Riskier Times ahead for the Risk Carrying Business

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Governance is no longer singular - with an 'E' and an 'S' as prefixes - it adds up as ESG - Environment, Societal and Governance. The governance of insurance business too should encompass environmental and societal components. Together with banks and asset managers - particularly as investors in fossil fuel value chain - they aid[1] climate change by insuring assets and activities that lead to it. Insurers ought to play the role of catalysts, through their ESG endeavours, precisely to facilitate such an outcome. Their investments and risk-carrying ability will support public goods projects and the scaling of equitable climate solutions. Like any other business - their boards ought to be climate competent and their executive compensation too be linked to the environment and social outcomes.

Key Words: ESG, Insurance Investment, Climate Change

Biodiversity

In order to highlight the gravity of the challenge on hand, I quote *ShareAction:* "The unprecedented technological change and economic growth achieved over the last few decades, while bringing prosperity to many, has come at a heavy cost to natural systems. Some *75 per cent of terrestrial and 66 per cent of marine environments* have already been severely altered by human activity. One million species face extinction - many within decades. Biodiversity loss is considered as *one of the greatest risks facing society today.* The destruction of nature is not only *affecting business bottom lines,* but also bringing ecosystems closer to destabilising tipping points, which may have serious consequences for human health, global food security and the efforts to contain catastrophic climate change. The challenge is complex, and tackling it requires a broad collective commitment. And the financial sector has a key role to play as well. The influence it

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wields through the ownership and financing of companies means its potential for change should not be underestimated." [2]

During a recent presentation at the *CICIRM 2021*, [3] I sought answers to:

1. what eludes insurers from an environmental societal and governance route?
2. their DNA surely needs to be revisited, but what ought to be embedded and what are the attendant risks?

Neither am I an ESG expert nor a climatologist. Nevertheless, this exploration is a must for insurers to urgently course correct their ways. They have a material role in ensuring a sustainable planet.

How's Europe Doing?

While Europe backs its resolve with real action, much more needs to be done. This ought to be driven by the International Association of Insurance Supervisors (IAIS) which has been slow to wake up and has happily abdicated its duty to address an existential crisis to the United Nations Environment Programme (UNEP). Likewise, the International Financial Reporting Standards (IFRS) did not till recently have sustainability anywhere on its radar. what gets measured gets done'. If the financial disclosures do not expect insurers to come clean on environmental and societal issues, they will merrily look elsewhere.

Capital Monitor, for instance, asked twenty-two top insurers for their positions on the recent International Energy Agency (IEA) report calling for an immediate cessation to investing in and building new oil and gas projects. Only seven responded with answers but none of them was prepared to make firm commitments, reports Polly Bindman.

With insured losses from the recent floods, in Germany, expected to touch US$ 6 billion, European insurers and reinsurers are waking up to climate change already at their doorstep. With all the fires raging in and around Southern Europe, one can imagine what a charged environment it must be and how badly it would impair the balance sheets of our industry.

"The floods", says *Wolfgang Kuhn* "are definitely focussing minds. It is almost embarrassing how politicians are now falling over themselves to demand the most ambitious climate action when, until two weeks ago, they dismissed such demands as unrealistic scaremongering'. 'Without the political will to take unpopular measures… our children (we ourselves will be ok, just) are doomed."

North American Insurers' Fossil Fuel Addiction

With its insurers deeply steeped into fossil fuel, the US has only woken up with the arrival of the Biden administration. With the exception of a few regulators in its long list of 50 (given the number of states in the US), it is the SEC and the law makers who have started nudging the insurance industry, to wake up to the reality.

Nothing can better demonstrate the resolve and urgency of the administration to rein in the US insurers from aiding and abetting the climate crisis than a letter sent out to CEOs of eight major insurance companies. "In order to better understand your fossil fuel underwriting and investment policies, we are requesting that you answer the following questions by April 16, 2021.

1. Have you studied how your company's annual claims and premiums will evolve as climate-related losses burgeon over the coming decades? Which climate scenarios have you studied?
2. Have you conducted a stress test of your company's exposure to fossil fuel assets? Which scenarios have you used? What did any stress tests reveal about your company's exposure to fossil fuel assets?
3. How are your company's fossil fuel underwriting and investment policies consistent with your broader commitments to sustainability?

"We write to you regarding your underwriting and investment policies pertaining to coal and other carbon-intensive projects such as oil and gas production from tar sands and in the Arctic and Amazon. As the leader of a major insurance company, you know the significant financial and economic risks climate change poses to both underwriting and investment."

