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Position paper

Ensuring sustainable insurance cover for industry and commerce

Executive summary

Insurance cover for industry and commerce is of paramount importance for the real economy. Any new regulations should allow this business model to continue so that insurers (and industrial insurance captives) can continue to offer insurance solutions in full. Insurers and the real economy therefore draw the attention of international, European and national standard-setters, legislators and supervisory authorities to the following issues:

- Companies in the real economy and in the insurance industry welcome the drive to strengthen the concept of sustainability.
- Moves to take sustainability factors into account must continue to ensure full insurance cover for the corporate sector and should strengthen, not weaken, Germany's status as an industrial hub. All permitted economic activities should continue to enjoy access to insurance cover to support them as they make the necessary transformation to sustainable business activity.
- Insurers already take relevant sustainability factors into account as part of their forward-looking risk management approach. The instruments already available are also ideally suited to ESG risks.
- Risk assessment and pricing (underwriting) is based on a two-stage process, with premium calculation based on economic risks on the one hand, and a strategic assessment, including a reputation-oriented ESG analysis, taking the insurer's individual sustainability strategy into account on the other. These two steps are motivated by different factors and have to be kept strictly separate.
- The use of sector heat maps in underwriting would not be sufficiently granular, as well as being static with regard to transformation processes and much less precise than the case-by-case assessment described above. Exclusion criteria or investment limits based on heat maps are also not precise enough.
- In terms of investment, sustainable investments should be assessed based strictly on the risks they entail. Blanket capital relief measures (green supporting factor) or surcharges (brown penalising factor) contradict this central precept of financial stability.
- Wherever possible, climate policy should make use of direct measures, even if these are often politically unpopular. Opting for an approach that uses the steering effect of the financial industry, however, is an indirect approach. It takes effect more slowly, and only indirectly, is associated with higher compliance costs and also has its limits in terms of effectiveness.

Importance and principles of insurance for industry and commerce

Insurance cover for industry and commerce is of paramount importance for the real economy. Effective risk transfer between the corporate and the financial sectors serves to secure growth and jobs. It provides stability and the security required to allow plans to be made, as well as strengthening the business location concerned. Insurers are aware of this economic responsibility and take both ecological and social factors into account.

When insurers underwrite risks, as a general rule all aspects relating to sustainability are taken into account as part of a forward-looking risk management system. This step uses a method established in the market economy for calculating risk-based premiums as a first step. In addition to economic factors, environmental, social and governance (ESG) risks also play a significant role. The second step involves looking at non-financial factors as part of a reputational review. This means that each insurer's individual sustainability strategy determines which projects are insured.

This approach ensures that insurance cover is also made available to companies that are just embarking on the process of transformation to sustainable activities. As a result, caution has to be exercised on the regulatory side in order to continue to support this key transformation process. This two-stage process is the best approach for progressing towards sustainable business.

Policymakers are right to set ambitious targets

On a global level, a number of targets and measures designed to strengthen sustainability emerged as a result of the 1997 Kyoto Protocol. The United Nations has defined 17 sustainable development goals and made climate protection a matter of survival with the Paris Agreement of 2015. The Finance Initiative[1] of the United Nations Environment Programme, in particular, addresses matters relating to the contribution that the financial sector can make to achieving the sustainability goals.

At European level, the European Commission's Directorate-General for Financial Stability, Financial Services and Capital Markets Union unveiled an ambitious programme to combat climate change with the Sustainable Finance Action Plan[2] in 2018. Key cornerstones in this context include taxonomy, transparency and benchmarking regulations to channel investment flows into sustainable economic activities. This approach is to be viewed as part of the EU climate strategy and the European Green Deal[3]. The Sustainable Finance Action Plan is aimed directly at the financial industry and is founded on the principle of voluntary action based on improved transparency, although it also has an impact on the real economy.

At a national level, the German Federal Financial Supervisory Authority (BaFin) published a Guidance Notice[4] on Dealing with Sustainability Risks in 2019. In addition, the German government's Sustainable Finance Committee is working on recommendations for Germany as a financial centre and the contribution it can make to sustainable development.

