

A GUIDE TO POLITICAL RISK INSURANCE

INTRODUCTION

Political risk insurance (or "**PRI**" to use its market abbreviation) is a form of insurance that protects assets and financial interests against losses caused by certain types of political action or political violence. It is typically taken out where an asset or investment is seen as being subject to a particular risk – for example, if it is located in a politically volatile country or is of a particularly sensitive category such as energy infrastructure. It is often used in the context of foreign direct investment and project financing, and taken out by companies operating in a wide range of industries and sectors.

PRI is typically a bespoke product, often with wording tailored to reflect the particular risks the asset or investment is exposed to or particular areas of concern for the insured. It may cover risks such as:

- **Confiscation, nationalisation, expropriation or deprivation:** the host government taking actions to acquire the relevant asset or investment
- **Contract frustration:** the non-performance of contractual obligations by a counterparty as a result of government actions
- **Currency inconvertibility:** the host government restricting the conversion or transfer of local currency to foreign currency
- **Forced abandonment and divestiture:** the host government forcing a company to abandon/divest itself of the investment, typically a physical asset
- **Licence cancellation:** the host government cancelling required licences, permits, or contracts
- **Non-honouring of arbitral award:** a form of more limited cover which applies where the insured has obtained an arbitral award (for example, under a Bilateral Investment Treaty) and the award is not paid
- **Political violence:** loss as a result of war, civil unrest or terrorism

PRI is typically triggered by first-party losses, being those where the asset or investment itself is impacted by one of the risks outlined above. It can, however, also provide cover for liability to third parties in certain circumstances.

This briefing provides an overview of how PRI works, and the considerations when taking out a policy, making a claim, and dealing with other parties.

Key issues

- PRI is typically a bespoke product that is tailored to cover particular risks.
- PRI is provided by the insurance market as well as state-backed firms.
- Policies may be structured in different ways depending on who is purchasing the policy and who is to be covered by it. They may be complemented by other agreements including in relation to how claims under PRI are to be managed and who is entitled to PRI proceeds.
- Claiming under PRI should be considered alongside other protections against losses arising from political actions or political violence. In particular, claims under Bilateral Investment Treaties may also be possible.
- PRI may require that an insured notifies not only claims but also circumstances which may give rise to them. It is important to check the notification requirements.
- Insureds will typically be required to keep insurers updated, consult them on decisions, and to mitigate their losses.
- Political perils may not be straightforward to identify and PRI claims may be disputed on grounds that the losses were not caused by a covered peril. Evidence held by the insured, such as correspondence with a counterparty, may be important, and expert evidence may be required.

TAKING OUT THE POLICY

Policy drafting

PRI policies require careful drafting to ensure that they provide the intended protection. Attention needs to be paid in particular to:

- **The covered perils.** An insured should consider the types of actions that it is concerned about and ensure that they are correctly covered. In particular, an insured should consider how government action might have an impact. Governments often do not take clear, formal action to expropriate assets, but may instead take actions that indirectly have that effect. Political perils may take effect over time (so-called 'creeping' expropriation) and without the host government declaring them. The scope of the covered perils and whether they have caused the loss is often a key battleground in a PRI claim.
- **Quantification.** PRI typically sets out a mechanism for calculating the loss payable under the policy. In some cases, PRI provides cover for the agreed value of the asset. In other cases, PRI provides cover for the market value of the property, which may require expert assessment, or for the cost of repairing it.
- **Insurable interest.** Often the insured will not have a direct exposure to the risk, for example because the asset is owned by a subsidiary. The policy needs to reflect this, and insure the insured's own insurable interest, which in this case would be its shareholding in the subsidiary which owns the asset. The quantification provisions (and other parts) of the policy should read consistently with that.

Other forms of protection

PRI is often considered alongside other protections against losses arising as a result of political risks including:

- **Contractual protections:** an insured event might also trigger contractual provisions, such as force majeure clauses, termination clauses, and indemnities.
- **Government compensation:** some states provide financial protection for losses caused by the occurrence of political risks. For example, each of the UK, Germany and France has a scheme for providing compensation for losses caused by riots. In South Africa, a state-owned entity provides insurance for damage caused by riots, strikes and public disorder.
- **Bilateral Investment Treaty (a "BIT").** A BIT is an agreement between two countries for the purpose of the promotion and protection of investments between them. In a BIT the countries typically agree to treat the other's investments fairly and to protect them from expropriation, and to allow investors to transfer funds related to the investments freely and without delay. A breach of a BIT may give a commercial entity a direct right to claim compensation from the breaching state.

