Moving to green: how insurance is the risk manager of society

Interview of Gabriel Bernardino by Jennifer Baker for De Actuaris

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Why does EIOPA think it is important for insurers to take into account the risks of climate change now and focus on this part of the strategic agenda of the European Union, rather than other challenges?

“Of course we prioritize all areas, but I think arguably all issues related to climate change and global warming are extremely urgent as we receive more and more information from climate scientists. It's also an area where there is some tangible evidence. So for us this prioritization is quite logical. Now, it's not the case that all insurers and all the financial sector have been dealing with these risks in the same way. We see in the market some differences between big, small and medium sized companies. The bigger companies have already been more focused and are making assessments of risks in this area. We believe the European industry, especially on the insurance side, definitely has a competitive advantage globally. But we need to emphasize the importance of making these issues tangible to the medium sized and smaller sized companies. And let's be honest, this is important – we see the severity and the frequency of natural catastrophes are increasing. You can argue if this is because of climate change or not, but we have evidence of the frequency of windstorms, or the frequency of forest fires, for example. This is increasing every year and the severity of it is also increasing, so, of course, there's a sense of urgency. But it's not only about physical risks, it's also about transition risks and this is a very important element. The push from our side to the industry is in relation to the transition risks to make sure that insurers do their best in creating incentives to a good transition towards a lower carbon economy. It's also in their own best interests, because otherwise they will be seated on stranded assets that will create a lot of instability in the business. So, all in all, climate change and issues related to global warming is the priority in our agenda. But we have others of course: issues related to sustainability and the use of water; issues related to waste prevention and recycling; issues related to protection of healthy ecosystems and biodiversity, etc."

For EIOPA, where does the corporate responsibility of the insurance and pensions sector end and do regulations around the societal impact start?

"That's a very good question, and to be honest that was actually part of our initial reflections on the supervisory side when we started to go deeper into this area two or three years ago. I think it's very difficult to have a clear-cut separation where one stops and the other begins. I prefer to see it from a much more holistic perspective, because I believe that these two elements are equally relevant. That's why from an economic perspective, we always made reference to these two points every time we gave advice to the European Commission on the new requirements related to sustainability. We want insurers to look at the risks of sustainability both on the asset side and on the liability side, as well as the risks to their business model – that's our duty in terms of being supervisors. But at the same time, we also want insurers to really understand the impact that they themselves can have on sustainability risks and factors. Not only in terms of individual corporate responsibility on environmental, social and governance procedures, but also as insurers. When you invest in sustainability, when you underwrite risks, you have an impact. So these two factors are very, very important for me, and I believe that they are part of a sound business practice. It's not just having a positive social impact, it's also that by doing that, they will have a better business for their clients in the future. When we think about sustainability, we are often thinking long term. In the financial sector, insurance and pensions are long term businesses, but dealing with risks that can materialize in the long term, doesn't mean that you don't take decisions and actions in the short and medium term – that's day-to-day insurance. So, it's very natural that insurers will be on the frontline of dealing with sustainability. And I don't think that there is a clear cut separation between the social impact and the corporate responsibility. I think that they should be together and looked at in aggregate."

What is the biggest challenge for EIOPA when it comes to raising awareness and stimulating sustainability in the insurance and pension sector? And what is your strategy for dealing with this challenge?

“Well, there have been a lot of challenges along the way in this process. First, making sure to have a clear message from the supervisory community. And I can tell you, in the discussions that we had we haven’t always spoken with one single voice! So firstly it is about raising awareness, then starting to provide expectations from our side in relation to what we expect from the sectors. That's where we are right now, moving towards requirements, and completing this I would say is a big challenge. The biggest challenge is going to be about implementation, because of the urgency. But I think that we have a huge opportunity. Of course, the sector is always, by default, looking at risks and how to manage the risk appropriately. And that's fine. But in every risk, there's always an opportunity. And I think in here there is a clear opportunity of doing this implementation right.

