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Insurers put to the (sustainability) test

Sustainable insurance is a strategic approach where all activities in the insurance value chain, including interactions with stakeholders, are executed in a responsible and forward-looking way by identifying, assessing, managing, monitoring and reporting about risks and opportunities associated with environmental, social and governance issues[1]. According to the Principles for Sustainable Insurance, published by the United Nation Environmental Program's (UNEP) Finance initiative, the aim is to reduce risk, develop innovative solutions, improve business performance and contribute to environmental, social and economic sustainability. In other words, do what is already being done, whilst contributing to the environment, promoting social factors and complying with a long list of governmental requirements. Easy, right? Well, yes and no.

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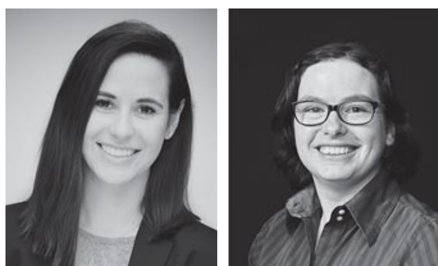


It is widely advocated that insurers play a pivotal role towards a sustainable future. Although social and governance considerations are receiving increased regulatory and stakeholder attention lately, it is environmental considerations, in particular climate change, that dominates the call for action. Insurer's triple role as risk managers, risk carriers and institutional investors, strengthen the call for action towards them in the need to meet the Paris agreement[2]. However, for insurers this is not an easy call. The industry is competitive and highly regulated and faces many challenges in the transition to managing ESG risks. Top of mind challenges include, but are not limited to:

i) the acceleration and volume of new regulation. The EU laid the foundations through its Sustainable Finance Action Plan[3] (SFAP) in 2018 covering a EU taxonomy, disclosures and a broad toolbox to support the flow of private finance towards sustainable economic activities. Meanwhile ambitions have been increased, global collaboration is better and the international context has changed. As such the 2018 SFAP has been renewed and evolved into the EU Sustainable Finance Strategy[4]. The strategy covers, to name a few, initiatives to increase insurance coverage, a proposal from the European Commission to amend the Solvency II Directive to require Insurers to perform climate change scenario analysis, a mandatory EU-level climate change stress test across the financial sector and the development of the Corporate Sustainable Reporting Directive (CSRD).

ii) the increased demand for reputational risk management stemming from stakeholder's pressures. As the call for action grows louder, shareholders, investors and customers expect insurers to adjust their business strategy accordingly. However, embedding ESG into the business strategy of an insurer is rather complex partly due to the "double materiality" and "dynamic materiality" involved. While physical risk and transitional risk can have a financial impact on an insurer's balance sheet, insurers are expected to manage their own sustainability contribution (inside-out), whilst complying to policyholder's expectations. Their reputation depends on it.

Double materiality relates to the inside-out (impact an insurer has on ESG i.e. the insurer's carbon footprint) vs. outside-in (how an insurer is affected by ESG i.e. extreme weather events due to climate change) considerations, whilst dynamic materiality implies that the materiality of the particular risk may evolve over time, potentially rapidly at times. What is not material today, might be material tomorrow.

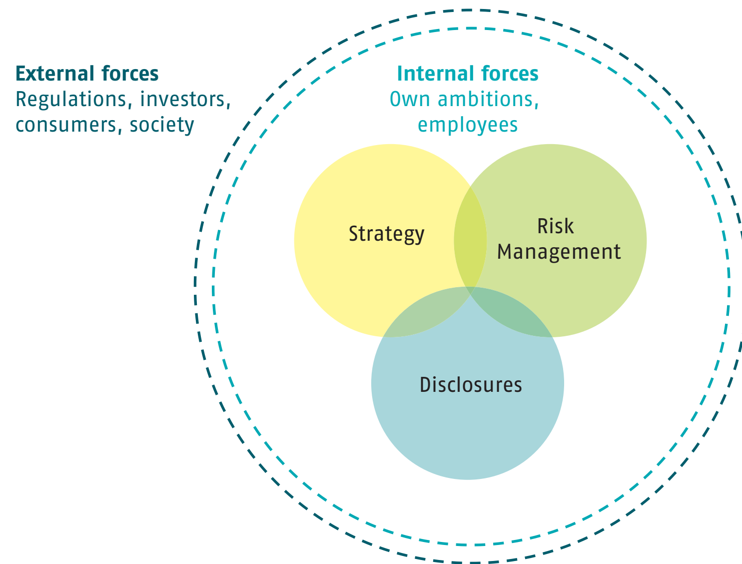
As regulatory and stakeholder pressure to manage ESG risks are rapidly building – Risk Management has a vital role to play, enabling insurers to:

i) set the appropriate ESG risk strategy for the particular business environment,

ii) have a view on managing ESG risks and opportunities driven by both internal and external forces,

iii) manage reputational risk by reporting and disclosing relevant and correct ESG risk information.

