
WHY INSURANCE IS THE MOST LOGICAL FORM OF FINANCIAL ASSURANCE FOR COMPENSATORY MITIGATION PROJECTS



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In my work as an insurance consultant for various governmental entities, I have participated in a few Proof of Financial Responsibility projects. A couple of times it was a project postmortem to figure out why a financial assurance requirement was a failure in practice. A common denominator in all of these projects is the financial assurance mechanism needed to be:

THE FINANCIAL ASSURANCE REQUIREMENTS IN WETLAND MITIGATION WORK SHARE THESE PRIMARY OBJECTIVES

- RELIABLE AS A SOURCE OF FUTURE FUNDING,
- TOTALLY INDEPENDENT FROM THE FINANCIAL FORTUNES OF THE REGULATED PARTY,
- COST EFFECTIVE,
- AND SUPPORTIVE OF THE REGULATED COMMUNITY.

However, in practice regulators often work in ways that undermine achieving one or more of these objectives. Nowhere is this more evident than in the use of the insurance mechanism as proof of financial responsibility in wetland mitigation projects. I doubt if anyone set out to create significant obstacles for the use of insurance for wetland financial assurance; it just turned out that way, usually as a result of false assumptions and lack of information on insurance custom and practice in the regulator community.

From my past work with various federal agencies analyzing why financial assurance models fail, sometimes spectacularly, I know that any form of financial assurance that is subject to annual renewability is likely to fail on three of the above criteria. In the final analysis, Compensatory Mitigation Insurance with policy terms at least four (4) years long provides a superior value proposition on all four criteria compared to all other forms of financial assurance.

In contrast the providers of bonds and lines of credit (LOCs) face regulatory constraints on obligations longer than one year. These insurance and banking regulatory constraints, which require posted collateral, can drive the total carrying costs of these options as high as a full cash escrow for the financial assurance amounts on a project. The resulting difference between the costs of carrying a multi-year obligation of cash, bonds, or LOCs are similar at around 17% of the face amount annually. Insurance, which does not require collateral, only a solid indemnity agreement, offers a 90% cost advantage. Lowering the total carrying cost of financial assurance ultimately enhances the performance of mitigation projects across the board for all of the stakeholders.

The use of cash as financial assurance is a grossly inefficient use of capital when the expected loss has only a small probability of ever happening. A cash escrow cannot take into account the probability of a loss, but insurance and bonds do. This creates a competitive advantage for these mechanisms.

RELIABILITY

As previously stated, in my experience annually renewable financial assurance will not be in place and available at the time when accessing the funds by the regulator to cure a Default situation is needed. Bonds and LOCs are basically credit instruments; a project heading into Default over a few growing seasons will not be a good credit risk. If the financial assurance instrument does not renew, it will be at the worst possible time to be looking for a replacement financial assurance mechanism. In all likelihood the non-renewal of the annually renewable financial assurance mechanism will trigger a pre-mature Default on the project and thus seal its demise.

It is important to realize a “automatic” renewal in a bond or LOC is not the same as a “guaranteed” renewal. With an automatic renewal, the underwriter gets the opportunity to not renew the mechanism at the end of its effective term of coverage. With a project heading into final default few underwriters will volunteer to renew the financial assurance mechanism when they have an option not to. In contrast, with a guaranteed renewal or “evergreen” provision, the underwriter must renew the policy at the discretion of the customer. Only Evergreen renewal obligations for annually renewable financial assurance mechanisms actually pass a reliability test for a multi-year

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performance obligation when combined with a time delay involving seasons to declare a Default on a project. The one exception to this general rule is if the FA mechanism in a single coverage term encompasses all the obligations in the Mitigation Plan. The problem with Evergreen renewal obligations is they have been constrained or eliminated by regulatory reforms after the financial crises of 2008.

A superior solution on wetland mitigation projects is an insurance policy term of up to 10 years.

The financial assurance period for a regulator can potentially extend beyond the policy term. If a claim is opened under an insurance policy during the policy term, the insurance company establishes a loss reserve for the expected cost to settle the claim. That loss reserve stays open in perpetuity until the claim is settled; there is no need for payment into a trust fund. When considering reliability, nothing comes close to a 10-year insurance policy or cash escrow. The only problem with cash escrows is they are a grossly inefficient use of capital which could double the cost of attaining credits.

