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From Risk to Opportunity: How Insurers Can Proactively and Profitably Manage Climate Change

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Dozens of new approaches to insurance, such as "green" building credits and incentives for investing in renewable energy, are emerging as the industry grapples with global warming and rising weather-related losses.

But the trend is just in its formative stages. The insurance industry has a long ways to go to minimize losses and make the most of business opportunities related to climate change. Most companies are still trying to limit their risks by imposing large rate increases or refusing to provide coverage altogether—a strategy that is reaping enormous profits, now that insurers have survived the 2006 hurricane season unscathed.

In the wake of Katrina and other devastating hurricanes in 2005, insurers were hit with record claims, rating downgrades and class-action lawsuits. Consumers in a dozen coastal states are still feeling the double whammy of premium hikes and reduced coverage, or no coverage at all. In Florida and Louisiana, more than 600,000 homeowners' policies have been canceled or refused for renewal in the past year. Allstate dropped 16,000 commercial customers in Florida in 2005, and some commercial businesses in the Gulf are being forced to "go bare"—meaning they cannot find property insurance at any price. Florida state Chief Financial Officer Tom Gallagher declared that commercial insurance "is where the crisis is now" in Florida.

With $10 billion in insured losses, including 116 oil platforms destroyed and 56 severely damaged by the 2004/05 Gulf Coast hurricanes, offshore oil producers saw their insurance costs jump by as much as 500%.

Governments and taxpayers are also feeling the sting. As more private insurers refuse to take on new policies or renew existing ones, mandated state-run insurance pools such as Florida's are being forced to take on more customers and more financial exposure. Federal insurance programs are faring no better. Nearly 3 million homeowners have had to move into public insurance pools. The federal government is increasingly becoming the insurer of last resort. With more claims in 2005 than in its entire 37-year history, the U.S. flood insurance program was bankrupted 10 times over by Hurricane Katrina.

But crisis often breeds opportunity, and climate change is no exception. Just as the industry historically asserted its leadership to minimize risks from building fires and earthquakes, insurers have a huge opportunity today to develop creative loss-prevention solutions and products that will reduce climate-related losses for consumers, governments and insurers, as well as cut the emissions causing global warming. The Ceres investor coalition has identified190 innovative products and services available, or soon to be available, from dozens of insurance providers in 16 countries.

More than half of the products come from U.S. companies, covering such services as green building design, hurricane-resistant construction, carbon emissions trading and renewable energy. Among the recent offerings that show promise for customers and insurers alike:

• Insurer-initiated hurricane-loss-prevention methods used at nearly 500 commercial locations along the

Gulf Coast avoided $500 million in property damage from Hurricane Katrina, one-eighth less damage than properties that did not make the engineering improvements. Insurer FM Global says the $500 million in savings came after customer investments of only $2.5 million and helped make the company profitable in a year of record claims across the industry.

• Fireman's Fund is launching first-of-its-kind "green coverage," including 5% rate credits, for commercial building owners who rebuild damaged properties using green, LEED-certified (Leadership in Energy and Environmental Design) building practices. Environmentally friendly buildings are considered more energy efficient and less prone to water and fire damage. They also improve air quality and overall employee performance. (The LEED green building rating system is the nationally accepted benchmark for the design, construction and operation of green buildings.)

• Industry giants Marsh and AIG are developing new renewable-energy-related insurance products that will let more companies and investors participate in carbon-offset projects and carbon emissions trading markets in Europe and elsewhere. The European Union's carbon-trading market is expected to hit $30 billion by the end of 2006.

But given the urgency of the climate change crisis, much more needs to be done. Most U.S. insurers are not yet experimenting with these types of products. And the burden does not fall solely on insurers. Regulatory agencies and the government should encourage development of such creative products and expedite approval of them so consumers and businesses can use them.

Where insurers desire to provide differentiated premiums or financial incentives that would encourage risk-reducing behavior, it is often necessary to show regulators that there will be an offsetting reduction in losses. This is done to ensure rate adequacy. Reviews vary from state to state and are negligible in some cases while quite thorough in others. Insurers interviewed by the Iowa Department of Natural Resources, for instance, cited difficulties in gaining regulatory approval for premium credits as a key barrier.

But requests or requirements to undertake the sorts of innovative strategies outlined in this report could originate from the insurance regulators. For example, regulators could call for separate rating of hybrid vehicles, keep track of loss experience and ultimately use the results to propose different treatment of customers owning these cars. Regulators could also call for more-complete disclosure of climate risks, both in the core business of insurance underwriting and in the selection of potentially weather-sensitive investments that could affect insurers' solvency.

Changes on that front may be in the offing soon. The National Association of Insurance Commissioners created an executive-level task force in 2006 to study the issue in detail.

To read the full report click here.
