Alert – Climate change beyond property damage: Prudential Regulation Authority report emphasises applied risks for the insurance sector

11 November 2015

The recent Bank of England Prudential Regulation Authority's report, 'Implications of Climate Change for the Insurance Sector', highlights two categories of risk that have received little attention to date – but which have significant potential implications for investment and general underwriting activities.

There has been significant commentary in the financial press about the Bank of England Prudential Regulatory Authority (**PRA**)'s report *on The Impact of Climate Change on the UK Insurance Sector* (**Report**), launched by Bank Governor Mark Carney at Lloyds of London on 29 September.

The Report represents a strong warning by the UK's prudential regulator on the significant potential impacts of climate change on both the investment and general underwriting activities of insurers, and on the stability of the financial system more broadly. Whilst it purports to provide 'an initial risk assessment' for the UK US$2 trillion financial services sector, its implications are likely to resonate across what is a globalised industry.

Beyond the physical

The Report identifies three broad channels of systemic risk for the insurance sector associated with climate change – **physical** risks, **transition** risks and **liability** risks – which it warns '*present a substantial challenge to the business model of insurers*'.[1]

The majority of the analysis focuses on the physical risks, which the PRA classifies as '*first-order risks which arise from weather-related events, such as floods and storms. They comprise impacts directly resulting from such events, such as damage to property, and also those that may arise indirectly through subsequent events, such as disruption of global supply chains or resource scarcity.*'[2] Such physical risks tend to be well-understood by Australian general insurers, who face regular underwriting exposures from extreme weather events such as bushfires, floods and storms.

The other risk channels identified in the Report – transition and liability risks – reflect the rapid evolution of climate change into a significant financial risk, with systemic impacts across the global economy far beyond direct physical damage. These risks are extremely significant for both investment and general underwriting activities. However, they have received little attention within the Australian insurance sector to date. So what are these 'under-considered' risks, and what are their key implications for Australian institutions?

Transition Risks

The PRA classifies financial 'transition' risks as those which could arise from the global economy's inexorable transformation to a lower-carbon norm. The Report notes:

---

[1] PRA Report, page 5.

[2] PRA Report, page 4.

> *The Intergovernmental Panel on Climate Change (IPCC) estimates that maintaining a greater than 66% probability of keeping human-induced warming within the globally agreed goal of 2°C would require total global carbon emissions from 2011 onwards to be less than around 1,000 GtCO2. Keeping within this '2°C carbon budget' would require a significant shift in the trajectory of carbon emissions – at current rates, the entire budget would be fully used within the next 25 years.*[3]

The Report explains that the transition risks for insurance firms primarily relate to 'stranded assets' in their investment portfolios – '*the potential re-pricing of carbon-intensive financial assets, and the speed at which any such re-pricing might occur*.' Such assets include the equities and bonds of both '*firms that may be impacted directly by regulatory limits on their ability to produce or use fossil fuels, ([including] coal, oil and gas extraction companies, and conventional utilities)*', and those with energy-intensive operations that may be significantly impacted by any increase in energy costs (including those in the '*chemicals, forestry and paper, metals and mining, construction and industrial production*' sectors).[4]

It is important to note that the portfolio transition risks identified in the Report are conceptually distinct from those arising from recent high-profile 'fossil fuel divestment' campaigns. The latter campaigns have prompted many faith-based, educational and private endowments to exclude investments in companies with carbon-intensive operations or outputs from their portfolios – based primarily on ethical, environmental grounds. In contrast, the Bank of England analyses the risks associated with climate change through a singularly economic lens, emphasising the need to manage the portfolio risks of a potentially rapid re-pricing of carbon-intensive assets. The PRA's approach echoes that increasingly adopted by leading international institutions, such as the Norwegian sovereign wealth fund, French insurance giant AXA and superannuation funds such as HESTA, LGS, Calprs and Calstrs, who have all recently committed to divesting from carbon-intensive equities on squarely financial grounds.

