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Risk Gaps: Executive Summary

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About CPI

Climate Policy Initiative is a global policy effectiveness analysis and advisory organization. Its mission is to assess, diagnose, and support nations' efforts to achieve low-carbon growth. An independent, not-for-profit organization supported by a grant from the Open Society Foundations, CPI's headquarters are in the U.S., with offices and programs in Brazil, China, Europe, India, and Indonesia.

San Giorgio Group Case Study Overview

This paper is one of a series – prepared by Climate Policy Initiative for the San Giorgio Group – examining the use of public money to catalyze and incentivize private investment into low carbon technologies and draw lessons for scaling-up green, low-emissions funding. The San Giorgio Group case studies seek to provide real-world examples of what works and what does not in using public money to spur low carbon growth. Through these case studies CPI describes and analyzes the types of mechanisms employed by the public sector to deal with the risks and barriers that impede investment, establish supporting policy and institutional development and address capacity constraints.

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Executive Summary

Risk, whether real or perceived, is the most important factor preventing projects from finding financial investors — or raising the returns that these investors demand. It is also a fact that policymakers can cause, control, alleviate, or help mitigate risk.

Whenever risk rests on parties who are unsuited or unwilling to bear it, there is demand for risk mitigation instruments. Not all risks need to be mitigated by policymakers. Indeed, investors may be willing to take on some risks, and may also be willing to assume certain risk categories or higher levels of risk if the price is very good. However, whenever supply for risk mitigation fails to meet demand, gaps in coverage result in bottlenecks that prevent capital from flowing to clean investments. The public sector (governments, policymakers, and development banks) has been called upon to supply a variety of risk mitigation instruments to help alleviate investment bottlenecks.

Risk Gaps comprises a series of related papers. The first paper, *A Map of Risk Mitigation Instruments for Clean Investments*, establishes a framework to map current risk mitigation instruments and assess how well these meet the demand for risk coverage in low carbon and climate resilient (green) investments (see Figure ES-1). Two discrete papers, *First-Loss Protection Mechanisms* and *Policy Risk Instruments*, analyze respectively the effectiveness of two potential instruments designed to address them: first-loss protection mechanisms and policy risk insurance.

As other risk mitigation instruments become available to investors, we will continue to apply and refine this analytical framework in order to highlight which elements are integral to a particular instrument's effectiveness, which issues are likely to challenge their implementation, and to understand whether these new instruments could themselves create additional risks.

Our key findings are:

There are gaps in risk coverage, particularly for policy risks and financing risks (including access to capital and investment exit/liquidity risks).

In developed markets, where policies have undergone frequent changes, there are gaps in risk coverage for policy risk. At the same time, there are also gaps in coverage for physical and technical risks for the least mature technologies. Both policy and technical risks increase the perception of financing risks. Project interventions address access to capital and counterparty risks for specific projects, but do not address investments' exit/liquidity risks, and thus do not encourage additional investment from the private sector.

In developing markets, both the perception of risks and the supply of risk instruments are higher than in developed markets. As with developed markets, there is a gap in policy risk coverage. Financing risks are higher than in developed markets, heightened by immature financial institutions and markets, and are insufficiently covered by existing instruments. Concessional resources address these financial risks at the project level, but so far have not addressed liquidity risks.

Two types of instruments can address some of these risk coverage gaps — first-loss protection instruments and policy risk insurance.

- 1. First-loss protection instruments shield investors from a pre-defined amount of financial loss, thus enhancing the credit worthiness and improving the financial profile of an investment.** In addition, they reduce the perception of liquidity risks by aiming to attract, at scale, institutional investors, thus increasing the number of participants in these markets.

Two recent initiatives could potentially apply first-loss protection instruments to clean energy investments, the **European Commission – European Investment Bank Project Bond Initiative (PBI)**, already in a pilot phase, which aims to support the credit rating of individual projects with a guarantee instrument, and the **Sustainable Development Bond Assurance Corporation (SDBAC)** which would establish a dedicated entity to provide first-loss insurance to various project finance collateralized loan obligations.

To be effective, first-loss protection mechanisms should:

- **address specific investor needs**, match their required risk-adjusted rate of return and allow

securities to obtain an investment-grade credit rating;

- **address institutional investors' unique circumstances**, such as liquidity of a secondary market and mitigation of some specific project-level risks;
- **be priced competitively**, below what investors would pay for both alternative instruments and for carrying the risks themselves; and
- **have a transformative impact**, so that they can help meet the clean investment challenge. This means not only must they appeal to both banking institutions and investors, but that their proceeds be used (at least in part) to support low-carbon and climate-friendly investments.

However, first-loss protection mechanisms can be complex, costly, and may create additional risks such as attracting developers with lower quality projects (i.e., moral hazard). For these reasons, only sponsors with significant resources, financial expertise, and a commitment to clean investment can simultaneously enhance securities' creditworthiness to investment grade level, at an affordable price and support emissions reduction goals.

- 2. Policy risk insurance provides coverage against the possibility that national governments can shift policies in ways that hurt the financial stability of projects.** The risk that new policies may harm the financial stability of existing projects — defined here as “retroactive policy risk” — is by far the most serious threat to investors' confidence.

Political risk insurance's expropriation coverage and partial risk guarantees (PRGs), which are time-tested models, and a recent policy risk insurance proposal by Overseas Private Investment Corporation (OPIC), all have the ability to address policy risk.

- **Public political risk insurances (PRIs) such as those offered by the Multilateral Investment Guarantee Agency (MIGA) and OPIC, can indirectly address policy risk under their expropriation coverage.** However, uncertainties about expropriation claims' approval processes, including the timing remedies, greatly limit their effectiveness.
- **Partial Risk Guarantees (PRGs) can also address policy risk** but only when it is clearly identified in the PRG contract and when a counter-guarantee

by the host government is available. Furthermore their focus is limited to debt investments.

