Guernsey Financial Services Commission

Green Insurance in Guernsey - Discussion Paper

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Overview

This paper considers how the Bailiwick might become a supportive jurisdiction for green insurance.

The paper has adopted a wider scope than is usual in a Discussion Paper as it covers not just regulatory changes but also wider sectoral issues relevant to the local insurance industry.

The paper focuses on two areas.

1. How the Commission might support the development of green insurance in Guernsey through regulatory change.

2. Private sector opportunities.

Why your views matter

The paper is intended primarily for insurance regulators and insurance professionals. However anybody interested in climate change might also be interested to understand the issues discussed.

What happens next

Next steps will depend upon the responses to this Discussion Paper.

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Green Insurance in Guernsey Discussion Paper
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GREEN INSURANCE IN GUERNSEY

DISCUSSION PAPER

October 2018

Introduction

This paper considers how the Bailiwick might become a supportive jurisdiction for green insurance. The paper has adopted a wider scope than is usual in a Discussion Paper as it covers not just regulatory changes but also wider sectoral issues relevant to the local insurance industry. Consequently, the paper focuses on two areas. The first asks how the Commission might support the development of green insurance in Guernsey through regulatory change. The second considers private sector opportunities.

'Green insurance' broadly means any insurance product that reduces, or mitigates against, climate change. This paper considers green insurance more specifically from the perspective of a small International Finance Centre (IFC).

The paper is intended primarily for insurance regulators and insurance professionals. However anybody interested in climate-change might also be interested to understand the issues discussed.

A Regulatory Conundrum

Green insurance should be set in the wider context of regulatory attitudes towards policyholder risk and asset allocation; especially around long-term life policies where most risk lies with the insurance company. Understandably, insurance regulators have always taken a cautious approach to both – the general assumption being that policyholder detriment should be negligible and that assets should be either government bonds or highly rated corporate debt.

With people living longer and interest rates remaining at low levels, this regulatory approach has led to long-term life policies becoming unattractive to the public, such that sales have fallen considerably. Some insurance companies no longer offer these polices.

As a result, the type of products sold nowadays involve the policyholder, rather than the insurer, taking on most of the risk. Ironically, regulatory policies intended to protect the public have in practice resulted in the public becoming more exposed to risk than hitherto. In addition, the approach has discouraged investment in innovative productive investments in favour of government or blue chip corporate debt.

Insurance regulators are aware of the problem. For example, much thought has gone into making long-term life policies more attractive within Solvency II for example though the Matching Adjustment. In September 2018, insurance supervisors, international organisations and senior industry representatives met in Argentina for a G20 Insurance Forum as part of that country's G20 Presidency. This meeting issued a communique that noted the protection gap and said that discussions had taken place to consider how insurance companies might invest in more infrastructure projects.

The communique shows that regulatory thinking is beginning to turn more towards whether some form of regulatory allowance might be given to insurance companies to allow them to invest in infrastructure projects. Indeed EIOPA has already taken some action in this direction. Such actions might make long-term life policies more affordable as it would better link long-term liabilities with long-term assets; although of course risks around investment portfolios are always present.

Whilst the focus has been on infrastructure, a significant proportion of infrastructure projects can be broadly defined as green. It is this asset class that concerns this paper. However this class needs firstly to be set in the distinct context of climate change.

A Greener World

The world is heating up. Whatever the reasons and consequences of this, there is an emerging global consensus that carbon production should be limited as far as is feasible. In addition, the world should prepare for a hotter climate – which will lead to, for example, rising sea levels, and a greater frequency of hurricanes, floods and windstorms.

In the 2016 Paris Accord, many countries formally committed to climate control. Since then, there has been some wavering around this commitment and this may well continue into the future. However, the fundamental challenge of a warming planet is not going to go away and there will therefore be a continuing demand for measures to mitigate climate change.

In recent years, both insurers and insurance regulators have begun to consider how to respond to climate change. For example, in January 2018, the Geneva Association produced a research brief on climate change and insurance. In July 2018, the International Association of Insurance Supervisors (IAIS) and the United Nations (UN) jointly issued a paper on the same subject.

Nearer to home, the Commission is an early joiner of the IAIS/UN Sustainable Insurance Forum (SIF). This is a collection of national insurance regulators drawn together to consider the relationship of insurance regulation to climate change. A key commitment of the SIF is that members commit to support a regulatory framework that specifically nurtures green insurance products.

There are therefore two related lines of thought at work. One is whether infrastructure projects might play a larger role in long-term life asset portfolios. The second is whether specifically green investments might compose a material element of this enlargement. The question posed here is whether Guernsey might help facilitate the latter.

