Invited Article

Mitigating Climate Crisis: Reigning in the ESG Metrics!

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Climate Change has transformed into Climate Crisis and as insurers we cannot be passive onlookers. Insurers need to consider a holistic performance metric of Environment, Society and Governance (ESG) with the focus on long term sustainability.

Keywords : Climate change, long term sustainability, ESG, Principles of Sustainable Insurance

Much of what I share here is derived from 'Three Dimensions: A New World Insurance Order' written for the Chartered Insurance Institute's *A World of Risk* (June 2019) and 'How ESG will change the Physics and Chemistry of Insurance', recently presented at China International Conference on Insurance & Risk Management (CICIRM), Chengdu, China (July 2019).

Everything we insure is not Benign!

Let us begin by being reminded that everything we insure is not benign. Insuring (and reinsuring) anything has its unintended consequences for our planet's well-being. With the growing realisation and urgency around environmental and societal implications of insurance - insurers must quickly distance themselves from anything that adversely affects overall sustainability. The Climate Crisis is a financial risk which not only threatens the very sustenance of the current business model but a potential source for the sixth extinction. This cannot, therefore, be business as usual. There is thus an urgent need to shift the performance metrics from a pure financial one into the fold of Environment, Society and Governance (ESG).

While some enlightened insurers are moving towards Principles of Sustainable Insurance (PSI, prescribed by the UNEP - FI) thereby attempting to create a more risk aware and resilient global society - these signatories represent 25% of the worldwide premium volume. Unfortunately, the framework is non-binding and its implementation does not necessarily result in a reduction of carbon-intensive positions in the industry's investment or underwriting portfolios - believe experts. In short, while the insurance sector would be capable of a substantial contribution to sustainable development, only a small proportion of its firms have voluntarily committed to explicit goals.

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True Cost of Risk!

The recent climate strikes[1] by school children, in many parts of the world, ought to be a wake-up call for the insurance industry, as well. Insurers are known for their expertise in pricing, risk management and quantifying risk. Notwithstanding that, they not only end up insuring what contributes to the carbon footprint but also investing their surplus funds into such businesses. Thus 'inadvertently' they end up aiding and abetting climate change. We are already beginning to see two camps emerging - the American players who allegedly continue to support the fossil fuel industry (with the exception of a lone player which recently announced the shift) and the Europeans who are increasingly distancing themselves from it.

Quoting Chandran Nair, author of *The Sustainable State*, the research firm Trucost estimated the scale of the external costs of major industries around the globe. They found that for the most polluting industries; the scale of their impact on the natural world was often as great as, if not several times greater than, the sector's total revenue. None of these industries would be profitable if they were forced to consider external costs in their business models. The industry with the greatest impact overall was coal power generation, with an estimated impact of over a trillion US dollars across the entire world. An honest accounting for their overuse of resources would almost certainly put most of them out of business. A blind-spot insurers need to start recognising - both when assessing and pricing the risk insured as well as investors.

Why must Asia be Paranoid?

There are some really compelling reasons as to why Asian insurers cannot afford to ignore the call for sustainability. Not only do we have the most polluted cities in the world, we are also witnessing an alarming pace of deforestation, rising seas, eroding coastline, falling ground water levels, melting glaciers, deteriorating air quality, vehicular and industrial emissions.

The climate strike has brought back into play what renowned author and climate champion Amitav Ghosh alludes to as the 'missing narrative'. He points *out Asia is conceptually critical to every aspect of global warming: its causes, its philosophical and historical implications, and to the possibility of a global response to it. It takes only a moment's thought for this to be obvious. Yet, strangely, the implications are rarely reckoned with – and this may be because the discourse on global warming remains largely Eurocentric.*

The brute fact is that no strategy can work globally unless it works in Asia and is adopted by large number of Asians. Yet, in this matter too, the conditions that are peculiar to mainland Asia are often absent from the discussion. (The Great Derangement: Climate Change and the Unthinkable by Amitav Ghosh).

While insurance remains highly under penetrated, insurers have enough information to be the go to for what is generally man made but referred to as 'Act of God' perils. By sheer instinct insurers are caught in their own silos and miss out on leveraging the humongous diversity they address.

[1] *An international movement of school children demanding action to prevent further global warming and climate change.*

My favourite story is what happened at Salamieh in Syria. One of the finest cotton growing areas in the world turned into a desert primarily owing to excessive ground water consumption. The dependent unemployed population moved into urban hinterland and fuelled the brewing socio-economic unrest that triggered a civil war. If only crop or micro insurers had picked the early signals and alerted the terrorism underwriters perhaps the narrative today could have been different!

Insuring and investing in fossil fuel industry are not the only triggers for Climate Change. Insuring, for instance, say hydroelectric projects in vulnerable geographies, asset creation in earthquake and storm prone zones will also ensure the fragility of the subject matter of insurance as well as the dependent population and businesses. Amitav Ghosh could not be more candid when he compared flooding vulnerability levels of say two important Indian cities - Mumbai and Chennai - to be no different than that of Miami. A Fukushima kind of scenario with an atomic energy plant sitting in the precincts of Mumbai seems outside the imagination of us all. Would not the thumb rule of one percent increase in insurance penetration resulting into thirteen percent reduction in uninsured losses sound ridiculous - if only we encourage the mushrooming of poor quality assets and then end up insuring them? How much more myopic can we be?

Beware of the Dirty Reinsurance!

The underwriting results - generally challenged that they are - make dependence on investment yields more compelling. In the meantime something more serious is likely to knock our doors from outside of Asia. The arrival of 'dirty' reinsurance! If Europe becomes a 'no zone' for providing reinsurance capacity to carbon intensive (fossil fuel driven) businesses - it could for want of additional capacity - potentially creep into our balance sheets.

