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Private Climate Governance and Policy Stability in the Financial Sector

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> It is not light that we need, but fire; it is not the gentle shower, but thunder. We need the storm, the whirlwind, and the earthquake.
>
> —*Frederick Douglass, 1852*

Frederick Douglass powerfully criticized those who sought a more comfortable path to the abolition of slavery. In our current context, his words seem appropriate for addressing the climate crisis. The evidence that climate change has already affected our environment surrounds us, as millions of people suffer through heat waves, droughts, and floods. The rate of warming since 1981 has almost doubled, and the ten warmest years in recorded history have all occurred since 2010, with 2023 on track to be the hottest on record (National Oceanic and Atmospheric Agency 2023). A recent Intergovernmental Panel on Climate Change (IPCC) report noted the "brief and rapidly closing window of opportunity to secure a livable and sustainable future for all" (IPCC 2022). Activists including youth groups and scientists have taken to the streets and public square to demand action. To prevent further disaster will require large-scale transformation of the basis of our economy. This is not simply a technical problem but rather one of significant societal change.

One of the central debates among those pushing for action is whether they should adopt strategies that stabilize the policy environment, and if so, what the political impact of doing so would be. It seems paradoxical to seek change through stability – "stability" often denotes the status quo, which could mean either doing nothing about climate change or continuing current inadequate efforts. As Paterson,

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Tobin, and VanDeveer discuss in their introductory chapter, stability can have other meanings: pathways to long-term emissions reductions, continuity in policy design, or engineering lock-in. Stable policy design can lock in practices and technologies that facilitate long-term emissions reductions pathways, linking together different goals. However, critics view this as a too-comfortable path that is inadequate for the challenge we face (Boykoff et al. 2010; Kouchakji 2023; Lamb et al. 2020).

In this chapter, I look at stability as policy lock-in with respect to the private sector, since industry is critical to the energy transition. Advocates argue that we must institutionalize norms and practices within industry that make it costly for business to maintain the current status quo. One prominent approach is through private governance initiatives, that is, voluntary industry self-regulation. These are collective voluntary standards-setting approaches that institutionalize principles, norms, and practices within a sector (Grabs et al. 2021; Vogel 2009). If industry collectively adopts common standards and practices, the argument is that this will prevent costly government regulation, create incentives for firms to comply, and help manage risks during the energy transition. Collective standards and practices can nudge firms off the old path and onto a new more sustainable one at lower cost and less pain.

Private governance initiatives narrow attention in ways that depoliticize debates by focusing on standards, reporting requirements, and appropriate technologies. The rise of global governance more generally, with its mixture of public and private authority, heralded the potential for a new kind of politics. Corporate social responsibility, private governance, and multistakeholder initiatives recast the role of business as partners in governance and not as political opponents. However, the promotion of industry-led climate initiatives is linked to political struggles within the climate movement, in which divisions over strategic choices can impact its effectiveness and coherence (Hadden 2015). These choices include the turn toward voluntary standards developed and adopted by the private sector. Green et al. (2021) argue that voluntary private governance reduces political conflict between NGOs and firms, but at the cost of slow – or even no – progress on climate mitigation or adaptation.

I argue here that private governance reflects a preference for policies that will provide a stable framework of expectations about the steps needed to make the energy transition and lock in particular standards and approaches. I explore this in the case of private climate governance in the financial sector. Banks, asset managers, and insurers all wield significant influence over policies and practices adopted by their customers. They set the conditions under which customers can borrow, invest, and manage risks. Therefore, the climate policies they adopt can ripple throughout the larger economy. For this chapter, I focus on the insurance industry

and the Net Zero Insurance Alliance (NZIA), which is a private sector initiative among insurers to establish common commitments regarding decarbonization of their portfolio of business.

