REPORT OF COMMITTEE TO COOPERATE WITH THE INTERNATIONAL COOPERATION ADMINISTRATION

(Agency for International Development)

Certain contracts which are being made available by the International Cooperation Administration (now the Agency for International Development) covering investment guaranties in foreign countries have been the subject of a study by your Committee as the result of a request submitted by the ICA to the Casualty Actuarial Society for review and actuarial comment. The Casualty Actuarial Society, as a public service, agreed to cooperate with the ICA. The submission was in the form of a request for answers to specific questions. Pursuant to the appointment made by Mr. William Leslie, Jr., President of the Casualty Actuarial Society, Messrs. Frank Harwayne, Chairman, Charles C. Hewitt, Jr., and N. Matthew Franklin, actively conducted an investigation of the matter submitted.

The Committee made use of all available material, corresponded with Mr. Laurence E. Potter, Associate Chief, Investment Guaranties Division of the ICA, held several meetings during the year and met with the ICA in Washington, D. C.

A brief summary of the nature of the ICA program is in order.

PURPOSES OF THE ICA CONTRACTS

Pursuant to Act of Congress, the ICA is authorized to issue guaranties on investments in foreign projects which are approved by the President as furthering the development of economic resources and productive capacities of economically underdeveloped areas.

"The risks which may be covered by guaranties are:

a. Inability to convert foreign currency receipts into dollars.
b. Loss through expropriation or confiscation.
c. Loss from damage to physical assets caused by war.

". . . The Government does not offer guaranties against failure to make a profit, general devaluation of a foreign currency, inability or failure of a borrower to repay due to a decline in his assets, or against other normal business risks that attend any investment. But it does, subject to the conditions stated below, offer a practical means of insuring against three of the chief dangers which have troubled prospective American investors abroad in the past."[1]

A capsule description of the content of these guaranties follows:

a. *Convertibility Guaranty:*

"An ICA convertibility guaranty contract provides protection against the risk of inability to convert investment receipts into dollars from the cur-

[1] Investment Guaranty Handbook, p. 1. See also Export-Import Bank and The Foreign Credit Insurance Association.

rency of the country in which the investment is made. Both transfers of earnings and repatriation of capital are protected.

"The convertibility guaranty contract in essence insures that a means, available at the time the contract is issued, for converting foreign currency investment receipts into dollars will continue for the life of the contract. Thus the ICA will not guaranty convertibility in the face of exchange regulations and practices under which it would be clear at the time a contract was issued that conversion could be effected only through the guaranty."[2]

b. *Expropriation Guaranty:*

"Governments expropriating property of foreign investors may offer compensation in some form and amount. This compensation may, however, be unsatisfactory to the investor and may involve negotiation and litigation.

"It is frequently in the form of securities or foreign currencies which cannot freely be converted into dollars. By means of an ICA expropriation guaranty contract, American investors may assure themselves that they will be compensated by the United States Government, in the event of expropriation, in dollars, in accordance with a formula for determining loss which is fixed in the contract.

"A guaranty against loss by reason of expropriation is also protection against confiscation (a taking without compensation), such as may occur if an unfriendly government succeeds to power in a country where a guarantied investment has been made."[3]

c. *War Risk Guaranty:*

"This guaranty will protect against loss resulting from direct damage to the depreciable physical property of a foreign enterprise caused by war, whether or not under formal declaration, including any hostile act by any national or international force as well as action taken by the government of the project country in hindering, combatting, or defending against an actual pending or expected hostile attack. This does not include consequential damage whether caused by a peril guarantied against or otherwise, or damage caused by civil war, revolution, rebellion, insurrection, or civil strife arising therefrom or action taken by governmental authority in hindering, combatting or defending against such occurrences, or as a consequence of such occurrences."[4]

Each guaranty described above is issued for a "fee" which is expressed as a percentage per year of the face amount of the guaranty. Unless sooner terminated by the risk, the guaranty may continue in effect up to 20 years.

[2] Ibid. p. 13.

[3] Ibid. p. 17.

[4] Ibid. p. 21.

Certain guaranties which were originated under the Development Loan Fund may have been authorized for longer periods (i.e., the Valco project). Although the use of the term "insurance" is avoided, there is apparently the hope that sufficient "fee" income could be accumulated so as to cover any significant losses which ultimately may be incurred under the guaranties. Therefore, to a certain extent there is some expectation that elements of the insurance mechanism would come into play here.

The actual report to the ICA follows:

REPORT TO THE INTERNATIONAL COOPERATION ADMINISTRATION

A review of the history and background of the Investment Guaranty Program convinces this Committee that the will of Congress goes beyond a pure insurance program. From the inception the Committee resolved to confine its expertise to the actuarial aspects of the program. It has attempted to isolate those elements of the program which are of an actuarial nature and has confined its attention thereto. The results of the Committee's activities take the form of answers to the specific questions posed by the ICA.

