

A Region in Transition: A Political Risk Analysis of the Middle East and North Africa

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Summary

- The civil unrests in Egypt, Tunisia, Libya and beyond serves as topical case studies of some of the political risks facing businesses operating in emerging markets.
- Deep underlying structural issues such as high levels of unemployment, significant income inequality and rapid population growth have led to large numbers of citizens becoming disaffected with the Governments that rule over them.
- Many of these Governments have been autocracies for decades with little institutional means for the disaffected to voice their opinions and influence policy outcomes. The result is that for many across the region there is a deep-rooted resentment of the ruling elite and limited options for achieving reform.
- However, these conditions are not necessarily sufficient for resentment to boil over into widespread public revolt. A key trigger for the unrest in Egypt and Libya has been the looming possibility of a power vacuum as leaders Mubarak and Gaddafi grow older without having adequately constructed a mechanism for succession.
- With similar underlying conditions present in many MENA countries, the current protests may mark the start of a new era of unrest in the region. It is important to note however, that the likelihood of unrest leading to regime change will be different depending on the country in question.
- The insurance market is likely to respond by undertaking a comprehensive reappraisal of political risk over the next few months, and underwriters will need to examine each country separately and assess the relative implications. This may mean an increase in premiums for political risk and violence cover in some countries.

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CII Introduction: with mass political protests sweeping the Middle East and North Africa, predictions on their political and economic implications are changing almost as quickly as the events themselves. In this latest thinkpiece, Adrian Lewers of specialist insurer Beazley plc provides an analysis of developments from an insurance risk perspective. While some of our previous articles in the series over the years have extolled the virtues and benefits of emerging market investment,¹ this paper provides a topical case study of the risks that investors must take into account when placing their bets. Like other risk assessments, political risk analysis involves reviewing all possible indicators and making judgments based on previous experience, so the views expressed may sometimes appear controversial. But the fact remains that no market is absolutely free of risk, even if the downsides do not appear on the hourly news headlines.

The civil unrest in Egypt and now Libya and across the Middle East and North Africa (MENA) region serves as a stark reminder that many emerging markets remain inherently risky places in which to operate. In recent years this fact has sometimes been obscured as macroeconomic progress and market liberalisation have lowered the costs and increased the appeal of operating in these environments. The deterioration in the risk profiles of developed states has intensified this trend, as the risk differential between the developed and developing worlds has decreased, contributing to a degree of complacency about political risk in emerging markets.

But it is worth revisiting the oft-cited definition of emerging markets as those in which politics matters as much as economics in determining market outcomes. The autocratic regimes or flawed democracies across the MENA region, despite in many cases having delivered stability for extended periods, have critical weaknesses that make eventual political upheavals almost inevitable.

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There is a complex interplay of factors that enables popular protests to gain sufficient traction to effect political change on a grand scale, and the key issue

¹ See for example Vanessa Rossi, *A Remarkably Rosy Economic Outlook to 2020?*, no.48 (Dec 2010); Mui Pong Goh, *The View from Singapore: Cautious Optimism About the Asian Economic Recovery*, no.45 (Oct 2010); Donald Hepburn, *A Passage to India: Towards Robust Economic Growth*, no.44 (Sep 2010); Rodrigo Delgado Aguilera, *Successes, Trials and Tribulations in Regional Economic Recoveries*, no.38 (Apr 2010); Vanessa Rossi, *Emerging Markets: Upwardly Mobile Economies and New Consumerism*, no.26 (Sep 2009). All articles can be accessed at: www.cii.co.uk/pages/research/internationalthinkpieces.aspx

is one of timing. But as protests sweep the MENA region with such dramatic results, the risk/reward calculus of taking to the streets, for individuals living in poverty under repressive leaders that have failed to represent their interests but are ostentatiously enjoying the trappings of power, is changing. Once the protests gain momentum, the costs of joining in lessen as the path of resistance is smoothed. This is true across the region. It is our assessment, therefore, that the current protests mark the start of a new era of unrest.

The implications are profound for business. As we are seeing in Egypt, political unrest can lead to investment losses and business interruption due to general strikes and curfews; postponement of government and private projects; loss of or damage to assets because of looting and sabotage; as well as the potential for insolvency risks, capital flight, banking sector restrictions, and capital controls. Regime change also frequently entails public contract reviews. We expect over the next few months that the insurance market will engage in a comprehensive reappraisal of political risk, which will see risk appetite curtailed and market capacity cut. This would mean an increase in premiums for political risk and political violence cover, and a shortening of tenors.