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[1] https://www.unepfi.org/
[2] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_de
[3] https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en
[4] https://www.bafin.de/SharedDocs/Downloads/EN/Merkblatt/dl_mb_Nachhaltigkeitsrisiken_en.html

Market-driven instruments prove effective

Even before the initiatives referred to above, German industry and finance were already undergoing a comprehensive, market-driven process of development towards even greater sustainability. In 2015, Germany's national greenhouse gas emissions were down by 28 percent on the figure for 1990. Global green bond issues increased by a factor of 6, from US$ 41.8 billion in 2015 to US$ 250 billion in 2019. Both the market and existing regulatory measures are already delivering impressive performance in terms of their impact on this development. In addition to climate protection, other environmental, social and governance factors are playing an increasingly important role. All public insurers have signed up to the "Principles for Responsible Investment[5]" and take environmental, social and ethical principles into account when making investment decisions.

Risk-based insurance protection strengthens business hubs

As well as strengthening sustainable investment by fostering transparency in an investment context, the current global, European and national regulatory debates are increasingly revolving around the topic of risk management. Both legislators and supervisory authorities are discussing how insurers should proceed with regard to sustainability considerations when underwriting risks. This applies in particular to underwriting in the fields of industrial and commercial property insurance. As a key element of economic risk transformation, it enables an efficient transfer of risks between economic players. As a result, industrial and commercial composite insurance (fire, liability, transport, etc.) is a key component of any developed business location. Insurance protection against fire risks or liability claims is in fact an essential prerequisite for business operations. Insurance policies like these are founded on a market-based and business management-based assessment of the relevant financial risks. Reputational risks have to be considered separately. The Association of German Public Insurers (VöV), the Federation of German Industries (BDI), the German Association of the Automotive Industry (VDA) and the German Non-Ferrous Metals Association (WVMetalle) are therefore committed to sustainable insurance that provides insurance protection for companies on the basis of premiums calculated based on economic risks. Many industrial companies have their own captive (re)insurers. These are already being used to insure risks for which the insurance market offers no, or limited or unattractive, solutions. Any new regulations also have to allow this business model to continue without putting it at a disadvantage, allowing captives to offer the full range of insurance solutions.

Consideration of all relevant sustainability risks

Insurers already take relevant sustainability factors into account as part of their forward-looking risk management approach. In its Guidance Notice on Dealing with Sustainability Risks, BaFin quite rightly states that "sustainability risks are factors of the existing risk types". This means that the best way for risk management to take them into account is using existing instruments, which may need to be expanded - there is no need for any additional tools. The associations also reject any interventions in underwriting on the basis of ESG considerations that do not relate to risk. ESG risks should be addressed using tried-and-tested risk manage-

[5] https://www.unpri.org/

ment tools as opposed to using new, duplicated underwriting measures. Recently, the "Principles for Sustainable Insurance Initiative"[6] of the United Nations Environment Programme launched a debate touching on these very issues in a discussion paper.

Risk-based premium calculation and reputational review

The associations support an approach that gives adequate consideration to all risks in two different steps. Risk-based premium calculation and the assessment of reputational risks have different motivations and have to be kept strictly separate. As part of the underwriting process, premiums are calculated using a market-based and business management-based assessment of all relevant risks. Sustainability criteria can also be included at this point insofar as they influence the economic risk. This highly complex process should certainly not, however, be overloaded with further aspects. Reputational risks for the insurance company are the central factor in the second part of the assessment. In order to adequately reflect these two, sometimes very different, risks, these processes must be carried out separately.

Reputational consideration of ESG factors as a second step

It is only in a further step that insurers analyse whether or not projects should be insured for reputational reasons in accordance with their specific ESG criteria. This decision considers the specific case in question and depends on the individual sustainability strategy pursued by the insurer, as well as socio-political aspects. The reputational effect of a negative decision also plays a role here. For example, the refusal to grant insurance cover to a major regional employer would have a considerable reputational impact. Mixing these two steps, the risk-based premium calculation on the one hand and the reputational ESG considerations on the other, would not, however, be appropriate. Nor would an ESG surcharge on the insurance premium represent an appropriate solution. First, this would result in an increase in the premium which would not be justified from an actuarial perspective. Second, this surcharge would not help to mitigate damage to the company's reputation if the reputational risk were actually to materialise.

