

Brighton NEWSLETTER

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Editor's Note

2022 has sailed by in a flash! By the time you read this, nine months would have gone and we are now heading into the final quarter of the year.

Despite unexpected global events and multiple economic pressures – inflation, rising energy costs, and looming recession – insurers have remained firmly focused on growth opportunities.

One of the areas for growth opportunities remain with the application of blockchain technology in the insurance industry. The article on “Linking The Chains: Application Of Blockchain In Captive Insurance”, highlights the ability of blockchain in creating efficiencies in captive ownership as well as management processes.

As ESG becomes more of a priority in the corporate sphere, emerging risks related to ESG issues such as greenwashing risks and carbon credit risks are developing into mainstream risks for insurers.

Our feature article “Greenwashing Risks: The Green, The Bad and The Ugly”, highlights how regulators and governments worldwide are increasingly concerned about greenwashing. Key risks related to carbon credits are also discussed at length in this issue.

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Greenwashing Risks: The Green, The Bad and The Ugly

As being green becomes in vogue, there has been an uptick in the number of companies that have invested in sustainability in their business activities and operations. These companies have realised that sustainable practices can lead to increased efficiency and a better bottom line. Although many companies are taking the green transition seriously, others have resorted to greenwashing; which undermines genuine efforts to go green.

What is greenwashing? Greenwashing is a term used to describe a false, deceptive or misleading claim made by an organisation that it's business, products or services are more environmentally positive than they actually are.

The term was first coined in 1986 by Jay Westerveld, an environmentalist. He criticised hotels for falsely promoting the reuse of towels as part of their broader environmental



strategy; when in actual truth this was merely a cost-saving measure to reduce laundry costs. This concept has since been extended to encompass instances where companies falsely claim that their products and services are sustainable.

Greenwashing continues to be a key concern for regulators and governments worldwide. The need to combat greenwashing came under the spotlight at the United Nations COP26 summit in Glasgow last November, as ESG becomes increasingly adopted and practiced by organisations around the globe.

Considered as material risk, regulators have been cracking down on alleged greenwashing and have made it clear that supervisory action will be taken against companies found to be misleading customers, investors and other key stakeholders over the sustainability of their product offerings or transition plans.¹

The calls for tougher actions to be taken against companies who greenwash have added another layer of risks that organisations are exposed to as they undertake their sustainability journeys, with the greatest risk being reputational risk.

In recent years we have seen how greenwashing has emerged as a major source of liability for directors and officers as companies struggle to live up to environmental

and sustainability credentials.² In a study conducted by QBE, one in ten senior leaders said their companies are already facing reputational risks or increased scrutiny over their ESG framework. The same study also reported that 42% of senior leaders are worried they could be found personally liable for business failing to deliver on environmental initiatives or by reporting climate related exposures.³ This is part of an overall trend in which directors and officers are facing increased regulation and, consequently, litigation around the performance of their roles.

While regulators have primarily focussed on the actions of asset managers, insurance firms are also exposed to greenwashing risks, which are driven by several factors. These include lack of common standards to define and measure what constitutes an ESG product, lack of consistency and accuracy of ESG data disclosed, and greater demand for ESG-related products by investors and consumers.



¹<https://www2.deloitte.com/uk/en/blog/auditandassurance/2022/identifying-and-mitigating-greenwashing-risk.html>

²<https://www.commercialriskonline.com/greenwashing-emerging-as-major-do-liability-risk/>

³<https://qbeeurope.com/news-and-events/press-releases/senior-leaders-personal-liability-at-risk-as-businesses-fail-to-deliver-on-environmental-initiatives/>