To manage this process and get the implementation right is by having a good sense of engagement with the different stakeholders. We have been quite open. We have published a lot of discussion papers and consultations. We don't pretend to have ‘truth’ on our side, because probably there is no truth right now. But we're all trying to have a clear objective. We want to contribute to a lower carbon economy. We want to contribute to a transition that is much more sustainable. But it's clear that benchmarks and methodologies that are widely accepted are being constructed right now as we speak. So our strategy has been, and will continue to be, a strategy of engagement with the different stakeholders. We have partnerships with academics and civil society that have been analyzing these risks, and trying to integrate that into our requirements in a way that really can benefit from all the developments that we see out there. There are a couple of points about implementation that are particularly important for me. One is to make sure that we have good quality information to base decisions on, as these areas are new for many companies, not only for the insurance, but also the real economy. We have some good principles and good bases, for example, on what kind of information companies should produce and should disclose in terms of sustainability. But we are still far from having a consistent and standardized approach to this information being provided. And, let's be honest, it will take some time to get there. Despite the sense of urgency, during a certain period, there will still be some insufficiency in terms of the consistency of the information. We really need to make progress in this area, because only when we have standardized information published by the real economy, can insurers use that data to make better decisions that are more informed. A second problem is 'greenwashing.' Because, of course, if we don't have complete information, there can be risks. For example, green products are sold to all of us as consumers, but in the end may not be as green as they claim to be. Now, this is an issue that requires good behaviour and understanding from the industry side, especially during this transition period. But it's also an issue that requires good supervision. So this is an area where we will focus on monitoring, enforcement and supervision of implementation from our side – particularly if there are situations that go beyond what is acceptable in terms of the information towards consumers."

What would you say to insurers and pension funds that are looking into adapting a more sustainable strategy, but worried about missing business opportunities? How should they manage a conflict between concrete results in the short term versus abstract benefits in the distant future?

"On that I've got quite a clear view. I don't believe that there is an issue of any kind of conflict between having real costs in the short term versus more abstract benefits in the future. I think that there are definitely benefits in the future. Let me be very clear on this, I don't think that the question will be if and when businesses in the financial sector will need to be more sustainable, because there will be no businesses that are not sustainable. People don't talk about them, but liability risks will emerge and this is going to be very critical for the insurance sector. But I think the EU policies are clear and I think that the shareholders and stakeholders are also becoming more and more demanding in relation to the attitude of the companies. So I see this as an opportunity and not a risk, because I clearly believe this is going to be one of the most important competitive advantages of the industry. That's why I'm happy to see that European industry, and especially the big players, are taking this very seriously. When I speak with CEOs, it's clear to me that most of them really understand that this is not only a good business practice, but it's also something that they will be accountable to, and that will create a business competitive advantage for them in the near future. So not managing these risks adequately in the short term is not an answer. If we want to have a sector that really has the trust and the confidence of consumers, I think that everything done in this area of sustainability will pay off. It will be a win-win situation for sure.”

Well, if that's the carrot, what do you think about the stick, if you like? For example what about the possibility of including climate risk in the capital requirements in Pillar 1?

“This is a discussion that has been had not only in relation to green or brown assets, but also in relation to other types of assets in the past. On that, EIOPA has had a clear policy since the beginning. We believe that the capital requirements, irrespective of the type of asset, should be brought in with evidence. We studied, analysed and assessed it, and, up to now, there has been little evidence of a clear differentiation in behaviour between green and brown assets. Now we start to see some first indications – if you look at the last year, a number of these more ESG type funds have had really good performance – probably even better performance than some of other types of funds. But I think there is still not sufficient evidence. So if we don't have evidence, we believe that the natural thing will be for insurers to continue to have their risk-reward assessment and analysis.

Our commitment and strategy in this area is to look at the evidence and the data that is out there on a yearly basis. As soon as we have an indication that we clearly see better behaviour or better performance from certain types of category assets, we will, of course, be happy to include that in the Pillar I capital requirements. Why do we do this? We do this because we don't believe that capital requirements should be there to give undue incentives. There are better ways through other types of policies to achieve that. For example through taxation. If you have a carbon tax being implemented, for example, then you will have a much easier way to have the value of the assets reflecting the risk. But the second element is that we continue to believe that if calibrations that are not based on evidence are put in place in prudential regimes, this could lead to bubbles and more instability and we don't want that. To be very honest, we don't think that will happen if there is a good alignment of risk-reward. The role of the insurance sector is not only about the risk charges or questions of ‘do I invest or do I not invest?’ It's about engagement and it's about stewardship. So we are very clear in our expectations towards the industry. But we are supervisors. We are not going to tell you to invest in asset A, or in asset B, or don't invest in asset C. That's your responsibility. We have what we call the prudent person principle defined in Solvency II, which means that the investment policies of insurers should be driven by this aspect of risk-reward and a prudent approach. What we expect from them is that they play a stewardship role. We expect them to be engaged with the companies they invest in and tell them ‘we want to continue to invest in you, even though we recognise that you still have some brownish things in your business model. But we will continue to invest if you show us that you have a clear plan to transition to a lower carbon economy’. We believe that’s the best way to deal with this process of change from a more brown economy to a more clean economy. But also it's the way to avoid instability, because if everybody in the financial sector all at once, from one moment to the next, stopped investing in companies that have still some brownish elements that are in the process of going more green, then we would have a big problem from a stability perspective because asset valuations would drop significantly.”

