitrators in these eight cases took a variety of different and sometimes inconsistent approaches. Each case hinged on two or three (or more) factors, but the tribunals generally did not state which factor was determinative in rendering an award, and did not comment on relative weighting of factors. Looking at recent arbitration cases to try to determine key elements of a workable standard for political risk insurance, we were able to ascertain some broad principles and common factors.

Three Key Dimensions Emerge

We believe that the factors that correlate closely with an overall finding that there was a regulatory taking can be grouped analytically in terms of the nature, subject, and effect of the regulatory action. Our analysis was limited to correlation between specific case factors and a finding of a regulatory taking.

Nature of the Host Government Regulatory Action The first dimension that we considered was the nature of the regulatory action that the host government took. In descending order of apparent correlation, the key factors for this dimension were as follows:

- **Confiscation** (of something) WAS correlated with a finding of a taking;
- **Transfer** (of something) to a third party WAS correlated with a finding of a taking;
- **Deprivation** (of something) to the investor WAS correlated with a finding of a taking; but
- Mere **interference** (with something) generally was NOT correlated with a finding of a taking.

In other words, these arbitral tribunals have generally found that, to be

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PRI and the Use of Credit Derivatives, cont'd.

spending power by utilizing credit. Credit allows us to consume far more than we can pay for with cash or other current assets, and therefore is the basis of consumerism. On a macroeconomic basis, credit is the driving force of the world economy. In its simplest form, offering credit means parting with value today against the promise of increased value in the future. Credit risk is simply the risk that this promise will be broken. The advent of credit derivatives has made it much easier to manage the myriad forms of credit risk in a transparent and legally enforceable framework.

The credit derivative market:

During the past ten years, credit derivatives have become a basic tool for risk management in the banking sector for both corporate credit and country risk management. Since the mid-1990s, banks have increasingly used credit protection to diversify and reduce corporate and emerging market exposure inherent in their lending activities. Insurance companies have also participated (mostly in the non-emerging market arena) both as providers of protection (to capture higher returns and better spreads), and as buyers of protection (to manage their exposure and diversify their portfolios). Corporates use the instruments to mitigate effects of adverse credit cycles, and asset managers use them in order to capture higher yields. According to the Wall Street Journal, (January 18, 2008) the current market for CDS is estimated at roughly $45 trillion.

The CDS market for emerging market sovereign/sub-sovereign obligations has also grown rapidly over the past ten years. The standardized documentation that was developed for credit derivatives within the framework of the International Swaps and Derivatives Association ("ISDA") Master Agreement in 1998 and 1999 contributed to this growth by facilitating participation of a wider range of protection for buyers and sellers. As a result, the market has become more liquid, and tenors for derivative products have increased up to 10 years, and even longer for certain countries. Today, the volume of emerging market credit derivatives is far larger than the underlying emerging market bond market itself.

Insurance companies have also participated [in the credit derivatives market]… as providers of protection (to capture higher returns and better spreads), and as buyers of protection (to manage their exposure and diversify their portfolios).

Credit protection from the PRI market:

As most readers of this Newsletter already know, PRI is a broad term which encompasses two very different, distinct categories of risk:

- **Pure political risks** such as expropriatory actions, currency inconvertibility or political violence, which lead to a loan default or loss of equity investment; and
- **Comprehensive nonpayment risks**, essentially loan defaults which occur for any reason (i.e. political or commercial).

The nonpayment insurance product, which for the purposes of this article we will call NPI, has become increasingly popular over the past five years as banks seek more tools to manage their credit exposures and country limits under the new Basel II Framework. For example, we at Sovereign have seen the demand for our NPI product more than double in the past three years. Because Sovereign does not underwrite private sector Trade Credit (NPI on loans to private sector corporates), for the purposes of this article, I will restrict the product discussion to what Sovereign underwrites, which is NPI for loans to sovereign and sub-sovereign (i.e. at least 51% government-owned) borrowers.

