AAE DISCUSSION PAPER

SUSTAINABILITY ISSUES AND REPUTATIONAL RISK FOR INSURANCE COMPANIES AND PENSION FUNDS

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SUMMARY

The pace of change in the sustainability field and associated changes in regulatory and public disclosure requirements emphasise the need to be careful about reputational risks stemming from Environmental, Social, and Governance (ESG) considerations. Stakeholders of insurance compa-nies and pension funds are increasingly applying these new ESG considerations as part of their business analysis. The approaches these undertakings adopt in relation to ESG reporting re-quirements now meaningfully impact their reputational positions. Reputational risk can also be turned into an opportunity and ESG reporting requirements can be used in a positive way to im-prove the reputation of a company. However, there are several sensitive areas which can endan-ger the reputations of insurance companies and pensions funds. This paper aims to describe the-se aspects. It is especially meant to support actuaries and risk managers in the identification, as-sessment, and evaluation of reputational risks in the context of sustainability issues.

Both in terms of public disclosure and when updating products so that they better follow ESG considerations, it is important to keep in mind that the economy and capital markets are still evolv-ing. The transition to a fully ESG compliant environment may take time. We may observe, e.g., that green-rated assets are not yet available to the extent we might want for some investment or savings products. Also, new ESG reporting requirements and standards are mostly principles-based and still under development, creating potential ambiguities.

The insurance industry has an important role to play in the transition to a low-carbon and more sustainable economy. Therefore, it is important to publicize, teach and explain in a transparent way what the industry brings to the table. Actuaries have the opportunity to contribute to sustain-ability developments within financial services, notably by bringing a strong risk culture and a long-term perspective. On the other hand, we can learn from examples from other industries that it is not just active greenwashing or explicit disregard of environmental protection that can lead to a big reputational issue. Not really showing a full commitment to change and fulfilling only the letter of reporting requirements could be interpreted as greenwashing by some and might also harm a company's reputation.

Potentially developing protection gaps are another aspect of reputational risk. Policyholders usual-ly expect the continued availability and affordability of insurance cover, as well as high standards of claims service in the wake of disasters. Sustainability-related risks may change this situation to the disadvantage of insurance clients, potentially leading to reputational issues for insurers and to a political and regulatory backlash.

Many financial institutions seem to be making ambitious long-term commitments (e.g. net-zero by 2050) but then taking limited immediate action. This might not be an immediate problem but could become an issue during the transition to a more sustainable economy if consistent actions and specific behaviour cannot readily be attributed to the ambitions and targets announced. Over time the public or NGOs could become more demanding. This might again increase the reputational risks such institutions face.

Finally, it is worth keeping in mind that reputational risk can quickly lead to actual litigation risk, such as regulatory sanctions or class actions.

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INTRODUCTION

Reputational risk is a broad topic and it can have origin in a variety of reasons. Recent developments and discussions concerning global warming and climate change and in this context also new developments in regulation and public expectations should advise us to be careful about reputation risks stemming from Environmental, Social, and Governance (ESG) considerations. Investors as well as clients are increasingly applying these new ESG considerations as part of their business analysis to identify material risks and growth opportunities. Therefore, the approach and positioning of insurance and pension companies in the context of ESG reporting requirements will also influence their reputation position.

As always, reputational risk could also be turned into an opportunity and ESG reporting requirements can be used in a positive way to improve the reputation of the company. On the other hand, there are several sensitive areas which could endanger the reputation of an insurance or pensions undertaking and each company should consider them. This paper aims to describe these aspects. It is especially meant to support actuaries and risk managers in the identification, assessment, and evaluation of reputational risks in the context of sustainability issues.

As the entire sector is currently developing extremely rapidly, these risks are difficult to assess and quantify. But even describing and being aware of them and defining relevant mitigating measures is a first step forward. As good practice, we believe that this should be considered in the ORSA process or ORA process for IORPS[1] and documented in the ORSA and ORA report, respectively. Here, at least the qualitative risk exposure of the insurance company should be described as part of the risk profile, and if possible, the risks should also be quantified for certain scenarios. As it might also affect the company's financial and solvency position in such adverse scenarios, it may also be important to explicitly document the risk appetite of the management and how such risks might be avoided or mitigated.

For both, public disclosure and updated products that follow ESG considerations, it is always important to keep in mind that the whole economy and capital market has still to develop and the transition to a fully ESG compliant environment may take time. We might still observe, e.g., that green rated assets are not yet available to an extent as we may need it for our own investments or savings products. In addition, new ESG reporting requirements and standards are mostly principle based and still under development, i.e., we might still face certain ambiguities. Hence, it is worth keeping in mind that

1 The relevance of reputation risk might depend on how pension business is organized in the respective European market. For those markets where IORPS do not exists, the risks are analyzed through the processes of the pensions management company, according to the regulation.

reputational risk can quickly lead to actual litigation risk, such as regulatory sanctions or class actions.

In Chapter 1 we discuss how listed companies might be affected by reputational risks and its impact on their share price. Chapter 2 then has a closer look at green products, consumer expectations and the potential risks in the context of greenwashing. Following that, we discuss in Chapter 3 what needs to be considered with respect to the asset management of the own assets and sustainability aspects of own operations of a company. To provide some general guidance on how reputational risk scenarios could be calibrated, Chapter 4 gives some examples of realized reputational risks stemming from the ESG context from other industries. All of them have in common that sustainability related reputational risks not just have resulted in bad press but also have had a financial or business impact on the respective companies. Chapter 5 again takes the consumers' perspective and discusses how a potentially increasing insurance gap for natural catastrophes due to the climate change might further induce reputational risks for the companies. To also discuss the opportunity that lies in establishing a more positive reputation, we explain in Chapter 6 some examples how this can be achieved. In Chapter 7 we conclude, present the main takeaways and give some further references in the last chapter.

