German Economic Team

Investment insurance for Ukraine: Enlarging the options

by Dr Hans Janus, Garry Poluschkin and Robert Kirchner

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About the German Economic Team

Financed by the Federal Ministry for Economics and Energy, the German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Kosovo, Armenia, Georgia and Uzbekistan on economic policy matters. Berlin Economics has been commissioned with the implementation of the consultancy.
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Content

1. Introduction

Investment insurance is a long established and strong instrument for promotion and protection of outward foreign direct investments. Export credit agencies, export-import-Banks, multilateral agencies as well as private political risk insurers (PRI) offer these instruments. The respective products are similar but not equal. They are, however, always limited to the cover of political risks. The pure commercial risk of an investment is a typical entrepreneurial risk which cannot be taken over by an insurer. The borderline between political and commercial risks has become less clear in recent years. New risks have emerged which are of a more systemic nature, which have to be analysed in every single case and need clarification whether they are covered as a political risk or more attributable to the commercial risks. Internationally, there is a progressively slightly decreasing demand for investment insurance cover. Countries for which investment insurance is acquired are usually developing countries or emerging markets in which political risks may arise and may threaten an investment. Most providers of investment insurance require a legal guarantee for FDI by the host country in the form of bilateral or multilateral investment protection treaties or, at least, an equivalent legal protection of foreign investments by the national legal system. An important driver for the acquisition of investment insurance, next to the coverage of financial investment risks, is the political support and protection of the investor in the pre-claim and claim phase. However, Ukraine's economy as it has been resisting Russia's war of aggression, requires new thinking to deal with political risks of FDI.

Both during the war as well as in a post-war reconstruction process, Ukraine will require private investment to find the way to sustainable economic growth rates and a green transformation. Net FDI inflows accounted for 3.3% of GDP in 2021 which was at a similar share as in Slovenia, Hungary and Poland. But the reconstruction needs will require much stronger inflow rates. Ukraine's opportunities from domestic investment are restricted due to damaged domestic businesses thus FDI will have to play a much larger role. Promoting FDI would reduce the need of public investment financed from official financial aid disbursements by partner countries and thus would limit crowding out effect of state government spending as well as increase productivity and efficiency of the economy in the reconstruction process. Already now the private sector accounts for 2/3 of investment in Ukraine.

However, two aspects are important both for Ukraine and partner countries. On the one hand, an ambitious reform agenda towards rule of law improvement would be a strong signal to foreign investors which can go hand in hand with Ukraine's accession to the EU and to adjustment of its standards. On the other hand, political and security risk will not be fully solved even when war ends. Therefore, the attraction of foreign investors would require insurance and/or guarantees schemes. Though foreign direct investors in Ukraine have already benefited from multilateral and bilateral schemes since the war in Eastern Ukraine in 2014 started. However, enlargements and adjustments of such schemes are worth considering as Ukraine is now facing a full-scale war with the economy expected to decline at 32% this year. Both Ukraine in its Lugano National Recovery Plan and the EU in its Strategic Reconstruction Plan 'RebuildUkraine' highlighted the importance of insurance/guarantee schemes. Ukraine estimated in its Lugano National Recovery Plan that war insurance needs would amount to about USD 500 m in 2022 and ca. USD 3 bn

between 2022 and 2032. EU member states already now account for 74% of FDI positions in Ukraine. Therefore, EU's role in the reconstruction and in the FDI attraction will be essential.

In this context, this Policy Paper considers available options based on international experience for Ukraine in its war economy as well as in a post-war reconstruction process. The next chapter deals with investment insurance options institutionalised by Ukraine, multi- or bilateral organisations or partner countries. Chapter 3 outlines the very limited available options for war insurance and some initial considerations for options for enlargements of insurance cover in the current war economy and the reconstruction process. Chapter 4 concludes.

