Infrastructure Finance
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Lecture - 35
Risk Management - Country / Political Risks

Welcome back to this course on Infrastructure Finance, this is lecture 35. We will continue our discussion on Risk management and specifically focus on Country and Political Risks, even in the lecture as well. Before we go on to the topic of today, we will try and spend some time to discuss the thought questions that we had in the previous lecture.

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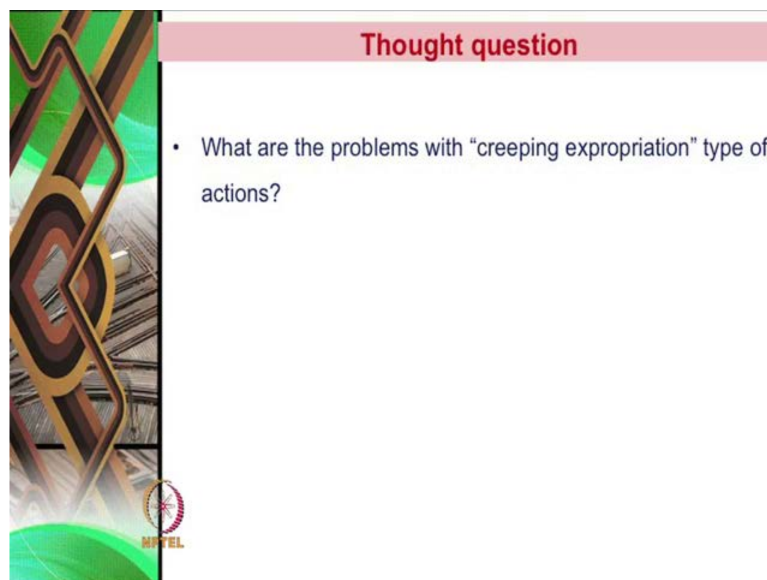

And if you go back to the question, the question that we had was, what are the problems with creeping expropriation type of actions.

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Generally if you look at creeping expropriation, what did we actually looked at creeping expropriation is, these are all very small actions taken by the government. So, if you look at it each and every action individually, would not have any substantial impact of the project, what was some of the examples of the creeping expropriation actions that we talked about. See for example, it could be some kinds of delays in issuing permits for the project, it could be in terms of holding up of stocks at the docks either in terms of export or in terms of import.

Or it could be in terms of some tax related investigations, or it could be in terms of some investigations started against the management and so on. So, individually these are all a very small actions, but then if you look at it cumulatively, they can actually have a substantial impact on the benefit of the project. So, therefore, it is going to be very, very difficult to really look at what do we actually mean by creeping expropriation; whether are all genuine issues, which the government is going to take an action, or these are all issues which are in the nature of trying to create a very unfavorable condition for the project.

And more importantly these kinds of actions are going to be very difficult to define in advance. So, one of the major feature of an insurance contract, as compared to the traditional contract between two parties is, the fact that one should be in a position to define very clearly what are the events. Unless, until it one is not able to define clearly

what are the events, that will actually result in a claim being filed, it is going to lead to a lot of disputes in the case of insurance clients.

So, in the case of a conventional contract not all of the events are well defined, most of it as well defined, but there are several grey areas, which needs to be handled as an when they arise. So, therefore, in a typical contractual situation, we have what is called as a dispute resolution mechanism, very often such dispute resolution mechanism are called, when there is a dispute that cannot be settled amicably between the two contracting parties. So, in the case of an insurance, such disputes are going to be much fewer as compared to what we seen a traditional contract.

And how can the disputes be fewer, it can be fewer only when the events that can actually result in an insurance claim being filed, or being very clearly defined. Not only they are very clearly defined, they should be in a position to be able to estimate it in advance. But, in a creeping expropriation kind of an action, it is going to be very difficult to determine, what are the different actions that will under the umbrella of creeping expropriation, or it will be very difficult to even recognize it, till it has actually taken place.

So, because of this factors the insurance in this sector is going to be very difficult, so normally what happens, there is going to be a lot of trust between the project company and the government, in terms of smooth functioning of the project company. So, unless until that trust is not there, it is going to be very difficult for the project to function. But, sometimes the governments can actually misuse the trust and can actually deliberately do some actions that can actually harm the project. So, there is no clear boundary, between the legitimate use of state power or deliberate harassment of the project.

So, how do we actually say that, it is for legitimate reason that the imports and exports are being held at the docks, how do we say that the delay in the issue and permits is because of some certain valid reasons. Or it is also possible that the government wants to extract, something from the project company and therefore, it is delaying giving some permits. So, the boundary becomes very clear and we are not able to say for sure, whether the state is following it is the rules, as per the legitimacy that it is been interested upon; or it is trying to result in actions that can deliberately harm the project company.

