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ESG Now Podcast

"California Gets Harder To Insure and the NZIA Gets Smaller"

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Bentley Kaplan: Hello, and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society, and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

On today's show, we are going to be dishing out a double serving of insurance. First, we'll talk to Cody Dong and Sylvain Vanston about the recent decision by State Farm to stop offering new personal or commercial property and casualty insurance in California as the state grapples with growing wildfire risks. And then, we'll ask Sylvain about the recent departures of big names like AXA and Munich Re from the Net Zero Insurance Alliance and what it might mean for global net-zero efforts. Thanks for sticking around. Let's do this.

On the 27th of May, State Farm General Insurance Company or State Farm said it would stop taking new applications for any business and personal property and casualty insurance in the State of California. This would not extend to personal auto insurance, so good news if you're thinking of buying a new car. Now for context, State farm is the largest provider of property and casualty insurance and auto insurance in the US. In 2022, its net worth was over 130 billion dollars, and the company handled an average of 26,000 claims every day. So, this was a big announcement by a big company. In its press release in May, State Farm acknowledged efforts by the state government to mitigate wildfire risks, but stated that the combination of rising construction costs and, quote, "rapidly growing catastrophe exposure" made it necessary for the company to take these steps to improve its financial strength. And there are a few questions that might pop up for you when you hear an announcement like this, and I promise we'll get to them in good time as we go through the segment.

Firstly, maybe it's not all that surprising to hear that insurers are wanting to throw in the towel in, in a place like California where wildfires are relatively frequent, and especially when big ones like the 2018 "Camp Fire" can cause damage to the tune of billions of dollars. But at the same time, wildfires are not a new phenomenon in the state. And naively maybe, I'm left thinking that this is exactly the point of insurance in the first place to help protect against damages from events that have a degree of predictability. So, I put this assumption to Cody Dong, out of our Shanghai office. Cody spends a lot of time thinking about ESG and the insurance industry, and as it turned out, State Farm wasn't the only insurer to be hitting the pause button in California

Cody Dong: In fact, another big insurer in the United States, Allstate also followed State Farm's move. These two insurers blamed catastrophes like wildfires for their decisions. But like you said, wildfire in California is not a new phenomenon. So why now? I think inflation definitely plays a key role. Insurers have to pay for the cost of replacement, and basically that covers reconstruction and repair so that your home is back to a similar shape as before, right? But construction costs have seen a significant rise due to inflation, both from the cost of construction and cost of labor points of view. And this rising construction cost in recent years really pushed insurers to the limit.

Bentley Kaplan: Okay. So California's wildfires have been getting more intense and more frequent, and no doubt there have been some significant events in recent years. The Camp Fire in 2018 was California's most deadly and destructive in the state's recorded history. And from a policy standpoint, in 2018, California passed a bill that basically stops insurance companies from canceling or not renewing residential insurance policies over a one-year period following a fire-related state of emergency.

For State Farm and Allstate, this increasingly challenging environment related to wildfires, blended in with inflation as well. Not only was risk higher, but rebuilding or restoring was suddenly way more costly. Now, inflation may ease off at some point, but looking at models and projections, we can't really say the same thing about wildfires. In truth, we can't really say the same thing about any physical climate hazards. For the most part, most of them are either going to become more intense or more frequent, or both.

From Australia's bushfires to hurricanes along the Gulf Coast to heat waves in China and coastal flooding in Japan, data is pointing to more challenging physical risk landscapes. And at a high level, that makes me wonder about how the insurance industry, which is supposed to be figuring out the likelihood of these risks and how to price them, is going to handle these intensifying climate hazards.

And one colleague who will be pretty handy at tackling a complex question like this is Sylvain Vanston out of our Paris office. Prior to joining MSCI, Sylvain had a long experience in the insurance industry, and so he brings a unique perspective to this challenge. To the question of how the industry is squaring off against shifting climate hazards, Sylvain highlighted a key consideration – the timeframes in which these risks are considered in the first place.

Sylvain Vanston: What we call physical climate risks in the investment world is natural catastrophes, NatCats in the insurance industry. And the insurers, of course, are well equipped to deal with those hazards. However, climate change obviously is impacting actuarial models on how to mutualize those risks. There is this thing that I sometimes call the curse and the blessing of the insurance market, whereby every year the market gets repriced by reinsurers and insurers.

So this annual repricing feature enables insurers to take into account the past year's events such as natural catastrophes into next year's pricing. Unfortunately, for some of them, it takes away the ability to have a long-term view on the evolution of those trends. Now, of course, that hasn't prevented many insurers from starting to take this long-term view, I would say since several years now. But for some of them, this is a new thing. So for example, the increasing frequency and intensity of wildfires in California is relatively new, just a few years. And obviously, what we're seeing is that some insurers need to catch up with the model change.