In what follows, I first discuss the concepts of stability and policy lock-in and their relationship to private governance. I then narrow my focus to the insurance industry, which is beginning to garner more attention for its climate policies. I provide a brief overview of how the insurance industry has responded to the challenge of climate change, its participation in the United Nations Environment Programme Finance Initiative (UNEP-FI), and the creation of the NZIA as a form of private governance. In the conclusion, I turn to the relationship between stability, private governance, and politicization.

8.1 Private Governance, Policy Stability, and Policy Lock-In

The idea of "lock-in," or path dependence, came out of the study of technological change, and the observation that initial technological choices constrain future options. Past decisions about how to design a car or a keyboard, for instance, make it costly to shift technologies as the context changes (David 1985; Lewin 2001; Liebowitz and Margolis 2012).[1] The same idea applies to policy adoption. For example, building highway infrastructure invites people to drive more and makes it harder to get support for policies that favor public transit. Policy lock-in figures in the literature on institutions and path dependence. The idea of *policy* lock-in has a narrower focus: policies are "locked in" when they are institutionalized, that is, when the initial choice of policy becomes a standard process that no longer requires a decision or choice. It is the default policy.

Unruh has written extensively on the idea of "carbon lock-in" as a form of negative path dependence (Seto et al. 2016; Unruh 2000, 2002). The policy choices about energy infrastructure taken in the past determine the technologies and energy sources we use today. This path dependence makes it extremely difficult to pursue an energy transition. Unruh argues that it is unlikely developing countries can develop further without fossil fuel-based industrialization because the carbon-based system has been so thoroughly globalized.

Climate activists often seek to create a *positive* path dependence by promoting policies that will do the opposite of carbon lock-in – policies that institutionalize alternative energy choices through support for new infrastructure, technology, and standards. Once in place, the goal is to move us irrevocably toward a green transition. In 2014, the IPCC report included a chapter on adaptation and implementation that highlighted institutionalization (Mimura et al. 2014). A year later, the Paris

[1] The concept of technological lock-in is a subject of contention in economics and law.

Agreement gave a greater role to sub-state and non-state actors to progressively reduce emissions, seeking to institutionalize their contributions (Hale 2016). In the succeeding years, institutions at all levels of government – international, national, and local – have developed climate adaptation and mitigation plans. These actions are embedding policies in institutions to create stable expectations regarding the direction of policy. As Paterson et al. (2022) note, the desire for this kind of policy stability can reduce political contention, with some observers labeling these solutions as "post-political." However, this approach sidesteps the need to do the political work to build coalitions supporting more significant change. Instead of pursuing policy stability, some argue we should be engaging in critical debates in the political arena. They ask whether we should "pump up the volume" instead of trying to avoid the messiness of mass politics (Adler and Kentikelenis 2022).

Private climate governance can be viewed as a way to institutionalize policy choices by firms. Grabs et al. (2021: 1183) define private governance systems as "the formulation of procedural and/ or substantive rules and standards by nongovernmental actors …, their monitoring and enforcement through the same actors or third parties, and the preferential treatment of actors in compliance with such rules, for example, through improved reputation, market access, pricing conditions, or access to financing." I include in private governance both the policies adopted by individual firms as they apply to their customers, clients, and business partners and the policies that are collectively negotiated and adopted.

There are four ways in which private climate governance is a strategy that favors stability and de-politicization:

1. *Private governance reinforces the market system*. Cashore, for instance, identifies a set of private initiatives that he calls "non-state market-driven" (NSMD) governance. These systems adopt processes such as certification and auditing to provide reputational benefits to participants. These benefits in turn provide an advantage in market competition, incentivizing participation and compliance (Auld 2014; Cashore et al. 2004; Grabs 2020; van der Ven 2019). Many voluntary initiatives rely on transparency as the mechanism for enforcement – firms are required to provide information revealing their compliance with standards set by the initiative. This approach assumes that public reporting will lead to a market response, such as consumers shunning a weakly performing company. Private governance thus relies on the market to lock in standards and stabilize policy choices.
2. *Private governance emphasizes consensus-building partnerships*. Pepermans and Maeseele (2016) note that climate politics multiplies antagonisms but also compels former opponents to partner. We see this in the collective nature of voluntary climate commitments among competing firms and in the proliferation

