Theme: Insurers' Role In Sustainable Economic Growth

Economic Growth

The modern insurance industry is indivisible from the major economic trends that have shaped the last 300 years of human history. It has grown out of the commercial and human needs of industrialisation; the enabling of trade, the protection of property and the provision of basic welfare. In doing so, the industry has built a scale and stake in modern economies that have made it vitally important in its own right as an owner and protector of assets, a major employer and tax contributor and source of macro-economic stability. At a time of unparalleled economic change, the question for the future is what role insurers can most usefully play in both the mature economies of the West and the fast-growing economies of the East, Latin America and parts of Africa, whether political and regulatory expectations are reasonable and how insurers can place themselves at the heart of the next period in human history.

There are five areas where its role will be important:

i) Provision of capital
ii) Funding of infrastructure
iii) Exercising of stewardship and stabilisation of the economy
iv) Protection of assets
v) Maximisation of export strength

Climate Change

Debate on the scale and impact of climate change will be at the forefront of the 2020s, in particular whether 4°C warming will be reached by the end of the century instead of the predicted 2°C. The 2020s would be the last chance for sustained global action to prevent this 4°C rise, as irreversible tipping points were reached in areas such as the Greenland ice sheet and Amazonian rain forests.

These changes will be just as relevant for insurers' asset management activities as their underwriting operations. If political leaders take sustained action to try and prevent 4°C warming, it would almost certainly lead to further restrictions on fossil fuels, reducing the value of reserves held by major energy companies in which insurers will be heavily invested. Meanwhile greater natural resource constraints, driven by both climate change and population growth could not just limit economic growth but, at worst, impact pension funds as assets deliver lower returns and costs rise against a backdrop of consistently rising commodity costs.

Think Piece 9: A step change in green investment

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Summary

- A strong, legally binding agreement at the UN Climate Conference in Paris would be a game changing 'signalling point', especially for the investment community.
- The reputational and economic drivers of green investment, and the reduction of regulatory barriers, will make a step change in investment behaviour not only feasible, but attractive.
- As a result, actively seeking opportunities to improve the sustainability of both fixed income and equity investment portfolios is likely to become a mainstream activity for all forward thinking insurance and savings firms.

Climate change is one of the great challenges of our time. 20,000 years ago, the world's average temperature was around 4°C lower than it is today; the same four degree variation as the Intergovernmental Panel on Climate Change (IPCC) expects us to rapidly reach by 2100 if greenhouse gas emissions are not constrained[42]. 20,000 years ago we were in a different period of geological time – the Pleistocene – and the majority of the UK was under hundreds of metres of ice.

A world with global average temperatures four or even six degrees higher than today would be a very different place, with increased thermal energy in the global climate system creating a more volatile and uncertain risk environment for individuals and for insurers. Sea level rises will threaten the viability of many of the world's most important population centres. With a one metre global sea level rise – not inconceivable over the next century - what would be a 1 in 100 year flood in New York today becomes a 2 in 1 year event – i.e. 200 times more likely[43].

In December 2015 leaders from around the world will come together at the UN COP21 Climate Conference in Paris to try and deliver a robust, legally binding global agreement on reducing greenhouse gas emissions. But while political agreement in Paris is vital in setting direction and providing certainty, it can only lay the groundwork – the transition to a low carbon world can only realistically be delivered with the help of trillions of pounds of private investment capital channelled in the right direction over many years.

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In this context, a step change in green investment behaviour by insurance and savings firms, which helps society to mitigate the risks of climate change, is vital if we are to transition to a low carbon economy and avoid this four degree world. Insurers have multiple incentives to do this:

1. To manage the risk environment in which they operate, maintaining insurability in existing areas, and strengthening the prospects for growth in emerging markets

Insurers' ability to act as carriers of climate related risk depends on that risk being maintained within acceptable levels of average annual loss, volatility, and uncertainty. Climate change will, in many geographies - particularly developing countries which are a key driver of future growth for the sector - create risks that are too volatile to capitalise effectively, or simply too costly to cover at affordable levels, rendering many people uninsurable before they have ever had access to insurance provision. To an extent, these problems are already locked in by inevitable climate change in the coming years, but they could become far more acute. Ultimately, the long term relevance of insurance across many parts of global society is linked to avoiding the exponentially increasing risk environment likely to be generated by global warming over 4°C.

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2. To contribute to minimising the macroeconomic risks presented by climate change

While the first point is primarily relevant to those firms insuring risks physically impacted by climate change, all insurance and savings providers have an incentive to contribute to maintaining value and growth in the economy. Recent research by the Economist Intelligence Unit[44], sponsored by Aviva, uses an economic forecasting model to estimate the Value at Risk to the global stock of manageable assets, which estimates an average loss of value by 2100 of $4.2 trillion[45]. In the extreme 6°C scenario, the Value at Risk rises to $13.8 trillion – around 10% of the world total investable assets. These permanent macroeconomic impairments have significant implications for growth and prosperity in the long term.

