CLIMATE AND SUSTAINABILITY RISKS IN THE INSURANCE SECTOR

1. The role of insurers in mitigating climate and sustainability risks

A regulator stressed that climate and sustainability risks are unquestionably the biggest risks faced not only by the financial industry or the public authorities, but society as a whole. There is a growing call from society, including people and politicians, for the financial industry to act. Insurers have a larger role to play here than other financial players. The panel would focus on the risks and the role of insurers in risk mitigation, ensuring a swift transition to a more sustainable and resilient economy and the role of insurers there, and how the industry can maintain its momentum and make progress.

1.1 The role of international standard setters on data gaps and gaps within supervisory standards

An official stated that the focus of the International Association of Insurance Supervisors (IAIS) around environment, social and governance (ESG) has been on the 'E' and, within the 'E', on climate risk. This risk is at the heart of the insurance industry's business model. The insurance risks from climate are at the heart of enterprise risk management for insurers. Building on international best practice, IAIS has issued practical guidance on how to supervise the risks that insurance companies face from climate on both sides of their balance sheet. Disclosure is essential for the development of proper information about the risks of climate change. Insurance Core Principle 20 discusses disclosure, and IAIS has supported the disclosures suggested by the Task Force on Climate related Financial Disclosures (TCFD). However, these ideas should be turned into concrete standards. In that context, IAIS welcomed the IFRS Foundation's workstream to develop sustainability standards. IAIS will very soon publish its Global Insurance Market Report, which is a macroprudential risk assessment of the risks faced by insurers at a global level. Following this, IAIS will assess the gaps within its supervisory standards in order to determine whether there is a need to address climate risk more specifically. Given that climate risk is a systemic and long horizon financial stability risk, IAIS is seeking to understand how it can be incorporated more regularly into its global monitoring exercise.

1.2 There are other important ESG priorities beyond climate related risks

1.2.1 The direction on general sustainability issues is not yet clear

An industry speaker highlighted the potential to use the UN's Sustainable Development Goals (SDGs). Insurers should consider the different components of the SDGs, how to measure them, and the requirement for data and methodologies. There are also other important areas such as biodiversity and nature based solutions. Regulators and industry should address these issues together and ensure there is transparency and accountability in how they are accounted for. The industry must determine how to move in one direction. For global sustainability, the direction is unclear. On carbon, the industry has made a good start. However, this cannot happen simply in the EU or the Americas; Asia must also be a part of this effort.

1.2.2 Priorities around diversity, equality and inclusion

An official highlighted the importance of diversity, equality and inclusion. The need for progress here has been endorsed by the Executive Committee of IAIS. The IAIS strategy will probably cover the implications of social risk in relation to treating customers fairly, governance and risk management, and IAIS members and IAIS itself. A public representative agreed on the importance of diversity. Female representation on boards is around 25%, which is clearly not enough. ShareAction published research in May this year suggesting that there is little board level investment on ESG. Only 31% of companies discussed sustainability related risk in their group risk committees.

2. Insurers are both risk underwriters and institutional investors

An official considered that the insurance industry and the regulatory community have a significant role to play around climate risk. Primarily, insurers face solvency risk as a result of climate related risks, the relevance of which is demonstrated by the higher number of catastrophes occurring around the globe. However, insurers also have a role to play as institutional investors. Insurers play a meaningful role by choosing what to invest in and whether a particular investment is viable.

2.1 The challenges around managing disruption and ensuring insurability require further action

The official explained that insurers must ensure the continued availability of insurance products around the globe. The significant increase in the frequency and severity of catastrophes creates concern over whether these risks will continue to be insurable in the future. The insurance industry knows the types of risks which they have an appetite to insure; they know the risks that they are willing to accept on their balance sheets and how much of their capital they are willing to expose to these risks. Insurers will have to liaise with the regulatory community and other stakeholders outside the industry to understand how communities can remain insurable in the face of these risks. As the climate transition begins, it will not be a question of whether insurance entities consider these things but how they are considered. There is a substantial amount of work on this underway at IAIS. In the United States, the National Association of Insurance Commissioners (NAIC) is undertaking a significant effort to consider these risks and work with stakeholders to determine the role it can play in this critical social issue.

