CULTURE EATS **SUSTAINABILITY** FOR BREAKFAST

In line with the Paris agreement, the insurance sector has decided to give climate risk a formal role in the Solvency II framework. Although the inclusion of climate risk in Own Risk and Solvency Assessment (ORSA) and standard formula will induce insurance companies to be more aware of the effects of climate risk, the authors believe that without a change in culture it will be hard to embed climate risk into the DNA of insurance companies. Besides regulatory incentives like capital relief, a change in habits is required to not merely comply, but excel on the topic of sustainability.

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WHY NOW?

Climate risk has risen in importance over the past couple of years. Where in the global risk report of the World Economic Forum, none of the risk were climate related in 2012, in 2021 4 of the top 7 risks are climate related[1]. Furthermore, each of the climate risks scores high on both the likelihood and impact scale, hence we are not only referring to high impact low frequency risks.

Also the financial sector has formalized the importance of climate change: in 2020 the Sustainable Finance Taxonomy was launched showing if an economic activity is environmentally sustainable. Companies will be required to report which percentage of a product can be considered as 'green'[2]. Although the taxonomy will make it more objective to determine which activities are sustainable, a concentration risk could occur where there is focus on a particular type of assets resulting in a lack of diversification. Furthermore as per 10 March 2021 the Sustainable Finance Disclosure Regulation (SFDR) has been enacted. This regulation prescribes disclosure requirements for financial product manufacturers and for financial advisors on sustainability levels. Furthermore central banks, like the Belgium national bank, have increased their attention to climate risk as can be seen from their annual reports.

[1] The Global Risk Report of the World Economic Forum

[2] De EU taxonomie: de noodzaak tot een duurzame transitie

Also the insurance sector has picked up on the importance of climate risk: EIOPA has written several consultation, discussion and opinion papers on how to include the effects of climate risk into the standard formula, ORSA, stress testing and pricing.

QUO VADIS?

From the latest EIOPA consultation it seems most likely that the insurance industry will include climate risk through scenario analysis (ORSA), capital requirements or relief (standard formula) or through updates in pricing. The latter will happen by default as insurance companies will change their price setting based on new insights and risk due to climate change. On the asset side, one can think of capital relief for green assets, like green bonds. These assets could receive a preferential regulatory treatment by capital relief such as currently EU government bonds. On the liability side, options exist for mainly non-life insurance, e.g. in case insurance companies refrain from insuring highly polluting commodities coal energy plants, or cruise ships.

Furthermore there are still considerable challenges on how to measure the effects of climate risk. Metrics like the CO2 index may provide an indication of sustainability however might not provide the full picture [3]. Also it will be challenging to achieve a look-through-analysis to understand the source of production materials: e.g. although the use of electric cars by itself might be beneficial for the environment, the extraction of materials to build electric cars comes with a higher human and health cost[4].

