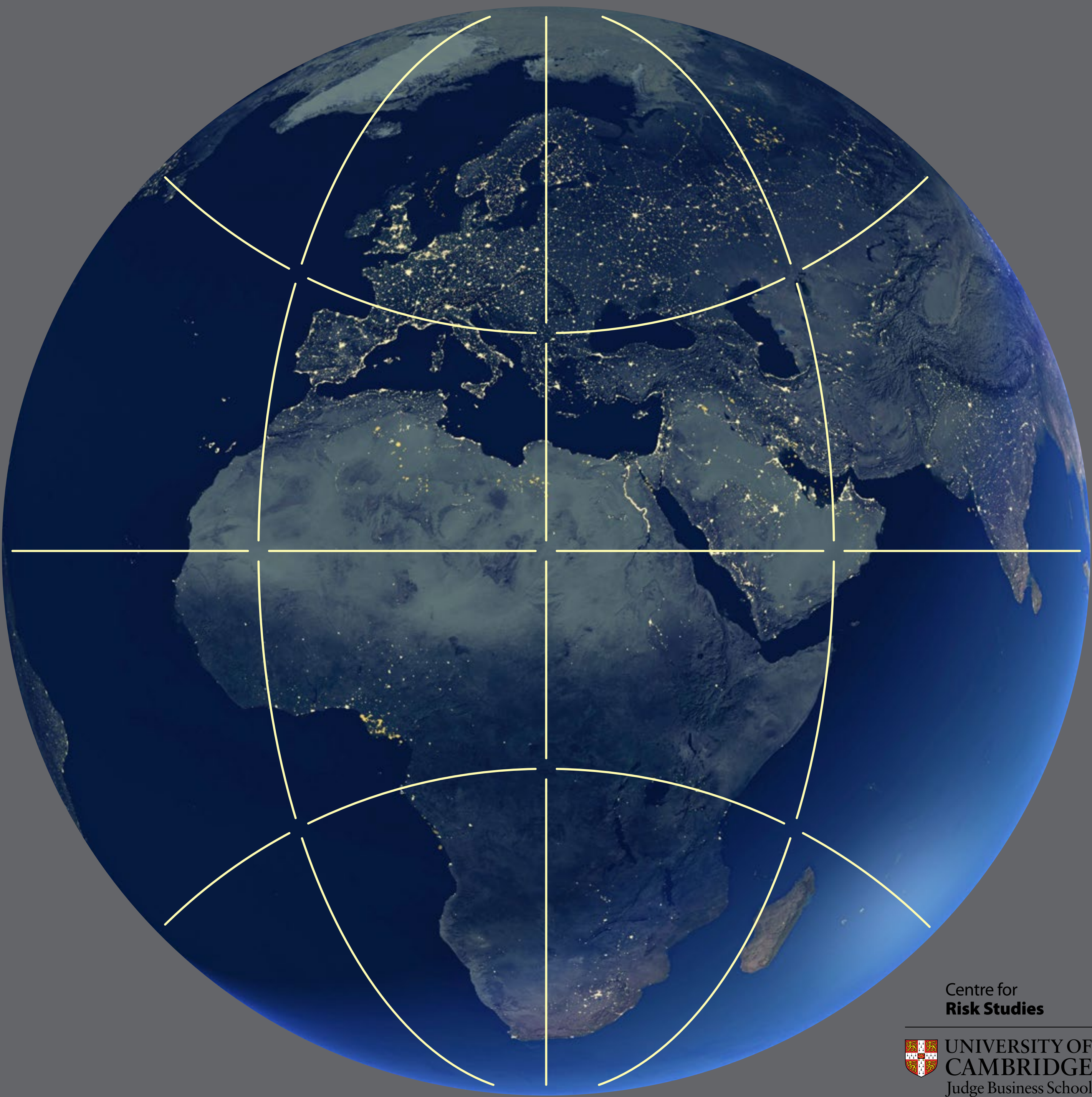
LLOYD'S

Lloyd's City Risk Index

Global analysis of political risk



Centre for
Risk Studies

UNIVERSITY OF CAMBRIDGE
Judge Business School

Lloyd's City Risk Index

Global analysis of political risk

Political risk has a high cost and is unpredictable

Key findings

Geopolitical risk accounted for almost a quarter – just over $133bn – of the total GDP@Risk in all 279 cities analysed in Lloyd's City Risk Index – 24.4% of the total. (Specific figures for each city can be found at https://cityriskindex.lloyds.com.)

Lloyd's City Risk Index splits up geopolitical and security risks into four categories: interstate conflict; civil conflict; terrorism; and social unrest. Interstate conflict is the costliest, followed by civil conflict.

Insurance take-up to protect businesses from these risks is still relatively low, particularly in emerging and underdeveloped economies, which are generally most vulnerable to these threats.

Small and medium-sized enterprises are least likely to buy this cover but remain exposed to these threats.

About this report

This report is is aimed at helping risk managers – for cities, businesses and other organisations – and insurers manage the complex area of political risk in established and emerging markets. It provides a snapshot of the level of political risk in cities across the world, allowing risk managers to see at a glance the level of risk in cities where they are headquartered, have regional operations or which are key sales markets or links in their supply chains. The report draws on research from the Lloyd's City Risk Index, which quantifies the annual threat to GDP in US dollars from these risks.

Political risk insurance covers losses arising from physical damage – for example, following a war, terrorist incident or riot – and business interruption. These are the focus of this report. Political risk insurance also covers financial lines – the loss of earnings due to credit restrictions being imposed, and the expropriation of assets by a public body, for example. These financial lines are covered in a different report (see lloyds.com/cityriskindex/finance).

Political risk often prevents international businesses from investing in a new market, and can also lead to businesses reducing or withdrawing their investment. In part, this is because political risk has a high (and hard to quantify) cost and is unpredictable. Lloyd's City Risk Index provides businesses with a snapshot of potential losses, setting out where they may occur and what the annualised cost might be. Risk managers can assess this against the value of the opportunities on offer. They can also use the data to identify where they need to build resilience, including by considering insurance solutions.

Political risk will always have a detrimental effect on foreign direct investment and the wider economy. However, improved data and access to insurance solutions may allow for investments to occur which benefit both the business and the local economy.

