

# Investment guarantees

Concept, critics and alternatives

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**weed**

**Weltwirtschaft, Ökologie & Entwicklung**  
**World Economy, Ecology & Development**

# Imprint

## **Investment guarantees**

The Publishers wish to express their thanks to the C. S. Mott Foundation for its financial support of the publication. The Publishers themselves assume full responsibility for the contents.

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Publishers:

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Layout: werk21

Berlin, June 2004

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# Introduction

Nowadays, several governments view Foreign Direct Investment (FDI) as a panacea for economic progress and development. In doing so, they are ignoring the experience of several countries that benefits will only arise for the host country if investments are carefully guided and regulated. Instead, developing countries are in fact underbidding each other to create optimally favourable conditions for foreign investors, while governments of the industrialised countries are putting their services at the disposal of companies to guarantee them optimum rights and minimum obligations.

While the negotiations at WTO level on an international framework agreement for investments have reached a stalemate and are being critically viewed by non-governmental organisations and trade unions, progress made in government promotion of foreign trade at national and bilateral level is going ahead virtually unnoticed by the public. So far, more than 2,000 bilateral investment agreements have been signed, the overwhelming majority of which are between industrialised countries on one side and developing countries on the other. They support overseas activities of companies and provide them with an optimum of protection.

Moreover, with the instrument of investment guarantees, the governments of the industrialised countries are offering their companies an insurance against political risks such as expropriation or restrictions on capital transfer. If there is a threat of damage, government authorities will take preventive measures on behalf of the company concerned. If such action fails, the company is awarded compensation, and the country hosting the investment is demanded to repay the sum involved in the long term. Thus the governments recoup risks entrepreneurial action may entail and ease access to bank loans for the respective companies.

The benefits investment guarantees offer companies are obvious. But what impact does this instrument have on developing countries? This question is examined in the following. Our paper sheds light on the darkness surrounding bilateral investment promotion, refers to critical environmental and development aspects of the current system and formulates concrete demands aimed at a coherent investment policy oriented on the goal of environmentally sustainable and socially just development.

## 1. Investment guarantees—who benefits from them?

With investment guarantees, the governments ensure companies and banks against the political risk they are taking in making overseas investments in developing countries and newly industrialising countries. If assets or the possibility of transferring profits back to the home country are lost for political reasons, the investing company will be reimbursed by its government, which will in turn demand repayment of the

sum involved by the host country in the long run. Thus the government recoups risks entailed by entrepreneurial decisions and enables investors to participate in projects the risks of which would not be borne by a private sector company on its own. As opposed to bilateral investment agreements, the government, in supporting its national companies with investment guarantees, not only creates more favourable

framework conditions but also offers them financial compensation in the event of damage incurred.

For the investor, the government's assuming an investment guarantee means more than imbursement of the investment sum by the government if claims are made. Even a mere threat of damage will prompt government authorities to step in and attempt to avert a conflict by negotiations and political pressure. In this way, the governments offer companies considerable backing against the host countries. If these efforts do not result in a resolution of the problems and the guarantee is brought into operation, the investor will initially have the investment sum replaced by the government that gave the guarantee. The latter in turn obliges the country the investment was made in to repay the amount of indemnification. In Germany's case, claims were made in the Congo, Iran and ex-Yugoslavia.<sup>1</sup> Not a single claim has been made since 1995. Pre-emptory activities sufficed to prevent losses.

Investment guarantees offer a further advantage in that they make it easier for companies to take up capital. Backed by an investment guarantee, they can enjoy better credit conditions with banks in order to finance an investment in advance. This creates advantages for companies over their rivals who have to make investments without government guarantees.

The governments of the industrialised and, to an increasing degree, newly industrialising countries argue that using the instrument of investment guarantees contributes to boosting their own companies' position in the competitive environment of a globalised economy. The uppermost goal of investment guarantees is to support national companies in carrying out their overseas operations and facilitating access to risky markets for them. To what extent the investments promoted actually add to the development of the target countries will at most play a subordinate role and is difficult to assess.

## 2. What is insured?

Unlike export guarantees, with which governments also protect exports of national firms against economic risks, investment guarantees merely offer protection against political risks. This encompasses the following possible events:

- nationalisation, expropriation or measures amounting to expropriation
- violation of legally binding commitments on the part of government or government-controlled bodies
- war, armed conflicts, revolution and rebellion
- freezing of payments or moratoria
- impossibility of converting currency and (re-) transfer of capital

In addition to direct investments, such as erecting production plant or acquiring shares of company partner

capital abroad, the types of investment that can be insured also include quasi-equity loans that are awarded to foreign companies. This means that the creditor, e.g. a private German bank, but frequently also a bank with government share capital, such as »Kreditanstalt für Wiederaufbau« (KfW), will be entitled to have a certain say in business affairs, e.g. the right to obtain information and the right of verification or will have to share the economic risk of the project. Capital resources for legally dependent subsidiaries and places of business (so-called endowment funds) or the rights acquired in the framework of service contracts with regard to crude oil or natural gas can also be provided with a guarantee. And on application, to a certain extent, the returns from participation and quasi-equity loans can also be covered by the guarantee. In all cases, an entrepreneurial interest in the investment has to be recognisable. This means that pure asset or finance investments, such as

<sup>1</sup> More than 80% of the entire amount of loss paid for so far has been awarded to companies that had made investments in ex-Yugoslavia.

portfolio investments, do not entitle investors to be awarded a guarantee in Germany.