And it is also going to be very difficult to prove that, the project would not have defaulted on it is payments or if this creeping expropriation acts had not taken place. So, when we actually claim an insurance, what do we actually indicate that the project has not been able to honor it is payments, because these actions have taken place. So, that is a if there is let us say an earthquake or there is a sabotage, then it is going to be very clear to identify that the project have not been able to function, because of these actions.

But, it is going to be very difficult to prove that, in a case of a creeping expropriation, how are we to prove that, that it is because of these actions that the project has not been able to honor it is commitments. Because, it is going to be, so difficult to establish a causal relationship, between the occurrence of the event and the non-payment to debtors or investors, it is also going to be very difficult to actually file a creeping expropriation. So, these are some of the challenges, and if you are actually going to take a loan for insurance for creeping expropriation. Then we need to be aware of these kinds of difficulties and therefore, some of the events have to be lot more clearly defined to ensure that, the disputes after the event has occurred is a very minimal.

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Now, let us continue our discussion on political risk. In the previous lectures, we have talked about the various types of political risks, and the impacts that it can actually have. Now, we will move to the next part of it, that is after having identified what is political risk, after having identified the different forms of political risks, let us see how we can

actually go about mitigating them. So, we even looked at specific instances of mitigating political risks for example, if you look at one of our earlier lectures, we talked about investment risk; under investment risk we talked about currency, convertibility and repatriation.

And under that we said there are some specific strategies that project companies follow to mitigate these investment risk. So, one of it is enclave projects that is you actually create a project, where the cash flows actually come in an account that is set up overseas, and we also looked at setting up of overseas reserve accounts, it could be overseas expenditure account, it could be overseas debt service reserve account and so on. So, these are some of the ways that we briefly looked at, in terms of mitigating the political risk. So, in this lecture we talked about other mechanisms by which we can mitigate political risk.

(Refer Slide Time: 07:50)

The first is what is called as your government support agreement. In fact, this is one of the important contracts that the project company executes, and this is a agreement with the government and the project company stating that, the government will create a favorable environment for the project company. So, there are various ways in which can actually facilitate the functioning of the project company, and the government support agreement is essentially for that purpose.

In fact, government support agreement can actually take various forms as we will see later, but the essence of it is very clear, the essence of it is there is some kind of an agreement with the government, by the project company to ensure that it is able to function in a fairly smooth way. But, there is a view that you know government support agreements are essential, only when there is no legal framework for the project. So, there is the general law of the country that sets up the framework for the project, there is no need for the government support agreement.

So, these essentially means that, when do we need a government support agreement, we need a government support agreement when the private sector finance is being used for the first time; and there are some particular local risk that needs to be considered. And when we actually have a support from the host government, it reduces the risk and encourages development, that would otherwise not take place, so this is a broad principle. So, we can see several instances of government support agreement being used.

Let us say for example, the Indian power sector, when the Indian power sector was thrown open for private sector investment, at that time there was no regulatory authority, at that time there was no history of foreign investment coming in the Indian power sector and so on. So, the framework today that we have, in terms of regulatory authority, in terms of facilitating foreign investment and so on, evolved over time. But, for the government did not wait for the framework to be developed, before getting investment, both of the things in some sense happened parallelly.

And when there is no history, when there is no law or regulatory framework obviously, the support from the government becomes very critical for the investors. Today if you are really looking at private sector investment, the kind of support the government gives is much much less as compared to what it was, in the early 1990's. So, this is just to indicate that, the role of the government support agreement becomes very important, in the early stages of getting private sector investment, when the law is evolves, when the regulatory environment evolves and so on.

So, today if you really look at the telecom sector, you do not really get a government support agreement, because there has been a long history of private sector companies operating in a smooth fashion in the country. So, if the country becomes a lot more evolved, if the country gets a lot more experience in attracting private finance in different

sectors, the government support agreement is not needed. Now, there are also different forms of government support agreement, so today if you really look at it I will take the example of the Bangalore International Airport Limited.

So, the Bangalore International Airport Limited, the government support agreement is essentially to provide some kind of funding support for the project, because the private sector is funding for the entire project might make it on unviable. So, therefore, the project needed some kind of subsidized capital from the government and therefore, the support agreement, the state support agreement was essentially with the objective of providing some capital for the project. Now, there was the agreement between the project company, and state government for providing that kind of support.

So, the support could be not just in terms of creating favorable environment, it could also be in terms of providing capital, but then the question that really comes is the government support agreement is all is fine, but is the government in a position to honor the obligations of the support agreement, when the time comes. So, all this agreement and all of these things is actually undertaken before, let us say the financial close, but should there be any difficulty in the future will the government be in a position to honor the terms of the contract.

