

Environmental insurance and its significance for business risk management

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Introduction



Current and future legislation on the environment, the circular economy and climate change, as well as trends in Corporate Governance, on both national and European levels, mean that organisations have to be concerned about and deal with financing environmental risk properly, since this can have a major impact on their balance sheets and profit & loss accounts, as well as add new risks that are hard to fund, such as reputational, image and brand risk, and/or for the share price itself in the case of those concerns that are listed on the stock market.

The new Code of Good Governance for Listed Companies of 2015 includes a specific principle (Principle 24) regarding corporate social responsibility (CSR):

"The company should advocate an appropriate corporate social responsibility policy as a non-delegable function of the board and provide adequate information on the development, implementation and results thereof in a transparent manner."

The fore-runner of this principle was article 529 ter "Non-delegable Powers" in Royal Legislative Decree 1/2010 of 2 July, which establishes that CSR policy is a non-delegable faculty of the board (which was likewise included in Law 31/2014 of 3 December amending the Corporations Act to improve corporate governance).

Another of the recommendations is for the board to seek to reconcile the company's own social interest with, as appropriate, the legitimate interests of its employees, its providers, its customers, and the rest of stakeholders that might be affected, as well as the impact of the company's activities on the community at large and the environment.

The current market situation is not as promising as in former years. In the past year we have seen certain reservations on the part of the market in relation to the demand for premium reductions from customers. Companies have made up for the virtually widespread refusal to cut premiums with a relative facility for improving the terms of cover.

The tougher market has been due to the rising loss rate in two major sectors: the petro-chemical industry and waste management. Added to this is the fact that there have been major loss events in the market and these could also take place in other sectors going forward.

We believe that we stand at a moment in time when society and companies are transparently advancing together towards increasingly sophisticated risk communication and management policies that will boost their development and growth supported by both shareholders and new investors.

Why do environmental risks pose a threat to the financial health of companies?

The future undertakings of companies are going to be increasingly shaped by national and international regulatory frameworks that are becoming stricter and stricter, as well as by a constant focus on the obligations of corporate governance.

In addition, the regulatory authorities are exerting an ever stronger influence, which entails “strict” liability and, in some cases, “unlimited” liability.

We must not forget that, while environmental risk is a threat that concerns severity rather than frequency, it can have a major impact regarding to the company's reputational risk and corporate image.

On the other hand, in the future, we must pay attention to the new risks that derive from the circular economy and climate change, being these understood to represent emerging risks of high potential impact which, as with those previously addressed, might impact upon the liability of directors and officers.

All of this has led to a growing need to assess the requirements for managing environmental risk in industry.

The Mandatory Financial Guarantee in Law 26/2007, now 11/2014

After seven years at a standstill following the publication of Order ARM/1783/2011 of 22 June establishing the order of priority and schedule for approval of the ministerial orders based upon which setting up a mandatory financial guarantee would become enforceable, the long-awaited Ministerial Order was published (APM/1040/2017 of 23 October), setting the date whereafter setting up mandatory Financial Guarantee would become enforceable (31 October 2018).

The compulsory date for performing a risk assessment and setting up a financial guarantee under contract for Priority 1 activities (should the cases for exemption not be applicable) was 31 October 2018, while, for Priority 2 activities, the date will be 31 October 2019. For Priority 3 activities we will have to wait for publication of a new Ministerial Order that sets the time-table for obligation for this group's activities to become effective.

It is important to remember that, even though approval of the Royal Decree amending the regulations partly implementing the Environmental Liability Law substantially reduces the number of companies that are not subject to the mandatory set-up of guarantees, **“not being obliged to provide a financial guarantee does not release companies and business-persons from liability”**.

It is important to recall certain points that take priority when looking at the subject of environmental liability:

- Law 11/2014 establishes liability for both natural and legal persons.
- Strict and unlimited liability regarding damage caused for the activities in Appendix III, “as well as for activities that are not included where intent, fault or negligence are present”.
- The limit required for the financial guarantee does not limit an operator's liability.