Top ten cities at risk

1. **Tokyo** $24.31bn
2. **New York** $14.83bn
3. **Manila** $13.27bn
4. **Taipei** $12.88bn
5. **Istanbul** $12.74bn
6. **Osaka** $12.42bn
7. **Los Angeles** $11.56bn
8. **Shanghai** $8.48bn
9. **London** $8.43bn
10. **Baghdad** $7.91bn

Top ten threats

1. **Market crash** $103.33bn
2. **Interstate conflict** $80.00bn
3. **Tropical windstorm** $62.59bn
4. **Human pandemic** $47.13bn
5. **Flood** $42.91bn
6. **Civil conflict** $37.15bn
7. **Cyber attack** $36.54bn
8. **Earthquake** $33.96bn
9. **Commodity price shock** $20.29bn
10. **Sovereign default** $17.97bn

About Lloyd's City Risk Index

Lloyd's City Risk Index, based on original research by the Centre for Risk Studies at Cambridge University's Judge Business School, measures the GDP@Risk of 279 cities across the world from 22 threats in five categories: finance, economics and trade; geopolitics and security; health and humanity; natural catastrophe and climate; and technology and space. The cities in the index are some of the world's leading cities, which together generate 41% of global GDP.

The index shows how much economic output (GDP) a city would lose annually as a consequence of various rare risk events that might only take place once every few years, such as an earthquake, or from more frequently occurring events such as cyber-attacks. GDP@Risk is an expected loss figure – in other words, a projection based on the likelihood of the loss of economic output from the threat. The resilience levels of each city are taken into account, including the city's governance, social coherence, access to capital and the state of its infrastructure. If some or all of these are resilient they can reduce the overall expected loss. One way of thinking about GDP@Risk is as the money a prudent city needs to put aside each year to cover the cost of risk events.

The index also shows the scenario costs – these are the one-off costs if a specified threat event like an earthquake or a cyber-attack takes place. The index shows two scenario cost numbers: the lower total is the loss that would occur from a moderate-sized event in that threat category; the higher total is the loss from an extreme event. If policyholders hold insurance that covers property damage and business interruption, then some of the economic losses would be compensated from claims payments on these policies.

Figure 1. Cities that stand to lose the most from geopolitical and security risks

