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COAL DIVESTMENT AND THE CALIFORNIA INSURANCE INDUSTRY

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INTRODUCTION

California voters in 1988 dramatically expanded the power of the state Department of Insurance and turned the insurance commissioner post into an elected position. It also gave the commissioner unprecedented authority to prescribe which specific factors private insurance companies may use in crafting rates. The department already had the duty to monitor domestic companies' financial solvency, in line with government's traditional role in insurance to make sure companies have the wherewithal to pay their claims. Without this oversight, consumers face the risk of paying premiums without getting promised benefits in return.

Current California Insurance Commissioner Dave Jones, a former Democratic Assemblyman who was first elected to the post in 2010, has in recent months been accused of "bootstrapping" that reasonable authority into something much broader and more political. Nominally toward the goal of assuring insurance-company investments are sufficiently safe to ensure the companies' long-term fiscal health, Jones has called for any insurers who write business in California to divest "voluntarily" from the bulk of their thermal-coal investments. He further has vowed to publicize the names of companies that don't comply with this "voluntary" order, he noted in a January 2016 statement,[1] "so that investors, policyholders, regulators and the general public can know the extent to which insurance companies are invested in the carbon economy.

California's "Climate Risk Carbon Initiative" divestment request applies to direct investments – whether in the form of equity or fixed-income securities, like bonds – in companies that gain more than 30 percent of their revenues from thermal coal and to utilities that generate at least 30 percent of their energy from coal. It also requires insurance companies that do business in the state – even if they are domiciled elsewhere – to answer a variety of questions about such investments.

This data call will "evaluate the industry exposure as well as potential financial impact upon insurers as the (California Department of Insurance) performs its financial analysis and conducts financial examinations." This will include "in-depth analysis and the valuation of the potential risk associated with these investments."[2]

An obvious question is raised as to whether this prescription really is about assuring the solvency of some of the most stable and conservative companies in the nation, or whether it serves primarily as an opportunity for an ambitious politician to champion a high-profile issue for long-term political gain. In announcing his recommendation, the commissioner described his rationale:

1. Dave Jones, "California Insurance Commissioner Dave Jones calls for insurance divestment from coal," California Department of Insurance, Jan. 25, 2016. http://www.insurance.ca.gov/0400-news/0100-press-releases/2016/statement010-16.cfm

2. Dave Jones, "Climate Risk Carbon Initiative," California Department of Insurance. http://www.insurance.ca.gov/0250-insurers/0300-insurers/0100-applications/ci/

> As utilities decrease their use of coal and other carbon fuel sources, as states like California limit the ability of the private sector to use coal and other carbon fuels for power generation and require their pension funds to divest from coal, as states like California and the United States impose more stringent air quality requirements which limit the ability to burn coal and other carbon fuels, and as nations across the world begin to implement the commitments they made to reduce their use of carbon at the recent United Nations COP21 Climate Summit in Paris, investments in coal and the carbon economy run the risk of becoming a stranded asset of diminishing value.[3]

Jones also cited his "statutory responsibility to make sure that insurance companies address potential financial risks in the reserves they hold to pay future claims." But critics say the commissioner, who attended the Paris climate summit, is far afield from what the statute requires and deny that it gives him this expanded authority. Indeed, some question whether the recommendation itself might not needlessly create financial jitters by implying that stable companies have potential solvency issues. While regulations have made it harder to burn carbon-based fuels, and likely will grow more stringent in the future, such information already is broadly shared by investors and priced into the securities of affected industries that insurers might hold.

This isn't the first time a politically ambitious California insurance regulator has sought to justify a divestment plan. While then-Insurance Commissioner Steve Poizner, a Republican, was running for governor in 2010, he floated a plan to force all insurers who operate in California to divest investments in any multinational companies that do business in Iran, deemed a sponsor of terrorism. After backing away, he declared "no investments that an insurer holds in any of those companies will be recognized on its financial statements in California."[4]

Some Iran-related disclosure rules are still on the books, even though the Obama administration has taken a somewhat different approach toward the Iranian regime. Such shifts in policy reinforce one of the key problems insurers have with divestment measures.

As is often the case, California is pioneering new ground with Jones' policy. No other state has adopted it. It does, however, have a sympathetic audience in Washington State and among some members of the National Association of Insurance Commissioners, which has for several years debated whether to demand climate-risk surveys from insurers. As *Insurance Journal* explained in May 2016:

> (Mike) Kreidler, the nation's longest-serving insurance commissioner, chairs the National Association of Insurance Commissioners Climate Change and Global Working Group. He has for the past few years been calling out the insurance industry for being unprepared for climate change and has said insurers are not taking climate change seriously enough.[5]

He and Jones have been the two leading voices for voluntary divestment.

INSURERS' INVESTMENT DECISIONS

Insurers typically make conservative investment decisions. While the impression conveyed by Jones and other advocates of divestment is that insurers hold the stocks of lots and lots of fossil-fuel companies, in fact, taken as a whole, insurers generally hold very few stocks at all. Insurers are overwhelmingly invested in bonds, and the distinction is crucial. Concerns about "stranded assets" are directly relevant to shareholders, whose equity represents a stake in the assets of the companies they hold; they aren't necessarily all that relevant to bondholders.

