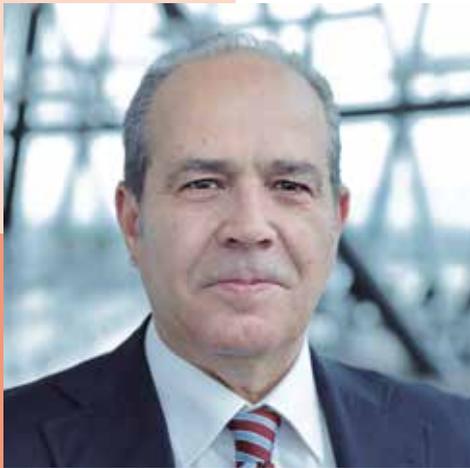


CLIMATE AND ENVIRONMENTAL RISKS IN THE INSURANCE SECTOR



FAUSTO PARENTE

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Growing recognition of sustainability risks in the insurance and IORP sectors

Sustainability risks are increasingly recognized by the European insurance sector, as they can materially affect the business activities of insurance undertakings, for example, through investment losses related to stranded assets or increased insured losses caused by more frequent and extreme weather conditions.

EIOPA's assessments started in 2018 with the EU-wide insurance nat-cat stress test exercise. Besides enhancing its stress test framework on climate change related risks,¹ EIOPA recently published a sensitivity analysis on transition risks² and several studies focusing on physical risks related to climate change.

The expected increase in frequency, severity and correlation of weather-related events will put significant pressure on non-life insurers, particularly regarding property-related lines of

business.³ Consequently, premium levels are expected to increase, thereby exacerbating the already substantial climate insurance protection gap and its potential macro-economic implications.⁴

Climate change adaptation is key to maintaining the future availability and affordability of non-life insurance products that provide coverage against natural catastrophes.⁵ EIOPA's report on impact underwriting shows that while insurance undertakings are making progress in implementing climate-related adaptation measures in their insurance products, the European insurance market overall appears to be at a relatively early stage in this regard.⁶

One of the main challenges for supervisors and the insurance industry to assess and manage sustainability risks relates to the availability of data and loss models. Comprehensive open-source data is needed to improve the accuracy of the risk assessments, in conjunction with open-source models integrating forward-looking climate considerations. In this context, EIOPA developed the "CLIMADA-app", a user interface to facilitate the use of the CLIMADA open-source catastrophe model.⁷ A thematic article published in the June Financial Stability Report discusses the key findings obtained using this tool. If no adaptation or mitigation measures are taken, climate change could significantly increase river flood risk across Europe over the coming decades, with larger losses expected in northern Europe than in southern regions.⁸

The European Commission mandated the ESAs to conduct a one-off climate risk scenario analysis in cooperation with the ECB and the ESRB, aiming to assess the resilience of the EU financial system and its ability to fund the transition towards EU targets on greenhouse gas emissions. The cross-sectoral exercise will be based on end-2022 balance sheet data, and will include two adverse but plausible scenarios that could affect the financial system over the period up to 2030.

EIOPA recently conducted its first climate stress test for the European occupational pensions sector. The results showed a sizeable drop in the value of assets (12.9%) in the context of a disorderly transition scenario, indicating that IORPs have a material exposure to transition risks.

Solvency II, as a forward-looking risk-based framework, can effectively enable insurers

to manage sustainability risks alongside other prudential risks. Many of the existing prudential tools for risk measurement and mitigation can be applied to address sustainability risks as well. For instance, EIOPA's application guidance on climate change materiality assessments and climate change scenarios in the ORSA illustrates how climate-related materiality assessments and scenario analysis of climate risks can be incorporated in this existing prudential tool, not only in the short term, but also in the long-term.⁹ EIOPA is currently evaluating the potential for a dedicated prudential treatment of sustainability risks,¹⁰ and is initiating the re-assessment of the standard formula for natural catastrophe risk in Solvency II.

The regulatory landscape is continuously evolving to effectively address sustainability risks.

Supervisors and the insurance sector in the EU have shifted their focus to sustainability risks. It remains essential that the insurance sector continues to evolve ensuring that future challenges are appropriately addressed.

