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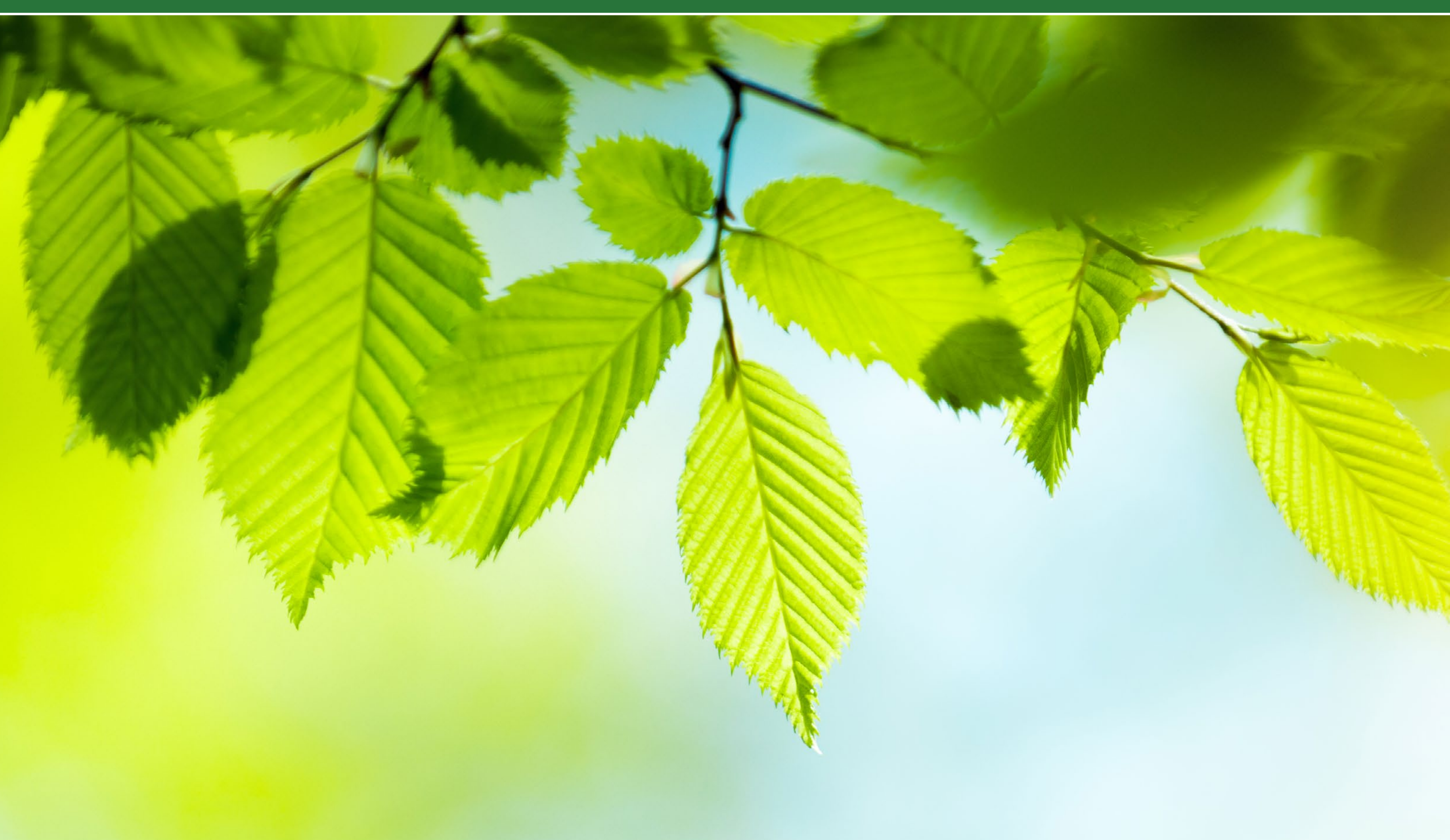

Sustainable Finance and Climate Change Risk in Financial Services

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Introduction

Financial services regulators have been particularly vocal in the last 12 months, specifically about the impact on the financial services sector as the world experiences, and attempts to respond to, climate change.

