

GARNAUT CLIMATE CHANGE REVIEW PAPER 2: FINANCIAL SERVICES FOR MANAGING RISK: CLIMATE CHANGE AND CARBON TRADING

Issues Paper 2 of the Garnaut Climate Change Review entitled Financial Services for Managing Risk: Climate Change and Carbon Trading states that the paper follows the second of a series of public forums held in Sydney on 31st October 2007. These were not public forums. I was not invited to either although I made a submission on the first Garnaut Climate Change Review Paper. I had to find out everything about the October 2007 event from reading the newspapers and when I contacted the Garnaut Review to ask for the relevant paper my requests were ignored until I also sent a copy of the request to the Department of Climate Change and the relevant ministers. I have no problem with Professor Garnaut holding a meeting with the financial sector. I most decidedly have a problem with his calling this a public meeting when it so obviously was not. The Productivity Commission would not do this. Have some respect.

Question for consideration: What is the appropriate burden of risk sharing responsibilities between government, individuals and the insurance industry?

Issues Paper 2 gives the impression that insurance companies are more interested in making money for their companies through trading the funds they may become lucky enough to underwrite, instead of effectively fulfilling their related business commitment to manage insurance claims effectively. They appear to have become obsessed by financial trading. Although the paper appears to assume that the insurance industry should underwrite the funds related to the risk of managing climate change, it definitely should not, for the reasons outlined below and others discussed in related papers attached.

It seems likely to be impossible to decide whether any extreme weather event which happens is the result of global warming. Those familiar with workers compensation insurance will be aware of a similar work related problem, which is that it is often impossible to determine if a person's bad back has been the result of their work routine or a range of other factors. This uncertain situation often creates a lawyers' picnic where the managers of any insurance fund protect their funding pool with lawyers who treat the fund as if it were money for the company shareholders' purposes. Then the lawyers of any plaintiff may take those who manage the insurance fund to court. The major winners in this structure are the lawyers on both sides of the case and also the insurance companies. The latter can invest the premium funds they underwrite on their own behalf and take the income for their company shareholders. Making money for their company is their primary goal. This is a poor structure for protecting the broader public interest. Innocent bystanders often bear the costs of their greatest financial successes and failures.

Insurer underwriting and competition on premium price also create a situation where high insurer profits are required to create a buffer against insurer insolvency, and yet insurers may become insolvent as a result of fierce premium discounting and market downturn, any unexpected calamity and related losses in court, or for other reasons. Governments and many others may pick up a large part of the bill for this. A related problem for

Australians who adopt any private insurance company underwriting model is that insurance companies operate internationally, so that Australians may find themselves bearing higher premiums because of an extreme weather event in another country. Australians can and should control their own risk of fire, flood, etc. but they would be foolish to become caught up in subsidising, through insurance, the costs of catastrophes in other countries, especially where low taxes may mean that those governments do very little to protect their populations from catastrophe or help their rehabilitation afterwards.

The court process provides no data for effective premium setting. This also undermines good management of all work and welfare systems which must interact with the court. Australian historical experience of health insurance and workers compensation schemes shows it would be better to have funds for managing climate change underwritten (owned) by government, industry and communities, with the fund *administration* privatized. Then the fund owners can compare the performance outcomes of all related public and private sector administrators and service providers. All injury prevention, rehabilitation, compensation, fund investment and related services are ideally managed openly and competitively so service outcomes can be identified comparatively, on a related industry and regional basis. Why give industry and government funds away for private sector insurers to reap the benefit of their investment on their own behalf? In a good fund management model, premiums are reduced by handling risks and injuries better, and investing productively, not by shifting the cost of risk onto others. A market driven approach to insurance underwriting supports unlimited financial protection for risk takers who appear able to pay the premiums required for protection from their risk. The assumption of risk can also be contracted out freely to other investors in the market.

