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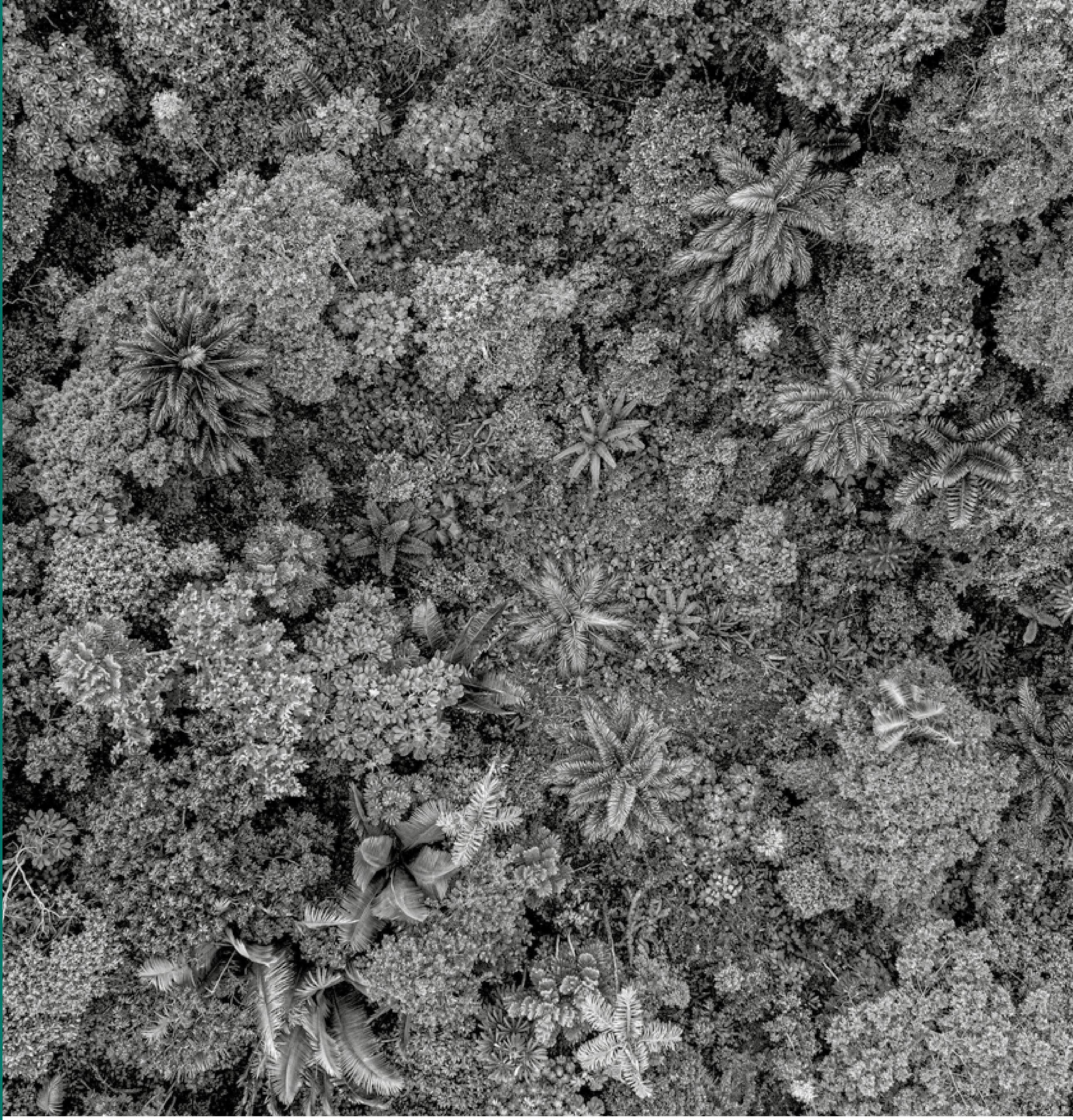

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> "Boards should be able to demonstrate they understand how their firm is integrating climate considerations into their business strategies, planning, governance structures and risk management processes."

REGULATORY

Climate change: PRA observations on insurers' management of climate-related financial risks

With COP 27 just concluded, climate change issues will be at the forefront of minds in the insurance industry. The Prudential Regulation Authority (PRA) has maintained its focus on the impact of climate change with the publication last month of further guidance on how it expects insurers to manage this risk, including examples of effective and poor practices.