2. Available options

2.1. Domestic options

Ukraine's Export Credit Agency (U-ECA) is not entitled to cover foreign investments in Ukraine against political risks in Ukraine, e.g. war risks. The Law on "Financial Mechanisms to stimulate Export Activities" is absolutely clear in this respect. U-ECA would only be entitled to cover investments beyond Ukrainian borders, but not investments inside Ukraine and is furthermore limited in its activities due to low capital and Ukraine's worsened sovereign rating. Various countries however considered proposals to cover investments in the own country against domestic political risks[1]. Such an insurance concept could be characterised as an insurance against "one-self". But the only example of an existing and operational insurance system against domestic political risks is FIPPA in Iran[2]. The major problem with any type of host country insurance of foreign investments is the missing trust of investors in guarantee schemes controlled by the host country. In Ukraine, under the current fiscal and budgetary situation in war times any kind of domestic financial protection of foreign investments is impossible. The only possible source of investment insurance during the war and, more realistically, in the period of reconstruction is foreign support in the form of investment insurance. It is, however, questionable whether the currently existing products and procedures are suitable to allow a massive use of such instruments. It needs to be analysed whether products and procedures of investment insurance or PRI products require amendments temporarily or permanently to cover the needs of investors in a period of reconstruction and modernisation of Ukraine's economy.

➔ **Ukraine's ECA currently neither has the mandate nor the financial capacity to insure foreign direct investment inflows.**

[1] Such plans were also considered in Ukraine in the late 1990s but have never materialised.

[2] Foreign Investment Protection and Promotion Act FIPPA with Agency "Invest in Iran".

2.2. Global and multilateral options: Public and private

The market for Investment Insurance has traditionally been a market for official export credit agencies (ECA) and multilateral investment insurance agencies, like MIGA belonging to the World Bank Group. In the last 25 years private insurers joined this area offering Political Risk Insurance products (PRI) of a more flexible and selective nature, where the customer can pick the specific risks, a customer wishes to cover. Private PRI insurance has gained a growing market share in recent years. Brokers and reinsurers followed this development offering their services in connection to private investment insurance.

Since global FDI has been weak during recent years both before and during the COVID pandemic, a recovery to pre-pandemic levels is highly unlikely. UNCTAD reports a 35% decrease of FDI from 2019 to 2020[3] with even higher decreases for transition economies. Figures of Berne Union, the International Union of Export Credit and Investment Insurers, show sharply reduced demand for PRI cover and decreasing new business for each of the years between 2017 and 2021[4.]

The low demand for investment insurance is clearly but not exclusively a consequence of the reduction of FDI in recent years. There are, however, insurance providers with resilient or even growing figures of investment insurance like MIGA or the Pan-African insurer ATI in Kenya. An element of their relative success may be their up-to-date approach of their PRI products and the broad approach to investment risks which goes far beyond traditional offerings of European ECAs.

The modern concept of some PRI providers is based on the understanding that political investment risks have changed sustainably in the recent years. There is an emerging grey zone between political and commercial risks. For a modern investment insurance product, the boundaries of cover need to be analysed and fixed. In important host countries for FDI a new class of political risks has emerged over the last years, for example:

- Structural disadvantages for foreign owned companies in public procurement procedures,
- State supported industrial espionage,
- Violations of intellectual property,
- Cyberattacks,
- Rampant corruption by a country's elite,
- Cronyism,
- State supported or officially tolerated corporate raiders,
- Unlawful attacks by security forces, secret services and/or other state administrative bodies,
- Arbitral awards default

The large and leading European ECAs try to handle such cases using their traditional products or start to consider a reform of their investment insurance products.

➔ **The modern concept of some multilateral or private PRI providers is based on the understanding that political investment risks have changed sustainably in the recent**

[3] UNCTAD (2021), "World Investment Report 2021", Link, p. 2.

[4] Berne Union Export Credit (2021), "Export Credit Business Confidence" Link, p. 13, 19.

years. Leading providers of official investment insurance have been adjusting to these challenges, but further steps will be necessary in the future.

2.3. Bilateral options: Public investment insurance in Germany

The German public investment insurance system has been mandated by the German Federal Government to PwC Germany as the handling agent. PwC administers the whole instrument from taking in applications through risk assessment up to proposals for decisions and claims management if necessary. The final decision whether risks are covered or not are taken in an Inter-Ministerial Committee (IMC) of the German Federal Government consisting of four ministries, Ministry of Economic Affairs and Climate Action, Ministry of Finance, Foreign Office and Ministry of Economic Cooperation. In the IMC also experts from large corporates and industry associations as well as representatives of PwC support the decision-making, but without own voting rights. Traditionally all decisions in the IMC are made unanimously, giving de-facto each involved Ministry a right of veto.

