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European Financial Services
Round Table

EFR PAPER ON RESILIENCE AND PROTECTION GAPS

Executive Summary

- The European economy is facing more and more risks with systemic features such as climate change, cyber-attacks, ageing, pandemic and geo-political developments. To address these risks, the European financial sector has a very specific expertise that it is ready to share with European policy makers so that it contributes to more resilient societies. Banks and insurers both have a critical role in supporting economic resilience, through investment and expertise in management of financial, business, and physical risks.
- EFR Members stand ready to provide insight and expertise to promote EU, national and local engagement and to support policymakers in better preparing for known and emerging risks.
- This Paper focuses on four specific areas where the European financial sector can play a role: 1) closing the climate protection gap; 2) enhancing responses to cyber crime; 3) managing ageing risks for a resilient society; and 4) managing geopolitical risks and future pandemics.
- The common denominator in terms of lessons learned in these four areas is the importance of joint efforts and close collaboration between public and private stakeholders, which could lead in some cases to the promotion of public-private partnerships, or new types of public-private risk-sharing mechanisms with the aim to create greater awareness, mitigate risks and enhance preparedness.
- Going forward, the EFR believes that the current challenging times can provide for real momentum for regulators, policy makers and the financial sector to take a bigger leap into the future and set ambitious goals.

Introduction

The world economy faces a large number of major and difficult challenges, with geopolitical turmoil, energy crisis, rapid technological change, inflation and macro-economic volatility having a major impact, also for Europe. Despite these turbulent times, the European financial services sector has been steadfast in supporting the European economy.

Banks and insurers both have a critical role in supporting economic resilience, through investment and expertise in management of financial, business and physical risks. Since the financial crisis, huge efforts have been put into making sure that European banks are resilient. Notably, this has come about through a sharp increase in capital requirements, liquidity requirements in the CRD-CRR framework[1], and increased attention to the management of operational risk and resilience (in line with BCBS Principles), recognising the role that banks themselves have in ensuring the resilience of the wider EU economy.

At the same time, there are multiple risk management challenges that the European economy as a whole is facing, and a number of systemic risks - from climate change to cyber incidents, pandemic-related business interruption and supply chain outages, as well as ageing populations - need to be assessed and addressed.

With this Paper, the EFR is aiming to clarify possible insight, expertise and perspective financial services can offer to address some of the most pressing issues of our times and to contribute to accelerating the spread of risk awareness and understanding as a foundation for addressing gaps in protection. We believe that the current challenging times can create opportunities and provide for real momentum for regulators, policy makers and the financial sector to take a bigger leap into the future and set ambitious goals.

[1] The aggregate Common Equity Tier 1 (CET1) ratio for European significant banks has raised from 7% in 2008 to more than 15%.

1. Closing the climate protection gap

The world is transforming at an unprecedented pace. The past seven years were the seven warmest on record and more severe, more frequent extreme weather events are becoming the new norm, threatening societal resilience. Furthermore, climate risk has an impact on capital markets and the economy at large, in particular, when the negative impact of large-scale disasters on GDP is high and the uptake of the natural catastrophe insurance (nat cat) in Europe remains low[2].

Between 2000 and 2016, climate-related disasters doubled compared to the previous 20 years, with economic losses from natural catastrophes continuing to increase. In 2021 alone, economic losses stood at USD 270 billion. Yet, only 30% of climate-related losses are covered by insurance at present, and global climate adaptation plans and financing still falls short[3].

The financial cost of climate change will only increase unless we act in a collaborative way between the private and the public sector to close this protection gap and enhance resilience.

Greater risk awareness is the first step in terms of enabling citizens, communities and business to manage risk better and build resilience. Insurers can help bridge the information gap through the industry's risk understanding and risk management expertise. In fact, insurers are already playing an active role in closing the nat cat protection gap and increasing risk prevention and resilience, in particular by fostering campaigns to insure buildings against floods and increase resilience and protection measures. As a result, the quota of nat cat coverage in building insurance has increased. However, it is still very different from country to country in the EU and it is still insufficient, as emphasised in a recently published EIOPA/ECB Discussion Paper on climate insurance protection gaps[4].

