

Howden M&A

HOWDEN

Responsible carbon offsetting

Warranty & indemnity insurance
for the voluntary carbon credit market

Using warranty & indemnity (W&I) insurance to enhance the quality of





voluntary carbon credits

Howden has developed a new policy that supports the buying and selling of carbon credits. The policy takes established best practice from the mergers and acquisitions (M&A) market and applies it to the nascent voluntary carbon market (VCM).

There have been historical problems with carbon credits. Common issues have included concern around whether the projects have had the desired environmental impact, if they have complied with the social benefit set out in the methodology and around the double counting of credits. Issues such as these have eroded trust in the market and led to limited buyer appetite, downturn in the price that projects have been able to achieve for their credits and volumes being depleted.

The W&I policy has the ability to address a number of these structural issues and act as a governance mechanism for the carbon credits.

How does the policy work?

Traditional W&I policies are an insurance tool used in M&A transactions (such as share and asset sales) which indemnify a buyer for a breach of warranty (or a claim under the tax indemnity) by a seller under a transaction agreement. This approach can be equally reflected for the sales contracts that stipulate the terms of the purchase of the “asset” – the carbon credits.

These contracts are known as Emission Reduction Purchase Agreements (ERPA). ERPAs include certain warranties from the seller to the buyer that include, but are not limited to:

- Carbon credits having been verified for environmental gains in accordance with an established third-party standards;
- Carbon credits having not been sold to anyone else, nor have credits been used to offset emissions (no double-counting);
- Information used to verify the credits being accurate;
- Other stakeholders (e.g. local communities or indigenous people) having been considered, treated fairly and have benefitted from the implementation of the project.
- Seller having the legal right to sell/legal ownership over the credits being sold;

The buyer is protected for these warranties through a W&I policy which provides an alternative right of recourse in the event of a breach by the seller against an A-rated insurer.

A much-needed innovation for the market

Applying W&I insurance to carbon credits addresses key structural issues at the heart of the VCM. The single biggest issue is lack of end-user demand. Many corporates who have bought carbon credits have been accused in the media of ‘greenwashing’ – i.e. buying lower quality (and hence cheaper) carbon credits enabling them to pollute as usual without the concern of reputational damage.

Corporates do not want to run the risk of spending money on credits to address their carbon footprint, only to attract negative attention and damaging their reputations for something that is entirely voluntary. The reality is most projects are beneficial to the environment and local communities, but it is hard for buyers to discern between a good or bad quality project.

By going through the W&I underwriting process, the policy can act as a governing mechanism, injecting trust and bolstering the perceived quality of credits.





How does this help buyers?

Even if buyers have experienced due diligence teams, navigating the risks of assessing a project can be complex.

The W&I policy is designed to streamline and reduce the transaction costs by giving buyers confidence that the credits they are buying have undergone a rigorous underwriting process conducted by a third party that not only specialises in risk management, but also is prepared to stand behind the position with their own balance sheet.

The W&I policy offers cash recourse (typically above the price that buyers pay for the credits) to allow alternative offsets to be purchased in the event of a Loss, and therefore ensure companies are not at risk of failing to meet their net zero targets.

How does this help sellers?

W&I insurance has multiple benefits to project developers, including a stamp of quality leading to stronger negotiating positions. Credits that are sold with W&I insurance have been proven to attract more competitive offers given the additional trust buyers have in the quality and functionality of the projects. sellers can demonstrate to buyers that their credits have met the highest levels of environmental, social and financial diligence, and are backed by an insurance policy that guarantees their provenance and efficacy.

Finally, akin to private M&A transactions, the W&I insurance acts as an advantageous deal tool during the transaction, facilitating and speeding up sales processes while improving cash flows.

Key policy parameters





Policy limits

100-125% (or above) of the transaction value to allow buyers to replace the credits accordingly in the case of a reversal.

Deductible/excess

0.5% - 1% of transaction value.

Premium

Typically, between 1.5% - 4% of the policy limit dependent on the project type, jurisdiction and size.

De minimis

Typically, around 0.01-0.05% of the transaction value, can be as low as £/€25,000.

Policy periods

Around 7 years for title warranties, 2-3 years for compliance warranties. We have been able to structure the policy to provide cover for longer periods such as 10 years for all warranties using a novel insurance structure in the form of a renewal type W&I policy.

Legal fee

Depends on the nature and complexity of the transaction but usually falls within the range of £/€20,000 - £/€50,000.

Bridging gaps between buyers and sellers.

Case study

Mere Plantations Ltd

The deal

In 2023 Howden was approached by Mere Plantations Ltd (Mere), a UK-based project developer of timber plantations to help distinguish the carbon credits issued from one of their reforestation projects in Ghana. Mere's aim was to demonstrate the quality of the project from an environmental and social perspective.

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The challenge

There were two key challenges:

- 1 To take a developed product (W&I insurance) and apply it to a new market. This involved finding insurers who were willing to support the initiative, work through the risks and create a new type of policy.
- 2 To collaborate with a client that had little experience with W&I insurance and assist in their understanding of the product and how it will benefit them and the buyer of their credits.

Deep dive

A key part of the due diligence was assessing the validity of the auditor report, which was produced by a validation/verification body (VVB) called Aenor. Aenor submitted the report to a Colombian standard called Cercarbono who verified the auditor report and approved the credits for issuance. Aenor was not known to the underwriters, so Howden arranged interviews with industry experts to explain the risks.

Insurers were unaccustomed to this diligence format but through a sell-side underwriting process, comfort was obtained through direct access to the project developer who provided a more detailed and complete understanding of the key environmental, financial, social and legal risks associated with the project.

Novel insurance-based solution

The W&I insurance was immediately recognised by Cercarbono as a way of highlighting the quality of the credits that it verifies. Soon after placing the first policy with Mere Plantations, Cercarbono approached Howden to form a partnership with the aim of bringing W&I insurance to all projects that they verify, indicating the high standard of the quality of their credits.

Next steps

The W&I policy today only exists for issued, or spot credits. The intention is to expand coverage to include forward credits.

The quality of our people
means we offer a truly unique
advisory approach.

Contacts





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Your best interest
is our best interest.



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