Key differences between NPI and credit derivatives:

Although NPI covers the same underlying risk as a credit derivative, the buyers and sellers of the product treat the two products quite differently. The key structural differences are:

- Conditionality: NPI policies have some of the same Representations, Warranties and Exclusions as standard PRI policies. Due to this conditionality, NPI is not considered "a guarantee of timely payment of principal and interest" as a credit derivative is, but rather as a conditional insurance contract. It should be noted though that some NPI policies now appear to qualify as accepted "Credit Risk Mitigants" under Basel II.
- Waiting Period: Like standard PRI policies, NPI policies have waiting periods of 90 to 180 days between the actual missed payment date and the date a claim can be made. Credit derivatives have no waiting period, just a settlement period of somewhere between 5 and 30 days.
- Non-Acceleration: Unlike credit derivatives, NPI does not follow an acceleration of an obligation and NPI does not pay the entire amount of a loss on the date of loss (as credit derivatives do). NPI policies typically indemnify the Insured over the original schedule of principal and interest payments, following the waiting period.
- Restructurings: In a restructuring scenario, a claim can be made under an NPI policy if the maturity of the insured obligation has been lengthened (since, in effect, there has been a deviation from a scheduled payment). With most credit derivatives, there must be an economic loss to trigger a claim, so that a restructuring under the same or better terms than the original reference obligation is not always considered a "credit event" (i.e., a loss).
- Premium Payments/Funding**:** Under a traditional NPI policy, in the event of a claim, premium must continue to be paid throughout the life of the deal whereas under a CDS structure no further premium is paid once there is a loss.
- Pricing: Because of the conditionality and waiting periods, NPI rates are generally around 70% to 80% of a transaction's all-in margin. Credit default swaps are generally priced in accordance with market conditions and generally capture 100% of the all-in risk price.

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PRI and the Use of Credit Derivatives, cont'd.

How do banks decide whether to use NPI or CDS on a particular transaction?

Banks have a wide variety of risk mitigation tools available to them. These include syndication, insurance, derivative protection and various forms of financial guarantees. In our experience, banks use whatever form of risk mitigant is the most strategically advantageous and the most cost efficient for a given transaction. On straightforward, short or medium tenor transactions with well known borrowers (for example, a three to five-year working capital loan to a large state company like Petrobras or Gazprom), banks tend to use CDS protection, as it is seen as a cleaner, less conditional and more efficient risk transfer tool than NPI. In more complex or longer-dated transactions, NPI may provide better protection by avoiding the "basis risk" (i.e. the risk that CDS protection is not sufficiently tailored and may not respond to certain transaction-specific risks).

As we are seeing the volume of inquiries for NPI increase significantly, it is clear that there are more and more circumstances where banks are choosing insurance over derivatives. The fact that NPI, depending on policy wording, may now qualify as an accepted Credit Risk Mitigant under Basel II, makes it more likely that NPI will become a more attractive alternative for banks protecting themselves against credit risk accumulation.

The CDS market is more limited than the insurance market in terms of the tenors available, the names which can be covered, and in many cases, the total amounts which can be covered. We are seeing a growing trend where large commercial banks are lending to sub-sovereign entities for which there is no CDS market, and also more and more cases where emerging countries are successfully demanding longer tenors (Vietnam is a prime example) than are available in the CDS market.

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Derivatives Utilization by the PRI Market

There are four main areas where PRI underwriters are using, or can utilize, credit derivatives:

Pricing benchmarks – Sovereign, and most PRI underwriters, use the CDS market every day to help us analyze and price risk for our NPI product. Looking at CDS pricing is a very efficient, transparent way to look at the global financial market's credit risk perception of countries and companies. Since taking CDS protection is an efficient and frequently used option for a bank to transfer risk (and therefore one of the prime complementary, and in some cases, competing products to NPI), looking at CDS pricing provides underwriters with a very accurate view of the pricing dynamics for sovereigns, sub-sovereigns and corporates.

