



Finance Watch

Making finance serve society

Transition Planning for Insurers

A supervisory tool to improve climate risk resilience

A Finance Watch Report



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Executive Summary

Over the last few years, it has become increasingly clear that the interrelation between the financial sector and climate change, if left unaddressed, will lead to a devastating financial crisis. In a vicious cycle that Finance Watch dubbed the ‘climate-finance doom loop’ the financial sector continues to exacerbate climate change by enabling fossil fuel companies to operate, thereby endangering its own existence through the threat climate change poses to financial stability.

Insurance companies support unsustainable economic activities, most notably fossil fuel exploration and production, in two ways: by investing in them through their portfolio management and by enabling them to operate through the underwriting of insurance contracts.

Economic and societal divergence from fossil fuels increasingly exposes insurers’ portfolios to the risk of stranding. In 2022, over 90% of the world’s GDP was subjected to at least one net-zero target, which, in principle, should drastically lower the level of future emissions. Comparing the amount of fossil fuel reserves currently owned by listed companies to the amount that can reasonably be exploited without missing the goals of the Paris Agreement, clearly reveals that numerous assets are doomed to become stranded.

Additionally, an increase in the occurrence of severe natural catastrophes carries with it an increase in damages. When the insurance sector is no longer able or willing to cover these damages, the burden is transferred to society. This phenomenon, known as the protection gap, has left governments and supervisors scrambling to find solutions.

Paradoxically, insurance companies are making a profit on activities that are actively undermining the future viability of the financial sector while simultaneously shifting the already apparent costs to the consumer.

According to Finance Watch, the financial sector can and should play their part in enabling a stable and orderly transition away from the fossil fuel-driven economy towards a sustainable net-zero economy. Such an orderly transition requires intensive cooperation and thorough planning. There is currently neither a single definition of what a climate transition plan for an insurance company should encompass nor is there consensus on how they should support a whole-economy transition. However, recent evolutions in EU legislation are increasingly emphasising the importance of transition planning for financial institutions in the quest for net-zero emissions.

This report provides direction by exploring different interpretations of climate transition planning for insurers and laying out essential elements to ensure that the sector tackles the transition in a meaningful manner. The report also highlights a supervisory perspective on transition planning and transition plans as tools to mitigate climate-related risks over time. This approach is informed by the consensus established among

supervisors and regulators that an orderly and timely transition is the most appropriate means to mitigate the risk of financial instability induced by climate change.

Considering the double materiality of climate risk, the focus of transition planning must lie on both effecting a real-world transition through the reduction of absolute greenhouse gas (GHG) emissions and on managing the risk incurred by insurance companies on account of climate change. As divestment does not automatically translate into a positive climate impact, insurers must take it upon themselves to actively engage with their counterparties to aid and promote a shift to net-zero business practices, both through their investing as well as their underwriting.

Key recommendations

1 Prioritise tangible, real-world impact for the insurers' asset and liability portfolios by incorporating all Scope 3 emissions, including underwriting, and focusing on the reduction of GHG emissions in absolute terms.

2 Formulate transparent investment and underwriting policies that encompass engagement procedures and are subject to identifiable milestones against which progress can be measured, alongside short (1–3 years), medium (3–5 years), and long term (5–10 years and beyond) targets.

3 Utilise all possible counterparty engagement tools to meet sustainability-related targets in investee and client (underwriting) practices and relationships.

4 Institute comprehensive governance by assigning accountability for the transition plan to senior management, identifying and developing necessary skills and linking a meaningful percentage of the remuneration plan to achieving transition goals, including using deferred remuneration and clawback mechanisms.

5 Establish robust prudential supervision by integrating transition planning into the supervisory review process, extending the definition of the long-term view beyond the usual time frames by considering sustainability-related impact mitigation as a means to ensure financial stability.

Introduction

“The era of global warming has ended; the era of global boiling has arrived. The air is unbreathable. The heat is unbearable. And the level of fossil fuel profits and climate inaction is unacceptable.” These were Secretary-General António Guterres’ opening remarks at a press conference on climate in July 2023.¹

The global insurance sector, highly regarded for mitigating risks and safeguarding economic activities, finds itself at a critical juncture. Historically, insurance has functioned as a stabilising force, absorbing shocks and ensuring business continuity in turbulent times. Yet, by their continued investments in economic activities incompatible with global climate objectives (notably fossil fuel exploration and production), insurers expose themselves to transition risks, such as stranded assets. Additionally, as the ramifications of climate change intensify, there is an emerging trend of these risks being transferred by insurers to consumers by increasing prices to unaffordable levels and even excluding entire regions from coverage.

In 2015, during the UNFCCC COP 21, the Paris Agreement was endorsed by most UN member states; the agreement aims to limit the rise in global temperature to below 2°C and pursue efforts for a limit of 1.5°C. This led to significant policy shifts, such as the EU’s 2030 Climate and Energy Framework and the European Climate Law, targeting a reduction in GHG emissions by at least 55% by 2030 from 1990 levels. These changes have major implications for the global economy, particularly for companies in fossil fuel extraction and distribution. The transition to a decarbonised economy could render a significant portion of fossil fuel reserves valueless, thereby heavily impacting returns on investments in the sector. For example, research suggests that achieving a 2°C scenario would necessitate leaving 77% of current fossil fuel reserves unexploited.² The potential value loss of these assets is enormous, with estimates ranging from 1.4 trillion USD by 2036 to between 4 and 11 trillion USD before 2050.³

Simultaneously, the world is experiencing a technological revolution in energy markets, as highlighted by the International Energy Agency’s (IEA) World Energy Outlook 2022. This shift, accelerated since 2020, is witnessing significant growth in investments in clean energy technologies, like solar cells and batteries, growing annually by 12% and aligning with the goal of reaching global net-zero emissions by 2050. All else being equal, this surge in renewable energy—reducing technology costs and facilitating cheaper, more accessible innovation—is a contributing factor to shifting away from a fossil fuel-based economy, thereby improving energy efficiency in numerous

1 António Guterres. ‘*Opening remarks*’. Transcript of speech delivered UN Headquarters, 27 July 2023.

2 Carbon Tracker. *Unburnable Carbon 2013: Wasted capital and stranded assets*, 2013.

3 Gregor Semieniuk, Philip B. Holden, Jean Francois Mercure, Pablo Salas, Hector Pollitt, Katharine Jobson, Pim Vercoulen, Unnada Chewprecha, Neil R. Edwards and Jorge E. Viñuales, “Stranded fossil-fuel assets translate to major losses for investors in advanced economies,” *Nature Climate Change* 12(6) (June 2022): 532–538.

industries and, thus, contributing to the stranding of fossil fuel assets.

