Complaint to the FCA

Lancashire Holdings Limited
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1 Executive Summary

1. Lancashire Holdings Limited ("Lancashire") is a company providing insurance products through its operating subsidiaries. It is listed on the main market of the London Stock Exchange.

2. The purpose of this complaint (the "Complaint") is to bring two breaches of Lancashire’s legal duties to the attention of the Financial Conduct Authority ("FCA").

3. Climate change is a principal risk affecting the property and casualty insurance sector. Furthermore, Lancashire’s business model suggests it may be particularly vulnerable to certain climate change risks. An analysis of both the general and specific risks posed by climate change is presented in section (3) of this Complaint.

4. Lancashire is legally obliged to disclose the principal risks and uncertainties affecting its business in its annual report. A detailed discussion of the relevant legal provisions is given in section (4) of this Complaint.

5. Notwithstanding the above, Lancashire has failed to mention climate change in its annual report at all. As a result, it is in breach of its legal duties under DTR 1A.3.2 R and DTR 4.1.8 R of the Disclosure Guidance and Transparency Rules ("DTRs"). Details are given in section (5) of this Complaint.

6. Lancashire’s breach of its disclosure obligations has potentially detrimental implications for its shareholders. These implications are considered in section (6) of this Complaint.

7. The FCA is responsible for enforcing the provisions of the DTRs. Accordingly, ClientEarth requests that the FCA i) imposes a financial penalty in an amount it considers appropriate, and ii) requires Lancashire to publish information so as to rectify the deficiencies in its annual report.

8. In the alternative, ClientEarth requests that the FCA publicly censures Lancashire for its failure to meet its legal duties. These submissions are detailed in section (7) of this Complaint.
2 Factual Background

2.1 ClientEarth

9. ClientEarth is a non-profit environmental law organisation based in London, Brussels, Warsaw, and Beijing. ClientEarth’s Climate Finance initiative analyses the legal implications of climate change-related risk for a wide spectrum of market participants, including insurance companies and regulators. We also engage and conduct advocacy with these stakeholders in relation to the specific and systemic risks of climate change.

2.2 Lancashire Holdings Limited

10. Lancashire is a Bermuda incorporated company (Registered Company No. 37415) with operating subsidiaries in Bermuda and London, and two Syndicates at Lloyd’s of London. It provides global specialty insurance and reinsurance products, with a focus on five main business areas: property, energy, marine, aviation, and the Lloyd’s market.

11. Lancashire’s common shares were admitted to trading on the AIM in December 2005. On 16 March 2009, they moved up to the Official List and have a premium listing on the main market of the London Stock Exchange. Their shares have been included in the FTSE 250 index since 22 June 2009.

12. This Complaint relates to the annual report produced by Lancashire for the year ending 31 December 2017.

3 The Materiality of Climate Change

13. In order to understand whether Lancashire has a legal duty to report on climate change-related financial risks, it is first necessary to understand the nature and extent of those risks. This section therefore considers how climate change-related risks are material to i) property and casualty insurers generally, and ii) Lancashire specifically.

3.1 The Materiality of Climate Change-related Financial Risks to Property and Casualty Insurers

14. Over the last few years, there has been a growing awareness of the risks which climate change pose to the insurance sector.

15. The Prudential Regulatory Authority’s ("PRA") seminal paper, "The Impact of Climate Change on the UK Insurance Sector"\(^1\) published in September 2015 provided an overview of some of these risks. Notably, its analysis suggested that "there is potential for climate change to present a substantial challenge to the business model of insurers."\(^2\)

\(^2\) Ibid, pg. 5.
16. The paper categorised the challenges posed by climate change into physical, transition, and liability risks. This Complaint shall adopt the same terminology and includes a short summary of each category of risk below, plus an additional discussion of reputational risk.

17. Following these summaries, the recognition of these risks by financial regulators and the insurance sector shall be addressed.

3.1.1 Physical Risks

18. The Intergovernmental Panel on Climate Change ("IPCC") is the pre-eminent global scientific authority on climate change. The IPCC anticipates that the impacts of climate change will include:

   a. extreme precipitation events intensifying and becoming more frequent;

   b. a continued rise in global sea levels and increased coastal flooding; and

   c. more frequent heat waves which persist over longer durations, and increased prevalence of drought and wildfires.\(^3\)

19. The broad scientific consensus is that increasing global temperatures will have a significant impact on weather-related natural catastrophes, and will account for an increasing proportion of natural catastrophe losses.\(^4\)

20. The IPCC has identified key climate-related risks that span sectors and regions. An example is systemic risks arising from extreme weather events which lead to a breakdown of infrastructure networks and critical services.\(^5\)

21. All these risks are likely to lead to increased claims where they cause direct damage to insured property. Analysis by Swiss Re has shown that insured catastrophe losses have been increasing. Indeed, insured losses from catastrophes in 2017 were the highest on record at around $140 billion (£107 billion)\(^6,7\).

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\(^4\) Ibid.

\(^5\) Ibid pg. 65.

\(^6\) All GBP £ figures in this Complaint are approximate based on an exchange rate of 1 USD = 0.763487 GBP.

\(^7\) Swiss Re Institute (2018), sigma No 1/2018. "Natural Catastrophes and Man-Made Disasters in 2017: A Year of Record-Breaking Losses".
22. Relevantly, insured assets are becoming highly concentrated in urban areas.\(^8\) For these areas in particular, the IPCC states that:

"climate change is projected to increase risks for people, assets, economies and ecosystems, including risks from heat stress, storms and extreme precipitation, inland and coastal flooding, landslides, air pollution, drought, water scarcity, sea level rise and storm surges."\(^9\)

23. On this point, the Lloyds’ City Risk Index discusses the economic consequences of climate change for the cities in its index. It anticipates that climate events will cost those cities $122.98 billion (£93.85 billion) every year, and that this sum will grow as extreme weather events become more frequent and severe.\(^10\)

24. Recent weather events provide an insight into the magnitude of the problem. Lloyd’s of London estimated that the storm surge from Hurricane Sandy increased surge losses by 30% due to the 20 cm sea level rise since 1950.\(^11\)

25. Furthermore, we know that the storm surge from Hurricane Sandy contributed significantly to the overall insured losses. For residential claims, insured losses were roughly split between wind and flood damage. However, for commercial claims, approximately 65 – 70% of insured losses were caused by flood.\(^12\)

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\(^9\) IPCC (2014), pg 69.


