June 2019

ClientEarth response to the UNEP FI PSI Consultation

Underwriting environmental, social and governance risks in non-life insurance business

1 Introduction

1. ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, New York and Beijing. ClientEarth's Climate Finance Initiative conducts research into the legal implications of climate-related financial risks for a wide spectrum of market participants, including insurance companies and regulators. We also engage with these stakeholders in relation to the specific and systemic risks of climate change.

2. In February 2019, the Principles for Sustainable Insurance (**PSI**) published a consultation paper (the **Consultation**) seeking views on draft guidelines for integrating ESG risks into non-life insurance underwriting (the **Guide**)

3. This document provides ClientEarth's general comments on the Consultation (section 2.1) as well as specific comments on sections of the Guide (section 2.2) and the heat maps (section 2.3) (the **Response**).

Please do not hesitate to contact Stephanie Morton (smorton@clientearth.org) for further information on anything contained in this Response.

2 Comments

2.1 General Comments

4. We are pleased that the PSI is encouraging industry participants to share their approaches to managing ESG risks. Collaborations of this kind are key to spreading good practice across the sector.

5. We understand that the Guide is seeking to address all ESG risks, including climate change which is referred to in both heat maps. ESG risks are wide-ranging and some ESG risks, such as climate change, can have material financial consequences for insurers whilst others may be more reputational in nature. We consider that the introductory section of the Guide (perhaps in section 6.3) should clearly state that ESG risks have varying implications, with some being financially material. For financially material risks, there may be legal requirements for insurers to include these risks in their mainstream risk frameworks.

6. While this Response only addresses risks arising from climate change, our comments might equally apply to other ESG risks with severe legal and financial consequences such as corruption and pollution.

7. The management of climate-related risks is receiving increasing focus from financial regulators. For instance, EIOPA has confirmed that financially material sustainability issues already fall within the Solvency II risk management framework.[1] Likewise, the UK Prudential Regulatory Authority (**PRA**) recently published its expectations on how insurers should be managing the risks from climate change under existing law.[2]

8. Companies who are seeking to comply with these new regulatory expectations may turn to the Guide for help. It is therefore crucial that the Guide does not unwittingly propose approaches that are less stringent than those required by law. This has the potential to both confuse and legally expose industry participants. It may also undermine the efforts of financial regulators to improve the management of climate-related risks.

9. This Response draws out some examples of where such confusion may arise, but is not intended to provide an exhaustive analysis of how the Guide interacts with insurers' legal duties in Europe or elsewhere. We therefore suggest that a specific comment is included in the Guide that draws attention to the fact that legal duties may require a more stringent approach.

10. Additionally, we note that the Guide does not comment on remuneration and incentivisation relative to ESG issues. This would be an interesting topic to see included in the Guide. Financial regulators have recognised proper incentivisation structures as being important to the proper management of risks such as climate change. For instance, in a recent policy statement on climate change, the PRA emphasised that it would enquire increasingly as to how the pay of senior managers will be affected by their success or failure in delivering supervisory priorities such as climate risk management.[3]

11. Finally, a strong ESG framework is useful for many business sectors in which insurers operate. However, it may not be a catchall solution. There are certain sectors - from cluster bombs to coal and tar sands - which cannot be insured responsibly, and in such cases straightforward exclusion policies may be more appropriate than an ESG framework. Accordingly, an ESG framework should be complemented by exclusion policies.

2.2 Comments on sections of the Guide

2.2.1 Section 6.4 Establishing your ESG risk appetite

12. Pg. 10 - "*ESG issues are often those which are not regulated, but present a reputation or ethical challenge for the organisation providing the insurance-related service".*

    This sentence could be misleading. As noted in our general comments, some ESG issues present financial risks which could in many cases be material and fall within the scope of

[1] https://eiopa.europa.eu/Publications/EIOPA-BoS-19-172_Final_Report_Technical_advice_for_the_integration_of_sustainability_risks_and_factors.pdf

[2] https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss

[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2019/ps1119.pdf?la=en&hash=CD95D958ECD437140A4C7CF94337DAFD8AD962DE

existing financial regulation. For instance, climate change presents significant financial risks to underwriters and regulators such as EIOPA and the PRA have confirmed that these risks fall within their remit.

13. Pg.10 - "*each organisation must consider their financial and strategic objectives. This must be taken into account to avoid creating unnecessary detection of ESG risks which the company is unwilling or unable to manage, or potentially avoid. Ultimately, each company must make a decision on balance these objectives against ESG risks*".

    This paragraph presents ESG risks as needing to be balanced against financial and strategic objectives and suggests that organisations have a choice as to whether to manage ESG risks. This reinforces unhelpful assumptions that ESG issues are purely ethical and require a financial trade-off. In many cases, ESG risks come hand-in-hand with financial and strategic risks. For instance, climate change is not only an environmental challenge, but is also associated with significant financial losses. In our view, this statement should either be clarified or removed.

14. We believe that the key questions at the top of page 11 should be updated to reflect the points raised above. In particular:

    "*What is your senior leadership's appetite to manage ESG risk exposure?"*

    Again, this question may give the impression that managing ESG risk exposure is optional, and entirely at the discretion of the Board. This may not be the case for financially material risks such as climate change.

    "*Have you determined which ESG issues are most material across your lines of business*?"