Mark Carney, outgoing governor of the Bank of England, highlighted how pressing an issue climate change was for the sector in October 2019, stating that,

"…changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset. Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist. The longer that meaningful adjustment is delayed, the greater the disruption will be."

Policy makers and regulators seem keen to adopt both a "carrot" and "stick" approach to channelling private finance sustainably. The carrot approach is to create incentives and opportunities for firms, including insurers, to drive the transition to a greener economy, whereas the stick approach requires firms to identify, assess, and manage the physical and transition risks arising from climate change and incorporate those risks into their traditional risk management framework.

This briefing will summarise the key international, European, and UK regulatory developments applicable to the insurance sector that have been recently implemented, considered, or proposed, and that will form the basis for the significant changes we expect to continue in 2020.

What is ESG and why should insurers care?

ESG is an umbrella term for a broad range of environmental, social, and governance factors, against which investors can assess the behaviour of the entities they are considering for investment.

A number of key factors that are particularly relevant to the insurance sector have driven the rise in the importance of ESG. First, public concern (*i.e.*, customers' concern) for the environment and social equity has grown. Second, institutions have come to better understand the risks associated with ESG issues. For example, the insurance industry is affected as the underwriter of risks, and is both directly affected by the impact of climate change — through increased climate-related risks to insured property (including flooding and fires) — and indirectly affected — through changes to claims costs, claims liability, and claims handling. Insurers are also significant financial investors, in many cases in respect of long-term finance initiatives and infrastructure assets. Assets and investments may be affected either directly — for instance due to the risk of climate-related flooding impacts to property investments and the impact of tightening regulations — or indirectly — for instance due to changing consumer preferences associated with ESG issues that affect demand for products or services. In the UK and EU, regulators have stressed that they expect insurers, along with other financial services firms, to play an important role in leading the way on the path to change.

Despite a strong focus on the social and governance aspects of ESG in recent years, most of the current policy momentum relates to the "E" in ESG. Therefore, the primary focus of this briefing is environmental issues in finance, for which Mr. Carney identified three key focus areas: disclosures, risk management, and returns.

General ESG drivers and developments in the financial services industry

Perhaps the most influential industry body in facilitating the recent rise of ESG among asset managers has been the United Nations Principles for Responsible Investment (PRI). The six principles set out by the PRI were developed by an international group of institutional investors and launched in 2006. When investors sign up to the PRI they commit publicly to these six principles, which include incorporating ESG issues into investment decision-making and ownership policies and seeking disclosure of ESG issues. Although voluntary, being a signatory of the PRI has become increasingly important, and is considered by investors as a good way of demonstrating their commitment to ESG. Further, the PRI has threatened to publicly revoke the membership of those signatories who fail to comply with the principles.

The Financial Stability Board's Taskforce on Climate-related Financial Disclosures (TCFD) is another key body. The TCFD aims to develop "consistent climate-related financial risk disclosures for use by companies in providing information to stakeholders". The TCFD's final report and recommendations, published in June 2017, set out information that companies should disclose to enable investors, lenders, and insurers to better understand how companies oversee and manage climate-related financial risk.

The TCFD is aiming to strike a balance between the need to raise existing climate disclosure standards and the desire to achieve widespread adoption. The recommendations are emerging as the lead framework for climate-related reporting, and national governments, the EU, and NGOs have promoted them extensively. The UK government has officially endorsed the TCFD, and certain listed companies in the UK are expected to be required to report in line with TCFD recommendations by 2022.

Specific developments in the insurance sector

A number of global, European, and UK-specific developments of specific relevance to the insurance industry have emerged over a relatively short period of time.