EU banks have recently started to disclose the exposure of their lending portfolios' to "physical risk" from climate change on a sectoral basis. This will allow investors and other stakeholders to push banks to reduce their exposures to these risks. It is paramount that reducing exposure to physical risk on the part of the banks does not lead to financial exclusion, particularly vis-à-vis retail clients (e.g. financing homes).

At the same time, we know that one actor or sector alone cannot tackle the negative consequences of climate change – the ultimate goal is not only a sustainable financial sector, but also a sustainable economy. We must work in partnerships to combine our expertise, for example by improving approaches to climate-related risk modelling and customised solutions, as well as partnering with public institutions and development banks (including the EIB as well as national promotional banks) to develop specific climate finance solutions. We consider public climate-related adaptation measures essential for society to prevent large-scale catastrophes and destruction. Among others, these public adaptation measures also help to keep insurance premiums affordable and avoid uninsured losses among the local communities.

Moreover, companies in the real economy need policy frameworks and incentives to re-engineer their production processes. Such frameworks also provide the certainty finance needs to make investments. Thus, we welcome the EU's Fit for 55 package and look forward to its rapid implementation to support the transition to the sustainable economy and society that we need.

The idea of public-private partnerships should be developed further, recognising that the private financial sector cannot cover large catastrophic events alone, and that a capital back stop by the public sector is required. Insurance associations in a number of EU countries have developed proposals for public-private partnerships and there are already existing pool mechanisms for nat cat events in some EU countries.

Building resilience in a world with increasing climate risks should go hand in hand with mitigating climate change itself. The financing of green projects is increasing rapidly, with European insurers and banks overwhelmingly committed to aligning their activities to the Paris Agreement, which will be formalised as multiple EU laws will mandate companies to disclose their transition plans. Financing this transition should not be primarily based on exclusion. Instead, it should help the real economy transition to a net-zero economy. In some sectors, this can happen quickly. In sectors that face "hard-to-abate" emissions, incremental improvements and the financing of breakthrough technologies should be prioritised.

2. Enhancing responses to Cyber Crime

Cyber criminals are becoming more sophisticated, with the number of cyber attacks growing continuously. This is also an effect of the geopolitical context, the digital transformation, implementation of new technologies and enhanced use of data. Governments – legislators and law enforcement – have an important task ahead to ensure that a (global) cyber security framework is in place.

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[2] EIOPA research sheds light on why households and businesses are reluctant to take out NatCat insurance (europa.eu)

[3] UNEP, "Too Little, too slow. Climate adaptation failure puts world at risk", 2022, https://www.unep.org/resources/adaptation-gap-report-2022

[4] EIOPA /ECB EIOPA and ECB call for increased uptake of climate catastrophe insurance (europa.eu)

Much has been done already to increase the level of cybersecurity and raise awareness of cyber risks for users by way of data privacy laws and cyber security acts, with the most recent proposal for an EU Digital Operational Resilience Act a clear example of public sector action to enhance cyber resilience.

Financial institutions are managing their own operational risks by continuously analysing cyber threats, investing in skills and increasing their efforts to protect themselves against cyber attacks. For their part, supervisory authorities are focusing on cyber resilience testing and a reporting framework for significant market participants and infrastructures within the overall EU financial sector.

Insurance companies' data show that the cyber risk protection gap for customers – i.e. the difference between total losses and insured losses – is still very high. It is therefore important to assess how the cyber protection gap for customers can be adequately addressed.

A key question is how we can raise the education and awareness of customers to help them be prepared against cyber attacks and mitigate the cyber threat consequences. The second key question is how the financial sector could advise them on risk prevention and protection and help close the protection gap so that customers are better insured in order to make society more resilient to cyber risk.