of public–private partnerships and multi-stakeholder initiatives (Westerwinter 2019). These are designed to combine the different competencies, resources, and authority of often antagonistic actors. These collective efforts institutionalize policies and reflect a strategy of stability. However, they are criticized for favoring superficial cooperation by adopting weak standards and emphasizing process over outcome (Gray and Purdy 2018; MSI Integrity 2020).

3. *Private governance empowers the private sector*. Industry has the resources, competence, and expertise required to achieve the energy transition. This capacity gives their participation in private climate governance a degree of legitimate authority (Haufler 2010). Firms have deep expertise regarding the specific ways in which their business generates greenhouse gas (GHG) emissions, and they have the technical capacity and organizational capability required for reducing them. When they make proposals for emissions reductions, they are viewed through this lens of expertise and capacity. In turn, this empowers firms in climate governance, which further reinforces market-based solutions, consensus-building partnerships, and technocratic problem-solving.
4. *Private governance favors process standards, technical indicators, and incrementalism*. Because they are based on voluntary membership, the initial standards in many private governance schemes must be low enough to attract members, although they also must be high enough to provide reputational benefits (Potoski and Prakash 2010). This is reinforced by the business penchant for benchmarking, that is, establishing standards to achieve over time. The standards are often about transparency such as reporting requirements and debates over indicators to report. This process rewards inching toward a desired goal over time instead of immediate achievement. Standards established at the creation stage may be raised over time as experience leads to acceptance and initial costs are absorbed, but slow steps forward protect the economic viability of the companies involved.

8.2 Insurance and Climate Change

The financial sector has long been viewed as a potential source of leverage to change the behavior of customers. Most attention focuses on the influence of investors and lenders, but the insurance sector has been a target of activists since the 1992 Rio conference (Paterson 2001). It is a critical element in adaptation to climate change, helping businesses and individuals assess risk, cushion losses, and strengthen resiliency. Insurers can signal a change in risk through shifts in pricing, deductibles, and insurance coverage (Surminski et al. 2019). Insurance itself favors stability because the financial cushioning it provides supports "business as usual" even in an era of disruption (Chandler and Coaffee 2016). Traditional risk models are backward-looking, based on historical data, and not oriented to future risks.