Whether a company in which an insurer invests is doing well or doing poorly often will affect its stock price. But in either scenario, it still has to pay its debts. How well-positioned a company is to do that is reflected in its credit rating, and insurers mostly hold bonds with the highest ratings – AA+ or AAA. Also relevant is a bond's "maturity" – that is, how long the company has to repay the bondholder. Longer-maturity instruments have higher risks, which means they pay higher interest rates, because any number of unforeseen events may transpire over a long time horizon. Shorter-maturity bonds are generally considered very low risk, and they pay very low interest rates.

In the extreme scenario that a company does go completely broke, by definition, holders of that companies' stock see their investments fall to zero. That isn't necessarily the case with holders of a companies' bonds. Those debts, just like all others the company had, will be resolved through a bankruptcy process. The debt may be restructured, and the bondholder may not get back 100 percent of their investment, but they also are unlikely to walk away with nothing.

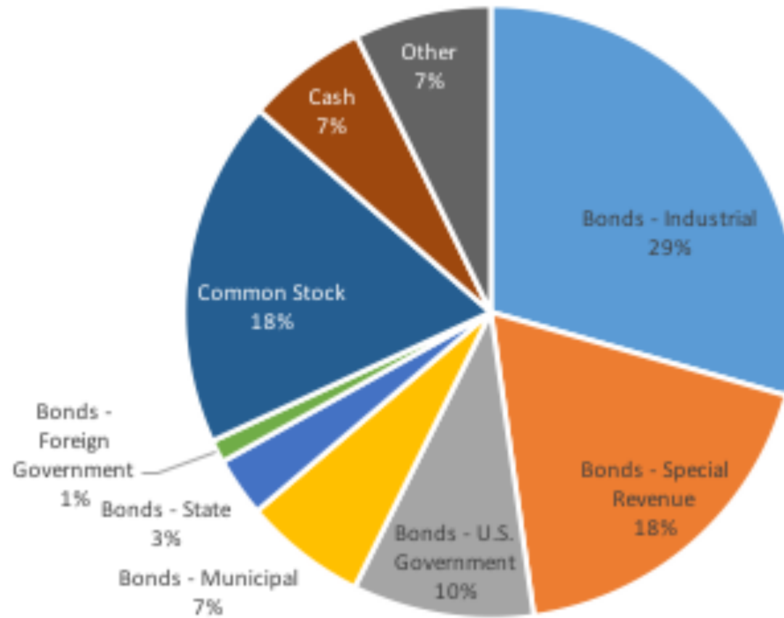
Because their claims may be particularly volatile from year-to-year, property/casualty insurers must be especially conservative in their investment portfolios, with very

3. Ibid.

4. Steven Greenhut, "Poizner's base motive on Iran," Orange County Register, Feb. 14, 2010. http://www.ocregister.com/articles/insurance-234093-iran-poizner.html

5. Don Jergler, "What University of Washington's Climate Risk and Insurance Summit has in common with Paris," Insurance Journal, May 26, 2016. http://www.insurancejournal.com/news/national/2016/05/26/410050.htm

FIGURE I: PORTFOLIO OF U.S. PROPERTY/CASUALTY INSURERS



SOURCE: S&P Global Market Intelligence

safe instruments that can be liquidated at any time. Data from S&P Global Market Intelligence on the $1.36 trillion in investments held by the U.S. property/casualty sector in unaffiliated assets at year-end 2015 shows that 68 percent were in bonds (mostly, various kinds of government bonds), with 18 percent in common stock. As seen in Figure 1, the sector also kept 7 percent of its assets in cash or cash equivalents, like money-market mutual funds.

Life-insurance companies have more regular and predictable claims costs, which allows them somewhat more flexibility in investments. Nonetheless, life insurers must make investments that are sound for decades, because of the long-term payout promises made to policyholders. Like property/casualty insurers, life insurers are overwhelmingly invested in bonds, holding hardly any common stock at all. The biggest difference between the two sectors' investment mixes is that life insurers are less invested in government-issued securities and have more freedom to purchase longer-dated instruments. According to data from S&P Global Market Intelligence, where 52 percent of the bonds U.S. property/casualty insurers held at year-end 2015 had maturities of five years or less, for life insurers, the number is just 32 percent. Just 5 percent of property/casualty insurers' bonds had maturities of 20 years or more, whereas, for life insurers, the number was 21 percent. Life insurers also make loans and play a particularly significant role as commercial real-estate lenders. The 2015 breakdown of life insurers' $3.55 trillion of investments in unaffiliated assets can be seen in Figure 2.

Most crucially, the investment time horizon for insurers of all types is, by necessity, far more enduring than the political winds blowing at any time. In 2010, Iran was much more of a headline issue than it is now, whereas in 2016, coal divestment is a bigger deal in the insurance world. Who knows what lies in store, politically, for the next commissioner?

