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The impact of climate change on the insurance industry: Insights from the UK Prudential Regulation Authority

In the wake of the recent 21st Conference of Parties of the UN Framework Convention on Climate Change held in Paris (**Paris talks**), it is timely to consider how insurers will need to come to terms with the challenges presented by climate change. Insurance, as with all financial services, responds to and is influenced by economic factors. However, the manner in which climate change will impact on the business of insurance specifically warrants close attention.

The UK Prudential Regulation Authority (**PRA**) issued a report to the UK Government in September 2015 which considered the risks of climate change from the perspective of insurers (**Report**). The PRA focused on how climate change may expose policyholders to risks by destabilising the financial integrity of their insurers and also potential losses to insureds arising out of new risks.

The Report cited three main areas for concern:

- the increased frequency and intensity of weather related events and the consequent damage to property due to climate change;
- the financial loss arising from the loss in value of carbon-intensive assets; and
- third party losses caused by climate change which will result in losses under liability policies.

Physical risks

One of the more obvious ways that climate change affects insurers is the potential for greater property and liability losses caused by weather-related events.

Climate change brings with it a greater degree of unpredictability with respect to floods, storms and other potentially catastrophic natural occurrences. The Report notes that there has been an overall increase in losses arising from global natural catastrophes, from around USD10 billion in the 1980s to around USD50 billion in the period between 2005 and 2015.

Property and liability cover will be, on the most part, the insurance products under which losses arising from extreme weather events are covered. There may also be business interruption claims in circumstances where there has been damage to commercial infrastructure.

Of course, the effects of climate change on the weather may be one of many factors that have impacted the increase in these types of losses. However, the PRA accepts that climate change is playing a part. As climate science develops, insurers will have a greater understanding of exactly how this is happening. In this regard, the PRA refers to the insurance industry's sophisticated economics modelling used to examine natural hazards. It is arguable that in the future some of the better data will come from insurers who have observed the changes in weather-related events. Insurers may not be climate scientists but they are keen observers of patterns and tendencies.

The PRA also indicated that it will consider climate change and catastrophic risks in the context of capital requirements and diversification of risks. In the report, it is noted that climate modelling will inevitably make up a part of the PRA's (and probably that of other regulators) analysis of how well diversified an insurer's risks are and how exposed they may be to large scale losses.

Transition risks

While there were problems and shortfalls in the agreement reached by the states parties at the Paris talks, the prevailing success was the consensus reached on reducing global emissions sufficient to limit global warming to 2°C. It is widely accepted by climate scientists that an increase to global temperatures of more than 2°C will be potentially catastrophic. Consequently, 2°C is pegged as the standard the world needs to be working towards.

To achieve this, worldwide carbon emissions have to drop by between 40 and 70 per cent by the year 2050. However, as they currently stand, emissions are increasing.

This means that the world economy faces some significant challenges in adapting to new means of production and new energy sources. It will also mean that industries that use carbon-rich assets will need to begin decommissioning those assets. Before that process begins, those assets will already be decreasing in value.

The Report looks at a class of risks it calls 'transition risks'. Transition risks are those faced by insurers arising from the move from a high-carbon economy to a low-carbon economy.

One potential impact to insurers of the transition risks concerns insurers' financial investments. The Report identifies two classes of companies in which insurers may have investments – those which will be impacted upon by regulatory limits on their ability to produce carbon (such as those companies involved in or supplying services to oil, coal and gas); and those which consume large amounts of energy and may therefore be impacted upon by the increase in energy costs (those engaged in secondary production).

The downturn in carbon-rich industries may also drive down premium income derived from business conducted in that sector. The Report indicates that nearly 7% of Lloyd's and 4% of general UK insurers' gross written premium is derived from energy sector accounts.

An ancillary impact that climate change is having and will have on insurers' investments has already been felt by AXA and Aviva. AXA has indicated it would divest its interest in EUR500 million worth of assets in coal. This was not only to preserve AXA's financial position but was done to meet AXA's corporate responsibility, as it sees it.

Aviva has announced it will work with 40 companies in the coal mining industry in which it has invested capital, with the aim that these companies will take substantial steps to moving to cleaner energy. Aviva said that if these steps were not taken, it would withdraw its capital.

Liability risks

In putting together the Report, the PRA conducted a survey of industry stakeholders. The respondents to the survey identified three potential causes of action which they saw as likely to increase in number as the world economy evolved to meet the emissions targets. These were claims for a:

- failure to mitigate (against those who are responsible for increased intensity or severity of physical impacts of climate change);
- failure to adapt (against those who have not reasonably accounted for the risks posed by climate change in the conduct of their business or operations); and
- failure to disclose (against those who have not complied with regulation concerning disclosure of information to government agencies and/or the public).

These potential causes of action would be relevant to liability insurers who may issue D&O, PI or public liability cover.

Of course, in Australia, these types of actions have not been seen. However, there have been instances of actions brought along these lines in the USA, a much more litigious jurisdiction.

The Report cites the case of *American Electric Power Co v Connecticut,* in which a number of US states brought an action against certain power companies, alleging that the carbon emitted by these companies created a public nuisance. The second example involved residents from a coastal town in Alaska, again alleging nuisance, against certain energy companies arising out of flooding which occurred in the area.

Neither of these actions were successful. However, it is not hard to see that over time, once the consequences of climate change are better known, Courts may be persuaded to expand conventional tortious principles in favour of claimants such as those mentioned in these examples.

It is also worth noting that unsuccessful actions can be expensive for insurers as well, especially class actions. These types of new claims arising from complaints concerning the effects of climate change would appear a fertile ground for shareholder class actions or class actions against large energy companies and government agencies.

What does this mean for insurers?

In an already challenging market, insurers will have a keen eye on developments just on the horizon. As the Report foreshadows, climate change and the global effort to reduce carbon emissions will be two of the most significant influences on how the global economy will operate over the next few decades.

And in considering these new risks, insurers may be best placed to model and forecast the material impacts on how people will do business in the future, how climate change regulation will impact upon growth and also how our day-to-day lives may be impacted upon by the effects of climate change.

In Australia, insurers will be following developments in litigation that occur in comparable jurisdictions. That being said, given the increase in class actions in Australia, this jurisdiction may be the first to see novel actions.

With a pro-active regulator such as APRA, insurers doing business in Australia should also be prepared for regulatory activity in response to the challenges faced by climate change.

In any event, insurers have a stake in how the economy responds to climate change, and will hopefully lead the way with initiative and leadership.

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