Insuring climate change and sustainability

UNLEASHING INNOVATION AND INTELLIGENT PARTNERSHIPS

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In the 1970s, the American economist, Milton Friedman, coined the maxim, "The business of business is business." However, with all the environmental, social and governance (ESG) issues that have evolved over the years, it is clear that it is also the business of business to act responsibly. There is growing expectation from society on the responsibility of business in helping ensure a sustainable future.

BUSINESS CASE FOR SUSTAINABLE FINANCE

The United Nations Environment Programme Finance Initiative (UNEP FI) believes that many of the most innovative and forward-looking companies recognise and understand the importance of environmental, social and governance factors in addition to traditional financial factors. Well-managed companies generally do not abuse the planet; do not unfairly exploit their employees, customers and suppliers; and adhere to high standards of corporate governance. ESG factors provide an additional lens that gives an excellent insight into the quality of management; that companies attentive to ESG risks and opportunities are more competitively positioned to deliver superior financial performance and long-term value, and more closely aligned with the goals of sustainable development.

Sustainability boils down to commonsense. Sadly, commonsense seems to be wanting in the financial world. One need not look further than the spate of episodic financial crises that we have experienced due to myopic thinking. Sustainability issues such as climate change generally require a long-term approach, yet many financiers have a short-term mindset – detrimental to value creation and, ultimately, to markets and economies.

ADVENT OF SUSTAINABLE INSURANCE

The financial sector has a key role to play in the quest for sustainability, and the insurance industry is a big part of it. Insurance is one of the largest industries in the global economy. In 2007, world premium volume exceeded US$4 trillion, while the industry's global assets under management stood at over US$17 trillion in 2006.

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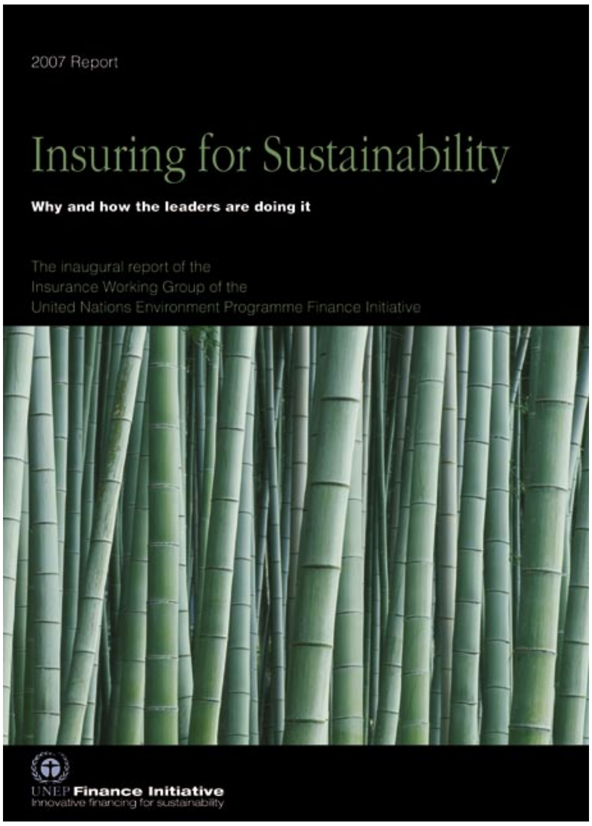
Insurance is essential for a viable economy since it assumes risks that could potentially result in financial ruin for an individual or enterprise. Sustainability reduces risks. And if risks are understood and managed well, it opens the door to new opportunities. A sustainable market is an impetus for greater financial stability and growth. Because of their extensive reach into the community, insurers have tremendous scope to encourage sustainable behaviour. Further, insurers are major contributors to the economy through their substantial investments and some, such as Allianz and Swiss Re, have established investment funds comprising companies dealing with renewable energy, pollution control and clean water.

In 2006, UNEP FI created an Insurance Working Group. Some of the world's largest insurance groups have united to drive sustainability forward. In its 2007 inaugural report, 'Insuring for Sustainability: Why and how the leaders are doing it', nine global sustainability issues are identified, vital for this generation of insurers due to their urgency and the scale of their potential impacts – climate change, microinsurance, lifelong income, health, emerging manmade risks, environmental liability, natural resources, recycling and internal resource efficiency.

