

A new perspective on the cost and benefits of political risk insurance for foreign direct investments



**S&P Global's
independent study,
commissioned by
Marsh Specialty,
shows political risk
insurance curbs
country risk premium,
improves valuation
of investments in
emerging markets, and
enhances internal rate
of return of projects.**

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Executive summary

The mitigation of country risk using political risk insurance (PRI) has long been undervalued by foreign direct investors. While the market intuitively understands the benefits of PRI, it is often perceived as “expensive”, because the financial benefits of coverage have not been adequately quantified. Customarily, when evaluating PRI as part of an investment, lenders and investors have assigned little to no value to the existence of a PRI policy in the valuation process. The result has been to impede broader use of PRI as a risk mitigation tool.

The lack of a robust analytical framework to guide decisions around whether to insure political risk has denied financial decision makers of the means to make informed and well-supported assessments. Conversely, we assumed that using a nuanced country risk premium (CRP), developed by dissecting the elements of country risk, and methodically integrating the potential benefit of PRI into valuations, could be of great value to investment professionals.

To help companies and investors better evaluate PRI, Marsh's Credit Specialties practice worked with S&P Global, an independent third party, to use its Country Risk Investment Model (CRIM) to evaluate the benefits of PRI. The study's initial hypothesis was that a well-crafted PRI policy should result in a non-zero improvement in the CRP, and that this should be captured for the benefit of investors when undertaking a valuations exercise. A more robust and granular approach to quantifying the benefits of PRI should enable companies to justify investing in one or more projects with a CRP that might fall outside their traditional internal risk tolerances. The new approach examined in this study demonstrates that PRI typically improves the CRP and credit rating equivalent of an emerging market investment, and improves the project's internal rate of return (IRR).

The key conclusions of the S&P Global study *Proof of Concept, Using Country Risk Investment Model to Analyse Benefits of Political Risk Insurance* (August 2021) are as follows:

- PRI can compensate companies for a significant percentage of potential cash flow losses associated with key areas of country risk — deprivation of ownership and operating rights, damage to assets, blocks on dividend repatriation, and state failure to honor contracts.
- Potential investors in a company or project need to be adequately compensated for taking on country risk, which is reflected in an increase in the hurdle rate of return achieved by adding a country risk premium to the discount rate applied to forecast cash flows.
- PRI cover is designed to indemnify companies against a proportion of potential losses, thus justifying a reduction in the CRP incorporated in the discount rate representing investors' required rate of return.
- Models developed by S&P Global quantify the expected cash flow losses associated with all sources of country risk, including those events that would be covered by PRI and can, therefore, be used to justify a reduction in the CRP and an associated improvement in the credit rating equivalent for the project and operating company.
- Annual premium payments for PRI protection paid by the investor negatively affect the insured project's future cash flows, although the negative impact on the expected net present value (NPV) of the project is materially mitigated where such premium expense is tax deductible.
- Historically, many companies purchasing or considering using PRI have carried the negative cash flow "expense" of the premium payments without also properly reflecting the positive impact of PRI in reducing the CRP (thus lowering the overall discount rate applied by investors). PRI raises the project's valuation (NPV) and internal rate of return (IRR) while providing other benefits arising from a de-risked project.
- Conventional wisdom has viewed political risk insurance as a cost to the project that inevitably results in a decrease in the project's IRR, but the results of this analysis in fact show the opposite: investment insurance can enhance the IRR of an insured project, despite the PRI insurance cost paid by the investor.
- PRI thus does more for a company than cover insured losses, as a lower CRP confers higher asset valuation, enables investment finance on more favorable terms, and other benefits.

Source: S&P Global

Impact of PRI on CRP, credit ratings, IRR and NPV

We selected a single, representative project and looked at it in three differently rated countries, ranging from B- to BBB S&P/Fitch equivalents, yielding varying results. A critical first step involved mapping the insurable perils covered under a standard PRI insurance policy against the 21 risk events that underpin S&P Global's CRP estimate (see [Appendix](#) for a full list).