CARRYING COST

In a sample project, I computed the total carry cost of a 10-year duration \$3,000,000 financial assurance obligation, assuming bonds and LOCs required some amount of cash collateral. Here are the results:

10 YEAR COST

Insurance	Bond	LOC	Cash
\$148,000	\$600,140	\$526,140	\$1,258,000

Insurance has a huge cost advantage once financial assurance covers more than a two year coverage term.

Ease of Use

One obvious advantage to a multi-year financial assurance mechanism is it can be a "one-and-done" transaction. If a project falls behind in its performance objectives the mechanism will need to be modified, but that is easy compared to renewing it. In the event of a Default, the idea behind all financial assurance mechanisms is monies will be available to the regulator to bring a project up to the performance objectives. The claims department of the insurance company has decades of experience with remediation projects. The involvement of experienced claims adjusters working in a claims department of an insurance or bonding company, offering support to a regulator during a Default situation is unique advantage bonds and insurance.

Clarity

With any financial assurance product, it's vital to know how it will respond in the event of a Default situation and what the responsibilities are for each party involved. In other words, who is going to do what, when, and for what amount? The insurance contract, over the course of eight pages, outlines precisely who is supposed to do what, when, and for what amounts. Insurance is clearly the winner on this parameter.

In contrast, when bonds, LOCs and cash escrows are used for financial assurance they are basically silent on who is supposed to do what and when. For example, when a LOC is called in to fund an escrow account at a bank, what happens next and where do the potentially unused funds go? The sponsor or permittee must pay the bank back along with interest, making the LOC simply a prearranged loan. In my experience, there is no clarity in what happens to funds held in escrow on a defaulted mitigation project.

REGULATED FOR SOLVENCY

On this parameter, all of the financial assurance mechanisms are essentially equal. Both banks and insurance companies are subject to regulatory scrutiny to protect their solvency. I have in practice noted some confusion in the regulator community with requiring insurance companies to be “licensed” to do business in various states. That turns out to be another well-intentioned but wrongheaded idea. Being a “licensed” insurance company in a state triggers a whole set of regulatory requirements that are not relevant to financial assurance and almost guarantees that no insurance company will bother selling financial assurance policies in that state. What should be a requirement is that the provider of financial assurance is “approved” by the state insurance commissioner to transact insurance on an Excess and Surplus lines basis.

Avoidance of Constructive Receipt on US ACE Projects

This criterion is important to all federal agencies, but not to the state-driven projects. Insurance and bonds, with their ability to create loss reserves and claims departments to help in settling Default situations, clearly have the advantage on avoiding constructive receipt of funds. Cash and LOCs, on the other hand, pay into a trust fund, which creates big problems with meeting the technical requirements of avoiding constructive receipt on funds.

With insurance maintaining a clearly superior solution for financial assurance on wetland mitigation projects, why has the uptake on the product line has been so poor for the past 15 years? The answer is there are many reasons. One is constraints within the insurance business itself; insuring environmental risks and providing multi-year policy terms are significant constraints in the insurance business. The stakeholders in wetland mitigation can do little to overcome those constraints in the insurance industry. However, my company has overcome those constraints by partnering with an A+ XV A.M.

Random, sometimes naive, commentary by regulatory agencies objecting to various provisions in the insurance policy form itself is the number one constraint keeping insurance out of the wetland mitigation marketplace. In many cases, the regulator commentary is good feedback on the necessary coverage provisions in the insurance policy. For example, the proper names of the regulator and authorizing regulations for a particular project is useful information for an insurance company trying to adapt an insurance policy form to a specific project. In another example of positive feedback, how a regulator plans to deal with Acts of God or Force Majeure as the cause of a project Default is very useful in tailoring an insurance policy to the performance obligations backed by the insurance policy.

However, some commentary and requirements for Compensatory Mitigation Insurance made by well-intentioned but uninformed regulators are self-destructive, ultimately denying access to a superior form of financial assurance for compensatory mitigation for both the regulator and the sponsors or permittee. Virtually all of these self-destructive recommendations on the Compensatory Mitigation Insurance policy can be attributed to the regulator not understanding corporate finance, the financial markets, and the regulations that affect insurance companies and banks.



