

RISK OUTLOOK

CREDIT, POLITICAL AND SECURITY RISK JULY 2015



GUATEMALA

Corruption scandals widen, further threatening political stability

Page 3

PERU

Humala under pressure as indigenous groups hold government to account

Page 5

CHILE

Bachelet under fire, investors keep their distance

Page 7

ALSO IN THIS ISSUE

JLT Risk Ratings Chart	4
LatAM Roundup	8
JLT Credit, Political & Security Risk Expertise	10

Overview

Latin America has been experiencing months of upheaval; many governments are dealing with the realities of left-wing politics, while others are facing growing anti-corruption movements. Governments that had based budgets on inflated commodities prices are being forced to contemplate austerity; which goes against every electoral promise made to address inequality by redistributing wealth. Governments require flexibility to deal with economic shocks, but policies such as subsidisation act as a political straitjacket. Significant commercial opportunities still exist, but investors must be ready for increasing levels of political volatility, and heightened legal and regulatory risks, as governments navigate through the challenges of the end of the commodities supercycle, an increasingly vocal middle class, backlashes against corruption, the influence of drug gangs, and potential capital flight.

LATAM SPECIAL



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In This Edition:





Guatemala

Corruption scandals widen, further threatening political stability

Guatemala has a long history of civil unrest on account of the country's poverty levels and the rise of violent gang crime. More than half of Guatemala's population lives in poverty while over 70% of all productive farmland is owned by just 2% of the population. With such disparities in wealth and with corruption endemic in the government, the judiciary and in local business, unrest is never far beneath the service in many local communities.

In April 2015 a series of corruption scandals emerged following landmark investigations by the UN-backed Comision Internacional contra la Impunidad en Guatemala (CICIG) that has resulted in a wave of high-level resignations, and criminal charges being levied against the head of the social security institute, the head of the tax administration authority and the president of the central bank. The two

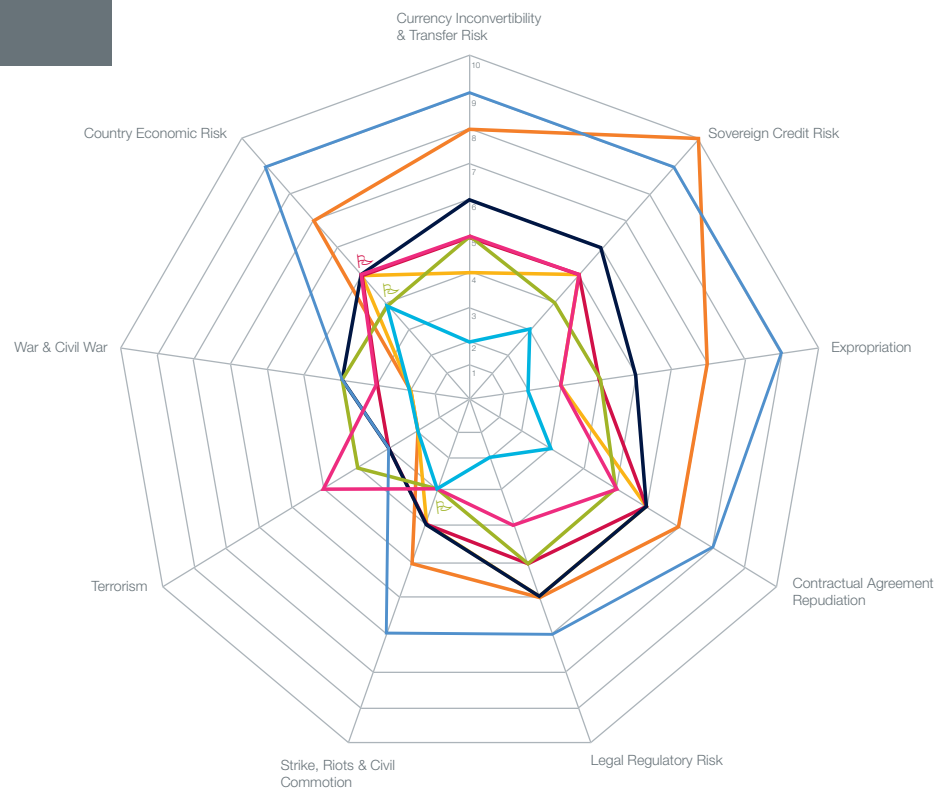
main corruption scandals known as the 'La Linea' and IGSS (Instituto Guatemalteco de Seguridad Social) have roiled the government and prompted public outrage. The La Linea scandal, named after the telephone line purportedly used by senior officials taking bribes in exchange for lower custom taxes, has resulted in 22 people being charged. Meanwhile, the IGSS scandal involved high-level government officials of paying inflated prices for medical equipment to a company lacking a licence to perform the services leading to 17 people arrested including the head of IGSS, Juan de Dios Rodriguez. The scandals have forced President Otto