Global developments

Principles for Sustainable Insurance: In February 2012, the UN Environment's Finance Initiative launched the Principles for Sustainable Insurance Initiative (the PSI or Principles). These Principles serve as a global framework for the insurance industry to address ESG risks and opportunities. A key commitment for signatories is to embed ESG issues in decision-making relevant to insurance businesses, raising awareness with clients and business partners, working with governments and regulators to promote action across society on ESG issues, and demonstrating accountability through disclosing publicly the progress made in implementing the Principles. Whilst not a legally binding framework, a number of significant global insurance groups are signatories to the PSI.

PSI guide on underwriting: In February 2019, a PSI working paper on underwriting ESG risks in non-life insurance businesses was issued and described as the first ESG guide for the global insurance industry. Developed for non-life insurers, it provides guidance on integrating ESG risk considerations into core insurance business processes and decision-making. The guide reflects Principle 1 of the PSIs — to embed in decision-making ESG issues relevant to insurance businesses and refer to the development of an ESG risk appetite for relevant insurance businesses in the light of their financial and strategic objectives and business models. The guide focuses on governance-related issues, such as establishing suitable roles and responsibilities for ESG-related matters, escalation to appropriate people, guidance on how decisions might be approached, and recording/reporting on decisions and output of the ESG risk management system.

Sustainable Insurance Forum Issues Paper: In response to the increasing international focus on the effect of climate change on the financial system, insurance supervisors have begun to scrutinise the relevance of climate change for insurance supervision. The Sustainable Insurance Forum (SIF), a network of leading insurance regulators convened by UN Environment, was launched in December 2016 to provide a global platform for international collaboration on sustainability issues. The SIF, together with the International Association of Insurance Supervisors (IAIS), prepared a joint Issues Paper to form the basis for a guidance document on climate change and insurance supervision, released in July 2018. The Issues Paper provides a detailed overview of how climate change might affect the insurance industry, including:

- **Liability risk:** Climate-related claims under liability policies, including through increasing climate-related litigation, as well as through D&O, PI, and third-party environmental liability policies
- **Transition risk:** Disruption caused by the shift towards a low-carbon economy affecting the value of assets or potentially leaving certain assets "stranded"
- **Underwriting risk:** Impact of climate change on the frequency and concentration of high-impact natural catastrophes or on mortality for insured lives
- **Market risk:** Increasing physical risk to insured property and assets affecting the capacity of insurers to write certain types of insurance business
- **Investment risk:** Adverse impact on the investments held by an insurer either from physical risk, such as property damage, or from transition risk
- **Reputational risk:** Adverse public reaction to underwriting of, or investment in, businesses associated with fossil fuels and coal-fired infrastructure.

The IAIS' Insurance Core Principles (the ICPs) are also considered in the Issues Paper, as they include ICPs relating to corporate governance, risk management and internal controls, investment, and conduct of business. The ICPs are broadly thought to provide a suitable basis for insurance supervisors to identify and respond to emerging risks associated with climate change, although the IAIS has signalled that it may seek to reflect further on the interaction of climate change and other ICPs.

UN Sustainable Development Goals and Insurance: There have been international initiatives focusing on specific areas in which environmental factors have been identified as particularly pertinent to the insurance industry. One such initiative focuses on the oceans and another on world heritage sites. In relation to the former, an Insurance Industry Statement was launched in October 2017, reflecting the role that marine insurers can play in helping to reduce illegal, unreported, and unregulated (IUU) fishing, under which signatories would agree to transact marine insurance in accordance with certain guiding principles. These principles encourage the use of risk management protocols and due diligence to help reduce the risk of insuring vessels or companies acting contrary to agreed international governance frameworks and international law relating to IUU fishing. In particular, insurers should not knowingly insure or facilitate the insuring of vessels that have been officially blacklisted for their involvement in IUU fishing.

