Zürcher Hochschule
für Angewandte Wissenschaften

School of
Management and Law

MANAGING ESG RISKS
A LOOK AT INSURERS' JOURNEY

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(Slides have been developed for training purpose with Singapore College of Insurance)

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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

(Not) defining ESG risks

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(…) 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)

Environmental aspects	Social aspects	Governance 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	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	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

- 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)

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

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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.

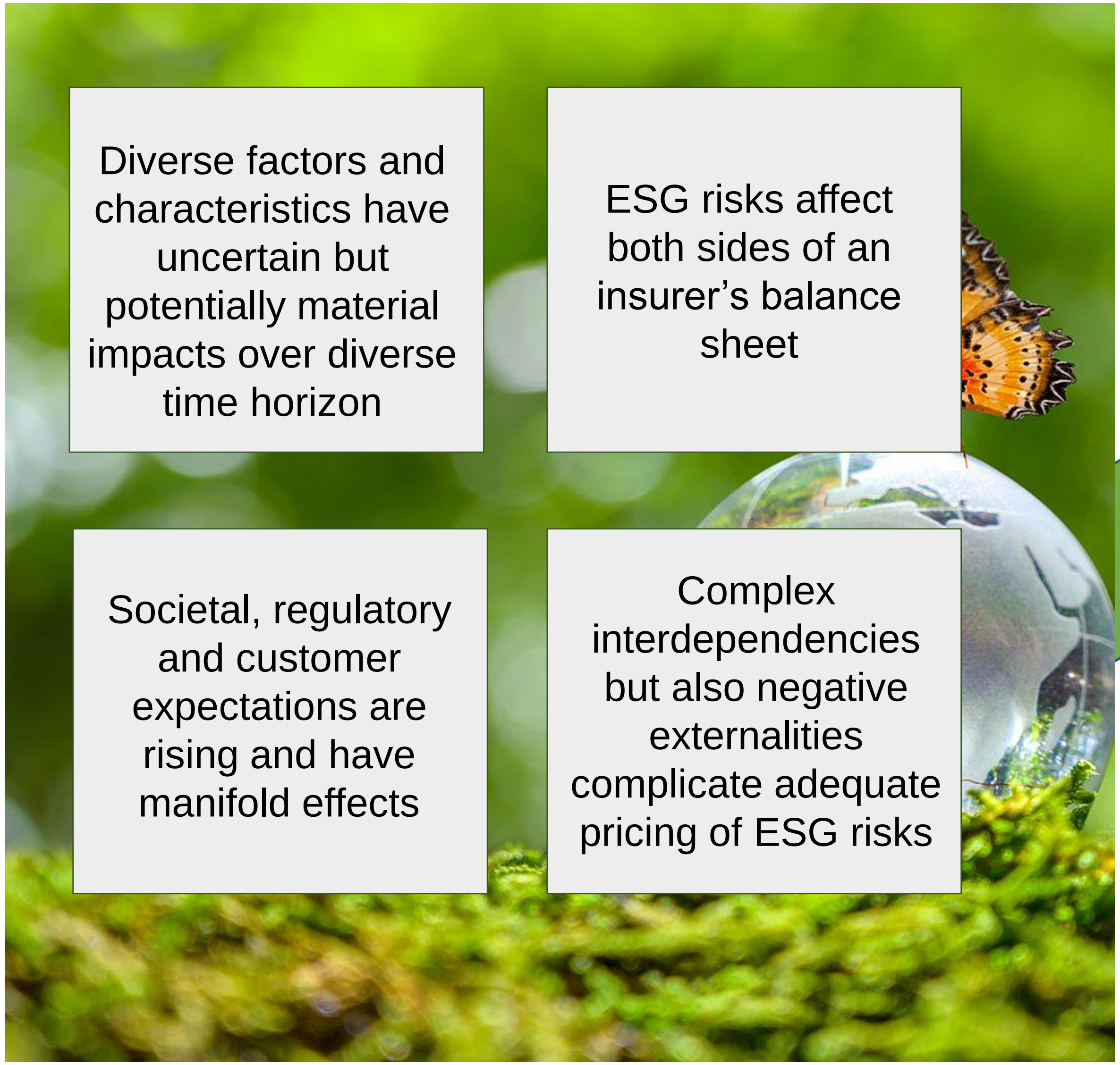
Transition risks are seen as an uncertain consequence of the transition to a sustainable, low-carbon economy such as public policies, regulations, technological advancement, market conditions and other aspects of societal transition that affect the level of climate change risk and the future risk landscape.

