Legal Backgrounder

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MANDATED "CLIMATE RISK" DISCLOSURE: TURNING PROFESSIONAL ACTIVISTS INTO INSURANCE INSPECTORS

by

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Given that insurance is the world's largest economic sector, and that insurers reach virtually every consumer and business in developed countries, the prospect for their involvement in the development and promotion of climate-change mitigation and adaptation strategies stands as an immense but, as yet, largely untapped opportunity.[1]

Government rules that require organizations to publicly disclose certain types of information sometimes serve nakedly ideological ends. A case in point is the current enthusiasm among global warming activists for mandatory "climate risk" disclosure—that is, rules to compel companies to answer questions concerning their greenhouse gas (GHG) emissions and their commitment to pursuing an anti-warming agenda in their business operations, the political arena, and the public square. While proposals for government-mandated disclosure have typically focused on industries associated with high GHG emission levels, some low emitting industries, such as insurance, have also been targeted.

This LEGAL BACKGROUNDER examines the successful effort by Ceres[2] to persuade the National Association of Insurance Commissioners (NAIC) to require all U.S.-domiciled insurers with annual premium of over $300 million to respond to a "climate risk disclosure survey" that the NAIC recently adopted. The article evaluates the insurer climate risk disclosure mandate against the backdrop of traditional rationales for mandatory disclosure, and analyzes the NAIC survey's potential impact on insurers, their policyholders, and public policy. It argues that the NAIC's climate risk disclosure survey serves few, if any, legitimate insurance regulatory objectives, and that its primary effect will be to impel insurers to take actions that may be detrimental to the interests of themselves, their customers, and the broader public interest.

The Insurer Climate Risk Disclosure Survey. The survey's instructions require insurers to submit the completed survey to the insurance department of the state in which they are domiciled on an annual basis. It consists of the following eight questions (or rather, clusters of questions):

[1]Ceres, FROM RISK TO OPPORTUNITY: INSURER RESPONSES TO CLIMATE CHANGE (2009), at 68.

[2]Ceres identifies itself as "a national network of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges such as global climate change." Its mission is to "integrate sustainability into capital markets for the health of the planet and its people." *See* www.ceres.org/Page.aspx?pid=415.

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1. Does the company have a plan to assess, reduce or mitigate its emissions in its operations or organizations? If yes, please summarize.

2. Does the company have a climate change policy with respect to risk management and investment management? If yes, please summarize. If no, how do you account for climate change in your risk management?

3. Describe your company's process for identifying climate change-related risks and assessing the degree that they could affect your business, including financial implications.

4. Summarize the current or anticipated risks that climate change poses to your company. Explain the ways that these risks could affect your business. Include identification of the geographical areas affected by these risks.

5. Has the company considered the impact of climate change on its investment portfolio? Has it altered its investment strategy in response to these considerations? If so, please summarize steps you have taken.

6. Summarize steps the company has taken to encourage policyholders to reduce the losses caused by climate change-influenced events.

7. Discuss steps, if any, the company has taken to engage key constituencies on the topic of climate change.

8. Describe actions your company is taking to manage the risks climate change poses to your business including, in general terms, the use of computer modeling.[3]

These questions raise numerous concerns. For instance, questions 3, 4, 6, and 8 refer to "climate change-related risks," "risks that climate change poses to your company," "losses caused by climate change-influenced events," and "the risks climate change poses to your business." Such phraseology presumes that "climate change" is a discrete risk, and that insurers are capable of predicting future loss costs caused by "climate change-influenced events." Insurers do this routinely with respect to *weather*-related risks such as hurricanes and tornadoes. But using historical hurricane loss data and computer models that analyze cyclical trends in hurricane activity over several decades to predict future hurricane frequency and severity is very different from attempting to predict how gradual, minute changes in the Earth's climate will affect the business of a particular insurance company. The problem is that, despite the unshakable conviction among global warming activists that climate change will cause a host of imminent environmental calamities (such as rising sea levels, more frequent and severe windstorms, more widespread and intense wildfires, higher rates of illness and mortality due to pandemic diseases), the current state of climate science is such that it is impossible to predict with a reasonable degree of certainty when, where, and how climate change will influence weather-related events.