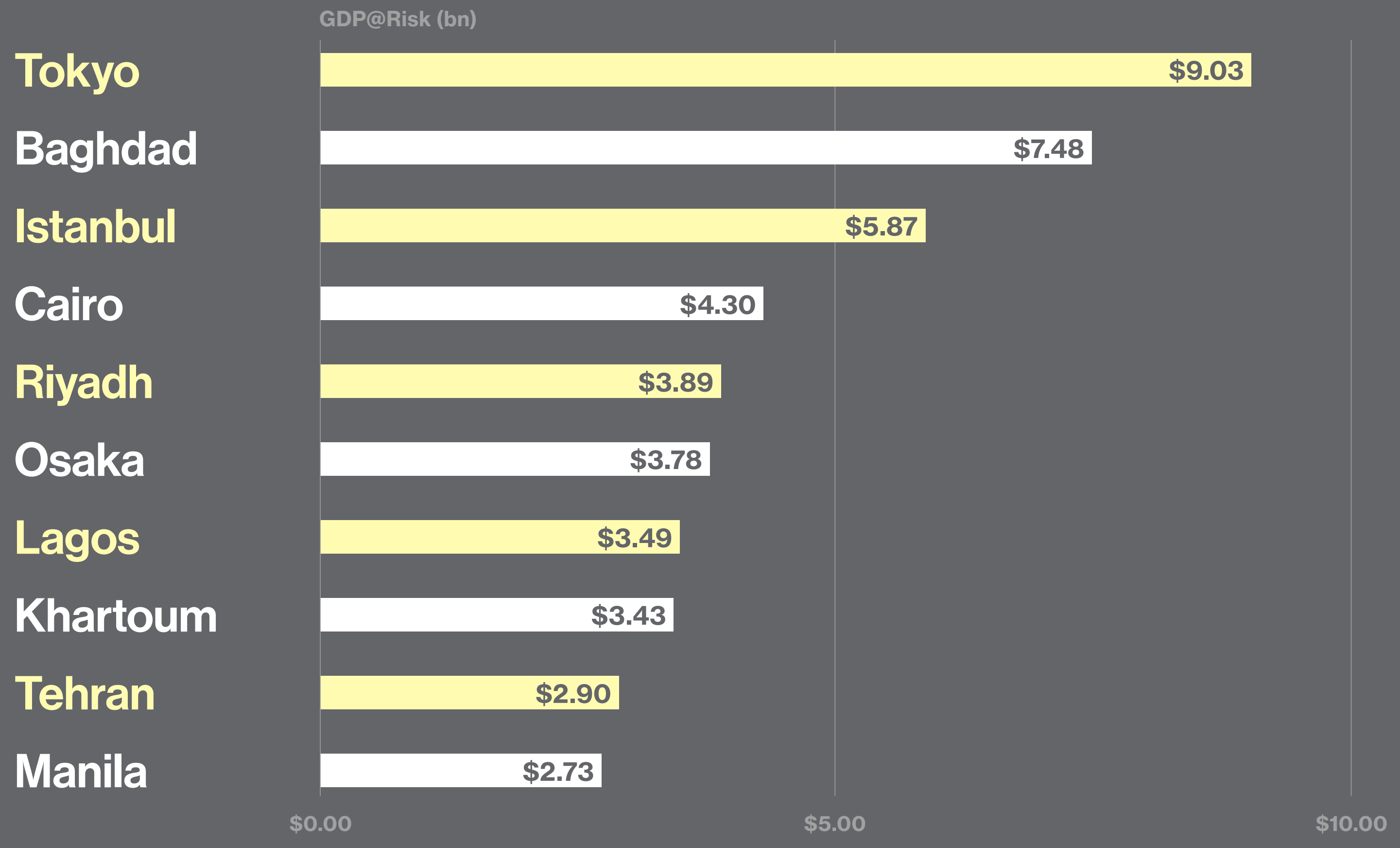
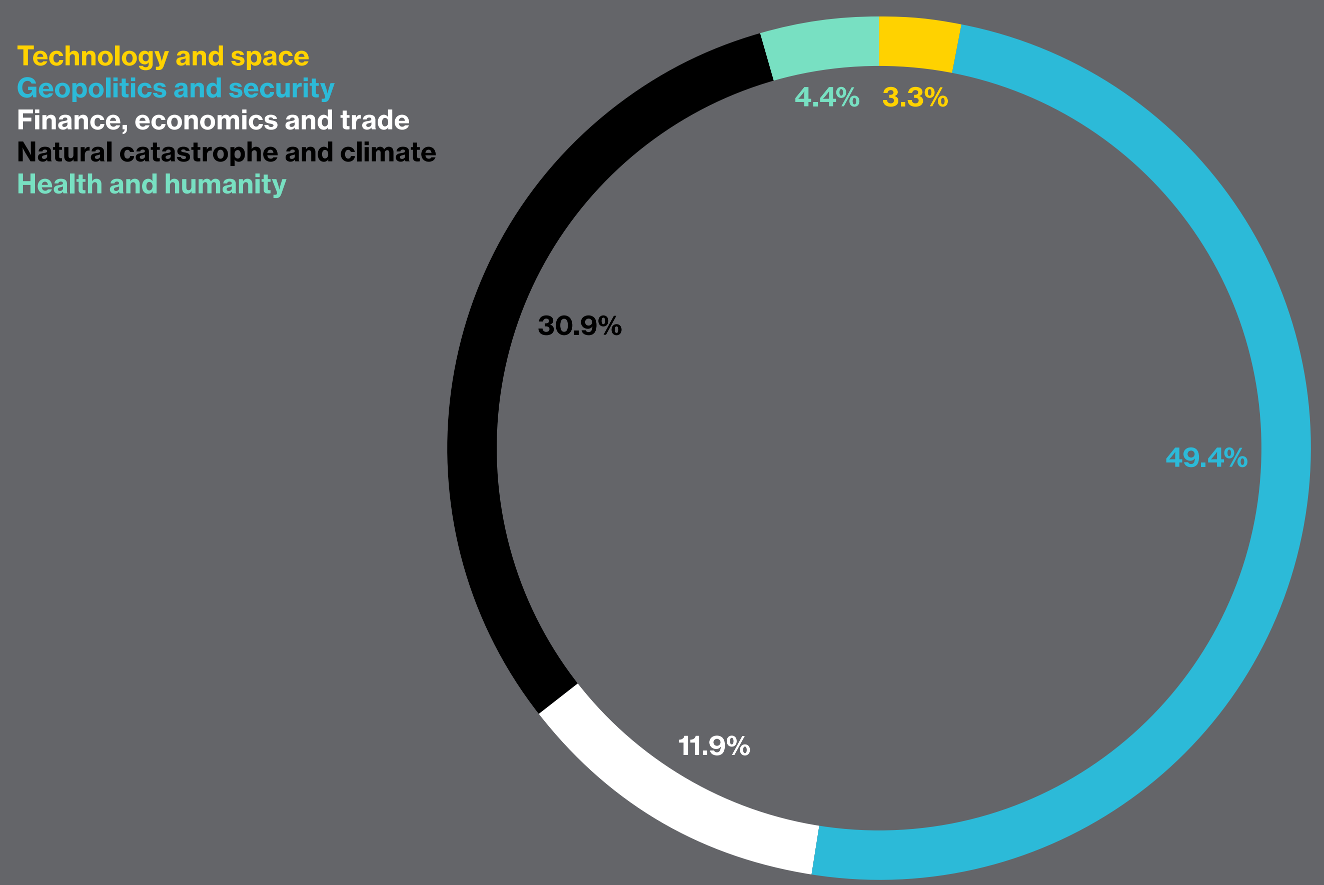


Figure 2. Geopolitical and security risks represent the largest threat to these cities



1. The report's findings

Emerging and underdeveloped markets are the most exposed to political risk – and the most underinsured.

At present, the political risk market is well-capitalised, with the take-up of insurance policies highest in developed economies, such as the US and Europe – 62% of US businesses purchased terrorism insurance in 2017[1], for example. Take up is lowest in those countries that stand to lose the most GDP to geopolitical and security risk. According to Lloyd's City Risk Index, nine of the 10 cities which stand to lose the most in this category are in the Middle East, Africa and Asia *(see Figure 1).*

Several of the cities most at risk – Baghdad and Khartoum, for example – are in countries which struggle to attract private investment. Lloyd's City Risk Index shows a correlation between political risks and countries that have very weak levels of resilience. The breakdown of these cities' GDP@Risk – primarily in Africa and the Middle East – shows that their losses will come from geopolitical and security risks *(see Figure 2).*

Public bodies such as the World Bank's Multilateral Investment Guarantee Agency (MIGA) and regional institutions, such as the Asian Development Bank, are playing an important role in developing insurance as a development tool but the involvement of private sector insurance is a critical and an interesting opportunity for the industry. Improved data on political risk losses can help insurers and risk managers understand these threats better – the first step to supplying or buying better protection.