3. To ensure we are on the right side of the fence reputationally

In the coming years climate and sustainability performance will be an important reputational driver for the sector, not least in the immediate period of political and media attention generated by the December 2015 UN Climate Conference in Paris. A worldwide survey on climate change involving 10,000 citizens across 79 countries found that 78% of respondents were 'very concerned' about the impacts of climate change, and nearly two-thirds said the world should do 'whatever it takes' to limit temperature increases to 2˚C.[46]

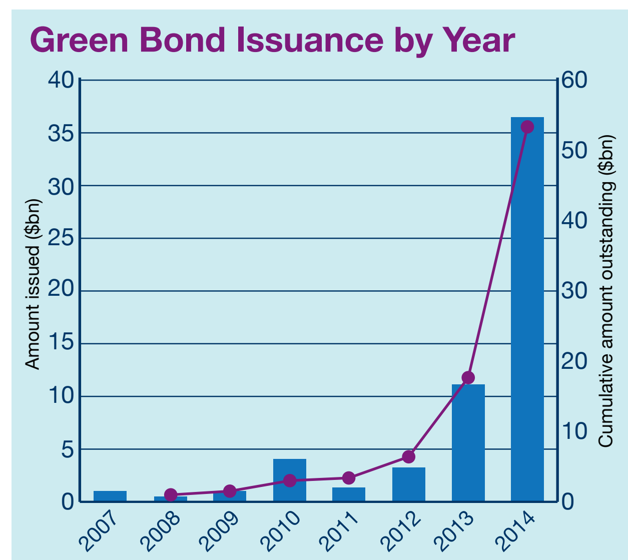
Leading insurance and savings providers are increasingly aware of these incentives, and are taking steps to align their investment behaviour to them.

Aviva's five carbon pillars

In July 2015 Aviva published its Strategic Response to Climate Change[47], setting out the following five commitments:

1. **Integrating climate risk into investment considerations.** Ensuring that environmental, social and governance issues remain embedded in investment analysis and decision making.
2. **Investment in lower carbon infrastructure.** Targeting a £500m annual investment in low carbon infrastructure for the next five years.
3. **Supporting strong policy action on climate change.** Supporting policymakers in negotiating a credible outcome at the upcoming UN COP-21 climate conference in Paris.
4. **Active Stewardship on climate risk.** Actively engaging with companies to achieve climate-resilient business strategies.
5. **Divesting where necessary.** Divesting from highly carbon intensive fossil fuel firms where it is felt they are not making sufficient progress towards the engagement goals set.

Direct investment in low carbon infrastructure – in particular renewable energy infrastructure – and broader investment in the green bond market (which includes funding low carbon projects and also climate resilience infrastructure that can almost immediately have benefits for insurers' underwriting activities.) have begun to 'take off'. The graph below shows that global green bond issuance in 2014 was over three times greater than the previous year at $36 billion.



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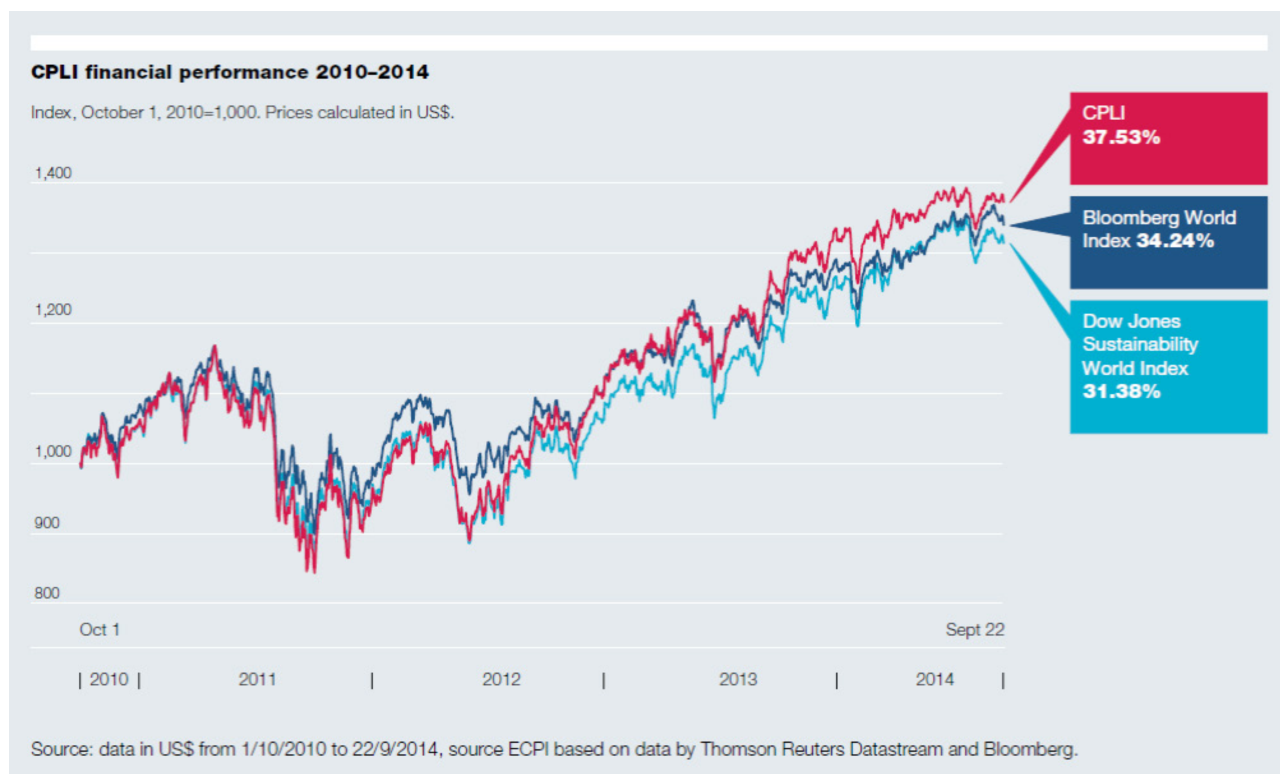