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 worthwile 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

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

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

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

ESG related risks

identify

evaluate

manage

monitor

report

“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)

Source: AXA
T. Daucourt,
15.11.2021

Taking an active role in fostering mitigation

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	Prevent (Frequency)	Reduce (Severity)	Transfer (consequences)
'Own' risk response	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	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	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	Leverage know-how and infrastructure (i.e. emergency response and claims handling)	Develop new solutions Incentivize risk management and green transformation

Thank you

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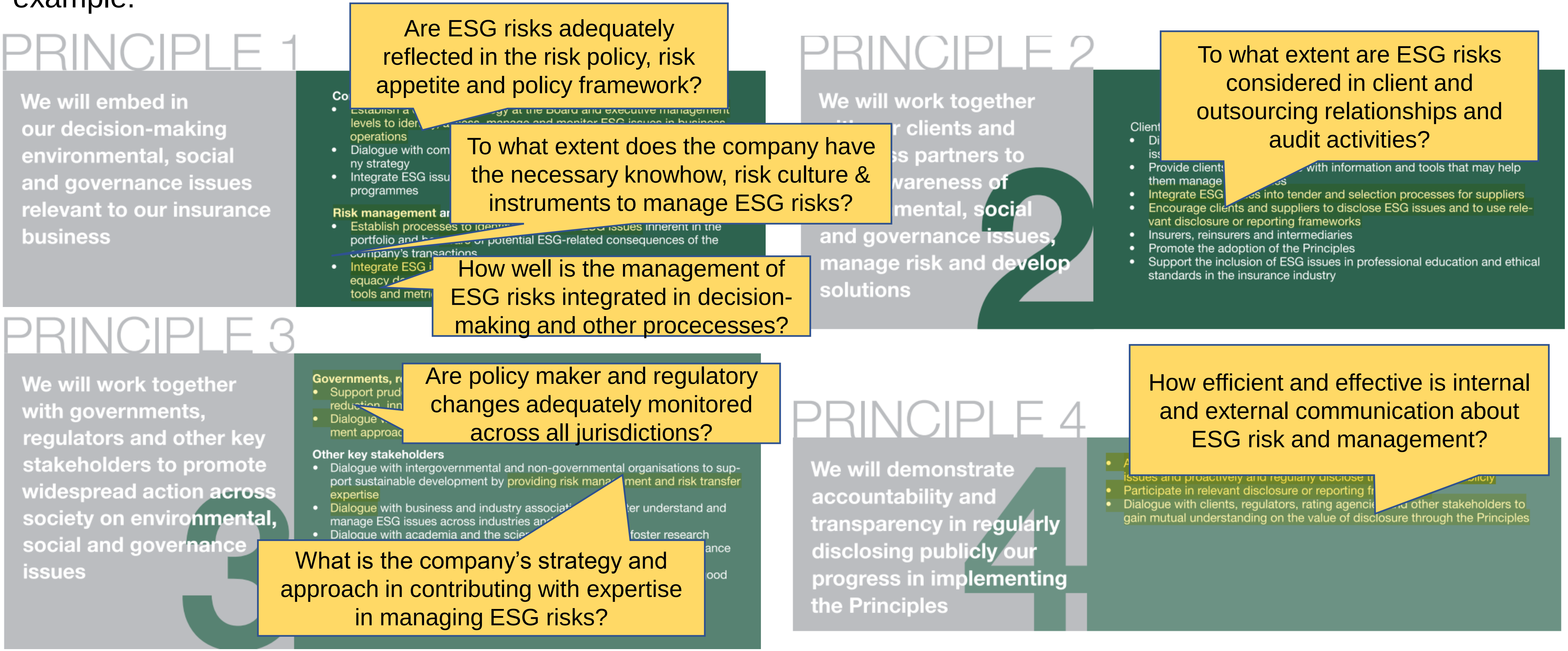
Wide role of risk management

