

# Political Risks in Engineering Insurance

## 1. Introduction

In the wake of the so-called global new order the demand for political risks cover in all insurance lines is clearly rising. Growing uncertainties accompany international trade and lead to an increased risk awareness which again triggers the growing demand for more and wider cover. Those companies which are likely to be most in need of political risk insurance are exporters, contractors working overseas and companies with overseas assets.

## 2. What are Political Risks ?

The first difficulty which presents itself is to determine exactly what is meant by the expression „political risks“. Whilst the word risks can be reasonably interpreted as „peril“ or „hazard“, it is not so clear what range of perils are implied by the adjective „political“ and what those perils encompass.

There are no generally valid definitions of political risks. In a broad sense, political risks are understood to encompass all political events which have an effect on contractual relationships governed by civil law, such as export credits. They all have to do with governments or comparable organisations exercising or aspiring power and occur in a political, economic or social environment. These events can manifest themselves in various forms which for our purpose shall be roughly subdivided in two categories :

1. risks of trade and credit
2. risks of physical damage and consequential loss arising from physical damage to the insured property.

The perils of the first group constitute purely financial and contractual risks. They range from import/export restrictions, project abandonment, contract frustration, unfair calling of bonds, confiscation of plant and equipment and other facets of any business transaction between private exporters and public buyers down to conversion and transfer risks. They also encompass the risk of government change, change of law, breach of contract and others. For this group of contractual and financial risks inherent

to the commercial activity of importers, exporters and contractors some examples are attached to this study. Broadly, there are two main markets for these purely financial risks :

There are highly specialized government schemes such as the ECGD in UK or Hermes in Germany. However, in practise these institutions only provide cover for contractors, exporters etc. of their own country, moreover they only offer a restricted scope of cover and consider many risk categories or export countries as not eligible. Secondly, there is the commercial insurance sector which does not only offer conventional credit guarantees but may also provide specialized tailor-made solutions to these commercial insurance needs.

They are not insurable under any Engineering policy which basically provides cover against losses arising out of physical damage or material loss to the insured property. Therefore they can be disregarded in our following consideration on political risks in Engineering.

The second group encompasses a spectrum of perils starting with war and stretching down to riot, strike and civil commotion all of which may cause considerable material damage to the insured property and, as a consequence, substantial loss of income.

There are a wide variety of occurrences subsumed under the title „political risks“. Some of these are listed below. In view of the divergent interpretations by courts the comments should not be considered as legally valid and exhaustive definitions :

Type	Meaning (for insurance purposes only)
War, Invasion	Employment of force between governments or entities essentially like governments, at least de facto .... Act of foreign enemy, armed hostilities between different governments in the country of risk location
Warlike Operations	infliction of violence by political groups (neither employed by nor representing governments) upon civilian citizens of non-belligerent powers and their property at places far removed from the locale or the subject of any warfare
Civil War	internal hostilities aimed at overthrowing the government
Guerilla War	sporadic violent actions directed against the government
Mutiny	violence against the government or a municipal or other local authority
Civil Commotion	spontaneous commotion of a certain number of persons in order to achieve a common aim, not necessarily amounting to rebellion; turbulence or tumult are essential elements

Military Uprising	conflict between army and government
Insurrection, Sediton	directed against the government, violent uprising by a group or movement acting for the specific purpose of overthrowing the government and seizing its powers; occuring in various places within a state and often the prelude to civil war
Rebellion	violent actions, often combined with conspiracy, directed at the government and aspiring to take over their power
Revolution, Military or Usurped Power	
Mutiny	the more or less organised, violent actions of members of armed forces directed against the authority under whose command they are placed
Social Unrest	
Riot	any tumultuous movement of people, in which a crowd, angered by some action taken by the government, rises against authority to obtain, by threats or violence, the realisation of their economic, social or political demands
Strike	spontaneous or preplanned refusal of persons to fulfill obligations out of an employment or works contract with the object to achieve a common social, economic or political aim
Sabotage	violence or intentional omission, generally committed secretly and aimed at large material damage or destruction or at preventing the normal functioning of a more or less vital service or enterprise or functioning communications
Malicious Acts	may be a political risk if committed out of a political aim; is a crime if perpetrated solely malevolently or in order to enrich oneself and therefore in most cases covered by basic policies (e.g. arson in EAR/CAR, malicious damage to computers etc.)
Vandalism, Looting	often subsequent to an uprising and committed with the intention to enrich oneself, i.e. unorganized and without a political aim
Terrorism	violent actions by any organisation aiming at spreading fear among the community, creating uncertainty and at overthrowing or influencing the government