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This is good progress, but it does not meet the scale of ambition required to drag society onto a 2°C trajectory. Weigh these figures against the global insurance sector's $32 trillion of invested assets and the need set out in the 2015 New Climate Economy report for society to "invest at least a trillion dollars a year in clean energy"[49], and it is clear there is a lot more that can be achieved if the industry has the will to make that step change and the external conditions are in place to facilitate it.

In parallel to positive fixed income investment behaviour, insurers are facing significant public and media pressure to consider environmental sustainability in their equity investments, with high profile divestment campaigns[50] encouraging firms to channel investment away from the most carbon intensive firms. The divestment debate is controversial and generally over-simplified, given the range of factors which investors need to bear in mind. Certainly, a firm shifting its focus away from carbon intensive industries rapidly and deeply is a decision not to be taken lightly. Nevertheless, the financial and risk based case for considered action in this space is growing. Firstly, to mitigate against the risk of asset stranding, where carbon intensive firms find that a significant part of their valuation is built on the ability to burn carbon that ultimately turns out to be unburnable in a low carbon world. Secondly because there is a growing body of evidence (see the graph above) that shows indexes covering the most progressive firms from a climate perspective consistently outperforming mainstream indexes.

So how can our industry build on the progress which has been made in recent years in order to deliver the step change in investment behaviour that underpins a two degree trajectory?

1. Make the most of Paris

The Paris summit promises to be a seminal moment, a window of opportunity for global climate policy, and will be a high point for the profile of the issue. Insurance and savings providers have an opportunity to achieve dual benefits. First, taking actions and making statements which demonstrate their important enabling role in solving a massive societal challenge, and as a result enhancing their individual reputations and that of the industry as a whole. Second, use any legally binding agreement from Paris to reassess the level of political certainty underpinning green investment. At present, a lack of long-term policy certainty increases risk and raises the cost of capital, particularly for long-term assets. A key outcome of Paris should be to improve this.

2. Send positive signals to issuers of green debt

There are many existing avenues that insurers can use to channel green investment. However, closer working with specialist green investment initiatives, such as the UK's Green Investment Bank, to align opportunities with the industry's needs, will be important, as well as sending an 'open for business' message to potential issuers of green debt such as cities, municipalities and major public sector institutions like the NHS, which may not be fully aware of the alignment between their needs and the needs of our sector.

3. Embrace collaboration

Responding to climate change is a complex, systemic challenge, which a collaborative response is vital to. ClimateWise[52] - part of the Cambridge Institute for Sustainability Leadership - is the global insurance sector's leadership group on climate change. It provides a platform for the sector to unite, share expertise and engage in collaborative action research with key stakeholders – such as issuers of green debt – to develop the knowledge on how the industry can respond to climate change in positive and proactive ways. Now is the ideal time for the industry to become more involved in collective leadership initiatives that organisations like ClimateWise can provide.

4. Continue to push for a more enabling regulatory environment

The industry can only deliver a step change in green investment if this is compatible with the regulatory framework in which it operates. This is not a given. For example, the treatment of infrastructure investments in Solvency II has been identified as a significant barrier to the industry investing in the infrastructure that is required for sustained economic growth in the EU. To 'sustained' we should add 'sustainable'. The European Commission has proposed tweaks to Solvency II to incentivise infrastructure investment, and it is vital that such changes are meaningful, and delivered promptly. Equally, in the UK, working with the Bank of England as they begin to align their growing climate agenda with their established regulatory practice, is an important next step.

Ultimately, long-term, sustainable economic growth, for which a step change in green investment is a critical precursor, is vital for the long term prospects of the whole insurance and savings market. It is literally an issue that no firm can afford to ignore.