A QUESTION OF SOLVENCY

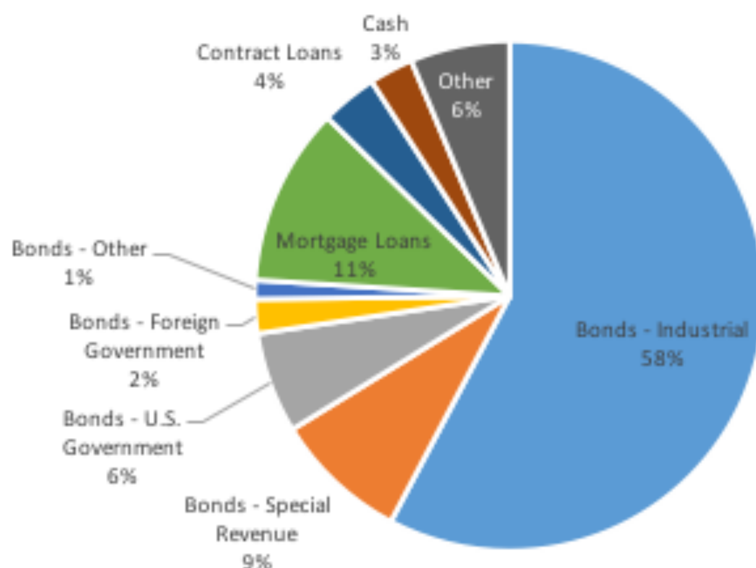
In his January statement, Jones based his argument for divestment from fossil-fuel interests on concerns about insurer solvency:

> The movement away from coal and the rest of the carbon economy poses a potential financial risk to insurance companies investing in coal and the carbon economy. The potential risk of continuing such investments is that they lose value over time or that they lose value quickly. In either case, such investments pose a potential financial risk to those who invest in them.[6]

Jones' argument was bolstered by a report by Ceres, which describes itself as a "nonprofit sustainability advocacy group." A 2014 report from Ceres looked at myriad insurers across all three sectors, which together make up 87 percent of the U.S.

6. Dave Jones, "California Insurance Commissioner Dave Jones calls for insurance divestment from coal," California Department of Insurance, Jan. 25, 2016. http://www.insurance.ca.gov/0400-news/0100-press-releases/2016/statement010-16.cfm

FIGURE 2: PORTFOLIO OF U.S. LIFE INSURERS



SOURCE: S&P Global Market Intelligence

market.[7] The report was not about coal divestment, specifically, but its forward by Commissioner Kreidler reiterated his concerns that insurance companies haven't done enough to prepare for climate change. A July 2016 study by the Global Risk Institute likewise calls for insurers to shift investments toward more environmentally friendly industries.

A June 2016 report published jointly by Ceres and the Mercer consulting firm took on the "dirty energy" issue more directly.[8] The report raised the concept of "carbon-asset risk." To meet the terms of the Paris Agreement, fossil-fuel companies may be forced to leave "a significant quantity of the world's fossil fuels in the ground," it explained. This regulatory situation poses financial risks to companies that have invested in assets that could be left in the ground and infrastructure that could be left to rot.

The report's conclusions at first sound alarming: "Cumulatively, the insurance groups analyzed owned investments of nearly a half-trillion dollars ($459 billion) in oil and gas, and electric/gas utilities at the end of 2014 – an amount roughly equal to the GDP of Norway."[9]

While that total may well be equivalent to the nation with the 28th highest gross domestic product in the world, it also represents less than 10 percent of the cumulative $4.91 trillion of assets in unaffiliated investments of the combined life and property/casualty sectors. The report found that coal companies represented only small portion of the 40 insurance groups' bond and equity holdings – $1.8 billion as of Dec. 31, 2014. Moreover, insurers' alternative energy investments, including renewables were significantly greater than their coal holdings.[10]

While Ceres and Mercer were looking only at insurers' investments in coal producers, S&P Global Market Intelligence ran the numbers earlier this year specifically on the question Jones says he's trying to answer.[11] The insurance data firm found that, among all life insurers that do any business in California, the fair value of the sector's holdings in coal-related firms totaled $58.49 billion, including $810 million in coal producers and $57.68 billion in generators who derived more than 50 percent of their power from coal. Among property/casualty insurers, there were $7.42 billion of investments, with $7.33 billion in generators and $90 million in producers. The life insurer with the biggest footprint was TIAA-CREF, whose $4.9 billion of coal-related investments constituted 1.76 percent of its net total assets. The property/casualty insurer with the largest coal investments was Travelers Cos., whose $600 million represented 0.79 percent of its net total assets.

7. Ceres, "Insurer Climate Risk Disclosure Report & Scorecard: 2014 Findings & Recommendations," 2014. https://www.munichre.com/site/mram/get/documents_E172407602/mram/assetpool.mr_america/PDFs/5_Press_News/News/Ceres_InsRiskDisclosureSurvey_102014.pdf

8. Ceres and Mercer, "Assets or Liabilities? Fossil Fuel Investments of Leading U.S. Insurers," June 2016. https://www.ceres.org/resources/reports/assets-or-liabilities-fossil-fuel-investments-of-leading-u.s.-insurers/view

9. Ibid.

10. Ibid.

11. Garrett Devine, "Drop it like it's hot: Calif. insurers asked to drop thermal coal, over $65B in holdings," S&P Global Market Intelligence, Feb. 16. 2016. https://www.snl.com/web/client?auth=inherit#news/article?id=35306580&KPLT=6&s_data=si%3D10%26kpa%3D8a66c9ac-7fae-4e1a-a1d6-4f0af8f277a4%26sa%3D

TABLE I: COAL INVESTMENTS BY INSURERS THAT DO BUSINESS IN CALIFORNIA

Sector	Investments ($B)			Proportion of assets (%)	
	Generators	Producers	Total	Invested assets	Total assets
Life	57.68	0.81	58.49	1.59	0.94
P&C	7.33	0.09	7.42	0.49	0.41

SOURCE: S&P Global Market Intelligence

The breakdown by sector can be found in Table 1. As the table makes clear, even including power generators that rely extensively on coal, these investments constitute less than 1 percent of the assets of life insurers that do business in California and less than half of 1 percent for property/casualty insurers that do. There is no way they constitute a solvency threat to the industry. And the data already is available, both by company and in the aggregate, to investors who seek it out.