Background

At the start of 2022, the PRA expected insurers to have fully embedded their approaches to managing climate risk and started actively supervising insurers against those expectations.[1] In line with this supervisory approach and following its findings from the Bank of England's Climate Biennial Exploratory Scenario exercise,[2] the PRA has published an additional Dear CEO letter[3] in respect of climate-related financial risks.

The letter provides feedback on insurers' risk management of the financial impacts of climate change to date and reminds insurers about the PRA's expectations as to the governance of climate risk moving forward.

Key points

The letter outlines the PRA's observations on insurers' levels of embeddedness of the PRA's expectations in SS3/19.[4] At a high level, the PRA expects insurers to be able to demonstrate how they are responding to the supervisory expectations and that they have taken action to embed those expectations and put relevant measures in place.

In order to aid insurers in embedding SS3/19, the letter outlines a summary of capabilities, which the PRA expects insurers to be able to demonstrate by now. These are accompanied by observations on whether insurers are meeting the relevant supervisory expectations and examples of effective and poor practices identified (these examples are set out in Annex A to the letter).

The PRA's observations highlight the following key areas:

1. **Governance and board oversight:** Boards should be able to demonstrate they understand how their firm is integrating climate considerations into their business strategies, planning, governance structures and risk management processes. They should be able to show the approach across these areas is coherent and supported by available metrics and risk appetites that provide an effective measure of vulnerabilities to climate risk. As part of managing the associated financial risk, where appropriate, climate should be considered in advance of business and strategic decisions.

2. **Risk management:**

- Frameworks and tolerances – firms should have embedded an appropriate understanding of climate risk within their risk management frameworks and structures, using both qualitative and quantitative measures.
- Modelling – firms should be able to demonstrate that climate risks have been appropriately factored into their quantitative analysis and explain what work has been undertaken to identify areas requiring development, and what actions are being taken to address identified data gaps relevant to their business.
- Counterparties' exposures – firms should have a counterparty engagement strategy. This engagement should inform firms about how their counterparties will look to manage climate exposures.
- Capital – Firms' Own Risk and Solvency Assessments should provide sufficient contextual information to allow a reader to understand analysis of climate risks and capital and assess whether assumptions and

judgements are appropriate, and whether outputs are being correctly factored into the firm's climate decisions. All firms should be able to explain to their supervisors how they have got comfortable that any material climate risks are appropriately capitalised.

3. **Scenario analysis:** Firms should have embedded scenario analysis into their risk management and business planning processes and be able to demonstrate how the results are being used in practice, including their impact on strategic and business decision-making. Firms should be able to explain how their current capabilities will develop over time.
4. **Data:** Firms should be able to explain how they identify their significant data gaps, what plans they have to close those gaps, and what processes they have in place to ensure that developments in data and tools will be identified and incorporated into their approach. Where data gaps exist, all firms should have put in place contingency solutions.

The letter also highlights that the PRA expects insurers' financial reporting-related priorities for 2022 and onwards to include enhancing their climate-related data and modelling capabilities, governance and controls, and market disclosures. Annex B to the letter sets out further detail on the PRA's approach to climate-related accounting.

The PRA also indicates that it is currently considering updates to its position on the relationship between climate change and the insurance regulatory capital regimes.[5]

Next steps

Compliance with the expectations in SS3/19 will be assessed on an ongoing basis. In particular, insurers should ensure that their boards and senior management team, including the designated Senior Manager Function for climate, demonstrate appropriate oversight and control of the firm-wide climate agenda.

In working to embed the SS3/19 expectations, insurers can use the following resources:

- The PRA's relevant previous publications, listed in Annex C to the letter.
- The guidance and tools developed by the PRA's and FCA's Climate Financial Risk Forum to support firms in identifying and managing climate risk.[6]
- The examples of effective and poor practices identified by the PRA as set out in Annex A to the letter.

Firms judged not to have made sufficient progress in embedding an understanding of climate risks should expect to be asked to provide a roadmap explaining how they intend to overcome any gaps from the PRA's expectations.

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Footnotes:

1 See the PRA's Dear CEO letter published on 1 July 2020
Climate Change Adaptation Report 2021 published on 28 October 2021.

