

# Operating risk in emerging markets



A report from the Economist Intelligence Unit

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## About this research

The Economist Intelligence Unit surveyed 177 executives around the world in October 2006 about their attitudes to operating risk management in the context of emerging market investments. The survey and paper were sponsored by ACE, IBM and KPMG.

Respondents represent a wide range of industries and regions, with roughly one-third each from Asia and Australasia, North America and western Europe. Approximately 50% of respondents represent businesses with annual revenue of more than US\$500m. Ninety-one percent of respondents have influence over, or responsibility for, strategic decisions on risk management at their companies.

Our editorial team conducted the survey and wrote the paper. The author was Alasdair Ross and the editor was Rob Mitchell. The findings expressed in this summary do not necessarily reflect the views of the sponsors. Our thanks are due to the survey respondents for their time and insight. We would also like to thank Riskcenter for its assistance in conducting the survey.



### Executive summary

Key findings from this research include the following:

- **A strengthening of emerging market investments.** In the past three years the vast majority of companies that already invest in emerging markets have deepened their investment in this area. Seventy-nine percent of respondents reported an increase in investment, 14% expected their level of investment to remain the same and only 7% reported a decrease.
- **A more favourable risk/return ratio.** As well as deepening their investment in emerging markets, respondents are also boosting the time and resources dedicated to risk management, with 66% reporting either a slight or significant increase. Fifty-five percent of respondents think that the risks associated with investing in emerging markets have increased in the past three years, but a slightly greater proportion (64%) report that the rewards have increased. In other words, respondents appear to think that the risk/return ratio is becoming more favourable.
- **Many companies do not adopt a formal approach to risk.** Although there is a clear recognition of the importance of operating risk in emerging markets, with the stability of the political regime identified as the single biggest threat, many companies still lack a formal process for assessing and managing such risk. Just 49% say that their company has a formal process for integrating political risk management into their investment process.
- **Risks force the cancellation of investments.** Concerns about political risk have forced 65% of respondents to cancel planned investments in

emerging markets, which suggests two important points: first, that these markets remain highly volatile; and second, that the due diligence processes of those questioned are fairly robust. More worrying is the finding that 26% have cancelled existing investments because of concerns about political risk. As well as indicating that these markets are subject to sudden upheaval, this finding could also demonstrate that, in some cases, investments are being made without assessing the true risks, or that companies are not spending enough time on ongoing risk management of existing investments.

- **Companies consult widely outside the company.** Respondents favour political and economic analysts as the main source of intelligence regarding operating risk in emerging markets, with 53% consulting the former as part of their risk management processes and 66% consulting the latter. Contacts in other companies are another important source of information, cited by 47% of those surveyed, while 40% consult the host government. This finding illustrates the importance of two types of risk information: independent, quantifiable data; and more qualitative information built around relationships on the ground.
- **Fewer than half of respondents perform an ongoing risk assessment.** For most companies the risk management effort is concentrated on the period when an investment opportunity is being considered. Eighty percent consider political and operating risk as part of the due diligence process, while only 44% monitor and manage risk on a continuous basis once the investment has been made. Given the fast-changing and volatile environment that characterises emerging markets, this absence of ongoing risk assessment is a worrying finding.



## Introduction

In the 25 years since the phrase was coined, emerging markets have seen mixed fortunes. Shaking off their status as junk-level exotics after the inflation-wracked 1970s and 1980s, they attracted attention as a high-risk, high-return asset class in the 1990s, as deregulation and privatisation brought an explosion of opportunity for investors.

A new bout of instability as the millennium came to an end served as a reminder of the link between risk and reward, with a succession of currency crises sounding uncomfortable echoes of earlier times. A few years further on, those echoes have faded; emerging markets have stabilised and entered a period of steady growth.

Healthy growth rates in the developed world, and in resource-hungry China, have driven up prices for the commodities upon which many emerging markets still depend. This has helped to assure a healthy balance-of-payments position and a comfortable foreign reserves cushion in central banks. At the same time, a huge amount of liquidity has flooded the international capital market, driving down the cost of finance and driving up the appetite for risk among corporate officers.

Emerging markets are safer, but the degree to which country risk has disappeared from the international bond market, reflected by the wafer-thin spreads on emerging market sovereign debt, is out of proportion with the improvement in economic fundamentals. These remain volatile markets where economic uncertainty can have a sudden and dramatic impact on the fortunes of foreign investors. In addition, and in spite of years of structural reforms, emerging markets remain prone to age-old vulnerabilities: corruption; weak government institutions; unreformed financial systems; patchy legal and regulatory regimes; and restrictive labour markets.

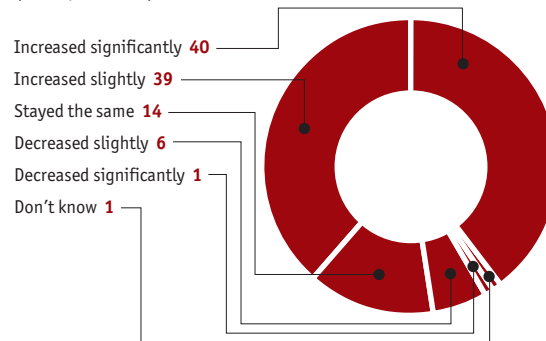
Thus, although emerging markets look a

considerably less risky bet today than five or ten years ago, it would be foolhardy to believe that the days of volatility have ended for good. Emerging market risk has not gone away. Indeed, because of the growing interdependence of the emerging and industrialised economies, managing it has become more critical than ever.

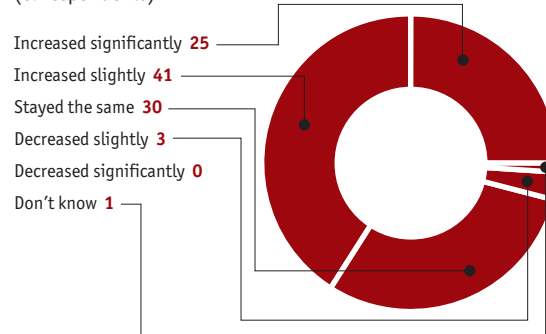
## A rising tide of investment

The attraction of emerging markets as an investment destination is clearly reflected in the findings of the survey conducted for this paper. Among those questioned, 79% said that their companies had increased the amount that they had invested in emerging markets over the past three years. Only 7%

**In the past three years, how has the extent of your organisation's investments in emerging markets changed?**  
(% respondents)



**In the past three years, how has the amount of time and resources that your organisation devoted to political and operating risk management changed?**  
(% respondents)



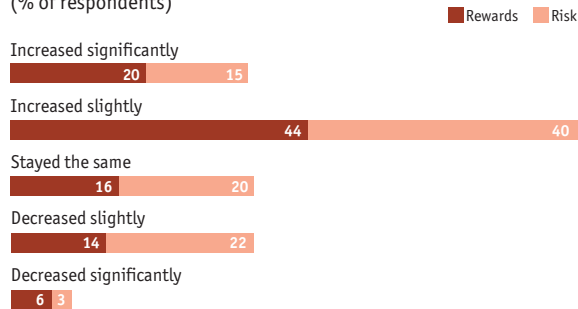
Source: Economist Intelligence Unit.



## Operating risk in emerging markets

**Thinking of your organisation's investments in emerging markets, how do you think the levels of both risk and reward have changed over the past three years?**

(% of respondents)



Source: Economist Intelligence Unit.

had seen a decline in investment.