So, the project company then follows various strategies, by which the government support agreement clauses are being enforced. Let us say for example, in the case of Bangalore International Airport, the issue was the state has actually given an agreement for providing funding support. And this funding support occurs over a period of time, and it is in line with the amount of investment that is actually been brought in by the private investors.

But, always a doubt is what happens, if the state government is not able to provide it is funding support in time, what happens if the state government changes or what happens, if the state does not have the resources to provide the support that is indicated. So, to overcome these uncertainties what the project company has done, is the project companies actually got a bank guarantee, from one of the largest banks in the country. So, the bank guarantee states that, if the state government is not in a position to actually provide the funding as indicated in the state support agreement, then the bank guarantee will make do the commitment of the state government.

So, this is in a way in which the state support agreement is enhanced by some level of guarantees, so in this case it is a very large national bank. There are other ways in which the strength of the government support agreement is enhanced, let us say for example, the agreement is with the state government. In the case of the power sector we talked about the example of the Enron project, so in the case of the Enron project, the state government made a support agreement indicating that, it will actually purchase the power that the power company had generated and then it will pay the tariffs on time.

So, that is a government from that is a support agreement from the state, but then there could always be a possibility of the state government remising on the commitment. So, the project company wanted to enhance a credibility of the state support agreement, so therefore it said that there has to be a counter guarantee by the federal government, that is by the central government. So, the central government guarantee actually has a lot more weight age, has a lot more credibility as compared to the state support agreement.

And therefore, for the first few projects, the private projects that happened in India, the government of India also gave a counter guarantee, so this substantially strengthens the government support agreement at the state level. So, there are several ways in which a project companies try and strengthen, the support agreements from the government.

(Refer Slide Time: 15:09)

What are the typical provisions in a government support agreement, the guarantee could be on key contracts that is, let us say if there is an agreement between, let us say a state

electricity board and the power generation company. The guarantee could be that, the state electricity board will fulfill it is obligation as an off taker, this is a guarantee provided in terms of ensuring the obligations of the offtaker. The second provision could be create conditions that prevents a project from being affected by non convertibility or non repatriation of the dividends.

Obviously, there are overseas investors they need to get return, so the government support agreement will provide for some provisions, that will prevent either non convertibility are reduced the chances of these non convertibility or non repatriation of dividends. Or it could be also to create favorable institutional conditions, such as issuing permits on time, such as insuring that exports and imports are cleared on time, ensuring that all the paperwork is with the support of the government.

The government provides the necessary support structure for example, if you need to create roads, if you need to create utility connections for the project side, all of this is beyond the control of the project company. But, the government will ensure that these are all provided on time, so these are all creating supportive institutional conditions, it could also be in terms of a provision of tax concessions, either in the initial stages of the project creating a favorable tax structure, so that private investment comes in. So, that again could be feature of the government support agreement.

So, the tax concessions might not be uniform, it might not be for the industry as a whole, but it could be for a specific project, for a specific duration. And sometimes the government support agreement also kind of has clauses, which says that what should be the dispute resolution mechanism. So, given the fact that, whenever there is a dispute, and if the disputes are going to be discussed within the country, then if the host government is one of the parties to the dispute. Then it is going to be the private investors will feel that, it is going to get a very fair resolution.

So, therefore, most of the government support agreement also provides for a dispute resolution mechanism that is outside of the country. So, either a jurisdiction is outside or the arbitration tribunal is also outside the host country. So, these are some of the typical provisions that you actually have in a government support agreement, and government support agreement is one of the ways, in which projects cannot try and mitigate the political risks.

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So, the other ways in which the project companies try and mitigate the political risk is, in the form of insurance and the finance market. So, there are four ways in which project companies use the insurance and the finance market, first is to actually have guarantees or insurance to political risks. So, like we actually cover for fire, like we actually cover for damages during construction and so on, you can actually also take an insurance covered for mitigating or political risk.

And this risk can cover all the risks both political and commercial, so if it covers all the risks both political and commercial risks, it is called as full cover, but if it covers only the political risk it is called as only the political risk cover. See what is the objective of having this political risk covered, the objective of having this political risk covered is to ensure that, the risk environment becomes manageable. The levels of risks are acceptable for private investors and therefore, they are comfortable and they are willing to actually come out with the making investments.

So, the insurance reduces the risk factors, that is prevalent, in the case of providing these kinds of insurance. So, another way to get investment apart from providing insurance is, they just provide the funding itself and therefore, loans to the project company from lenders that are prepared to accept the level of political risk. So, the traditional conventional private investors will not be comfortable with certain level of political risk and therefore, they are demanding political risk insurance.