The conditions under which actuarial standards may be applied presuppose that there will be substantial continuity of valid and reliable experience. Under such circumstances past experience may be used as a guide to the future. If there is to be no continuity as to the significant nature of the exposure, then past experience, even if reliable to an acceptable level of confidence and whether favorable or unfavorable, is invalid, irrelevant and of doubtful value in measuring potential experience. Moreover, as the program contemplates free entry and egress from the conditions of the contract, it is important that the "fees" or premiums reflect the best estimates of costs to be incurred during the life of the contract. Adjustment of premiums or "fees" should not be contemplated for recoupment for adverse past experience. In this connection it is important to consider the role which the maximum authorized guaranty funds of $200 million (in United States Treasury Notes) plays in the program. It is the current belief of ICA representatives that, should it become necessary to draw upon these funds for payments under the guaranties, the fund would be replenished by future "fees" charged. The United States Treasury Notes therefore appear to function like a revolving fund. Replenishment of these funds probably would be in the form of an increase in the "fees" charged. This would effectively be a form of recoupment even though resulting from a re-evaluation of more reliable experience. In the situation described, some doubt naturally arises whether risks which are located in countries which honor their commitments would continue to purchase the guaranties, particularly if the cost of all guaranties were raised apparently to recoup for losses which had taken place in countries which do not honor their commitments. Under such circumstances there would appear to be created a type of anti-selection which would act counter to the maintenance of a market adequate for the continuance of the program.

The specific questions which have been posed by the ICA have been carefully reviewed and are discussed hereafter.

1. *CAN THE EXPERIENCE TO DATE BE USED IN ANY MEANINGFUL WAY?*

The magnitude of the potential liability is indicated by the fact that the guaranties outstanding as of December 31, 1960 were $443,634,000 (including some duplication for the three types of contracts). Against this, accumulated "fee" income through December 31, 1960 was $6,412,000, or less than 1.5% of the amount of guaranties outstanding. As of November 1961 the guaranties outstanding were $488 million.

Assuming that some portion of the guaranty liability would be realized in the years to come, one could formulate a table which would show how many years an annual premium of 0.5% of the amount of each guaranty would need to be accumulated to cover losses equal to the assumed portion of the guaranty liability.

Assuming the money deposited as premium could be assigned an interest yield, (although we understand the Treasury Department does not credit the ICA with interest on its deposits with the Department), calculations can be made which would indicate the number of years required for premium accumulation in order to cover losses of stated portions or percentages.

For example, a premium rate of $5 per thousand dollars of amount of guaranty would need to be accumulated for 28 years (assuming 4% interest) in order to cover a net loss at the end of the 28th year equal to 25% of guaranty liability. At a 6% interest rate, 24 years of premium accumulation would be required to cover the same net loss at the end of the 24th year.

If administrative costs[5] are chargeable against "fee" income then the number of years of accumulation required would be extended.

It is readily apparent that these guaranties are long term in nature. Coverage for such long term possibilities cannot be entirely separated from possible appreciation or depreciation of money rates of various currencies throughout the world. Also, the possibility of subrogation must reflect the likelihood of long periods of time elapsing for successful conclusion of subrogation claims between sovereign countries.

Assuming the business venture covered by guaranties is successful, as time goes on, the amount of the guaranty should become a lesser percentage of the value of the investment in the country. The investor would then acquire a larger stake in continuing the enterprise and in effect would become a co-insurer to a greater extent than at inception.

The evaluation of experience must be coupled with an evaluation (by our nation's policymakers)of the host government's attitude for a specified considerable time in the future.

Although the guaranty program has not actually incurred any loss at the present writing, it is fair to conclude that from an actuarial standpoint, the

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[5] Whitman, Marina von Neumann, *The United States Investment Guaranty Program and Private Foreign Investment*, p. 70 reports administrative costs were approximately 12% of fee income for calendar year 1958 and about 20% for the previous year.

occurrence of a loss is more significant than the non-occurrence of a loss (where losses are assumed to occur relatively infrequently).

In this connection, it is only fair to draw attention to the potential for loss that recently existed in Cuba. The ICA has estimated that approximately $70 million of investments in Cuba would have been eligible for guaranty during the period 1957-1960. If we were to assume that such guaranties had been issued and were exposed to loss at the time the present Cuban Government came to power, and if we were further to assume that only 20% of the guaranties exposed produce a net loss to the guarantor, we find a potential loss to the guaranty program of approximately $14 million, or twice the amount of all "fee" collections to date.

The Cuban situation by itself, which is highly pertinent and suggestive of the potential loss inherent in the guaranty program, is obviously more meaningful from an actuarial standpoint than the non-occurrence of a loss on the guaranties issued to date.

An evaluation of the experience to date must recognize the increasing hazard resulting from the shift in emphasis since 1958 from guaranties issued with respect to the developed countries (principally the Western European countries whose post war reconstruction and rehabilitation had been largely completed) to guaranties issued with respect to the underdeveloped countries (in Latin America, Africa and Asia) as well as the increasing importance of th expropriation and war risk guaranties as more bilateral arrangements for such guaranties are effectuated in addition to the convertibility guaranties. The 1961 enactments by Congress emphasize there may be future changes in emphasis (e.g., housing developments) and coverage ("all risk coverage").