Perez Molina to dismiss the energy, interior and environment ministers as well as the country's intelligence chief.

As the corruption scandals have widened, large protests have taken place – particularly centred around Constitution Square in Guatemala City. Civil unrest has escalated dramatically, with protestors now calling for Molina's resignation.

On 8 May, Guatemala's Vice President Roxana Baldetti resigned amid investigations that implicated her and her private secretary in a customs corruption scandal. While indigenous farmer protests are fairly common in Guatemala, the

“More than half of Guatemala's population lives in poverty while over 70% of all productive farmland is owned by just 2% of the population.”

JLT RISK RATINGS
FOR JULY 2015

protests seen during June 2015 have cut across socio-economic, political and even class lines. Led by a middle class, educated crowd, the protestors have relied on smartphones and social media to organise their movements. With the country facing underlying social issues of rampant gang violence, widespread poverty and sky-high homicide rates, the corruption scandals have served as the final straw for many Guatemalans. In the latest turn of events, on 18 June, the Corruption Chief, Baudilio Hichos, who had headed the CICIG, resigned following accusations of conspiracy and fraud.

President Molina has insisted that he has not been implicated and intends to serve out the remainder of his presidential term, due to end in January 2016. The constitution typically grants the president

immunity from prosecution while in office, yet the Attorney General has demanded the Supreme Court to grant a temporary removal of this privilege. On 2 July, Guatemala's constitutional court revived the process which is likely to be approved. As such, we could now see the president resign amid increasing pressure from his party, Partido Patriota. If Molina resigns, the new vice President Alejandro Maldonado Aguirre would step in to finish the term. Elections are due to be held in September 2015.

In the short term, political uncertainty will slow down policymaking and temper investor sentiment. Guatemala has a history of high administrative turnover; no government has secured re-election in the last 20 years, further fuelling public disenchantment and entrenching widespread poverty as government

policies fail to deliver change. Even if Molina resigns, protests are likely to continue in line with demands to improve the transparency of campaign financing and anti-corruption protections. Such risks pose as additional obstacles in an already unstable and dangerous operating environment that is plagued by violent crime and powerful drug gangs, paramilitaries and vigilante groups that operate with impunity. As violent crime levels spike as the government continues to come under strain, investors could find the security environment deteriorate further as drug gangs capitalise on the political chaos. Meanwhile, the legal and regulatory system remains poorly articulated and inconsistently applied, causing considerable risks for foreign investors. ■



Rating outlook: Under Review (Strikes, Riots & Civil Commotion / Legal & Regulatory Risk)



Peru

Humala under pressure as indigenous groups hold government to account

At the start of 2011, Peru's economy was the fastest growing economy in South America. Booming on account of high commodity prices and favourable investment terms, mining companies were understandably concerned when ultra-nationalist candidate, and close ally of Hugo Chavez, Ollanta Humala won the 2011 general election. Campaigning on a populist platform, Humala's commitment to sharing mining wealth with Peru's poorest resonated strongly with the electorate, yet foreign investors feared that Humala's time in office would be characterised by resource nationalism. Instead, fears of political risks, including creeping expropriation, slowly receded as Humala's policies proved to be moderate, pragmatic and, crucially, investor-friendly.