In the discussion paper on the potential inclusion of climate change in the Natural Catastrophe standard formula you suggest adding a loading for climate change. On the other hand you mention in the pilot dashboard of the protection gap that EIOPA is concerned about affordability and insurability of natural catastrophes. This seems contradictory. How should we see those two publications in combination?

“Well, we don't believe it's contradictory. I think the key issue for us is that we should reflect the risks in the best way possible because that's the way that will give the right incentives. It's true that many insurance policies and products take a more short term horizon – they are renewed on an annual basis – but if you want to think about sustainable business, and actually to continue to have business, you also need to think about the medium and long term implications of all of that business. So we believe that there should be a way to better reflect climate science and integrate that into the calibration. Of course, if you can as an insurer through the underwriting process, better reflect the risks in those policies when you sell products to your clients, and also in the pricing, this gives good incentives to the clients and also adequate mitigation and prevention. It's the traditional role of insurance to give discounts if you have good behaviour and lower the price. If you have behaviour which is not so good, well... So that's the carrot and the stick.

This is the very important role that insurance has in giving the right incentives to move in the right direction. It's also in the interest of the industry, because if we don't move in this direction and we don't collectively make the effort to understand that this is urgent and that we need to take action, then insurers will be out of business because they know many of the risks will not be insurable anymore. There are reports that show very clearly that if we arrive in a couple of years with two or three degrees of global warming, a good percentage of business will be completely uninsurable. So it's not a risk anymore, it's a certainty. Everything that insurers can do in the short term in relation to that will first, give good incentives to the clients to move in the right direction, and second, be in their own interest because it will preserve the insurability and the basis for the business."

You started in your role as chairperson of EIOPA almost 10 years ago, and your 2nd term will end this coming March. When looking back on those 10 years, what do you see as your biggest achievement – in general and for sustainability in particular?

"It has been a fantastic journey of 10 years! We started in the years of the big financial crisis and the sovereign crisis in Europe, so it was a tough time to start. And now, of course, nobody was expecting to have 2020 and 2021 with the pandemic. So although it has been quite challenging, it has also been a fantastic period. And it showed one thing for me: that when we are truly committed to building something that is European, with an objective of protecting all citizens and engaging with all nationalities and all the interests, we really can achieve a lot. That's one of the things that I'm most proud of. I think over these 10 years we have fulfilled an important role. And the results that we have now from the sector, from this crisis, showed clearly that the measures we took were central – like developing Solvency II. If we didn't have that, I think we would have other problems right now. Looking back, I think the biggest achievement was definitely being able to develop a common framework for insurance regulation and supervision that is, I think, the best in class worldwide and recognised everywhere.

And we made a strong contribution in having stronger and more consistent supervision throughout Europe with the focus of making sure that when promises are made to consumers that those promises will be fulfilled. I think we are in a much better position nowadays than what we were when we started which is a great achievement."

Finally, can you gaze into your crystal ball and tell us where the insurance world will stand in terms of sustainability in ten years?

"I think that the insurance sector in particular, has everything to be one of the most relevant sectors in the coming years. Not only because our world and our societies are facing more and more risks – and we've seen concretely the scale of those risks with the current pandemic – but also in terms of climate change, issues related to natural catastrophes, and risks related to cyber. Insurers are risk managers of our society and I think that they will have a more and more important role in the future. To what extent, is in the hands of the industry, but also in the engine of the public authorities. I'm very happy that we started this work and put it in motion. I hope that in the coming years, it will be effective in helping insurance to protect our societies, because there is a huge protection gap out there. If you look at natural catastrophes, for example, in the last 10 years, only 35 percent of the losses associated with natural catastrophes have been insured. So most of the consequences of natural catastrophes end up on the shoulders of individuals, companies and governments. I'm not saying that insurers can be the silver bullet, but using insurance is logical and can really be part of a solution. I think this is something that the insurance sector should be focused on in the coming years and the public sector should also be open to creating more of these shared resilient solutions, where public and private entities can work together. That is something worthwhile to do for the benefit of all of us and for the benefit of the economy.”

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