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THE CAPCO INSTITUTE
JOURNAL
OF FINANCIAL TRANSFORMATION

ESG

Transitioning to a low
carbon economy – (re)insuring
climate change and potential
business risks and opportunities

JONATHAN GALE | ANDREW MACFARLANE

**CRISIS
MANAGEMENT**

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DEAR READER,

Recent events in the U.S. banking sector, and broader concerns around instability and contagion within the global financial services industry, have meant that crisis management is once more front of mind for many institutions.

In addition, the world of business and finance is facing broader geopolitical and socioeconomic challenges, ranging from conflict, climate change, inflationary pressures, and precarious energy resources. Factor in heightened regulatory and competitive pressures, and it becomes clear that financial institutions must prioritize risk management, within their own organizations and with their counterparties.

The papers in this edition of the Journal address the theme of crisis management through various lenses, including regulatory compliance and traditional risk management, as well ESG, the low carbon economy, and sustainable finance. Our authors also explore topics such as the impact of social change on the world of finance, the rise of artificial intelligence and virtual reality technologies, and cybersecurity.

Contributions in this edition come from a range of world-class experts across industry and academia, and showcase some of the very best expertise, independent thinking, and strategic insights within the financial services sector.

As ever, I hope that you find the latest edition of the Capco Journal to be engaging and informative. Thank you to all our contributors, and thank you for reading.

A handwritten signature in black ink, appearing to read 'Lance Levy', with a stylized, flowing script.

Lance Levy, Capco CEO

TRANSITIONING TO A LOW CARBON ECONOMY – (RE)INSURING CLIMATE CHANGE AND POTENTIAL BUSINESS RISKS AND OPPORTUNITIES

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ABSTRACT

(Re)insuring the risks related to a changing climate is a challenge and an opportunity – new risks are being created and existing risks are being amplified. As businesses seek to understand, and play an active role in mitigating, the effects of climate change they often focus on the physical risks associated with the changing environment. However, a key part of the business risk can come from the substantive change in consumer behavior, technological advances, and the change in operations needed of almost every company globally – the “transition risk”. As the world works to decouple the link between the continuous need for economic growth and increasing emissions, we consider the pathway to manage that change.

1. INTRODUCTION

The transition to a lower carbon economy is a challenge and an opportunity for businesses now and for generations to come. As new risks are being created and existing risks are being amplified, we believe companies that set themselves up to understand and play an active role in the transition will perform better than those that don't.

Society currently focuses on physical risk, but a key part of the risk probably comes from the substantive change in consumer behavior, technological advances, and the change in operations of almost every company globally – what we call “transition risk” – as the world works to decouple the link between the need for economic growth and increasing emissions.

At AXA XL, the commercial P&C and specialty risk division of AXA Group, we have established expertise in traditional risk, but we need to understand the inherent volatility that will accompany this transition, which may manifest

in geopolitical tension, mass migration, social unrest and polarization, increased income inequality, food shortages, and energy insecurity.

Companies across all sectors and geographies are at different stages in their journey to help in the fight against climate change. For the (re)insurance industry, working with clients to understand the risks and opportunities presented by the transition is both a challenge and an imperative.

2. PHYSICAL RISK – (RE)INSURING PHYSICAL ASSETS

Through the (re)insurance business that we underwrite, and the exposure that we have to natural catastrophes, (re)insurers are acutely aware of the physical risks associated with climate change; the effects of changes in the chronic and acute hazards that the world faces. To date, the ways that the impact of these risks can be modeled, mitigated, managed, and transferred has dominated much of the industry discussion.

When thinking about the physical risks associated with climate change, the (re)insurance industry considers all elements of the risk equation: hazard, exposure, and vulnerability,¹ where the “hazard” is the potentially destructive phenomenon, the “exposure” is the location and assets that could be affected by that hazard, and the “vulnerability” is the extent to which those assets are able to withstand the hazard.

In recent years, the volatility in the frequency and severity of extreme weather events, combined with exposure to growth driven by enlarged populations, urbanization, and inflation, has served to underscore the physical impact of climate change, resulting in large economic losses and widespread damage to property and infrastructure, as well as devastating effects on communities around the world, often in developing economies or vulnerable societal groups.