For example, the most reliable peer-reviewed research on the relationship between climate change and hurricane activity is anything but conclusive. Kerry Emanuel of M.I.T., a leading climate scientist who once confidently predicted that global warming would significantly increase the frequency and severity of global hurricanes, published an article based on new research in March 2008 which concluded that "global warming should *reduce* the global frequency of hurricanes, though their intensity *may increase* in *some locations*."[4] This was followed by a May 2008 study by Thomas Knutson and a team from the National Oceanic and Atmospheric Administration (NOAA), which assessed large-scale changes in climate that are projected to occur by the end of the twenty-first century. Its conclusion: "Atlantic hurricane and tropical storm frequencies are reduced [by global warming]…. Our results do not support the notion of large increasing trends in either tropical storm or hurricane frequency driven by increases in atmospheric greenhouse-gas concentrations."[5]

Commenting on the discrepancies between the science of global warming as it relates to hurricanes and the politics of global warming, Bill Read, Director of the National Hurricane Center, told the Associated Press that the purported link between global warming and hurricanes carries "so much emotional baggage" that it can be "really hard to sift out the science." Dr. Read said he agreed with other scientists at NOAA that the link

[3]National Association of Insurance Commissioner, *Insurer Climate Risk Disclosure Survey*, at 2.

[4]Kerry Emanuel, et al., "Hurricanes and Global Warming: Results from Downsizing IPCC AR4 Simulations," *Bulletin of the American Meteorological Society* (Mar. 2008). (Emphasis added.)

[5]Thomas R. Knutson, et al., "Simulated reduction in Atlantic hurricane frequency under twenty-first-century warming conditions," *GeoNature* (May 10, 2008). Available at www.nature.com/ngeo/journal/v1/n6/abs/ngeo202.html.

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between global warming and hurricanes "is still to be determined."[6]

Given the difficulty insurers face in trying to assess the impact of global warming on their business operations, it follows that they are in no position to "encourage policyholders to reduce the losses caused by climate change-influenced events," as contemplated by Question 6. To be sure, insurers know a great deal about steps that property owners can take to mitigate the risk of losses due to windstorms (e.g., install storm shutters), wildfires (e.g., clear underbrush from land surrounding the insured structure), and other natural hazards. And insurers do in fact encourage hazard mitigation by offering lower premiums to policyholders who undertake such efforts. But the survey questions refer specifically to *climate change*-influenced events, and we have no way of knowing (and least not yet) which events will be influenced by climate change, the nature and extent of this influence, and when and where climate change-influenced events will occur.

In theory, a company could simply respond to the survey questions by pointing all of this out. But a key element of the insurer climate risk disclosure survey calls for insurance departments and the NAIC to make the responses accessible to the public. Given the "emotional baggage" that weighs on public discussions of climate change, it is easy to imagine global warming activists using heretical responses to condemn an offending company for its selfish indifference to the Earth and its people. It is no less difficult to imagine the plaintiffs' bar using insurers' answers to conjure global warming liability class action lawsuits against insurers and their commercial policyholders, on the theory that an insurer's failure to incentivize its insureds to reduce their carbon footprints makes the insurer culpable for the harm allegedly caused by global warming.

For clues to the kind of answers likely to be judged correct or acceptable by activists such as Ceres, one need look no further than Ceres' prescribed "best practices" for insurers, which include exhortations to:

> •Utilize terms and conditions to foster the right decisions by customers. This could range from rewarding risk-minimizing behavior to excluding climate change liabilities for those who make imprudent decisions either as emitters of greenhouse gases or managers of risks associated with climate change.
>
> •Rebalance investment portfolios to recognize climate-related risks to investments and capitalize on opportunities for emerging industries that will participate in climate change solutions.
>
> •Actively participate in emerging markets for carbon-free energy and carbon trading, both as investor and risk manager.
>
> •Actively engage in public policy discussions about climate-change.[7]

The last item is closely related to Question 7 in the NAIC survey, which asks about the company's efforts to "engage key constituencies on the topic of climate change." It goes without saying that the messages companies convey in their public policy discourse on climate change should conform to the policy predilections of global warming activists. The danger of challenging or contradicting that agenda is hinted at in a section of a Ceres report that warns of the liability companies could face from disseminating "disinformation" about climate change. The report ominously cites a *Newsweek* exposé of "well-funded naysayers who still reject the overwhelming evidence of climate change."[8]

The tendentiousness of the eight questions that comprise the NAIC survey leads to a more general consideration of the legitimacy and potential abuse of mandatory climate risk disclosure focused on insurers.