More and more frequently, various instruments of foreign trade promo-

tion are combined, i.e. an investment is secured by an investment guarantee while export guarantees are simultaneously given for supplies.

### 3. What have BITs and investment guarantees to do with each other?

In Germany, Bilateral Investment Treaties, BITs are generally a precondition for the award of investment guarantees. This is intended to ensure sufficient legal protection for capital investments. The BITs provide for the protection of German investors against damage resulting from political upheavals. An investment guarantee relieves the investor of the need to independently and, possibly, tediously assert his rights stipulated in the bilateral agreements. Instead, the Federal Government will represent him and reimburse funds if claims are made. If no bilateral agreement has been signed with a country, investment guarantees may nevertheless be awarded in exceptional cases if the capital investments are adequately safeguarded by the national legal framework. This is assessed case by case by the mandatories the Federal Government has commissioned. Brazil is one of the countries that have always boasted one of the biggest shares of the German investors' guaranteed volume but with which no bilateral investment treaty has been signed up to this day<sup>2</sup>.

However, assessing the need for a BIT as a basis for the award of invest-

ment guarantees will vary from country to country. Whereas the existence of a bilateral investment treaty »positively influences« the award of investment guarantees in The Netherlands, France, Slovenia or Germany, the United Kingdom and South Korea, for example, do not make any corresponding formal demands on the recipient country.

Conversely, the existence of a BIT does not ensure the award of investment guarantees. If a country's economic and political situation happens to be particularly unstable, coverage will only be very limited or will not be offered at all, as is currently the case in Argentina. This is why the volume of awards fluctuates considerably in times of major economic crises. For example, the volume guaranteed by Germany dropped from 4.2 billion euros in 2000 through 2.7 billion euros in 2001 to 2.3 billion euros in 2002 and 1.7 billion euros in 2003. And although Germany has signed 126 bilateral investment treaties, guarantees were only awarded for 24 countries in 2002.

### 4. Extent and regional distribution of investment

Since 1996, the volume of coverage assumed by the Federal Government has been between 1.7 and 4.2 billion

euros annually (cf. Fig. 1).<sup>3</sup> By comparison, the volume of German foreign direct investments was 26.1 billion euros in 2002. In developing countries, newly industrialising countries and countries in transition, between 10 and 20% of German investments is annually insured by such investment guarantees.

<sup>2</sup> The BIT negotiations have been in cold storage for years. Further countries Germany has not signed a BIT with for which the award of investment guarantees is nevertheless possible include the Dominican Republic, Guatemala, Colombia, Taiwan as well as Trinidad und Tobago.

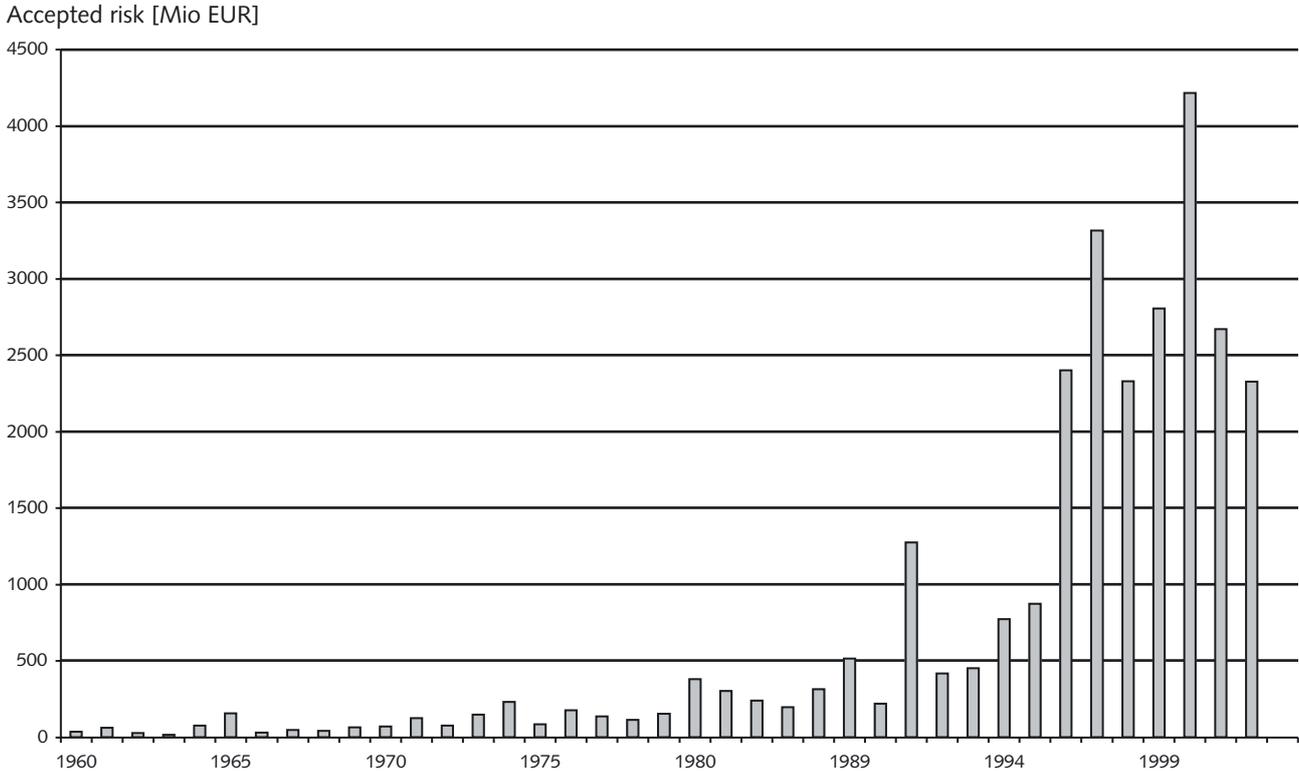
<sup>3</sup> PwC-Jahresbericht 2002: Investitionsgarantien der Bundesrepublik Deutschland. Direktinvestitionen Ausland, p. 52.