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This does not mean that we consider regime change to be inherently negative. Once the dust has settled, there is every reason to be optimistic that the removal of a corrupt and reactionary regime will result in a long-term improvement in the business environment. Indeed, our longer-term outlook for Egypt tends towards the positive. We expect a democratic process eventually to be instituted, which is likely to deliver a moderate and pragmatic – and probably coalition – government, in which the Muslim Brotherhood will be the dominant, but not sole, force. We would expect this government to continue to respect the interests of international investors. From our perspective as an insurance provider, however, until this outcome is secured, we cannot discount the risk of a military coup, an extremist government or a protracted period of uncertainty, which will impede business planning, discourage investment inflows and weaken economic activity.

What are the Triggers for Trouble Ahead in MENA?

It has been a momentous few weeks in the region. Tunisia's president has fled, Egypt's has resigned on 11th February, Yemen's has promised not to seek re-election and the Jordanian king has sacked

the government. Lebanon's moderate government has fallen as its Hezbollah members were always likely to ensure it would. How to identify those regimes next in line to fall is a question that has acquired great urgency.

Autocracies under threat

Of course, it is far from an exact science. But there are a few key ingredients that we consider necessary to provide fertile conditions for an effective unrest. First, most obviously, there must be an autocratic regime - or defunct democracy - that operates with impunity and fails to act in the interests of its population. Most current rulers have been in power some time: while Zine al-Abidine Ben Ali ruled Tunisia for 23 years and Mubarak has clocked up 30 years, Colonel Gaddafi of Libya is Africa's longest-standing ruler, having been in power for 41 years. The story is similar across the region: Omar al-Bashir of Sudan has 17 years; President Bouteflika of Algeria 11 years; Ali Abdullah Saleh of Yemen - who has bowed to popular pressure to name his departure date - 16 years; Saudi Arabia's King Abdullah 14 years (from 1996 to 2005 he was de facto head of state as his brother was incapacitated).

It is also not so much the fact that the leadership may be hereditary per se, but the way they apply this power on their system of governance. Of this list above, perhaps the most benign is the Jordanian King, who has managed to neutralise anger of protesters by taking steps to change the government. But across the board there is a lack of accountability, questions of corruption and the perception that leaders are more interested in courting international favour - including western donors and investors - than in representing the interests of the people (who in the region are often opposed to greater international involvement). Wikileaks' revelations about the lifestyles of the Tunisian leadership certainly added fuel to the fury of protesters; members of the Gaddafi family have had their decadent lifestyles similarly exposed.

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Moreover, such long-standing and privileged rulers, and their small coteries, are simply out of touch with the concerns of their populations and have little incentive to address them. Just as a company can rapidly lose market share by failing to adapt to changing customer preferences, so a regime can be caught out by failing to appreciate the depth of anger in a population. An authoritarian regime denies its consumer choice, so people-power can only be exercised on the street, either in critical mass or in self-sacrificing style like the suicides

seen in Tunisia, Mauritania, Morocco, Yemen and Egypt.

Demographic and social factors stoke unrest

Then there are the demographic and social factors - in order for a body of protestors to build up, there need to be sufficient numbers of people who feel they have little to lose. Unemployment and underemployment are high across the region, and this, coupled with rapid population growth, means that pressure for resources - housing, public services etc - is acute. Stable and strong economic growth does not preclude the possibility of widespread dissatisfaction; if wealth distribution is extremely unequal, as it is in Saudi Arabia, Sudan, Algeria and Libya, the cause for complaint worsens. The initial impetus in Tunisia and Egypt has come from the unemployed and disaffected, for whom the marginal impact of rising food prices has been severe enough to foster desperation. In Libya protestors occupied houses under construction to protest poor living conditions and rising wealth disparities.

Fudged succession planning intensifies risk

A lack of succession planning has intensified the risks in many of these countries. Autocrats tend to be reluctant to name their successors too soon, for fear that their own authority will be undermined. The temptation to keep it in the family is high - witness Mubarak's efforts last year to lay the ground for his son Gamal's accession, Gaddafi's hopes - likely not to be realised - for the anointment of his son Seif al-Islam, Bouteflika's abortive efforts to groom his brother for the job, and the ongoing deliberations in Saudi about which son or grandson of founding father Abdul-Aziz will take over once the ailing king and crown prince have both passed on.

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Inevitably, the uncertainty intensifies transition risks, as the early demise of the autocrat can unleash waves of factional and sectarian violence and bring normal economic life to a standstill. The assumption, moreover, that the incumbent is entitled to dictate the course of succession, particularly when the incumbent is widely reviled, is provocative to opponents of the regime. The stakes are incredibly high, because of the rarity of the opportunity to grasp power and the winner-takes-all result. We expect that in every state that we consider to be at risk of regime change, the moment of succession will prove to be a flashpoint, if one hasn't already arisen.