As might be expected, this rise in investment has been accompanied by an increase in the amount of time and resources devoted to managing risk in emerging markets, although the percentage of respondents who reported a rise—66%—is slightly lower than the percentage who reported an increase in overall investment.

At first glance, these figures seem surprising, because they suggest that the time and resources that companies devote to risk management is lagging behind the extent of their investments. This may not be the case, however. In cases where companies are investing in new operations or markets, an increased focus on risk management is to be expected. A reported increase in overall investment, however, would also include cases where companies are devoting more resources to existing operations, for which there would often be no requirement for additional risk management.

At the broadest level, however, the reason for the rising tide of investment in emerging markets is also clear from our survey: the risks associated with the asset class have risen, but the rewards have increased even more.

Fifty-five percent of respondents said that risk had risen in the past three years, while only 25% said that it had declined, with 20% reporting it

unchanged. In the same period, however, the rewards on offer in emerging markets had increased for 64% of respondents, and decreased for only 20% (still a notable proportion, especially given the finding that just 7% of respondents are actually cutting back their investments).

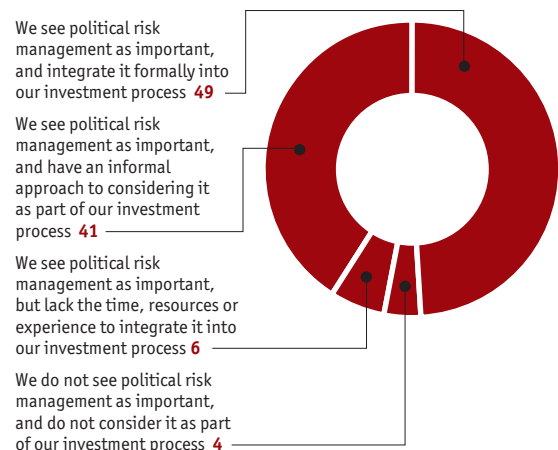
## Politics is the biggest risk

Although most people feel they know an emerging market when they see one, the phrase is hard to define (*see box*). One widely quoted description says that an emerging market is one where politics matters at least as much as economics. This is because political institutions in emerging markets tend to be weak, and power is often captured by an unrepresentative elite. In such conditions, the process by which laws and regulations are drafted and applied is easily subverted, which means that investors can face a changeable and unpredictable operating environment.

For these reasons, political risk management is of particular importance for companies that operate in emerging markets. This is reflected in our survey, where 96% of respondents said that they recognised

**Which of the following statements best describes your organisation's attitude to political risk management?**

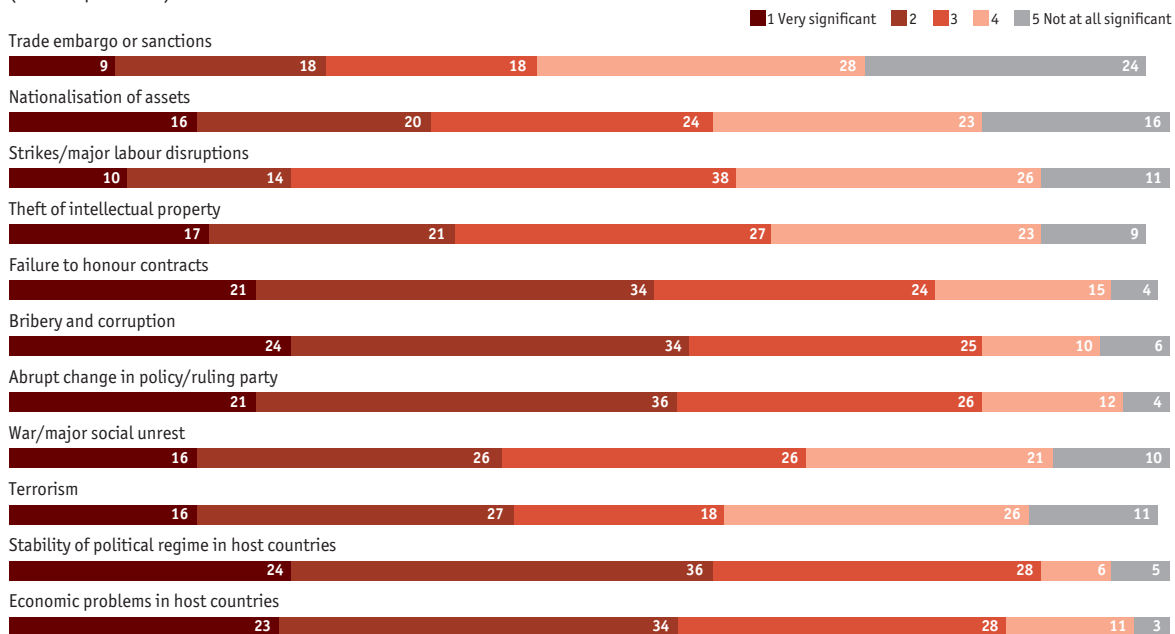
(% respondents)



Source: Economist Intelligence Unit.



**How significant do you consider the following risks to be in the context of your organisation’s emerging markets investments?**  
(% of respondents)



Source: Economist Intelligence Unit survey.

that political risk is important to their operations. There is considerable variance, however, in the approaches taken to manage political risk.

Only 49% of respondents said that they had a formal process for dealing with political risk management; 41% deal with it on an informal basis; and 6% say that they recognise its importance, but lack the resources to consider it at all. Given the importance of political risk management to the success of emerging market investments, it is perhaps surprising that such a high proportion lacks a formal approach to its consideration. While an *ad hoc* approach at least demonstrates some commitment to risk management, it will leave companies exposed to a far greater level of risk than a formal approach, which by definition implies a systematic consideration of the changing operating environment.

When asked to identify the key operating risks that they face, respondents selected stability of the political regime as the main threat, with 60% citing it as either significant or very significant. The extent of

disruption and policy shift that accompanies regime change can vary considerably, and is likely to be more acute in emerging markets. Consider, for example, the difference in impact between two contested elections: following the close-run US presidential election in 2000, the market was barely affected even though the Supreme Court was needed to decide the outcome; by contrast, the Czech Republic is still struggling to overcome the failure of the June 2006 election to produce a clear winner.

Bribery and corruption, encountered everywhere, but especially prevalent in emerging and undeveloped markets, is second on the list of concerns and seen as significant or very significant by 58% of respondents. Abrupt changes in policy is third on the list, cited by 57%, along with economic instability in the country hosting investment, also cited by 57%. Failure to honour contracts, a factor related to the often arbitrary nature with which political power is wielded and to the inefficiency and partiality of legal and regulatory systems, is next, cited by 55% of respondents.



### In search of a definition

What makes an “emerging” market? Compared with developed markets, measures such as relative economic wealth and sophistication clearly matter, as do wealth measured by income per head, sophistication by diversity of product, degree of capital intensity and the contribution of high value-added activities. There is also an implied direction in the term: to qualify, these should be markets that are emerging rather than submerging, at least on average.

There are numerous other elements associated with being an emerging market. The first is a high degree of volatility in growth rates, with the boom-and-bust cycle of the developed world exaggerated into a roller coaster of vertiginous increases and precipitous declines. The second is an immature political system. These run from the serial dictatorship to the flawed

multi-party democracy, but they have a tendency to personalise authority in a way that undermines rules-based life.

As a result, emerging markets can be difficult environments in which to operate, but they also have a number of attractions that persuade many companies to make the effort. One is the prevalence among them of territories rich in the natural resources required by the industrialised world. Oil is the most important, and international oil companies have been among the earliest and most energetic investors in emerging markets. Coal, copper, gold, lead and a range of other minerals also serve as potent lures for investors.

