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Sustainable underwriting

Key steps to achieving a net zero insurance balance sheet

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Last year's United Nations Climate Change Conference, known as COP26, ended with a commitment to "phase down" coal, stop deforestation, reduce methane emissions by the end of the decade, and accelerate the move towards renewable energy.

In the build up to COP26, and following the climate conference, there has been a continuation of investors and corporations announcing their commitments to delivering net zero emissions. So far, about 40% of the global financial sector has aligned to a net zero target, while more than 20 global insurers and reinsurers have joined the Net Zero Insurance Alliance (NZIA). And with leading scientists estimating that about 90% of global GDP is covered by a net zero target, more and more carriers are likely to follow suit.

This raises the question of how insurers and underwriters can steer the emissions associated with underwriting to net zero. As they start out on their net zero journey, three main areas of enquiry are likely to arise:

1. How to measure emissions and what to measure.
2. Armed with measurement, how they can steer their portfolio towards net zero emissions.
3. How they can operationalize their strategy to achieve their ambition and commitments, while still protecting their profitability within a competitive marketplace.

Measurement

Until there is an industry standard methodology that can be adopted across the board, insurers must first decide on the emissions metric they will use. There are various options available, including:

- Absolute emissions — the total quantity of greenhouse gas emissions being discharged.
- Emissions intensity — the amount of emissions per unit of economic output.

Taking a lead from the financial institutions that have been tackling this question slightly longer than the insurance industry, it becomes clear that the make-up of an individual portfolio makes some metrics more logical for certain insurers than for others, depending on the industry or sector they are underwriting.

In the case of energy, for example, there is a fundamental difference between the power and the oil and gas sectors. The power sector's emissions intensity can continually be driven down towards net zero emissions as renewables, such as solar and wind, come online and thermal generation is displaced. The oil and gas sector, however, faces a much harder challenge because chemistry sets a fundamental limit on how far you can drive down the emissions intensity of a barrel of oil.

As a result, we may see insurers using absolute emissions as the metric for the oil and gas sector and a form of emissions intensity metric for the power sector. The key point here is that the metric can be chosen on a sector-by-sector basis to reflect the realities of the transitions in that industry.

The next thing an insurer can take a view on is the scope of emissions that are going to be included. A business can include the emissions of the entire value chain, including supply and distribution, of the companies in a particular sector, or instead, focus on the core operation emissions of Scope 1 (direct) and Scope 2 (indirect) emissions.

Once an insurer has agreed which emissions will be measured, it can make a decision on how it attributes emissions to a particular insurance transaction. Traditionally, this has been easier for banks and investors because they can take an approach based upon enterprise value, as they know the total debt and equity value of a particular company and their share of that debt or equity. They can then apportion emissions based on that ratio.

Insurers can also look at premiums or limits as a way to attribute emissions, although they may not necessarily have the data on a particular company's total purchase premiums, or the total limits it has outstanding with different carriers.

Carriers will then have to decide how different lines of business should be treated. Construction or property covers, for instance, may have quite a different contribution to emissions than general liability cover. This opens the question of whether certain types of policy be excluded from this framework or weighted differently.

There is also the question of data. An insurer may want to have an accurate, forward-looking view of emissions from a particular client to understand how they may align to a portfolio's objectives. But this kind of data can be very hard to get for smaller unlisted companies, SMEs, or individual assets.

Insurers may increasingly need to turn to new methods to come up with benchmarks and proxies to use in those instances. This isn't to say they shouldn't attempt to obtain the best data possible, but a strategy is needed to help improve the data environment over time and also leave room for an assessment of a client's path to net zero emissions.

Achieving a net zero portfolio

How is an insurer likely to steer a portfolio towards net zero emissions? Typically, carriers drive and manage change around industry or sector-based strategies. In this instance, many carriers have started with the most emissions-intensive sectors, including oil and gas, power, and so on.

By using benchmarks — standards to measure performance — and integrated assessment models from climate scientists or institutions, such as national energy agencies, insurers have set possible routes towards net zero. They are then able to analyze how their portfolio lines up to that path and start to answer the question of whether the key milestones for the transition are achievable for a particular sector they are providing cover for. If the goals are achievable, insurers can then introduce a framework to push these targets in the sectors they are insuring while at the same time providing the insureds with sufficient latitude to manage differences in market conditions and competitive tensions.

Another consideration is the consistency of approach on the underwriting side of the business, across different product lines, and what might be happening within the carrier's own investment portfolio. This inward and outward alignment is something that may move at a different pace and be more relevant to certain insurers than others.

There is also the question of whether the Russia-Ukraine conflict will have any bearing on insurers' sustainable underwriting ambitions. There may be demand for insurance of projects that do not necessarily align with this agenda, as countries seek to reduce their reliance on Russian fuels. Italy, for example, has already said it is considering expanding its coal footprint. Nuclear power may be pushed back onto the agenda, as governments address energy security issues.

Consequently, these shifts could potentially result in a short-term spike in carbon emissions. However, in Europe, especially, it may be greater energy security is achieved in a sustainable way, accelerating the transition to a more resilient energy infrastructure and decarbonized future.

Application

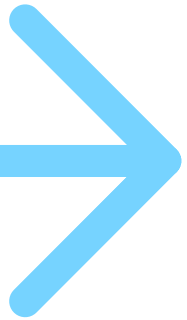
How these various metrics and business decisions are translated into key performance indicators and incentives for the different lines of businesses and then embedded in key processes, risk management, product innovation, strategic planning, and, critically, underwriting is key to the long journey ahead.

Carriers will need a framework to segment clients based upon this analysis. Critically, they can then engage with clients on the transition, their view of how it is going to unfold in their sector, and what that means for the journey they are going to go on together.

The last thing to consider is the training of staff in using and applying the framework. Frameworks are likely to be complex and will impact the way that people work and possibly their financial incentives. The application of frameworks is generally only going to be successful if key staff engage throughout the whole process — that is envisioning, developing, testing, and then finally rolling out the framework.

A change agenda of this scale will take time and, no doubt, will be bumpy. Marsh is staying close to the various relevant groups and will continue to keep clients appraised.

If you have questions on net zero insurance balance sheets, please contact your Marsh advisor.



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