## 6

In analogy to the world-wide increase in foreign investments in the nineties, the volume of investment guarantees also multiplied. Towards the end of 2002, the total amount of guarantees awarded by the German

To a large extent, the regional award of German investment guarantees corresponds to the focal regions of German foreign investments. Target regions that can be assigned to the risky markets account for a considerable share

**Fig. 1: Amount insured by the investment guarantees awarded by the Federal Government (per year)**



Federal Government grew to 14.7 billion euros, so that Germany has assumed a leading role in awarding investment guarantees. By comparison, the insurers organised in the Berne Union (cf. Fig. 2) had a combined volume of 72 billion USD in guarantees by the end of 2001. In other countries, investment guarantees are far less significant. Whereas the UK's ECGD annually insures 0.8 to 1.5 billion USD, investment guarantees are only awarded sporadically in, for example, Switzerland, Slovenia or Australia.<sup>5</sup>

of the amount insured by the guarantees awarded<sup>7</sup>. Over the last few years, German investment guarantees have focused on the Central and Eastern European region (see Fig. 3)<sup>8</sup>. However, individual large-scale projects have resulted in shifts in the annual distribution of the volume guaranteed, e.g. to the large share of Central and South

<sup>6</sup> Berne Union: Yearbook 2003, p. 190.

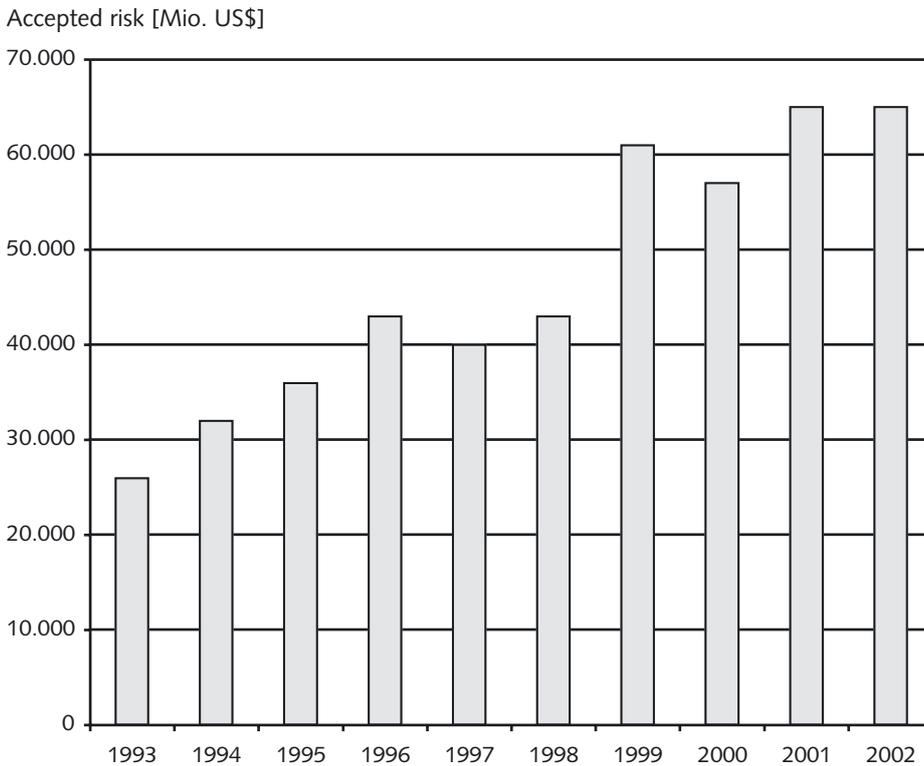
<sup>7</sup> Foreign investments in other industrialised countries accounting for the lion's share of FDI for which, as a rule, no investment guarantees are however awarded, are of course not considered.

<sup>8</sup> In other countries, there is an even greater concentration on individual regions, e. g. in South Korea, which awards 99.9% of investment guarantees to investments in other Asian countries (China, Vietnam, Thailand), or Slovenia and Poland, where more than 90% goes to other Central and Eastern European countries. In the UK, guarantees focus strongly on Asia (more than 40%) and Central and South America (between 25 and 35%), while Eastern Europe only accounts for 1 to 4% of the amount insured.

<sup>4</sup> PwC-Jahresbericht 2002: Investitions Garantien der Bundesrepublik Deutschland. Direktinvestitionen Ausland, p. 54.

<sup>5</sup> An accurate country by country comparison is difficult since the insurances offered often vary considerably, different systematics are partly applied, financial years do not coincide, etc. Moreover, the annually insured volumes severely fluctuate depending on individual major contracts.

**Fig. 2: Amount insured by the investment guarantees awarded by the insurance companies organised in the Berne Union (total volume)<sup>6</sup>**



America in 1998 and that of Asia in 2001 and 2002.

Within the individual regions, the investments are, in turn, concentrated in a handful of countries: in Asia it is mainly China and the Philippines, in Europe Russia and Croatia, in Africa South Africa (formerly Libya) and in South and Central America Brazil<sup>10</sup>.

