



Institute
and Faculty
of Actuaries

IFoA response to a call for evidence for an opinion on sustainability within solvency II

IFoA response to EIOPA

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About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

1. Definitions

Sustainability risks

Sustainability risks are operationalised via the concepts of environmental, social and governance risks. Sustainability risks could affect both the investments and the liabilities of insurance and reinsurance undertakings. Currently the assessment of environmental factors, in particular climate change, is most advanced in theory and practice.

Climate risks will be the main, though not exclusive, focus of call for evidence. *Environmental, social and governance (ESG) factors* [Reference is made to the European Commission proposal "on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341", in Article 2(o) "sustainable investments".]

Environmental: factors that contribute to an environmental objective. Such objectives include climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, waste prevention and recycling, pollution prevention and control and protection of healthy ecosystems. [See Article 5, Commission Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, COM(2018) 353 final.]

Social: factors that contribute to a social objective, and in particular to tackling inequality, an investment fostering social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities.

Governance: factors that contribute to good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance;

Physical risks

Risks arising from increased damage and losses from physical phenomena associated with both climate trends (e.g. changing weather patterns, sea level rise) and events (e.g. natural disasters, extreme weather). Climate trends and shocks could pose economic disruptions affecting insurers, the economy, and the wider financial system. At the macro-economic level, losses from physical risks may affect resource availability and economic productivity across sectors, the profitability of firms and individual assets, pose supply chain disruptions, and ultimately impact insurance market demand. Losses arising from physical risks, especially when uninsured, may have cascading impacts across the financial system, including on investment companies and banks.

Transition risks

While the transition to a low-carbon economy may create opportunities, it may also create risks (e.g. credit, liquidity) and/or significantly constrain economic growth, especially in the case of too sudden or too late policy changes. Transition risks are arising from disruptions and shifts associated with the transition to a low-carbon economy, which may affect the value of assets or the costs of doing business for firms. Those risks may be motivated by policy changes, market dynamics, technological innovation or reputational factors (see figure below). Key examples of transition risks include wrong assessments of climate-induced risks and opportunities and policy changes and regulatory reforms which affect carbon intensive sectors, including energy, transport and industry. Policy and regulatory measures may affect specific classes of financial assets (such as real estate portfolios), in addition to those affecting capital markets.

Liability risks

These pertain to risks that industries, companies and possibly individuals may be held liable for contributing to climate change or climate change-related events, or fail to disclose the climate impact of their operations.

Q1. Do you agree with these definitions? If not, please provide the definitions you usually use when defining climate change related-risks, from existing legislation or of other sources you refer to?

We agree with the proposed definitions. We note the definitions for physical, transition and liability risks are consistent with the definitions included in the IFoA Climate Change working party's forthcoming report. This report will be used to support IFoA members to understand the financial risk arising from climate change and to respond to these.

Q2. What types of gaps and barriers (information, data, scenarios), if any, are currently complicating the identification and assessment of climate change risks?

Identification and assessment of climate change risk, including climate-related financial risk, is essential to successful mitigation of these risks. Lack of appropriate data, knowledge and clarity are all factors which complicate this process.

Firstly, we acknowledge the gap in climate data. Despite insurers' increasing interest in mapping and understanding exposure to climate-related risk, environmental scientists are not yet producing physical climate and environmental risk data in a way which allows these risks to be fully taken into account. Climate scientists are communicating model results largely for an audience of government and international organisations. Although they have information on the full range of outcomes, their projections concentrate on averages. However, they are increasingly focusing on influencing the financial and infrastructure sectors and reporting averages is not fit for purpose for that context. There is a major opportunity for more and better communication between the two groups.

A lack of available climate scenarios also presents a barrier. A possibility to address this would be EIOPA seeking to develop and share potential scenarios. However, such scenarios may quickly become the effective default scenarios for the industry, creating undue influence and systematic vulnerability to events outside those scenarios, as well as reducing broader thoughtfulness and engagement by firms. As such, it may be more effective for EIOPA to consider providing resources to help firms prepare (such as frameworks and workshops), rather than to specify certain parameters. It should also look to ensure there is international comparability in the approaches firms use to devise scenarios, where possible. Further, EIOPA should encourage a range of appropriate time horizons to be used in scenario analysis, including longer time horizons in line with liabilities.

In addressing these barriers, we encourage EIOPA to consider future outputs of the United Nations Environment Program Finance Initiative's (UNEPFI's) Principles for Sustainable Insurance (PSI), of which we are a supporting institution, to determine whether there is merit to encourage their use by regulated firms. UNEPFI launched a partnership with 16 of the world's largest insurers to develop a new generation of climate change risk assessment tools. We also draw attention to the Principles of Responsible Investment's work on the Inevitable Policy Response (<https://www.unpri.org/climate-change/the-inevitable-policyresponse-to-climate-change/3578.article>) to climate change as another high profile global collaborative initiative focused on development of qualitative scenarios with accompanying quantification of these. We note that climate risk quantification is an area where there is significant development currently with a variety of specialist providers active in the market, and we welcome this. Services available now include both stock specific analyses of physical and transition risks, as well as macro-economic estimates of the impact of different climate scenarios on various economic indicators.

However, despite the continuous improvement in the availability of data and in methodologies to assess and quantify climate and other ESG risks, there is a cultural challenge in embedding such practices in companies. Education and practice in the financial services sector qualifies, rewards and promotes financial outcomes exclusively, often over a very short timescale. This cultural challenge should not be underestimated and is, in our view, a major barrier to the rapid adoption/integration of ESG and/or climate across the industry.