The Role of Insurance in the Energy Transition

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CCLS Insurance, Shipping and Aviation Law Institute

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IPCC, ‘AR6 Synthesis Report - Climate Change 2023’: Widespread and rapid changes in the atmosphere, ocean, cryosphere and biosphere have occurred. Human-caused climate change is already affecting many weather and climate extremes in every region across the globe. This has led to widespread adverse impacts and related losses and damages to nature and people.

Energy transition – the international stage

2015 Paris Agreement

- Preamble: “Climate change is a common concern of humankind”
- Paris goals:
  - Art.2(1)(a): limiting the temperature increase “to well below 2 °C” and “pursuing efforts” to limit it to 1.5 °C (= temperature goal; climate change mitigation)
  - Art.2(1)(b): adapting to the adverse impacts of climate change and fostering climate resilience and low greenhouse gas emissions development (climate change adaptation and resilience)
  - Art.2(1)(c): climate finance for lowering GHG emissions and climate-resilient development (climate finance)
- 194 signatory countries
- No binding targets and no enforcement mechanisms

2023 UAE Consensus – Outcome of first Global Stocktake

- Parties are not yet on track towards achieving Paris goals
- Parties called upon to contribute to the energy transition:
  - Tripling renewable energy capacity globally and doubling the global average annual rate of energy efficiency improvements by 2030;
  - Accelerating efforts towards the phase-down of unabated coal power;
  - Accelerating efforts globally towards net zero emission energy systems and transitioning away from fossil fuels in energy systems
  - Accelerating zero- and low-emission technologies;
  - Accelerating the reduction of emissions from road transport, including through development of infrastructure and rapid deployment of zero and low-emission vehicles; and
  - Implementing urgent, incremental, transformational and country-driven adaptation action
- Urges non-Party stakeholders to increase ambitions and contribute to solutions
- Recognizes the role of the private sector to reach the scale of investments required to achieve a global transition towards low GHG emissions and climate-resilient development and encourages Parties to continue enhancing their enabling environment
- Integrated approaches from public and private sectors

The insurance industry’s **enabling role** in the energy transition

- Triple role: risk carrier, risk manager, investor
- **Insurer as enabler** of policyholders, investee companies and other stakeholders in their energy transition: supporting actors in insurer’s value chain and in the wider community to take climate mitigation action, to adopt climate change adaptation measures and to build resilience
- Theoretical frameworks:
  - Investor stewardship (Hirschman, UK Stewardship Code 2020)
  - Stakeholder capitalism (2020 Davos Manifesto)
  - Corporate social responsibility theories (Carroll, Elkington)
  - ‘Governance conception’ of insurance (Ericson and Doyle)

Role of insurance industry in energy transition

- Insuring green: Provide insurance cover for green infrastructure projects, energy systems and technologies that expedite decarbonization during built / development stage and operational phase to de-risk projects and lower costs of capital
- Greening insurance: Develop new insurance products and adjust existing insurance products that shift policyholders' behaviours and processes towards taking climate change mitigation and adaptation measures and building resilience
- Green risk management: Provide risk management services and tools in relation to physical, transition and liability climate change risk
- Green investment: Invest in green infrastructure projects, energy systems and technologies

