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GLOBAL RECESSION: THE MAGNIFYING GLASS FOR POLITICAL INSTABILITY

Control Risks

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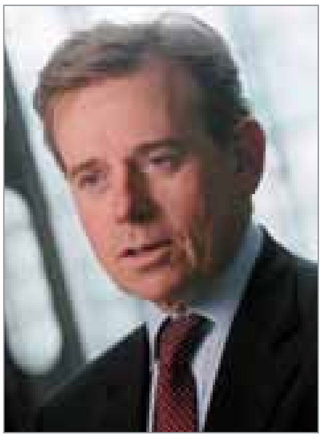
LLOYD'S 360° RISK INSIGHT

GLOBAL RECESSION: THE MAGNIFYING GLASS FOR POLITICAL INSTABILITY

FOREWORD
FROM THE CHIEF EXECUTIVE OFFICER OF LLOYD'S



"INCREASINGLY GEOPOLITICAL INSTABILITY WILL HAVE SIGNIFICANT EFFECTS ON GLOBAL BUSINESS."

The world's economy is currently suffering the worst recession for 70 years and with no immediate prospect of a recovery, its impact is likely to be severe and long-lasting. We are already seeing political and social systems around the world coming under increasing pressure as the recession deepens, with growing political instability in developing countries where embryonic political systems are unable to withstand recessionary pressures and growing social and political discontent. Although the doomsday scenarios that some media have painted – such as the so-called summer of rage in Europe – seem increasingly unlikely to happen, increasing geo-political instability will still have significant effects on global business.

Lloyd's has a key role to play in supporting organisations to manage increasing political risks as the recession intensifies. To this end, we have commissioned Control Risks Group to analyse some of the key emerging political risk issues which are impacting on business and to produce a report that can help companies manage the risk of political instability across their operations and investments.

Political risk is not new and threats, such as piracy and civil unrest, have been around for centuries. However, these risks are being redefined and evolving in response to the global financial crisis and general economic downturn. In this report we will focus on three potential political risk-related threats to business: expropriation, or the socially-motivated confiscation of private property; civil unrest; and piracy and kidnap.

As the recession bites, the assets of companies operating and investing in emerging markets with fragile or fractured political systems could come under increasing threat of expropriation. We will examine expropriation risk in three potential hotspots: Africa, Latin America and Russia. The recession is not just increasing political risk in developing and emerging countries, growing civil unrest is a potential threat to businesses throughout the world including developed countries. Perhaps one of the most prominent and well-reported manifestations of political risk is the increasing threat of piracy, particularly around the Horn of Africa, but also evident elsewhere in Africa, as well as in Latin America and Asia.

"THE RECESSION IS NOT JUST INCREASING POLITICAL RISK IN DEVELOPING AND EMERGING ECONOMIES."

With political instability heightening and the global political risk map likely to change, it is more important than ever that businesses undertake thorough risk assessments across all their global operations and investments and plan thoroughly for future potential instability. To enable companies to do this it is vital they understand the dimensions and nature of the threat they face and the key trends and issues in political risk. Lloyd's 360 Risk Insight is all about making business aware of the potential emerging risks they face and highlighting ways they can practically manage these risks. We hope his report will go some way to helping business plan for and mitigate the risks of expropriation, civil unrest and piracy and kidnap.

Lloyd's and Control Risks Group would like to thank the following people for their invaluable input and guidance in developing our report and for providing commentary and expert advice on understanding and managing political risk:
Andrew Perry, Miller Insurance Services Limited; Peter Jenkins, Beazley; David Guest, Hiscox; Clive Washbourn, Joint War Committee, LMA.

Dr Richard Ward
Chief Executive Officer
Lloyd's

EXECUTIVE SUMMARY

1. CONTINUING ECONOMIC TURMOIL COULD HAVE A SIGNIFICANT IMPACT ON THE LEVELS OF INSTABILITY AND POLITICAL RISK FOR GLOBAL BUSINESSES – WHICH MAY OUTLAST THE RECESSION.

Recession and economic hardship is likely to put businesses and their leaders at growing risk from threat groups, such as terrorists, disgruntled citizens and hostile governments. The economic crisis will place a clearer premium on reputational risk management over the next few years, and as companies seek growth in a difficult economic environment, it will be important to align business plans with a corporate and social responsibility strategy that takes account of the wider political risk environment. However, as the risk map grows more complex, it will be dangerous for boards to generalise about political risk on a global or regional basis. Companies need to do more to analyse and understand the individual threats they face.

2. BUSINESSES SHOULD NOT BE FOOLED IF AUTHORITIES IN EMERGING MARKETS APPEAR MORE INVESTOR-FRIENDLY IN THE SHORT-TERM: EXPROPRIATION RISK WILL RISE IN PROPORTION TO THE SEVERITY OF THE RECESSION.

In recent years, high asset prices have led some governments to renegotiate contracts, increasing their stakes or seizing projects outright to swell their coffers. The falling prices of commodities, such as oil and minerals, might therefore encourage more investor-friendly attitudes, but any respite is likely to be short-lived. Ultimately, recession will place greater pressure on state finances, increase the temptation of protectionism and could lead to populist policies becoming more attractive as a means of deflecting criticism from national problems. The extent to which this happens, and the level of risk for business, will depend on how the recession plays out.

3. COMPANIES MUST CONTINUE TO ASSESS EXPROPRIATION RISKS ON A COUNTRY-BY-COUNTRY BASIS. THE HISTORY AND CULTURE OF SOME LATIN AMERICAN COUNTRIES COULD ENCOURAGE MORE OUTRIGHT ACTION BY THEIR GOVERNMENTS, WHILE MORE INDIRECT FORMS ARE LIKELY IN SOME AFRICAN COUNTRIES.

Direct expropriation is not the only tool of government interference – some countries will lean towards other forms. Nationalising an industry requires the capability to take over operations, but many African states lack a strong state infrastructure, something that recession will only serve to reinforce. In these countries, companies are most likely to run the risk of repeated contract review and other forms of creeping expropriation.

Meanwhile, in certain Latin American countries where the political elite instils in its citizens a sense that their resources are being plundered by rich foreigners, expropriation risk is more explicit, and recession could encourage a self-perpetuating cycle of nationalisation for many years to come.

4. DESPITE THE HYPE ABOUT A SUMMER OF RAGE, PUBLIC PROTESTS SEEM UNLIKELY TO CAUSE SUSTAINED DISRUPTION TO BUSINESS

IN DEVELOPED OR DEVELOPING MARKETS. BUT THEY ARE LIKELY TO AMPLIFY EXISTING TENSIONS, AND GIVE RISE TO A GREATER NUMBER OF MORE DISRUPTIVE LABOUR DISPUTES OVER THE NEXT FEW YEARS.

'New world disorder' has become a media cliché, but most incidents of social unrest do not pose a major risk to business. In general, the disorder experienced recently in Europe has been of the kind seen during the good times, only on a larger scale. This is not to downplay the risk of unrest as recession deepens, but in Western markets the targets and the security measures needed to contain the risk are well defined. Other factors notwithstanding, long-term prospects for growth in China and India, and their suitability as business environments, are unlikely to be challenged by unrest alone. Everywhere, it is the lower profile and more local operation-specific risks that hold the potential to cause the greatest disruption to business: labour and business disputes are already on the rise, and a deep and long recession is likely to exacerbate this trend.

5. IF CURRENT PIRACY LEVELS WERE TO CONTINUE COMPANIES EVERYWHERE COULD PAY A GROWING 'PIRACY TAX' TO MAINTAIN THEIR GLOBAL TRADING NETWORKS OVER THE NEXT FEW YEARS.

There has been a clear shift in the centre of gravity of piracy from Asia to Africa, as effective co-operation by countries in Southeast Asia is established and the collapse of the Somali State becomes an intractable problem. Piracy levels increased in Southeast Asia in the wake of the Asian financial crisis, and a similar trend is likely in East Africa, not least because recession will hinder efforts to establish a more stable Somalia and international offshore co-operation will take time to bear fruit. Meanwhile, we are likely to see ever adaptable pirates change tactics and spread their influence further out to sea and into less policeable waters. Costs borne by the shipping, transport and energy sectors are likely to be increasingly felt throughout the supply chain, with most of the increasing burden resulting from higher operational and security costs. Furthermore, an escalation of violence is possible, bringing additional human and financial costs for business, as Somali piracy shifts towards a militarised conflict.

6. FUELLED BY THE RECESSION, PIRACY HOTSPOTS MAY RE-EMERGE OVER THE NEXT FEW YEARS, AND THE KIDNAP TACTICS SUCCESSFULLY EMPLOYED IN AFRICAN SEAS COULD BE COPIED BY CRIMINALS ELSEWHERE, INCREASING THE RISKS FOR LOCAL AND FOREIGN STAFF.

Even aside from what is happening off the East African coast, piracy is likely to remain a significant risk in many other regions over the next few years. As global recession leads to higher unemployment and reduced public spending, other piracy hotspots may emerge. Southeast Asia has been hit hard by the collapse of global trade, which is likely to contribute to an increase in maritime theft, and low-intensity incidents of maritime theft and armed robbery will continue to increase in Latin America. Although the conditions for piracy around Africa may not be easily replicable elsewhere, successful hijackings here will continue to fuel the globalisation of kidnap risk. Already there are signs that some groups are operating across borders. As these groups develop their capabilities and increase their operational range, both expatriate and local staff will be at greater risk of being kidnapped in a growing number of recession-hit regions, particularly in Africa and Latin America.

THE CHALLENGE FOR INSURERS AND RISK MANAGERS ALIKE IS TO IDENTIFY THE FACTORS THAT LEAVE SOME COUNTRIES – AND PROJECTS – MORE VULNERABLE TO EXPROPRIATION RISK.