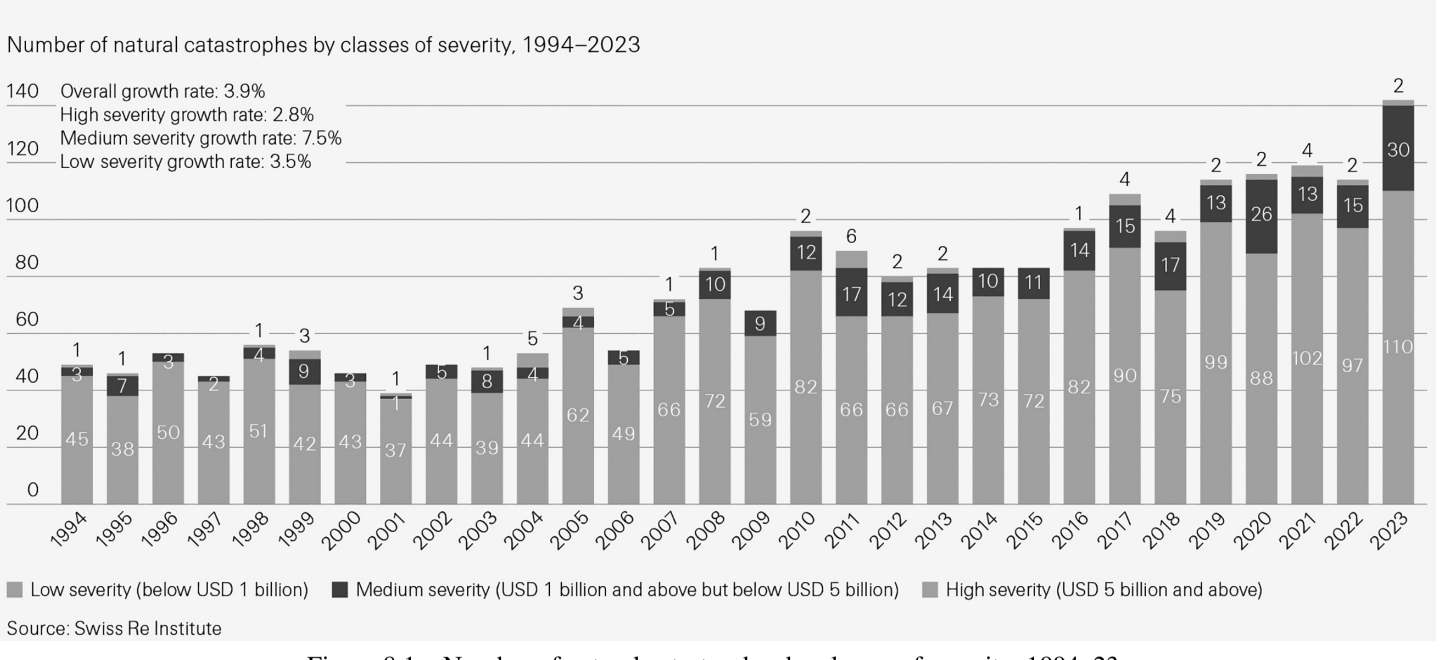

Figure 8.1 Number of natural catastrophes by classes of severity, 1994–23.

The industry is already experiencing costly payouts linked to a changing climate. The record for insured losses from natural disasters was set in 2017, reaching $170 billion due to a particularly severe hurricane season in the United States. In 2021, insured losses from natural catastrophes added up to around $130 billion globally, the fourth-highest on record (Reuters 2022).[2] The first half of 2023 experienced $50 billion in losses, and Swiss Re – one of the world's largest reinsurance companies – estimates 68 percent were due to severe storms. Not only the number but the severity of natural disasters has increased (see Figure 8.1). Devastating floods and damage from high winds and excessive rainfall, extreme heat combined with severe drought, and massive wildfires around the world all may have been supercharged by global heating.

The insurance industry has two sources of leverage over other industries to promote climate mitigation and adaptation – through insurance underwriting contracts and through its investment portfolio ("Scope 3" emissions according to the Greenhouse Gas Protocol).[3] Insurers can set prices (premiums) and conditions for coverage in their insurance business and selectively invest income from insurance premiums in their investment portfolios. They are on both sides of the asset revaluation dynamic laid out by Colgan et al. (2021): They are climate-forcing asset holders on the investment side because they can impose conditions on the firms in which they invest. They are climate-vulnerable asset holders as insurers because they insure assets that are vulnerable to climate impacts. On the investment side, their choice of where to invest can influence who gets financing – fossil fuel projects versus renewables. On the insurance side, their choices about how to evaluate and price risk or what behavioral conditions to include in contracts influence customer choices about home construction or transportation. The most powerful signal they can send about how they understand risk is by withdrawing insurance coverage entirely from activities or locations at high risk.

8.3 Private Climate Governance, Insurance, and Policy Stability

Private governance in insurance is process-oriented, focused on technical standards, and relies on market incentives to encourage compliance. Meeting standards typically means measuring and reporting emissions. Ideally it requires firms to revise insurance products and policies to incentivize climate-sensitive practices by clients and set prices (premiums) to reflect forward-looking climate risk. If

[2] These figures include earthquake disasters. Notably, estimates by Munich Re are that 40 percent of natural disasters worldwide are not covered by insurance.

