

# ADDRESSING SUSTAINABILITY RISKS

## 1. What the sustainability risks are

### 1.1. The categories of risks and their differences from other risks

A regulator noted that the definition of 'sustainability risk' is complex and still undefined. It can be considered with regards to the long-term impact of current economic, business and social models. Due to the short-term focus of politicians, managers of companies, regulators and supervisors, the fact that the costs are long-term and to be carried by the next generations is overlooked.

Much is heard about the sustainability of public finances, but there is not as much about the sustainability of pension promises, climate change and the business changes there will be due to digitalisation.

There are physical risks, liability risks and transition risks. The physical risks are known and understood. For climate change and natural disasters, the impact on property and infrastructure can be perceived. This issue of liability risks is less visible, but that is changing as more companies and authorities are sued due to not acting. There will be responsibilities for the consequences of the longer-term risks. The transition risks are very important for the financial sector because of the possible impact on assets with respect to climate change, governance, social factors and the digital economy. The biggest risk is doing nothing and believing that the issues will solve themselves.

A Central Bank official added that the physical and transition risks manifest as risks everyone faces in business as usual. However, they are distinctive along three dimensions. First, they are far-reaching and affect every sector, customer and geography. They are correlated and they are non-linear. Together, that makes them potentially catastrophic. The second dimension is that they are eminently foreseeable. Though the specifics cannot be predicted, there will be some combination of physical and transition risks. The third aspect is that the size of the future risks is determined by the actions that everyone takes today.

A Central Bank official noted that when trying to measure the size of the risk the models are partial, do not capture the non-linearities, have poor data and lack feedback loops. That suggests that current estimates are probably under-estimates. Absent action, the impact on the global economy will be very large in terms of physical risk. The more sophisticated models suggest that towards the second half of this century average global incomes could be reduced by as much as a quarter. Particular geographies and sectors are going to be hit more significantly and could see the effects earlier.

There will be a transition at some point, because the costs of the physical risks are too high, and there will be winners and losers there. The numbers are very large. It is 1-4 trillion for just the energy sector. It is 20-40 trillion for the economy more broadly. Those losses are a large share of global financial assets. While the risks are large, people today can control the size of those risks by acting. The window for an orderly transition is finite and closing.

An industry representative explained that an environmental heat map looking across 84 different sectors and covering approximately \$75 trillion of fixed income bonds and

other debt outstanding demonstrates that 11 sectors already have elevated credit risk as related to Environmental, Social and Governance (ESG) factors. That is about \$2 trillion of debt outstanding. The credit quality of coal mining, coal terminals and the ratings of those sectors have already deteriorated. Other industries in the report are ranked accordingly. Banks and asset managers rank low when it comes to environmental risk. However, given what those industries and the insurance industry have to go through, for them it is more about the changes in the focus, products and liability.

The Chair added that there are risks in terms of consumer choices. The youth of today do not want their own cars. They are, in a way, less well off than the previous generation and they link those things together and understand them much better. An industry representative confirmed that attempts have been made to identify, in terms of overall operating capacity, what the impact will be of the different demands either from consumer preference, ESG factors or consolidation and changing business models.

An industry representative added that there are technological changes occurring, irrespective of carbon considerations and the move to electrification. There are overall regulatory changes that are coming in at different times that will impact the overall transition.

### 1.2. The need for a taxonomy

An industry representative explained that it is important to have a very clear definition and taxonomy when it comes to discussing ESG. In addition to a clear taxonomy and the overall disclosure regime in the ESG space, there is a need to distinguish the different types of risk so that they are not misclassified as credit changes.

An industry representative emphasised that sustainability can mean different things to different companies, governments, individuals and entities. A taxonomy would be helpful, even though the prioritisation of the relative risks will differ depending on the industry. It has been estimated that \$1 spent on resilience saves \$5 on costs in relation to weather related events.