Insurers' continued investment in unsustainable activities exacerbates climate risk, which leads to both an increase in insurance claim payouts and a widening protection gap. The European Insurance and Occupational Pensions Authority (EIOPA) reports that only 23% of weather-related losses in Europe are insured. Uninsured damages need to be covered by society, thereby straining government budgets.⁴

To manage the size of insurance claim payouts, insurers apply risk mitigation strategies—such as premium increases, mitigation-linked discounts, coverage exclusions, catastrophe (CAT) bonds—and call for private-public partnerships to share the increasing risks. However, these measures often transfer the financial burden to policyholders, investors, and taxpayers. For example, premium increases may impact affordability and availability of insurance, particularly for vulnerable populations. Coverage exclusions can leave entire regions uninsured, impacting homeownership and business operations and shifting the burden to governments in case of disasters.

Thus, it is incoherent from the regulatory perspective and at odds with public interest that the insurance sector continues to finance and underwrite unsustainable business, jeopardising an orderly transition and fuelling the risk of financial instability. The sector is currently operating without due consideration of the risks of climate change and its effects on the global economy, while simultaneously providing solutions to natural catastrophes that predominantly transfer risks and financial burdens to the end consumer and taxpayer. This misalignment emphasises the urgent need for financial institutions to adapt and recognize the threats of a decarbonizing world. To mitigate these risks, proactive measures like mandatory transition plans for financial institutions and stronger capital requirements are justified.⁵ These strategies aim to align financial regulation with government climate policies and manage climate-related risks effectively. Additionally, with voluntary initiatives falling short of the declared ambition, financial regulators must set robust requirements and establish a level playing field.⁶

It is undeniable that we cannot postpone taking actions to mitigate climate change effects. Yet, we still do not see well-coordinated actions from the very financial institutions that support and enable our entire economic system. It is time for the insurance sector to play its part by contributing to an orderly transition, which requires having and implementing thorough and science-based climate transition plans.

4 EIOPA, *Dashboard on insurance protection gap for natural catastrophes* (2022).

5 See also previous Finance Watch reports on capital requirements *A Silver Bullet against Green Swans* (2021) and *Insuring the uninsurable* (2021).

6 For an overview of voluntary initiative shortcomings, see, for example, ShareAction, *Going Beyond Insurers' Voluntary Initiatives*, (2022) and Michel Cardona, *The limitations of voluntary climate commitments from private financial actors* (Institute for Climate Economics, 2023).

I. Need for transition planning and transition plans

Financial institutions, specifically insurers—although not big emitters of GHGs through their own operations—are a central actor in the speed and success of real-world transition.⁷ As finance and service providers, without whom the economy would not be able to operate, they are in a unique position to direct the real economy towards an orderly transition. This provides them the opportunity and the responsibility to be an important force in a Paris-aligned decarbonisation of the economy. The role financial institutions play in allocating capital in the economy also implies that finance can hamper the transition process—for example, if financial institutions’ perceptions of low risk from a warming world or low opportunities from a transition fail to trigger a reallocation of capital into sustainable investments. Therefore, the behaviour of financial institutions themselves influence the transition process and associated risks. As Battiston et al. stated, “the presence of the financial system may induce a path dependence in the complex dynamics leading to lock-in effects.”⁸

Aligning financial institutions’ business models with climate objectives is a necessary precondition for an orderly transition and, with it, financial stability. Optimising their means for attaining this goal requires thorough screening of their operations, investees, and clients (whose operations are the source of the insurers’ Scope 3 emissions) and long-term planning to make a real-world impact in the net-zero transition.

While climate transition planning is a fast-growing concept, there is currently no single definition of what a transition plan implies for a financial institution other than the consensus that it expresses an organisation’s strategic perspective on its business, its role, and responsibilities in the transition to a sustainable economy.

Examining the definition of transition planning in the Corporate Sustainability Reporting Directive (CSRD), European Sustainability Reporting Standards (ESRS), Glasgow Alliance for Net Zero (GFANZ), and the UK’s Transition Plan Taskforce (TPT) reveals how heterogeneous current working definitions are.

The EU’s Corporate Sustainability Reporting Directive (CSRD) defines transition plans as “the plans of the undertaking, including implementing actions and related financial and investment plans, to ensure that its business model and strategy are compatible with the transition to a sustainable economy and with the limiting of global warming to 1.5°C in line with the Paris Agreement under

⁷ For example, the UK insurer Phoenix Group estimated its investment portfolio to account for 99% of its overall emissions.

⁸ Stefano Battiston, Irene Monasterolo, Keywan Riahi, Bas J. van Ruijven, “Accounting for finance is key for climate mitigation pathways,” *Science* 372(6545) (May 2021): 918–920.

the United Nations Framework Convention on Climate Change adopted on 12 December 2015 (the ‘Paris Agreement’) and the objective of achieving climate neutrality by 2050 as established in Regulation (EU) 2021/1119 of the European Parliament and of the Council (*), and, where relevant, the exposure of the undertaking to coal-, oil- and gas-related activities,” among other details for describing the plans.⁹

The ESRS, further detailing the disclosures in CSRD, provide the following description: “The objective of this Standard is to specify Disclosure Requirements which will enable users of sustainability statements to understand: (a) how the undertaking affects climate change, in terms of material positive and negative actual and potential impacts; (b) the undertaking’s past, current, and future mitigation efforts in line with the Paris Agreement (or an updated international agreement on climate change) and compatible with limiting global warming to 1.5°C; (c) the plans and capacity of the undertaking to adapt its strategy and business model, in line with the transition to a sustainable economy and to contribute to limiting global warming to 1.5°C; (d) any other actions taken by the undertaking, and the result of such actions to prevent, mitigate or remediate actual or potential negative impacts, and to address risks and opportunities; (e) the nature, type and extent of the undertaking’s material risks and opportunities arising from the undertaking’s impacts and dependencies on climate change, and how the undertaking manages them; and (f) the financial effects on the undertaking over the short-, medium- and long-term of risks and opportunities arising from the undertaking’s impacts and dependencies on climate change.”¹⁰

The GFANZ defines transition plans as “a set of goals, actions, and accountability mechanisms to align an organisation’s business activities with a pathway to net-zero GHG emissions that delivers real-economy emissions reductions in line with achieving global net zero. For GFANZ members, a transition plan must be consistent with achieving net zero by 2050, at the latest, in line with global efforts to limit warming to 1.5 degrees C, above pre-industrial levels, with low or no overshoot.”¹¹

9 Directive 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU regarding corporate sustainability reporting.

10 Annex to the Commission Delegated Regulation (EU) 2022/2464 supplementing Directive 2013/34/EU of the European Parliament and of the Council regarding sustainability reporting standards.

