

ENVIRONMENTAL LIABILITY AND INSURANCE

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Abstract

Environmental risk is described in this article from a risk management perspective as well as from the identification, evaluation and insurance risk transfer point of view.

This risk is special as it has unique characteristics compared with any other third party liability risk because it is difficult to be identified and it can cause catastrophic losses. Although at a first glance this risk seems to be specific to some industries, the reality is that it does not spare any economic activity. From a risk treatment point of view, companies have to identify the potential sources of pollution, the population that could be affected as well as the routes that could lead to the target population.

Whilst environmental liability leads to catastrophic losses, its financial consequences transfer through insurance is often ignored most of the times by the companies. While on the international market the insurance products offer is quite diversified, in Romania the offer is narrow probably due to the reduced demand. The environmental insurance liability market in Europe is estimated at about Euro 250-300 million, the international insurers having a capacity of up to US\$ 200 million for any one insurer.

The demand for environmental insurance liability in Romania could be stimulated by imposing "financial warranties" for environmental damages, using the models from other countries from the Western or Eastern Europe. From the growth of the insurance market would benefit not only the Romanian insurers, but also companies as they would be better protected, and the economy, as the premium generated would be invested by the insurers in various financial instruments, thus returning the money back to the economy.

Environmental problems are amongst the main concerns of the Romanian authorities, the intense administrative activities being complemented by loads of debates in the society and mass-media due to Romania's obligations to fulfill its environmental duties as part of the European Union. Romanian legislation (Law 265/2006, Law 261/2004 with all its further modifications and additions) regarding soil, air or water pollution (either historical or accidental) are just a few examples that generate environmental risks to the Romanian companies. It is however wrong to think that only companies that produce, store, sell or transport chemical substances (or dangerous substances in general) are prone to

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environmental risks. From an environmental liability point of view no company is spared by this risk.

The environmental liability risk is a very special one from the way it occurs because it can be a "silent killer"... as it could be days, months or even years until a pollution is detected due to leaks from a storage tank in which are stored dangerous substances for instance. These can produce catastrophic environmental consequences, their effects could be very difficult to be countered – automatically the potential losses could be very large. A well known example is the explosion of an oil drill maritime platform in the Gulf of Mexico in 2010 that led to a 4 million barrells oil spillage for more than 80 days, the polluter, BP, being forced by the courts to pay damages in excess of US\$ 18 billion.

The environmental liability risks have a few common characteristics:

- First, they are difficult to be identified. A mere physical inspection of a dangerous substances storage tank may not help in identifying a pollution. More, even a soil pollution detection equipment may not be enough to detect it, because of its low sensitivity, but as the technology advances, new sites that in the past were considered clean, could be discovered as polluted.

- Second, environmental liability is not necessarily generated by dangerous substances. For instance noise pollution or elecromagnetic waves could be potential pollution sources. An example could be the accidental spill of milk from a revervoire in a trout tank farm (the fish need pure water at a constant temperature to survive). The pollution could kill the fish causing losses to the fish farm.

- The environmental loss extent cannot be exactly estimated because it is very difficult to calculate how large and deep is the pollution.

- There is a proverb that says that "the best medicine is prevention" therefore managers/business owners must take into account three things when assesing environmental risks:

- first is to identify all materials and substances that could lead to a pollution; as mentioned before they do not have to be obvious as chemical/dangerous substances; even depositing debris could lead to bodily injury of the tresspassers and consequently an environmental liability of the polluter.

- second is the population that could be affected if a pollution would occur. The larger the number of those that could be affected, the more serious one should act.

- -third the routes a potential pollution that could follow to affect the target population must be identified.

Taking into account the above, one may say that any company is exposed to environmental liability risk and to potential third party liability costs generated by bodily injury, material damages, clean-up costs (both for the third parties as well as their own), and last but not least, defense costs. All of these can be covered throught insurance, and the international insurance market is very "generous" in supplying various clauses or types of insurance policies to cover environmental risks, in 2015 there were, according to the *Institute of Risk Management and*

*Insurance (IRMI)*¹ over 100 types of insurance policies that could cover eventual losses generated by environmental risks. The underwriting capacity is up to US\$200 million for any one insurer. It is obvious that if anyone would need a higher limit this could be done by syndication of several insurers. In Romania, the insurance policies supply (both from the number of types as well as of risks covered) is narrow, due to the reduced demand of the Romanian companies. Although the covers/clauses differ from one insurer to another, the policies could be grouped as follows:

1. Sites specific environmental liability policies where the insured has its main activity. These types of policies are amongst the only ones that exist on the Romanian insurance market, noting however that in Romania most of the policies do not cover clean-up costs. A main characteristic of this policy is that it does not have a retroactive date, which means that the historical pollution is not covered, and in general they are “claims made” policies (they cover only claims discovered and reported during the policy period). Fines are not covered although they exist in the Romanian legislation.