Key Risks Related to Carbon Credits

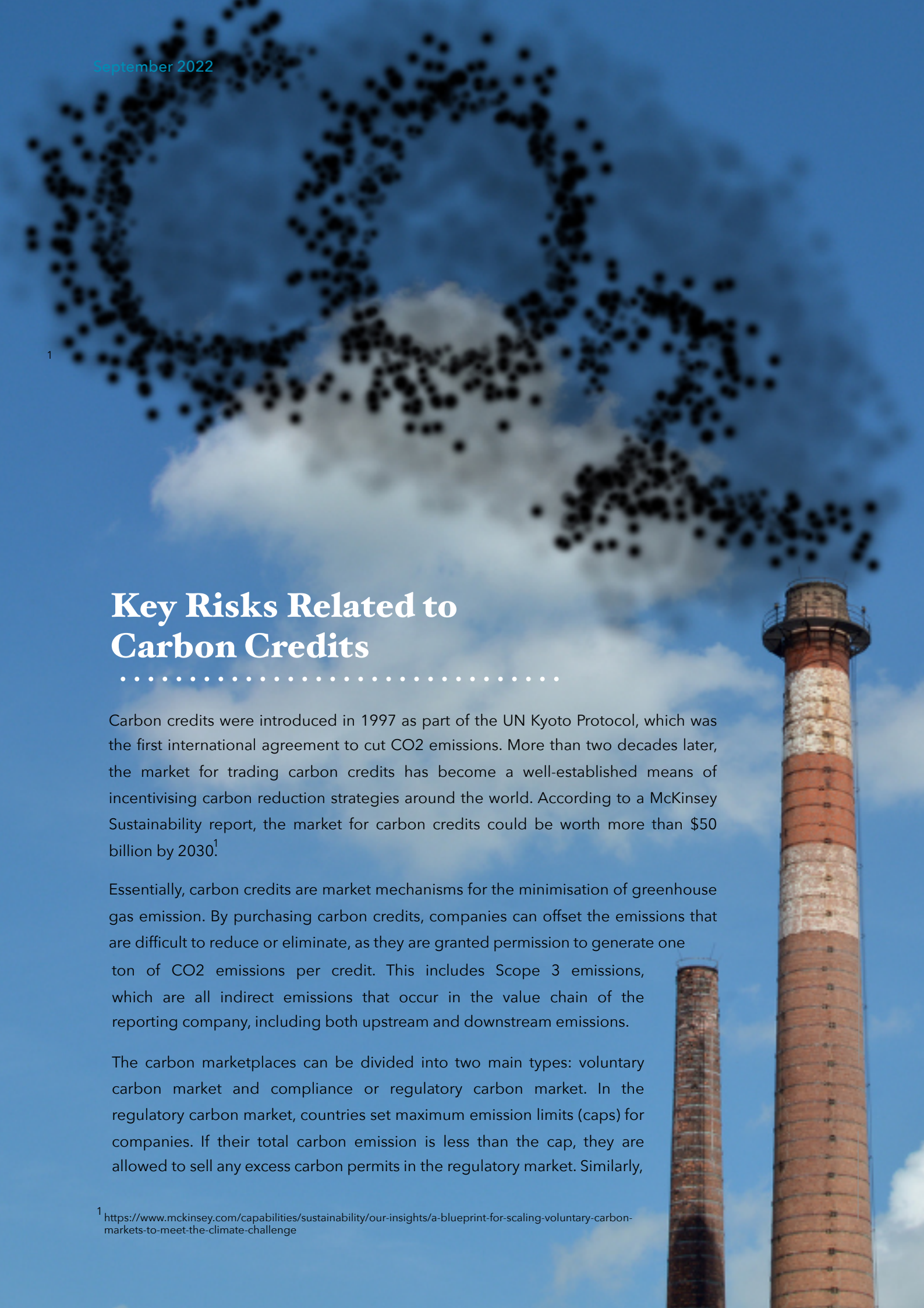
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Carbon credits were introduced in 1997 as part of the UN Kyoto Protocol, which was the first international agreement to cut CO₂ emissions. More than two decades later, the market for trading carbon credits has become a well-established means of incentivising carbon reduction strategies around the world. According to a McKinsey Sustainability report, the market for carbon credits could be worth more than \$50 billion by 2030.¹

Essentially, carbon credits are market mechanisms for the minimisation of greenhouse gas emission. By purchasing carbon credits, companies can offset the emissions that are difficult to reduce or eliminate, as they are granted permission to generate one ton of CO₂ emissions per credit. This includes Scope 3 emissions, which are all indirect emissions that occur in the value chain of the reporting company, including both upstream and downstream emissions.

The carbon marketplaces can be divided into two main types: voluntary carbon market and compliance or regulatory carbon market. In the regulatory carbon market, countries set maximum emission limits (caps) for companies. If their total carbon emission is less than the cap, they are allowed to sell any excess carbon permits in the regulatory market. Similarly,

¹ <https://www.mckinsey.com/capabilities/sustainability/our-insights/a-blueprint-for-scaling-voluntary-carbon-markets-to-meet-the-climate-challenge>



if the companies' total carbon emissions exceed the cap, they can buy extra carbon permits in this market or pay a fine. Each year the caps are adjusted, ideally downwards, thus incentivising companies to find innovative ways to reduce greenhouse gas emissions.

