Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues by the Vale Columbia Center on Sustainable International Investment

No. 27, August 2, 2010

Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
Editor: Lisa Sachs (Lsachs1@law.columbia.edu)
Managing Editor: Amanda Barnett (ab3089@columbia.edu)

Political risk insurance and bilateral investment treaties: a view from below

by

Lauge Skovgaard Poulsen[*]

Many of the risks covered by bilateral investment treaties (BITs) are also covered by political risk insurance (PRI). Although there are important differences between PRI and BITs, both in terms of coverage and underlying purpose, the considerable overlap between the two instruments suggest that PRI providers should take BITs into account when assessing the risk of investment projects. But while the relationship between BITs and PRI has often been alleged to be considerable,[1] in practice there is practically no publicly available evidence to sustain this assumption. This *Perspective* reviews evidence from a recent survey of officials in private and public (or mixed private/public) PRI providers.[2]

Government-sponsored agencies

Several governments provide their investors abroad with insurance against political risks, and a few of these, such as those of Germany and France, make their guarantees contingent

---

[*] Lauge Skovgaard Poulsen (l.n.poulsen@lse.ac.uk) is a PhD-candidate at the London School of Economics. This *Perspective* summarizes part of a broader study on the relationship between BITs and FDI: Lauge Skovgaard Poulsen, "The importance of BITs for foreign direct investment and political risk insurance: revisiting the evidence," in Karl P. Sauvant, ed., *Yearbook on International Investment Law & Policy 2009/2010* (New York: Oxford University Press, forthcoming). The author would like to thank Geza Feketekuty, Mark Kantor and Michael Nolan for their helpful comments on this *Perspective.* The views expressed by the individual authors of this *Perspective* do not necessarily reflect the opinions of Columbia University or its partners and supporters. *Columbia FDI Perspectives* is a peer-reviewed series.

[1] See, e.g., United Nations Centre on Transnational Corporations, "Bilateral arrangements and agreements related to transnational corporations," Official Records of the Economic and Social Council, 1986, p. 23 ("the existence of a bilateral agreement with the respective host country is very often a pre-condition for political risk insurance by the investor's home country."); UNCTAD, "UNCTAD hosts bilateral investment treaty negotiations by group of fifteen countries," press release, January 7, 1999 ("In many cases, they [BITs] have become a sine qua non for the availability of political-risk insurance."); R. Dolzer and M. Stevens, *Bilateral Investment Treaties* (The Hague: Martinus Nijhoff, 1995), p. 156 (BITs "reduce the 'risk profile' of a covered investment to a level where it can be prudently insured by the investor's Home state …."); J. M. DeLeonardo, "Note: are public and private political risk insurance two of a kind? Suggestions for a new direction for government coverage," 45 *Vanderbilt Journal of Transnational Law,* 737 (2005), p. 753 (BITs "increase insurers' abilities to offer favourable insurance terms to investors.").

[2] Further details and discussion can be found in the full study.

on investments being covered by BITs. This is notable because practically all BITs allow government-sponsored PRI agencies to "subrogate" insured investors' claims against host countries, thereby providing a legal basis for the government's insurance agency to recover benefits paid out to investors. These programs are an exception, however, in that most public investment guarantee programs do not incorporate BITs as a precondition for coverage. And while BITs may at times provide comfort when PRI agencies of capital-exporting states issue guarantees in risky jurisdictions, interviews with officials from nine of them[3] indicate that it is exceptionally rare that the treaties have a decisive impact on either coverage or pricing.

The Multilateral Investment Guarantee Agency (MIGA)
For MIGA insurance, a foreign investment has adequate legal protection if covered by a BIT, and the treaties are relevant for other parts of MIGA's operational regulations as well. But whereas BITs may thereby make the underwriting process easier within MIGA, the treaties are often not crucial. A BIT is a sufficient, but not necessary, condition for coverage. And with respect to the pricing of expropriation risk, MIGA has to consider no less than 57 rating factors when determining the underwriting premium rates. Only one of these relate to the existence of an "investment protection agreement" – a rather broad term which covers trade agreements with investment chapters, for instance, the Energy Charter Treaty. Suffice it to say that, if countries engage in conduct that signals a scale-back of investor protections - such as withdrawing their consent to submit investment disputes to international arbitration - that would naturally be factored into MIGA's underwriting decisions. But for developing countries that remain committed to foreign investment and the rule of law, past and current high-ranking officials confirm that the absence of a BIT rarely impacts pricing or coverage, and is never in itself a sufficient reason for MIGA to withhold a guarantee.