In relation to world heritage sites, in July 2018, an Insurance Industry Statement was launched that included a commitment to develop risk management and insurance and investment principles to prevent or reduce the risk of insuring or investing in companies or projects whose activities could damage world heritage sites. Guidelines have since been issued to supplement both of these Insurance Industry Statements.

EU measures

The key EU sustainable finance measures centre around the European Commission's Sustainable Finance Action Plan (the Plan). The Plan was first published in March 2018, with the aim of helping to position the EU financial sector at the forefront of establishing a green economy. The Plan was followed in May 2018 by a series of legislative proposals, which include the four following primary measures:

1. Creating a u**nified EU classification system** (a taxonomy) for determining whether an economic activity or investment qualifies as environmentally sustainable. This measure will establish consistent criteria for labelling a product as "green". These criteria will be applied by financial market participants marketing sustainability-themed funds, and by Member States setting out national rules on labelling investment products (and would apply to insurance products offering such investments).

   The taxonomy is crucial to the Plan, as without a common standard for what is classed as green, the labelling of products will not be consistent, readily understood, or reliable. However, perhaps due to its anticipated significance, the taxonomy has proved controversial, and political agreement was only reached in December 2019. It is not clear at this stage when the taxonomy might take effect, but the Council has signalled that the EU should work towards establishing the taxonomy by the end of 2021, with full application by the end of 2022. As the various other initiatives outlined in the Plan will benefit from this taxonomy, many industry participants are keen to see it established as soon as possible.

2. Improving through legislation how institutional investors, including insurers, disclose integration of ESG factors into their decision-making processes. Institutional investors will also have to show how their investments correlate to, and comply with, their ESG targets. This piece of legislation is often referred to as the **Disclosure Regulation**, and is intended to ensure that financial product providers are more transparent about the way in which they invest.

   The Disclosure Regulation was adopted in December 2019, and most of its provisions will apply from 10 March 2021. The legislation is designed to encourage uniformity in ESG disclosure, by establishing a consistent set of rules on how financial market participants inform investors on the integration of ESG risks and opportunities. These rules will address the widely reported problem of inconsistent reporting of ESG issues to date. They are designed to provide stakeholders with valuable information about the potential ESG risks of investments, and clearly delineate the potential financial impacts of those risks.

The Disclosure Regulation is supported by three pillars, which are intended to underpin its implementation:

Elimination of greenwashing. Greenwashing is the provision of unsubstantiated or misleading claims about the sustainability characteristics of an investment product. The Disclosure Regulation aims to eliminate greenwashing and, in parallel, raise market awareness of sustainability.

Regulatory neutrality. The Disclosure Regulation provides a disclosure toolkit that different financial market operators will apply uniformly. The European Supervisory Authorities will monitor harmonisation of disclosures in all relevant sectors.

Level playing field. The Disclosure Regulation covers investment funds, insurance-based investment products, private and occupational pensions, individual portfolio management, insurance advice, and investment advice, to ensure a harmonised approach across investment sectors.

3. Amending the EU Benchmarks Regulation to introduce **a new category of low-carbon benchmarks**. This new market standard will help insurers and other investors effectively allocate their assets into sustainable portfolios.

The amendments to the EU Benchmarks Regulation came into force on 10 December 2019 in response to the perceived lack of uniformity among existing low-carbon indices. The EU and market participants alike considered this inconsistency to be unsatisfactory, as investors were unable to use benchmarks as reliable and easy tools to compare the low-carbon attributes of investments and portfolios. The new measures will introduce the following:

A new category of benchmarks, including two types of financial benchmark: an EU climate transition benchmark and a “Paris-aligned” benchmark that brings investment portfolios in line with the Paris Agreement. Benchmark administrators will have to publish detailed information on whether or not, and to what extent, the benchmarks ensure a degree of overall alignment with the target of reducing carbon emissions, or the attainment of the Paris Agreement objectives.

An obligation for all benchmarks (with the exception of those related to interest rates and foreign exchange) to disclose in their benchmark statement whether or not they pursue ESG objectives, and whether or not the benchmark administrator offers ESG-focused benchmarks.

