ClientEarth

To: Inga Beale
Chief Executive Officer
Lloyd's
One Lime Street
London
EC3M 7HA

274 Richmond Road
London E8 3QW
United Kingdom
+44 (0)20 7749 5970 / tel
+44 (0)20 7729 4568 / fax

info@clientearth.org
www.clientearth.org

19 February 2018

Dear Ms Beale,

Subject: Change to investment policy and further actions on coal risk

Thank you for taking the time to provide a reply to Peter Bosshard of Unfriend Coal's request for clarification regarding the role of the Corporation of Lloyd's ("Lloyd's") and the Central Fund with respect to coal business risk. ClientEarth is providing assistance to Unfriend Coal and I therefore write on behalf of ClientEarth but with respect to your previous correspondence on this issue.

The Chain of Security remains exposed to risk from coal

Your correspondence confirms that the Central Fund will, from 1 April 2018, implement a policy of divesting and ceasing to invest in companies heavily associated with coal. You anticipate that this will impact 75% of Central Fund assets. This is great progress.

However, based on the figures in your 2016 Annual Report, the Chain of Security[1] which supports the business underwritten at Lloyd's amounts to £77,545m and the Central Fund therefore represents just 2.5% of assets for which Lloyd's has oversight.[2] As such, a very large proportion of the Chain of Security remains potentially exposed to coal related risks, such as stranded asset risk, through both the underwriting of and investment in coal business.

[1] The Lloyd's capital structure supports the business underwritten by members. This capital structure (the so-called "Chain of Security") comprises of three layers:

1. Syndicate Assets – premiums held in trust by managing agents to provide working capital for members.
2. Funds at Lloyds – members' capital held in trust by Lloyd's in order to meet the syndicate or member's Solvency Capital Requirement.
3. Central Assets (including the Central Fund) – capital available at Lloyd's discretion as a final means of meeting claims that cannot be met by Syndicate Assets or Funds at Lloyd's.

[2] Syndicate Assets - £53,890m; Funds at Lloyd's - £21,703m; Central Fund (as part of Central Assets) - £1,952m

Lloyd's 2017 report 'Stranded Assets: the transition to a low carbon economy - Overview for the insurance industry' (the "Stranded Asset Report") makes it clear that underwriting coal risks corresponds with an increased risk of insolvency.[3] With increased insolvency/credit risk comes an increased likelihood of an insured's failure to maintain owned insured assets and a concomitant increased risk of loss due to maintenance failure. This condition translates directly into increased expected loss calculations for the purpose of reserves calculations under the PRA rules.

While some have attempted to suggest that investment risk and insurance underwriting risk should be evaluated differently, insurance underwriters, actuaries and regulators are well aware that insolvency risk, credit risk and stranded asset risk all impact claims patterns - and thus expected loss - directly. As capital is constrained for coal, insurance underwriters can reasonably expect deferred maintenance and safety practices with a concomitant rise in property and casualty claims. Proper modeling and governance practices must ensure that the Minimum Standards practice reflect this reality in the governance obligations necessary to assure the Chain of Security.

Further change is needed

The planned amendment of the investment policy of the Central Fund is a very important step in demonstrating to the market the declining viability of coal business. However, as set out above, the proportion of assets this policy change represents within the Lloyd's asset structure is very small. While we recognise that Lloyd's is not responsible for setting the investment policies of syndicates, **we would like Lloyd's to recognise the systemic impact of continued coal investment and underwriting to the Lloyd's market by incorporating a robust assessment of the risks of such assets into the Lloyd's Minimum Standards**. Taking this step would be a logical extension of the steps you have taken to protect the Central Fund from the risks of continued investment in coal.

As well as ensuring the common recognition of risk within the Lloyd's market, we believe that there is a regulatory imperative for amending the Minimum Standards. Under the PRA's Fundamental Rules, members, syndicates and the Society of Lloyd's (the market which the Corporation of Lloyd's represents) have an overriding obligation to act with prudence and conduct business with due skill, care and diligence.[4] The PRA Rulebook also requires that they invest only in assets the risks of which they can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of overall

---

[3] Asset stranding is already taking place in some industries. For example, the increase in renewable energy generation, worsening air pollution, and decreasing water availability caused by climate change, coupled with widespread social pressure to reduce China's demand for thermal coal, have negatively impacted coal-mining assets in Australia. See Caldecott, B., Howarth, N. & Mcsharry, P. 2013. Stranded Assets in Agriculture: Protecting Value from Environment-Related Risks [online]. http://www.smithschool.ox.ac.uk/research-programmes/stranded-assets/Stranded%20Assets%20Agriculture%20Report%20Final.pdf

[4] http://www.prarulebook.co.uk/rulebook/Content/Chapter/212227/14-02-2018

solvency needs. Further, assets must be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.[5]

In respect of its supervisory role, we note that Lloyd's has stated how important it is that "Lloyd's market oversight is supportive of sustainable, profitable growth".[6] We further note the efforts to address climate risk that Lloyd's has taken though the ClimateWise principles and annual reporting, including the distinction drawn between Lloyd's and the Lloyd's market. However, the voluntary compliance of managing agents to these principles is not sufficient to realise the changes required to address the scale of these risks.