Certainly, the Ceres/Mercer report raises an issue that should be, and already is, a concern to insurers, which have a fiduciary responsibility both to make sound investments and to price their products properly to assure ongoing solvency. But despite its use to champion the divestment call, the report's main conclusions are something of a yawner: "It is crucial that insurers, industry regulators and market oversight bodies work together to keep abreast of these emerging investment risks to ensure that they are appropriately managed."[12] It's a safe bet no one in the insurance industry would object to that suggestion.

INSURER RISK ANALYSIS

The main objection to the rules is obvious: insurance companies already are skilled at analyzing risk. It's difficult to predict the future, but there's no question private firms – investing their own dollars, in the hopes of remaining profitable and solvent well into the future – have a better track record than government officials, especially ones touting a shorter-term political agenda. As noted earlier, the "stranded asset" risks already are widely known and factored into the value of the investments.

Also keep in mind that insurance-company solvency involves many factors beyond investment income. Their rate structures, mortality expectations, promised benefits and so forth are far more important than a small percentage of their investments. Insurers have question why the California Department of Insurance has become so fixated on the latter part of the equation.

If the true goal were to protect insurer solvency, then why focus solely on coal? Other investments might certainly have questionable futures or even presents. As my R Street Institute colleague R.J. Lehmann wrote shortly after the Jones announcement:

> One can't help but notice that he obviously is not calling for divestment from the alternative energy sector. Yet alternative energy is one of the riskiest investment markets around. So much so that the industry site Greentech Media publishes an annual list of solar company failures and has noted that '(k)eeping track of failing solar companies in 2011 and 2012 bordered on full-time work.'[13]

Insurers are in something of a bind when it comes to rebutting any insurance commissioner. The commissioner has so much authority over insurers that they rightly fear retribution when it comes to, for example, rate hike requests. So while the commissioner and his supporters say the divestment request is voluntary, it's easy to see why insurance companies might believe there is some duress involved.

Like all institutional investors, insurers have fiduciary responsibilities. All insurers are responsible, first and foremost, to ensure that investments are appropriately matched to the nature of the contract risks they support. Mutual insurers have duties to policyholder members. Publicly traded insurers have further duties to shareholders to maximize revenues. Bailing out of lucrative, safe and/or appropriately matched investments because of political pressure would threaten an insurer's ability to uphold these duties. For life insurers, in particular, liquidating bonds with longer-dated maturities (again, the life sector holds only a negligible amount of common stock) could imperil the long-term commitments to which they've agreed. In a statement provided to R Street, the department explained:

> Although the request for voluntary divestment applies to all securities, including fixed income investments and debt instruments with fixed returns and laddered maturity dates, the commissioner recognizes that companies will have to weigh the potential and magnitude of any losses associated with immediate divestment of fixed return assets with the potential greater risk of loss associated with continued holdings in thermal coal investments.

Insurance regulators often push insurers to offer the lowest-possible rates and broadest number of products. But limiting their ability to earn market returns on investments in the

12. Ibid.

13. R.J. Lehmann, "Jones' coal divestment call is irresponsible, blatantly political," Insurance Journal, Jan. 25, 2016. http://www.insurancejournal.com/blogs/right-street/2016/01/25/396284.htm

service of “social” goals works against those ends. California currently is enjoying a period of relatively low insurance rates, notably in the politically volatile markets of personal lines home and auto coverage. But if rates start to soar, it will be interesting to see which of these two incompatible objectives a future insurance commissioner will emphasize.

Should it be the role of state government to place private companies on a “shaming” list for making perfectly legal and honorable investments? In a February letter to Jones, leaders of California’s major insurance trade associations wondered why the request had been made to insurers domiciled in other states. It also made the following point:

> There are many situations where divestment will cause unwarranted financial loss. Many legacy investments in coal companies can profitably pay their debt service and principal, but the price at which an insurer can liquidate the investment is significantly below carrying value.

In an April letter, the insurers questioned the wisdom of divestment from utility companies. Those companies already “are addressing the transition from coal-based to clean and renewable energy sources.”

> The risk of stranded costs is not new and is, in fact, an important part of our members’ credit analysis process. For regulated utilities, the risk of loss due to stranded assets is remote. Utility companies operate on a cost-plus system. Precedent is in place that supports the recovery of all costs deemed to have been prudently incurred.

In its May letter to the commissioner, the Washington, D.C.-based Edison Electric Institute, which represents all investor-owned utility companies, pointed to the financial strength of investor-owned utilities, which “are the largest issuer of notes, bonds and other indebtedness in the U.S.” Edison noted its members have some of the best credit ratings in the country and “the retirement of a thermal coal electrical generation facility does not generally have an adverse financial impact on a utility.”