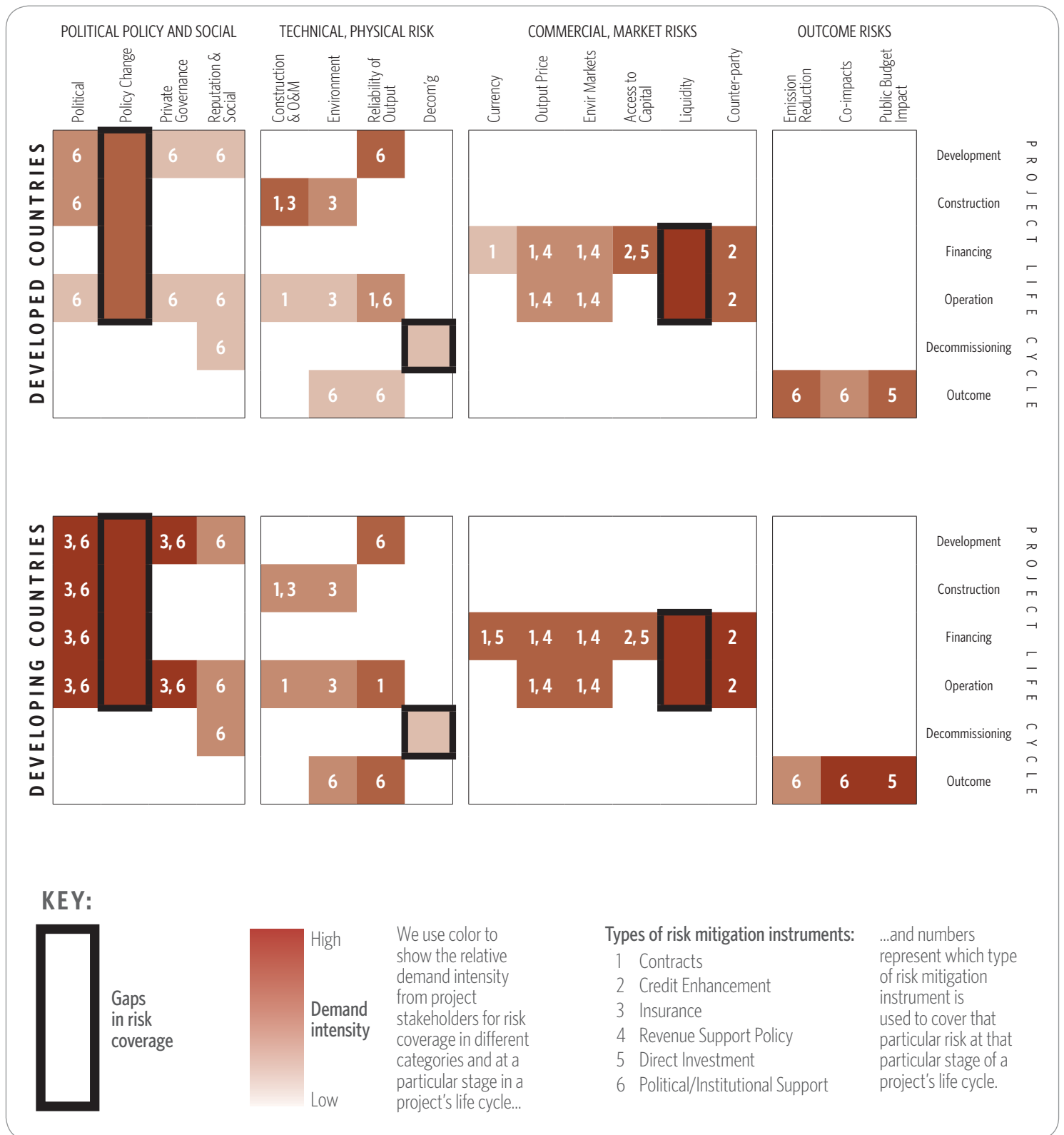
- **OPIC feed-in-tariff insurance**, on the other hand, reduces the impact of policy risk by providing coverage for changes to national policies that would harm the financial stability of existing projects. While OPIC's proposal includes improvements on expropriation coverage, significant issues remain to be addressed.

On a positive note, both MIGA's expropriation coverage and OPIC's feed-in-tariff insurance have been successful in securing remedies from host governments and obtaining compensation when breaches have occurred. However, there are still significant uncertainties about timing, transaction costs, and compliance requirements, which limit the scope of these instruments to large projects only. These uncertainties have also made credit rating agencies reluctant to fully acknowledge their effectiveness and enhance projects' credit rating.

Streamlining procedures, increasing certainty and timeliness of remedies, and significantly reducing transaction costs can greatly improve policy risk instruments' effectiveness. OPIC's new policy insurance coverage seems to be a step in the right direction, but as it has not yet been implemented, its effectiveness remains to be seen.

Finally, new, innovative risk mitigation instruments are needed to bridge the gap between supply and demand for risk coverage. The novelty of low carbon and climate resilient technologies, public and private budgetary constraints, weakness in capital markets and retrospective policy changes have all increased the perception of risks in green investments to a level that prevents finance to flow, at scale, towards much needed investments in climate friendly infrastructure. While new risk mitigation instruments are emerging, gaps remain. CPI remains committed to improving the understanding of existing and emerging instruments to help develop an effective solution to fill this financing gap.

Figure ES-1: Demand and supply of risk coverage for green investments



For a detailed analysis of the different categories of risks and the available risk mitigation instruments, please refer to the report *A Map of Risk Mitigation Instruments for Clean Investments*.