A European Perspective on Insurance-Associated Emissions

Executive Summary:

Carbon dioxide equivalent (CO2e) emissions have become one of the most important metrics for climate reporting across industries. Indirect Scope 3 emissions form the main source of emissions for insurers – with CDP reporting finance portfolio emissions are over 700 times larger than direct emissions[1]. As financial institutions, re/insurers enable emissions through their financing and insuring business.

Guidance for greenhouse gas emissions (GHG) disclosure is provided by the GHG Protocol. Building on the GHG Protocol, the Partnership for Carbon Accounting Financials (PCAF) has developed Standards for Financed and Insurance-Associated Emissions[2] (IAE). While the scope of the PCAF Standard for IAE is currently limited to personal motor and commercial lines insurance, future scope development is expected - depending on PCAF members' feedback in property, treaty reinsurance and potentially life and health. Meanwhile, the Science-Based Targets initiative (SBTi) is expected to launch their Financial Institutions Net Zero Standard in early 2024 at the latest, to enable financial institutions to set net zero targets that are consistent with achieving a net zero world by 2050.

[1] CDP Financial Services Disclosure Report 2020 | CDP
[2] The Global GHG Accounting and Reporting Standard for the Financial Industry | PCAF

The UN-convened Net Zero Insurance Alliance (NZIA) published its first Target Setting Protocol in January 2023[3], initially requiring member insurers to set and disclose science-based, interim decarbonization targets but has since made the Target Setting Protocol a voluntary best practice. The following months have shown adverse developments for the NZIA, with major insurers leaving the NZIA following threats of antitrust legal action in the USA. We note that re/insurers who have left the NZIA have still committed to net zero targets and are, therefore, preparing to measure their IAE.

Moreover, we expect that most re/insurers will assess emissions of the underwriting portfolio as material when assessing double materiality and therefore be required to disclose IAE under EU Corporate Sustainability Reporting Directive (CSRD) if they fall within the scope of the Directive. Insurance and reinsurance companies generally have an indirect role in facilitating emissions for the real economy. For example, insurers provide risk transfer services to key sectors such as energy or transportation.

The huge challenge re/insurers are facing is to consider how they can influence the vast amount of indirect emissions they re/insure. In addition, key practical challenges for re/insurers include enhancing the quality of data used to determine IAE and weighting sustainability key performance indicators (KPIs) with financial KPIs to paint a coherent overall picture of their activities. Re/insurers will have to adapt their underwriting and policy management procedures and standards, as well as implement overarching master data management standards and tools to effectively meet the requirement of assurance of CSRD disclosures.

Whilst we expect the PCAF Standard on IAE to expand the emission measurement scope beyond commercial and personal motor lines for non-life re/insurance, we anticipate that life re/insurers will initially continue focusing primarily on reducing organizational emissions through their investment portfolio.

[3] Target Setting Protocol | NZIA

Re/Insurers’ catalyst role in decarbonizing the global economy

Preventing further climate change is at the core of sustainability targets. We have unequivocal evidence that the earth is warming at an unprecedented rate due to atmospheric greenhouse gas (GHG) emissions, leading to increasing impacts linked to anthropogenic climate change. Landmark publications, such as the World Economic Forum’s Global Risks Report 2023, have shown that climate-related risks outrank other risks in expected severity for the years to come.

Although re/insurers account for only a negligibly small proportion of total global emissions by means of their own business operations, the insurance industry plays a crucial role in driving the transition to a net-zero economy through its roles as institutional investors, underwriters and risk managers. The insurance industry has a significant impact on the climate through its investments, re/insurance activities, claims repairs, and risk advisory services, as they enable and support various business activities. To reduce emissions associated with their operations, contribute to the transition to a net-zero economy, and effectively manage climate risks, re/insurers will need to focus on the development, implementation, and ongoing monitoring of measurable and actionable metrics over time.

Various frameworks have been developed to give financial institutions guidance on determining their GHG emissions. At the core of GHG measurement is the GHG Protocol – the corporate accounting and emission reporting standard. The GHG Protocol classifies carbon emissions into Scopes 1 (direct emissions), 2 (indirect emissions from energy purchased and used) and 3 (indirect emissions upstream and downstream in the value chain of the business). Scope 3 emissions are by far the largest source of emissions for financial institutions like insurers.

Scope 3 Emissions

The GHG Accounting and Reporting Standard for the Financial Industry (GHG Accounting Standard) developed by the Partnership for Carbon Accounting Financials (PCAF) has formalized methodologies around assessing emissions most relevant to the financial sector: Financed Emissions and Insurance-Associated Emissions.