Insurance to manage the risks of climate change ideally is instead a form of social insurance. A suitable management structure is addressed in more detail in the attached article entitled, 'Recent Australian perspectives on health and social insurance'. The Australian government risk management ideal in regard to climate change and its effects would be to design insurance and related financial services to achieve more sustainable regional development. This in turn requires more open and therefore effective, competitive management and investment of all public and industry owned funds, to achieve key national goals, driven first by the identification of major greenhouse gas emissions. Ideally, all other business costs are reduced as a result of designing these more openly competitive industry and community investment processes. This structure also cuts all future, unknown costs of risk re-insurance and flattens the underwriting cycles which produce business volatility and its added costs.

Question for consideration: To what extent, and on what basis, might it be desirable that permits are not allocated via an auction system?

From the Australian government, industry and regional community perspective, the point of introducing carbon trading is so that the risks of climate change are dealt with as effectively as possible within a specified time frame, not so that insurance company shareholders can make money. Yet paper 2 does not discuss the ideal relationship between greenhouse gas permits and insurance premiums. What is it? From the public

interest perspective, insurance should support competitive national, regional and internationally planned programs for sustainable development. It should not primarily give incentives to insurers to try to make money for their company shareholders.

From the perspective of the public interest, insurance premiums and carbon trading permits must be logically related. Greenhouse gas risk prevention, environment rehabilitation, compensation and all related development functions must normally be managed effectively through openly competitive, stable and low risk fund investment. The funds should be owned by Australian government, industry and communities and managed in order to reduce all regional problems related to climate change. This is most sensibly undertaken by putting the control of the apparently worst risks first, on an industry and related regional community basis. A preliminary industry audit undertaken in cooperation with the Department of Climate Change in accordance with its Regulations Policy Paper entitled 'National Greenhouse and Energy Reporting System' (Feb. 2008) would be a good beginning. (Also see attached discussion of pollution control in the Illawarra. My first submission to the Garnaut review also discussed offsets.

Ideally, Australian governments, industries and their related regional communities need to invest in the control of clearly identified risks to the environment in Australia and elsewhere in a way which is not driven primarily by the insurance company shareholders' desire for profit. The latter leads to a socially dysfunctional choice of financial risk control and to a perversely related treatment of investments. The United States health care system provides many examples of this problem. Insurance companies cater to the rich health care consumer's needs and to their related research interests, in order to reap most potential profit, while the poor and their problems can go hang. There is no money in control of dengue. The problems of the poor can probably be best resolved through the financial controllers being provided with very large economies of production scale. Australia government, industry and communities should logically seek to work with Chinese government, industry and communities and with other willing countries to resolve all related problems. (See attached discussion on how this may be conceptualized and undertaken to protect health in Chinese or related industry and community contexts.)

Ideally, greenhouse gas permits represent taxpayers' money which is provided to industry and the community on a related regional and industry basis to address the environmental problems caused by greenhouse gas emissions. This is ideally implemented through risk management processes which first identify and then seek to deal with the worst risks to communities and environments, prior to dealing with those of the second order. Level of risk is normally estimated by its potential severity and its frequency of occurrence. Government provision of permits to a polluting organization should reflect the level of risk to the environment its emissions pose. This is a scientific treatment of permit provision. Auctioning permits undermines any scientific measurement of risk and its management. Provision of permits must also be designed to support the Australian Government's key aims of fighting inflation first and achieving sustainable development fairly. I don't understand the potential effects of any permit introduction on inflation.

In general, however, the more governments, the biggest polluters and communities put into an early, joint premium/permit fund to address problems related to climate change the better, as long as the money is well managed to achieve the desired triple bottom line results – economic, social, and environmental. Fund management is ideally open, consultative, and designed scientifically to achieve the goals of sustainable development through open service competition. On the other hand, the primary goal of the private sector insurance company is shareholder profit. This provides perverse incentives from any perspective that values the public interest in sustainable development first, because it is driven overwhelmingly by competition on premium price and opaque trading to meet management and shareholder interests, until the market inevitably turns and bites back. The social insurance perspective instead can stabilize the market and reduce its costs.

