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Building Investor's Confidence Through Political Risk Insurance In Developing Markets

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***Abstract:** Businesses operating in developing markets face a number of political risks that may adversely affect business returns and jeopardize their investments, these risks include currency inconvertibility; confiscation, expropriation, and nationalization; and risks associated with political violence. The culminating effects of these risks, can only be ameliorated through a well-developed insurance market with the capacity to provide the needed cover that meets the dynamic needs of investors who seek adequate protection and cover for their investments. Although the political environment in Nigeria since 1999 had been influenced by democratic tendencies, yet there seems to be tension in the air due to unstable government actions which constrain investment and hinder the flow of Foreign Direct Investment (FDI). The objective of this paper was to highlight the importance of Political Risk Insurance (PRI) in safeguarding investments in developing markets. The paper adopted survey research design; secondary data was reviewed while primary data was collected from a purposive sample of 50 investors. The hypotheses were tested with Simple Regression statistical test. The findings revealed that investments in developing markets although very promising have been constrained by political risk. It was concluded that the insurance industry in Nigeria should be strengthened to provide adequate cover for investments in the country. The paper recommended that an investment friendly policy should be evolved in the country and that the government should abide by international conventions and best practices with regards to FDI.*

***Keywords:** Developing market, foreign direct investment, investors, political risk, insurance.*

I. INTRODUCTION

The magnitude and effect of the 2008 global financial crises which affected national economies, crippled businesses and rendered investments worthless has continued to haunt investors all over the world (Multilateral Investment Guarantee Agency, MIGA, 2010; Njiforti, 2015). Following this fallout, investment enthusiast pursue investment opportunities with caution and increased skepticism. But for firms and investors who are interested in incremental profits, business expansion beyond their home country, internationalization is an option which presents them with a new kind of risk, known as Political Risk (Kulasingam, 2015; MIGA, 2011). Political risk results from actions or inactions of home government which have adverse effect on the investments and business interest of foreign investors and companies (Wagner, 2012, as cited in Iftinchi & Hurduzeu, 2016).

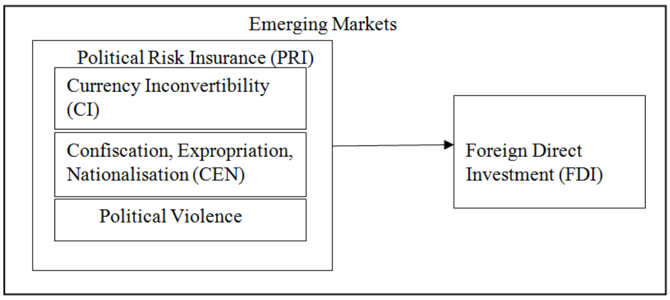
Although, political risk losses do occur in both developed and developing nations, political risk exposure is very high in emerging markets (Aon, 2011). According to Oxford Analytica (2018), 55 per cent of companies with over USD 1 billion in revenue have suffered a political risk loss, with 43 per cent of political risk losses above USD 100 million, consequently compelling about 68 per cent of companies operating in developing markets to scale down their operations, with Russia reported to have recorded the highest and most frequent political risk losses.

