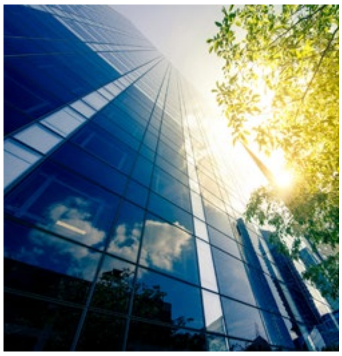
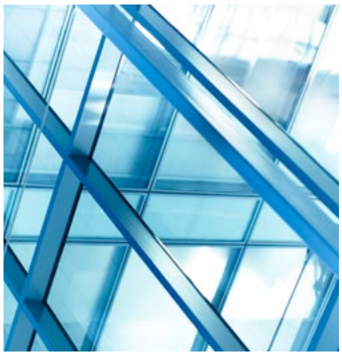
COP26 and insurance
A general primer





Insurers are moving to reposition themselves for the net-zero age. We assess the progress and key issues ahead of COP26

Insurance has for decades been one of the key means for firms to manage and transfer risk. One of the biggest risks facing us all is climate change and its impact across sectors and society.

With climate change coming into focus ahead of the United Nations' COP26 conference in November, the insurance sector is adapting its approach. Such developments generally seek to:

- encourage transition to new fuels, materials and methods to reduce climate change and its effects
- promote consideration of climate change in the underwriting process
- provide better solutions for managing climate change risks

These changes are likely to affect corporates in many areas of their businesses, with an impact far beyond stakeholders in the insurance sector.

Understanding the risks

Climate change brings an increase in exposure to corporates, falling into the broad categories below.

Physical:

Rising temperatures will increase the frequency and severity of extreme weather events, increasing insurers' exposure to large claims and losses. This likely affects life, marine, property and business interruption insurance policies.

Transition:

As society moves to new fuels, materials, methods and transport, there will be changes in insurers' approaches to underwriting and investment. We already see a shift in focus among some insurers as they move away from insuring and reinsuring coal and more closely scrutinise coverage of other high-carbon industries.

Potential litigation and liability:

Greater pressure on corporates to tackle climate change will inevitably bring increased liabilities. For example, there is increased risk associated with non-compliance with regulations such as the Task Force on Climate-related Financial Disclosures framework. There has also been a recent increase in climate litigation against corporates by shareholders, campaigners and individuals on grounds such as non-disclosure, human rights and product liability. Companies will come under mounting pressure to report their environmental impact and ESG ambitions, with an increasing risk of misstatements to investors. This is likely to impact liability insurance classes, principally directors and officers (D&O) and public and products liability.

Reputational:

As public opinion shifts against companies, projects and products perceived as harming the environment, there is an impact on the insurance industry, which is under scrutiny for its role in enabling such businesses. Conversely, there will be an opportunity to bolster reputation through insurance to enable the transition towards more sustainable projects.

Insurers stepping up to the plate

The insurance industry has already responded to many of the proliferating challenges of climate change, with key areas assessed below. Further announcements will be forthcoming in the run-up to COP26.

Changes to underwriting approaches:

In July 2021, the launch of the Net-Zero Insurance Alliance (NZIA) was announced. The NZIA is a UN-convened group of eight insurers including AXA, Allianz, Munich Re and Zurich that have pledged to move their underwriting portfolios to net-zero emissions by 2050. Membership is expected to grow, with the launch coming amid wider industry developments. Last year, Lloyd's of London committed to asking managing agents not to provide new cover for oil sands, thermal coal-fired power plants, thermal coal mines or new Arctic exploration activities from the start of 2022 and not to renew such cover from 2030. In July 2021, Swiss Re announced it would phase out thermal coal-related insurance in OECD countries by 2030, in the rest of the world by 2040 and phase out cover for the world's most carbon-intensive oil and gas companies by 2023.

Some areas of the insurance market are also looking to encourage climate-friendly projects. The Lloyd's of London Sustainable Markets Initiative Insurance Task Force, for instance, has a commitment "to provide climate positive financing and risk management solutions to support and encourage… transition to a sustainable future". While many in the sector are looking to underwrite more climate-friendly risks, there is still uncertainty around the realities that some newer, low-emission technologies and projects are seen as unproven risks. This is where new insurance products may play a part in expanding coverage of such risks. Credit insurance may also enable investment in emerging sustainable sectors by reducing risk.

However, it should be noted that while some insurers exit risks perceived as damaging the environment, this will not remove the short-to-medium-term need for many extractive and energy companies to secure cover. As a result, they may be driven to insure with other markets, including insurers with less focus on the energy transition. There can also be unintended consequences of underwriters exiting projects or sectors. For example, insurance will often be required for de-commissioning oil and gas projects or mining the resources to make batteries required for the energy transition. Some power companies driving the energy transition may also have legacy assets requiring insurance to meet finance requirements in less environmentally desirable locations or activities.

Climate change in the underwriting process:

Climate change, and environmental, social and governance (ESG) factors more generally, will be increasingly embedded in underwriting decision-making. This is one of the United Nations Environment Programme's Principles for Sustainable Insurance (UN PSI). The Association of British Insurers (ABI) joined this programme in 2021.

The ABI has stated its intention to help customers make sustainable choices during the claims process, for example, by switching to an electric vehicle after a car is written off. To enable the transition in their underwriting portfolios, insurers may also seek to influence policyholder conduct by encouraging behaviours through policy terms and lower premiums or other advantages, or by penalising behaviours through exclusions or premium hikes. For example, some insurers are offering premium discounts to owners of hybrid cars or more energy-efficient buildings.

It will be important to track efforts to change corporate behaviour through contract language in policies. While climate change exclusions in policies are currently rare, there are initiatives to develop terms for use in a wide range of contracts to prevent the insurance of certain risks or activities. These well-intentioned efforts need to be approached thoughtfully. There will be a balancing act between motivating positive change and the risk of hindering corporates' ability to raise finance for the energy transition.

New insurance products and services:

Another goal of the UN PSI is to manage risk and develop ESG-friendly products. Insurers and brokers are already offering new products with Lloyd's facilitating development of policies for electric vehicles to cover a breakdown in internet connection. AXA XL is working with other bodies to create the first mangrove insurance policy and it is understood that a coral reef insurance product paid out for the first time last year in Mexico. The Insurance Development Forum (IDF), which was officially launched at COP21 in Paris in 2015, is reportedly working on an "ambitious risk modelling agenda with the hope of announcing a major initiative at COP26".

Parametric insurance – where loss is paid when a predetermined index such as rainfall level or the Richter scale is triggered – is also gaining ground. This may be particularly important in sectors where profits are dependent on weather, such as agriculture. The IDF refers to a project where Hannover Re and Willis Towers Watson created a parametric flood and earthquake product and indemnity landslide protection for the Colombian city Medellín.

Conclusion

The pace of change in the insurance sector creates risks and opportunities for policyholders. Companies may notice changes in their ability to obtain cover for certain risks and changes in the process of placing insurance. It will be important for firms to stay alert to unintended consequences of efforts to change behaviour through exclusionary measures rather than incentives. But policyholders may also be able to take advantage of premium discounts or other benefits if they take climate-friendly actions. Meanwhile, new insurance products may help manage emerging climate risks.

There is no single answer to climate risks for the insurance sector or policyholders. But momentum is clearly gaining in the industry to be part of the solution rather than the problem.

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