[3] The Greenhouse Gas Protocol defines Scope 3 emissions as "the result of activities from assets not owned or controlled by the reporting organization, but that the organization indirectly impacts in its value chain." (US Environmental Protection Agency 2023). The Protocol itself is a set of standards for measuring emissions developed by the World Resources Institute and the World Business Council for Sustainable Development.

these policies become institutionalized as standard policy clauses, they will lock in climate mitigation and adaptation by customers. For instance, customers may be offered better prices and coverage if they strengthen roofs and waterproof basements in storm-prone locations. This approach focuses on modifications to reduce losses and technocratic models of risk. It is not intended to redistribute costs and benefits but rather emphasizes business as usual. This result is policy stability and continuity with existing practices (Paterson 2021).

Many insurers participate in private climate governance and public–private partnerships addressing climate issues. The overarching framework for their commitments is the United Nations Environment Programme Finance Initiative (UNEP-FI), founded in 1992. UNEP-FI established standards on sustainable finance for bankers, investors, and insurers. But insurers belong to other initiatives: the UN Global Compact, the Principles for Responsible Investment (PRI), the Equator Principles, the Poseidon Principles for Marine Insurance, and the UN Sustainable Blue Finance Initiative. The most relevant one for examining the relationship between private climate governance and policy stability is the Net Zero Insurance Alliance (NZIA), which was orchestrated by the UNEP-FI.

In 2021, criticism of climate action by the financial sector centered in part on how financial firms were all pursuing different climate policies, targets, and indicators. Leading CEOs formed a new partnership, the Glasgow Financial Alliance for Net Zero (GFANZ), to bring different initiatives under one umbrella group. Members would align their efforts with the UN Race to Zero campaign, which means their policies are science-based, cover all emissions, have interim targets, and commit to transparency. Under this umbrella, different sectors – banks, asset managers, and insurers – launched collective commitments to net zero.

Facilitated by the GFANZ, the NZIA was launched by some of the largest international insurers in July 2021. These included Allianz, a German company with more than 150,000 employees earning around 754 billion euros in premiums in 2020; AXA, a French firm that is even bigger; Lloyd's, a private company based in the UK; the big reinsurers Munich Re and Swiss Re; and firms based in Italy, Spain, Kenya, South Korea, and Japan (Cox 2022a). The NZIA commits members to achieve net zero emissions in their insurance and reinsurance portfolios *by their customers and business partners* by 2050, with interim targets every five years after 2030. In other words, the commitment is not about their own carbon emissions but those they insure. Insurers are required to report regularly on their progress. All members must also sign the UNEP Principles for Sustainable Insurance, align with the 1.5°C ceiling established by the Paris Agreement, and advocate for science-based and socially just transition policies. Participants would be delisted if they did not meet deadlines (Cox 2022a, 2022b).

Initially, they were stymied by a lack of consensus on how to measure the emissions of their customers (Scope 3 emissions). They could not set net zero targets for

underwriting because they had no common standard for measuring the emissions of those they insure. This led NZIA to work with the Partnership for Carbon Accounting Financials to develop metrics, which were published in November 2022. Insurers will use them in developing insurance contracts and pricing policies going forward. They will have to develop new underwriting standards to include these metrics, particularly for the GHG-intensive activities of clients. They also plan to develop incentives for reducing emissions, such as special insurance for new technologies, nature-based solutions, and claims management (Cox 2022a, 2022b; UNEP 2021).

One goal of the NZIA was to change how insurers evaluate climate risks in their underwriting. Insurance models are backward-looking, with risk estimates based on historical experience with losses. If natural disasters in the past were few and far between, then the evaluation of risk in long-term insurance contracts assumes the probabilities remain the same. This is one element of the conservative character of the industry, binding it to historical experience. The industry now recognizes the need to develop future-oriented models that incorporate climate change.

