ACTUARIAL ASSOCIATION OF EUROPE

Sustainable finance – update on the recent developments

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Sustainable finance – overview 1/3

- **EU is strongly supporting the transition to a low-carbon, more resource-efficient and sustainable economy**. EU has also been at the forefront of efforts to build a financial system that supports sustainable growth. The main landmarks:
  - UN 2030 agenda and sustainable development goals
  - Paris climate agreement → 40% cut in greenhouse gas emissions, investment gap €180 billion per a year.
  - European Green Deal → Europe to become the first climate neutral continent by 2050
    - the European Green Deal Investment Plan (Jan 2020) which will mobilise at least €1 trillion of sustainable investments over the next decade. It will enable a framework to facilitate public and private investments needed for the transition to a climate-neutral, green, competitive and inclusive economy.
- In the EU's policy context, sustainable finance is **understood as finance to support economic growth while reducing pressures on the environment** and taking into account social and governance aspects.
- Aims at **supporting the delivery on the objectives of the European Green Deal** by channeling private investment into the transition to a climate-neutral, climate-resilient, resource-efficient and just economy, as a complement to public money.

Sustainable finance – overview 2/3

The **Commission's action plan on financing sustainable growth** has the following steps:

- Establishing a **clear and detailed EU taxonomy**, a classification system for sustainable activities
- Creating an **EU Green Bond Standard** and labels for green financial products
- Fostering **investment in sustainable projects**
- Incorporating **sustainability in financial advice**
- Developing **sustainability benchmarks**
- Better integrating **sustainability in ratings and market research**
- **Clarifying** asset managers' and institutional investors' **duties regarding sustainability**
- Introducing a **'green supporting factor'** in the EU prudential rules for banks and insurance companies
- Strengthening **sustainability disclosure and accounting** rule-making
- Fostering **sustainable corporate governance** and **attenuating short-termism** in capital markets

Sustainable finance – overview 3/3

- **Expert group**s (HLEG, TEG, MSEG, platform on sustainable finance) have been active helping on the work publishing reports widely used in the decisions making and development.
- **Sustainability related reporting requirements** are developing fast track in EU and the insurance sector has been bit worried on the speed and unawareness. Delegated regulation on regulatory technical standards (RTS) being drafted including a wide set of new demands. Also methodologies for EU climate benchmarks and disclosures for benchmarks are being developed.
- AAE has **actively commented** on different proposals
  - Sustainable finance strategy (https://actuary.eu/wp-content/uploads/2020/07/ec-consultation_sustainable-finance-strategy_aae-response-0720-final.pdf)
  - Reporting (https://actuary.eu/wp-content/uploads/2020/09/ESA_ESG_AAE_RESPONSEFORM.pdf)

taxonomy

- A lot of development has been made on taxonomy documentation, excel tools etc.
- Agreed in EU in Dec 2019 but final EU parliament approval still pending – implementation scheduled for 12/2021
- For insurers having the ability to report how its investments meets the taxonomy criteria is a question mark.
- Insurers need a lot of information from the variety of asset it has been investing and this is not there yet
- Requires new skills for insurers or anyone responsible for providing the taxonomy based reporting information
- The update (taxonomy 2.0) plan considering also circular economy, waste protection, usage of water etc. – criteria 12/2021 and implementation 12/2022

AT A GLANCE

The EU Taxonomy is a tool to help investors, companies, issuers and project promoters navigate the transition to a low-carbon, resilient and resource-efficient economy.

The Taxonomy sets performance thresholds (referred to as 'technical screening criteria') for economic activities which:

- make a substantive contribution to one of six environmental objectives (Figure 1);
- do no significant harm (DNSH) to the other five, where relevant;
- meet minimum safeguards (e.g., OECD Guidelines on Multinational Enterprises and the UN Guiding Principles on Business and Human Rights).

The performance thresholds will help companies, project promoters and issuers access green financing to improve their environmental performance, as well as helping to identify which activities are already environmentally friendly. In doing so, it will help to grow low-carbon sectors and decarbonise high-carbon ones.

The EU Taxonomy is one of the most significant developments in sustainable finance and will have wide ranging implications for investors and issuers working in the EU, and beyond.

- Climate change mitigation
- Climate change adaptation
- sustainable and protection of water and marine resources;
- transition to a circular economy
- pollution prevention and control;
- protection and restoration of biodiversity and ecosystems.