In Germany, the branch priorities in the distribution of investment guarantees are the areas of energy, extractive

industries (in particular crude oil/natural gas), services (mainly financial services such as leasing), infrastructure and vehicles construction<sup>11</sup>. Distribution among sectors in Japan is similar, with the electricity sector accounting for 21.5% and crude oil and natural gas for 38.5% in 2001, whereas in the UK, at more than 70% of the amount insured, the water and energy sector has been at the forefront for years.

## 5. The actors: national and international

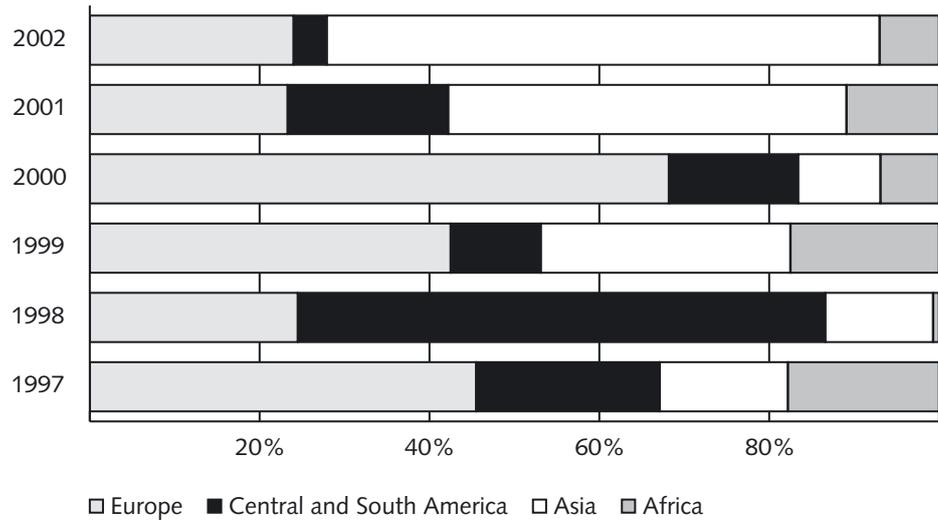
At international level, the insurance agencies responsible for exports and investments have organised themselves in the Berne Union, the International Union of Credit and Investment Insurers. In contrast with its name, the Union, which was set up in 1934, is seated in London. The aim of this association is to harmonise standards and principles world-wide, thus creating a favourable investment climate at interna-

tional level. Here, the development of standard technical conditions with regard to finance, deadlines, fees, etc. is at the forefront. Environmental issues and social standards are hardly relevant. In addition to the government

<sup>10</sup> PwC-Jahresbericht 2002, Investitions Garantien der Bundesrepublik Deutschland. Direktinvestitionen Ausland, p. 53.

<sup>11</sup> In 1998 and 1999, more than 35% of the guarantees were awarded in the areas of energy and the extractive industries, and in 2001 30% in the infrastructure sector and more than 25% in the area of services, with the focal area of financial services.

<sup>9</sup> PwC-Jahresberichte Investitions Garantien der Bundesrepublik Deutschland. Direktinvestitionen Ausland, 1997-2002.

**Fig. 3: Regional distribution of the amount insured for investment guarantees in Germany<sup>9</sup>**

Source: PwC Jahresberichte 1997-2002

export credit and investment insurers, representatives of the private insurance market are being increasingly integrated.

The MIGA (Multilateral Investment Guarantee Agency), which belongs to the World Bank Group, plays a special role. After Germany, it awards the second largest volume of investment guarantees to private companies and banks. However, unlike the other investment guarantee agencies, it is subject to a development mandate, i.e. the official target of the guarantees is supposed to be that of supporting developing countries in their development efforts (see Box 1).

In Germany, companies are advised ahead of being awarded a guarantee, while applications are reviewed and subsequently processed by a consortium of PricewaterhouseCoopers Deutsche Revision (PwC) and EulerHermes

Kreditversicherungs-AG (formerly Hermes Kreditversicherungs-AG). They operate as mandataries commissioned by the Federal Government and are remunerated for this. PwC is in charge of awarding investment guarantees, while EulerHermes are the chief contact for Hermes guarantees. However, the Federal Government itself sets the political framework conditions, assesses the country risks and makes final decisions on the applications. An Inter-Ministerial Committee (IMA) comprising representatives of the Ministries of Economics and Employment (overall supervision), Finance and Economic Co-operation and Development as well as the Foreign Office is responsible. The Committee consults specialists from industry, banks and associations but does not seek advice among experts on environmental and development issues.

## 6. Award procedures

The award procedures for investment guarantees vary from country to country. The spectrum of responsible institutions ranges from private companies (e.g. Coface in France) through companies with government shares (Slovenia with a 90% government share) to government ministries (ECGD in the UK). However, regardless of the legal form, the government will hold liability for major losses. In most countries, the agencies are responsible both for the award of investment guarantees and for export credits and insurances for exports. Often, the range of services comprises credits, insurances and guarantees, on commercial and non-commercial conditions, with long,

medium and short terms, and to safeguard against political and/or economic risks. Frequently, the award procedures for investment insurances have been adopted from those for exports, since export insurance traditionally plays a more important role. However, in some countries, e.g. in the USA and Austria, an institutional division is in place that partly results in different guidelines.

