The Legal Intelligencer
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Insurance

Climate Change for the Insurance Industry

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July 21, 2016

Defining Climate Change

The burning of fossil fuels produces CO2 and other so-called greenhouse gases (GHGs) that scientists have linked to global warming and other changes in the Earth's climate. In just the last year, so-called carbon extractors and heavy users of fossil fuels have come under heightened scrutiny. Insurance companies should pay close attention to developments related to climate change and make certain that they remain proactive in the way in which they address risk to their respective organizations.

Specifically, insurers should be concerned with any aspect of climate change that could adversely impact insurer assets, including claims, investment losses or regulatory fines.

Is Climate Change the New Asbestos?

Similar to asbestos 40 years ago, climate change has enormous potential to develop into a mass tort; but, while the scientific community seems to be lining up on the side of causation, liability has yet to be established. In contrast, both causation and liability for asbestos-associated illness has been established in the United States since 1971 in *Borel v. Fibreboard Paper Products,* (No. 72-1492). Thus, while it is premature to draw a parallel with asbestos, climate change demands the attention of insurers due to the magnitude of potential losses should liability be established.

Where Do Insurers Have Exposure?

Property and Casualty insurers have exposure in the following areas:

• Property and Business Income Claims

The mere change in the Earth's climate may lead to increased exposure for insurers from the perils of wind, hail, flood or earthquake. Insurers are exposed to property and business income

losses from these perils, without regard to whether the change in climate is determined to be man-made or not. Actuaries, underwriters, as well as the buyers of reinsurance should be tuned in to these changes.

• **General Liability Claims**

General liability policies covering fossil fuel extractors and heavy users, such as the utilities industry, could be called upon to pay, provided liability can be established in a court of law.

In fact, there has been an attempt to establish such liability in U.S. courts. In 2011, the Supreme Court of Virginia was the first to make a determination in an insurance-coverage matter. The Inupiat Eskimo Village of Kivalina, Alaska, had filed a claim against numerous coal-burning utilities including AES Corporation for damages relating to climate change. The village alleged that Arctic sea ice melting as a result of global warming was ruining the village. Steadfast Insurance Company denied coverage. The Virginia Supreme Court found that Steadfast had no duty to defend such a lawsuit.

While this matter failed to establish liability on the part of the insurer, the mere potential of liability raises questions relating to accounting, claims, underwriting and investments, solvency and regulation. To the extent that liability might be established in the future, underwriting restrictions and policy exclusions on any new policies could serve to protect the insurer's capital.

• **Investments**

There is a risk that insurers' investment portfolios will lose value if carbon extractors and heavy users of fossil fuels become financially impaired due to litigation, a declining market for their products or inability to raise needed capital from major investment funds that eschew carbon investing altogether.

In response to this risk, in January 2016, California Insurance Commissioner Dave Jones asked insurers to "disclose annually their carbon-based investments including those in oil, gas and coal," and, "voluntarily divest from investments they hold in thermal coal," so that they would not be left with "stranded assets that have lost their value ... ."

• **Directors & Officers (D&O) Claims**

D&O insurance exposure has often to do with the potential lack of disclosure from a Director or Officer of a policyholder to its stakeholders. For a public company, this is especially important due to SEC regulations.

Public companies may now be required to disclose any potential liability for causing climate change, to the extent that it makes an investment in the company more "speculative or risky." Directors and officers of such companies (and their insurers) might ultimately be required to defend suits alleging inadequate disclosure.

In March 2016, the SEC forced Exxon Mobil to allow a climate change vote at its shareholder meeting in May. New York state comptroller Thomas DiNapoli, who spearheaded the proposal, stated: "Investors need to know if Exxon Mobil is taking necessary steps to prepare for a lower carbon future, particularly now in the wake of the Paris agreement." In addition, California Attorney General Kamala Harris has opened an investigation as to whether Exxon Mobil Corp. "lied to the public and its shareholders about the risk to its business from climate change—and whether such actions could amount to securities fraud and violations of environmental laws."

Enhanced financial statement risk disclosure associated with climate change, at least for industries involved heavily in the extraction of fossil fuels and the emission of GHGs, will soon likely become a larger part of the management discussion and analysis section of companies' SEC filings.

• **Regulatory Disclosure**

-State Disclosure

Just as the SEC has required policyholders to disclose climate change exposure, so state regulators are requiring the same of insurers.

The National Association of Insurance Commissioners (NAIC) developed an insurance company survey on climate change that was adopted by insurance regulators in California, Connecticut, Minnesota, New York and Washington in 2013. Any company licensed in one of these states, with nationwide direct written premium over $100 million, is required to respond to the survey.

-Enterprise Risk Management, Model Audit Rule and ORSA

In addition, insurers are required to manage their control environment well beyond Sarbanes-Oxley (SOX) requirements. First, the NAIC imposed Enterprise Risk Management (or ERM) requirements on insurers. ERM requires that a holistic framework be established in order that an insurer can better understand and control its risk-taking activity across underwriting, investment and operational risks. Second, the requirements of the Model Audit Rule (MAR), more closely mirror Sarbanes-Oxley requirements, requiring insurers with $500 million in gross premium to file a report addressing the company's assessment of its internal controls over statutory financial reporting. Further, in January 2015, the Own Risk and Solvency Assessment (ORSA) went into effect for insurers above a certain premium threshold. ORSA requires insurers to complete a confidential summary report addressing risk as it relates to the company's own solvency.

Conclusion

Insurers should recognize that ERM, MAR and ORSA, each provide a tool that is already in place (at companies above the threshold levels), to address enterprisewide risks they face with the uncertainties surrounding climate change. The ability to use these tools to assess, report and then re-assess climate-change risks will be critical in the coming years. Where the risks are unclear, it will be incumbent upon insurers to seek help in identifying risks that could impact their entire organization. •

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