11 GFANZ, *Recommendations and Guidance Financial Institution Net-zero Transition Plans* (2022): 8.

The UK's TPT defines it as “integral to an entity’s overall strategy, setting out its plan to contribute to and prepare for a rapid global transition towards a low GHG-emissions economy.”¹²

Over the last few years, numerous voluntary commitments and publications have emerged, mostly building on standard-setting frameworks such as the Task Force on Climate-related Financial Disclosures (TCFD)¹³ or the aforementioned GFANZ framework. Although these initiatives benefit the general attention to the subject, we cannot expect such voluntary initiatives to deliver what is needed without appropriate accountability processes. Financial institutions that have committed to net-zero transition planning rarely even pledged to stop financing fossil fuel projects, nor have they given specifics on how they aim to achieve their targets.¹⁴ The exit of the major players from the Net-Zero Insurance Alliance (NZIA) in May of 2023, following pushback from US lawmakers, clearly reveals the lack of resilience of these initiatives.

The solution presents itself in mandatory transition planning, which has recently gained ground in European legislation. Notably, the revised text of the Solvency II Directive obliges insurers to implement “specific plans, quantifiable targets, and processes to monitor and address the financial risks arising in the short, medium, and long term from sustainability factors, including those arising from the process of adjustment and transition trends towards the relevant Member States and Union regulatory objectives and legal acts in relation to sustainability factors, in particular those set out in Regulation (EU) 2021/1119 (European Climate Law).” From a prudential perspective, introducing clear requirements on transition planning ensures the appropriate management of growing climate-related risks, including those at the systemic level. Formulating clear prudential requirements and aligning these with the existing rules on transition planning would ensure legal certainty and a level playing field. Additionally, it would mitigate the risk of failure inherent to voluntary commitments, which follow different self-imposed standards and rely on self-governance.¹⁵

As transition planning establishes itself as a strategic tool and a tool to manage climate-related and other sustainability risks and becomes increasingly integrated into regulation, we must look beyond establishing obligations and elaborate on what transition planning for insurers actually implies. A policy brief on the future of the sustainable finance agenda published by Finance Watch in January 2024 identified the different standards and legislative frameworks linked to transition planning.¹⁶

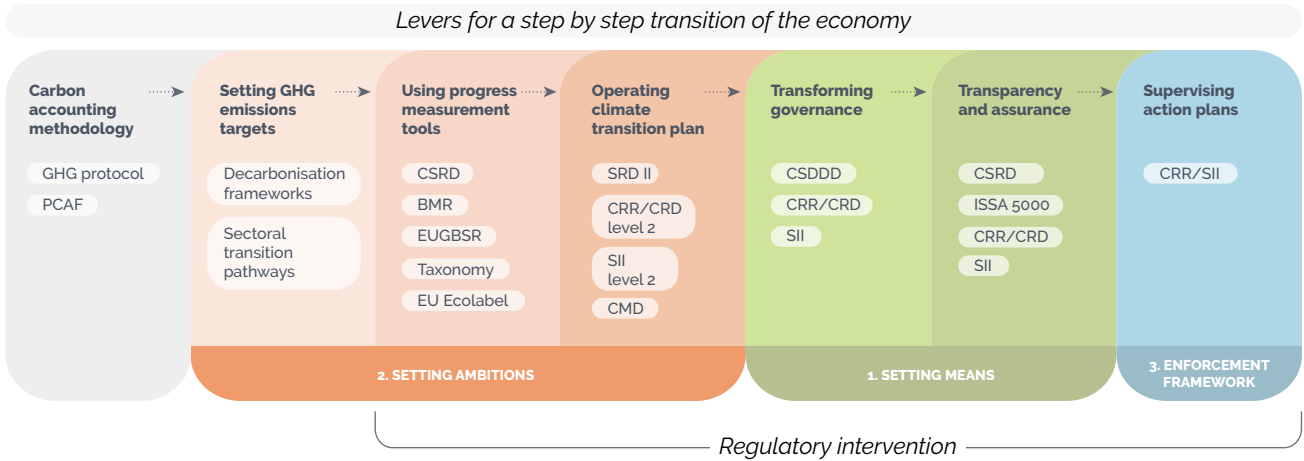
12 The Transition Plan Taskforce, *Implementation Guidance* (2022): 6.

13 See, for example, Task Force on Climate-Related Financial Disclosures, *Guidance on Metrics, Targets, and Transition Plans* (2021).

14 Yevgeny Shrago and David Arkush, *Supervising the Transition: How Banking Regulators Can Address the Coming Shift to Net-Zero Emissions* (Roosevelt Institute, Public Citizen, 2023): 4-8.

15 See also Finance Watch’s blog [Europe must harmonise its patchwork of transition plan requirements](#) (2023).

16 [A guide to the next sustainable finance agenda](#) (2023).



As insurers play an essential role in the evolution of the real-economy transition, this report highlights some of the most critical aspects that will shape transition planning as a powerful tool for insurers to mitigate climate-related transition and physical risks. It outlines key aspects of insurance transition planning: target setting, corporate governance, focus on whole-economy transition, engagement, and transparency. We close by discussing the role supervisors can and should play in both guiding and monitoring the path to success.

II. Setting targets and measuring progress

Science-Based Targets, Metrics, and Scope

In short:

- Prioritise real-world impact through enabling the reduction of absolute GHG emissions.
- Decide on or develop a common set of scenarios in line with a 1.5°C trajectory and sectoral pathways on which to base target setting.
- Set targets on a sectoral basis to prevent reallocation of assets within a company's portfolio instead of facilitating sector transition.
- Account for all forms of Scope 3 (financed) emissions, including emissions associated with insurance underwriting.
- Set impact- and action-oriented targets with identifiable milestones against which progress can be measured, alongside short (1–3 years), medium (3–5 years), and long term (5–10 years and beyond) targets.

