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3 December 2022

SUSTAINABILITY AND CLIMATE CHANGE: MAIN POSITIONS OF THE AAE

The AAE is deeply concerned about the effects of the climate crisis endangering mankind and imposing unprecedented risks for all economic sectors and in particular for insurance, reinsurance and finance.

Current ongoing climate change is – as stated in the IPCC report AR6 – scientifically proven to be caused by human greenhouse gas emissions. Although this has basically been known for decades, emissions have continued to grow. In 2020, global warming reached 1.2°C relative to the pre-industrial era. Changes in nature have become obvious and show how unprecedented this warming level is for mankind. Warming beyond 1.5°C will increase physical consequences significantly. At approximately 2°C irreversible tipping points in the climate system will be reached.

Consequently, almost all countries committed in the 2015 Paris Agreement to a 1.5°C warming target. However, this target is far from being reached. All current national pledges taken together do not suffice to limit global warming below 3°C. This climate action gap is huge. Closing it will require unprecedented action in the 2020s.

The physical risks and transition risks originating from the climate action gap together form what is called the **climate crisis**. Financial services (e.g. investment processes, but also the provision of insurance and reinsurance) can play a key role in the transition towards a sustainable economy. Actuaries can play a key role in analysing Environmental, Social and Governance (ESG) risks and supporting impact underwriting. There can be a role for adapting capital requirements to include climate risk.

However, a political framework for the real economy – such as robust carbon pricing – is an absolute precondition for reaching the Paris target and for solving the climate crisis. At COP27 in Sharm El-Sheik in November 2022, a first step has been taken by setting up a loss and damage fund, which aims to provide financial assistance to nations most vulnerable and impacted by the effects of climate change. However, concrete financing arrangements for this fund are still open.

At the heart of insurance and pensions are sustainability principles - to ensure financial security in old age and to protect against severe events both for individuals and for organisations. With man-made climate change, economies and societies are in transition whilst facing increased climate related events. We need to ensure that the pensions and insurance industry stay true to these principles by addressing the following questions:

The Actuarial Association of Europe (AAE) was established in 1978 under the name Groupe Consultatif to represent actuarial associations in Europe. Its primary purpose is to provide advice and opinions to the various organisations of the European Union - the Commission, the Council of Ministers, the European Parliament, the European Supervisors and their committees – on actuarial issues in European legislation. The AAE currently has 37 member associations in 36 European countries, representing over 27,000 actuaries. Advice and comments provided by the AAE on behalf of the European actuarial profession are totally independent of industry interests. The Actuarial Association of Europe is registered in the EU Transparency Register under number 550855911144-54

1. How can we effectively manage the risks posed to insurance and pension systems from short and long-term policy impacts of climate change and other environmental or social trends? – *social and financial sustainability*
2. How can insurance and pensions contribute to the needed transition through investment policy and transition project insurance as well as via pay-outs linked to climate related physical risks which are insurable? – *climate sustainability*
3. For climate risks borne by society which are not currently insurable (or may become uninsurable as market conditions evolve), how can public policy work with insurance and pension systems to ensure that society is covered in these areas? – *climate protection gap*

Social and financial sustainability

The EU-Commission published its proposals for an amendment of the Solvency II Directive on 22 September 2021. We highlight a basic principle we think is still key: "**same risk - same capital**". If so-called 'green supporting' or 'brown penalising' factors are introduced into Solvency II capital requirements, they should be scientifically based and reflect the quality of the investments and their inherent risks (while acknowledging that the integration of emerging risks cannot rely solely on historical statistics but needs to factor in forward-looking considerations). If such factors are also introduced on the underwriting side (e.g. for insurance products which encourage the mitigation of sustainability risks), they should be similarly justified on scientific grounds based on the nature of the risks inherent in the covered exposures.

We support already proposed initiatives that contribute to an appropriate **integration of climate risk in the Solvency II framework** (e.g. climate scenarios in the ORSA).