Guernsey

Guernsey has certain characteristics such as:

- Political stability;
- The rule of law;
- Tax neutrality;
- Distinct legal structures such as the Incorporated Cell Company;
- A developed finance sector including insurance;
- A history of innovation;
- A track record of working with the City of London;
- A global presence; and
- Emerging green credentials – for example the recent launch of green funds

In summary, Guernsey is an established small International Finance Centre (IFC). Generally, most commentators have considered that the solution to the problems outlined at the start of this paper lies with the regulatory authorities of the G-20 or regional bodies. This paper however asks the question as to whether the distinct characteristics of an IFC mean that an IFC like Guernsey might have a role to play.

What might the Commission do to support green insurance in Guernsey?

The Commission is a unitary regulatory entity with authority to licence financial entities that serve local and/or global stakeholders; including life and general insurance policyholders. This section considers, in concrete terms, actions that the Commission might - or should - now take around green insurance. It considers arguments in favour, and against, a change to its current approach.

<u>Long-term life insurance - assets</u>

The Commission could take action to offer life insurers capital requirement based on incremental to invest in assets that damage the environment less in terms of carbon emissions; assuming that policyholder expectations are still met.

This refers to the traditional life sector where investment risk is taken by the insurer rather than the policyholder. Guernsey is a home to expat life insurance and products currently sold continue to include an element of guaranteed returns. Moreover, it is still worthwhile to consider traditional life insurance as it is still potentially attractive if it can be produced on a cost effective basis.

Insurers, especially life insurers, hold stocks of long-term investments in order to meet their long-term liabilities. In particular, insurers seek investments that are long-term and provide reasonable and certain yields – 'green' investments may in particular fit that category. Take, for example, a wind farm. It produces energy dependent on wind with minimal carbon production. Subject to maintenance, it will continue to produce energy well into the future. On the other hand, its economic viability depends on the price of energy, itself related to complex technological, physical and governmental factors.

At a high level, it may be argued that the suggestion that life insurers might invest more in green projects conflicts with the fiduciary obligation of life companies to maximise returns. However, there may be no conflict here. In the first place, life insurers have a commercial obligation to look forward and judge which assets have long-term commercial potential. The answer to that question may be green assets which are, by nature, long-term. In the second place, insurers generally are increasingly exposed to the liability risk that could stem from climate-related lawsuits. Green assets may be safer assets in this respect.

At present, the Commission's regulatory standardised solvency approach makes no distinction around 'green investments'. The latter term covers a wide range of assets. In practice many insurance companies tend to buy debt rather than equity, but, with more appropriate capital changes, green equity investments might well become attractive.

All debt under the standardised approach carries the same regulatory weighting at the Commission, dependent only on whether it is rated - a not uncommon approach amongst regulators. The question arises whether, in such a case as a wind farm or a green bond, the Commission should apply a different regulatory weighting.

It could be argued that green debt will become more attractive without regulatory action as the rating agencies will rate more green debt over time as investment grade. This may indeed be the case. However, it can also be argued that rating agencies tend to look to the past rather than the future and are unlikely to give equal treatment to a sector with a limited track record.

Regulators such as the Commission may therefore wish to take a different view. One approach for example would be to carve out green investments and give them a lighter regulatory weighting.

This is not a new debate. Risk weighting is one of the topics under discussion by the European Commission as part of a wider initiative on sustainable insurance. However, there are few signs that any regulator is taking an active approach to implementing such a policy in the next year or so. This is an area where Guernsey has an advantage in speed-to-market; not least, as it is not subject to Solvency II.

The argument in favour of a lighter approach is that, given climate change, green debt may make commercial sense and align with the need to meet long-term obligations. The proviso is that over-dependence on green investment would be avoided by insurance companies placing only some funds in this sector, encouraged by standard regulatory penalties against non-diversification and concentration risk; that any such decision would be that of the insurer alone, that any resultant capital number would have to withstand appropriate stress-testing and so on.

The argument against this approach is that green debt may be as uncertain as any other investment, not least because of the risk, for example, of a reduction in government support or a slow-down in the trend towards lower marginal green costs due to unforeseen technology constraints. There may also be unforeseen liability risks associated with green investments. For example, a wind farm might incur liability costs relating to environmental damage. There is limited historic data to determine the level of risk and the past may be no guide to the future. There is also a history of governments incentivising regulators to favour one asset class that later turns out to be not in the interest of policyholders.

The above suggests that there are arguments both for and against giving green assets a lower risk weighing. However the relevance of this conclusion is that an argument can be made in favour of such an approach; in such a way that perhaps has not been forcefully made before. The next relevant question therefore is how might an appropriate weighting be devised?

One problem here is to define green. One solution is to adopt the approach already taken by the Commission in relation to funds. Broadly, this is based on a definition of green issued by a number of multilateral development banks – The Common Principles for Climate Mitigation Finance Tracking.