Risk Management can best fulfil this role by integrating ESG risks into the Risk Management Framework, with attention to the following five areas:



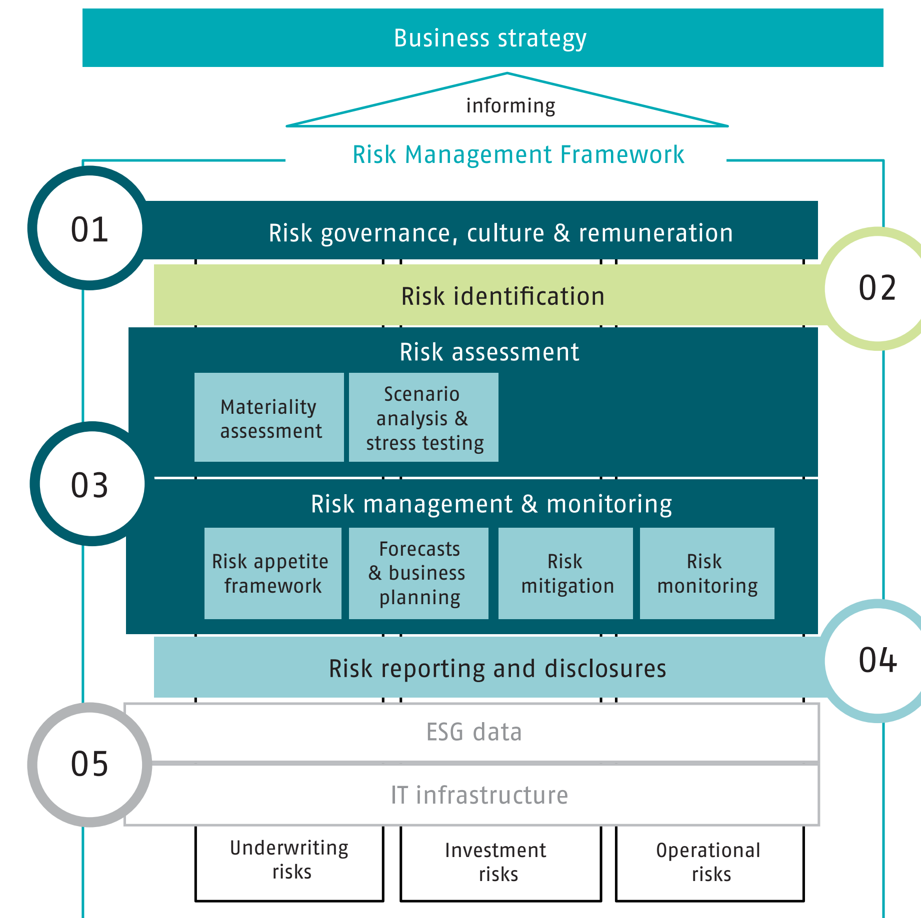
1. Risk governance, culture & remuneration. ESG risks virtually impact all divisions within the three lines of defence. Therefore, identifying accountability, committee oversight and various roles and responsibilities across the three lines of defence are required. Defining a sound ESG risk governance structure will enhance the roles and responsibilities of existing functions, closely linking to the need to revisit required policies that govern how business should be conducted in a sustainable manner as well as aligning the remuneration policy with the companies ESG strategy. Building an internal ESG culture by enabling purposeful employee education on ESG will strengthen the internal forces towards sustainable insurance.

2. Risk identification is the first step to integrating ESG considerations into the Risk Management Framework. Since ESG risks are multifaceted and diverse, it could best be approached as a risk type that applies across the established risk taxonomy and to subsequently define the linkage between ESG risks and key risks such as underwriting, operational, investment market risks etc. It requires a good understanding of the transmission channels and potential second order relationships. For example transition risk has the potential to affect investments via market or liquidity risks. A possible second order effect includes indirect losses in the insurer's investments due to changes in market value caused by changing investor sentiments.

3. Risk assessment is a key step to establish a view on the impact of ESG risks on the business and to provide the insights needed to further integrate ESG considerations into the Risk management & monitoring framework. Materiality of ESG risks depend highly on the business model, geographical location and organizational horizon. Due to this dependency and given the emerging nature of ESG risks, their assessment is currently further maturing with organizations deciding what scenarios to consider, the appropriate granularity level of the assessment, where to obtain the data, and how to establish reasonable assumptions for qualitative and quantitative assessments.

4. Risk reporting and disclosure. There is a growing demand for ESG risk disclosures, promoting transparency and long-termism. In addition to regulatory required ESG disclosures, companies should aim to publish meaningful information and key metrics on ESG risks i.e. in line with their ESG strategy and risk appetite. Internal reporting on exposures to ESG risks towards top management is essential and links back to establishing an appropriate committee oversight on managing ESG risks.

5. ESG data and IT infrastructure. Integrating ESG risks into the business considerations will result in new type of data to be captured and requires changes in IT infrastructure. Although, IT infrastructure and data are not necessarily an identified step within the Risk Management Framework or in scope of the Risk Function, for ESG risk management it is a key dependency to be developed and maintained in parallel.



CONCLUSION

The challenges faced by insurers to manage ESG risks exceed far beyond the accelerating regulatory and stakeholder pressures. Embedding ESG considerations into the Risk Management Framework will enable insurers to take the necessary key steps towards effectively managing risks and opportunities related to ESG. Insurers should avoid late action inevitable resulting into the never ending cycle of playing catch-up. Instead, action should be taken now and risk management can and should lead the way. ■

1 – The Principles « UNEP FI Principles for Sustainable Insurance

2 – Paris Agreement | Climate Action (europa.eu)

3 – EUR-Lex - 52018DC0097 - EN - EUR-Lex (europa.eu)

4 – Strategy for financing the transition to a sustainable economy | European Commission (europa.eu)

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