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Concerned about climate change?

6 ways for insurers to future-proof their portfolios

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In California, PG&E Corp. is being called the first climate-change bankruptcy and is likely a harbinger of more to come. In Australia, a 24-year-old is suing his pension fund for not adequately assessing the impact of climate change on its investments. And in Alaska, 31 towns face imminent destruction from rising water levels and some, such as the village of Newtok, are being relocated inland.

For insurers, climate change is a major risk because of their exposure to insurance claims and long investment horizons. Globally, the cost of catastrophic events to insurance companies is up 20-fold since the 1970s to an average annual rate of $65 billion in the past decade and $85 billion last year.

Some insurers are beginning to future-proof — or risk manage — their exposure to climate change risk. Most recently, Hartford Financial Services Group Inc. announced it would phase out policies and investments related to coal and oil from tar sands.

While some firms are taking action, adapting to climate change can be overwhelming given its magnitude and complexity. But the consequences are becoming too urgent to ignore.

Whether you have put off future-proofing altogether or have already begun, here's a blueprint for becoming a more adaptive organization and making preparations to protect your portfolios.

1. Understand the impact

To assess the magnitude of climate change, insurers need to follow the data to track its growing severity. Because it isn't a finite problem, insurers must keep up with its evolving impact and keep adapting.

Globally, the warmest years on record were in the past five years, the highest global average sea temperatures occurred in the past four years, and ocean levels are steadily rising. Together, these factors are causing extreme weather events to occur more frequently and with greater intensity.

Meanwhile, the policy response is ramping up as well, which stands to affect insurers just as dramatically as climate change itself. To keep global temperatures to below 2 degrees Celsius above preindustrial temperatures, 187 countries have signed the Paris Agreement, pledging to reduce carbon dioxide emissions and increase renewable energy market share. Cities and states are also beginning to limit investments in fossil fuels.

2. Frame the types of risk

By understanding the four types of climate-related risks, portfolio managers can prioritize and build the right teams to respond to:

- **Physical risk** — damage to physical assets from storms, hurricanes and floods, including the effect on productivity and economic growth.
- **Liability risk** — lawsuits about losses to physical assets, including recent lawsuits targeted at oil and gas companies for their alleged complicity in climate change.
- **Transition risk** — industries and commodities negatively affected by the transition to a low-carbon economy.
- **Market risk** — declining prices of assets, securities, commodities and services due to climate change or its remedies.

3. Establish a process

Future-proofing introduces change in an organization, and you need to mitigate the potential pain. A framework for assessing bottom-up credit risks and top-down economic impacts gives you a repeatable process, so you're prepared and less reactive. You don't have to create something new each time:

- Identify physical assets, businesses and supply chains in locations exposed to extreme weather events and long-term climate change.
- Reduce exposure to assets vulnerable to transition risk to a low-carbon economy by industry, such as oil, coal, high-energy users, carbon emitters, and by resource impacts, such as water usage, commodity consumption and toxic emissions.
- Evaluate second-order effects of transition risk, such as rising regulatory costs, taxes, surcharges, subsidies, and shifts in supply and demand.
- Seek out transition beneficiaries, such as clean/renewable energy technology, electric vehicles, battery technology, LED technology, green bonds and the carbon credit market.

4. Prioritize immediate risks

It's not enough to define the types of risk — you need to segment by the urgency they represent and prioritize accordingly. First-order effects of climate change include physical holdings in regions more exposed to extreme weather conditions, as well as sectors directly exposed to transition risk, such as oil and gas, coal, utilities and natural resources.

Forward-thinking insurers are already introducing policies that discourage investment in the thermal coal market. According to the California Department of Insurance, 53% of U.S. insurers excluded coal from their portfolios in 2018, up from 50% in 2016, and 10% of insurers were committed to divesting coal holdings going forward, up from 6% in 2016. In announcing its new policy to phase out thermal coal investments and underwriting, Liberty Mutual Insurance Co. acknowledged its responsibility to stakeholders.

5. Don't ignore longer-term risks

Some risks are easy to disregard because their impact isn't imminent. But the point of future-proofing is preparing for what's to come. For insurers, that means identifying the appropriate course of action needed to mitigate the risk of stranded assets — a resource that no longer has value. Developing policies to address second- and third-order effects of stranded assets is critical to prepare for the future.

Geographic regions that have significant economic exposure to these sectors will see an effect on real estate holdings, tourism and hospitality businesses, and regional municipal debt. While not yet reflected in pricing for municipal bonds, credit rating agencies are beginning to factor climate-change risks into their municipal ratings.

Another long-term consideration is how to anticipate demands from regulators, shareholders, pension recipients, policyholders, and activists for investments and business policies that do not contribute to climate change.

6. Establish dedicated resources

Think of climate change as a new and necessary priority that requires appropriate resources. Insurers should build out dedicated teams to analyze climate change and its effect on macroeconomic and investment risk.

To start, insurers should follow the critical data in the battle against climate change, including carbon emissions, global temperatures and rising sea levels. The progression of these data points will play a role in the timing and costs of protecting a portfolio from the future effects of climate change, and inform the critical risk analysis for industry, security and assets. Firms should also partner with subject matter experts to stay informed and develop expertise in green bonds and carbon pricing markets.

There is time to prepare for the longer-term consequences of climate change, but insurers should not be complacent now just because many of the worst outcomes might not be felt for decades. This "tragedy of the horizon" means that once climate change becomes a defining issue, it may be too late to take action.

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