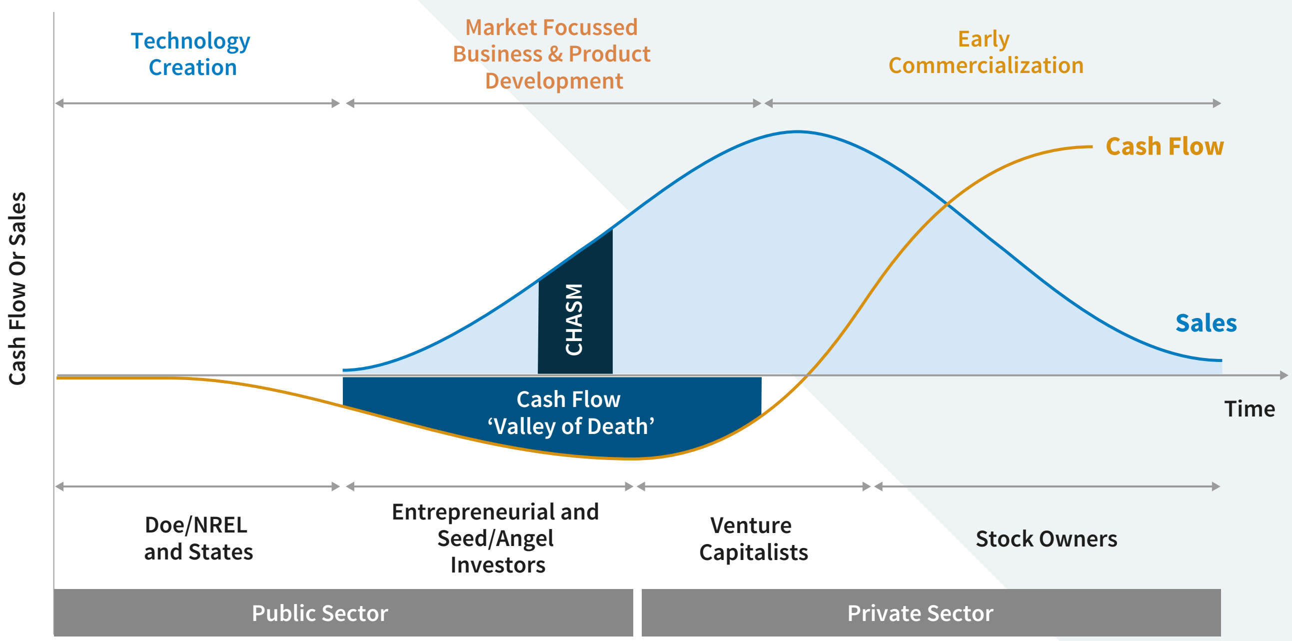
COMPLY OR EXCEL?

The current focus of climate risk thus seems to be coming from a governance perspective. In ESG terms (Environmental, Social, Governance) the G dominates the discussion. Although governance will help create more awareness for climate risk, it is not clear if this will be sufficient to go the extra mile and embed the importance of climate risk into an organization or industry. As climate risk is a long term challenge, this does align with the time horizon of the insurance industry which is also long term. What changes would be required instead to not only comply but instead excel on sustainability?

HABITS

Taking lessons from the disrupted technology companies and building habits techniques we can explore ways to implement ESG and learn from

FIGURE 1. CROSSING THE CHASM TEMPLATE



success stories from other industries.

We all heard for the lifecycle of adoption of new products from early adopters to early majority. However, what we have not been taught is that there is a chasm[5] between each stage. In other words a major investment in resource are needed (valley of death) to develop the product in order to reach the next stage of customers. This investment will be focusing on adopting the product to the masses in term of lower cost, higher quality, performance, customer service, standardising process, training and support in order to compel customers to purchase.

In order for habits to develop to an automatic response[6] the environment has to be designed. The environment allows every action to cast a vote in the direction of the habit. In essence the environment needs to adopt the following:

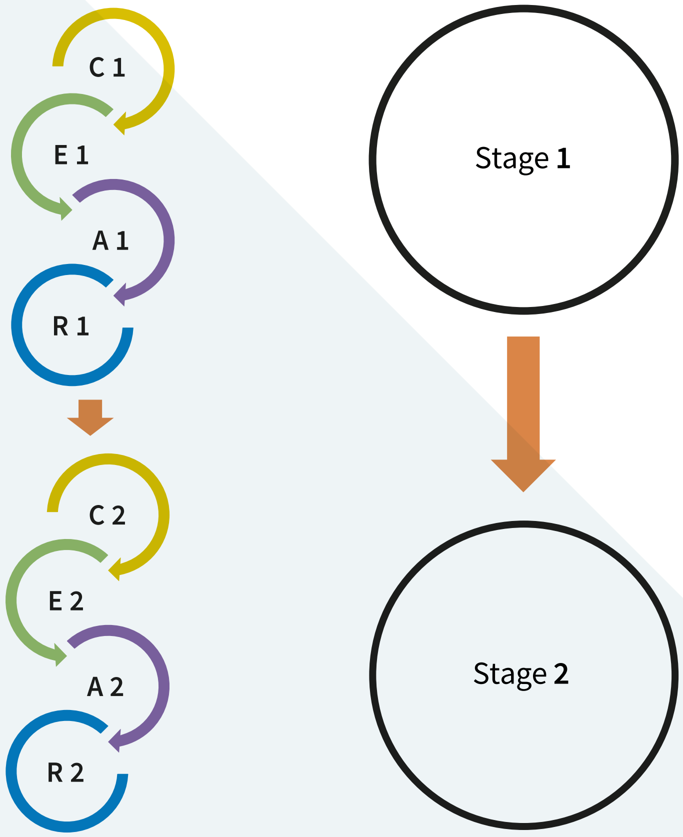
1. Cues that catch attention by making the action obvious, available, visible
2. Actions that can be easily adopted with other existing habits
3. Attractive actions could be associated with the final outcome
4. Rewards reinforce the action that leads to the habit to be reinforced.

