The climate change gamechanger

Insurance companies and banks have until 15th October to inform regulators which senior figure(s) in the business will now be responsible for identifying and managing climate change risks.

This bold step by the Prudential Regulation Authority (PRA) centres upon individual accountability under the Senior Managers and Certification Regime (SMCR), which the government and the Bank of England set up to address concerns that, following the last financial crisis, it was all too easy for individuals to hide behind the corporate veil.

The PRA, as the insurance supervisory authority for stability and viability, started looking seriously at the impact of climate change on the insurance industry in 2014 and published its first analysis of the financial risk posed by climate change in September 2015. This document sets the tone for what has followed more recently.

For the first time, senior managers will now be held personally accountable for governance failures relating to the financial consequences of climate change. This will not mean that the board of directors will escape responsibility. Ultimately the board remains responsible for the company's assessment, mitigation, adaptation and disclosure of financial risks resulting from climate change. Accordingly, those at the highest level of the company will be vulnerable if the company is found not to have taken appropriate steps.

"Insurance companies occupy a unique position in that they are directly impacted on both the asset and liability sides of their balance sheets."

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Further, they hold significant historical data on climate-related events and trends and are no strangers to scenario analysis. This provides an opportunity to lead the way, but also imposes a high standard of care on those who are in charge.

Global ramifications

In 2015, the Task Force on Climate-Related Disclosures (TCFD) was established by the G20's Financial Stability Board to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders and insurers.

Since the establishment of the TCFD, financial regulators have shown a greater interest in climate change globally. The UK may be at the forefront, but the EU is almost on par, and Australia's local prudential regulatory authority AFRA has also taken action. Japan may well be the first country to enshrine mandatory measures in legal frameworks. These moves have been closely monitored by other countries that are yet to formally announce their approach, such as New Zealand, Canada, Singapore. Insurers should be aware of where regulatory discussions are ongoing in various jurisdictions, and the UK model seems likely to be followed by others.

In the US, insurance is regulated at state level and, while the Trump administration has not shown a great interest in climate change, this view is not necessarily shared at local level. California is the largest insurance market in the US, and it envisions that its Sustainable Insurance 2020 Roadmap will "pave the way for innovative risk management, insurance and investment solutions that reduce climate risks and protect natural ecosystems" .

What are the PRA's immediate requirements?

By 15th October 2019 insurers must (1) file an updated Senior Management Function form identifying the existing Senior Manager responsible for identifying and managing the financial risks from climate change; and (2) have an "initial plan" in place.

The latest Supervisory Statement from the PRA, SS 3/19, released in April 2019, is only 11 pages long and does not provide detailed guidelines. It does not set out what the "initial plan" should look like. Instead, it outlines its general expectations for companies to assess, mitigate, adapt, and explain their actions with respect to the financial risk of climate change.

Insurers' "liability side" financial risks

Many insurers' policyholder clients will have significant vulnerability to "physical" risks from extreme weather events and longer-term climate trends such as rising sea levels. This is likely to cause increased frequency and severity of claims on property and casualty policies, increasing the overall cost of claims.

In addition, such policyholder clients will be facing "transition" risks arising from the challenges involved in moving away from traditional business models towards a low-carbon economy. These business risks are likely to increase the risk of claims on a variety of available business insurance products.

> **"Where problems occur, policyholders' legal risks from climate-related liabilities can be transferred through liability protection, such as casualty, professional liability and D&O insurance."**

Policyholder liability risks could drive losses for insurers in two ways. Most obviously, fossil fuel companies are already the target for litigation from private individuals and local authorities, principally in the US. These claims have had limited success so far, but this will change as liability theories develop with experience. Secondly, companies that have failed to address the financial risks from climate change will inevitably suffer financial damage that leaves the board open to potential D&O liability. In April this year, the PRA stated that it would become increasingly difficult to argue that impacts on corporate value arising from a failure to manage risks associated with climate change are not reasonably foreseeable. D&O risks are considered in further detail later in this article.

Insurers' management of their exposure to physical losses in their existing books of insurance business will likely include consideration of catastrophe modelling, and whether policies should continue to be written annually. There will be increased volatility, and, from a modelling perspective, it will be important to factor in which areas may be evolving in terms of appetite and insurability.

Insurers should also review how much of their revenue derives from industries that could be impacted by the energy transition. The global departure from fossil fuels is gaining momentum, and insurers need to prepare for public policy situations, carbon taxes, or even bans for particular technologies. Insurers' growth plans hinging upon penetration and coverage in areas experiencing significant risks from climate change will need to be revisited.

As investors and regulators are asking policyholders to think more long term and account for climate change risks, this could create opportunities for insurers and stimulate the need for innovative, new insurance products. However, the insurance industry will need to be wary of succumbing to the temptation of new (but untested) revenue streams from climate change.

Insurers' "asset side" financial risks

Insurers are significant investors in other businesses. When developing an asset allocation strategy, insurers must now question how different climate scenarios may impact asset classes. As with liabilities, asset classes should be broken down into "physical" and "transitional" risks. In the first instance, insurers should think about real estate, utilise their understanding of cat risk, and apply this expertise to real assets they hold.

In terms of transition, insurers don't hold huge amounts of equities and corporate bonds, but if any have significant exposure to fossil fuels, then they need to decide whether to adopt an engagement or divestment strategy.

"It would be beneficial for insurers to engage with rating agencies to determine how they are going to incorporate climate change risk into some of their rating decisions. Monitoring rating agency behaviour is necessary as, from a solvency perspective, there is always going to be a need to hold bonds with a particular credit rating."