In developing markets, especially in sub Saharan Africa (SSA), some factors have been identified to be responsible for low foreign investments, among these factors are political risk, governance/corruption, and limited market size with political risk having the highest proportion of 31 per cent, governance, and corruption 21 per cent, while limited market size had 17 per cent, other factors include fear of political interference, and lack of legal/regulatory reforms (MIGA, 2010; Vincent, 2012). This perceived heightened level of political risk has continued to stand as a hindrance to the flow of the much-needed Foreign Direct Investment (FDI) for economic growth and developmental purposes in these countries (Aon, 2011). To manage political risk and mitigate its effect on investment there is need to provide adequate cover and protection for FDI by exploring the insurance market and having professional risk managers assume the responsibility of effectively managing risks (Akpan & Joseph, 2017). Unfortunately, the Political Risk Insurance (PRI) market in Africa remains underdeveloped and relatively uncharted as the majority of PRI has been handled by international organisations (Jones, 2009), as the African Trade Insurance Agency (ATI) which was established in 2001 (to provide export credit insurance, PRI, investment insurance and other financial products) and a few private players in the Southern region of Africa such as Credit Guarantee Insurance Corporation of Africa (CIGC) and Export Credit Insurance Corporation (ECIC) of South Africa; Botswana Export Credit Insurance (BECI) of Botswana are some of the known indigenous providers in the African PRI market in a lucrative sector of the insurance business which is dominated by private and public companies from the developed nation including some notable multilateral agencies and private providers such as MIGA, an agency of the World Bank, Overseas Private Investment Corporation (OPIC); Export Development Canada (EDC) of Canada; Export Finance and Insurance Corporation (EFIC) of Australia; *Office National Du Ducroire* (ONDD) of Belgium; *Compagnie Francaise d'Assurance pour le Commerce Exterieur* (COFACE) of France; Nippon Export and Investment Insurance (NEXI) of Japan; American International Group (AIG); Chubb; Lloyd's of London; and Sovereign Risk Insurance of Bermuda and Zurich, among others with a high concentration of these companies located in London, Bermuda, and the United States of America, USA (Iftinchi & Hurduzeu, 2016; Jones, 2009; Kulasingam, 2015).

Thus, with a very low percentage on the count of PRI insurance contracts recorded within the past two decades in Africa (MIGA, 2009), to the best of the knowledge of the researcher, research publications on PRI is mostly conducted by researchers in the developed countries and have a wide coverage of emerging markets, with almost non-existent studies among researchers from developing countries, and studies with particular focus on Nigeria, for instance, Iftinchi and Hurduzeu (2016) conducted a study on the place of political risk insurance in the political risk management strategy of Multinational Companies (MNC's); Mayer (2018) had a focus on political risk insurance and its effectiveness in supporting private sector investment in fragile states; Waszkiewicz (2017) conducted a study on political risk on financial markets in developed and developing economies; while Waters (2015) in that line equally conducted a comparative analysis of public and private political risk insurance policies with strategic applications for risk mitigation. This present study attempts to address this gap in the literature. Therefore, with the aim of accentuating the importance of PRI in safeguarding investments in developing markets with particular emphasis on Nigeria, this paper is guided by the following objectives: highlighting the need for PRI to improve FDI flow into Nigeria, and to provide an understanding of the PRI market in Nigeria. Following this introduction, the rest of the paper is structured as follows, in section two existing literature is reviewed, in section three the methodology of the study is presented, the results and discussion is presented in section four, while the conclusion and recommendations are presented in section five.

II. LITERATURE REVIEW

CONCEPTUAL FRAMEWORK



Source: Authors construct

Source: Department of Economic and Social Affairs (2017)

Figure 2.1: Emerging market and the effect of political risk insurance on FDI

POLITICAL RISK

Host country political risk needs to be put into consideration and managed effectively to mitigate losses especially in developing markets. Wagner (2012, p. 97) as cited in Iftinchi and Hurduzeu (2016, p. 202) defined political risk as "arbitrary or discriminatory actions taken by home or host governments, political groups, or individuals that have adverse impact on international trade or investment transactions". Three categories of political risks are identified in the literature, these are Currency Inconvertibility (CI), Confiscation, Expropriation, and Nationalisation (CEN), and political violence, others include breach of contract/arbitration award default, and non-honoring of sovereign financial obligation (Hamdani, Liebers, & Zanjani, 2005; Iftinchi & Hurduzeu, 2016). According to a survey on risk perception (see table 2.1), on a continuum which had six (6) levels of risk perception which are low risk, medium-low risk, medium risk, medium-high risk, high risk, and very high risk, Democratic Republic of Congo (DRC), Iraq, Afghanistan, and Iran are countries identified to have very high risk perception; Ethiopia, Burma, Nigeria, Lebanon, and Palestine were identified as having high risk perception; while Kenya, Tanzania, Syria, and Madagascar recorded medium-high risk perception. With high risk perception (Aon, 2011), Nigeria may be losing a lot in terms of FDI interests because investors are not ready to lose their funds and capital in an investment unfriendly porous political environment that has been marred with socio-political issues such as disruption of oil exploration activities and pipeline vandalism in the Niger Delta region, kidnapping, herdsmen attack, armed banditry, political uncertainty, rising corporate debt, and armed conflict among other such vices which have affected business operation in the country (Department of Economic and Social Affairs, 2017; Kulasingam, 2015; Organisation for Economic Co-operation and Development (OECD), 2018; The Economist intelligence Unit, 2006).