\(^12\) Swiss Re Institute (2013), sigma No 2/2013. "Natural catastrophes and man-made disasters in 2012: A year of extreme weather events in the US".
26. The insured loss of Hurricane Sandy was reported as being $35 billion (£27 billion).\textsuperscript{13} A conservative estimate therefore suggests that sea level rise due to climate change increased insured losses by at least $5 billion (£4 billion). Swiss Re estimate that if sea levels rise by 0.25 metres by 2050, extreme flood losses will almost double as shown below.\textsuperscript{14}

![Graph showing insured losses and sea level rise](image)

Source: Swiss Re Institute (2018), sigma No 1/2018.

27. In the same vein, the Union of Concerned Scientists ("UCS") recently published a report which found that sea level rise will put billions of dollars of property at risk. Their analysis concludes that more than 300,000 of today’s homes and commercial properties in the coastal United States are at risk of chronic disruptive flooding within the next thirty years.\textsuperscript{15} The threat to coastal property has been recognised for decades. Television reports as far back as 1958 discuss the potential consequences of continued greenhouse gas emission on coastal cities in the United States such as Miami.\textsuperscript{16}

28. These combined impacts have profound consequences for insurers. Maurice Tulloch, the Chief Executive Officer International Insurance for Aviva, has remarked that "the exponential increase in risk exposure, in many global cities, is undermining large parts of our existing business model. The cost of extending sustainable insurance cover is now simply not affordable in many places. A proactive response is required."\textsuperscript{17}

29. However, climate change is not only likely to result in increased claims for property damage. Climate change will also impact supply chains, distribution networks, customers and markets.\textsuperscript{18}

\textsuperscript{13} Ibid.
\textsuperscript{14} Ibid, pg. 15.
\textsuperscript{15} Union of Concerned Scientists (2018). "Underwater: Rising Seas, Chronic Floods, and the Implications for US Coastal Real Estate".
\textsuperscript{17} ClimateWise (2017), pg 4.
\textsuperscript{18} European Bank for Reconstruction and Development (2018). "Advancing TCFD guidance on physical climate risks and opportunities."
30. Accordingly, the indirect effects of climate change could also lead to increased claims activity, e.g. business interruption claims due to extreme weather events. Given the global nature of the supply chain in many sectors, the impact could be profound.

31. In many cases, companies have a poor understanding of the exposure that their supply chains have to extreme weather events. Nick Wildgoose, the Global Supply Chain Product Leader of Zurich Insurance Group, states that:

“Most companies in our interconnected world depend fundamentally on their supply chain. There's hardly anybody running industry now that doesn't. And I'm afraid to say that many of these companies still fail to understand where their critical suppliers are, from an extreme-weather point of view.”

32. A recent example is the catastrophic flooding in Thailand during 2011. The floods gave rise to an estimated $12 billion (£9 billion) of claims, mostly for commercial properties and business interruption losses. The high losses were ascribed to a combination of the following factors:

a. Thailand’s role in the global manufacturing supply chain;

b. the scale of the affected areas;

c. a high concentration of property values;

d. high insurance penetration; and

e. insufficient pre-disaster preparedness.

33. Beyond an increase in claims activity, the physical risks from climate change may significantly impact the value of insurers’ investment portfolios.

34. For example, the value of real estate is expected to fall in flood-prone areas. The UCS considers that “the cliff’s edge of a real estate market deflation due to flooding and sea level rise is already visible for many communities.”

35. Furthermore, credit downgrades are anticipated for municipalities that do not engage in addressing climate change threats. Local governments are considered more likely to default where they suffer direct financial losses due to climate change and sea level rise, combined with a decreasing tax base resulting from water hazards.

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22 Union of Concerned Scientists (2018), pg 25.
36. When one also factors in the risk of business interruption on asset value, it is clear that both sides of insurers' balance sheets are vulnerable.

37. Climate change may result in downgrades to national bonds, municipal bonds and corporate bonds due to an increased likelihood of default. There may also be sharp reductions in the value of climate-vulnerable companies and real estate. Finally, climate change may significantly increase the risk of investments which are secured against real estate.

38. The correlation of these risks on both sides of the balance sheet only compounds the problem. The credit rating agency, Moody’s, considers that this correlation results in a negative credit impact for P&C (re)insurers. Their view is that “the property and casualty (P&C) insurance and reinsurance sector have significant exposure to the economic consequences of climate change.”

39. Consequently, the physical risks from climate change go to the heart of insurance. As ClimateWise have recognised, “growing physical risks driven by climate change and an increasing population vulnerable to these risks means insurers need to rethink the traditional insurance model”.

3.1.2 Transition Risks

40. The Paris Agreement entered into force in 2016 and set out a global action plan to curb dangerous climate change by holding increases in global average temperature to well below 2°C above pre-industrial levels, and to pursue efforts to limit the temperature increase to 1.5°C.

41. If the world is to achieve the objectives of the Paris Agreement, a significant shift in the trajectory of carbon emissions will be required. This transition to a low carbon economy could have a significant impact on the value of financial assets and their capital returns. These could result from policy changes, legal actions, technological changes, market responses, and reputational considerations.

42. Such a transition would result in a wealth of business opportunities for many sectors. However, it also poses serious challenges to certain sectors who do not or cannot adapt.

43. In particular, the fossil fuel industry faces significant stranded asset risks as a result of the transition to a low-carbon economy. Stranded assets can be defined as assets which become obsolete or non-performing, leading to premature write-downs, devaluation or conversion to liabilities.