Examining existing insurance transition initiatives, significant differences can be identified both in how an institution defines net zero and how it can credibly decide on targets. The Intergovernmental Panel on Climate Change (IPCC) defines net zero as a point in time “where anthropogenic emissions of greenhouse gases to the atmosphere are balanced by anthropogenic removals over a specified period.”¹⁷ The Science-based Target initiative (SBTi) translates this definition for companies in the following manner: “setting corporate net-zero targets aligned with meeting societal climate goals means:

- (1) achieving a scale of value-chain emissions reductions consistent with the depth of abatement at the point of reaching global or sector net-zero in 1.5°C pathways;
- (2) neutralising the impact of any residual emissions by permanently removing any equivalent volume of CO₂.”¹⁸

Consequently, insurers' net-zero commitments are only meaningful if they aim at having a real-world impact by aligning their services directly with the reduction of absolute GHG emissions instead of focusing on reducing emissions only at the level of their

¹⁷ Intergovernmental Panel on Climate Change, *Global Warming of 1.5°C, An IPCC special report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty* (2019).

¹⁸ The Science Based Targets initiative, *Foundations for Science-based Net-Zero Target Setting in the Financial Sector* (2022).

portfolios, as has already been highlighted in earlier Finance Watch work.¹⁹

The first step towards setting credible goals is understanding the company's current position. The foundations for this are already laid out in the obligatory reporting of non-financial information in the EU.²⁰ Each institution conducts transition planning based on a preselected climate scenario in order to assess its climate-related risks and opportunities, which can guide it further in developing key priorities and ambitions. Moreover, only by utilising scenarios aligned with a 1.5°C trajectory can insurers build credible plans to achieve the goals of the Paris Agreement.²¹

Companies have been using a variety of scenarios for their transition planning. Setting aside the use of scenarios that are not aligned with a 1.5°C future, which is in any case not acceptable, the multitude of existing 1.5°C scenarios still lead to targets being set on very different assumptions. In order to make transition planning comparable across undertakings, which is necessary for supervisors to assess and compare transition plans, there is a need to agree upon which scenarios and pathways should be used in transition planning. A consistent use of such agreed upon granular and science-based scenarios and pathways will enhance both the credibility and comparability of transition plans and targets. Recognising that transition scenarios and sectoral pathways have not yet been defined by public policies for all geographic regions and sectors, particularly outside the EU, there is a need to accelerate work on this. In particular, in the EU, prudential regulatory and supervisory authorities should cooperate with authorities or public bodies in charge of climate change and environmental supervision.

No two institutions will have identical portfolios, cater to the same range of clients and stakeholders, or operate in the same regions. This diversity makes target-setting, the choice of metrics, and the choice of engagement strategies a company-specific exercise. Nonetheless, to support uniformity and enhance real-world impact, several metrics are essential. In particular, for insurers, as well as financial institutions more generally, targets should be both impact- and action-oriented. The former could be largely tracked and reported based on the clients' and investees' reporting. The latter should reflect insurers' sustainable corporate governance and risk management arrangements as well as efforts towards engaging with their clients and investees to facilitate their transition.

As climate change and the associated risks are irreversible, unpredictable and non-linearly changing, insurers' transition plans should adapt to the environment they operate in. To monitor progress at any given point in time and possibly adjust the measures, transition plans should have identifiable milestones against which progress can be measured. These interim targets should be in the short (1–3 years), medium (3–5

¹⁹ Finance Watch, *The problem lies in the net* (2022).

²⁰ For insurers and other financial and non-financial entities, non-financial information disclosure is mandated through the Corporate Sustainability Reporting Directive (CSRD).

²¹ Finance Watch recognises that reaching the 1.5°C target of the Paris Agreement is no longer feasible, as mentioned in our 2023 'Finance in a hot house world' report. However, as 1.5°C is a widely established term for the best-case scenario in climate change, we will keep it in use throughout this report.

years), and long term (5–10 years and beyond). These milestones serve both a transition risk management and a transition management purpose in a broader sense. Without them, the insurer cannot identify areas where the plan is lagging or where it can change the course of its strategy based on new data or methodologies. Furthermore, clear milestones enable slowly steering away from assets at the risk of value loss/stranding, thereby reducing the financial risks for the company and the wider economic system.

Whenever available, insurers should take into account the different sectoral pathways when deciding on targets as well as the ambition of their counterparties' respective transition plans. They need to identify the metrics that are best suited to support the net-zero strategy and can be reliably used to monitor progress. To achieve higher impact, insurers should set targets on a sectoral basis²², rather than as an overall strategy, to take into account sector-specific transition needs and pathways. Each sector has specific challenges to transitioning to a sustainable future. Setting targets on a sectoral level enhances effectivity and creates more leeway to adapt targets and metrics in response to new developments. Additionally, non-sector specific target setting might inadvertently lead to fast and uncontrolled divestment from assets in sectors that are difficult or slow to transition, resulting in possible market and industry destabilisation.

For a holistic approach to transition planning, Scope 3 emissions are to be understood to encompass all services insurers provide, including insurance associated emissions (IAE). Currently, underwriting is often omitted as a part of Scope 3 emissions.²³ However, as the leading service provided by the insurance sector, insurance underwriting enables numerous economic activities and, thus, impacts real-world emissions and provides a considerable opportunity for real-economy guidance.

Emissions linked to underwriting activities have to be accounted for as Scope 3 emissions and integrated into the relevant business processes by linking them to clients' transition plans and integrating clients' emissions into the transition risk measurement. Emission reduction targets for underwriting might not necessarily be relevant from the short-term financial materiality perspective at an individual insurer level, particularly for insurance products not impacted by the clients' own exposure to the transition risk. Yet, at the level of the financial system, they are imperative to support transition and mitigate climate-related systemic risk over time.

Insurers are increasingly recognizing the need to manage IAE across their entire portfolio, which requires not only phasing out insurance for high-emission activities like thermal coal and unconventional fossil fuels but also supporting policyholders in transitioning to greener practices. Measuring and managing IAE involves complex data collection in close cooperation with the insured entity.

²² For commercial underwriting. Retail underwriting requires target-setting differentiated by business line.

²³ For example, insurance underwriting is considered out of scope in the SBTi target guidance, and optional in the Greenhouse Gas Protocol's standards.