More recently, however, it has become the human resources of emerging markets that are most likely to attract investors, both as a market for goods among a growing middle class and as a source of relatively cheap labour.

Few markets can claim to have crossed the watershed into developed market status.

By one measure, the achievement of an investment-grade credit rating, Mexico has done so, but few would be prepared to declassify the country just yet. The Asian tigers of Hong Kong, Taiwan, Singapore and South Korea were on a rapid convergence course in the mid-1990s, but were knocked back by the rolling currency crisis of 1997. Brazil, Russia, India and China, the so-called BRICs, are expanding rapidly, but none will be considered developed for a few years yet, even in the best circumstances.

For organisations seeking to sell in new territories or diversify their production base, however, there are two key issues: first, whether economic growth will be sustained; and second, whether the operating environment is consistent with long-term profitability. For a growing number of markets, the latter can be answered in the affirmative with increasing confidence. With regard to the former, the recent run of economic expansion is too brief an episode to warrant anything but cautious optimism.

### Staying informed

If information is the most valuable commodity in any market, it is in the nature of emerging markets that information is particularly difficult to obtain. Who, then, do companies consult when they are evaluating an investment target or assessing risks to existing assets?

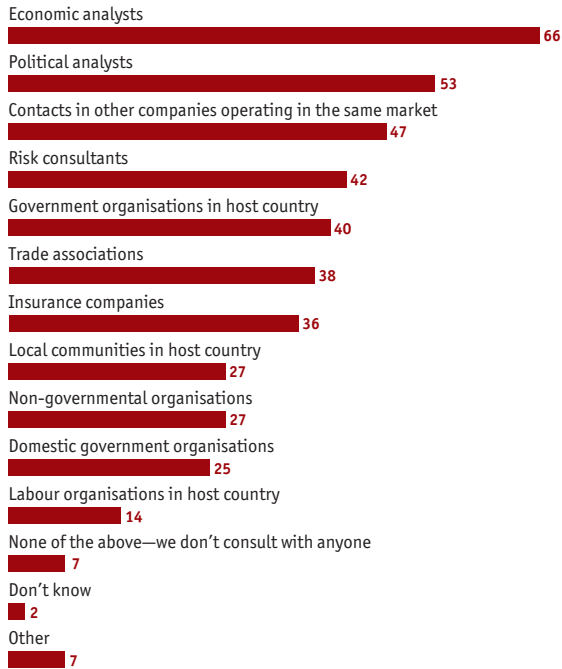
In the context of emerging markets, executives are looking for measurable data on the operating, economic and political environment that they can use to make comparisons between countries and guide them in their decision processes. Our survey suggests that independent sources of analysis, such as the Economist Intelligence Unit, are the first port of call, with 66% saying that they consult economic analysts and 53% that they consult political analysts.

In addition to formal analysis, companies also need to build direct relationships on the ground so that they gain a better understanding of the nuances of a particular market. One of the most effective ways to do this, according to the respondents, is by engaging with other companies (including competitors) that are operating in the same market, a category that is cited by 47% of respondents. This finding reflects the particular nature of competition in emerging markets, where sharing a common purpose may sometimes count for as much as courting the same customers.

Government organisations in the host country are also identified as an important source of information, with 40% of respondents saying that they consult them. This finding would resonate with many emerging market governments, which invest substantial resources in attracting and facilitating



**Which of the following does your organisation consult as part of its political or operating risk management processes?**  
(% respondents)



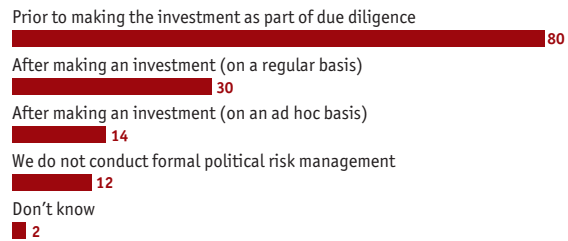
Source: Economist Intelligence Unit survey.

foreign investment and would no doubt like to be seen as valuable sources of market intelligence. More importantly, however, it reflects the reality that few foreign investors in emerging markets will get far without engaging with the host government and ensuring that they gain support for the investment.

**Due diligence, then complacency?**

Gaining access to the best information is most critical when companies are preparing an investment strategy. The one-off costs associated with making the wrong decision about where to invest, or in what, can be devastating, and the mistake can depress earnings over many years. It is no surprise, then, that 80% of respondents said that they conducted political and operating risk management prior to making an investment as part of the due diligence process.

**At which stages does your organisation usually conduct political and operating risk management of emerging market investments?**  
(% respondents)



Source: Economist Intelligence Unit survey.

While the initial strategic decision about whether to invest is undoubtedly critical, careful monitoring of investments on an ongoing basis is also important to detect any changes in the environment. The single most reliable characteristic of emerging markets is that they are volatile, even in these times of strong growth and stability. The conditions in place when a company entered the market may be transformed within a few years, or even a few months; labour codes and tax regimes can be reformed, regulations drafted or scrapped, political power brokers may rise or fall, while transfer risks can emerge without warning.

It is therefore concerning that a relatively low proportion of respondents seem to conduct regular ongoing risk assessment, with only 44% reporting that they continued their risk management efforts after the initial investment had been made, and only 30% saying that they did so on a regular basis. This suggests that many companies with investments in emerging markets are overly complacent about the risks that they face.

It is unreasonable to expect that a risk assessment made at the outset of an investment will protect operations over the longer term. Foreseeing and preparing for the kind of threats that plague emerging markets requires permanent and continuous risk assessment, preferably within a formal, enterprise-wide framework. The findings from our survey, however, suggest that this approach is the exception rather than the rule.



## Operating risk in emerging markets

**Have concerns about political risk in a host country ever caused your organisation to cancel either of the following?**  
(% of respondents)



Source: Economist Intelligence Unit survey.

### Cancellation of investments

The high-risk nature of investment in emerging markets, even in these days of relative stability and optimism, is reflected in the extent to which organisations are sometimes forced to change plans as a result of political risk concerns. Among respondents, 65% reported that they had cancelled a planned investment as a result of such concerns.

In many cases, this could simply be an illustration that companies are conducting robust due diligence prior to making an investment. It is, of course, preferable to cancel a planned investment if there are good reasons for doing so than to press ahead regardless.

A far more serious and costly situation arises when companies are forced to cancel existing investments because of concerns about political risk. Fewer respondents have ended up in this position, although still a relatively sizeable 26%. In extreme cases, the cancellation of an existing investment because of political risk concerns may be appropriate but, often, this eventuality could be prevented by carrying out careful due diligence and ensuring that the risk situation is continuously monitored.

### Degrees of confidence

When asked how they rate their organisation's capabilities in managing different aspects of risk management, respondents are most confident about their ability to assess risks and report on them to key managers and executives. Despite the fairly low proportion of respondents that monitor risk with existing investments, this is an area in which

respondents feel confident, with 50% rating their company as capable in this area. Meanwhile, only 47% felt the same regarding new investments.