But then there could be some other investors, who may be comfortable in investing with this level of political risk and therefore, they can directly provide funding, they can directly provide loans, instead of actually asking for political risk insurance. So, getting finance from those sources, who are acceptable to the levels of political risks is another way of mitigating political risk. And mitigating political risk is not only important for the lenders of the project, it is also important for the investors in the project that is, the equity investors in the project. So, we are really looking at trying to mitigate it for all types of investors, and we are looking at different ways in which this can be mitigated, now let us try and discuss them one by one.

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The main sources for political risk cover, and as well as for loans in difficult environments is basically four folds. One is you actually have the export credit agencies, the second is you have the financing and guarantee provided by bilateral institutions. And the third would be loans and guarantees from Multilateral agencies and then the fourth is you have your private insurance market, so let us look at the export credit agencies to start with.

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So, what are export credit agencies, so these are also denoted in the short form as ECA, there is each and every country today have their own export credit agency. So, these export credit agencies are public sector institutions established in their respective countries, to provide support for exports. So, today in India we have an export credit agency, it is called as the Exim bank, so when Indian producers want to actually export their product, then they actually use the service of the Exim bank. Because, Exim bank provide financial and there forms of assistant to help the exporters to export their products.

So, these kinds of financial institutions are specifically setup to provide support for exports. So, these export credit agencies can actually provide political risk cover, when equipment for the project is important, so the important thing in this case is, it is largely for the equipment. So, when you really look at the project company actually needs capital for many types of activities for example, you need to buy equipment, you need to funding for different kinds of services, you need funding for designs and so on, and so forth.

But, when you actually have a export credit agency, the political risk cover is largely for the equipment that the project is importing. The ECS can provide the direct funding support or they can actually provided interest rate subsidies.

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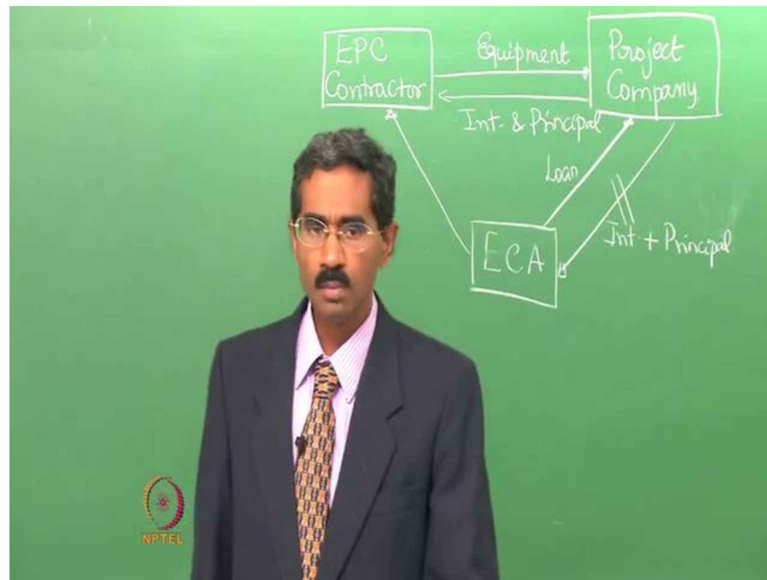

So, the how it works is, so let us say you have the EPC contractor, who is responsible for let us say the equipment and so on, and then you have the project company. So, let us say the EPC contractor provides equipment and then you have the project company, which will actually repay the equipment, in terms of your interest and your principal repayment. But, now if the contracting company or if the equipment supplier finds the project company to be too risky or the project company is exposed to political risk.

Then they may actually rely on some kind of political risk mitigation mechanism, so what actually happens is instead of direct transaction between, the project company and the EPC contractor, you actually have what is called as you export credit agency. And the export credit agency provides a loan to the project company, and the project company in turn actually repays to the ECA by interest and principal repayment. And the ECA in turn pays back the EPC c contract, so this is the kind of an agreement that you have in an export credit agency.

Some risk, because of political risk, if the project company is not able to repay interest and principal, then the ECA will actually ensure that, the equipment supplier gets the amount that it is supposed to get from the project company. So, this is a guarantee that in case of a political risk, now if the interest and principal repayment actually is defaulted, because of events other than political risk, then the ECA cover might not be applicable.

Now, there are various reasons why there could be defaults, so the defaults could be because of commercial risk, commercial risk either is the project not functioning or either the project is getting delayed and so on and so forth. So, in those cases the political risk by the ECA will not be applicable, this cover is applicable only in the case of political risk. So, what we can actually have is that, there could be different types of support, so ECA can actually provide funding to the project company to finance his equipment.