In many instances these protections will be complementary to insurance, but will not replace the need for it. They are rights against entities who are likely to be interested in the underlying facts, and may face pressures of their own not to pay compensation. To illustrate, whilst BITs can offer valuable protection, relying on them may not be straightforward as countries may be concerned about the political or broader financial consequences of accepting liability. PRI

Who provides cover?

- PRI will usually be procured with the assistance of a broker who advises on the availability and suitability of cover.
- It should not be assumed that PRI will be available in relation to any given risk. Insurance market capacity for PRI varies across geographies and industries and is reactive to geopolitical events.
- The market for PRI comprises the private insurance market, which includes insurance companies and Lloyd's Syndicates and state-backed providers.
- State-backed providers include national export credit agencies, such as the Export-Import Bank of the United States, and multilateral export credit agencies, such as the Multilateral Investment Guarantee Agency (part of the World Bank).
- State-backed providers are motivated by foreign policy objectives and accordingly may have appetite for PRI different from that of the private insurance market.

may therefore be attractive even where a BIT is in place, as seeking coverage from an insurer may be more straightforward than enforcing rights under a BIT.

Who is protected by PRI?

PRI is used in a range of contexts. It is taken out by, or for the benefit of, owners of assets and investors in or lenders to projects, amongst others. For example, an investor in an infrastructure project, such as a power plant, transportation systems or telecommunication networks, may take out PRI against the risk that the host government (i) disrupts the development and this results in business interruption or other losses, or (ii) confiscates the asset once completed.

Careful consideration needs to be given to who is insured under a PRI policy, and who has rights in respect of it. For example, in the context of project financing:

- an investor or lender may purchase PRI in their own name to insure their interests; or
- the project company may purchase PRI and the investor/lender may take security over it. There are various security structures that may be used, which provide varying degrees of control for the lender/investor, including:
 - (a) an assignment of rights under the PRI policy and to the PRI proceeds;
 - (b) a charge over the PRI in favour of the investor/lender; and
 - (c) the investor/lender being entitled to the PRI proceeds as a 'loss payee'.

These give different levels of protection, and it will be necessary to consider carefully which is the most appropriate. Consideration also needs to be given as to who has control of the insurance claim and how the parties are to cooperate in such circumstances, noting in particular that those with the knowledge and documents required to bring a claim may not be the same as those who bear the ultimate economic risk.

Duties from the outset

PRI typically imposes duties on insureds from the time it is taken out. Those duties will vary between policies but may include the following:

- **Disclosure.** PRI typically requires insureds to provide at the outset and on an ongoing basis information in relation to the risk insured. This might, for example, involve sharing with insurers any particular concerns which led to the decision to take out the policy.
- **Compliance with local laws.** PRI is typically conditional on the insured acting in compliance with local laws and having necessary licences and permits in place. Careful attention should be given to this requirement, and whether local advice is necessary to ensure compliance, as any breach might invalidate cover.

NOTIFICATION OF A POTENTIAL CLAIM

The policy will set out requirements for notification of a claim, and may also require that a policyholder gives prompt notice to the insurer of any circumstances which are likely to give rise to a claim.

Those at the insureds who are involved with the investment or asset should be alert to and understand these requirements and the circumstances which might trigger them. It may not always be clear when a notification threshold has been

met, and policies may have different trigger points – for example, where there are circumstances that are "*likely*" to give rise to a loss or where there are ones that "*may*" do so. Political perils may take effect through a series of actions rather than a single measure, and they are unlikely to be described as a political peril (e.g., expropriation) by the host government.

This can make the emergence of political perils difficult to identify. However, it is not uncommon for there to be serious consequences for a failure to notify, and where the notification requirement is a condition precedent to cover, a failure to comply may invalidate the claim.

