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4 March 2019

Dear Mr. Neal,

Subject: Financial Risks from Coal Underwriting and Investment

We write further to our letter addressed to Inga Beale dated 19 February 2018 regarding investment in and underwriting of coal business (the "February 2018 Letter"), as well as the recent letter from a coalition of 73 NGOs regarding the Carmichael coalmine in Australia (the "Civil Society Letter").

Coal Exclusion Policy

We note that the Coal Exclusion Policy applicable to the Lloyd's Central Fund was due to come into effect on 1 April 2018. Nevertheless, no public announcement was made by Lloyd's of London ("Lloyd's") regarding the criteria for divestment and exclusion. We call on Lloyd's to confirm publicly both that the Coal Exclusion Policy has now been implemented, and how it has been implemented including details of the applicable criteria.

Additionally, as highlighted in the February 2018 Letter, the Central Fund only represents about 2.5% of the assets at Lloyd's. It is clear that a Coal Exclusion Policy which does not apply to over 97.5% of the chain of security¹ cannot be considered meaningful from a practical risk management perspective.

It is less clear whether any measures have been taken to protect the remaining 97.5% of assets from the risks associated with coal business. These remaining assets all form part of the chain of security whose management is the responsibility of Lloyd's.²

In the February 2018 Letter, we called for Lloyd's to ensure that the risks associated with underwriting and investing in coal assets were subject to a robust risk assessment through the provisions and oversight of the Minimum Standards³. Has Lloyd's taken any action in this

¹ The name of the capital structure which backs all insurance policies at Lloyd's.

² Section B, Article 6(b) of Co-operation Agreement between the Prudential Regulatory Authority and the Society of Lloyd's dated December 2013.

³ The Minimum Standards are the minimum requirements that managing agents must meet to operate at Lloyd's.

regard, or followed its own recommendations as set out in the Lloyd's report on stranded assets?⁴

Risk Management and Disclosure Requirements

Article 3.1 of the PRA's Conditions Governing Business requires that “[a] firm must have an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis the risks, at an individual and at an aggregated level, to which it is or could be exposed, and their interdependencies.”⁵

Additionally, firms are subject to the prudent person principle by which they must “only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report...”⁶

Furthermore, firms are required to disclose a Solvency and Financial Condition Report (“SFCR”)⁷. The SFCR must include a description of the material risks that the undertaking is exposed to, together with qualitative and quantitative information regarding those risks.⁸

Lloyd's SFCR as at 31 December 2017 made no mention of the risks from coal, or climate change more generally. This calls into question whether such risks are being adequately addressed, and whether the legal requirements set out above are being met.

While managing agents are also directly supervised by the PRA, it is Lloyd's who is responsible for “the overall strategic direction of the market, control over how much (and what type of) risk to allow into the market as a whole, the market-wide control framework..., and management of both the Central Fund and the ‘chain of security’.”⁹ Accordingly, strategic decisions regarding risks from coal which may affect the market as a whole fall directly within its remit.

Strategic Inconsistency

In its 2017 annual report, Lloyd's states that “[i]ndustrialisation combined with a growing population has resulted in rising levels of CO₂ and other greenhouse gas emissions that cause global warming. Global risks are changing and the potential consequences are severe. Increased frequency and severity of major weather events mean that climate change has increased the risks and costs of insurance.”¹⁰

Lloyd's reported a pre-tax loss of £2 billion for 2017, which was primarily driven by natural catastrophe events. These events included Hurricanes Irma, Maria and Harvey as well as significant claims arising from the wildfires in California and Chile, and Cyclone Debbie in Australia.¹¹

⁴ Lloyd's of London (2017). “Stranded Assets: the transition to a low carbon economy. Overview for the insurance industry.”

⁵ Article 3.1 of the PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015.

⁶ Article 2.1(1) of the PRA Rulebook: Solvency II Firms: Investments Instrument 2015.

⁷ Article 3.1 of the PRA Rulebook: Solvency II Firms: Reporting Instrument 2015.

⁸ Section 295 of the Commission Delegated Regulation (EU) 2015/35.

⁹ Section B, Article 6(b) of Co-operation Agreement between the Prudential Regulatory Authority and the Society of Lloyd's dated December 2013.

¹⁰ Page 13 of Lloyd's of London 2017 Annual Report.

¹¹ Pages 31-33 of the Lloyd's of London 2017 Annual Report.