Financed Emissions	Insurance-Associated Emissions
Emissions from loans and investments	Emissions associated with re/insurance underwriting portfolios
• Can be considered through equity share, operational control approaches as the financier may or may not have control of business activities, depending on the nature of financing • Financing could be provided over a multi-year basis • “Follow the money” principle, whereby emissions are linked to the financing of different business activities • Lower risk of double counting as financing is negotiated at specified amounts across time among both parties • May have more direct influence due to negotiations that happen with the financers prior to both parties entering the financial relationship	• No financial or operational control to business activities as there is no transfer of equity or ownership • Insurance coverage mostly renewed on an annual basis • “Follow the risk” principle, whereby emissions are tied to premiums that are paid for specific insured risks • Higher risk of double counting within a re/insurer across different lines of business or between insurance and risk management services • May not have direct influence over insured risks as transactions can be completed through insurance brokers

PCAF, with its iterative approach towards improving emission measurement, currently provides an approach to measure the emissions associated with commercial and personal motor insurance lines. Yet, these only form part of all lines of business for the insurance sector. Key lines including property, treaty reinsurance, and health insurance remain missing from the current standard and are expected to be included in future iterations. These lines contribute significantly to global emissions, with energy use in buildings estimated between 18%-40% of global emissions[4,5].

The transition towards net zero underwriting has started

COP26 gave rise to the Glasgow Financial Alliance for Net Zero (GFANZ), a global coalition of financial institutions committed to accelerating the decarbonization of the global economy. From this group, the Net Zero Insurance Alliance (NZIA) was created in July 2021 to help the insurance industry transition towards a net zero economy. The NZIA grew to around 30 leading global insurers and reinsurers who, as signatories, commit to reach net zero emissions for their underwriting portfolios by 2050.

The NZIA published its first Target Setting Protocol in January 2023. The Target Setting Protocol builds upon PCAF's GHG Accounting Standard for IAE and aims to enable insurers to set science-based, interim decarbonization targets. It defines five target types within three target categories (i.e. two types for emissions reduction, two types for the engagement category, and one for re/insuring the transition). The protocol previously required NZIA members to set at least one of the five target types by mid-2023, and at least one target type in each of the three target categories by mid-2024, but have since removed the requirement.

[4] World Greenhouse Gas Emissions: 2019 | World Resources Institute
[5] A guide to decarbonizing the built environment | World Economic Forum

However, fears of anti-trust legal action in the United States of America (where insurance is regulated on a State-by-State basis) led several NZIA members to leave the Alliance since the first half of 2023. In May 2023, Attorneys General from 23 US States sent a letter to the NZIA seeking documents and information over "legal concerns brought about by commitments to collaborate with other insurers in order to advance an activist climate agenda", notably citing increased insurance costs and inflation. This letter accelerated the exit of NZIA members with US exposure, as of the time of writing, the member count stands at eleven insurers. Nonetheless, we have observed that some governments have given companies the green light to collaborate on tackling climate change, alleviating concerns about collusion.

Despite these adverse developments, many insurers have reaffirmed their ambition to steer towards net zero underwriting portfolios, although it may now primarily play out on a company-by-company basis. Civil society and Non-Governmental Organizations (NGOs) keep the pressure on the insurance sector through campaigning (e.g., Insure Our Future's scorecard) and climate-related litigation (e.g., the ongoing legal battle over insurance for the East African Crude Oil Pipeline). Countries have also started enshrining net zero targets in law with explicit references to their financial sectors (e.g., UK in 2019 passed laws to set emission targets to net zero by 2050; Switzerland recently by popular vote in June 2023). The SBTi has also published guidance for the financial sector. Some leading individual insurers have now started setting specific interim targets for reducing their insurance-associated emissions by 2030.

