MANAGING ESG RISKS
A LOOK AT INSURERS’ JOURNEY

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Angela has 20+ years experience in insurance. She started her career with Winterthur International in Casualty Underwriting. At Chubb Insurance Europe she led the finance and operations area. Since 2012 she is with ZHAW focusing on the management of insurance companies, business model innovation and risk governance. Angela holds a Ph.D. from the University of St. Gallen, MBA from California State University and an Associate in Risk Management (ARM) of The Institutes.

Some current research projects and publications
- [Risk Manager Insights for Insurers](#) – study series
- [Risks and their handling in Smart Homes](#) - project
- [Platform economy in insurance](#) - project
- [Implication of individualization in insurance](#) - study
- [Insurability of pandemic risk](#) – SVV publication
- [Publications](#)
While there is general agreement that ESG factors represent the main three pillars of sustainability, a single definition of ESG factors is lacking.

- ESG factors are environmental, social or governance characteristics that may have a positive or negative impact. Risk management typically focuses on effects of current and future assets and liabilities, financial performance, liquidity or solvency.

- ESG risks are events or conditions related to environmental, social and governance aspects that if they occur have potential or actual negative impacts on the financial position, performance, reputation of the entity. (BaFin, 2019)

### Environmental aspects
- Climate mitigation; adjustment to climate change; protection of biodiversity; the sustainable use and protection of water and maritime resources; the transition to a circular economy; the avoidance of waste, and recycling; the avoidance and reduction of environmental pollution, the protection of healthy ecosystems; sustainable land use

### Social aspects
- Compliance with recognised labour standards (no child labour, forced labour or discrimination); compliance with employment safety and health protection; appropriate remuneration, fair working conditions, diversity, and training and development opportunities; trade union rights and freedom of assembly; guarantee of adequate product safety, including health protection; application of the same requirements to entities in the supply chain; inclusive projects and consideration of the interests of communities and social minorities

### Governance aspects
- Tax honesty; anti-corruption measures; sustainability management by the board; board remuneration based on sustainability criteria; the facilitation of whistle blowing; employee rights guarantees; data protection guarantees; information disclosure

(...sustainability risks should be understood as risks that could affect the insurance and reinsurance undertakings' risk profile, on the investments and liabilities side, due to ESG factors”. (EIOPA, 2019)

BaFin (2019); COSO and WBCSD, (2018); EIOPA, (2019); European Banking Authority, (2020); Pfeifer & Langen (2021)
Sustainability (ESG) risks impact all risk categories

Credit risk/counterparty default risk: Providing a loan to an entity with a business model that is significantly negatively affected by political decisions on ESG issues.

Market risk: Investing in companies who do not demonstrate sustainable management or do not use the invested monies for transition towards sustainability.

Liquidity risk: Bank run after a catastrophic flood. The credit institution has to sell assets to cover these outflows.

Insurance risk: Homeowners' insurance as well as business interruption claims rise unexpectedly as a result of storms, floods or hail.

Strategic risk: A credit institution specialized in financing coal mining loses the basis of its business.

Reputational risk: The entity holds investments in a clothing factory owned by a well-known brand. The factory burns down as a result of inadequate safety standards, workers die. Reports in social media also name investors.

Operational risk: A catastrophic flood destroys branch offices.

Based on BaFin (2019)
Climate change is current focus of the industry

Insurance industry observations:

➢ ‘Asset side approach’ is more developed than the liability side
➢ What concerns are liability risks: Who will next generations hold responsible?
➢ Spelling out possible scenarios is a worthwhile exercise to gain insights as interdependencies are complex
➢ Also deliberately using simple methods is valuable rather than creating control illusion with complex models
➢ Many organizations share climate scenarios, see some in the appendix

Physical risks are related to actual climate change and the impact on the value of assets and liabilities. Can be driven by events or longer-term shifts in climate patterns.

Transition risks are seen as an uncertain consequence of the transition to a sustainable, low-carbon economy such as public policies, regulations, technological advancement, market conditions and other aspects of societal transition that affect the level of climate change risk and the future risk landscape.

Golnaraghi, (2021); Stanislav, (2020); DAV, (2021)
“Differentness” of ESG risks from risk management perspective

Diverse factors and characteristics have uncertain but potentially material impacts over diverse time horizon.

ESG risks affect both sides of an insurer’s balance sheet.