1 REPUTATIONAL RISKS FOR LISTED COMPANIES AND EFFECT ON CAPITAL MARKET

The insurance and pension industries occupy a unique position in the ESG fields, as both a risk carrier and an institutional investor. Hence, we as actuaries working in these industries have to ask ourselves how we can actively support insurance and pensions in the transition to a low-carbon and more sustainable economy. Especially in our roles as model validators or risk assessors we have influence on pricing of the risks and also may support finding ways for managing these risks.

To build on the positive momentum of joining forces for solving the issues of climate change, there are several organisations, NGO's and movements that advocate for the urgent need to fully integrate ESG considerations as a key issue in government strategies and push companies to be active in this field, increasing their focus on the relevant topics and issues. All these actions are helpful for the financial and insurance sector to better understand ESG issues and improve the way how to deal with them.

An example of this, is the initiative 'The Greening Financial Regulation Initiative (GFRI)', developed by WWF with the aim to support central banks, financial regulators, and supervisors, as well as relevant policymakers, and to enhance the financial sector's stability and resilience to climate-related and other environmental and social risks, while enabling the mobilization of capital for the transition to a low-carbon, resilient and sustainable economy. Through this initiative, WWF will deepen its work with policymakers, central banks, and financial supervisors, advocating for the urgent need to fully integrate climate, environmental and social risks into their mandates and operations – mainly through financial regulation and supervision – as well as monetary policy. This will notably entail the provision of targeted support, research, and capacity building to equip institutions with the necessary tools and knowledge.

Friends of the Earth Europe (FoEE) as another example is a network of 31 environmental organisations that actively contribute to European environmental policymaking and implementation. The overarching aim of the FoEE's work programme is to engage the EU and Members States' policy processes to achieve strong environmental policies in different areas, including sustainability in the EU financial regulations.

While these organisations can play an important role in helping the financial and insurance industry to improve on ESG matters, they can also take a more critical stance denouncing inaction or greenwashing, using 'name-and-shame' tactics with specific companies being identified. We observe that NGOs in particular are putting more and more pressure on listed insurance and pensions undertakings to implement ESG criteria in way they do business and introduce a consequent strategy for becoming a sustainable company.

We can find examples of these actions:

- Activists from the environmental group Greenpeace gate-crashed Credit Suisse's annual shareholder meeting in 2017 to protest against the Swiss bank's dealings with companies behind the Dakota Access Pipeline. Greenpeace unfurled a banner from the stadium ceiling criticizing the crude oil pipeline during Chief Executive Tidjane Thiam's speech, with two people on wires holding the banner[2].

- Insure Our Future 2021 Scorecard on Insurance, Fossil Fuels and Climate Change[3] published by the Insure Our Future campaign, reveals that insurers around the world are continuing to retreat from coal, and this is having a tangible impact on coal mining and power companies. However, it also says that major companies in the US, Lloyd's market and East Asia are still insuring coal, and the insurance industry has so far failed to take comprehensive action on oil and gas, although there are signs that this is starting to change.

With the increasing influence of social media as well as activist sites this issue can escalate very quickly in the public, and it can threaten the insurance industry's reputation more significantly than in the past. As a result of this, we have to take care of the messages coming from NGOs, organizations and associations because otherwise it might lead to reputational risks for insurance companies and pension funds, resulting in further issues on the capital market or with the clients of the undertaking. But taking care does not always mean to give in to the pressure: we have to analyse and learn from many different views.

2 https://www.reuters.com/article/us-credit-suisse-gp-agm-greenpeace-idUSKBN17U1BW

3 https://insure-our-future.com/scorecard

2 REPUTATIONAL RISKS FOR PROVIDED PRODUCTS AND CONSUMER ATTRACTIVITY

As seen above the reputational pressure from the NGOs, public and increasingly government actions we are pushing financial institutions to work faster to offer a new portfolio of green products and to transform their operations to become greener. This widely spreading trend is followed by more and more financial institutions and is implemented either based on stricter regulation (e.g. SFDR & EU Taxonomy) or on voluntary commitments (e.g. UN PSI principles). As an example, JP Morgan Chase announced in 2021[4] to provide investment plans on '*green initiatives that support climate action, with the goal of accelerating the deployment of solutions for cleaner sources of energy and facilitating the transition to a low-carbon economy*'. The program is expected to attract capital of as much as US$ 2.5 trillion till 2030. This demonstrates that 'green' is less a fashion and more a relevant development that will be mainstream quite soon. Such a shift of investments is generating 'sustainability premium' which will naturally impact the asset prices and perceived attractiveness of the offered financial products. This increasing focus also amplifies significantly the reputational risk related to such investments.

Firstly, if an insurance company is not acting in a sustainable way or is not able to present itself with the proper green reputation, it will not be considered in allocation plans of the trending sustainable funds. Due to the joint rise of ESG and ETF investing, any insurance company not included in sustainable indices will automatically lose a significant investor base. Hence, the share price could eventually drop or stagnate making the company look less attractive not only for the investors but also for consumers.

Secondly, the financial markets' reaction on the investment of 'sustainability premium' impacts the offered investment products, too. A limited offer of ESG related portfolios might create a decline in new business sales, as investment potential is perceived by clients to be lower. Additionally, the existing in-force products without attractive sustainability ratings may suffer from increasing lapses and higher cash outflows, if no adequate sustainable upgrade can be provided. Both situations are a materialization of the reputational risk and then the reaction of the financial-rational investor to potential future market returns managing their own transition risks.