Energy investments also often are bundled in investment blocks (whether in sector-specific mutual funds, hedge funds or exchange-traded funds), which frequently include green-energy companies along with coal companies. Even where it can be properly identified what proportion of a given fund is devoted to thermal coal – a task easier said than accomplished – dumping these investments can mean dumping renewables, as well.

No wonder some prominent voices are blasting the plan as a politically motivated attempt to grab attention rather than a serious measure to deal with climate change. “Divestment comes at the expense of meaningful action,” wrote Frank A. Wolak, director of the Stanford University Program on Energy and Sustainable Development. “It will do nothing to reduce global greenhouse emissions. It will not prevent these companies from raising capital.”[14]

“There is no end to the different sectors of the economy that you could single out,” said Robert Hartwig, president of the Insurance Information Institute, the New York-based insurance industry group.[15] “Each and every insurer makes its own investment decisions, but all of them have portfolios that are extremely well-diversified and, generally speaking, there is going to be an energy component in the portfolio of every investor.”

BUFFETT REJECTS MORE REPORTING

Few investors are savvier or better-known than Warren E. Buffett, chairman of the Berkshire Hathaway Corp., whose insurance holdings include the commercial insurer National Indemnity, the reinsurer General Re and the auto insurer GEICO. Berkshire is the third-largest property/casualty insurance group in the United States, behind only State Farm and Allstate, with $30 billion of direct written premium in 2015.

Buffett is no climate denier. He argued in a 2009 New York Times column that “doubling the carbon dioxide we belch into the atmosphere may far more than double the subsequent problems for society. Realizing this, the world properly worries about greenhouse emissions.”[16] His firm also is one of the biggest investors in renewable energy in the world, with BHE Renewables holding major wind and geothermal assets, in particular.

As Insurance Journal reported in March, a nonprofit group, the Nebraska Peace Foundation, used its standing as a relatively small Berkshire shareholder to call on the company to report on the risks to its investments from climate change.[17]

“Claims exposure to weather-related events requires that insurance and reinsurance companies take the lead in evaluating and managing the impact of extreme weather,” the group’s resolution read. “Reporting on the impact of climate change for Berkshire Hathaway insurance companies would

14. DivestmentFacts, “Commissioner Jones’ Call for Coal Divestment is Just the Latest Gesture,” Jan. 29, 2016. http://divestmentfacts.com/commissioner-jones-call-coal-divestment-just-latest-gesture/

15. Ibid.

16. Warren E. Buffett, “The Greenback Effect,” *The New York Times*, Aug. 19, 2009. http://www.nytimes.com/2009/08/19/opinion/19buffett.html

17. Jonathan Stempel, “Berkshire Hathaway Balks at Reporting on Climate Change Risks,” *Insurance Journal*, March 13, 2016. http://www.insurancejournal.com/news/national/2016/03/13/401679.htm

confirm their status as leaders in the global insurance industry, complementing the leadership BH energy companies demonstrate in the provision of renewable energy."[18]

Though not about thermal coal investments, per se, the group's resolution also made reference to stranded assets: "For insurance firms, this risk factor is mainly about the potential repricing of carbon-intensive financial assets, and the speed at which any such repricing might occur."[19] It pointed "transition risks" as markets move toward "a lower-carbon economy."

Buffett rebutted the resolution in his letter to shareholders, writing that:

> It's understandable that the sponsor of the proxy proposal believes Berkshire is especially threatened by climate change because we are a huge insurer, covering all sorts of risks. … The sponsor may worry that property losses will skyrocket because of weather changes. And such worries might, in fact, be warranted if we wrote ten- or twenty-year policies at fixed prices. But insurance policies are customarily written for one year and repriced annually to reflect changing exposures. Increased possibilities of loss translate promptly into increased premiums.[20]

Furthermore, because of the possibility of increased premiums, he argues that climate change could actually add to the insurance sector's profitability. In particular, more regular or more costly "super" catastrophes could increase demand for reinsurance written by firms like Berkshire's General Re, rates for which have been flat or falling for years:

> Up to now, climate change has not produced more frequent nor more costly hurricanes nor other weather-related events covered by insurance. As a consequence, U.S. super-cat rates have fallen steadily in recent years, which is why we have backed away from that business. If super-cats become costlier and more frequent, the likely – though far from certain – effect on Berkshire's insurance business would be to make it larger and more profitable.[21]

"As a citizen, you may understandably find climate change keeping you up nights," Buffet added. "As a homeowner in a low-lying area, you may wish to consider moving. But when you are thinking only as a shareholder of a major insurer, climate change should not be on your list of worries."[22]

Of course, Buffett's remarks sparked controversy. The counterargument, made in a *Huffington Post* feature from February, sums it up as such:

> Markets, governments and companies aren't properly pricing the risk of climate change. … Experts reckon that only once markets and others attach a price to the threat of climate change will the rest of the world finally move to limit the potential consequences.[23]

Yet markets – the billions of individual decisions made by billions of individual actors – are going to be far more accurate than central planners. They are using their own money. As Buffett made clear, none of us really know for sure what's happening with the climate. It may be, as he argued, wise to consider Pascal's Wager on the Existence of God: even if there is only a small probability he exists, the consequences of getting it wrong are huge. The same goes for climate change. But the real question is how best to analyze this complex set of risks and make real-world financial decisions based on them.