Risk perception level category	Countries
Very high risk	Democratic Republic of Congo, Iraq, Afghanistan, and Iran
High risk	Ethiopia, Burma, Nigeria, Lebanon, and Palestine
Medium high risk	Kenya, Tanzania, Syria, and Madagascar

Source: Adopted from Aon (2011) as cited in Vincent (2012).
Table 2.1: Political risk perception level

POLITICAL RISK INSURANCE

"Reducing real or perceived risks to investors across macroeconomic, business, and financing dimensions is a prerequisite for creating markets that can attract the investment needed to create opportunity" (World Bank , 2017, p. 19). "PRI policies are insurance contracts that offer cover for the political risks excluded under typical commercial insurance contracts" (Hamdani, *et al*., 2005). It is a tool used by MNC's to manage risks in emerging markets (MIGA, 2011). PRI market includes three broad providers, public, private, and reinsurer's (Gordon, 2008; Iftinchi & Hurdizeu, 2016). Host country political risk presents an increasing level of difficulty to understand due to variations resulting from variations in institutional arrangements (Biouin, Wang, & Wellman, 2018). Thus, MNC's establish and sustain local relationships commensurate with the anticipated level of political risk in the host country in order to influence local institutions. CI insurance cover cushions against the effects of losses resulting from imposed restrictions by the host government on currency transfer, scheduled interest payments, repatriation of capital or dividends. CEN insurance cover cushions against the effects of losses resulting expropriation, outright confiscation of property or funds by the host government. While Political violence insurance cover cushions against the effects of losses emanating from war, civil disturbance, or terrorism (Hamdani, *et al*., 2005). but, PRI does not have a wide sectorial coverage in SSA, as it is concentrated on certain sectors in different countries in SSA; in Nigeria it is found mostly in the petroleum imports, in Angola it is focused on the oil industry, Ghana, Burkina Faso and Cote d'voire has it in their commodity market, while Zambia and Democratic Republic of Congo (DRC) has it focused in the extractive industry (Vincent, 2012). This is a clear indication that the PRI market in Africa is still largely underdeveloped.

FOREIGN DIRECT INVESTMENT

In developing markets, both FDI and Foreign Portfolio Investment (FPI) are required to close the investment gap resulting from the inability of domestic savings to solely fund infrastructural development (Ebekoziem, Ugochukwu, & Okoye, 2015). Although FDI flows into Africa had suffered a remarkable decrease between 2015 and 2016, with a further decline of 21 per cent from the 2016 figures in 2017 amounting to USD 42 billion, Nigeria still ranked third among the top five FDI recipients in the continent, behind Egypt and Ethiopia (OECD, 2018). A number of countries with emerging economies including those in the developing nations have created investment promotion agencies for the purpose of attracting FDI into their domestic market (OECD, 2018). FDI could be in the primary, manufacturing or service sector of an economy. But due to high risk and the low competitive environment in SSA, the returns from manufacturing FDI is usually very high (Chen, Gieger, & Fu, 2015). FDI is not just about making funds available in foreign countries but it is the presence of an enterprise and its operation such as capital, technology, skills, and management practices beyond its home country, but most FDI in Nigeria are concentrated in the extractive industry (Ebekozien, *et al.* 2015). However, the top five investor countries in Africa are United States of America (USA), France, United Kingdom, South Africa, and China (OECD, 2018) respectively, with remarkable FDI increases in the African market recorded among these countries between 2010 and 2015 (OECD, 2018). Therefore, FDI is used to measure investors' confidence in this study.