Since larger projects, above all investments in infrastructure in the shape of operator models, are increasingly being implemented in international co-operation, collaborative schemes are regularly set up between the export credit and investment insurance agen-

### Box 1: The Multilateral Investment Guarantee Agency (MIGA)

The object of MIGA, which was founded in 1985, is to »promote the flow of investments for productive purposes among the member states, especially in the developing countries« and »advise the developing countries on how they can improve their ability to attract investments«<sup>12</sup>. It awards investment guarantees to companies of the member states. In Germany, these are above all banks such as WestLB or Deutsche and Dresdner Bank. As part of the World Bank, the MIGA disposes of a minimum of guidelines designed to ensure environmental and social compatibility of the projects promoted. Projects are divided into the categories A to C depending on their environmental relevance. The submission of an environmental impact assessment is required for projects that could have grave environmental consequences. The assessment is publicised 60 days before the decision is made on the investment guarantee in order to give the public the opportunity to comment. The World Bank Group's Pollution Prevention and Abatement Handbook (PPAH) sets quantitative environmental standards, and safeguard policies are in place to ensure the protection of natural habitats, the safety of dams and the observance of the rights of indigenous people and people affected by involuntary resettlement<sup>13</sup>. An ombudsman can be appealed to if those affected by a project are of the opinion that the guidelines have not been complied with.

However, with these regulations, the MIGA does not reach the standards of other World Bank committees some of which cover more aspects with safeguard policies, provide for a longer commentary period and also publicise environmental statements for less harmful projects. Moreover, non-governmental organisations criticise that, from case to case, deviations from the guidelines may be permitted so that an effective protection of human beings and the environment in the project regions is not possible<sup>14</sup>.

The ventures promoted by MIGA also include investment projects with grave consequences regarding ecological, social and human rights issues, such as the Antamina copper and zinc mine in Peru, the Bolivia-Brazil gas pipeline, the Julietta gold and silver mine in Russia's Far East and the Omai gold mine in Guyana.<sup>15</sup>

<sup>12</sup> Cf. [www.miga.org](http://www.miga.org)

<sup>14</sup> Friends of the Earth et. al. (2001)

<sup>13</sup> So-called safeguard policies on natural habitats, forestry, pest management, safety of dams, projects on international waterways, involuntary resettlement, safeguarding cultural property, indigenous peoples

<sup>15</sup> *ibid.*

cies, if necessary with the involvement of international development banks. In these cases PwC signs collaborative agreements as the representative of the Federal Government. If problems occur, a co-ordinated approach among the insurers will ensure more determination in addressing the government authorities of the host country to assert the interests of the investors.<sup>16</sup>

In Germany, an investment has to fulfil the following conditions to be eligible for a government guarantee<sup>17</sup>:

- The investor's seat must be in Germany, with no reference being made to whether it has to be the main seat, a subsidiary or merely a letter-box company. In addition, a »German interest in the execution of the project« has to be recognisable<sup>18</sup>.
- An investive character has to be apparent (as opposed to pure finance investments).
- The project has to be economically viable.
- Investments have to be made in new plant and equipment (which can, however, also include investments aimed at extending existing plant).
- The project has to be worthy of promoting from an environmental and development angle.
- Required legal protection has to be ensured.

Since June 2001, PwC have been using a »Merkblatt Umwelt« (environmental instructions) in which the test procedure for environmental aspects of the planned investments is described. This strongly resembles the procedure applied in awarding Hermes guarantees. In April 2001, the Federal

<sup>16</sup> Cf. [www.agaportal.de/pages/dia/deckungspraxis/kooperationen.html](http://www.agaportal.de/pages/dia/deckungspraxis/kooperationen.html)

<sup>17</sup> Cf. [www.agaportal.de/pages/dia/grundlagen/garantievoraussetzungen.html](http://www.agaportal.de/pages/dia/grundlagen/garantievoraussetzungen.html)

<sup>18</sup> This includes e.g. »whether investments contribute to furthering the relations of the German Federal Republic with the investment countries. In this context, the substitution of imports, earning foreign exchange with exports, creating and preserving jobs, continuation of training measures, transfer of modern technology and improvement of infrastructure is given attention. The extent to which the environment is affected by the project and the measures that are taken to protect it is a further criterion in assessing whether it is worthy of promotion.« ([www.pwcglobal.com](http://www.pwcglobal.com) vom 17.7.2003)

Government issued an environmental guideline for export promotion after years of campaigning by non-governmental organisations (NGO) highlighting the grave environmental and social impact of Hermes guarantees in the recipient countries and their calling for a comprehensive reform of the award procedure.

The majority of export credit insurers in the OECD countries agreed on similar guidelines in November 2001. In December 2003, both the USA, which had originally called for stricter environmental criteria, and Turkey, which had not signed the 2001 draft version for the opposite reason, joined the revised version of these »Common Approaches on Environment and Officially Supported Export Credits«. Transferring the test procedure to investment guarantees can be regarded as a side-effect of the NGO campaign. However, the non-governmental organisations criticise both the Common Approaches and the Hermes guidelines for being insufficient when it comes to actually preventing the negative development and environmental impacts of export credits and guarantees.<sup>19</sup>

The test procedure applied now incorporates a screening of the project proposals, i.e. they are divided into three categories depending on their probable environmental relevance:

- Category A: projects that are probably going to have severe environmental impacts most of which do not appear to be locally confined or are of an irreversible nature. This especially includes projects intruding into protected areas or settlement areas of indigenous peoples or entail resettlement on a large scale.
- Category B: projects that will probably have restricted environmental impacts that are, as a rule, locally confined and reversible.
- Category C: projects in which no or only insignificant environmental impacts are to be reckoned with.

