Making a difference in mitigating climate change risks

Insurance companies are directly affected by large-scale "non-financial" environmental and social risks, such as climate change, resulting in increasing natural catastrophe losses. These risks challenge the insurance companies foremost, but also open up opportunities to develop innovative products and services to mitigate climate change risks. Examples for concrete actions include:

- Improving climate risk prediction and traditional risk management: Swiss Re, Munich Re and other companies have established special research teams on climate change. As a traditional risk management measure, an improved predictability of climate risks can be used as a basis for premium differentiation. Allianz and AXA have started to integrate emerging risks, including climate change, into their standard risk assessment processes.

- Innovative insurance products and services: some insurance companies have developed insurance protecting against the consequences of climate change. AXA has partnered with the World Food Program on a humanitarian insurance for droughts and other weather risks in developing countries. Product innovations supporting climate-friendly behaviour and technologies include pay-as-you-drive car insurance or property insurance with premium credits for green buildings (Aviva).

- Financing climate-friendly technologies: Allianz for instance plan to invest between €300 and €500 million into renewable energy projects by 2010.

- Services supporting emission reduction and energy conservation: The European Emission Trading System is the central political instrument to reduce carbon emissions in the EU. Some companies like Swiss Re have established emission trading and consulting services.

Sustainable Investment – Reducing risks and capitalising on opportunities in asset management

- Insurance companies are very important institutional asset owners in the economy and derive a large portion of their profits from this activity. Social and environmental "extra-financial" risks can have substantial impact on the economy and hence the financial performance and valuation of insurance companies' assets. Some companies have integrated SRI (Socially Responsible Investment) elements into their investment processes in order to reduce these risks or capitalise on related opportunities.

- Storebrand applies a comparatively comprehensive approach by using social and environmental criteria for all of its pension, insurance and mutual fund products. All pension and life insurance investments are subject to exclusion criteria (manufacturing of landmines, cluster bombs or tobacco products, involvement in human rights violations, weak environmental and social responsibility performance).

- Less rigorously, Munich Re screens its investments in shares and bonds by using sustainability ratings. According to the company, more than 80% of its assets meet their sustainability requirements. Allianz applies a similar screening approach but has also invested a small part of its assets into dedicated SRI funds.

- Some insurance companies have also directed investments into companies offering environmentally friendly technologies such as renewable energy.


Insurance sector report 4th in a series

This sector report has been compiled with research by Bank Sarasin. It describes the major social and environmental challenges facing the European insurance industry and the associated risks and opportunities these pose for long-term returns. As the direct environmental and social impact of the insurance sector is comparatively small, a comprehensive sustainability management approach (including indirect impacts) is still lacking in most companies. However, awareness of current environmental and social risks such as climate change has grown.

**INSURANCE OVERVIEW**

- More than 5,000 insurance companies are operating in the European market, employing about one million people and generating a premium income of about €1 trillion.
- Insurance can be divided into two types of activities: Life (61% of premium income) and Non-Life (39%).
- More than 7% of European market, employing about one million people and generating a premium income of about €1 trillion.

**INSURANCE TRENDS**

- In Europe, Life Insurance is growing fairly fast (more than 7% per year in 2000-2005), compared to Non-Life (less than 1%) and global insurance (around 3%).
- Demography is a major driver of the insurance business, especially for life and health insurance. The aging population in most industrialised countries is posing a burden on public retirement schemes and contributes to increasing health costs. This opens up new growth opportunities for Life Insurance, as a private supplement to public retirement schemes, and a growing demand for health insurance coverage.
- As a consequence of rising investment risks and marketing issues, the sector has been the target of stricter regulations and litigation. At the European level, the new “Solvency II” regulation (to be effective by 2010) will require a re-assessment of capital requirements and the establishment of improved risk assessment and management procedures.

- Losses from natural catastrophes (attributed to some extent to climate change) and geopolitical risks are on the rise. For Non-Life insurers this growing risk exposure has resulted in larger capital cover relative to premium income.

- For both Life and Non-Life, asset management activities (investment income and fees) have been the most important sources of profit, rather than the underwriting result (margins of premiums over incurred losses). In the case of Life, this is due to the development of saving oriented products (fixed and variable annuities). The dependence on the capital market involves related risks, such as stock market crashes (e.g. 2001-2003), inflation and low interest rates.