HERE ARE SOME OF THE MORE GRIEVOUS EXAMPLES OF MISDIRECTED GUIDANCE ON INSURANCE AS A FORM OF FINANCIAL ASSURANCE:

1. A requirement that an insurance policy coverage policy term must exceed 10 years from the same regulator that allows for annually renewable bonds and LOCs. In my opinion, experience, and in practical application, using annually renewable financial assurance to back an obligation that will take growing seasons to resolve is not reliable financial assurance for the regulator or sponsor/permittee alike. The optional renewability of insurance, bonds, and LOCs should not be confused with the coverage period of the mechanism. A troubled project headed towards Default will not pass the underwriting process for any financial assurance mechanism by the second year in Default status. The coverage term of all financial assurance options needs to be the same and at a minimum, all financial assurance mechanisms should be set with a coverage period of at least 3 growing seasons in duration. There is no need to cobble the use of insurance for financial assurance by requiring significantly longer coverage periods for insurance than the unreliable annually renewable bonds and LOCs.

2. Requiring that an insurance policy form be completely created for a particular regulator. This is an unrealistic request and there is no parallel requirement for bonds or LOCs. In practice, insurance companies start with a standard policy form and adapt that policy through endorsements to fit the needs of a particular insurance buyer. Endorsements override the preprinted standard policy form.. In my experience, two states' In Lieu Fee programs have required a completely customized insurance policy without endorsements before insurance could be accepted as financial assurance on their projects. In custom and practice in the insurance business that is not a reasonable request.

In another example of well-intentioned but misdirected efforts, a state In Lieu Fee program developed their own model insurance policy. In practice, insurance coverage specifications are used to dictate the needed coverage provisions in an insurance policy; nobody develops a mandated insurance policy. One of the mandates in the state's model insurance policy would in practice violate that state's insurance regulations. This obviously creates an unresolvable obstruction for any insurance company seeking to sell Compensatory Mitigation Insurance policies in the state.

Of interest, the same state with its own wetlands FA insurance policy required a 13-year insurance policy term while allowing for annually renewable bonds and LOCs.

Obviously, a 13-year policy term cannot compete on a cost basis with annually non-renewable options for financial assurance. Since this particular state allows for annually renewable bonds and LOCs, the state could save a lot of time and effort by simply stating in the regulations that insurance cannot be used for financial assurance on the state's mitigation projects. In my opinion, doing so would relegate the approvable financial assurance mechanisms to the lowest common denominator on reliability, which is not likely the intended goal behind the mandated use of the model insurance policy by the regulator.

These are just some examples of why I think there is some well-intentioned but misguided effort on the part of regulators; why go through the work of dictating insurance requirements if the end goal is to make sure insurance is never used as financial assurance in the state? The remedy is simple, all financial assurance mechanisms should have the same coverage periods,

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but never longer than 10 years before it needs to be renewed. A functional set of insurance specifications not model insurance policies should be developed with the assistance of experts in commercial insurance.

3. Random required changes to the insurance policy by regulators working in the same organization. USACE districts are the best examples of this activity. Some of these changes directly conflict with other required changes in other districts. Some of these required changes to the Compensatory Mitigation Insurance policy that I have seen reflect a lack of understanding of the insurance industry in general and are unnecessary. In practice, if the same factor at issue in an insurance policy was analyzed for efficacy in bonds or LOCs, the regulator would find the unamended insurance policy functions better than the other two alternatives, which are accepted financial assurance without question.