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44. To put this into context, a study from University College London concluded that to have a 50% chance of limiting warming to 2°C, 33% of oil reserves, 50% of gas reserves, and 80% of coal reserves should remain unused.\textsuperscript{30} 31 Such assets are therefore especially vulnerable to being written off and becoming stranded assets.

45. The most striking example is that of coal. In recent years, US coal has been in drastic decline. Between 2008 and 2016, coal production fell by 38%. As a result, its share of energy generation in the US fell from 50% to 30% within the same period.\textsuperscript{32}

46. Financial analysts do not expect this picture to change, despite the actions of the Trump Administration, due to competitive pressure from natural gas and renewables.\textsuperscript{33} Carbon Tracker estimates that the total stranded asset value for US coal owners is $104 billion (£79 billion) for the period to 2035 under the International Energy Agency’s “Beyond 2°C Scenario”.\textsuperscript{34}

47. These issues are not unique to the US. Carbon Tracker has also found that 54% of operating coal capacity in Europe is cash flow negative today, increasing to 97% by 2030. This makes units reliant on lobbying to secure capacity market payments and avoid air pollution regulations.\textsuperscript{35}

48. However, the fossil fuel sector is not the only sector which is exposed to transition risks. Many other sectors may be significantly affected.

49. For instance, it is anticipated that the world’s biggest meat and dairy companies could surpass major fossil fuel companies as the largest climate polluters in the world within the next few decades. The top five meat and dairy corporations are already responsible for more annual greenhouse gas emissions than ExxonMobil, Shell or BP.\textsuperscript{36} This footprint exposes the sector to potential changes in policy, technology, and consumer preferences in much the same way as the fossil fuel industry.

50. Overall, research indicates that the combined exposure to sectors that could be affected by the climate and energy transition is about 45 – 47% of equity portfolios. However, the same research also concludes that climate-related risks tend not to be fully captured or priced in by current financial models, analyses, or recommendations.\textsuperscript{37}

51. As a result, the Bank of England has warned that "a wholesale reassessment of prospects, as climate-related risks are re-evaluated, could destabilise markets, spark a pro-cyclical


\textsuperscript{31} Indeed, this assessment may be conservative in light of the fact that the Paris Agreement in fact aims to keep global temperature increases “well below” 2°C, rather than simply limiting them to 2°C.


\textsuperscript{33} Ibid.


\textsuperscript{36} Institute for Agriculture & Trade Policy and GRAIN (2018). “Emissions impossible: How big meat and dairy are heating up the planet”.

\textsuperscript{37} Kepler Cheuvreux Transition Research (2018).
crystallisation of losses and lead to a persistent tightening of financial conditions: a climate Minsky moment. ³³⁸

52. It is often assumed that these risks are contingent on governments adopting Paris-compliant policies. However, a recent study concludes that this risk exists as a result of our current technological trajectory, regardless of whether new climate policies are adopted. Nevertheless, new climate policies may amplify the impact.³³⁹

53. Consequently, it is estimated that losses from stranded fossil fuel assets alone could amount to a discounted global wealth loss of $1 - $4 trillion (£0.8 - £3 trillion), with some regions being disproportionately affected.⁴⁰

54. The timeframe for these risks to crystallise is inherently uncertain and could be unexpectedly abrupt. A recent survey found that the fund management sector agreed that transition risk will significantly affect oil company valuations in the next five years, while 90% expected at least one risk to significantly impact valuation within two years.⁴¹ Climate change presents a short, medium and long-term risk.

55. Transition risks could again impact both sides of insurers’ balance sheets. First, they could reduce demand for insurance from carbon-intensive sectors. Second, it could detrimentally impact the value of insurers’ investment portfolios.

56. Partly as a response to concerns raised by the Bank of England, Lloyd’s of London released a report on how stranded asset risk may affect the assets and liabilities of the (re)insurance sector. Their view was that “physical environmental change and societal response to these changes could potentially strand entire regions and global industries within a very short timeframe, with direct and indirect impacts on international insurance markets.”⁴²

57. A recent analysis was also conducted by the California Department of Insurance with regard to insurers’ investments.

58. This revealed that Californian insurers were heavily exposed to the stranded asset risks associated with coal as their portfolios were consistent with a trajectory of six degrees of warming.⁴³ This over exposure is unlikely to be confined to Californian insurers, and insurers globally should be assessing and managing their exposure to high-risk sectors such as coal.

59. Accordingly, transition risks are therefore a material business risk for property and casualty insurers which must be identified, managed and disclosed to investors.

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⁴⁰ Ibid.
3.1.3 Liability Risks

60. If parties suffer losses as a result of climate-related risks, they may seek to recover those sums from those they allege are responsible. As a result, the insurance industry faces the prospect of increased third-party liability claims.

61. Although climate litigation is highly varied, the cases relevant to insurers can broadly be categorised as follows:

   a. Claims for failing to mitigate the impacts of climate change;

   b. Claims for failing to adapt to the impacts of climate change; and

   c. Claims for failing to disclose climate-related risks, or to comply with legislation or regulation.

62. A brief description of each category is given below by way of background. This is followed by a short explanation of the relevance of these claims to the insurance sector.

3.1.3.1 Claims for Failing to Mitigate the Impacts of Climate Change

63. An increasing number of claims are seeking to hold companies accountable for their contributions to climate change and its consequences. This growth is apparent not only in the number of cases, but also the number of jurisdictions in which climate litigation is being pursued.44

64. For example, a growing number of lawsuits have recently been filed by communities in the United States seeking compensation for the effects of climate change from fossil fuel companies. These include claims from the local governments of San Mateo, Marin and Imperial Beach in California for the projected impacts of sea level rise.45 While many of these claims have yet to be successful, this is not unusual in the early days of new liability issues, which often take time to gain traction.46

65. In part, this kind of litigation has been facilitated by research into the greenhouse gas emissions of major fossil fuel companies. Peer-reviewed research has found that nearly two-thirds of carbon dioxide emitted since the 1850s can be traced to the 90 largest fossil fuel and cement producers.47

66. Furthermore, it has been shown that more than half of global industrial greenhouse gases since 1988 can be traced to 25 fossil fuel producing entities.48 The data forming the basis for this research is collated and maintained in the Carbon Majors Database.49

49 See the Carbon Majors website at http://carbonmajors.org
67. Such data makes these companies clear targets for future litigation.