Not all of the risk events were insurable under a PRI policy, such as natural disasters, and some might be covered by other types of insurance policies. However, a significant number did correlate. This allowed S&P Global to disaggregate the relevant risk events covered by PRI from their CRP estimate, and to focus on the impact of a well-crafted PRI policy on the CRP in a valuation exercise.

The study results validated our initial hypothesis by demonstrating that PRI typically improved the CRP and related credit rating equivalent of an investment project, unless the starting value for the CRP was zero, as in highly rated, developed

market countries. However, the magnitude of this improvement varied with the overall starting risk level of a given country, as demonstrated in the summary table below, which shows variations across three representative countries used for evaluating the same project.

In the case of Ghana, PRI cover moves the expected project NPV out of negative territory with a seven-notch improvement when converted to a sovereign credit rating scale. The characteristics of the specific project and its economic sector also make a difference to the magnitude of the impact of PRI.



Figure 1 | Impact of political risk insurance on net present value and internal rate of return of an energy project in alternate countries.

	Base			Post-PRI			Change		
	Ghana	Indonesia	Brazil	Ghana	Indonesia	Brazil	Ghana	Indonesia	Brazil
Country risk premium	6.30%	1.84%	2.91%	2.23%	1.05%	1.41%	-4.07%	-0.79%	-1.50%
Moody's rating (equivalent)	B3	Baa2	Ba2	Baa2	A3	A3	7	2	5
S&P/Fitch rating (equivalent)	B-	BBB	BB	BBB	A-	A-	7	2	5
NPV adjusted for country risk	-89.2	83.4	25.5	80.0	113.9	101.5	169.2	30.4	75.9
IRR adjusted for country risk	2.44%	6.05%	7.44%	7.02%	7.84%	8.34%	4.58%	1.80%	0.89%

Source: S&P Global

The above analysis assumed that the project had obtained a full package of political risk coverage; benefits would be reduced if not all standard PRI coverages were included in the policy.

While the project included a power purchase agreement (PPA) with a termination payment that could be subject to arbitration, it should be noted that the Marsh co-authors felt that S&P Global did not give enough credit to the presence of the element of PRI cover commonly called "breach of contract" or "arbitration award

default" which, would further improve the predicted financial benefits of PRI¹. S&P Global agreed to continue to review the benefits of breach of contract as their model is further developed.

For more background, see the [Appendix](#).

¹ Typically, in a power project, the PPA, incorporates a dispute resolution mechanism based on independent arbitration proceedings to resolve disputes among the parties over the PPA. If the project company or the investor wins a monetary award, but the losing side fails to pay, PRI insurance will pay instead, according to policy terms and conditions.





Benefits and uses of PRI in investment valuations

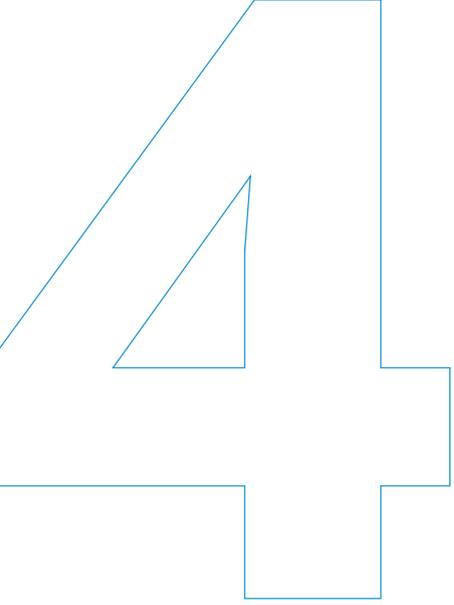
Historically, investors seeking to mitigate political risks of projects in developing countries often turned to PRI as a means of risk transfer. PRI is widely used today, but is sometimes perceived as “expensive” in relation to its well-defined costs, which must be attributed to the project. Little work has been done to quantify the benefits of using PRI on international projects, a gap that S&P Global and Marsh Specialty hope to fill with a better substantiated cost-benefit analysis than was previously possible.