PART 1: EXPROPRIATION RISK

HEADLINES FOR THE NEXT FEW YEARS

- **In many African states, recession will weaken state infrastructure further, reducing the risk of outright expropriation for business, and could lead to a heightened risk of more subtle government interference, especially contract frustration.**

- **In certain Latin American countries, recession could fuel a 'victim culture', increasing the risk of expropriation and contributing to a cycle of nationalisation that could affect the business environment for many years to come.**

- **In some former Soviet states, the economic downturn is likely to temper the authorities' appetite for expropriation over the next few years unless recession becomes deeper than expected. But it may also create the perfect environment for nationalisation further down the line.**

- **Even where it seems that there is very little that can be done in the face of external threats, an organisation can still take steps to control its degree of exposure to those risks through developing its understanding of the local environment and conducting thorough risk assessments.**

> "It is not just expropriation but other forms of government interference – particularly in respect to contracts being frustrated by governments that is also of concern to investors, corporates, banks and insurers."
>
> **Andrew Perry**
> Director,
> Special Risks,
> Miller Insurance Services Limited

CONTEXT

In recent years, high asset prices have tempted some governments to cash in, by renegotiating contracts, increasing their stakes or seizing projects outright. As the global economic downturn hits commodity prices, many will expect the threat of expropriation to recede. But will this happen?

In theory, falling commodity prices should certainly encourage more investor-friendly attitudes. However, the drop in asset prices is likely to be temporary – and any drop in creeping expropriation is likely to be short-lived. Moreover, the global slowdown will create other pressures: as state finances are stretched, protectionism and popular anti-globalisation and anti-business sentiment could increase the attraction of populist policies, depending on the depth and severity of the recession.

While changing economic circumstances will have a substantial effect on expropriation and government interference, they will vary significantly across jurisdictions, and companies must continue to assess the risks in the context of what is taking place in any given country or region. The challenge for boards and risk managers is to understand the factors that leave some countries – and projects – more vulnerable to expropriation risk than others as the impact of recession begins to hit home.

"THE INTENTION TO EXPROPRIATE OR INTERFERE IS NOT JUST A RESULT OF IDEOLOGICAL ORIENTATION OR ECONOMIC CONDITIONS, EVEN THOUGH BOTH FACTORS PLAY A PART."

In assessing the risk, companies must take three broad factors into account – state capability, state intent and the specific vulnerability of the target company. Understanding how each of these factors plays out in a given jurisdiction will provide companies with a more sophisticated understanding of expropriation risk. It will also assist in forecasting how governments are likely to respond when commodity prices are restored. Most important of all, understanding the interplay between these factors will be key in developing strategies to mitigate or respond to the risk of expropriation and government interference.

THREE KEY FACTORS FOR BUSINESS IN ASSESSING EXPROPRIATION RISK

State capability: Do political and economic circumstances – both domestic and international – mean that expropriation is a viable policy option? Nationalising a project requires an alternative operator. The existence, size and capability of state-owned companies, or the presence of alternative operators, is a key factor. Constraints such as judicial integrity, political checks and balances, and the level of external leverage can be equally important. Deficiencies in state capacity can drive government interference in other directions: African leaders whose state machinery is inadequate to take on nationalised assets have turned to repeated rounds of contract review.

Intent: The intention to expropriate or interfere is not just a result of ideological orientation or economic conditions, even though both factors play a part. Domestic political dynamics, vested interests, economic strategy and the constantly shifting balance of power between governments and foreign partners – whether commercial or governmental – are all significant.

Vulnerability: How susceptible to expropriation risk is a given project or business? This last element raises a frequently overlooked dimension of expropriation risk: the role of companies themselves. This is highly relevant in sub-Saharan Africa, where a company's record and ability to respond to a host of development needs can make a genuine difference to the likelihood and impact of attempted expropriations. The level of control enjoyed by companies in managing such risks clearly differs from country to country and from company to company. In Latin America, this issue is less relevant: during phases of nationalisation, the entire principle of private ownership is challenged. But even here, corporate conduct – particularly short-term investment strategies during phases of liberalisation – has reinforced the vicious cycle of expropriation. High corporate profits prompt accusations of exploitation that feed into government ideology during periods of nationalisation.

AFRICA: INCREASING RISK OF CREEPING EXPROPRIATION FOR BUSINESS

Little over a month ago – amid the publication of some of the country's worst economic indicators since the end of the civil war in 2002 – Congo's Deputy Mines Minister Victor Kasongo issued a stark warning to six foreign-controlled mining joint ventures. If the companies do not approach the government with improved contractual terms within six months, Kasongo insisted, "we'll shut down everything".

Investors who have followed the government's convoluted mining contract review process over the past two years have become wearily accustomed to Kasongo's provocative comments hinting at multiple expropriations. But the timing of his latest statement was a surprise, given the government's recent conciliatory line on the outstanding contracts, and the assumption that the collapse of copper and cobalt prices would focus the government's energies on maintaining investor confidence in the troubled mining sector.

△ The collapse of copper prices has caused troubles for the mining sector

Kasongo's comments seem to challenge the assumed relevance of economic factors in determining the level of expropriation risk. They also point to a fundamental capriciousness at the heart of Congolese governance that detracts from the administration's stated desire to attract and maintain foreign investment in the mining industry. In either case, they are deeply unsettling for investors exposed to substantial financial losses at the merest mention of an expropriation, and global recession is only likely to increase uncertainty.

However, expropriation for the purposes of nationalisation – a key feature of trends in Latin America and the Former Soviet Union – will not be a major risk for investors

"It is essential that the brokers, as well as the insureds, do their homework in terms of assessing the risks faced by different projects. The term 'Know Your Client' has never been more pertinent."

Andrew Perry
Director,
Special Risks,
Miller Insurance
Services Limited

"We will see an upswing in demand for traditional political risk insurance again; clients will recognise that they need it as the global economy falters and it becomes a necessity rather than luxury."

Peter Jenkins
Political Risks Underwriter, Beazley Group plc

in Africa, at least in the medium-term. Many Congolese and their leaders may dream of a revival of the debt-ridden state mining company, Gécamines, but its technical, administrative and financial dilapidation means that a return to state domination of the mining sector is unimaginable for the foreseeable future. Across the continent, this capacity deficit is the single greatest constraint to nationalisation as a policy option. Angola's national oil company Sonangol, arguably sub-Saharan Africa's most sophisticated state-owned company outside South Africa, could not operate a deepwater oil block independently and it entered a joint venture with Sinopec. Recession will only reinforce this situation.

However, it would be equally implausible to suggest that capacity deficits and external dependence are an absolute constraint against other forms of expropriation and government intervention. Institutional dilapidation may be a constraint on nationalisation, but it is arguably an important enabling factor for less extreme forms of government intervention, which could become more likely as recession takes hold. A wide range of tactics has been developed to interfere in private-sector activity over recent decades, with the general objective of capturing a greater share of the benefits of commercial activity (whether to the ultimate advantage of the state or individuals). Likewise, the need to cultivate an appearance of protection for foreign ownership to encourage inward investment may deter the most extreme forms of government intervention, but will not hinder less overt forms of interference. We therefore expect recession to increase the risk of such action.

Evidence from past economic cycles suggests that during a time of recession, political upheaval will become more likely

Evidence from past economic cycles suggests that during a time of recession, political upheaval will become more likely. In such periods dynamics can change. The withholding of international recognition from an unconstitutionally installed government may increase its readiness to play fast and loose with its reputation. Long periods of isolation may also give an incentive to seek new strategic partners that are willing and better able to accommodate the needs of an illegal or questionable regime. The transfer of mining rights to certain Zimbabwean companies during the Congolese civil war is one example of this, and moves by the new junta in Guinea to contest licences held by foreign companies provides another.

"LESS EXTREME FORMS OF GOVERNMENT INTERVENTION, COULD BECOME MORE LIKELY AS RECESSION TAKES HOLD."

LEARNING LESSONS FROM AFRICA: WHAT CAN BUSINESS DO?

Any strategy to manage expropriation and government interference risks in Africa must be founded on a detailed understanding of, and engagement with, political stakeholders.

The principal objective should be to enhance a company's bargaining power by maintaining stakeholder support for the project, while minimising exposure to 'feedback' risks – which materialise as a result of an earlier risk-mitigation measure, such as a non-governmental organisation's exposure of corrupt practices or retaliation in the event of sudden political change. In the Congolese context, there will always be some stakeholders who will make inappropriate project champions (for instance, because of reputational liabilities), and some stakeholder needs that a company is unwilling or unable to satisfy, such as demands for illicit payments. The dual process of stakeholder mapping and needs assessment enables a company to identify appropriate project champions with achievable and acceptable needs.

Companies will also benefit from designing their projects in a way that increases stakeholders' dependence on the company itself. This could include the use of non-replicable technology, resisting the temptation to pay cash upfront, offering support for home-country development initiatives and the advancement of ties to multilateral lending and insurance agencies, which can ensure that the project has international leverage.

In Africa political risks, including expropriation risks, are often connected at national and local levels, since a company's performance in delivering benefits to host communities is often a component of how the project is perceived by national-level stakeholders. In this sense, political licence at national level is often enhanced by the development of social licence to operate at local level. Among

"VICTIM CULTURE IS THE MAIN CHARACTERISTIC THAT SETS APART THOSE COUNTRIES THAT HAVE OPTED FOR THE NATIONALISATION OF KEY INDUSTRIES."

other steps, companies should ensure that environmental, social and security issues are managed in a sensitive way, and that all corporate social responsibility programmes are similarly sensitive and appropriate to the local context.

LATIN AMERICA: HEIGHTENED RISKS FOR BUSINESS FROM 'VICTIM CULTURE'

The behaviour of Venezuelan President Hugo Chávez over the last five years – nationalising segments of the oil, telecoms, energy and agricultural sectors – has come to symbolise the risk of nationalisation and other government interference in the region, and has inspired other leaders to follow suit.