OPPORTUNITIES FOR INNOVATION

Based on studies by UNEP's Renewable Energy and Finance Unit, insurance and other financial risk management instruments can enhance the viability of renewable energy projects in terms of reducing default rate, improving credit rating and cash flow, and achieving a higher internal rate of return. AXA provides comprehensive insurance coverage for wind farms, which generated US$14 million in premium revenue in 2006, while Carbon Re and Munich Re have developed products covering carbon credit delivery. Pay-as-you-drive insurance schemes that use satellite technology and 'climate-friendly' motor and travel policies are increasingly being offered by insurers including Allianz, Aviva, AXA, and Tokio Marine & Nichido.

Microinsurance, insurance for low-income people, has become a serious business opportunity with potentially huge markets emerging worldwide. A 2008 Swiss Re report states that emerging markets registered growth of nearly 12 per cent in 2007, and accounted for 10 per cent of world premium volume. This trend is expected to continue in all lines of insurance business. Major insurers such as Achmea, AIG, Allianz, AXA, Folksam, MAPFRE, Munich Re and Swiss Re are now offering microinsurance schemes in developing countries. Microinsurance is an effective climate change adaptation tool, and can help poor people transition out of poverty traps and contribute to achieving the Millennium Development Goals, particularly in the areas of poverty reduction, health, education and gender equality.



An innovative example is the drought cover Swiss Re provides to smallholder farmers in Africa, in partnership with the Earth Institute at Columbia University and the Millennium Promise Alliance. The insurance protects farmers in several villages in Kenya, Mali and Ethiopia from severe drought, which leads to food shortages and famines. Payouts are linked to a weather index (eg. amount of rainfall) based on climate models and satellite data. Aside from being an ex ante solution (ie. payout is made prior to crop failure) to mitigate climate risk, it also improves farmers' access to credit from microfinance institutions.

Forests provide another potential opportunity for insurers. WWF has estimated that carbon stored in Canada's boreal forests and peat lands alone is worth CA$3.7 trillion, virtually mirroring the US$3.7 trillion worldwide premium income of the insurance industry in 2006. A clear response to climate change, embedded in the Bali Roadmap forged in December 2007, is Reducing Emissions from Deforestation and Degradation (REDD). It is essential for REDD policies to be included as a key component, from both a mitigation and adaptation standpoint, of the successor agreement to the Kyoto Protocol. The question is, how does one insure a carbon-sequestering and vulnerability-reducing forest from going up in flames or being decimated by natural disasters or pests?

Given the potential for catastrophic losses, and the difficulties in assessing and monitoring risks and settling claims, insurance for forests is still a specialist and nascent field. This presents an opportunity to look into alternative risk transfer and financing solutions such as index-based insurance, weather derivatives and catastrophe bonds that link the capital markets. Risks could be spread by constructing portfolios from a wide geographic scope and variety of forest types, and risk management could be dramatically enhanced by the use of satellite technology and earth observation instruments. The initial research and development could be costly, but once established and seen to be cost-effective, normal market forces would ensure their continuation. A suitable approach might be for the public sector to encourage the insurance industry to become involved in pilot projects, either as underwriters or investors.

Forests could form part of a broad portfolio of responsible investments. With their long maturation, forests would be a suitable asset to match with pension funds' commitments to long-term income streams and enhance portfolio diversification. Potential investors who wish to support the environmental benefits of forests would want to reduce the risks to their new assets as much as possible, for which insurance and SFM (sustainable forest management) certification would be crucial factors.

Another emerging area is insurance for carbon capture and storage (CCS) systems. However, due to the risk complexities and various uncertainties surrounding CCS technologies, let alone capital outlays, financial risk management instruments will definitely require concerted efforts involving the public and private sectors. Nevertheless, as with forestry, the situation for CCS systems is a major opportunity for innovation.