This classification is compiled on the basis of statements made by the applicant. In the case of projects be-

<sup>19</sup> Information on the Hermes campaign in Germany at [www.weed-online.org](http://www.weed-online.org) und [www.urge-wald.de](http://www.urge-wald.de), information on the international campaign at [www.eca-watch.org](http://www.eca-watch.org)

longing to Category A and (to a less detailed degree) B, further statements on environmental impacts, environmental standards to be complied with and possible counter-measures are required. In Category A projects, it is expected that »the investor will, as a rule, be able to submit a report by a recognised environmental expert«. There is no explicit requirement for an environmental impact assessment in accordance with international standards. Compliance with the standards of the investment country is sufficient for the approval of an investment guarantee. While compliance with international standards will be given a positive appraisal, it is no condition for the award of a guarantee.

In some other countries, e.g. Australia and the USA, and in the MIGA, at least the submission of a true environmental impact assessment is required for Category A projects. This offers the advantage that internationally recognised standards are referred to and there is an obligation to consult and inform the population affected at local level. In contrast, a less binding procedure similar to the one applied in Germany is practised in most OECD countries, such as France, the UK and The Netherlands. A small group of agencies in countries such as Slovenia

and South Korea do not assess environmental impacts at all.<sup>20</sup>

In order to claim an investment guarantee, the investor has to pay a once-off processing fee the percentage of which depends on the amount insured as well as an annual guarantee remuneration. Since there is a ceiling of 10,000 euros for the fee, major investments tend to be preferred. Only very recently has special support been introduced for very small applications (less than 5 million euros) that incorporates the fee being waived for them. Accordingly approximately 90% of the overall volume for investments with guarantees flows into large-scale corporations that make a smaller contribution to the national economy than small and medium-sized enterprises both in terms of job creation and tax revenue.

According to PwC, the guarantee instrument is self-supporting, since compensations hardly become necessary owing to political pressure being exerted ahead of damage suffered. This is in contrast to the Hermes guarantees, in which an overall deficit of approx. 12 billion euros has accumulated since the debt crisis of the eighties that has only recently started to gradually decrease thanks to higher fees and increased returns from the indebted developing countries.

## 7. Critical points

### a) Economic policy versus development policy

Especially when the government covers risks that private insurance agencies do not wish to insure against, the support criteria ought to include that overarching targets to the benefit of the public at large are not violated. In a number of conventions and its Constitution (Grundgesetz), German policy has committed itself to environmental protection and to observance of human rights, and in the field of development policy, it has pledged to combat poverty. While investment guarantees may not be designed as an instrument of environmental protection and development policy, this foreign trade

instrument is also required to be coherent with other policy areas and must not undermine environmental, development policy and human rights goals.

As the example of the Paiton power stations in Indonesia demonstrates, developing countries are forced to continue projects clashing with their own development interests if they want to avoid being hit by sanctions imposed by the governments awarding the guarantees.

<sup>20</sup> Result of a survey conducted by WEED in the winter of 2001/2.

## b) Transparency and information policy

The government's accountability towards the public is an important element of all democracies. In turn, a basic prerequisite for any public influence and control is comprehensive transparency. Merely informing the public about decisions that have already been taken is not enough. Rather, the public must have the opportunity to be-

coming actively involved in the decision-making process. When it comes to awarding investment guarantees, this is not the case in many countries. A more detailed publicising practice is only maintained in exceptional cases (Australia, USA). Ahead of a decision being made, applications for Category A Projects are put in the Internet with reference to the sum and the category or the screening procedure. Usually, information about a project is only pub-

### Box 2: Test procedure for investment guarantees in Germany

Inhalte des Antragsformulars: Bundesgarantien für Direktinvestitionen im Ausland

#### Contents of the application form: Federal guarantees for foreign direct investments

1. Statements on the investor  
chiefly regarding capital reserves, finance-technical information
2. Statements on the project  
Data on the company running the project, motives for the investment, statements on the impact of investments in the investment country and in Germany, statements on other support measures that have been applied for, statements on the investment

#### Statements on environmental relevance:

- Description of the activities carried out by the foreign project company as well as the chief operational processes
- Factors of particular environmental relevance:  
(the points below are answered with »yes« or »no«)
  - The environmental impacts of the project are of a cross-border nature
  - Project is in the proximity of designated nature conservation areas, protected wetlands, tropical rainforests, coral reefs
  - Project is in unused or unsettled area
  - Project causes refuse that has to be monitored in accordance with German law
  - Project comprises nuclear technology
  - Project intrudes into settlement areas of indigenous peoples
  - Project requires the temporary or permanent resettlement of more than 1,000 persons
  - Project inhibits cultural heritage
  - Project requires an environmental assessment in accordance with the law of the investment country
  - Project is executed in accordance with the environmental standards of the investment country
  - Project is executed according to German environmental standards

#### 3. Notes in the Annex:

Here, one of the aspects pointed out is that the Federal Government will not assume liability for investments that have materialised on the basis of criminal offences, in particular corruption. Also, reference is made to the OECD guidelines passed in 2000 with the words: »The OECD guidelines represent recommendations made by the governments for a responsible entrepreneurial conduct in accordance with valid law in overseas activities. The companies are to observe the guidelines wherever they are pursuing their business activities taking into account the special conditions of the respective host country.«

### Box 3: Investment guarantees as a »development policy« instrument of foreign trade promotion?

#### Case study: Coal-fired power stations Paiton I and Paiton II, Indonesia<sup>21</sup>

Towards the end of the nineties, the largest power station complex in the Indonesian island of Java was created with the two power stations Paiton I and II. Both projects were executed by international operating companies and secured by foreign guarantees. In the case of the 1,200-megawatt power station Paiton II, the German Siemens subsidiary KWU was in charge of operations.