The Chair stated that the issue of transition is central to any type of transformation. There was a great deal of discussion about transition when the new resolution system was put in place in Europe. The Chair queried what the role of proportionality in a common taxonomy should be, particularly with respect to the disclosure requirements.

A Central Bank official replied that the point of a taxonomy is to help everyone understand what the risk looks like. It must not be a box ticking exercise, not least because where a company currently is, may not be indicative of where it is going to go. A common language is needed, but it is important to recognise that the measure is dynamic and not static.

Being proportionate involves recognising that there are different degrees of disclosure required, reflecting the exposure of the company, its size and its sophistication. Climate change will affect every company so, whatever the answer, it cannot be nothing. A regulator noted that a taxonomy will look at different economy activities and determine the important criteria to take into account in the transformation.

The Chair suggested that some operators may have fewer instruments for understanding and may have to rely more on a clear taxonomy, while other operators may have greater abilities to reflect. The action plan was in March 2018. There were the three regulations in May 2018. Two out of three have already received political endorsement. 10 months, in European terms, is particularly fast. On benchmarks, there is both the transition benchmark and the Paris aligned benchmark. That is quite a remarkable achievement.

## 2. How to mitigate sustainability risks

### 2.1. The transition to a low carbon economy

A Central Bank official noted that with the transition there will be un-burnable carbon, and there is infrastructure, agriculture and real estate for which the value will be affected by the measures taken to stop the physical risks materialising.

The Chair noted that the young will progressively be taking over, and they are more logical about the issues. A Central Bank official replied that everyone has to act. There are opportunities for the financial services sector to deliver products that those young, new investors want to buy. For financial institutions thinking about the upside, the opportunities to finance the transition are important too.

An industry representative suggested thinking about the risks that the joint approach to sustainability has already embedded and identified. The public and private sectors must come together and work with common interests. To effectively bring business in, the impact on business must be understood. On disaster risk, there is a concept of building back better. That should be reflected more, because it is a fundamental part of the response to risk.

The second matter is business models. There are three kinds in nature: those who fight to survive, those who aim to prevail and those who want to leave a legacy. With the financial sector's business model 10 years ago, it was clear that everybody wanted to prevail. Today, everybody wants to leave a legacy. The question is what makes business models sustainable.

For the third matter, to build on Commission action plans, there are two issues. The first is that this is part of a broader plan where a joint response is needed. The second matter is that the Commission builds on existing international frameworks. It builds on UN 2030 and the Paris agenda. There are 17 goals for UN 2030, but the first of those is people.

### 2.2. The threats and success factors to further enabling sustainability

An industry representative noted that another potential enabling factor concerns incentives and neutrality. Regulation should generally be neutral, but sustainability is one good reason for an exception.

Nonetheless, the regulation has to be correct. There is a significant risk of 'hype bias' whereby something is deemed good because it is green, resulting in relaxed due diligence. It should not be pretended that all of the responses are available today. The issue is a long-term one, but it is fundamental to also identify what is meant by 'long-term'.

Shortcuts are to be avoided. There is a question on how to bring sustainability with the Insurance Distribution Directive (IDD). The audience will advise investors to buy green assets, but from the perspective of fiduciary duty there may be something else to ask.

There is an economic education bias, as economists think in cycles, which demand certain types of responses. However, this is a trend and trends demand structural responses. Approaching the issues as if they are cycles will mean the wrong actions being taken.

It would be premature to introduce reporting requirements regarding the valuation of any impacts because the baseline assumptions are already made with a significant amount of uncertainty. It is also not known what actions will be taken by governments, individuals and companies to mitigate weather-related events emanating from climate risks. The Solvency II framework already allows for sustainability risks to be captured, as long as all short-term and long-term risks are considered.

An industry representative added that there could be an artificially lower calibration of capital requirements to push the move from brown to green. Solvency II is about risk management. As part of the risk mitigation techniques these types of actions could be part of a framework like Solvency II. That would send an extremely powerful message in terms of getting things right and would be embraced by the global community.