Underwriting NPI on Single Names or Portfolios – Although Sovereign does not, several PRI underwriters do underwrite nonpayment risk on CDS structures (generally for investment banks). This is typically done by modifying NPI policies to cover credit derivative-structured transactions. Although this can be done on a single name basis, it is usually done as a portfolio of synthetic Credit Default Obligations (CDOs), in which a bond is the underlying asset. In the latter, a CDO portfolio can be structured as a "basket" of sovereign credits which are then "tranched" into equity (in insurance terminology – "first loss"), mezzanine ("first excess") and senior ("high excess") layers. "Coverage" would then be assumed on a first, second, third, etc. to default basis (i.e. a loss would not occur until a number of the individual names in the portfolio had defaulted). This is a similar structure to an excess-of-loss insurance policy.

Alternatively, credit default exposure can be structured as a single name (i.e. – one credit) basis or on a "first-to-default" position on a portfolio basis. Like insurance, pricing is higher the closer the underwriter gets to assuming a first loss position. These structures also allow PRI underwriters (sellers of protection) to structure coverage in accordance with their individual risk/return appetite as well as their regional and country-specific portfolio balancing requirements.

One of the attractive features of this type of "synthetic portfolio" is the ability to cherry pick the countries which go into the "basket". Both excess of loss (second/third/fourth to default) portfolios and/or first loss positions can be structured with the mix of exposures that best fit the portfolio balancing needs of each individual underwriter.

Counterparty Limits Management - Because major PRI insurers underwrite a large volume of business with the leading commercial and investment banks, on occasion the bank will reach its counterparty limits on the insurer. Some banks will solve this problem by buying CDS protection on the individual insurance company, and can therefore undertake further transactions with the insurer without adding additional counterparty credit risk to the bank's balance sheet. The bad news for insurers is that this "counterparty credit charge" is generally deducted from the premium being paid to the insurer.

Individual Credit Risk Management - Unlike insurance risk, which is generally taken on an "underwrite-and-hold" basis, derivatives can be actively traded and hedged. Depending on what the derivatives market will look like once the current sub-prime crisis subsides, it is likely that credit derivatives will become an increasingly common form of risk management, complementing traditional reinsurance programs, for the major PRI underwriters. As seen in the following example on Argentina, with sufficient macroeconomic analytical foresight, large 'meltdown' scenarios can potentially be hedged through credit derivative protection. As currency inconvertibility (and, to a lesser extent, expropriation), are collateral risks stemming from economic meltdown/default events, it seems clear that having the knowledge and ability to use CDS protection will be a valuable tool in managing large PRI and NPI portfolios. It seems inevitable that a more active management of risk will be a natural and prudent evolution for the PRI industry rather than continuing to operate indefinitely in the traditional "underwrite-and-hold" format.

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PRI and the Use of Credit Derivatives, cont'd.

Hypothetical Argentina Hedging Scenario:

As an example of how the CDS market could be used in a scenario where traditional PRI underwriters are facing large losses, several years ago Sovereign undertook a study of how credit derivatives could have been used to hedge risk during Argentina's economic meltdown in 2000-2001. We found that over the sixteen-month period preceding the Argentine default in December 2001, the cost of a one-year CDS for Argentina grew from 360 bp to 8039 bp, and the cost of a two-year CDS for Argentina grew from 460 to 7020 bp. Assuming a PRI underwriter had a CEN/CI portfolio totaling $500 million in Argentina and NPI exposure of $100 million, the following strategies could have been implemented:

In December 2000, a year from the crisis, the insurer could have spent $10 million and purchased two-year CDS protection on Argentina for 585 bps. When the default occurred 12 months later, the CDS default protection would have paid out roughly $170 million. This would have covered not only the $100 million NPI exposure but could also have been used to compensate up to $70 million in potential CEN and CI losses as well. Even assuming the insurer had waited until April, 2001, the same $10 million expenditure for CDS protection would have paid out roughly $81 million.

We also found that significant recoveries could also have been achieved by buying CDS protection in increments at intervals over the same period.