Many of these events are likely to have been significantly influenced by climate change. For instance, researchers estimate that human-induced climate change likely increased Hurricane Harvey's total rainfall by at least 18.8%.¹² Similarly, it is notable that 15 of the 20 largest fires in California have occurred since 2000.¹³ The broad scientific consensus is that increasing global temperatures will have a significant impact on weather-related natural catastrophes, and that disaster related losses shall increase.¹⁴

In November 2018, the Insurance Group of Australia warned that a failure to reduce greenhouse gas emissions could result in a world that is "*pretty much uninsurable*".¹⁵ This echoes comments made by the CEO of AXA in December 2017 that "[a] +4°C world is not insurable".¹⁶ Likewise, Aviva has warned that "[a]t 4 degrees the insurance business model fails to exist. We could not underwrite to the price that the economy can afford."¹⁷

Despite the risks they face from climate change, many insurers continue to enable the mining and burning of coal. Coal-based power is the most important cause of carbon lock-in today, with all currently operating plants committing the world to a combined 190 GtCO₂ of carbon emissions. Coal plants that are currently under construction would contribute a further 150 GtCO₂ over their lifetimes – severely undermining the aims of the Paris Agreement.¹⁸

By contrast, the most recent IPCC report determined that energy from coal would have to be reduced by 59% – 78% on 2010 levels by 2030 to limit global warming to 1.5°C.¹⁹ That increases to a reduction of nearly 100% by 2050. A study from University College London concluded that 80% of coal reserves should remain unused to have a 50% chance of limiting warming to 2°C.²⁰

Against this backdrop, it is unclear how continued underwriting and investment in coal fits into a coherent risk management strategy that properly accounts for the market's own long-term financial interests. By facilitating activities that fuel dangerous climate change, insurers are sabotaging their own business model.

Carmichael Coalmine

In addition to these long-term strategic considerations, are short- to mid-term financial risks. These risks have already been extensively discussed in relation to coal investment.²¹ However, they are also relevant to underwriting. Interdependencies of risk, aggregation of risk, and fundamental underwriting risk of loss are all relevant in the context of coal underwriting.

This is well illustrated by the Carmichael thermal coal mine and rail project in Queensland, Australia, proposed by the Adani Group of companies (the "Carmichael Coalmine"). The

¹² Risser, M.D. and Wehner, M. F. (2017). "Attributable human-induced changes in the likelihood and magnitude of the observed extreme precipitation during Hurricane Harvey." *Geophysical Research Letters*, 44, 12,457 –12, 464.

¹³ http://fire.ca.gov/communications/downloads/fact_sheets/top20_acres.pdf

¹⁴ IPCC (2014) "*Climate Change 2014: Synthesis Report. Contribution of Working Groups I, II and III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change [Core Writing Team, R.K. Pachauri and L.A. Meyer (eds.)*." IPCC, Geneva, Switzerland.

¹⁵ <https://www.reinsurancene.ws/iag-says-climate-change-could-make-world-uninsurable-financial-review/>

¹⁶ <https://www.axa.com/en/newsroom/press-releases/axa-accelerates-its-commitment-to-fight-climate-change>.

¹⁷ House of Commons Environmental Audit Committee (2018). "*7th Report - Greening Finance: Embedding Sustainability in Financial Decision Making*." 04 June 2018, pg. 6.

¹⁸ United Nations Environment Programme (2018). "*Emissions Gap Report 2018*" pg. 22.

¹⁹ International Panel on Climate Change (2018). "*Global warming of 1.5 °C: Summary for Policymakers*" pg. 19.

²⁰ McGlade, C. & Ekins, P. (2015). "*The geographical distribution of fossil fuels unused when limiting global warming to 2°C*" *Nature* volume 517, 187– 190.

²¹ For example, see Lloyd's of London (2017) and Carbon Tracker (2018). "*Mind the Gap: the \$1.6 trillion energy transition risk*".

Carmichael Coalmine carries a host of financial and social risks which may directly impact underwriters, two examples of which are given below.

i) Stranded Asset Risk

After a large number of banks ruled out funding for the Carmichael Coalmine, it has been announced that Adani intend to self-finance the project.²² The ongoing failure to secure institutional funding raises serious questions regarding the financial viability of the project.

A report by the Institute for Energy Economics and Financial Analysis (“IEEFA”) found that the project is likely to be cash flow negative for the majority of its operating life.²³ A copy of the report is attached for your ease of reference, and highlights numerous weaknesses such as:

- IEEFA’s projection that the global thermal coal price will remain below the project’s cash cost of production for the foreseeable future.
- The stated objective of the Carmichael Coalmine to supply thermal coal to India. In India, the domestic price of coal is in the US\$20-30 per tonne range²⁴, and IEEFA projects the energy-adjusted price of Carmichael Coalmine coal will be over US\$ 95 per tonne, inclusive of shipping.
- The fact that the Adani Group is highly geared. In particular, Adani Power is loss-making with net debt of over 300% of its market capitalisation at the time of the IEEFA report.
- Adani does not have a long or successful history of coal mining.²⁵

Underwriters have long understood that projects with risks to operational cash flows are at risk of greater frequency and severity of property and casualty claims. Such financial pressures often restrict funds available for general risk management, maintenance and safety activities. This can lead to damaged equipment, business interruption, and imperil worker safety. Managerial negligence, faulty equipment, and design or structural failure can lead to mining disasters that result in hundreds of millions of pounds in fines, clean-up costs and lost profits.²⁶

The financial analysis of the Carmichael Coalmine therefore suggests the project could be highly risky for underwriters.

