



COMMENTARY PAPER

Climate change and  
risk management –  
challenges today and  
solutions for tomorrow

# Climate change and risk management – challenges today and solutions for tomorrow

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While climate change regulation remains a highly debated issue among nations, an increased burden falls to corporations and individual organizations to step up initiatives as a means of reducing carbon footprint and changing future risk trajectory. We recently hosted a risk management club with partners in France – a gathering of experts discussing current and future challenges and opportunities – and climate change was on the agenda. Risk managers in France and around the world recognize climate change as one of the top risks for the next decade<sup>1</sup>. Understanding its history, considering upcoming trends and keeping an eye on continued challenges will lead the way for potential solutions.

At Sedgwick, as we collaborate with risk managers and organizational leaders across our spectrum of clients, we are keenly aware of shared concerns related to climate risk, no matter the size of the organization, where they are located or the industry they serve. The landscape has changed significantly, even over the past few years. Historically, from the risk manager's perspective, climate change and related risk were on the radar but didn't significantly impact an organization's insurable risk profile. Tough storm seasons would come, but then so would lengthy periods of relative calm. Known risks were straightforward to insure. Plus, insurance was inexpensive.

Fast-forward to 2021, when last year's natural disasters gained even more attention from risk managers around the world. In fact, 2021 was one of the costliest catastrophe years in recorded weather history. More than 300 catastrophic events were recorded – costing \$111 billion in insured losses<sup>2</sup>. That number takes into account the floods in China, British Columbia and Australia, cyclones in Bangladesh and India, and a typhoon in the Philippines. Three natural disasters alone – Hurricane Ida, Winter Storm Uri and the floods in Europe – generated damages estimated at more than \$50 billion.

As times have changed and we've literally weathered the storms, the industry – insurers and risk managers alike – started connecting the dots – perhaps not yet calling out climate change but certainly seeing more extreme weather patterns and noting that significant event years were coming more regularly. The conversation among C-suites began to shift. No longer is overall good stewardship of the planet a sound strategy. Proactively reducing environmental impact has become essential to reducing risk.

Several things have driven this shift in thinking:

- Clear changes in the pattern of events – severity, frequency
- The strong focus around the world on environmental, social and governance (ESG)
- Stronger evidence that climate change acts as a catalyst for natural catastrophes
- The growing importance of brand to company value and growth potential
- The cost of insurance

Today, climate change – specifically, the impact of extreme weather events – is seen as real and undeniable. In 2021, the concentration of carbon dioxide in the atmosphere reached a historically high level: 414.72 particles per million<sup>3</sup>. Increased carbon dioxide leads to higher temperatures and rising temperatures lead to more frequent and intense natural disasters. Based on this trajectory, the global economy could contract by 10% by 2050<sup>4</sup>. Looking ahead, no geographical area will be spared. Countries in Southeast Asia and Latin America will be more exposed to the risk of drought. Northern and Eastern Europe are expected to experience unprecedented episodes of rainfall and flooding.

<sup>1</sup> PWC SURVEY, FRANCE, JANUARY 2022

<sup>2</sup> NATURAL CATASTROPHES 2021: FLOOD GATES ARE OPEN – SWISS RE SIGMA

<sup>3</sup> CLIMATE CHANGE: ATMOSPHERIC CARBON DIOXIDE | NOAA CLIMATE.GOV

<sup>4</sup> THE ECONOMICS OF CLIMATE CHANGE | SWISS RE

Accordingly, companies must embrace climate-related risk management principles, and more broadly ESG, and factor them into planning or face rather extreme consequences, such as liability exposure, brand exposure, loss of customer base, loss of physical assets and business interruption.

## What climate-related risks should be on your watch list?

Let's look at three key areas: physical risks, business continuity risks and liability risks.

### Physical risks

As extreme weather patterns have changed, have your physical risk management programs — those that address damage to property, disruption of supplies, loss of productivity or income — kept pace? We continue to see catastrophes increasing in intensity. In many cases — such as recent flooding in Yellowstone National Park in the U.S. following a year of wildfires in the region — we find the relatedness of extreme events in the same area more than a coincidence.

