Russian Roulette

What do crises like the recent turmoil in Russia and Ukraine mean for carriers, and is coverage and capacity taking a hit as a result?

by Lori Chordas

In 1991, Ukraine was basking in a growing modernization and national rebirth with its independence from the Soviet Union.

Slightly more than two decades later, the Eastern European country is at the center of a volatile revolution with Russia stemming from a secession crisis on its Crimean Peninsula.

Earlier this year, Ukrainian government forces and state buildings were attacked by armed groups. Ukraine’s exiled president, Viktor Yanukovych, requested Russia use military forces “to establish legitimacy, peace, law and order.” That same day, the Russian Parliament authorized the deployment of Russian troops to Ukraine and took control of Crimea.

The result of those actions? A series of hard-hitting economic sanctions by the United States and Europe that have frozen assets and imposed travel bans on a number of Russian businesses and political leaders. And the number of those sanctions, which Cozen O’Connor partner Andrew Tobin dubs “moving targets,” may continue to grow.

That has carriers with risks and economic interests in Russia and Ukraine on high alert.

Tobin said that over the past several months his firm has been receiving a growing number of calls from insurers both in the United States and the United Kingdom in response to the sanctions. Sometimes the question, he said, is as simple as “Is the sanctions exclusion in my policy sufficient to ensure I comply with sanctions rules?”

The answer, however, may not be so simple, Tobin added.

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—Andrew Tobin, Cozen O'Connor

exclusions alone will be sufficient to protect insurers. In the broadest terms, regulators expect insurers to ensure that they do not renew policies, pay claims, accept premiums or otherwise deal with sanctioned entities, without permission,” he noted. “The precise situation will depend on whether EU and/or U.S. sanctions apply and the facts of each case.”

But one thing for certain, Tobin says, is that carriers need to be paying close attention to sanctions and coverage affected by the turmoil on Ukrainian soil.

Taking Cover

Property insurance and business interruption—to name a few—could suffer some losses by entities insuring risks in Russia. But two coverages that are “particularly close to the epicenter of risk” are political risk and trade credit, said Stephen Kay, senior vice president and U.S. practice leader of structured credit and political risk for Marsh USA.

Political risk covers losses caused by government acts or political disruption in a country, while credit insurance protects businesses against nonpayment of commercial debt.

Political unrest in Ukraine has prompted a series of actions to those coverages over the past several months, including carriers halting the underwriting of new political-risk policies in the countries, said Nadine Moore, a senior vice president at Lockton Companies.

In addition, capacity and appetite in the market have been tightening, added Lila Rymer, head of the U.S. political risk team for specialist insurer Beazley. “There’s been a lot less appetite for Russia on both political risk and trade credit, basically since the annexation of Crimea. Political risk appetite in Ukraine also has tightened a lot and the appetite for credit insurance in the country is also very limited due to the precarious economic situation there this year.”

The good news, says Moore, “is that we really haven’t seen claims on those policies yet crystallize. Most clients have capacity in Russia or western Ukraine, which haven’t been damaged or destroyed.”

But that could change at any time. “It’s possible we might start to see claims arising from a variety of factors, such as from credit losses in Russia and Ukraine due to economic deterioration, or political violence losses in Ukraine from physical damage to assets we’re covering,” Rymer said. “There could also be possible credit losses in Europe if gas from Russia that goes via Ukraine is shut off and European gas prices rise, leading to weakened corporate and economic performance. And, we could see expropriation losses in Russia if [Russia President Vladimir] Putin were to seek retaliation against the West by way of U.S. or European corporations.”

The sudden adverse shift in Russian political risk is a hard pill to swallow for carriers because of their large stake in the country. At year-end 2013, Kay said, numbers illustrating exposure to the Berne Union—the membership of political risk insurers based in London—show that “Russia was the most insured country within the political risk insurance world, with about $27 billion of policy limits in force. So events in Russia and Ukraine are of great concern to the markets and carriers are watching very closely.”

Kay says the “Armageddon trigger” would be if the United States and the European Union eventually imposed ever tougher sanctions on Russia. “That could go to a whole new level, where insurers would expect to start suffering losses on exposures they already have. That could become a major loss event for political risk and credit insurance, depending on how biting and severe the sanctions are.”