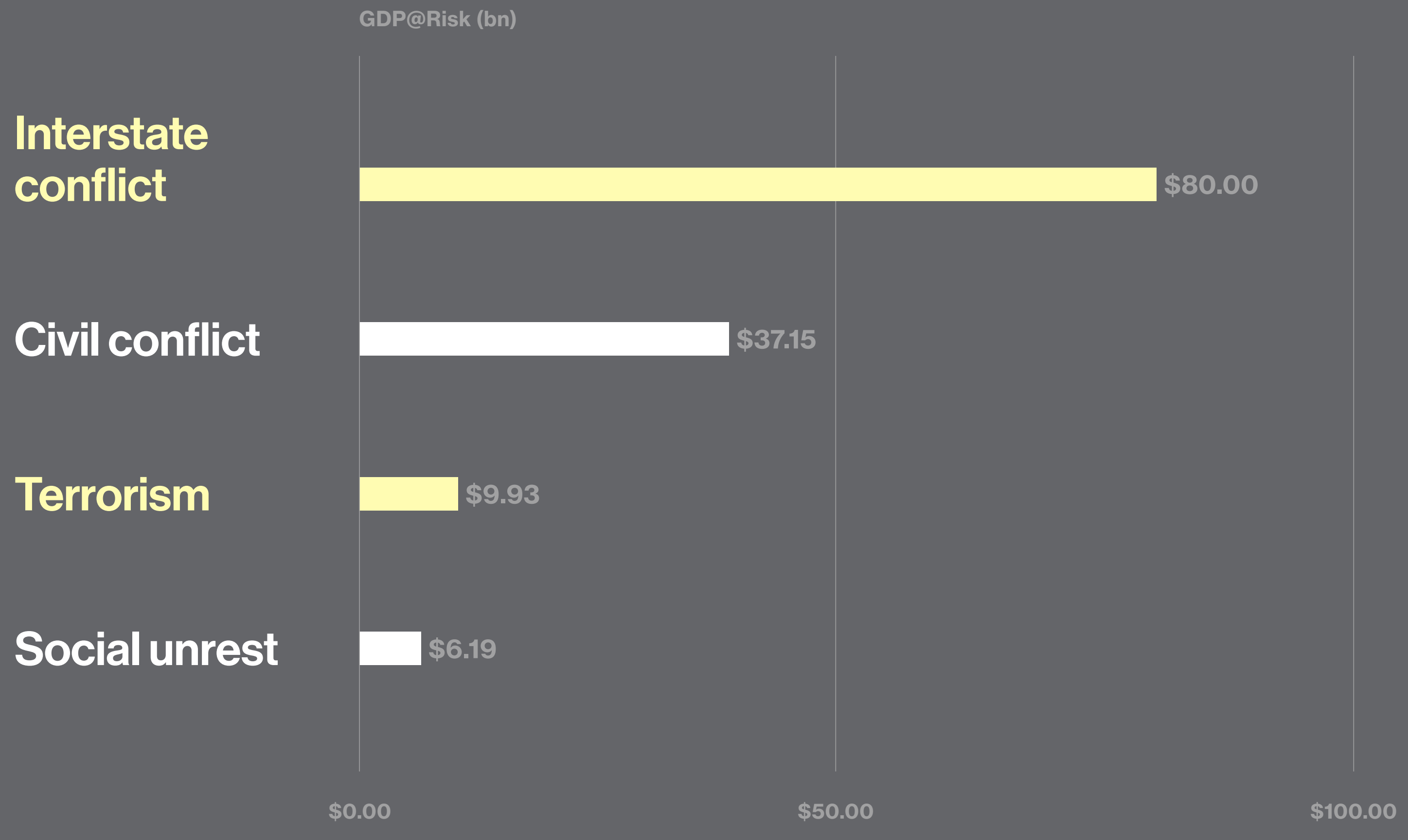
Several cities with the lowest levels of resilience and the highest levels of GDP@Risk from political risk (e.g. Lagos, Delhi, Mumbai, Dhaka) also have insurance penetration of under 1% as set out in Lloyd's recent report on global underinsurance, A world at risk: Closing the insurance gap. The transfer of these geopolitical risks to insurance markets could improve resilience and encourage economic growth in these cities.

Small and medium-sized businesses at risk

If certain geographical areas are underinsured in terms of political risk, it is also the case that small and medium-sized enterprises have less cover than large business, and consequently remain vulnerable to geopolitical risks. The attack on Borough Market in London, UK caused traders to lose an estimated £1.4bn[2]. Many were small, even sole, traders who may not have had terrorist policies in place and were most vulnerable to loss of earnings.

Lloyd's syndicates have recently developed 'Loss of Attraction' insurance, which provides cover to businesses that suffer financial loss but not physical damage following a terrorist attack – from being in an area closed off by police or that fails to attract tourists or other visitors after an attack, for example. This is a risk that has also been encountered by, for example, Egyptian holiday resorts and businesses in European cities, such as Brussels, where 'lone-wolf' terrorist attacks have taken place. This insurance is available to both first and third parties.

Figure 3. Interstate conflict has the most impact on GDP of all geopolitical and security risks



Interstate conflict could cost cities almost nine times more than terrorism

2. Risk analysis: Interstate conflict

As *Figure 3* shows, interstate conflict accounts for $80bn of GDP@Risk per annum, more than half of the $133bn GDP@Risk annually from geopolitical and security risks. This is the second highest GDP@Risk figure of the 22 threats analysed in the index, with only market crash causing higher GDP losses.

Interstate conflict has a much larger effect on city GDP than any of the other risks in the geopolitical and security category; it could cost cities almost nine times more than terrorism and more than twice as much as civil conflict. This is because war affects the whole economy, lowering confidence, depressing trade, and causing physical damage to property and infrastructure.

The three cities that stand to lose the most to this threat in the index are Tokyo, Baghdad and Osaka. The two Japanese cities feature highly because of ongoing tension in East Asia including the unclear nuclear aspirations of North Korea. In Allianz's 2018 Risk Barometer[3], Japanese respondents placed political risks and violence in sixth place, higher than other Western nations, such as the US, UK, France and Germany. The index's findings do not suggest Tokyo is most likely to be impacted by war; rather that the impact of war would be the costliest in terms of lost GDP because the city's multiple high value assets would be at risk.

Risk managers should check their insurance cover includes conflict risk

2. Risk analysis: Interstate conflict

Baghdad, which stands to lose $4.37bn of GDP to conflict each year is a good example of a city which desperately needs to attract investment to unlock its economic potential and grow; the country takes first place in the 2018 Global Terrorism Index, despite the number of deaths from terrorism halving in 2017.

Lloyd's City Risk Index finds the one-off cost of a single extreme terrorist event could cost Baghdad $97.78bn; a moderate event could cost $37.08

The incentive to build resilience and reduce geopolitical threats to Baghdad is Iraq's potential for considerable economic growth – it holds the fifth largest oil reserves in the world. Baghdad currently has the lowest score – very weak – for resilience. However, if it were to achieve the highest ranking, it could reduce its GDP@Risk across all 22 categories to $4.06bn – a reduction of almost $4bn.

