The climate risk 'hot potato' – which sector will be left with burnt fingers?

At a glance

- We are seeing the consequences of the increasing and rapid growth in global average temperatures. If we accept that climate impacts are real, and will impact our economies, then someone will have to bear the costs
- The insurance and reinsurance industries are already changing their behaviour in terms of pricing and offer, with government-backed insurers sometimes having to step in
- Big property owners are increasingly investing in climate risk modelling and in-house climate expertise to limit their exposure, but smaller players are less able to do this
- Could we end up in a scenario where individuals and smaller commercial owners of property end up holding the riskiest assets, and what might this mean for lenders, governments and investors?

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Hot potato

noun

"A situation or subject that people disagree strongly about and that no one wants to deal with."

Does anyone remember Uruk, the ultra-modern city nestled amid the planet's most fertile farmland? What about Skara Brae, the beachfront town with state-of-the-art homes, beautiful ocean views and mild weather? Nope? Well, 5,000 years ago both communities were among the world's more desirable places to live, but the shifting climate changed things and these settlements were consigned to history. Now, the rate and magnitude at which the climate is changing, driven by the increasing amount of CO_2 in the atmosphere, is unprecedented for millennia, so we must be prepared for more rapid changes.[1]

Six months into 2024 we hit a new climate milestone: the first 12-month streak with global average temperatures consistently 1.5°C above pre-industrial levels. Weather events that used to be considered "rare" are becoming more frequent, as increasing average global temperatures shift the probability distribution of local weather events. As a result, what was once considered "extreme" is increasingly becoming the "new normal".

We are already seeing the consequences of rising global temperatures, with multiple examples from the past 12 months alone: the UK's intense rainfall and storms (winter 2023/24), which damaged crops and infrastructure, have been tied to climate change[2]; local heat records were shattered across the globe; and wildfire seasons in Canada, Greece and California (to name a few) caused large losses of land and property.

In addition, Hurricane Beryl became the earliest ever recorded Category 5 hurricane.[3] Record North Atlantic Ocean heat supercharged the storm's intensification rate, surprising even experienced meteorologists. Climate change has also impacted commodities globally, such as olive oil, avocados, oranges and coffee, with cocoa prices hitting record highs.

Where are we heading?

Though recent temperature trends do not necessarily mean that the Paris Agreement's goal of limiting warming to 2°C (and ideally 1.5°C) is fully lost, it is a stark warning that we are dangerously close to the threshold. Unless there is a drastic change in the rate at which we decarbonise our economy, we will overshoot 1.5°C within the next decade and will struggle to limit warming to 2°C.[4]

In our view, the escalating impacts of climate change and its risk-transfer are not yet fully understood by most market participants. If we accept, however, that climate impacts are real, that these will affect our economies, and that trends are structural, the conclusion is that someone, somewhere will have to bear the costs.

Understanding how climate risks will manifest themselves, and which economic channels they will transfer through, is a key task for asset managers. By following the "climate risk hot potato" through a range of sectors, we question if a regime shift is happening: are increasing weather events leading to a widening "insurance gap"? Are increasing insurance premiums a structural trend? Will self-insurance become more prevalent? If so, how will this manifest in those sectors that need insurance to protect their assets? And finally, who will be left with burnt fingers?

This is a problem for the insurance industry, right? Well, no, not really

In the global property and casualty (P&C) insurance market, demand for insurance is exceeding supply.[5] Which is great news for insurers. Demand has been spurred by the frequency and location of large loss events – for 2024, the average forecast is predicting 23 named storms, 12 hurricanes and five major hurricanes, around double the long-run average![6] The level of insured losses will be determined by the category of the event at landfall rather than the absolute number of storms, but more storms bring increased risks.

Meanwhile, there has been a reduction in supply as insurers seek to limit overall exposures to climate-impacted areas. Insurers manage their exposure to large loss events by modelling probable maximum losses (PMLs). This represents the probability a loss will exceed a certain threshold over a one-year period. For example, a $68 billion loss in the state of Florida is a one in 100-year event for the industry.[7] As the climate becomes more volatile, insurance companies are seeing these figures change: one in 100-year loss events are turning into one in 50-year events!