India/South Asia : The Bad News from 'Inter Governmental Panel on Climate Change' (IPCC)

- In all potential futures charted by the Sixth Assessment Report, the planet is expected to be warmer by at least 1.5º C by 2040.
- In Asia, this means more heatwaves, greater risk of wildfires, sea levels rising faster than in the rest of the world and rapid melting of the Himalayan glaciers.
- We should expect "more frequent and severe coastal flooding and erosion, along with extreme sea level events that were previously occurring once in a hundred years, but may now happen every year by the end of the century.

- From the Himalayan glaciers to the Bay of Bengal and the coastal megacity of Mumbai, India is home to some of the planet's most vulnerable hotspots. The IPCC scientists are now able to **investigate regional climates on a more granular level,** and understand what climate change may mean for South Asia's ecosystems and communities.

Global warming, the authors explain, is likely to **intensify the global water cycle**, leading to more erratic weather and more violent rain, floods and drought across the globe. In Asia, in particular, **heatwaves and humid heat stress** will become more frequent by the end of the century, and in the long term the region will face a greater amount of rain throughout the year. Glaciers in the Hindu Kush-Himalayan regions **will keep shrinking** and snow cover will retreat to higher altitudes, the IPCC report says. Something I addressed as 'Extreme Risks' in a blog[4] for the Chartered Insurance Institute.

Studies suggest that in the coming decades the main rivers will due do glacial melt; but while this may be beneficial to communities downstream, an **excess of rain and unstable frozen** terrains are likely to cause disasters such as ice and rock avalanches that hit the northern Indian state of Uttarakhand in February, 2021.

Sea levels **will keep rising across the globe**, by up to 55 cms under a low emission scenario, and up to 76 cms under the current emission trajectory that takes into account the 'Paris climate pledges'.

In India, the rising sea levels would expose millions of people living along its 7,500 km coastline to a host of risks, including **increasing salinity intrusion** into areas such as the Bengal Delta and creating a favourable ground for cyclones and linger along the coasts and become more destructive. "About 50 percent of sea level rise is due to thermal expansion, and because the Indian Ocean is warming at a higher rate [than the global average], that means that sea level rise can also increase across the region," explained Swapna Panickal, a scientist with the Indian Institute of Tropical Meteorology and a lead author of the report. Also at a press conference, "This will contribute to more frequent and severe coastal flooding and erosion," she said, "along with extreme sea level events [such as storm surges] that **were previously occurring once in a hundred years, but may now happen every year by the end of the century.**"

Pricing and Reserving : Ticking Time-bombs

In another recent blog,[5] I recall, the two big insurer failures, a couple of decades ago, in two distinct parts of the world. Inadequate pricing and dubious reserving with questionable governance is how it all came about. They were neither the first nor will be

the last. However, the frequency and severity will only go up with the unfolding climate crisis. Will it be only the fossil fuel insurers, who also invest in them, that will be vulnerable? Climate crisis encompasses physical and transition risks for all shades of insurers that is rapidly assuming a systemic form. If one were to begin with the end in mind, pricing and reserving are where it all begins and ends. Needless to mention, 'facilitated' by a CEO as the hijacker and/ or a board in an abdication mode, as in the 'HIH' and 'Independent' tales.

Apart from the environmental and societal nuances, governance ought to ensure that the industry has enough capitalisation to withstand the expected losses caused by climate change. 'A crucial factor in managing climate risk is making sure that the current risk is properly priced' reminds Karthik Ramanathan. His company, *AIR Worldwide*, deploys modeling tools and solutions to capture the current and future views of the risk, as the Earth's atmosphere continues to warm.

Shareaction[6] recently analysed how the top seventy insurers in the world are performing? Here are their findings:

- Majority of the large insurers do not live up to their role as 'risk experts' as they fail to adequately address systemic risks, such as climate change and biodiversity loss.
- Insurers' boards remain ill-equipped to appropriately manage the environmental and social impacts of their organisations.
- Despite the insurance sector's focus on risk, the world's largest insurance companies are largely failing to assess the impact of climate change on their investment portfolios.
- Vast majority of insurers have not yet started to develop their approach to biodiversity losses.
- Most of the world's largest insurers show severe negligence to the impact on human and labour rights across their investment and underwriting activities.

A special report by the ratings agency *AM* Best highlights as to how insurers and reinsurers that ignore ESG in their underwriting and investment decisions and confront serious reputational risks. In turn, this risk can cause buyers and investors to flee to competitors, affecting the companies' creditworthiness and ratings.