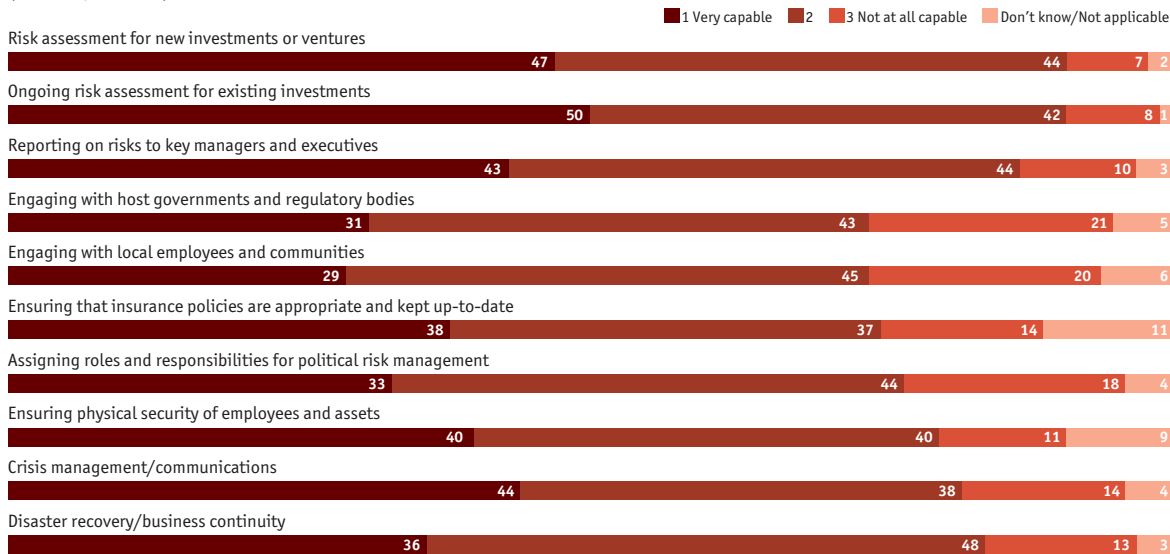
How to explain this apparent contradiction? One possibility may be that companies think that, even without formal risk management processes, the kind of informal dialogue that goes on between local markets and central management is sufficient to stay abreast of emerging risks. Alternatively, local markets may simply be left to get on with their own *ad hoc* risk assessment and, because no major incident has happened yet, there is an assumption that this process is working fine. Neither approach is to be recommended: by limiting themselves to informal dialogue on risk, managers may have only a partial knowledge of the situation; and by leaving risk to local markets, the business may unknowingly be exposing itself to risks that it would prefer not to take or that are inconsistent with its defined risk appetite.

Another area in which respondents professed confidence was their ability to report on risks to key managers and executives, with 43% saying that they are capable in this area. The flow of risk information around the organisation is a key function of a strong, enterprise-wide risk management framework, and formal processes to facilitate this are essential to ensure that relevant information reaches the right people.

However, while respondents seem relatively comfortable about putting in place processes to assess and report on risks, they are much less confident about some of the softer, relationship-driven aspects of risk management. Only 33% endorsed their company's ability to assign roles and responsibilities



**How would you rate your organisation’s capabilities in managing the following aspects of political or operating risk management?**  
(% of respondents)



Source: Economist Intelligence Unit survey.

in risk management, 31% felt that they were doing a good job of engaging with host governments and 29% thought that their companies were engaging well with local communities and employees.

## Tools of the trade

Once the risks facing a company have been identified, the risk manager must next decide what to do about them. Respondents to our survey quoted a range of options.

The technique that was considered most effective, selected by 63% of respondents, was the use of a joint venture or alliance with a local company. The use of joint ventures is a well-trodden route to investing in emerging markets. It enables companies to share risk and has the advantage of providing investors with a limited exposure, while leaving open the possibility of deeper involvement further down the line. Moreover, in some countries or sectors, the joint venture may be the only entry strategy available to foreign investors due to legislative constraints.

While there are advantages to the joint venture approach, however, there are also risks to consider.

In markets where credit ratings and other risk information are scarce, it can be difficult to determine the trustworthiness of a potential partner. Furthermore, once a joint venture is up and running, the objectives of the partners may diverge, making the partnership difficult to manage and sometimes forcing an early termination of the agreement.

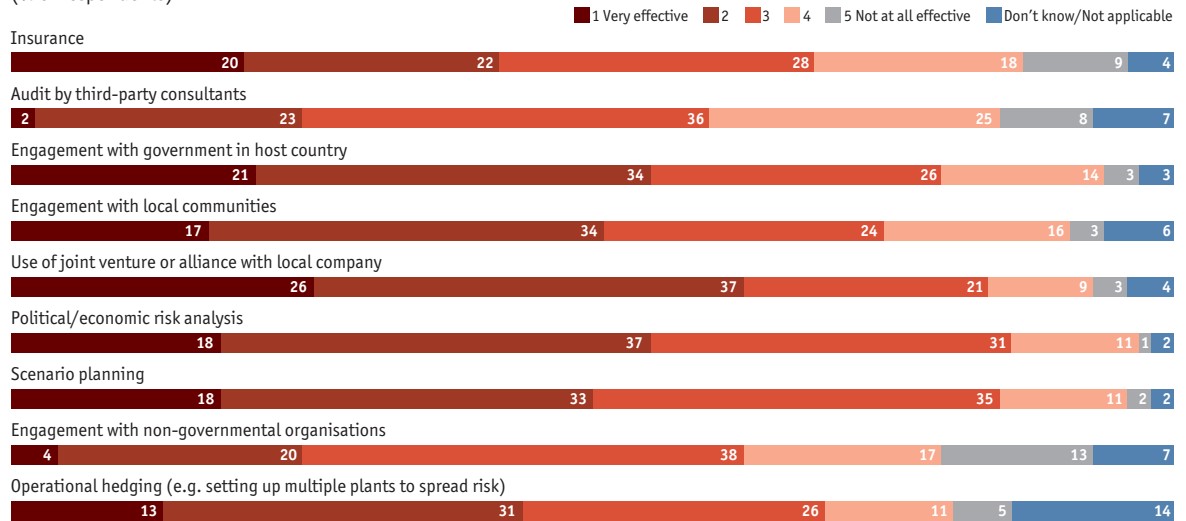
Engagement with governments in host countries—an area where respondents felt that their capabilities were not particularly strong—is also seen as an effective way of managing risk, cited by 55% of respondents. Although this is unlikely to be sufficient alone as a method of mitigating the risks to a new operation, there is a good chance that, in many emerging markets, no investment will prosper without it.

Political and economic risk analysis, whether conducted internally or with the help of organisations such as the Economist Intelligence Unit, is also seen as an important technique, and is cited by 55% of respondents as either effective or very effective. The related discipline of scenario planning which, as earlier reports in the *Global Risk Briefing* series have



## Operating risk in emerging markets

**How effective do you think the following techniques are as a means of mitigating political risk in the emerging markets where your organisation operates?**  
(% of respondents)



Source: Economist Intelligence Unit survey.

indicated, has become a widely used technique for managing risk, is seen as effective or very effective by 51% of respondents.

Engaging with local communities was also considered an effective technique by 51% of respondents. Although undoubtedly important in some sectors that require a large workforce drawn from local communities, such as mining, agriculture or manufacturing, this may be less relevant for those industries that are most heavily represented in our sample, such as the financial and professional services sectors. As a result, this finding seems somewhat surprising.

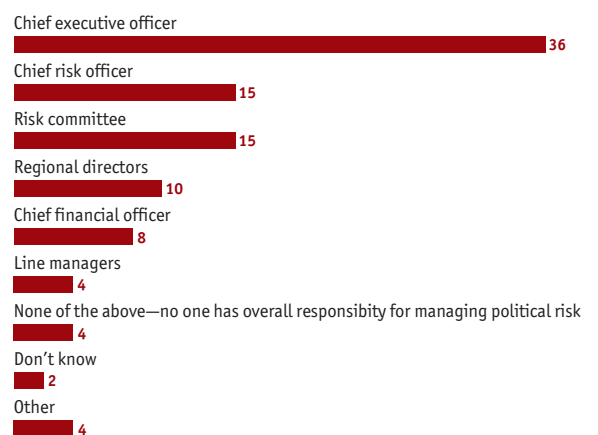
### Who is in charge?

