Financial education and sustainable finance: investing in the future

The role of the insurance sector to support the transition from brown to green economy

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I would like to thank the organisers for inviting IVASS to participate. The title of this conference is very significant and effective. Financial education and sustainable finance are two fundamental investments for the future, which are closely linked to one another.

The insurance industry – and in particular the larger companies – have long since become aware of the role and responsibility that their action has in the transition to a circular, eco-sustainable, low-carbon economy.

The traditional contribution of the insurance sector to economic development is twofold: as a professional operator able to offer cover for the risks to which businesses and households are typically exposed and as an institutional investor.

Seizing the risks and opportunities associated with climate change requires new tools and sensibilities. Traditional time series or past experience are now no longer sufficient to estimate the probability and impact of climate events; they must necessarily be supplemented with probabilistic projections and a focus on future climate scenarios. At the same time, already in the transition phase from a brown to a green economy, the selection of sustainable investments requires that the foreseeable impact of climate change-related trends on the value of the securities be carefully factored in.

Climate change requires an update of the insurance culture of insurers, distribution networks, households and businesses.

The role of the insurance sector to support the transition from brown to green economy

There are three strategic guidelines for the insurance sector to support the transition towards balanced, fair development: innovating products, directing investments towards sustainability and developing insurance culture.

IVASS has conducted two climate change studies. The most recent of these, in 2018, investigated the level of preparedness of the main insurers and the strategies adopted in terms of mitigation and management of the related risks and of investment policies. This was also done in the light of a regulation introduced by IVASS in 2018 (article 4, paragraph 2 of IVASS Regulation 38/2018) which was among the first in Europe to require the boards of directors of insurance companies to consider environmental and social risks in business planning.

In 2019 we launched two more data collection initiatives[1].

The analysis showed, in particular, that:

- insurance companies are in many cases already increasing the share of "green" investments focused on environmental, social and governance (ESG) profiles;
- about half of the sample surveyed explicitly considered the impact of climate change on their investment portfolio while, in some cases, the development of a "responsible investment" strategy is in the process of being defined;
- carbon intensive exposures are not significant (between 0 and 6% of investments) with some entities having already zeroed their equity exposure to issuers classified as non-green-oriented, while others have undertaken to do so over the next few years;
- the largest insurers have adopted policies to contain and gradually phase out insurance protection offered to countries/sectors/initiatives that are significantly dependent on the coal sector (e.g. for the construction of new fossil fuel power plants). Attention is also being paid to the search for an ongoing dialogue with issuers, customers and other stakeholders in order to monitor their environmental plans and strategy for a transition to low-impact activities.

The importance of governing the transition at the global and local level is entirely evident.

The environmental and industrial policy choices of governments and other authorities will have to modulate interventions and incentives over time so that investors and

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[1] The first sought to assess financial sustainability factors and risks in view of the revision of the prudential requirements of the *Solvency II framework* (the opinion was published on the EIOPA website on 30 September 2019: https://eiopa.europa.eu/Publications/Opinions/2019-09-30_OpinionSustainabilityWithinSolvencyII.pdf). The second concerned the voluntary implementation by insurers of the TCFD Final Recommendations, in view of the drafting of an IAIS-SIF paper.

subscribers are able to adequately assess prices and risks during the transition to a low-carbon system, and more generally to create an environment capable of managing the social and employment effects of this phase. A "good" transition must aim first and foremost to make non-environmentally sustainable companies sustainable ('*greening the brown').*

For their part, insurance companies are preparing to support the transition with new forms of cover. One example of this is the development of insurance products with an environmental and social impact:

- *products with high environmental value*, such as those covering the risks associated with the production of renewable energy in case of low solar radiation. Similar contracts cover underlying risks relating to: the intensity and distribution of rainfall; the degree of snow cover; heat waves and drought in the agricultural sector; and high and low temperatures**.** Forecasts use corrected, recalibrated time-series based on probabilistic models of future climate scenarios subject to continuous refinement;
- *anti-pollution products*, pollution liability policies which indemnify the costs of urgent, temporary interventions to prevent or limit indemnifiable losses.

On the investment front, insurance companies hold investments totalling 923 billion euros, of which about 256 billion euros in shares and corporate bonds. “Responsible” investment choices by the insurance industry can provide a strong boost towards sustainability.

The industry is already convinced that, in a medium-long term perspective, investments in companies with a low carbon footprint or with adequate safeguards against the potential impacts of climate change yield attractive economic returns, especially when compared to the expected trend of investments in non eco-sustainable businesses.

The first green bond was recently launched by a major insurance group, designed to raise resources to invest in projects with low environmental impact. This is a particularly interesting possibility because it complements the offer of similar products by industrial companies to finance projects with a positive impact on the environment. It is a clear example of how insurers can bring non-speculative finance to innovative projects and sustainable development objectives.