There are two major hurdles in moving from Stage 1 to Stage 2 in Figure 2:

1. Within the stage. (e.g. from C1 to E1)
2. From one stage to the next. (e.g. from stage 1 to stage 2)

Hence, with the habit model we can reduce the effort to move within each stage and the step to the next stage. The general idea is that forming habits is challenging (stage 1 to 2) and by making smaller subsets it is easier to make progress.

FIGURE 2
C = Cue , E = Easy, A = Attractive, R = Reward



[3] **Climate Transition Risk – A Quantitative Impact Study for ORSA Scenarios**

[4] **Nickel mining: the hidden environmental cost of electric cars | Guardian sustainable business | The Guardian**

[5] See the book **Disruption Crossing the Chasm** by Geoffrey A. Moore

[6] See the book **Atomic habits** by James Clear

CULTURE – RECYCLING AS AN EXAMPLE OF A SUCCESSFUL HABIT

Recycling in the Europe is now fully accepted and widely applied. However to get to the current habit of recycling the following steps were necessary:

1. Make it clear what can and can't be recycled. Images on recycling bins, and colour of bin Black (anything), Green (Glass bottles), Brown (plants, food). Unfortunately, depending where you go in the Europe the colour indication is different which can be standardised. Schools educate the children which indirectly forces parents to recycle, everywhere
2. Wide enough to fit through narrow doors, wheels, handle and right volume
3. Feel good help the environment
4. Financial reward to individual and companies

COMMON CULTURE TO CREATE CONSISTENT HABITS

Unfortunately, there were and still are mistakes or areas to develop. One such example is each EU country and region within a country adopted slightly different colour scheme due to type of recycling plant installed. When different regulations or cues are applied across different regions, it requires more effort to enforce the habit with customers as more effort is required by them to do the right thing:

CREATING SUSTAINABLE AND PERMANENT CHANGE IN BEHAVIOR IN THE INSURANCE SECTOR

Rules alone are not enough, cultural change and habits are required.

A successful ESG policy can be implemented as follows:

1. Find visionary (innovators/ early adopters) customer to develop new products and these customer will be the evangelist for your product for the early majority.
2. Implement the habit process with your visionary customers.
   a. Easy to differentiate between good vs bad policy: Create labels for investments and insurance products showing the level of sustainability so it is easier for the client to distinguish a green vs brown insurance policy. Create a consistent framework and labelling within the EU which allows companies and consumers to get familiar with the different sustainability levels allowing them to do the right thing without too much additional effort from their side
   b. Few steps to implement: limit the number of steps required from both the insurance company perspective and the policyholder
   c. Show benefit: consider both financial benefits (like capital or tax benefits) and non-financial benefits
   d. Reward customers: Ensure there is a financial reward for both the insurance company (capital relief) and the customer/policyholder (lower premium, tax deductible premiums)

We therefore believe that in the current sustainability discussion within the insurance industry, focus should not only be on the governance aspect, but instead building sustainable habits and culture should be central instead to enable long term change.