To have an effective sovereign hedging strategy using CDS instruments, it is imperative to maintain a steady, consistent and detailed analysis of macroeconomic and political trends in countries of high exposure. As seen from the movement in CDS spreads leading up to Argentina's default, a buyer of default protection will always be racing against market sentiment once the negative economic trends become increasingly acute. This will almost certainly conflict with insurance underwriters' views that a crisis will work itself out (as they often do) rather than go all the way to a full scale meltdown and default. It is also important to keep in mind that CDS protection does not pay out unless there is a defined 'credit event' (debt default), so that even if a PRI underwriter adopted the strategy outlined above, they could still be liable for CEN and CI claims had there been no sovereign default (and therefore no payout by the CDS instrument).

Why derivatives may not work for everyone.

There are several issues that we at Sovereign have had over the years which have prevented us from entering into transactions where insurance policies would be used to cover derivative instruments or baskets of derivatives. The principal issue has been the accounting practice known as "mark-to-market".

Mark-to-market is the practice of monitoring the changes in the daily (or quarterly) value of a derivative contract by calculating the gain or loss in cash flows in relation to the current market value of the position. This practice ensures that the account between counterparties is supported by the minimum amount of margin funds required by the Federal Reserve Board, the Stock Exchange and/or the brokerage house involved. With a relatively small team and a rapidly growing business volume of traditional PRI and NPI business, we do not have the resources to conduct a mark-to-market exercise every quarter, which would be required if a PRI underwriter insures a derivatives portfolio or individual names.

In a broader, more philosophical context, it has been our experience that it is very difficult to convince senior management of large multinational insurance companies that sovereign or sub-sovereign bond exposures are more efficiently handled by writing insurance protection (and getting paid less than the full bond spread), rather than simply buying the bond, or slice of a bond portfolio, adding it to the insurer's investment portfolio (and getting paid 100% of the bond or portfolio spread). As the fallout from the current sub-prime crisis escalates in global markets and the financial guarantee industry faces downgrades and massive write-downs, it may also be some time before the ultimate utility of credit derivatives as a risk management tool for our industry is clear. It does appear, however, that recent developments have made traditional NPI products comparatively attractive as a means of managing risks. ■

PEOPLE AND ORGANIZATIONS

Zurich Emerging Markets Solutions (ZEMS) reports that it has opened a new office in Frankfurt, Germany. Ulrich Hoffmann, formerly of Zurich's German credit insurance and surety affiliate, is Deputy Regional Manager there for Europe.

Albert Barbe, formerly with COFACE, has joined ZEMS' Tokyo office as a senior underwriter. In London, Paul Sanders was promoted to Regional Manager. ZEMS is also in the process of opening an office in Beijing.

Navid Farooq, formerly Head of Zurich's London operations, will head up Caatlin's political risk insurance team.

Rod Morris returns to the Overseas Private Investment Corporation as its Vice President for Insurance.

Bernie de Haldevang has resigned from Atrium to start up a direct underwriting business.

Roland Pladet will be joining the Asian Development Bank's (ADB) Office of Commercial Cofinancing in May 2008 as a Senior Guarantees and Syndications Specialist, based in Manila. He is currently Chief Underwriting Officer at the African Trade Insurance Agency in Nairobi and prior to that was with MIGA.

At its October, 2007 meeting the Berne Union elected the following:

Hidehiro Konno of NEXI, Japan, as the President of the Berne Union for the term 2007-2009, succeeding Lars Kolte of EKF (Denmark);

John Salinger of AIG as Vice President, following the terms of Angus Amour of EFIC (Australia);

Dan Riordan, Zurich (USA) as Chair of the Investment Insurance Committee, with Rainer Wietstock, PWC (Germany) as Vice Chair.

Political Risk Coverage of Regulatory Takings, cont'd.

compensatory, a regulatory action must involve the confiscation, transfer or deprivation of an asset, but not mere interference with an asset. Thus, a law forbidding foreign ownership of paper mills would clearly be confiscatory and satisfy this prong, while a law requiring paper mills to have only local managers might be an interference, but would not satisfy this prong.