    This question heads in the right direction, but we would recommend inserting the following additional question: "*Have you considered which risks are financially material to the business, and what legal duties there are to manage those risks?"*

2.2.2 Section 6.5: Integrating ESG issues into your organisation

15. It is clear that insurers will adopt different approaches to integrating ESG risks. Nevertheless, financial regulators are beginning to issue guidance on how this should be done. For instance, the PRA proposes that "*firms address the financial risks from climate change through their existing risk management framework, in line with their board-approved risk appetite, while recognising that the nature of financial risks from climate change requires a strategic approach*." They also comment that "*the PRA considers it unlikely the financial risks from climate change can be managed effectively from a siloed climate change function*."[4]

16. The final remark of this section appears overly permissive against this backdrop: "*There is no single best approach to ESG integration. It can be successfully carried out in a number of ways, but flexibility is key in the development internally.*" In cases where ESG risks are

[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss

financially material, those risks must be properly managed and flexibility is only key insofar as it facilitates that requirement.

The Guide currently suggests that showing cross-linkages to the core risk framework is the minimum standard required. It is questionable whether this approach would actually satisfy the minimum standard under current regulatory expectations in jurisdictions such as the UK.

Sub-paragraph 6.5(b) indicates that ESG risks may often fit within the reputational risk policy. This comment could give the misleading impression that ESG issues are chiefly ethical and primarily pose reputational risks. We would recommend removing this comment as the reputational risk policy is unlikely to be sufficient to manage financially material ESG risks.

2.2.3 Section 6.6: Establishing roles and responsibilities for ESG issues

17. Pg. 12 - "*Support from the CEO and senior executives / board members is advisable to make implementation a success*."

    Pg. 12 - "*These senior-level representatives might take individual ownership of ESG issues or form part of a wider ESG committee overseeing implementation*."

    These statements appear to present Board engagement as beneficial, but potentially optional. In the case of climate change, involvement by senior management may be legally required. For instance, the PRA requires firms to have clear roles and responsibilities for the board in managing financial risks from climate change. Indeed, the boards of UK-regulated insurers must identify and allocate responsibility for identifying and managing financial climate change risks to a Senior Management Function by 15 October 2019. We would therefore recommend adding the following key question: "*Is there a legislative or regulatory requirement for allocating specific responsibility for ESG issues such as climate change?*"

2.2.4 Section 6.7: Escalating ESG risks to decision-makers

18. The second paragraph of this section gives the example of reputational risk with regard to routes of escalation. We would recommend also giving an example of escalating financial risk in respect of ESG issues such as climate change.

2.2.5 Section 6.9: Decision-making on ESG risks

19. We would recommend making reference to financial materiality in the first sentence of this paragraph. For instance, the sentence could more helpfully be drafted as "*When analysing an ESG risk, it is important to consider i) how severe you believe the ESG risk is, ii) whether it is a materially financial risk (such as climate change), and iii) if this is a regularly occurring issue with the company or project*."

2.2.6 Section 9: Risk mitigation and good practices

20. Section 9 provides resources which may assist entities in managing ESG risks. We consider that sub-section 9.2 on climate change should be bolstered by including references to the following resources:

- The Task Force on Climate-Related Financial Disclosures

- The Paris Agreement

- Bank of England's resources on climate change, including:

    - Framework for Assessing Financial Impacts of Physical Climate Change: A Practitioner's aide for the general insurance sector

    - Supervisory statement 3/9: 'Enhancing banks' and insurers' approaches to managing the financial risks of climate change'

    - Report on the impact of climate change on the UK insurance sector

- ClimateWise

- Unfriend Coal's Insurance and Reinsurance briefings

- IAIS Issues Paper on Climate Change Risks to the Insurance Sector

- CFRO Forum Paper 'The heat is on – Insurability and resilience in a Changing Climate'

2.3 Heat maps

21. The Guide presents two heat maps: one for ESG risks and economic sector, and another for ESG risks and lines of business. It would be helpful if the Guide set out the methodology for arriving at the risk levels indicated in the maps. At present, some of the ratings seem low.

22. For instance, it is not clear why climate change is not considered a high risk to the agriculture / livestock sector. It is anticipated that the world's major meat and dairy companies could surpass major fossil fuel companies as the largest climate polluters in the world within the next few decades.[5] Furthermore, on the business-as-usual climate pathway there will be 50% less water availability by 2100 with profound impacts for agriculture.[6] The impacts of climate change on agriculture are already visible, as can be seen by the dramatic effect of increased rainfall on Midwestern farms this Spring.[7]

23. Similarly, climate change is not listed as presenting a high risk to real estate. In May, the Climate Council in Australia warned that climate change could wipe $571 billion off the property market within the next decade.[8] Again, such risks are already materialising. This can

[5] https://www.iatp.org/emissions-impossible

[6] https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html

[7] https://www.ft.com/content/ab09d220-87bd-11e9-97ea-05ac2431f453

[8] https://www.climatecouncil.org.au/resources/climate-change-could-wipe-billions-off-property-market-new-report/

be seen in a separate report which found that sea level rise flooding had already led to property loss of $14.1 billion in 8 states along the US east coast since 2015.[9]

24. Other unexpectedly low rankings include the yellow rating for the risk of extreme weather events for agribusiness and liability business lines.[10]

[9] https://assets.floodiq.com/2018/08/17ae78f7df2f7fd3176e3f63aac94e20-As-the-seas-have-been-rising-Tri-State-home-values-have-been-sinking.pdf

[10] For instance, see the following article for a discussion of how legal duties are impacted by attribution science: https://www.nature.com/articles/ngeo3019