Climate and environmental risks in the insurance sector

1. Aspects of sustainability risk

The panel will focus on how to measure the impact of climate risk on insurance companies and how to communicate the risks, exposure, and sustainability activity.

1.1 Insurance gap

A market expert remarked that there is hardly a need to repeat the messages about how insurance business models see themselves impacted by climate risk. There have been many discussions recently about insurance companies withdrawing coverage, raising premiums, and advocating for private/public partnerships to help cover the risks.

1.2 Sustainability risk's impact

A market expert highlighted that despite the gravity of the discussion and what is happening, the scenario analyses have concluded that things are fine, which is at odds with reality. The main conclusion of these exercises is that they are currently not useful for deriving any meaningful measures to mitigate and address the risk.

These exercises still have many limitations and are increasingly at odds with what climate science says. Many models used for scenario analyses are inherently flawed from an economic perspective. For example, the scenario analyses conducted by the NGFS do not consider extreme weather events, sea level rises or major societal impacts from climate change, such as mass migrations. Although these exercises should not be abandoned, they have to be improved and be both realistic and based on the climate science facts.

2. Improving risk measuring tools and data

A regulator stated that the European Insurance and Occupational Pensions Authority (EIOPA) is trying to create a bridge between scientists, universities, the people involved in measuring climate risk and the practitioners in the industry. That is being done with the CLIMADA app. Especially for smaller, medium-sized insurers, the capacity to measure the impact of climate risk on their businesses is limited by the lack of data. User-friendliness of data is an area EIOPA has tried to improve.

Improving the quality of the data is one of the topics in EIOPA's sustainability agenda. The European Central Bank (ECB) and EIOPA are working on how to enhance the capacity of the system to cope with natural catastrophe risk linked to climate risk.

Thanks to application guidance issued by EIOPA on how to reflect climate change in ORSA, insurers are coping more with the risk and are trying to measure it.

2.1 Data availability and quality

An official stated that insurance supervisors consider climate risk to be a driver of many risks that insurers are exposed to, so it needs to be embedded in the risk management and supervisory work, both on the macro and micro prudential sides. What matters is having a forward-looking perspective, and that is where scenario analysis is needed.

The first challenge is that there are still many data gaps. Relevant data is needed to carry out the analyses and entities do not necessarily have all the necessary underlying data. Progress has been made in filling the data gap, but, for example, geolocalisation data are still sometimes missing.

The second aspect is that the climate scenario is still rapidly evolving and not all of the industry or all supervisors are specialists in climate science. A great deal of capacity building needs to take place. Sharing experiences between supervisors is very important.

The last element is that there is a great deal of complexity due to the many aspects to consider in the balance sheets of the insurers, as well as volatility in the results. It is not linear work, so sometimes a small change in some assumptions can have drastic results. That involves selecting whether to only look at baseline scenarios or how extreme the scenarios should be, in order to give an evidence base to supervisory decisions and incentives for insurers to adapt.

An industry representative added that entities have to look at their portfolios and the exposures on companies that are heavily involved in fossil fuel activities. The biggest challenge is how to assess the impact of transition-related risk and physical risk on other sectors in the portfolios. One example is how such risks could affect the banking sector, which is typically one of the sectors that life insurance companies invest a great deal in. There is a reliance on ratings and assessments, which are provided by third-party information providers and rating agencies. That is a challenge because there is a need to improve the quality of such data from external sources.

Even more challenging is incorporating, on a forward-looking basis, climate-related risk analyses in the solvency capital assessment. These efforts are aimed at determining, from what there is in the portfolio, what could happen in the long term. There are guidelines from regulators on how to do that, but a common industry framework has to be developed.

An official remarked that another aspect is disclosure at corporate level. The International Sustainability Standards Board's (ISSB's) work is welcome. It will help to create momentum and resolve many of the issues around data gaps. IAIS is engaging with the ISSB on the industry-specific aspect, to assess the level and quality of information that insurers need to disclose. One issue is

how to use the disclosures to improve the approach of climate-scenario analyses and how to translate the enriched disclosure into the supervisory work and insurers' disclosures.