1. EIOPA (2022): *Methodological principles of Insurance stress testing – Climate change component.*
2. EIOPA (2020): *Sensitivity analysis of climate-change related transition risks.*
3. EIOPA (2022): *European insurers' exposure to physical climate change risk and (2022): FINANCIAL STABILITY REPORT.*
4. ECB and EIOPA (2023): *Staff Paper on Policy options to reduce the climate insurance protection gap.*
5. EIOPA (2022): *EIOPA's dashboard identifies the European natural catastrophe insurance protection gap.*
6. EIOPA (2023): *Pilot Exercise on Impact Underwriting.*
7. EIOPA: *Open-source tools for the modelling and management of climate change risks.*
8. EIOPA (2023): *FINANCIAL STABILITY REPORT.*
9. EIOPA (2022): *Application guidance on climate change materiality assessments and climate change scenarios in ORSA.*
10. EIOPA (2022): *Discussion Paper on the Prudential Treatment of Sustainability Risks.*



SACHA SADAN

Director, ESG - Financial
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UK Financial Conduct Authority is taking action on ESG

The financial sector has a vital role to play in helping the economy adapt to a more sustainable long-term future. The UK Government has called out the important role the Financial Conduct Authority (FCA) has in achieving their vision for the UK to be the world's first net zero aligned financial centre. We take this role very seriously and are proud that financial services have been front and centre in helping to drive positive, sustainable change. Within this, we are committed to international alignment, and we have been doing a lot of work to make sure that we are developing global solutions to global problems.

We were delighted to see IOSCO endorsement of the International Sustainability Standards Board (ISSB) standards in July. We have worked with the ISSB since the start and are hugely supportive of its mission to create a common, global language for companies around the world to communicate their sustainability stories in a consistent and comparable way. It is great to see ISSB and the European Finance Reporting Advisory Group (EFRAG) working hard on interoperability to help build global standards. The UK Government has also signalled its support for ISSB and once available for use in the UK, we will update our rules to reference the ISSB standards.

In parallel, we have been working very closely with the UK's Transition Plan Taskforce (TPT) to develop a framework for credible net zero transition plan disclosures, which complements ISSB standards. While the TPT was launched in the UK, it has a truly international focus. We know there is no 'one size fits all' approach here – every business model is different and what works for one might not work for another. But what is important is that we get started, get it wrong, make mistakes and then learn from them. Small iterative steps that are started tomorrow are better than achieving a perfect solution in 10 years' time.

Timely, complete, and consistent global adoption of the ISSB standards, combined with high-quality, forward-looking transition plan disclosures, can give investors the confidence to invest in a sustainable future and help the market for sustainable finance scale with integrity. As part of the FCA's commitment to 'walk the walk', we published our own Net Zero Transition Plan in July, which we have developed using the TPT's framework.

We are also working to build a world-leading and competitive sustainability disclosures and labelling regime that will help the UK's asset management sector thrive by setting standards that improve the sustainability information consumers have access to. Our Sustainability Disclosure Requirements and Investment Labels consultation set out a package of measures to build confidence and help consumers navigate the market and make better informed decisions. We are working with the EU and are making sure our requirements are consistent with the EU's Sustainable Finance Disclosure Regime (SFDR). We just have different starting points – consumers are at the heart of our proposals.

To create a UK market that functions competitively and effectively for the benefit of consumers, they must be able to trust sustainable investment products. Investors have a really important role as stewards of capital to make sure the economy rapidly becomes more sustainable. Our proposed sustainable improver label for example, is designed to legitimise investment in firms that, while not sustainable today, are on a credible path to becoming more sustainable over time.

We have said for some time there is a clear rationale for a globally consistent regulatory approach for certain ESG data and ratings providers. So, we welcomed the Government's consultation, which closed in June, on whether and how to bring ESG ratings into the FCA's regulatory perimeter. Should the

Government decide to extend our perimeter, setting up a new regulatory regime would take time. That is why, last November, we announced the formation of an industry group to develop a voluntary Code of Conduct, which is currently being consulted on. It is grounded in IOSCO's recommendations and is considering developments in other jurisdictions.

Looking back on recent years, we have made significant progress – as a regulator and as industry – but there is lots more to do.