All of these political perils share some essential elements but the degree usually varies widely according to local jurisdiction :

1. Violence is used against a government or the community, affecting persons or property
2. There is a common purpose to achieve a political, social or economic aim

3. There is a varying number of persons contributing to the achievement of their common aim. Sometimes they come together spontaneously, e.g. in Civil Commotion, sometimes they are organized ( Strike, Terrorism etc.)

As an example, riot has been defined by five constituents :

1. as a gathering of three or more persons
2. with a common purpose to commit an unlawful act,
3. with overt acts to accomplish that purpose,
4. with an apparent intention and ability to use force if necessary against any person who may oppose them in the execution of their common purpose,
5. and with force or violence displayed in such manner as to deter from opposing them at least one person of reasonable firmness or courage who might otherwise oppose them.

(Field vs. Metropolitan Police Receiver, 1907)

However, this definition may not be valid in another country or another language. Similar definitions exist for other political perils. As another example, a typical London market loss event definition for terrorism is quoted :

„Terrorist acts shall mean any person or persons acting on behalf of or in connection with any organisation the object of which are to include the overthrowing or influencing of any de jure or de facto government by force or violence or by any other means.“

Suffice it to say that there is a high degree of overlap between the various perils. It may well be that under certain circumstances the same occurrences could be considered as two distinct perils. The interdependence between distinct perils as riot, civil commotion, social unrest are descriptions of particular degrees of failure in government control. In conclusion, one would then appear to be faced with a scale of perils stretching from riot and civil commotion to foreign war and back. As a result one peril seems to be the origin of another whilst they merge imperceptibly with one another to form a continuous series and, in fact, many of the elements which constitute a particular peril are also present in others, the difference frequently being one of degree only.

As a consequence, the whole spectrum must be clearly listed in the exclusion clause. On the other hand, enormous difficulties will arise once the insurer decides to cover certain political perils whilst excluding others. In this case he may be faced with the problem of having to indemnify a loss under a covered peril which he considers excluded under another peril.

Much has been written in the past years on the topic „Political Risks“. One of the main problems which obviously cannot be solved is the impossibility to clearly and unambiguously define its meaning. This does not only apply to insurance terms but - and this has far reaching consequences - also for jurisdiction and court decisions. Even

within the boundaries of one state as a legal entity there is no conformity and important definitions have to undergo significant changes in ever increasing shorter intervals.

These problems are intensified if a policy is issued in one language but covers risks in another state of another language. Semantic congruence as suggested by dictionaries between terms as civil commotion and émeutes or mouvement populaire does not exist. Whenever a policy has to be interpreted by courts of another state or language some unexpected surprises may be the result for the insurer.

### 3. Criteria of Insurability

Generally, for any transfer of risks the following basic philosophy applies :

- risks which can be calculated with an adequate accuracy can be transferred to the insurer as the professional risk carrier,
- a threat to the public order must be carried by the community,
- the remaining commercial risks shall be carried by the enterprise which as a participant in the economy has declared its readiness to accept the risks immanent to this activity.

When dealing with the question whether certain political risks should be insured or not, answering the following questions will be helpful :

Is there a legitimate need for cover ?

Does cover of the risk belong in the realm of private insurance industry ?

Would cover of the risk go against the basic principles of ethics ?

Is the special peril insurable at all ?

Generally, the insurability of any risk depends on some basic criteria.