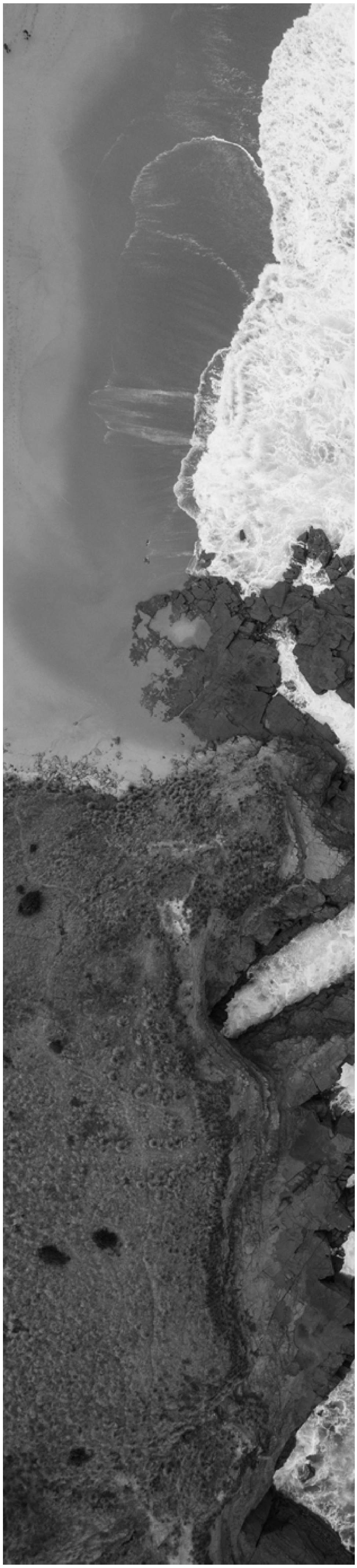
2 The Bank of England published the results of its Climate Biennial Exploratory Scenario exercise in May 2022. See our article discussing the main points arising from the exercise in the June 2022 edition of the Bulletin - https://www.hfw.com/Insurance-Bulletin-June-2022.

3 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2022/october/managing-climate-related-financial-risks.pdf

4 PRA Supervisory Statement SS3/19 – Enhancing banks' and insurers' approaches to managing the financial risks from climate change published in April 2019.

5 The Bank of England's latest plans for future work on this relationship are outlined in its Climate Change Adaptation Report 2021 published on 28 October 2021.

6 All of the Climate Financial Risk Forum's outputs are available here and cover climate risk management, scenario analysis, disclosure, data and metrics, and innovation



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> **"Insurance plays a key role in nature related adaptive projects and new technologies by assessing and insuring the relevant risk."**

COP 15 – A key moment for biodiversity and nature positive insurance

Although there has been plenty of focus in the insurance industry on climate change and the reduction of greenhouse gas emissions (GHGs), there is also growing attention being paid to biodiversity and ecosystem loss. This will come further into the spotlight with the Biodiversity COP 15 about to take place in December.

Background

Biodiversity loss is intimately interconnected with and equally as critical as climate change. The Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES) report[1] flagged an unprecedented species extinction rate with up to 1 million species of animals and plants facing extinction. It also found that 75% of the land-based environment and 66% of the marine environment has been significantly altered by human actions.

Not only is biodiversity essential for human life, the natural world provides a crucial function for the economy. The World Economic Forum (WEF) has indicated that more than half the World's GDP is moderately or highly dependent on nature and the service it provides.

The loss of nature contributes to climate change in obvious ways, but conversely nature based solutions are expected to provide one third of climate mitigation required to limit temperature rise[2]. This was recognised at COP 27 which has just taken place, where a Biodiversity Day was included, and a number of nature-related initiatives were announced. In particular this included the ENACT partnership (Enhancing Nature-based Solutions for an Accelerated Climate Transformation) aiming to bring together actions for upscaling nature-based climate solutions.

Against this background, the United Nations 15th Conference of the Parties to the Convention on Biological Diversity or COP 15, will be taking place in Montreal on 7 – 19 December 2022. The aim at COP 15 is for countries to adopt a Post-2020 Global Biodiversity Framework. It is hoped it will have a similar impact to the Paris agreement. The last draft of the Framework, discussed at the fourth meeting of the Open-ended Working Group in Nairobi in June 2022, sets out four long-term goals for 2050 and 22 action-orientated targets to achieve by 2030. These relate to areas that will reduce the threat to nature, relating to, for example, conservation and reduction of pollution; the mainstreaming of biodiversity into policy and regulation and increasing the financial resources available in this area; and sustainable use and management of nature.

What is the relevance of nature to the insurance industry?