We can identify some of the characteristics that I argue illustrate the ways in which strategies of private climate governance are oriented toward policy stability, locking in particular approaches to action. First, insurance itself is a market-based lever to induce customers to reduce GHG emissions. The NZIA was launched in part due to the recognition by executives of the market signals about climate change, such as recent insured losses. Policymakers such as US Special Envoy for Climate John Kerry lauded the GFANZ as evidence that financial firms recognized the commercial opportunities of the energy transition (Jessop 2021). These all indicate that the "business case" for pursuing net zero was a significant incentive for participants. In turn, the NZIA adopted practices that would preserve the market and not overturn it.

Second, the NZIA, and the GFANZ which facilitated it, is a partnership among its corporate members. It is embedded within the UNEP-FI and linked to a number of other private governance efforts, reflecting a preference for public–private consensus building (Dubash 2021; Mills 2005; Mills and Lecomte 2006). NZIA members must commit to the UNEP Principles on Sustainable Insurance, launched in 2012. Its leaders have expressed public support for the recommendations of the Task Force on Climate-related Financial Disclosures led by Michael Bloomberg, and for emerging frameworks such as the Task Force on Nature-related Financial Disclosures, in addition to the United Nations Sustainable Development Goals (UNSDGs) and the Global Biodiversity Framework. This complex network favors consensus-building partnerships that obscure some of the fundamental conflicts within the private sector.

Third, the NZIA empowers the private sector by leaving it to the insurers to develop standards and set their own goals. Each firm develops their own approach to reducing GHG emissions to avoid anti-trust accusations. The NZIA says nothing about divesting from fossil fuel projects entirely, which would do the most to

achieve net zero commitments. The idea of "net zero" itself reflects the ability of firms to redirect attention away from hard goals. Net zero allows industry to continue with GHG emissions in some activities by offsetting them with reductions elsewhere. The NZIA lets insurers themselves off the hook, as it does not include provisions about GHG emissions by the insurers themselves.

Fourth, the NZIA focused a lot of its attention on reporting standards, emphasizing the process involved in commitments to transparency. Technical debates over how to evaluate the emissions of clients were an early stumbling block. Unlike other initiatives, the NZIA has established interim targets between now and 2050, but overall, it favors gradual approaches. The timeline to achieve net zero is slow and aspirational and involves regular reporting and incremental improvements. According to one industry representative, insurance is too often viewed only as a way to absorb financial shocks, leaning more toward adaptation and resilience than mitigation and decarbonization (Cox 2022a, 2022b).

8.4 Disruptions and Repoliticization?

The NZIA does not *require* participants to stop insuring fossil fuel projects – but strikingly, many are doing so, as they recognize the rising risks and costs of these projects (Insure Our Future 2022). Their decisions have been reinforced by clear signals from governments, particularly in Europe. The founding members of the NZIA include firms that started to phase out coal from their insurance portfolio some years ago. Swiss Re and Zurich Insurance led the charge to end coal insurance and also began divesting from coal projects. Lloyd's of London has committed to end insurance for coal-fired power plants, although not all Lloyd's members are going along with this. AIG adopted a comprehensive new coal and tar sands exit policy, committed to ending insurance for new projects and customers, and will phase out existing customers by 2030. Munich Re recently committed to end insurance for new fossil fuel projects and established new climate targets for its clients. Around thirty-eight major insurers are exiting coal (Insure Our Future 2022). Some observers view the end of insurance for coal projects as a sign that it will be phased out entirely as a major energy source. However, this optimistic take is undermined by big players such as Berkshire Hathaway that continue to cover these projects, and by the recent spurt of coal development projects in China (Centre for Research on Energy and Clean Air 2023).

