

Vol. 21 No. 36

November 17, 2006

CLIMATE CHANGE & INSURANCE: SWEEPING REGULATIONS ARE NOT THE ANSWER

by

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Many experts studying the recent climate history of the earth believe that human activities—such as the release of heat-trapping gases from smokestacks, tailpipes, and burning forests—have contributed to observed increases in the surface temperature of the Earth and will lead to the longer-term climate change that has been termed “global warming.” Various natural catastrophe scenarios have been attributed to such climate change, including more frequent and/or more intense hurricanes, floods, heatwaves, wildfires, droughts, and crop failures, along with a rise in certain insect populations, molds, and pollen. More positive developments stemming from warmer temperatures include fewer winter storms and increased agricultural yields in some regions.

The insurance industry is playing an increasingly active role in the climate change debate. However, several regulatory measures that have been suggested are unwise and unnecessary and would reduce, rather than enhance, insurers’ resilience to potentially adverse consequences of climate change, as discussed below.

What Does Climate Change Signify for the Insurance Industry? Even less certain than the possibility of changing weather patterns that may result from global warming is the effect of such weather phenomenon on the financial condition of the property/casualty insurance industry (“p/c insurance”) and the health of property/casualty insurance markets. Insurance is *not* the “canary in the coal mine” that will serve as an early warning of the consequences of climate change; rather, it is a large and resilient industry that, given proper loss control, underwriting, and rating tools, can continue to help individuals and businesses deal with risk and uncertainty associated with extreme weather events:

- Damage from weather events is only one of many perils covered by p/c insurance—in fact, the majority of the premium is associated with insurance products that are not weather sensitive or are weather-related in only a minor way. Only about 20% of property/casualty insurance products (e.g., homeowners and commercial property coverages) are associated with significant weather exposure; another 20% (e.g., comprehensive automobile coverages) are associated with moderate weather exposures; and the balance (e.g., auto liability or workers’ compensation) is associated with minor or no weather exposure.
- The most significant factor leading to higher hurricane insurance losses has been explosive population and economic growth in hurricane-prone coastal regions. In Florida, for example, the population has increased from 2.8 million inhabitants in 1950, to 6.8 million in 1970, 13 million in 1990, and a projected 19.3 million

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in 2010 (a nearly 600 percent increase in 60 years). Had Hurricane Andrew occurred in 2002 rather than 1992, it would have caused twice as much loss, due to increased coastal development and rising asset values. Land use planning and strong building codes can help to reduce the vulnerability of coastal residents but they cannot erase the effects of overdevelopment.

- Atlantic hurricane activity has remained persistently high since 1995 (except in El Niño years, average activity rates are likely to persist for at least a decade, causing higher insurance losses). However, scientists are not in agreement as to whether this increase is a cyclical pattern or due to climate change.
- Although hurricanes like Katrina can cause tens of billions of dollars in insured losses, other weather events that are cited for their association with climate change—such as hail, wildfires, and ice storms—are less threatening to insurer solvency. Here, too, mitigation and land use planning can play a role in reducing loss.
- Even “rapid” climate change scenarios developed by some scientists do not predict significant warming for several decades, during which time there should be an increase in insurance losses due to climate-related weather events and predictions of higher losses in the future. The insurance regulatory process *should* be responsive to rate filings that reflect the need for higher rates, thus protecting insurer solvency. That said, the rate approval process is highly political in many states, and rate suppression is common in catastrophe-prone regions. Meaningful regulatory reform is long overdue and an important tool in assisting insurers to respond to higher catastrophe losses, whether due to climate change or other factors.

The Role of the Insurance Industry in the Climate Change Debate. Insurers continue to monitor the scientific debate about climate change, and several have issued reports that review and comment on the potential linkages.¹ The industry will continue to pay close attention to the science of climate change as it develops; however, the insurance industry does not have the expertise to evaluate conflicting interpretations of scientific evidence or positions on climate change. Nor will extensive data collection mandates advance the research or solve the climate change puzzle.