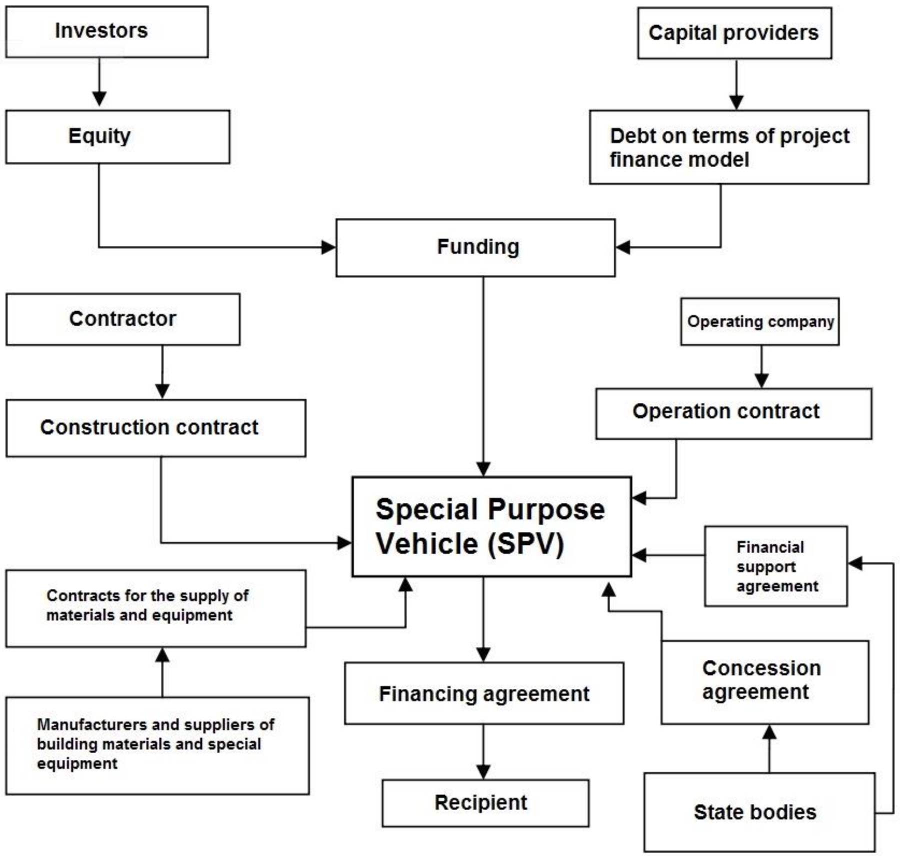
Today’s focus …

… insuring green:

- infrastructure projects relating to renewable energy systems
- technologies relating to energy efficiency, reducing and capturing emissions

… and withdrawing from insuring brown

Projecting financing structure



Insurance contracts and parties

Risk + Premium →

Insured ⟷ Insurer

← Indemnity

- Definition / description:
  - *Prudential Insurance Co –v- Commissioner of Inland Revenue* [1906] 2 KB 658
  - FCA Handbook PERG 6
- Most insurance contracts are contracts of indemnity: the insurer promises to indemnify the insured against its loss caused by an insured peril in return for a premium (NB: contingency insurance)
- Key dramatis personae:
  - Contract of insurance between the insured/s (also ‘assured/s’ / ‘policyholder/s) and the insurer/s
  - Co-insureds (project parties and finance parties) and co-insurers
  - Reinsurers
  - Parties with an interest in insurance arrangements: beneficiaries / loss payees / assignees
  - Advisors: insurance brokers, lawyers, in-house risk managers

What risks are insured in a project financing?

- Core risks in construction and operational phase of projects:
  - Loss or damage to assets, including as result of physical climate change risks
  - Legal liability
  - Loss of earnings
  - Political risks (offshore)
- Construction phase insurances:
  - Construction (or Contractors) All Risks (CAR) or Erection All Risks (EAR)
  - Delay in start-up insurance (DSU)
- Operational phase insurances:
  - Property all risk
  - Business interruption (BI)
  - Equipment breakdown (EB)
  - Public liability (PL)

→ Insurance de-risks the transaction → lowers the cost of capital

Insuring green - legal and practical issues

- Insuring green ≠ lower risk (untested technologies, transition risk, location vulnerable to physical climate change risks and political risk, sustainable materials and construction methods can give rise to increased physical hazards such as fire)
- Insurers cannot take uncommercial underwriting decisions:
    - Accountability to their shareholders / directors' duties / corporate purpose
    - Regulatory capital requirements
    - Regulatory and corporate governance and risk management requirements
    - Impact on availability of reinsurance
- Prudential treatment: should insurers be allowed regulatory capital relief for providing insurance for green infrastructure projects and assets?
    - Incentivise insuring green –v- maintain strict risk-based prudential treatment
    - Precedent: EU Regulation 2019/876 amending the Capital Requirements Regulation introduced limited preferential treatment of loan exposures to corporates specifically set up to fund public infrastructure where the assets being financed contribute to certain environmental and sustainability objectives and satisfy various other tests
    - PRA: no; EIOPA: consultation on prudential treatment of assets and activities that are associated substantially with environmental objectives or harms.
- Disclosures: corporate disclosures; regulatory ESG disclosure (limited in scope) and anti-green washing regime
- Other potential legal issues: local regulation and licensing requirements, documentation, risk presentation, co-insureds (project parties and financing parties), payment/assignment of claims, subrogation rights

Not insuring brown

Should insurers cease insuring coal, oil and gas?