Capability to nationalise or interfere in business is relatively high across the region. Most countries have the ability to run expropriated or nationalised projects through state companies, such as Venezuela's PDVSA, Mexico's Pemex and even Chile's Codelco.

But the intent to nationalise varies more significantly, and may be a more useful indicator of risk levels, in Latin America. The key driver is a 'victim culture' that is found in certain countries, which may be considered as a determining factor in nationalisation.

Victim culture is the main characteristic that sets apart those countries that have opted for the nationalisation of key industries – which include Venezuela, Bolivia, Ecuador,

The behaviour of Venezuelan President Hugo Chávez over the last five years in nationalising parts of industry has come to symbolise the risk of nationalisation in the region.

pre-Castro Cuba, Nicaragua and even Argentina. In these countries, the political class instils in citizens a sense that they have been victims of historical circumstances, and that their country's resources have been plundered by rich locals and foreigners – whether companies or institutions such as the International Monetary Fund or World Bank. No one encapsulates this better than Chávez, who has built his career around accusations levelled against foreign oil companies, the US and local 'oligarchs' for 'raping' the country and its poor citizens.

Always done for political gain, this undermines respect for private property and investment, weakens political institutions and expands the role of the state. Citizens expect compensation and reparation, even if it entails expropriating private property or cancelling concessions and contracts. Expectations rise when profits from these concessions – fuelled by high commodity prices – seem very large. This culture fosters nationalisation and significantly raises the periodic intent of regimes to seize key industries. Chávez's actions are only the latest in a series of Venezuelan takeovers and openings of the oil sector since the turn of the century.

As recession takes hold over the next few years, it is likely to encourage this victim culture, and increase the tolerance for transgressions against private property. As it does so, it will encourage countries such as Venezuela to enter into a self-perpetuating 'cycle of nationalisation', and raise risk levels for business further still.

THE CYCLE OF NATIONALISATION – A RISK FOR BUSINESS THAT WILL OUTLAST THE RECESSION

A successful economy or highly profitable project – usually based on commodities – brings high profits for local or (more usually) foreign companies. A populist leader who is bent on pushing for compensation capitalises on anger at high profits or the lack of 'trickle down'. Getting into power, the leader proceeds to extend his personal grip on the state, and then the state's control over the economy, with a view to maximising revenues and establishing personal networks of patronage.

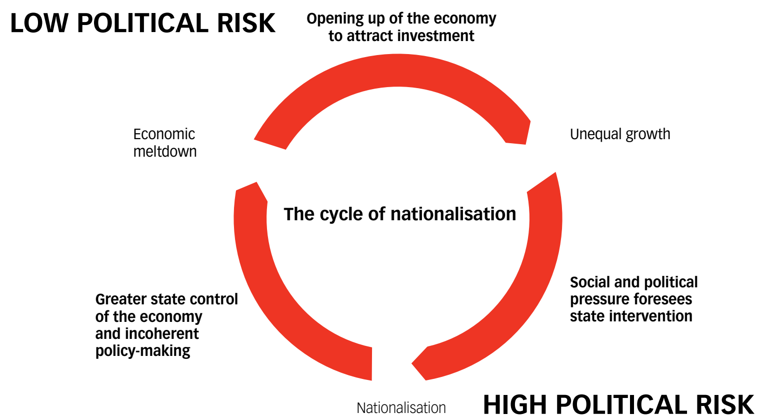
This invariably leads to the erosion of state institutions, deterioration in the business environment and an increase in state corruption, causing economic or political meltdown. When the populist regime falls, the new leaders often seek to reverse these policies, leading to overly generous liberalisation, economic resurgence – and thus eventually the rise of new populists.
The cycle resumes, but in a state with weaker foundations. This explains why seemingly anachronistic and often discarded ideas are revived repeatedly

"Low asset prices make expropriation less attractive to governments when everything else stays the same – but at the moment we have a commodity price plunge and huge macro-economic issues affecting many of the important destinations for foreign investment in the emerging world. Traditional political risks are still an important consideration for investors in most emerging economies. Concerns about these risks are still there in Andean Latin America and in Russia, as well as other parts of the world."

Peter Jenkins
Political Risks Underwriter,
Beazley Group plc

"THE LIKES OF VENEZUELA, ECUADOR AND BOLIVIA WILL FIND IT EXTREMELY DIFFICULT TO BREAK THEIR CYCLES OF INSTABILITY."

in certain Latin American countries, and provides the perfect context for understanding developments in Venezuela over the last few decades, including the rise to power – and eventual fall – of Chávez.



Other Latin American countries, such as Chile, Peru, Brazil and Colombia, offer more stable business and political environments. Their political maturity and economic diversification should enhance their capacity to withstand internal and external shocks as recession takes hold: they are unlikely to relapse into expropriation, even if they are as resource-dependent as some of the more vulnerable economies. In contrast, the likes of Venezuela, Ecuador and Bolivia will find it extremely difficult to break their cycles of instability: Venezuela appears condemned to keep alternating cycles of nationalisation and liberalisation for many economic cycles to come.

LEARNING LESSONS FROM LATIN AMERICA: WHAT CAN BUSINESS DO?

Key factors for business to consider:

'Reading' the signs and timing a project: Knowing where a given country and sector lies in the economic/political and business cycle will enable the planning of investments and projects to minimise the risks of nationalisation and government interference – maximising the time that a project will be reasonably providing returns on investment.

Beware of false friends: Some investors in Latin America believe local contacts, good government relations and/or partnerships with local companies mitigate the risk of nationalisation or expropriation. This is not always the case. In countries where the risk is higher, governments have a tendency to act more arbitrarily – even against their friends – as when

Venezuela nationalised Argentine-controlled Sidor, the country's largest steelmaker. Constant changes in power or power coalitions, as in Ecuador, mean today's friends can be tomorrow's liabilities.

"WHEN COMMODITY PRICES WERE HIGH – GOVERNMENTS SOUGHT GREATER STATE CONTROL OVER THE MOST IMPORTANT ENERGY ASSETS."

The share of Russian oil production under state control has risen from 10% in 2004 to over 50% in 2007

THE FORMER SOVIET UNION: RECESSION MAY LOWER SHORT-TERM RISKS BUT MAKES THE LONG-TERM ENVIRONMENT FOR BUSINESS LESS PREDICTABLE.

Russia, Ukraine and Belarus are all capable of carrying out expropriation. The key issue for business to monitor throughout the recession is the way in which changing economic circumstances influence their intent to do so. In all three countries, the rule of law and court systems are generally too weak to constrain the regime: this is why the economic crisis is far more likely to prompt nationalisation or re-privatisation here than in the Baltic States, for example.

When commodity prices were high – along with the profits of the foreign investors – governments sought greater state control over the most important energy assets to redress what they saw as unjust terms. The share of Russian oil production under state control has risen from 10% in 2004 to more than 50% in 2007, with headline cases including pressure on Russo-British joint venture TNK-BP and Royal Dutch/Shell, both of whom sold stakes in major fields to Gazprom. The Kazakh government brought

"THE CALCULATION WHEN EXPROPRIATING IS ALWAYS ONE OF RISK AND REWARD."

pressure to bear on an ENI-led consortium operating in the large Kashagan field to boost the state company's stake in the project, and Uzbekistan has seen tax pressure used against Oxus Gold and Newmont.

By and large, when economic conditions are poor and commodity prices low, a country that is dependent on the export of single or few commodities is likely to welcome external investors to generate the exports that provide the bulk of state revenue (through taxation). In the mid-1990s, Russia and Kazakhstan offered attractive terms to foreign companies to persuade them to invest capital and expertise.

In the next 12 months, with investment capital likely to remain at a premium, companies that are able and willing to invest in the modernisation and development of oil and gas fields are less likely to experience government interference in any of these three countries. But in the event of a very deep and protracted economic crisis over the next two to three years, the downturn would have the opposite effect: once a government has lost hope of attracting foreign investment, either because there is insufficient capital in the global economy or because it faces economic meltdown, it has little reason to restrain from dramatically stepping up taxation levels or introducing trade barriers to protect its industries. The calculation when expropriating is always one of risk and reward.

In Russia, where the same clique has held power for almost a decade, the methods and aims of the authorities are at least relatively well known, and this provides for greater predictability of who might be the targets of any government interference – namely disloyal entrepreneurs. The situation is unlikely to change unless the crisis becomes so deep as to precipitate reforms as a last-ditch attempt for the ruling elite to cling on to power.

Foreign influence will also be a factor. Aspirations for greater integration in the international economy – not least hopes for World Trade Organisation entry – probably moderated the methods used (if not the goals) in recent years to help Russia's state companies Gazprom and Rosneft gain control over strategic energy assets. Russia employed administrative pressure and allegedly selective use of environmental investigations against Royal Dutch/Shell in 2006, but there was no outright expropriation.

However, social factors will also influence intent. Large income inequality – particularly when the poor become poorer during a very sharp downturn – fuels social resentment that populist leaders can exploit by calling for the nationalisation of natural resources. The Communist Party in Russia is already starting to adopt such rhetoric and in such cases the overall ideological spectrum may gradually shift in a nationalist direction, from where expropriation would be an easier step a few years down the line.

Poverty may fuel social resentment in Russia

"BUSINESSES NEED TO ASSESS THE LIKELIHOOD OF AUTHORITIES SEIZING CONTROL OF FOREIGN ASSETS AS THEY ATTEMPT TO CLING ON TO POWER."

LEARNING LESSONS FROM THE FORMER SOVIET UNION: WHAT CAN BUSINESS DO?

