GLOBAL FEDERATION OF INSURANCE ASSOCIATIONS

December 2020

Advancing the sustainable agenda: Perspectives on insurers' capacity as sustainable investors

Global (re)insurers, in their capacity as investors (asset owners), generally support directing funds towards quality investments that support sustainable activities. The industry agrees that the shift to a more sustainable society will be one of the greatest challenges of this century.

Sustainable finance, while a work in progress, faces numerous challenges (eg lack of supply of sustainable investments, lack of reliable data at asset level, etc). Along with these challenges, the move to sustainability presents new opportunities for (re)insurers. These opportunities include:

- Developing innovative solutions (eg transition bonds, crowdfunding) which can help meet the evolving preferences of customers and markets, as well as climate solutions that contribute towards health, wellness, longevity and equality.
- Fostering resilient economies and societies. (Re)insurers' investments can help finance the development of sustainable assets and projects.
- Enhancing informed investment decisions by raising awareness of environmental, social and governance (ESG) risks and sustainable investment strategies. Furthermore, embedding sustainability in investing strategies can contribute towards more stable economic growth.

The transition towards a sustainable economy needs cross-sectoral action involving all economic stakeholders and decision-makers. (Re)insurers and policyholders share an aspirational responsibility to encourage this transition.

The (re)insurance industry is committed to a resilient financial system and increasingly supports efforts to make the financial system sustainable. Many (re)insurers have already individually committed to meeting the targets set in the Paris Climate Agreement.

The transition to sustainability is in line with the essential role that (re)insurers are already playing in addressing climate risks. Building on their expertise in effectively transferring and managing risk, identifying opportunities to innovate on adaptation instruments, and directing risk-appropriate investments. Through risk-based pricing, (re)insurers provide critical economic signals about climate-influenced risks.

The COVID-19 pandemic presents an opportunity for societies to invest in a shift towards an inclusive, low-carbon and climate-resilient world. It is also an opportunity to evaluate how many of the successful adaptations made during the pandemic can be continued to help improve the sustainability of our economies in the future.

Definitions

Sustainable finance usually refers to the process of taking account of ESG considerations in decision-making. While different definitions exist, they are generally aligned on the concept of sustainability, with differences in the ESG factors.

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Sustainable finance (ICMA definition of May 2020 and Canadian Expert Panel on Sustainable Finance)

Sustainable finance includes capital flows, risk management activities and financial processes incorporating green finance — meaning climate finance and other environmental objectives such as natural resource conservation, biodiversity conservation and pollution prevention — and social finance while also adding wider considerations concerning the longer-term economic sustainability and the corporate governance practices of the organisations that are being funded, as well as the role and stability of the overall financial system in which they operate. In this sense, sustainable insurance meets the needs of the present without compromising the ability of future generations to meet their needs.

Green taxonomy (ICMA definition in the World Bank Guide 2020 on Developing a National Green Taxonomy)

A green taxonomy is a classification system for identifying activities or investments that will move a country toward meeting specific targets related to priority environmental objectives. […] A green taxonomy aims to help financial actors and others determine which investments can be labelled "green" for their jurisdictions. This support for making informed decisions on environmentally sustainable investments can encourage the undertaking of projects and activities that help scale up environmentally sustainable economic development and contribute to specific environmental objectives.

Environmental, social and governance (ESG) factors (United Nations Environment Program Finance Initiative (UNEP-FI), the seventeen UN Sustainable Developments Goals (SDGs) and the Principles for Responsible Investments (PRI) Reporting Framework definition, 2018)

Also known as sustainability issues, ESG factors are issues relating to the quality and functioning of the natural environment and natural systems; issues relating to the rights, well-being and interest of people and communities; and issues relating to the governance of companies and other investee entities.

Key messages

I. (Re)insurers already contribute to a sustainable economy

The insurance industry is committed to contributing to collective efforts to make the economy more sustainable

- Policymakers, businesses and consumers must understand the scope and scale of the impact of climate change on various risks. Through risk-based pricing, (re)insurers provide critical economic signals about the changing risk environment. Risk-based pricing is one of the most fundamental contributions that (re)insurers can and do make to addressing climate change. It is critical that regulators fully support it.

- Alongside other players, the insurance industry is well positioned to contribute to global resilience and sustainability. Given the extent of its direct consumer support, its reach into people's lives, assets and businesses, and the significant role it plays in the economy, the impact and influence of (re)insurance goes beyond the perimeter of its stock capitalisation and short-term financial performance.

- Many (re)insurers have a strong interest in contributing to sustainable finance goals through their traditional risk transfer role, through their expertise in geo-engineering and, increasingly, through their role as investors. At the same time, their investment strategies must also fulfil regulatory requirements (eg solvency requirements) and regulatory criteria, which are paramount. For instance, diversification is one of the key elements that enable insurers to maintain financial soundness. To this extent, GFIA endorses the formulation of clear and credible objectives in relation to the Paris Agreement.