Some of these are :

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|--------------------------|--|
| 1. Legal Restrictions    | ban on cover of certain risks; are there important restrictions for certain cover extensions ?   |
| 2. Public Policy         | does the public policy allow certain cover extensions and does it create an environment of public stability ?  |
| 3. Randomness            | is the event foreseeable or does it occur with a certain randomness ?  |
| 4. Size of Loss          | can the size of a loss and the accumulation within a certain period and within a certain area be predicted with reasonable accuracy ? Can the average loss amount per occurrence be calculated within certain limits ? |
| 5. Average return period | can the average period of time between two occurrences be defined with an acceptable accuracy ?  |
| 6. Insurance Premium     | is it possible to calculate an adequate, technically based premium ?   |

7. Moral Hazard            does the granting of cover further negligence on the side of the insured ? Will he and can he contribute to minimizing the loss and does he dispose of the necessary possibilities ?
8. Cover Limits            can the cover be described with a satisfactory unambiguity ?

Criteria 1 and 2 do of course depend on the legal situation in the country of the risk location and have to be assessed individually. The application of the remaining criteria will quickly result in the conclusion that neither the criteria of randomness, of loss calculability, accumulation control nor of assessing a reliable return period for the single occurrences can be satisfactorily fulfilled.

For example, according to criteria 3 any premeditated, well-planned acts of damage such as sabotage (of course also some perils which we already disregard in the context of engineering, e.g. confiscation, expropriation etc.) have to be considered as uninsurable as they are not random at all. On the other hand, emotionally motivated, spontaneous acts of violence can be to a large degree random occurrences. However, these spontaneous acts also have to fulfill the remainder of criteria.

Or, as another example, in the case of War, among others, criteria 4 is not fulfilled. No accumulated loss can be calculated with reliable accuracy. This may lead to an extent of damage far beyond any possibility of prediction. It undermines the basis of insurance statistics and so convulses the society that these risks must be borne by the community itself. Other criteria are hurt as well, e.g. Criteria 3 : the damage is not unforeseeable etc.

Furthermore the „War and Civil War Exclusion Agreement“ 1937 which was signed by most insurers and reinsurers does not allow cover to be granted for war, civil war and its various forms.

Terrorism : The damage is planned in advance, caused by intent and can often, at least to some degree be expected by the government or the community. This would mean that the criteria of randomness is not fulfilled.

Very often, other political risks events do not occur at random either, e.g. a strike can very often be influenced by the community or the government and the insured.

In view of these considerations the generally reluctant attitude of insurers towards granting political risk cover can be well understood. Moreover, the fact that there is a clear antiselection and that the scope of cover very often falls victim to the impossibility to clearly define or at least to satisfactorily circumscribe the intended meaning of the used terms does not contribute to a more optimistic approach of the underwriter. On the other hand, some political perils, which at first glance appear to be uninsurable, may under certain circumstances and by applying insurance instruments be made insurable.

Summarizing these considerations political risks may be divided into three groups, namely insurable, insurable under certain conditions and uninsurable :

insurable	insurable - only under certain conditions	uninsurable
Riot	Terrorism	War, invasion
Strike	Sabotage	Acts of foreign enemy
Lock-Out	Vandalism	Hostilities and warlike operations (whether war declared or not)
Disturbance of public order	Malicious Mischief	Mutiny
Lawful action of authority against riot, strike, lock-out and disturbance of public peace	Civil Commotion Looting, pilferage	Civil Commotion assuming the proportions of a popular rising
Physical damage during temporary dispossession		Military rising Rebellion
		Insurrection Revolution
		Military or usurped power

However, underwriters generally abstain from granting selected political perils covers whilst excluding others. Enormous difficulties may arise from the unclear interpretation of terms in different languages, countries, jurisdictions and even courts and the insurer may find himself faced with the problem of having to indemnify damage under a covered peril which he clearly considered excluded under another peril.

And again, insofar as particular political perils are consequences of a failure in government control or as a breach of conditions by a government de jure or de facto or of an organized attempt to overthrow the government or to destabilize the public order, the principle should apply that these perils shall not be transferred to the insurer but be carried by the community, i.e. its government. Consequently, the underwriter assessing his risk will carefully evaluate this aspect when determining if a certain peril is insurable or not.

For the sake of completeness, mention should be made that various governments have created individual solutions for the need of terrorism cover within their boundaries.

#### 4. Scope of cover

When it comes to legal disputes coverage terms capable of more than one meaning will be construed favourably to the insured. It is a standard doctrine that doubts and ambiguities are resolved against the insurers because they are generally responsible for

the wording of the insurance contract. This means that an exclusion from general coverage will be effective only when it is clear, explicit and unambiguous.