Along with climate change, nature loss presents great challenges but also opportunities for the sector. There is:

- The potential for the exacerbation of physical loss, for example as natural barriers to flooding are destroyed, or natural carbon sinks are decimated exacerbating climate change.
- Transition risk, where assets are stranded when a sudden radical shift in policy, law, or societal approach takes place.
- Litigation risk. We have seen biodiversity-related litigation picking up around the world, for example aimed at preventing destruction of habitats, or relating to waste generation such as plastics. We will undoubtedly see a growth in such litigation as well as potentially greenwashing claims and D&O claims.

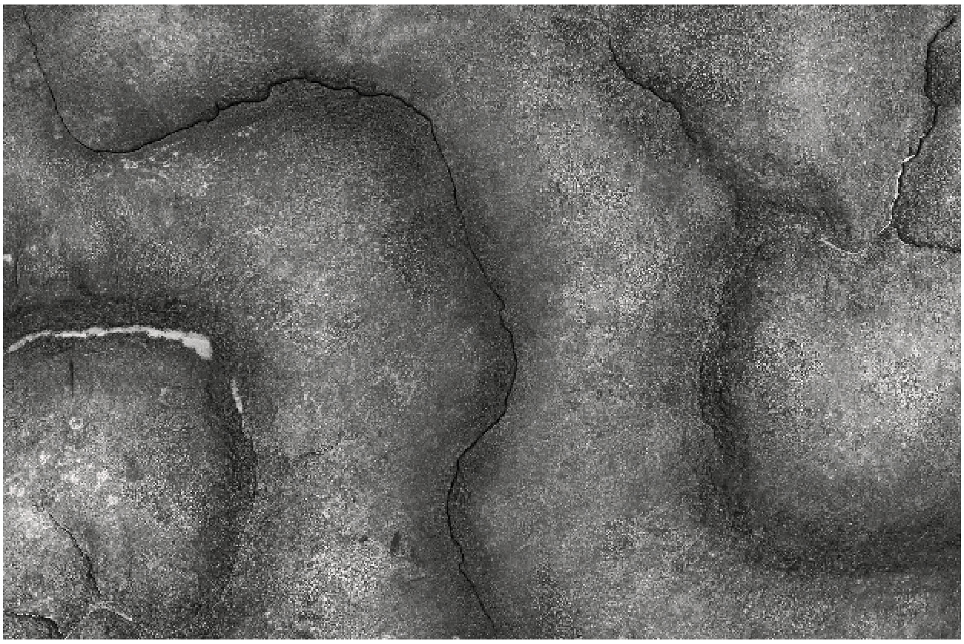
On the other side of the coin, as with climate change, it is possible for the industry to use its experience of risk management and extensive risk data to help drive positive solutions to the issues biodiversity loss presents. Insurers have, for example, been involved in the insurance of nature, devising solutions to insure coral reefs and mangroves, and utilising products such as parametric insurance to fill protection gaps.

Insurance plays a key role in nature related adaptive projects and new technologies by assessing and insuring the relevant risk.

What developments are taking place?

Again, on a similar trajectory to climate change one of the key building blocks to taking action is establishing a framework for the assessment and disclosure of financial nature-related risk. The Taskforce on Nature-related Disclosures (TNFD) was established in June 2021, and is working on its framework, currently testing in phases, aiming for final release in September 2023. This builds on the existence of the successful TCFD (Task Force on Climate Related Financial Disclosures) framework. The TFND will initially be voluntary, but like TCFD may become embedded in regulatory and accounting frameworks, and may well do so on a faster scale than TCFD – the TNFD Forum has reported that there is appetite from stakeholders for this. It is possible that Target 15 of the Post-2020 Framework, if agreed in December, will involve taking measures to ensure assessing, monitoring and reporting on biodiversity impact is mandatory.

It is reported that the challenges that insurers testing the Framework have found include: lack of data (a familiar but even more difficult challenge than in relation to climate change), the complexity of the impact on the underwriting side of the business across different product lines; the various risk horizons that need to be considered and modelled; and how to make the trade-off between climate, nature and other factors. It is difficult to assess what the effect of an underwriting decision might be on nature, something more qualitative than determining the effect on GHG emissions. Something that may appear positive from a climate change point of view may be destructive to ecosystems. For example, although hydropower is one of the most dominant sources of renewable energy, the WWF published in June 2022 an insurer's guide[3] to hydropower which flags up the high cost of some of these projects in terms of freshwater



diversity and other risks, and the importance of ensuring such projects are low impact.