Understanding cyber threats is of the utmost importance for customer awareness. In general, financial institutions already inform their customers about threats related to the services provided, such as phishing, identity theft etc. Customers – especially businesses – should furthermore be aware of the value of data in their systems. To mitigate the consequences of cyber attacks, cyber risk scoring - assessing the level of cyber protection - is provided within the underwriting process, as are ways of increasing the protection of IT systems. In the event of a cyber attack, a support team also intervenes to help contain the damage.

Enhancing data quality is essential for this and it is also important to strive for more standardised data of cyber losses so that the current uncertainty regarding expected losses can be tackled.

The accumulation potential of cyber risk lies in the fact that a large number of cyber incidents may occur in a wide geographical area, or across sectors, at the same time. This could result in significant losses for insurance companies, which can be difficult to manage and then strongly limit insurance capacities.

Joint efforts by governments, the financial sector and businesses are important to keep the financial sector and its customers cyber-resilient. Improved capacity in the real economy to invest in cyber insurance benefits the entire economy as it would increase business continuity in the event of major and simultaneous attacks.

3. Managing ageing risks for a resilient society

Demographic and societal changes are putting unprecedented pressure on health and pension systems globally, requiring them to sustain more people as the expected lifespan after retirement increases alongside the number of people entering these systems. Also, fewer people in the workforce support the inflow of funds into the schemes due to falling birth rates.

The increase in life expectancy after retirement affects the soundness and sustainability of health and pension pay-as-you- go systems, especially in countries with low levels of savings and high dependency on the government-provided first pillar pension.

As a consequence of ageing, the health and pension gap is growing significantly in Europe, with the pension protection gap defined as "the difference between the savings needed to sustain a reasonable standard of living (65-70% income replacement) for the next generation of retirees and the currently projected inflows into the system[5]."

As such, close collaboration between public and private stakeholders is necessary. While public stakeholders play an important role in building an appropriate regulatory environment, private stakeholders could help address the gap by introducing new products and services, for instance. One example could be the creation of a truly European pension fund scheme with the same regulatory and (beneficial) tax treatment across all Member States. That would contribute towards mobilising savings, help develop the CMU and build the third pillar.

Both the European Parliament and the European Commission have argued that the mandatory pension systems (first pillar) should be complemented by collective occupational pension systems (second pillar) and individual pension products (third pillar), with the three-pillar structure of pensions considered to be the most balanced by European institutions.

In fact, the development of social security systems increases savings levels at the national level, reducing dependence on external financing. Likewise, it favours the development of the economy and capital markets, contributing decisively to the financing of companies and productive investment as well as to economic growth.

[5] GFIA Report: *"Global protection gaps and recommendations for bridging them"*, April 2023, https://gfiainsurance.org/topics/487/protection-gaps (page n.10)

Besides the green and digital transition, it is necessary to address a social transition for ageing populations, improving resilience, sustainability, and the competitiveness of the European Union.

The European Commission has also pointed out in its *green paper on ageing*[6] that older societies have a greater demand for intensive medical services for pathologies associated with ageing. This will increase pressure on the public accounts. As pointed out in a recent report by the Geneva Association[7], this new environment should lead insurers to develop new care models offering more value to society.

4. Managing Geopolitical risks and Future Pandemics

Societal shocks like the war in Ukraine and the COVID-19 pandemic can have a wide-ranging impact on the financial sector. Our sector's key role is to manage risks to financial stability and help society be more resilient against these types of shocks.

The war in Ukraine is an example of geopolitical risk, which can be a catalyst for the risks that financial institutions face, such as credit, market and reputational risks. In order to manage these kinds of shocks, banks and insurers perform scenario analysis to better understand the fallout from this type of scenario, including potential economic sanctions that this might entail. This can include the mapping of supply chain disruptions that can pose material threats to some sectors, and building in protections for exposures to jurisdictions and sectors that could face high geopolitical risk. Banks and insurance companies also use new stress tests and models against geopolitical risk. The latest bank stress test adverse scenario, for example, included a deterioration of geopolitical risks. Good dialogue between public authorities, supervisors and the sectors are paramount for performing this work. All this can help prevent a geopolitical crisis turning into a financial stability crisis.