This even amplifies the risks for companies which simply pretend to be a sustainable player in the market but actually try to rather 'greenwash' the product portfolio. Originally coined in by environmentalist Jay Westerveld in 1986 about the hotel industry's practice of promoting reuse of towels to 'save the environment'[5], greenwashing refers to the practice of providing misleading information to exaggerate a company's claims to helping

4 https://www.jpmorganchase.com/ir/news/2021/jpmorgan-chase-sustainable-development

5 https://en.wikipedia.org/wiki/Greenwashing#Terminology

the environment. This may happen in the following ways referred by TerraChoice as 'The Seven Sins of Greenwashing'[6]:

1. **Sin of the Hidden Trade-Off**
   A claim suggesting that a product is green based on a narrow set of attributes without attention to other important environmental issues. Paper, for example, is not necessarily environmentally preferable because it comes from a sustainably harvested forest. Other important environmental issues in the paper-making process, such as greenhouse gas emissions or chlorine use in bleaching, may be equally important.

2. **Sin of No Proof**
   An environmental claim not substantiated by easily accessible supporting information or by a reliable third-party certification. Common examples are facial tissues or toilet tissue products that claim various percentages of post-consumer recycled content without providing evidence.

3. **Sin of Vagueness**
   A claim that is so poorly defined or broad that its real meaning is likely to be misunderstood by the consumer. All-natural is an example. Arsenic, uranium, mercury, and formaldehyde are all naturally occurring, and poisonous. All natural isn't necessarily green.

4. **Sin of Worshipping False Labels**
   A product that, through either words or images, gives the impression of third-party endorsement where no such endorsement exists or where labels with weak requirements have been established by the industry for marketing purposes.

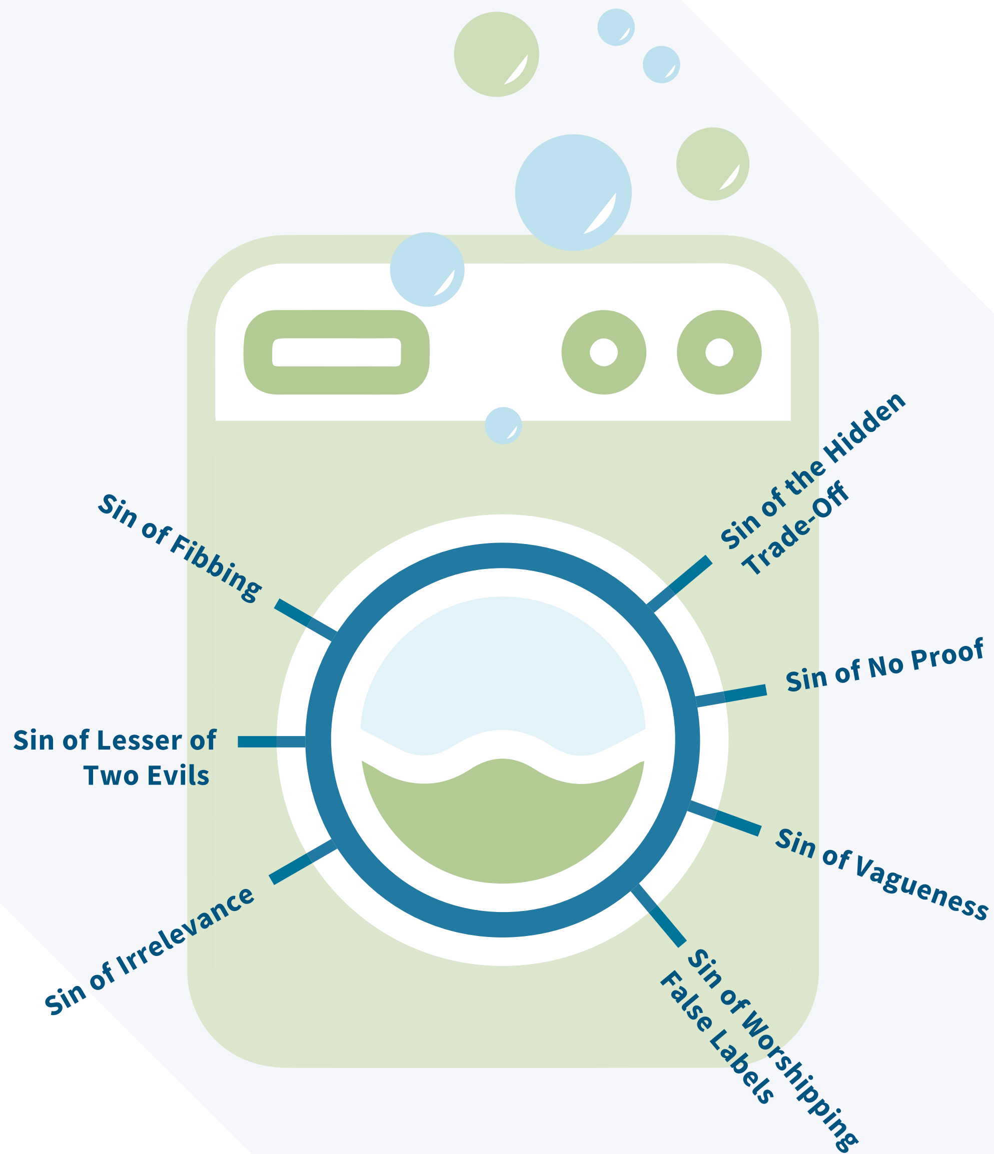
5. **Sin of Irrelevance**
   An environmental claim that may be truthful but is unimportant or unhelpful for consumers seeking environmentally preferable products. CFC-free is a common example, since it is a frequent claim despite the fact that CFCs (chlorofluorocarbons) are banned under the Montreal Protocol.

6 **Sin of Lesser of Two Evils**
   A claim that may be true within the product category but that risks distracting the consumer from the greater environmental impacts of the category as a whole. Organic cigarettes or fuel-efficient sport-utility vehicles could be examples of this sin.

7 **Sin of Fibbing**
   Environmental claims that are simply false. A common examples are products falsely claiming to be energy efficient certified or registered (e.g. ENERGY STAR® in US).