The financials of insurers and reinsurers would thereby be further exposed to the 'E & S' factors. Collateral damage in the form of reputation risk and shareholder activism could trigger, as well. So what must insurers do? Let's look at the full chain. *It is often forgotten that large parts of the global economy, and of the industry sectors that contribute significantly to climate change in the form of carbon emissions, are highly insured. The insurance covers many of the assets that process fossil fuels, from cars to coal-fired power plants. In other words, the insurance industry is not only linked to much of the future damage that may result from climate change, but is also connected to many of the sources of greenhouse gas emissions* (Source: Olivier Jaeggi in MIT Sloan Management Review).

The Handmaiden's Woes!

That Insurance is a handmaiden of the Industry was almost a gospel truth when I started in the trade. From an initial sense of detest to try positioning insurance into the mainstream of consciousness has been a personal exploration. With the arrival of 'Stranded Assets' into insurance lexicon the luxury of biding any more time seems to have passed us by. Climate Change or more appropriately the Crisis if I may say is the cause of the handmaiden's woes resulting into asset stranding. It is important that we recognize how the governance of our economics and politics is converging globally into the troika of ESG? Whether or not we choose to take that seriously, we have already set a ticking time bomb.

Diminishing Carrying Capacity and the resulting Stranded Assets!

Let us indulge in some diagnostics ailing the handmaiden. At the heart of it all is the crying need to bring a balance between Anthropocentrism and Ecocentrism. *The individual, cultural, and technological skills of humans are among the attributes that make Homo Sapiens special and different. However, the true measure of evolutionary success, in contrast to temporary empowerment and intensity of resource exploitation, is related to the length of time that a species remains powerful - the sustainability of its enterprise. There are clear signals that the intense exploitation of the environment by humans is causing widespread ecological degradation and a diminished carrying capacity to sustain people, numerous other species, and many types of natural ecosystems. If this environmental deterioration proves to truly be important, and there are many indications that it will, then the recent centuries of unparalleled success of the human species will turn out to be a short-term phenomenon, and will not represent evolutionary success. This will be a clear demonstration of the fact that humans have always, and will always, require access to a continued flow of ecological goods and services to sustain themselves and their societies (http://science.jrank.org).*

Decarbonising the Global Society is the Key Risk!

Owing to its enormous size and capital base, the insurance industry should occupy a key role in the achievement of UNFCCC climate goals. If only a fraction of the sector's USD 25 trillion in investments worldwide could be directed away from carbon-intensive assets, this would constitute a substantial contribution to the efforts against global warming. It is doubtful, however, whether voluntary initiatives will be enough to genuinely implant the sustainability paradigm into the industry DNA. (Source: Are Insurance Balance Sheets Carbon Neutral? Harnessing Asset Pricing for Climate-Change Policy, by Alexander Braun, Sebastian Utz and Jiahua Xu).

Climate Change is not only universal; it is also cross-class. It impacts lives, health, assets and supply chains. It invokes intergenerational and trans-region justice. The melting glaciers of the Hindu Kush Himalayan region (termed the Third Pole) will impact the watersheds of the Ganges, the Brahmaputra, the Yellow River, the Irrawaddy and the Mekong - affecting multiple countries with close to a quarter of the world's population. 'A new, highly complex and destabilised 'domain of risk' is emerging – which includes the risk of the collapse of key social and economic systems, at local and potentially even global levels,' warns the Institute for Public Policy Research. 'This new risk domain affects virtually all areas of policy and politics, and it is doubtful that societies … are adequately prepared to manage this risk.'

The Arctic is changing exactly the way scientists thought it would but faster than even the most aggressive predictions. The recent behaviour is off the charts…These trends signal trouble for *people around the world. The last time the Arctic was only slightly warmer than today – about 125000 years ago – oceans were 13 to 20 feet higher. Goodbye Miami, New Orleans, the naval base in Norflok, Va., most of New York city and Silicon Valley, as well as Venice, London and Shanghai.*(Source: Jennifer A. Francis in Scientific American).

A whole new approach: Mindful Underwriting, Risk Management & Investments!

Until recently, most studies of environmental risk examined threats in isolation: climate scientists evaluated disruption to weather systems, biologists focused on ecosystem loss and economists calculated potential damages from storms and droughts. But a growing body of research is assessing how these factors create a tipping point in human society as well as the natural world (www.guardian.com).

Insurers need to reign in all the Diversity at their disposal to not just improve their understanding of these high velocity changes but evolve their risk management practices, offerings and pricing. So alarming are the consequences of the Climate Crisis that the wait for a physics of ironclad regulatory controls to ensure a 100% ESG compliant industry would be truly reckless. While the financial reporting standards too need to be aligned with ESG - thereby bringing into focus the triple bottom line - the only litmus test ought to be Sustainability. The physics may wait for whatever time it takes, the chemistry need to change urgently. Insurers cannot any longer be the handmaiden of the industry - thereby quietly facilitating the stranding of assets it insures and invests in! It must quickly get into the driving seat by re-engineering itself for the New Order.

Post Script:

A ray of hope has emerged as a global group of 415 investors managing $32 trillion in assets just released a combined statement urging governments to accelerate their actions to mitigate climate change. This represents nearly 50% of the assets globally managed. In order to limit global warming below 2 degrees C compared to preindustrial levels, global economies must significantly and quickly curtail their emissions. Schroders, a member of the global investor's group, warns that a temperature rise of 4 degrees C could cause $23 trillion in global economic losses over the remainder of the century. (Source: Forbes).

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