3.1.3.2 Claims for Failing to Adapt to the Impacts of Climate Change

68. Claims could also be brought against companies which suffer losses due to their failure to manage the physical and transition risks of climate change. These claims are likely to be highly varied given the broad range of physical and economic impacts which climate change is expected to cause.

69. The following examples give a flavour of the kinds of claim which could foreseeably arise:

   a. Professional indemnity claims against engineers for failing to account for the impact of rising sea levels on infrastructure projects.

   b. Derivative actions by shareholders against companies for losses which have resulted from a failure to strategically align with the Paris Agreement.

   c. Professional indemnity claims against professional advisers for failing to identify climate change risks during the due diligence stages of asset acquisition.

   d. Professional indemnity claims against investment consultants for losses arising from investment portfolios’ exposure to stranded assets.

   e. Derivative actions by shareholders against companies for failure to take reasonable steps to make its supply chains resilient to the physical impacts of climate change.

70. A current example of such a case is *Conversation Law Foundation v ExxonMobil* in connection with a marine distribution channel. The plaintiffs allege that ExxonMobil was aware that a significant rise in sea level would put the Everett Terminal at risk, but that no actions had been taken to protect the public or the environment.

71. Accordingly, the plaintiffs allege that ExxonMobil’s past or present handling, storage, treatment, transportation, or disposal of hazardous and solid waste might present an imminent or substantial endangerment to health or the environment.50

72. Hurricane Harvey gave rise to a similar case, when flooding resulted in a chemical plant in Texas exploding and burning for four days. This required the evacuation of local residents within a 1.5 mile radius and the hospitalisation of several emergency workers.

73. The incident led to a number of law suits against the owner of the facility on the basis that they ought to have been prepared for such an eventuality. In response, the US Chemical Safety Board released a report which found that the sector must improve its emergency management

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50 *Conservation Law Foundation v ExxonMobil Corp.* 1:16-cv-11950-MLW.
response, and assess how climate change affects the risk of future flooding for assets in flood prone areas.\textsuperscript{51}

74. Claims for failing to adapt to the impacts of climate change could be brought against the company, but also personally against its directors.\textsuperscript{52}

3.1.3.3 Claims for Failing to Disclose Climate-related Risks, or to Comply with Legislation or Regulation.

75. As this Complaint serves to illustrate, climate change can present a material business risk to companies. In many jurisdictions such as the United Kingdom, the law will require public disclosure of such risks. Furthermore, regulation in this area is rapidly evolving which may lead to more stringent disclosure requirements in due course.

76. If a company fails to disclose material business risks in line with its legal obligations, it may face regulatory penalties and/or claims from shareholders who have incurred losses as a result.\textsuperscript{53}

77. A recent example is given by \textit{Abrahams v Commonwealth Bank of Australia} where shareholders brought a claim against the bank for failing to disclose climate change-related business risks in its 2016 annual report.\textsuperscript{54}

3.1.3.4 Relevance to the Insurance Sector

78. The liability risks described above may impact insurance companies in two ways. First, they may lead to increased claims under liability policies. Second, such claims could be brought directly against an insurance company and/or its directors where that company has failed to disclose or adequately adapt to climate change risks.

79. Focusing on the former, an insurers' exposure will be determined by the degree to which its historic and existing policies provide coverage for climate change-related claims. Relevant lines of business may include commercial general liability, environmental liability, professional liability, product liability and directors’ and officers’ liability insurance.

80. In many cases, climate-related exposures may not have been considered when the coverage was written, and no premium collected for the climate change-related liability risks. Furthermore, it may not be clear from the policy wording whether climate-change related claims fall within the policy or not. For instance, climate change may not fit easily within the wording of certain pollution clauses.\textsuperscript{55}
81. Liability claims can be incredibly costly for the insurance industry. For example, Lloyd’s of London nearly collapsed as a result of asbestos claims in the 1980s. Furthermore, the long-tailed nature of these liabilities means it can take decades for the true cost to crystallise.56

82. The development of the litigation pattern thus far has significant parallels to asbestos claim liability development. Swiss Re has previously argued that they “expect climate change-related liability will develop more quickly than asbestos-related claims and believe the frequency and sustainability of climate change-related litigation could become a significant issue within the next couple of years.”57

83. It is clear that climate-related litigation is becoming increasingly common.58 Both scientific and legal developments mean this area could evolve quickly.59

84. If these claims increase in volume, the insurance industry is potentially exposed to significant losses. The duty to defend may result in mounting legal defence costs for insurance companies even where underlying claims are ultimately unsuccessful.

85. Disputes over coverage may further increase those costs. The case of AES v Steadfast provides an example where an insurance company sought a declaration that it had no duty to defend its insured in an underlying climate lawsuit.60

86. The insurers were ultimately successful because of law regarding the interpretation of policy triggering language that is unique to Virginia. However, it was necessary to go to the Virginia Supreme Court for a judgment.

87. The same policy litigated in a different national or subnational court could have the opposite outcome for the insurer if the legal precedent on the interpretation of policy triggering language differed. In such a situation, the insurer may be found to have a duty to defend its insured.

