

C O M M E N T

The Future of FAMs

by Rosalie L. Donlon

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Zachary Arnold's proposal of a policy framework to prevent coastal industrial disasters is quite timely, coming as it does after the 2017 hurricane season on the East Coast, followed by the equally devastating wildfire season in the West. Arnold suggests that imposing financial assurance mandates (FAMs), such as minimum insurance coverage, would induce coastal industries to proactively manage climate adaptation, and thus, proactively manage risk.

Arnold points out that government at all levels—local, state, and federal—could do more. A major drawback is that many governments are not encouraging businesses or developers to invest in climate adaptation. Without a government directive, it is likely to take longer to convince businesses of all sizes to be proactive.

I. Climate Does Not Equal Weather

In describing “climate adaptation,” Arnold uses scientific terms that, while accurate, may have the effect of turning off those who should be paying better attention. Generally, businesses and governments are not composed of scientists, and as Dr. Louis Gritzso, vice president and manager of research at FM Global, has said, “climate science is not a long-term weather forecast.”¹ As long as the public, including policymakers and business owners and operators confuse the two, there is likely to be resistance to the need for a FAM and no interest in gaining greater understanding.

At least one state appears to have adopted Arnold's idea, at least in part. Louisiana has adopted an aggressive response to climate-linked flooding in the United States. The plan calls for prohibitions on building new homes in high-risk areas, buyouts of homeowners who live there now, and hikes in taxes on those who won't leave. Commercial development would still be allowed, but developers would need to put up bonds to pay for those buildings' eventual demolition.²

According to published reports, the draft plan is part of a state initiative funded by the federal government to help

Louisiana plan for the effects of coastal erosion. That erosion is happening faster in Louisiana than anywhere else in the United States, due to a mix of rising seas and sinking land caused in part by oil and gas extraction. State officials say they hope the program, called “Louisiana Strategic Adaptations for Future Environments,”³ or LA SAFE, which focuses on community adaptation, becomes a model for coastal areas around the country and around the world that are threatened by climate change.⁴

II. EU Environmental Liability Directive

The European Union has begun dealing with climate change in a more formal way, as Arnold proposes for the United States. In 2004, the European Commission (EC) issued Directive 2004/35/EC, the Environmental Liability Directive (ELD).⁵ The Directive established a framework based on the polluter-pays principle to prevent and remedy environmental damage. The ELD is an administrative approach, based on the powers and duties of public authorities.⁶

Under the ELD, European Union Member States are expected to ensure the effective implementation and enforcement of the Directive. Although the Directive was issued by the EC, Member States had three years to enact appropriate domestic legislation adopting the terms.

In practice, the ELD has not been as successful as the EC hoped it would be. On Oct. 26, 2017, the commission issued a resolution noting that⁷:

[O]wing to the discretionary powers awarded in the ELD and to the significant lack of clarity and uniform application of key concepts as well as to underdeveloped capacities and expertise, the transposition of the ELD into national liability systems has not resulted in a level playing field and that, as confirmed in the Commission report, it is currently totally disparate in both legal and practical terms, with great variability in the amount of cases

1. Dr. Louis Gritzso, *The Economic Risk of Climate Change*, PROPERTYCASUALTY360 (July 29, 2014), <https://www.propertycasualty360.com/2014/07/29/the-economic-risk-of-climate-change>.

2. Christopher Flavelle, *Louisiana, Sinking Fast, Prepares to Empty Out Its Coastal Plain*, Bloomberg (Dec. 27, 2017), <https://content-service.bloomberg.com/articles/P1CORY6JTSEA>.

3. Liz Russel, *Louisiana Strategic Adaptations for Future Environments*, <https://lasafe.la.gov> (last updated Apr. 27, 2018).

4. Flavelle, *supra* note 2.

5. European Commission, *Environmental Liability*, <http://ec.europa.eu/environment/legal/liability/> (last updated July 2, 2018).

6. *Id.*

7. Implementation of the Environmental Liability Directive (2017) Eur. Parl. Doc. PV 0414.

between Member States; is therefore of the opinion that additional efforts are required to enable regulatory standardisation to take place across the EU.