6 https://www.ul.com/insights/sins-greenwashing

FIGURE 1: THE SEVEN SINS OF GREENWASHING



As a cherry on top comes the complexity of the emerging climate change itself and the growing public knowledge and expectation on best practices with respect to sustainable products and transparent reporting. This may cause actions undertaken now to comply with ESG will be assessed by investors or the public to be not adequate in the future and generate reputational issues. Here, well defined and consistent regulation over time might solve this problem of potential risks of change.[7]

7 'Apocalypse Never: Why Environmental Alarmism Hurts Us All' book by Michael Shellenberger

Clarity on green / ESG standards helps to minimize these reputational risks. Especially dedicated regulations referring to the management of sustainability related issues in the financial sector like the EU's 'green taxonomy' guidelines support this. Although creating potential conflicts of interpretation of its own and even being controversial in several topics, it serves as a reference standard and thus limits the potential of the related reputational risks. As clients' preferences might be different with respect to green / ESG standards and to provide sufficient transparency during the sales process, MiFid II will make it mandatory for companies selling financial products to ask their clients about their sustainability preferences.

In this context, it is important to consider that reputational risks may be especially relevant during the transition period when differing interpretations may appear in parallel and local legislation and jurisdiction can differ in Europe. This is particularly relevant for more specific regulation and reporting requirements, e.g., how 'grandfathering' should be considered? With grandfathering, companies would be allowed to continue to apply older rules and classifications of green standards to existing capital market instruments even though under a stricter up-to-date regulation they wouldn't be any longer classified as green. Especially during its introduction in the 2020s we expect reputational risks in the context of ESG to also have an effect on compliance, legal or even political risks. Since a violation of climate regulation requirements can also have legal consequences such as fines, these reputational risks often also have a financial impact on the company and thus are also relevant for quantitative risk management.

3 SUSTAINABILITY AND REPUTATIONAL CONSIDERATIONS FOR OWN OPERATIONS AND ASSET ALLOCATIONS

Insurers and other financial services companies should not only factor in sustainability considerations and reputational risks associated with the products they sell, but also with their own operations and the asset allocations that are under their direct or indirect control.

Unlike the agricultural and industrial sectors, the financial sector typically does not operate factories or similar facilities. Therefore, the main impact of financial companies on the environment and society is not through their own direct activities and operations, but indirectly through the economic activities they choose to finance, insure and thus enable. Communicating only on their own operations (such as advertising the energy efficiency of a new headquarter building) might even trigger suspicions of greenwashing by drawing away attention from the more material financial aspect of their activities ('sin of irrelevance').

The financial sector's leading companies increasingly acknowledge this reality. Together with international organisations such as UNEP-FI (the United Nations Environment Programme Finance Initiative) and PCAF (the Partnership for Carbon Accounting Financials, a Dutch not-for-profit organization[8]), they have launched net zero alliances for asset owners, asset managers or insurers. The members of these alliances commit to reaching zero net financed or insured emissions (typically by mid-century, sometimes earlier for more ambitious participants). These net zero alliances are now collectively referred to as the Glasgow Financial Alliance for Net Zero (GFANZ[9]), following COP26 in Glasgow in November 2021 which included numerous discussions on the role of finance for mitigating climate change. As the membership of the net zero alliances grows and their members' commitments attract more scrutiny, the reputational risk grows as well for companies who do not make such pledges or do not adequately follow up on the implementation of their commitments.

This is not to say that sustainability efforts linked to the own operations of financial services are unimportant. While not sufficient, they remain necessary, if only because of ethical considerations and because they are the most directly visible aspect of what an insurance company or a bank is doing. The largest retail insurers and banking groups may also employ a workforce numbering in the hundreds of thousands of people, which raises the materiality and public visibility of internal governance topics such as fair employee treatment, workplace diversity or gender pay gaps.

8 https://carbonaccountingfinancials.com/

9 https://www.gfanzero.com/

As mentioned above, the most material sustainability impact of the financial sector remains however associated with what it finances. Together, banks, insurers and pension funds constitute the largest institutional investors. They exercise a large degree of control over how they choose to allocate the money they own or manage. This control might either be direct (for their own investments funds or investment funds on behalf of their clients) or indirect (through the arrays of investment funds an asset manager or a life insurer proposes and recommends). There are further specificities for life insurers and pension funds. Due to the long-term contracts they sell, they are the financial institutions with the highest vested interest in how the world's economy will look like 10, 20 or 30 years ahead in the future. They can thus take advantage of the long and often illiquid liabilities on their balance sheet to invest in new asset classes such as green infrastructure or energy-efficient real estate. But this also means that they may be the investors who are the most expected to factor in ESG considerations into their investment decisions. The long-term nature of their portfolios and asset-liability management can also constrain and slow down their ability to reinvest their asset portfolio towards more sustainable investments over time, which might frustrate some of their stakeholders and lead to bad publicity.

A growing number of insurers and banks have started to exclude thermal coal from their investments (and from what they insure). Some leading financial institutions go further and exclude some unconventional fossil fuel projects such as arctic drilling or tar sands[10]. Overall, public pressure is mounting on the financial sector to broaden these exclusion policies, in line with the conclusions of the International Energy Agency who stated in 2021 that achieving carbon neutrality by 2050 requires that no new fossil fuel projects are developed (and hence not financed or insured). It is however worth noting that only parts of the financial sector (typically large public and listed companies) are primarily concerned about maintaining their public reputation and keeping their 'social license to operate', to borrow an expression from the mining industry. The fossil fuel and otherwise unsustainable investments divested by ESG-compliant companies might be picked up by hedge funds, private equity, sovereign funds and other actors who are not directly responsible before the public. Engagement and the use of shareholder voting rights to make investee companies green their operation is thus emerging as a complementary course of action to outright divestment, with an increasing number of climate resolutions being brought to the vote in general assemblies.

