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Weather or Not?

INSURANCE COMPANIES MAY HAVE TO SAVE THE CLIMATE TO SAVE THEIR BOTTOM LINE

By MATTHEW YEOMANS

There hasn't been a hurricane in London since last, oh, ever. But there has been an insurer there, Lloyd's, since 1771. And because it's an outfit that historically insured ships, weather is never too far from its mind. Last year Hurricane Katrina turned heads at Lloyd's. The storm didn't just flood New Orleans; it also swept away the insurance industry's trust in its catastrophe modeling, the tool it depends on to evaluate bad-weather risk. The model assumed that a hurricane like Katrina couldn't happen in the same year as two other superstorms. Nor did it envision the off-the-scale damage caused by Katrina--275,000 houses destroyed, 10 times the number flattened by the previous worst-case model, Hurricane Andrew. Katrina prompted Lloyd's and other insurers to do some corporate soul searching that, surprisingly, could speed up the world's counterattack against global warming.

More than any other sector, insurers need to separate the reality from the myths of global warming. "There is a growing body of expert opinion that our climate is changing. For Lloyd's of London, ignoring that was not an option," says Darragh Grey, senior manager of the 360 Risk Project at the storied high-risk underwriters and author of a new report on the insurance industry's failure to confront climate change.

As our climate continues to warm and catastrophic weather events increase, insurers will suffer or gain on the basis of their environmental-risk projections. If they get it wrong--as when many U.S. insurers were sideswiped by large-scale asbestos-pollution claims--or if they are blindsided by the kinds of terrorist attacks that simultaneously generate claims for lives and business lost and damage to real estate and infrastructure, they could find themselves insolvent.

Issued in May, Grey's report, "Adapt or Bust," delivered a stark message. It read, "So far, the industry has not taken changing catastrophe trends seriously enough. Climate change is likely to bring us all an even more uncertain future. If we do not take action now to understand the risks and their impact, the changing climate could kill us." Its sobering conclusion: "The insurance industry must now seize the opportunity to make a difference, not just to the future of our own industry, but to the future of society."

Insurance has always prided itself on taking a leadership role on societal issues. In the U.S. the insurance industry pushed for the establishment of official fire departments in the 19th century. More recently, the British insurance industry, as part of its campaign to be able to keep offering flood insurance, lobbied hard in the 2005 elections for better flood-defense funding.

In keeping with that history, the Lloyd's warning might be seen as a wholesale call to combat climate change. But few issues in the insurance business are that simple. The fact is, most big insurers like Prudential, Travelers and AIG are heavy investors in businesses that are believed to contribute to global warming. A 2000 report by Friends of the Earth on the investment portfolios of Britain's top insurance companies, for instance, found they invested heavily in such global oil and mining companies as ExxonMobil, Elf Aquitaine and Rio Tinto.

The problem is that insurers have historically not managed risk between their investment portfolios and their underwriting portfolios. As a result, they invest in energy companies because the return is good, without considering the risk for their underwriting side. They don't see the need to hedge their position.

For that reason, some close industry watchers doubt whether Lloyd's apocalyptic tone will revise anything. Andrew Dlugolecki, an independent climate-change consultant and a veteran of the insurance industry, says, "It's good that they have spoken out, but I don't see them as serious in changing the insurance industry." That sentiment is echoed by Michael Brune, executive director of Rainforest Action Network, which has successfully lobbied Bank of America, Citibank and major U.S. retailer Home Depot to change their sustainable-development positions. "If you want to be an environmental leader, then you need to switch from relying on dirty old energy and embrace new, renewable strategies."

You might think, from a corporate-coherence perspective, that insurers would coordinate their underwriting and investment strategies. You would be wrong. Traditionally, the underwriting and investment divisions of Big Insurance have been run as autonomous operations. "There's a real disconnect between the investment side and the acknowledgment of climate change," says Matthew Arnold, who tracks the U.S. insurance industry as a director of the consultancy Sustainable Finance.

Some insurers, however, insist that they are going to begin investing in more environmentally friendly energy projects. For the past year, German giant Allianz Capital Partners has been assembling a team dedicated solely to renewable-energy investments and led by David Jones, Shell's former head of wind energy. The company estimates it will have about $600 million invested in renewable-energy infrastructure projects over the next five years--notably in wind-turbine hardware. "We have identified renewable energy as an absolute growth market," says Thomas Pütter, chief executive of Allianz. He points to China's embrace of wind power. The government has wind-mapped the entire country and is committed to building the world's largest wind-power farm, with an eventual output of 200 gigawatts.

Meanwhile, Swiss Re, which has a large U.S. presence after buying GE's reinsurance business, is breaking down the wall between investing and underwriting. By comparing its underwriting and investment portfolios, the company hopes to maximize profits from both sectors and minimize its overall risk.

Profit, of course, is what this is ultimately all about. Savvy insurance companies have realized not only that they need smart catastrophe modeling to minimize risk and help price their underwriting effectively but also that they must understand the middle- and long-term liabilities of their investments. With the growth of carbon-trading markets in Europe and the U.S.--and industry's begrudging acknowledgment that its carbon footprint is likely to be taxed in the future--polluting sectors and companies begin to look like less attractive investments.

Is there enough momentum to keep this industry movement going? There seems to be. Whereas insurers used to pass off environmental liability onto government, they now believe that climate change is so serious a threat to their business that they can't wait for government to take the initiative. "The industry is crucial to the functioning of the global economy," says Andrew Logan, energy and finance program director at the ethical-investment organization CERES. As the storm season winds down, activists pray the industry doesn't lose focus. "If there isn't a big hurricane season this year, it could slow things down. That is the larger risk," says Logan.