### 2.3. The role of stewardship and risk management

An industry representative noted that their organisation has a sustainability team, which reports to the Group Chief Risk Officer who sits on the Executive Committee. That is sponsorship at the highest level of the group. Within that space it essentially goes through a process to identify the risks, assesses them and then takes action. For climate change that has resulted in commitments in four specific areas.

The first area is to develop insurance and risk management solutions to support transition. The second area is to work with customers to enhance their resilience. The third is a commitment to mitigating 5 million tonnes of CO<sub>2</sub> emissions through impact investing. The fourth is minimising the organisation's own impact.

Typically, one to three areas flow through the underwriting channel or the investment management channel. Once a position is taken and a risk is identified, assessed and the action determined it will typically flow through underwriting defining attractive products.

A regulator noted that there has been engagement with the insurance sector and also the asset management and pension sectors, both during and prior to formal consultation. The sectors are looking at the issues. There was a true act of leadership by the Commission in having a vision for the future and acting. This is already going on in a niche way in the risk management areas of the financial sector, and specifically on the insurance side. However, it now starts to be mainstream.

This consultation is the first part on the policy side. Advice will be delivered to the Commission shortly. Companies should integrate sustainability in their own risk management system. Not only ESG related products are needed, institutional investors have taking up a stewardship role. In addition, to know the impact, transition risks have to be managed. Excluding certain sectors entirely and too rapidly, will only create huge transition risks. Instead of creating a 'brown' list, a taxonomy should help the 'brown' sector becoming greener. With this stewardship element the transition can be managed and potential financial stability issues mitigated. The legislation will be fine-tuned to clarify that sustainability risks are considered within the overall framework of risk management. It does not prescribe that companies do certain types of investment or underwriting. Beyond customers having a preference for ESG products and providing them and an investment policy that is conducive to that, there is more of a stewardship role for insurers which again should hold for all institutional investors.

The Chair noted that one question indicated that the International Association of Insurance Supervisors (IAIS) has been a front runner in terms of highlighting good supervisory

practice in managing climate risk in the insurance sector but queried what comes next and how to move from awareness to implementation.

A regulator confirmed that in addition to consideration in risk management, the impact of the relevant investment and underwriting policies on sustainability should also be considered. Many companies in the insurance industry initially indicated that they did not want to invest in the areas. That is fine, but it needs to just be the first step.

The real desire is for engagement from the institutional investors. There should be engagement both on the investment side and from insurers on the liability side, as well as engagement with customers to allow for a transition that avoids instability and stranded assets. It will come back to the portfolios of the financial sector.

That cannot be the way to move from the current carbon-based economy to a low carbon economy. A button cannot be pushed to bring into existence a new economy tomorrow. The companies of today need to be moving and adapting.

Institutional investors should respond by investing in the companies but confirming they are looking at what is being done in relation to the criteria. They should want companies to create long-term, sustainable value for them and their clients. The stewardship element is what will lead to a good outcome without creating problems with transition and instability.

A speaker asked how Europe should deal with the situation where an important government follows a different path. An industry representative replied that a very systematic approach is being followed with methodologies and heat maps. Depending on the country or region, the speed at which that will move, and the level of disclosure and overall policy, will affect how investors will think about the matter.

Transition will be an inevitability, whichever country an entity is in. Whether there is an upfront requirement to move in a certain direction, or if there is an impairment on the back end, there will be very obvious signs for whether entities are moving along in their industry.

An industry representative explained that when it comes to the ability of any institution or government to meet their obligations the question is whether they are able to generate the cash flow from the assets that they are in. That will also be the main decision for whether investors will actually put their money up in the first place. There may be incentives in certain countries to go much earlier than others, but as time moves on there will be, in the case of energy, different inputs that will come at different costs.

A Central Bank official added that it is important to remember that financial institutions, in their decisions about where to invest and where to lend, can substitute for government climate policy. The risks will materialise regardless of what governments do, and so it is in financial institutions' commercial interests to think about where those risks are.