- Article 13 of the Law establishes the secondary liability of, among others, de facto and de jure managers and directors for legal entities whose conduct has been decisive in the liability of the latter (hence the importance of having good Directors and Officers -D&O- liability insurance).
- NGOs are interested parties in initiating proceedings and the Prosecutor's Office may participate.
- The penal code includes aggravated forms for offenses against natural resources and the environment.

Irrespective of the fact that the law establishes an insurance policy as one of the instruments that validly constitutes a financial guarantee, along with endorsed guarantees or ad-hoc funds, it is important to make the point that the insurance industry belongs to the private arena and can thus choose whom it insures, what types of cover to offer and what price to charge for the risk borne. This is why, in order to transfer environmental risks via this means, it will be important for the companies to develop effective environmental policies to make such risk more appealing to the insurers.

Market

The insurance option of environmental liability is perhaps the most practical and cheapest option when it comes to transferring/financing the environmental risk of companies in relation to any potential incident involving environmental pollution or damage.



We stand at a moment when the insurance market has developed tailor-made services, programmes and products that are highly sophisticated and adequate for the industry, although, to a large extent, these products have only been bought by larger or listed companies and one or two responsible SMEs. That said, there are many SMEs that will not take out such policies until it is obligatory for them to do so.

Insurers are making efforts to adapt their products to the new legislative framework. In this respect, it is important for the insurance market to not only offer forms of cover that are based on the initiation of administrative proceedings based on Law 26/2007 (now 11/2014), but also to extend their coverage commitment to the entire set of sources of potential environmental liability of their customers in a general sense, so as to offer them broad transfer of the risks they face.

The future of the maintenance and growth of portfolios, in this insurance class, will involve quality service and handling, and swiftness in paying and settling claims, and being able to devise international programmes with high added value.

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Even so, the emergence of new insurers that are interested in risks of this kind has, to some extent, softened the trend towards a harsher market and they remain competitively priced.

Looking ahead to 31 October 2019, the insurance industry must prepare for and adapt to fresh demands and needs from the Spanish market and we must be able to offer solutions to these promptly and decisively so as not to jeopardise both many years of effort and our future credibility.

We believe that the enforceability of obligatory financial guarantees will have a positive effect on the degree of liability of companies and development of the insurance market as regards the environment, given that this will have to keep developing and tailoring its policies to market requirements.

Environmental cover is of great importance in the current context of a trend towards applying to court proceedings to resolve many claim procedures, all furthermore bearing in mind the rising tendency of making liability strict in many cases when it was not so before.

We consider that there is still a long way to go and that there are big opportunities for growth in environmental liability product lines, on both a national and an international level, since there is a sizeable demand among traditional projects and sectors of activity that have potential environmental impacts (e.g. the waste, energy, chemicals, petro-chemicals, pharmaceutical industries etc.), in newly created sectors, as well as in terms of new projects that arise from current customers abroad who generate a big demand for international programmes and services.

The main forms of cover in the market are:

- Contractor cover (active third party risk situations).
- Damages and prejudicial consequences, whether bodily and/or involving property, caused to third parties and occurring either within or outside insured risk situations.
- Cleaning and clear-up costs outside the insured risk situations.
- Cleaning and clear-up costs within the insured risk situations.
- Environmental damage resulting from the haulage of the insured's freight.
- Business interruption from environmental damage.
- Electro-magnetic fields and waves.
- Environmental damage (including preliminary, supplementary and compensatory remedy).
- Environmental damage or pollution at a specific time and place, disturbances and obstruction.
- Preventive costs.
- Palliative and/or avoidance costs.
- Defence and bonds.

As regards mandatory financial guarantee cover, we can find preliminary remedy cover up to the limit that arises from the risk assessment for this level of remedy and cover for prevention and avoidance costs (10 %).

Conclusions

Now, more than ever, insurance plays a highly important role in environmental risk management.

Considering the present insurance market, there is no reason not to finance and transfer potential financial losses arising from environmental risks at any kind of company.

Analysing where we have come from and where we have been in the past 10 years, we can conclude that Spain is at the forefront in developing products and services that are aimed at improving the financing and management of environmental risks, and far ahead of other countries around us.