The insurers' targets should be clear in scope and timing and set absolute GHG reduction targets in addition to intensity-based targets, as the latter do not necessarily lead to real-world emission reductions.²⁴ When considering financed emissions, which compose the insurers' Scope 3 emissions, existing methodologies such as the Partnership for Carbon Account Financials (PCAF) can be utilised. However, the most useful source of information will be the transition plans of the clients and investees themselves. External entities should provide assurance of the plans and targets to ensure they are robust, credible, and feasible. Insurance undertakings can then rely on their clients' and investees' transition plans for their own transition planning.

Companies' transition plans, disclosed to fulfil the obligations under CSRD/ESRS, will be a valuable source of information for the insurance sector, alongside several tools established by the EU to aid the transition. The EU's Climate Benchmarks, Green Bond Standards, and Taxonomy have all been created to position finance as the driving force for a sustainable world. The appropriate use of these tools should guide the insurance sector towards sustainable decision-making. However, there remain several points of improvement to be addressed in the near future. Finance Watch's Guide to the next sustainable finance agenda provides an in-depth overview of the limitations of the current framework as well as recommendations for improvement.²⁵

24 For a detailed commentary on absolute versus intensity-based GHG emissions, see the Finance Watch report [The problem lies in the net](#) (2022).

25 Finance Watch, [A Finance Watch guide to the next 'sustainable finance agenda'](#) (2023).

III. Transition plans in action

Enabling a Whole-Economy Transition

In short:

- Develop clear investment policies for the management of the investment portfolio, including engagement procedures.
- Commit to an immediate halt in investment or underwriting of projects incompatible with a 1.5°C pathway, such as development or expansion of new oil and gas fields.
- Disengage from any business not willing to transition or consistently not delivering on transition objectives within set timeframes.
 - Engage with investee counterparties through
 - use of disclosed transition plans to make informed investments in support of transition efforts and climate solutions;
 - use of public statements, letters to the board, and open communication of voting intentions;
 - tabling voting resolutions; and
 - use of all voting possibilities to push for sustainability-related decisions based on a clear voting policy.
 - Engage with underwriting counterparties through
 - use of disclosed transition plans to offer risk-adjusted insurance in support of transition efforts and climate solutions,
 - use of underwriting covenants to promote transition efforts (mitigation and adaptation), and
 - clear escalation procedures up to and including contract termination.

In addition to their role of serving the needs of the real economy, financial institutions are unique in their ability to play a decisive role in enabling economic activities. They can assert their influence to support a whole-economy transition by increasing finance and services for activities in support of sustainable transformation and climate solutions. This is exactly the role that transition plans for insurers should foster. The set targets should steer insurers' actions towards supporting the economy's transition and mitigating transition risks.

Bearing in mind the effects both climate change and the disorderly transition have and will continue to have on societies and global economies, one can only conclude that mitigating these effects as much as possible is perfectly in line with the risk ma-

agement role of the insurance sector. Passively engaging in the real-world economy by continuing to finance and service business-as-usual in favour of short-term profitability will eventually lead to an economic reality in which the insurance sector can no longer function.

Additionally, taking an active role in promoting counterparties' shift to a net-zero business model is faithful to the prudent person principle, to which all insurers operating in the EU are held under Solvency II. This principle mandates insurers to invest with due diligence, thereby ensuring their investments are qualitative and profitable. Specifically, it emphasises the importance of investing in assets whose risks can be appropriately identified and managed to enhance the security of the portfolio as a whole, while avoiding excessive risk. Given the potential for a disorderly transition and the risk of stranded assets disrupting the economy, promoting the transition to net-zero is necessary to avoid "excessive accumulation of risk in the portfolio as a whole".²⁶

The insurance sector must go beyond only reducing financed emissions through divesting heavy emitters from asset and underwriting portfolios. A pure divestment policy can inadvertently lead to increased emissions in the real world, as companies operating in less regulated economies may acquire the dropped counterparties. Therefore, insurers should use the opportunities provided through their roles as risk managers and asset holders to guide counterparties towards low-carbon business models. Full divestment or refusal of coverage should be reserved for sectors incompatible with net-zero objectives and scenarios, such as fossil fuel expansion and thermal coals, and for counterparties that are unwilling to evolve on a sustainable path. For example, Zurich RE excluded five fossil-fuel companies from its investment and underwriting activities in 2021 based on its engagement campaign's escalation procedures.²⁷

This chapter explores the various tools and levers available to insurers, examining how they can effectively influence both the asset and liability sides of their portfolios. We discuss the engagement as well as strategic implementation of investment and underwriting policies geared towards fostering a net-zero transition.

Transition of investment portfolios

In their role as shareholders, insurers can utilise existing channels such as periodic and annual investor meetings to discuss sustainability concerns and climate-related risks with their investees. When these standard engagement efforts fail to produce results, they can pursue escalation steps by calling for specific meetings on concerns with the investee management or board. Alternatively, they can bring the concerns into the public sphere by means of public statements, tabling resolutions during annual general meetings (AGMs), or asking for a change in board constitution. Second, AGM voting serves as the main mechanism for active stewardship for shareholders

²⁶ According to Article 132, paragraph 4 of the Solvency II Directive.

²⁷ InsuranceERM, "Engagement processes help insurers tie the knot on net-zero," *Climate Risk and Sustainability for Insurers, a special supplement for InsuranceERM* (July 2023): 16.

to push the investee to implement concrete transition measures or remove board members who have proven to be holding back transition efforts. Insurers should use their voice as institutional investors to table voting resolutions and inform other investors about their voting intentions in upcoming AGMs.

The use of these shareholder levers has to be fully integrated into the insurers' transition plans through detailed engagement and voting policies. No shareholder should be able to make sustainability claims if they do not utilise the full extent of their powers to push the transition forward.

However, insurers are primarily bondholders, which does not give them voting rights. Without these voting rights, asserting one's influence over transition efforts becomes less straightforward. Yet, bondholding still provides the creditor with the leverage of holding future uncertainties over the investee. Issuers whose transition strategies and progress are assessed as insufficient might face diminished demand for their debt in the future, might not be able to roll-over their maturing bonds, and/or be forced to offer higher interest on their debt.

We recognize that the impact bondholders exert is limited by the nature and size of their investment. Nevertheless, large insurers are among major asset owners in the economy and, thus, are important investors in the bond markets with the potential to influence demand for corporate debt. Thus, for bondholding, insurers' investment strategy should be a key element of transition planning. By incorporating transition risk analyses into their investment policies and ongoing investment portfolio monitoring, insurers can contribute to risk mitigation efforts.