²² <https://www.theguardian.com/environment/2018/nov/29/adani-to-begin-work-immediately-on-self-financed-mine-but-hurdles-remain>

²³ Institute for Energy Economics and Financial Analysis (2017). “Adani: Remote Prospects – Carmichael Status Update 2017.”

²⁴ US\$40-60 per tonne on a Newcastle coal benchmark energy equivalent basis.

²⁵ Also see IEEFA’s financial analysis submitted to the Senate Environment and Communications Legislation Committee inquiry into the Galilee Basin (Coal Prohibition) Bill 2018 available at <https://www.aph.gov.au/DocumentStore.ashx?id=9758ab46-0ffb-4cb8-8cc6-18c83382cb50&subId=664930>

²⁶ Lloyd’s of London (2018). “Unearthing opportunity: Risk considerations for a new era of mining”. pg. 17.

ii) Social Licence to Operate

Societal factors are also relevant to understanding the project's overall risk profile. A recent mining report from Lloyd's emphasises the importance of having a social licence to operate ("SLTO"). An SLTO is described as *"the acceptance and permission granted by a local community to an organisation for it to mine the assets within the community's area of influence."*²⁷

A recent survey found that 65.1% of Australians either oppose or strongly oppose the Carmichael Coalmine.²⁸ In December 2018, thousands of protestors marched in major cities across Australia against the project.²⁹ The fact that Lloyd's has already received the Civil Society Letter on behalf of 73 NGOs also points to the scale of the controversy surrounding this project. News services such as Bloomberg have described the project as the *"world's most controversial coal mine"*.³⁰

At a more local level, the Carmichael Coalmine is set to be built on the lands of the Wangan and Jagalingou Traditional Owners. This group is opposing the project and is currently contesting a proposed Indigenous Land Use Agreement in the Federal Court of Australia.³¹ In addition, farming groups collected more than 120,000 signatures opposing the project due to its impact on water supplies.³² In December 2018, the Australian Conservation Foundation filed an application for judicial review of approvals for the project's water pipeline.³³

The contentious nature of the Carmichael Coalmine casts doubt on whether it has ever had a SLTO. According to the Lloyd's mining report, a failure to maintain a SLTO may have a significant impact on underwriters. For instance, civil unrest may result in physical damage and production stoppage for prolonged periods. Adani may subsequently seek to recover these losses from their insurers.

The Lloyd's mining report proposes that underwriters benchmark and measure a project's performance regarding its SLTO to safeguard against an avoidable claim pay-out. Accordingly, an analysis of the SLTO appears to be a vital part of any underwriting decision. We query whether the Lloyd's market has incorporated this recommendation into its own underwriting practices.

It is therefore questionable whether an effective risk-management system would permit the underwriting of the Carmichael Coalmine once all the relevant risks were accounted for. Given these challenges, a decision to underwrite the Carmichael Coalmine may indicate an inadequate risk-management system.

²⁷ Ibid. pg. 42.

²⁸ <https://www.smh.com.au/politics/federal/big-surge-in-opposition-to-adani-new-polling-reveals-20180131-p4yz4o.html>

²⁹ <https://www.theguardian.com/business/2018/dec/08/adani-thousands-protest-across-australia-against-carmichael-mine>.

³⁰ <https://www.bloomberg.com/news/articles/2018-12-18/the-world-s-most-controversial-coal-mine-is-set-to-break-ground>.

³¹ <http://wanganjagalingou.com.au/traditional-owners-continue-to-resist-adanis-invasion/>

³² <https://www.theguardian.com/environment/2017/jun/30/farmers-join-fight-against-adani-coalmine-over-environmental-concerns>;

<https://www.change.org/p/premier-annastacia-palaszczuk-rescind-adani-s-unlimited-water-license-and-support-australian-farmers>.

³³ https://www.acf.org.au/acf_challenge_water_trigger

Furthermore, where such activity amounts to a material risk, syndicates underwriting risky coal ventures such as the Carmichael Coalmine must disclose those risks in their SFCR. The involvement of syndicates in these types of project should also be disclosed in the Lloyd's SFCR where it constitutes a material risk.

Taking Action

We hereby put Lloyd's on notice of the financial risks associated with underwriting the Carmichael Coalmine. Should you or your syndicates fail to take these factors into account as part of your risk management processes, this may constitute a breach of your legal duties.

A number of the world's largest insurance companies have already explicitly refused to insure the Carmichael Coalmine, or have previously pledged not to provide insurance cover for new coal projects.³⁴

We therefore invite Lloyd's to make a public statement confirming:

- i) the criteria and implementation of its Coal Exclusion Policy;
- ii) the steps it has taken to assess and manage the financial risks associated with underwriting and investing in coal; and
- iii) its position on the underwriting of the Carmichael Coalmine by its syndicates.

If you would like to discuss the contents of this letter, please contact Joanne Etherton (jetherton@clientearth.org) or Stephanie Morton (smorton@clientearth.org).

Yours sincerely,

ClientEarth

³⁴ <https://unfriendcoal.com/worlds-biggest-insurers-will-not-cover-adani-groups-carmichael-coal-mine/>