An industry representative explained that stewardship is exactly the role that their organisation recognises and why it takes the position it does. It is committed to the FSB Task Force on Climate-related Financial Disclosures (TCFD) recommendations. However, there is no need to mandate disclosures because the industry is adopting them voluntarily.

A regulator wants to see companies voluntarily disclosing. Time will be needed to understand what the best practices are, but eventually there will be a need to standardise. Standardisation is what improves the quality of analyses by everybody in the market. To have the whole sector take up a

stewardship role, the small and medium-sized companies are also needed, which requires standardisation.

### 3. The broader scope of sustainability issues

#### 3.1. The burden on future generations

A speaker queried how to deal with the required investment in emerging markets, where there is presumably more pollution. A week previously there had been a large conference in Brussels about scaling up sustainable finance. The buy-in from emerging markets had been significant. Europe is 7% of the world population, produces and possesses 22% of the world GDP and produces 11% of the emissions. Even if it was fantastic and had 0% emissions, there remains 90% to take care of. Leveraging Europe's political strength will, and determination is a necessity.

An industry representative noted that there is an opportunity dimension. In Japan, the insurance sector's reputation before Fukushima was even worse than that of banking. In response to Fukushima, insurance fulfilled its business model by delivering on its promises. Insurers used to be risk takers and now they are becoming risk managers. By acting on resilience and building back better, they will diminish the impact of the next type of event. The reputation of insurance in Japan is now great because the insurance sector responded at a time of need.

The costs resting on the next generation is exactly the type of inter-generational transfer underlying pensions. Pensions could be under the ESG agenda. Rather than thinking of how ESG and sustainability as affecting people, the question is how they can affect it. That will probably help to ensure it is dealt with correctly.

A speaker noted that much of the burden for funding the climate transition will come from households buying new cars, making homes more energy efficient and independent, etc. It is not possible to segment the debate on funding to sustainable finance and focus on household savings and access to funding more broadly.

A Central Bank official added that the issue is not about greening only a part of the financial system but the entirety of the financial system. That will only succeed if green finance becomes mainstream. It comes through to banks, for example, when they are thinking about mortgage underwriting criteria they have. The question will be whether they are prepared to lend for 25 years against houses that are built of flood plains and if it is sensible to do so with an annual insurance premium that may not be renewed.

#### 3.2. Other factors that could impact industries beyond the ESG factors

A regulator noted the importance of looking at natural catastrophes and the protection available there. It is now being discussed more seriously and it will definitely be in the public discussion. The evidence of climate changes can be seen. The economic losses of natural catastrophes are increasing tremendously, and the insurance part of these losses, in terms of percentages, is reduced. There is a protection gap which is increasing. For natural catastrophes the contracts are basically on a one-year time horizon basis, so it is possible to really be affected but then either the entity goes out of business or the pricing is adjusted.

It is a systemic risk for society and for the financial sector. The more there are natural catastrophes without protection the more the balance sheets of the banks will shoulder the cost.

This is an area where the insurance sector can have a bigger role by closing the circle in terms of giving the right incentives. If, for example, it is mandated that there should be coverage on natural catastrophes, there will be an incentive

because the insurers should do risk-based pricing. Having a house in a flood plain will mean having to pay or not building on the location.

There are also good solutions with public/private partnerships around the world, but there is more that can and should be done to raise awareness, have better risk mapping and to use insurance as a good risk management tool.

An industry representative agreed about the protection gap. However, it is not something for emerging countries only. The Nepal earthquake cost 25% of GDP. Italy had recent earthquakes. That is increasing everywhere. Companies have publicly stated that they do not discuss this risk at the subsidiary level because it is part of the global policy. That should concern regulators.

An industry representative added that as claims experience, risk maps and floods develop that must be reflected in the pricing. However, it is difficult today to say what the pricing will look like in 30 or 50 years. There should be caution around expressing a protection gap that is currently uncertain.