Surviving Sanctions

As of early July, the list of sanctioned entities has been limited, Tobin said. But breaches of sanctions come at a hefty price. In the United States, penalties can carry up to a 20-year prison sentence and $1 million in fines per transaction, he noted.

The challenge for carriers, he says, is determining whether they’re dealing with a sanctioned person. “In the U.S., Office of Foreign Assets Control rules list more than 50 individuals and 30 companies, including significant entities like Russian Railways and the Russian bank, Bank Rossiya. But those sanctions apply to all the properties and interests of the blocked person, which, as defined in the rules, is property and interest in property in which a company

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directly or indirectly owns a 50% or greater interest.”

That has companies questioning whether entities with whom they are dealing may be sanctioned. The answer, says Tobin, may not be obvious.

While there are no specific exclusions on sanctions, says Moore, “there are exclusions that say companies can’t insure against the laws of their country. The worst case scenario for American companies, which have billions of dollars at work in Russia, would be if the U.S. government put some sort of trade embargo in place. Policies then would be voided.”

Political risk insurance is a cover that cannot be rescinded, noted Moore. “Credit insurers, however, have rescinded capacity and in some policies they’re able to rescind coverage while the policy is in force for future trade.”

As for the effect of sanctions on current investment exposures covered under existing political risk policies, “they’re less clear,” Kay said. “If overnight Russia becomes a sanctioned country, what effect it would have on a U.S. company insuring a plant in Russia, for example, is uncertain. Would insurers still pay out to U.S. insureds? We think probably yes, but there is a risk the policy may be viewed as facilitating an illegal investment in Russia. Legal counsel would have to weigh in and make opinions.”

Tobin suggests contracts be carefully scrutinized. “People need to consider if they’ll be breaching sanctions if they roll over a contract with someone who might be sanctioned.” Issues may also arise around contract wording, he said. “In many policies, at least in the London market, there’s a clause, LMA 3100, that offers a contractual answer to nonpayment due to sanctions. So it removes the cover and obligation to pay claims to an extent prohibited by United Nations, EU or U.S. sanctions.

“Regulators recognize there can be room for doubt and that situations may arise where sanctions are inadvertent breached,” Tobin said. “But both regulators in the U.S. and the EU expect to be contacted promptly if anyone discovers an issue. They’ll then deal with it as they see fit. It may be possible to ask regulators for a license to handle a particular transaction. The main thing is that regulators expect good communication.”

Under Watch

Underwriters have been busy in the wake of Russian events.

“I’ve had at least one underwriter call me asking what the personal effects of sanctions might be on him,” Tobin said. “People want to be confident that their employers have robust systems in place to protect them personally.”

Underwriters’ concerns also are focused on the Russia economy, Moore said. “That could drive losses and prohibit them from insuring trade. Political risk underwriters are also apprehensive of the sanctions. As of now, confiscation and expropriation aren’t of high concern but they’re certainly in the realm of possibility.”

Existing policies have “low underwriting implications,” Kay said. “Carriers can’t do anything about them now; they exist and are usually noncancelable in credit and political risk. The best [carriers] can do is monitor their exposure, continue reporting to management and reinsurers and create scenarios of what losses could be under certain future events.

“New political risk insurance business has already ground to a halt in Russia and Ukraine,” he added, “so now it’s really about the Russia risks that carriers already have and whether they will turn into a loss-yielding portfolio.”

The industry remains in a wait-and-see mode as to how things in Russia and Ukraine will shake out.

“This is a moving target and unless the situation gets diffused we can likely expect to see sanctions get tighter, which could spur claims,” said Tobin.

Stiffer sanctions also could further economic deterioration in Russia, “which could lead to credit claims there,” added Rymer. “Also, they could bring about a shift in geopolitical alliances. If Russia is further isolated from the West and aligns more with countries like China or even Iran that will prompt even more geopolitical risks for our market to keep abreast of.”

As for what the political risk and trade credit markets can expect to see going forward, “the political risk market currently is quite soft,” she said. “The diminished appetite amongst underwriters for Russia and Ukraine could even further soften the market as underwriters look to make up for this lost business elsewhere.”

Interest in the coverages, however, likely won’t diminish. “There are opportunities in areas like Latin America and Thailand that may bring about future concerns similar to those now occurring in Russia,” noted Moore.

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