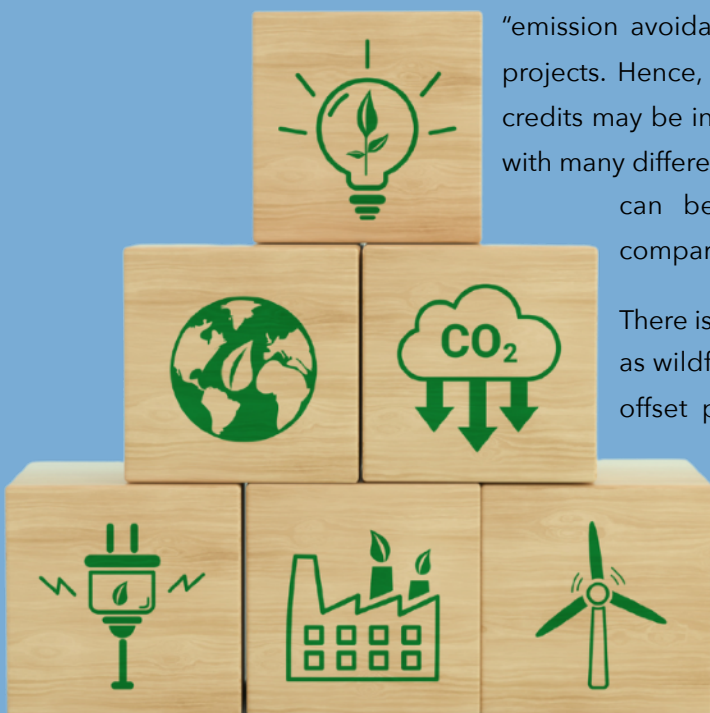
Unlike regulatory markets, companies that participate in voluntary markets don't face legal penalties if they fail to reduce their carbon output or purchase offsets. Under the voluntary carbon markets; investors, governments, non-governmental organisations and businesses can voluntarily purchase verified emission reductions in the form of carbon credits. Examples of projects that generate carbon credits include planting trees and investment in renewable energy.

With "green is the new black", a growing number of companies that are not required to reduce their emissions are now participating in this market as part of their net-zero commitments. A total of 60% of Fortune 500 companies have now set climate targets and these commitments point to substantial increase in demand for voluntary carbon credits. In 2021, voluntary carbon markets were valued at around \$2 billion,² and this value is expected to triple in the next 5 years. However, voluntary carbon markets globally remain poorly conceptualised, weakly regulated, and lack the proper frameworks to validate prices and trade offsets.³

These have exposed companies and investors to a plethora of challenges and risks associated with using carbon credits to offset green house emissions. First of all, companies face carbon credit risks as the credits are purchased on a forward basis long before regulatory approval of carbon savings are secured. There is also the issue of the quality of the credits and its authenticity. For example, if the quality of the credits and their underlying projects is not guaranteed, buyers of carbon credits may risk doing harm to the environment, climate, communities and their own reputation.

The quality of carbon credits can also vary widely. For instance, "emission avoidance" credits carry lower quality than reforestation projects. Hence, there is the risk that some of these lower quality credits may be invalidated. As the market is currently over crowded with many different kinds of credits of varying quality and rigour, this can be challenging for companies and investors to compare and evaluate the many carbon credits available.

There is also the physical risks related to carbon credits such as wildfire destroying trees in a forest preservation carbon offset projects. Other risks include greenwashing risks, financial risks, market risks and regulatory risks. In mitigating such risks, a carbon credit insurance that provides coverage for risks related to carbon credit generation and transactions would create greater certainty and confidence in the carbon markets.



² <https://www.ecosystemmarketplace.com/articles/the-art-of-integrity-state-of-the-voluntary-carbon-markets-q3-2022/>

³ <https://spectra.mhi.com/partner-asias-booming-carbon-market-the-road-to-net-zero-or-a-minefield-of-risks>