The fourth costliest year to date for natural catastrophes occurred in 2021, when the world was also grappling with the effects of the COVID-19 pandemic. Insured losses from natural catastrophes topped U.S.\$105 bln in 2021.²

Notably, as well as major events such as hurricanes, the physical and economic impact of perils such as flooding or wildfire is also increasing, with several such events topping U.S.\$10 bln in terms of losses in recent years. Losses caused by flooding, for example, are both frequent and severe; in 2021, there were more than 50 severe flood events globally, resulting in more than U.S.\$80 bln of economic losses, of which approximately U.S.\$20 bln were insured.³

2.1 The protection gap

As well as having a significant impact on (re)insurers, these physical losses highlight the so-called “protection gap” – the gap between economic losses caused by events and the proportion of those losses that are insured. This is a major focus for the (re)insurance industry, which has a vital role to play not only in assisting our clients in understanding their own exposure and resilience to hazards, and paying claims when events occur, but also in helping more vulnerable communities improve their resilience to natural catastrophe events.

A study by the Cambridge Centre for Risk Studies (CCRS) commissioned by AXA XL and published in 2020 looked at

the impact of insurance penetration on the speed and quality of recovery for more than 100 events over a 30-year period.⁴ In general, the higher the insurance penetration, the faster and better the recovery, with most high-insurance-penetration countries recovering to pre-disaster levels within 12 months and low-insurance-penetration countries⁵ recovering more slowly, and in a number of cases never returning to pre-disaster levels. AXA XL funded an open source online Disaster Recovery Hub developed by Cambridge that gives a lot more detail on the selected items used to classify recovery and highlight the speed to recovery (cambridgebusinessriskhub.com).⁶

(Re)insurance is uniquely positioned to deliver non-contingent funding (no debt to pay back) immediately after an event, allowing both swift and reformative recovery – “Build Back Better”. However, the gap between insured and economic loss remains high and the recent Turkish/Syrian earthquake will likely be another tragic example of this protection gap (albeit, even if the cause is not a climate related issue). Moody’s RMS recently estimated the economic loss from the earthquake to be in excess of U.S.\$25 bln and the insured loss to be greater than U.S.\$5bln (a gap of 80 percent).⁷ The (re)insurance industry, in partnership with governments or international financial institutions, such as the World Bank, can help close the gap, provide non-contingent funding, and help promote resiliency for future disasters – “Build Better Before”.

2.2 Transition risk: Transitioning to a low carbon economy – risks and opportunities

The impacts of a changing climate, driven by the increasing concentration of greenhouse gases (GHGs), manifest in the impacts we see on the physical risk described above. The challenge of climate change is in managing and reducing these emissions; the world’s response means that industries of all types around the globe are in transition. With that transition comes opportunity but also risk; as companies transition to a lower carbon economy, they change the way they operate, the way they produce and transport goods, the energy they use, and the way they interact with their customers and other stakeholders. All of these changes – driven through technology, consumer behavior, and regulation – will have implications for their risk profiles now and into the future.

¹ <https://bit.ly/3lQaVI5>

² <https://bit.ly/3Jg6rM8>

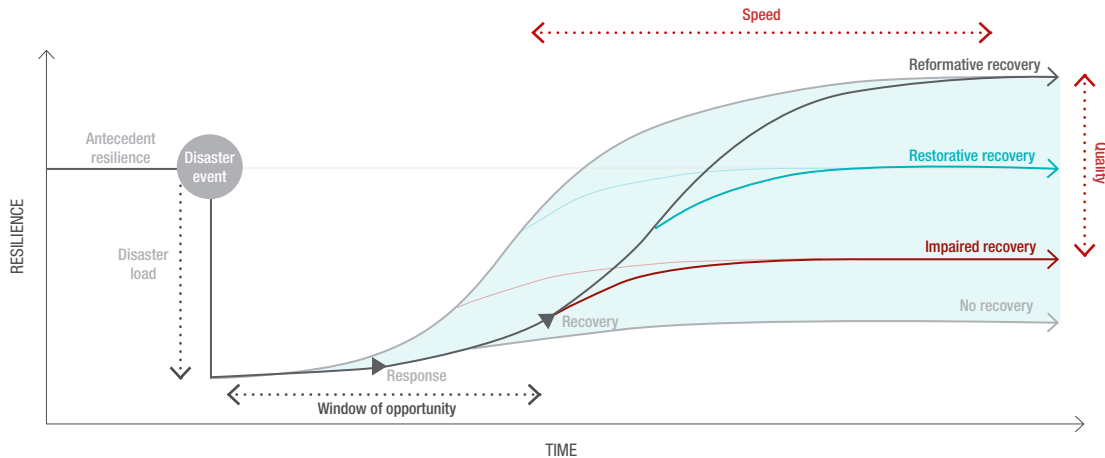
³ <https://bit.ly/3Zl5TnH>

⁴ <https://bit.ly/3ZFy1b8>

⁵ Insurance penetration was assessed as premium as a percentage of GDP.