4. **Amending the Insurance Distribution Directive** to help insurance distributors to incorporate ESG factors into the advice process. This will ensure that ESG considerations become part of the product distribution process.

   The European Insurance and Occupational Pensions Authority (EIOPA) is considering how ESG considerations can be woven into the product distribution process. However, these changes could not be finalised until the Disclosure Regulation had been agreed, therefore progress has been slow. Now that the Disclosure Regulation has been adopted, work on these changes likely will conclude. EIOPA has produced technical advice on equivalent amendments to the Insurance Distribution Directive and Solvency I Level 2 measures.

The Commission expects the European Supervisory Authorities to provide the necessary support through the Sustainable Finance Action Plan to help the Commission achieve its goals. EIOPA issued an opinion on Sustainability within Solvency II in September 2019 in response to a request from the Commission. This opinion will be taken into account as part of the wider review of Solvency II, due 1 January 2021. The opinion focuses mainly on the integration of climate-related developments for the valuation of assets and liabilities, investment and underwriting practices, the calibration of market, and catastrophe risk into the Solvency II framework and internal models. The EIOPA opinion reached the following high-level conclusions:

- **Valuation of assets:** The general valuation principles of Solvency II are neutral to risk types, including sustainability risks, and assume market valuations reflect all relevant risks. The methodology behind external ESG ratings should be sufficiently understood in respect of the investments held and scenario analysis should be applied to assess the impact of climate change on asset valuations over time and how to mitigate them.

- **Valuation of liabilities:** Accounting for climate change in the valuation of liabilities is difficult as a practical matter, although no gaps in the regulatory framework were identified. Use of historical loss data, which should be kept up to date, and scientific data and forward-looking models (if appropriate) is recommended when calculating liabilities. Businesses with longer term liabilities should use more elaborate modelling or stress testing methods.

- **Investment practices:** Insurers should be required to take into account the impact of their investment activity on sustainability factors, noting the development of the EU taxonomy and disclosure of sustainability risks.

- **Underwriting practices:** Insurers should also take into account the impact of their underwriting activity on sustainability factors and contribute to mitigation of climate change. “Impact underwriting” is highlighted, which requires insurers to take into account climate-related issues in product development and product pricing.

- **Capital requirements:** Tangible evidence of a change in risk as against the status quo would be needed before capital requirements should be amended for a risk-based framework such as Solvency II. Looking at the market risk and catastrophe risk as the underlying key risks, either more granular data is necessary before a view can be reached, or no meaningful difference was identified. However, for capturing catastrophe risk in the ORSA, a more forward-looking approach to climate change-related events would be appropriate, as past data would be unlikely to be a good predictor for the future given how experience has already changed and is expected to continue to change. This area seems likely to be the focus of future evidence gathering and analysis.

- **Technical advice on delegated acts:** EIOPA also issued technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD in April 2019. These proposals sought to integrate specific references to sustainability risks into the delegated acts, for example, through the incorporation of sustainability risks into the prudent person principle.

5 **The Commission has also published guidelines on corporate disclosure of climate-related information under the Non-Financial Reporting Directive**, which is applicable to EU-listed issuers, insurance companies, and banks.

The guidelines (which are voluntary) incorporate the TCFD recommendations, and are designed to address the perceived gaps and inconsistencies in climate-related disclosures.

The new Commission President, Ursula von der Leyen, has emphasised that sustainable finance will be a key priority for the new Commission. The Plan forms a constituent part of the EU's broader Green Deal, formally launched in December 2019, which has been one of the von der Leyen Commission's most high-profile proposals to date. Among other initiatives, the Green Deal pledges to enshrine into law the EU's target of Carbon neutrality by 2050, and that the Commission will start preparing another set of green finance initiatives, scheduled for publication in autumn 2020.