3.1.4 Reputational Risk

88. The role that the insurance industry plays in underwriting and financing the fossil fuel sector is coming under increased public scrutiny. Prominent civil society movements, such as the Unfriend Coal campaign, are insisting that insurance and reinsurance companies cease facilitating projects that fuel climate change. To date, this mounting pressure has led insurers to introduce a tide of new restrictions on their underwriting and investment activities.61

89. Unfriend Coal estimates that nearly half of the global reinsurance market has now divested from coal. Reinsurers such as Hannover Re, Swiss Re, Munich Re, SCOR, and Lloyd’s have all introduced divestment policies within the last year or two.62
90. Overall, seventeen (re)insurers are reported to have adopted divestment policies in respect of joint assets over $6 trillion (£4.5 trillion). Unfriend Coal estimates that $30 billion (£23 billion) has been withdrawn from the coal sector as a result.\textsuperscript{63}

91. With respect to underwriting, several (re)insurers have introduced policies to cease providing insurance cover for the construction and operation of coal mines and coal-fired power plants.

92. These developments are notable for several reasons:

a. First, insurers who remain engaged in such activities are likely to become targeted by campaigners which could result in direct reputational damage. As increasingly ambitious policies are adopted, laggards may find it challenging to justify their inaction.

b. Second, they are indicative of a growing movement away from activities and investments that are contrary to the aims of the Paris Agreement. For a large part, this can be seen as a response to reputational risk. As such, reputational pressure may be a key driver of the transition risks discussed in section 3.1.2 above.

3.1.5 Regulatory Recognition of the Risks posed by Climate Change

93. Given the substantial challenges detailed above, climate change is a rising priority on the regulatory agenda. The risks associated with climate change and their impacts have been noted by three of the major financial regulators in the United Kingdom: the Prudential Regulatory Authority, the Financial Conduct Authority, and the Financial Reporting Council. These are discussed in turn below.

3.1.5.1 The Prudential Regulatory Authority (PRA)

94. The PRA is responsible for the prudential regulation of financial institutions including insurance companies. Over the last few years, the PRA has been increasingly vocal about the financial risks posed by climate change.

95. Paul Fisher, then the Executive Director of Insurance Supervision at the PRA, identified some of the financial risks associated with climate change in a speech in early 2015. He commented that:

"Insurers, as long term investors, are also exposed to changes in public policy as this affects the investment side. One live risk right now is of insurers investing in assets that could be left ‘stranded’ by policy changes which limit the use of fossil fuels. As the world increasingly limits carbon emissions, and moves to alternative energy sources, investments in fossil fuels and related technologies – a growing financial market in recent decades – may take a huge hit. There are already a few specific examples of this having happened."

\textsuperscript{64}

\textsuperscript{63} Ibid.

\textsuperscript{64} Speech by Paul Fisher (2015), 'Confronting the challenges of tomorrow's world', 3 March 2015.
96. The governor of the Bank of England, Mark Carney, expanded on the financial stability risks associated with climate change in a speech at Lloyd’s of London in 2015. In this speech he discussed physical, transition and liability risks facing the insurance sector. Carney remarked that:

“In insurers are therefore amongst those with the greatest incentives to understand and tackle climate change in the short term. Your motives are sharpened by commercial concern as capitalists and by moral considerations as global citizens.”

97. At the same time, the PRA published its report on climate change and the insurance sector which explored the issues in greater detail. This was followed by a quarterly bulletin published by the Bank of England in 2017 which revisited these risks and their relevance to financial regulators.

98. Carney further addressed climate-change related risks at the International Climate Risk Conference for Supervisors in April 2018. In that speech, he spoke extensively about the impact of climate change on insurers.

99. Carney reiterated that insurers were on the “front line of the physical risks posed by climate change”. He also warned that insurers needed to be wary of cognitive dissonance whereby climate risks are ignored by insurers’ asset managers.

100. Furthermore, Carney emphasised that insurers will need to consider the longer-term impacts of climate change on their business models. Annual repricing and the withdrawal of coverage could only mitigate the risks to an extent.

101. The PRA is clearly aware of the systemic financial risks that climate change poses, and the particular vulnerabilities of the insurance sector. Notably, it has alluded to further regulatory scrutiny of climate change risks in the future with a focus on disclosure.

3.1.5.2 The Financial Conduct Authority (FCA)

102. The FCA has recently discussed climate change risks as part of its response to a Law Commission report on pension funds and social investment.

103. In its response, it confirmed that “the FCA consider that financially material ESG risks, including climate change risks, should be incorporated into investment decision making”.

104. While the comments are made in the context of pension funds, the investment challenges they face largely mirror those facing insurers. Both pension funds and insurers are vulnerable to

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68 Speech by Mark Carney (2018).
the physical and transition risks discussed above. Against that backdrop, the FCA’s comments are equally relevant to the present Complaint.

105. Furthermore, the FCA recently responded to the Environmental Audit Committee’s Green Finance report. They listed a number of proactive steps which they are taking with regard to climate change-related disclosures.

106. As part of this, the FCA stated it will “highlight to issuers the need to make adequate disclosures regarding materially important information, including information that allows investors to understand how ESG matters affect the valuation of a listed company’s securities and how these matters are managed by the company.”

107. It is ClientEarth’s submission that this Complaint represents an opportunity for the FCA to take action in line with its recent statement.

3.1.5.3 The Financial Reporting Council (FRC)

108. The FRC is responsible for monitoring corporate reporting and compliance with accounting requirements. Climate change has been a strong theme identified in the FRC's Annual Reviews of Corporate Reporting for both 2015/2016 and 2016/2017.

109. In the 2015/2016 Review, the FRC states that: "We encourage companies to consider a broad range of factors when determining the principal risks and uncertainties facing the business, for example cyber-crime and climate change."

110. In the 2016/2017 Review, the FRC stated that "we expect reference to be made to the impact of climate change where relevant for an understanding of the company’s activities."

111. In 2017, the FRC also published a draft of proposed amendments to their Guidance on the Strategic Report, which specifically highlights climate change as an example of the type of risk that entities should be considering.