The value of ncreasing insurance cover in developing countries impacted by conflict

Risk managers should use the data in the index to assess their operations in countries which are vulnerable to interstate conflict and establish plans to protect their employees, assets and supply chains. They should also check their insurance cover includes conflict risk.

In 2018, the Multilateral Investment Guarantee Agency (MIGA), an arm of the World Bank, issued its first guarantees using its International Development Association's Private Sector Window, a facility designed to reduce project risk, and attract private sector investment into low-income and conflict-affected countries.

MIGA's initiatives show the benefit of insurance in highly volatile regions. It recently provided political risk insurance coverage of up to US$5.2 million for a new raisin-processing plant in Afghanistan. The policy provided 10-year cover against the risk of war and civil disturbance. This will allow the plant to double production and improve the quality of its goods. It is helping to create a much-needed export market and improve the lives of local farmers. In the country's volatile political climate, the plant would have struggled to secure investment without insurance.

MIGA also covered 90% of a EUR 84m investment in a mobile telecommunications network in Sierra Leone, a country which has been plagued by conflict. The project is expected to improve quality of service, reduce costs to end-users, and create direct and indirect jobs, thus boosting wider economic development.

Figure 4. Cities that stand to lose the most from civil conflict

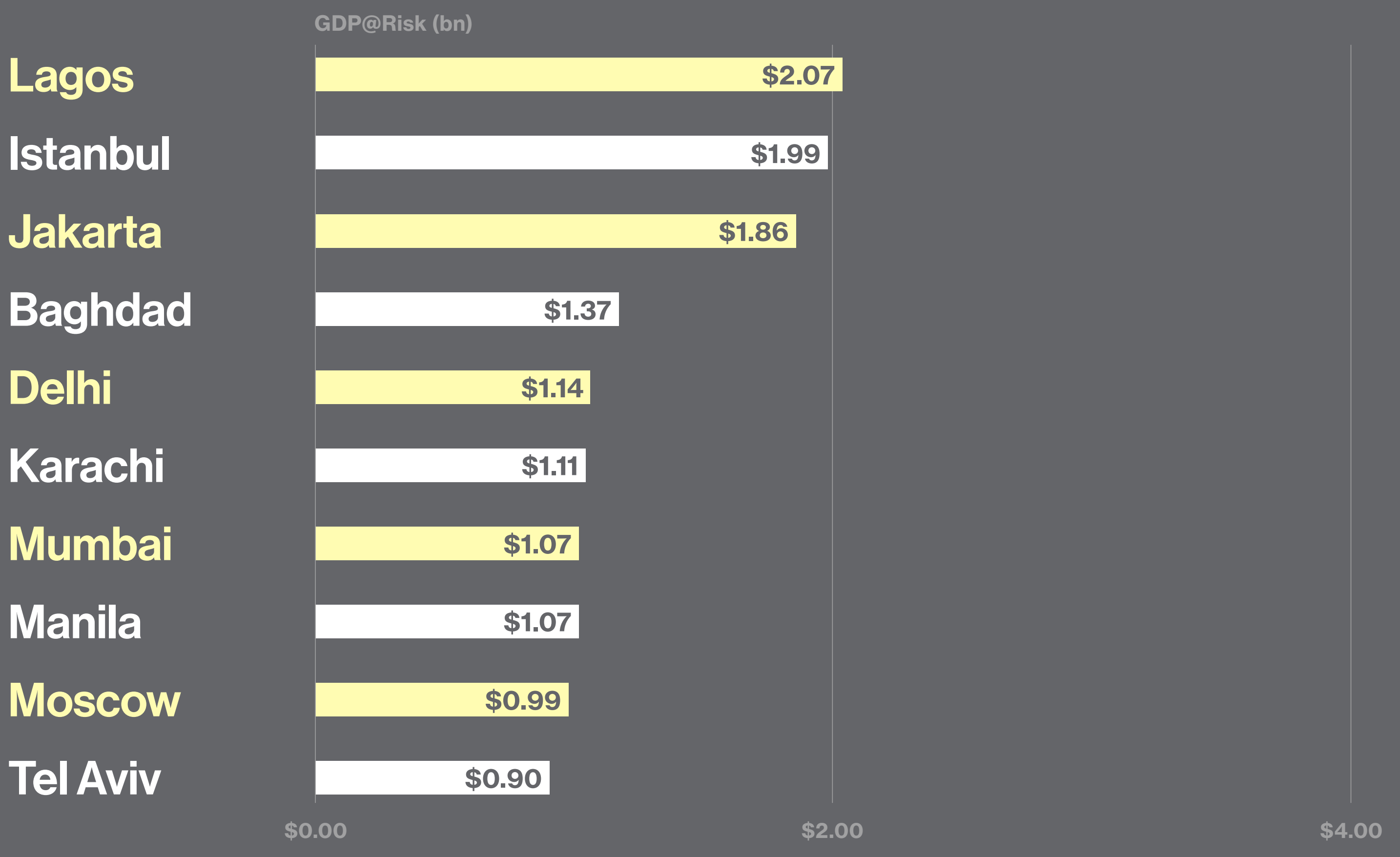
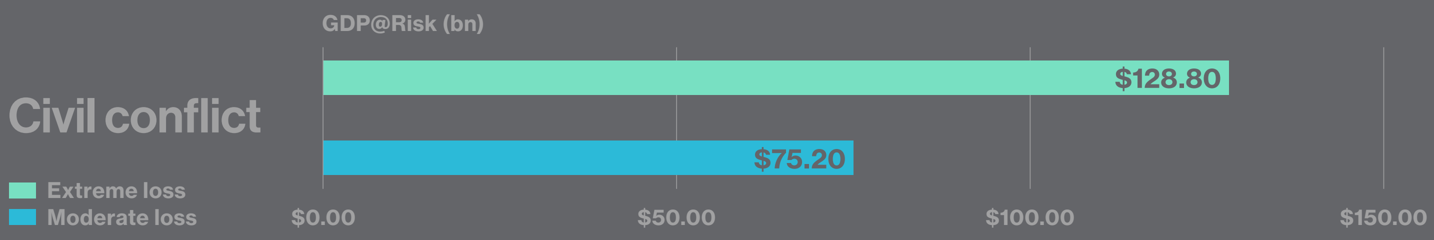


Figure 5. The one-off costs of a civil conflict event in Mexico City



3. Risk analysis: Civil conflict and social unrest

Civil conflict affects more than two-thirds of cities in the index, with a cost to their GDP of just over $37bn per annum. However, there is a strong regional variation, with cities in the Middle East and Africa accounting for 42% of the total GDP@Risk from civil conflict and Asian cities accounting for a further 38%.