Bentley Kaplan: Right. So insurers have a degree of adaptability or even flexibility here, in that they can reprice risk every year. But as Sylvain sees it, some insurers may have been so focused on this year-to-year cycle that the longer-term shifts in risk landscapes may always have been part of the day-to-day decision-making.

But that approach of living in the moment is rapidly shifting as it becomes clearer that the damage from climate risks in the last 12 months or the years preceding that, is not always a reliable predictor for the damage that will occur in the next 12 months. And as changing climate hazards become more embedded in the planning of insurance companies, they will need to take decisions accordingly. For State Farm and Allstate, it was about leaving a market altogether or at least refusing to offer any new policies. And this may have been on the more extreme end of things. Many stakeholders will be wondering though, if outside of this more drastic step, whether there's a way to make insurance work in a world with escalating climate risk. And to help answer this, I asked Cody about how insurers may be thinking about this challenge and what strategic options they have at their disposal. Here's Cody.

Cody Dong: So, the insurance business is all about pricing risk. If risk is high, then insurers can charge higher premiums. But in reality, things aren't that simple because there are other factors at play. One is regulation. In California's case, there are regulations that impose a limit on how much insurers could raise their premiums. So in this sense, insurers' hands are tied in terms of pricing, but even if there are no regulations and insurers can adjust their prices freely, I think the second factor at play is competition. An insurer will find it priced out of the market if their policies are too expensive.

The breakeven points for different insurers are different. The abilities to properly price any risk, catastrophe risk included, are also very different. And lastly, I think the third factor of play I'll say, is about where insurers can maximize their ROE or profits. If ensuring climate risk in one region is becoming less attractive business-wise, even if it is still profitable, that insurer might deploy the same capital to other regions that may offer more lucrative returns.

Bentley Kaplan: Right. So raising premiums is an option with asterisks, it's not always permitted and if you turn that dial too much, you end up pricing yourself out of the market. And also, because insurance is a business, you don't necessarily want to be operating in markets where your margins are too narrow, where you're keeping fingers crossed that flooding events don't creep into worst-case model scenarios. So under these constraints, what avenues are open to insurance companies if they want to keep operating, despite more frequent and severe climate hazards?

Cody Dong: What insurance can do except just leaving the market altogether, obviously, first is to work with policymakers to discuss options. More room to adjust premiums. There are examples of government subsidies as well. The second option insurers could do is to use reinsurance or issue catastrophe bonds. So reinsurance transfers risks other insurance companies. And when you issue a catastrophe bond, it helps transfer risks to the overall financial market or investors. However, these mechanisms only work if someone else are willing to take that risk, right? And State Farm actually commented that reinsurance market is tough actually, at least for the California catastrophe risk market.

Last but not least, insurers can decide which markets to enter. It's not all about exiting. For example, hurricanes are moving north each year due to climate change. So residents of northern states of US, or even Canada, they may need more homeowner insurance, and that's more insurance demand. When you look at catastrophe models that insurers use, it is often backward looking and use historical disaster data, but incorporating forward-looking climate models that may provide more insights and could help insurers not only with their risk management, but also with their long-term business planning as well about exiting or entering certain insurance markets.

Bentley Kaplan: So Cody and Sylvain have laid out how insurers may be thinking about climate hazards, how climate change may be affecting their businesses. For this next segment, we're going to flip things around by looking at the role that insurers may be inadvertently playing in exacerbating or mitigating climate change through their insurance policies. And the story starts where any good sustainable investment story starts – with an acronym. And this particular acronym is the NZIA or the Net Zero Insurance Alliance. And the NZIA is a global group of insurers and reinsurers representing a significant percentage of world premium volume.

It was convened by the UN in July 2021, and members have committed to, quote, "Transition their insurance and reinsurance underwriting portfolios to net-zero greenhouse gas emissions by 2050, consistent with a maximum temperature rise of 1.5 degrees above pre-industrial levels by 2100 in order to contribute to the implementation of the Paris Agreement on climate change.” A bit lengthy but precise.

And the NZIA is actually a bit of a Matryoshka doll, an acronym within an acronym as it falls under the broader GFANZ or the Global Financial Alliance on Net Zero. The GFANZ was established in April 2021, a few months ahead of the NZIA. And GFANZ is, quote, "The world's largest coalition of financial institutions committed to transitioning the global economy to net-zero greenhouse gas emissions.” And under GFANZ are a bunch of sector-specific alliances, including insurance for one, but also asset owners, banking, and asset managers. And all of these different alliances were established with a strong commitment to action, to addressing a significant global challenge that calls for global action, which is why a flurry of big names officially leaving the Net-zero Insurance Alliance might have raised a few eyebrows. Names like Lloyd's of London, Allianz, AXA, Munich Re, and Sompo Holdings.

To dig into more about what this might mean in terms of global efforts to mitigate climate change, I asked Sylvain to stick around.

