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The role of insurance in sustainable economic and social development

Global warming, as a result of climate change, is intensifying various natural risks, such as flooding, storm surges, hurricanes and drought. These natural hazards are increasingly resulting in catastrophes, which pose a risk to society and different organisations. This is just one area in which the insurance industry has a dual role. While, on the one hand, it should cover these risks and their consequences, it is also contributing to sustainable financing in its role as long-term investor.

ESG in the insurance industry: challenges and opportunities

In March 2018 the European Commission launched an action plan on financing sustainable growth, which contains a roadmap to facilitate more sustainable investment. The plan will fundamentally change the Swiss financial market and offers the financial sector in this country extensive new business models. This will only be the case, however, if the government adjusts the rules on sustainability in the financial sector and if companies fundamentally change their way of doing business, as highlighted by the study published by PwC and WWF Switzerland entitled “Paradigm shift in financial markets: the economic and legal impacts of the EU Action Plan Sustainable Finance on the Swiss financial sector” (PwC and WWF Switzerland, 2019).

For a commercial activity to be considered sustainable it must promote certain objectives, including mitigating climate change, adapting to a changing climate, making sustainable use of and protecting water and marine resources, transitioning to a circular economy with recycling and waste prevention, preventing and reducing pollution and protecting healthy ecosystems. These should be the guiding principles that will make future regulation effective. At the same time, low-carbon benchmarks and benchmarks for a positive impact on CO_2 emissions are being introduced.[1]

With regard to the three aspects of sustainability – environmental, social and governance (ESG) – the following trends can be seen in the insurance industry (extract):

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E – Environmental

A key risk for the insurance industry is weather-related catastrophes. According to Lloyd's of London, global weather-related losses increased from an average of USD 50 billion in the 1980s to almost USD 200 billion in the last ten years. Insurance Banana Skins 2019, a survey conducted by the Centre for the Study of Financial Innovation (CSFI), highlights that climate change is one of the biggest risks for the entire insurance industry. It is viewed as the third biggest risk for non-life insurance and the second biggest risk for reinsurance. Several participants were also of the view that climate change could make certain risks more difficult or even impossible to insure.[2]

S – Social

The ageing global population means the cost of healthcare within national budgets is continuing to grow. Governments are increasingly seeking to pass on part of these growing healthcare costs to the insurance industry. However, the demand on social security (occupational disability, unemployment), particularly in developing countries, is also continuing to grow. Microinsurers have the potential to provide cover for certain risks to low-income individuals and small companies that would otherwise not have access to financial services. These risks include both health risks (illness, injury, death) and material risks (damage, loss). Microinsurers can therefore play a role in reducing poverty and, with the help of new technology, improve access to and distribution of insurance products.

G – Governance

Supervisory authorities at the Bank of England have warned that legal proceedings against companies that contribute to climate change could soon be the biggest threat for insurers (Schoenmaker and Schramade, 2018).

Insurance companies can use a materiality matrix to identify and prioritise the most important sustainability topics for them and their stakeholders. The aim of this materiality matrix is to identify the risks with the biggest impact on society, and also to capitalise on the new opportunities presented by a changing world.

More and more leading insurers are taking these long-term sustainability trends and factors into account in their risk assessments and claims management processes.

As one of society's biggest risk bearers, the insurance industry should maintain active and continuous dialogue with its stakeholders. Sharing risk competencies helps stakeholders and society find answers to ESG challenges. In turn, the insurance industry benefits from this dialogue as it can gain a better understanding of the most important risks, including those relating to ESG, and can prioritise. With this knowledge, new solutions can be developed and processes adapted to support sustainable development.

The role of an insurer as investor and risk manager: an asset and liability perspective

Sustainable investment is also growing in importance in the light of climate change and more and more insurance companies are committing to integrating ESG criteria into their investment processes. Many financial service providers have already positioned themselves as active contributors to environmental transformation. However, there are still many hurdles to overcome when designing green investments. A research brief by the Geneva Association summarises these hurdles as follows (The Geneva Association, 2018):

- Limited market capacity to accommodate green investments
- Lack of clear classifications, standards and methodologies for assessing green investments
- Regulatory risk capital requirements that make green investments less attractive
- Supervisory risk capital requirements that could restrain long-term green investments
- Need for green technology investment opportunities and structures that better satisfy the European Union requirements
- The insurance industry's risk appetite
- Lack of adequate pricing mechanisms for CO2 and linkages to the financial industry's risk appetite
- Lack of data and transparency for targeted investment

On the liability side, (re)insurance companies are establishing underwriting standards that include ESG criteria and also define limits and exceptions for certain risks and activities. The way insurance companies behave in terms of coverage commitments can also influence their customers' ESG behaviour.

Modelling and assessing risk is an important part of calculating technical reserves for expected losses as well as the buffer for unexpected losses and therefore constitute an integral part of an insurance company's competitiveness.

Climate change and its consequences lead to[5]

- an increase in losses and greater variation in losses as a result of more frequent and serious events,
- higher risk capital requirements for insurers and reinsurers,
- a challenge in terms of affordability of nat cat cover for certain risk regions and
- increasing difficulty closing disaster protection gaps.

The insurance industry is seeking to share its knowledge of modelling and assessing risk with customers as well as the public and private sector, with the goal of increasing risk awareness and thus risk-based decision-making.

Insurance companies are increasingly supporting research initiatives and the establishment of incubators in an effort to develop innovative solutions that can serve as preventative measures as well as to improve their risk models and risk information. However, insurers are also building new incentives into their products with the goal of reducing risk, for example by reducing premiums if a policyholder implements preventative measures. Another effective measure is adjusting products and services that help a customer improve their climate resilience and reduce their greenhouse gas emissions.