⁶ <https://bit.ly/3ZnHVyw>

⁷ <https://bit.ly/3ZpY0sb>

Figure 1: Process of disaster recovery

Against the backdrop of a changing and increasingly volatile climate, companies are evolving to try to address this challenge. There are several drivers prompting them to do so, which act in different ways on different companies, and eliciting differing responses depending on factors such as industry and geographic location. All of these changes create new risks and new opportunities.

The major drivers of the transition are changes in policy, advances in technology, and changes in consumer behavior. These affect companies to a lesser or greater extent for reasons related to their sector, geographic scope, shareholder base, customers, and so on. It is also important to understand that companies are at different stages of their transition journey – a challenge for risk professionals.

By and large, public sentiment appears to support the notion of policy changes and regulatory intervention to help drive the transition to a low carbon global economy. This is, however, currently variable across regions as well as between different industry sectors.

Politicians, though, have publicly made commitments not only to reduce carbon emissions and aim for net-zero by 2050, but also to put in place policy instruments to effect this change. In the U.S., for example, the Inflation Reduction Act of 2022 (IRA) pledges to create loans to try to curb emissions and increase investment in clean energy and energy innovation.⁸ Policy moves like these send a clear message to businesses around

the world that changing strategy to become more carbon-friendly is not just a good thing to do, it is imperative.

Questions arise, however, about the way that funding will flow through the economy. How can fair distribution be ensured? Can a just transition, whereby vulnerable and developing economies are not penalized, but brought along on this transition, be achieved?

Regulators too are increasingly focused on how investments are made and the disclosures companies make about their net-zero strategies. Collectively, the (re)insurance industry is one of the largest investors in the world, and individual (re) insurers have not only potential regulatory and shareholder pressure but ethical obligations too when determining how and where they invest. The Net-Zero Asset Owners Alliance (NZAOA), convened by the United Nations, is a member-led initiative of institutional investors committed to transitioning their investment portfolio to net-zero GHG emissions by 2050 – consistent with a maximum temperature increase of 1.5 degrees Celsius.⁹ (Re)insurers, as one of the biggest investors globally, have a role to play in contributing to these commitments.

Alongside the NZAOA, the Net-Zero Insurance Alliance (NZIA), more recently convened in 2021 by the United Nations, supports its members in the journey to de-carbonizing their underwriting portfolios. This recognizes the role that (re) insurers have as enablers of economic activity in the global economy.¹⁰ The NZIA's first target-setting protocol requires

⁸ <https://bit.ly/3JimZ6u>

⁹ <https://bit.ly/3ZqnDnQ>

¹⁰ <https://bit.ly/3Jin2iG>

members to set and disclose initial targets from a variety of options; decarbonization, engagement, and actions to support the transition for (re)insurance portfolios by July 2023, which is an important milestone in our own industry's transition journey.

2.3 Liability risks – allegations of greenwashing and increasing litigation

Policymakers and activists are paying ever closer attention to the climate behaviors, policies, and commitments of companies and the sectors in which they operate. There has been an uptick in litigation involving people and communities who attest that their homes and livelihoods are being adversely affected by a changing climate and who are trying to hold companies to account for these impacts driven by their activities and their emissions. A landmark case involving a Peruvian farmer and his community and an energy provider is currently making its way through the courts.¹¹

As well as legal and policy action to address the physical impacts associated with climate change, activists are seeking to hold companies to account for the pledges they make. There are now legal precedents for claims of so-called greenwashing, illustrating how companies need to ensure they are meeting the promises they make.

Policymakers are requiring ever more information from companies about their climate performance, transition plans, and net-zero commitments. In the U.K., for example, large companies have since 2022 been required to make climate disclosures in accordance with the Taskforce on Climate-Related Financial Disclosures (TCFD).¹²

In some instances, the legal cases and policies around climate performance are not necessarily motivated by a desire for financial redress, rather they are about holding companies to account for their actions and commitments and trying to effect change.

A major risk here for companies is around their reputations. Accusations of greenwashing or a failure to meet targets can be hugely damaging to a company's brand.