PwC has a broad mandate and a strong product offering. The guarantee covers up to 100% of equity participations, investment-like loans, participations through holding companies, endowment capital and rights qualifying as assets. Earnings like dividends and interest on the investor's capital investment or investment type subordinated loans can also be included in the cover. Covered risks include expropriation, war, payment embargos or moratorium risk, conversion, and transfer risk, as well as breach of contract. The guarantee duration is up to 15 years. In addition to handling fees, the premium amounts regularly to 0.5% p.a. of the maximum guarantee amount. In (potential) claims cases, Germany's government mediates directly or through its diplomatic representations abroad.

2.3.1. Legal framework for official investment insurance

The legal basis for Germany's official investment insurance system is the annual Budget Law. Currently (2022 Budget Law) in Art. 3 par. 2 there is a ceiling of EUR 60 bn which is, among other official financial measures, dedicated to coverage of political risks of foreign direct investments eligible for official financial support.

2.3.2. Governmental guidelines to cover capital investment abroad

The more specific legal basis for Germany's official investment insurance system are guidelines published by the Federal Ministry for Economic Affairs and Climate Action in the version of 2004, last modified in July 2017. These guidelines regulate the purpose and preconditions of guarantees, the objects of guarantees, events of loss, scope of cover, payment of indemnification, premium rates etc in a general way. Even more detailed are the General Terms and Conditions of Cover (version of 2017) which are the basis of the individual investment guarantee.

2.3.3. Eligibility for cover

Direct investments abroad have to be "eligible for promotion". What this means is only indirectly explained in the guidelines. Guaranteed investments shall "preferably

contribute to intensifying the relations between the Federal Republic of Germany and the host countries". In fact, there is a wide room for interpretation for the decision-making body, the IMC. Most certainly hardly any German direct investment in Ukraine would fail this eligibility test.

2.3.4. Bilateral investment treaty

Usually a Bilateral Investment Treaty (BIT) is required as a precondition for granting investment insurance. Such a BIT exists between Germany and Ukraine.[5] If no BIT has been agreed upon or an existing BIT has been unilaterally terminated, investment insurance may be granted only exceptionally if the level of investment protection in the host country is classified as adequate and identical with the level of protection for domestic investors. In the EU the legal competence for concluding BITs lies exclusively with the EU and no longer with individual member states since 01 December 2009.[6] Until the EU makes use of its competence to negotiate and conclude a BIT, the existing BITs of member states are grandfathered and remain in force. A BIT between EU, its 27 member states and Ukraine does not exist yet, so that Germany's BIT with Ukraine stays in force.

2.3.5. Pricing

The pricing of investment insurance consists of two elements: handling fee and insurance premium. The handling fee is covering the administrative costs of handling the guarantee application. Guarantee applications with a maximum amount up to EUR 5 m (cover for capital and cover for earnings) are free of charge. For amounts exceeding that amount (cover for capital and cover for earnings) a handling fee of 0.05% is charged, however, with a maximum of EUR 10,000.

The annual insurance premium is usually 0.5% of the maximum amount of the guarantee for the cover for capital (invested capital). If earnings (dividends, interest) are included in the cover, an annual premium based on the earnings covered at the beginning of the guarantee year and corresponding to the same percentage as for the cover for capital is charged.

2.3.6. Germany's cover policy and guarantee business for Ukraine

For several years since 2017, no cover for German investments in Ukraine has been granted. Applications for cover have not been filed in this period. Due to earlier and temporary transfer restrictions in Ukraine, earnings like dividends and interest payments, were not covered and the substantial cause of loss "conversion and transfer risk" was excluded from coverage. This made official German investment guarantees for Ukraine unattractive for investors.

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[5] Bilateral Treaty between the Federal Republic of Germany and Ukraine on the promotion and protection of capital investments dated 15.2.1993, which entered into force on 29.6.1996.