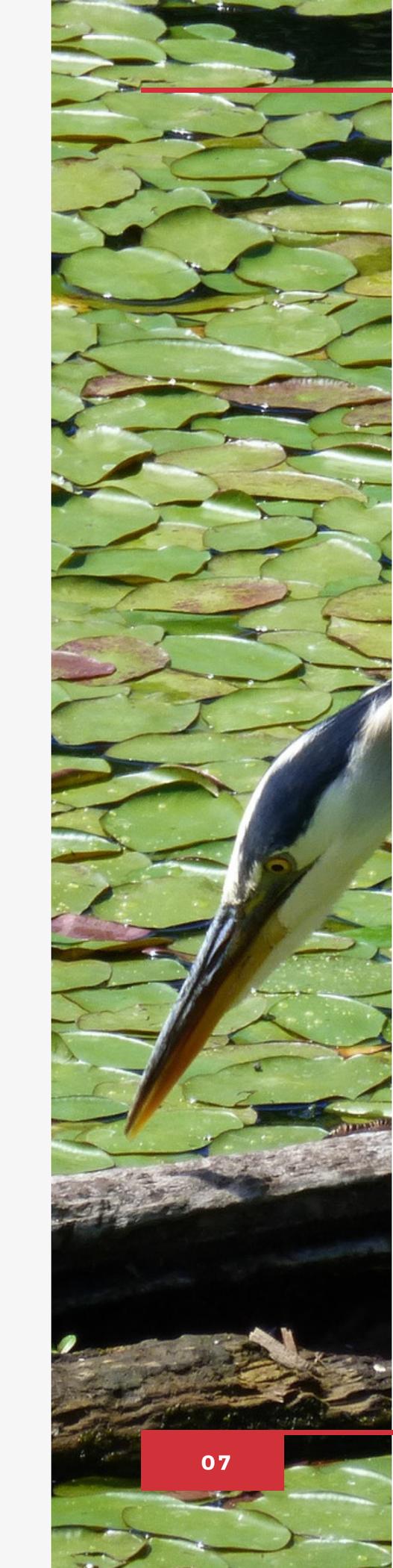
4. Forcing Sponsors of mitigation banks to endure the risk that a proposed financial assurance insurance policy will not be approved for use on a project. The potential that projects could be delayed for months in the approval process forces the use of financial assurance mechanisms that are known to be acceptable, regardless of the mechanism's likely reliability. Preapproval of policy forms would greatly enhance the uptake of insurance as a form of financial assurance.

5. Payment of the full insurance policy limits into a trust fund. This is a perfect example of regulators not understanding the difference between insurance and bond claims in practice, and drawing upon a LOC.

Ultimately payment of insurance proceeds into a trust fund is a really bad idea for bonds and insurance. Doing so undermines the administrative help that the claims adjusters in a claims department in an insurance company can tap into to settle a Default situation at the direction and approval of the regulator. It is also completely unnecessary and adds cost to the premiums paid for bonds and insurance with no benefit to the insured or regulator. When a claim is reported under a bond or insurance, the insurance company sets up a loss reserve as a liability on the insurance company's books. That loss reserve is subject to regulatory oversight by state's insurance commissioner. Loss reserves for insurance and bonds totally eliminate the need for payment into a trust fund.

Mandated payment into a trust fund for the full amount of financial assurance also raises a number of unanswered questions that concern the providers of all financial assurance mechanisms. For example, where do the unused funds go if the project is brought up to its performance objectives for less than the financial assurance amount. Unanswered questions like these drive the cost of financial assurance mechanisms up for no reason when payment into a trust fund serves no purpose with bonds and insurance.

So where did the idea of payment into a trust fund come from? In the case of Default 100% of the face amount of the LOC needs to be drawn upon and placed into escrow before the LOC comes up for renewal. Upon Default declaration, it will be a race to tap into the full amount of the LOC before the lender looking at the financial picture of the failing project refuses to renew the LOC.



A borrower without revenue and unanticipated remedial expenses on a project is not a good credit risk. In practice, no lender will extend new credit to a failing borrower. With a couple of growing seasons for the lender to run away from the project upon annual renewal of the LOC, it is unlikely there will be a LOC to draw upon in year three; but if there is, getting 100% of the face amount into a trust fund while there is still a LOC in place is a really good idea. However, that problem doesn't apply to insurance company loss reserves. Therefore, requiring bonds and insurance to pay into a trust fund makes no sense.

CONCLUSION

INSURANCE PROVIDES A CLEARLY SUPERIOR SOLUTION FOR FINANCIAL ASSURANCE

Insurance provides a clearly superior solution for financial assurance when the goals are, reliability as a source of future contingent funding, operating totally independent from the financial fortunes of the regulated party, and offering FA on a cost-effective basis are considered.

What has been missing is the support of the regulator community, which has in numerous examples inadvertently placed mandates on insurance coverage that other forms of financial assurance, such as bonds and LOCs do not have to adhere to. For example, requiring insurance policies with a minimum of 13 years of coverage duration while simultaneously allowing annually renewable bonds and LOCs. Eliminating these misdirected artificial barriers to the use of insurance will benefit all of the stakeholders in wetland mitigation.