Insurance cover only ensured via insurers

Insurance protection is of paramount importance for the real economy. If a company cannot obtain insurance cover (e.g. to protect against fire risks or liability claims) in the market, the company's ability to operate is called into question. Unlike in the field of corporate finance, where there are several instruments (loans, bonds, equity, etc.) available, insurance cover can only be obtained from insurance companies or industrial insurance captives. This means that assessments always have to be performed on a case-by-case basis. In addition, public insurers have a regional mandate when it comes to providing insurance cover. Moves to take ESG factors into account must continue to ensure full insurance cover for the corporate sector and should strengthen, and not weaken, Germany's status as an industrial hub.

[6] https://www.unepfi.org/psi/

Ensuring efficient risk transfer for the corporate sector and private individuals

Insurers must be able to perform their core function. Political instrumentalisation for purposes which other measures are appropriate for, or are already in place, would jeopardise this key function that they perform in an economy. Achieving ecological targets in the process is also possible within certain limits as a side effect. Within this framework, all forms of permitted economic activity also have to be able to obtain insurance cover. If this is no longer the case, citizens would ultimately have to shoulder the risks involved, for example in cases of environmental damage caused by a power plant. Excessive focus on sustainability risks would pose a threat to the holistic approach to underwriting. First of all, this would constitute an unjustified and disproportionate intervention in insurers' business models and would have a huge impact on the (no longer) insured companies concerned, their employees, value chains, the regional economy and tax revenues. Second, the approach would not provide any incentives for companies to move towards more sustainable practices.

Rethinking the impractical heat map methodology

Ideas for incorporating ESG factors into the industrial and commercial insurance underwriting process are usually based on the methodology of using heat maps for particularly critical industries[7]. The associations would like to point out some of the decisive weak points of these heat maps.

> First, the definition of economic sectors is **too broad and too undifferentiated to allow them to be used in a meaningful way**. As an example, the energy production sector includes renewable energy sources as well as fossil fuels. If further, more detailed classifications are required in most sectors, the original classification would appear to be impracticable. Insurance for industry and commerce always involves a case-by-case assessment. Sector allocations are not granular enough to reflect individual cases and result in entire sectors being stigmatised.
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> Second, the heat maps are based on **purely static considerations** and do not take any dynamic factors into account. At first glance, while certain sectors appear to be associated with higher ESG risks, they are essential for a transition to a more sustainable, lower-risk economy. Industrial value chains are highly complex and the sector classification fails to do justice to this complexity. This aspect is also being intensively discussed in the European Commission's technical expert group on sustainable finance. A "best-in-class" approach could encourage the development of less sustainable companies into companies with very good ESG factors. This means that a potential classification system has to consider individual companies, if not individual products. For example, the use of energy-saving technology by a raw materials producer undoubtedly improves the company's sustainability performance, especially since these materials are the very prerequisite for ecological improvements, i.e. in the design, manufacture and use of buildings, vehicles and equipment. The proposed classification of an entire sector would not create any incentives for the company in question to make this sort of technological leap.

[7] e.g. p. 18, http://www.unepfi.org/psi/wp-content/uploads/2019/02/PSI-Guidance-for-non-life-insurance-underwriting.pdf

Third, the heat maps could be **inconsistent with other classification systems**. EU legislators are currently working on technical regulatory standards for sustainability classification in the Taxonomy Regulation, and inconsistencies, or even conflicts, between the two frameworks would impose severe restrictions on applicability.

Fourth, the treatment of the financial sector is not consistent with other sectors. As service providers, financial market players usually have a negligible direct environmental impact. Heat maps, however, provide for **consideration of indirect effects** and rest on an assessment based on the investment. This approach is **inconsistent with the approach taken in other sectors**, which is limited to direct effects. Otherwise, the entire value chains of these sectors would also have to be taken into account. For example, a plant manufacturer can produce designs for power plants using renewable or fossil fuels. As a result, heat maps should initially be limited to direct effects in all sectors. Reflecting entire value chains in all sectors of the economy would raise considerable methodological issues and entail a huge amount of bureaucracy.