Private providers
As an alternative to public investment guarantee schemes, private companies have offered PRI for the past three decades. The survey summarized here included feedback from underwriters and senior managers from firms and Lloyds' syndicates accounting for around 50% of the total "confiscation, expropriation and nationalization" capacity of most PRI providers. Their feedback may appear surprising to those convinced that BITs are crucial for the PRI industry. A few providers incorporate BITs into their products (for instance by insuring treaty-based arbitration award defaults), and some occasionally use the treaties as a guiding tool when assessing investment risks, but most private firms find BITs largely irrelevant for the underwriting process. Naturally, if cancelling or failing to honor existing BITs can be taken as signals that a host country plans to weaken its investor protections, this will be noted and taken into account (as with MIGA). But for developing countries that treat foreign investors fairly and in a non-discriminatory way, BITs very rarely provide a "positive return" in the private industry's underwriting process.

Conclusion
Naturally, what has been discussed here is only one out of several possible links between BITs and PRI. An additional—and obviously related—question is the relevance of BITs when PRI providers resolve claims with host governments. This remains almost entirely

[3] Covered countries are, Austria, Denmark, Finland, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States.

unexplored in the literature due to the short supply of information about the PRI industry. The conclusion is nevertheless notable: While BITs are basically aimed at reducing the risk of investing abroad, many agencies that price the risk of foreign investments rarely take them into account. Why might that be? If the reason is ignorance about the potency of BITs among some PRI providers, then the treaties should increase in importance once more underwriters realize their potential. But even among those well informed about BITs, major providers remain sceptical about their practical relevance as a risk-mitigating tool. Ultimately, however, it remains to be studied exactly why BITs may be decisive for some underwriting decisions, but have nevertheless not had a transformative impact on the global market for PRI.

*The material in this Perspective may be reprinted if accompanied by the following acknowledgment: "*Lauge Skovgaard Poulsen, 'Political risk insurance and bilateral investment treaties: a view from below,' *Columbia FDI Perspectives, No. 27, August 2, 2010. Reprinted with permission from the Vale Columbia Center on Sustainable International Investment (www.vcc.columbia.edu)."*

A copy should kindly be sent to the Vale Columbia Center at vcc@law.columbia.edu.

For further information please contact: Vale Columbia Center on Sustainable International Investment, Lisa Sachs, Assistant Director, (212) 854-0691, Lsachs1@law.columbia.edu.

The Vale Columbia Center on Sustainable International Investment (VCC), led by Dr. Karl P. Sauvant, is a joint center of Columbia Law School and The Earth Institute at Columbia University. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. VCC focuses on the analysis and teaching of the implications of FDI for public policy and international investment law.

Most recent *Columbia FDI Perspectives*

- No. 26. "FDI incentives pay -- politically," by Nathan M. Jensen and Edmund J. Malesky, June 28, 2010.
- No. 25. "The response to the global crisis and investment protection: evidence ," by Kathryn Gordon and Joachim Pohl, June 17, 2010.
- No. 24. "Foreign direct investment and U.S. national security: CFIUS under the Obama Administration ," by Mark E. Plotkin and David N. Fagan, June 7, 2010.
- No. 23. "Thinking twice about a gold rush: Pacific Rim v El Salvador ," by Gus Van Harten, May 24, 2010.
- No. 22. "How BRIC MNEs deal with international political risk ," by Premila Nazareth Satyanand, May 5, 2010
- No. 21. "Is a model EU BIT possible—or even desirable?," by Armand de Mestral C.M., March 24, 2010.

All previous *FDI Perspectives* are available at http://www.vcc.columbia.edu/content/fdi-perspectives