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Introduction

Charter cities are new cities granted a special jurisdiction to create a new governance system focused on enabling economic development. Building charter cities requires significant capital investment. Like all investments, there are risks involved. The Charter Cities Institute has created this risk mitigation guide to assist charter city developers in safeguarding their investments. Specifically, the guide provides advice to charter city developers on how to mitigate four main types of risk: (i) social risks, (ii) security risks, (iii) currency risks, and (iv) the risk of host country expropriation.

Social Risks

Building a charter city requires that developers first understand the social risks at play, and then formulate a strategy to mitigate these risks. Social risk refers to community action that can interrupt the development of a charter city. There are three key social risks that charter city developers and investors should take concerted steps to ameliorate: (i) risks associated with land acquisition, (ii) risks around labor market disruption (including unemployment), and (iii) risks from local elites.

First, any new charter city project necessitates acquiring land. This land, no matter how greenfield, has pre-existing communities either living on or using the land who claim formal or informal rights to it. To ensure that land acquisition does not generate social resistance, the developer must engage in extensive consultation with a wide range of stakeholders including the host country government, local community leaders, business associations, religious institutions, and civil society groups, among others.

Second, it is also important to take into consideration the disruption of the labor market brought about by a charter city. Developers must conduct in-depth due diligence in order to understand both the level and the mix of skills within the pre-existing community. Disruptions of the labor market, if not properly managed, can lead to social unrest. To this end, one promising way for charter city developers to mitigate potential labor market disruption amongst the local community is to agree to employ a particular number or proportion of these pre-existing community members within the charter city (with youth employment being an especially promising option).

Third, it is critical to get buy-in from elites in the host country. To do this, the charter city developer has several options. The developer can secure investment from local business groups and high net worth individuals, and encourage them to start their own factories and businesses in the city itself. In addition, once up and running, charter city businesses should be encouraged to contract with local partners and integrate supply chains into the broader regional economy to further local elite buy-in. Ultimately, if elites have a vested financial interest in the charter city, they are likely to use their influence to minimize the risk of social disruption, as well as expropriation (discussed below).
Security Risks

The host country is responsible for the security of a charter city, specifically against the threat of external actors. However, as charter cities will often be built in emerging markets with relatively more fragile governments, it's important for developers to plan for the possibility that the host country cannot fully or consistently meet its security obligations to the charter city. A breakdown of security in any part of a host country, or even the surrounding region, poses a threat to the long-term viability of a charter city.

To mitigate these risks, prior to investing in a charter city, investors must properly analyze the security situation in the host country and surrounding region. As part of this analysis, developers and investors should be aware of host country membership in any intergovernmental military alliances. Ideally, situating a charter city in a host country that is part of such an alliance may serve as an extra level of protection to the charter city in the event of a security breakdown. As a part of the negotiations for concessions made to the charter city, developers should discuss security with the host country and come to a firm understanding of the obligations of both parties. Beyond general security agreements, charter cities can pursue several other options to incentivize the host country government to provide adequate security.

One such option is a revenue sharing agreement. That is, charter city developers can agree to a particular proportion of their revenues being remitted to the host country government each year. These agreements incentivize the host country to follow through on their security guarantees. A failure of the guarantee would lead to a loss of revenue for the government, as businesses and residents leave the charter city.

A second option for charter cities to reduce the likelihood of a host country failing to meet its security obligations is through the use of a minimum revenue guarantee. In a typical minimum revenue guarantee (commonly used in public-private partnerships), the government agrees to compensate the concessionaire if the project revenue falls below a specified threshold. Such a guarantee can be included as a provision in the concession agreement negotiated with the host country. The provision should stipulate that the minimum revenue guarantee will only apply in the event of a security breach in the charter city. In this scenario, the host country would be obligated to provide some level of compensation to the charter city developer or investors for a lapse in security. This agreement, like other agreements between states and investors, will likely be enforceable in international courts and helps de-risk the charter city project.

A third option to mitigate security risks is through specific financial instruments. These include, for example, political risk guarantees and insurance products that the developer can purchase. Although private insurers underwrite such risk, institutions like the World Bank may be better suited.

MIGA, a member of the World Bank Group, exists to promote cross-border investment in developing countries by providing guarantees (political risk insurance and credit enhancement) to investors and lenders. MIGA insures investments made by foreign investors in developing countries that are members of the World Bank Group. In certain cases, the agency may also insure an investment made by a national of the host country, provided the funds originate from outside that country.

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Currency Risks

Charter city investors inevitably face currency risk. Many emerging markets have volatile currencies (especially relative to the US dollar). With debt in USD and revenue in a local currency, a devaluation of that local currency can make it difficult for developers to pay back debt, threatening the viability of a charter city.

Given the above risks, when possible, investors should consider borrowing in the local currency where the charter city is located to avoid such a currency mismatch. Groups like the IFC offer long term local currency financing throughout emerging markets.iv

Investors can also consider utilizing currency swaps. Under a currency swap, two parties agree to exchange principal and/or interest payments of a loan in one currency for an equivalent loan in another country.