A regulator emphasised that it is important to return to practicality. The ISSB's work helps in that respect, as will endorsement from international regulators and ensuring that there is interoperability with the European Financial Reporting Advisory Group (EFRAG). In the UK, insurance companies, banks and others have become signatories to net zero commitments. However, we need to move from commitments to action, to ensure firms can achieve the targets they have set. UK insurance companies have started to act in relation to their investments, such as disposing of coal assets. Transition plans will be key in helping firms to assess what more they may need to do.

2.2 Top management involvement is a prerequisite

An industry representative remarked their organisation decided to involve the top management of the company on climate-related risk, and it developed and implemented some guidelines. It has a policy for responsible investments, guidelines on how it invests in 'sensitive sectors', and guidelines on how it engages with counterparties, including how to exercise voting rights. The implementation of those policies is under the direct responsibility of the top management. The challenge has to be tackled from the top.

3. Disclosing consistent forward-looking projections

3.1 Defining disclosure standards on transition planning

A regulator remarked that an entity indicating what its scope three emissions were for the previous year does not help them reach 2050 targets. Investors and supervisors want to see credible plans to get to 2050.

The UK Government, along with companies and regulators, have set up the Transition Plan Task Force to develop a framework for private sector climate transition plans. The draft framework mentions the ISSB standards 29 times, so although set up in the UK, it has a truly global focus. The TPT has used the regulator's digital sandbox to allow firms, including insurance companies, to test the TPTs draft framework to see how this works in practise.

3.2. Defining transitional finance

An industry representative indicated that when formulating the company's transition plan to net zero in August it was hard to find the right balance between the commitment and the uncertainties around the world. A definition of transitional finance is not yet shared among stakeholders. The G7 Hiroshima Summit communiqué mentions the importance of transitional finance, but to integrate transitional finance into transitional planning, consensus is needed on what kind of finance that is transitional.

In general, the energy composition of Asian countries, for example, is highly dependent on coal-fired power generation. Temporarily increasing financing for brown sectors, such as high-efficiency gas-fired power plants, is inevitable to secure stable and affordable alternatives. Activities and sectors considered as 'supporting the transition' can vary between jurisdictions and over time. There is a need for concrete green energy transition roadmaps at the national level. The transition plan has to also be just so no one is left behind. That involves social dimensions, such as labour mobility, re-skilling people and reimbursing communities. How to deal with hard-to-abate sectors and provide them the transitional finance has not been sufficiently discussed and will be a major theme for 2023 United Nations Climate Change Conference (COP28).

4. Reducing green washing

4.1 Improving disclosures and label accuracy

An official stated that part of IAIS's work plan was on climate disclosures. There is increasing demand from policyholders for sustainable products, either in life or non-life. That creates market conduct risk for greenwashing. The appetite for sustainable products should not lead to false or unfair representations from insurers or distributors. IAIS aims to publish another application paper later in the year considering the steps insurers and supervisors can take to avoid this risk. That might include recommendations on common definitions.

A regulator added that EIOPA is working under the mandate of the Commission to tackle greenwashing. The legislation in place is not complete or clear and with the increase in demand for more sustainable products this can lead to abuse and greenwashing. An insurer could say that for each product it sells it plants a new tree but then not do so. The conduct side is an area where there can be misguidance to clients about the sustainability features of a product or a disregard for the sustainability preferences of the client during the advice process.

This sustainability feature has begun to be integrated into supervisory activities at the national level. There are challenges, such as a lack of skills, but there are also opportunities. For example, supervisory technology (suptech) might help in screening the information and the disclosures. The authorities are also working to suggest improvements to the implementation of the Sustainable Finance Disclosures Regulation (SFDR). Behavioural research, for example, indicates that people still do not understand what a sustainability feature of a product is when looking at the key information document.

Currently the insurance sector does not have enormous greenwashing cases, but there have been such cases in other, non-financial fields. There can be optimism and confidence that the industry is playing its role, but the legislative framework can be improved and the supervisory skills and activities have to develop further.