The financial sector needs to be broadly and effectively controlled by government, industry and communities or few except the comparatively rich will benefit effectively. (See attached discussion on financial service and development issues from a consumer perspective.) Insurance premiums and/or clearly related permits for carbon trading must first be risk rated on an industry and related community basis. This can be introduced by a baseline research audit of the worst polluters. Permits for carbon trading should then be allocated to industry by government in a suitably coordinated and openly managed fashion. Otherwise it will not be possible to carry out any greenhouse gas related rehabilitation or compensation functions, let alone any greenhouse gas injury prevention functions, effectively and scientifically. Deal with the worst identified problems first.

In order to get the biggest bang for buck in regard to the provision of greenhouse gas prevention program and related regional offset program planning, it seems logical for government first to provide the biggest polluters with the relevant number of permits. This will then enable their organization to begin control of its emission risks or to become involved in related regional and community offset schemes. The aim is to manage the risks of climate change in a way which also achieves all related regional government, industry and community sustainable development objectives. This also provides an opportunity to introduce triple bottom line accounting. From the perspective of the public interest, this recommend system appears to be the only one which is consistent with the achievement of sustainable development as quickly, scientifically, competitively and effectively as possible. Permits are managed incentives to change.

Ideally, the appropriate premium, permits or carbon credits associated with greenhouse gas emissions must first be established in regard to the biggest polluters. The level of noxious emissions an organization is delivering into the environment must be estimated, in order to reduce them at their source, to invest in offset activities instead or to do both. One therefore must first consider the Department of Climate Change Regulations Policy Paper entitled 'National Greenhouse and Energy Reporting System' (Feb. 2008) and the National Greenhouse and Energy Reporting System Discussion Paper entitled 'Technical Guidelines for the Estimation of Greenhouse Emissions and Energy at Facility Level (Energy, Industrial Process and Waste Sectors in Australia) (Dec. 2007). (See attached related comment on how large polluters should measure their greenhouse gas emissions.)

As a result of reading the above papers, I recommended immediately turning the Regulation Policy Paper on a National Greenhouse Energy Reporting System into a National Industry Code of Practice and implementing it as an audit based industry research project. This would also allow the technical side of the Energy Reporting System to be more consultatively worked upon and tested. This ideally occurs through experimental audit and report. On page 8, the Regulation Policy Paper states that an external audit will be undertaken by an external auditor who may use an audit team. However, no individuals who represent the registered corporation can be members of the audit team. I think this is wrong and recommended that a member of the registered corporation should be present on the external audit team to inform it about any source of confusion. I think this would promote mutual learning and lead to more informed and less vague reports by external auditors, who also cannot escape their responsibility for producing the final report. This would mean fewer mistakes and fewer lawyers. Once an industry audit of the largest polluters has been undertaken, the level of risk their emissions deal to the surrounding environment can be more clearly and appropriately estimated for government to match in some logically related fashion, through the provision of permits for investment in offset programs. The concept of 'indirect emissions', who should measure them, and how, requires much more clarity.

The issue of how much money is made available by industry and by government for sustainable development related premiums and/or permits or carbon credits to attain sustainable development is ideally considered in the light of all the concerns addressed earlier. What major risks must be controlled? How and in what time frame? What will it cost? Establishing funds to invest in remedies is integrally related to knowing this.

Question for consideration: Does the insurance industry have the capacity to provide adequate and affordable insurance products in a future of climate change?

In its quest for increasing market share, the traditional insurance industry underwriter has an incentive to produce as many products as possible in an attempt to meet a differentiated market. However, the insurance industry shareholders also have an interest in ensuring that their products are opaque and compensation is hard to access. This increases costs to premium purchasers and to end users of the products. For evidence of this one only has to compare US health care provision with that in Europe, Canada or Australia. The US provides comparatively expensive health care driven by the rich consumer, and the poor cannot afford insurance cover. Climate change and carbon trading systems designed on the US model will increase social and environmental extremes and problems not reduce them. A planned and competitive approach to control of regional risks is required instead.