On the policy front some jurisdictions are further ahead in their thinking on biodiversity issues than others, for example the EU has adopted a Biodiversity Strategy for 2030 to protect nature and reverse the degradation of ecosystems. In June, the commission proposed a Nature restoration law with binding restoration targets.

What are insurers doing?

A number of insurers have announced work or initiatives on this front. As set out above, this includes insuring natural resources, as well as work on biodiversity impact metrics, partnering with NGOs and academics, and carrying out due diligence around certain insureds to ensure activities are sustainable from a nature-related point of view..

In September 2022, the University of Cambridge Institute for Sustainability Leadership's ClimateWise initiative published a report on "*Nature-related risks and opportunities for insurance underwriting*"[4]. This outlines the approaches that insurers can take to reducing the impact of its business on nature or contribute to its restoration. These include:

- Incentivising nature-positive behaviours with clients, such as providing information on how to avert damage, or putting relevant conditions in policies, reducing premiums where nature-positive measures are in place or allocating additional capacity for those with strong ESG credentials.
- Innovating in asset protection, for example by insuring natural infrastructure such as mangroves or coral reefs.
- Acting as facilitator of capital flows by innovative underwriting instruments
- Collaborating with governments by sharing their risk management expertise.

Conclusion

There is no doubt that some in the industry will already be considering nature risk in the context of underwriting, within the broad umbrella of sustainability, although some will be further along the path and others just beginning.

Developments at COP 15 will be followed with much interest.

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Footnotes:

1 Global assessment report on biodiversity and ecosystem services of the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services. E. S. Brondizio, J. Settele, S. Díaz, and H. T. Ngo (editors). IPBES secretariat, Bonn, Germany. 1148 pages. https://ipbes.net/global-assessment

2 Nature-Based Solutions | UN Global Compact

3 https://files.worldwildlife.org/wwfcmsprod/files/Publication/file/2t1djg6spj_insuring_a_nature_positive_future___an_insurer_s_guide_to_hydropower__wwf_low_res_.pdf?_ga=2.151416369.928859780.1669218490-1359411570.1669218490

4 University of Cambridge Institute for Sustainability Leadership (CISL). (2022). Why nature matters: *Nature-related risks and opportunities for insurance underwriting*. Cambridge, UK: University of Cambridge Institute for Sustainability Leadership.

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"The Court confirmed that where is a solicitor is found liable to its client to return its own fees, such fees are covered under a professional indemnity (PI) policy where the solicitor had a contractual right to the fees."

DISPUTES

High Court decision on recoverability of claim for solicitors' fees under a professional indemnity policy

In *Tughans v RSA* [2022] EWHC 2589 (Comm), in which judgment was handed down last month, the Court confirmed that where a solicitor is found liable to its client to return its own fees, such fees are covered under a professional indemnity (PI) policy where the solicitor had a contractual right to the fees. Permission to appeal has been granted.

Background

This was RSA's appeal of an arbitral decision that RSA's insured, the Northern Irish law firm, Tughans, was entitled to recover a lost success fee under its PI policy. The background to the dispute was Tughans' involvement in a sale by the National Asset Management Agency (NAMA, the "bad bank" set up by the Irish government in 2009 in response to the Irish financial crash) of its Northern Irish property loan book. Mr Coulter, the then managing partner of Tughans, was interested in facilitating the sale and contacted the English firm, Brown Rudnick LLP (BRUK), in this regard.

BRUK was formally engaged by Cerberus, the potential buyer of the loans, and BRUK in turn entered into a formal engagement letter with Tughans. Pursuant to these engagement letters: (i) BRUK would receive a success fee of £15 million (plus VAT) if the transaction was successful, 50% of which would be shared with Tughans; and (ii) BRUK and Tughans represented and warranted that, inter alia, neither firm nor its partners would make directly or indirectly any payment to any Government official. This was notwithstanding the fact that Mr Coulter had apparently agreed to pay part of Tughans' fee to a former member of the Northern Ireland Advisory Committee.

The transaction completed in June 2014. Mr Coulter's misrepresentations came to light when he disclosed to his firm in November 2014 that he had transferred the majority of Tughans' success fee into an account for his own benefit. A claim was subsequently brought against Tughans by BRUK and its insurers to recover Tughans' £7.5 million success fee (in addition to other sums). RSA denied cover of the claim on the basis that, contrary to the insuring clause, it was not "*in respect of any civil liability... incurred in connection with the Practice carried on by or on behalf of the Solicitor*". RSA further argued that no loss had been suffered by Tughans in relation to the success fee, because it was only payable as a consequence of Mr Coulter's fraudulent misrepresentation, and Mr Coulter intended to share the fee with someone else. Tughans began an arbitration against RSA.