As well as relying on country expertise, companies can mitigate the risks of government interference by establishing co-operative relations with local or national authorities (depending on the scale of the investment). Contributing to local social initiatives, provided these are not just a front to line the pockets of the local governor, would go a long way in Russia to meet the unspoken expectation that foreign investors should share some of their profits with the community. Strictly adhering to all business regulations is a way to minimise – if not eliminate – the risk of facing undue pressure by government agencies for alleged violations.

The experience of the Former Soviet Union highlights another risk to consider. If the downturn turns out to be more severe and protracted than currently expected, businesses need to assess the likelihood of authorities seizing control of foreign assets as they attempt to cling on to power.

Across the world, governments face a shifting balance of incentives and disincentives to interfere in business, varying over time and by sector, in response to economic conditions, prevailing ideology, foreign policy aims and other issues. With such factors often pulling in different directions, it is essential to ground risk assessments on in-depth country expertise and up-to-date knowledge.

ECONOMIC PROBLEMS WILL EXACERBATE EXISTING RISKS OF UNREST, NOT CREATE NEW ONES.

PART 2: CIVIL UNREST

HEADLINES FOR THE NEXT FEW YEARS

- **Recession will amplify existing risks across the world. However, the vast majority of incidents of unrest will not pose a major threat to business, and in countries where risks were manageable before the economic crisis, they will mostly remain so during the downturn and afterwards.**

- **In the West, companies and their executives perceived to be associated with financial market collapse and management failure will be most at risk, but any company could become caught up in civil disruption. In all cases, closer risk monitoring and enhanced security procedures will be key to mitigating heightened risks.**

- **In China and India, levels of unrest may increase in certain areas and sectors amid economic strife, but neither country is especially vulnerable to risks from widespread civil disorder.**

- **Operation-specific labour and business disputes may pose the most significant civil unrest risks for companies everywhere as the recession continues. Local knowledge and engagement will be the best defence mechanisms.**

> "The financial turmoil has exacerbated underlying problems. The insurance market has seen that, across the globe, existing stress points are being put under further stress."
>
> **David Guest**
> Underwriter,
> Hiscox

CONTEXT

As 2008 drew to a close and the forecasts for 2009 began to emerge, most commentators agreed that the year ahead was likely to see increases in the frequency and severity of social unrest worldwide. Businesses were concerned that higher rates of civil disturbance would increase threats to supply chains, resulting in delayed delivery of, or damage to, goods being transported. Retailers, traders and insurers alike depend on the safe passage of goods through economies threatened by escalating industrial discontent and growing potential for civil unrest.

Forecasts that appeared in advance of the disturbances in Athens in December 2008 took them to be the first major example of the 'new world disorder', while commentary that emerged later saw the protests as a template that would be replicated elsewhere. The central idea was that the crisis would be a 'spark' that would ignite latent civil unrest in both rich and poor countries worldwide. But as we edge into mid-2009, it is becoming clear that a more apt metaphor, in both the developed and developing worlds, would be that of a magnifying glass: economic problems will exacerbate existing risks of unrest, rather than create new ones.

"THE BEST PREPARED MULTINATIONALS WILL HAVE THOROUGHLY ASSESSED POTENTIAL THREATS AND VULNERABILITIES, AND IDENTIFIED PRIORITY RISKS."

As well as looking at the potential for unrest in Europe, we focus on Asia, and in particular on China and India. These are likely to be the fastest growing major economies over the next few years, leading many businesses and investors to see them as rare bright spots, even as conditions deteriorate. Fast-growing emerging markets in the developing world are inherently more susceptible to pronounced cyclical economic fluctuations than developed economies. They are also typically more socially and politically vulnerable to the stresses that such fluctuations inflict. Many of these countries are thus no strangers to civil unrest, regardless of global economic conditions.

So, will the economic crisis cause a substantial change in the level or type of unrest in major economies, and what should business be doing to manage these risks both now and in the future?

The best prepared multinationals will have thoroughly assessed potential threats and vulnerabilities, and identified priority risks. They will recognise that some risks cannot be fully controlled and are ready to respond in a crisis. Crucially, they will establish mechanisms to assess and understand developments in the countries where they are exposed, enabling them to stay on top of emerging risks in an increasingly uncertain and fast-changing environment.

LESSONS FOR BUSINESS FROM EUROPE: THE MYTH OF THE SUMMER OF RAGE

With a few exceptions, the disorder seen in various European countries in recent months has been of the kind that could be expected to take place in good times as well as bad, only on a larger scale. Disturbances involving people who would not usually be tempted to participate in such events have remained on a relatively small scale, or at least taken place in relatively small countries – Iceland fits both cases. This is not to say that more serious outbreaks of unrest will not happen as the economic turmoil deepens. Human nature dictates that in times of crisis, people occasionally depart from their normal spectrum of behaviour, but in general they behave as they would usually.

In Greece, despite strong economic growth and relatively stable two-party politics during the 1990s and 2000s, there has always been an undercurrent of political extremism, and a vocal minority dedicated to noisy public protest. Even in the relative boom years of the mid-2000s, the Greek government followed a programme of austerity, and there were regular and long-lasting strikes in several sectors. Significant protests took place in Athens weekly.

Significant protests against the state took place in Athens in December

"MORE RECENTLY THERE HAVE BEEN HIGH-PROFILE INCIDENTS OF LABOUR DISRUPTION IN FRANCE."

The economic angle on the difficulties seen in Greece in December may well have been overstated. Fundamentally, the mass demonstrations stemmed from anger directed against the state after the shooting by police of a seemingly innocent 15-year-old boy. The shooting could be termed as a 'spark', but not the economy, which was more of a constant irritant. Meanwhile, leftists, anarchists and anti-capitalists took advantage of the fertile conditions to push their own agenda and continued the disturbances for several weeks. There has been a similar situation in Hungary, with global conditions prompting the closer examination of long-running protests in the last six months.

More recently, there have been high-profile incidents of labour disruption in France, with the use of some fairly novel protest methods. International attention has focused on 'boss-napping', but there have been a number of incidents of vandalism by workers against plants threatened with closure, as well as more prosaic strikes and demonstrations. Again, this represents an evolution of the risk environment in France, rather than a major departure: French unions have always been among Europe's most active, and workers' protest methods certainly the most creative. This trend has generally been more applicable to the public sector or to independent traders, such as farmers or fishermen, but is now being seen among private-sector employees as well. Nevertheless, while polls suggest public sympathy for boss-nappers and other protesters at threatened companies, this has not yet translated into mass action.

Other countries that have been hit hard by the recession are following this latter pattern to the one above. An unprecedented series of large labour protests in

"THERE IS CERTAINLY SOME POTENTIAL FOR UNREST DURING THE HOTTER SUMMER MONTHS TO COME."

Ireland during January and February – chiefly from the public sector – appears to have backfired, with public sympathy evaporating in the face of the government's determination to impose austerity across the board. People who would not usually attend demonstrations may have done so, but in current circumstances appear unlikely to do so again.

Similarly, in Spain, which has experienced half of all new EU job losses during the last year, there has been little organised public response. The unions are struggling to gain much traction against the Socialist government, and many of those in the most severely affected sector, construction, are migrant workers who have either already returned to North Africa or Southeastern Europe, or are planning to do so. Issues such as water scarcity, energy supply and political structure have all prompted larger demonstrations in 2009 than pure economic unease.

A glance around Europe's other big and struggling economies – Germany, the UK, Benelux and to an extent Italy – tells a similar story. Activists are responding with rage; non-activists seem more prone to depression than anger. Protests at the G20 summit in London or the NATO meeting in Strasbourg that followed may have sought to exploit popular anger at the causes and proposed solutions to the economic crisis, but they would undoubtedly have happened anyway. As signals of a 'new world disorder' go, they are faint and inconclusive.

This is not to say that we have seen no unusual patterns of protest anywhere. The recent elections in Iceland end a period of political uncertainty referred to in some quarters as the 'pots and pans revolution'. Street protests in Reykjavik were quite a departure in a country so unused to public displays of anger that it often appeared as if neither protesters nor police knew quite what to do, but the transition between governments occurred entirely within the constitutional framework. The crisis, not the popular response, brought down the government. Perhaps the most genuine outburst of crisis-sparked unrest has been seen in Latvia, where there is undoubtedly a correlation between the depth of the crisis and the severity of public protests.

Of course, everyone knows what happens if the sun's rays are focused through a magnifying glass, and there is certainly some potential for unrest during the hotter summer months to come. But again, this is often expected in Europe – commentators pull out the 'long, hot summer' cliché at the first sign of any industrial action or social unrest at the mid-point of the year, irrespective of the prevailing economic circumstances. However, there appears to be a sense of grumbling resignation that will limit the numbers flooding on to the streets of the continent, reflecting the wider sense of political apathy that has developed since the last global recession in the early 1990s.

△ Police presence at protests in London

"THE STEPS NEEDED TO MANAGE THE RISKS LARGELY INVOLVE ENHANCEMENTS TO EXISTING SECURITY PROCEDURES."

This is not to downplay the risks posed by social unrest in Europe as the recession deepens. We may yet see some protests in Europe this summer. In 2010, as the effects of unemployment are felt more keenly, protests are likely to continue, and may flare up in individual countries in response to national events, particularly in states with unpopular governments. However, the instigators' ambitions for a continent-wide wave of protest seem unlikely to be matched by reality. In the meantime, the targets within the business community remain fairly clear, and the steps needed to manage the risks largely involve enhancements to existing security procedures.

"ALREADY VULNERABLE REGIONS WILL REMAIN THE FOCAL POINTS."

KEY TARGETS AND POTENTIAL PROTEST SITES

- Premises of high-profile businesses or other brands proving controversial in the current environment, including banks and financial services companies, and other failing or downsizing businesses.
- High-profile executives, particularly those from the types of businesses mentioned above.
- Key symbols of national political or economic power, such as parliament buildings or central banks.
- Iconic buildings or structures that guarantee striking images.
- Transport infrastructure used by financial services employees, especially those working for the businesses highlighted above.