As asset owners, insurance companies often delegate the management of their investment portfolios to asset managers. Asset owners' mandates to their asset managers should include clear investment criteria and preferred voting and escalation policies. Yet, the smaller the size of investments to be made and their stake in the target investment vehicle, the smaller the ability of the insurer to contractualise its investment preferences. In the latter case, carefully selecting the asset manager based on the sustainability profile of the investment products offered and the manager's take on the transition remains the only actionable option.

Transition through underwriting

As is the case for investment policies, underwriting for new fossil fuel exploration or expansion should be restricted. Additionally, the insurers should develop policies to phase-out existing client relationships with companies or sectors that are not compatible with Paris-aligned transition pathways.

When committing to new or continuing existing client relationships, particularly in high-emission sectors such as agriculture or steel manufacturing, insurers should prioritise decarbonisation through the products they offer. Insurers should enhance the adoption of sustainable practices by linking contractual provision to better terms or lower premiums for clients who meet sustainability-related targets or pursue envi-

Environmentally sustainable activities. Linking the provision of insurance to non-financial covenants holds significant potential for driving real-economy impact. By tying coverage to sustainability criteria, insurers can directly influence corporate behaviour. If an insurer makes sustainability claims, it should prove that it utilises these covenants to draw attention to climate-related issues. However, this will require insurers to set up a process of regular accountability checks either internally or through external verifiers. Failure to meet the environmental covenant should result in negative effects for the client by, for example, reducing coverage, a premium increase, or contract termination. Similar use of provisions can also be employed as a tool to incentivise adaptation measures to reduce harmful activities or to drive risk reduction measures on the client side. Insurers should include this process in their transition plans through clear targets that can be scrutinised by supervisors.

As insurance contracts are primarily arranged through brokers, it is vital that insurers involve brokers in their transition strategies. They should ensure that brokers carry forward the sustainability considerations imposed by the insurance company by integrating sustainability criteria into the selection and sales of insurance products. Additionally, as brokers' profits are based on sales commissions, these can be incentivised to further promote sustainability considerations in contract underwriting.

IV. Transforming governance

Corporate Governance, Accountability, and Remuneration

In short:

- Assign accountability for the transition plan to senior management.
- Link a meaningful percentage of the remuneration plan to achieving transition goals, including using deferred remuneration and clawback mechanisms.
- Identify and develop necessary skills across all personnel.
- Translate transition plan goals into relevant employee KPIs.
- Ensure that board members have a comprehensive understanding of the targets and commitments.

Transition planning requires an aligned effort throughout the organisation. To effectively implement its transition plan, all personnel functions in the company need to play their part in a relevant and meaningful manner. Undertakings should put in place a company-wide change management strategy to identify and develop the necessary skills and competencies for all personnel to enable them to deliver the plan. In addition to training personnel, any goals relevant to an employee's role must be translated into clear KPIs linked to the remuneration plan.

The board and management tend to prioritise short-term performance over the long-term health and viability of the company, as this is often the more easily measurable standard to which they will be held accountable by shareholders. However, as climate change and its risks are a long-term issue, fostering sustainable corporate governance and reducing short-termism is crucial.

The responsibility for the transition plan should lie with the senior management and board, again linking the plan's short-, medium-, and long-term goals to incentives and accountability. To create adequate behavioural incentives, a meaningful percentage of management remuneration should be linked to achieving transition goals in the entity's transition plan. Prioritising the long-term view of climate change over the short-termism of profitability can be done through remuneration by utilising schemes such as deferred compensation and clawback mechanisms.²⁸

Furthermore, management as well as board members must fully understand the details of their responsibilities in the context of the company's transition planning and

²⁸ Linking management remuneration to sustainability targets is part of the political agreement on the review of the Corporate Sustainability Due Diligence Directive. However, it provides a high level of flexibility and, at the time of writing, has not been officially approved by legislators.

how these will be evaluated. This requirement fits within the fit and proper requirements for key personnel on professional qualifications, knowledge, experience, and integrity, as described in Article 42 of the Solvency II Directive. Additional training should be provided as necessary.

Lastly, transition plan governance should include clear escalation procedures up to the most senior management level to enable them to act in cases where the transition performance of the undertaking deviates from the plan and transition targets are not being met.

V. Transparency and assurance

The Role of Transparency in Transition Planning

In short:

- Annually disclose financed GHG emissions, current net-zero targets, as well as efforts and progress towards meeting them, including information on scenarios, metrics and methodology, and internal training.
- Update the transition plan at least once every three years based on prior performance or earlier in case of significant deviations or revisions.

A transition plan lacks credibility if it is not publicly communicated in a thorough manner. Core elements of such disclosures should include GHG (financed and insurance-associated) emissions, including short-, medium-, and long-term transition targets and the progress towards meeting them. All information relevant to their target setting and its results—that is, scenarios, metrics and methodology—must be disclosed in a comprehensive manner. This also includes an overview of the actions, in particular client engagement and related escalation steps, investment policies, management responsibilities and training, changes to internal procedures, remuneration schemes, and human resources development.

Disclosure on engagement efforts should provide a clear overview of the scope of engagement, the types of engagement, sectors and asset classes engaged with, and the outcomes, if measurable, of the engagement with the counterparties.

Identifying data gaps and reporting on results of the past period's performance should lead to at least an ad hoc update of the transition plan, every three years at minimum, in order to effectively readjust the strategy. To promote the comparability of efforts, the disclosure of insurers' transition plans should be aligned among different EU regulations to avoid duplications and be as uniform as possible among jurisdictions, for which the interoperability of different disclosure frameworks is a necessary precondition. In the EU, sector-agnostic sustainability reporting standards (ESRS) include requirements on transition plans as well as sustainability risk identification and assessment. These have been adopted through the CSRD Delegated Acts published by the European Commission on 31 July 2023.²⁹ Unfortunately, the sector-specific standards have been delayed until 2026, deprioritising detailed guidance on the sectoral level that has been left out of the sector-agnostic standards. The Corporate Sustainable Due Diligence Directive proposal further extends the disclosure obligation on transition plans to the obligation to effectively adopt and implement such plans.

²⁹ As of the time of this writing, the Delegated Acts are under scrutiny of the European Parliament and the Council.

