

INSURANCE FUTURES

The politics of climate change

By Tom Burke – The Oracle Partnership

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2019 is the year the global conversation on the climate changed. The children's climate strikes, the arrival of Extinction Rebellion, the EU's Green Deal and the importance of climate change in choosing a Democratic presidential candidate illustrated the strength of public anxiety. The ceaseless procession of harrowing images on our screens from floods, fires, storms and droughts showed why. A stream of ever more alarming reports from climate scientists, culminating in the World Meteorological Organisation's projection that this would be the warmest decade ever, validated their concern.

No other challenge in human history has simultaneously threatened the prosperity and security of every single person on the planet. There are many millions of people whose lives are being disrupted by conflict, disease, poverty or extreme weather. There are many more millions living lives that are peaceful, healthy, comfortable and sheltered. Climate change will disrupt the life of all eight billion people on the planet if we fail to keep the rise in global temperature below 2°C. Or even lower, if estimates of the relationships between carbon emissions and temperatures prove understated.

Europeans had a foretaste of what this might mean in the 17th Century. As Geoffrey Parker's monumental study, *Global Crisis*, documents in depth, a changing climate is a stress multiplier.¹ The then cooling produced disruptive weather extremes that intensified the political, economic and religious tensions roiling a primarily agrarian European population. The consequent famine and disease reduced the population of Germany by 40%.

Today's warming will add similar amplification to the far greater stresses already churning the planet's still growing population. Delivering prosperity and security to a now predominantly urbanised population in a highly interconnected world depends on the integrity of a vast network of relationships and institutions. This network has coped well with the explosive growth in the global demand for goods and services over the past century. However, as the expanding realm of climate attribution science makes clear, it is already being disrupted by the limited climate change we have so far experienced.

The interaction between the climate and human affairs is neither sequential nor linear. It is our skill at adapting to our environment that makes us so successful as a species. It is a skill that copes best with incremental change. What climate scientists fear most about our current disruption of the earth system is the likelihood of non-linear change leading to accelerating, abrupt and irreversible shifts in the climate.

We also succeed as a species because we are able to anticipate as well as react to change. We do not always wait for something to happen before thinking about how to respond to it. Anticipation of how the climate might change is already casting an ominous shadow on a wide range of decisions today—from where to invest to whether to have children. As events continue to validate the projections of climate scientists that shadow will grow darker.

The politics of climate diplomacy

There is a further way in which climate change is unique. Although there are likely to be hard power consequences of climate policy failure, there are no hard-power pathways to climate policy success. Human beings have only a limited set of tools to induce others to do what they want them to: coercion, bribery or persuasion. We can force people to do something by the threat of violence or the law; we can bribe them by monetary or other rewards, or we can persuade them by argument or deception.

This tool kit scales from the family to the nation. Solutions to serious problems require some permutation of all three tools. It is hard to see how military force, or the threat of it, could be used to compel recalcitrant countries to decarbonise their economies in the next thirty years, or sooner. This puts a premium on strengthening the limited coercive power of the Paris Agreement while intensifying the use of bribery and persuasion.

There is considerable misunderstanding outside the ranks of government officials about how such agreements actually work. Much criticism focuses on the absence of strong mechanisms to enforce compliance leading to a fear of free riding. This misses two crucial points.

Nations signed up to the Paris Agreement because it was in their interest to do so. China and India did not sign the Agreement in order to curry favour with the US or the EU. They did so because climate change threatens to disrupt their own internal stability. To protect that stability, they need other nations to act so they must be, and be seen to be, willing to act themselves. Naturally, each nation negotiated commitments which minimised its own burden but remained sufficient to keep other nations in the Agreement.

The bargain thus struck is messy and far from optimal. It will not keep the climate manageable. That does not mean it is futile. Climate change is not an event. It is an evolving condition of the planet. In many ways it is like type two diabetes, a manageable problem, which, if untreated, becomes progressively unmanageable, and eventually catastrophic. Recognising this, the Paris Agreement established a specific process to allow the bargain to be strengthened if the state of the climate so required. There will be a global stocktake in 2023, and every five years thereafter, to determine what more needs to be done.

There is no question that much more needs to be done—urgently—for there to be a reasonable chance of meeting the goals of the Paris Agreement. It is important to remember that goal is to limit the rise in the global average temperature to below 2°C. The actual climate driven temperature change will vary from place to place. The Arctic has already experienced a rise of more than 3°C bringing with it graphic pictures of melting ice sheets and boreal forest fires. These temperature differences will be regional but their physical, economic and political consequences will often have global impacts.



There is understandable frustration within both the public and the climate policy community at the sluggish response by governments to the urgency of climate change. This has led some to doubt the value of the United Nations Framework Convention on Climate Change (UNFCCC) process. Such doubts are at best a distraction and at worst dangerous. Climate change is a time bound problem. If we do not succeed in decarbonising the global economy by the middle of the century, at the latest, climate policy will have failed. There is simply no time to build an alternative mechanism for international cooperation on climate change. In any case, the same political failures that might allow the UNFCCC process to collapse would still face some new mechanism.