STEPS FOR MANAGING RISK

- Keep in contact with local police if and when protests are announced in advance.
- Assess any particular vulnerabilities that may cause your business and neighbouring companies to be targeted by protestors.
- Consider de-branding the exterior of your site if protests are likely.
- Consider how practical it will be to operate normally if protests are planned, as well as accounting for direct physical threat.
- Ensure that you maintain full communications with employees in areas targeted and minimise footfall in those and surrounding areas during protest periods.

LESSONS FOR BUSINESS FROM INDIA: MAGNIFYING EXISTING PROBLEMS

India's exposure to the global economic downturn is likely to be limited, given its less export-dependent economy and relatively mature banking system. Nevertheless, claims that the Indian economy would be decoupled from the world economy have proven false. The country is in the midst of a slowdown fuelled by falling trade and capital flows, rather than a full recession. The Reserve Bank of India has lowered its growth forecast for 2009-10 to 6%, compared with 6.5%-6.7% for 2008-09, the slowest rate of growth since 2003.

As in Europe, the global downturn is unlikely to be a catalyst for new sources of unrest, but may stoke existing tensions. However, the effects are unlikely to emerge as a nationwide wave of civil unrest, but rather as an intensification of localised pressures that are likely to affect both indigenous and foreign companies. Already vulnerable regions will remain the focal points: these include states with communist administrations (West Bengal and Kerala); poor law and order (Uttar Pradesh and

Bihar); communist or separatist insurgencies (Central, Eastern and Northeast India) and tense communal or ethnic relations (Maharashtra and Orissa).

As economic pressures rise, India's communist parties may find renewed support for their anti-globalisation, anti-Western and anti-privatisation agenda, which could encourage greater local opposition to foreign investment. There have been a number of high-profile incidents of companies having to relocate or cease operations because of unrest over the allocation of agricultural land for industrial use – notably the forced relocation of the production plant for the Tata Nano from West Bengal to Gujarat state in 2008, and violent opposition to the planned construction of a petrochemical plant in the Nandigram district of West Bengal in 2007. Further incidents may happen, but will depend on the interplay of local economic and social conditions with political opportunism.

Long-standing ethnic, caste and communal (religious) tensions are also likely to be magnified. Militant ethnic nationalist groups have been growing in influence as the slowdown causes a backlash against migrant labour. This has been most visible in Mumbai, where groups such as Shiv Sena and Maharashtra Navirman Sena have incited attacks on migrant labourers from north Indian states such as Uttar Pradesh and Bihar. Such unrest is likely to grow as unemployment rises with the return of migrant labourers from overseas. The growth of local religious extremist groups – both Islamist and Hindu – will add to this mix. Gujarat state is an obvious flashpoint, with a record of communal unrest (2,000 people were killed in Hindu/Muslim riots in 2002) and a suffering economy, with the local diamond industry shrinking by 30%-40% and 250,000 of the industry's 700,000 skilled workers being laid off.

"THE GLOBAL DOWNTURN IS UNLIKELY TO BE A CATALYST FOR NEW SOURCES OF UNREST, BUT WILL STOKE EXISTING TENSIONS."

△ In Mumbai, radical ethnic-Maharashtran groups have incited attacks on migrant labourers

"A RESURGENCE IN INFLATIONARY PRESSURES PRESENTS A GREATER THREAT OF SOCIAL UNREST THAN THE GLOBAL SLOWDOWN."

Export-oriented sectors such as business process outsourcing, information technology, financial services and manufacturing have been hardest hit, but are not major sources of employment or votes, unlike the agricultural sector. Rather than targeting the industries worst affected by the slowdown, the government's stimulus measures have flaunted its pro-poor, rural credentials to strengthen its prospects in the April-May 2009 general elections. The lack of help for export-oriented sectors could lead to anti-government protests in urban areas, especially if the downturn is prolonged and spills over from the manufacturing and service sector into the rural and informal sectors, where social safety nets are often lacking. Adding to the government's woes are its limited resources to revive the economy.

△ 60% of India's workforce are employed in the agricultural sector

In reality, a resurgence in inflationary pressures – which manifested itself last year with the rise in global grain and oil prices – presents a greater threat of social unrest than the global slowdown. Although food prices remain high as a result of the weakening rupee, India's wholesale price index dropped from a 13-year high of almost 13% in August 2008 to 3.6% in February 2009. But a poor harvest or renewed surge in food and fuel prices would affect a large proportion of the population, and thus be a greater catalyst for social instability than the global recession, which has so far only directly affected a small proportion of the population.

INDIA: MITIGATING BUSINESS RISK THROUGH CLOSER LOCAL ENGAGEMENT

Companies operating in India need to have a particularly strong understanding of the local political, economic, security, operational, regulatory and social environments to mitigate the risk of unrest. This differs by state, and often according to district, city and village. India's democratic system, in which authority is increasingly diffused to the local level, requires investors to appease numerous vested interests, including national and state governments, and grassroots social and religious groups, to enable them to proceed with projects successfully. The experience of UK-based mining company Vedanta in Orissa state is a case in point. Vedanta has continued to face protests from environmental activists and local residents despite a ruling by the Supreme Court in August 2008 that it could proceed with mining bauxite in the Niyamgiri Hills, provided that it used profits to alleviate poverty and protect the local environment.

"INDIA'S DEMOCRATIC SYSTEM... REQUIRES INVESTORS TO APPEASE NUMEROUS VESTED INTERESTS."

India's exposure to the global economic downturn will be limited given its less export-dependent economy

LESSONS FOR BUSINESS FROM CHINA: SLOWDOWN NOT MELTDOWN

Among major economies, China is perhaps subject to the most speculation about what the economic crisis means for social unrest. The country is now home to substantial operations or markets for most multinational corporations, and its global economic and

"THE ECONOMY IS IN THE MIDST OF A SLOWDOWN, NOT A MELTDOWN."

business significance will increase in the coming years – a prospect reinforced rather than shaken by the economic crisis.

The economic crisis is not going to derail China's rapid economic growth, nor alter its status as a generally secure business environment. The economy is in the midst of a slowdown, not a meltdown, and the likelihood of severe instability occurring as a result of the crisis is extremely low. Although growth forecasts of 4% or 5% (or lower) have become common, and are widely perceived to be accurate, a less dramatic slowdown to around 6.5%-7.5% is much more likely. Even amid a truly dismal export performance, government-led domestic consumption and investment have long driven rapid growth and will continue to do so. The staggering scale of government stimulus spending and credit growth, along with serious industrial over-capacity, all point towards future difficulties, but there are also very real, fundamental sources of rapid growth – particularly urbanisation, and associated infrastructure and housing construction.

Urbanisation is a source of rapid economic growth in China

In this context, some of the risks associated with economic strife look less alarming. There is no doubt that unemployment is a major challenge for China. The number of people estimated to have lost their jobs since the onset of the downturn – 15 million or 23 million, according to two different studies – seems huge, and of course implies major social pressures. However, reports of these headline numbers rarely put them into context: 15 to 20 million people translates very roughly into 2.5% of China's labour force, and in many developed Western economies unemployment has risen significantly more than that. Meanwhile, the nature and scale of unemployment is an important consideration. Most job losses have indeed been among Chinese migrant labourers, and the manufacturing sector has undoubtedly been hit hard. But this has not resulted in huge numbers of unemployed migrant labourers in China's major cities. Evidence suggests that some have returned home, whereas some have found other jobs. Yet more are struggling to find work, but this is not totally dependent on an export recovery, which looks unlikely. Construction is a crucial source of migrant jobs and the main target of government stimulus efforts, so some jobs will return as these measures are implemented.

China has lived with rural unrest for years, and can continue to tolerate this without facing real instability. Meanwhile, the overwhelming majority of business operations and assets are concentrated in urban areas. Farmers periodically riot in the provinces without any impact on investors.

Contrary to common perceptions, the government, while certainly the target of frustration and disaffection among some of the Chinese population, enjoys a considerable degree of support. This will not evaporate just because of slower economic growth and while this has made civil unrest a topic of speculation, the risks for business remain low.

△ There is no doubt that unemployment is a major challenge for China.

"CHINA HAS LIVED WITH RURAL UNREST FOR YEARS AND CAN CONTINUE TO TOLERATE THIS WITHOUT FACING REAL INSTABILITY."

"COMPANIES MUST NOT IGNORE LOWER PROFILE, BUT MORE LIKELY SOURCES OF RISK."

Nevertheless, recession is exacerbating some long-standing risks for business, which are increasingly likely to claim victims among unaware or unprepared investors. Most of all, companies must not ignore lower profile, but more likely sources of risk, which are more localised and operation-specific. For example, an operation exposed to a land dispute between local communities and officials, or to allegations of environmental pollution, faces a more significant risk of being affected by unrest. Although very rare, cases ranging from negative publicity and vandalism to violent protests have vividly displayed the potential cost of failure to understand the local environment and existing tensions.

△ China is now home to substantial operations or markets for the vast majority of multinational corporations

RISK MANAGEMENT IN CHINA: STAYING AHEAD OF THE GAME

Panasonic and Danone are examples of leading multinationals that have faced difficulty in China despite their extensive experience in the country. Danone's severe problems with its one-time flagship joint venture with Wahaha (China's largest beverage manufacturer) provide an example of the serious risks that can arise from business disputes. Amid a long-running and acrimonious struggle in local and international courts, Danone has lost control of one division of the company, lost effective control of the whole joint venture, and is unable to prevent its partner from operating parallel companies worth some $800m outside the joint venture using the Wahaha brand. The joint venture was ten years old when it hit trouble, but it is costing Danone $25m per month. It has also suffered significant reputational damage in China and on the international stage.