These considerations lead to the conclusion to exclude political perils by applying an unusually detailed exclusion clause and by comprehensively listing all the particular political perils one does not want to cover - whatever they may be called.

The following exclusion clause forming part of the General Exclusions of a contract works policy may serve as an example :

„The Insurers will not indemnify the Insured in respect of :

loss, damage or liability directly or indirectly caused by or arising out of war, invasion, act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, mutiny, riot, strike, lock-out, civil commotion, military or usurped power, or malicious persons acting on behalf or in connection with any political organisation, confiscation, commendeering, requisition or destruction of or damage to property by order of the government de jure or de facto or by any public authority.

In any action, suit or proceeding where the Insurers allege that by reason of the provisions of this exclusion loss, destruction, damage or liability is not covered by this insurance the burden of proving that such loss, destruction, damage or liability is covered shall be upon the Insured.“

One important and indispensable aspect of the exclusion of political risks cover is that the onus of proof is reversed. This means that the Insured has to prove that a material loss or damage does not arise from an excluded political peril, but is indemnifiable under the policy.

In this widely used exclusion strike, riot and civil commotion are clearly excluded. In certain cases, however, these special perils may, after careful consideration, be reincluded by applying a carefully worded endorsement which should clearly highlight those perils which remain excluded under any circumstances and should also repeat the reversal of onus of proof.

Some of the indispensable essentials of this endorsement are :

- cover is granted for material damage or physical loss arising out of some named political perils (riot and strike) and does not include consequential losses,
- the extension only applies to own damage sustained by the insured, i.e. any Third Party Risk is not subject to this extended cover,
- the extension is subject to average, that is to say, if the property covered proves at the time of any loss to be of greater value than the sum insured thereof the insured shall be entitled to recover such proportion of the loss only as the sum insured bears to the total value of the insured property.



- all the exclusions which shall remain excluded, such as cessation of works, dispossession, confiscation, war, mutiny, civil commotion, uprising, terrorism etc. are clearly repeated,
- the inception of the cover extension period is clearly defined,
- the cover extension may at any time be terminated by the Insurers on notice
- and an additional premium is agreed.

If strike and riot cover is granted, this does not necessarily and automatically mean cover for consequential losses. Such an extension must be considered as highly exposed, antiselective and requires extremely careful and cautious consideration and profound assessment of possible accumulation. For Construction Plant and Equipment it cannot be granted at all.

## 5. Engineering Considerations

Without doubt, most of the occurrences conceivable and arising from political perils are fire and explosion. But modern technology also renders new possible catastrophic scenarios, e.g. opening flood gates, infesting whole computer systems with dangerous viruses and paralysing complete industries. Generally, there are no limits for a highly motivated person or organization intending to cause damage or to spread fear among the community.

Whilst annually renewable business may benefit from well proven security systems such as fencing, trained and experienced guardsmen, electronic access control and other more or less sophisticated protection devices etc. there remains a high risk

- stemming from employees who may work for an underground organisation and who know the most vulnerable elements of the plant
- and, moreover, for risks situated in remote areas which cannot be effectively protected, such as power transmission lines, high speed trains etc.

The persons perpetrating violent political acts aim at the highest possible damage in order to spread fear among the community, at efficiently paralysing government actions and, very often, at occupying radio and TV-stations in order to spread their message.

Therefore, among the highly endangered risks for which no political risks cover should be considered at all there are TV- and radio-stations, air traffic control stations, power distribution networks, power transmission lines, substations, water supply facilities (which are easily accessible and cannot be efficiently protected), refineries, airports, railways, pipelines etc., specially in remote areas, and others. Due to the impossibility of adequate protection measures this also applies to plant and equipment in remote areas such as agricultural machinery or contractor's plant and equipment. Laboratories, for

instance in the field of genetic research, may also become more and more eligible for single violent acts which under these circumstances may cause large single losses but will not account for catastrophic accumulations of damage.

