Parhelion
Underwriting Ltd

The Role of Insurance in Climate Policy.

Removing Policy Risk from Renewable Energy Investment and Supporting Investment Grade Policy in Climate Finance through the Creation of a Green Insurance Agency

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1. The competition for capital has arguably never been higher than in the currently economic environment. The supply of capital is constrained and risk averse but demand has continued to rise. One growing source of demand for capital is climate finance[1], for which we saw governments make limited pledges under the 2009 Copenhagen Accord and agreement to form a 'Green Climate Fund', in the context of recognising the need to mobilise $100 billion annually by 2020. The source of these funds was not specified but it will undoubtedly require major contributions from both the public and private sector.

2. The willingness of the private sector to commit capital to this sector will be driven by the perceived risk / reward profile of such investments, relative to all other investment opportunities available. Parhelion's experience shows that there is not a lack of capital interested in investing in green projects, but rather it is unwilling to do so because of the risk / return profile.

3. Since the market for climate finance only exists due to the policies being implemented to tackle climate change the key drivers in this risk / reward balance will be the perceived risk of policy and regulatory change[2]. **Policy risk** is therefore the biggest risk investors face in this market and has a significant role in dissuading investors from allocating capital to this sector. Parhelion, as the leading insurance and risk finance innovator in this sector, has significant first-hand experience of requests for Policy Risk coverage from potential investors.

4. To varying degrees, governments recognise these risks and have employed a number of tactics to manage them such as the UK Climate Act 2008, which seeks to establish long-term legislatively backed targets. The UK Climate Act 2008, is limited by constitutional barriers that prevent any Government from binding a successor Government. This means that the Climate Act is subject to the same policy risk[3] as any other policy measure it seeks to manage.

5. **Private Sector insurers will not currently underwrite Policy Risk**. This is because of a lack of alignment of interest with the risk influencer i.e. government, and the risk carrier, be it investors or insurers. Underwriting this risk without aligned interest has the potential to create perverse incentives and moral hazard, and thus insurers are unwilling to accept this risk.

6. There are also numerous other risks that investors are keen to manage through innovative insurance instruments. There are however critical **structural barriers** to new product development in the insurance industry. This includes a lack of incentive for Insurance brokers to undertake the R&D required for new product development as they work mostly on success

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1 For the purpose of this report, we define 'climate finance' as the provision of financial resources and investment, both public and private, in projects and actions partially or wholly intended to support action on mitigating greenhouse gas (GHG) emissions and adapting to climate change.

2 For detailed analysis of risks to climate finance see: 'Can Capital Markets Bridge the Climate Change Finance Gap' - September 2010 - Standard & Poor's and Parhelion Underwriting. See also 'Financing Renewable Energy in Developing Countries' UNEP FI February 2012. See also, among others: Nick Robins and Mark Fulton, 'Investment Opportunities and Catalysts. Analysis and proposals from the climate finance industry on funding climate mitigation', in Richard B. Stewart, Benedict Kingsbury and Bryce Rudyk (eds.), Climate Finance. Regulatory and Funding Strategies for Climate Change and Global Development, New York University Press, New York and London, 143-151; and Green Investment Bank Commission (2010), Unlocking investment to deliver Britain's low carbon future, London, 5-7.

3 This paper will use the terms "policy risk" and "regulatory risk" interchangeably. The term "policy risk" includes legal and regulatory changes. "Legal changes" refers to changes in laws (which are passed by parliament or some other legislative arm of a government). "Regulatory changes" refers to changes in a rule issued by a government (body) or by some agency that the government has given authority to regulate an industry.

commission. Brokers should however be a critical part of the innovation process within the industry as they bring syndication services and create constructive competitive tension between insurers. This often leaves the innovation for the industry to be undertaken by the re/insurers. However without the competitive tension and syndication, the insurer's innovation is limited both in ambition and scale.

7. Parhelion's core proposal described here is for the establishment of a public / private funded **Green Insurance Agency** to make available to investors insurance policies to **underwrite the specific risk of changes in policy and other insurance policies that the private sector are unable to do on a standalone basis**.

8. **Specific single peril** policies differ significantly from direct investment and guarantees currently being considered by a range of public funded schemes. These policies avoid the public sector assuming wide-ranging risks that are arguably not the role of the government[4]. It can easily be argued that Government has a role in reducing policy risk but not a role in guaranteeing whether a company will succeed or fail for any reason.

9. Having available an insurance scheme to underwrite policy risk will remove key barriers currently dissuading investors from committing the capital to the climate related policy signals currently being sent by governments around the world thus stimulating business. It will also create an **alignment of interest** between those that have the most influence over a particular risk (in this instance the legislators and executive) and those exposed to the risk (business and society).

10. Creating such an alignment of interest would also allow **private sector insurers to act as co-insurers and or reinsurers** in partnership with the **Green Insurance Agency**. This would unlock a huge pool of underwriting capital that has largely been overlooked or is not generally available.