Whether for own operations or for investment considerations, carbon compensation is another area worth mentioning in connection to reputational risks. Many financial institutions purchase carbon offsets (e.g. planting trees, or helping developing countries to improve their energy efficiency) to neutralize some or all their greenhouse gas emissions and CO_2 footprint. However, this can attract public criticism on several grounds. The use of such mechanisms may indeed divert attention and efforts from the urgent need to reduce CO_2 emissions in the first place. The carbon offsets purchased may also

10 https://oilgaspolicytracker.org/

be of inadequate quality, exist only on paper (‘phantom forests’), or be managed from abroad in a way contrary the human rights and interests of local indigenous populations (e.g. cutting access to traditional hunting grounds and sacred landmarks). Better solutions for financial companies to offset their unavoidable emissions may include investing in carbon capture and removal (although the technology is only developing and not yet deployable at scale) and/or voluntarily applying internal carbon pricing mechanisms[11].

11 Example as implemented by Swiss Re: https://www.swissre.com/sustainability/sustainable-operations/co2netzero-programme.html

4 EXAMPLES FROM OTHER INDUSTRIES

To better understand potential quantitative and qualitative effects of reputational risks arising from sustainability issues as discussed in the last three chapters and to use these events and examples as a benchmark for our own assessments and scenarios, we find it valuable to provide the reader with a (not meant to be comprehensive) overview of events from the last ten years where companies violated regulation or did not meet expectations from customers, shareholders or the public and the effects they had to endure.

We structure the examples as follows

1. Company name and industry
2. Brief description of event and what lead to the breach
3. Reputational impacts
4. Quantitative instantaneous impacts on stock price and sales (if publicly available) and fines to be paid

4.1 SIEMENS RAIL SIGNAL SYSTEM FOR THE CARMICHAEL AUSTRALIAN COAL MINE

1. Siemens, public, business service, engineering and construction
2. A contract with Adani coal mine in Australia to build a rail signalling system to connect the mine with the maritime freight terminal at Abbot Point was signed 10 Dec 2019 and confirmed by Siemens CEO 13 January 2020.
   The coal mine was under longer public discussions since 2010 and has been judged to have a negative effect on the greenhouse gas emissions, water resources and endangered species.
   Greta Thunberg explicitly took position in January 2020 to stop the project with Siemens playing a key role in supporting the development of the mine.[12]
3. The announcement that Siemens still supports the project led to a worldwide negative press coverage. The existing Climate Change policy at Siemens was questioned and Siemens was compared to any other fossil fuel company. An outcry on social media started. Even BlackRock rebuked Siemens on its environmental record (6 Feb).

12 https://en.wikipedia.org/wiki/Carmichael_coal_mine

4. It is not clear how much of the observed stock price development can be attributed to this reputational risk event.

4.2 VOLKSWAGEN EMISSION SCANDAL

1. Volkswagen, public, automotive

2. In September 2015 the United States Environmental Protection Agency (EPA) issued a notice of violation of the Clear Air Act to Volkswagen Group. The EPA had found that Volkswagen had intentionally programmed TDI diesel engines to activate their emissions controls only during laboratory emissions testing, which meant that the NOx emissions where only met during testing but not during the typical use of the car. Regulators in multiple countries began to investigate Volkswagen after this incidence.[13]

3. Volkswagen Group CEO, the head of brand development, Audi R&D head and Porsche R&D head were suspended. In January 2017 Volkswagen pleaded guilty to criminal charges and signed an agreed Statement of Facts which set out how engineers had developed the devices. Volkswagen Group CEO was charged in the United States with fraud and conspiracy on 3 May 2018.

4. The stock price fell in value by a third in the days immediately after the news. In addition, as of 1 June 2020, the scandal has cost Volkswagen $33.3bn in fines, penalties, financial settlements and buyback costs.

4.3 DWS GREEN-WASHING ACCUSATION

1. Deutsche Bank former subsidiary and spin-off DWS, public, banking

2. In August 2021, the German Federal Financial Supervisory Authority (BaFin) and several U.S. authorities investigated the sustainable investment products of Deutsche Bank's subsidiary DWS. According to the allegations, DWS had set sustainability ratings too high.
The investigations are said to have been triggered by allegations made by the former head of sustainability at DWS. She left in March 2021 after only six months in office. She publicly stated in Augusts that DWS was exaggerating information about its sustainability efforts.[14]

13 https://en.wikipedia.org/wiki/Volkswagen_emissions_scandal

14 https://www.wiwo.de/finanzen/geldanlage/nachhaltige-geldanlage-fondsgesellschaft-dws-unter-greenwashing-verdacht/27555326.html

3. ESG rated funds launched by DWS were seen critical as they seem to invest mainly in standard titles like Microsoft and Apple. Generally, confidence in these investments was lost.

4. The stock price fell 26 August 2021 by 13.7%.

4.4 BP GREEN REPOSITIONING

1. BP plc, public limited, oil and gas

2. BP rebranded itself to 'Beyond Petroleum' in 2001 and publicly added solar panels on their gas stations. In December 2019, an environmental group called ClientEarth lodged a complaint against BP for misleading the public with its advertisements that focused on BP's low-carbon energy products, when more than 96% of its annual spend is on oil and gas.[15]

3. This and further negative reporting on misconduct in 2019 lead to a material reputational issue for BP. Several journalists including BBC and The Guardian featured negative reports on BP.

4. Despite these events, the stock price remained rather stable in 2019.

4.5 CREDIT SUISSE INSUFFICIENT DISCLOSURES ABOUT FINANCING ACTIVITIES

1. Credit Suisse, public, bank

2. In March 2022, co-ordinated by Ethoos Foundation and NGO ShareAction, eleven investors filed a climate shareholder resolution due to concerns about the activities the bank finances.
   Investors ask the bank to urgently back its long-term net-zero ambition with robust fossil fuel disclosures, policies, and targets.

