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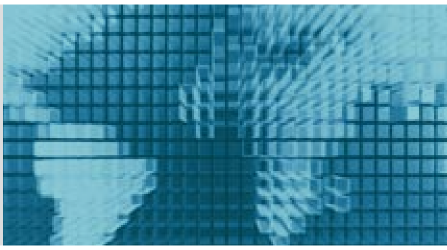

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The Law on Energy Transition: the impact on insurance companies

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Key Takeaways

- Article 173 of the Law on Energy Transition requires that French insurance companies publish a report on the manner in which they assess risks relating to ESG issues, in particular the climate.
- For insurance companies, climate change means a greater risk of natural disasters to insure against, coupled with a potentially unsustainable increase in the price of insurance premium for the insured persons and, finally, a risk on the value of their investments.
- The most advanced insurance companies have gone beyond the "Best in class" SRI, exclusion and core/satellite approach, and made the climate one of the key focuses of their investment policy.

What measures have you taken to adapt your investments to the fight against climate change? This is the key question that must be answered by French institutional investors subject to Article 173 of the Law on Energy Transition voted by the French Parliament, and in particular insurance companies. "This legislation requires investors to publish a report on the manner in which they assess risks relating to environment, social and governance (ESG) subjects, but with a specific focus on climate issues as this law was introduced in response to the COP 21 held in Paris that year (in 2015)", stresses Hervé Guez, Head of Research and Equities & Fixed Income at Mirova (an affiliate of Natixis Investment Managers dedicated to sustainable investment).

Insurance companies called upon to keep pace with the energy transition

The first reports by French investors relating to Article 173 were published in the summer of 2017. Certain reports were harshly criticised by observers, such as the French entity of the WWF, for the lack of clarity in information provided by insurance companies. Is this a case of France lagging the field? Not really, quite the contrary, this French legislation was quite innovative. Put into perspective on an international scale, we have seen an acceleration in the political agenda relating to the urgency of climate issues and an increasing number of incentives targeting the financial sector, with events such as Climate Finance Day. An increasing number of regulators are following in the footsteps of France and are seeking to align investments with the energy transition. Certain countries in Asia-Pacific such as Australia and Japan are already ahead of the game with others, such as South Korea and Singapore, slightly behind but hot on their heels.

And yet, addressing the urgency of climate issues comes naturally to insurance companies, which are built around risk management. First and foremost, climate change means a greater risk of natural disasters, disasters which they are required to insure against. And their cost is rising. In terms of hurricanes, 2017 was one of the most destructive seasons ever seen, with 21 billion dollars of damage in the United States caused by three category four hurricanes (Irma, Harvey and Maria) according to Swiss Re, the global reinsurance leader. As Henri de Castries pointed out a few years ago, a world where the temperature increases by four degrees is not insurable. If climate risk is therefore a systemic risk, insurance companies which are not correctly prepared would expose themselves to double punishment: an increase in the physical risks they must insure against, coupled with a potentially unsustainable increase in the price of insurance premium for the insured person and a risk on the value of their investments. We must also consider stranded assets: if a share of fossil fuel reserves were subject to a mining ban, this would have a major negative impact on the valuation of the shares and the credit quality of the companies in question.

Going beyond regulatory requirements and placing ESG at the heart of its investment strategy

What can asset managers do to support insurance companies in the necessary transition of their investments? "As a group with several affiliates that have an ESG filter, including Mirova which is entirely dedicated to sustainable investment, we have worked extensively with our insurance company clients on this subject" explains Estelle Castres, Head of Key Insurance Clients Group at Natixis Investment Managers. "Each client is unique. First, we discuss with each one, both broadly and in depth, their exposure to climate issues, before proposing tailor-made sustainable investment solutions." "Insurance companies need to ask themselves what climate risks means for them, to define a scenario and set targets" explains Hervé Guez. "This allows us to discuss fairly technical subjects with them, such as the correlation between financial performance and climate risk. The provision of an intellectual capital is key at this stage".

The core/satellite approach is well suited to climate issues

Insurance companies can take a step forward in their risk management through their core/satellite approach: the climate risk approach can thus be implemented across the entire portfolio, economically and with a limited tracking error. ESG criteria can be used for scoring purposes for the portfolio's core segment. In the satellite segment, insurance companies can integrate solutions with greater social or environmental impacts, invest in open-ended funds carrying the French SRI or TEEC (Transition Energétique et Ecologique pour le Climat - Energy and Ecological Transition for Climate Change) label or in illiquid assets via equity investments. Climate risk measurement may thus lead an insurance company to modify its asset allocation.

The most advanced insurance companies in terms of strategic thinking and the transfer of their climate-related beliefs to their investments have gone beyond the "Best in class" SRI, exclusion and core/satellite approach, and made the climate issue one of the key focuses of their investment policy in a holistic manner.

And although this subject remains in its early stages in certain countries, Estelle Castres confirms that there is a widespread desire among European insurance companies to go further than simply excluding certain sectors from their investments. The European Commission's action plan promoting sustainable finance - which is based on the final recommendations set out by the High-Level Expert Group on sustainable finance, of which Philippe Zaouati, CEO of Mirova and Chair of Finance for Tomorrow, was a member - clarifies, in particular, the duty of asset managers and institutional investors to take sustainability into account in the investment process and enhance disclosure requirements. This proves that French legislation has inspired European regulations. The rationale behind the energy transition is going strong, despite the US setback following the United States' withdrawal from the Paris agreement, and it is in insurance companies' interest to take the lead rather than be overtaken by the masses.

The more advanced insurance companies ensure that the climate footprint of their investments are in line with the climate path of +2°C set out in the Paris agreements. "We believe that a quick-fix approach limited to just removing a few major direct emitters of carbon from our portfolios is inadequate" explains Hervé Guez. "Carbon risk is not limited to a few coal-fired plants and we must analyse the direct and indirect footprint of each sector".

Insurance companies which address this issue can expect to have a real impact on the climate, by systematically taking ESG criteria into account in their investments or by offering their own clients financial products which clearly show their commitment to the climate. French and European savings can thus be steered towards green and socially responsible products. This is the aim of the creation of a European label for green financial products based on a system for classifying green assets.

Natixis Investment Managers and Mirova strive to support insurance companies in their overall reflection on factoring ESG, and in particular environmental, criteria into their strategy as the climate is a major issue which goes beyond the scope of compliance with regulatory requirements.

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