A regulator suggested that the UK is similar to other places in terms of greenwashing. There have not been many guardrails or metrics like those from the ISSB, and as firms increasingly make sustainability-related claims about their products and services, there are growing concerns that some of these may be exaggerated or

misleading. The UK's SDR and labelling regime will help to combat this, and the FCAs approach has consumers at its heart. Entities do not have to have green products, but if they do, then those products should do what they say they do and be able to demonstrate that. One of the labels that the UK's SDR labelling regime will introduce, will be the 'sustainable improver' label, designed for investments in firms that, while not sustainable today, are on a credible path to becoming more sustainable over time. It is acceptable to be a transitioning oil and gas company, but that has to be explained and the transition plan has to be credible.

The FCA is pushing investors. It regulates the asset managers, and many of them are the asset owners of the insurance companies. They are now pushing insurance companies to state what is meant by their commitments. In the UK, the government is consulting on whether ESG ratings should be regulated because they have a powerful role in giving valuations. That involves asking how they are doing their jobs, what methodology they have, what the transparency is like and how conflicts of interest are managed.

4.2 Consistent definitions and standards to combat greenwashing

A market expert remarked that for investors to be willing and encouraged to move to green products there have to be products available that effectively contribute to real economic activities towards being green, or which are already green. Credibility and transparency are needed so users have trust. Understanding of the complex sustainable finance terms there are also needed, so that users' wishes can be effectively translated into how these products are designed and regulated.

For the EU there is a need to create a robust and reliable concept of what a sustainable investment is, and that means SFDR. There is also a need to differentiate sustainable investment from transition finance, which would relate to creating a united concept of what transition finance is and having a consistent and robust framework for entity-level transition plans that are credible and followed up on. That means not only covering how nice the plan is currently but also the year-on-year progress.

Transparency has to align with all of that, which means product disclosure rules. Robust and consistent rules on sustainability preferences are also needed. The Insurance Distribution Directive (IDD) and Markets in Financial Instruments Directive (MiFID) rules should be aligned with SFDR and the transparency rules.

5. SFDR's contribution to shaping credible investment products targeting unsophisticated individual investors

An industry representative noted that their group serves more than 30 million clients, the majority of which are unsophisticated investors with relatively small net worths and who do not necessarily want to put in the time and effort to understand the detailed content of the financial products they buy. That is why they go to institutions that do this on their behalf.

A great deal of time and care is spent to understand the preferences of clients, including on sustainability. The organisation's clients have been asked, since 2020, about their preferences in terms of sustainability when conducting periodic risk profiling and assessments in compliance with MiFID II and IDD. More than 70% of clients expressed either an interest or a high interest in investing in sustainable financial products.

Some years previously, the organisation started to develop insurance-based investment products (IBIP) targeted specifically at retail investors that embedded some ESG characteristics. That led to the launch of the first product, which is compliant with Article 8 of SFDR and promotes sustainable investments. Many other Article 8 compliant products have since been launched. The organisation's target is to have the vast majority of products at least Article 8 compliant by the end of 2023.

The experience so far has been positive because it encouraged internal teams to focus on the kind of ESG characteristics to expect from a very low risk financial product, such as those typically distributed to retail investors, and the characteristics expected by the market, regulators and clients. Rolling out sustainability disclosure standards globally is ongoing and raises some challenges, notably regarding overseas subsidiaries and small and medium-sized enterprise (SME) counterparts.

An industry representative detailed that, with the revision of the Japanese Corporate Governance Code in June 2021, the 1,839 companies listed on the prime markets are required to disclose information related to climate change based on the Task Force on Climate-Related Financial Disclosures (TCFD), starting from this year's financial results.

The ISSB finalised two standards at the end of June and the Sustainability Standards Board of Japan (SSBJ) will develop a Japanese version. An exposure draft would be published by March 2024 and finalised by March 2025. Although using scope three as a disclosure standard is well supported, issues with the data availability and the calculation method have been highlighted and it remains difficult to accurately measure this information. In addition, the ISSB requires disclosure on a group basis, but it is very difficult for global players to collect data that includes overseas subsidiaries by the deadline.

There is a need to raise awareness of these issues with the local economies and SMEs. Glasgow Financial Alliance for Net Zero (GFANZ) is trying to construct guidance or practical facilitation activities to provide ideas that are more familiar to SMEs.

The Chair summarised that although there are challenges, there are positive messages that could improve confidence about how the sector might deal with climate risk. There is significant awareness of the need to work urgently on this issue.