Major multinationals have also faced penalties for violations of the US Foreign Corrupt Practices Act (FCPA) in China. For example, Siemens last year paid fines totalling approximately €1bn, following proceedings against it in Germany and the US over corrupt activities, including some taking place in China.

Both cases pre-date the economic crisis, but the risks from corruption and business disputes are now somewhat elevated amid greater financial stress and scope for increased friction with local partners.

Boards would do well to focus on these types of issues as the recession continues. Areas for attention include introducing controls and policies to mitigate the risks stemming from corruption ensuring that the necessary contacts and communications are in place with local managers and partners, workers and officials to prevent and resolve crises; and implementing crisis management and business continuity plans for when all else fails.

Sitting behind all of these measures, companies must maintain a strong, current awareness and understanding of the business environment, from micro-level (for example, local community and security situations, and activity among business partners, suppliers and officials), to national, regional and global trends and developments. This applies equally to new development activity (for example, due diligence and pre-entry threat assessments) and managing established businesses and investments.

"COMPANIES MUST MAINTAIN A STRONG, CURRENT AWARENESS AND UNDERSTANDING OF THE BUSINESS ENVIRONMENT."

THE INTERNATIONAL COMMUNITY HAS ADOPTED MORE ROBUST RULES OF ENGAGEMENT AUTHORISING ARMED CONFRONTATIONS AND THE CAPTURE OF SUSPECTED PIRATES.

PART 3: PIRACY AND KIDNAP RISK

HEADLINES FOR THE NEXT FEW YEARS

- **Piracy risk is likely to get worse before it gets better. The cost of keeping global trade routes open could result in a growing 'piracy tax' that will be felt by a wider range of businesses and consumers, already battered by the effects of recession.**

- **Somali piracy looks set to migrate from a chiefly business transaction towards a militarised conflict, with a possible increase in violence, bringing new human and financial costs for shipping companies.**

- **Recession could fuel the (re)emergence of other piracy hotspots in Asia and Latin America, and the tactics successfully employed in African seas could be copied by criminals elsewhere – increasing the potential risks for business.**

CONTEXT

While the global economy falters, Somali pirates appear to be beating the credit crunch. In the last 15 months, pirate crews operating from the Gulf of Aden to the Seychelles seized more than 60 merchant vessels and earned as much as $80m in ransom payments – all under the nose of a growing flotilla of international warships.

Foreign naval forces are impaired by the sheer size of the affected area – more than six million square kilometres – but also because pirates operate with impunity in the vacuum created by the collapse of the Somali state. It is clear that piracy is unlikely to abate without lasting improvements to onshore stability and security, no matter how many warships are sent to the region.

However, improvements in stability are not on the immediate horizon. Islamist insurgent group al-Shabab may have captured most of southern Somalia and forced the retreat of Ethiopian military forces, but it lacks acceptance among the local population and clans. The installation of former Union of Islamic Courts leader Sheikh Sharif Ahmed as President has failed to placate hard-line Islamists, who maintain their opposition. Meanwhile, coastal fishing villages are reluctant to give up the rich spoils of piracy for the uncertain promises of a distant and feckless government. With the prospect of onshore stability distant, Somali piracy is likely to persist into the foreseeable future.

Given its fierce reputation, Somali piracy has been surprisingly non-violent; thus far, pirates appreciate that ransom money will not be paid for a boat that is destroyed or a crew that is missing. Consequently, the key costs for business in the last year have been long delays in releasing vessels – often frustrating contractual obligations – and

"Since its inclusion as an area of concern in May 2008, piracy attacks are increasingly being included under war policies, and rightly so."

Clive Washbourn
Joint War Committee,
Lloyd's Market Association

"We in the insurance market don't anticipate an improvement for the passage of ships through the Gulf of Aden in the foreseeable future. Until there is a solution to the political issues in Somalia, there is unlikely to be one on the water. Although some companies are choosing the longer route around the Cape, others are looking into taking preparatory and onboard mitigation measures. These measures paint them in a much more favourable light to underwriters."

Clive Washbourn
Joint War Committee,
Lloyd's Market Association

high costs associated with ransoms, which reportedly inched into the $3m range after the seizure of the Sirius Star, a tanker loaded with two million barrels of Saudi crude oil.

△ 60 merchant vessels were seized by Somali pirates in the last 15 months

LESSONS FOR BUSINESS: LEARNING FROM EAST ASIA

Endemic piracy in the archipelagos of Southeast Asia intensified as a result of the 1997-98 regional financial crisis. The threat of piracy was also amplified after 11 September 2001 by separatist and Islamist extremist movements in Indonesia and the Philippines, sparking concerns that a terrorist attack could close off the vital Malacca and Singapore straits, through which 40% of the world's shipping travels. Faced with the prospect of reduced shipping activity – a key driver of economic recovery – Singapore, Malaysia and Indonesia agreed to co-operate on anti-piracy surveillance and suppression, and were supported in their aims by regional powers, including Japan, China and Australia. The result of a concerted security co-operation, backed by credible onshore institutions, was a 70% decline in the number of piracy incidents from 2003 to 2008.

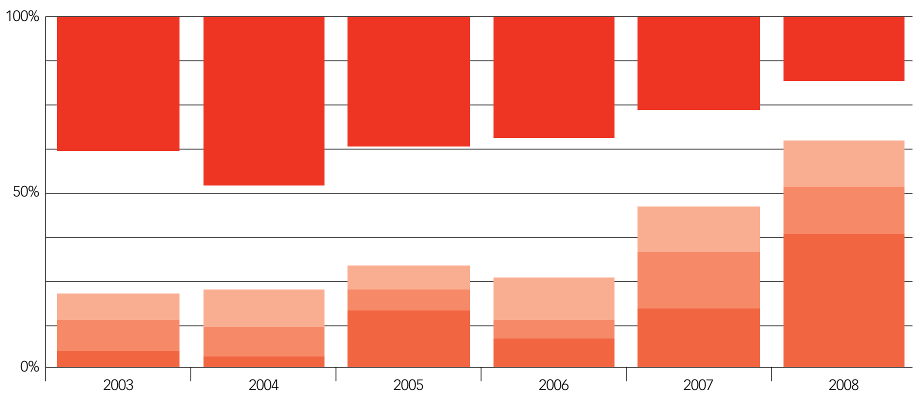
Piracy still troubles the Malacca Strait and other parts of East and Southeast Asia, but is becoming increasingly uncommon and less intense. There are clearly several well-organised groups targeting tugs and other small vessels for high seas attacks, but many recently reported incidents are small-scale thefts of cash, personal items and engine spares from ships at anchor.

With the decline in Southeast Asian piracy, the balance of the global threat has shifted overwhelmingly to Africa. In 2008, Somalia and Nigeria alone accounted for more than half of piracy incidents, according to the International Maritime Bureau.

Hearkening back to the co-operative strategy that worked for Southeast Asia, nine countries around the Horn of Africa signed an anti-piracy 'code of conduct' in Djibouti in January 2009, vowing to share information and pass domestic laws to prosecute suspected pirates. The agreement could eventually bear fruit, given enough time and ample investment in law enforcement. In the short-term, however, the failed state of Somalia presents a far more intractable problem than even the East Asian financial crisis.

"THE FAILED STATE OF SOMALIA PRESENTS A FAR MORE INTRACTABLE PROBLEM THAN EVEN THE EAST ASIAN FINANCIAL CRISIS."

Proportion of total piracy attacks taking place in Southeast Asia and Africa, 2003-2008



Southeast Asia Somalia Nigeria Rest of Africa

LESSONS FOR BUSINESS: THE OUTLOOK IN AFRICA

There looks to be no immediate end to the issue of piracy around Somalia. Pirates can operate with impunity from coastal havens, where they can hold captured vessels for two months or more, while receiving support and manpower from local villages that have seen a tremendous influx of new construction and vehicles in the last year from the resulting profits. If its origins reside in resistance against illegal fishing and dumping in Somali waters, the future of Somali piracy is in the economic opportunities that it provides.

Global supply chains, which pass through shipping choke points, such as the Gulf of Aden, are increasingly likely to suffer. Some shipping companies have recently opted to re-direct vessels around the African continent rather than risk the Gulf of Aden, but

"Good risk management advice and insurance provision provided by excellent insurance companies can expand the choices shipowners have in dealing with this complex issue and help them continue to trade."

Clive Washbourn
Joint War Committee, Lloyd's Market Association

ever-adaptable pirates have taken to raiding these shipping lanes as well, with attacks and hijacks as far as 600 nautical miles from Somalia. Whether by incurring the added fuel and time costs of re-routing around the Cape, or the security and insurance costs of a Gulf of Aden route, ship owners are likely to pay an increasing toll for maintaining their global supply routes. Until now, most of the costs have been borne by the shipping, transport and energy sectors. But as costs increase and recession bites, they will increasingly be passed on to other companies in the supply chain. A wider range of businesses will begin to feel the impact, and their ability to help mitigate these risks will increasingly be called upon, while the consumer could face higher prices for goods imported from Asia and the Middle East. All such consequences will be unwelcome pressures at a time of economic downturn.

Recent evolutions in anti-piracy countermeasures carry particular implications for the shipping industry, marine insurers and vessel crews. Under pressure from domestic constituencies to do something about piracy, the international community has adopted

The international community has adopted more robust rules of engagement authorising armed confrontations and the capture of suspected pirates more robust rules of engagement, authorising armed confrontations and the capture of suspected pirates. Merchant ships, meanwhile, are increasingly employing armed protection, despite the thorny legal questions involved and evidence that unarmed countermeasures are highly effective when deployed properly. The primary concern is that armed escalation increases the risk to crew, cargo and vessel by raising the stakes for pirate gangs and increasing the chances of fatalities, while there are specific risks for ships carrying hazardous cargo.