**What is important is
that we get started,
get it wrong, make
mistakes and then
learn from them.**

Creating positive, sustainable change isn't just about climate change. It's about looking beyond and considering wider environmental issues, such as biodiversity and nature, as well as social and governance issues, such as diversity and inclusion, the living wage, fair taxation, and supply chains. As firms adapt to this changing world, their governance arrangements, incentive structures and capabilities must keep pace. We all know that what gets measured and incentivised, gets done.

To deliver the transition to net zero, we will need a transformation of unprecedented pace and scale. We know that many firms in the market are already on their transition journey, but we want to work with industry to make sure firms are able to do this well and are doing it consistently.



ANDREA NOVELLI

Chief Executive Officer - PosteVita

Sustainability and adaption in the insurance business: from insurantal imaginary to stark reality

In his 1991 book, *The Foucault Effect*¹, Francois Ewald, a French philosopher, described the insurance business as an abstract technology of statistical combinations. Ewald defined the complexity of those combinations as an 'insurantal imaginary'. According to his views, the insurance business was about extracting potential scenarios from those combinations, assigning them probabilities, but without the capacity to mirror that imaginary in full.

As a result, according to Ewald, in the practice of insurance, it was possible² to separate different classes of risks that could impact us and define different branches or business lines of our own insurance activities.

Each risk, still quoting Ewald, is insured as to protect oneself from an accident, or 'like a roulette number, a card pulled out of the pack'. Companies and regulators have discreet approaches to the matter. That period of discreet insurance activities is up for change.

The series of extreme events we witnessed in the last 3 years heralded a wider concept of risk and of insurance: the Covid-19 pandemic, followed by the war in Ukraine and the solid manifestation of extreme weather in Europe are examples of global and pervasive trends, with the capacity to impact not only on a class of assets or insured items or people, but at multiple levels.

The summer of 2023, one of the hottest recorded in Europe, shows clear signs of this: we are witnessing its impact on agricultural production, morbidity rates health claims, ranging from respiratory to mental health issues and damages to assets like homes and cars.

2023 is becoming our year zero: it is not only about hotter weather, but about uncertainty and potential disruptive 'peak' events, as we witnessed in Italy this year so far.

The insurance sector in Europe will have to be at the forefront of analyzing current impacts, as to build a heatmap of critical points and adaptiveness.

Our imperative will be to treasure the information these events are providing us and modelling around 2023 as benchmark. Understanding extreme events and subsequent adaptation is the first step towards a long-term sustainable model. Before any of the investments on greening our economies and activities will start to have some substantive effect, we will need keep managing emerging extreme events.

The insurance business, quoting again Francois Ewald, is about 'controlling the hazard of contingency'. Some ideas on how to keep sustainability at the centre:

- *Model climate and society change into our own forecasts* – Recent reports (i.e. the UK Institute and Faculty of Actuaries, 2023) questioned how economists assess the impact of climate change on scenarios for financial services, including pensions and life insurance. As reported by Carbon Tracker, while temperature increases up to 5 Celsius degree by 2100 is expected to reduce the Global GDP by 10% - as claimed by a series of economic papers – we know that this would be an existential threat. We all need to consider the full extent of climate

change and adaptation needs across the spectrum of risks we all manage.

- *Include adaptation risks into the premia* – Whatever risk we ensure our clients against, we need to have adaptive pricing: over time, we should be able to include impact components, translating them into different premia according to the transition quality of the solution offered to our customers. This is valid for damage and loss insurance and for life products.
- *Build long term sustainability into your investment* – The long-term play for the insurance business is to be sure that our portfolios transition into sustainable-linked and ESG-rated investments. This requires additional transparency and clarity on how assets are defined in relation to different taxonomies.
- *Redefine the transferability of some risks* – Climate global externalities need a substantial rethinking of transferability, including what a risk is and how it can be mitigated by the market through reinsurance or other means, or what the risks are that we are facing requiring collective action and policy choices. As highlighted by the UN Environment Programme on a 2021 Report (*"Insuring the climate transition"*), the transformation to our ecosystems requires major interventions, including being mindful of where transferring a risk is only compounding its effect.