Net-Zero Conundrum

An innovation in the ESG insurance space is the arrival of *Net-Zero Insurance Alliance* in the ESG insurance space - includes seven insurers that are already leaders of the Net-Zero Asset Owner Alliance. These insurers are recognising the importance of the exiting fossil fuels for good, although whether they are moving fast enough, and in line with the latest International Energy Agency **recommendations**, is less certain.

According to the Net Zero theory, companies are expected to first physically reduce their actual CO2 emissions, then take other actions, such as purchasing carbon offsets[7], to at least equal the remaining unabated emissions.

Mathematically, the "net" CO2 emissions attributable to the company then become zero. Yet not every entity is taking reasonable steps to curb their emissions before turning to offsets.

In order to achieve the Paris Agreement of 1.5-degree scenario, global spending trends must change. Today, companies expend more effort on offsets and other financial "solutions" than on actual emissions reductions, including pollution control technologies, clean energy production and energy efficiency.

Financial expenditures on actual reductions must almost quadruple from its 2019 level according to the **International Energy Agency** (IEA) to achieve alignment with the Paris Agreement.

Claims that Net Zero is merely greenwashing are, not surprisingly, growing. The Washington Post **criticized** the financial sector for its focus on solutions that some argue do not contribute to actual emissions reductions, instead emphasising offsets.

The world has always dealt with natural disasters,[8] but climate change means we are facing them with higher volatility, said Matthew Kahn, an environmental economist at the USC.

Insurance companies are struggling to keep up because of the way in which they calculate risk. "Most insurance companies, the way they look at the world is very backward-looking. When you have a phenomenon like climate, the past is no longer representative of the future", says Kia Javanmardian, a senior partner at McKinsey.

Eight of the world's leading insurers and reinsurers are in accelerating the economic transition through the establishment of the Net-Zero Insurance Alliance (NZIA). However, the progress has been too slow, and the top policy bodies have pressed the sector to show more ambition.

ShareAction has made a whole host of recommendations for the next steps to be taken in Insuring Disaster report. However, they strongly believe that the sector cannot do it on its own. A supportive regulatory landscape will also be vital.

Regulating for Supportive Transition

The report reveals that larger European insurers perform better than their Asian and US counterparts on responsible investment and underwriting. This is likely due to the strong regulatory signals on sustainable finance within Europe. All the same, no European insurance company that was evaluated received an 'AAA' or 'AA' rating. There is clearly still a lot of work to be done to raise standards, believes *ShareAction.*

Based on this, *ShareAction*[9] recommends that regulators:

- Incentivise long-term investments aligned with a low-carbon emission, by increasing capital requirements for insurers with portfolios with higher climate transition risks.
- Require stewardship policies, practices and reporting, for investments and underwriting. As our research shows, only a small minority have robust stewardship strategies to ensure engagement with clients and investee companies.
- Include a "double materiality" approach in legislation for the insurance industry. While it is increasingly being regarded as a good practice for insurers to consider how environmental factors constitute financial risks, holding global warming to well under 1.5 degrees will require the insurers to also consider how their own business operations and investments are impacting climate change.
- Mandate the insurance industry to report on financial disclosure obligations of the Taskforce on Climate-related Financial Disclosures (TCFD) to allow for a better assessment of sustainability risks.

Rejigging the DNA

Of the one-fifth of the world's largest companies that have set a net zero target, the vast majority are nowhere near actually meeting them, and, very few have set interim targets to keep them honest, writes Jamie Beck Alexander. Companies are pursuing emission reduction in their sustainability teams, but their investments, lobbying activities, governance practices, trade associations, financed emissions, products and relentless focus on growth completely eclipse any incremental reduction in emissions.

This moment in human history calls for nothing less than a transformation.[10] Using

solutions we already have in hand, we need to fundamentally shift the ways we grow and produce our food, warm our homes, move about from place to place, construct and power buildings, and relate to nature, our communities, and one another. This kind of change, and the urgency with which we need to pursue it, prescribes Alexander, requires a symbiotic relationship between government, business, advocacy groups, communities, and individuals as collaborative agents of change.

Insurers ought to play the role of catalysts through their ESG endeavours, precisely to facilitate such an outcome. Their investments and risk carrying will support public goods projects and the scaling of equitable climate solutions. Like any other business, their boards ought to be climate-competent and their executive compensation too be tied to environment and social outcomes. We are faced with an existential risk and insurers have a role in ensuring the planetary well-being. Will they live up to it?

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