(Re)insurers are already key players contributing to sustainable finance

- Insurers' existing long-term investments are already predisposed to support sustainability objectives. While seeking to meet contractual obligations to policyholders and to maximise their investment performance in line with their obligations (the investment decisions need to match with liability and asset duration), (re)insurers can factor in sustainability considerations when choosing an asset in which to invest. This can include supporting both green activities and those that encourage the just transition to sustainability, which might still be driving economic growth and a wider distribution of the benefits of globalisation (ie investments in infrastructure, real estate investments and sectors that need financing to transform their business model to be more climate resilient). Not only are (re)insurers the purchasers of assets that promote sustainability, but many also actively seek to issue sustainability-linked bonds and to work with partners to finance and develop green infrastructure.

- Engagement and dialogue with investee companies and the use of shareholders' voting powers are important components some may use in the transition to a low-carbon economy. (Re)insurers have been increasingly involved in collective engagement initiatives. They also have a role to play in the stewardship of investee companies and their carbon trajectories and in wider climate change considerations such as the efficient usage of resources or biodiversity. (Re)insurers are increasingly embracing material sustainability considerations and this has led to an update and upgrade of existing corporate governance.

Many (re)insurers have integrated ESG factors into their corporate governance and investment strategies

- Over recent years, and on their own initiative, many (re)insurers have integrated the consideration of ESG factors into their corporate governance and investment strategies and have participated in sustainable finance initiatives:
  - Most insurers have also made significant sustainable investment commitments (particularly through long-term life insurance investments) and have contributed to the development of several sustainability initiatives.
  - The Principles for Responsible Investments, launched in 2006, works with more than 500 asset owners in 60 countries worldwide in 2020. The PRI is a partner organisation of the United Nations Environment Programme Finance Initiative (UNEP FI).
  - Launched in 2012 the UN Principles for Sustainable Insurance serve as a global framework for the insurance industry to address ESG risks and opportunities. They encompass all aspects of insurance activity, including the integration of ESG issues into investment decision-making and ownership practices.
  - The UN-Convened Net Zero-Asset Owner Alliance is an initiative gathering 29 institutional investors representing nearly $5trn of assets under management, which are committed to transitioning their investment portfolios to net-zero greenhouse gas (GHG) emissions by 2050, which is consistent with a maximum rise of 1.5°C above pre-industrial temperatures.

- The Task Force on Climate-Related Financial Disclosures (TCFD) has issued a set of recommendations for voluntary climate-related financial disclosures that are consistent, comparable, reliable, clear and efficient, in order to enhance investment decision by lenders, (re)insurers and investors. Many (re)insurers are public supporters of the TCFD.

II. Public authorities must support sustainable investment

Building a constructive dialogue between stakeholders

- Many policymakers, industrial sectors and individuals have identified the need to direct investments in a way that promotes climate resilience. A close collaboration between the public and public sectors can lead to mutual understanding to facilitate the industry's work in reducing and transferring sustainability risks, including climate risks.

- (Re)insurers are also in the best place to carefully assess the risks and embed climate-related sustainability criteria into their own investment decisions. A constructive dialogue with supervisors, enhancing cooperation will be helpful in this regard.

Acknowledging current limitations to long-term sustainable investments

- The ability of (re)insurers to invest in long-term sustainable assets could be improved if:
  - More sustainable assets met institutional investors' needs and basic investment criteria: according to the Green Bonds Global State of the Market 2019, $260bn of green bonds were issued in the overall market. While there was an increase in the volume of suitable climate-resilient and green infrastructure projects that provide appropriate risk/return profiles, more action is needed in this respect.
  - More reliable, comparable and material ESG data was available from investee companies to aid insurers in their investment decisions.

- Public stakeholders and capital investors should work together to encourage the development of financially sound sustainable assets. Those assets should meet basic investment criteria, including the reasonable probability of an adequate risk-adjusted return. In more concrete terms, (re)insurers need investment-grade green investment opportunities. This would enable (re)insurers to take more investment decisions that contribute to the fight against climate change. (Re)insurers, therefore, support a reassessment of the current requirements of rating agencies for investment grade products to allow for more diversity and alternative asset classes (without substantially increasing risk). Such a reassessment should be based on the rating agencies' fair evaluation of investment performance and should be independent of political considerations.

Possible solutions to overcome current limitations

- To increase the range of firms in which (re)insurers can invest, policymakers are encouraged to share their expectations and to indicate clearly defined trajectories to facilitate the transformation of the real economy. One approach might be to put an adequate price on GHG emissions or to use another cost mechanism that provides appropriate incentives for GHG emitters to reduce their emissions. It could also include modernising public sector infrastructure in many areas to reduce carbon emissions and the impact of climate risks. Many (re)Insurers are ideal partners for such long-term projects, particularly those in the life insurance sector. Public sector incentives and risk-mitigating measures such as public guarantees, first-loss instruments or co-financing should be effective for institutional investors. At the same time, it is critical that regulators recognise the importance of enabling insurers to make a profit in order to uphold the robustness of the industry and its ability to fulfil its obligations to policyholders.

