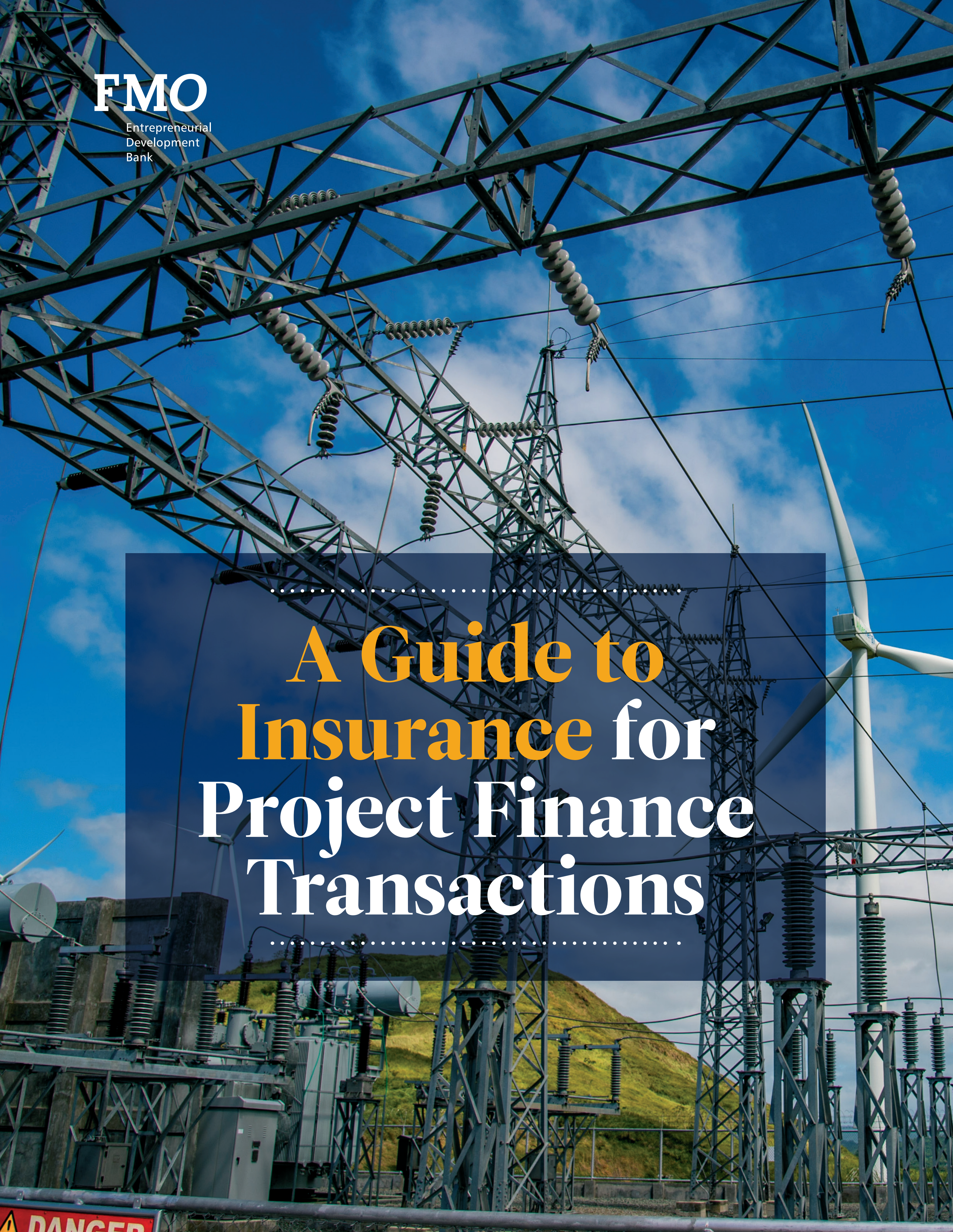

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A Guide to Insurance for Project Finance Transactions

This guide is meant to inform energy clients of FMO about lenders' basic insurance requirements for project finance transactions. It is important to bring the topic of insurances to the transactional agenda at an early stage of the financing process. FMO is in the unique position to have dedicated in-house insurance staff (the FMO Insurance Advisors) allocated to its deal teams.

