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RESEARCH BUZZ

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Checking the Weather: Climate Change and Its Impact on Financial Services

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In recent months, financial services consulting firms, institutional investment firms and other groups have been issuing reports, studies, and position pieces on the risks and opportunities of climate change for the financial sector. One of the earliest of such reports, the June 2005 "Climate Change & the Financial Sector: An Agenda for Action," is a joint publication of the integrated financial services concern Allianz Group and the World Wide Fund for Nature (WWF) and sets the two-sided tone of many such reports and articles. Allianz and WWF cite both the negative effects on business and consumers and the positive opportunities implied for the financial services sector to mitigate risks, and drive a low-carbon economy. Establishing at its outset that a European Commission study of all "potential cumulative global damage" is estimated at 74 trillion euros, this Allianz/WWF study elaborates on the governmental and business policy changes toward low carbon existence globally that will spur a series of both protective and opportunistic responses from banking, insurance and asset management industries.

Subsequent to the Allianz/WWF report, a range of other reports have been issued in quick succession. Goodwin Procter issued a January 2007 *Environmental & Energy Advisory* update, "Climate Change Strategies for the Financial Services Industry." In December 2007, Oliver Wyman and its Senior Advisory Board released their report, "Financial Services Firms Should Grasp Emerging Opportunities from Climate Change, While Preparing for Long-Term Threats to Value." In January 2008, we saw the release of a study conducted by RiskMetrics Group and commissioned by Ceres, the United States' biggest investor and environmental coalition, and the Investor Network on Climate Change: "Corporate Governance and Climate Change: Banking Sector" surveyed 40 banks in the U.S., Europe, Asia, Canada and

Brazil. The study scores banks based on a climate change governance index, its 14 indicators examining "board oversight, management execution, public disclosure, emissions accounting and strategic planning." Not surprisingly, because of the EU's leadership and focus on this issue, European banks and investment firms generally score ahead of their U.S. and Asian counterparts in their response to climate change. Affirming the recent trend of financial services attention to the climate change issue, this study reveals that 57 of the 100 climate change research reports written by banks were issued in 2007. Investment product leaders in this study are ABN AMRO, Credit Suisse, Deutsche Bank, HSBC, ING, JP Morgan Chase, Merrill Lynch and UBS. Retail product leaders are Bank of America, Barclays, BNP Paribas, Fortis, HBOS, ING, Societe Generale, and Wells Fargo. Lastly, carbon trading leaders include Bank of America, Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, Fortis, Merrill Lynch, Mitsubiushi UFJ, and Morgan Stanley.

Following on the heels of the RiskMetrics study, four U.K. institutional investors (Henderson Global Investors, Insight Asset Management, RAILPEN Investments and the Universities Superannuation Scheme) announced their collaboration with the specialist environmental consultancy Acclimatise, to issue a series of reports in a range of sectors, including electrical and water utilities, oil and gas, and real estate. Their preliminary report, accompanying the announcement, is "Managing the Unavoidable: Understanding the Investment Implications of Adapting to Climate Change." Intending to improve long-term investment performance, the report enumerates climate change risks, implications for cash flows and balance sheets, and the disclosures required by investors to allow them to evaluate corporate exposures to climate-based risk.

In addition to the flurry of activity in the area of corporate research, news blurbs in the financial press reveal a continually increasing focus on the relationship between the financial sector and the issue of climate change. The financial media, both scholarly and popular, are reporting on the implications of climate change for the financial services industry. Investment firms in the U.S. and, even more so in Europe and globally, are announcing product launches associated with climate change, while many experts argue that the implications of and risks associated with climate change are increasingly a factor in all investment portfolios. In Britain, Hargreaves Lansdown and Schroders PLC, amongst others, have announced the launch of investment products that proffer solutions to climatic change or congregate around investment themes such as energy efficiency, green building, or sustainable environmental resources. In Sydney, Australia, in 2007, the Financial and Energy Exchange was opened, complete with a launch event featuring former U.S. Vice President and

Nobel Laureate Al Gore, author of both *An Inconvenient Truth* and *Earth in the Balance*.

Banks and other financial institutions are marketing environment-friendly or "green" investment and services options to an increasingly environmentally aware and motivated populace. Citi, for example, in May 2007 announced a $50 billion, 10-year commitment to addressing global climate change. Various media reports discuss the Equator Principles, a banking industry framework for addressing environmental and social risks in project financing. Originated in 2002 and revised in 2006, the Equator Principles came about when a small number of banks, together with the World Bank Group's International Finance Corporation (IFC), convened in London, to discuss how to develop a common and coherent set of environmental and social policies and guidelines that could be applied globally and across all industry sectors. Publicly launched in Washington, DC on June 4, 2003, the Principles have been adopted by over forty financial institutions (http://www.equator-principles.com/). U.S. signatories to the principles include ABN AMRO, Bank of America, Citigroup, JP Morgan Chase, Wachovia, and Wells Fargo.