Even before the contracts were signed, there had been sufficient reasons to doubt the soundness of the venture. For example, at the point of signing the contract for Paiton II, Indonesia was already producing a major surplus of electricity, and the World Bank had warned of overcapacities in electricity generation in 1994. In spite of this, power supply contracts were signed with foreign contractors for the construction of 27 new power stations. In the contract on Paiton II, which had been drawn up under President Suharto and Federal Chancellor Kohl, the Indonesian electricity company PLN committed itself to buying electricity generated there at a fixed price of 6.6 cents per kWh for 30 years—a rate that was already regarded as excessive at the time. Djiteng Marsudi, who was then director of PLN, remarked later: »I had to sign the contract without being able to negotiate the conditions. It would have been suicide for me to refuse.« For the Suharto family attached considerable significance to this contract—after all, one of Suharto's sons had a 15 % stake in Paiton III!

In spite of the obviously justified accusations of corruption, the then Federal Government awarded the project a Hermes guarantee of 494 million US dollars. »Kreditanstalt für Wiederaufbau« (KfW) awarded a »quasi-equity loan« to the tune of 250 million US dollars that was secured by an investment guarantee. In contrast with usual Hermes and investment guarantee practice, in the case of Paiton II, the German Federal Government did not demand a counter-guarantee by the Indonesian government. So there was no legal requirement for the Indonesian government to assume liability for the financial obligations of the Indonesian electricity company.

But when the provisional government cancelled 13 of the 27 power contracts in 1998, following the end of the Suharto regime, and ordered that all further projects be scrutinised with regard to allegations of corruption, this put the foreign guarantors on alert. They feared that claims would be made for damages. Their apprehension proved all the more justified since the power generating company PLN had emerged from the Asian crisis in a highly indebted and insolvent state, for while its income had been in rupees, its expenditure had accrued in dollars.

In the case of Paiton I, the new PLN head pressed for an annulment of the power supply contract, arguing that it was based on corruption and nepotism. Paiton I was operated by General Electrics, and the US government had granted it a government guarantee. Now it threatened to confiscate Indonesian property in the USA if Indonesia refused to meet the financial obligations of PLN. The German Federal Government pursued its goal of fending off claims for damages by exerting political pressure in a similar manner. In a joint letter with the Japanese and the US governments to the Indonesian Minister of Finance, it called on the Indonesian government to »protect the fundamental rights of the investors«. It gave special emphasis to this demand by stating that: »The future investment climate of your country as well as our prospects of further co-operation are going to depend on finding a solution to the power issue.«

With its response, the German Federal Government proved that foreign trade promotion by no means benefits the developing countries while simultaneously serving the interests of German industry, as is claimed so often. On the contrary, financing the economically dubious Paiton II project in spite of obviously corrupt practice and subsequent exertion of political pressure on Indonesia to fend off claims for damages clearly demonstrates where the Federal Government's priorities lie when it awards investment guarantees.

<sup>21</sup> Source: Der Spiegel 20/2000, Financial Times Deutschland 24.11.2000

licised after an approval, as is the case in Germany. Nothing is published in South Korea.

In Germany and in several other countries, the investor's consent is required for any publicising of the projects. As a result, there is only incomplete information about which companies are awarded investment guarantees and into which sectors they flow. There are grounds for the assumption that critical projects in particular are not presented in the annual reports of PricewaterhouseCoopers but that above all the »socially acceptable« projects are selected. It is quite possible that only a handful of major German corporations really benefit from the guarantees. But without a complete list, this can be neither confirmed nor refuted.

As a result, civil society—whether it be from the investor's country or the recipient country—can only take influence in exceptional cases, when information happens to be leaked. For in many target countries of investment guarantees, the local population have no opportunity whatsoever to take action against investment projects even if their livelihoods are immediately affected. So frequently, they are unable to assert their rights against an investor. If the investment insurers were to make informing and consulting the local population a precondition for the approval of an investment guarantee (at least with Category A projects), this could be the most effective contribution to already preventing the threat of environmental damage and violations of human rights in the run-up to a project. Instead, owing to their lack of transparency, the investment guarantee agencies add to reinforcing undemocratic procedures in the target countries.

The campaign to reform the Hermes guarantees criticised the lack of transparency in the award procedures. In response, the Federal Government announced that a greater level of transparency would be established in awarding investment guarantees in the 2000 Annual Report published by PwC. So far, however, this measure has been limited to the publication of additional information material for investors on the PwC Homepage.

### c) Environmental assessments

Since 2001, in awarding German investment guarantees, environmental aspects have formed a test criterion to assess whether an investment is worthy of support. However, binding regulations defining which environmental impacts can be tolerated and which ones rule out support exist neither in Germany nor in the majority of the other countries. On the contrary, the PwC Annual Reports give rise to the assumption that environmental assessments do not present a serious hurdle to be taken by the applicants. In 2001, for example, it was noted that »practice [had] shown that the IMA (Inter-Ministerial Committee) does not put any excessive demands on German investors ».<sup>22</sup>

No complete environmental impact assessments are even required for environmentally particularly relevant Category A Projects. Neither are straightforward provisions made on what standards have to be applied. The PwC environmental instructions describe finding a decision as follows: »The minimum prerequisite for a project to be eligible for support in environmental terms is compliance with the standards of the investment country. As a rule, observance of further reaching international environmental standards will result in environmentally related eligibility for support being confirmed. In making a decision, whether and to what extent the investor plans further measures to improve environmental quality standards is also considered.«