The research carried out under the *Global Risk Briefing* programme has repeatedly indicated the importance of ensuring that risk management is conducted at an appropriately senior level in the organisation. The survey confirms this view among companies operating in emerging markets; 59% of respondents reported that responsibility for risk management in their organisation was with the 'C' suite of executives:

either the chief executive officer (36%), the chief risk officer (15%) or the chief financial officer (8%). A further 15% use a risk committee, which is a high-level cross-functional group that co-ordinates risk management across business divisions. In only 4% of cases was it reported that nobody had overall responsibility.

### Who is primarily responsible for managing political risk management in your organisation?

(% respondents)



Source: Economist Intelligence Unit survey.



## Conclusion

The growing market power of the emerging economies and their increasing integration into the global economy will ensure their relevance to transnational corporations for years to come. Our survey demonstrates that companies are aware of this, and are expending increasing resources on managing the associated risks.

It also suggests, however, that the focus tends to be on testing the ground for planned investments, rather than on monitoring and managing risks to

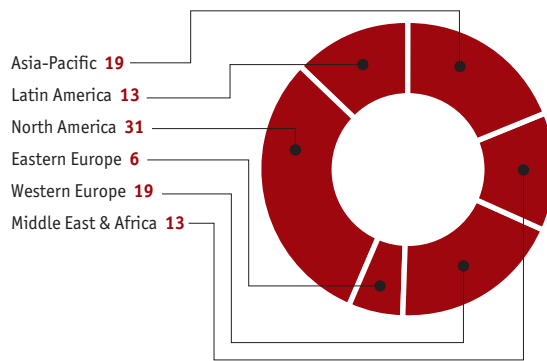
existing operations. This complacency is dangerous. Volatility is a defining feature of emerging markets and political risk will linger even as their contribution to global trade and economic activity grows.

Companies that fail to recognise the continuous nature of risk in emerging markets may be exposing themselves to big losses in future. Where emerging markets have become a critical element in an organisation's business model, such losses could prove catastrophic.

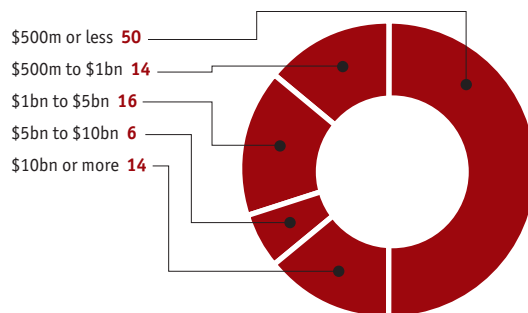
## Appendix

During October 2006, the Economist Intelligence Unit surveyed 177 executives from a range of regions and industries. Please note that not all answers add up to 100%, because of rounding or because respondents were able to provide multiple answers to some questions.

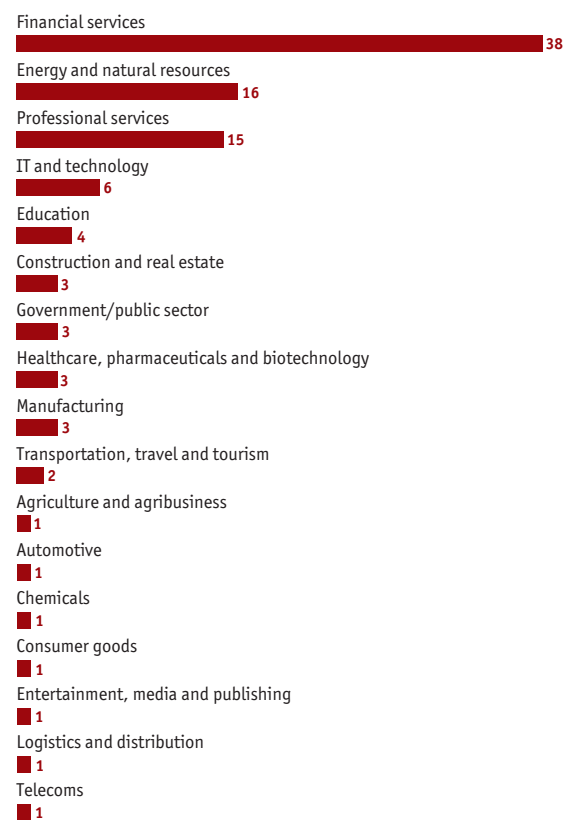
### In which region are you personally located? (% respondents)



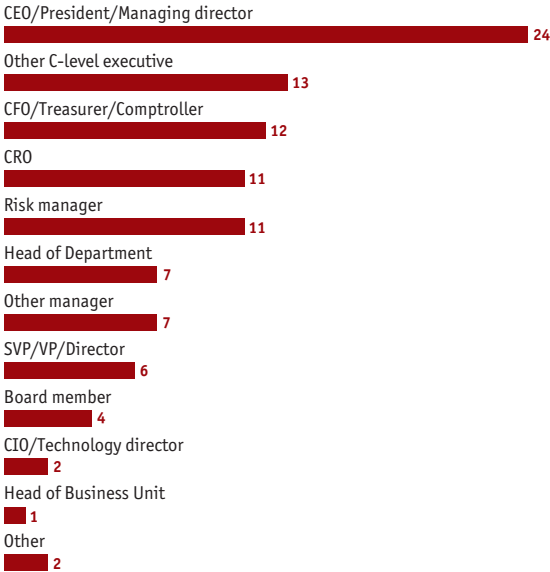
### What are your organisation's global annual revenues in US dollars? (% respondents)



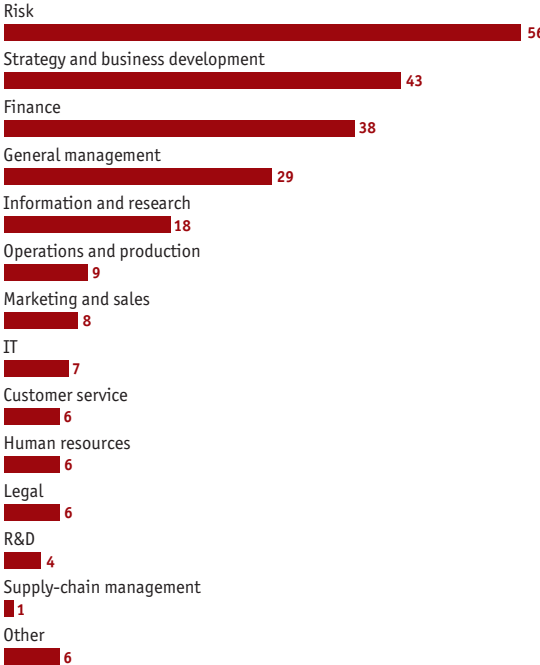
### What is your primary industry? (% respondents)



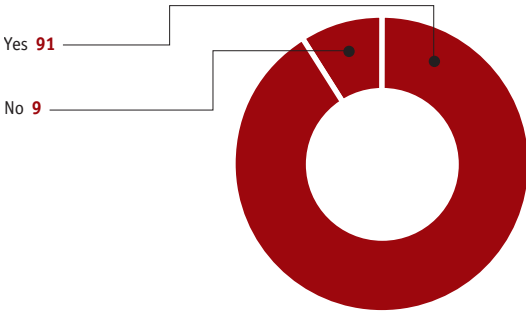
**Which of the following best describes your title?**  
 (% respondents)