Substantially contribute to at least one of the six environmental objectives as defined in the Regulation

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Do no significant harm to any of the other five environmental objectives as defined in the proposed Regulation

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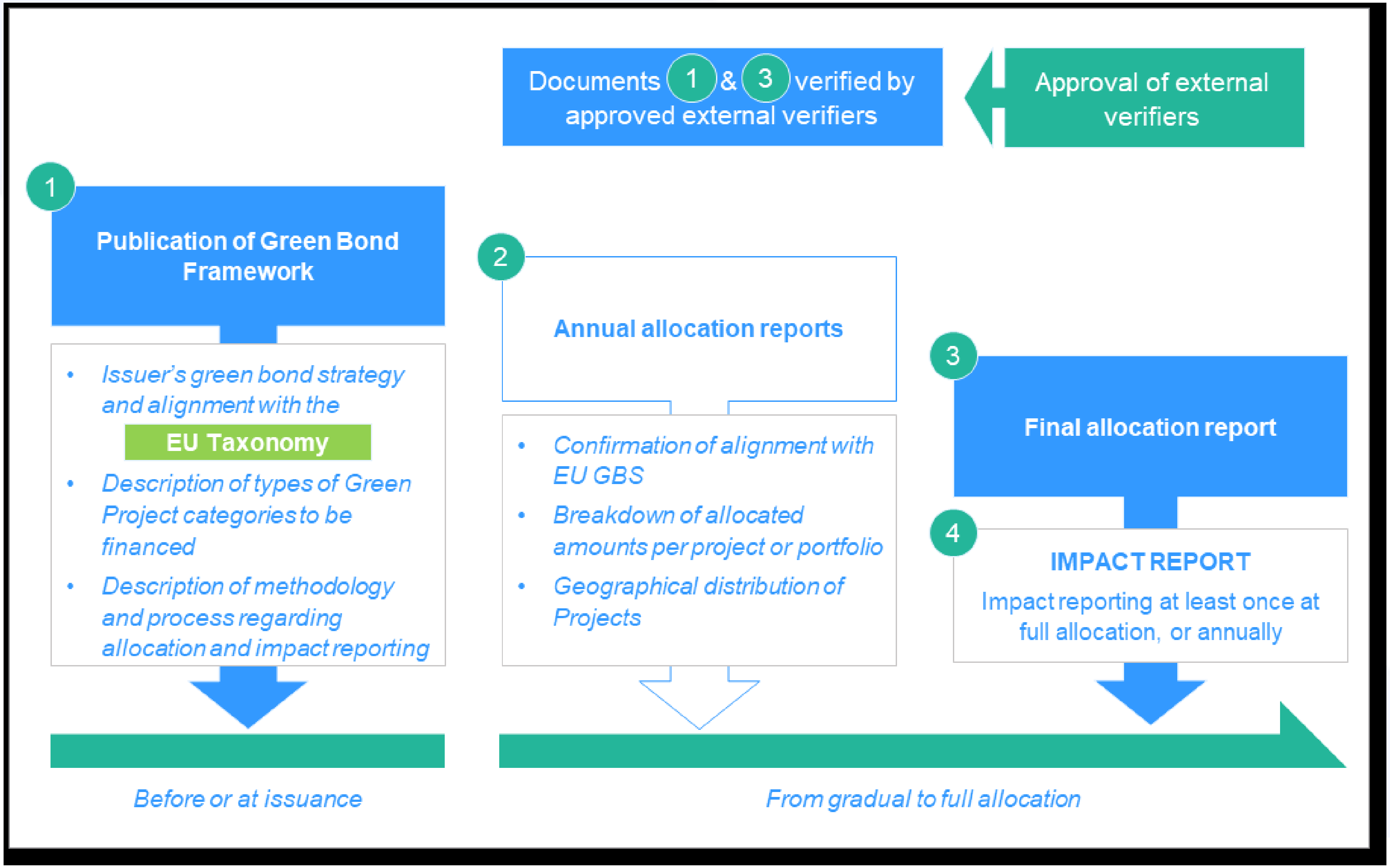
Comply with **minimum safeguards**

Green bond standard (GBS) – the proposed model which is planned to start on voluntary basis

- The alignment of the use-of-proceeds with the EU Taxonomy;
- The content of a Green Bond Framework to be produced by the issuer;
- The required Allocation and Impact Reporting; and
- The requirements for external verification by an approved verifier



Sustainable underwriting

- insurers have an **important role in societies** so the ways societies changes in time will inevitably affect also insurers important to understand, influence and be part of this change
- **On the S (social responcibility and G (good governance)** the ground seems to be already stable in EU but there certainly might be new public responsibilities for insurers on what is considered to be the 'new norm'
  - e.g. **good governance** certainly has nowadays growing needs for transparency, gender and age – balance.
  - **social responsibility** might mean more and more offering products to a wider range of customers (excluding might not be possible in similar ways). Also there might growing pressure on how to deal with issues around information, tech and data regulations.
  - The social medial takes care excesses are told to a wide audience with reactions to follow…
- When customer needs change then new products and different covers are needed.
  - Currently we are dealing with **cyber risks** and the new needs consumers have. Insurers are struggling with what data and models should they use in setting the price and modelling the risks and what would be the critical policy conditions
- The asset side **'exclude – avoid – invest in'** – principle is already applied in underwriting in term of how risks are understood. Usually e.g P&C insurers have had to decide what risks they are underwriting and what not, how to price and whether a third party (re-insurer) is part of the puzzle
- **Avoid investing vs. avoid underwriting**. In national legislations there is a lot of requirements for certain type of industries to have an insurance cover – and it might be mandatory also for the insurer to provide the insurance cover. How should these be handled? through decades also more responsibilities that governments used to have towards companies or citizens have been passed to the private side which might have been a good progress but puts then the pressure on insurers when changes

