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The big flaw in Warren Buffett's view of climate change

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In an annual shareholder letter to be discussed next month, the "Sage of Omaha" claims that climate change poses no risks to insurers – but the claim flies in the face of growing scientific evidence

Monday 7 March 2016 21.28 GMT

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At least 19.3 million people worldwide were driven from their homes by natural disasters in 2014, 90% of which were related to weather events, according to the Geneva-based Internal Displacement Monitoring Center. Photograph: Zakir Hossain Chowdhury/Barcro

Each year, investors eagerly await Warren Buffett's annual letter to Berkshire Hathaway's shareholders. And well they might: under his leadership, Berkshire's compounded annual growth rate from 1965 to 2015 was 20.8%, far better than the 9.7% achieved by the S&P 500.

But this year, the storied "Sage of Omaha" expanded his focus to encompass larger issues. In his shareholder letter, he tackled the controversial subject of climate change, suggesting that, while it threatens the planet, it might also provide some business opportunities for Berkshire Hathaway.

The flashpoint in this struggle is a proposal that is scheduled to be discussed at Berkshire Hathaway's shareholder meeting on April 30. Submitted by the Nebraska Peace Foundation, which owns exactly one share of Berkshire, the proposal asks the company to "report on the dangers that this change might present to our insurance operation and explain how we are responding to these threats".

Buffett is quick to acknowledge the existence – and dangers – of climate change, and it has likely informed his investments in the past. As he says in the shareholder letter, "It seems highly likely to me that climate change poses a major problem for the planet". In fact, as he wrote in the letter, Berkshire Hathaway Energy "has invested $16bn in renewables and now owns 7% of the country's wind generation and 6% of its solar generation".

But Buffett also predicts that climate change will increase the profits of insurance companies underwriting catastrophic risks, therefore it will be good for Berkshire's insurance business.


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The key, Buffett suggests, is timing. Noting the concern about skyrocketing property losses from climate change, he explains that "such worries might, in fact, be warranted if we wrote ten- or twenty-year policies at fixed prices". He says the short term nature of most policies should offset this problem: "Insurance policies are customarily written for one year and repriced annually to reflect changing exposures. Increased possibilities of loss translate promptly into increased premiums."


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There are some potential flaws in Buffett's argument. To begin with, recent developments in climate science show an accelerating rate of climatic change that could throw his timetable into disarray. Buffett also seems to lack an understanding of the severity of climate change-related weather: he says that "up to now, climate change has not produced more frequent nor more costly hurricanes nor other weather related events covered by insurance".

This claim flies in the face of growing scientific evidence. In 2014, the federally funded National Climate Assessment stated that: "Certain types of extreme weather events with links to climate change have become more frequent and/or intense, including prolonged periods of heat, heavy downpours, and, in some regions, floods and droughts."

Other insurers have already expressed concern about these changes. Carl Hedde, head of risk accumulation for insurer Munich Re America, says: "The number of loss-relevant, weather-related natural catastrophes worldwide has almost tripled since 1980 [...] we do think that the warming climate – depending on region and peril concerned – does play a certain role."

Buffett does believe the possibility of more frequent and damaging hurricanes and floods in the future. Rather than costing his company money, he expects these future catastrophes will actually raise profits. He draws an analogy with Berkshire-owned car insurance company Geico. In 1951, he explains, Geico's "average loss-per-policy was then about $30 annually. Imagine your reaction if I had predicted then that in 2015 the loss costs would increase to about $1,000 per policy".

But rather than destroying Geico, these rising losses were actually indicative of handsome revenues. "[T]hese increased costs have been promptly matched by increased premiums," Buffett explains. "So, paradoxically, the upward march in loss costs has made insurance companies far more valuable."

Buffett seems to argue that, as Geico paid out more in claims, it made more money with higher premiums. By extension, he seems to argue that increased premiums will more than balance the increased cost per policy that will come with global warming.


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But cost per policy and premium per policy weren't the only variables affecting Geico's profitability. Over time, cars have also gotten safer: between 1994 and 2013, the number of deadly auto accidents fell from 23.21 deaths per 100,000 licensed drivers in the US to 15.42 deaths per 100,000 licensed drivers.

This is where Buffett's analogy breaks down. Unlike cars, the Earth isn't getting safer; in fact, risks to insurers are increasing. A growing body of research suggests that the planet is in serious trouble. As warming melts arctic permafrost, it releases methane, a potent greenhouse gas, which further increases temperatures. Meanwhile, melting glaciers mean that the Earth can reflect less of the sun's rays back into space, which also amplifies the warming effect.

As the rate of global warming increases, so will the rate of climate change-related disasters – and presumably the rate of insurance payouts. It's a lot easier to make money off of declining risks – as in the case of auto accidents – than increasing risks, as in the case of climate change.

Of course, Buffett argues that insurance prices can be adjusted upwards each year to take account of new climate information that emerges. But if climate change is accelerating, even a yearly "true-up" in insurance rates will not be enough to protect insurance company profit margins. Current rates will always lag behind accelerating growth in damages and claims. The annual adjustment will merely slow down the widening gap between them. Airlines illustrate just how hard it can be to keep rates rising in step with fluctuations in jet fuel prices.

It would be rash to prematurely write off anything Buffett does, but it's worth noting that he is definitely hedging his bets. While Buffett seems bullish on climate change, he has also been shifting his insurance portfolio away from its catastrophic risks.

Yet Berkshire still holds two reinsurance firms, which are the types of insurers that Buffett's letter tells investors will insure risks that "no one else has the desire or the capital to take on". Could the canny "Sage" be downplaying catastrophic risks because he is preparing to sell off these entities? Savvy investors will be watching his next move closely.

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