In addition to banks and investment firms, the insurance sector is broadly affected by climate change issues. Though climate change represents a niche for new insurance and reinsurance products, the industry has paid a heavy price for weather-related claims in recent years and anticipates the weather-related risks for insurance will continue to increase. In addition to weather-related risks, the implications of climate change and global warming for insurance touch on issues such as the availability of resources, the price of energy, the value of companies, and the wealth of societies.

The most consistent and probing examination of the relationship between financial services and climate change is taking place under the auspices of the United Nations Environment Programme Finance Initiative (UNEP FI). The Climate Change Working Group (CCWG) of UNEP FI exists to:

- Identify and communicate the financial sector's role in mitigation and adaptation to climate change;
- Raise awareness of the global and regional challenges of climate change not only within the sector but across all sectors and industries, including policymakers and the public at large;
- Position the financial sector as a credible and proactive partner by catalyzing concrete action within the institutions;
- Provide input to the United Nations Framework Convention on Climate Change (UNFCCC) process through support of the Kyoto Protocol flexible mechanisms – international emissions trading, Joint Implementation (JI) and the Clean Development Mechanism (CDM), and other initiatives;
- Continue to develop strategies to overcome political and regulatory barriers, which hinder a more proactive role for the finance industry on climate change issues.

UNEP FI's CCWG has issued a 2007 "Declaration on Climate Change by the Financial Services Sector." Intended to provide a brief but high-impact follow-up and update to its landmark 2002 study, *Climate Change and*

the Financial Services Industry: Threats and Opportunities, the declaration does not pull any punches. Identifying human activity as the driver of climate change, it predicts possible global annual economic losses as high as USD 1 trillion by 2040, with extreme weather events, disease and agricultural failures and their impacts falling most consequentially on the world's regions and peoples least able to sustain them. Urging governmental and business leaders to respond with effective and immediate regulatory and market solutions, the declaration claims that a failure to do so spells threats and disruptions for "markets, societies, ecosystems and cultures," summed up as "one of the greatest threats to humanity and the future well being of the planet." The declaration concludes with an 8-point series of recommendations targeting greenhouse gas emissions reduction, emissions trading mechanisms and carbon pricing and investment in low carbon technologies, improved renewable energy production, climate-friendly economic development strategies, energy efficiency, and adaptation strategies to integrate realities of climate change into disaster reduction and management and sustainable development.

Visit http://www.unepfi.org/work_streams/climate_change/working_group/ for UNEP FI's CCWG list of publications and events, which is extensive. Their repeating series *CEObriefing* contains recommendations specific to carbon-related challenges including mechanisms for finance of carbon solutions, adaptation and vulnerability to climate change in financial services, global economic risks, and future policy changes that will impact financial services. Additionally, they offer a framework for climate risk disclosures by corporations for purposes of investor protection and, of course, the 2002 landmark study cited above.

Networks Financial Institute, at its 5th Annual Insurance Reform Summit on March 5, 2008, will introduce the issue in a forum for public discussion and examination of these groundbreaking issues. We recognize the vast and industry-wide implications for the financial sector, and specifically insurance, to respond with alacrity to the global climate crisis, all too often, as media and research reports stress, in the absence of robust data.

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Interstate Healthcare and Health Insurance Mandates

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With the cost of healthcare continually rising, various groups continue to look for innovative ways to cut these costs. Congressman John Shadegg (R, AR-3) recently introduced a bill, H.R. 4460, known as The Health Care Choice Act of 2007, (HCCA), that would enable consumers obtain health insurance from companies located and licensed to do business in other states than their own. Currently, consumers in one state are prohibited from obtaining health coverage from another state since health insurance is regulated by the state where one resides. This bill's objective is to let market forces determine the cost of health insurance by giving consumers choices beyond their state. It would also reduce the regulatory process to just one regulator per company, as opposed to up to 51 for a company doing business in multiple states.