3. Credit Suisse will need to publish additional disclosures about its Paris Agreement alignment strategy and about the short, medium- and long-term steps it plans to take to reduce its exposure to coal, oil and gas assets.

4. No direct effects on the stock market observed, yet.

15 https://www.clientearth.org/latest/latest-updates/news/bp-greenwashing-complaint-sets-precedent-for-action-on-misleading-ad-campaigns/

4.6 BNY MELLON INVESTMENT ADVISER MISSTATING ESG CONSIDERATIONS

1. Bank of New York Mellon Investment Adviser, US incorporated, registered investment advisor

2. The Securities and Exchange Commission judged 24 May 2022 that, from July 2018 to September 2021, BNY Mellon Investment Adviser represented or implied in various statements that all investments in the funds had undergone an ESG quality review, even though that was not always the case. The order finds that numerous investments held by certain funds did not have an ESG quality review score as of the time of investment.[16]

3. BNY Mellon Investment Adviser promptly undertook remedial acts and cooperated with Commission staff in its investigation. Hence, the reputational effects on their business seem limited, till now.

4. To settle the charges, BNY Mellon Investment Adviser agreed to pay a $1.5 million penalty. The share price of the BNY featured a relevant decrease of 3% on 24 May.

4.7 OTHER RELEVANT EXAMPLES

You may find some more interesting examples on the following two webpages, where the topic green washing is made public:

- ‘Greenwashing: 7 recent stand-out examples’
https://thesustainableagency.com/blog/greenwashing-examples/

- ‘10 Companies and Corporations Called Out For Greenwashing’
https://earth.org/greenwashing-companies-corporations/

16 https://www.finextra.com/pressarticle/92730/sec-charges-bny-mellon-over-greenwashing

5 INSURABILITY, AFFORDABILITY, AND POST DISASTER CLAIMS SERVICE

Another major threat to insurers' reputation revolves around the continued insurability, affordability and post-disaster claims service of sustainability-related risks. The insurance industry traditionally assumes a key role as society's risk manager, and governments, businesses and individual policyholders implicitly expect that in the future insurance cover will remain available at affordable prices. In case of adverse events, they also count on insurance provider to settle the claims in full and within a reasonable timeframe.

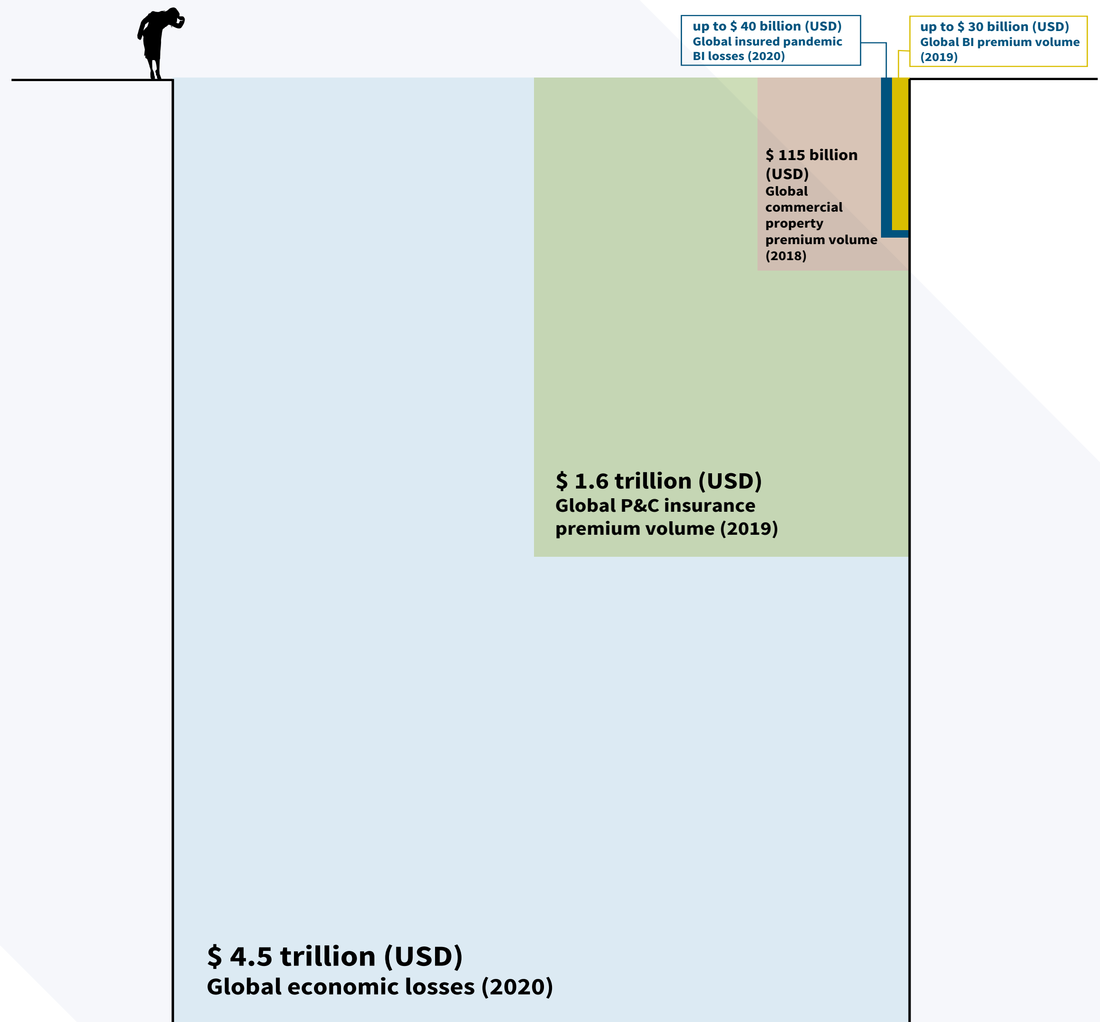
The ongoing COVID-19 pandemics provided a stark reminder that this cannot be taken for granted. As governments in Europe and around the world ordered lockdowns during the worst phases of the pandemic to minimize disease transmission within communities, companies suffered massive financial losses due to closed shops and cancelled events. Some businesses thought they were financially protected by their business interruption insurance policies, but they found out that in most cases they were only covered against an interruption due to physical damage, and that pandemic-related closures fell in the category of non-damage business interruption. While this may be properly rooted in the fine print of contractual terms and conditions, it created bad press for the insurance industry and led to lawsuits from disgruntled business customers. In the UK, for instance, a test case was brought before the FCA's High Court seeking legal clarity on the meaning and effect of certain business interruption insurance policy wordings, with the aim to resolve contractual uncertainty and to ensure that policyholders are treated fairly by insurers and insurance intermediaries. The few (re)insurers who covered non-damage business interruption generally declined to renew their annual contracts in 2021, and the insurance industry collectively argued (for example in a report from the Geneva Association[17]) that pandemic-related economic losses were not insurable. Some (re) insurers or insurance associations suggested the creation of Public-Private Partnerships to insure these risks, usually with an overwhelming share of the risks being supported by governments[18]. At the time of writing, none of these proposed co-insurance schemes have been established, yet, and governments have intervened directly to provide financial support to affected businesses and individuals.

