Risk selection in the London political risk insurance market: the role of tacit knowledge, trust and heuristics.

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KBS RESEARCH BULLETIN

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Synopsis

The availability of Political Risk Insurance represents a key driver of economic activity, especially in the developing world. This study is devoted to an analysis of political risk underwriting and decision-making process in the UK political risk insurance market, an area which has been largely overlooked by regulators and academics alike. It breaks new ground by conceptualizing and examining different underwriting methods and strategies employed in the private insurance market. The process of political risk underwriting can be described as combination of art and science. The market does not rely on statistical tools, as in more traditional insurance sectors. Instead, what we find in the political risk insurance business is a privileging of experience and intuitive knowledge over actuarial protocols.

Introduction and Background

Political risk insurance is a relatively new line of business in the private insurance market. The origins of the contemporary market can be traced back to the Marshall Plan in 1948, under which the US government offered to provide coverage against certain political risks for its investors investing into post-war Europe (Zakariya, 1986). However, the private market expansion did not start until 1971, the year when Lloyd's signed a reinsurance agreement with Overseas Private Investment Corporation (OPIC). With three lead insurance syndicates providing coverage for nationalization, confiscation and expropriation perils in 1973, the Lloyd's of London insurance market was at the forefront of the private political risk insurance market development. During the late 1980s and early 1990s as political risk insurance broadened to cover contract frustration and public buyer default perils. The new products became popular with banks which started buying public buyer default policies to protect their loan books in less developed countries. This contributed to market's growth beyond Lloyd's with new markets opening in New York, Washington, and in mainland Europe. Today, the political risk insurance market remains a niche and specialised industry with a total of 82 public and private insurance providers worldwide, of which 49 are the members of Berne Union (Berne Union, 2010).

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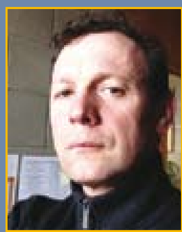

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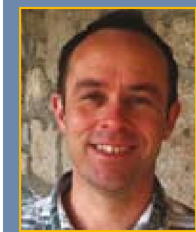

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A full copy of the paper can be obtained from the authors at:
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The UK is the largest private political risk insurance market with a total of 34 insurance providers (Gallagher London, 2012). The industry generates around US$1 billion in premiums annually and underwriting profit appears to be substantial (MIGA, 2010). The primary purpose of political risk insurance is to protect investor's rights and assets against the actions or inactions of host governments.

Issues and questions considered

The academy has made little progress in understanding the mechanics of political risk underwriting in the private insurance sector. Most of the existing political risk insurance literature can be divided into two streams. A number of studies focus on the worth of political risk insurance as a risk mitigation and management tool (see e.g., Zakariya, 1986; Etstratiades, 1987; Russ, 1997; West, 1999; Galvao, 2001; Wagner, 2002; Minor, 2003; Coffin, 2004). The other stream compares and contrasts the types of political risk insurance providers (see e.g., Rowat, 1992; Curtis, 1995; DeLeonardo, 2005: Gordon, 2008; Spagnoletti and O'Callaghan, 2011). There are only a few studies carried out by those close to the industry that address the issue of political risk insurance pricing (see e.g., Palmer, 2009; Coppola, 2009; Sundberg, et al, 2009; Ascari, 2010; Rolfini and Paciotti, 2010). However, these studies are concerned with public sector pricing which may or may not be different from that of private sector pricing. Private political risk insurance providers have to deliver returns to their shareholders, whereas public providers are not altogether driven by the profit objective. This, in turn, can result in pricing and risk selection differences between the two types of insurance providers. This is the first known study to analyse the process of political risk selection in the insurance market using well established research methods. The paper addresses the following questions, previously unaddressed in the literature:

1. How does the UK Political Risk Insurance market select political risks for a portfolio of risks?; and
2. Which factors impact on the perceptions of political risk underwriters as to what risks are acceptable for a portfolio of political risks?

Methodology

The research approach applied is based on grounded theory methodology (Glaser and Strauss, 1967). This method is well suited to those domains that are under-theorised, in that it allows the researcher to identify thinking/behaviour sets that drive decision making in a particular field. Given the lack of integrated theory in the risk and insurance literature regarding political risk underwriting, an inductive approach that allows theory to emerge from empirical data/research seemed the most appropriate. Grounded theory research design is particularly suited to this study for a number of reasons. First, it has a set of established guidelines both for conducting research and for interpreting thus offering a sense of security when delving into the relatively new area of research. Second, grounded theory is especially strong in terms of its application for the study of human behaviour. Human nature plays an increasingly important role in the political risk insurance market in two ways: political risk is essentially a socio-political phenomenon and also the London political risk insurance market is a market where business activities are conducted in a close proximity which adds an extra human interdependence dimension to the underwriting process.

Outcomes and Findings

In conceptualising this particular insurance market, the findings contained in this paper demonstrate that political risk underwriters use a two-layer risk selection model. Insurers use both explicit criteria (i.e., based on tangible factors such as country, industry, client and policy properties) and implicit criteria (i.e., based on intangible and abstract factors such as heuristics, reputation, risk sharing and trust) in their decision making process. When a risk is presented to a political risk underwriter it has to firstly satisfy the implicit risk selection criteria and secondly, it has to comply with the explicit criteria. If it is found acceptable on both criterions then the risk is considered to be a good fit for a portfolio of political risks. Explicit and implicit risk selection criterions address two different aspects of political risk. Explicit risk properties are analysed by political risk underwriters in order to arrive at a relative level of risk or at a subjective probability of the loss event happening, whereas implicit risk properties are utilised in order to manage adverse selection and moral hazard problems which arise from the uncertainty surrounding political risks. Implicit criteria can be dominant if a particular political risk is considered to be relatively more complex in comparison to other risks.

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