UNEP PSI principles

- Already a **number of insurers comply with the principles** globally (10% in premium or $6 trillion in assets)
- **4 main principles** for insurers to take into account when making business decisions, publishing reports and offering products. Some that might concern actuaries in the near future (subsections on the main principles):
  - **Integrate** ESG issues into risk management, underwriting and capital adequacy decision-making processes, including research, models, analytics, tools and metrics
  - **Develop products and services** which reduce risk, have a positive impact on ESG issues and encourage better risk management
  - **Support** prudential policy, regulatory and legal **frameworks** that enable risk reduction, innovation and better management of ESG issues
  - **Dialogue with governments and regulators** to develop integrated risk management approaches and risk transfer solutions
  - **Participate** in relevant disclosure or reporting frameworks
- **In future** more pressure might come to comply with these principle but also for the principles itself to be updated

Sustainable finance and scenario work

- **Soft requirements** for actuaries and risk management on taking into account sustainability related matters in their responsibilities – will have an impact on modelling and the use of scenarios (e.g Best estimate, ORSA)
- In some countries **more detailed requirements** especially on the **ORSA** process
- **EU stress test 2021 i**s planned to introduce climate change related stresses for insurers calculate and report.
  - The **length of these scenarios** still open, if long (say 10+ years) then new approaches might be needed and actuaries needs to be active
  - Also might need **new ways to model the impact** of the risks as the balance sheet and own funds can easily be affected in many ways.
- **Scenario providers** exists and part of the work might need to be outsourced
- Difficulty lays in the way different matters **are connected with each other's** – Societal change, market reactions, macro-side and in which way this all is driven by consumers and the changing mind-set of citizens

Actuarial climate index *

BACKGROUND. The first Actuaries Climate Index (ACI) was developed in North America and went live in November 2016 and 2018 in Australia (AACI).

STRUCTURE OF THE ACI. The ACI is based on analysis of seasonal data for six index components collected since 1961.

- The index measures changes in extremes of high and low temperatures, high winds, heavy precipitation, and drought, as well as changes in sea level, expressed in units of standard deviations from the mean for the 30-year reference period of 1961 to 1990, for the United States and Canada combined and by region.
- Combining six components over a five-year measurement period, the index's moving average smooths out monthly and seasonal fluctuations for a meaningful measurement of long-term climate trends.

DATA ISSUES. The ACI uses gridded datasets for all of the components except mean sea level. Each of these grids covers an area of 2.5 degrees latitude by 2.5 degrees longitude, and the data values are in effect averages over that area. This provides more manageable amounts of data, which have been collated and checked by the data provider.

- The European Climate Assessment & Dataset (ECA&D), which is based in Utrecht, collates data provided by European meteorological services, and produces gridded data sets for Europe.
- The question of missing data will need to be addressed, as the availability of readings in some parts of Europe is quite limited. The gaps may be filled by the use of reanalysis but this does introduce a level of approximation which might not be considered acceptable.
- Also satellite data might become one option, e.g Space4Climate, in this regard.

USAGE OF THE INDEX. The Index will provide information on trends in the frequency of extreme events that could be attributed to climate change. Decisions to follow how could be published.

- Climate indices provide useful information for actuaries, insurers, regulators and policy makers in relation to the frequency of the occurrence of extreme climate events.
- They do not provide information on the losses which arise due to these events. Anyway there's progress on the development of an Actuaries Climate Risk Index, which would incorporate information on the losses arising from past events which could be of assistance in setting reserves and capital requirements and indeed pricing for such risks (e.g American Academy of Actuaries publication).

NEXT STEPS. AAE to make decisions about the development of the EurACI to make the Index available.

- This may require some pragmatic decisions to be taken about the level of data quality and scope of the index
- The AAE will need to establish governance procedures in relation to the publication of the Index and to keep it under constant review
- Ultimately, the target should be a global actuaries climate index, which is likely to rely significantly on satellite data to cover the oceans as well as land areas where reliable data is sparse

*) full story, published by Society of actuaries in Ireland can be found here: https://web.actuaries.ie/development-european-actuaries-climate-index

Sustainable finance – Why this considers actuaries?

- The investment side has a lot of developments going on the EU side – to have an understanding of this help to be on track when sustainability related reports and business practises flows widely to insurers
- Actuaries might be closely related on the different reports insurers provide – also purely sustainable finance related issues (Asset reports, non-financial reporting) might require the attention from actuaries working in the insurance company.
- In Solvency II by now only soft requirements has been brought in on sustainability at the first stage – but even bringing this to ORSA might be a major work. Also stress tests are assumed to start including in future also the sustainability related scenario
- When any updates on requirements relating to information provided for insurance customers (PRIIPS, IDD) are put in place then also new and holistic understanding on this subjects will be needed
- The assumption is that sustainability will be more and more part of all of the insurance business. Therefore the general understanding is needed for all employees and deep understanding from many of the experts
- The ways actuaries analyse and bring awareness of risks is of key with sustainability – this understanding will be needed across the insurance business – pricing, reserving, ALM, Risk management etc.

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