

# Climate Change Heats up UK Insurance “Stress Test”

22 July 2019

**Debevoise  
& Plimpton**

On 2 July 2019, the Prudential Regulation Authority (the “PRA”), the Financial Conduct Authority, the Financial Reporting Council and the Pensions Regulator made a joint statement on climate change that highlighted that firms should consider the likely consequence of climate change on business decisions in addition to meeting their responsibility to consider their respective impact on the environment. Consistent with that joint statement, on 18 June 2019, the PRA launched its 2019 insurance stress test, which for the first time includes what the Bank of England named an “exploratory exercise” in relation to climate change. This follows the PRA’s request, on 11 April 2019, for industry feedback from several UK firms ahead of the insurance stress test for the largest UK-regulated life and general insurers that will take place from July to September 2019. On this occasion, the PRA informed UK firms that this year’s stress test would include a climate scenario “designed to provide additional market impetus in this area, and to inform the Bank’s development of a consistent and effective approach to climate-focused scenario analysis”. This addition to the stress test comes just six months after the World Economic Forum, also known as Davos (the “WEF”), ranked climate risks at the top of its Annual Global Risks Report for the coming 10 years and is another indication of how climate change has become a mainstream concern. Businesses of all types, and especially boards of directors tasked with anticipating risks, need to pay attention to the risks of climate change as well as to the opportunities that can arise from it.

**Background.** In October 2018, the Intergovernmental Panel on Climate Change (the “IPCC”) issued an urgent warning that humanity has just over a decade left to make the unprecedented and drastic changes necessary to keep global warming below 1.5 degrees Celsius. In 2019, and for the third year in a row, the WEF’s Annual Global Risks Report classified climate-change-related risks as the top macroeconomic risks for the next 10 years in terms of both impact and likelihood. Corporate leaders who contributed to this report considered that three of the five major risks are environmental, such as extreme weather, failure of climate change mitigation and adaptation, and natural disasters, ahead of economic risk such as a new financial crisis.

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**Scenario Specifications.** As with previous stress tests, this year's test comprises the core stress-test scenarios reflecting a downturn in the economic environment. It also includes a set of severe liability shock scenarios, four of which are natural catastrophes: hurricanes, earthquakes, windstorms and flooding. The third part of the test consists of an exploratory scenario, which is not a stress test per se but is designed to "capture information about how different firms are exposed to difficult-to-assess risks" such as climate change. As part of this exploration, firms must consider the impact of three greenhouse emissions scenarios on their liabilities and assets valuations. Firms now need to consider the impact of climate change on liabilities, which encompasses physical risks, and on investments, which encompasses both physical and transitional risks. Climate change does indeed have the potential to adversely affect insurers that cover natural disasters, but new disclosure and regulatory obligations can also lead to lower investment returns.

**Risks and Opportunities.** As with any form of global disruption, climate change creates risks—including natural disasters, liability risks associated with nondisclosure, directors' responsibility and liability and reputational risks—but it also creates investment opportunities across sectors. These include the rise of green bonds and a high demand for green and socially responsible funds. On the one hand, as the WEF noted, it is estimated that between now and 2100, the potential financial losses resulting from climate change could range from \$4.2 trillion to as much as \$43 trillion. On the other hand, predicting how to mitigate and adapt to climate change could represent investment opportunities worth up to \$26 trillion between now and 2030.

**Major Challenge: Coordinating.** The main difficulty in all industry sectors is the lack of an integrated and strategic approach to addressing climate-change risks and opportunities. Yet, companies need to be equipped to face climate-change challenges and the scientific, macroeconomic and policy uncertainties they encompass. The PRA acknowledged this need for a coordinated approach to secondary natural catastrophes when it published the results of the last stress test in December 2017. This obligation falls mostly on corporate boards, since it is part of the board's role to develop and review long-term strategies. As the world acknowledges that climate-change threats are so high, climate governance has become increasingly valuable as a tool to enable companies and their boards to face these challenges.

**WEF's Guiding Principles.** On 17 January 2019, the WEF published, as part of its Climate Governance Initiative, eight "Guiding Principles" on how corporate boards can drive climate governance effectively. The WEF, in collaboration with PwC, consulted over 50 board members and corporate executives to elaborate on these Guiding Principles. As boards' duties encompass consideration of climate change in the same way as any other issue presenting financial risks, these principles will guide boards of all industries in preparing for climate risks and for climate opportunities. The WEF's

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Guiding Principles are built on existing recommendations, such as the Financial Stability Board’s Task Force on Climate-Related Financial Disclosures (the “TCFD”) and the International Corporate Governance Network’s Global Governance Principles (the “ICGN”). These recommendations aim to elaborate on guidelines for boards to demonstrate an integrated and strategic approach to addressing climate-change risks and opportunities. The WEF’s Guiding Principles purposely aim to be “broadly applicable and practically useful for organizations”. The WEF’s first four Guiding Principles—“climate accountability on boards”, “command of the subject”, “board structure” and “material risk and opportunity assessment”—set the short-term foundation for the fifth principle, “strategic integration”, while the three final ones—“incentivization”, “reporting and disclosure” and “exchange”—target long-term attention to climate change issues.

**Joining Initiatives and Navigating New Obligations.** The WEF designed the Guiding Principles for a wide range of organisations, sectors and jurisdictions. Recent regulatory obligations across sectors and jurisdictions bring a common focus to mandatory disclosure of climate risks.

Among initiatives focusing on companies’ reporting obligations, the TCFD published its final Recommendations in June 2017. Whilst these are voluntary, the Recommendations have been endorsed by over 238 companies including 150 financial institutions representing US\$81.7 trillion in assets under management.

In November 2018, the Commonwealth Climate and Law Initiative (the “CCLI”) published “The Climate Risk Reporting Journey: A Corporate Governance Primer”. In theory, the primer aims to guide companies willing to engage in the voluntary disclosure path promoted by the TCFD. In practice, the primer is intended to assist boards and their committees embarking on the climate-related financial risk reporting journey by offering key questions relevant to the assurance of a corporation’s reporting on climate-related financial issues.

With the rise of voluntary initiatives and mandatory obligations, the increase in climate-related disclosure is only beginning. This is also the case for new mandatory greenhouse gas reporting programs: as of 2015, at least 40 countries, including the United States and members of the European Union, already had mandatory emissions reporting programs in place.

The latest environmental news promises many incentives for boards to engage in upstream climate governance. Corporates would thus be in a position to confront climate change-related risks and to exploit opportunities to be transparent and to invest with environmental responsibility and thereby position themselves as “market leaders”.

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Please do not hesitate to contact us with any questions.

**LONDON**



Wendy J. Miles  
wjmiles@debevoise.com



David W. Rivkin  
dwrivkin@debevoise.com



James C. Scoville  
jcscoville@debevoise.com



Benjamin Lyon  
blyon@debevoise.com



Simon Witney  
switney@debevoise.com



Clare Swirski  
cswirski@debevoise.com

**NEW YORK**



Line Chataud  
lchataud@debevoise.com



Philip Orange  
porange@debevoise.com



Catherine Amirfar  
camirfar@debevoise.com