As outlined in the previous sections, the study demonstrates that the benefits of PRI can be estimated using robust methodologies. Using S&P Global's CRIM allows the disaggregation of the CRP associated with overseas investment projects into discrete and measurable component risks. That in turn permits a granular, ground-up quantitative evaluation of each risk factor that together add up to a more accurate CRP estimation, which we believe to be more precise and sensitive to industry sector, capital intensity, and other project-specific attributes than blunt, one-size-fits-all alternatives (such as sovereign bond spreads) widely used for valuation purposes in today's market. Insurance coverage for events routinely offered within PRI policies to foreign direct equity investors can be successfully mapped to a subset of corresponding components of country risk used by S&P Global in their CRIM model.

The above presents the possibility of a new type of analysis: contrasting a project's valuation and the CRP embedded in the discount rate used, before and after applying PRI. S&P Global's work performed for Marsh Specialty demonstrates the concept that using PRI has measurable positive financial impacts — by way of reducing certain components of the CRP, which in turn decreases the discount rate used for valuing project cash flows. A lower discount rate then can feed directly into improving the NPV of the project, in some cases by a significant margin, depending on project location and specifics. By tempering the impact of political risk events on the future cash flows of the insured project, volatility and country risk can be measurably improved, in some cases resulting in a multiple notch improvement in adjusted country risk ratings for the project or an enhanced IRR of as much as 5% in the cases examined.

These results are quantifiable in a way that was formerly beyond reach for financial or corporate investors contemplating overseas projects, opening the door for new use cases, which potentially include:

- 01 Evaluating new project(s), investment decision(s).** This is especially powerful where a project is in a perceived difficult location, and therefore appears to fall outside of the investors' country risk tolerances. Using a blunt and unmitigated CRP drawn from indiscriminating "one-size-fits-all" sources can inadvertently inflate the discount rate used to value cash flows, such that a project's returns may seem low or even negative. Applying PRI through the lens of the CRIM tool may demonstrably improve the IRR of a project and also better reflect the mitigating impact of the protection PRI affords. The additive effect to the returns and valuation of the project can in fact make the difference in terms of whether the investment decision is a "no-go" or a "go" decision with PRI.
- 02 Supporting PRI decision making with a data-driven framework.** The use of PRI is most often justified by an intuitive recognition by the investor of the benefits of coverage, or by an external party requiring the coverage. It is arguably appropriate and advisable for investors to recognize the quantitatively measurable positive effects of using PRI achieved through a reduced CRP and an improved project NPV and IRR.
- 03 Optimizing the PRI design process.** Using the CRIM model methodology discussed here can help investors to extract maximum measurable benefit from PRI by selecting specific coverages, which may affect the insurers' premium and other factors.
- 04 Helping to prevent impairment and reduce volatility on an investor's balance sheet.** Generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS) rules require holders of illiquid direct investments to periodically mark investments "to market." Following the occurrence of adverse political event risks in countries hosting projects that the investor has an interest in, the investor may be required to accept a charge against the investment's value, which would then need to be reported to its stakeholders. Using the CRIM methodology around PRI can help companies and financial investors alike to properly, consistently, and fairly model the value of their investments in light of such events considering their PRI protection as a tool to reduce and minimize such volatility.
- 05 Broadening the set of investment opportunities beyond countries with investment grade rating for certain classes of investors.** Institutions with statutory or other restrictions limiting their investments to better rated investments and territories can use the methodology around PRI discussed in this report to justify the consideration of investments in new territories that were formerly out-of-scope, due to a demonstrable improvement in the country risk factors for a project once a PRI policy is in place.
- 06 Providing help in selling assets/exiting projects by having a better rated, better valued project.** Provided that PRI protection is assignable to new owners that may acquire the project from a current insured, political risk insurance may create conditions favoring an eventual exit by the current insured by enhancing the value of the project and improving the buyer's perception of the insured country risk.
- 07 Assisting in discussions with lenders.** Providers of debt to an insured project can benefit from viewing how PRI protection of cash flows reduces risk of default on interest payments and loan repayment.