112. This echoes the increasing importance that investors are placing on climate-related disclosures. Stephen Haddrill, CEO of the FRC, has written that investors have "expressed surprise that risks relating to data protection in IT system / cyber risks and risks from climate change are not reported more often as principal risks."

3.1.6 Sectoral Recognition of the Risks Posed by Climate Change

113. The Sustainable Insurance Forum ("SIF") has recognised that "climate change is one of the most serious long-term threats to the financial system. Insurance is one of the financial sub-sectors most exposed to climate-related risks, being potentially exposed on both sides of its

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72 Letter from David Geale, Director of Policy at the FCA, to Mary Creagh MP, Chair of the Environmental Audit Committee, dated 6 July 2018.
76 Letter from Stephen Haddrill to the Audit Committee Chairman dated 15 December 2015.
balance sheet.” This has been echoed in research with LeBlanc and Linkin identifying insurance as the “canary in the coal mine” for climate-related financial risks.

114. Importantly, SIF also warns insurance companies against “prematurely concluding that climate-related risks are not material based on a certain perception of their longer-term nature.”

115. As a result of the significance of climate change risks, SIF has been working with the International Association of Insurance Supervisors ("IAIS") to produce an "Issues Paper on Climate Change Risks to the Insurance Sector". The paper states that "physical and transition risks may pose different strategic, operational, and reputational risks to insurers across underwriting and investment business. While certain climate-related risk factors are long-term in nature, some are already having material impacts".

116. Some insurance companies have already made progress in recognising the material risks posed by climate change. This can be seen in the annual reports produced by other leading insurers.

117. For instance, AXA recognises in its annual report that "the consequences of climate change are expected to significantly impact the insurance industry, including with respect to risk perception, pricing and modelling assumptions, and the need for new insurance products, all of which may create unforeseen risks not currently known to us".

118. Thomas Buberl, the CEO of AXA, has further commented that "a +4°C world is not insurable". This drives home that insurers' business models may be fundamentally threatened by climate change.

119. Another example is provided in the annual report of Aviva. In describing their principal risks, they include "Climate change - potentially resulting in higher than expected weather-related claims (including business continuity claims) and inaccurate pricing of general insurance risk, as well as adversely impacting economic growth and investments markets. Trend - increasing. Risks impacted: General insurance risk, credit risk, market risk."

120. Steve Waygood of Aviva has commented that "Many scientists are saying that 4, 5, 6 degrees is at least a risk that we need to be considering. At 4 degrees the insurance business model fails to exist. We could not underwrite to the price that the economy can afford. At 6 degrees […] the present value of risk from 6 degrees change is £42 trillion. Of course, these are models

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but, in terms of the hazards that we would experience, we are talking about economic meltdown. 84

121. The insurance industry has been aware of these issues for some years. In 2006, a former CEO of Swiss Re, John Coomber, stated that “climate change is the number one risk in the world ahead of terrorism, demographic change, and other global risk scenarios.” 85 Indeed, in surveys conducted by PWC, insurance companies have consistently ranked climate change and natural catastrophes amongst the most significant risks. 86

122. These concerns were echoed in this year’s Global Risks Report published by the World Economic Forum. Their survey found both “natural disasters” and the “failure of climate-change mitigation and adaptation” ranked in the top 5 risks for likelihood and impact. 87

123. Research supports these conclusions, finding that “Climate change is influencing capital accumulation in the insurance industry by increasing the frequency and intensity of damage from extreme weather events, which threatens the availability and affordability of coverage and the ability to diversify risk across investment portfolios.” 88

124. The same research concludes that the majority of insurance companies do not integrate climate change into their risk management practices. Instead, they rely on their existing governance, underwriting and investment practices. Their approach is usually predicated on an assumption that annual adjustments to rates are sufficient to manage climate risk. They also rely on third-party vendor catastrophe models to determine premiums and reserves. 89

125. This is problematic as existing risk management frameworks are ill suited to managing climate risk which acts across an unprecedented range of temporal and geographical scales. In particular:

a. The majority of third-party catastrophe models do not expressly account for climate change. This is despite the fact that models can be conditioned to reflect possible future changes. 90 Rather, they rely on implicit climatic trends embedded in historical data. 91 Relying on this approach assumes that climate change will continue to increase gradually in line with historic trends.

Such assumptions are dangerous, especially since global weather patterns could mask the true impacts of climate change on historical data sets. Furthermore, there could be

86 See PWC “Insurance Banana Skins” series.
89 Ibid.
91 Lloyd’s of London (2014).
abrupt shifts in climate change once tipping points are surpassed which such models are blind to.\textsuperscript{92}

This is echoed by some of the major insurers. According to Iwan Stalder, Zurich's Head of Global Cat Management, "It's important that we look at the risk beyond the historical record. If we believe nothing worse can happen than what we have seen so far, we will miss the worst event." He adds that "the historical record is a good starting point, but for [natural catastrophe modelling] it is not enough."\textsuperscript{93}

b. Relying on annual rate adjustments involves similar assumptions of gradual, manageable changes in climate. For the reasons stated above, this assumption is questionable. It also ignores the spectre of assets being rendered uninsurable if risks become too great. Premiums can only increase so much before a line of business becomes unviable. Furthermore, endlessly increasing premiums may not be feasible where governments intervene.

c. Finally, it is unclear whether the existing risk management approach acknowledges the degree to which climate risks are correlated. A significant increase in natural catastrophe and liability pay outs could be more difficult to meet if stranded asset risks are concurrently materialising in insurers' investment portfolios.

In light of the above, it is clear that climate change poses challenges beyond the traditional risks often identified by insurance companies. It is therefore imperative that insurance companies disclose these risks to their shareholders and explain how they are being managed. Indeed, SIF has recognised the "critical importance" of adequate climate disclosure.\textsuperscript{94}

A framework for disclosing climate-related financial risks was published by the Task Force on Climate-related Financial Disclosures in June 2017.\textsuperscript{95} This recommended framework was accompanied by sector-specific supplemental guidance on implementation for the insurance industry.\textsuperscript{96} Accordingly, there are existing sources of advice on how material climate-related risks should be disclosed.