There is a need to be aware of this growing activism, the regulatory reporting requirements, and accountability of a businesses' actions. Liability cases that are on the rise globally

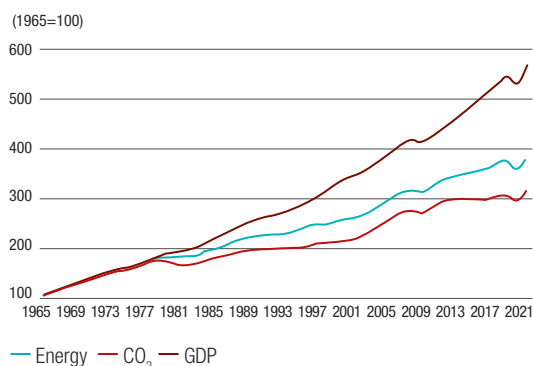
bring with them potential impacts to reputation and brand if the commitments and disclosures that have been made cannot be supported.

3. BREAKING THE LINK BETWEEN ECONOMIC GROWTH AND INCREASING EMISSIONS

Moving away from (re)insurance and considering the economy as a whole, governments can look at managing and reducing emissions and break the link between economic growth and emission levels.¹³ Academics have pointed to four main levers to achieving this: through managing population growth, producing energy more efficiently, generating economic output more efficiently, and consuming less.

In terms of producing both energy and economic output more efficiently, technology has a major role to play. As an economy, we need to be able to demonstrate that we can create a sustainable society – while reducing emissions. Figure 2 presents the relationship between GDP growth, energy, and emissions.¹⁴ It is evident that there is a strong relationship between all three. In order to achieve net-zero ambitions and continue to generate GDP growth, this relationship needs to be decoupled: we need to see the energy and emission lines flatten out (or reduce) to show how we are becoming more efficient as a society whilst the GDP line continues to grow. This is where expectations of energy efficiency and technology will contribute towards meeting these objectives. If this does not happen, we need to contemplate the other levers around volume of consumption, which is likely to be driven by population size.

Figure 2: Emissions, energy, and GDP



Source: Fitch Ratings, BP, IEA, EIA

¹¹ <https://bit.ly/3ZKU0ds>

¹² <https://bit.ly/3ZqiGLK>

¹³ <https://bit.ly/3yd9LSb>

¹⁴ <https://bit.ly/3F114PP>

There is both a demand and a desire to increase the efficiency of energy production, driven in no small part by the public net-zero commitments made by governments and companies operating in that sector. (Re)insurers have many years of experience working with energy clients to understand their risks and the technologies they use. The energy transition is a continuation of that journey. There are, however, challenges here, including the need for new technology and the speed with which society needs to scale this implementation. The availability of materials, the need to develop and repurpose infrastructure, and the need to find new ways to store and distribute the energy produced, all come with risks.

While this technology develops, and the demand for energy continues to grow, especially within the developing world, society needs to make sure that all the advances that have been made over the past 100 years are not reversed. We need to ensure that this technology and investment happens globally, reinforcing a just transition for all.

Likewise, the need for other goods and services to be produced more efficiently creates both opportunities and risks. Underwriters are working with risk engineers and risk managers to understand the nuances around topics such as carbon capture and storage, the electrification of vehicles, battery storage and power grids, and the production of materials like steel and cement with newer low-emission processes.

Companies across all sectors are aware of the need to become more efficient in their production, a need fueled at the macro level by policy and regulation and at the more micro level by the demands and priorities of stakeholders, including shareholders, employees and, crucially, customers.

Consumer behaviors are changing. Now more than ever before buyers want to know where the goods they are purchasing are from, the conditions in which they were produced, and how they have been packaged and transported. This is particularly noticeable for certain sectors, such as food and beverage and transportation.

Given that consumers are also voters – as well as investors, employees, and even activists – policy will, to an extent, be driven by these changes in consumer habits. Some studies have found that consumers are willing to pay more for a

brand they deem environmentally responsible and that good corporate behavior is a driver in their purchasing decisions – so there is a business opportunity for companies that make changes to operate more sustainability.¹⁵

Consumers' altering behaviors will continue to bring about change, but consumer behavior can also be influenced by the behavior of a company's supply chain; get this right and there is a real opportunity for companies to create meaningful change.

3.1 How do individual businesses accomplish the transition, and what is the role of (re)insurance?

All industries are somewhere on the road to transition. It might not be a linear journey, and companies are at differing stages, but the need and the will to transition the global economy are gathering pace. The question then becomes: what does this mean for individual businesses? How can companies not only play their part in the global shift but achieve their own transition goals and make this work for their customers, employees, and supply chain?

