Policy Risk Insurance Mechanism (PRIM) for Clean Energy Technologies

UNEP

Background

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. Governments have recognised the need to mobilise $100 billion annually by 2020, which will require major contributions from both the public and private sector.

The willingness of the private sector to commit capital to the clean energy and wider climate finance sector will be driven by the perceived risk/return profile of such investments. Key drivers in this risk/reward balance for investors are therefore the anticipated risk of policy and regulatory change. Policy risk is the biggest risk that investors face in this market, often dissuading investors from allocating capital to this sector.

Separate work undertaken by a range of stakeholders including the Climate Policy Initiative (CPI), Parhelion Underwriters, the Organisation for Economic Co-operation and Development (OECD), the United Nations Environment Programme (UNEP) and the World Economic Forum (WEF), has identified policy risk as a major barrier to investment flows in to the climate finance sector.

Addressing the Need for Policy Risk Insurance

It is useful to clarify the distinction between policy risk and political risk since there is an established insurance market for political risk but not for policy risk. Political risk insurance will only cover illegal or illegitimate changes in law whereas changes in policy which are entirely legitimate would not normally be covered.

Private sector insurers will not currently underwrite policy risk. This is because of a lack of alignment of interest with the risk influencer (government), and the risk carrier (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.

It is therefore proposed to establish a public/private funded Policy Risk Insurance Mechanism (PRIM) to make available to investors insurance cover that underwrites the specific risk of changes in policy that the private sector are unable to do on a standalone basis.

Such a specific single peril policy differs significantly from the direct investment and guarantees currently being considered by a range of public-funded schemes. By insuring the single specific risk of policy change, it is possible to avoid the public sector assuming wide-ranging risks that are arguably not the role of the government. It is clearly appropriate for Government to play a role in reducing policy risk but not a role in guaranteeing whether a company will succeed or fail for any reason.

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Benefits from a Policy Risk Insurance Mechanism (PRIM)

Having available an insurance scheme to underwrite policy risk will remove key barriers currently dissuading investors from committing capital to positive climate-related policy signals, thus stimulating business. It will also create an alignment of interests between those that have the most influence over a particular risk (the legislators) and those exposed to the risk (business and society).

Creating such an alignment of interests would also allow private sector insurers to act as co-insurers and/or reinsurers in partnership with the Policy Risk Insurance Mechanism. This would 'crowd-in' a significant pool of capital (the insurance market, both domestic and international) that has largely been overlooked or is not generally available.

Through existing insurance mechanisms, there is no option 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 the wider economic and social environment that is beyond the reasonable foresight of investors. These changes, though legitimate, create a barrier to achieving significant investment in clean energy applications. The Policy Risk Insurance Mechanism will not differentiate between the motive or type of policy change but would rather provide potential investors with some universal guarantee over the consequences of such change.

Current Status

In October 2012 the World Economic Forum convened a workshop in Nairobi, Kenya under the title 'Unlocking Financing for Clean Energy in Kenya'. One of the Working Groups confirmed that the issue of policy risk is generally significant to investment in clean energy technologies. A key factor for the success of a PRIM will be the direct involvement of local insurers to create awareness of this market restraint and to develop a mechanism that can be effectively demonstrated in a country such as Kenya.

The current products available to cover policy risks have already been considered by UNEP. It is clear that, whilst there are a number of initiatives that could in theory address the issue, they are limited in scope, access or ability to crowd-in domestic and other sources of capital.

The WG concluded that it would be possible to secure investment from 10 local insurance companies, but the majority would need to be covered by international reinsurers (probably a consortium). Local insurance companies are probably best addressed through the African Trade Insurance Agency (ATI). Discussions in this respect have already been initiated.

In addition, the UK government recently undertook a ministerial trade mission to East Africa where specific invitations were made to the host country governments for participation in PRIM. UKDECC is now leading an initiative to further assess and potentially develop the concept of PRIM in Africa.

Solution

By helping to provide specific insurance coverage for policy risk, significant benefits can be quickly delivered. These include:

- Enhanced regulatory competitiveness of Participating Countries
- Support for the delivery of low carbon policy objectives
- Creating a revenue and profit stream for Participating Countries
- Attracting private sector re/insurers - a huge pool of capital under-utilised for clean tech investment
- Efficient use and leverage of public funds
- Aligning the use of public funds with the risk the government has control over
- Improving the attractiveness of the Participating Countries for low carbon investment

As such, a green PRIM could play a powerful role in unlocking £multi-billion investment into the green economy and delivery of government decarbonisation policy objectives, particularly in developing countries.

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