This risk is more prevalent in South and South East Asian cities. Latin American cities are responsible for a further 12%. On a country basis, Indian cities account for 13% of the total. In terms of cities, Lagos, Nigeria is the most exposed in the index to this threat with $2.07bn of GDP@Risk annually, followed by Istanbul and Jakarta *(see Figure 4).* The cost to Lagos' economy of a single civil conflict event could be up to $45.97bn.

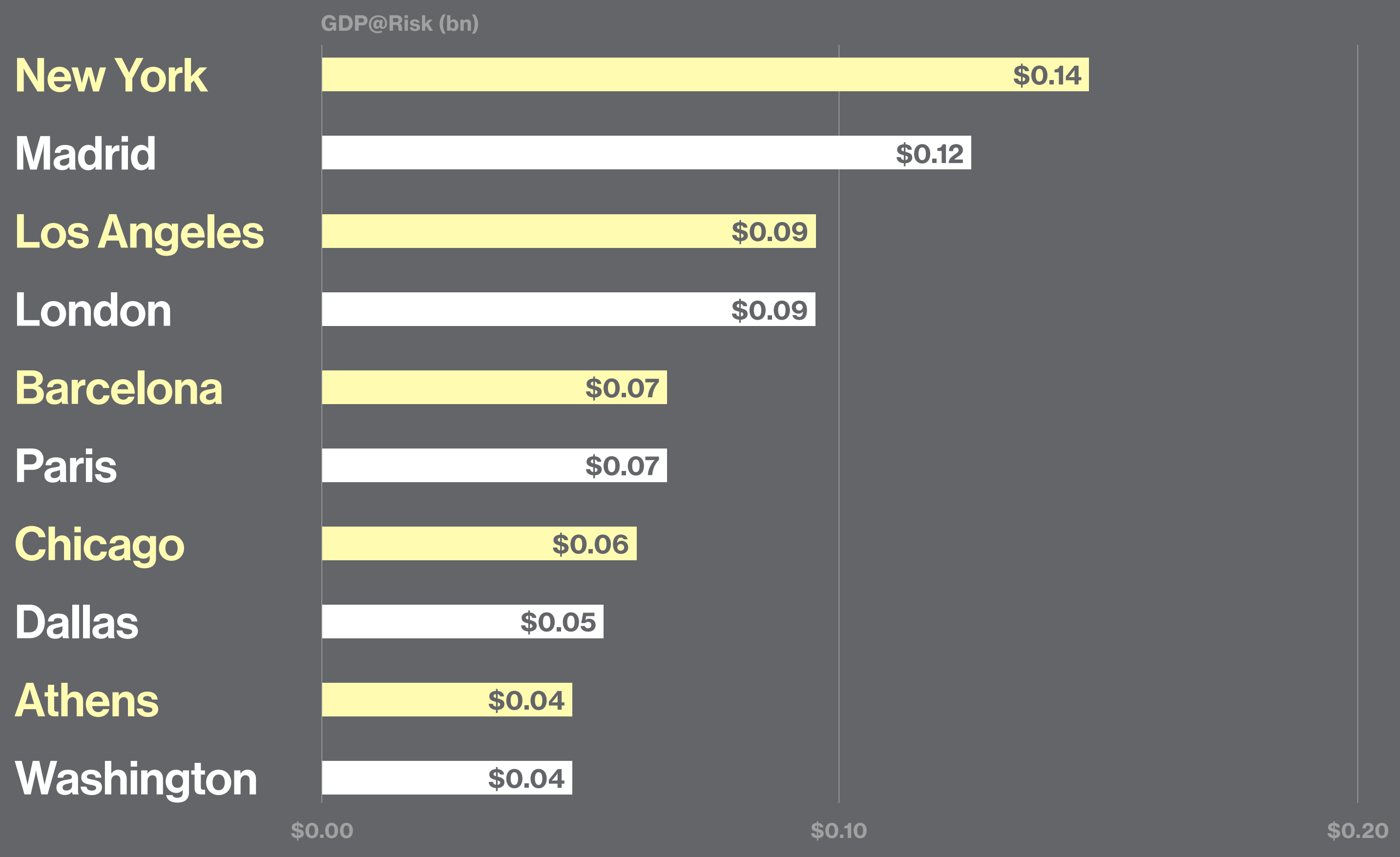
To put this in context, civil unrest presents a greater threat to the economies of African, Middle Eastern and Latin American cities than flood does. The chart *(see Figure 5)* shows a single civil conflict event in Mexico City could cost $128.80bn.

There are a number of factors exacerbating the threat of civil conflict and social unrest. As cities in emerging economies have grown, so have their informal settlements: the World Bank estimated that in 2011 880m residents lived in informal settlements, which represented 11% growth from 2000. The International Monetary Fund believes 53% of countries have seen a rise in wealth inequality in the past three decades. These factors are fanning the embers of discontent around the world, embers which occasionally burst into flames.

Indeed, the World Economic Forum's 2018 survey of business leaders identified "rising income and wealth disparity" as the third most important risk facing economies today.

A 2016 Lloyd's report found that a combination of autocratic governments, high percentages of young people in populations and growing internet use should be monitored to identify where and when civil unrest might take place. Other factors, such as economic slowdown, financial crises and commodity price fluctuation should also be monitored[4].

Figure 6. Cities that stand to lose the most from social unrest



The 2011 riots in London resulted in an estimated $200m in damages

3. Risk analysis: Civil conflict and social unrest

Prolonged widespread rioting decreases consumption and disrupts economic supply, impacting GDP growth. Civil unrest is less prevalent in Western cities but has high impact, costing US and European cities $1.64bn annually, for example.