**What are your main functional roles?**  
 Please choose no more than 3 functions.  
 (% respondents)



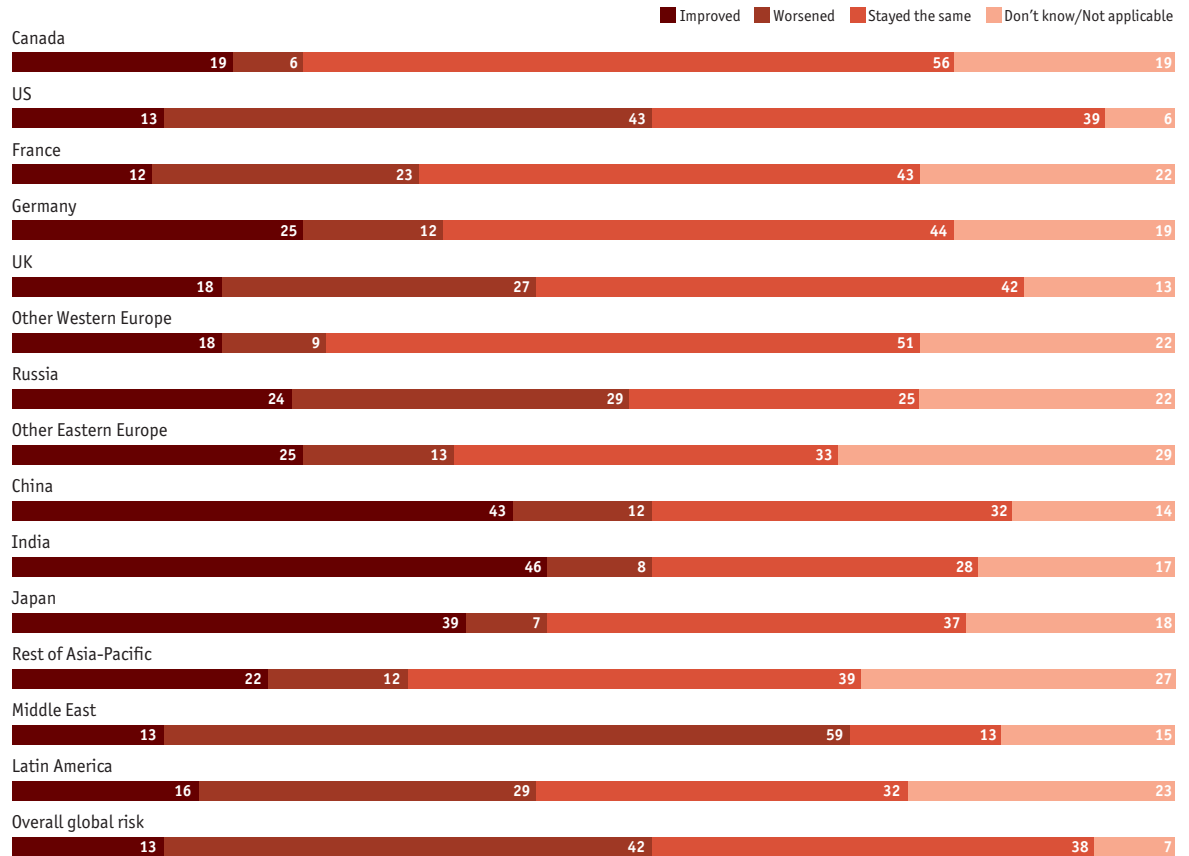
**Do you have responsibility for, or influence over, strategic decisions on risk management in your company?**  
 (% respondents)



## Appendix

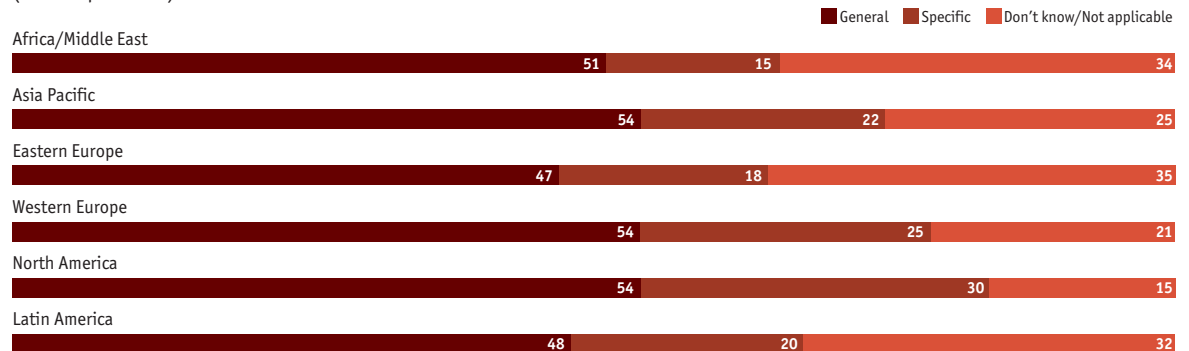
### Operating risk in emerging markets

Over the past three months, do you think the business environment has improved or worsened in the following countries or regions?  
(% of respondents)

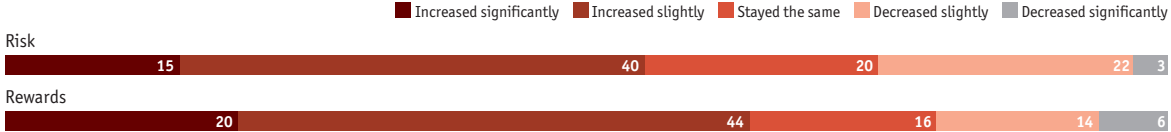


In each of the following regions, are the majority of risks to your business considered to be general (i.e. likely to affect many other companies operating in the same location or industry) or specific (i.e. relating to your organisation's internal systems, processes or people)?

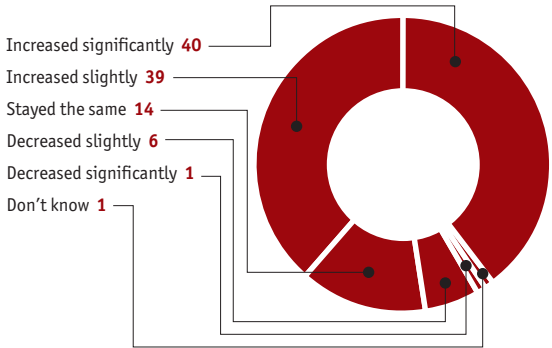
(% of respondents)



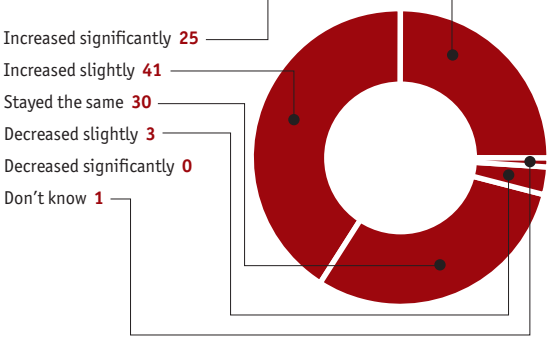
**Thinking of your organisation's investments in emerging markets, how do you think the levels of both risk and reward have changed over the past three years?**  
(% of respondents)