Transition strategy

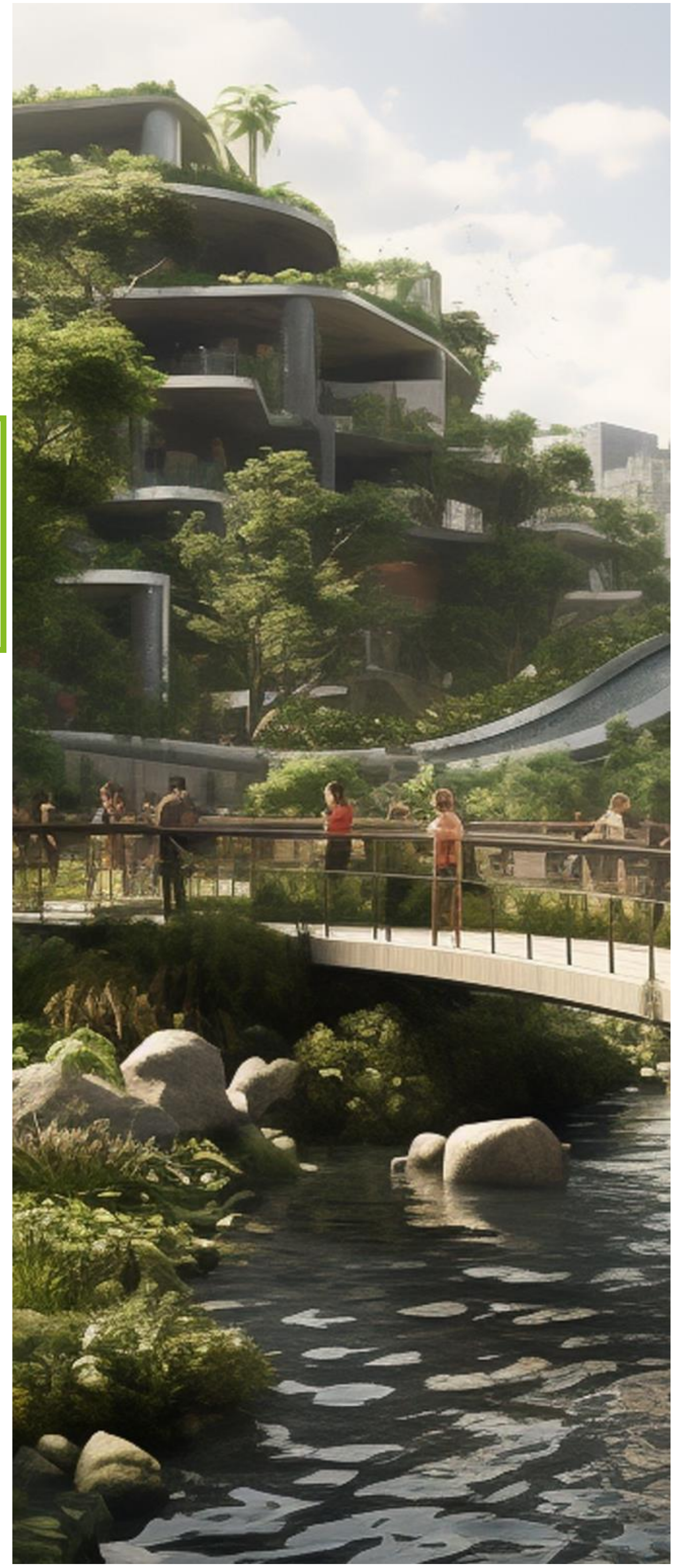
In addition to these interim targets for IAE, a growing number of insurers (most of them European-based) have started phasing out insurance for thermal coal and unconventional fossil fuels (such as Arctic drilling, fracking, or tar sands). By doing so, these insurers often bring their underwriting policies in line with their existing investment policies, gradually closing potential loopholes in asset-liability risk management. A few re/insurers such as SCOR have gone further by committing to exclude standalone direct insurance and facultative reinsurance coverage for new gas field development projects, thus following the recommendations from the International Energy Agency to end fossil fuel expansion and its financing.

While implementing fossil fuel exclusions should mechanically reduce insurers' IAE, they only address the most carbon-intensive aspects of their underwriting activities. Further, the real economy impact of such policies can also be debated as the risks are likely to be transferred to other, willing parties, who might be less concerned with a net zero transition and therefore unlikely to influence positive behaviors.

IAE should be managed and measured across the whole insurance portfolio (once methodologies such as PCAF's develop to cover more lines of business). Therefore, they should also consider how to support and provide incentives for policyholders to switch to greener mobility, more energy-efficient housing, and in general lifestyle and economic activities that are compatible with stated public and private net zero objectives and halting climate change. We provide many such examples of emerging good practices from insurers around the world in our latest report with WWF Underwriting Our Planet[6]. Furthermore, insurers should also consider the social impacts of their evolving underwriting practices (Fair Transition) and make sure their climate action is embedded in the context of a holistic ESG strategy.

[6] Underwriting our planet | Deloitte Switzerland

Overview of regulatory requirements



CSRD, a guideline for non-financial reporting, was established to improve overall quality around sustainability reporting. CSRD entered into force in 2023 as part of the European Green Deal and aligned with the EU's wider commitment to achieve climate neutrality by 2050. The CSRD requires companies to provide comprehensive disclosures about respective environmental, social and governance (ESG) performance, and is expected to impact tens of thousands of companies across the EU. The phase-in of CSRD is divided into several steps at different paces depending on the company's size (asset, revenue, number of employees). A comprehensive overview is provided by Deloitte[7].