Or it can actually provide interest rate subsidies to commercial bank, let us say for example, instead of export credit agency, there is a commercial bank which is financing this transaction. But, for a commercial bank to finance this transaction, the risk is not an acceptable level or it needs a higher return for the risk it assumes. So, the export credit agency can actually provide interest rate subsidies to a commercial bank, so instead of an ECA export credit agency, if we have a commercial bank.

Then export credit agency can reduce, the effective rate of interest by providing interest rate subsidies. And by providing interest rate subsidies it is also reducing, let us say the interest burden on the project company. So, broadly if you look at it, the support by export credit agency can be in two forms, one is to provide financial support, and the other is to by way of credit support. Financing support is of direct loans or it could be in terms of interest rate subsidies.

Credit support is also provided by two ways, in terms of direct loans or credit insurance for loans made by private sector banks. So, credit insurance in the sense that, if there is a commercial bank which is actually providing a loan for the project company, and ECA can actually provide a credit insurance stating that, if the commercial bank is not getting payments on time. Because of, defaults by the project company, due to political risk, then the export credit agency will ensure that the payments due to the commercial bank are paid. So, that is a broad scheme by which the export credit agencies work.

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When is the default regard, we should also know there is a difference between payment guarantee and the performance guarantee. When we actually have export credit agencies ensure the loans, an insurance payment is figured only if the covered risk lead toward default in payment. Let say for example, there is a delay in plant starting operations, and if this delay results in a default of the interest being paid, then the insurance will be triggered.

On the other hand, let us say for example, the plant has begun operations and for a particular reason and for a particular period, the plant is not functioning at let say 80 percent or plant is functioning only at 80 percent of the capacity. So, because of the revenues might be lower, and because of the revenues might be lower the company's profitability might be lower and so on. So, this is a performance issue, but even at this, lower performance level, if the project company is been able to meet the interest and principal payments, then export credit agency insurance will not be triggered.

So, the insurance will be triggered only when there is a default in payment, if there is any impact on performance, because of political risk or even otherwise, there could not this insurance will not be triggered. So, is an important distinction that we need to be aware of, this is not the case with let say guarantee from the equipment manufacturer. Now, in equipment manufacturer, if the equipment is functioning beyond certain promised efficiency levels, then performance guarantee gets triggered.

This is also very different for let us say an operating maintenance contract, where you also have performance guarantee. If the quality is beyond a certain level, then some penalty mechanisms gets triggered, but in the case of an insurance, only if there is problem with the payment will the insurance gets triggered. And the payment coverage are the protection is normally not for 100 percent for the total insurance being covered, let us say the total project cost, if you look at export credit agency they will actually cover only the equipment cost.

So, let us assume that out of 100 percent of the project cost, 80 percent is your equipment cost, so the coverage from the export credit agency will be only for this 80 percent. And for this 80 percent, the credit rating agency will cover 95 percent of the risk, let say the total equipment cost is 80 million, then the export credit agency will cover only for 76 million, the remaining 5 percent is expected to be risk is assumed by the lenders. So, they will not be able to provide the coverage for 100 percent, so that is something that needs to be remembered.

The lenders will have to assume certain level of risk, so this is something that we also see in a day to day life in many insurance. Let us say for example, in the case of the health insurance, the insurance provider will not be in most cases providing 100 percent of the health cost. There is something called as the co-payment, where the patient is expected to pay 10 percent or 15 percent, and then the remaining expenses are provided by the health insurance company.

This also can be seen in other forms of insurance, let us say in a vehicle insurance, let us say you got a car and you got a car insurance protection, and whenever you are actually filing an insurance claim there are some detectables. So, out of the total approved claim, the insurance company will going to reimburse only certain amount, after a compulsory deduction. So, these are all mechanisms that will ensure that, the lenders also assume certain level of risk, it is 100 percent of the risk is not going to be covered by these kinds of insurance claims.

And ECA is also expect the commercial risk, to be borne by the commercial banks, so for example, if there is a delay in completion, then that is actually a commercial risk. So, the commercial banks are expected to absorb those risk, and not the export credit rating agencies. And particularly the ECAs guarantee only political risks during the

construction period, because the commercial risk is largely managed by is, largely governed by the EPC contracts and various other contracts. So, the project company or the EPC contractors are in a better position to manage this commercial risk, rather than the export credit rating agencies.

(Refer Slide Time: 32:26)

What are the general coverage of risks by the export credit rating agencies, so they look like the standard investment risk, we discussed them this currency convertibility there is repatriation, expropriation, political violence. So, these kinds of risks are actually covered by the export credit rating agencies, some of the agencies do not provide coverage for creeping expropriation. Remember, creeping expropriation is difficult to define, though it is part of a political risk process, sometime it is going to be difficult to say what comes on a creeping expropriation.