The insurance sector in Europe will have to be at the forefront of analyzing current impacts, as to build a heatmap of critical points and adaptiveness. Our aim is to reduce risks before reaching a point where they will not only difficult to transfer, but, as explained by the IMF in 2020³, the impact will be perceived at any level of the financial markets, including sovereign issuers, the backbone of our life insurance businesses.

1. *'Insurance and Risk' in "The Foucault Effect: Studies in Governmentality", 1991, London.*
2. *And it is happening today, showing the deep influence that Ewald and his master, Foucault had on the actuarial sciences in France.*
3. *IMF Working Paper 20/79 – 2020 - This Changes Everything: Climate shocks and sovereign bonds, by Serhan Cevik and Joao Tovar Jalles.*



HIDEHIKO SOGANO

Chief Sustainability Officer -
Dai-ichi Life Holdings, Inc.

The importance and challenges of formulating the “transition plan”

Financial institutions around the world, not just in Japan, are tackling sustainability risks with a strong awareness of the issue. Especially with regard to climate change, GFANZ and Net Zero Alliances are functioning as a base for accumulating the best practices of private financial institutions. This spring, GFANZ established its first country chapter here in Japan, which would surely accelerate a positive momentum in the whole Japanese financial sector to achieve net zero. As an example of recent momentum, a small number of banks and insurance companies have started announcing transition plans for climate change in line with the GFANZ framework this year. Dai-ichi Life Insurance will also announce its transition plan for the first time this August.

This has three positive effects.

First, the plan provides an opportunity to broaden our understanding of what the transition means for us and the actions we are taking to support decarbonization in the real economy. of stakeholders.

Second, by publishing a plan, members of the Executive Committee and Board

of Directors of the financial institutions, can comprehensively review the approach and clarify what additional efforts are needed to continue on the path to net zero.

Finally, our net-zero transition depends on our clients taking action toward decarbonization and business transformation. Unfortunately, there is still no clear indication of how much each industrial sector will decarbonize in every five-years-term toward the ultimate goal of decarbonization in 2050. Still, the transition plan provides a means to involve our clients in their own transition planning.

At the same time, when formulating the transition plan, it is necessary to find the right balance between uncertainty and our commitment, since we need to recognize the changes beyond our control, such as developments of technology, various changes in policies, and geopolitical risk.

In particular, I would like to share issues related to “hard-to-abate sectors” from the perspective of Asia, including Japan.

First, the definition of transition finance is not yet shared among stakeholders. The G7 Hiroshima Summit communiqué mentions the importance of transition finance. This is good news, but in order to integrate transition finance into transition planning, more consensus needs to be reached on what kind of finance should be trusted as transition finance. In general, the energy composition of Asian countries, including Japan, is highly dependent on coal-fired power generation. Temporarily increasing financing for the brown sector, such as high-efficiency gas-fired power plants, is inevitable in order to secure stable and affordable alternatives to coal-fired power. In order for such finance to be recognized as transitional finance, it is necessary to build a consensus to enhance mutual understanding.

Clear definition of transition finance, national level of roadmap, and just transition are needed.

Second, there is a need for concrete green energy transition roadmaps at the national level. For example, we must clarify whether and how we will accept gas and nuclear power as temporary alternatives. Currently, private financial institutions such as GFANZ are making

efforts to draw a pathway for each industry’s transition, but I would like the government to clarify the major direction that will serve as a premise.

Moreover, it must be a “just transition plan” so that no one is left behind by the transition. This contains some social dimensions such as labor mobility, reskilling of people who have engaged in the abated sectors, and rebirth of the community with governmental support.

This challenge in Asian coal-fired power generation is also applicable to other hard-to-abate sectors. How to deal with sectors that are particularly difficult to reduce, and how to provide them the transition finance, are the areas that have not yet been sufficiently discussed, and are considered to be one of the major themes for COP28.

Financial institutions, including insurance companies, have high hopes for the development of new technologies to realize decarbonization and are in a position to provide them with the necessary finance, which means they see this as an opportunity. It is certain that the awareness of risks and opportunities around sustainability is steadily spreading, we should recognize at the same time that the deadline for addressing decarbonization is fast approaching.

As we have made great progress with respect to disclosure standards such as the TCFD, we hope that the importance of a transition plan will also be shared with regulators so that it will be understood and promoted in markets around the world.