The FMO Insurance Advisors can advise in tailoring the insurance package. A sound insurance package is beneficial to the project and takes country specific regulations and circumstances into account. This Guide provides a summary of the required construction and operational insurance programs as well as key points of attention during the transaction process.

Importance of managing insurance deliverables early on in the process

Insurance is a risk transfer mechanism which provides a degree of certainty of the future at a known cost and provides indemnity for accidental unintended loss or damage. It forms an integral part of any project finance transaction as it provides protection to both the borrowers and the lenders.
Compliance with the insurance requirements of the finance documentation is a critical path item in the financing process. It is important that insurances are dealt with in a timely and professional manner. In this Guide we provide key points and recommendations to ensure that an efficient and cost-effective bankable insurance program is arranged in alignment with the overall project timelines.

Two phases of the insurance program:

The insurance program is normally divided in two phases, being the Construction Phase and the Operational Phase. The relevant required policies can be summarized as follows:

A. Construction Phase

A. **Construction All Risk (CAR)** – covers physical loss or damage to works during construction
B. **Advanced loss of profits (ALOP)** – provides reimbursement of financial losses caused by the delay resulting from physical loss or damage under the CAR policy
C. **Marine All Risks** – covers loss or damage to materials and machinery during transit; by sea, air, rail and road. It also covers good in storage during the ordinary course of transit.
D. **Marine Delay in Start Up (MDSU)** - provides reimbursement of financial losses caused by the delay due to damage to materials and machinery in transit
E. **Third Party Liability** - covers legal liability to third parties for bodily injury or damage to their property
F. **Terrorism/Political Violence (assets and revenue)** – covers loss or damage to works and resultant financial losses following a terrorism or PV event
G. **Insurance required by legislation** – such as workers' compensation, employer's liability and auto insurance (liability)

Explanatory notes:

- In principle, the policies are purchased by the Borrower/Project as contractors generally do not purchase ALOP and MDSU cover (contractors have no interest in financial losses caused by delays). The ALOP and MDSU policies can also not be purchased as separate policies.

  Furthermore, the borrower and lenders have more control of the terms and conditions of the policy when a borrower-controlled insurance structure is put in place.

- It is typical for Construction Phase insurers to restrict cover for damage caused by defects in material, workmanship, design, plan or specifications. Cover excludes the defective part but includes the cost of damage to other (non-defective) items affected as a result of the defect. This is called the LEG 2/96 wording.

  Depending on the type of construction, there is wider cover available under LEG 3/06, which also includes the cost to reinstate the defective item. The latter is highly recommended although it might be more expensive.

B: Operational Phase

A. **All Risks / machinery breakdown** – covers loss or damage to works during operations
B. **Business Interruption Insurance** – covers loss of revenue caused by the interruption in operations due to the material damage event (covered under the All Risks policy)
C. **Third Party Liability** - covers legal liability to third parties for bodily injury or damage to their property
D. **Terrorism/Political Violence (assets and revenue)** – loss or damage to works and resultant financial losses following a terrorism or PV event
E. **Insurance required by legislation** – such as workers' compensation, employer's liability and auto insurance (liability)

Explanatory notes:

The Terrorism or Political Violence policy is not always required during the construction phase. The decision whether it forms part of the requirement is driven by the country and type of investment. The cover is however always required during the Operational Phase.

The country of investment will also determine whether Terrorism or Political Violence cover needs to be bought. Political Violence provides much broader cover and includes cover for insurrection, revolution or rebellion, mutiny, coup d'etat, war and civil war.