[6] Art. 64 par. 2 Treaty on the Functioning of the European Union; Regulation (EU) No. 1219/2012 of the European Parliament and of the Council of 12 December 2012 establishing transitional arrangements for bilateral investment agreements between Member States and third countries, Official Journal of the EU, L 351/40 of 20.12.2012.

With an overall exposure of EUR 400 m Ukraine is until today among the top-ten countries for investment guarantees for Germany. Cover had been granted for 20 guarantee applications of mainly SME. In 2021 the demand for cover has picked up again with four new applications, bringing Ukraine on third position of countries for which new cover has been applied for.[7] Considering that at the same time, Germany's direct investment position was USD 3 bn in Ukraine in 2021, it becomes obvious that official investment guarantees have much room for future growth.

After the beginning of the war on 24 February 2022, the German government immediately stopped granting cover for exports to and investments in Russia and in Belarus. The options for cover in Ukraine were kept open.[8] Even under conditions of war, cover for exports to or investments in Ukraine are not excluded. It is, however, necessary and understood, that the IMC has to define under which preconditions cover for German investments in Ukraine can be granted. In late August 2022 the IMC took a positive cover decision connected to an already covered German investment in Ukraine.

A new cover policy for Ukraine will have to distinguish between cover during war times and thereafter. Furthermore, it needs to be taken into consideration whether the investment is an already existing one or a new investment. A distinction between SME and large corporates should be made. Last but not least the definition of a new cover policy should send out a clear and bold political message. For doing so, it could be considered to introduce new and innovative elements in the cover policy published after the respective decision has been made.

➔ **Germany has been already covering investments in Ukraine in the amount of EUR 400 m. However, the legal basis brought limitations in extending guarantee cover in the past. The current war and investment needs requires steps that go beyond traditional procedures and limitations.**

3. Special investment Insurance features for Ukraine during/after the war

According to conversations with UkraineInvest and based on a UkraineInvest survey among foreign investors operating in Ukraine, there is a strong interest in investment insurance, even under the current war situation. Not surprisingly, 95% of the respondents wish to cover their assets in a physical way as well. Insurance cover of physical damages in a current war situation therefore seems to be of first priority among investors.

War insurance is a very rare product in the insurance market, and it is mainly common in marine and aviation insurance. Under certain conditions physical damages of investment assets are covered by an investment guarantee as a political cause of loss. However, this clause helps only in a very few cases and cannot be regarded as a general protection of physical assets in wartime.

[7] BMWK (2021), "Annual Report Investment Guarantees 2021", Link, p. 11.

[8] Investionsgarantien.de (2022) "Official statement of the German government", Link.

3.1. Public investment insurance

Public investment insurance schemes are long-established systems; however, they are limited to the cover of political risks. The commercial risk is a purely entrepreneurial risk which cannot be covered by investment insurance. The "events of loss" which public investment insurance schemes usually cover, are expropriation, war and civil unrest, payment embargo or moratorium, currency conversion and transfer risk, as well as breach of contract. In this respect, the German public investment scheme corresponds very much to investment insurance schemes in other countries.

Most public investment insurance schemes also rely on a minimum-security standard of a BIT or an equivalent level of protection by the host country's national legal system. There is a broad network of ca. 65 BITs between Ukraine and partner countries in force and several others signed, but not yet ratified. These treaties represent all relevant investor countries for Ukraine, perhaps except for Cyprus, British Virgin Islands and other "tax havens".

3.2. War insurance in general

In the private insurance industry, war risks are regarded as incalculable risks. Therefore, war risks are in most countries and in most branches of the industry uninsurable. Damages caused by acts of war are simply regarded as uncontrollable and potentially too great to be insured.
In a response to this concern, the Lloyd's Underwriters Association (LUA) and the Association of British Insurers (ABI) entered already in the 1930s into an agreement to exclude war and civil war on all policies issued by Lloyd's and London Companies subscribing to the agreement. This led to the introduction of the War and Civil War Exclusion clause NMA 464 1/1/38, which is still in use today in many non-marine policies worldwide. This clause reads as follows:

"*Notwithstanding anything to the contrary contained herein, this Policy does not cover Loss or Damage directly or indirectly occasioned by, happening through or in consequence of war, invasion, acts of foreign enemies, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power, or confiscation or nationalization or requisition or destruction of or damage to property by or under the order of any government or public or local authority*."