### 3.2 Additional Material Climate-risk Factors Applicable to Lancashire

The previous section gave an overview of the challenge which climate change poses to property and casualty insurers generally. However, climate change is likely to impact insurance companies differently depending on their business models. This section provides some additional examples of how Lancashire may be particularly vulnerable to climate change.

\textsuperscript{92} For instance, see Alley et al. (2003). “Abrupt climate change” Science, 299, 2005 – 2010, and American Association for the Advancement of Science.

\textsuperscript{93} See https://www.bloomberg.com/news/sponsors/zurich/interconnected-risks-put-global-businesses-in-path-of-extreme-weather-events/?adid=6712&px_t=1LgDAAAAAAAFENA

\textsuperscript{94} Sustainable Insurance Forum (2017).

\textsuperscript{95} Task-Force on Climate-related Financial Disclosures (2017).

3.2.1 Business-wide

129. Lancashire has previously identified that "Changes in sea levels leading to greater flooding and storm surge losses, changes in extreme drought/ precipitation patterns causing crop insurance losses and increased frequency or severity of weather related losses such as hurricanes, cyclones, tornadoes, storms and floods can directly impact Lancashire’s expected profitability and ultimately capital and business model."

130. They rated the magnitude of the impact as "high" and estimated that "An increase in potential catastrophe losses could decrease our annual expected profit and increase capital requirements".

131. Lancashire has also previously identified the following climate-related risk: "The insurance industry as a whole and Lancashire specifically could suffer a loss of reputation if unable to respond to client needs based on inability to respond to or predict changing business needs for risk mitigation, which in turn could lead to loss of shareholder value."

132. Again, the magnitude of impact was rated as "high".97

3.2.2 Property

133. Property insurance accounts for 33.5% of Lancashire’s business by gross premiums written. Lancashire acknowledges that its property business is exposed to large natural catastrophe losses.98 This makes it particularly susceptible to the physical climate change risks detailed above.

134. In addition, Lancashire provides property reinsurance. Reinsurance has been found to be "disproportionately exposed to climate-change risk"99 as it covers infrequent events which cause significant losses.

135. Furthermore, it relies on geographical spread to diversify risk. Given that climate change is a global problem, such geographical diversification presents a challenge. Accordingly, mitigation of and adaptation to climate change is more important for reinsurers.100

3.2.3 Energy

136. A significant proportion of Lancashire’s gross written premiums derive from insuring energy risks.101 This business is potentially exposed to all three categories of climate risk discussed above: physical, transition, and liability.

101 See Lancashire Annual Report 2017, pg. 5.
137. Where policies include cover for physical damage, energy installations are vulnerable to the same kinds of extreme weather events as any other property. This may be exacerbated where policies include cover for business interruption losses.

138. In addition, the demand for insurance is likely to be closely connected to the demand for fossil fuels. A relationship between oil price and demand is acknowledged on page 22 of Lancashire’s annual report. Accordingly, a transition to a low-carbon economy could lead to substantially reduced demand for Lancashire’s products.

139. In its 2017 CDP report, Lancashire identifies general environmental regulations, including planning, as a risk driver. They write that “This has its principal effect in relation to Lancashire’s policyholders, certain of whom may be heavily affected by changes in environmental licensing and regulation which could impact their business and their requirement for the insurance products sold by Lancashire.”

140. Furthermore, they write that “It is possible that our energy clients could face restrictions on their operations pursuant to legislation arising from concerns on GHGs.”

141. They acknowledge that there is a “Possibility of reduced income if energy clients faced restrictions on their operations.”

142. Finally, Lancashire’s energy liability business means the group may have particular exposures to the increasing climate litigation discussed in section 3.1.3 above.

4 The Law

143. The Transparency Directive103 was issued on 15 December 2004 and revised in 2013. Its purpose is to increase transparency and promote the flow of information to market participants in order to enhance investor protection and market efficiency.

144. According to the preamble, ”the disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an informed assessment of their business performance assets.”

145. The section of the FCA Handbook which relates to the implementation of the Transparency Directive in the United Kingdom is the Disclosure Guidance and Transparency Rules (“DTRs”). The three provisions of the DTRs which are relevant to this Complaint are set out below.

   a. DTR 1A.3.2 R states that “an issuer must take all reasonable care to ensure that any information it notifies to a [Regulatory Information Service] is not misleading, false or deceptive and does not omit anything likely to affect the import of the information.”

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103 See Lancashire CDP Report from 2017 available at https://www.cdp.net/en
104 Directive 2004/109/EC
102 Paragraph (1) of Directive 2004/109/EC
b. DTR 4.1.5 R states that "an issuer’s financial report must include:… (2) a management report…"

c. In turn, DTR 4.1.8 R states that "the management report must contain: … (2) a description of the principal risks and uncertainties facing the issuer" (emphasis added).

146. The DTRs do not provide a definition of the term "principal risks and uncertainties". However, these requirements appear to be synonymous with section 414C(2)(b) of the Companies Act 2006 which requires companies to disclose “a description of the principal risks and uncertainties facing the company” in the “strategic report”.

147. On that basis, we can look to secondary sources for guidance on the term "principal risks and uncertainties". In 2014, the FRC published its Guidance on the Strategic Report ("FRC Guidance").

