Addressing sustainability risks

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

2020 Solvency II Review – Macro meets Micro

The review of a regulatory framework constitutes a window of opportunity to further enhance the existing frameworks as regards efficiency and effectiveness and by that to ensure better consumer protection and better contribution to the stability of the financial system.

A clear example is the 2020 Review of the Solvency II Directive which the European Insurance and Occupational Pensions Authority (EIOPA) is currently working on. It is clear that Solvency II has proven to be a significant step forward in the regulatory landscape. However, EIOPA supports the view that the framework can be further strengthened both from a micro- and from a macro-prudential point of view.

On the macro-prudential front, EIOPA's latest publications shed some light on what changes are needed. The first publication entitled "Systemic risk and macro-prudential policy in insurance" sought to better understand if and how insurance can create or amplify systemic risk considering three different sources of systemic risk, i.e. entity-, activity- and behaviour-based sources. The second publication on "Solvency II tools with macro-prudential impact" identifies, classifies and provides a preliminary assessment of the tools or measures already existing within Solvency II. The main conclusion is that, although Solvency II contributes to mitigate some of the sources of identified systemic risk, there is still room for improvement. This is further explored in the third paper presenting "Other potential macro-prudential tools and measures to enhance the current framework" including an initial assessment of possible tools and measures.

We welcome that the European Commission has included a specific item on macro-prudential policy in its recent Call for Advice to EIOPA on the review of the Solvency II Directive. And similarly, adding two additional items on recovery and resolution and Insurance Guarantee Schemes (IGS) is a logical step to enhance Solvency II also from a micro-prudential point of view.

Indeed, in its 2017 Opinion to the European Union institutions, EIOPA stressed that there is a need to move towards more harmonisation in the field of recovery and resolution. Furthermore, EIOPA always considered that a harmonised

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>>> framework should be aligned with Solvency II. Therefore, EIOPA has put forward several proposals for each of the building blocks identified in the Opinion, namely, preparation and planning including the request of pre-emptive recovery and resolution plans, early intervention, resolution covering relevant aspects such as objectives, conditions and powers of supervisors as well as cooperation and coordination.

EIOPA's ongoing work on IGS is closely linked with the work towards a minimum harmonised recovery and resolution framework. In fact, an IGS can be seen as an important tool for the effective resolution of insurers and can play a relevant role in the resolution process. And – as it is the case with the currently existing national recovery and resolution frameworks - the current fragmentation is definitely not optimal, particularly when it comes to failures involving cross-border business. And this is not simply a theoretical situation. On the contrary, we are already observing exactly this type of issues in the European Union. The absence of a consistent framework for IGS in the European Union led to a situation where policyholders across Europe are not protected to the same extent in case of liquidation of an insurer. Furthermore, this creates an un-level playing field in the single market. As a result of this ongoing work, in July 2017 EIOPA published a "Discussion Paper on resolution funding and national insurance guarantee schemes" to gather stakeholders' views. The feedback received is currently thoroughly analysed and will be considered in the development of the Advice to the European Commission.

Now is the time that the relevant micro- and macro-prudential proposals find their way into the legislative process. EIOPA will follow a thorough, evidence based and transparent approach in its process of consultation with all interested stakeholders, effectively using this window of opportunity to make Solvency II a more complete and sound prudential framework. ●

Sarah Breeden

Executive Director, International Banks Supervision, Bank of England

Financial risks from climate change: far-reaching, foreseeable, for action today

Climate change brings financial as well as environmental risks. These financial risks arise in two ways.

Physical risks arise from damage to property, land and infrastructure from weather-related events such as heatwaves, droughts, floods and rises in sea level. Inflation-adjusted insurance losses from such events have increased by a factor of five in recent decades.

Transition risks result from changes in climate policy, technology and market sentiment as we adjust to a lower carbon economy. While the timing and the form of transition is inherently uncertain, risks are already materialising now - for example, through tightening energy efficiency standards impacting on the UK property market or credit risks associated with the low-carbon transition emerging in the automotive and energy sectors. >>>

>>> The Bank of England has therefore been working to deepen our understanding of the risks that climate change poses to the financial system, whilst remaining firmly grounded in our financial stability and safety and soundness mandates.

Our view is not only that these risks are financial, but that they are far-reaching, foreseeable and for action today.

The risks are far-reaching in breadth and in magnitude. They affect all customers, all sectors and all geographies. Their impact will likely be correlated and non-linear.

While uncertain, the risks are eminently foreseeable. Even if we do not know now exactly what will happen and when, we do know now with a high degree of certainty that some combination of physical and transition risk will materialise at some point in the future.