The outlook for Peru's economy is now rather different. The falls in international prices for some of Peru's most vital

commodity exports, such as silver and copper, have hit GDP growth prospects and put pressure on public finances as mining revenues have dipped. In addition to falling prices, lower production and weaker Chinese demand have also contributed to a slowdown.

"The outlook for Peru's economy is now rather different."

In 2014, Peru grew just 2.4% in 2014, the slowest pace since 2009, resulting in the central bank drastically cutting borrowing costs. While GDP growth is expected to rebound slightly in 2015, growth estimates have already been downgraded from 5% to 4.2%. Despite a troubled outlook, Peru has reasonable levels of foreign exchange reserves

totalling USD59.9bn, equivalent to 18 months import cover and 30% of GDP which can serve as a buffer in the medium term. Meanwhile, in an attempt to attract foreign investment in a difficult global climate, Humala has begun to offer investors new incentives, such as tax cuts, and is also planning to increase government spending on infrastructure.

The mining sector underpins economic growth in Peru with 62% of export revenues derived from the sector, providing jobs for thousands of Peruvians. Yet, in mining zones, indigenous groups, typically the country's poorest, feel betrayed by Humala's government and his support for mining giants to capitalise on Peru's wealth of natural resources. The anti-mining sentiment of these groups continues to pose significant risks to mining investors on account of project delays, property damage, or project stoppages.

In April 2015, protests erupted in cities across Peru including Arequipa to oppose the Southern Copper Corporation's Tia Maria project. The USD1.4m Tia Maria mining project, a copper mine in the Moquegua Region in southern Peru, has been stalled since 2011 on account of continued environmental protests. The project is expected to add 120,000 tonnes of copper to the company's annual output. Protests have escalated; with unions, university students and local political groups joining the fray. The protests have been violent on numerous occasions, with protestors clashing with police.

"Environmental concerns will continue to spark protests."

Following the deaths of seven protesters, over 200 people injured, and with the protests unlikely to abate, on 18 June Congress passed an emergency congressional bill that grants Humala legislative power to pass laws for 90 days without approval from parliament. The state of emergency also empowers security forces to conduct warrantless searches. Humala has since deployed troops to the Tambo valley to support more than 2,000 police in a bid to quell the unrest. The last time the Peruvian government declared a state of emergency was back in 2012, after protests erupted against the Conga gold mining project in the northern region of Cajamarca, leaving 5 dead.

Peru is now facing a significant conflict of interests. Whilst Humala is keen to attract foreign investment into the country to boost economic growth, the protection of indigenous human rights must remain the government's priority



if it is to ensure social stability and reduce the likelihood of strikes and protests that ultimately hit mining projects the hardest. Environmental concerns will continue to spark protests, and the government will be keen to demonstrate that the old mantra of 'growth at any cost' no longer applies as Humala will be acutely aware that indigenous communities constitute a central pillar of his support base. The latest conflict has heightened disillusionment among the electorate, sparking concerns over Humala's focus

of interest. Those foreign investors that are alleged to have caused environmental damage, meanwhile, will increasingly come under close government scrutiny, and may see heightened risks of licence reviews, or possible cancellation. There is also a risk that the protests might prompt stricter environmental controls, which could translate into additional costs for investors, particularly if new legislation is applied retrospectively. ■



Rating outlook: Under Review (Strikes, Riots & Civil Commotion / Contractual Agreement Repudiation)



Chile

Bachelet under fire, investors keep their distance

President Michelle Bachelet, who was returned to office in March 2014, has been focused on her election promise of addressing social inequality. Yet Bachelet, like her peers in Argentina and Brazil, has in recent months been facing serious corruption allegations. Bachelet's son, Sebastian Davalos, was questioned in April 2015 about an illegal real estate transaction during which he used public money to purchase a property to later sell at a profit. Bachelet was forced to dismiss rumours that she was considering resigning. Simultaneously, a series of allegations were levelled at leading businessmen, including the CEO of mining company Soquimich, accused of laundering cash and influencing political parties.