One must bear in mind that climate change is one of many sustainability issues. Sustainability is more than being 'green'. For example, asbestos has been a curse to the insurance industry for decades, and escalated into the greatest loss in insurance history because the early indicators of its damaging effects on human health were underestimated. Could nanotechnology be the next asbestos? Recent research reveals that nanoparticles can enter the human body which may cause immune reactions and even penetrate the central nervous system. With ageing populations and reduced social security benefits in developed countries, will 'baby boomers' have enough for their retirement years? These factors are already driving the shift to pension-linked life insurance products and annuities, which are estimated to become major sources of premium income over time.

But as serious as these sustainability risks are, they can become tangible business opportunities, as shown by case studies of best practice by industry leaders.

LEADING BY EXAMPLE

A considerable number of insurance companies now have corporate policies to reduce their own environmental footprint. It is important to set a good example when requiring clients and suppliers to manage their risks in a sustainable way. Indeed, certain insurers have taken the lead and have made it clear that by reducing their own carbon footprint, they are also helping abate climate change. Large institutions such as Aviva, AXA, Folksam, HSBC Insurance Brokers (as part of the HSBC Group), Munich Re, Storebrand and Swiss Re have all committed to internal emission reductions, energy efficiency improvements and carbon offsetting schemes. Insurers have also embarked on stakeholder and research partnerships to better understand climate change and sustainability risks and opportunities.

MAJOR INITIATIVES IN THE WORLDS OF FINANCE AND BUSINESS

For the institutional investment community, the Principles for Responsible Investment (PRI), an investor initiative in partnership with UNEP FI and the UN Global Compact, is a powerful signal that sustainability matters. PRI signatories believe that environmental, social and governance issues can affect the performance of investment portfolios and that implementing the Principles can better align investors with the broader objectives of society. The Principles, launched in April 2006, have the endorsement of UN Secretary-General Ban Ki-moon. To date, over 400 institutional investors worldwide representing more than US$16 trillion in assets under management have committed to implement the Principles.

In this vein, UNEP FI is set to commence the development of 'Principles for Sustainable Insurance' for the global insurance industry in 2009.

Another key initiative is the Carbon Disclosure Project (CDP). On behalf of institutional investors, representing US$57 trillion in assets under management, CDP gathers information on the business risks and opportunities presented by climate change and greenhouse gas (GHG) emissions data from over 3,000 of the world's largest companies. CDP has become the benchmark for carbon disclosure methodology and process and is the world's largest repository of corporate GHG emissions.

In the banking industry, the Equator Principles – based on International Finance Corporation guidelines and backed by banks representing more than 85 per cent of the global project finance market – have introduced sustainability criteria necessary to drive systemic change.

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Finally, there is the UN Global Compact, a framework for businesses committed to aligning their operations and strategies with 10 universally-accepted principles within the areas of human rights, labour, the environment and anti-corruption. As the world's largest corporate citizenship initiative, including over 4,000 companies in 120 countries, the UN Global Compact is principally concerned with exhibiting and building the social legitimacy of business and markets.

UNEP FI and these global initiatives have articulated profound insights. Firstly, sustainable finance and business is not philanthropy. Secondly, the most innovative and forward-looking financial institutions and businesses are addressing sustainability issues not simply to reduce risks; increasingly, they are doing so to enhance competitive positioning and seize new opportunities.

AN INTELLIGENT PUBLIC-PRIVATE INTERFACE

Governments cannot do it alone, and neither can the private sector on its own. There is an urgent need for the public and private sectors to understand each other better and work together. Global sustainability issues require a collective response from all sectors.

In 2009, the international community will be gathering in Copenhagen for the climate change negotiations that will determine the post-Kyoto Protocol regime. An important aspect of the intergovernmental process of the UN Framework Convention on Climate Change (UNFCCC) is whether the global financial sector will have a clear voice and structured input to help shape a policy and regulatory framework that is pro-market. The financial sector, compared to other industry sectors such as energy, oil and steel, has seemingly been underrepresented in climate negotiations of past years.

But there have been encouraging developments recently. In February 2008, UNEP held its Governing Council and Global Ministerial Environment Forum in Monaco with the theme, "Mobilising finance for climate change." That same month, UN agencies and Ceres, the largest coalition of investors, environmental and public interest organisations in North America, organised the third Investor Summit on Climate Risk at the UN headquarters in New York. The event attracted nearly 500 institutional investors to accelerate thinking and action on climate change.