Better, therefore, to focus on how to build political support for a more ambitious outcome to the 2023 stocktake. Negotiators at international treaty meetings work on the basis of the instructions they are given by their governments. The political space within which an eventual agreement will be struck is thus defined by the sum of those instructions. To achieve an ambitious outcome you need an ambitious set of instructions.

The most critical work towards a successful outcome in 2023 will take place in national capitals not international negotiating rooms. Attention on the politics of climate change typically focuses on the annual round of UNFCCC meetings. This inevitably leads to an over-concentration on short-term difficulties with the treaty text and distracts attention from the more strategic developments in the real economy that are fundamental to decarbonisation.

The Paris Agreement marked a number of crucial turning points. Prior to Paris, the dominant climate policy conversation was about how best to constrain economic development in order to reduce its carbon burden. Unsurprisingly, positioning yourself in the middle of a collision between the economy and the climate was not a compelling prospect to many politicians. Hence the prevarication that has been such a feature of climate policy in many countries.

The climate opportunity

There has been a marked shift in the climate conversation since Paris. Opportunity has now become a significant driver of global decarbonisation. The costs of the renewable and battery technologies essential for decarbonising power and transport have fallen both further and faster than was anticipated even then. They are continuing to fall. Globally, renewable energy capacity has quadrupled in ten years to take power sector carbon emissions 15% below where they would otherwise have been. It is now likely that renewables will become consistently cheaper than fossil fuels early in the twenty twenties, around the world.

This has changed the fundamental political equation shaping the response to climate change. The political risks of inaction on the climate are rising and those of acting are falling. In a policy conversation dominated by constraint, climate change looked to most politicians like a choice between today's winners (the fossil fuel industries and those dependent on their revenues) and tomorrow's possible losers (future victims of a changing climate) plus tomorrow's possible winners (renewable industries). Politically, this is a no brainer. You back today's winners with what you do, and you shield yourself from the future with warm words.

Since Paris this has begun to change. The low carbon opportunity narrative has taken hold and the growing number of extreme weather events has begun to register with the public. The emerging political equation pits today's fossil fuel incumbents against tomorrow's cheaper innovators and increasingly harrowing images of today's victims. This is much more difficult politically and is, paradoxically, currently intensifying the prevarication on climate policy as politicians struggle to accelerate the energy transition without alienating key voters.

The horns of their dilemma have been brought sharply into focus this year. Despite their increasing efforts to paint themselves as energy companies, the oil and gas industry invested nearly half a trillion dollars in new supply last year. This is not compatible with achieving the Paris goal. Meanwhile public anxiety about climate change has found increasingly forceful expression in many countries.

A new debate

Greta Thunberg's schools strikes, Extinction Rebellion's street protests and Alexandria Ocasio-Cortez' Green New Deal are not so much creating a wave of public anxiety as riding it. The wave has been created by the extraordinary series of extreme weather events in all parts of the world over the last two years which have led to \$225 billion in insured losses. These have so focussed public attention on climate change that London's Evening Standard recently devoted its front page to declaring that 85% of Britons are now worried by climate change.



The political impact of these events has been reinforced by the entry of a new, powerful and wholly unexpected voice into the climate policy debate: central bankers. Since Bank of England Governor, Mark Carney, gave his first climate speech in 2015 an organised network of central bankers, the Network for Greening the Financial System has emerged. It now has 42 members representing countries with over half of global GDP. His speech led to the creation of the Task Force on Climate Related Disclosure. This has now developed a set of detailed protocols for how companies should disclose their exposure to a spectrum of climate risks so that the financial community can be adequately well informed to assess their impact on investments. Transparency is key. When central bankers speak investors and politicians listen.

Subsequently the Bank of England has begun to develop a regulatory framework for the financial services industry's management of climate risk through the Financial Conduct Authority and the Prudential Regulatory Authority. Long-term scenarios and strategic options that demonstrate how individual listed companies will respond have a central role. There is much to be done. For many listed companies, this perspective is new and unfamiliar territory. This public sector response has been matched in the private sector by the creation of the investor-led Climate Action 100+ network designed to tackle both the emissions reduction challenges and low carbon technology opportunities of climate change. It now involves 289 investors from 29 countries with over \$30 trillion in assets.²

The result of all these developments has been to elevate climate change to the top tier of mainstream politics. With both the public and financial institutions increasingly concerned about climate change, the pressure on governments to act urgently and effectively is growing. It is now clear that technology is not an insurmountable problem. Thirty years of deep analysis and innovation mean that we have, or have in sight, the technology we need to stop burning fossil fuels without depriving people of affordable energy services. Nor will we wreck our economies to do so.

Some two thirds of the energy from burning fossil fuels is simply waste heat that does no useful work. Much of the \$1.8 trillion the world invested in energy last year added no real economic value. As we make the energy transition out of fossil fuels by spending that capital on a carbon free energy system we will also be improving the overall productivity of the economy.



It would be wrong to think that there are no real technological and economic problems to be solved to avoid dangerous climate change. There are. However, the amount of systematic study of both over the past thirty years has been sufficient to justify a high level of confidence that they can be dealt with should we wish.