The scandals have dramatically impacted Bachelet's approval ratings in recent months; undermining the president's message that the government is committed to equal opportunities for all. There are concerns that Chile's impressive growth rates over the last decade have made it vulnerable to the 'middle income trap' which sees emerging economies lose their competitive edge as wages and

expectations rise. Bachelet's solution is to reform the country's education system, which protestors have long labelled as 'elitist.' The student protests seen in 2006, during Bachelet's first administration, and the protests in 2011 and 2013 – the largest marches since the fall of Dictator General Augusto Pinochet – were wake up calls to the government. By spending nearly USD5bn annually on education – funded by a corporate tax increase introduced in late 2014 – Bachelet is addressing the chief demand of the student protest groups.

However, violent protests reignited in June 2015 across Santiago, Concepcion, and Valparaiso following Bachelet's education system reforms. The landmark reforms, which entitle 60% of Chile's poorest students to free university education (rising to 100% by 2020), have been accused by students of falling short of Bachelet's campaign promises. Indeed, the student cause has now broadened to a far wider spectrum of issues; including rewriting the nation's constitution that harks back to the dictatorship era. Meanwhile, teachers went on strike for over a month over

reforms that would link pay to performance. Even the sacking of the education minister in late June 2015 did little to placate the protest groups.

Undoubtedly more revenues will be required, as will further reforms. While the tax reform helped to fill the government's coffers, it will be the mining sector which will be the government's cash cow for future educational reform investment. Yet despite Chile being the global lynchpin of the copper industry, foreign investment into mining remains at reduced levels as a result of the impact of the end of the commodities supercycle and as investors have taken a 'wait and see' approach to Bachelet's tax reforms, and upcoming labour reforms – which are anticipated to strengthen trade unions. With more investment into the education system required – especially if Bachelet is to recover her approval rating – the mining industry will need to be reassured that upcoming reforms will not be too populist in orientation. Investors have already seen the government take a tougher regulatory stance over issues such as environmental infractions; mining companies will be watching Bachelet's next moves carefully. ■



Rating outlook: Under Review (Strikes, Riots & Civil Commotion)

LATAM ROUNDUP

Argentina

Over the course of her presidency, Cristina Fernandez de Kirchner has tarnished the reputation of Argentina's investment environment by engendering a hostile environment for private enterprise and foreign investors. The President has positioned the country as an opponent of the international free market and has arbitrarily renegotiated Argentina's terms of trade. Kirchner's eight years in office have been characterised by state intervention in the form of repeated expropriations and renationalisation, and drastic economic decline – which has been further exacerbated by the country's default in July 2014. In April 2015, Argentina controversially announced its plans to seize the assets of six European and US companies drilling for oil around the Falkland Islands. The assets are valued at approximately USD156m. The UK has since accused Argentina of a politically motivated and illegal attack on the fledgling oil industry. In June 2015, an Argentine federal judge ordered the seizure to go ahead, which is expected to reignite tensions between the UK and Argentina. With the presidential elections approaching in October, nationalistic rhetoric over the Falklands dispute is likely to be ramped up. ■

Brazil

Historically, corrupt practices have been an operational risk for foreign investors to manage when investing in Brazil, but it has been the Petrobras scandal that has highlighted the extent to which corruption has permeated the business environment. The investigation into the Petrobras scandal has revealed widespread bribery and corruption involving leading Brazilian politicians and businessmen that have allegedly been involved in illegitimate contracts, money laundering and racketeering. The on-going scandal has also had serious repercussions for President Dilma Rousseff's reputation, who was chairwoman of Petrobras between 2003 and 2010. In June 2015, Petrobras announced plans to slash investment by 37% over the next five years in a bid to reduce debt and recover investor confidence. The cutback will have huge implications for Brazil; Petrobras projects attract the lion's share of all foreign investment into Brazil, so the cutbacks will have a direct impact on economic growth. With the Brazilian economy already set to contract by 1.2% in 2015, with the government making spending cuts across the board, and with foreign investors nervous of risks to brand and reputation by partnering with firms with links into Petrobras, Brazil's short term economic outlook remains negative. ■