So, not all of the ECAs provide cover for creeping expropriation, then we also talk about breach of contract, breach of contract is when the government does not honor, it is side of the agreement. For example, there is a government support agreement and the government does not make payments or any such events that may unfold, so this actually a breach of contract. So, the export credit agency sometimes do not provide for such breach of contract.

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What is a overall view of the ECA cover, we need to really look at some of the limitations and benefits of the ECA cover, the limitation as we have seen earlier is, they do not fully cover the amount of risk they are insuring. And second is they generally cover only for equipment see for example, if you look at a large construction project, a construction project cost is not only equipment. There is a lot of construction, there is a lot of design, there is a lot of development that needs to be done, which is also accounting for substantial percentage of the project cost.

But, the e c a cover will be largely available only for equipment, and sometimes the premiums charged for political cover can be very high. So, it makes attractive for commercial lenders, only they are not willing to provide finance otherwise. So, if the risk is acceptable and the commercial lenders are willing to provide finance, then it may be better off to actually fund project without this political risk cover, because of the cost that is involved. Some of the benefits of ECA cover is, whenever they actually provide funding assistance the interest rates are low, and not only that the interest rate also fixed as well.

So, it helps the project company to get an understanding of, what is going to be the overall interest outgo from the project. And then because of the fact that ECAs are public sector institutions; and there is always mutually reciprocal relationship between one

public sector institution, vis-a-vis government of the host country. Then it provides a degree of intangible political support.

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The next type of political risk mitigation mechanism is, what we talked about is funding from a bilateral agencies. So, there we also describe it as the untied covered in financing, we call this export credit agency as tied cover, because it is largely related to the equipment. Now, if we talk about bilateral lending agencies, these are all development finance institutions that actually provide certain amount of loans, or they also make direct equity investments in different countries.

So, because of the fact that, these are development finance institutions, they are able to assume certain level of political risk, which might not be able to be assume by private investors. So, they do not actually provide an insurance, but by investing in countries which having a high degree of political risk, they actually reduce the risk levels for the other investors in the project. But, each and every organization has it is limitations in terms of maximum amount of investments.

So, though the project might be very large, some of them might not be able to contribute beyond a certain level, it also depends on the percentage of investment. So, there are limitations in terms of how much percentage of investment they will make, how much of absolute quantum of investment they will make. And it also in terms of the time of

coverage, how long will they be able to provide funding or coverage to the project whether it will be 15 years, whether it is going to be 10 years and so on.

But, it also needs to be remembered that, many of those require some level of involvement from the country of the bilateral agency, let say for example, you have the overseas private insurance corporation, this is an organization of the US. So, whenever we are talking about support getting from OPEC, it assume that a part of the equity is also from the US investors. Similarly, if you talking about Japanese bank for international cooperation in Japan, there has to be some level of Japanese involvement in the project. So, this is basically untied cover in the sense, this is not tied to equipment, there are certain limitations in kind of accessing this source of capital to mitigate the political risk.

(Refer Slide Time: 38:00)

Then we talk about the Multilateral lending agencies, Multilateral lending agencies this is apart from direct lending, they play key role in mobilizing private sector funding for projects in developing countries, so they play catalytic role. If the Multilateral agencies lend, let say 100 million, then they will be able to mobilize other private capital for 400 million. So, that is the kind of a leverage that they will be able to do, so who are these Multilateral lending agencies.

So, there are several for example, you have organizations like the World Bank, then you have other World Bank agencies, like the International Finance Corporation you have,

International Development Association. Then you have some of the regional development banks, like the Asian Development Bank, African Development Bank, European Investment Bank, Inter American Development Bank.

So, these are all essentially Multilateral lending agencies, and it is critical that many of these Multilateral agencies, they actually have a relationship beyond a particular project. So, most of the time these MLA's, Multilateral Agencies are involved with the overall economy of the host country at many levels. So, they provide support for several projects in the host country, so they are considered, they actually have a lot of importance in terms of the overall national development. And because of that, they have access to government at the highest level.

So, should the project run into any kind of political difficulties, having an investment from Multilateral Agency can actually give large benefits. Because of the fact that, the Multilateral Agencies play an important role in the Nation Development; and because of that, the kind of visibility and the kind of access that they have among the country, political decision makers is very high.

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It is also been seen in the past that MLA's get preferred creditor status, when there are difficulties in repaying loans to external creditors, then Multilateral lending agencies get a preferred status, that is they get paid first as compared to other private lenders. So, therefore, any private investors which also has Multilateral agency is going to be a lot

more comfortable. Because, should the country experience any difficulties, they have a good chance of getting their capital earlier as compared to other projects, which do not have any Multilateral lending.