Finally, and most importantly, the size of future risks will be determined by actions taken now. The carbon we release today is creating the physical and transition risks of tomorrow. Climate change therefore represents the tragedy of the horizon: by the time it is clear that changes to the climate are creating risks that we want to reduce, it may well be too late to act.

So the question is not if these risks exist, when they will crystallise, or why central banks, supervisors and the financial sector should care. The question is how we can best manage them, especially in an uncertain world, where data may not be readily available, and where our technical capabilities are still developing.

In support of this aim, we have published reports on the impact of climate change on the UK insurance and banking sectors. We have issued proposals on how firms should enhance their approach to managing these risks – in particular to:

- embed consideration of the financial risks from climate change in their governance arrangements;
- incorporate the financial risks from climate change into existing risk management practices;
- use scenario analysis to inform strategy setting and risk assessment and identification; and
- develop an approach to disclosure on the financial risks from climate change.

The desired outcome is that firms take a strategic approach to managing the financial risks from climate change, taking into account current risks, those that can plausibly arise in the future, and identifying the actions required today to mitigate current and future financial risks.

Recognising that approaches to managing these risks are understandably immature, and that best practice will take time to develop, the Bank has established with industry participants a Climate Financial Risk Forum to help build intellectual capacity in this emerging field.

And importantly, while the Bank of England is playing a lead role, we are not alone. Internationally we have supported the work of the FSB Task Force on Climate-related Financial Disclosures. And we have been a founder member and work closely with what are now 28 partners in the central bank and supervisors Network for Greening the Financial System.

It is not for the Bank of England, as a financial policymaker, to drive the transition to a low-carbon economy. But we expect financial firms to manage these far-reaching, foreseeable, future financial risks today. The window for minimising these risks and ensuring an orderly transition to a low-carbon economy is finite and closing. And while the challenges are significant, it is better to be roughly right now, not exactly right later. This work could not be more important.

Michael West

Managing Director, Global Ratings & Research, Moody's Investors Service

Assessing ESG risks in credit analysis continues to evolve

The drive to reshape the financial ecosystem to appropriately reflect Environmental, Social and Governance (ESG) considerations and their long-term effects is not limited to redirecting capital flows and increased corporate disclosure. Assessing the credit effects of ESG is complex and multifaceted but is an important sub-element of the ESG initiative.

Take the credit exposure of environmental risks, for example. Moody's analysts have undertaken a comprehensive study to assess the exposure of 84 sectors globally - representing around EUR 65 trillion in rated debt - to environmental risks. From this universe, 11 sectors with EUR 1.9tn in rated debt have elevated credit exposure from environmental risks. These sectors have clear exposure to environmental risks that are either already material to credit quality or could be within the next three to five years. The most impacted sectors today include, e.g., unregulated utilities and power companies and the coal mining industry.

Other sectors show greater susceptibility to more direct environmental risks, such as natural and man-made hazards and water shortages. This includes, among others, central and local governments in developing economies, which will have to deal with the aftermath of extreme weather events and natural disasters or seek to prevent them by investing in climate adaptation and resilience measures.

That said, not all debt issuers will have the same degree of exposure. In general, companies that have the capacity to diversify product portfolios or assets away from exposed operations will be better positioned to mitigate environmental risks. For others, the transition to a low-carbon and climate-resilient global economy may present opportunities by offering consumers cleaner, more sustainable products and services.

Going forward, the broad adoption of the Task Force on Climate-related Financial Disclosures recommendations would allow for a more discernible and comparable assessment of the relative credit exposure of rated entities to carbon transition risk. For instance, additional visibility into the potential financial effects of different warming and emissions scenarios would provide credit analysts with a toolkit to evaluate the potential impact on creditworthiness. Furthermore, broad access to harmonised metrics and targets, such as greenhouse gas emissions by scope or water use per unit of revenue generated, would facilitate a better understanding of an issuer's progress in managing and adapting to climate issues. It would also allow for cross-comparisons of the relative impact and performance of organisations in a given sector.

"11 sectors with EUR 1.9tn in rated debt have elevated credit exposure from environmental risks."

\- MICHAEL WEST

The ability to effect change is not something the private sector can do alone. The significant policy intervention introduced through the Commission's action plan on financing sustainable growth is an important step in the evolution to better incorporate ESG factors into the workings of the financial sector. Moody's will continue to review its rating methodologies to incorporate new information and analysis that flows from the ESG disclosure and policy initiatives. ●

Carlos Montalvo Rebuelta

Partner, EMEA Insurance
Risk and Regulatory Leader, PwC

The challenges around sustainability: turning need into a virtue

There is consensus that long term strategies of financial institutions must encompass value creation for all their stakeholders, rather than focusing only on shareholders. Indeed, customers and employees, but also Society, shall be part of this win-win model, the only sustainable one. This is already the right starting point, Isn´t it?