Insurers are also withdrawing insurance from areas affected by extreme natural disasters, most notably in the United States. In Florida, property insurance has become harder to find as repeated storms and flooding have caused significant losses to insurers. Small firms have gone out of business while the major players have withdrawn. The same is happening in California due to wildfire risks and is spreading to Texas and other states. Insurance rates have gradually increased in response to a recalculation of

future risk. Recent reports express concern that the insurance industry itself is being destabilized by climate change, and this could have wider implications for financial stability in general (Frank 2023). The insurance industry is shifting its approach to one that takes climate risk into account, instead of looking at the past for data on risk.

The combination of losses from natural disasters linked to climate change, and efforts to develop common policies and approaches to address it, has led to two kinds of backlash. Within the climate advocacy community, a more prominent radical wing has mobilized against the weakness of efforts by insurers. For instance, net zero commitments are viewed as particularly weak, and are unlikely to be achieved in time to prevent irrevocable changes (Dyke et al. 2021; Wilkes 2023; Wilkes et al. 2023). While groups such as Extinction Rebellion get a lot of media attention for their tactics, groups targeting insurers have become more active. The NGO Insure Our Future campaigns to get insurers to end completely all insurance for coal, oil, and gas. It scores companies on their efforts – or lack of them – and engages in public protests outside insurance company headquarters. This is a shift from previous strategies.

But the more significant political contention comes from outside the climate advocacy community and from insurers themselves. A recent article in an industry journal asked in its title, "Are insurers being bullied?" (Moorcraft 2022). While insurers may view climate advocates as too pushy, it is the climate deniers who pose the greatest threat. Insurers have become targets of the "anti-ESG," anti-"woke" culture wars pursued by the radical right in some US states ("ESG" is shorthand for environmental, social, and governance indicators that are often used as a means of labeling "ethical" investment portfolios). Some states in the United States now ban government agencies from working with financial firms that incorporate ESG standards into their decision-making or who offer ESG products. Texas recently banned insurance companies from using ESG criteria in setting premiums, thus excluding climate risk from consideration (Ahmed 2023; Malone et al. 2023). Others such as North and South Dakota are considering similar legislation targeting insurers, while around twenty states have passed broad anti-ESG bans. In contrast, California is considering legislation that would require incorporating ESG considerations into business decisions (Wolman and kahn 2023).

These local political and legal threats have had global impact. State attorneys-general in twenty-three US states warned members of the NZIA that their collaboration could violate US anti-trust laws, threatening to pursue litigation. In response, member firms left the NZIA, including some of its founding companies. In July 2023, the NZIA chose to end the requirement for members to set GHG reduction targets in an effort to avoid the political contention, but the group was down to only fourteen members at that point (Fellowes-Granda 2023). The GFANZ, the global umbrella for eight net zero industry groups, also has been undermined by these anti-trust threats and corporate withdrawals.

The insurance industry, and the financial sector as a whole, have been buffeted from both sides during the 2020s. Their lagging and weak response to demands for action on climate change, despite increased losses due to natural disasters, along with the potential collapse of their most visible effort – the NZIA – could lead climate advocates to repoliticize the issues. At the same time, even those weak efforts have been too much for the deeply politicized divisions fomented by climate deniers. The political response to the stability embedded within private governance systems may take the shape of a U-curve. The NZIA demonstrates this dynamic, at least with respect to the United States. We may see cycles of stability and repoliticization in the relations between industry and activists, a dynamic that Paterson, Tobin, and VanDeveer highlight in their introductory chapter.

The policies of the financial sector can be a powerful force for policy stability and lock-in. At the same time, they can stimulate a powerful political backlash, especially when they are reinforced by the costly impact of a warmer climate. While private industry pursues incremental change, many people today would argue that we need contentious political debate to generate the political will to take the costly steps that are needed to prevent the climate crisis from getting worse. At the start of this chapter, I posted a quotation from Frederick Douglass, the noted Black abolitionist and statesman. He framed the issue of slavery with a powerful analogy that resonates when it comes to climate action. We do not need the light, we need the fire; not the gentle rain, but the thunder.

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