In order to save premiums for the borrowers, lenders generally accept an insured amount based on a Probable Maximum Loss ("PML") study, performed by an independent consultant.

Further detail on all policies, as well as policy extensions, can be provided by the FMO Insurance Advisor.

1 Insurance provisions during the EPC process

It is quite common for Lenders to become involved in project finance transactions after EPC selection and negotiations have started. Sometimes EPC Contractor arranged insurance programs are made part of the EPC tendering process by Borrowers. In order to make sure that Lender requirements remain compatible with Borrower's and EPC Contractor's expectations it is important to engage early on with FMO's insurance Advisor.

In order to overcome this issue, it is highly recommended that borrower-controlled insurance programs are agreed upon, as opposed to contractor-controlled. This needs to be kept in mind when lenders are approached for financing.

2 Appointment of a re-insurance broker and lenders' insurance advisor (LIA)

The insurance and re-insurance structure, the design and placement should be driven by the (re)-insurance broker, who should be appointed early on. The reinsurance broker should ideally be based in London as London-based reinsurance brokers have the necessary knowledge and expertise of meeting lenders' insurance requirements. Other re-insurance centers of expertise are Dubai and Singapore. Ideally, the re-insurance broker will appoint the local broker who will place the local policies, as per the specifications of the re-insurance policies. In case a local insurance broker was already appointed by the Borrower then it is important that the local broker is well connected to the London re-insurance brokerage market.

At the time of the broker appointment, the external Lenders' Insurance Advisor (LIA) should be appointed. Their early appointment will quickly identify and resolve any potential issues which could arise later in the process. In turn, if the re-insurance broker and LIA engage with lenders at an early stage in the development of the insurance strategy, the requirements of lenders can be included in all project and finance agreements, as well as broker submissions, and the lenders' expectations can be managed.

3 Direct interaction between the LIA, legal and technical advisors

An early dialogue between the insurance brokers and lenders legal advisors will ensure that all the legal and regulatory requirements are known at the start of the insurance program design.

The LIA should also be advised early on whether project documents of precedent transactions will be used, and if so, these should be provided as part of the due diligence review.

Also, communication between the LIA and the lenders technical advisors is key to ensuring that there is a clear understanding of the project risks, which will influence the size and shape of the insurances.

This will also assist the re-insurance broker in the design and marketing of the insurance program as technical issues which influence limits, sub-limits and indemnity periods, will be known in advance. The FMO Insurance Advisor is a facilitating factor in the entire process.

4 Local insurance legislation

Local insurance legislation, which controls the insurance placement with local carriers, differs from country to country. This legislation needs to be kept in mind in the design of the insurance program as this may have an impact on the security profile of the project.

5 Lenders' security documents

Lenders' clauses and assignment documentation form an integral part of the lenders' security structure. It is important that insurers and re-insurers are aware of these requirements and that these documents form part of the placement discussions.

Lender security documents also include broker letter of undertakings (BLOU) from both the local and reinsurance brokers, which can only be executed once all the policies, lender clauses and assignment documents are executed.

Draft templates of all the documents can be circulated to the brokers and the prospective insurers and re-insurers in order to avoid possible delays.

6 Managing timelines and deliverables

Throughout the insurance due diligence process, the principle objective of the lenders is to ensure that the risks of the project are adequately covered in line with prudent industry practice. In principle lenders will be aligned with Sponsors. The deadlines for signing of the finance documents and for financial close are generally driven by dates imposed by contractors and/or governments. Early engagement of the FMO Insurance Advisor is key to ensure a smooth and timely implementation during transaction process.

FMO is the Dutch development bank. FMO has been investing in the private sector in developing countries and emerging markets for more than 47 years. Our mission is to empower entrepreneurs to build a better world. We invest in sectors where we believe our contribution will have the largest long-term impact: financial institutions, energy and agribusiness, food & water. **www.fmo.nl**

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