The *Huffington Post* editors questioned the ability of markets and governments to price things correctly. Yet who are these "experts" that can be relied upon instead?

RISKS TO INSURERS

Other key players in the insurance industry and elsewhere are more outspoken than Buffett in their assessment of how pressing the risk may be, but they all make clear this point: the industry actively is evaluating and responding to the risk of climate change, despite suggestions by critics. In particular, *Huffington Post* pointed to 2015 remarks by Bank of England Governor Mark Carney to the Lloyd's of London market.[24] As Huffington Post put it:

> Buffett's views against disclosure put him in sharp disagreement with … Carney, who has said that financial markets can help limit the effects of climate change, but only if companies – such as insurers – supply the kind of information that Buffett doesn't want to disclose.[25]

18. Ibid.

19. Ibid.

20. Warren Buffett, "Letter to Shareholders," Berkshire Hathaway Corp., Feb. 27, 2016. http://www.globalwarming.org/wp-content/uploads/2016/02/Warren-Buffet-letter-Feb-27-2016.pdf

21. Ibid.

22. Ibid.

23. Alexander C. Kaufman, Shahien Nasiripour and Ben Walsh, "Warren Buffett Is Wrong About Climate Change," *Huffington Post*, Feb. 29, 2016. http://www.huffingtonpost.com/entry/warren-buffett-climate-change_us_56d36cade4b03260bf773563

24. Mark Carney, "Breaking the tragedy of the horizon – climate change and financial stability," Speech to Lloyd's of London, Sept. 29, 2015. http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx

25. Alexander C. Kaufman, Shahien Nasiripour and Ben Walsh, "Warren Buffett Is Wrong About Climate Change," *Huffington Post*, Feb. 29, 2016. http://www.huffingtonpost.com/entry/warren-buffett-climate-change_us_56d36cade4b03260bf773563

It is true that Carney calls for more disclosure. In his view, more information "could encourage a virtuous circle of analyst demand and greater use by investors in their decision making. It would also improve policymaker understanding of the sources of CO_2 and corporate preparedness."

Carney is making a market case – the more transparency and information, the better able investors are to make good choices. He agrees that climate change poses great risk to insurers and to all sorts of private companies and governments. He disagrees with Buffett about whether to require more disclosure. But they are in agreement on the central point that insurance companies believe there are risks and are taking steps to address them. Investors therefore factor those risks – as best as any of us can – into their decisions. Carney points to three categories of risk:

1. Physical risks that floods and storms pose to assets covered by insurance.
2. Liability risks from those who suffer losses as they "seek compensation from those they hold responsible."
3. Transition risks, such as those discussed above about stranded assets as utilities and energy companies move from coal to renewable energy forms.

Carney argued that "insurers are amongst the most determined advocates for tackling it sooner rather than later. And little wonder. While others have been debating the theory, you have been dealing with the reality." Indeed, as a 2008 report by Sean B. Hecht of the University of California at Los Angeles School of Law points out:

> The insurance industry is our society's primary financial risk manager. … (C)limate change poses an unprecedented challenge to the insurance industry, because factors such as increasing uncertainty and the potential for highly correlated losses will make it difficult to insure against climate change-related risks.[26]

OPPORTUNITIES FOR INSURERS

The flip side of the risks posed to insurers by climate change is the range of financial opportunities it could offer these companies. As Evan Mills, a staff scientist at Lawrence Berkeley National Laboratory, explained in a Climate Action Programme article:

> Regarding the business opportunities presented by climate change, hundreds of billions of dollars will be spent on clean energy technologies and other responses, which represents an enormous new capital base with associated business operations requiring insurance. … Just as the insurance industry has historically asserted its leadership to minimize risks from building fires and earthquakes, insurers have a huge opportunity today to develop creative loss prevention solutions and products that will reduce climate change-related losses for consumers, government and insurers.[27]

However, one major confounding variable to insurers' ability to price these risks appropriately is state governments' tight control of insurance rates. This is especially the case in California, thanks to the regulatory framework imposed by Proposition 103. Mills' analysis pointed to the possibility of insurers reducing rates for consumers who, say, drive hybrid cars, based on their supposed carbon-reduction benefits. But such a rating factor would not obviously be allowed to be taken into account under Prop 103. Even if some regulatory forbearance allowed it to be included in the mix, it would have to be weighted in such a way as to be meaningless. The bottom line is that it's not easy to change one's rate structure in a state where the rating process is as cumbersome, bureaucratic and politically charged as California's.

Furthermore, the National Association of Insurance Commissioners has argued that "changing weather patterns and rising ocean temperatures as a result of climate change will also likely continue to put financial stress on the National Flood Insurance Program," which already is more than $23 billion in debt to federal taxpayers.[28] The NAIC recommends "eliminating subsidies and charging actuarially based premiums for all policyholders, even if such pricing must be phased in over time." That's sensible. People continue to build homes in flood-prone areas because the subsidized flood insurance cushions them from the true cost of their decisions – a cost that will get larger as sea levels continue to rise.