Role of Security Services is Key

The role of the security services is critical. Mubarak has been undone by the army's refusal to act against the protesters. In fact, the army would never have been able to exercise a brutal clampdown because it is heavily dependent upon the US for funding, receiving around US\$1.3bn a year. Elsewhere in the region, the armed forces are less beholden to external influences, and are deeply intertwined with the governing regimes. Fears of a brutal crackdown will be a significant restraining consideration for protesters, and does reduce the likelihood of successful revolution in all the vulnerable states we have identified. But it certainly does not rule it out.

Governments must play their hand with care

The response of the government is key to whether or not the protests can gain the necessary momentum to topple the leadership. Whereas the Tunisian and Egyptian presidents were caught out by the suddenness and intensity of the demonstrations, the Algerian government has had the opportunity to appease protesters by offering certain concessions - agreeing to lift the 19-year old state of emergency, subsidising wheat prices and agreeing to consider further political freedoms through a "national dialogue" with citizens.

Libya similarly has cut taxes and duties on food products and is meanwhile benefitting from rising global oil prices. Such measures do not address the root causes of the discontent, however, and at the time of writing, the country's future hangs in the balance.

Other critical factors include the unity of purpose of opposition groupings; their degree of organisation and ability to mobilise; access to free media, social networks and other communications; and sectarian rivalries.

What Next?

It is always difficult to make a call on such fast-moving targets. However at time of writing there seemed to be little doubt that major change will take place in several countries across the region in the weeks, months and possibly years to come. It is also clear that such transition will be less tumultuous in some countries than in others.

For insurers, the losses from these developments will be felt across London's political risk market on an equally varied timescale. Those political risk professionals will have to closely track the intensity of the developments and take a view on the relative risk characteristics between the countries, and degree of exposure they are prepared to live with.

Beazley's interactive risk map is one example of a tool to assist this process, including information on Africa and the Middle East. Each page includes a country summary, key statistics, a breaking news alert and a dashboard indicating Beazley's risk rating and risk appetite. The Risk Map can be accessed at www.beazley.com/riskmap

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Some recent articles in the series:

No.50: [Wanted: A Visionary Navigator and Innovative Thinker for Retail Financial Distribution](#) by Lucian Camp (1 February 2011).

The distribution of financial products has undergone significant changes in recent times as firms have begun to utilise new technologies to reach consumers. In this Thinkpiece, Lucian Camp notes the progress made by what he calls the "D-I-Y driven distribution revolution" but controversially asserts that financial planning is still failing to engage the mass market. Ultimately, he argues, the industry needs a Bill Gates like visionary.

No.49: [Culture and Ethics: A New Crucible for Regulator Thinking?](#) by Duncan Minty, MSc, Chartered Insurance Practitioner (5 January)

Corporate responsibility and business conduct consultant Duncan Minty argues that culture could form an important part of the regulatory environment. He then begins to develop a framework for how this could be achieved and reflects on the strides already being made through voluntary market led initiatives.

No.48: [A Remarkably Rosy Economic Outlook for 2020?](#) by Vanessa Rossi, Senior Research Fellow in the International Economics, Chatham House, **International Series no.13** (23 December 2010).

Attention is moving from the 2010 rebound in the global economy and world trade towards the outlook for 2011 and beyond. After the gyrations seen in the last couple of years, it is not surprising to see considerable short-term uncertainty: predictions vary given the risk of double dip recessions in the US and Europe. Vanessa Rossi of Chatham House summarises her take on the global economy to 2020.

No.47: [Insurance Contract Law Reform: Bringing the Underpinning Law into the Twenty-First Century](#) by Peter Tyldesley (17 November)

The author examines the problems with English Law regarding the treatment of insurance contracts. He shows that much of the problem stems from trying to underpin a twenty-first century insurance market with law written in Georgian times. He summarises recent steps taken by the Law Commissions and discusses some of their implications.

No.46: [What Happens Once the Ink is Dry? Claims and the Parties' Post-Contract Duties](#) by David Hertzell, Law Commissioner of England & Wales (8 November)

Law Commissioner David Hertzell examines his team's latest review of insurance contract law. He sets out some of the problems with the existing law underpinning insurance contracts, and discusses some solutions to clarify the insurer and policyholder responsibilities especially after the contract is signed.