Conclusion

The S&P Global proof of concept study performed for Marsh Specialty was a first-ever attempt to quantitatively measure the benefits of PRI on foreign direct investment projects. The marshaling of S&P Global's long-established analytical framework to this question has demonstrated a strong case for the measurable benefits of PRI, its effects on curbing insured risks embodied in the CRP that factor into assessing cash flows, and the ensuing positive results that flow through to a project's valuation.

Though the results would vary by underlying project, sector, and country, the overall outcome should be informative to financial investors and lenders alike. For emerging markets, PRI can significantly improve the overall country risk assessment and expected cash flow of a project. Further, the cost of PRI is (counter-intuitively) neutral to positive for the project's valuation, upending common misconceptions that PRI is "expensive" and reduces investment returns. Use of the methods outlined here suggest a paradigm shift: PRI coverage is not only worth more than its cost, but it may be a potential tool for enhancing project value.

Our conclusions are subject to the underlying assumptions used, but the results are replicable and robust. The PRI-specific model should evolve and be further refined, but given the extensive use of CRIM and S&P Global's background in investment evaluation, the process is grounded by a time- and project-tested model.

A strength of the CRIM model is its flexibility and versatility in providing a nuanced view of country risk and the specific measurable effects of insuring — or not insuring — a project. Results of using this methodology will vary according to the type of project, its industry sector, the country hosting the project, and model assumptions. The CRIM model's application to evaluating PRI is expected to evolve and develop as it is further tested on a broader selection of countries and projects, which we expect will yield additional insights into the use and application of these new tools.

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Key conclusions are:

- CRP used within a project or asset valuation discount rate applies material downward pressure on asset valuation when factored into investment decisions in emerging markets.
- The CRP should be sufficiently nuanced to reflect significant differences in a given project risk profile.
- PRI can substantially reduce the CRP and enhance a project's or an asset's valuation.
- The resultant asset valuation improvement factoring PRI to the CRP can significantly (and potentially completely) offset the costs of the coverage (on a non-cash basis), and even be accretive to the project's NPV, leaving the project or asset protected on a cost neutral to positive basis.

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The S&P Global economics and country risk team takes an intelligence-led approach to forecasting the full spectrum of commercially relevant political, economic, legal, tax, operational, and security risks, in 211 countries. They provide risk solutions that are data-driven, leverage data science and geospatial analytic tools, and are informed by the largest team of country, banking, and sector risk analysts in the market. The country risk team has more than 110 dedicated analysts and data scientists.

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Methodology Appendix

Background on Country risk premium

Country risk is a key element, along with sector- and business-specific risk, used to value a company or project if located overseas, primarily in emerging markets. In the valuation process, this usually takes the form of a country risk premium (CRP) added to a given discount rate used to set internal hurdle rates and to calculate the net present value (NPV) of expected project cash flows. Over the years, country risk factors have been refined and have evolved as the demand for analytics has grown. Best practice in assessing a CRP involves a more nuanced and granular approach than simply using a single benchmark, such as a sovereign bond spread or CDS, as a proxy.

In their 2016 paper, [Turning Country Risk into Opportunity](#), the S&P Global co-authors of this paper, argue that when evaluating potential investments, companies need to quantify country risks in financial terms to more profitably evaluate, compare, and select investment opportunities. Further, current tools like sovereign risk indicators reflect only a limited view of commercially relevant risks and don't account for the significant variability of risks by sector.

Many financial institutions and companies base the CRP on the sovereign rating for the country where the investment is located. Several methods can be used to derive a value, but a popular benchmark used by many investors employs a three-stage methodology:

- Start from a sovereign rating (Baa2, B1, for example) for the country.
- Convert the rating to a bond default spread based on the observed relationship between rating class and the government bond spreads and CDS spreads.
- Adjust the default spread for the relative volatility of equities to bonds.

