DeNederlandscheBank

EUROSYSTEEM

“Are we doing enough?”

Speech by Frank Elderson at EIOPA 9th Annual Conference
19 November 2019

At EIOPA’s 9th annual Conference, Frank Elderson was asked to present a keynote speech. In this speech Elderson explains how climate change impacts insurance companies and pension funds. He also describes the efforts the different parties in the field have taken, in order to discuss whether these efforts are enough.

This year, 2019, has been a year of great momentum. No time to sit back, but we must take some time to look back and see how far we have come. EIOPA has come a long way in addressing climate and sustainability. And I would like to commend EIOPA, under the leadership of Gabriel Bernardino, for this. It is encouraging to see how much progress we have made. This needed all hands on deck. Not only from the financial sector, but from national and international regulators, as well as the government. And this is what we have done.

But before I highlight some of our achievements, I want to ask you a question. One important question for all of you. About climate change. A question to which I would love to hear your answers: Are we — we as supervisors, central bankers, and the financial sector — are we doing enough? Doing enough to manage and prevent climate risks?

When we will be looking back, in ten or even only five or three years from now… Will we be convinced that the level of ambition we showed in November 2019 was proportional to the scale and magnitude of the problem, as it was already abundantly known at that time? This is an important question that we need to keep asking ourselves. As we continue on our journey of embedding climate-risks into our practices. Both in the sector, and in our supervision.

How climate change impacts insurance companies and pension funds

We all remember the scorching heatwaves and droughts of recent years. 18 of the 19 hottest years have all been this century. You all will have seen the images of flooded Venice, where San Marco square is now completely shut off by local authorities, after the second-worst flood ever recorded… Heatwaves, hail storms and floodings have a direct impact on the economy. Reduced productivity… More epidemics and transport disruption… These are just a few of the effects we experienced this summer. Climate-related events and disasters like these present physical risks to the financial sector. And they are of course extremely costly: Insured losses have risen five-fold in the past three decades due to extreme weather.

Heatwaves and other natural disasters have a drastic impact on human health. Life and health insurers face mounting claims. Non-life insurers and reinsurers also bear the brunt of claims from property damage caused by storms. The 2018 EIOPA stress test showed that reinsurers are hit particularly hard by losses from natural disasters. Piling extra pressure on this sector. Events in other countries could also lead to higher foreign currency risks. And these effects cascade through the sector. This also brings to mind the issue of the Protection Gap that EIOPA recently studied. Only 35% of losses due to extreme weather and other weather events are insured. That leaves 65% of economic losses uninsured.

This begs the question: will these climate risks still be insurable for the sector or even be affordable for consumers in the future? And what can we do about those potential uninsured losses?
Are we doing enough to address this issue? And then there is the transition to a sustainable economy. This transition also exposes insurers and pension funds to risks from adapting to new climate policies, rapidly advancing carbon-neutral technology and changing market conditions.

But a low carbon economy will ensure sustainable growth and financial stability. A smooth transition is paramount: In 2018 DNB conducted a stress test for a disruptive energy transition. We concluded that it could lead to severe losses for Dutch financial institutions.It is likely that this also applies to financial institutions outside the Netherlands.

Steps taken by insurance companies and pension funds

Insurers and pension funds did take important steps to integrate sustainability in business models and risk management practices. Good progress has been made in Risk management. Many institutions are embedding climate risk into their risk management. And climate change is also discussed and strategized more often in the boardroom. What's more, we see institutions conduct scenario analyses. This helps them better understand their risks on the liability and asset-side.

This is a big leap in the right direction. However, forward-looking risk management methods still need to be refined. This includes improved scenario analyses: to better understand the effects of climate-related risks on the institution. We have seen insurers conducting these. Next to this is modeling climate change trends and Nat Cat.

I do agree that this comes with a challenge. We cannot predict the future. However, we cannot and must not depend only on historical data to predict the future, certainly when the changes we are seeing are without precedent. Failing to include climate change trends in models, will undoubtedly result in a failure to estimate its impact.

Effective risk management should take place, through better informed investment decisions and through considering sensitivity of assets to the energy transition. This includes insurers assessing how best to integrate ESG criteria. Not only in their underwriting practices, but also in their investment decisions. Insurers should also keep customers informed by reporting on sustainability. A DNB study has shown that most Dutch institutions now publish an ESG report. I know that Dutch institutions are not alone in this.

Institutions have developed a method to measure the carbon footprint of their investments and loans. They do this through the Platform for Carbon Accounting Financials (PCAF). The Platform helps financial institutions to disclose and align investments with the Paris Agreement.

Such methods are vital for investment practices. This is because major institutional investors, insurers and pension funds have potentially large exposures to transition risks. Stemming from the carbon-intensive assets on their balance sheets.

The investment portfolio of European pension funds and insurers together amounts to over 15 trillion euros. Over 15 trillion euros to be invested… The volume of green bonds and products is rapidly growing. Think about investments in renewable energy. To achieve the EU's 2030 goals of the Paris Climate agreement, including a 40% cut in greenhouse gas emissions, we need to bridge an investment gap of 180 billion EUR per year. We should be able to achieve this with the collective volume of investments we have in this room today.