However, it bears recalling that insurance companies the world over invest heavily in government bonds; in Italy the share is in just over 50% of total investments where the risk is borne by insurers. It would be very important to fund national plans to support the transition by issuing 'green' bonds. Some countries have already embarked on this path. I am certain the insurance industry would not fail to do its part.

Management of transition risks would also benefit from the development of the market for “cat bonds” (catastrophe bonds), securities the performance of which is conditional on the non-occurrence of a given catastrophic event, such as flooding. They represent an alternative to more traditional forms of reinsurance and, at the same time (for institutional investors), are decorrelated from financial market performance.

To support the transition, it is important that companies, including insurance companies, provide quality, science-based, non-financial disclosure of strategies and actions to govern the transformation process.

The initiatives described are important and provide tangible evidence of the increased sensitivity to the issue of transition. It is essential, especially during this initial phase, to define an institutional framework favouring sustainable development that is clear and harmonised at European level, made up not only of rules. We need a common taxonomy. Results should also be certified by recognised independent entities.

Raising awareness of environmental risks among households and businesses: from risk prevention to risk transfer.

Stopping and managing the consequences of climate change require the combined efforts of institutions, businesses and individuals. Let us look at them in this order.

As noted by the Governor of the Bank of Italy on 26 September[2], at the global level the last four years have been the hottest since 1880, and last July was the hottest month since

[2] I. Visco, *Sustainable development and climate risk: the role of central banks,* Bank of Italy.

data became available. In Italy, 2018 had the highest average temperature of the last 200 years.

Moreover, Italy is, due to its geomorphological and hydrological characteristics, an area of high risk. Through increasing winter rainfall and summer droughts, climate change is increasing the frequency of flash floods and weather or water damage[3].

Italy is at the same time the European country with the greatest exposure to the risk of natural disasters (earthquakes and floods in particular) and the country with the greatest share of wealth – more than two thirds – invested in houses and real estate. This should result in the widespread use of insurance coverage to protect homes against such risks, yet this is not the case!

There are about 35 million housing units in Italy. Of these, about 15 million are exposed to flood risk (typically those located on the ground or semi-basement floors); 700 thousand are at medium to high flood risk. Despite this, only one in three homes has a fire insurance policy - already an extremely low percentage compared to other EU countries - and only one in a hundred also has flood coverage.

First of all, there is an important gap in awareness that needs to be bridged. If insurance education - as defined by the OECD - is about providing the tools to improve knowledge of risks and insurance products, then developing an insurance culture is an integral part of the policies to address the threats of environmental risks.

We need to ensure that everyone understands the potential of insurance contracts as a means of mutualising risk by transferring it from the individual to a group. *Unity means strength* could be the motto of the insurance approach. In addition to an understanding of this concept, there must be an ability to appreciate risks, an adequate level of knowledge of insurance products and an ability to apply this knowledge in order to make coherent, rational decisions. Adequate insurance literacy should also make it possible to understand when it

[3] See R. Cesari and L. D'Aurizio, *Calamità naturali e coperture assicurative: valutazione dei rischi e politiche opzioni per il caso italiano,* IVASS volume no. 13.

is appropriate and useful to seek qualified professional support from an insurance intermediary.

To respond to the risks associated with climate change and to those resulting from natural disasters more generally, it is therefore important to strive:

- to improve the awareness of individuals and companies of the existence and intensity of risks and the possible consequences for assets (such as homes and industrial buildings) or for the sustainability of the business;
- to spread basic knowledge of insurance instruments capable of transferring and mitigating the negative effects of a natural disaster, together with details of how they function (deductibles and excesses) and how this may affect the amount of risk transferred and therefore the amount of the premium;
- to make it clear that maximum effectiveness in terms of protection is achieved when effective prevention measures are taken, at either a territorial level or at the level of individual assets and infrastructures (embankments, compliance with town planning instruments, construction and renovation in compliance with standards, climate-controlled greenhouses, etc.), capable of mitigating the "residual" risk and thus containing the insurance premium and in general achieving the best result in terms of resilience.

It is no coincidence that many of the most innovative insurance products pay great attention to prevention through the inclusion of benefits for "virtuous" behaviour (for example, in the presence of environmental certification) or through the definition of risk management models that integrate insurance coverage with government intervention, or that involve entire industrial areas and districts. A resilient environment and active prevention policies are of significant importance in formulating insurance coverage.

In short, the challenge is to improve insurance literacy, to increase the culture of prevention and mutualisation of risks, including climate risks.

To this end, with financial support from the Ministry for Economic Development IVASS has promoted an insurance culture test aimed at the Italian population. The initiative, which is also unique at the international level, aims to create a system for measuring insurancespecific knowledge and skills. The work has begun in the last few days; the results of the survey, which will become available next year, will make it possible to design more targeted training actions to drive informed choices that best meet the risk coverage needs of businesses and households.