Yet, the list of challenges remains high; let me focus on two I am concerned about: firstly, regardless of the long term focus that Sustainability embeds, progress has to be made already in the short term, with the risk of shifting means, such as incentives, into ends. Let me elaborate: Reorienting capital flows towards more sustainable investments, one of the objectives of the Commission Action Plan on sustainable finance, entails a risk: Whilst investing in "green" makes full sense, as it does an underlying taxonomy to help us all speak the same language, not all "Green" investments will make similar sense from a risk return view point, and regulatory incentives should not hide that fact if they want to be efficient. Beware this is an area where not only we

need incentives, including regulatory, but we cannot afford not bringing the right ones. Furthermore, focusing only >>>

>>> on regulatory incentives may be tempting, yet it will not give us a long term solution. Financial sector players must play a role beyond investing in green assets, by accelerating change in those entities they invest in. Yes, it can be done!

Secondly, the traditional approach to risk management has been over-reliant on past experience (rear mirror approach), and this will not work when it comes to Climate change, where once in a century is becoming the new normal. Here, the role of the regulator, "enhancing awareness" of risks stemming from climate change (e.g. via stress tests), must be combined with a holistic approach by the regulated entities, in terms of risk taking and managing, assets holding and risk appetite, both for direct as well as transition risks.

"Regardless of the long-term focus progress has to be made in the short-term."

\- CARLOS MONTALVO REBUELTA

There is another issue worth raising, due to its impact on people: the Protection Gap, and the fact that (counterintuitively) it has increased in the last 20 years, both in developing countries and in developed ones. This is an area of great opportunity particularly for Insurers, let´s not make it a lost one. An opportunity to put into value the delivery of the promise made, and one of enhancing resilience to Climate risk via management of claims, underwriting and pricing processes, making steps to reduce the probability and impact of the next catastrophe, thus better protecting people.

Let me conclude not with a message of optimism, but with a new idea to debate: Shouldn´t we also focus, under an ESG agenda that is also Social, on Sustainability (and adequacy) of the Pensions model and the role of all stakeholders in order to ensure that people will live in dignity? Between you and I, this is a much bigger challenge! ●

Eugenie Molyneux

Chief Risk Officer of Commercial Insurance, Zurich Insurance Group

Integrating sustainability risks

At Zurich, to ensure our businesses are applying our purpose and values, we have a systematic and fully integrated approach to potential ESG risk and opportunity areas from a sustainability perspective. Particularly for Investment Management and Underwriting.

The Group Chief Risk Officer (CRO) acts as executive level sponsor for the Zurich's sustainable business framework with responsibility for overseeing its implementation and integrating sustainability risk into the overall risk management framework. Climate change is a central pillar of the Group's sustainable business framework.

The Group Chief Investment Officer is responsible for execution of Zurich's responsible investment approach and climate change investment strategy.

Zurich assesses risks, including climate risk, systematically and from a strategic perspective through its proprietary Total Risk Profiling™ (TRP) process, which allows Zurich to identify and evaluate the frequency and severity of a risk scenario. The Group then develops, implements and monitors improvements. The TRP process is integral to how Zurich deals with change.

ESG positions relating to underwriting are generally reflected in risk appetite, product development, or updates to pricing for sustainability risks, which reflect trends in weather, and climate related risk, for example, assessment of natural catastrophe risks. Where appropriate these updates are reflected in our capital models and pricing models as a natural catastrophe load.

Overall, the Group considers its near-term (3 - 5 years) climate change-related risks to be manageable and foreseeable. The longer- term view (5 – 10 years) is deemed more relevant when considering the long-term sustainability of the organisation, and here risks are highly uncertain.

Today, any evaluation in relation to `longer term` future physical climate impacts, is made with a significant uncertainty. Adding to that uncertainty is the relatively unknown climate risk adaptation actions of customers, governments or other bodies. To the extent those actions are effective at reducing the impacts from climate risks, then any expected future 'longer term' physical climate impacts may by mitigated.

The current Solvency II risk framework allows sustainability risks to be captured without needing to add their explicit specification.

"Climate change impact valuations mean it would be premature to require any reporting in that regard."

\- EUGENIE MOLYNEUX

Further, we consider it unnecessary to make climate change related disclosures mandatory. The industry is in the process of adopting disclosures voluntarily. Disclosures can develop along with the further development of risk assessments.

Last but not least, the significant uncertainty surrounding climate change impact valuations mean it would be premature to require any reporting in that regard. ●