Riskybusiness

IS THERE A ROLE FOR INSURANCE IN THE CARBON MARKET? ASKS **JULIAN RICHARDSON**

For several years, a small band of people have been pushing insurance in the carbon market. However, the take up has been slow. Why is this? Fundamentally, is there a role for insurance in the carbon market?

Insurance is an important tool for any risk management strategy. It allows you to transfer risks you are unable or unwilling to take to someone more willing and able to bare them. This statement identifies important elements in insurance buying and so let's break it down.

Firstly, insurance 'allows you to transfer risk.' This implies you have undertaken a rigorous risk identification process to know what risks you are facing. In the clean development mechanism (CDM), much of the concern focuses on 'delivery risk' of carbon credits. There is no such thing as delivery risk; non-delivery is a consequence, not a risk. The risk is what caused the non-delivery.

Secondly, you are 'unwilling or unable to take' the risk. This indicates that there is some quantitative understanding of the risk. Typically, a risk should be measured according to its frequency and severity, or its likelihood and impact. Without this, it is difficult to assess your risk appetite and ability to take a risk.

Some people offer coverage for everything. This is a waste of money. If you have transferred away all the risk, it is likely you have given away all the return. And, since it is a near certainty that a project will have some losses, if you seek to insure these losses you are handing the insurer money that they will hold and give back, once a claim has occurred and settlement agreed.

Thirdly, insurance transfers risks to someone 'willing and able to bare them.' The 'willing' element is important when considering the risks to transfer. Some investors are engaged in the CDM to take the risk of non-delivery. Some are not. Insurers will not take all risks. Furthermore, they will not accept risk that might change the behaviour of the project participants. An insurers' willingness to accept a risk will depend on their knowledge and understanding of the risk and the competitive pressure they are under.

With regard to being 'able to bare them', it is important that an insurer is creditworthy and able to pay any claim. Naturally, ability to pay must be matched by a willingness to pay.

Therefore, I propose some advice:

Julian Richardson: Insurance offerings have been overpriced, poorly defined and narrow

- Know the risks you face. Do a detailed and specific risk identification process and make sure you can define the risks well. Make sure when you say 'risk' you don't mean 'consequence';
- Understand the impact a risk can have on your business and your risk appetite;
- Be reasonable in your expectation. Not all risks are insurable;
- Do not go directly to insurers, they will give you what they want, not necessarily what you want. You may think it will save the cost of an intermediary, but they should add value by creating competitive tension and advising you what can be achieved. There are also very few insurers that know the carbon market;
- Do not buy insurance you do not need;
- Work with your intermediary, they are on your side; and
- There is nothing as expensive as cheap professional advice. Do not buy purely on price.

So why have there been so few insurance-related transactions in the carbon market? Unfortunately, some of the PR by the re/insurers has encouraged direct selling. This has often resulted in the clients being underwhelmed by offerings. My experience is that they have been overpriced, poorly defined and narrow.

The carbon market has come a long way, but it is still immature. Early movers are the risk-takers and initially their focus is on getting risks on their books. It is only later that they think about how to manage it. Equally, they are not familiar with how insurance should be used as part of a risk management strategy. Buying insurance is not straightforward. Furthermore, the insurance market is a dynamic environment with underwriters' appetite and capacity for risk changing frequently. In more mature industries, companies will have dedicated risk managers responsible for buying insurance and an established relationship with their intermediary.

When properly used insurance should improve your business by removing the risk that could impact your business objectives. ●

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