Another problem is the methodology that the Commission might use to arrive at a credible weighting for green insurance. Various options might be:

a) Apply traditional actuarial techniques to a pool of debt instruments but either apply a lower risk weighting to green investments or extract stranded investments and apply a higher weighting to them – the problem here is one of data availability for green investments;
b) Use future scenarios and statistical theory to project a default rate for green debt – the problem here is credibility with actuaries;
c) Revisit the pro cyclical market valuations assumptions currently built into insurance capital charges for equity investment (listed and unlisted);
d) Equate 'green' with infrastructure investment and thereby facilitate the broad use of the lower regulatory weighting for infrastructure investment, perhaps developing that produced by EIOPA further to permit broader green infrastructure investment (albeit only about half of infrastructure debt is green); or

e) Apply an arbitrary discount to the current standard weighting - say 30%. Whilst crude, a number of regulatory calculations by global regulatory bodies are based on such approaches.

None of these options gives an easy solution. For example, in September 2018, Deloitte produced a study of default rates on green infrastructure projects from 1983-2016. Broadly, the study produced evidence that green debt is safer than brown debt but in turn is no safer than an aggregate of all infrastructure debt; at least in certain developed countries. In addition, the paper showed material variations according to region and financing type and was based on past data; as well as containing detailed data that on further examination could be used to argue several points of view (indeed almost simultaneously the World Bank issued one interpretation). Papers like these show the difficulty of arriving at an easy solution to this problem; at least using classical backward looking modelling techniques.

In terms of investment weighting, there is also the possibility that an insurer might choose to build into its internal capital model a new approach to green. Given the above caveats, this would involve significant investment by the insurer. However, the Commission could then engage with that insurer to agree the regulatory capital treatment.

Another approach is around asset valuation. The Commission allows firms to align valuation with accounting treatment. No matching adjustment is applied. Where a fair value approach is adopted, the Commission could consider ways to apply a more appropriate approach for green investments. This could be done either by carving out green investments from a market based valuation approach or by applying an amended matching adjustment approach. This approach might of course apply more widely to infrastructure investment generally.

<u>Regulatory barriers</u>

Apart from life insurance assets weighting, the Commission can take action in trying to reduce the national regulatory barriers that stand in the way of catastrophic reinsurance (either alternative or traditional) written out of IFCs such as Guernsey. Examples of barriers might include the mandatory posting of collateral or the limitation of direct distribution rights. The Commission might in future highlight these barriers so as to bring pressure that they are removed to enhance free trade. Guernsey could make this case at, for example, the IAIS/UN Sustainable Insurance Form of which it is a member. Other bodies around the world also argue for a more liberalised re-insurance market.

Nevertheless, direct action here is not in the gift of the Commission so the ultimate impact of Commission activity in this area is perforce limited.

Guernsey uses a logo for green funds and it may be possible to consider a similar idea in the context of green insurance.

What global private sector opportunities exist in Guernsey?

Apart from flexible and effective regulation, Guernsey may also offer opportunities to the private sector – wherever based – for green insurance. The opportunities are set out here.

<u>Life insurance – investment- based</u>

Life policies are increasingly investment-focussed with the investor taking almost all the investment risk. Guernsey is the home of several investment-based insurance entities. There is of course nothing stopping an investor choosing to invest using criteria in line with his or her own ethical preferences. Guernsey has recently launched green funds that are obliged to fit green criteria as set down by the Commission – which also regulates them in line with these green criteria. An investment-led insurer could set up a green insurer in Guernsey to access these local funds.

Insurance-Linked Securities (ILS)

Guernsey has a thriving ILS sector. There is the opportunity to increase the branding of ILS in relation to climate change, a form of alternative reinsurance. ILS has contributed to the global increase in available catastrophic reinsurance. Despite this, climate change means that the total pool of catastrophic reinsurance available globally remains too small. This means that many affected people cannot obtain insurance - causing actual distress. Guernsey has not branded ILS as part of a global climate change strategy and could do this. For example, NGOs might act as ILS funders. Given that ILS is largely an offshore vehicle this could lead to a new market for Guernsey and benefit everybody.

Global climate–related general insurance

A Guernsey general insurer could set itself up to cover general insurance risk relating to climate change. To describe the latter in more detail, in many parts of the world it has become difficult for the private sector to insure against the incremental effect of climate change; and governments have not been able to step into the breach. For example, houses that are prone to more flooding; or houses more at risk from fire hazard. Although where generally caused by climate change, these risks may not materialise around the globe in the same way or at the same time. It may therefore be possible for a general insurer writing business on a global – rather than local - basis, to offer a better rate than local insurers, due to the ability to capture the classic benefits of diversification across all countries and risk type. General insurance of course already exists on a global basis not least to capture the benefits noted above. However traditional, global general insurers may be themselves vulnerable to new entrants seeking to acquire new business, or desirous of setting up a new business deliberately isolated from its traditional concerns. In addition, at ground level, much retail and commercial general insurance, especially outside the G-10, is still delivered by insurers operating in one or a few local jurisdictions. Such insurers cannot deliver benefits based on global diversification.