Complex interdependencies but also negative externalities complicate adequate pricing of ESG risks.

Societal, regulatory and customer expectations are rising and have manifold effects.

The benefits for companies taking an active role in developing an ESG approach not only helps mitigate reputation risk to their organisations and manage societal expectations but will also help them capitalise on developing understanding of the financial benefits of clients with strong ESG performance”.

(UNEP Finance Initiative & PSI Principles for Sustainable Insurance, 2020)

However!

“It is not a strategy for the half-committed”.

(Cappucci, 2018)
Charging more premium for increase of natural disasters will not be the solution

Source: AXA
T. Daucourt, 15.11.2021
Taking an active role in fostering mitigation

Prevent (Frequency)

- Adjust strategy, risk appetite and limit framework
- Identify current and emerging factors, evaluate impact incl. accumulation
- Engage with peers, organizations, stakeholders
- Recruit, lead and train

Reduce (Severity)

- Optimize exposure of assets and liabilities
- Ensure governance framework incl. BCM is effective and organization resilient
- Take forward-looking, active approach incl. early warning indicators
- Leverage know-how and infrastructure (i.e. emergency response and claims handling)

Transfer (consequences)

- Co- / Re- Insurance
- Financial market transfer
- Insurance pools
- Public-private-partnerships

Engage with customers

- Role model with action, transparency & accountability
- Take active role as risk expert with research, data and consulting

- Develop new solutions
- Incentivize risk management and green transformation
Thank you
References (I)


References (II)


IFoA. (2021) Sustainability practice area: practical guides. (series),  


https://www.ngfs.net/en/liste-chronologique/ngfs-publications

NGFS (2021). NGFS Climate Scenarios for central banks and supervisors.  
https://www.ngfs.net/en/liste-chronologique/ngfs-publications


References (IV)


Wide role of risk management

The references of the UN SDG to risk management objectives and tasks are manifold (UNEP, 2020), for example:

- To what extent are ESG risks considered in client and outsourcing relationships and audit activities?
- Are ESG risks adequately reflected in the risk policy, risk appetite and policy framework?
- To what extent does the company have the necessary knowhow, risk culture & instruments to manage ESG risks?
- How well is the management of ESG risks integrated in decision-making and other processes?
- Are policy maker and regulatory changes adequately monitored across all jurisdictions?
- What is the company’s strategy and approach in contributing with expertise in managing ESG risks?
- How efficient and effective is internal and external communication about ESG risk and management?
Risk management challenges

- Narrow CSR or RM perspective
- Lack of ownership and commitment
- Inconsistency in approach and reporting
- Shortage in resources and expertise
- Lack of 3rd party management
- Uncertainty of timing and impact, irreversibility
- Methodological constraints, model risk
- Multipoint impact, non-linear effects
- Scarcity of data
- Time horizon
- Not insync with business planning
Embedding ESG in Risk Management

1. Analyzing risks related to business model against the background of ESG issues
2. Formulating and communicating risk strategy and risk appetite
3. Operationalizing appetite into actionable targets, limits and control framework
4. Revising and testing the policy framework to reflect ESG aspects

- Communicating and disclosing risks and actions to int. and ext. stakeholders
- Fostering expertise, accountability and dialogue across the organization
- Reviewing risk (emerging) risk management processes and running ESG scenarios
- Updating decision-making guidelines and escalation procedures
- Analyzing risks related to business model against the background of ESG issues
- Formulating and communicating risk strategy and risk appetite
- Operationalizing appetite into actionable targets, limits and control framework
- Revising and testing the policy framework to reflect ESG aspects

Picture source: Unepfi (2020), p. 6
Embedding ESG in Risk Management
Example: climate scenario

➢ An exercise of high **complexity** due to interdependencies

➢ **Challenging time horizon** as climate change perspective tends to be considerably longer than business planning horizon, e.g.: (EIOPA, 2019)

  ➢ Current climate change: “up to today” records of the impact of climate change
  ➢ Short-term climate change: projected view of climate change for the next 5-10 years
  ➢ Mid-term climate change: projected view of climate change for the next 30 years (by mid-century)
  ➢ Long-term climate change: projected view of climate change for the next 80 years (by end of century)

“The insurer should identify and simulate scenarios, which are plausible and relevant to the insurer, while factoring in the interlinkages between environmental risk and other risks”. (MAS, 2020)