Recognizing that much uncertainty remains, the insurance industry supports a number of initiatives that can help the environment and facilitate the management of catastrophic risk. These initiatives make good economic and safety sense regardless of any potential effect of climate change on extreme weather events covered by insurance:

Extreme weather losses can be reduced through mitigation. Mitigation tools supported by the insurance industry include strong building codes, policies that encourage retrofitting of existing buildings, land use planning to make communities more disaster resistant, and preservation of undeveloped land to serve as a buffer zone. These measures will not stop natural catastrophes from occurring, but they can reduce the economic and human toll. The insurance industry actively supports the Institute for Business and Home Safety (“IBHS”) and other organized research, communications, and advocacy efforts to promote mitigation.

Increased reliance on public transportation and other non-driving alternatives will reduce automobile emissions. Consistent with their efforts to promote highway safety, insurers are supportive of increased investments, and improvements in public transportation, and other initiatives that encourage less driving, including “smart growth” strategies, HOV lanes, and pedestrian and bicycle access. These strategies curb energy usage, promote cleaner air, and reduce congestion in urban areas and stress on drivers that leads to

¹See, e.g., Allianz Group and World Wildlife Fund (WWF), *Climate Change and Insurance: An Agenda for Action in the United States, October 2006*; Association of British Insurers (ABI), *Financial Risks of Climate Change, June 2005 Summary Report*”; American Insurance Association, *Property-Casualty Insurance and the Climate Change Debate: A Risk Assessment*, 1999; Canadian Underwriter, *Institute for Catastrophe Loss Reduction (ICLR) Calls for Federal Strategy on Climate Change*, Feb. 2005; Lloyd’s of London, *Climate Change Adapt or Bust*, Apr. 2006; Swiss Re and Harvard Medical School, Center for Health and the Global Environment, *Climate Change Futures: Health, Ecological, and Economic Dimensions*, Nov. 2005; Swiss Re, *Opportunities and risks of climate change, 2005*; Insurance Information Institute, *Global Climate Change and Extreme Weather: An Exploration of Scientific Uncertainty and the Economics of Insurance*, May 2006.

increased accident rates.

Risk-based insurance pricing helps discourage overdevelopment in high-risk areas; it also allows insurers to adapt to climate change scenarios that may affect insurance losses over time. Insurers have the actuarial tools to adjust rates based on changes in loss experience and predictions about the future. Unfortunately, state insurance regulators often suppress risk-based prices due to concerns about affordability or other political pressures. Risk-based pricing, including use of the best possible scientific information, is essential to insurers' ability to provide protection against extreme weather events without jeopardizing their solvency. Equally important, appropriate pricing encourages loss prevention, thus reducing the individual and societal costs of disasters.

Use of computer catastrophe models can further assist insurers to incorporate climate and weather predictions in order to measure and reflect risk. Over the past decade, the insurance industry has significantly improved its ability to monitor natural catastrophe accumulations through computer-based models that measure risk on a probabilistic basis using sophisticated simulation techniques. However, some states remain opposed to models, particularly if they indicate that higher rates are needed. Modeling firms should continue to refine their models, and states should allow for and encourage the use of computer catastrophe modeling in ratemaking.

Numerous insurance companies have developed risk management products that promote the use of "green technologies." Several insurers specialize in providing insurance solutions to the high tech sector, including policyholders that are attempting to reduce greenhouse gas emissions through innovative technologies. Other insurers are providing discounts for the use of hybrid vehicles. These voluntary underwriting and pricing decisions are helping to improve the environment and address some of the concerns about climate change.

Liability laws should encourage the development of new technologies to prevent and possibly reverse global warming. Additionally, the development of innovative global warming countermeasures can be enhanced by targeted liability reforms that recognize that none of these technologies have been tested over the long-term. Similar liability protections have been put in place to encourage the development of anti-terrorism technologies.