- Too much water or not enough — floods, sea level rise, droughts
- Hurricane and cyclone severity — and not just at the coast
- Secondary perils — hail, thunderstorms, tornadoes, storm surge
- Wildfires
- Winter storms

Physical risks can dictate where we build. Perhaps, as people migrate to areas less prone to weather events, businesses will need to move as well. Organizations may choose to relocate to reduce risk in shipping, or to remain in proximity to water supplies. Yet, no place can completely avoid the potential for extreme weather. How much can we outrun?

Physical risks also have become more influential in determining how we build, the specs and planning related to elevation, site location and ability to mitigate secondary and related perils. You must account for things like wind tolerance, snow load, temperature protection, flame retardancy. Consider backups and redundancies as precautionary measures. Factor risks into inventory levels, what to keep onsite instead of warehoused elsewhere, how your supply chain may be impacted. Incorporate building methods and designs that will protect your people. Resilience is the key.

As we face a changing environment, most companies' risk tolerance/ risk profile will need to adjust or shift related to physical property and business interruption. Insurance availability will be tight as more focus is placed on how the retained risk impacts the enterprise. Holistic program review is essential; we can't look at "insurable risks" in a vacuum. Higher risk in one area must be balanced with lower business risk elsewhere. We can't expect insurers to put their capital into play below a breakeven point.

### Business continuity risks

Business continuity risks affect an organization's ability to rebuild or repair following an event, as well as resulting business interruption. Factors include:

- Availability of materials
- Availability of skilled labor
- Availability of cash (with less/no insurance)
- The impact of inflation on repairs and replacements

Think about an event's potential impact to your customer base. Will customers still be present after a catastrophe? Will their habits change post-event? Will they remain loyal customers? What will they need post-event?

Think about an event's potential impact on your facilities. Will you rebuild in the same location? Will you rebuild in the same format, as that could impact whether to structure your policy for replacement cost or actual cash value?

Think about an event's potential impact to your supply chain, which these days may seem fragile. Will extreme weather in any part of the world affect the availability of completed products and component parts needed for your business? How stable are your export and import ports' capacity and flow? How will you account for fluctuating availability and cost of ships and containers? Are you prepared for or able to avoid extra time in transit, particularly of seasonal goods or perishables? Are you prepared to address challenges connected to labor migration, availability of workers, attitudes toward work, ability to scale? Are you able to withstand the impact of social and political instability or world events, such as COVID lockdowns or military conflicts?

Select industries or business units must consider even more in assessing preparedness, such as unique risks they may face in transition to a low-carbon economy. Could carbon-heavy industries face limited availability of insurance due to their risk profiles? If looking at alternative fuels, what are the potential risks of alternatives, for example, disposal challenges of electric vehicle batteries for a business with fleet and motor elements?

Organizations may face brand and reputational risks tied to public opinion of ESG compliance. How will investors react to your organization's ESG strategies, or lack thereof? Will you face the impact of additional regulation and reporting requirements as climate measures come into play?

Every risk manager needs to have eyes and ears wide open in these areas to stay ahead. Watch the trends and think about how changing norms will shape or threaten your business. But don't go it alone. In assessing and addressing business continuity, it's important to have a partner with experience, scalability and expertise who can leverage partners and resources to support risk management and claims administration objectives. Be prepared; have a solid partnership in place before an event occurs.

### **Liability risks**

Liability risks continue to grow as we see a rise in climate-related accountability. From litigation challenges and nuclear verdicts to reputational hits tied to your corporate policies, it's clear each on the list below has captured corporate and/or public attention.