Mandatory Disclosure in Theory and Practice. The seminal mandatory disclosure initiatives in the U.S. are the Securities and Exchange acts of 1933 and 1934, which required promoters of new stock issues to file extensive registration statements with a new regulatory agency – the Securities and Exchange Commission – and instructed all corporations registered with the agency to furnish periodic reports of certified financial product information. Another example of mandatory disclosure is the informal agreement reached in 1970 by the Federal Trade Commission with the major American cigarette manufacturers, whereby each package of cigarettes would show the number of milligrams of tar and nicotine contained in each cigarette. These examples reflect the

[6]Jessica Gresko, "Hurricane intensity prediction expensive" (June 25, 2008). Available at www.sunherald.com/local/story/646148.html.

[7]Ceres, *op. cit.*, at 66-67.

[8]*Ibid*, at 59.

consensus view that mandatory disclosure is a justified response to incomplete distribution of protective information and widespread confusion among consumers, workers, or investors.[9]

In theory, information conveyed through mandatory disclosure has two salutary effects: first, with pertinent information the individual consumer, worker, or investor can avoid risky products or situations and, instead, pursue safer, more reliable alternatives. Second, the market pressure exerted by informed consumers, workers, and investors creates incentives for producers to furnish safer, more reliable products and safer, healthier workplaces.[10] Judging from its preamble, the goal of the Insurer Climate Risk Disclosure Survey appears consistent with these objectives:

> The goal of the *Insurer Climate Risk Disclosure Survey* is to provide regulators, shareholders and the public with substantive information about the risks posed by climate change to insurers and the actions insurers are taking in response to their understanding of climate change risks.[11]

There are, however, at least two problems with this goal. First, the survey requires much more than a straightforward disclosure of discrete, identifiable risks. By demanding that insurers disclose *actions* they are taking in response to their *understanding* of "climate change risks," the survey implies that insurers ought to take concrete action in response to risks that they may not fully understand. It could be argued that insurance policyholders and the public interest would be better served if insurers refrained from taking action in response to things they don't understand. Second, even if the insurance risks stemming from global warming were fully documented and well understood, it is far from clear which actions available to insurers would actually be effective in combating global warming.

What, then, should an insurance company do to give the impression that it is taking the kind of action that will withstand the scrutiny of environmental activists and their allies in the regulatory community? Ceres no doubt hopes that companies will look to its "best practices," which might lead an insurer to refuse coverage to "those who make imprudent decisions either as emitters of greenhouse gases or managers of risks associated with climate change"—even if there is no actuarial justification for doing so. They might be tempted to invest policyholder surplus in "emerging industries that will participate in climate change solutions," not because the putative solutions are likely to work or because such investments are likely to generate a greater return than other investments, but because the survey questions imply that this is what insurers ought to do. Similarly, insurers could promote "carbon-free energy" and engage in "carbon trading" not because evidence exists that such actions will be effective in curtailing global warming, but because this is apparently what global warming activists and insurance regulators expect of them.

Conclusion. Activist groups have every right to attempt to persuade business firms to adopt their point of view on issues ranging from environmental protection to social justice. They are free to organize public demonstrations and consumer boycotts of companies that refuse to go along. And of course, they can petition the elected branches of government to enact their policy preferences through legislation. But mandatory disclosure rules, especially when they are unilaterally put in place by administrative agencies such as state insurance departments, should not be used for such ideological ends. The coercive effect of rules that require companies to disclose actions they are taking to address issues that are the subject of considerable debate and uncertainty should not be dismissed because of the supposed benign effect of "mere disclosure" (as opposed to direct prescription of behavior) and of "only asking them to tell the truth."

Though the NAIC has instructed insurers to file the Insurer Climate Risk Disclosure Survey with the insurance department of their domiciliary state starting in May 2010, the decision as to whether this requirement will be enforced ultimately rests with each state insurance department. The NAIC has no authority to compel a state to administer its survey. One hopes that most states will decline to do so for the reasons explained above.

[9] Eugene Bardach and Robert Kagan, GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS (Temple University Press, 1982), at 251.
[10] *Ibid*, at 243.
[11] National Association of Insurance Commissioners, *op. cit.*, at 1.

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