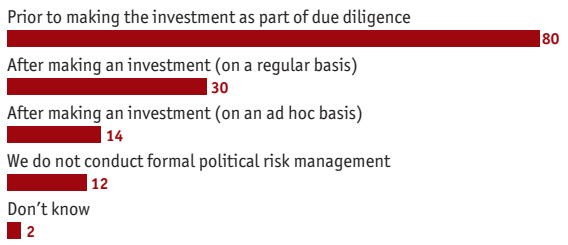
**In the past three years, how has the extent of your organisation's investments in emerging markets changed?**  
(% respondents)



**In the past three years, has the amount of time that your organisation dedicates to political and operating risk management of emerging market investments changed?**  
(% respondents)



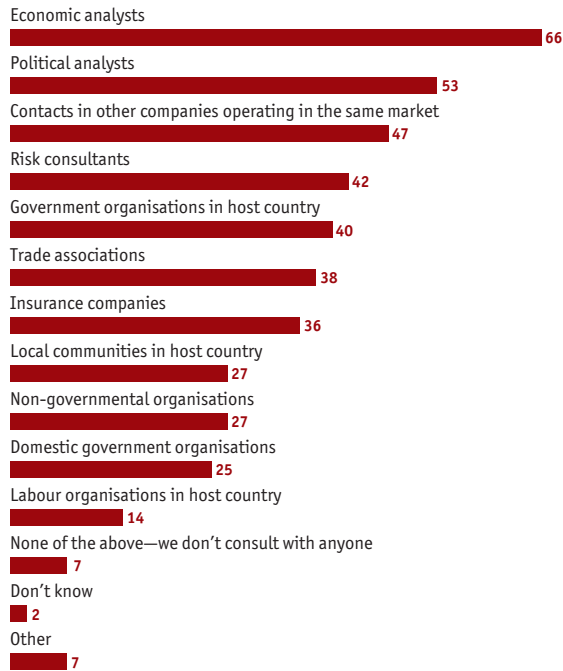
**At which stages does your organisation usually conduct political and operating risk management of emerging market investments?**  
(% respondents)



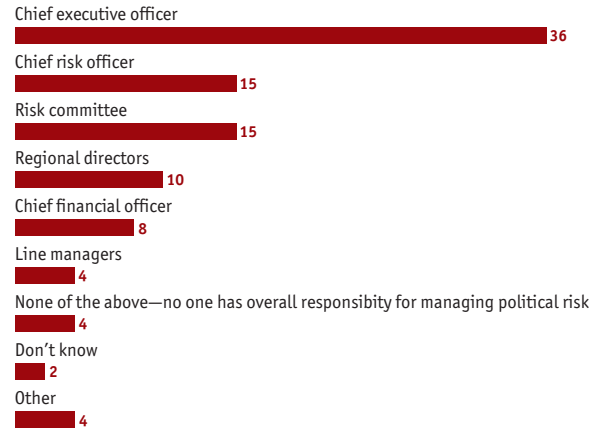
## Appendix

### Operating risk in emerging markets

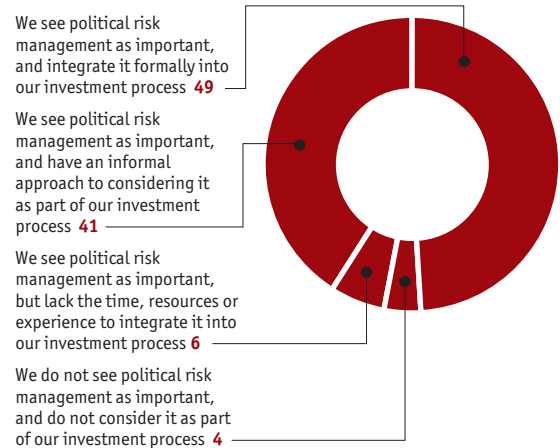
#### Which of the following does your organisation consult as part of its political or operating risk management processes? (% respondents)



#### Who is primarily responsible for managing political risk management in your organisation? (% respondents)

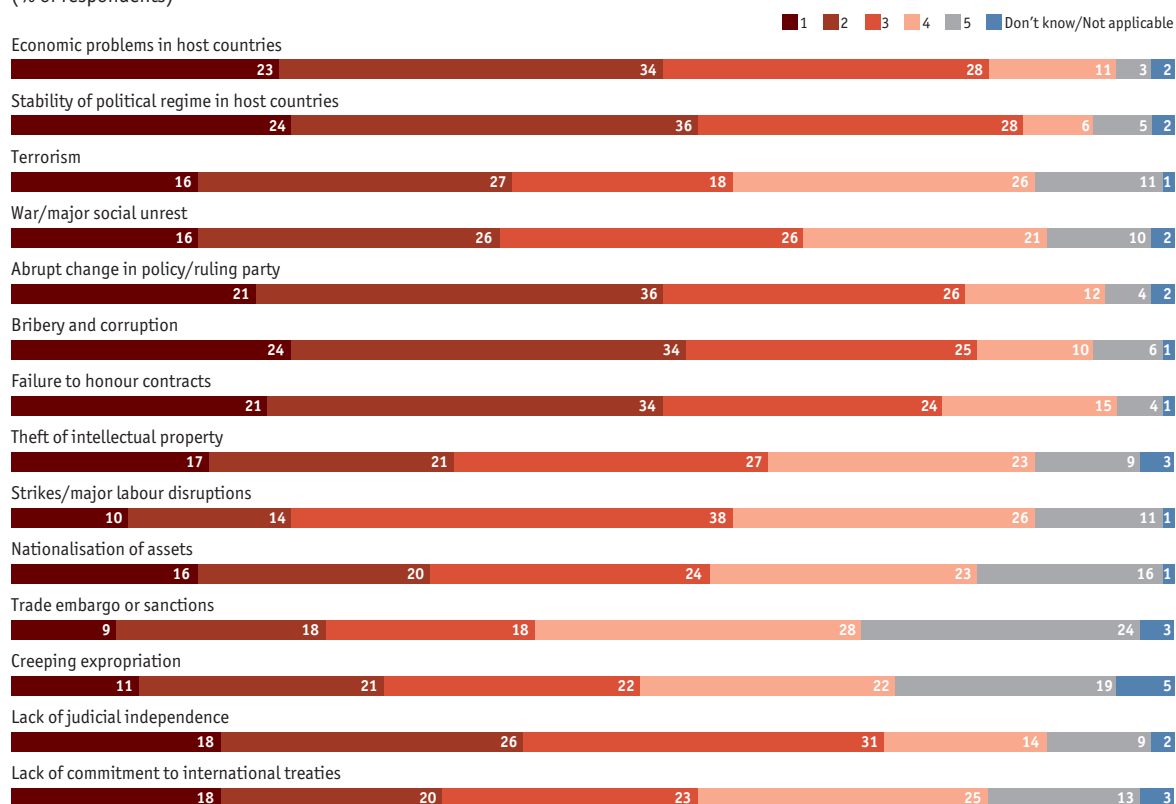


#### Which of the following statements best describes your organisation's attitude to political risk management? (% respondents)