The economic risks (and opportunities) associated with climate change continue to rapidly – and radically – evolve. Many corporations and their investor asset owners still struggle to conceive climate change as a material financial issue, rather than a non-financial environmental externality. The PRA Report provides an unequivocal message that a failure to respond to the dynamic financial risk landscape presents a serious risk to their firms. It reflects the view that a proactive, substantive approach to climate risk governance is increasingly required – with evidence that its implications for medium-long term strategy have been duly considered and meaningfully disclosed. And it goes even further – to suggest that a failure to do so is potentially actionable.

Liability risks

The last risk channel identified in the Bank of England's Report is that of **liability risks**, in the form of increased liability exposure under third-party liability policies such as professional indemnity and directors' and officers' insurance. Such risks '*arise from [third] parties who have suffered loss and damage from the physical or transition risks from climate change seeking to recover losses from others [the insured] who they believe may have been responsible.*'[5]

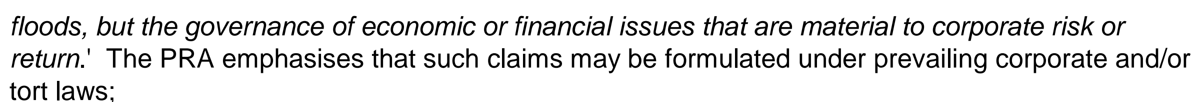
This category of risk has received the least attention in the weeks following the release of the Bank's Report. It may, however, prove to be the most significant, given its low profile within the Australian insurance industry to date.

The Report identifies the potential for third-party liability claims against insured entities in three broad categories:

a. **failure to mitigate** – claims alleging that '*insured parties are responsible for the physical impacts of climate change, for example through emissions of greenhouse gases, and therefore can be held directly liable for loss or damage to third parties*';

b. **failure to adapt** – claims alleging that '*insured parties have not sufficiently accounted for climate change risk factors in their acts, omissions or decision-making. In principle, this could apply to a range of climate change-related risk factors, not just those from physical risks such as storms and*

[3] PRA Report, page 7.
[4] PRA Report, page 7.
[5] PRA Report, page 57.



floods, but the governance of economic or financial issues that are material to corporate risk or return.' The PRA emphasises that such claims may be formulated under prevailing corporate and/or tort laws;

c. **failure to disclose or comply** – claims alleging that insured parties '*have not sufficiently disclosed information relevant to climate change, have done so in a manner that is misleading, or have otherwise not complied with climate change-related legislation or regulation*.' The Report suggests that this may be 'one of the quickest' categories of claim to evolve.[6] This has indeed been borne out in international regulatory activity following the publication of the PRA's report. Perhaps most significantly, in November 2015 the New York Attorney-General announced that it was investigating whether a number of corporations in the energy and resources sector had made misleading disclosures concerning climate change risks and their potential impacts on the companies' businesses. These investigations have led to settlements (under an Assurance of Discontinuance) being reached with at least one corporation listed on the NYSE, under which the corporation agreed to modify its disclosures going forwards.

The Report concludes that:

> *'The PRA views legal liability risks from climate change as an area that may evolve adversely; firms are encouraged to consider all aspects of this risk and be forward-looking in their approach.'*[7]

Further action

Minter Ellison has been at the forefront of thought leadership on climate change liability risks. Our cross-divisional reports on fiduciary liability exposures for inaction on risks associated with climate change (such as *Institutional investment, corporate governance and climate change: what is a trustee to do?; From 'ethical' crusade to financial mainstream: is climate change reaching a tipping point for institutional investors?; and The first class action salvo? Breach of duty claim filed against fiduciary trustees of coal company pension fund*) have been nationally and internationally recognised. We would be delighted to share these leading publications with you upon request.

A full copy of the Bank of England's Report is available here. For further analysis of the technical aspects of the report and its particular ramifications for the Australian financial services and insurance sector, please contact Sarah Barker.

[6] PRA Report, page 59.
[7] PRA Report, page 64.

MinterEllison