UK measures

On 2 July 2019, the UK government published its Green Finance Strategy (the Strategy), which is seen as a crucial aspect of helping the UK achieve its own target of carbon neutrality by 2050. The Strategy sets out how the government aims to accelerate the growth of green finance and enable the UK to seize the commercial potential arising from the transition to a sustainable economy. According to HM Treasury, financial services will have a bigger role to play in tackling climate change than any other sector. The Strategy has two objectives: to align private sector financial flows with clean, environmentally sustainable and resilient growth, and to strengthen the competitiveness of the UK financial sector. The government plans to use three strategic pillars to achieve these objectives:

Greening finance. Ensuring current and future financial risks and opportunities from climate and environmental factors are integrated into mainstream financial decision-making and that markets for green financial products are robust. The Strategy recognises that the transition to a green financial system will require fundamental changes to the economy and to decision-making processes, noting that the financial sector as a whole will need to incorporate these financial risks and opportunities. Actions include ensuring that all listed companies and large asset owners disclose environmental and climate change information by 2022, in line with the TCFD Recommendations (the FCA is currently consulting on this matter — see *General ESG drivers and developments in the financial services industry*).

Financing green. Accelerating the flow of private finance to support the delivery of the UK's carbon targets and clean growth, resilience, and environmental ambitions, as well as international objectives. The Strategy recognises that specific actions are required to redirect private finance flows into clean growth and environmental sectors, for example, improving access to finance for companies wishing to attract green investment.

Capturing the opportunity. Ensuring UK financial services capture the domestic and international commercial opportunities arising from the other pillars, such as climate-related data and analytics, and new green financial products and services. The government aims to consolidate the UK's status as a global green finance hub and to position the UK at the forefront of green financial innovation, data, and analytics.

Financial regulators and climate change

The UK government also plans to clarify the need for financial regulators to consider climate change when advancing their objectives and discharging their functions. The PRA, FCA, Financial Reporting Council, and The Pensions Regulator issued a joint statement in reaction to the Strategy, welcoming the government's action. The government must now set out concrete and specific proposals pursuant to the Strategy.

At regulator level, the PRA has been actively considering the impact of climate change on the UK insurance sector for some time, issuing a climate change adaptation report in September 2015, which formed part of a wider UK Climate Change Risk Assessment to be put to Parliament by DEFRA, and helping to inform the Bank of England's further work on climate change.

The PRA and the FCA began to place even more importance on climate change and green finance in 2019. In April 2019, the PRA published a Supervisory Statement (SS3/19) on banks' and insurers' approaches to managing the financial risks from climate change. The PRA uses the Supervisory Statement to explain how financial risks from climate change arise, how they present unique challenges for firms, and how the PRA expects firms to take a strategic approach to tackling these risks. In particular, the PRA expects a firm's board to understand and assess the financial risks from climate change that are relevant to the firm, and expects a senior manager to be formally allocated responsibility for identifying and managing these risks. The PRA also requires firms to address the financial risks from climate change through their existing risk management frameworks, conduct scenario analyses to inform their strategic planning, and consider whether any extra disclosures are necessary to enhance transparency on their approach to managing climate-related financial risks.

Conclusion

In recent years, ESG implementation has transformed from a niche to a mainstream activity, as the collective attention and actions of policymakers and lawmakers have been increasingly focused on sustainability and other ESG issues. The corporate world is also now questioning whether the prioritisation of shareholder value above all other objectives is appropriate, and whether we need a softer form of capitalism that equally prioritises other social responsibilities (or stakeholder capitalism, as described by the organisers of the World Economic Forum at Davos).

The financial sector is playing, and will continue to play, a central role in this economic transformation, and the "winners" will be those firms that respond best to the opportunities and obligations that will be presented in the years ahead. The developments summarised in this briefing show that the EU and the UK are looking to lead the way on ESG issues globally. While ESG has not gained the same level of traction among policymakers in other jurisdictions, this position is now also starting to change.

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