There are some of the concerns with Multilateral lending agencies as well, because most of them try and evaluate project, whether it is appropriate or not the wider economic context of the host country. So, it is not going to be with respect to any one project, but they like to see, how this project is going to impact the overall economic development. So, this broader evaluation sometimes could be resented by the host country, because they might feel that these agencies are trying to play into the wider economic and political scenario of the host country.

They may be seen as interference that can be seen as some form of very soft intuition into the decision making of the host country. Now, as far as the lenders are concerned, the objectives of the Multilateral agencies are very different as compared to some of the private lenders. So, many of these Multilateral agencies, if the project is undergoing difficulties, they may be willing to risk restructure their debt, because of the fact that the potential benefits of projects can be much larger at later date.

So, they may be willing to extend the term of the loan, they may be willing to subsidize the interest rate and so on and so forth. But, then some of this might not be acceptable for the private lenders, private lenders might not have anything beyond that particular project or investment. So, therefore, they may not be comfortable with some of these strategies, such as extending the terms loans and so on.

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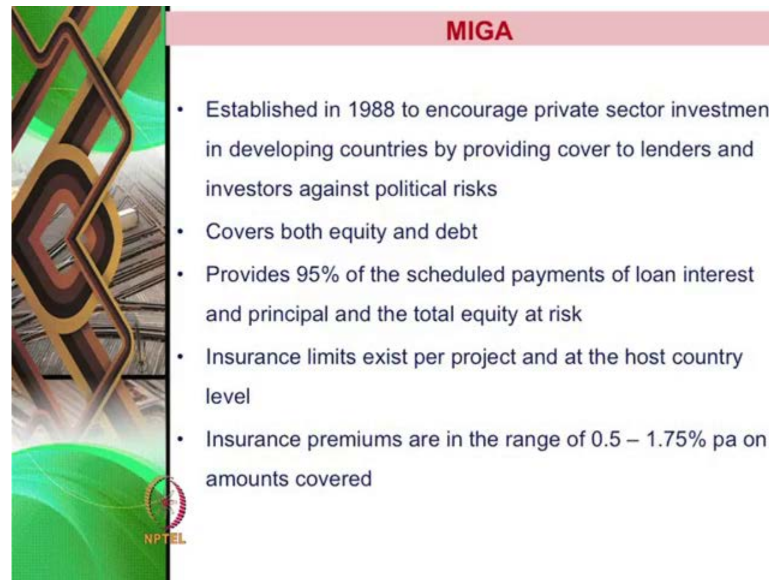

So, the next organization that we will have to discuss is an organization called MIGA this is Multilateral Investment Guarantee Agency. So, this is an agency setup by the World Bank in 1988, to encourage private sector investment in developing countries, and the objective of this organization is essentially to provide political cover to lenders and investors. In fact, if you look at World Bank, different World Bank Agencies, MIGA is only agency which does not provide any funding assistance.

The role of MIGA is only to provide guarantee against political risk that means, it actually involves no funding at all, except to provide a guarantee to the private investors. So, what does it cover, it covers both equity and debt, so therefore this guarantee is going to be applicable both for project investors, as well as the project lenders. It provides for up to 95 percent of the scheduled payments of loan interest and principals, so like the export credit agencies 5 percent of the risk will have to be borne by the lenders.

And in terms of equity, the total equity value at risk is provided for under the guarantee, so obviously, this guarantee is not a blanket guarantee, this does not provide for any blanket insurance, there are insurance limit that exist per project. Let us say for example, if the project is 500 million, you cannot actually take an insurance protection for the entire 500 million, you can probably get insurance protection for 100 million, or it could be 150 million. So, these limits keep changing over time, and it is very important for the project company to be up to date, in terms of what are the current limits.

And it also limited at the host country level for example, the maximum guarantee that would be provided by MIGA, at the host country level could be, let us say 500 million. So, even though there might be more projects, and if the total insurance coverage guarantees to MIGA, exceeds host country level. Then it may not be possible to actually get the guarantee from MIGA for a future project, till the insurance till the projects are released from some of the MIGA insurance covers. And obviously, this guarantee does not come free, the private investors will have to pay some kind of insurance premium. These are in the range of 0.5 to 1.75 percent per annum on the amounts covered.

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What are the risks that are covered, the common risks that are covered include currency convertibility and transfer, it also covers for expropriation, including some elements of creeping expropriation. And it also covers for civil disturbance, it covers for sabotage, terrorism and acts of war, and it also covers for the breach of contract by the host government. So, whenever we talked about a breach of contract by the host government, we also remember talked about dispute resolution mechanism.