Investor Rights That are the Subject of the Regulatory Action In descending order of apparent correlation, the key factors for this dimension were as follows:

- Impairment of **ownership rights** of the investor in the foreign enterprise WAS correlated with a finding of a taking
- Impairment of **management and control** of the foreign enterprise WAS correlated with a finding of a taking
- Impairment of other **fundamental rights** or benefits of the investor WAS correlated with a finding of a taking
- Impairment of **enjoyment of property** by the investor was NOT correlated with a finding of a taking
- Impairment of **revenue stream** to the investor was NOT correlated with a finding of a taking

That is, arbitral tribunals tend to find regulatory takings where fundamental ownership rights, including ownership, management and control of an enterprise, are affected, and no takings where only enjoyment of property and revenue streams are affected, even if the investor's ability to realize a profit from that investment is curtailed. For example, a new tax on a paper mill as a foreign-owned enterprise might appear unfair and would certainly affect revenue streams, but would not likely constitute a taking. Although some panels have found a total or near total deprivation of revenue streams to be a taking, tribunals generally do not find a taking where the investor retains control of its investment.

Required Degree of Effect Generally we found that:

- A regulation that had a **permanent effect** on the investment WAS correlated with a finding of a taking, whereas one that had only a temporary effect was NOT correlated; and
- A regulation that affected the **total investment** WAS correlated with a finding of a taking, whereas one that had only a partial impact on the investment was NOT correlated; and

For a regulatory action to constitute a taking, its effect must be permanent. An emergency regulation that shuts a factory down for a week may affect profits, but does not rise to the level of a taking. Accordingly, tribunals are likely to find that delays in economic opportunities caused by regulations do not constitute a taking. Similarly, the regulation must have a total or near total effect on the investment. Interference with some rights of ownership (e.g. requiring one board member to be government appointed) would not constitute a taking, while deprivation of all rights (e.g. requiring a controlling majority of the board to be government-appointed) likely would.

Three Approaches to Avoid in Regulatory Takings Analysis

Finally, we note three aspects of political risk insurance policy language that are not helpful in delineating legitimate from wrongful regulatory actions.

Exclusion for Police Powers Not Relevant Some political risk insurance policies exclude actions taken within an exercise of a host government's so-called police powers (a government's authority to regulate behavior and enforce order within the country). However, several tribunals have found that governments invoking police powers nevertheless violated international law, essentially concluding that the defense cannot excuse an inequitable expropriation. In other words, the international legal concept of "police power" provides no effective safe harbor for expropriating regulation. The trend seems to be that tribunals in general pay little heed to "police powers" arguments, such that they are basically inoperative. We therefore conclude that there is no longer any correlation under international law between the use by a government of its police powers and the finding that there has been no expropriation.

Exclusion for "Regulation of the Economy" Overbroad Many political risk insurance policies also include an exclusion from coverage for " . . . bona fide non-discriminatory measures of general application of a kind that governments normally take in the public interest for such purposes as ensuring public safety, raising revenues, protecting the environment, or regulating economic activities"

The first three examples (ensuring public safety, raising revenues, protecting the environment) seem generally to correlate with a finding of a legitimate action by the host government. However, "regulation of economic activities" is not helpful in defining a legitimate action by the host government. Because those three words describe almost all regulation, they effectively eviscerate any coverage for regulatory takings.

Purpose Doctrine Not Relevant Increasingly tribunals look to the effect of a Host Government action, rather than the intent behind it. Similarly, some political risk insurance policies exclude acts taken by the government with the intent to achieve legitimate public policy objectives. This language invokes the so-called "purpose doctrine", in which a claim of regulatory taking is analyzed paying particular attention to the government's purpose (whether stated or not) in enacting it. Applying the "purpose doctrine" serves only to increase the already unpredictable nature of tribunal decisions, and has fallen into disfavor generally.

[R]eference in a political risk insurance policy to a "violation of international law" is confusing and unsatisfactory to insureds, and in any event causes more problems than it solves.