Increasing the discount rate by adding the CRP to the weighted average cost of capital (WACC) is the equivalent of reducing the expected future cash flows and thus the NPV of the project. In this way, the CRP can be said to account for potential losses associated with the various sources of country risk. However, the CRP value derived in this way from sovereign ratings is a single blunt number that does not distinguish between political risks faced by an investor.

There is significant value to be gained by considering the cash flow impacts of country risk as it varies not only by location, but also by sector and project specifics. To do this, country risk should be incorporated in the valuation of a new investment or existing business by adjusting cash flows for specific event impacts rather than by adding a one-size-fits-all value to the discount rate. This is what the S&P Global Country Risk Investment Model (CRIM) endeavors to do.

A more nuanced incorporation of country risk premiums in investment appraisals enables a more accurate view of individual investments and projects, as well as overall portfolio exposure to country risk. Further, it allows for a careful application of PRI, which is defined by the specific risks it covers in any particular coverage plan. A more detailed understanding of the impact of country risk on NPV can help companies make better investment decisions as well as enable more effective and cost-efficient risk mitigation strategies.

S&P Global Country Risk Investment Model (CRIM)

CRIM uses a “bottom-up” approach, where expected cash flow losses are calculated from individual specific risk scores and event thresholds, rather than a single central proxy. CRIM is able to measure the relative importance of each source of risk; thus, the results can be used to disaggregate the CRP into contributions from each risk event. From this, the precise country risk events covered by PRI can easily be identified.

CRIM calculates the contribution of each risk event to the CRP through simulations of the projects' cash flow forecast. Therefore, the results are affected by the variations in the composition of cash flows associated with different economic sectors and features of specific projects; results also reflect variations in sensitivity to individual risk events.

In individual countries or projects, the risk scores may be spread over a wide range — it is quite possible for a country to have low fiscal risk, but a high risk of political violence. Therefore, the applicability of each insurable event potentially covered by PRI may vary considerably by country and investment project. This is the way that political risk insurance underwriters generally would assess and price risk, rather than using a single risk score, such as a sovereign rating.

See [Appendix](#) for the list of the CRIM country risk factors and PRI insurable risks.



Adjusting the CRP to reflect purchase of political risk insurance – methodology

The study's initial hypothesis was that a well-crafted PRI policy should result in a non-zero improvement in the CRP, and that this should be captured for the benefit of investors when undertaking a valuations exercise.

The basic methodology for adjusting the country risk premium was to:

a. Map typical PRI coverages against country risk events included in CRIM.

For this exercise, Marsh provided S&P Global with their proprietary PRI template policy, which included essentially all the standard perils covered by the PRI market. S&P Global mapped their country risk factors against the policy coverage and compensation after discussion with Marsh. There was not a complete match as some of the CRIM factors are not covered by PRI and for others PRI does provide compensation, but on a catastrophic basis only, while CRIM factors in compensation on a partial loss basis. There were, however, a significant number of country risk events that did in fact correlate with insurable PRI perils².