Expropriation Risks

A successful charter city risks being expropriated by the host country. This expropriation could entail a sudden change in the concessions granted to the charter city, or, in a more extreme form, a direct takeover of key infrastructure or of the city itself. Mitigating such risk is important to attracting investment to the charter city, as well as to its longer-term success.

The first step to mitigate expropriation risk is to minimize the likelihood that the host country decides to expropriate the charter city in the first place. This can be accomplished in several ways.

First, the developer should understand the existing laws in the host country around eminent domain, as well as the relevant international treaties that apply in the host country concerning eminent domain. National constitutions and laws typically refer to compulsory acquisition being used for “public purposes,” “public uses,” and/or in the “public interest.” In some jurisdictions, these terms have distinct or overlapping meanings. In other cases, these distinctions are blurred or non-existent.v

Disputes thus often turn on whether or not there is a public use or interest, and whether the compensation is prompt, adequate, and effective. However, before the dispute stage, it is important that investors understand their likelihood of winning based on the local definitions of public use or interest that exist in different jurisdictions.


The second thing the developer can do is to align their own incentives with those of the government from the onset of the project. By giving the national and local government an ownership stake in the charter city and establishing a revenue sharing agreement, it becomes in the best interest of the government not to interfere. For a host government, taking ownership of the land and property in a charter city risks the future streams of revenue that can be expected to come from a prosperous city. Model legislation developed by the Charter Cities Institute includes such a mechanism to align the incentives of host country politicians and bureaucrats with those of the charter city.

Third, as mentioned in the social risk section, the developer can engage elites within the host country. By ensuring that influential families and business groups have a vested interest in the success of the project, the host country is less likely to expropriate charter city assets because it risks angering key stakeholders.

One final method to help limit the risk of expropriation is to list the city developer on the host country stock exchange. By publicly listing the company, expropriation threatens the financial standing of not just the city developer, but hundreds or thousands of local stockholders. Pension funds and other entities that buy large amounts of stock tend to have political influence and would work to limit anything that would harm their bottom lines.

In addition to limiting the risk of expropriation by aligning incentives, there are also legal means to recover losses in the event of expropriation. Because charter cities are not sovereign, they are subject to all the international treaties signed by the host country, including international investment agreements. Typically signed on a bilateral or regional basis, these investment agreements provide grounds for a lawsuit in international courts and enforcement of arbitral awards. Thousands of such treaties are currently in force, including in low- and middle-income countries where charter cities would be located. The existence of investment treaties increases the volume of foreign direct investment a country receives because such treaties reassure investors that restitution in the event of expropriation is possible.

Although there are exceptions, states involved in international arbitration do tend to abide by arbitral awards made, subject to the terms of the relevant international agreements. In addition to the bilateral and regional investment agreements, international arbitral agreements like the UN’s New York Convention have been signed by most countries. Model international arbitration laws have also been adopted, including in low- and middle-income countries.

One mechanism that exists to help resolve such disputes is the International Centre for the Settlement of Investment Disputes (ICSID). ICSID is an independent and effective dispute-settlement institution. Its availability to investors and to states helps to promote international investment by providing confidence in and legitimacy to the dispute resolution process. However, not all states are parties to the ICSID convention and it is important for investors to know whether the host country is a signatory.

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In addition to understanding the dispute resolution processes available, investors must also understand the related insurance products. Collecting a judgment against a sovereign state can be a challenge. However, Arbitration Award Default Insurance (AADI) guarantees payment of a legally enforceable arbitral award against a sovereign entity.

AADI comprises bespoke insurance solutions provided by a rated insurer, designed to mitigate enforcement risk in proceedings against states or state-owned entities. In exchange for a premium, the insurer will guarantee payment of an award up to a pre-agreed limit of indemnity.

Generally, the first step is for the legal team to prepare a proposal setting out the background to the case, the merits of the claim (including jurisdiction, liability, and quantum) and any view on the prospects of enforcement. Following this, a specialist broker will undertake an initial review and then market the risk to select insurers. Those insurers will, subject to initial underwriting queries and their appetite for the risk, provide a non-binding indication of terms.xiii

**Conclusion**

As with any major infrastructure project, it is important for charter city developers to mitigate potential risks. This is particularly important as charter cities are inherently more political than the average infrastructure project. The key to success for charter cities is careful stakeholder management to ensure that all relevant stakeholders, including the host country government and the local community, benefit from the success of the project (and incur a cost for project failure).

In this guide we have outlined four important types of risk that a charter city developer should work to mitigate. While we have endeavored to be comprehensive, there will be risks that arise that are not included in this discussion. A comprehensive approach is necessary for every charter city development to understand the particular risks in the region and in the community within which the charter city is being considered.

Lastly, it is important to note that risk mitigation cannot be accomplished in a single action, but instead should be viewed as an ongoing process. Continual communication with not only charter city residents, but citizens of the host country and various civil society groups, is crucial to the long-term success of the charter city.

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