Possible Policy Language and Some Conclusions

As noted above, reference in a political risk insurance policy to a "violation of international law" is confusing and unsatisfactory to insureds, and in any event causes more problems than it solves. Therefore,

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Supporting Clean Energy Projects with Carbon Finance Guarantees

We asked Martin Endelman of the Asian Development Bank to explain how the ADB and other institutions are working to support clean energy project financing. Mr. Endelman is Principal Financial Sector Specialist, Central and West Governance and Finance Division, and a veteran of the ADB's co-financing operations since 1998.

Well structured "clean energy" (CE) projects, which improve energy efficiency or use indigenous forms of renewable energy, are playing a vital role in helping developing economies of Asia address their energy security and climate change concerns. But many of these CE projects can be difficult to finance because they are small, are located in unfamiliar markets, use newer technologies, or depend on untested laws, regulations and international treaties, including the Kyoto Protocol.

Under the Kyoto Protocol (and possibly under similar post-Kyoto Protocol mechanisms), industrialized countries listed in Annex B of the Protocol can in part satisfy their emissions reduction obligations by purchasing certified emission reduction credits (CERs), often called "carbon credits", generated by CE projects in developing countries. Because of this, a portion of CE project financing needs can be met with (a) prepayments for CERs made by carbon credit funds or individual buyers under emission reduction purchase agreements (ERPAs) at a discount to the "pay on delivery" price, or (b) carbon finance provided by specialist project financiers, secured by "bankable" ERPAs and the cash flows they will generate when CERs are delivered in the future.

To mobilize either form of finance - and minimize the discount or margin used to compensate for risk - certain risks may need to be reallocated to or shared with private sector insurers, ECAs, multilateral institutions, and other risk takers through carbon finance or delivery guarantees. These guarantees could cover a carbon credit buyer against a portion of the risk of non-performance by the CE project, or cover a project lender against these risks as well as buyer payment risk. The ADB and other public and private institutions are collaborating on ways to do this.

> *[G]uarantees could cover a carbon credit buyer against a portion of the risk of non-performance by the CE project, or cover a project lender against these risks as well as buyer payment risk.*

Carbon Finance Guarantees – Risks Covered

Carbon finance guarantees could broadly cover project, host country or carbon buyer risks depending on the needs of the project, client and financiers. But more capacity and better pricing might be achieved if brokers and lead underwriters sell down or reinsure some or all of following 'sub-risks' with ECAs, multilateral institutions and other specialist risk takers who have a particular appetite for or ability to mitigate such risks.

- Project sub-risks, including a) commercial risks such as project completion, operator, technology, supply and off-take, insolvency and other similar risks; and b) natural force majeure risks such as fire, storms, wind damage, pestilence, floods or droughts.

- Host Country sub-risks, including a) denial of justice risk involving the arbitrary decision by the Host Country to repudiate any required regulatory approval without due cause; b) export/import license cancellation and embargo risk; c) war and political violence risk (but this will depend on the location of the project and the availability of project level insurance for such risk); and d) community or NGO opposition risk causing modifications or delays in project implementation.

- Carbon Credit sub-risks, including a) documentation risk associated with delivery agreements that include broad force majeure clauses making the timing of CER delivery uncertain, and that generally have inadequate terms and conditions to deal with prepayment mechanics; b) legal title disputes due to host country jurisdictions having inadequate or unenforceable legislation recognizing CER rights; and c) mark to market risk caused by the project entity or CER buyer trying to renegotiate or defaulting on its obligations should the market price for CERs at the time of delivery be substantially higher or lower than the contracted price.

- Kyoto Protocol sub-risks, such that (a) the project may be rejected by the Protocol authority; b) CERs may be restricted in their import into the European Union Emission Trading Scheme or individual EU member states ; c) the basis on which the project is initially assessed and approved changes to exclude certain activities and project types; and d) actual greenhouse gases may not be properly monitored and accounted for so that the project will not generate as many CERs as expected.