Huge losses from tropical cyclones, severe conductive storms, and heatwaves will affect the financial performance of insurers' investments and how rating agencies rate bonds. Other asset managers, whether they are attached to banks or independent, are starting to weigh up the potential for this type of climate change double whammy. Insurers need to realise they are part of a bigger ecosystem and, if banks already have a competitive edge, then the insurance industry could end up saddled with a mountain of undesirable "stranded" assets.

What the PRA expects from insurers

The insurer's board needs to understand and assess the financial risks from climate change and oversee these risks as part of the firm's long term strategy. This means there needs to be:

- clear roles and allocation of responsibilities;
- evidence the board exercises effective oversight of risk management and controls, deploying appropriate resources and skills/ expertise to managing these financial risks;
- establishment of risk management frameworks to: identify, measure, monitor, manage and report on exposure to these risks.

When trying to ascertain how a major climate incident may impact them, insurers will need to rely on scenario analysis. However, this approach will only work if a robust governance structure is in place. While the buck may stop with the board, part of establishing an effective strategy involves deciding who will support in managing these risks across the business. As climate change is a systemic issue, a fundamental aim must be the avoidance of information silos and miscommunication.

"Based on experience from the last financial crisis, regulators are worried about a breakdown of internal communication where people are not clear about climate change risks and aren't communicating properly. A priority for insurers is how to safeguard against the risk of misallocating capital."

Ultimately the board will need to make business decisions based on the financial risk analysis it has received. These will need to be proportionate and may result in the insurer exiting some markets. Having excellent risk management is important, but if it means pulling out of markets and raising premiums, the reputational and political backlash will need to be considered. At the same time, insurers need to figure out how to innovate, maintain penetration, and keep insurance affordable. A failure to make decisions in the face of advice will invite scrutiny from regulators, and possibly the courts (see below).

How will insurers' senior executives be exposed?

"The board at the highest level of executive management should identify and allocate responsibility for identifying and managing financial risks from climate change to the relevant existing Senior Management Function(s) (SMF(s)) most appropriate within the firm's organisational structure and risk profile, and ensure that these responsibilities are included in the SMF(s)' Statement of Responsibilities" PRA SS 3/19

"It's clear that a failure to follow the PRA's approach will have regulatory consequences for individuals, boards and companies. However, it doesn't end there. The regulators' stated expectations will be relied upon by courts when assessing the liability of insurance company executives in civil litigation."

This could be via two channels: (1) disclosure related liability; and (2) breach of fiduciary duty.

Disclosure related liability:

Disclosure related D&O liability may arise where an insurer has failed to set out, or incorrectly stated, the financial impact of climate change on its business in its representations to investors. Companies may thereby be guilty of misrepresenting their financial strength and resilience, which could give rise to claims, particularly following a capital raising. In particular, if they have undertaken an IPO or rights issue, they would have made disclosures about the company which may turn out to be untrue, and investors would have the right to bring actions under s90 of the Financial Services Markets Act 2000.

Breach of fiduciary duty:

Directors owe fiduciary duties to the company. Two duties under the Companies Act 2006 immediately come to mind. Firstly, the duty to exercise reasonable skill, care and diligence. If executives have been negligent in their handling of financial risks as a result of climate change, and the company suffers a loss, that could result in claims.

Secondly, there is the duty to promote success of the company. The factors include the impact of the company's operations on the community and environment. While this duty is yet to be truly tested in court, it seems tailor-made for the bringing of claims against directors within industries that are closely connected to climate change. Insurance companies may be more removed, but where they continue to invest in, insure or prop up polluting companies, the executives could be vulnerable to claims they have not promoted the success of the company.

Courts will not be very sympathetic to directors who have not done enough: given the statements by the PRA and TCFD, we are now past the point where directors can credibly say that they could not reasonably have appreciated the financial risks associated with climate change.

Who could bring these claims?

Rights to sue based on climate change will be exercised by individuals whether or not regulators legislate, and boards that are slow to change will find their actions challenged.

Directors who are not interested in addressing their company's financial risks from climate change are not going to recommend to the shareholders that the company sues them for their failings! Besides, it is likely they will be long gone when the company suffers the consequences.

The company's claims will come in two or three other guises. Firstly, a board that inherits poor financial performance or is obliged to spend large sums in taking unplanned steps as a result of the inaction of predecessors will likely recommend to the shareholders that the company pursues those former directors. These claims have the potential to be brought long after directors have left the company, and limitation periods cannot necessarily be relied upon to come to the directors' rescue.

The second possibility is that a shareholder forces the company to bring a derivative claim against the directors, for damages or to order the directors to be more proactive in addressing climate change. Courts have been strict in their consideration of whether these actions can proceed, but climate change inactivity may see them allow more claims through. Finally, if the worst happens and the company becomes insolvent, it would be open for a liquidator to bring the company's claims for breach of fiduciary duty under the Insolvency Act 1986.

Are you protected?

Directors (and non-director senior managers) need to check their D&O insurance. There is no reason to suppose that regulatory and civil claims arising out of or connected to climate change should not be covered, subject to the particular circumstances. Pre-claim coverage will be important for the early stages of a regulatory investigation or self-report event, particularly if there are conflicts between the individual and the company. Run-off cover for retiring directors should be maintained. Executives should also re-evaluate the extent of their indemnities from the company. As a company can't indemnify a liability to itself, primary protection falls back to the D&O policy.

[1]http://www.insurance.ca.gov/0400-news/0100-press-releases/2019/release056-19.cfm