[1] IPCC, 2021: Summary for Policymakers
[2] Imperial College London, Autumn and Winter storms over UK and Ireland are becoming wetter due to climate change, 22 May 2024
[3] Climate.gov, Category 5 Hurricane Beryl makes explosive start to 2024 Atlantic season, 3 July 2024
[4] Global temperatures are tracking towards 2.5-2.9°C by mid-century, according to the UN Environment Programme's analysis of current national climate pledges (November 2023).
[5] McKinsey & Company, Global Insurance Report 2023: Expanding commercial P&C's market relevance, 16 February 2023
[6] National Oceanic and Atmospheric Administration, NOAA predicts above-normal 2024 Atlantic hurricane season, 23 May 2024
[7] Paragon Strategic Solutions, Florida Hurricane Catastrophe Fund, 1 June 2024

Insurers have three main options to combat this structural change: (i) drastically increase rates, (ii) shed some of their risk through reinsurance, or (iii) severely limit new business growth. The result of these decisions has been a decrease in supply and, therefore, an increase in pricing.

What about reinsurance?

It's a similar story for reinsurers – higher prices and pulling back on coverage. US insurers hedge correlated or severe risks, such as hurricanes and wildfires, by purchasing reinsurance, which are secondary insurance contracts with global insurers. Reinsurers have been leaving more of the risk with primary insurers and shifting away from covering lower severity but higher frequency "secondary" events (floods, torrential rain and wildfire, for example) to more severe "primary perils" (tropical cyclones and earthquakes). Thus the cost of reinsuring climate risk-prone areas is increasing. Global and US property catastrophe reinsurance prices have gone up 51% and 67% respectively from 2021 to 2024.[8] However, when you look at this within the most impacted areas, such as Florida and California, policies have increased by more than 150% since 2019.[9]

The bottom line?

That all sounds fine for the insurance industry, but surely someone must foot the bill? Ultimately, higher insurance prices will fall to the property owner. However, regulators know that if they move too aggressively to try to limit premiums, insurance companies might stop offering coverage altogether. In practice, securing cover in climate risk areas can be tricky, with a growing "protection gap" – the difference between insured and broader economic losses. In 2023 only 31% of total global economic losses were covered by insurers. In 2022 that number was 42%.[10]

How do we bridge the gap?

Households and businesses are falling back on taxpayer-funded schemes – the insurers of last resort. Government-backed entities in California, Florida and the UK[11] have been ramping up coverage to households caught in the "gap" – where insurance is too expensive or simply unavailable from the private sector. Pooling the risk at a state or national level is a useful idea and has been suggested at the EU level.[12]

However, it is not a good time to be adding additional contingent liabilities to sovereign or state balance sheets. Sovereign indebtedness ballooned in the Covid years as governments spent money stabilising economies. In many developed market countries, debt-to-GDP is topping 100% – a level seen as uncomfortably high. Recent wobbles in the UK and French sovereign debt markets serve as a serious warning to governments that markets will demand fiscal discipline. It may be that taxpayers are unwilling to subsidise those who own properties in riskier areas.

We are left thinking that property owners will be footing at least part of the bill here. A more sustainable solution could be for governments to encourage the adaption of property to be more resilient (for example, to flood risk) or to promote migration by building homes in areas not as exposed to climate risk.