17 https://www.genevaassociation.org/research-topics/socio-economic-resilience/investigation-insurability-pandemic-risk-research-report

18 https://www.eiopa.europa.eu/sites/default/files/publications/eiopa-staff-paper-on-measures-to-improve-insurability.pdf (Annex 1)

FIGURE 2: AN ILLUSTRATION OF THE GLOBAL PANDEMIC BUSINESS INTERRUPTION PROTECTION GAP

SOURCE: THE GENEVA ASSOCIATION - all figures are estimates



Environmental risks and climate change are another area where the continued insurability and affordability of insurance is under pressure, with serious potential consequences for insurers' reputation. The increase in frequency and severity of climate-related catastrophes, compounded by the rising concentration of insured value in vulnerable areas (such as coastal cities), can translate over time into premium increases, higher deductibles, additional exclusions, or even outright denial of covers from insurers. And one must keep in mind that the starting point is very far from universal coverage: the European supervisory agency EIOPA estimated in 2021 that only about 35% of damages from natural catastrophes are covered by insurance mechanisms in the EU[19]. As a combined result of this high initial protection gap and of increasing climate-related claims, entire geographical areas and segments of the population risk becoming more exposed to financial hardship as a consequence of natural perils, which does little to enhance the reputation of the insurance sector.

19 https://www.eiopa.europa.eu/document-library/feedback-request/pilot-dashboard-insurance-protection-gap-natural-catastrophes_en

Property insurance is customarily written for one year and repriced annually to reflect changing exposures. This short-term legal contract traditionally upheld a balance between the interests of consumers (who are theoretically free to find a better cover or lower premium every year) and the interests of (re)insurance providers (who can reprice or exclude risks on an annual basis). However, emerging climate risk is challenging this implicit bargain, as the search for a new cover in areas exposed to flooding or wildfires can prove costly and time-consuming at best, and impossible at worst. Such repricing or withdrawals of cover may make perfect sense for (re)insurers from a profitability and risk management perspective and seen through a micro-prudential regulatory lens. However, most (re) insurers are in effect reacting in the same way in the face of increasing systemic risk, with consequences for financial stability and for the reputation of insurance sector as a whole. Cover denials on a large scale can leave consumers under the impression that they are being abandoned by an insurance industry which runs away right when their risk-carrying capabilities are most needed. Continued cover associated with steep premium increases (as advocated by Warren Buffet in his 2016 annual letter to shareholders, for instance) is not a viable long-term solution either. High insurance costs mean that some policyholders won't be able to afford them, and insurers may be seen as profiteering off people's distress.

Since policyholders are also citizens and voters, dissatisfaction with insurers' coverage and claims service may translate into regulatory or political intervention. Following the devastating wildfires that struck California over the last years, the local Insurance Commissioner has imposed a mandatory moratorium on non-renewals for fire insurance in certain zip codes[20]. In France, flood insurance has long been mandatory, and the French government negotiated in 2020 a freeze of insurance premiums for the economic sectors most affected by the COVID-19 pandemic, after having threatened insurers with additional taxes. Between these two extremes (unfettered market mechanisms failing policyholders on the one hand, and state intervention on the other hand), other paths should be explored to develop collaborative models between insurers and policyholders for the benefit of both. EIOPA is for instance promoting the concept of 'impact underwriting', whereby insurers would incentivise policyholders to mitigate the insured risks via pricing and other contractual terms (for example with lower premiums rewarding the flood-proofing of house walls). Similar insurance mechanisms are being promoted by the EU taxonomy for sustainable economic activities. Smart claims payment to 'build back better' after a disaster could also increase the resilience of society and align better the interests of insurance companies and their customers. The traditional one-year contract horizon of non-life insurance covers remains however a major obstacle to such developments, as it undermines the longer-term horizon necessary for such risk-mitigating measures to make financial sense for all parties. However, to have the certainty of not increasing premiums or to grant the insurance coverage for customers with annual basis and to not have the option to reprice longer term insurance policies will come with a price, as it provides additional guarantees.

20 Mandatory One Year Moratorium on Non-Renewals (ca.gov)

6 REPUTATIONAL OPPORTUNITIES

Most risks are two sided, and reputational risk presents opportunities as well as threats. Other sections of this paper focus on reputation risk's downside, a risk to be measured and reserved for. The examples in Section 4 measure reputational risk as the loss of market value of portfolio assets arising from a controversial event, even though attributing losses to reputational risk may be technically challenging. Similarly for reputational events in subsidiaries, penalties levied against the subsidiary are an alternative measure of reputational risk.