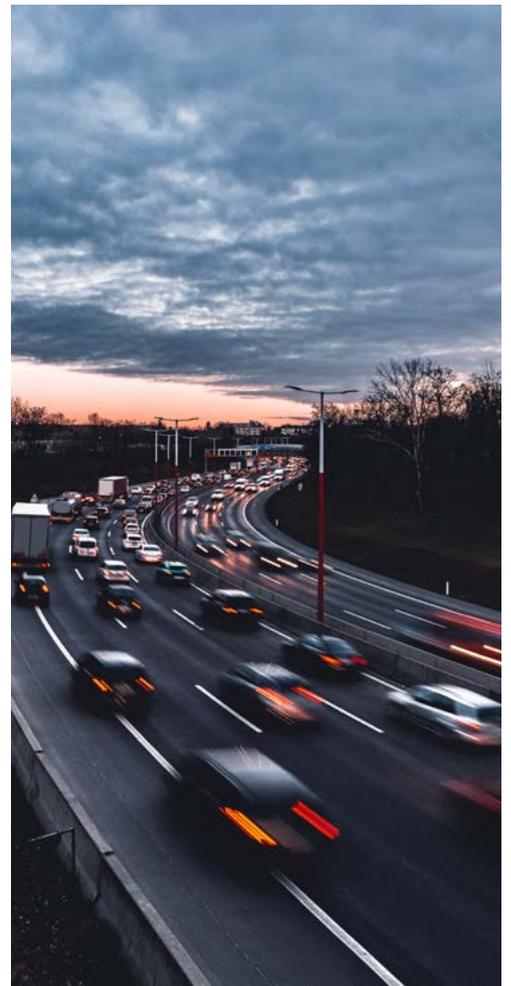
b. Project premiums. Based on the definitions of typical PRI cover and compensation, S&P Global identified the subset of country risk scores generated by CRIM to calculate expected cash flow losses arising from the risks associated with each insurable PRI type and to estimate from these scores the corresponding PRI premiums in order to analyze PRI costs and benefits.

c. Develop a model. S&P Global developed a model to evaluate from the insured company's point of view the direct benefits and costs of each type of PRI cover, and not just an overall package.

d. Evaluate the impact of PRI on CRP. S&P Global developed a system that uses the CRIM results to evaluate — by country and for different sectors — the impact PRI has on the country risk premium to be applied by investors (and financial institutions) when evaluating investment projects undertaken by companies in different countries and sectors.

In order to test the above methodology, we agreed on a sample transaction of an anonymized gas-fired power plant.

S&P Global used external and internal sources of information to produce a cash flow forecast for this type of investment, which was then used in the model that was developed and in the CRIM evaluations. To provide a comparative analysis, results were run for the same investment with an identical cash flow forecast in three emerging market countries for which we see continual high demand for PRI cover (and that also exhibit different sovereign ratings and CRP profiles), namely Ghana, Brazil and Indonesia.



² For example, corruption, natural disasters, currency depreciation/devaluation or construction material, energy and labor shortages or criminal violence - which are included in the 21 country risk events that S&P Global uses in CRIM [see next page for a full list of CRIM country risk events].