- Actions that lead to the transition to a sustainable society, including the green taxonomy designation, should be respected and supported. Any regulatory barrier to long-term investment by the insurance industry is also a barrier to sustainable investment. Therefore, while always maintaining the risk-based nature of insurance, investors and regulators should work together to examine whether and how such regulatory disincentives to long-term investment could be revised. Also, the industry does not support artificial incentives based on a green qualification. Before such treatment is hard-wired into regulations, it is important to step back and evaluate the objectives and guiding principles of prudential regulation in the context of climate/environment-related risks, given the global nature of the issues and the importance of globally consistent supervision.

- Taxonomies could be developed if they are suitable for regional and local needs, in order to incentivise the improvement in both sectors' and companies' environmental performance, and to help identify which activities are already contributing to material sustainable objectives such as climate mitigation and adaptation. This will also help address the need for reliable, comparable and material ESG data.

- Finally, increasing the financial and sustainability literacy of citizens is necessary to mobilise retail savings in support of sustainability. Both private and public sectors need to act collectively to help achieve this goal.

II. Supervisors should support insurers' smooth, stable transition to financial sustainability through dialogue and beta testing of any new supervision, and only then implementation of new supervision that respects materiality, proportionality and confidentiality

A smooth transition to a sustainable, low carbon economy warrants appropriate communication

- Insurers can be enablers of the transition to sustainability. Supervisors should encourage clear communication on sustainability-related matters so that market expectations are well-informed and consistent with a stable transition to greater financial sustainability.

- Supervisors should support insurers' ability to facilitate a smooth and stable transition. The limited availability of quality sustainability-related information, climate change uncertainties and underdeveloped taxonomies could result in decisions that lead to a volatile and unpredictable transition if these limitations are not fully recognised. Close collaboration and communication with the industry at both global and local level is vital if supervisors are to better understand the challenges and approaches of insurers with the aim of avoiding reporting requirements that place undue reliance on uncertain information, particularly about long-term climate risks.

Flexibility and proportionality are needed in climate risks supervision

- Transparency about climate risks is welcome but, given the uncertainties and limitations that exist, supervisors should avoid rigid, prescriptive approaches. Supervisors should be flexible and support (re)insurers in managing climate risks and their related disclosures. If they believe there is a need to supplement existing regulatory tools, (re)insurers suggest a consultation process with the industry to develop appropriate risk disclosure responsibilities. Flexibility and proportionality should apply when considering any new disclosure requirement for the insurance sector.

- GFIA wishes to highlight the wide variety of existing practices and tools available to deal with sustainability risks across jurisdictions. Different levels of climate disclosure obligations can be seen around the globe. While promoting global consistency in standards is beneficial, if a company, building on a materiality analysis, concludes that a different reporting framework is more appropriate to its needs or business model, it should be able to apply it instead of the TCFD recommendations. Such alternative frameworks should be found enough to help stakeholders assess how a company is effectively managing climate risk.

- Supplementary guidance on climate risk disclosures for insurance companies may need to be refined, not only to better align with the characteristics of insurance business, but also to take into account the business sensitivity of some Key Performance Indicators contained in the TCFD-guidance, such as the aggregated risk exposure to weather-related catastrophes of property business (ie annual aggregated expected losses from weather-related catastrophes) by jurisdiction.

- Sharing good practices on disclosure of climate-related risks should be encouraged.

Consider the pros and cons of using climate-related scenario analysis and stress testing to gain further insight into the financial risks arising from climate change, not as a solvency assessment

- The materiality of climate risks differs across entities and may change over time. It is therefore vital that (re)insurers are given maximum flexibility to apply the most appropriate tools and assumptions to their own risk management frameworks. For instance, while the use of climate-related scenario analysis can be a useful tool for climate-risk identification, its outcomes are strongly dependent on underlying assumptions, data and methodologies. This is why GFIA takes the view that insurers should have ownership of their stress-testing analysis.

- GFIA is of the view that the objective of any sector-wide, climate-related stress-testing exercises should be exploratory: to help develop and improve the capacity of institutions to integrate climate risk into the measurement, evaluation and day-to-day management of their financial risks.

- In some jurisdictions, supervisors have decided to incorporate climate risks into existing, sector-wide stress-testing exercises. Where an insurer is subject to group-wide supervision, such stress testing should be conducted by the applicable supervisor on a group-wide basis.

- Whether or not stress testing is applied on a voluntary or mandatory basis, the results are not fit for solvency assessment for the following reasons:
  - There are many uncertainties relating to climate change itself, its impact on the environment and its complex interactions with economic and social systems, which are difficult to rationalise through the macroeconomic and financial shocks commonly used in traditional stress-testing exercises.
  - Climate risks materialise over a long-term horizon, which exceeds the three-year period generally used by supervisors for stress-testing exercises.
  - The scope and hypothesis are necessarily far more detailed than in traditional stress testing due to the global impact of climate change and the variation in impacts between sectors and sub-sectors (ie losses vs opportunities).

- All things considered, sustainability related risk analyses should not be used to assess the solvency of (re)insurers as this might result in ill-informed market signals and be inconsistent with a stable transition to greater financial sustainability.

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About GFIA

Through its 41 member associations and 1 observer association, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 64 countries. These companies account for around 89% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.