- Distribution is of strategic importance for insurance companies, both in terms of sales promotion and expenses. Although distribution channels differ largely between countries, independent distribution is gaining importance everywhere.

**Market Capitalisation of Largest European Insurance Companies**

- **Market capitalisation of the largest European insurance companies**
- **Listed insurers 1970-2005**
- **2005: €500 million**
- **2006: €1 trillion**

**Case studies**

- *Making a difference in mitigating climate change risks*
- *Sustainable Investment – Reducing risks and capitalising on opportunities in asset management*

**Insurance companies wish to acknowledge the support and direction provided by the Insurance Sector Report Steering Committee:**

- Crédit Agricole Asset Management
- Dexia Insurance Services
- Fosfor – Groupama Asset Management
- Oddo Securities

This sector report, created with the support of the European Commission, has been compiled by:

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1 Source: Swiss Re, December 2006
2 Source: Swiss Re, January 2006
3 Source: Swiss Re, January 2006
4 Source: Swiss Re, January 2006
5 Source: Swiss Re, January 2006
6 Source: Swiss Re, January 2006
7 Source: Swiss Re, January 2006
8 Source: Swiss Re, January 2006
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In contrast with other industries, insurance companies are primarily affected by the consequences of global environmental and social challenges, rather than directly causing them.

Climate change, caused by greenhouse gas emissions, is increasing the frequency and intensity of natural disasters. Their risks are also getting more and more unpredictable. As a result, the monetary volume of damages resulting from natural disasters such as floods and storms is increasing continuously. Recent examples include hurricanes in the US which pushed global insured losses to record heights: they surpassed $100 billion in 2005, while they had never exceeded a level of $40 billion in a single year since 1970.

The occurrence of geopolitical risks, including social and political tensions or terrorist attacks, is also hard to predict and can entail high claims for insurers. The damages caused by the terrorist attacks of September 11, 2001 were over $20 billion.

The impact of new technologies on human health and the environment, such as genetic engineering or nanotechnology, is not yet fully understood and could result in product liability claims in the future.

Other long-term issues include rising costs related to unsustainable lifestyles and growing consumption levels, such as food consumption resulting in ever increasing problems with obesity or traffic density resulting in health issues (accidents, noise and air pollution).

Insurance policies can be complex and some clients may not understand all the contract details (fees, coverage and related restrictions). This can result in complaints from clients over coverage or premiums and in legal controversies.

Life insurance as well as some casualty insurance companies attempt to single-out high-risk client groups in order to exclude them from coverage or differentiate the risk premiums. While this strategy is rational and to some extent in the interest of the insured, some practices are perceived as discriminatory. Examples include the systematic genetic screening of clients to single-out high-risk groups for life insurance contracts. While genetic screening is forbidden in some European countries, it is still debated in others.

Some underprivileged and low-income groups, especially in developing countries, cannot afford insurance coverage.

Sustainable Asset Management (Life mainly)

Neglecting general environmental and social impacts in asset management can result in a reduction in returns or an increase in volatility of asset management overall.

Some insurance companies have integrated extra-legal issues (for example on road safety, healthy lifestyles or environmental protection) and a premium differentiation can contribute to a reduction of long-term risks and stimulate a more "sustainable" behaviour of clients.

To improve the management of these sustainability-related risks, insurance companies can set up specific research programs into their causes and effects. Doing so, insurers will increase the predictability of potential events and amount of claims and will allow for risk selection in insurance premiums.

The development of prevention schemes and campaigns (for example on road safety, healthy lifestyles or environmental protection) and a premium differentiation can contribute to a reduction of long-term risks and stimulate a more "sustainable" behaviour of clients.

Developing innovative insurance products or new business areas related to the management of environmental and social risks can even represent market opportunities for insurance companies. Examples include the development of insurance products to mitigate climate change risks (see case study).

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Mislending advertising for insurance products, lack of transparency, such as "small print" in contracts, or misleading information by sales agents are issues which have given rise to controversies with clients and the public at large. This led to a tightening of regulations imposed by financial supervisory bodies.