BUILDING INVESTOR'S CONFIDENCE THROUGH POLITICAL RISK INSURANCE IN DEVELOPING MARKETS

Executives who are highly averse to risk avoid investing in politically risky countries rather than taking up PRI as a strategy for managing risk (Giambona, Graham, & Harvey, 2017). Developing economies like Nigeria need FDI for its development, to close the resource gap resulting from the inability of domestic savings to solely fund infrastructural development (Ebekozien *et al.*, 2015). Although PRI provides a form of boost to investor's confidence it cannot replace the important role of economic, political, and legal reforms which encourage and foster the required environment FDI in emerging markets (Hamdani, *et al.*, 2005). The private market for PRI in Africa is comparatively low, this could be confirmed from the low PRI claims recorded during the recent Arab spring as no claims were recorded in Tunisia. But Yemen, Bahrain, and Syria witnessed few PRI claims, few political violence losses were witnessed in Egypt, while Libya had over USD 500 million claims (Vincent, 2012). Iftinchi and Hurduzeu (2016) identified three factors responsible for the avoidance of PRI by investors and lenders, these are fluctuating capacity of the market, high premium rates, and small compensation value in the event of political risk losses. Also, high premium, coverage gaps, limited market capacity, and un-insurability of many transactions are factors identified as responsible for the limited penetration of PRI and reduced flow of FDI in emerging markets (Hamdani, *et al*., 2005).

PRI encourages FDI, it acts as a form of guarantee to encourage investors and lenders of businesses in developing markets of host government fulfilling their obligation to international investors (Iftinchi & Hurduzeu, 2016). The benefit of PRI includes, secured investment (Waters, 2015), access to funds on favourable contractual terms, regulatory reprieve for lenders, and it protects against host country arbitrariness (Iftinchi & Hurduzeu, 2016). Such as the recent announcement of the Nigerian National Petroleum Corporation (NNPC) to renegotiate the fiscal terms of its existing deep offshore Production Sharing Contracts (PSC's) with some International Oil and gas Companies (IOC's), may trigger stabilization clauses in the PSC's which were intended to protect the investors (Templars, n.d.), is a form of political risk causing event with far reaching implications on FDI.

EMPIRICAL LITERATURE ON POLITICAL RISK INSURANCE AND INVESTMENT IN DEVELOPING MARKETS

Using Generalized Method of Moment (GMM) panel data analysis, it was found that a positive relationship existed between FDI and economic growth in four African countries, which are Tunisia, Moroco, Algeria, and Egypt (Sghaier & Abida, 2013). In a study on the impact of political environment on business performance in Nigeria covering 27 companies operating in the country, the degree of stability and absence of political violence were used as measures of political environment while business performance was measured in terms of the profitability level achieved by these companies between 1999 and 2013. The findings indicated that the political environment in Nigeria exerted a negative significant impact on the operations of these business and as such on their long-term performance as a result of frequent change of government and government policy on business operations in the country.

III. METHODOLOGY

The objective of this paper was to highlight the importance of political risk insurance in safeguarding investments in developing markets. The paper adopted survey research design, this research design was adopted because it afforded the researcher the opportunity to collect categorical data from a population under study with time and cost saving advantage. Secondary data was reviewed while primary data was collected from a purposive sample of 50 investors. 33 of the administered questions were returned and used for the analysis, indicating a return rate of 66 per cent. Simple Regression statistical tool was used to test the hypotheses raised in the study, because it is a useful tool when test of relationship between variables is required.

DATA PRESENTATION AND ANALYSIS

H_{01}: Availability of PRI does not have significant effect on investor's confidence as it relates to FDI's in developing markets.

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.721a	.677	.525	85474100154.5414	2.51

a. Predictors: (Constant), Availability of PRI

b. Dependent Variable: Investor's confidence as it relates to FDI's in developing markets

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	541416329	41023109		2.210	.005
	Availability of PRI	4.141	3.210	.671	3.21	.001

a. Dependent Variable: Investor's confidence as it relates to FDI's in developing markets

Source: SPSS version 25 output

Table 2: Coefficientsa

R Sqaure explain the relationship between variable. As shown in the model summary, there is positive relationship between Availability of PRI and investor's confidence as it relates to FDI's in developing markets, and this account for about 67%. R being the determinant of correlation explain the extent to which the independent variable could explain the dependent variable. R square as shown in model summary is about 72%, this implies that the independent variables can predict or determine dependent variables up to 72%. This simply means that Availability of PRI can determine changes in investor's confidence as it relates to FDI's in developing markets up to about 72%. This study revealed that a unit change in Availability of PRI account for about 4.1 positive unit change in investor's confidence as it relates to FDI's in developing markets. This study revealed that Availability of PRI has a significant positive effect investor's confidence as it relates to FDI's in developing markets.