An industry representative described how people can talk about how they want the world to be and how they might influence it, but the world itself is changing. Clearly, climate risk impacts both sides of insurers' balance sheets. It affects both assets and underwriting, but this is often not straightforward. Many of the risks that insurers underwrite are second, third or fourth order climate risks. Employers' liability risk seems distant, but it can be impacted by climate risks. The insurance industry and government have a strong history of risk pooling. It cannot be beyond the ability of the insurance industry to work with governments and private finance to develop solutions not only for climate change adaptation but to improve society's resilience to the consequences of climate change.

An official described how the asset side of the balance sheet is one part of the insurance industry's role in the transition. However, any sustainable economy must be able to withstand more frequent catastrophes and recover from them extraordinarily quickly. One of the reasons the insurance industry exists is for this process of recovery. Regulators are developing their own ways of addressing climate risk, but the insurance industry can play a role here through Own Risk and Solvency Assessment (ORSA) reporting, enterprise risk management reporting and comprehensive assessments of asset and liability risk. When natural catastrophes happen, it is important to minimise the disruption for the economies that are impacted and the insurance companies that pay the claims. Coverage gaps exists in relation to a number of different catastrophes, and the industry must determine how to provide more robust coverage for these catastrophe risks. A regulator noted that these coverage gaps are developing at a time when these catastrophes are no longer once in a century events. There must be a way to manage these events as a society instead of relying on public solutions.

An official explained that IAIS is currently working on global standards and gaps. The insurance sector has a crucial role to play in this debate, but climate risk affects all areas of financial services, which means that similar exercises are happening in banking and elsewhere, including by the Financial Stability Board (FSB). As the global standard setter in insurance, it is important for IAIS to assess global risks, develop the data and methodologies to make this assessment and feed into the FSB's cross sectoral risk assessment. IAIS members have different mandates, however; as a global standard setting body, IAIS must take a global approach and focus on risks and policyholder protection.

An industry representative highlighted the importance of the propensity to pay, which is a more acute issue on the liabilities side than on the assets side: for example when an ESG fund is launched by a firm, money flows to them, while when insurers or reinsurers launch a climate dedicated product, clients do not bang on the doors of agents and brokers to say they are happy to pay higher premiums to compensate for the risk. The propensity to pay and the ability to fund the transition will be key, because there is a collective benefit and a positive externality here.

2.2 Competition issues around cooperation on climate insurance solutions

An industry speaker highlighted the need to 'shout out' governments and politicians, and explained the antitrust issues caused by firms' cooperation on climate issues. Each Net Zero Insurance Alliance (NZIA) meeting begins by reading an antitrust statement in the presence of lawyers. The NZIA has done multiple studies to assess where the green lines, red lines and grey areas are.

3. The high expectations on insurers and the need for mobilisation

A public representative stated that there are very high expectations on insurers, which is somewhat concerning. There is a question around who will lead if insurers do not. On the asset side, insurers have trillions of euros of assets under management, but only a fraction of that sum is invested sustainably. On the liability side, the consequences of climate change have been evident in the recent forest fires and flooding in Europe. At this stage, only 35% of the potential damage is insured. The insurance companies are allies in this fight. Some insurance companies are frontrunners here, and they can lead the rest of the sector. At present there are more words than actions in the financial industry. After 100 companies signed up to a financial industry roundtable in the US, two researchers assessed their actions and found that the companies did nothing. The world cannot afford this type of greenwashing.

3.1 Leveraging the frontrunners through common standards, appropriate underwriting practices and a reduction in uncertainty

An industry speaker agreed that different parts of the industry are allies who will have to work together. Being a frontrunner will pay off in terms of competitive advantage, but the existence of frontrunners will not create change on a global scale. This demonstrates the need for global standards and transparency around standards in order to make advances across the industry.