Most insurance companies work with large networks of internal and external agents or alternative channels such as broker-dealers. Business practices are difficult to control in these networks, because of their complexity and size, as well as the independence of the external agents and brokers. Furthermore, as they are usually paid on a commission basis, their financial incentives can be contradictory to clients' interests.

Controversial contracting and marketing practices and improper handling of complaints have frequently resulted in legal controversies, prosecution and finally considerable fines and compensation payments for the insurance companies involved.

Companies striving to install high ethical business standards and quality of services not only avoid such financial risks, but will also benefit from a high loyalty of their clients. Establishing formal quality and ethical standards in the companies' distribution organisation is essential. The enforcement of these standards, through training, information programmes and monitoring procedures, is equally crucial.

Marketplace conduct (Life, Non-Life)

High ethical standards and initiatives to raise financial literacy levels can contribute to more transparency and a reduction in controversies and client complaints. A few leading insurance companies are active in offering basic financial education to customers, especially women and young people. Other insurers work on simplifying contracts (e.g. the Plain English standards in the UK) in order to increase their understanding.

Exclusion of high-risk client groups from insurance coverage can cause public criticism and intervention, whereas the inclusion of specific risks will provide niche market opportunities for insurers. Examples include affordable insurance products for low-income households, such as affordable housing insurance schemes offered in the UK or special insurance products for disabled persons in Norway. Another example is micro-insurance for developing countries, which makes an important contribution to economic development in emerging and developing countries (e.g. accident and life coverage at affordable premiums).

Many insurance providers have not yet taken the opportunities offered by micro-insurance for developing countries, which makes an important contribution to economic development in emerging and developing countries (e.g. accident and life coverage at affordable premiums).

Insurance companies, Life Insurance especially, are very important institutional asset owners. It has become conventional wisdom that sustainability issues (greenhouse gas emissions causing climate change, resource consumption, globalisation of production processes, etc.) have an impact on the financial performance of companies and hence their stock prices.

Some insurance companies also experience an aging of their staff.

Some insurers attempt to control the situation by means of thought-out downsizing programs will improve employees' loyalty and motivation, as well as attract and maintain talent.

For companies with an aging workforce, retirement departures need to be properly pre-empted in the recruiting and training processes, in order to avoid loss of technical know-how and experience among the staff.

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Insurance companies are continuously working to increase efficiency and reduce administrative costs. As personnel expenses are usually the highest for one third of acquisition and administrative expenses, a number of companies have reduced staff significantly in recent years.

Similarly to other service industries, the outsourcing of sales forces (to independent agents) and the "off-shoring" of call centres and back-office functions to developing countries (India and Sri Lanka) have been measures to reduce costs.

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Sustainable Insurance - Reducing risks and capitalising on opportunities in asset management

Insurance Sector Report - 4th in a series

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INSURANCE OVERVIEW

- More than 5,000 insurance companies are operating in the European market, employing about one million people and generating a premium income of about €1 trillion.

- Insurance can be divided into two types of activities: Life (61% of premium income) and Non-Life (39%).

- The insurance sector is a mature industry with modest growth rates. Europe accounts for 36% of global premium income (North America 36%, Japan 15%). Emerging markets only account for 12%, but experience a faster growth (4.5% per year compared to 3% in industrialised countries for 2000-2005).

- In Europe, Life Insurance is growing fairly fast (more than 7% per year in 2000-2005), compared to Non-Life (less than 1%) and global insurance (around 3%).

- Demography is a major driver of the insurance business, especially for life and health insurance. The aging population in most industrialised countries is posing a burden on public retirement schemes and contributes to increasing health costs. This opens up new growth opportunities for Life Insurance, as a private supplement to public retirement schemes, and a growing demand for health insurance coverage.

- As a consequence of rising investment risks and marketing issues, the sector has been the target of stricter regulations and litigation. At the European level, the new “Solvency II” regulation (to be effective by 2010) will require a re-assessment of capital requirements and the establishment of improved risk assessment and management procedures.

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- Distribution is of strategic importance for insurance companies, both in terms of sales promotion and expenses. Although distribution channels differ largely between countries, independent distribution is gaining importance everywhere.

- Insurance companies, especially Life, are important institutional asset owners. In 2005 the European assets under management stood at about 4.5 trillion (more than 50% of GDP).

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