"SOMALI PIRACY LOOKS SET TO MIGRATE FROM BEING CHIEFLY A BUSINESS TRANSACTION TOWARDS A MILITARISED CONFLICT WITH INCREASING STAKES."

The recent death of a hostage during a rescue attempt – the first violent hostage death since piracy surged last year – as well as vows of retribution against French and US nationals after special forces raids testified to the changing character of piracy risk around Somalia. While such threats have yet to materialise, Somali piracy is migrating from being chiefly a business transaction towards a militarised conflict with increasing stakes, which may ultimately reward the most violent and tactically sophisticated groups, and increase the risks for businesses dependent upon the trade routes affected. This has been shown by the expanded deployments and escalated response of navies to incidents in the Gulf: in November 2008, an attack on a Thai fishing boat incited a response from an Indian warship that destroyed the vessel when it was mistakenly identified as a pirate 'mother ship'.

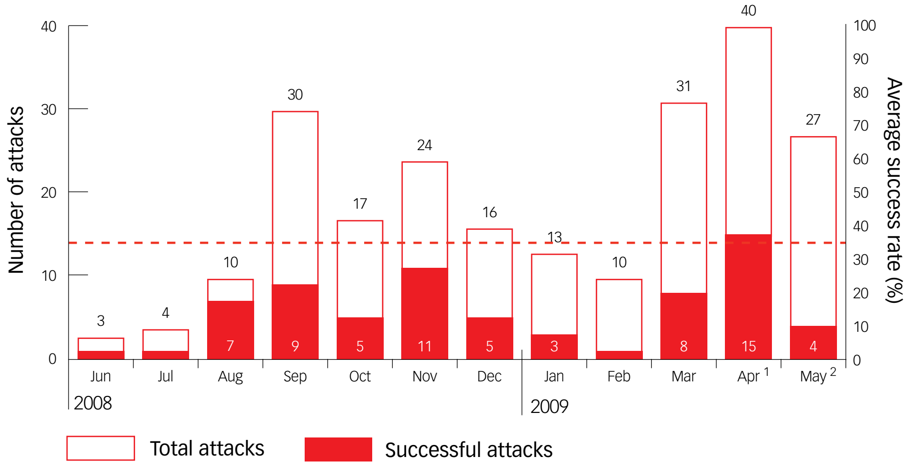
In the Gulf of Guinea, maritime insecurity is more explicitly linked to militancy in the Niger Delta, and shows signs of spreading into neighbouring countries through organised criminal networks and tangential separatist movements. Several bank robberies over the last two years in Benin, Cameroon and Equatorial Guinea, for example, were conducted using speedboats and heavy weaponry. Formerly low-profile groups in Cameroon's Bakassi Peninsula on the border with Nigeria have stepped up their activities, mounting their first high-profile attack on an oil and gas industry support vessel in October 2008.

On the back of such attacks, there is speculation that some Bakassi-based movements in Cameroon may have operational or motivational links to Nigeria's ethnic Ijaw Movement for the Emancipation of the Niger Delta (MEND). Given that these militant movements specifically target oil and gas operations – both onshore and offshore, and often with kidnapping in mind – and are engaged in a running armed conflict with local and national security forces, the risks to personnel and vessels may be even more severe than around Somalia. Although MEND has a distinctly different history, motivation and background from the Somali pirates, the activities of MEND are analogous to the activities of Somali groups, and it is thus appropriate to draw some analytical parallels. Certainly, engagements in the Gulf of Guinea are frequently more violent than around Somalia and kidnap ordeals are more dangerous.

"Retailers are highly reliant on their increasingly global supply chains and any unrest or piracy could have an impact on this crucial process. Although none have been confirmed, there have been rumours of deviations in delivery because of piracy events, the Gulf of Aden being a crucial route for many retailers in the UK."

Paul Howard
Head of Insurance and Risk Management, Sainsbury's Supermarkets ltd.

Success rate of African piracy attacks, June 2008 - May 2009



PIRACY AND KIDNAP: A MERGING AND GLOBALISING RISK?

In the short-term, it is hard to see how piracy around Somalia and the Gulf of Guinea could be replicated elsewhere. The key enabling conditions in Somalia – the lack of a functioning central government in a territory with 2,000 miles of coastline along a major shipping route – simply do not exist anywhere else. Neither does an entrenched militant movement in close proximity to a major offshore oil industry arise outside the Niger Delta and neighbouring areas.

However, even in the absence of a situation similar to Somalia, piracy risks are likely to be significant in many regions. New piracy hotspots may emerge and formerly inactive ones may re-emerge in the coming year, particularly as the global recession generates unemployment and reduces levels of public spending. Southeast Asia has been hit hard by the collapse in global trade, which will likely contribute to an increase in maritime theft, although regional efforts to date suggest that this will be limited. Low-intensity incidents of maritime theft and armed robbery are increasing in Latin America, particularly in Peru. Companies need to prepare for these risks and build them into their operational and risk management planning.

The adoption of kidnapping by pirates in Africa is also a stark change from piracy tactics prevalent in former Asian hotspots, which were principally geared towards theft of goods. Just five years ago, around two-thirds of documented kidnap-for-ransom cases occurred in Latin America – principally in Colombia. Since 2003, both the incidence and global

[1] April 2009 recorded the most attacks and hijacks of any month to date.

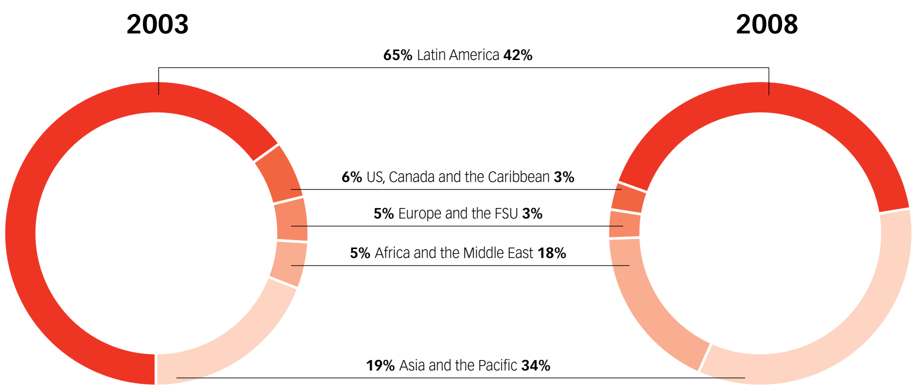
[2] The fall in the overall number of attacks in May was due to sea conditions and this number might rise again later in the year.

spread of kidnapping have increased significantly, with dramatic increases in both Africa and South Asia. By mainly targeting foreign nationals (mostly from South and Southeast Asia, but increasingly from Europe and the US), this differs from onshore kidnapping incidents, which mostly victimise local people.

In several regions, the risk of kidnap-for-ransom is spreading out of core zones into neighbouring areas. Entrepreneurial gangs are spreading out of Colombia into Ecuador and Venezuela, from Somalia into Ethiopia, Kenya and the Seychelles, and from Nigeria into Cameroon and Equatorial Guinea. In both Somalia and the Gulf of Guinea, maritime piracy plays a major role in the cross-border spread of kidnap risk. As always, it is vital to understand the local drivers behind kidnap risk in order to appreciate the risk to expatriate and local staff.

"IT IS VITAL TO UNDERSTAND THE LOCAL DRIVERS BEHIND KIDNAP RISK IN ORDER TO APPRECIATE THE RISK TO EXPATRIATE AND LOCAL STAFF."

Trends in kidnap risk – % of kidnapping incidents by region 2003–2008



LESSONS FOR BUSINESS: FIGHTING PIRACY

While it is important to note that no countermeasure can ever be completely effective, a comprehensive defence strategy – backed up by a good crisis management plan and response capability – goes a long way towards mitigating the risk to vessels and crews from piracy.

Investment in crew and training

A ship's crew is the 'first line of defence' against piracy, according to naval commanders in the Gulf of Aden. As the threat has developed over the last year, this first line has become increasingly effective at thwarting pirate attacks, often through simple, common-sense countermeasures. It is important for vessels to have clear policies and procedures to follow in the event of a suspected or actual attack.

"IN NUMEROUS CASES, GOOD PLANNING AND PREPARATION HAS HELPED DETER PIRATE ATTACKS."

Preferably, crews will receive training from a maritime security expert. In numerous cases, good planning and preparation has helped deter pirate attacks and created time for coalition naval forces to respond.

△ Global supply chains, strung through shipping choke points such as the Gulf of Aden, will increasingly suffer

Security countermeasures

An important countermeasure – not just in the Gulf of Aden but indeed worldwide – is maintaining a standing 24-hour radar and visual watch in areas at risk from piracy. To quickly and effectively deploy any anti-piracy defence, it is essential that vessels anticipate attacks. In Southeast Asia, a night watch can often make the difference between a vessel being robbed and being left alone. In the Gulf of Aden, a 360-degree watch can alert the ship's master to approaching skiffs, providing time to issue distress calls and activate crisis training. When pirate attacks take as little as 20 minutes to be successful, every second gained is vital. Other countermeasures, such as hardening the vessel and rigging fire hoses or flares, can make boarding more difficult for pirates. These countermeasures should be determined in consultation with a maritime security expert, with each vessel preferably receiving a vulnerability assessment and security review.

Gathering intelligence

A related, key measure is maintaining links to recent intelligence about pirate activity. This is particularly the case in the Gulf of Aden, where information clearing houses have been established under the auspices of UK Maritime Trade Operations and the EU's Maritime Security Centre (Horn of Africa) – MSC(HOA). Good communication links also facilitate interaction with coalition naval forces. MSC(HOA)'s piracy updates, for instance, single out vessels that fail to adhere to standing recommendations about position reports and transit advice, implying that these failures put them at higher risk of pirate attack.