Generally, re/insurers will have to disclose under CSRD starting from fiscal year 2024 onwards. It is important to note that CSRD regulations also affect non-European companies. Non-European groups with European subsidiaries who are required to report under CSRD starting from 2029 should consider reporting at the same time as the subsidiary for efficiency purposes, especially when sustainability disclosures need to be aligned across these entities.

To be included in the first wave of reporting companies, a regular listing within the EU is a major criterion. However, from 2028 onwards, non-listed companies are also required to report under CSRD if they have a significant turnover in the EU.[8]

Furthermore, CSRD has introduced the concept of double materiality. Companies are required by CSRD to report on their company's impact on society and the environment (inside-out), in addition to how sustainability issues may impact the company itself (outside-in). The European Sustainability Reporting Standard (ESRS) Delegated Acts, specifying the detail of the reporting required under CSRD, have been adopted by the European Commission. The IFRS aims to establish comparable, reliable sustainability reporting and increased interoperability with other reporting standards, such as the IFRS S1 and S2 standards from International Sustainability Standards Board (ISSB). IFRS S2: Climate-related disclosures, in particular, outlines expectations for companies involved in financial activities to disclose gross GHG, disaggregated by industry exposure and asset class. For insurers, this links to disclosing emissions in Scope 3 - Category 15 emissions, or IAE. **Notably, IFRS S2 and ESRS E1 both outline criteria to disclose climate-related transition plans, which go beyond quantification of IAE.** At the same time, EU Taxonomy has set expectations on companies to assess impacts of their operations against key established considerations such as those covered within the 'Do No Significant Harm' criteria – in the case of fossil fuel-related companies, this means to assess direct GHG emissions of specific economic activities, among other criteria.

Entities within the scope of CSRD must obtain limited assurance on their disclosures beginning in the first year of reporting.

[7] The European Sustainability Reporting Standards – unpacking the Commission's first Delegated Act | Deloitte UK
[8] The EU Corporate Sustainability Reporting Directive -what non-EU companies should know (harvard.edu)

Changes to ESRS

After receiving feedback on November 2022 and June 2023 ESRS drafts, the final Delegated Acts were published in July 2023. In contrast to the earlier drafts, the final Delegated Act no longer explicitly lists part C "Insurance-Associated Emissions". The Act rather highlights Part A, which only considers financed emissions:

> *AR 46. When preparing the information on gross Scope 3 GHG emissions required under paragraph 51, the undertaking shall: […] (b) […] if it is a financial institution, consider the GHG Accounting and Reporting Standard for the Financial Industry from the Partnership for Carbon Accounting Financials (PCAF), specifically part A "Financed Emissions" […].*

However, the wording of the final Delegated Act leaves room for interpretation. We expect IAE to be considered in the sector-specific standard anticipated by late 2024 at the earliest, but most likely towards 2026.

IAE – a key climate metric for insurers under CSRD

The European Commission recently postponed the adoption of sector-specific ESRS from June 2024 to June 2026[9]. It is likely that IAE will be considered a key climate metric in the sector-specific standards. This is premised on a few arguments as below.

CSRD requires all companies conduct double materiality assessments to identify material topics for further management and reporting purposes. As we have established earlier in this article, climate risks and impacts have been rising across the globe, and given the unique position of re/insurers' business models, it is challenging to imagine them excluding climate change from their list of material topics.

Upon confirmation of materiality, companies will be required to develop disclosures around governance, strategy and impact, risk and opportunity management plans in relation to climate change. The ESRS E1 Standard further aligns with the recommendations from the Task Force on Climate-related Financial Disclosures (TCFD), wherein TCFD discusses the importance of using climate-related metrics to aid in strategies, as well as risk management. As such, usage of IAE would arguably be among the key climate metrics for re/insurers, especially when there is high potential of IAE developing into secondary financial risks via:

- Short-term transition risk in the form of reputation and litigation risk
- Long-term physical risk if re/insurers enable economic activities that alter the climate and lead to increased high-impact and more frequent weather events, ultimately causing more claims and threaten an re/insurer's business

Additionally, re/insurers may encounter complexity in constructing non-materiality arguments when underwriting businesses with significant GHG emissions. This challenge arises due to analyses conducted by various well-known organizations, which have pointed to increasing transition risks for such industries

Moreover, TCFD released sectoral guidance for insurance in October 2021. The guidance recommends re/insurers to disclose weighted average carbon intensity or GHG emissions associated with commercial property and specialty lines of business where data and methodologies allow, under the Metrics & Targets pillar.