A 2007 UNFCCC report estimates that in 2030, global additional investment and financial flows of US$200 to US$210 billion will be necessary just to return emissions to current levels, equivalent to 0.3 per cent to 0.5 per cent of estimated global GDP, and 1.1 per cent to 1.7 per cent of global investment in 2030.

Recognising the vital role of the financial sector, in June 2008 the President of the UN General Assembly convened a special session in New York to discuss "Global Private Investments and Climate Change." Representatives from the banking, insurance and investment industries briefed member governments on the views and expectations of the financial sector on climate change and the development of robust carbon markets. It was stated that the while the global renewable energy market has experienced significant growth in the last four years, the growth rate is still very far from the estimated total investments needed until 2050 to cut GHG emissions to half of today's levels. Therefore, it is imperative for policymakers to better understand the needs of the financial sector in order to build a policy and regulatory framework that will catalyse finance and investments that address the mitigation and adaptation dimensions of climate change in an efficient manner. An appropriate framework will accelerate the development of liquid carbon markets, channel much-needed investments in renewable energy, energy efficiency and disaster risk reduction and management, and foster innovative insurance solutions and financial risk management instruments.

The monumental challenge of climate change is but one example where forging public-private partnerships is crucial.

INSURING A SUSTAINABLE FUTURE

The insurance industry is society's early warning system, crucial to recognising risks and making informed decisions. The insurance-sustainability nexus in today's interconnected world requires adapting to a risk landscape that is changing at an increasingly greater speed. This calls for greater knowledge, deeper understanding and relentless innovation. For the insurance industry, the promise of a sustainable tomorrow lies in how it can master the risks of today, and mine the opportunities these entail.

Integrating sustainability into the core strategies and operations of financial institutions will not happen overnight. However, it is clear that we want to arrive at sustainability through enlightenment – and not because we were left with no other choice. We have been drawing down Earth's capital when we should be living off its interest. Awareness is the first step, but sustainability will never be realised without action. And, ultimately, failure to act is not an option. Are insurers meeting our generation's myriad of environmental and social challenges by acting responsibly and insuring for sustainability? Are policymakers and regulators providing the appropriate framework to foster innovation and drive sustainability in the insurance industry?

This report is an outstanding opportunity to call on key decision-makers worldwide to better understand and respond to the policy framework and regulatory environment needed by insurers to embed sustainability in their organisational DNA as a key to long-lasting business success, to unleash innovation and combat climate change vigorously, and to contribute to goals of sustainable development. This intelligent public-private interface is imperative if the insurance industry and the broader business community are to be vital catalysts in the transformational process to our common – and sustainable – future.

Author

Butch Bacani oversees asset management and insurance at the United Nations Environment Programme Finance Initiative (UNEP FI). The UNEP FI Asset Management Working Group is a global platform of asset managers from Brazil, Canada, France, Italy, Japan, the UK and the US that collaborate to mainstream the integration of environment, social and governance (ESG) factors into the investment process. The UNEP FI Insurance Working Group is an alliance of insurers and reinsurers from Australia, Bermuda, Canada, France, Germany, Greece, Japan, Norway, Spain, Sweden, Switzerland, the Netherlands, the UK and the US committed to embedding ESG factors in their core strategies and operations as an integral part of their corporate responsibility. Butch is a member of the Management Team and leads the Investment Team engaged in the activities of the Principles for Responsible Investment (PRI), an investor initiative in partnership with UNEP FI and the UN Global Compact.

Organisation

The United Nations Environment Programme Finance Initiative (UNEP FI) is a public-private partnership between UNEP and the global financial sector. Over 180 banks, insurance companies and investment firms worldwide work with UNEP to understand the impacts of environmental, social and governance (ESG) considerations on financial performance and sustainable development. Through a comprehensive work programme, regional activities, training and research, UNEP FI carries out its mission to identify, promote and realise the adoption of best environmental and sustainability practice at all levels of financial institution strategies and operations.

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