Arbitrator's Decision

The arbitrator found that, contrary to insurer's position, the claim did fall within the insuring clause: work including strategic advice, facilitation of political contacts, intelligence gathering, and deal structuring had been carried out by the two law firms for "clients". The arbitrator was also unpersuaded by RSA's argument as to the impact of Mr Coulter's conduct, holding that RSA was liable to indemnify Tughans for any award of damages in respect of the Tughans fee (but not in respect of any liability in restitution).

RSA appealed the decision under the Arbitration Act 1996 (the Act) on a number of grounds. Of particular interest to PI policyholders and insurers is RSA's appeal under Section 69 of the Act, on the basis that the Arbitrator's conclusion on coverage of the success fee was incorrect in law. RSA argued:

- If BRUK established liability against Tughans, Tughans would never become entitled to the success fee and so would suffer no loss in returning it.
- Further, it is not the purpose of a

PI policy to pay solicitors' profit costs to which they were never entitled, as this would violate the principle of indemnity.

High Court's Decision: Was the success fee covered by the PI policy?

The Judge dealt first with the indemnity principle: an insured may only recover its actual loss, but not more than its actual loss. In this regard, the Judge noted that there are obvious forms of liability to which a PI policy would not respond (such as rent arrears or over-charges for work not actually done). However, the Judge said that where a solicitor who has performed work negligently is sued for damages that include wasted fees paid by the client, the solicitor's liability in respect of the wasted fees is capable of constituting loss under the PI policy. The solicitor will have committed the time necessary to earn the fees and foregone the opportunity for other work. A contractual right to the fees will have been accrued and the solicitor will have done what is necessary to earn them.

Further, the Judge noted that in modern litigation the mechanism by which solicitors earn fees may be more complicated than the traditional application of hourly rates. It may include an uplift or fees may be entirely contingent in nature. The judge was satisfied that if the solicitor has done what is required as a matter of contract to accrue the right to the fee, an award of damages in that amount will ordinarily constitute loss for the purpose of a PI policy, including any uplift or contingency fee.

The situation is, however, different where solicitors receive money to which they never had a contractual right in the first place. Taking into account the SRA minimum terms and Tughans' policy wording, the judge held that having to return a sum of money to which an insured never had any legal entitlement was not an indemnifiable loss under a PI policy in the absence of clear language to that effect.

Applying these findings to the facts, the Judge considered whether Tughans had been contractually entitled to the success fee.

The Judge noted that for the fee to fall due, amongst other things it was necessary for the transaction to be successfully completed, and for Tughans to provide the representations and warranties set out in the engagement letter. Insurers had sought to argue that:

- If the representations given were untrue (which, as set out above, appeared to be the case), Tughans would not have satisfied all of the pre-conditions to the contract and would not become entitled to the fee; and
- If the allegations against Tughans were true then the fee had been procured by fraudulent or negligent misrepresentations, but for which the fee would never have been payable

Although noting it was a finely balanced issue, the Judge ultimately concluded that:

- The truth of the warranties and representations was not a pre-condition to payment of the fee – what was important was that the warranties and representations had been made.
- BRUK had not rescinded the contract (which would have raised a question as to whether Tughans were entitled to an allowance for services performed), but had affirmed it and claimed damages, and so the contractual rights arising under it remained.

The Judge therefore held that a claim for damages against Tughans in the amount of the fee to which it had acquired a contractual right under a subsisting contract constituted a loss to Tughans for which it was entitled, if other pre-requisites to cover were established, to an indemnity (as to whether those pre-requisites were established in this instance, this question was remitted to the arbitrator on the basis that insurers had not been provided with the opportunity to address a re-formulated claim by Tughans that it was entitled to the entirety of the success fee).

In a subsequent judgment, dated 9 November 2022, RSA was granted permission by the Judge to appeal on the issue of what constitutes an insured loss.

Comment

Until now there has been no reported court decision in this jurisdiction on the issue of whether a claimant seeking to recover the fees that it has paid its solicitor are indemnifiable under a professional indemnity policy, and this decision will be welcome to insured professionals.

PI insurers will follow with interest any appeal, and will need to consider their wordings in light of outcome, and particularly whether they expressly exclude a claim for return of fees and the extent allowed by the Minimum Terms and Conditions.

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