Also, banks and insurers have a societal role to play to help mitigate the fallout of geopolitical tensions. In light of the war in Ukraine, banks have rolled out programmes to make it easier for refugees to open bank accounts and transfer money to Ukraine. Many insurance companies have provided free insurance to refugees and the households supporting them, e.g. free extension of liability insurance.

Finally, pandemics act as a catalyst for risks. Learning lessons from the COVID-19 experience enables policymakers as well as decision-makers in the real economy and financial services to be better positioned to respond to the next pandemic, caused by emerging infectious diseases for example.

Better preparedness is vital as the next pandemic could be even worse, depending on contagiousness, case fatality rate, availability of vaccines or therapies, and the effectiveness of immunity over time. For instance, stress tests based on pandemic shocks can help the consideration of critical risk factors and identify potential vulnerabilities[8].

Conclusion

The challenges of our times - from the climate protection gap to cybercrime – cannot be tackled by one actor or sector alone. Instead, private and public stakeholders should act in a collaborative way to close protection gaps and enhance resilience.

Greater awareness is the first step towards enabling citizens, communities and business to manage risk better and build resilience. Understanding risks is key and for this, the quality of data is of the utmost relevance. Better cooperation between governments, the financial sector and its customers is aimed at enhancing the understanding of risks and the potential to address them. This cooperation could also involve new types of public-private risk-sharing mechanisms.

EFR overarching recommendations:

As risks are interconnected, volatile and spread rapidly, EFR Members call for:

1) **Scenario definition:** enhancing communication between public and private actors to collectively work on plausible but also extreme scenarios, e.g. future pandemics.
2) **Private-Public partnerships:** for risks with systemic features, and based on shared data on protection gaps, public authorities and the private sector should work on defining Private-Public Partnerships that would help sustain the overall economy in the event of a major crisis. Only carefully crafted PPPs that empower all actors to be clear about their role in the development and execution of suitable, structured projects will be able to optimally leverage public and private sector insight and capabilities.

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6 The Green Paper on Ageing was adopted by the European Commission on 27 January 2021, COM (2021) 50 final.

7 The Geneva Association, *New Care Models: How insurers can rise to the challenge of older and sicker societies*, August 2021, https://www.genevaassociation.org/publication/health-and-ageing/new-care-models

8 CRO Forum: A new perspective on pandemics: Covid-19 insurance impacts and challenges CROF-Pandemics-paper.pdf (thecroforum.org) 2022

3) **Prevention:** promote collaboration between Public Authorities and Private actors:

- **Climate risks:**
  - Help the real economy transition to a net-zero economy, with policy and regulatory frameworks focused not just on finance but also on supporting and incentivising the broader corporate sector in the transition. In sectors that face "hard-to-abate" emissions, incremental improvements and the financing of breakthrough technologies should be prioritised.
- **Cyber risks:**
  - Define the minimum set of cyber security measures that SMEs and individuals should implement,
  - Define educative programs and circulate them.
- **Ageing:**
  - Foster debates about ageing societies and increase awareness of the need to save for retirement, e.g. by seizing the opportunity to modernise regulation and foster financial literacy via the EU Retail Investment Strategy,
  - Encourage pension schemes with a balanced three-pillar approach -and promote Private-Public Partnerships in schemes that complement public systems and introduce tax incentives.
- **Geopolitical risks and future pandemics:**
  - Map supply chain disruptions that can pose material threats to some sectors,
  - Build in protections for exposure to jurisdictions and sectors that could face a high geopolitical risk,
  - Assess the development of stress tests based on pandemic shocks to help take account of critical risk factors and identify potential vulnerabilities.

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.

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