New Insurance Regulatory Requirements Will Not Solve the Climate Change Puzzle. Some climate change advocates, perhaps frustrated by the slow pace of governmental counter-initiatives in the U.S., have called on the property/casualty insurance industry to work closely with them to advance business and regulatory strategies to combat global warming. As noted above, the insurance industry, as well as individual insurance companies, is engaged in numerous proactive initiatives to address climate change. However, several of the insurance regulatory measures being proposed by the climate change advocates are unwise and unnecessary and would reduce, rather than enhance, insurers' resilience to potentially adverse consequences of climate change. Moreover, insurance should not be used as a surrogate regulator if other government agencies are unable or unwilling to take environmental actions to address climate change concerns.

More positively, insurance regulators can use their access to the public, through web sites and other vehicles, as a means of educating policyholders and the public on the importance of building codes and their enforcement; land use policy in environmentally sensitive areas; building "green"; and steps property owners can take to reduce their exposure.

- ▶ **Insurance regulators should not impose underwriting restrictions intended to curtail specific activities that are associated with higher levels of greenhouse gases.**
- Insurance is a tool to protect individuals and businesses from risk; it is not a vehicle that regulators should use to manage behavior through the underwriting process. Underwriting restrictions justified by climate change concerns are likely to substitute "politically correct" environmental judgments for underwriting decisions based on careful exposure management and actuarial analysis.

- Insurance regulators should focus on insurance solvency and not environmental protection. Because of the long-term nature of most climate change scenarios, insurers should be able to manage their exposures by careful attention to changing loss and weather patterns. Regulators should be responsive to rate filings that reflect higher loss projections—ideally eliminating rate approval requirements entirely—but should not impose underwriting restrictions that may bear little relation to policyholder risk factors during the time when the coverage is in force.
 - Moreover, climate change potentially affects only a few business lines of the p/c insurance industry. Additional underwriting restrictions are not needed to enhance solvency, which should be the regulator’s first concern.
 - Insurance should not be used as a surrogate for environmental regulation; if federal and state governments want to restrict certain activities, they should do so directly and not rely on insurance underwriting restrictions as a proxy.
- ▶ **Insurance regulators should not require copious financial disclosures that reveal little about climate change or its financial implications for insurers.**
- It is not clear what kind of financial data would be relevant to assessing the effect of climate change on the financial condition of p/c insurers. Insurers are currently subject to a myriad of SEC and state financial disclosure requirements, which are designed to identify risk factors that could have a material impact on financial condition. Additional requirements for specific disclosure of financial risks associated with climate change would be superfluous. The current disclosure standards impose upon insurers the responsibility, and provide the discretion, for evaluating, determining, and reporting on any and all material risk factors.
 - It is not clear what regulators would do with additional financial disclosures—or if they would use the information to either buttress insurer solvency or address concerns about climate change. It makes no sense to impose extensive new data collection requirements that will lead only to the warehousing of the data.
- ▶ **Insurance regulators should not impose investment restrictions that stem the flow of capital into certain sectors of the insurance industry.**
- The imposition of investment restrictions based on climate change considerations is a “slippery slope” toward broader investment restrictions based on various political factors, rather than prudential factors. Such restrictions not only undermine insurers’ financial condition, but also represent an inappropriate insertion of the insurance regulators into the capital markets.
 - Some environmental investor groups have advanced climate-related shareholder resolutions during the recent proxy season, some of which call for investment restrictions. The targets of these resolutions are addressing them on a case-by-case basis, a much more appropriate approach than broad-based restrictions on insurer investments.

Conclusion. Insurers have an active interest in the science of climate change but should not be forced to play an inappropriate role in the climate change debate through underwriting constraints, financial disclosure requirements, or restrictions on investments in certain industrial sectors. None of these regulatory responses will improve the global environment, yet they may impair the financial condition of insurance companies whose solvency is the primary responsibility of the insurance regulatory community.