Engagement onshore

Both Somali piracy and maritime militancy in the Gulf of Guinea currently appear intractable. A durable political solution to Somalia's woes is not in sight and available international warships are short of what is required to adequately patrol the Gulf of Aden, let alone a large section of the Indian Ocean. Neither is a short-term solution to instability in the Niger Delta on offer, considering the long-standing grievances and arduous process of economic development that need to be addressed. Over the next 12 months, the business community generally will need to assess the value of closer local engagement onshore in order to mitigate the risks and the resulting costs of piracy and kidnapping offshore.

A 24-hour radar should be maintained in areas at risk of piracy

> "Risk managers whose remit includes colleagues travelling overseas on company business need to understand security and kidnap risk – for example, it is essential that travellers provide clear itineraries to their line managers and are aware of where to find up-to-date information on the areas they are visiting. Colleagues are a key asset to any organisation and the duty of care that is owed to them cannot be underestimated."
>
> **Paul Howard**
> Head of Insurance and Risk Management, Sainsbury's Supermarkets ltd.

IMPLICATIONS FOR BUSINESS

As companies adapt to the changing geopolitical environment, investment decisions and operational plans cannot be developed in a vacuum, and business must work harder than ever to understand and mitigate the specific geographical, sectoral and project-specific risks they face.

MONITOR RELIABLE INFORMATION SOURCES TO UNDERSTAND HOW RISKS EVOLVE

Accurate and timely information is critical. Companies should not underestimate the value of monitoring and understanding the dangers posed by political entities or threat groups in the countries in which they operate. Those that succeed in hostile or complex investment environments have, unfailingly, done their homework. Understanding how an investment interplays with national and local economies is always important, but becomes vital as those economies become subject to the pressures of global recession (see trusted source list on page 46-47 for means of improving such understanding).

ADVANCE PLANNING AND PREPARATION IS KEY

All strategies for entering emerging markets should involve a comprehensive pre-entry risk assessment – one that maps key local and national stakeholders, assesses their influence and plans on keeping them involved in the project. Any pre-entry risk analysis should assess how business can best mitigate risk, down to the level of individual locations and recommendations for ongoing risk management strategies. In the case of outright nationalisation, there may sometimes be little that a company can do, but the degree of exposure to any given risk is often within a company's control. There are measures that a company can take to facilitate an effective response when enthusiasm for nationalised industry fades and an upswing towards liberalisation takes hold. Although the best-prepared multinationals will thoroughly assess threats and vulnerabilities, and set strategies for managing those risks, they also recognise the value of careful crisis planning to enable them to respond to emergencies should the worst happen.

GREATER INVESTMENT IN SECURITY IS NEEDED NOW

As piracy risk has increased over the last year off the coast of East Africa, common-sense security countermeasures have proven to be the most effective. Maintaining a 24-hour radar and visual watch in high-risk areas is vital when pirate attacks can take as little as 20 minutes to be successful. Meanwhile, in cases of civil unrest, the targets and the protagonists are often fairly clear and the implementation of practical security steps will often effectively mitigate risk.

KNOWLEDGE – AND LOCAL ENGAGEMENT – IS POWER

In the case of civil unrest, knowledge is vital, especially local knowledge gathered from the right sources. It is important to consider what the local population thinks, and look at potential adversaries, particularly in terms of their stake in your investment and their previous responses to similar investors. In China and India, where some fear growing civil unrest following industrial slowdown, it is important to understand the potential for unrest at a local level when building business plans. Ultimately, whatever the risk (expropriation, civil unrest or piracy), the value of local engagement by the business community is becoming increasingly clear. Contributing to local economic development in a way that reduces instability will not only help mitigate political risks experienced during the downturn, but will contribute to a more stable operating environment for companies over the long-term.

INSURANCE SOLUTIONS CAN PLAY A KEY ROLE IN MANAGING POLITICAL RISK

Effective risk management strategies involving appropriate insurance solutions do not and cannot resolve the world's political risk issues. The best political risk insurance provision does not prevent Latin American, Russian or African governments from arbitrarily revoking a contractual arrangement or enacting anti-market policies. It cannot prevent disgruntled individuals or groups from causing damage to the insured's physical assets in the developed world or in leading emerging economies. Least of all does insurance guarantee a safe passage for ships passing Somalia (nor facilitate the creation of a stable onshore state), or any other area in which trade routes are stymied by pirates.

However, effectively functioning insurance markets give companies and organisations the choice to continue doing business in the face of hostile political events. The protection against losses afforded by good political risk insurance reassures companies that normal operations can be continued. The value of such reassurance should not be underestimated.

The actions of governments, disgruntled social groups or pirates may well undermine the successful honouring of a business's obligations to clients and shareholders. But in the same way, insurance – by providing assurance to clients should these hostilities ensue – can enhance a business's chances of success. Political risk insurance allows new projects to be financed in countries where a government has previously expropriated assets; it allows production to resume in places where unrest may have damaged assets and it enables trade contracts to be honoured because shipowners feel assured when using their traditional routes.

APPENDIX: TRUSTED SOURCES

Lloyd's 360 Risk Insight
www.lloyds.com/360 Latest news, views, analysis and reports on emerging risk from Lloyd's and the world's leading business, academic and risk experts.

Asian Development Bank's Asian Development Outlook 2008
Authoritative publication, up-to-date regional data and forecasts.

Barry Sergeant, Mineweb
Sergeant offers periodic reporting and analysis of developments in the Congolese mining contract review process. He is one of the most respected mining journalists in South Africa and he has extensive experience of covering the mining sector in Congo.

Briefs from the Moscow Carnegie Centre
The Centre gathers scholars from the US and Russia, covering a broad range of topics, from foreign policy to centre-regional relations, economy security and terrorism. It is clearly slanted towards public policy. Scholars affiliated with the Centre are among the most insightful observers of Russia.

China Leadership Monitor
Hoover Institution, Stanford University. Quarterly academic articles on political, social and economic developments in China; contributors include some of the leading academics specialising in China at numerous institutions across the world.

China's Road Ahead: A Study of Stability
Control Risks, 2007. In-depth analysis of social unrest in China and prospects for stability. Produced by experienced country analysts specialising in political and security risk in China, based in-country and with strong on-the-ground knowledge and sources.

Control Risks
www.control-risks.com Control Risks is one of the world's leading global business risk consultancies. As a trusted adviser to almost three-quarters of the Fortune Global 500, the company protects its clients' most valuable assets: their people, their brand and reputation, and their business infrastructure. Its support and advice enables clients to manage the political, security and integrity risks that come with doing business internationally.

Control Risks' Country Risk Forecast Service (CRF)
www.crg-online.com CRF provides daily analysis of political and security events, including unrest, and provides archival access to past coverage, from 2002.

Dragonomics research and China Economic Quarterly
Published by Dragonomics. An economic consultancy focusing only on China, led by Arthur Kroeber, one of the most respected and experienced economists specialising in China.

Empires of Profit: Commerce, Conquest and Corporate Responsibility by Daniel Litvin
Provides readable historical accounts of how poorly managed political engagement strategies are at the root of many of the most notable failures in foreign investments over the past 400 years.

IMB Quarterly and Annual Reports
Analysis of piracy and armed robbery threats against shipping worldwide. The IMB provides consistent blanket reporting of global maritime security incidents, summarising and detailing incidents at the end of each quarter and year. The IMB receives information directly from shippers and is the original source of most media reports regarding piracy.

IMF Regional Economic Outlook, Asia and the Pacific
May 2009. Analysis and forecasts for Asian economies in the context of the global financial crisis. Up-to-date research by one of the most authoritative and well-resourced teams of economists in the world.

International Maritime Organisation (IMO)
www.imo.org A specialised agency of the United Nations, with 168 member states and three associate members, the IMO is based in the UK, with around 300 international staff. Its committees are the focus for technical work to update existing legislation or to develop and adopt new regulations, with meetings attended by maritime experts from member governments, together with those from interested intergovernmental and non-governmental organisations.

Lloyd's Marine Intelligence Unit Handbook of Maritime Security
Comprehensive overview of current maritime security issues, from terrorism to shipping standards. Each chapter is written by an expert on the subject and includes detailed information written in an accessible manner.

NewsBase, FSU Oil & Gas Monitor
A weekly specialist publication that covers technical aspects of oil and gas operations in Russia and the FSU, which are not usually found in general purpose information outlets.

RAND Database of Worldwide Terrorism Incidents
www.rand.org/ise/projects/terrorismdatabase
RAND has developed and maintained a database of terrorism incidents since 1972, which is widely regarded as the gold standard for comprehensive information on international and domestic terrorism. Over the years, many public and private sponsors have contributed to the maintenance of the RAND Database of Worldwide Terrorism Incidents and its predecessors, the RAND Terrorism Chronology and the RAND-MIPT Terrorism Incident Database.

ReCAAP Monthly, Quarterly and Annual Reports
Analysis of piracy and armed robbery threats against shipping in Asia. The ReCAAP Information Sharing Centre, located in Singapore, is a joint venture of the Japanese, Singaporean, Malaysian and other regional governments to share surveillance and information pertaining to pirate activity. Analysis is presented clearly and in several formats.

World Bank Doing Business
www.doingbusiness.org The site reports on governance and bureaucracy issues. This provides objective measures of business regulations and their enforcement across 181 economies and selected cities at the sub-national and regional level.

World Economic Forum report on global risks in 2009
www.weforum.org/en/initiatives/globalrisk/index.htm
The World Economic Forum is an independent, international organisation incorporated as a Swiss not-for-profit foundation. It strives towards a world-class corporate governance system, where values are as important as rules.

Worldwide Threats to Shipping Report
Weekly running compilation of maritime piracy, armed robbery and direct action incidents worldwide, published by the US Office of Naval Intelligence – part of the National Geospatial-Intelligence Agency. It draws from a range of open and closed sources.

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