In order to capture the advantages of such a globalised model, an IFC may be a logical place to locate such a business; especially one with the characteristics of Guernsey as specified above. In addition, it is possible that local general insurance restrictions will stand in the way of such an insurer. The Commission, if prompted, could identify, and argue against, such local restrictions; not least in the Sustainable Insurance Forum.

New local insurance

A new local insurer in Guernsey could be set up to combine insure-tech with green insurance. Such an insurer would use Guernsey as a testing ground for a larger business proposition later on; although the test bed could still be profitable (not least due to limited local competition). Guernsey is an affluent jurisdiction with an above-normal need for certain types of insurance. For example, most local people need travel and health coverage off-island. The Bailiwick has a mixed healthcare provision model so health insurance is common. The Bailiwick has a large finance sector, which creates, for example, demand for Directors and Officers coverage. The Bailiwick also has an emerging IT sector. A local green insurer could offer for example automatic pay-as-you-go travel insurance linked to a flight app, reduced insurance rates for electric vehicles (starting on-island), insurance reduced if the house meets green criteria, health insurance based on lifestyle and Directors and Officers based on the green credentials of a business.

Takaful

Takaful already has a presence in Guernsey by virtue of a securitised Takaful fund. Islam enshrines the principle of solidarity together with a respect for the natural world. Takaful also allows a less formulaic approach and this may enable green issues to be more easily embraced in Takaful. Certainly, several of those nations likely to be directly affected by climate change have large Muslim populations. Guernsey offers an established finance centre in which to nurture green Takaful.

The above lists several ways in which the Guernsey insurance sector could be expanded to embrace green insurance with the particular advantages of Guernsey in mind. No doubt there are other opportunities that may occur to others.

Customers

The above proposals suggest ways in which Guernsey, besides playing a part in the world's response to climate change, can help certain people; these being:

- Expats (and others via reinsurance) who need long-term life insurance and want it to be affordable and green;
- People affected by climate change but who find general insurance too expensive or unavailable ;
- Funds who want to fund catastrophic insurance to mitigate the impact of climate-related events on people; and
- Followers of the Islamic faith who are looking for a relevant green Takaful product.

Conclusion

This paper began by drawing attention to the unexpected consequences of regulatory prudence. It acknowledged that an initiative was underway to tackle the problem of long-term mismatching through the consideration of infrastructure projects. The paper went on to argue that green investments are broadly a sub-set of that categorisation and that there were also reasons to do with climate change as to why regulators might take action. The paper made some suggestions around both risk weighting and valuation. More broadly, the paper went on to consider how a small IFC like Guernsey might support green insurance, on both the general and life sides.

In certain areas, a small niche international finance centre offers several distinct advantages to addressing climate change. As with all global economic development, the long-term prize usually goes to that jurisdiction that invests at an early stage. At present, this space is unoccupied and there is something like a 2-5 year window, starting now, for a jurisdiction like Guernsey to occupy this slot.

Questions

This paper has intentionally asked more questions than it has answered. Such questions are:

1. *Should the Commission be proactive in considering green insurance?*
2. *Should the Commission consider a lower risk weighting for green assets?*
    i. *If so, what methodology should be used?*
    ii. *If a backward looking actuarial approach cannot be devised, should a forward looking modelling approach be taken?*
    iii. *Can a different approach to valuation help green assets and if so how precisely?*
3. *How should green insurance be defined?*
4. *Are there any insurers interested in building a green model?*
5. *How can green be factored into valuation?*
6. *Does a green logo make sense?*
7. *Should the local industry brand ILS as green and if so how?*
8. *Is a global green general insurer possible – are firms already offering this facility?*
9. *Is there a gap in the local market for a green insure-tech firm?*
10. *Can Takaful be made green in Guernsey?*
11. *Has Guernsey any other way of supporting green insurance?*

Next Steps

The prime purpose of this paper has been to provide a platform for third parties to consider and take forward ideas. Next steps will depend on reaction to this paper. The Commission encourages feedback online through the Commission's Citizen Space Consultation Hub which can be found here https://consultationhub.gfsc.gg/banking-and-insurance-supervision-and-policy/green-insurance-in-guernsey.

Responses may also be sent to green@gfsc.gg or in writing to

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