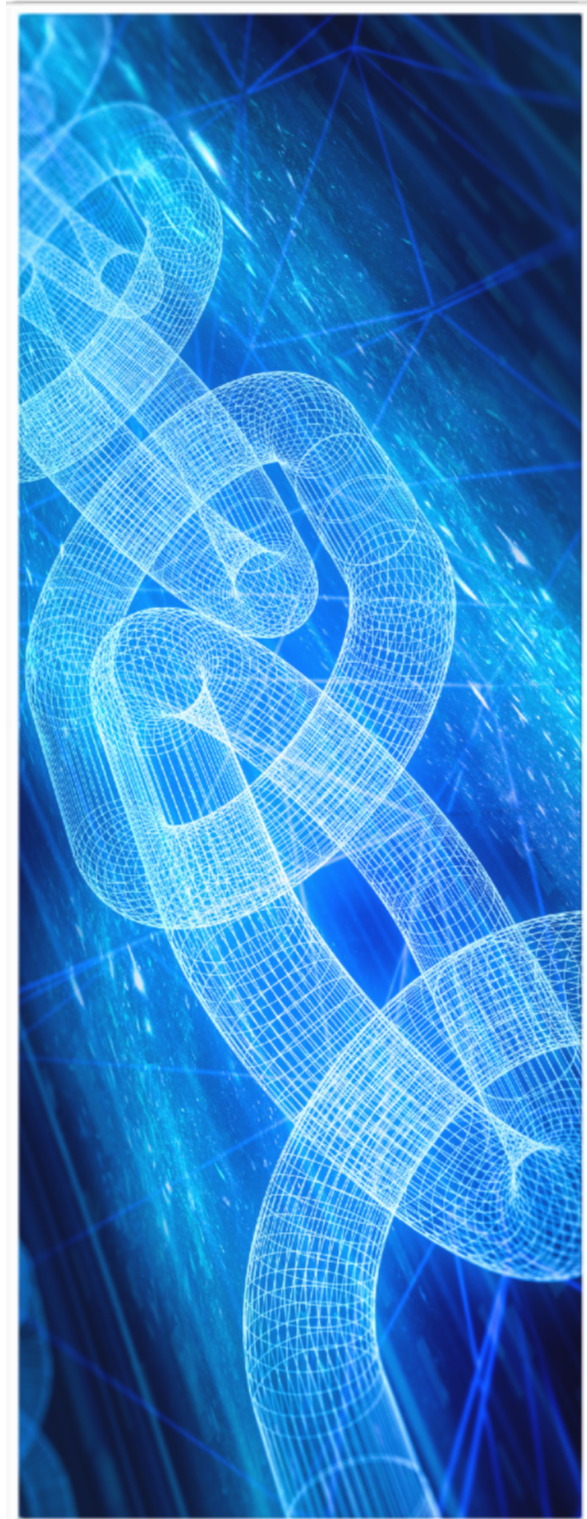
Linking The Chains: Application Of Blockchain In Captive Insurance

Blockchain was first introduced as the distributed ledger behind bitcoin transactions, but the technology has innumerable applications that go beyond cryptocurrencies. Blockchain technology has taken on a life of its own in recent years, primarily attributed to the rising demand for digital identity across the globe. The global market for blockchain technology has registered a massive surge in growth and is estimated to be valued at \$138 billion by 2030.¹

Blockchain is essentially a digital ledger in which transactions are duplicated and distributed over the network of computer systems on the blockchain. Since all transaction that occurs on the blockchain is recorded in every participant's ledger in real time, blockchain technology allows simultaneous access to the same data. Furthermore, as information shared is encrypted as an electronic list of records or blocks, it cannot be erased; which helps to ensure trust between users sharing the information.

Given its intrinsic nature, blockchain has become synonymous with a growing need for security, transparency and data integrity. Today, the application of blockchain is expanding. It has moved beyond the use of bitcoin to solving specific problems in a wide spectrum of sectors including supply chain, logistics, energy, finance, and legal. Within the captive insurance space, blockchain technology is already making its mark.

The adoption of blockchain technology into captive programmes has the potential to open the door for expansion and growth. There are several ways that blockchain can add value to captive insurance.



¹ <https://www.marketresearchfuture.com/reports/block-chain-technology-market-1708>

Blockchain-based smart contract, for example, helps speed up claims processing each time there is a claim as it is executed automatically when a particular condition is met; without the need for verification or lengthy checks. This in turn reduces claims administration costs as well as the risk of fraudulent claims. In addition, smart contract can also be useful for solving complex and large claims to support quick payments.

Since information on the blockchain is stored on the ledger in real time, it can be used to share claims data with external insurers and reinsurers, which enables automatic reconciliation and reduces both time and processing errors.

This also enables captive insurers to enhance their risks management and underwriting analytics as well as policy design. By leveraging this, captives would be able to better adapt coverages offered to its current capacity and risk appetite, rather than based on potentially outdated models.²

Blockchain also provides for an efficient and transparent form of digital identification and verification. This is valuable for streamlining client on-boarding processes, including know-your-customer and anti-money laundering requirements.

One of the main benefits of blockchain comes from the ability to share information and streamline data exchange seamlessly and in real time. For captive insurance providers, insurers and regulators; information can be shared more rapidly and securely by establishing shared rules and standards for sharing of information. This has the added advantage of enhancing governance, creating greater transparency and resulting in faster, better-informed decision making.

The application of blockchain technology can be also used to optimise the payment processes involved in international fronting for captive insurers, where multiple process steps are involved in transferring premium from a corporate to its own subsidiary.

Captives are in a position to adapt to future technological trends and developments since they are generally smaller and newer as compared to traditional insurance companies. However, much of the blockchain applications so far have been focused on cost reduction efforts.

This may be only the beginning of the blockchain revolution, but it is only a matter of time before the technology matures to be integral to every aspect of the insurance industry, including captives.



² https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/financial-services/ey-from-pipe-dream-to-pipeline-blockchain-for-captives.pdf 6