Floods can be so catastrophic that many private insurers historically have been loath to offer insurance, at least not at rates that can compete with the highly subsidized coverage offered by the federal government. Congress passed the Bigger-Waters Flood Insurance Reform Act of 2012 to bring premiums more closely in line with market prices, but gutted many of the changes just a year later when rates began to rise. After years of subsidies and private decisions based on those subsidies (e.g., building a house in a flood plain),

26. Sean B. Hecht, "Climate Change and the Transformation of Risk: Insurance Matters," *UCLA Law Review*, Vol. 55, No. 6, 2008. http://www.uclalawreview.org/pdf/55-6-3.pdf

27. Evan Mills, "Responding to climate change – the insurance industry perspective," Climate Action Programme, accessed July 15, 2016. http://evanmills.lbl.gov/pubs/pdf/climate-action-insurance.pdf

28. The National Association of Insurance Commissioners, "The Potential Impact of Climate Change on Insurance Regulation," 2008. http://www.naic.org/documents/cipr_potential_impact_climate_change.pdf

it's politically challenging to move back in a market-based direction. As noted in a 2013 article in PropertyCasualty360:

> With such a litany of potential losses staring them in the face, one reasonable response of insurers might be to drastically reduce capacity in regions and risk classes highly susceptible to the negative consequences of climate change. But this isn't expected to happen – as long as insurers can respond to the additional risks presented by climate change with that most basic but essential tool at their disposal: rate.[29]

The problem, per the article, is state regulators' ability to limit insurers' ability to charge risk-based rates. This process has essentially chased private insurers out of certain markets, leaving only state-backed insurance pools or state-run insurance companies like the Citizens companies in Florida and Louisiana. There long has been a good opportunity alliance between free-market conservatives and liberal environmentalists – such as the SmarterSafer coalition of which R Street is a longstanding member – to push for greater rate freedom as a practical way to battle climate change. Such efforts represent useful ideas that run counter to the command-and-control tendency of the California Department of Insurance.

A BROADER CONTEXT FOR DIVESTMENT

Insurers aren't the only companies targeted for divestment from coal-based industries in California. In October 2015, Gov. Jerry Brown signed into law S.B. 185, which forces the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) to divest from many thermal-based coal investments. The pension funds have until July 1, 2017, to dump their investments in any companies that generate more than half their revenue from mining thermal coal.

Because of the narrowness of its scope, the law is more symbolic than substantive. But as DivestmentFacts.com reported in January, the CalSTRS chief investment officer noted that he has "been involved in five divestments for our fund. All five of them we've lost money, and all five of them have not brought about social change."30 Of its $188.7 billion of assets under management, the massive pension fund has only about $40 million in thermal-coal companies.

The even-larger CalPERS is known for using its Wall Street clout to push for a variety of (largely union-oriented) political priorities. Yet the coal divestment push sparked pushback from CEO Anne Stausboll, who wrote in March 2015 in *The Financial Times*:

> Such lobbying is well intentioned but flawed. If investors sell, we simply pass the buck to those who buy. A more constructive and proven approach is for us to engage with the companies we own.[31]

It was a similar story at the University of California. According to a *Los Angeles Times* report in September 2015, the University of California system sold off $200 million of its endowment and pension-fund holdings in coal and oil sands companies, which it said was due both to environmental concerns and financial concerns about those sectors. However, the system continued to hold about $10 billion in various energy investments, representing about 10 percent of its $100 billion of assets under management, and said there were no plans to sell off oil and natural gas investments.[32] The sell-off represented a small amount of their total holdings, dumped in response to political pressure. As one U.C. Regents committee member put it:

> It was really the belief of everyone on this committee, myself included, who cares about climate that simply divesting from a list of a couple hundred companies that the students were presenting would absolutely do nothing. So we sell a few shares and stocks in a company. It won't change their behavior in any way.[33]

SUNSHINE OR RED TAPE

Insurance companies already are required to disclose significant amounts of financial information and have multiple layers of oversight. Are more such disclosures really needed – or is this yet another example of symbolism and posturing?

California has for several years required insurers that do business in the state to complete the "Insurer Climate Risk Disclosure Survey." It questions companies on whether they have a plan to reduce or mitigate emissions, and whether they have a climate-change policy to address risk management. The survey also asks for details about those programs and whether "the company considered the impact of climate change on its investment portfolio."

29. Bryant Rousseau, "Climate Change & Insurance: Existential Threat – or Extraordinary Opportunity?" *PropertyCasualty360*, Feb. 5, 2013. http://www.propertycasualty360.com/2013/02/05/climate-change-insurance-existential-threator-ex

30. "Commissioner Jones' Call for Coal Divestment is Just the Latest Gesture," *DivestmentFacts*, Jan. 29, 2016. http://divestmentfacts.com/commissioner-jones-call-coal-divestment-just-latest-gesture/

31. Anne Stausboll, "Selling out of fossil fuels no solution for climate change," The Financial Times, March 22, 2015. http://www.ft.com/cms/s/0/def47f8c-bb8d-11e4-b95c-00144feab7de.html#axzz4Eh1RXp1E

32. Larry Gordon, "UC sells off $200 million in coal and oil sands investments," *Los Angeles Times*, Sept. 9, 2015. http://www.latimes.com/local/education/la-me-ln-uc-coal-20150909-story.html