The revised EU Solvency II Directive also includes the provisions for undertakings to align the plans which will have to be prepared by the undertaking under Solvency II with the transition plans prepared in accordance with the CSRD. Insurers will also have to disclose certain elements of their 'prudential transition plans', including relevant quantifiable targets, in their reports on solvency and financial condition (SFCR).³⁰ The elements to be covered in the plans, which will be prepared under Solvency II, including the ones disclosed via SFCR, will be defined by EIOPA in regulatory technical standards. Eventually, these elements could refer to the relevant parts of the transition plans included in the ESRS and, where necessary, be complemented by specific prudential elements.

On the international level, the efforts of the International Sustainability Standards Board (ISSB) and the Global Reporting Initiative have paved the way towards uniform disclosure for companies operating outside of the EU, even though they will have to be endorsed by the national regulators before becoming applicable. Additionally, cooperation between EFRAG and ISSB has resulted in a degree of interoperability between the ESRS and ISSB standards, although the ISSB does not follow the double materiality approach adopted by the ESRS.

³⁰ The exact elements to be included in the SFCR will be defined by EIOPA.

VI. Supervision

The role of Supervisors in Overseeing Transition Plans

In short:

- Integrate transition planning into the supervisory review process (SRP), extending the definition of the long-term view beyond the usual time-frames.
- Move from a retrospective approach to a forward-looking one.
- Examine insurers' commitments and the credibility of their transition plans to identify misalignments indicative of incorrect risk assumptions.
- Empower supervisors to impose penalties on insurance companies that fail to achieve their net zero objectives.

According to a survey by the Network for Greening the Financial System (NGFS) in 2023, only 3 out of 48 responding members had defined what a transition plan should entail.³¹ The different voluntary initiatives and frameworks that exist today all display diversity in approaches, objectives, and metrics, which can lead to confusion and a lack of robustness, comparability, and credibility in transition planning.

The same NGFS exercise also identified the role transition plans can play in micro-prudential supervision as a source of information to develop a forward-looking view on the institutions' strategy and risk management approach with regard to transition risk. The NGFS stated: "Transition plans can support risk management and business strategies. They can help financial institutions and micro-prudential authorities overcome some conceptual challenges with climate-related risks, including, for example, limited data availability, challenges with different time horizons, and the backward-looking nature of current methodologies. Against that background, transition plans can be used as a proxy for long-term risks."³²

In the chapters above, we emphasised the importance of considering insurers' transition-related risks as well as their impacts on climate as a proxy for the systemic risk perspective, without assuming that a financial institution's contribution to climate change is always mirrored by its own vulnerability (risk) in the short term. From a long-term perspective, impact materiality can be considered a proxy for the financial materiality of transition risk, particularly given uncertainties related to the materialisa-

31 The Network for Greening the Financial System, "Stocktake on Financial Institutions' Transition Plans and their Relevance to Microprudential Authorities" (2023): 17.

32 Ibid., 30.

tion of transition risk and lack of widely accepted methodologies for its assessment.³³ Supporting economic transition via the mitigation of climate-related impacts is a necessary measure to mitigate the risk of financial instability associated with unabated climate change and/or disorderly transition.

Taking both micro- and macroprudential perspectives together, having double materiality-based transition plans is essential for supervisors to monitor the stability and soundness of financial institutions and the system as a whole. A double materiality perspective fully represents a company's vulnerabilities and contribution to climate-related systemic risk, thereby feeding the climate-finance doom loop.³⁴ From a company-centric perspective, consideration of climate impacts often runs contrary to the objective of (short-term) profit-maximisation, which is how delivering value to shareholders is mostly defined. Yet, the longer-term perspective on impacts as proxies for transition risk, which was mentioned above, increasingly becomes relevant in the short-term, as we are approaching the important intermediate milestones of the Paris Agreement and climate-related risks increasingly materialise for insurers. The recent geographical exclusions by State Farm and AIG in the US are proof of the tangible impact of climate change on insurers' operations.³⁵ In both cases, the rapid increase in natural catastrophe exposure has made underwriting new contracts in certain regions economically unviable, leaving consumers and businesses without coverage. These drastic measures, although understandable from a pure risk management perspective, push the burden of climate change on society and undermine the insurers' business model viability. The resulting financial pressure on policyholders and governments will ultimately lead to economic destabilisation.

The revised Solvency II framework addresses these issues by integrating transition plans into insurers' risk management under Article 44 2b and, thus, prudential oversight under Article 36 of the Solvency II Directive. Additionally, Article 44 2c (b) mandates EIOPA to issue guidelines on the contents of these plans and their interlinkages with the existing own risk and solvency assessment (ORSA) requirements. EIOPA has developed supervisory guidance for climate risk management³⁶ covering guidance on climate risk materiality assessment and utilising climate change scenarios in the insurers' ORSA. Given the recent developments on the prudential role of transition plans as well as the revised text of the Solvency II Directive, this application guidance could be further enhanced to incorporate requirements on transition plans as tools

33 Jean Boissinot, Sylvie Goulard, Erlan Le Calvar, Mathilde Salin, Romain Svartzman and Pierre-François Weber, *Aligning financial and monetary policies with the concept of double materiality: rationales, proposals and challenges* (Centre for Sustainable Finance - University of London, Grantham Research Institute on Climate Change and the Environment - London School of Economics, 2022): 4.

34 See also Finance Watch, *Breaking the climate-finance doom loop* (2020).

35 See, for example, *State Farm California statement* (26 May 2023) and *claims of similar plans* by AIG and Allstate (WSJ, 8 June 2023).

36 European Insurance and Occupational Pensions Authority, *Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA* (EIOPA-BoS-22/329) (2022).

to manage climate-related transition risks.³⁷ Thus, transition targets and achievement of those over time will be considered in assessing the materiality of transition risk for the insurers' business model, assessing the level of risk and designing any necessary risk management and mitigation measures. The latter should notably focus on insurers' engagement with their clients and counterparties, which have been discussed in earlier chapters.

Given that prudential supervisors are not equipped to assess all the above elements of transition plans in terms of the climate-related expertise, it is important to emphasise the role of the assurance function. The CSRD mandates the assurance of transition plans of the institutions subject to the Directive, which will be essential to establish the credibility of insurers' transition plans, including targets. In turn, prudential supervisors should focus on the risk mitigation and adequacy of insurers' risk management processes for transition risk.