The p value of 0.001 is lower than 0.05, we hereby conclude that Availability of PRI has significant effect on investor's confidence as it relates to FDI's in developing markets, and hereby reject the null hypothesis.

HYPOTHESIS TWO

Ho_2: Availability of PRI for investments in emerging market do not have significant effect on MNC's investment interest in developing markets.

Model	R	Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.518a	.471	.495	77414100154.5414	1.51

a. Predictors: (Constant), Availability of PRI

b. Dependent Variable: MNC's investment interest in developing markets

Source: SPSS version 25 output.

Table 3: Model Summaryb

Model		Unstandardized Coefficients		Standardized Coefficients	t	ig.
		B	Std. Error	Beta		
1	(Constant)	641416329	41003109		-1.210	011

Availability of PRI	-3.141	2.210	.411	-2.21	001

a. Dependent Variable: MNC's investment interest in developing markets

Source: SPSS version 25 output

Table 4: Coefficientsa

There is positive relationship between availability of PRI for investments in emerging market and MNC's investment interest in developing markets, and this account for about 47%. R being the determinant of correlation explain the extent to which the independent variable could explain the dependent variable. R square as shown in model summary is about 51%, this implies that the independent variables can predict or determine dependent variables up to 51%. This simply means that availability of PRI for investments in emerging market can determine changes in MNC's investment interest in developing markets up to about 51%. This study revealed that a unit change in availability of PRI for investments in emerging market account for about 3.14 positive unit change in MNC's investment interest in developing markets.

The p value of 0.001 is lower than 0.05, we hereby conclude that availability of PRI for investments in emerging market have significant effect on MNC's investment interest in developing markets, and hereby reject the null hypothesis.

IV. DISCUSSION OF FINDINGS

The study revealed that availability of PRI affects investor's confidence as it relates to FDI's in developing markets, and the availability of PRI for investments in developing market improves MNC's investment interest in developing markets, this implies that PRI plays an important role in attracting FDI's to emerging markets by boosting investor's confidence. The literature review provided a vivid understanding of PRI and the benefits which include, guarantee to encourage investors and lenders of businesses in developing markets of host government fulfilling their obligation to international investors, secured investment, access to funds on favourable contractual terms, regulatory reprieve for lenders, and protection against host country arbitrariness (Iftinchi & Hurduzeu, 2016; Waters, 2015), This is in agreement with the findings of the study which revealed that investments in developing markets although very promising are constrained by the investor's perception of very high political risk in these markets if there is absence of a risk mitigation mechanism. Therefore, to achieve economic development through investments in Nigeria, a strong and virile PRI is key to remarkable growth in FDI's. The findings are in agreement with another study in which it was found that a positive relationship existed between FDI and economic growth in four developing economies, which are Tunisia, Moroco, Algeria, and Egypt (Sghaier & Abida, 2013).

V. CONCLUSION AND RECOMMENDATIONS

FDI in developing markets although very promising have been constrained by political risk and that as a high-risk sector, the private and public PRI market in Africa is yet to be charted as just a few African indigenous insurers are involved in the sector at present due to its huge capital requirements. Although insurance companies in Nigeria are constrained with limited capacity for PRI contracts.

The findings in the study indicated that the availability of PRI affect investor's confidence as it relates to FDI's in developing markets, and also, that the availability of PRI for investments in emerging market improves MNC's investment interest. This implies that PRI plays an important role in attracting FDI's to emerging markets by boosting investor's confidence.

Hence, it was concluded that the insurance industry in Nigeria should be strengthened to provide adequate cover for investments in the country and that an investment friendly environment for business operations is needed in the country. Therefore, the paper recommended that:

- ✓ An investment friendly policy should be evolved in the country to encourage foreign investors.
- ✓ The Nigerian government should abide by international conventions and best practices regarding FDI.

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