Ultimately, this benchmarking process, i.e. the comparison with international standards, gives the Inter-Ministerial Committee any scope it may require to approve projects at its own discretion. There are no exclusion criteria at all. Observing the national laws of the investment country as the sole precondition ought to go without saying. But practice has shown that, in many developing countries and countries in transition, environmental and social welfare legislation is insufficient or that where good legal regulations are in place they are undermined at local level. However, as long as PwC do not demand binding environmental impact assessments by independent

<sup>22</sup> PwC 2001, p. 17.

experts but strongly rely on the statements made by the investor, one cannot expect violations to be exposed. Moreover, it is hardly conceivable that, with their handful of environmental experts, PwC should have the capacity to monitor compliance with the respective national laws. Stipulating the observance of standards that have already been agreed on internationally would improve this state of affairs.

Industrial associations argue that standardised environmental impact assessments are too complicated and would therefore create competitive drawbacks. This argument is refuted by award practice in the USA, Japan and Australia, where environmental impact assessments for environmentally particularly relevant projects is already part of the process. Moreover, the American Overseas Private Investment Corporation (OPIC) categorically rules out support for certain types of project, e.g. projects entailing the resettlement of more than 5,000 people or major dam projects that would destroy natural ecosystems or flood large areas of land. It is not comprehensible why the application of similar procedures in Germany should result in putting national investors at an economic disadvantage. On the contrary, straightforward standards would rather tend to result in a simplification of the procedure and to more clarity for the investors. While a standardised environmental impact assessment would still not be a guarantee of environmentally or socially dubious projects being ruled out, it would be an important step in this direction.

In the framework of the environmental assessment, PwC also examine social and cultural aspects. However, this merely comprises resettling those affected by a project and the latter's impact on indigenous peoples and on cultural assets. While these aspects may well be important, they are far from sufficient to ensure that an investment is compatible with development. So far, human rights aspects have been

ignored in project assessments. Neither are foreseeable micro- and macroeconomic consequences addressed in the decision-making process. In this context, aspects would, for example, be price increases (in connection with the privatisation of public services, e.g. in the water or energy sector), labour migration, a drain of skilled labour from local companies or competition with local production.

#### d) Privatisation

»Increasing privatisation of what used to be government operations in utilities in the infrastructure sector is opening up good prospects for German industry to participate in these projects in the target countries with its technical know-how and entrepreneurial abilities. However, the integration of government authorities (e.g. in supplying the power that has been generated and in setting and adapting rates) causes a particularly large number of risks. But these imponderabilities are significant aspects in making investment decisions. It is important to include such assurances in insurance protection.«<sup>23</sup>

Already, investment guarantees are being awarded to German companies investing in privatisation projects in developing countries or countries in transition. Examples of this are a sewage plant in Zagreb in the framework of a Public-Private Partnership (PPP) that has been praised as the first adoption of communal activities financed by private industry or Deutsche Telekom's participation in the privatisation of Croatian Telekom. While this may be an area in which German companies will also be able to establish themselves well in the future, from a development policy angle, the penetration of basic services by private enterprises is highly problematic. Several surveys are now on hand that demonstrate the negative impact that privatisation has on the population. Such consequences can frequently be summed up as: »poorer service at a higher price«.<sup>24</sup>

<sup>23</sup> PwC 2002, p. 25

<sup>24</sup> Cf. e.g. the Social Watch Report 2003, Uwe Hoering (2001 and 2003).

## 8. Consequences and demands

- Awarding investment guarantees must not counter the goals of a sustainable, i.e. environmentally viable and socially just development. Even if foreign trade promotion is not turned into an instrument of development co-operation, it must nevertheless not undermine environmental and development measures. The precondition for this would be an explicit pledge to comply with internationally agreed environmental conventions and social standards as a basis for the award of investment guarantees.
- Companies wishing to benefit from government investment guarantees have to be committed to comply with the highest social and environmental standards in return. Observing internationally agreed human rights and environmental conventions, the Core Labour Standards of the ILO and the guidelines of multilateral development agencies has to become a precondition for the approval of investment guarantees. In Germany, this includes the submission of an independent environmental impact assessment incorporating obligatory consultation of the local population for Category A projects.
- Support has to be ruled out for environmentally particularly harmful projects. This applies e.g. to nuclear projects, infrastructure projects in or close to nature conservation areas, primary forests or other particularly sensitive ecosystems and projects in indigenous areas without prior consent of the population affected.
- The impact of an investment on development, in particular the longer-term micro- and macroeconomic effects to be reckoned with, have to be given comprehensive consideration. According to the annual reports on investment guarantees of the Federal Republic of Germany (issued by PwC Deutsche Revision), investment guarantees contribute to job creation in developing countries and have a positive impact on development. However, the Federal Government has failed to come up with any empirical evidence of this. A thorough evaluation of the impact the projects with investment guarantees have, covering both effects on jobs and long-term consequences such as decapitalisation effects, is urgently required to assess the benefit or harmfulness of investment guarantees.
- In order to give civil society the opportunity to voice its doubts about possible negative impacts of an investment both in the home country and the target country of an investment, the award procedure must progress in a transparent manner. This requires that statements on investment guarantees be publicised long before a decision is taken.
- Environmentally sensible projects, for example in the field of renewable energies, ought to be given preferential support. In contrast, the large share of projects in the area of fossil energies in the insured sum in Germany should be reduced. The latter are mainly quasi-equity loans from German banks that are, for example, awarded to major oil corporations operating at international level.

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