A higher allocation to green investments could slow the rate of climate change. This also serves to decrease the risk on the liability-side. But, again, we need to keep asking ourselves: Are we doing enough to lower risk?

Role of supervisor and regulators

We cannot talk about progress without discussing the role of supervisors and regulators. Climate risk transcends borders. The scale of the challenge calls for a national and international supervisory and regulatory approach. At national, European and global level, much work has already been done to embed climate-related risks into our supervisory practices and regulation.

Following the European agenda, EIOPA has developed an opinion for the incorporation of sustainability into the Solvency II framework and has also delivered its opinion on the European Commission's Sustainable Action Plan. One of the EC's most important projects is the development of a taxonomy. This taxonomy provides a uniform definition of which activities or financial instruments could be considered environmentally sustainable.

This will allow us to better see where the risks and opportunities are and gives us a clearer path towards the Paris goals. This will ultimately help insurers and pension funds to determine their investment strategy.

De Nederlandsche Bank is also working to take into account climate-related risks in our supervisory framework. Here, we see scope for insurers to take all material risks into account in the Own Risk and Solvency Assessments (ORSA). We have developed and published a good practice document that gives insurers more guidance on how to deal with these risks. For example, as part of their risk management and through scenario analyses.

And then there are initiatives on a global level. The establishment of the Network for Greening the Financial System (NGFS) has brought together central banks and supervisors from all over the world, aiming to aid a smooth transition to a low carbon economy and to strengthen the efforts of the financial sector in achieving the Paris goals. The Network will create a document for financial institutions, including asset managers, on good practices for conducting risk analyses. This will be a compilation of methodologies practiced in the market, focused mainly on case studies on Environmental Risk Assessments by financial institutions. The NGFS will also produce a handbook for supervisors on how to assess the climate-related risks of individual firms. We hope this work will be valuable for both the sector and regulators.

The Sustainable Insurance Forum (SIF) and the International Association for Insurance Supervisors (IAIS) have joined the NGFS as observers. They are raising awareness and making a valuable contribution to our work. Next year, the IAIS will publish an application paper on climate-related risks. This paper aims putting these risks in the context of the global standards for insurance supervisors. The global standards that are leading for all 200 IAIS members all over the world.

There is still more that needs to be done and major milestones to reach, too: supervisors need to continue to build and refine their knowledge on these risks and setting further expectations for the sector. Governments still need to further discuss the protection gap and the issue of a carbon tax…. A carbon tax cannot come quickly enough. The implementation of robust climate policy can prevent further burden and costs for the economy.

Beyond climate
And speaking about risks, other risks are coming into view… Almost all governments have decided on the Paris agreement - and these decisions may lead to transition risks I spoke of earlier. And other global challenges might also lead to comparable global agreements. And thus to new policies, rules and regulations. And hence new transition risks might occur: from biodiversity loss for instance, from water scarcity, from resource scarcity more in general and from human rights abuses.

These are addressed in the UN Sustainable Development Goals. Yet they also bring financial risks with them. Financial risks that must be managed. Financial risks that must be supervised. Just as climate related risks lead to financial risks via the physical and the transition channel, so does - via similar channels – biodiversity loss translate into financial risk. As does water scarcity. And resource scarcity more in general. And human rights abuses. All these financial risks must be managed. And the management of all these financial risks must be supervised.

A recent study published by De Nederlandsche Bank found that the majority of Dutch financial institutions have committed to contributing to the SDGs and various sustainability standards and frameworks. The challenges that the SDGs aim to address, if not considered, ultimately will affect the operational environment, the risk management and the business of financial institutions. Above all, these challenges are interlinked. With climate change and rising temperatures comes a decline in biodiversity, in water scarcity, and mass migration.

We cannot afford the luxury of ignoring these interlinkages. We cannot afford the luxury of ignoring the multiple and related risks. We cannot focus solely on addressing the risks related to the climate-change during the next decade and only then – somewhere around 2030 - turn our attention to biodiversity-related risks. Or water scarcity. We will need to look at and deal with all these challenges at the same time. Which is now.

Supervisors and Central Banks understand that climate change and the transition lead to risks on the one hand and business case opportunities on the other hand. That is why this issue falls within our mandate as supervisors and that is why we are speaking out on this matter. That is why we expect financial institutions to develop sustainable and responsible business practices and to invest responsibly. That means taking SDGs into consideration to ensure responsible decision-making… taking into account all the relevant risks. Do we do enough?

We have made relevant progress. And I have mentioned an array of activities we are already undertaking. But there are still many things to work on. Many goals we must still strive towards. Steps have already been taken: I have mentioned the Network for Greening the Financial System (NGFS), Partnership for Carbon Accounting Financial (PCAF), the Commission's Action Plan on sustainable finance, EIOPA's opinions published in July, climate stress tests and various national initiatives.

We are all aware that there is a need for change. If the climate is changing then so must we. But although we have come very far… Every step of the way, we need to remind ourselves not to ask whether we already have done a lot, but rather we should ask ourselves: are we doing enough?