2. Environmental liability property transfer policies. This policy is used by those who want to sell a piece of land, and, because there is a possibility that the land to have been contaminated in the past, although not proved, the potential buyers are reluctant to acquire it, due to potential decontamination costs following the transaction. Therefore the seller can buy such a policy that, despite other insurances policies that are not transferable, covers both the seller and the buyer of the property.

3. Insurance policies that cover decontamination of the properties already polluted. The names of these types of policies may seem unusual as it suggests that it may cover a risk that already occurred. This policy covers only an sudden and accidental risk as well. The owner of the site that may want such a policy must do an expertise of the extent of the pollution/contamination of the property and with the experts to estimate the cost of the clean-up. This cost (to which it is added a 15-20% margin) will be the retention of the insured over which the policy will pay. The main purpose of this policy is to reduce the potential uncertainties regarding the “surprises” that may appear during the contamination. As mentioned at the beginning of the article one of the characteristics of the environmental risks is that the exact estimation of the extent of the potential losses is not possible, thus the main purpose of the policy is to put a cap on the indemnities that have to be paid following these losses. In Romania there are many land pollution clean-up projects (many with EU money), and such a policy would fit like a glove when the decontamination costs were not exactly estimated.

4. Secure creditor environmental liability policies. If a creditor (e.g. a bank) does not trust that a debtor has the financial capacity to finalize an investment project on a property that is not polluted, but it could, due to the investment, it could force the debtor to conclude such a policy to improve its credit rating.

5. Contractors environmental liability policies. If the contractor of a project could potentially pollute the environment, it can conclude such a policy for its protection.

6. Environmental consultants professional liability policy. An environmental consultant has a liability for errors and omissions for the environmental advices offered to clients, consequently it can protect itself concluding such a policy. Such policies can be found on the Romanian insurance market as well.

According to a report of the insurer ACE² environmental insurance gross premium underwritten in Europe was in 2011 between Euro 250-300 million being about 1% of the total third party liability insurance market. Because in Romania there is no environmental liability specific reporting of the insurance companies for this line of business, one can only estimate the gross premium underwritten which is probably in the order of a few million Euros (maybe Euro 5-10 million, but the latter is probably an optimistic number).

The Romanian environmental liability insurance market could probably be boosted by tightening the legislation and imposing "financial warrantees" (not necessarily insurance, could be a collateral cash or parental warrantee for large group of companies, but the insurance option is more economical) for potential losses produced by pollution at least for companies that produce, store, sell or transport dangerous substances as defined by the local legislation. Compulsory financial warrantees required for potential polluters already exist in Western Europe in countries like Belgium, Germany, Spain, Portugal etc, but also in Eastern Europe in Slovakia, Czech Republic, Hungary and Bulgaria. For instance in Spain the minimum financial warrantees³ are set by the competent authorities depending on the type of activity, location and the specific risks and cannot be larger than Euro 20 million. If the authorities consider that the potential losses that can be produced by a potential polluter are not higher Euro 300.000 companies are not forced to constitute financial warrantees.

Romanian companies could win from tighter environmental regulations. Environmental losses have generally low frequency, but large severity. Consequently, in case of catastrophic losses companies might not have the financial resources to deal with them and their existence could be endangered. On the other hand, the Romanian economy, generally speaking could be a winner. Environmental liability insurance is "long tail" meaning that from the moment of premium payment and the payment of losses it is a long time, and hence, meanwhile insurers invest the collected premium in various financial instruments (usually bonds), returning money implicitly to the economy. Even more, imposing financial warrantees for potential environmental losses would be a "motivation" for Romanian companies to invest in a better protection against environmental losses because insurers impose conditions to insure such risks.

Finally, the Romanian insurance market could win through diversification of portfolios and the Romanian society as well, as it would benefit from a higher degree of protection.

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