Finally, our interpretation of the current industry-agnostic ESRS Delegated Act not specifically mentioning IAE, but having the wordings of "…specifically part A "Financed Emissions"…". We believe this implies the beginning of a non-exhaustive list, in addition IAE remains part of the PCAF GHG Accounting Standard which is referenced within the same sentence.

[9] 2024 Commission Work Programme | European Commission

Challenges and next steps

In summary, re/insurers, as investors and risk carriers, have a substantial role to play in the transition to a sustainable future, addressing issues related to climate change and nature impacts, risks, and opportunities. ESG regulations, such as CSRD, provide stakeholders with insights into the contributions of re/insurers to this transition, and IAE serves as a key metric for measuring and guiding the climate impact of the insurance sector.

Leading insurers have established their baseline IAE, reduction pathways and intermediate targets, which should be backed up with credible transition plans. Secondly, re/insurers have begun preparing their first CSRD report. The PCAF GHG Accounting Standard IAE method aims at estimating a share of re/insured customers' emissions to be associated with the re/insurer by determining an attribution factor. For commercial lines, the attribution factor is a re/insurance premium over customer revenue ratio, whereas for personal motor lines it is a re/insurance premium over cost associated with vehicle ownership ratio.

Measuring IAE presents several operational and modelling challenges for insurers. Re/insurers have recent experience with IFRS17 implementation and should take lessons learned from the large-scale data and accounting transformation into their approach towards steering on IAE.

Estimating re/insured client's emissions

The only effective approach for re/insurers to tackle the data issue on IAE in the long term is to engage with their clients and request up-to-date, standardized and audited emission data for commercial lines, and actual kilometrage for motor lines. This is in line with CSRD's requirement for having reported sustainability data assured. However, with a limited time remaining before re/insurers' first IAE disclosure and the fact that only a small portion of companies in the real economy have begun measuring and disclosing their emissions, re/insurers may initially need to acquire external emission data where available or use proxies to estimate emissions of their clients. Thus, IAE disclosures will initially largely be based on estimated, rather than reported, emissions of the re/insured clients. Given the lack of carbon emissions data availability, granularity and quality, re/insurers are adopting novel approaches for modelling, such as applying expert judgment, using sector-average data and other proxies.

Integrating external data with internal data

Estimating IAE requires external data, such as customer emissions and customer financial data for commercial lines, as well as actual kilometrage, vehicle type-specific emissions, and vehicle un-specific emissions coefficients for personal motor lines. The sourcing, integration, and mapping of external data with internal data, such as re/insurance premium, is critical. Unified company identifiers are a must, but those available are usually country-specific, e.g., ISIN, company registration number or vehicle identification number (VIN). Leading practices include amending underwriting and policy administration systems to collect and store carbon emissions or other customer attributes for commercial customers, evolving master data management standards and tools to optimize the mapping between external and internal data, and automating IAE calculations for lines within the scope of the PCAF calculation standard.

Meeting external assurance standards

CSRD disclosures, and therefore IAE, are subject to external limited assurance, which ultimately proves worrisome to insurers given the data challenges. Embedding IAE calculation into the finance operating model and governance will be critical. Insurers must implement robust automated data collection and aggregation procedures and implement adequate internal controls to enable measurement of IAE based on high-quality data sources and to ensure accuracy and trustworthiness of their reports. Some insurers are already taking steps to automate the calculation of IAE and other ESG metrics. They are actively progressing in their journey to integrated reporting, by including non-financial metrics into their broader reporting data model, system landscape, processes and controls.

Standardizing IAE measurement

While PCAF provides guidance on how to measure IAE and introduce a general data quality scoring framework, the practice of estimating IAE is relatively nascent, and the differences in estimation methodologies result in a lack of IAE comparability across the industry. We expect the PCAF Standard for IAE to drive progressive standardization of IAE measurement approaches, as well as the expansion of its scope beyond commercial lines and personal motor lines. Depending on PCAF member's feedback, property, life and health insurance and treaty reinsurance could be considered next.

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Glossary of Relevant Reporting Standards

CSRD – Corporate Sustainability Reporting Directive, the new EU legislation requiring companies to publish regular reports on topics related to ESG

ESRS – European Sustainability Reporting Standards, topical standards that outline specific disclosure

EU Taxonomy – A classification system that clarifies that environmental sustainability of business activities

ISSB – International Sustainability Standards Board, a body that launched the IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2: Climate-related Disclosures

TCFD – Task Force on Climate-related Financial Disclosures, a management reporting framework that outlines governance, strategy, risk management, as well as metrics and targets considerations for climate-related risks and opportunities

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