There are many examples. Lloyd's City Risk Index shows how the issue of Catalan independence has adversely affected the risk profiles of Madrid and Barcelona, which appear in the top 10 cities in the index which stand to lose the most. The 2011 riots in London resulted in an estimated $200m in damages and in November 2018, 250,000 people demonstrated against tax rises across France.

Poverty and income inequality have risen in OECD economies since the 2008 global financial crisis with unemployment, particularly amongst the young, rising to more than 20% in some southern European economies. The rise in polarised and populist politics, and the widespread use of social media may also have led to an increase in social unrest.

The GDP impact of social unrest compared to other threats is relatively low *(see Figure 6).* Social unrest puts $140bn of GDP@Risk annually in New York, for example. However, in one-off cost terms, social unrest can be very damaging to city economies – a single civil unrest event in New York could cost $5.40bn.

Implications for risk managers

A prudent risk manager might want to compare what they spend on insurance for political risks to what they spend on covering geophysical threats in these highly exposed cities. It is usually possible to expand terrorism and political violence coverage to include, for example, organised crime coverage.

Risk managers should also consider the impact of civil disturbance on sales and operations. In some cases, their operations may be a target; goods and services could also be boycotted through a social media campaign and steps should be taken to demonstrate the social value of their investment. Even if specific investments are not targeted, businesses should consider possible routes or focus points for demonstrations. Can employees get to work, can goods be shipped? Is insurance cover in place for interruption to operations?

Figure 7. The cities that stand to lose the most from terrorism

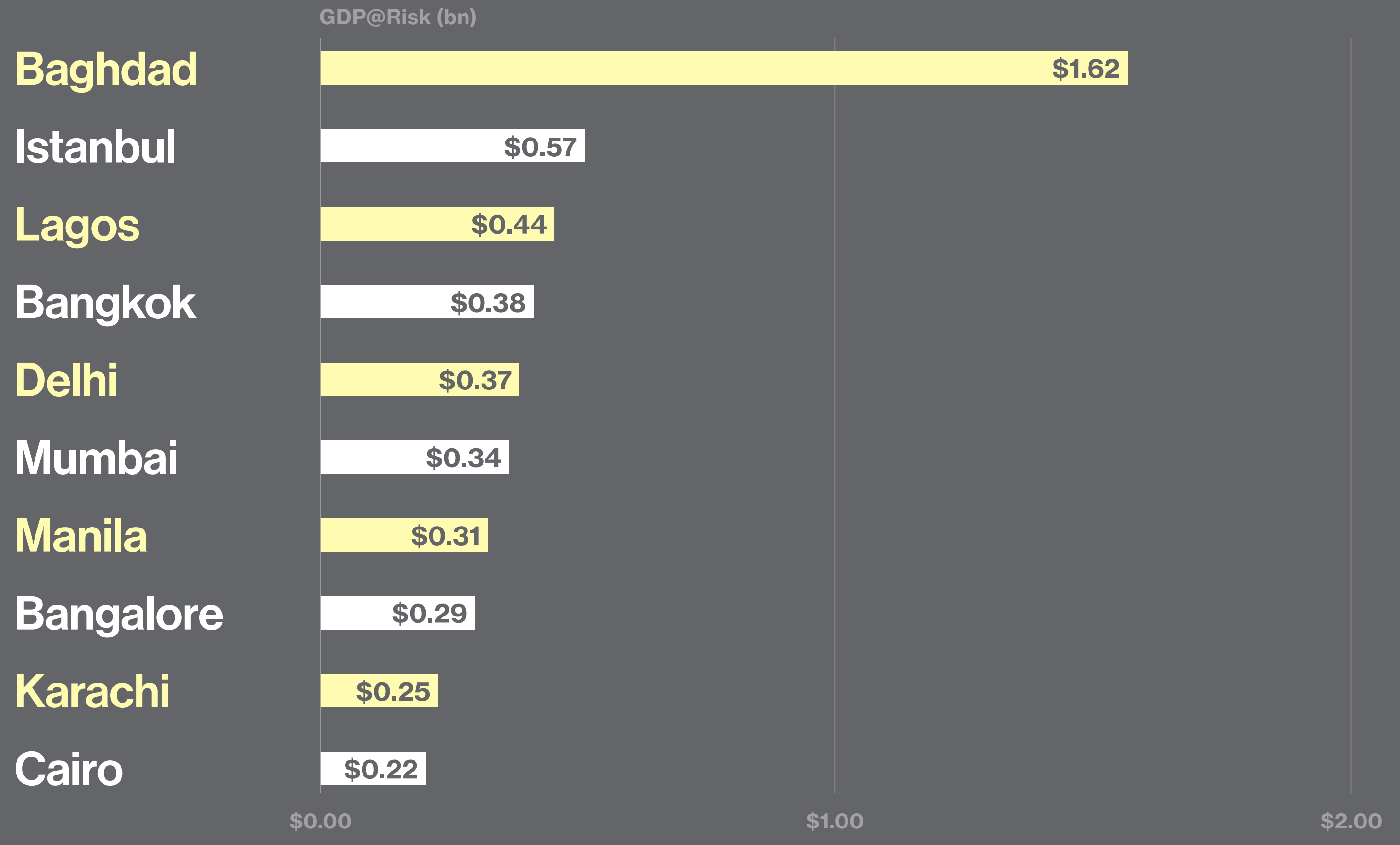
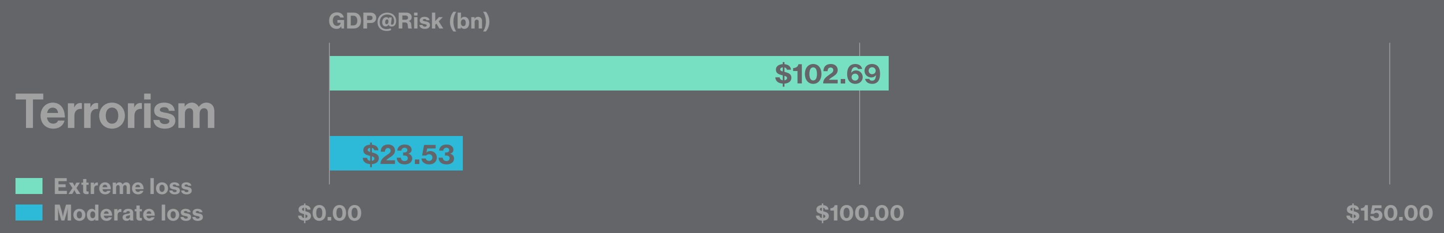


Figure 8. The costs of a single terrorism event in New York



4. Risk analysis: Terrorism

Lloyd's City Risk Index estimates terrorism will cost cities $9.93bn each year. Terrorism is, however, difficult to quantify, as high impact, low probability events are hard to predict and price in insurance terms.