The resolution also stresses that all stakeholders have reported problems in holding operators strictly liable for “dangerous activities” in relation to successors of liable parties.⁸ In the United States, it has also been difficult to track owners and possible insurance coverage for environmental spills or other similar actions. Here, organizations with significant exposure to such liabilities are consulting “insurance archaeologists” to conduct specialized research that could recover or reconstruct old liability policies.⁹

Before adopting a requirement for FAMs as part of a climate adaptation program, we should carefully study what is going well and what is not working with the ELD.

III. Increased Complexity

Arnold suggests that FAMs would operate as an “outsourced” regulatory scheme. The regulatory program as outlined would require the affected business to have insurance coverage, but the program would leave it up to the insurance companies to decide what risks to insure, how to underwrite them and how to mitigate the risk. “All the regulator has to do is *verify compliance*” [emphasis added].

Arnold’s idea would require setting up an additional layer of bureaucracy and regulation to ensure compliance. Auto insurance, Arnold’s example, is verified by state departments of motor vehicles (DMV) when cars are registered. (And we know how much we all hate DMV.) Would the responsibility be with the state department of insurance to verify that a certain level of insurance coverage is in place? How would policymakers select the industries to be regulated—in addition to those that might be regulated currently? Would the requirement for coverage be based on where the business is located or the industry that it’s part of?

IV. Status of Environmental Insurance Market

Arnold’s point that private insurance is unlikely to be very expensive or unattainable is borne out by the current state of the environmental insurance market. According to a recent report from USI Insurance Services, the environmental marketplace is estimated to be more than \$2 billion in annual premiums with double-digit growth, outpacing

the annual growth rate of the general property and casualty market.¹⁰

The insurance industry is poised to provide FAMs without additional government regulation because the market for environmental coverage is highly competitive. The underwriting, however, is complicated by limited data that doesn’t provide an accurate assessment of the risk in many areas.¹¹

USI also predicts that profitability will be delayed because there are currently about 50 insurers with more than \$600 million in capacity.¹² Although insurance is available, ten-year term transactional risk policies, once the most common, can only be purchased from certain insurers.¹³ For more difficult and complicated risks, such as the day-to-day operations of energy, mining, petrochemical, and power and utility firms, one-year policy terms are becoming the norm, creating volatility for these classes of business as well as a risk of gaps in coverage.¹⁴

Buyers of environmental insurance are generally construction contractors or vendors related to construction. A requirement by the local permitting authority to have pollution liability coverage or other similar policies could provide the FAMs that Arnold proposes without an added layer of bureaucracy—assuming state and local laws allow them to impose such a requirement. Generally, larger construction firms are aware of their risk of liability and are requiring the subcontractors they work with to also have environmental insurance. In addition, lenders on large projects are requiring FAMs of their own as a condition precedent to making the loans.¹⁵

V. Insurers in Agreement

In its recent report on storms from Super Storm Sandy in 2012 to Hurricane Maria in 2017, global insurer Allianz notes that many of its builder’s risk insureds who previously would have resisted discussions concerning high wind, flooding and storm surge events impacting their construction projects are now paying much more attention.¹⁶

Allianz clearly agrees with many of the points that Arnold makes: “After catastrophes like Sandy, customers may relocate and the business base evaporates until recov-

8. *Id.*

9. Sheila Mulrennan & Michele Pierro, *Insurance Archaeology & Environmental Claims*, PROPERTYCASUALTY360 (Feb. 15, 2018), <https://www.propertycasualty360.com/2018/02/15/insurance-archaeology-environmental-claims/>.

10. Dough O’Brien et al., *2018 Insurance Market Outlook: Insights From Our National Practice Leaders*, USI, http://www.usi.com/content/downloads/16038_2018_Insurance_Market_Outlook_Book_V9.pdf (last visited Apr. 2, 2018).

11. Joyce Anne Grabel, *Is the Environmental Market too Low-Priced for Its Own Good?*, PROPERTYCASUALTY360 (Feb. 8, 2018), <https://www.propertycasualty360.com/2018/02/08/is-the-environmental-market-too-low-priced-for-its/>.