List of S&P Global factors included in CRIM



CORPORATE TAXES



SKILLED LABOR SHORTAGES



STATE CONTRACT ALTERATION



RECESSION



CONTRACT ENFORCEMENT



EXPORT DISRUPTION



EXPROPRIATION



IMPORT DISRUPTION



ENVIRONMENTAL REGULATIONS



INFRASTRUCTURE DISRUPTION



BUSINESS REGULATIONS



STRIKES AND PROTESTS



CAPITAL TRANSFER



MANMADE DISASTER



CURRENCY DEPRECIATION



NATURAL DISASTER



CONSTRUCTION MATERIAL SHORTAGES



CORRUPTION



ENERGY SHORTAGES



CRIMINAL VIOLENCE



LABOR COSTS

Menu of political risk coverages

Coverage	Protects owners of tangible assets and foreign direct investments against:	Compensation based on:
Expropriation	<p>Acts by the host government that interfere with fundamental ownership rights of the insured's investment including, but not limited to, confiscation and nationalization.</p> <ul style="list-style-type: none"> • Can also cover expropriation of funds, held in a deposit account in a host country. • Selective discrimination: Imposition of laws, orders, decrees, regulations, export restrictions, or import measures by a foreign government that are selectively and discriminately applied to a company or category of companies. 	Net investment value or net book value of the insured investments.
Forced abandonment	Abandonment of a foreign enterprise by the insured resulting from ongoing political violence in the host country or a relevant region physical damage is not required.	Net investment value or net book value of the insured investments.
Forced divestiture	Legal requirement by insured's own government ordering the insured to permanently divest itself of all or part of its shareholding in a foreign enterprise located overseas.	Net investment value or net book value of the insured investments.
Non-repossession, deprivation	Refusal or failure of the foreign government to allow the insured to exercise its right to repossess the insured equipment (when held as collateral for a lease or loan), in accordance with the terms and conditions of the agreement, or to remove the equipment or commodity from the foreign country.	Value of the insured goods.
Political violence	Physical damage to investments and assets located overseas caused by political violence (war, revolution, insurrection, strikes, riots, civil war, sabotage, and terrorism). Also can include willful destruction by the government of the host country.	Replacement cost if replaced; lesser of repair or replacement cost, or book value of equipment/assets if not replaced.
Arbitration award default	The risk of non-payment of an arbitration award obtained by a foreign investor against a host government or a state-owned enterprise, in accordance with the terms and conditions of a project agreement, such as a power purchase agreement.	The investor's share the amount of the unpaid award.
Business interruption	Financial losses to the insured directly resulting as a consequence of the insured's business operations having been interrupted by political violence physical damage or in some cases, expropriation.	Ongoing operating expenses, extra expense, and lost profit during the period of restoration. Usually sub-limited.
Inconvertibility/non-transfer	Delay or inability of a foreign enterprise to exchange local currency into hard currency or to repatriate funds to the insured parent corporation.	Estimated profits or dividends to be remitted, parent company loans to be repaid, for example. Usually sub-limited.
Government deprivation of creditor's rights	Deprivation by the host government of the insured's fundamental rights as a creditor in respect of a scheduled loan payment in default for reasons other than a covered political risk event, including rights against collateral security and/or commercial guarantees of repayment, thereby preventing the insured from enforcing security or receiving the proceeds of sale thereon.	Value of such collateral security or guarantees not realized as a result of government action.

Endnotes

1. Moody's has rated projects that rely on arbitration award default cover, which while not an absolute equivalent, do indicate the benefits of the PRI and the structure to the rating of the project bonds.

This is borne out by the Moody's report on the Energoatom project as described below:

"Central Storage Safety Project Trust (the Issuer) will issue approximately U.S. \$250,000,000 of senior secured notes maturing 2038 (the Notes) for the purpose of funding a senior term loan facility of up to \$250,000,000 (the Loan) to State Enterprise National Nuclear Energy Generating Company "Energoatom" (Energoatom or the Borrower), pursuant to a credit agreement between the Issuer and the Borrower (the Credit Agreement), and to fund related reserves. Energoatom is a state enterprise organized under the laws of Ukraine (Government of Ukraine, Caa2 positive), and is the largest electricity producer in the country, with nearly 15 gigawatts of nuclear capacity, contributing approximately 50% of Ukraine's electricity generation.

The political risk insurance policy provided by OPIC supports our view of likely lender recovery, and covers expropriation (defined in the policy as Non-payment of an Arbitral Award and Denial of Justice) in relation to the Credit Agreement and Guarantee;

On 18 January 2018, we assigned a Aa2 rating with stable outlook to the Notes, based solely upon our view of the credit benefit of a political risk insurance policy provided for the benefit of the Issuer by the Overseas Private Investment Corporation (OPIC), an agency of the government of the United States (Government of United States of America, Aaa stable), as described herein."

(Moody's Investors Service, Central Storage Safety Project Trust, January 22, 2018).

In the more recent November 5, 2021 "Rating Action: Moody's assigns a definitive Aa2 rating to Platinum's Blue Bonds for Belize Blue Investment Company", Moody's notes: "The proceeds of the Blue Bonds are lent by the Issuer ("Platinum Loan") to Belize Blue Investment Company, LLC ("BZBIC"), a special purpose company and an indirect subsidiary of The Nature Conservancy, VA ("TNC"; Aa2 stable). BZBIC provided a loan ("Blue Loan") to the Government of Belize (Caa3 stable), that is insured by the U.S. International Development Finance Corporation ("DFC"), under a political risk insurance policy covering non-payment of Arbitral Award and Denial of Justice."

Marsh Specialty's Credit Specialties practice and S&P Global are happy to discuss the conclusions and the application of these concepts to any overseas investment:

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