The index identifies the largest losses in cities which face the most frequent incidents. Baghdad therefore tops the list of cities who will lose most from this threat, followed by Istanbul and Lagos *(see Figure 7).*

However, businesses in cities with concentrations of high value assets, such as New York, London and Paris, will lose more than emerging cities in terms of direct and indirect losses on an annual basis. One-off costs can be very high. Although New York does not feature in the top 10 cities that stand to lose the most from terrorism annually, a single extreme terrorist event in the city could lead to losses of up to $102.69bn *(see Figure 8).*

The Lloyd's market has been a pioneer in the development of political risk cover. Following the rise of expropriation, nationalisation and confiscation in the 1960s and 70s, Lloyd's syndicates took the lead in establishing political risk cover which, until then, had been limited to the public sector. Lloyd's paid billions in claims following the 9/11 terror attacks.

Most recently, there has been a trend towards 'loan-wolf' terrorist attacks where a single or small group of terrorists, often armed with knives, have been able to cause considerable loss of life and disruption to a city's economy.

Insurance solutions

Traditionally, insurance has covered businesses that have been directly damaged by terrorism, for both physical damage and business interruption. However, recent terrorist events in Australia, France and the UK have demonstrated that it is not only businesses that suffer direct losses that are impacted. If a business finds itself in the vicinity of an event, or even behind crime-scene cordons, they can suffer substantial losses even if they are not directly harmed.

Insurers in the Lloyd's market are taking the lead in finding insurance solutions to this issue. Beazley, Hiscox and Talbot are among those that have developed terrorism cover as a standalone policy, or as an add-on to property insurance cover, for denial of access to compensate businesses that end up behind a police cordon, and loss of attraction cover to insure against lost earnings.

Business interruption cover is particularly attractive to companies in the hospitality industry, as, typically, room rates fall after a terrorist incident. Following terrorist attacks in Paris in 2015, revenue for hotel rooms fell 14%. Insurers use forensic accountants to identify the losses involved for a specific business.

Terrorism is the best insured of all geo-political risks

4. Risk analysis: Terrorism

The Lloyd's market has also developed policies relating to losses from lone shooter events. These tragedies can cause bodily injury to employees and customers, property damage, direct or indirect business interruption, and reputational damage. Some businesses have lobbied for these crimes to be defined as terrorist events.

Terrorists may also be looking to target supply chains. According to the BSI Supply Chain Services and Solutions, in 2016, terrorist groups undertook 346 attacks on global supply chains.

Political risk insurance does not only cover financial losses, it can also provide practical support and expertise to clients to prepare for an attack should one take place. Terrorist events remain rare and, therefore, most businesses, even large multinationals, may not have the experience to deal with an incident. Several Lloyd's syndicates provide assistance under kidnap and ransom policies; they supply the services of expert PR firms, who provide crisis communication support, and emergency response experts to evacuate employees. It is a good example of insurance providing valuable expert assistance following an event, not simply cash payments.

Implications for risk managers

Terrorism is the best insured of all geo-political risks. However, traditionally, this market has focused on physical damage arising from a threat.

Risk managers should also consider the implications if an event – or multiple events – were to occur in a city where they have sales, production or supply chains. What would be the impact on operations? Is insurance in place, and if not, could loss of attraction cover be a solution?

Political risk represents a serious threat to business growth

5. Conclusion

Lloyd's City Risk Index provides a snapshot of how the risk of political violence affects city economies across the world. This is a starting point for risk managers to establish the level of the threat in the places they work or are thinking of working in.

Political risk, with a total annualised cost in the index of $133bn, represents a serious threat to business growth. It also has the greatest impact on business confidence – terrorist attacks or riots cause people to stay away. Several such events can cause businesses to reduce investment in a city, thus depressing GDP for many years.

Although political risk can be a difficult threat to manage, it can, as this report shows, be reduced and prepared for, and both commercial insurers and intergovernmental agencies are working together to develop viable insurance solutions. Businesses looking to enter markets in cities that Lloyd's City Risk index identifies as having a high level of GDP@ Risk from political violence should be circumspect, but they should not rule these opportunities out.

6. Conclusion

Possible actions for insurers and risk managers

Insurers could:

Be clearer about the exact cover provided by insurance policies. There can be ambiguity in terms of determining whether an event is conflict or terrorism, or of how losses will be dealt with as they spread through the supply chain or become complex liability issues. A positive step in this regard was the recent UK Motor Insurers Bureau's decision to assume liability to compensate the victims of vehicle-related terrorist attacks[6]. This came into effect in January 2019.

Continue to innovate. The recent development of policies which cover policyholders who have not experienced physical damage is a good example of responding to clients' evolving needs.

Consider opportunities to work with development agencies to develop insurance or reinsurance cover for markets seen as "uninsurable" and which currently have little insurance penetration.

Risk managers could:

Carry out a pre-entry risk assessment which covers both physical damage, security of employees and the trade climate which could lead to financial risks.

Identify likely targets and implement practical security steps to protect both foreign direct investment and supply chain.

Discover how the company is viewed by local residents. If an organisation is known to provide clear economic and social benefits, it may reduce the likelihood of being targeted.

Talk to employees and customers about how the business can and should add value to society, and act on their recommendations. This is increasingly important to prevent companies from becoming a target of activism.

Invest in effective political risk insurance which provides the ability to trade in the face of hostile political events.

Political risks pose a threat to foreign direct investment and supply chains, but there are mechanisms to manage and mitigate these risks, including insurance, which businesses should consider.

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