Moreover, CAR- and EAR-risks are particularly vulnerable. On the one hand, they are often located in remote areas which may influence the government's ability to adequately protect the project. On the other hand CAR- and EAR-projects usually require the uncontrolled and frequent coming and going of many contractors, subcontractors, suppliers etc. These projects wherever they are located are easier accessible and clearly more exposed to spectacular sabotage acts. This especially applies to infrastructure projects, energy projects, and other projects which are passionately disputed in the public eye and are therefore considered as attractive targets by terrorists or other politically motivated radical groups or persons. When assessing these risks, underwriters should also bear in mind the increasing inclination of environmental and other groups in taking resort to violence against operating plants and projects under construction.

Therefore, there is a clear tendency towards antiselection whenever a cover extension for political risk is required.

As a consequence, from the reinsurers point of view, granting certain political perils in a reinsurance treaty for experienced insurers normally has to be restricted to clearly defined and annually renewable business. In the case of CAR- and EAR-risks it may be advisable to consult an experienced reinsurer.

## 6. Underwriting Considerations :

In case certain political perils shall be covered this should not be incorporated in the basic policy but be agreed separately by an additional endorsement to the basic policy. There is no need to mention that these political risks can only be granted, if at all, additionally to an underlying engineering policy such as Machinery Breakdown, Electronic, Computer.

As shown in the samples quoted in chapter 4 of this study, „Scope of Cover“ the reversal of onus of proof should be clearly mentioned and moreover, an acceptable cancellation clause be agreed upon.

It also goes without saying that selected political perils such as strike and riot should only be granted for risks in countries where a satisfactory social and economic stability can be assumed and expected for the insurance period.

Underwriters also will carefully consider

- whether there are legal schemes which provide insurance cover for certain political risks in the country of risk location and whether they will attach as subsidiary protection only,
- which experiences have been made with the country's jurisdiction,
- which jurisdiction applies for the engineering policy and
- which safety measures are taken in order to protect the insured property

Usually, underwriters apply a spectrum of insurance instruments such as

- a clearly shown additional premium, which, depending on the risk parameters and the location ranges from 10 to 25 % of the total premium,
- a sublimit per event (e.g. 10%, min ...) and in the aggregate per year (in case political risks are exceptionally also conceded with respect to BI these sublimits must of course be clearly stated as combined sublimits for material damage/BI)
- a reasonable deductible or time deductible (waiting period); as an example only, this deductible is usually 10 to 20 % of the claim, min. 2 to 5 % of the sum insured.

## 7. Reinsurance Aspects

On the reinsurance side, particularly where treaty reinsurance is concerned, there is a considerable exposure of accumulation. Hence, the general rule is to make clear provisions for the exclusion of political risks in reinsurance agreements. In case special extensions are agreed, the maximum sum insured is defined as well as the cession limits to the treaty. The cessions of the underlying Engineering policy and the political risk extension must of course be identical. In order to enable the reinsurer to control his accumulation the insurer will in special cases have to submit to the reinsurer in regular intervals, i.e. every three months, a bordereau stating

- the number of ceded risks,
- the sums insured,
- the sublimits / first risk sums,
- the premium
- the claims paid and reserved.

A clear definition of occurrence also has to form part of a cover extension granted for treaty cessions. As an example, the following clause has been widely used :

„It is agreed that as regards the hazards of Strike, Rots, Civil Commotion the Reinsurer's liability in respect of each and every occurrence shall be determined as follows :

All losses resulting from the above-mentioned hazards which occur during each period of seventy-two consecutive hours and within the confines of any one City, Town or District shall be considered as having been caused by one occurrence. The Reinsured may elect the moment from which the first aforesaid period of forty-eight consecutive hours shall be deemed to have commenced."

Many treaties do not so far clearly exclude strike, riot and civil commotion nor claims arising from the kind of political activity which by the courts as well may be considered as simple malicious or criminal acts. This leaves the ceding company with the possibility to insure strike, riot and civil commotion without reference to the reinsurer, an astonishing fact in view of the enormous power of destruction which modern technology has placed at the disposal of any politically or criminally minded person or group and which may mean the possibility of catastrophic accumulations for reinsurers.

Further problems may arise from the use of technical legal terms outside the context of their own legal systems. This applies to policies issued in different countries as well as in different jurisdictions for original policies and reinsurance treaties. Such unintentional differences between the exclusions in the reinsurance treaty and the insurance policy only can be avoided if the exclusion clauses in both documents have identical terms and are subject to the same jurisdiction.