Viewed from the opposite direction, however, a company that exposes wrongdoing would enjoy a positive reputational effect. This 'halo effect' may be difficult to measure, but it may be potent. A practical advantage of exposing reputationally compromised behaviour might be to exit early any portfolio assets, thus avoiding a market loss. In the case of subsidiaries, exiting may not work as well if the circumstances can be perceived as damage control or green washing. Similar statements apply to insurance clients.

Engagement and shareholder activism clearly provide a positive reputation for companies. These may not have directly measurable market value effects. However, these could increase sales, or allow premium priced products, even if those products are not directly ESG related. This halo effect could have strong effects on the financials of a company. There may be questions regarding how to attribute the positive effects to reputational risk, but this type of expert judgement is no more difficult than the attribution of the downside risk, and may be easier since customer surveys or similar methods could provide a strong indication.

A more systems-thinking example is validating ESG ratings. As a professional standard, actuaries validate all models used in insurance companies, even those provided from third parties. ESG ratings should be validated like any other model before being employed. While all models have deficiencies, ESG ratings may have deficiencies that actuaries would need to consider. Companies which expose deficiencies in ESG ratings, especially deficiencies that detriment society, and further correct those deficiencies with new methods would have a strong message to make for customers. Below are two deficiencies of ESG ratings that could be considered.

ESG ratings often use monetary exposures, such as (Carbon Emissions) / (Revenue). Instead of 'revenue' in the denominator, other similar exposures include profits, market share, market capital and GDP. Monetary exposures are also used in TCFD, though this is not typically considered an ESG rating. But this monetary-exposure-based measure may

be inappropriate in many cases. A company can appear to be improving with respect to ESG if it's monetary exposure, the denominator, is larger than its carbon emissions growth, the numerator. The use of monetary exposures often distorts the societal impact. For an example, as of this writing oil prices have risen precipitously, allowing the above measure to decrease carbon intensity measures year on year for oil companies even while emissions are increasing. Using non-monetary exposures (kWh for electricity, BTU for heating, km-kg for logistics, etc.) could correct the distortion, and may be easy to implement.

Another distortion which permits a potentially easy fix is exclusionary or negative investment screening. To illustrate, a portfolio (of assets or of insurance clients) can look less carbon intensive simply by avoiding energy sector investments, since companies in this sector generally have higher emissions. However, if all investors left the energy sector, none would be investing in less carbon-intensive alternative. Why should a company get a greener rating when washing their hands of a troublesome industry? This could be addressed by changing the benchmark to reflect industry-sector allocation vis-à-vis the portfolio, while not employing monetary exposures (as described above).

Both in appropriate monetary exposure usage, and exclusionary / negative screening represent examples in which the measure distorts the ESG effect on society. In both cases, the solution is easy for actuaries to understand an employ. There are likely other potential deficiencies that have similarly easy fixes for professionals with actuarial training.

A pioneer or first mover to correct such short comings could gain considerable reputational advantages that could affect their underlying sales and pricing.

7 CONCLUSION

The insurance industry has an important role to play in the transition to a low-carbon and more sustainable economy. In fact, it is already doing so, both as a risk manager and as an institutional investor, with a number of tangible results, which are often not well-known and unacknowledged. Therefore, it is important to publicize, teach and explain in a transparent way what the industry brings to the table. Actuaries have the opportunity to contribute to the further sustainability developments within financial services, notably by bringing in a strong risk culture and a long-term perspective.

On the other hand, in examples from different industries, we can learn that not only active greenwashing or explicit disregard of environmental protection might lead to a big reputational issue for the company. Also not really showing a full commitment for the change and rather only fulfilling reporting requirements might be interpreted as greenwashing and might harm the reputation of the company. This is especially difficult, as requirements and expectations currently change quite quickly and companies really need to invest resources and be focussed not to miss important developments.

Protection gaps are another, lesser-known aspect of reputational risk. Policyholders usually expect the continued availability and affordability of insurance cover, as well as high standards of claims service in the wake of disasters. Sustainability-related risks may change this situation to the disadvantage of insurance clients, potentially leading to reputational issues for insurers and to a political and regulatory backlash.

Many financial institutions make ambitious long-term commitments (e.g. net-zero by 2050) but take limited immediate action. This might not be immediately a problem but could become an issue during the transition when consistent actions and specific behaviour cannot really be attributed to the ambitions and targets announced. Over time the public or NGOs could react more demanding and this might again increase the reputational risk for such companies.

Finally, it is worth keeping in mind that reputational risk can quickly lead to actual litigation risk, such as regulatory sanctions or class actions. For example, a member of the Australian pension fund REST (Retail Employees Superannuation Trust) took them to court in 2018 for failing to disclose climate risk information and plans to address those risks, ultimately forcing REST to incorporate climate in their investments and to implement a 2050 net-zero target.[21]

21 http://climatecasechart.com/climate-change-litigation/non-us-case/mcveigh-v-retail-employees-superannuation-trust/

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THE ACTUARIAL ASSOCIATION OF EUROPE

The Actuarial Association of Europe (AAE), founded in 1978 under the name of Groupe Consultatif Actuariel Européen, is the Brussels-based umbrella organisation, which brings together the 37 professional associations of actuaries in 36 countries of the EU, together with the countries of the European Economic Area and Switzerland and some EU candidate countries.

The AAE has established and keeps up-to-date a core syllabus of education requirements, a code of conduct and discipline scheme requirements, for all its full member associations. It is also developing model actuarial standards of practice for its members to use and it oversees a mutual recognition agreement, which facilitates actuaries being able to exercise their profession in any of the countries concerned.

The AAE also serves the public interest by providing advice and opinions, independent of industry interests, to the various institutions of the European Union - the Commission, The Council of Ministers, the European Parliament, ECB, EIOPA and their various committees - on actuarial issues in European legislation and regulation.

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