- Event-driven litigation — directors and officers (D&O) coverage
- Securities class actions — “greenwashing”
- D&O fiduciary duty breach — inadequacy of ESG actions
- Liability for “not doing enough” — or for an organization's carbon footprint
- Liability for a large loss — and for not having foreseen the consequences
- Impact of social inflation — fueling the exposure
- Regulatory risk as governmental agencies develop disclosure and action requirements — uncertainty around what is required

## **How can risk managers prepare?**

Corporate conversations and action plans to address climate change are evolving. Why? For many companies, ESG principles have become an extension of their culture and value system. And for others, it's because their shareholders, customers, investors and now regulators are driving them toward change. The security of their brands demands it, and the risks of failure to adapt and adopt are simply too high.

But from a specific risk management angle, not all companies are fully prepared and equipped to address climate-related risk. Many unknowns remain about future impact and because it's the weather, it's impossible to predict with accuracy. Where can improvements be made? I point to three main areas of focus for future success — coverage, data and mitigation strategies.

### **Coverage**

Dynamics between the demand and supply sides of the insurance market are changing. While it was not true at the start of the hard market in 2019, we now see insurers differentiating among insureds in terms of their risk profile and rewarding those who are less exposed — either through location or mitigation. The risk of loss will have to be shared between business and insurers. And insurers should not be expected to shoulder the risk if businesses are not willing to pay reasonable rates.

We can't just operate in an “insurable loss” world; we need to understand how insurable losses fit in with the enterprise's broader risk profile. Risk managers should revisit their role in the enterprise risk management process — times have changed. Lead the effort to evaluate your company's risk appetite/tolerance.

Think beyond insurance. The low cost of insurance has made risk managers into insurance buyers these past 15 years. However, transferring risk should only be part of your strategy when required or when it's the most efficient option. Insurance may or may not be available — and certainly at a higher cost. Consider areas viable for self-insurance, what risks you can/should take, and which risks you should hedge.

Rely on your risk map and monitor the weaknesses that emerge by applying the potential impacts of climate change. Offer alternatives beyond the traditional, such as a network of captives, trigger-based parametric insurance policies, or catastrophe (CAT) bonds, and vet concepts early on and not just when you're in a bind. Get out of the annual insurance renewal cycle. Instead, think about strategy in terms of where you want to take your program over the next three to five years.

## Data and analytics

With so much we don't know and the factors of fate at play, there is still room for improvement in the analysis of data, its structuring, its presentation and the use of artificial intelligence tied to climate. Predicting the consequences of different types of climatic events — provided the predictions are based on robust models — will help risk managers prepare for the future.

Don't just rely on your insurers and brokers to do the actuarial work, the loss analysis and the loss projections. Develop your own understanding of the analytics and be able to apply them to your strategies. The industry is experiencing a talent exit — and different talents and approaches are needed anyway; insurers and brokers might not have the right skillsets to serve your need. Additionally, loss modeling in the industry has not yet mastered the concept of factoring in such an unknown as climate change — so have your own perspective on it.

## Mitigation

Risk managers may agree with the saying that “an ounce of prevention is worth a pound of cure.” As a risk manager, you should feel empowered to lead your organizational effort on mitigation opportunities and be open to exploring program options. As both cost and availability of insurance coverage fluctuate, your analysis of the potential ROI of the initiatives on the list below may also change.

- Safety and ergonomics
- Facility and vehicle cameras
- Telematics
- Weather protections in buildings

Ultimately, the risk manager is poised to be more influential than ever — as long as organizations are willing to listen. The challenges of climate change are not going away. Now is the time to step up efforts. Educate your leaders. Don't be afraid to explore the power of partnership to implement proven programs rather than trying to build them yourself. Build strategic plans around coverage, data and mitigation. Protect your organizations against physical risks, business continuity risks, liability risks and risks to brand reputation or compliance.

While the approaches that got us to where we are today will not be the same that work in the future, the foundational elements of ERM won't change. The basics — identifying and assessing risks, response planning, risk mitigation and risk monitoring — are still there to ground the decisions you make. Thinking bigger and being prepared for what's next will set you and your organizations up for success as we navigate the challenges of climate risk together.





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