12. O’Brien et al., *supra* note 10.

13. *Id.*

14. *Id.*

15. Grabel, *supra* note 11.

16. *From Sandy to Maria: Increasingly Destructive Perfect Storms*, ALLIANZ, http://www.agcs.allianz.com/PageFiles/9507/Allianz_Hurricane%20Sandy%205%20Years%20Later_2017.pdf (last visited Apr. 2, 2018).

ery progresses. The key to recovery is to establish a plan in advance that identifies crucial operations so a company can be up and running before the competition.”¹⁷ This suggests that the insurance industry would be open to discussions with clients about climate adaptation and providing FAMs. The industry might also take the lead in such discussions instead of waiting for clients to come to them.

One significant aspect of environmental disasters that Arnold does not appear to factor in extensively is the long time frame for environmental claims. Many contaminated properties require years to clean up, and the potential losses to businesses as well as claims can quickly mount up.

As part of the requirement to have a FAM in place, would there be a time limit on liability? Would the legal standard for liability be immediate, as the source would be known after a natural disaster? Or, would it be “knew or should have known” for an incident that starts as a natural disaster, appears to be cleaned up, but actually results in ongoing contamination?

None of these issues would argue against FAMs. However, the devil is in the details, as they say. In creating the program, possible ramifications and unintended consequences should be considered.

VI. More Than Coastal Properties

According to a new study led by the University of Bristol, 41 million Americans are at risk from flooding rivers.¹⁸ That’s more than three times the current estimate of 13 million people, the study says, and it’s a problem that dovetails on coastal flooding and may also be related to climate adaptation. The study is based on a new high-resolution model that maps flood risk across the entire continental United States, whereas the existing regulatory flood maps produced by the Federal Emergency Management Agency (FEMA) cover about 60% of the continental United States.¹⁹

The estimate of 41 million doesn’t include the millions of additional Americans that are at risk of coastal flooding, the report says. The increase is a result of the expanded coverage of the map combined with its ability to estimate flooding on small streams, which wasn’t adequately

captured in previous flood-risk models, according to the study’s researchers. The study predicts that more than 60 million Americans may be vulnerable to a 100-year flood by 2050—sooner than we think.

The report highlights, as does Arnold, that relying on traditional flood maps from FEMA may not be the best way to mitigate risk from flooding. Several catastrophe modeling companies have shown with better and more current data that flooding risks—and thus risks of chemical spills or other environmental hazards—are more significant than previously believed. The modelers may help reinforce Arnold’s premise that climate adaptation is needed more than ever. Certainly, private insurers rely on their accumulated data as well as models from sources other than FEMA to assess risk.

VII. FAMs Have a Future

Arnold has succeeded in his effort to show that FAMs can efficiently and equitably promote climate adaptation. As with most policy issues, despite the data about economic losses from recent natural disasters, demonstrating the importance of adopting climate adaptation measures sooner rather than later is likely to be difficult. If a natural disaster hasn’t had a direct impact with the same devastating results as Hurricane Harvey or Super Storm Sandy, governments are less likely to insist that businesses undertake climate adaptation or provide financial assurances.

Along with governments encouraging high-hazard businesses to provide financial assurances in the event of a natural disaster, the insurance industry and risk managers could be enlisted to educate the businesses that are underpreparing for climate change. An appeal to the company’s bottom line, encouraged by risk managers and insurers who could emphasize any cost-saving measures and demonstrate a return on investment in the form of reduced premiums, might be more successful and better accepted than another government regulation.

Arnold’s idea is definitely one worth pursuing and discussing at all levels of government, as well as with risk managers and environmental insurance providers.

17. *Id.*

18. Denny Jacob, *Americans’ Flood Risk Is Far Greater Than Previously Thought*, PROPERTYCASUALTY360 (Mar. 8, 2018), <https://www.propertycasualty360.com/2018/03/08/flood-risk-for-americans-is-highly-underestimated/>.

19. *Id.*