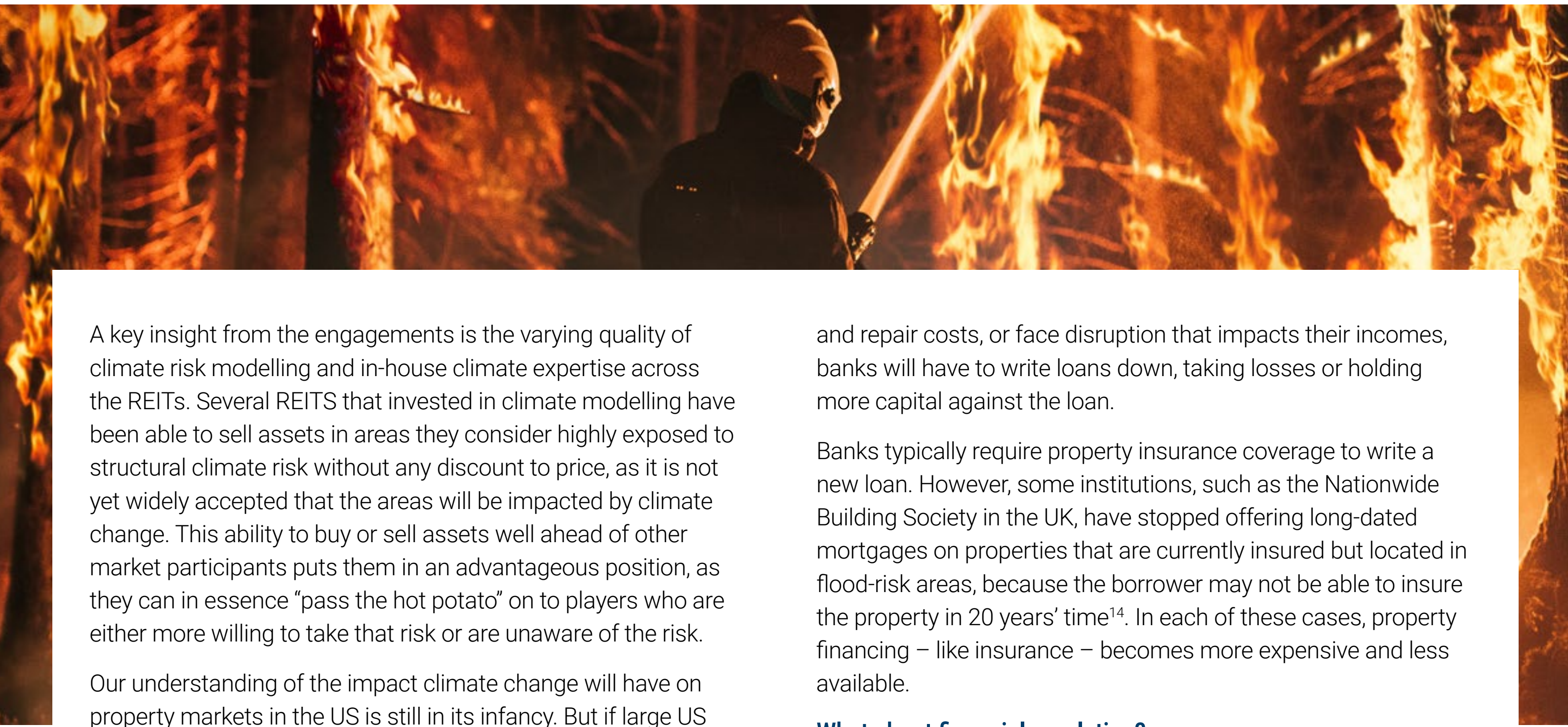
What about big owners of property - Real Estate Investment Trusts (REITs)?

The increasing cost and reduced availability of insurance in areas vulnerable to climate events could lead to more "self-insurance" by REITs, where third party insurance is no longer obtained. Instead, risks are transferred on to their own balance sheets to reduce exposure to a hardening insurance market.

To explore the hypothesis that self-insurance is growing, in Q3 2024 we spoke to six US REITS located in states with high risks of climate events. Across the board, they reported double digit rises in insurance premiums over the past two years, although price growth on average seems to have moderated within renewals from 2023 to 2024. We did see evidence that many REITS are increasing the amount of "self-insurance", either by changing the terms of the deductibles (to take on more costs per loss occurrence) or by growing the scale of their own captive insurance solutions. This indicates that some REITS are willing to take on more risk in favour of lowering insurance premiums.

> Across the board, REITS reported double digit rises in insurance premiums over the past two years

[8] Artemis, Guy Carpenter Regional Property Catastrophe Rate-on-Line Index
[9] California Fair Plan Property Insurance, June 2024; and Citizens Property Insurance Corporation, 2024
[10] AON, 2024 Climate and Catastrophe Insight Report, 2024
[11] Fair Plan, Citizens and Flood Re respectively
[12] Financial Times, EU regulator urges action on climate threat to insurance, 22 April 2024



A key insight from the engagements is the varying quality of climate risk modelling and in-house climate expertise across the REITs. Several REITS that invested in climate modelling have been able to sell assets in areas they consider highly exposed to structural climate risk without any discount to price, as it is not yet widely accepted that the areas will be impacted by climate change. This ability to buy or sell assets well ahead of other market participants puts them in an advantageous position, as they can in essence "pass the hot potato" on to players who are either more willing to take that risk or are unaware of the risk.

Our understanding of the impact climate change will have on property markets in the US is still in its infancy. But if large US REITS continue to consider the impacts of climate change on their buildings – and start to trade assets using those considerations – there is a risk that property values in some areas could see rapid shifts once the rest of the market begins to "price" climate risk. Therefore, housing areas prone to extreme events such as flooding and wildfire could be overvalued. For example, a 2023 paper published in Nature Climate Change suggested that US residential properties exposed to flood risk could be overvalued by $121-$237 billion.[13]

The little guy foots the bill

Companies which adopt good climate strategies are at an advantage. However, more than 90% of commercial real estate in the US is owned by small private businesses, not large REITS. The ability of these small businesses to simply trade out or swap housing due to escalating climate impacts and/or insurance pricing is limited, ultimately putting them at the greatest risk of financial loss.