For the current war situation in Ukraine the most affected insurance sectors are property insurance (buildings, plants, technical equipment), transport insurance and business interruption insurance (operational downtime due to lack of power, interruption of communication channels, interruption of the supply chain, workforce shortages etc.) accounting for 79% of infrastructure damages which are estimated at USD 121 bn by mid of September[9]. War risks can generally be regarded as excluded from cover of those risks that are described above. If damages to insured property, to transport vehicles or

[9] Kyiv School of Economics (2022), "Damages to infrastructure", Russia will pay project, Link.

transported goods, or events falling under business interruption cover occur, on a case-by-case basis it must be determined whether they are a result of war or not.

3.3. Exception for marine and aviation insurance

The only lines of business in the insurance industry which can, in principle, include war risks in their insurance policies are marine and aviation insurance. In the marine hull and marine cargo insurance, war risks are normally excluded as well. They can, however, be insured separately in a standalone war coverage policy. In the case of enhanced risks of vessels in a certain area, insurers can send cancellation notices to ship owners on very short notice and exclude such a region from insurance cover or increase insurance premium. Termination of cover for war-related risks includes transport by sea in the territorial waters of Ukraine and by air in or over Ukraine.

It should be added that war-related risks concerning goods transported by land in vehicles or on trains and goods in storage are also excluded from cover in transport insurance policies. Also, this kind of insurance cover can be terminated on very short notice. Many insurers have been making use of their right to special termination and terminated cover for insured risks for Ukraine.

3.4. Investment guarantees: The illusion of physical damage protection

Investment insurance guarantees cover the war risk as one of the classical political risks. The wording of this cause of loss in nearly all countries is like this (example: Germany, General Terms and Conditions, Art. 4):

"The guarantee of the Federal Government covers the loss of the capital investment or its earnings as far as such loss was caused by the following political events or measures in the host country:

[…] c) war or other armed conflicts, revolution, civil commotion or acts of terrorism in connection with such events (war risk)"

This wording clearly includes physical damages of the insured investment. The next article of the General Terms and Conditions (Art. 5) makes clear, however, that only the "total loss" or quasi-total loss is treated as an insured "cause of loss".

The "Operational Policies" of MIGA are similar in its meaning, but somewhat smoother worded:

[…] "*1.52 In all cases, coverage shall be restricted to cases where the assets of the Investment Project have been removed, destroyed or physically damaged, or where there have been other forms of substantial interference with the operation of the Investment Project. Coverage may be extended to losses due to business interruption, including operating costs and lost net income*."

The reason for this unsatisfactory result is a systematic and substantial difference between investment guarantees and property insurance. Investment guarantees protect the investment as such and to a much lesser extent individual assets. Only the complete or very substantial destruction of the investment's assets is recognised as a case for indemnification as a realisation of war risk.

➔ **Since private property insurance and business interruption insurance generally exclude the war risk (see above) and Investment Guarantees cover in most cases only the total or quasi-total loss of the investment, there is an immense gap in insurability of physical assets against damage or destruction by war.**

3.5. Public-private partnership

As shown above, the private insurance market offers no cover for war related physical damages and investment insurance cover (PRI) is also very limited in this respect. There might be, however, options for coordinated actions or partnership between private insurance companies and providers of official investment guarantees. Practical experience does not exist yet. Especially in a situation of reconstruction the opportunities of harmonised and coordinated approaches are worth exploring more deeply. In Germany and a few other European states there is at least one example for enhanced insurance cooperation in the form of a public private partnership.

Terrorism insurance: An example of public private partnership
The events of 11 September 2001 had significant effects also for the insurance business. Since insurers regarded such risks as too big and incalculable with their risk valuation models, they inserted into their insurance policies in addition to the exclusion of war damages an exclusion of damages originated by acts of terrorism. Their clients, however, urgently requested to provide cover against damages from terrorist attacks as well. In Germany an arrangement was achieved between the private insurance industry and the German Government in 2002. The insurers accepted to abolish the exclusion of terror risk clause from their property risk and business interruption insurance policies and to establish a specialised insurance company for extreme risks, Extremus Versicherungs-AG. Extremus covers no terrorist risks below EUR 25 m– this insurance cover must be provided by the private first insurer – and takes risks up to ca. EUR 2.5 bn in total. In the case of even larger damages Extremus can draw a sovereign government guarantee of another ca. EUR 6.5 bn. Extremus' cover is only available for terrorist acts in Germany. A few similar insurance systems have been established in other EU member states as well. Extremus cover of terrorist acts is a very rare example of a joint private and public risk insurance protecting private corporates against terror risks.