In a sense, this is a large change-management exercise. Our own experience as a (re)insurer and as a part of a large, global financial services group, may be useful here in trying to assess how this change can be set in motion.

When we were devising our own climate strategy, we took into account the fact that we are an investor, a (re)insurer, and a company/employer that is part of the financial system and the global economy.

Across these three areas of activity, AXA has seven targets. As an investor, we pledge to play our part in reducing the carbon footprint of the AXA Group's investment portfolio by 20 percent by 2025 and to help increase AXA's green investments to reach €26 bln by 2023.¹⁶

Within AXA XL, we recently launched our latest sustainability strategy: Sustainability takes root; why sustainable business means better business.¹⁷ Following interviews with key stakeholders to define the ESG issues most material to our business, we created a strategy to put sustainability at the center of what we do.

¹⁵ <https://bit.ly/3mn130h>

¹⁶ <https://bit.ly/3YjJEp>

¹⁷ <https://bit.ly/3muPuVx>

As a (re)insurer, we have committed to a green business target aimed at increasing the share of business we write supporting climate adaptation, climate mitigation, the circular economy, and the prevention of biodiversity loss. We are also committed to providing inclusive insurance protection to more vulnerable populations.

We are committed to leading the transformation by taking people and teams with us on this transition journey through training our colleagues on climate issues by 2023; embedding climate risk as part of our business strategy as well as by reducing the carbon footprint of our own operations.

As a founding member, and current chair, of the aforementioned NZIA, we will also be looking to transition our underwriting portfolio to net-zero in line with the NZIA commitments.

The final commitment is a general performance indicator around maintaining AXA's position in the Dow Jones Sustainability rating Index, recognizing the goal of maintaining AXA's leadership position in this space.

With any strategy, and particularly a climate strategy, embedding it is key; the people with whom you work, trade, and invest need to be on board. There needs to be key performance indicators to benchmark successes and make targets real.

This is a process, of course. The transition will not be linear, rather it will be jagged and disorderly. We tend to think in straight lines and envisage an orderly transition, but we can expect – and maybe already are seeing – increasing geopolitical tensions, mass migration, social unrest and polarization, food shortages, and energy insecurity. Climate change strategies must, therefore, evolve and flex as we all move along the road to transition and consider the inequities already inherent, which may be amplified by the transition.

(Re)insurers have always played a vital role in enabling economic activity, from ships delivering cargo to space craft sending satellites into orbit – and everything in between.

As technology develops to enable the transition and meet evolving consumer preferences, (re)insurance must have a seat at the table. We can use our risk expertise to help companies develop and then scale these new technologies. And, uniquely, as we have previously alluded, (re)insurance can achieve this with both sides of the balance sheet; with the products and solutions we provide and with the investments and partnerships we make.

4. CONCLUSION: TOWARDS A GREENER FUTURE

The risks and opportunities inherent in the transition to a net-zero carbon economy will vary in magnitude and complexity. These risks and opportunities will be dependent on the emissions pathways that we choose, driven by our actions and characterized according to the so-called shared socioeconomic pathways (SSPs).¹⁸ SSPs examine how the actions of societies and geographies will impact emission pathways up to 2100. SSPs form an important input into models that explore how societal choices will affect greenhouse gas emissions and feed into the climate policies of the Intergovernmental Panel on Climate Change (IPCC).

The speed and impact of changes may vary by geographic region and industry; the risk landscape is changing and the transition will not be straightforward. Business owners, managers, and the (re) insurance industry need to be aware of this evolving risk landscape and the impacts on their own businesses and on the societies in which they operate. They need to adapt operating models and consider multiple scenarios in an uncertain environment.

To work with clients to understand and manage these risks – and to help them take advantage of the opportunities – (re) insurers will need even more data, more detailed information, a continuing dialogue, and, of course, imagination. The key question again is: what does climate change mean for your business? What are the risks you will face going forward, and how will they evolve? What are the opportunities of the transition to a lower carbon economy? And how will you develop your business to respond to these potential risks and opportunities now and into the future?

We are all learning about the transition, all of the time. (Re) insurers will use their risk expertise to try to understand this changing landscape, its nuances and complexities, while continuing to facilitate economic activity and support companies on this journey.

¹⁸ <https://bit.ly/3F3GXPF>

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Capco, a Wipro company, is a global technology and management consultancy focused in the financial services industry. Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its award-winning Be Yourself At Work culture and diverse talent.

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