Managing Green Swans

Why thinking like a futurist can help manage ‘green swans’ and the greenwishing of 2030 sustainability targets

INTRODUCTION: UNDERWRITING 2030 PROMISES

Most financial service companies have pledged their commitment to achieving a net zero carbon footprint by 2050 with a significant stepping-stone in this being interim targets typically set for 2030. Many commentators have suggested a ‘negative split’ (acceleration in progress between 2030 to 2050) is required to meet the second leg of the journey[1]. The insurance business model, much like many financial service companies, is underpinned by trust. Between now and 2030 this will undoubtably be tested as we see greater transparency on progress against these targets as sustainability disclosure frameworks and taxonomies such as the EU Corporate Sustainability Reporting Directive (CSRD) go ‘live’.

As 2030 rapidly approaches, we also need to be mindful of the looming spectre of ‘Green Swans’— unpredictable and unforeseen events that cause drastic environmental impact. The paradox, then, isn’t just to achieve 2030 sustainability targets but rather, how to plan for ‘un-plannable’ risks while also working diligently towards these substantial goals. One answer: to adopt a futurist perspective – an outlook bolstered by foresight and obligation to prospective contingencies.

PERSPECTIVES: WHAT DOES IT MEAN TO THINK LIKE A FUTURIST?

Thinking like a futurist requires seeing beyond the numbers and envision what lies ahead. On one side, you're a mathematician assessing data, on the other, you're an artist painting future scenarios. Compare this with the traditional actuarial control cycle where policies and processes often drive decisions. This cycle can be void of exciting viewpoints or non-cyclical approaches such as ‘systems thinking’ (an approach to problem-solving that views 'problems' as parts of an overall system, rather than reacting to specific parts or events).

HEREIN LIES THE THIN LINE BETWEEN TANGIBLE ANALYSIS AND INTANGIBLE CREATIVITY

By becoming futurists, we break free from this cycle! We dare to push boundaries, invite external insights, and include diverse perspectives by delving into an explorative world of layered possibilities. Herein lies the thin line between tangible analysis and intangible creativity—the latter seldom associated with an actuary. Welcome to a new risk management framework where the 'Four Ps' – people an planning, politics, pathways and pacts, and predictions and polycrises (the confluence of crises) conspire to script tomorrow's narratives.

1. People and Planning: Reflecting individual and collective behavior in decision-making processes.
2. Politics: A need to balance the external environment with evolving ethnical norms.
3. Pathways and pacts: Recognizes differing trajectories and opportunities for collaboration.
4. Predictions and polycrises: Considers multiple crises unfolding simultaneously and unpredictably, rather than predicting ‘best-estimates’.

PEOPLE AND PLANNING

As the world emerges from recent pandemics amongst ongoing health crisis it is important to consider how we navigate the storm ensuring that people, planet, and profit our balanced on our scale of priorities? These queries aren't mere speculative musings but a harbinger to the necessity of proactive preparedness—a lesson we can learn from Enterprise Risk Management (ERM).

ERM goes beyond traditional risk management; it considers uncertainties at the enterprise level and forecasts them. It is an encompassing approach in risk recognition which not only focuses on the financial and operational facet but broadens the landscape to strategic and hazard risks. In a world stunned by a pandemic, the ERM approach often adopted by futurists paints a comprehensive canvas to navigate future challenges.

ESPECIALLY ASSET MANAGERS ARE RIGHTLY CONCERNED ABOUT GREENWASHING AND LITIGATION RISK

POLITICS AND ETHICS

The need for companies to set internal ethical standards and ambitions is perhaps most clearly paralleled in the shift in the international environmental negotiations. Recently we've seen the move from the 'carrot and stick' approach of the last decade to a more nuanced use of peer pressure and the so called Nationally Determined Contributions in the recent Paris agreement[2]. This non-prescriptive model underscores the need for a more adaptive, futurist approach.

The evolution of politics, consumer sentiment, and ethical considerations have given rise to an ‘anti-ESG’ movement. A futurist perspective enables us to go beyond strictly factual considerations to incorporate normative concerns - considering not only what might occur, but what is desirable or acceptable. For instance, where banks are establishing credit risk exclusion criteria for financing activities outside of their sustainability risk appetite, they must communicate these changes effectively to customers and ensure no one is left behind in a ‘just transition’ (ensuring that the process is fair and inclusive for all people involved).

Financial service companies, especially asset managers, are right concerned about greenwashing and litigation risk. Examples can be found in responsible investment strategies where simple negative screening strategies may not meet retail investors' high expectations and aspirations for sustainability impact. Additionally, traditional fiduciary duties, once viewed as barriers to ESG factor integration, are gradually shifting. As regulators try to keep up with this shift, the labeling intermediaries involved in evaluating companies' ESG performance will also have an important responsibility[3].

Protection gaps (where consumers or businesses are exposed to risks that are inadequately covered by private insurance or social security systems due to the unavailability, unaffordability, or inadequate amount of insurance) are causing regulators and governments to step in. Classic examples include the UK FloodRe scheme, a joint initiative between the government and insurers designed to make affordable home insurance available to owners of residential properties at high risk of flooding. This strategic collaboration signals futurist thought in motion- a conscious effort to move beyond simple commercial frameworks to jointly creating a sustainable, insurable world against unpredictable environmental risks.

PATHWAYS AND PACTS

At the heart of the global climate challenge lies the 'Race to Net Zero'— an ambitious commitment that demands coordinated strategies. Consider, for example, the antitrust concerns surrounding the breakdown of the Net Zero Insurance Alliance (NZIA). To sustain credibility, organizations need to devise robust interim plans based on comprehensive scenario analysis to mitigate concerns of ‘greenwishing’ (a scenario where firms and investors showcase good sustainability intentions but without having solid strategies, effective measures, or sufficient commitment to achieve them)

Could we have possibly misread the race to net zero? Amid the breakdown of these alliances, the pivotal role of organizations such as the Network for Greening the Financial Services (NGFS) hints at a paradoxical coming together amidst divergence. Meanwhile, the coexistence of multiple non-financial reporting frameworks —TCFD, CSRD, and SASB to name a few!— creates a proverbial ‘acronym soup.’ Thus, achieving harmonization and interoperability among these different frameworks will be key to transparency. As per the evolution in international environmental negotiations, the road ahead inspires a thought: will we see a 'race to the top'?

WILL WE SEE A RACE TO THE TOP?

PREDICATIONS AND POLYCRISIS

The discourse around sustainability risk has historically circled around three pillars—physical, transition, and litigation risk. However, in a world faced with rapidly deteriorating ecosystems and consequent financial instability, emphasizing these dimensions alone feels inadequately myopic. Trust emerges as an overarching theme in ESG risk management. For instance, the European Central Bank acknowledges that ~75% of Euro Area banks placing corporate loans rely critically on at least one ecosystem service yet, the strides made in quantifying and understanding nature-related risks remain underwhelming compared to progress in climate risk mitigation[4].

However, we must also embrace the futurists mindset to prepare for the unforeseen - the unknown unknowns. If I were to predict anything it's that reshaping finance isn't solely about financial viability or sustainability mainstreaming, but the integrity of the means employed on route to 2030. ■

1 – https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp231114~5bf50e8b7a.en.html

2 –https://unfccc.int/process-and-meetings/the-paris-agreement/nationally-determined-contributions

3 – https://www.fca.org.uk/news/press-releases/sustainability-disclosure-and-labelling-regime-confirmed-fca

4 – https://www.ecb.europa.eu/press/blog/date/2023/html/ecb.blog230608~5cffb7c349.en.html

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This article is written in a personal capacity.