11. Political Risk Insurance is already available to manage risks of illegitimate policy change in third world countries, typically emerging markets. There is no option however to manage the risk of gradual changes in policy that may be due to change in political philosophy of a new government or gradual change in wider economic and social environment that is beyond the reasonable foresight of investors. These changes are of course legitimate but nonetheless create a significant barrier to achieving a meaningful flow of investment in clean energy, emission reduction and adaptation projects. The **Green Insurance Agency** would not differentiate between the motive or type of policy change (i.e. legitimate or illegitimate) since it is not always practical or relevant to do so.

12. The insurance policy would be issued for a **premium paid by the investors** (the insured) to indemnify them against **loss resulting from a change in policy** up to a pre-agreed limit over a specific time frame. Since the decision to cause a loss under these insurance contracts remains entirely within the hands of the government, the provision of these contracts offers participating countries a good opportunity to **guarantee a profit to their governments**.

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4 The US Government faced significant criticism over government guarantees to Beacon Energy and Solyndra, companies which both failed despite massive government funding /guarantees, $43million and $535million respectively.

13. Furthermore since the contracts would be a **contract of indemnity** it limits the **Green Insurance Agency's** payout to the actual loss incurred. Therefore minor changes in policy are unlikely to trigger a major loss. For instance, in the UK if an investor had the benefit of such an insurance today, current proposal to change the ROC (Renewable Obligation Certificate) regime to one of FITs with CFD (Feed-in-Tariffs with Contracts for Difference) would be limited to an administrative change rather than a threat to long term revenue and viability of projects, which would be covered by the policy. Whilst in reality, many investors benefiting from ROCs today will also benefit from FITs in the future, the *perceived* risk and uncertainty increases the risk premium investors demand to operate in a forever-changing policy environment.

14. The **Green Insurance Agency** would be structured to allow multi-country participation. Each participating country would benefit from **match funding** from funds committed under the Copenhagen Accord, the UK International Climate Fund for example. In the first instance individual country 'cells' could be used for individual country participation. This would avoid perceived unacceptable cross country exposure. However to benefit from diversification and capital optimisation a pooling arrangement could be established for higher layer exposures.

15. The **Green Insurance Agency** would be **capitalised and managed as a standalone risk-bearing entity**. Due to the capital structure of insurers, the **Green Insurance Agency** could gain significant advantages over the current investment product contemplated by the public sector guarantee and funding schemes as it would be able to underwrite many more projects than could be invested in for the same amount of capital. Capitalisation of the **Green Insurance Agency** should reflect normal insurance market practice.

16. **Total aggregate liabilities** of the **Green Insurance Agency** should reflect the policy target of individual member countries. For instance if a government seeks to promote 2000MW of Solar PV projects, rather than investing directly in such projects, the **Green Insurance Agency** would issue policies up to a proportion of that espoused target (e.g. 120% of policy target). The insurance would only be offered to projects that are in the final stage of development i.e. have financing committed. This will further reduce the potential perils of government bias.

17. Furthermore, any concern about creating significant liabilities for future governments would also be avoided since the capitalisation of the **Green Insurance Agency** would be to a level that would not create future liability. Indeed, future governments may benefit from reserve releases from the **Green Insurance Agency** as governments deliver their espoused commitment and the liabilities expire.

18. Strong and effective precedents such as MIGA, OPIC, ECGD[5] etc. can be identified to demonstrate the effectiveness of focused public / private insurance mechanism. These precedents may also be drawn on to ensure appropriate design of checks and balances necessary to allow the creation of an effective **Green Insurance Agency**.

19. A public / private partnership allows a number of crucial benefits including:

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[5] MIGA: Multilateral Investment Guarantee Agency, part of the World Bank Group; OPIC: Overseas Private Investment Corporation; ECGD: Exports Credit Guarantee Department

a. enhancing the regulatory competitiveness of the host country it supports;
b. attracting large private market capital source (insurers) to an area they have traditionally avoided;
c. creating alignment of interest between the party most able to influence the risk (government) and those exposed to the risk (investors);
d. more projects can be insured by a **Green Insurance Agency** than can be invested in by direct public capital injection or full guarantee due to the capital structure and risk profile of an insurer;
e. innovation and competition are ensured by allowing the market to select individual investment rather than a government investor which may be exposed to project &/or technology selection bias;
f. it ensures credit-worthy counterparties by having host country government backing;
g. a public/private partnership will allow sufficient capital to be attracted;
h. it provides an opportunity to create profits for governments;
i. It provides for entrenchment of policy objectives without loss of government flexibility / infringement of parliamentary sovereignty.

20. Obvious problems of such a proposal can easily be managed. It may for instance be argued that the participation of a country in the **Green Insurance Agency** would hamper a government's flexibility in policy development and the promotion of the political philosophy for which it was elected. In reality any such loss of flexibility would be extremely limited and indeed positive to the extent that a future government would have to consider the direct impact on businesses which have responded to previous policy signals and with which it now has a financial alignment.

21. The concept of Investment Grade Policy[6] (IGP) is an effective way to consider the link between policy objectives and the risk of success or failure in the delivery of the policy goals. Commercial market investments that on their own standing do not achieve Investment Grade have a long established process to seek credit enhancement through insurance. The same can be true for government policy.

Julian Richardson,

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6 Kirsty Hamilton, 'Unlocking Finance for Clean Energy: the Need for Investment Grade Policy', Energy, Environment and Development Programme Paper 09/94, Chatham House, December 2009, p.13.