2. *DO THE RATES REFLECT THE RISKS TAKEN?*

It is self-evident that the risks taken by businesses when they invest in foreign countries vary by country. This probably accounts for the fact that capital tends to gravitate toward those countries which afford the greatest return with the least risk. Even short term guaranties, such as that afforded by a private American insurance company for export credit insurance, distinguishes among different countries in the world. In dealing with such credit insurance, that company's insurance rates take into consideration individual variations in the risk such as the insured buyer's

(a) general credit standing
(b) management and business experience record, and
(c) liquidity and past payments record

Recognition is also afforded to the degree of co-insurance and the length of time credit is outstanding after goods are shipped.

The values insured by the ICA are such that a single loss could wipe out all prior "fee" collections. Further, the nature of the convertibility and war risk coverages is such that all or most risks in a particular country would be affected simultaneously. Effects of expropriation may exhibit some temporary variation by type of industry. A mere listing of some countries which have been recently in the news suggests the widely diversified risk of loss under a guaranty program for investments in such countries compared with other countries. It is suggested that areas such as Cuba, Congo (Leopoldville), Egypt, Laos, North Viet Nam, Korea, Venezuela, British Africa, Algeria, Tunisia, Berlin and Brazil present greater risks of loss on the guaranties than other more stable political areas.

3. *CAN ANY ACTUARIAL BASIS BE DEVELOPED FOR THE PROGRAM?*

As suggested in 1, it might be possible to consider a hypothetical investment including an assumed annual plowback of earnings to such time when accumulated "fee" income would cover possible losses with or without the compounding of interest earnings. Such a procedure would tend to be overly conservative, except that the element of contagion (i.e., broad scale renouncements of commitments by foreign countries) would need to be given separate and thorough consideration in formulating such a basis.

The "fee" for the guaranty might be considered somewhat akin to the charges for insurance or guaranties afforded by such United States Government agencies as the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation and the Federal Housing Administration.

Consideration would need to be given to measuring geographical dispersion of risk and the possibility of an international program of "reinsuring" such risks (perhaps through the Organization for Economic Cooperation and Development). A system of fractional reserve[6] may be required. There should be a certain awareness in connection with the failure to limit the percentage of guaranties outstanding in any one country and the possible effect of such a failure upon the fiscal soundness of the program. A similar awareness is needed in connection with the failure to limit the maximum liability assumed on any one risk, dependent upon the total amount of guaranties outstanding and their concentration.

4. *HOW MUCH EXPERIENCE IS NEEDED TO DEVELOP AN ACTUARIAL BASIS?*

As implied by the discussion above, the amount of experience is not nearly as important as the expectation that future conditions would not be materially different from the past. This involves the continuation of existing attitudes on the part of sovereign powers. If some conclusion with respect to such continuation can be reached, then attention should be devoted to spread of risk within a country and among the various countries. If the ICA, for example, could be reasonably assured that it will not be required to cover a loss (net as to subrogation) of more than 10% of the face value within 15 years, the program could possibly be made self-supporting. However, the degree of reasonable assuredness must be weighed against the possible magnitude of the consequences of error. Moreover, if large individual risk values continue to be afforded guaranties, it is possible that the first claim

[6] Ibid. p. 33 indicates one fractional reserve basis has been effectuated.

could exhaust all "fee" income and create a demand upon the Treasury Notes, authorized as reserves. Tied in with this is the very deep evaluation of responsibility or irresponsibility (along the lines of Western custom and thought) of newly emerged governments.

CONCLUSION

The Committee is of the opinion that within the narrow limits outlined, actuarial aspects of the program may be soundly conceived and executed. It would appear more equitable to credit the ICA with interest earnings on deposits made with the Treasury or permit such deposits to be made in public depositories at interest. "Fees" or premiums proportional to the risks assumed in various parts of the world may be developed. However, it is by no means clear that the real world situation will remain confined within narrow limits. Questions which remain unanswered cover a wide range such as the responsibility or irresponsibility of newly emerged governments. In the face of dynamic and radical changes throughout the world, the amount of the Treasury Notes which implement the program may have to be increased so as to almost entirely absorb losses without being replenished by "fee" income at some future date. Likewise, with the large individual risk values that are commonly involved, it is possible that the first claim might be of such magnitude as to require such an increase in the "revolving fund".

Despite the conservative actuarial view which has here been expressed, the Committee wishes to re-emphasize that the actuarial aspects are by no means the complete consideration to be given to a program which envisions raising the living standards of peoples in underdeveloped countries. Indeed, in a world of ferment, the non-actuarial considerations (which, as stated at the outset, are excluded from this report) may be over-riding for the continuance of a free world. Such considerations may need to be met squarely by the government of the United States as outright subsidies or as indirect encouragement in this vital struggle.

The findings pursuant to the Committee's review of the situation are herewith respectfully submitted with grateful acknowledgment of the wealth of material which was made available to the Committee by Mr. Laurence E. Potter, Associate Chief, Investment Guaranties Division of the ICA.

Respectfully submitted,

Committee to Cooperate with the
International Cooperation Administration
FRANK HARWAYNE, *Chairman*
CHARLES C. HEWITT, JR.
N. MATTHEW FRANKLIN

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