33. DivestmentFacts, "Commissioner Jones' Call for Coal Divestment is Just the Latest Gesture," Jan. 29, 2016. http://divestmentfacts.com/commissioner-jones-call-coal-divestment-just-latest-gesture/

The answers are public information and can easily be accessed on the Department of Insurance website. Companies appear to have answered the regulators' questions thoroughly, although it should be noted that many of questions included in the survey's first iteration were essentially unanswerable. One prompt requested that insurers "discuss steps, if any, the company has taken to engage key constituencies on the topic of climate change," which certainly sounds like it is imploring insurers to lobby on climate issues.[34]

But do these answers actually help shareholders, members or the public or even regulators, for that matter? Insurance companies invest in a diverse portfolio, which includes a small portion of old-school energy firms. Companies have entire divisions that examine their portfolios and their risks, including the intersection of underwriting and investment risks. Beyond that, state regulators already review the credit quality of insurers' investments as part of their prudential oversight of the industry, while third parties like rating agencies, equity analysts and institutional investors parse the data much more thoroughly. What does this rather limited survey add to that process that wasn't there already?

Supporters might say that such documents don't hurt and that sunshine always is better than darkness. But the light is cast through a politically tinted filter that makes even ethical and prudent investment behavior appear dubious.

CONCLUSION

Asked to reply to the charge that the divestment and disclosure calls are motivated by politics, the California Department of Insurance offered the following response:

> As a responsible regulator, the Commissioner's decision to ask insurance companies to divest from thermal coal and to require insurance companies to disclose investments in the carbon economy arises from his statutory responsibility to make sure that insurance companies address potential financial risks in the reserves they hold to pay future claims. Politics has nothing to do with the decision to ask insurers to divest from thermal coal.
>
> The commissioner decided to request voluntary divestment from thermal coal enterprises this year following consideration of recent studies that show coal investments represent significantly higher financial risk than other investments over time. ... Moreover, since 2011, coal prices, cash flows, and company valuations have fallen sharply, thus adversely affecting and bankrupting numerous coal companies. ... In addition, J.P. Morgan has joined three other major United States banks in announcing that given the financial risks associated with thermal coal, they will no longer invest in new coal infrastructure in wealthy nations...
>
> Finally, international, national, and state authorities have entered into agreements, enacted legislation, promulgated regulations, or otherwise adopted policies that are designed to or will have the effect of limiting the ability to burn thermal coal, as well as oil and gas, and there is a significant likelihood that more of these agreements, laws, regulations or policies will be enacted or adopted, further reducing the ability to burn coal and other carbon based fuels and creating a potential for these assets to further decline in value and returns – to become 'stranded assets.'

The department certainly makes the best-possible case for its actions. But it's still hard to look at this policy outside the realm of politics, given the points outlined throughout this report.

Under the United States' state-based system of insurance regulation, state regulators are charged with monitoring the solvency of companies domiciled within their own jurisdiction. Some are better at that task than others, and some regulatory dictates may seem bureaucratic and pointless. But by and large, they fit within the legitimate scope of proper insurance regulation.

But there's no legitimate role for an insurance commissioner, or any regulator, to pick and choose which investments private companies should be allowed to make based solely on the latest political winds. Firms investing their own money and concerned about their own financial future tend to make better decisions than government planners with a different set of motives. It's best to let the market sort things out.

At a recent Stanford conference on insurance for cyber risks, Commissioner Jones underscored the importance of letting that newly emerging insurance market evolve on its own, without excess government interference. He was absolutely right, but that advice also applies to companies' investment portfolios. The evidence suggests they already are deeply involved in planning to deal with – and find new opportunities in case of – a significantly warmer climate.

As the Bank of England explained in a September 2015 report:

> General insurance is perhaps the more obvious sector for actively insuring against weather-related events. As a consequence, general insurers are at the forefront

34. Robert Detlefsen, "Regulators and the Business of Climate Change-Related Risk," *Insurance Journal*, April 2, 2012. http://www.insurancejournal.com/magazines/closing-quote/2012/04/02/241140.htm

of evaluating and managing the day-to-day impact of extreme weather.[35]

To be sure, there are risks that energy-sector assets, or any assets, might hold less value in the future than they do currently. But those risks already are best managed by credit and equity analysts doing their due diligence, and by investment officers ensuring a company's portfolio is appropriately balanced and diverse. Divesting from any given set of companies won't improve the climate and won't guarantee any kind of fiscal protection. If there are benefits to such strategies, they flow entirely to the elected officials who promote such things.

As the University of California investment committee member said of the Regents' recent divestment: "It's just symbolism without real impact and maybe gets a quick headline." Surely, such a serious potential problem deserve a more thoughtful – and less political – approach.

ABOUT THE AUTHOR

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He is the author of the 2009 book, "Plunder! How Public Employee Unions Are Raiding Treasuries, Controlling Our Lives and Bankrupting the Nation" and the 2004 book, "Abuse of Power: How the Government Misuses Eminent Domain."

35. Foreword, "The impact of climate change on the UK insurance sector," Bank of England, September 2015. http://www.bankofengland.co.uk/pra/Documents/supervision/activities/pradefra0915.pdf