Colombia

Terrorism has long been a risk associated with Colombia, but for a time, the security environment in Colombia had a more positive outlook as the government committed to peace talks with the Revolutionary Armed Forces of Colombia (FARC). When in 2012 President Juan Manuel Santos embarked upon peace talks, the move was met with scepticism. Although Santos secured a second term in office and urged Colombians to stick with the peace negotiations, by mid-2015, progress had slowed as major divisions remain over amnesty and reparation agreements. In July 2015, the government's top negotiator threatened that the government could walk away and that the peace talks had reached its 'worst moment.' If the peace negotiations fail, investors will have to manage increased operational risks. Given that there are estimates that removing the threat posed by the FARC could deliver a 1% uptick in GDP growth, and given the political capital already committed, the government will want to stay the course. Yet even if a deal is reached, Santos will have to make some difficult decisions around funding for post-conflict investment - estimated to be in excess of USD40bn. With government spending cuts on the horizon, and as inflation rises, there is a risk that as government funding is directed towards ex-rebels requiring reintegration into society that public support could further waver, potentially resulting in protests. ■



Mexico

While President Enrique Peña Nieto and his Institutional Revolutionary Party (PRI) and its allies held onto its majority in the June 2015 legislative elections, the extreme levels of public disaffection with the federal government were abundantly clear. Campaigning was marred by severe protests, while elsewhere drug cartels carried out political assassinations with impunity. The election was one of the most violent in Mexico's recent history, with widespread popular condemnation over governmental corruption, education policy and the ongoing lack of public security in the face of increasingly well-armed drug cartels. Having fulfilled his main economic pledges, including widespread reform to the monopolised energy sector and opening up the telecoms sector, Peña Nieto's presidency has not been entirely unsuccessful. His inability to provide greater transparency, oversight and security, however, has limited his effectiveness in the eyes of the public, for whom 'security' is the paramount concern. The ongoing drug wars that have claimed the lives of in excess of 100,000 people in the last eight years appear to be escalating in intensity. Governmental reaction to this enduring crisis has been increased militarisation, yet the 'show of strength' method appears not to have intimidated the cartels, with a coordinated government attack in May 2015 resulting in the shooting down of an army helicopter. Mexico's drive towards deeper political plurality reflects the population's despondency – Peña Nieto's next term must see success in its legal and security spheres to meet Mexico's potential as a destination for foreign investment. ■

Venezuela

Venezuela's economy has been left reeling in 2015 as the global drop in oil prices has further pushed the economy into recession, dollar shortages have intensified, crime rates have peaked, and protests have been sparked by shortages. President Nicolas Maduro, leader of the Partido Socialista Unido de Venezuela (PSUV) has become increasingly isolated as fissures have appeared within the ruling party and as sections of the public become disillusioned. Maduro's approval rating has fallen to just above 20%. While for fifteen years the Venezuelan opposition remained disorganised and fractious, a new opposition coalition, led by Jesus Torrealba, has been polling strongly in recent months. The Democratic Unity (MUD) alliance has united 29 opposition parties and has encouraged the public to stand firm in their criticism of Maduro. On 28 June the PSUV held primaries ahead of December's parliamentary elections. Current polls show that the ruling party is expected to lose their majority, as such, there is some optimism that the MUD may shortly be in a position to successfully challenge PSUV policies, and may push the PSUV to pursue reforms to re-attract foreign investors. However, even if the MUD secure a majority and oust the PSUV, progress will be slow; Venezuela's current economic chaos cannot be remedied overnight and the MUD will struggle to keep voters onside while implementing what are set to be highly contentious reforms. ■

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