Another industry speaker highlighted the need for consensus and collaboration in the transition. The most profound changes happen when industry and regulators sit across the table from each other, roll up their sleeves and collaborate. Tackling climate change is a shared goal, and the CEOs of companies have a vested interest in addressing the climate crisis. In respect of the transition, there is a need to operate with due speed while highlighting the importance of operating deliberately and cautiously. In 2020, an FSB report highlighted the dangers of making policy changes too quickly. Unexpected policy changes can create financial stability risks, but the industry does want to move swiftly and deliberately.

An official emphasised the role of global coordination. It is a very positive development that colleagues from the industry are calling for global standards and a global level playing field, but this is also a task for governments. Governments must set out stable climate paths and policies against which the regulators and the industry can assess their progress. In terms of methodology, there has been good work done by supervisors on scenario analysis and stress testing. This type of analysis is dependent on carbon prices, scenarios and assumptions about what will happen if there is a disorderly transition. The existence of globally coordinated climate policy paths would make this exercise much easier.

An industry speaker emphasised the importance of underwriting standards, noting that these could be incorporated into risk mitigation. The industry speaker highlighted the example of the Brumadinho dam breach in South America. After such a disaster, it is beneficial to analyse underwriting standards and determine global best practice. Governments and industry associations can set standards, but global insurers can push for the best standards to secure the best outcome for the transition.

An industry representative stated that this is something that must be done in partnership with all parts of the finance industry, governments, and the carbon intensive sectors themselves. The first key ask for government is around carbon pricing. It will be difficult to set a carbon price. Even the current US administration has no appetite to establish a tax, but the situation is different in Europe. Establishing a carbon price could involve removing or changing fossil fuel subsidies, providing sustainable fuel or renewables subsidies, the use of feed in tariffs, or scaling the voluntary carbon markets to set a proxy price. A carbon price must be established, however, because without an economic driver it will be very difficult for insurers to make the right decisions for business and the finance sector.

3.2 The frontrunners are participating in global initiatives, engaging with carbon intensive companies and integrating sustainability into their businesses

An industry speaker stated that the progress made by Allianz consists of three 'plus one' areas. First, Allianz has integrated sustainability considerations into its core business activities. A considerable amount of work has been completed across the business from underwriting standards to core processes. Second, Allianz has developed qualitative and quantitative reporting and controlling processes based on the adaptation of internal corporate and functional rules. Thirdly, Allianz has integrated sustainability assessment processes into its risk management frameworks. In terms of 'plus one', the insurance industry is participating in voluntary projects such as the UN sponsored net zero initiatives such as the Net Zero Asset Owner Alliance (NZAOA). The industry has made tangible commitments; some insurers are 'putting their money where their mouth is' and transitioning their investment portfolios.

An industry representative agreed on the need for the industry to 'get its act together' by transitioning from words to action. The question of climate risk is not only about investment decisions; it is also about underwriting. This issue is about the industry 'standing on its own two feet'. This is why eight of the world's leading insurers and reinsurers formed the NZIA, which produced a set of tangible commitments at the G20 Venice climate summit. The group wants to steer the net zero effort to ensure that insurers play their role fully. The industry is only one part of the ecosystem, however. The players in the insurance industry are allies: the regulators; the industry in its roles as insurer and investor; and the clients. This chain of responsibilities creates the possibility of collective action, which is a founding principle of the NZIA.

3.3 The importance of ESG issues beyond climate and sustainability risk

An industry representative highlighted the importance of the broader topic of ESG. It is easy for people to focus on climate as a subset of the 'E' in ESG and forget the 'S' aspects of climate risk, such as the just transition. The world needs to figure out how to manage the complex changes that will have to happen in the coming decades if it wants to reach the net zero goals set by the Intergovernmental Panel on Climate Change (IPCC). There will be dramatic impacts on economies, citizens and individual companies.

3.4 It is essential for investors to engage with carbon-intensive companies

An industry representative described how people make commitments, state ambitions, and sign up to being net zero, but there is a risk of this being 'just talk'. CA100+ is an investor group that seeks to engage with the most carbon intensive investee companies. Almost all of these companies have net zero commitments, but a recent benchmarking exercise conducted by CA100+ indicated that these companies are not spending money on this. It is prudent to be sceptical and hold people to account. Data and its ability to inform the commitments being made through the NZAOA and NZIA will be a very important topic.