The Geneva Association's research brief (The Geneva Association, 2018) summarises the challenges for the insurance industry as follows:

- Limited access to risk information and therefore difficulty in setting prices
- Political, regulatory and legislative issues
- Lack of awareness of insurance
- Weaknesses in domestic insurance markets
- Limited uptake of catastrophe cover
- Regulatory hurdles to accessing global reinsurance
- Scalability and sustainability of insurance programmes

Need for action regarding ESG and sustainable finance expected to increase

The regulatory action taken and current developments show that measures are needed in many areas: on the one hand to improve the quality and make it easier to compare sustainable finance products and services and, on the other hand, to hedge the consequences of catastrophes through comprehensive risk management and to develop preventative measures.

This is what motivates the actors currently steering the ship to reduce information asymmetries among financial market participants when it comes to sustainability. The availability of relevant information is essential for modelling and assessing risks related to ESG events, as well as for determining how they influence the value of investments. It is an essential foundation for integrating sustainability risks.

Surveys and assessments of disclosures with reference to the framework by the Task Force on Climate-Related Disclosures (TCFD) show that action is needed:

- *Disclosure of climate-related financial information has increased since 2016, but is still insufficient for investors.* The availability and quality of climate-related financial information has improved. Yet, if you consider that climate change and the need to limit global warming call for absolute urgency and speed, more companies need to consider the consequences of climate change and disclose material findings.
- *More clarity is needed on the potential financial impact of climate-related issues on companies.* If the impact of climate change on society in general and on individual companies in particular can be better quantified, users of climate-related financial information and data can more clearly identify the financial impact on businesses. Up to now, the financial implications have not really been adequately

covered. Without this information, an investor cannot make an informed investment decision, nor can a risk manager calculate the relevant risks.

- *Of companies using scenarios, the majority do not disclose information on the resilience of their strategies.* Three out of five companies responding to the TCFD survey that view climate-related risk as material and use scenario analysis to assess their resilience do not disclose information on the resilience of their strategies. This is an obvious gap with regard to the TCFD's requirements of companies facing material climate risks.
- *Mainstreaming climate-related issues requires the involvement of multiple functions.* While sustainability and corporate responsibility functions are seen as the primary drivers of TCFD implementation, they are not the only functions that need to be involved. Risk management, finance and executive management are increasingly being involved as well. The TCFD is of the view that involving multiple functions is critical to mainstreaming climate-related challenges. This is particularly the case for risk management and finance functions, as several elements that are key for assessments and disclosures are pooled here.

The TCFD's findings are also mirrored in the central goals of the UN 2030 Agenda, which advocates a risk-based approach to managing risks connected to extreme events and climate change. This framework, as well as the Addis Ababa Action Agenda on Financing for Development, explicitly mentions insurance as a key tool for developing the risk distribution and transfer solutions that are needed to improve global resilience. To support such projects, representatives of UN organisations, the World Bank and the insurance industry set up the Insurance Development Forum (IDF), whose goal is to embed the insurance industry's risk know-how into government risk reduction policies and to improve access to the insurance system for population groups most in need of protection.

According to studies by Lloyd's and the Centre for Economics and Business Research (CEBR), an estimated USD 163 billion of global assets are currently uninsured. This means there is a risk gap that puts livelihoods and global prosperity at significant risk (Lloyd's, 2012).

By sharing risk information as well as its expertise in the fields of risk management, innovative insurance solutions and new digital distribution channels, the insurance industry is already making a significant contribution to improving financial and socio-economic resilience to extreme events and other physical risks. Many insurers have already recognised this potential. Others, however, still need to seize this opportunity because it is now clear that it will be essential in order to be competitive in the insurance industry (The Geneva Association, 2018).

Conclusion

Global competition among financial centres around ESG factors is now also penetrating the insurance industry. In this context, it is becoming increasingly important for insurers to have efficient processes, take into account legal compliance requirements, gather risk modelling data and develop innovative solutions.

At the Climate Summit in 2015, insurance tools were already identified in the Paris Climate Agreement as solutions for making adjusting to climate change easier. The climate insurance initiative InsuResilience[6], founded by the G7 in the same year, has set itself the goal of providing access to insurance protection against weather disasters to 400 million at-risk people by 2020. This highlights the importance of risk transfer strategies, particularly for developing and emerging countries.

Together with governments and organisations, the industry must find ways of deploying its expertise in risk management and underwriting as well as its investment functions to support climate-resilient and low-carbon infrastructure. Successfully adapting to climate change will only be possible if public institutions all work together and tackle the existing hurdles in a coordinated manner. Together with the insurance industry, the foundation can be laid for a low-carbon economy that strengthens society's resilience to climate risks. But this can only happen if insurers recognise climate change as a topic of central importance in their company.

According to the Geneva Association, to meet ESG requirements and be in line with the regulatory framework, insurers must continually develop their internal scenario analyses and stress tests. This also includes making available environmental and socio-economic data that can help formulate clear climate action plans. The insurer of the future must give due importance to all of these aspects in order to demonstrate to its stakeholders that it is future-ready.[7]

Notes

1 See https://www.pwc.ch/en/insights/fs/sustainable-finance-regulation.html.

2 See CFSI (2019).

3 See https://group.axa.com/en/page/materiality-analysis.

4 See https://group.axa.com/en/page/materiality-analysis.

5 See https://www.svv.ch/sites/default/files/2017-12/prof._dr._alexander_braun_-_klimawandel__ils.pdf.

6 More information on InsuResilience available at https://www.insuresilience.org/.

7 See The Geneva Association (2018).

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