While the HCCA increases competition across state lines and thereby aims to reduce cost of insurance and for healthcare, it does so without putting the federal government at the head of the line as a regulator, as the Optional Federal Charter (OFC) proposal does for life, as well as health, property and casualty companies. Efforts have been made in Congress to introduce an OFC that would enable insurance providers to choose whether to have one federal regulator or multiple state regulators, as is the case today. Those against an OFC for the insurance sector say that it would stifle innovation, which is best promoted when regulation is conducted and tested at the state level. The American Council on Life Insurance (ACLI) underlines the various benefits of an OFC. Consumers would have access to the same product or services regardless of where they live and the introduction of new products would occur faster and with less extraneous cost if multiple state regulators can be avoided. It is estimated that under the current system, it takes up to two years for a new life insurance product to be licensed within the 51 states. There would be uniform rules for sales and marketing practices, regulatory responsiveness would improve and there would be equal protection under the law. Estimated savings of about $5.7 billion a year in compliance costs would result, according to the ACLI, reducing the cost of insurance.

Under HCCA, patients could potentially take charge of their medical care. One of the biggest advantages of HCCA is that it eliminates state-sponsored coercion in the purchase of mandated healthcare. If a consumer did

not want to purchase and pay for healthcare mandated by their state, they could find a company elsewhere that does not offer such mandated care as part of their insurance package. The bill offers consumers an opportunity to choose coverage from a state that may have fewer cumulative mandates piled onto an insurance policy.

The Council for Affordable Health Insurance (CAHI) defines a mandate as "a requirement that a health plan or an insurance company cover, or offer coverage for, healthcare providers, benefits and patient populations. Each state has typically set up its own insurance requirements, therefore the number and types of benefits mandated differs from state to state. Table 1 shows a sample of benefits mandated in some states, the estimated additional cost and the number of states that have implemented the mandates. In their 2008 state by state breakdown of mandates, CAHI indicates that there are currently 1,961 mandated benefits and providers.

There are proponents and opponents of mandates. Those against mandates argue that they are costly, since insurance companies pass the additional cost of the coverage on to consumers, even if only incrementally and slowly, over time. Critics say that some consumers end up paying for add-ons that they would not typically need, thus driving up costs with little or no benefit. It is argued that many of these mandates are passed without adequate studies of the cost implications. CAHI suggests that, depending on the type of bill and the state, mandates could add to the cost of insurance anywhere from less than one percent to about 10 percent, and perhaps even up to 45 percent in some markets. The cumulative impact of various mandates is what drives up the cost to unbearable levels. Proponents of mandates argue that they offer more comprehensive coverage than would otherwise be offered by healthcare providers and that by bundling them into all plans, they reduce the incremental cost of the additional coverage.

Table 1

BENEFITS	Total	Est. Cost	AK	AL	AR	AZ	CA	CO	CT	DC	DE
Chlamydia	3	<1%									
Cleft Palate	14	<1%						Y			
Clinical Trials	23	<1%				Y	Y		Y		Y
Colorectal Cancer Screening	28	<1%	Y	Y	Y				Y	Y	Y
Congenital Bleeding Disorders	2	<1%									
Contraceptives	31	1% to 3%	Y		Y	Y	Y		Y		Y
Dental Anesthesia	31	<1%	Y		Y		Y	Y	Y		
Diabetes Self-Management	27	<1%	Y		Y	Y	Y	Y		Y	
Diabetic Supplies	47	<1%	Y		Y	Y	Y	Y	Y	Y	Y

Source: Council for Affordable Health Insurance

While the Health Care Choice Act mainly focuses on affordable healthcare choices for consumers, it, as a result, also avoids costs associated with a new regulatory structure. This setup could potentially be used for other insurance lines besides healthcare.

In contrast to the United States, availability of health insurance differs in the United Kingdom. The National Health Service (NHS), which falls under the Department of Health, provides universal healthcare for every U.K. resident. However, United Kingdom residents and employers can opt not to use the NHS, but can upgrade to private health cover, depending on affordability (not so in Canada, although the lock is breaking down, just as it did in Britain). The United Kingdom's financial sector, including insurance, is regulated by one body, the Financial Services Authority (FSA), which being U.K.'s "financial watchdog", is the *sole* insurance regulator for private medical insurance. Each state in the United States has its own healthcare regulations with no umbrella regulator. A consumer in the United Kingdom who opts for private insurance can add on to their policy only items that one feels they need to be covered. This is unlike private insurance in the United States, where mandates drive up insurance costs and do not allow consumers to choose the appropriate level of cover. The World Health Organization reports that total expenditure on healthcare per capita in the U.K. (including both private and public insurance provision) is $2,560 while the expenditure on healthcare is 8.1 percent GDP. The U.S. figures are $6,096 and 15.4 percent, respectively. Despite the lower cost, the United Kingdom still has all residents receiving insured healthcare. Although debatable, the quality of healthcare in the United Kingdom seems to be just as competitive. The choices offered by the United Kingdom healthcare setup would suggest that the issue of mandates may not be as significant on healthcare cost there as it is in the United States, yet millions of people in the U.S. remain uninsured.

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