Proposal to amend Minimum Standards to manage coal risks

As we understand it, to qualify for membership of the Lloyd's marketplace and for the benefits associated with participation in the marketplace, including financial backing for purposes of solvency demonstration, syndicates must comply with the Minimum Standards.

We further understand that the Minimum Standards are grouped into 12 areas (see Annex, Figure 1), each of which, in part, has provisions that must be met to ensure proper governance, financial risk management and solvency standards and each of which, in part, are affected if a risk being underwritten or an asset invested in includes the risk of being a stranded asset.

We are aware that not all of the Lloyd's syndicates will invest in, or underwrite, coal. However, like many other emerging stranded asset risks - from asbestos, to cyber - coal operations have the potential to create outsized risks, consuming extensive amounts of capital to satisfy property losses, business losses and litigation exposures. As such, if not excluded from portfolios, extraordinary scrutiny of and stress testing for the stranded asset risk related to coal is warranted, consistent with the Stranded Asset Report.

Stress testing and reporting standards

The Stranded Asset Report suggests four specific actions that can be taken by investors - including insurers - to reduce the risk associated with stranded assets, including coal. The first of these is stress testing of portfolios for environmental risks, followed by investing in sustainable assets, divesting from unsustainable assets and engaging rigorously with investee companies. These are consistent with the recommendations from the Task Force on Climate Related Financial Disclosures (the "TCFD Recommendations").

We would like to suggest that Lloyd's modifies its Minimum Standards to ensure that stranded asset identification and stress testing be adopted with respect to coal and coal related operations.

[5] http://www.prarulebook.co.uk/rulebook/Content/Part/212926/14-02-2018
[6] Market Oversight Plan: Key Risks 2018, page 3

Further, Lloyd's could state that the TCFD Recommendations set out industry best practice in relation to how the Minimum Standards apply more broadly to governance, financial risk management and solvency in the context of a changing climate and the low carbon transition. Using the TCFD Recommendations would enable members and syndicates to demonstrate that they are acting with prudence and conducting business with due skill, care and diligence.

We would also like to confirm and clarify that Lloyd's expressly includes the TCFD Recommendations, and coal as an identified stranded asset risk, in its oversight and administration of the Minimum Standards.

Further, we would like to confirm that Lloyd's requires, expressly, the use of current and peer reviewed climate science, including attribution science, in the stranded asset risk evaluation as part of the enforcement of the Minimum Standards. This approach would be consistent with Lloyd's own Stranded Asset Report.

We would like to see Lloyd's take the actions outlined above as a matter of governance, through exercise of its authorities as expressed through the Minimum Standards, to reduce risk to insureds, insurers and their investors with respect to the determination of how and when to make capital available for coal. Such additional requirements could be implemented though the means of guidance and implementing guidance (see Annex, Figure 2), clarifying the expectation that Lloyd's has in respect of members of the Lloyd's market.

Next Steps

We believe there is an opportunity for you to champion the role of the Lloyd's market in consolidating the industry's view that underwriting of and investment in coal is both risky and unprofitable. We would be grateful for an audience with you to discuss the above, prior to 1 April 2018 when your policy is due to be announced.

Yours sincerely,

Alice Garton
Company and Financial Lead, ClientEarth
+44 (0)303 050 5937
Agarton@clientearth.org

Annex

Figure 1:

WHAT AREAS DO THE MINIMUM STANDARDS COVER?

The Minimum Standards have been split into the following twelve relevant areas:

MINIMUM STANDARDS	
CODE	**NAME**
MS1	Underwriting Management
MS2	Claims Management
MS3	Governance
MS4	Risk Management
MS5	Scope, Change and Use
MS6	Modelling, Design and Implementation
MS7	Validation
MS8	Investment Management
MS9	Reserving
MS10	Regulatory
MS11	Conduct Risk
MS12	Operating at Lloyd's

© Lloyd's 4

Figure 2:

HOW A STANDARD IS STRUCTURED

The Structure in which the Standards are set out is as follows:

ELEMENT	DEFINITION
Standard Group (Section)	Groups of standards, generally aligned to Lloyd's technical review teams.
Minimum Standard	A brief statement of capability or level of conduct required.
Requirement	A sub-set of requirements that specifies key areas that must be addressed in meeting the standard. Lloyd's will seek positive assurance that each requirement has been met.
Guidance	Explanation of how Lloyd's will assess whether standards have been met as well as potential ways of achieving this.
Implementing Guidance	Practical advice and examples showing how agents can address selected problems. Not primarily aimed at helping to meet Lloyd's Standards, but it is consistent with them.

Shows on Lloyds.com and the documents attached

Linked via Lloyds.com and within the attached documents