- Other structures that can help mobilize finance for CE projects that are being developed include a) risk-sharing mechanisms that help local financiers support smaller CE projects with loans in local currency; b) subordinated contingent loans, which can help facilitate deployment of clean coal power generation and other technologies for much larger CE projects; and c) new and more broadly available prepayment vehicles that could support post-2012 mechanisms. Readers interested in more details regarding these structures and other ways to mobilize finance for clean energy projects in developing countries in Asia may refer to Josh Carmody and Duncan Ritchie's 2007 *Investing in Clean Energy and Low Carbon Alternatives in Asia*, Manila ADB which can be found at www.adb.org/Documents/Studies/**Clean-Energy**-and-**Low-Carbon**-Alternatives-in-Asia/default.asp ■

Political Risk Coverage of Regulatory Takings, cont'd.

given the principles outlined in this article, a political risk insurer could attempt to define in policy language those regulatory takings that are violations of international law -- or at least the subset of them that the insurer wishes to cover. Some political risk insurers have discussed the following sample regulatory takings language that addresses most of the issues (direct expropriation would be defined separately; provisions in brackets relate to issues not addressed in this article):

- **Indirect Expropriation** means an act or series of acts by the Host Government, whether expressly regulatory in intent or not, that result in:
- the Permanent **confiscation, transfer** or destruction of **substantially all** current and future economic benefit to the Insured of owning the Insured Investment, whether or not legal ownership has been affected, or
- the Permanent **deprivation** of **substantially all** the **fundamental rights and benefits** to the Insured of ownership of the Insured Investment; provided, however, that it is not Indirect Expropriation if:
- The acts constitute mere **interference** with the use, enjoyment, or disposal of the Insured Investment or **diminution of the revenue stream** or **rate of return** to the Investor from the Insured Investment; or
- The acts (x) are taken by the Host Government to achieve legitimate public interest objectives, such as protection of the environment, public health, and public safety, and [(y) are proportional to the public interest intended to be served, taking into account the legal protection granted to the investment and the degree of financial impact on the investor]; or
- [the actions violate international law principles of "fair and equitable treatment" or "national treatment" or "most-favored nation treatment", but do not otherwise meet the requirements of an Indirect Expropriation as defined herein.]

Caveats and Conclusion

Given that there is no consistency in international arbitral awards with respect to regulatory takings, this language -- and indeed any policy language constructed to embody the current international law on the topic -- will prove to be imperfect. Nevertheless, some variation on this language would more closely align the expectations of insureds and insurers with respect to regulatory takings coverage. Surely some improvement is long overdue.■

LOSS AND RECOVERY JOURNAL

ZEMS has paid a $9.8 million claim resulting from the nationalization of an insured asset in the mines and metals industry. Although complex, ZEMS reports that it was adjusted in a timely fashion as a result of close cooperation among co-insurers and the insured.

An arbitration between ROTA International Exporting, LLC and the Overseas Private Investment Corporation concluded with a dismissal of ROTA's expropriation claim for $810,000 in connection with its investment in an agricultural project in Guinea-Bissau. The arbitrator determined that the net book value of the investment was negative, thus disposing of the matter without the necessity of addressing other issues in the claim.

about this newsletter

Our intention is to provide a forum for the exchange of information and opinions relating to topics that will be of interest to political risk insurers, buyers, brokers, attorneys and others. We invite contributions and suggestions from professionals in the field.

We also encourage readers to submit information about notable transactions, personnel changes and other important developments in the political risk insurance sector.

If you would like to receive future editions of the PRI Newsletter electronically, or if you have friends or colleagues who would be interested in joining our distribution list, please e-mail us at *info@robertwraypllc.com*. This and previous editions of the newsletter are available at *www.robertwraypllc.com*

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about robert wray PLLC

robert wray PLLC is a specialized law firm focused on analyzing complex issues and providing innovative solutions in the areas of political risk insurance, project finance, transportation infrastructure, privatization, aircraft finance and microfinance. The firm's political risk insurance practice, led by Robert T. Wray and Felton (Mac) Johnston, offers comprehensive advice related to the mitigation of risks and selection and acquisition of political risk insurance associated with international investments.

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