Insureds should keep in mind that PRI may permit insurers to amend cover, for example, by removing cover for assets insofar as they are in certain territories, on notice to the insured. Insureds and their brokers should be familiar with such provisions and consider what steps might be taken in the event insurers exercise rights under them. Insureds should also factor in the risk of loss of cover when considering their overall exposure to the relevant risks.

MAKING A CLAIM

PRI imposes requirements in relation to how a claim is made. These requirements will vary between policies but may include the following:

- The insured must present the claim within a specified timeframe. This may be shorter, potentially significantly so, than the time period for pursuing a counterparty in legal proceedings.
- The claim must be supported by all relevant evidence. Claims on PRI often require analysis of the facts underlying the loss, as discussed above, and so this may take some time to collate.

Insurers will have rights in relation to claims that are or may be covered by PRI. These will vary between policies but may include the following:

- The right to obtain information from the insured in relation to the claim.
- The right to be consulted on or to direct strategy in relation to recoveries against third parties. This may go hand-in-hand with a requirement that an insured does not engage in settlement discussions without insurers' consent. The insured also needs to consider the extent to which it is required to mitigate its loss, either under policy terms or under a legal duty.

PRI is sometimes written by an insurer in the territory in which the project or asset is located, and then reinsured in an established insurance market (e.g., the London market). This structure is particularly common in jurisdictions which restrict the ability of foreign insurers to issue policies, and insureds should consider whether they require security over the reinsurance proceeds in such a situation.

In general, it is advisable to keep insurers apprised of developments and to agree material decisions with insurers. However, this can present difficulties, particularly where the subject matter of the dispute is sensitive.

A DISPUTED CLAIM

Typical areas of dispute in PRI claims include the following:

- **Whether loss was caused by a covered peril.** Political perils (e.g., government confiscation) may take effect over time and without being formally declared. It may be necessary to determine whether the acts of the

counterparty which resulted in the loss were commercially or politically driven. In order to determine points such as these, it may be necessary to conduct a forensic analysis of the facts underlying the loss and the evidence held by the insured, such as correspondence with counterparties. For this purpose, it may be necessary to obtain input from expert witnesses, such as on the political system of the territory in which the loss occurred, in order to contextualise the relevant facts.

- **Quantum.** Assessment of the value of the loss may require expert input, particularly where it relates to unique property (e.g., an infrastructure project). In addition, quantum may be difficult to assess if the insured does not have access to the property (e.g., because it is in a warzone).

If a claim is not accepted by insurers, it may be necessary to commence court or arbitral proceedings. There are advantages and disadvantages to each, including in relation to speed, cost, and privacy. Given political sensitivities, PRI typically stipulates that disputes be resolved by arbitration, which is a private process. PRI will also state which law governs the policy and in which jurisdiction proceedings must be brought. An insured should consider carefully its choice of dispute resolution procedure, and the forum provided for in related contracts may not always be appropriate for the insurance.

See our practical guide to PRI claims [here](#).

IMPACT ON OTHER RELATIONSHIPS

The insured may continue to be involved in the PRI even once its claim is paid. For example:

- **Subrogation.** Insurers will be permitted to 'step into the shoes' of the insured in order to pursue rights of recovery against third parties responsible for the loss. This may give rise to sensitivities for the insured as the claim is brought in the insured's name and may be against parties with whom the insured wishes to maintain a relationship. The insured may be required under the terms of the PRI to assist insurers with a subrogated claim including by providing information or assisting with negotiations or legal proceedings.
- **Salvage.** Insurers may seek to recover value through taking ownership of damaged or expropriated assets. The insured may be required by the terms of the PRI to cede ownership of the imperilled assets to insurers and to assist with insurers' salvage efforts.

CONCLUSION

PRI is typically a specialised product that is tailored according to the risks arising in a particular context. As political risks can be complex and may develop quickly, it can be challenging to place PRI that covers all relevant contingencies.

PRI can offer valuable coverage. However, given its subject matter disputed PRI claims may not be straightforward to resolve. PRI often needs to function in the context of other contractual and legal rights. It should be considered alongside, and indeed may complement, other protections against political risks including BITs.

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