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



Risk management challenges

Narrow CSR or RM perspective

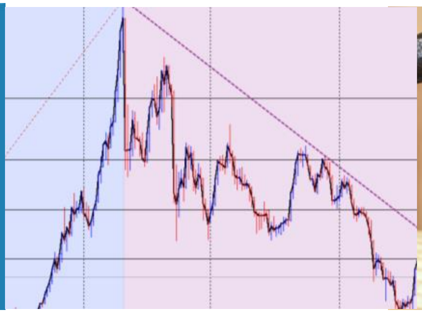
Lack of ownership and commitment

Uncertainty of timing and impact, irreversibility

Methodological constraints, model risk

Multipoint impact, non-linear effects

Scarcity of data

Inconsistency in approach and reporting

Shortage in resources and expertise

Lack of 3rd party management

Time horizon

Not insync with business planning

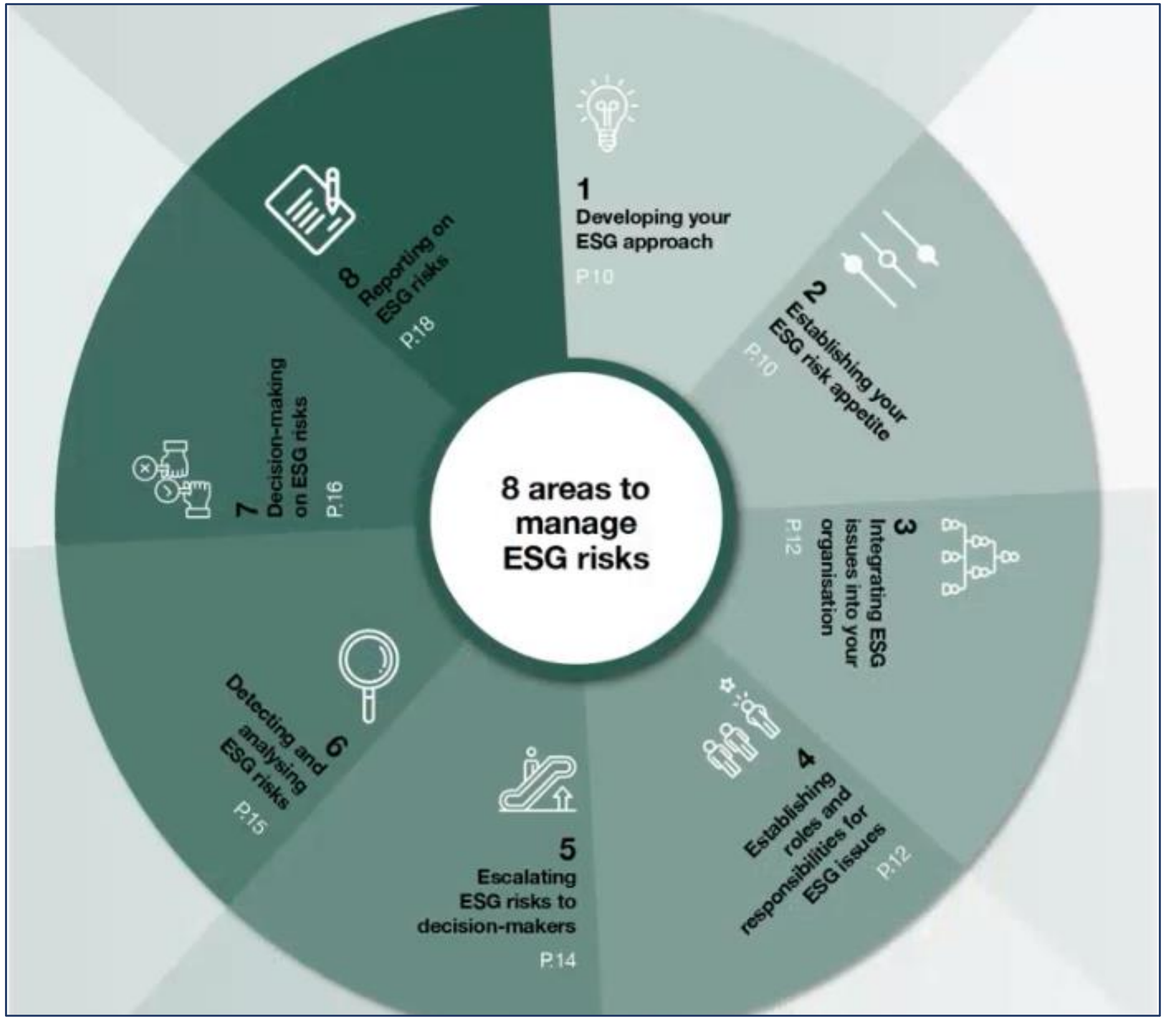
Embedding ESG in Risk Management

⑧ Communicating and dis-closing risks and actions to int. and ext. stakeholders

⑦ Fostering expertise, accountability and dialogue across the organization

⑥ Reviewing risk (emerging) risk management processes and running ESG scenarios

⑤ Updating decision-making guidelines and escalation procedures



Picture source: Unepfi (2020), p. 6

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

Embedding ESG in Risk Management
Example: climate scenario

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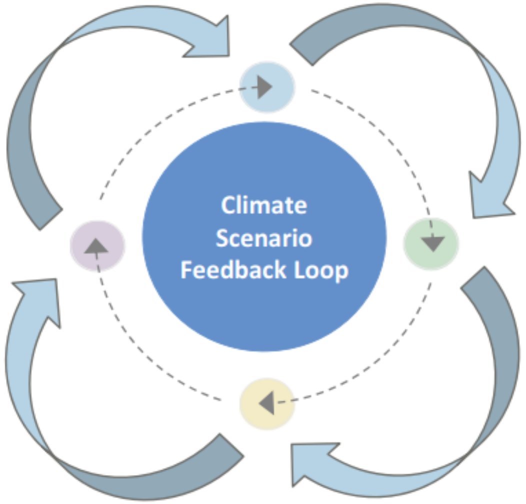
The socioeconomic context lays out the scenario backdrop, defining the economy's tolerance for climate change

The emissions pathways represent trajectories of greenhouse gas concentrations in the atmosphere. These concentrations result from the interaction of the three previous factors, and influence the scale and nature of physical climate impacts. Different pathways reinforce or abate the socioeconomic challenges



The **climate policy landscape** is represented by policy ambition, which is in large part influenced by socioeconomic challenges

(FCA, 2021)

Technological evolution influences the economy's ability to effect and cope with transition. Policy has an important role in facilitating technological evolution and diffusion

"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)

- 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)