Sylvain Vanston: So the Net Zero Insurance Alliance's quick demise is a bit of a surprise, to be honest. Many of its founding members have left, including the chair, AXA. Of course, no one had protected this back then. But the good news is that most of the insurers who have left the NZIA has stated that they remain committed to their goals, to their climate commitments, the ones that they formed when they joined the alliance. And typically, this would mean one way or another decarbonizing their insurance portfolios.

So it seems that a lot of the founding members and a few other insurers have decided that it makes more sense now to act alone rather than in collective framework. There are some concerns that have been raised by some policymakers on potential antitrust issues when it comes to the NZIA. It is, however, a significant reversal of the logic that we have seen over the past few years when companies, investors, bankers, and so on have decided to form alliances to tackle issues that are bigger than the sales, and that requires strength in numbers. This is what led many investors to form alliances over the last years, and especially since the Net Zero Insurance Alliance and then GFANZ, the Glasgow Financial Alliance for Net-zero.

Bentley Kaplan: OK, so Sylvain points out that yes, there are big names leaving the NZIA. He also mentioned that anti-trust concerns raised by policymakers may have something to do with these departures. And a quick internet search will give you an idea of the debate surrounding this topic. But I'll be the first one to tell you that we are not a legal podcast, and we are not about to go on an anti-trust side quest. Instead, what's much more interesting for us, is what a smaller Net Zero Insurance Alliance could mean for global net zero efforts. As Sylvain tells it, even though they are leaving the NZIA, these big insurers are not leaving their climate targets at the door. Many have restressed their commitment to a low-carbon transition and to meeting their net-zero ambitions. In fact, some of these insurers still remain members of the NZAOA, or the net zero asset owners' alliance – one the sector alliances that falls under the bigger umbrella of the GFANZ. And insurers are also part of this alliance, because, side bar, in addition providing insurance, insurers also have these big piles of premiums that they either invest themselves, or allocate to an investment manager, but let's leave that out of this particular discussion, because let's face it, we already have enough acronyms. So, what gives? Why are we seeing this rapid exit from the NZIA, but not from other alliances under the GFANZ?

Sylvain Vanston: That's a really good question why the NZIA to this extent? My hypothesis is that there is a lot less insurance capacity in the market than there is investment capacity or financing capacity. So when you lose a shareholder amongst many others, you can live with this. When you lose your banker, it's a bigger problem perhaps, but they might be easily replaced. When you lose your insurer, especially when it comes to highly technical risks, considering that there is not so much insurance capacity on the market, then that really becomes a significant threat to a company's license to operate.

And as a case in point, for example, in a previous role when I was in charge of some investment exclusions, it didn't really trigger much reactions from the companies, from the issuers, who were impacted by these exclusions. However, when those exclusions were extended to the insurance business, then it got a lot of clients really worried and the phone started ringing.

Bentley Kaplan: The insurance industry essentially underpins an operating environment, and that's because the absence of insurance can mean that a particular activity effectively becomes a no-go. In our full interview, Sylvain stressed the importance of insurers as carriers of risk effectively being able to influence the behavior of both their corporate and personal clients. As Sylvain argues, it's maybe because insurance is such a linchpin of modern economic activities that the NZIA is proving to be a more complex alliance to maintain than the others that fall under the GFANZ. A world with a limited pool of insurers means that decisions by just a handful of companies to raise premiums on carbon-intensive assets, or to simply decline to offer cover, can create massive economic ripples. And because of this potential leverage, many different stakeholders with sometimes competing economic priorities are laser focused on the decisions and targets of these insurance companies. For those stakeholders rooting for insurers and reinsurers to drive decarbonization, it doesn't sound like a smaller NZIA means that all is lost, even if you make the case that alliances like these drive greater accountability. As Cody so clearly highlighted, insurers are not only connected to climate change by insuring activities that might accelerate or mitigate global warming, but also through the hazards that result from climate change. State Farm and Allstate have hit the pause button in California. But other climate hazards will create headaches in other markets. And sure, insurance companies will have three broad options – specifically trying to influence regulations governing the industry, or dispersing risk through reinsurance or catastrophe bonds, OR looking to opportunities in new markets where physical climate risks weren't prevalent historically. But, to tie together points from Sylvain and Cody – insurers using climate models to look forward, beyond year-to-year repricing cycles, may see a fourth option. And instead of being a passive party to a rapidly changing climate and modelling how risk might change, becoming an active player in mitigating climate change through the powerful lever of insurance, and ultimately toning down the future intensity of physical climate hazards.

And that is it for this week! A massive thanks to Cody and Sylvain for their take on the news with an ESG twist. Thank you very much for tuning in. I know that the insurance industry has its diehard fans, but hopefully you got something out of this even if you happen to not be one of those diehard fans. As always, if you enjoyed this episode or the ESG Now show in general, please drop some stars on your platform of choice and nudge it over to a friend or relative that might enjoy it too. Thanks again. Until next time.

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