No.45: [The View from Singapore - Cautious Optimism about Asian Economic Recovery](#) by Mui Pong Goh, Research Fellow, Chatham House, **International Series no.12** (19 October)

Due to its unique vantage point at the heart of Southeast Asia, Singapore is well placed to provide an informed view of global economic developments and their implications for this influential part of the world. This paper discusses the tremendous growth surge underway this year, and reflects on the current wave of cautious optimism regarding the region's economic future.

No 44: [A Passage to India: Towards Robust Economic Growth?](#) by Donald Hepburn, Associate Fellow in International Economics, Chatham House, **International series, no.11** (29 September)

Published in the backdrop of the Commonwealth Games, it unpicks some of the underlying economic trends with India's developing economy. The paper begins by identifying the reasons for India's relative success during the financial crisis, before outlining the future prospects for growth and the infrastructural and political barriers to prosperity.

No.43: [Time for collective action? Redressing the damaging effects of cartels on small businesses](#), by Ingrid Gubbay and Antony Maton, Hausfeld & Co LLP (10 September)

This paper, by the authors examine some of the harmful effects of cartels on small businesses and discusses reasons why firms remain reluctant to claim for damages. The paper then moves on to highlight the affordable options open to SMEs for redress, and the opportunities for insurance firms to become the underwriters of collective action.

No.42: [Speedy Recovery or Lingerin Crisis in the Gulf Economies?](#) by Vanessa Rossi and William Jackson, Chatham House, [International Series no.10](#) (30 July)

Over a year after covering this region in an [earlier thinkpiece](#), the author returns to examine how the Gulf economies have fared especially following the Dubai property crisis last autumn. Despite the setback, Chatham House's forecasts nevertheless show much promise for significant growth in insurance and financial services over the next 5 to 10 years.

No.41: [Charging fairly for pensions](#) by Steven Cameron, AEGON UK (20 July)

The Head of Business Regulation at AEGON UK summarises the 2012 pension reforms introducing a controversial new charging structure for the National Employment Savings Trust (NEST) scheme which will combine a fund management charge with a charge on contributions. Examining both sides of the argument, AEGON concludes that a combination charging structure is a positive move for all parties.

No.40: [The Future of International Financial Regulation](#) by Eric Pan, Associate Fellow in International Economics, Chatham House, [International Series no.9](#) (8 June)

This thinkpiece summarises the challenges confronting attempts to strengthen the global financial regulatory architecture. Prepared by a prominent regulatory law professor based in New York, the paper helps readers make sense of the various interlocking institutions such as the G20, IMF and European Union, and sets out the key issues and challenges facing them as they deal with the effects of the financial crisis.

No.38: [Successes, trials and tribulations in regional economic recoveries](#) by Rodrigo Delgado Aguilera, [International Series no.8](#) (22 April)

The developing world is seeing the same sort of multi-speed recovery as elsewhere. While the Asian economies have responded well following lessons learned from earlier crises, Latin America and the Middle East seem to have for the most part escaped the turmoil's major effects, but emerging Europe's recovery is still far from over.

No.37: [UK Election 2010 Special: What the Parties Say](#), by Stephen Timms, Mark Hoban and Vince Cable (Published 1 April)

We have compiled an election special as part of our regular CII Thinkpiece series. The three main parties – represented by the Rt Hon Stephen Timms MP for Labour, Mark Hoban MP for the Conservatives and Dr Vince Cable MP for the Liberal Democrats – set out their respective visions for financial services.

No.36: [The End of Dollar Dominance? Signs of Change in the International Financial System](#), by Vanessa Rossi [International Series, no.7](#) (17 March)

Changes in the international financial arena following the global recession could challenge the West's dominance the monetary system. In this latest addition in our special series of thinkpieces on global themes, Vanessa Rossi of Chatham House explores these changes.

No.35: [Making Sense of it All: Convergence and Investor Protection in EU Financial Regulation](#), by David Doyle (Published 9 March)

While events in Brussels may seem far away to some, recent proposals for European financial regulation will have more impact than usual on financial practitioners in the member states. EU expert David Doyle looks at some of the proposals under consideration right now and discusses their implications.

No.34: [Something Must Be Done! Sir Humphrey writes: Lessons for Financial Regulation](#), by Richard Hobbs (11 February)

The author explores the government's response to the financial crisis. He warns that drastic, politically expedient intervention that is seen to be "doing something" risks stifling competition while failing to address the underlying causes of the crisis.

No.33: [Too Big to Ignore: The Protection and Perception Gaps in Life and Health Insurance](#), by Ron Wheatcroft and Stephen Bale (29 January)

A consumer-focused view of the long-term insurance market with a particular emphasis on long-term protection business. The authors explain why the time is ripe for that industry to engage with all stakeholders in a concerted effort to close the protection and perception gaps.

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