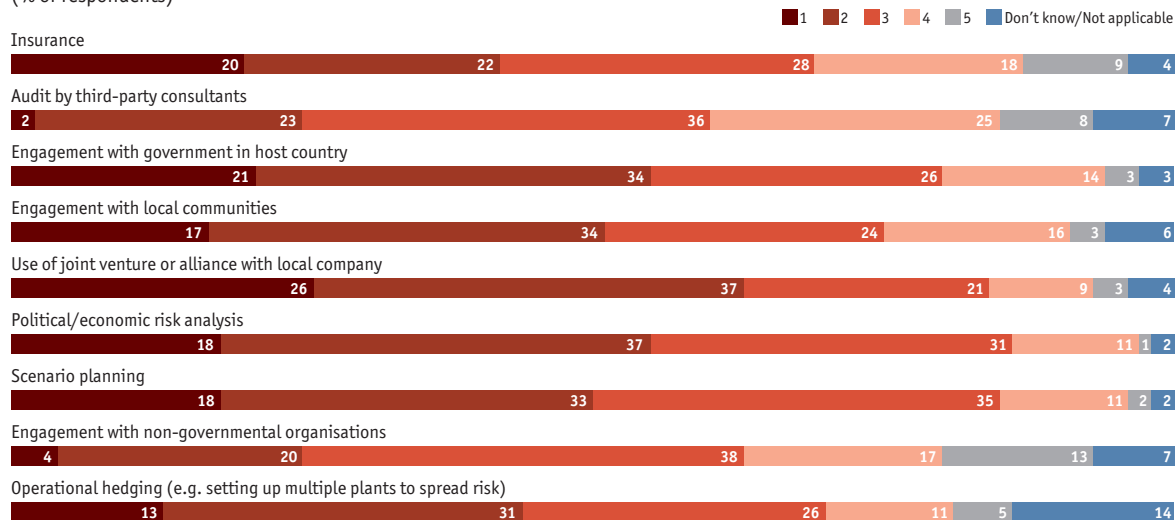
**How significant do you consider the following risks to be in the context of your organisation's emerging markets investments?**

(% of respondents)



**How effective do you think the following techniques are as a means of mitigating political risk in the emerging markets where your organisation operates?**

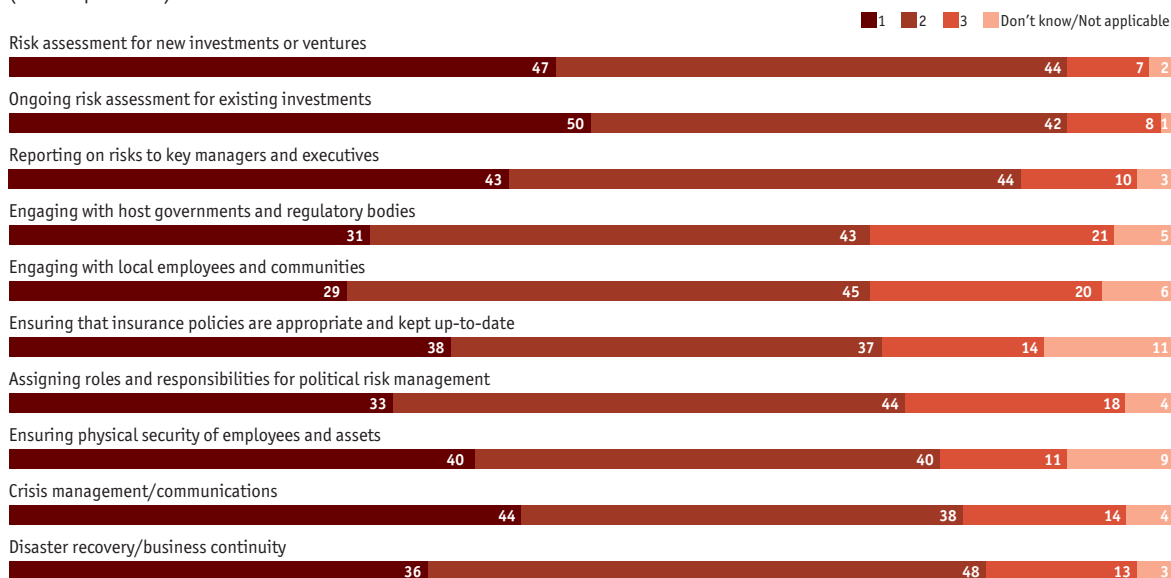
(% of respondents)



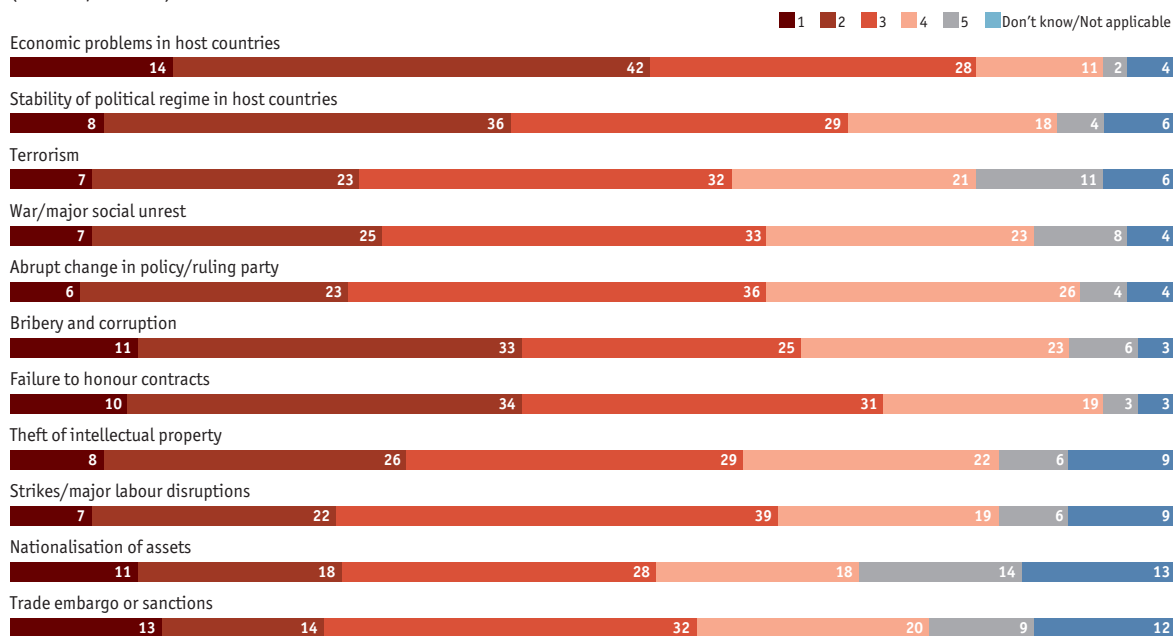
## Appendix

### Operating risk in emerging markets

**How would you rate your organisation's capabilities in managing the following aspects of political or operating risk management?**  
(% of respondents)



**How confident do you feel that your organisation has taken adequate precautions against the following risks in emerging markets?**  
(% of respondents)



**Have concerns about political risk in a host country ever caused your organisation to cancel either of the following?**  
(% of respondents)



**Please indicate whether you agree or disagree with the following statements.**  
(% of respondents)



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## ACE Political Risk

As one of the most experienced political risk insurers in the world, ACE offers innovative and comprehensive solutions that deliver confidence, security and peace of mind to clients across the globe. ACE possesses broad knowledge and understanding of the intricacies of country and credit risk and continues to lead ongoing development in this field, including the evolution of many political risk lines.

ACE provides cost-effective strategies to mitigate cross border risk. Solutions are customer driven, but designed around 4 categories:

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### **Exporters and importers**

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Solutions protect equity investors (FDI) against the risk of loss of a foreign enterprise due to government action or political force majeure.

### **Contractor's plant and equipment**

Solutions provide protection against the risk of loss of plant and equipment due to government action, war or political violence.

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