SUSTAINABILITY RISKS IN INSURANCE

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Integrating sustainability considerations in risk management

Currently, integrating sustainability considerations in the risk management is one of the most challenging objectives of insurers.Sustainability considerations could affect the company's performance and value, especially in the long-run. Achieving this objective certainly requires significant adaptations to how insurers manage their risks and business. This is not an easy task.

Difficulties mainly arise because of the complexity of the nature and impact of sustainability risks. These can affect both assets and liabilities and can include the mitigation of the risks influencing the value and performance of the company (outside in) as well as the impact of the company's activity on sustainability issues (inside out). The latter, in turn, could affect the value of the company given their reputational consequences.

Most of these challenges obviously depend on the uncertainty about a clear classification of sustainable activities. The EU Taxonomy, together with the consequent enhanced transparency of financial entities and markets, is going to shed light on that, but more work is needed to complete the classification and to provide indications on how to apply the classification in practice. The level of alignment between what is classified as sustainable and its actual riskiness, in terms of expected losses for the insurers, also remains to be considered.

Sustainability risks, in general, do not materialize as specific risks, but affect the profile of other, more traditional risks. Climate risk, for example, affects market risk on the asset side via transitional risk, through the potential change in value of "brown" assets, as well as underwriting risk on the liability side, due to the increase of damages resulting from natural events. This implies a change in the approach and methodology used up to now to manage those risks.

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The challenges on the identification of these risks add to the inherent difficulties to measure them. The historical data that are necessary to produce estimates are still lacking and, very often, estimates require a forward-looking approach. The measurement and management of sustainability risks, in general, do not follow the logic and metrics of traditional risks and sometimes build on factors that are not under the control of insurers, or are even unknown to them. This is the case, for example, of transitional risks, which depend on the modalities and pace of the public policy actions for a transition toward a sustainable world.

It is understandable that those challenges are limiting the insurers' capability to identify, measure and mitigate sustainability risks and to set a strategy and a governance to drive the business accordingly. The integration of sustainability considerations is a work in progress and a lot of work remains to be done.

Climate risks are now the focus of attention and, in this context, transitional risks seem to be the most addressed. Organizational and governance safeguards within companies are heterogeneous and mainly dependent on the size of the insurers. The measurement of the specific effects of climate change on expected losses is still difficult. Pricing of relevant coverages relies mostly on the annual repricing in order to consider the long-term effects of climate risk.

As in the case of the introduction of the risk culture in the management of insurers, which the implementation of Solvency II has enhanced, the regulation itself could be a catalyst of the integration of sustainability considerations in risk management. Regulators and standard setters are working extensively in this field, even if at the moment this is mainly limited to environmental aspects and, among those, climate change considerations.

The work of EIOPA in relation to climate change, for example, spans from Pillar I aspects (e.g. NAT CAT capital charge), to risk management enhancement (e.g. scenario analysis in ORSA), from disclosure (e.g. KPI) to business considerations (e.g. "impact underwriting"). IAIS has also set an ambitious work plan. However, also in terms of regulations and standards, further work remains to be done.

What is important, I think, is that both regulators and the industry remain committed to sustainable objectives, but using risk based regulations and practices, supported by a proper cost-benefit analysis. They should openly cooperate to cross fertilize the knowledge of these risks, develop methodologies, collect relevant data to measure them, and enhance transparency in the market.

It is a long journey, to approach with perseverance and balance. We should avoid that the mitigation of sustainability risks leads to reducing the accessibility of coverages and increasing the protection gap, which in some regions is already too wide. This would limit the widely recognized contribution that insurance should make in the path toward a more sustainable world.