Exclusion criteria or investment limits based on heat maps are also inappropriate for the reasons already mentioned. There are instruments that are better suited to this purpose and are already established on the market, such as the Principles for Responsible Investment.

Consideration of risk-based approaches and financial stability as a maxim

A financial system can only function if risks are priced correctly. This means that all sustainability risks have to be examined, assessed and priced in terms of their potential financial impact. The higher the financial risk, the higher an insurance premium has to be. If, however, sustainability risks are of a purely political nature and are not reflected on the financial side, this cannot have any implications for underwriting. This approach applies equally to investments. Sustainable investments should be assessed based strictly on the risks they entail. Blanket capital relief measures (green supporting factor) or surcharges (brown penalising factor) contradict this central precept of financial stability.

Taking political responsibility instead of delegating responsibility to the business world

Political decision-makers have a broad repertoire of possible instruments at their disposal with regard to climate policy. A large number of direct measures are already having an immediate impact on greenhouse gas emissions, and further instruments could also be used. Numerous examples show that these direct climate policy measures are often politically unpopular, which is why they are rarely selected. Opting for the sustainable finance approach that uses the steering effect of the financial industry, on the other hand, is an indirect approach. It takes effect more slowly, and only indirectly, is associated with higher compliance costs and also has specific limits in terms of effectiveness. The associations are committed to using the steering effect of the financial industry through transparency and an voluntary approach to strengthen sustainable economic activity. Hindering other business models by creating higher financing costs and hurdles in insurance cover would, however, be the wrong approach.

The associations and their member companies are prepared to contribute their expertise in the fields of politics, supervision and administration. They are more than happy to be involved as members and discussion partners for the Platform on Sustainable Finance with regard to the EU taxonomy, the German government's Sustainable Finance Committee and other bodies. The real economy and the insurance industry look forward to engaging in further dialogue on sustainability in the field of industrial and commercial insurance and will be more than happy to answer any questions that arise.

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Association of German Public Insurers

The Association of German Public Insurers (VöV - Verband öffentlicher Versicherer) is the umbrella organisation of the German public insurance companies and a corporation established under public law. Founded in 1911, it represents 10 primary insurers across Germany that are deeply embedded in their regions. The group is the second-largest primary insurance provider in the German market, with more than EUR 140 billion of investments under management, thereby making a significant contribution to the European economy. It has 50 million insurance contracts and pays out 18 billion Euros each year to its clients.

Federation of German Industries

The Federation of German Industries (BDI - Bundesverband der Deutschen Industrie) conveys the interests of German industry to the political decision-makers and in the process it provides support for business enterprises engaged in global competition. The BDI has at its disposal a widely branching network in Germany and Europe, in all important markets and in international organizations. The BDI takes care of the political flanking of international market opening. And it offers information and economic policy consultations for all topics related to industry. The BDI is the umbrella organization of German industry and industry-related services. It speaks for 40 trade associations and more than 100,000 enterprises with around 8 million employees.

German Association of the Automotive Industry

The German Association of the Automotive Industry (VDA - Verband der Automobilindustrie) was founded in 1901 and represents the interests of more than 600 companies with around 800,000 jobs. The automotive industry shows an annual turnover of about 130 billion Euros and thus represents one of the key sectors of the German economy. The VDA members are divided into three manufacturer groups automobile manufacturers, automotive suppliers, and trailers, special bodies, buses.

German Non-Ferrous Metals Association

The German Non-Ferrous Metals Association (WVMetalle - WirtschaftsVereinigung Metalle) represents the interests of the non-ferrous metals industry with 650 companies and 111,000 jobs. In 2018, this sector generated total sales of 52.4 billion euros. The non-ferrous metal industry covers light metals, other non-ferrous metals, rare and precious metals as well as the production stages of production, semi-finished products, further processing, casting and hot-dip galvanizing. The metals aluminium, copper, zinc, lead and nickel are used in the automotive, construction, chemical, electrical engineering and electronics industries, in mechanical and plant engineering, as well as in aviation and aerospace industries.