The remaining political problem

This is not true of the political problems of making the transition to a carbon-free energy system. Little sustained effort has been put into identifying, let alone solving, these problems.

If we are to have any realistic prospect of making an orderly and timely transition to a carbon free global energy system then we need to urgently deepen our understanding of its politics. The scale and pace of the technology changes that climate policy success requires will be accompanied by a similar scale and pace of change in the patterns of winners and losers in the energy world. Politics is how we choose who wins and who loses. Typically, those interests that will lose make a noisy and sustained effort to oppose the changes. Those that will win tend to quietly get on taking advantage of them. Prevarication is a typical response of governments faced with hard choices and it is often a wise way to ease the pain of change. This will not work for a time bound problem like climate change.

The change from fossil fuels to carbon free energy will create large numbers of jobs and opportunities for investors. They will not be jobs or opportunities for the same people with the same skills in the same places. Climate policy makers have a great deal to say about the shape of an energy policy that is Paris compatible. They have had far less to say about the labour, skills and regional development policy that must accompany it. Without such a policy the political obstacles to the energy transition will be formidable.

The EU countries derive some €400 billion a year in revenues from taxation on the fossil fuel industry. While we can see how to replace the energy from fossil fuels by new technologies it is much harder to see how to create the same opportunities for taxation and dividends. There is far less headroom for the extraction of rents. The reason why pension funds have such significant holdings in oil and gas companies is because they are such reliable providers of dividends. Climate policy makers have had nothing serious to say about how those revenue streams are to be replaced. Given an orderly transition, replacing dividends can be left to the market as investors adjust their expectations.

Replacing the public revenues will be more difficult. The relative inelasticity of demand for fossil fuels has made them a reliable tax base. They are familiar and broadly accepted by voters. Since the purpose of carbon taxes is to drive carbon out of the economy they cannot provide the same underpinning for tax policies because the more successful they are in changing behaviour, the less they produce in revenue. Nor is it sensible to tax renewables at precisely the point when one needs to see a massive investment in, and increase in their use. This means new taxes need to be imposed elsewhere in the economy and new taxes are always unpopular and will be resisted. Failing to replace the public revenues, however, will undermine support for ambitious climate policies. There are already some politicians in Europe arguing that dealing with climate change will lead to a prolonging of austerity.

For climate policy to succeed we must end the burning of fossil fuels by around the middle of the century, or earlier. We have to keep in mind that climate science, including the work of the Intergovernmental Panel on Climate Change (IPCC) has consistently underestimated the severity of systemic impacts and the rate of change. This will have significant geopolitical consequences which are yet to be fully understood. Some countries, Saudi Arabia and Russia among them, depend critically on revenues from oil and gas exports for their national budgets. There has been little serious examination of the options available to those countries to replace those revenues. Mozambique, one of the world's poorest countries, was devastated by two powerful and unusual hurricanes this year. Climate change makes the likelihood of further such catastrophes in Mozambique greater. It is also a country with large offshore gas resources on the verge of development. Climate policy makers have yet to propose any advice to the government of Mozambique as to how it should handle the dilemma this presents.

There is a growing risk that governments will be caught between a rock and a hard place. As the scale of the political obstacles to the necessary change for climate policy success becomes more apparent the temptation to continue prevaricating will grow. As climate events drive an ever more anxious and better informed public to demand urgent action the inducement to panic will also grow. Governments oscillating between prevarication and panic are probably least able to construct an orderly path to a carbon free global system.

Insurance: Some critical questions

Against this background, the insurance industry has a vital role to play. Insurers underpin everything from corporations, to cities and municipalities. More important, insurance is a pre-condition for investors. If rates increase and cover is withdrawn, confidence in the financial system will quickly be undermined. Some insurers, like Swiss Re, are supporting communities in developing long-term resilience, often integrating 'natural' solutions with conventional infrastructures. This is, in one sense, enlightened self-interest. It may limit the growing 'protection gap', as governments themselves fail to provide insurance of last resort.

At the same time, the cities and insurance systems are vulnerable to sudden corrections, some triggered by changing public attitudes and levels of confidence. Severe weather events may put insurer's capital under pressure, as both insured losses and investment returns are hit. In the longer term, the success or failure of climate policy will impact on asset valuations and therefore on capital adequacy requirements.

There will also be multiple opportunities. By understanding complex risk and modelling the potential for long-term systemic crises, the industry can provide new risk products, services and advice, partnering with specialists. The same applies to modelling individual businesses and sectors, as we explore in the role of 'Radical Innovation'. This may take the industry into new markets where they act as risk managers, advisors and primary actors, rather than providers of transactional services. It will also require an increasingly mature relationship with governments in order to maintain the flow of affordably priced capital into the economy as the dial shifts on the success or failure of climate policy.

1 Geoffrey Parker, *Global Crisis: War, Climate Change and Catastrophe in the Seventeenth Century*, Yale University Press, 2017.

2 <http://www.climateaction100.org>

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