148. This guidance is described by the FRC as being persuasive although not mandatory. As such, the following paragraphs of the FRC Guidance provide an authoritative indication as to what constitutes a principal risk or uncertainty.

a. Paragraph 5.1 states that "Information is material if its omission or misrepresentation could influence the economic decisions shareholders take on the basis of the annual report as a whole."

b. Paragraph 5.3 states that "Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the actual or potential effect of the matter to which the information relates in the context of an entity’s annual report. It requires directors to apply judgement based on their assessment of the relative importance of the matter to the entity’s development, performance, position or future prospects."

c. Paragraph 5.4 states that: "Materiality in the context of the strategic report will depend on the nature of the matter and magnitude of its effect, judged in the particular circumstances of the case."

d. Paragraph 5.7 states that "the terms ‘key’ … and ‘principal’ … refer to facts or circumstances that are (or should be) considered material to a shareholder’s understanding of the development, performance, position or future prospects of the business."

e. Paragraph 7.24 states that "The risks and uncertainties included in the strategic report should be limited to those considered by the entity’s management to be material to the development, performance, position or future prospects of the entity."

f. Paragraph 7.25 states that "Directors should consider the full range of business risks, including both those that are financial in nature and those that are non-financial. Principal risks should be disclosed and described irrespective of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control."
149. In light of this guidance, it is ClientEarth’s submission that:

a. in order to satisfy DTR 4.1.8 R, the management report must include a description of all the principal risks and uncertainties facing the company;

b. for the purpose of DTR 4.1.8 R, ‘principal risks and uncertainties facing the company’ means facts or circumstances that are (or should be) considered material to a shareholder’s understanding of the development, performance, position or future prospects of the business;

c. for the purpose of DTR 4.1.8 R, ‘material’ facts or circumstances are facts or circumstances which a reasonable director in the position of Lancashire’s directors would identify and consider could influence the economic decisions shareholders take on the basis of the annual report as a whole.

150. It was shown in section (3) above that climate change-related risks are material to Lancashire. Furthermore, a reasonable director of a FTSE 250 property and casualty insurer should be aware of these risks given that UK financial regulators have repeatedly flagged climate change-related risks since 2015. Accordingly, Lancashire must disclose material climate change-related risks in their annual report.

5 Lancashire’s Breach of its Legal Duties

151. The discussion in section (3) of this Complaint made it clear that climate change poses a material risk to the insurance sector. In addition, Lancashire’s business model comprises numerous elements which are particularly susceptible to climate risks.

152. In accordance with the laws set out in section (4) of this Complaint, Lancashire has a legal duty to disclose the principal risks and uncertainties facing its business.

153. Despite this, Lancashire makes no reference to climate change in its annual report.

154. Lancashire is therefore in breach of DTR 4.1.8 R as it has failed to disclose a principal risk and uncertainty affecting its business. (Breach 1)

155. Consequently, Lancashire is also in breach of DTR 1A.3.2 R for omitting information which is likely to affect the import of the annual report. (Breach 2)

6 Implications of Lancashire’s Breach

156. The annual report is a key resource which enables investors to assess the nature and value of a particular business. Failure to adequately disclose principal risks may therefore hamper investors’ ability to make an informed assessment.

157. This is particularly relevant where a risk may have negatively impacted a company’s financial performance.
158. By way of example, Lancashire reported losses of $171.5 million (£131 million) in connection to hurricanes Harvey, Irma, Maria and the California wildfires in 2017. Both hurricanes and wildfires are events which are likely to become more frequent and intense as a result of climate change.

159. Historically, the role of climate change in individual events has been difficult to quantify. To meet this challenge, a new field of scientific research has been rapidly developing. Probabilistic event attribution science aims to determine the degree to which anthropogenic climate change has altered the probability or intensity of a particular weather event or events.

160. A recent study concluded that human-induced climate change likely increased Hurricane Harvey’s total rainfall by at least 19%. Lancashire reported losses of $47.8 million (£36.5 million) arising out of Hurricane Harvey.

161. A rudimentary analysis would therefore suggest that $9 million (£7 million) of Lancashire’s losses may have been directly attributable to the effects of climate change on Hurricane Harvey. That figure alone would account for over 10% of Lancashire’s annual losses after tax.

162. If one was to carry out a similar exercise in connection with Hurricane Maria, Hurricane Irma and the California wildfires, there is a real possibility of finding that climate change has made a direct and substantial contribution to Lancashire’s losses during 2017.

163. Lancashire’s failure to discuss climate change-related risks may therefore leave investors blind to these financial risks.

7 Request to the FCA

164. The FCA has the following powers under section 91(1ZA) of the Financial Services and Markets Act 2000 (“FSMA”):

“If the FCA considers that -

(a) an issuer who has requested or approved the admission of a financial instrument to trading on a regulated market,

(b) a person discharging managerial responsibilities within such an issuer, or

(c) a person connected with such a person discharging managerial responsibilities,


IPCC (2014).


has contravened any provision of disclosure rules, it may impose on him a penalty of such amount as it considers appropriate."

165. Furthermore, the FCA may take the following measures under LR 1.3.2 R of the Listing Rules:

(1) “The FCA may, at any time, require an issuer to publish such information in such form and within such time limits as it considers appropriate to protect investors or to ensure the smooth operation of the market. [Note: Article 16.2 CARD]

(2) If an issuer fails to comply with a requirement under paragraph (1) the FCA may itself publish the information (after giving the issuer an opportunity to make representations as to why it should not be published). [Note: Article 16.2 CARD]"

166. In light of the legal breaches detailed above, ClientEarth requests that the FCA:

a. imposes a financial penalty on Lancashire in an amount it considers appropriate; and

b. requires Lancashire to publish information so as to rectify the above-referenced deficiencies in its annual report.

167. These steps are vital to ensure that investors have adequate information on Lancashire’s exposure to climate change-related risks. For the reasons given above, it is important that the information in the public domain is both accurate, and legally compliant.

168. In the alternative, ClientEarth requests that the FCA publishes a statement censuring Lancashire in accordance with section 91(3) of FSMA.

169. Again, a public statement of this nature would put investors on notice that the information in Lancashire’s annual report does not adhere to the standards required by law.

170. Please do not hesitate to contact us if we can be of any further assistance in relation to this complaint.
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ClientEarth is funded by the generous support of philanthropic foundations, institutional donors and engaged individuals.

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