BANGOR BUSINESS SCHOOL

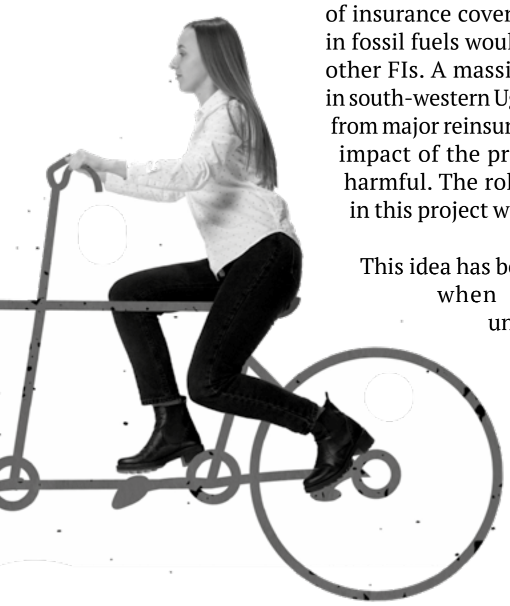
Profit and purpose must work in tandem

M. Iqbal Asaria CBE, Visiting Faculty, Bangor Business School, predicts greater scrutiny of insurance providers and their decisions to underwrite fossil fuel projects. He argues that FIs have a pivotal role to play in meeting carbon targets and facilitating the move towards sustainable energy sources.

The inadvertent role of finance and insurance in enabling some activities can become evident much later when those activities are viewed as undesirable.

In the debate that ensued after the Black Lives Matter movement, an interesting premise emerged. It was argued that if insurance companies had declined to offer cover for slave ships, the number of slaves transported across the Atlantic would have been dramatically smaller, as the loss of vessels mid-ocean was so high. These thoughts encourage us to comprehensively consider the role of insurance and finance institutions in a vast range of activities.

Today, the discussion about the enabling role of finance and insurance in enabling or mitigating climate change has fortunately emerged much earlier in the debate. The role of insurance companies in facilitating the growth of carbon-polluting industries such as coal, fossil-fuel mining and energy generation is being debated. It has been argued that, in the absence of insurance cover, many of the massive investments in fossil fuels would have been shunned by banks and other FIs. A massive oil project under consideration in south-western Uganda is currently awaiting clearance from major reinsurance companies. The environmental impact of the project is predicted to be incredibly harmful. The role of major reinsurance companies in this project would be definitive.



This idea has been discussed since the early 1980s, when multilateral institutions came under pressure from NGOs to decline to finance environmentally harmful projects. As a result, the World Bank instituted a protocol for Environmental Impact Assessment before agreeing to finance projects. As a result of the protocol, the Three Gorges Dam project in China (started in 1994 and completed in 2006) and the Sardar Sarovar Dam project in north-western India (started in 1979 and completed in 2017) were refused support from the bank. Both projects eventually went ahead when private finance was secured. It was becoming clear that private funds would also have to play a role if these harmful projects were not to be financed.

As the impact of climate change becomes more evident and governments sign up to net-zero commitments under the COP agreements, the role of FIs in helping achieve these targets is gaining greater attention. In parallel, public pressure on FIs to limit their carbon-polluting project financing is also having an impact. Regulators and supervisors have also begun to put in place frameworks requiring FIs to have a transparent reporting regime, which is gradually becoming mandatory.

Regulatory bodies in many jurisdictions now require corporations to report on their carbon footprints and demonstrate plans to reduce those impacts. It's expected that, in future, FIs will be required to marry their regulatory requirements with those of corporations to achieve sustained reductions in their carbon footprints.

As investment in fossil fuels declines, there have been developments in renewable and sustainable sources of energy. Solar, wind and tidal power generation has increased dramatically. As volumes have grown, costs have fallen. Indeed, in many cases, costs of some renewable power generation have fallen below those of conventional fossil fossil-fuel-based power generation. Some of these developments had to be funded from state resources because private finance was ill-equipped to take these long-term risks. Increasingly, many companies now have access to normal bank and institutional finance.

As the move towards renewable sources of power gathers pace, there are calls for the inculcation of a regime of 'patient' finance. Development of renewable and sustainable power generation typically has a longer gestation period to become commercially viable and it's likely that financial institutions will face demands for innovative product provision to provide patient finance. We can expect the development of some path-breaking financial instruments in this space.

The Russian invasion of Ukraine has temporarily disrupted the move towards renewable and sustainable energy. However, given the growing climate change crisis, these are likely to be short-term setbacks and the emphasis on mitigating climate change will remain a primary focus of governments and regulators.

Some FIs have been aware of the impacts of climate change for decades. Leading reinsurance companies such as Munich Re were keen to fund large-scale projects such as the Desertec initiative back in 2009. This project was designed to power European energy requirements via solar energy generated in the vast Sahara Desert. The rationale for providing funding was that the companies expected many of their future claims to result from the impact of climate change. They argued measures to mitigate climate change would be in their own long-term interest. Similar arguments are now emerging to limit investments in fossil-fuel-based projects, as the risks of massive losses from stranded assets become evident.

It is now also becoming evident that FIs including major insurance and reinsurance companies will be required to play a leading role in achieving the net-zero targets, such as disincentivising carbon-polluting industries and enabling renewable and sustainable activities. In this endeavour, profit and purpose will have to work in tandem.

For banks and FIs, a clear challenge is emerging to develop appropriate instruments to enable them to become leaders in climate change mitigation while increasing their value to their shareholders. The case for long-term vision and resources to achieve this will be easier to make given the fact that most regulators will be firmly on their side. This, in turn, will lead to a major revolution in the traditional study of banking, finance and insurance. CB