Transition plans can function as a strategic and risk management tool for insurers and are now being incorporated into the prudential review for microprudential authorities to help overcome supervisory problems in assessing risks related to climate change. The prudential approach is currently largely based on the use of historical backwards-looking data, which contrasts with the forward-looking, rapidly changing, unpredictable, and non-linear nature of climate-related (financial) risks. This approach makes it difficult to accurately predict losses if a disorderly (or no) transition occurs. Prudential authorities deal with forward-looking information and scarce data. Integrating transition plans in prudential oversight could partially help overcome these challenges.³⁸ A review of transition plan disclosure by prudential authorities will likely yield usable data sets in the short to medium term and highlight where data is lacking, thereby encouraging the development of forward-looking information.

Further, supervisory oversight of insurers' transition plans will enable conclusions on the institutions' risk management. An insurer who makes certain climate commitments while implementing a transition plan that cannot credibly honour these commitments reveals that the institution is unable to mitigate its risks, which could jeopardise the resilience of the institution—its solvency and/or the sustainability of the business model. This complements existing prudential supervision in assessing the possible materialisation of risk in the short and medium terms. The conclusion that the insurer is misaligned with its transition plan should trigger the prudential authority to scrutinise if its management understands and can credibly manage the risk to deflect the build-up of financial risks in the longer term as well.³⁹ In addition, sector-wide supervision

37 The Network for Greening the Financial System (2023); Morgan Deprés and Hugh Miller, *Prudential transition plans: the great enabler for effective supervision and regulation of climate-related financial risks?* (Centre for Sustainable Finance - University of London, Grantham Research Institute on Climate Change and the Environment - London School of Economics, 2023).

38 Simon Dikau, Nick Robins, Agnieszka Smolenska, Jens van 't Klooster and Ulrich Volz, *Net zero transition plans: a supervisory playbook for prudential authorities* (Centre for Sustainable Finance - University of London, Grantham Research Institute on Climate Change and the Environment - London School of Economics, 2022): 12.

39 *Ibid.*, 20; Shrago and Arkush (2023): 11-12.

of insurers' transition planning as a means to align insurers business models and risk management with the net-zero transition can provide a high-level understanding of the aggregate (mis)alignment of the insurance sector as a whole. In turn, this will deliver insights into possible systemic risk and serve as an indicator to warrant implementing macroprudential instruments to cover climate-related risks that are not covered by the existing Solvency Capital Requirements at an individual entity level.⁴⁰

In line with the revised provisions of Solvency II, supervisors will have to integrate insurers' transition plans into their supervisory practices—most notably the supervisory review process (SRP). As the risks of climate change occur beyond the usual timeframes for risk assessments, they will have to adapt their definition of long-term view to credibly supervise transition planning within the SRP (currently business and financial planning are done with a three-year time horizon with longer-term considerations being incorporated qualitatively). As the central authority, supervisors are also expected to identify best practices on transition planning together with international standard-setting bodies to set expectations.⁴¹ The supervisory review should cover the following aspects:

- The overall compliance of the plan with regulations.
- The scope of the transition plan, with specific attention to the policies and actions taken both in investment and underwriting activities, notably including engagement efforts.
- The credibility of the target setting, including the usage of underlying scenarios and pathways.
- The frequency of the plan's updates.
- Progress made towards meeting the targets and
 - the timing/speed of meeting them,
 - reasons for any deviations from the targets, and
 - corrective actions and risk mitigation processes in case the targets are not met.

Based on this supervisory assessment, competent authorities can decide whether the institution is sufficiently addressing the risk it is exposed to or whether additional risk measures should be considered. All of the above fits within the existing boundaries of Article 36 of the Solvency II framework, which details the supervisory review process.

Finally, supervisors should use their powers—preventive and corrective measures, including capital add-ons—in case business model, strategy, and risk management practices are not aligned and deemed inadequate to manage the risks and ensure

40 A Systemic Risk Buffer was also proposed by the European Systemic Risk Board in 2020. See European Systemic Risk Board, *Enhancing the macroprudential dimension of Solvency II* (2020).

41 For insurers' specifically, this will be the International Association of Insurance Supervisors and the Network for Greening the Financial System.

the solvency and financial condition of the insurance undertaking.⁴² Based on the SRP, supervisors issue recommendations to insurers, which range from requests to improve risk management and risk assessment practices to requests such as senior management training or supervisory interventions to push a change in composition of the management or the Board, intervention in dividend payouts to shareholders, or in the institution's planned remunerations.⁴³ Thus, reviewing insurers' transition plans from the risk management perspective would enable the supervisors to ensure that insurers are adequately managing and mitigating their transition risks over time and have sufficient risk-bearing capacity (capital) to bear the remaining risk.

⁴² Shrago and Arkush (2023): 19; These powers are provided by Solvency II Arts. 36 and 37.

⁴³ Dikau et. al. (2022): 28.

Conclusion

As vital actors in the global economy, insurers possess not only the financial power but also the operational incentive to lead the charge against the looming spectre of climate change. However, alarmingly, investment and underwriting practices spurred by short-term profit ambitions have exacerbated the crisis and shifted the weight of its consequences onto consumers and governments.

Stranded assets and societal burdens signal a disorderly transition. By continuing business as usual, insurers not only endanger their own future viability but also the stability of global financial systems and the well-being of countless individuals. This emphasises a depressing irony: institutions intended to protect against risk have become purveyors of it.

This report calls for transformative change wherein insurers enable transition towards a sustainable future. Divestment from fossil fuels and other activities misaligned with the transition pathways to the EU and international climate objectives, although significant, is merely a starting point. The need of the hour is a holistic realignment of strategies and operations, emphasising entire-economy transition, cooperation, transparency, and rigorous oversight.

The future beckons insurers to be more than passive observers. With their vast resources as asset owners and indispensable facilitators of economic activities as underwriters, insurers can catalyse transformations, innovations, foster collaborations, and shape industry standards. Beyond the short-termism of the returns on equity and narrow view on the balance sheet-related risks, it is about securing the long-term viability of the insurers' business model and the global economic system. By leading the way in sustainable practices, insurers can help ensure the necessary transition and, with it, a stable and resilient economy that benefits future generations, thereby aligning profitability with sustainable progress.

To conclude, we reiterate that the time for half measures is long gone. The stakes are monumental, and the window of opportunity is closing. The path forward is undoubtedly a challenge, but also an unparalleled opportunity to redefine the legacy of the insurance industry.

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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