3.6. Options for cover of war risks connected to investments in Ukraine

The relevant question is whether an insurance solution is conceivable for Ukraine that could protect investments satisfactorily against physical damages resulting from acts of war.

A private sector solution by insurance companies should not be expected. Currently war risks are generally excluded from insurance cover. Even if an insurance company should consider abolishing the exclusion of war risks, such initiative would have no chance for

realisation. The war risk is just incalculable for the insurer, and in a situation of war, like the current situation, the probability of loss is much too high. Premium rates would have to be extremely high making the product completely unattractive for clients.

Public investment guarantees do not really cover the risk of physical damages. Especially if only parts of an investment are destroyed but the investment company continues to exist, no indemnification may be expected.

A satisfactory solution during war times is practically impossible. Investment guarantee instruments are backed by public money in one or the other legal form. Insuring investments during a war situation will hardly ever be acceptable for the decision-making bodies, because such decisions would bear a very high probability of loss. In most countries it is forbidden by public law to accept such kind of unbalanced risks.

A theoretical option for the period of reconstruction after the end of the war could be a cooperation in the form of a public-private partnership (PPP) on the insurance market between private insurers and official investment guarantee programmes, including re-insurance cover by large reinsurers or other forms of risk pooling. Additional (partial) sovereign guarantees might also be relevant and/or official support for insurance premium. This, however, evokes a number of very complex questions, like the following:

- Which instrument is used at which time period: war time and/or post-war reconstruction process?
- What is the target group for which instrument: Domestic investors and/or foreign investors?
- What kind of PPP can be established?
- Which instruments can be brought to PPP and which need to be enlarged or newly established?
- What are stakeholders for PPP?
- What are coordination mechanisms needed to be aligned for PPP?
- What kind of institution is needed for monitoring?

All in all, international insurance coordination can play a fundamental role for attracting investments in Ukraine as part of ensuring survival of the economy during the war and its long-term recovery.

➔ **War risk is generally excluded in private corporate insurance products like e.g. property or business interruption insurance. As the reconstruction process as such will require private-public partnerships, this approach can be applied on investment insurance as well. Cooperation possibilities between official investment guarantees and private insurance and re-insurance coverings are worth to be further analysed.**

4. Conclusion

Investment Insurance is a long established and strong instrument for promotion and protection of outward foreign direct investments. Ukraine’s war economy and economic

transformation in a post-war reconstruction process would require large scale domestic and foreign investments to come back to the growth trajectory. Such investments, however, will require rule of law reforms and policies to deal with political risks. While the first one might become a part of the EU accession process, the second one would require coordinated international effort to adjust schemes to Ukraine's economic challenges of war and reconstruction later on.

Both multilateral and bilateral investment guarantee schemes can be of great support for foreign investors in Ukraine. During the war there might be a certain demand for smaller amendments, increases and improvements of the few existing guarantees for investments. New investments with request for cover are not very likely and issue of an investment guarantee including cover for war risks hardly possible during this period. Now is the right moment in time for preparing the established instruments and make them better suited for future developments. In this period speed and flexibility count. Without disregarding investment risks and in full responsibility for the budget law requirements, it seems very well possible to modernise, improve and make products of official investment insurance more flexible for future use in Ukraine. The understandable intention to get investment insurance in combination with property or business interruption insurance is very difficult to achieve. Neither official investment guarantees, nor private insurance policies cover the risk of war-related physical damages satisfactorily, if at all, today. The only theoretically possible option seems to be a partnership of official and private risk-takers with either an official ultimate risk participation or a premium support or both. Thereby, a coordinated approach within the EU and possibly other countries would support long-term reconstruction of Ukraine.