Not insuring brown

- No legal requirement to withdraw and no legal prohibition on withdrawing, but:
  - Accountability to shareholders / directors’ duties / corporate purpose
  - UK: regulators must consider the UK’s climate targets in the exercise of their functions (FSAM 2023, s.27) but BoE is not considering penalizing capital treatment of carbon underwriting
  - EU: alignment with the EU Taxonomy - do no significant harm; Corporate Sustainability Reporting Directive – disclosure of transition planning for alignment with Paris Agreement temperature goal and adverse impacts connected with the undertaking’s own operations and with its value chain (Art.1 Point 4); proposals for Corporate Sustainability Due Diligence
  - US: anti-ESG legislation and anti-ESG litigation; anti-trust challenges relating to commitments by members of the Net Zero Insurance Alliance to collaborate on phasing out carbon underwriting
- Accountability to investors, regulators and the public through disclosure requirements on emissions and transition plans (GHG emissions, insurer transition plan and engagement with carbon clients) – risk of ‘green-washing’
- Can carbon underwriting be challenged in court? Lawsuits against insurers for contributing to climate change by supporting heavy emitters with insurance cover? No reported lawsuits yet, but:
  - *ClientEarth v Shell Plc* [2023] EWHC 1137: unsuccessful derivative action on CA 2006 s.172 factors – they do not constitute separate duties and that it is for the directors themselves to determine the weight to be attached to them
  - *R. (on the application of Friends of the Earth Ltd) v Secretary of State for International Trade* [2023] EWCA Civ 14: unsuccessful judicial review of investment decision by the Export Credits Guarantee Department in a liquefied natural gas project in Mozambique
  - *McGaughey v Universities Superannuation Scheme Ltd* [2022] EWHC 1233, affirmed [2023] EWCA Civ 873: unsuccessful claim by members of pension scheme against trustees, inter alia for failure to create a credible plan for disinvestment from fossil fuel investments

Greening insurance and risk management

- Insurance products and services that shift policyholders' behaviours and processes towards taking climate change mitigation and adaptation measures and building resilience
- Existing insurance products that are adapted with green features and objectives and development of new insurance products and services
- Greening the product cycle … and potential legal issues:
    - Product development / adjustment: target market and fair value (UK: FCA Handbook PROD 4, EU: IDD art.25 and Commission Delegated Regulation (EU) 2021/1257)
    - Pre-contractual information / advice:
        - Policyholders with/out green objectives: product suitability and product disclosures (UK: FCA Handbook ICOBS 5/6, EU: IDD art.20)
        - Ascertain sustainability preferences? EU – for IBIP (Regulation (EU) 2021/1257)
        - Green-washing - anti-green-washing rules (UK: FCA Handbook ESG 4.3; EU: Proposal for a Directive on Green Claims)
    - Climate change risks and climate impacts as part of the pre-contractual risk presentation: Insurance Act 2015 Pt.2 and CIDRA 2012
    - Pre-contractual climate change risk assessment, provision of information and recommendations to prompt action: NB duty of care, restrictions on non-insurance business (PRA Rulebook SII Gen Con 9.1), consumer duty (FCA Handbook PRIN 2A)
    - Climate change risk reflective premium pricing (discounts and uplifts): corporate purpose; TCF / consumer duty issues (pricing protection gaps, relevance of climate change mitigation measures to risk profile, timing and value disconnect)
    - Terms: warranties, exclusions, 'nudge' terms (IA 2015 s.10/11; construction, verification and remedies for breach; for consumers: consumer duty and unfair terms legislation; interface with climate policy and legislation; corporate purpose; privity; and prudential requirements where extra costs arise)
    - Claims: build back better / more sustainably / more resiliently: green reinstatement / green replacement; betterment; utilising subsidies; advance payments for loss prevention
    - Disclosures: corporate disclosures; sustainability disclosure and anti-green washing regime at product and entity level