3.5 Data and transparency are vital to avoid greenwashing

An industry speaker emphasised that the role of the insurance industry is to accelerate this transition. In order to do this while avoiding the pitfalls of greenwashing, it is important not to move excessively fast but also to move at sufficient speed. One key challenge is around the availability of data, how to use that data and the consistency of the data. Data is an essential part of the solution, but it cannot be used without a methodology. Carbon is an instructive example here. The CRO Forum developed a methodology for measuring carbon intensity, which the TCFD and the Partnership for Carbon Accounting Financials (PCAF) are now using. The methodology is not perfect, but the data it produces is sufficiently accurate to be able to record, for example, what the carbon footprint of an underwriting portfolio is on a step by step basis. Reinsurers also face a further challenge, because their clients are other insurance companies, which have to provide data to the reinsurers for them to report. Regulators, standards setters and the industry should develop these measures together. If an insurer 'does their own thing', it will not help anybody if what they are doing is not aligned with what is happening in the real world and what other insurers are doing. The industry must compare 'apples to apples'. The more collaboration there is between regulators, supervisors, and the industry, the easier it will be to develop standards. Ultimately, carbon standards are relatively simple. The more difficult ones will come with the other dimensions of sustainability.

3.6 The significant challenges around data require common pragmatic solutions

An industry speaker agreed that data is a significant challenge. When it comes to managing data, firms look at what companies disclose and then apply methodologies and metrics. The modelling will improve as the industry 'follows the science' and more historical data becomes available.

Another industry speaker stressed the importance of data, especially in relation to carbon. In the reinsurance industry, data is very important for treaty insurance business, which is a large bucket of risks underwritten in one contract. This is similar to the look through issue on the asset side. To measure and steer the data in respect of carbon, the industry will require proxies and assumptions that it can use to develop a picture that is meaningful for the move towards decarbonisation. The NZIA's important metrics workstream would be an appropriate place to begin these discussions.

An industry representative reiterated the importance of data. It is important to ensure the industry does not wait for everything to be flawless before it begins this work; the world will be 'roasted and toasted' by the time it is ready. The industry must act now based on the available scientific evidence. The industry will also learn by doing. The metrics currently available are not perfect, but they are certainly better than nothing. The learning curve will be steep, but this means the metrics will improve quickly.

Another industry speaker stated that the insurance industry requires high quality and comparable sustainability data. Close cooperation with the IFRS Foundation, for example, could be a good way to develop global sustainability data. Another industry representative agreed on the need for standardised data. It is extremely important that regulation enables transparency and disclosure here. There are substantial pitfalls around double counting, for example, especially in underwriting portfolios.

3.7 The insurance industry can have a real world impact by using more sustainable practices

On a positive note, an industry speaker highlighted two examples where insurers could have a real world impact without waiting for regulation. First, in claims handling and claim payment, there are some double win or triple win situations. Remote or smart assessment can enable insurers to pay claims without visiting a site and insurers can foster a 'repair versus replace' paradigm in order to drive the circular economy, along with green replacement or green mobility replacements.

4. Concluding remarks: the public perspective

On the subject of the call for governments and other institutions to support the efforts of insurers, a public representative highlighted the "Fit for 55" proposal, which is about reducing CO2 emissions 55% by 2030 and moving to zero by 2050. The public representative stressed that the transformation of societies and economies must be inclusive. ESG is not only about the 'E'; it is also about the 'S' and the 'G'. The transition could be a 'very bumpy road', and there are always elections ahead. Currently, Europe is looking to 26 September and what will happen in the German elections. Next year, Europe will look to France and then Italy. While the road could be 'bumpy', the financial industry is 'on the road'. Sustainable finance is a work in progress, and this also applies to the insurance industry. The review of Solvency II is approaching, and it will be important to enshrine double materiality and to consider stewardship, the reporting requirements and investment in long term assets. However, the public representative stressed that the discussion gave him a 'warm feeling'. The alliance here could be called the Eurofi alliance. Hopefully, it will be about actions, not words. A regulator hoped the present discussion would indeed result in action and not simply words. Hopefully, all the participants would act on this call to work together and build this Eurofi alliance.