Insurance (life & health) and pensions contribute to ensuring **financial security in old age** and contribute to **protecting against loss of ability to work or financing medical treatment and care**. Ideally, existing solutions should be extended to broaden their attractiveness and their effectiveness as solutions against old age poverty, especially for 'gig economy' workers with minimal employment benefits and socially disadvantaged persons.

For savings products in pensions and insurance, it is important for policyholders to be well informed about the investment strategy and the sectors in which their money will be invested. We support a transparent **classification of savings, pensions and investment products by** (potentially even more standardized) **ESG criteria** and a clear and **informative sales process** to support policyholders' decisions.

How and what gets measured in a business context often drives the behaviour of firms. Where current accounting and valuation standards inappropriately externalise (i.e., exclude for the firms themselves) costs of non-green activities, these standards should be adapted to provide stronger incentives to close the climate action gap.

Climate sustainability

As long-term investors, pension funds and insurers can also play a relevant role in financing the desired societal transition to a more sustainable future with a reduced carbon footprint. It needs to be noted that, due to the long-term investment strategies in place and insurers having a duty to service existing guarantees in long-term products, some investments held by insurers may not be practically capable of being resold immediately. We expect that indirect incentives, like **green supporting or brown penalising factors under Solvency II, might be justified but might not necessarily have the full envisaged effect just by themselves**, as risk capital sometimes plays a secondary role in investment decisions. However, delayed transitioning of asset portfolios may suffer from insufficiently deep markets at the time the transition occurs and some assets may become stranded assets. We encourage pension funds and insurers to anticipate these asset transition risks.

We support the direct facilitation and development of investments especially structured **green bonds relating to debts or loans for transition projects**. Governments and Central Banks may need to provide guarantees on such bonds and the credit risk levels of different tranches within such structures will need to be clear. Such structures could make direct support of transition projects more attractive for insurers and pension funds because of their long-term horizon, stable guarantees, attractive interest rate expectations and denominations that may be accessible to smaller undertakings.

To address the current lack of sustainability data, i.e., data about whether investments (on the asset side of the balance sheet) or insured exposures (on the liability side) are sustainable or not, and to reach a common understanding regarding which economic activities and which financial products are sustainable or not, we support the development and the use of a science-based taxonomy such as the one initiated by the EU Commission, as well as the establishment of Green Bond standards. Such level-playing rulebooks will also serve the purpose of fighting greenwashing.

Non-life insurance can play a major role **during the transition** in **protecting companies** against physical losses and by providing supporting services. Here, we believe that underwriting approaches that include ESG criteria in the assessment of risk exposures are important for developing sustainable solutions that price climate change risks appropriately. Companies can use such approaches to judge effectively which climate risks they are willing to take and which future effects of climate change they need to take into account when pricing or agreeing to insure such risks, as well as the economic capital they need to face these risks.

Climate protection gap

While we expect non-life insurance to continue to play a major role in protecting individuals and companies against losses arising from natural catastrophes, insurers adopting well-informed underwriting processes that **include ESG-criteria** may need to decline some coverages. Protection against some risks may need to be provided by the government or through state-supported vehicles. As climate change risk becomes climate change trend, some risks may cease to be practically insurable by the private sector alone.

Insurance protection gaps, by definition, are areas in which societal risks are not covered by the insurance industry, either because of lack of penetration, or because the risks are uninsurable in profit-oriented markets. While the former might eventually be covered by normal market forces, the latter can only be covered by public policy encouragement. We support the early identification of **potential protection gaps** arising from climate change and the development of joint solutions between the insurance industry and public protection facilities where appropriate.

Conclusion

Climate change is not just a European issue. Solving the climate crisis will need action not only from European actuaries or European insurance and pensions undertakings. We also need a global view. Ideally, there should be no worldwide inconsistencies or local European regulatory loopholes that can be exploited to manoeuvre around risk-based and scientifically evaluated assessments of any of the topics mentioned above. We as the AAE stand ready to support development of comprehensive, proper carbon and pollution accounting and valuation approaches to make any such loopholes more transparent.