That means, there is there is a litigation, there is an arbitration mechanism under which the breach of contractor will be arbitrated. So, the question that you may ask is when you actually have an arbitration mechanism, why should we actually guarantee for breach of contract. Now, the arbitration mechanism does not abide, it is not into the host country need not abide by the arbitration mechanism particularly, if the arbitration decision is

unfavorable to the host country, it is legally not bond that it has to honor the terms of the arbitration.

So, in case there is a dispute resolution mechanism, and if mechanism has been in favor of the project company, then the host government will have to make some payment for the project company. But, if the payment is not received from the host government, then how do we actually cover for the risk, so MIGA actually provides for this kind of risk coverage, when there has been a favorable dispute resolution, in terms of the project company. But, the government or the host country has not honored the arbitration award, and it has not made the payment to the project company; in that case the guarantee from the MIGA can be used to recover the cost.

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And the fourth way of mitigating political risk is your private sector insurance, private sector insurance in political risk, initially did not have a big role, because of the fact that most of acts are beyond the control of private sector. The role of private sector insurance has been very limited, but today there are several private sector insurance, which are offering political risk coverage. Because, the insurance industry has actually been able to develop various actuarial models, so that they can most accurately evaluate and asses their political risk that, each of the project might face.

And because of that they have been able to offer a various insurance protection, for the project companies at last count there were more than 20 companies which are offering,

some kind of political risk coverage. Some of the examples include AG LOID which actually provide some form of political risk insurance. As in the case of what we see export credit agencies are MIGA, the investors would be required to read in some of the insured risk, that is the insurance will not provide for 100 percent of insurance coverage.

Let us say for example, the project is 100 crores and the private sector insurance will be willing to provide political risk insurance for about 150 crores. So, out of the risk coverage of 150 crores, the private investors might have to retain 5 percent or 10 percent and the remaining would be covered under the private sector insurance. And there is a important difference between getting Political Risk Insurance from private sector and the public sector like the Export Credit Rating Agencies or the Multilateral banks.

Now, whenever we have a political risk coverage from public sector insurance, they generally require that, their presence to their transactions is publicly known. So, these World Bank would like to know that World Bank is providing some funding for the project, and MIGA would like to know that the political risk of the project is been guaranteed by MIGA and so on. But, when we actually have private insurance, they make it a condition that, the existence of the insurance is not revealed, it is simply because of the fact that, they do not want people to, they do not want investors not properly performing their duties. And they do not want people to know that insurance exist, so that any loss can be actually passed on to the private insurance. So, there is a difference in the way in which both the insurance players function.

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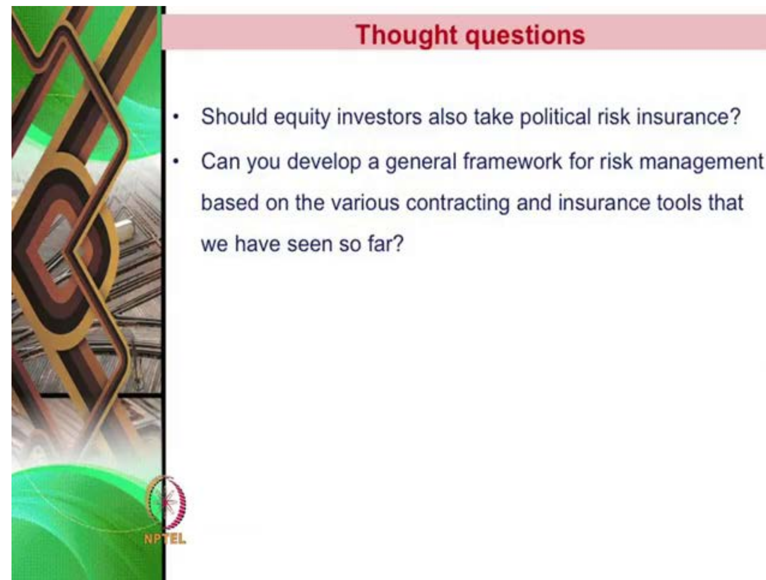

Now, we have come to the end of this lecture, and the questions for this lecture are two, the first question is we talked about political risk insurance. Now, who should actually take political risk insurance, should the political risk insurance be taken only by lenders, or should the risk insurance also be taken by the equity investors. Second question is can you actually develop general framework for risk management, based on the various contracting and insurance tools that we have seen so far.

Remember, we talked about whole lot of strategies by which we can manage the project risk, broadly this can be classified as contracts and insurance. Now, can we actually develop a framework which will kind of give us, some indication as to when do we actually go for contracts, and when do we actually go for insurance. So, think about it and we will discuss it in the next lecture.