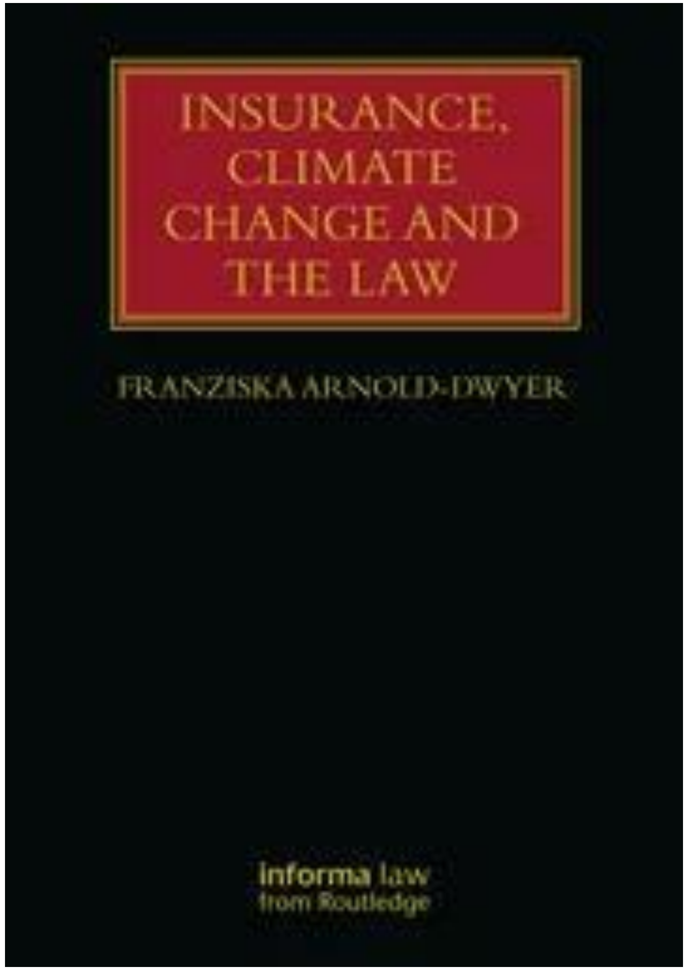
Also see: F Arnold-Dwyer, A Legal Framework for Net Zero Aligned Insurance Products, (2023) 29(2) Conn Ins LJ 1

Green investment

- Insurers are major institutional investors; holding $40+ trillion in assets (Statistica, 2021)
- Impact investment approaches: **intention** to generate positive and measurable climate impact (= **additionality**) alongside achieving an acceptable financial return, by:
  - providing additional capital to actively contribute to climate change solutions;
  - applying positive and exclusionary criteria to the selection of investments to achieve climate goals;
  - withholding investment / divesting from fossil fuel projects: additionality? Could disable an investee company from pursuing fossil fuel activities and can thus indirectly contribute to the reduction of further harm
- Investor stewardship:
  - engaging with investee companies to promote climate change mitigation and adaptation measures to be taken by the investee
  - more effective for equity investors who can exercise voting rights and file shareholder resolutions, and for direct lenders who can exert influence through contractual rights against borrowers under loan documentation and security interests; less effective for investors in debt security and bonds
- 'Green pills': contractual obligations on the investee company to reduce GHG emissions by meeting specified milestones coupled with an undertaking by the investee company to make a payment or sell discounted debt upon the non-compliance with a target
- Legal issues:
  - for insurers' own investments: Solvency Prudent Person Principle; corporate purpose, FCA business conduct regulation of stewardship – compliance with UK Stewardship Code; competition and market abuse issues arising from collective stewardship action
  - for investment-based insurance products: client's best interest rule; product suitability and product disclosures, investment labels, green-washing
- Blended insurance and finance solutions: Climate Resilient Development Bonds- see F. Arnold-Dwyer and J. Enoizi (https://www.guycarp.com/insights/2023/06/the-need-for-a-sea-change-in-climate-related-insurance.html)

Why should the insurance industry take a supportive role in the energy transition?

- PwC Insurance Trends 2024 Report: "to build relevance and trust with climate solutions"
- Insurers should be incentivised to take an enabling role for risk management, business opportunity, competition and reputational reasons:
  - there are new business opportunities in providing insurance cover for green technologies and infrastructure projects and offering insurance products with environmental objectives or other green characteristics;
  - as average annualised losses increase as a result of a build-up in climate risk, insurers might either pass on the cost of higher claims into premiums or refuse to renew insurance for some policyholders. If insurers do not respond effectively, climate risks could cause a persistent and material drag on their profitability and erode their market share, which could make individual insurers more vulnerable to other shocks that can impact their financial stability;
  - green investments can diversify an insurer's investment portfolio and may produce returns equal to, or better than, conventional investments. Emerging theoretical research and (tentative) empirical evidence suggests that 'greeniums' are already priced into the value of companies that commit to reducing GHG emissions;
  - the emerging climate and sustainability-related disclosure regimes will allow investors and policyholders to distinguish between insurers who do and who do not engage with climate change issues and take an enabling role;
  - climate-related impact underwriting and investment can reduce an insurer's exposure to reputational damage and environmental litigation risk.



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