Where are the banks in all of this?

Globally, banks are the primary financiers of property. As the self-insurance trend begins to shift some of the physical climate risk from the insurance sector on to owners of residential and commercial real estate, it could lead to increasing credit risks for banks. For example, damage from wildfires or hurricanes can impact property prices. As collateral values fall, banks need to hold more capital against loans secured on those properties. Similarly, if property owners take on more debt to pay for damage and repair costs, or face disruption that impacts their incomes, banks will have to write loans down, taking losses or holding more capital against the loan.

Banks typically require property insurance coverage to write a new loan. However, some institutions, such as the Nationwide Building Society in the UK, have stopped offering long-dated mortgages on properties that are currently insured but located in flood-risk areas, because the borrower may not be able to insure the property in 20 years' time[14]. In each of these cases, property financing – like insurance – becomes more expensive and less available.

What about financial regulation?

Regulators in the financial sector are alert to this risk, although approaches differ across markets. In the EU, where only around a quarter of climate-related catastrophe losses are currently insured[15], both the banking and insurance regulators (the European Central Bank and the European Insurance and Occupational Pensions Authority) have started to explore the implications of this growing protection gap. The US Federal Reserve's recent climate scenario analysis exercise explicitly includes scenarios with different assumptions around insurance coverage[16]. What's more, this is now feeding into broader discussions around the potential use of capital requirements to ensure resilience of the financial sector to climate-related financial risks.

Through our research and engagement with global banks and insurers, we have been monitoring the investment implications of climate risk and regulations for several years[17]. It is an integral part of our fundamental research process.

Over this time, we have noticed an increase in the sophistication of financial institutions' physical climate risk management, with enhanced modelling capabilities, the use of increasingly granular data to understand exposure, and strengthened governance and risk oversight.

[13] Nature Climate Change, Unpriced climate risk and the potential consequences of overvaluation in US housing markets, 16 February 2023
[14] Insurance Journal, Unpriced climate risk and the potential consequences of overvaluation in US housing markets, 30 April 2024
[15] ECB and EIOPA, Policy options to reduce the climate insurance protection gap, April 2023
[16] Federal Reserve, Pilot Climate Scenario Analysis Exercise, May 2024
[17] Columbia Threadneedle Investments, Climate change to bear upon banks' financial performance, 20 September 2021
[18] Small domestically chartered commercial banks (regional banks) are defined as all domestically chartered commercial banks not included in the top 25.

The hot potato is rolling downhill!

Regulators are making progress with larger financial institutions around climate risk regulation. However, smaller banks and insurers, especially in the US, remain under the radar. In the US, around 70% of commercial real estate (CRE) loans are held by smaller banks[18], and these institutions are much more exposed to CRE relative to capital. CRE makes up 40%-50% of loans for small US banks, compared with around 11% for large banks. Larger, more sophisticated property players are selling to smaller, less sophisticated investors who in turn are funded by smaller banks, which are subject to little or no scrutiny around climate risks.

So, who's left with burnt fingers?

The companies we cover – such as large insurers, banks and REITs – have increasingly sophisticated approaches to climate risk and are taking logical steps to protect their balance sheets. How they respond to climate change is a key part of our fundamental analysis and we spend a lot of time talking to them about these risks.

We think individuals and smaller commercial owners of property are likely to end up holding the riskiest assets, which will be more expensive or impossible to privately fund or insure. This could create regional imbalances in wealth and employment. Governments may have to intervene with schemes to insure or fund property in riskier areas, but they are loathe to take on additional risk. Ultimately, capitalism may just do its thing, forcing people to make the simple economic decision to own property where the physical climate risk is lower.

Conclusion

Over the ages, human beings have been but pawns to the shifting climate. However, the rate at which change is happening today means we are entering a new regime, and that the pace at which we must adapt and migrate is picking up. London and New York have been trendy places to live for a couple of centuries. Babylon was uber-cool for longer; nowadays not so much. Due to the rate of change it is likely that many of our modern cities in areas sensitive to climate change could be impacted sooner than we think. We are already experiencing the beginning of this.

At Columbia Threadneedle Investments we are committed to deep fundamental research into how companies and economies are exposed to these changes so that our clients' portfolios are prepared for the warmer world that lies ahead.

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