

## About us

Marsh & McLennan Companies<sup>1</sup> is a global professional services firm with two operating segments, **Risk and Insurance Services** and **Consulting**. With 75,000 colleagues around the world, we provide advice and solutions in risk, strategy and human capital to clients in more than 130 countries. Marsh & McLennan is comprised of four major companies:

- **Marsh** - Insurance broking and risk management solutions
- **Guy Carpenter** – Reinsurance and capital strategies
- **Mercer** - Health, wealth and career consulting and solutions
- **Oliver Wyman** - Strategy, economic, and brand consulting

## Marsh & McLennan Companies response to the EU Renewed Sustainable Finance Strategy consultation

Marsh & McLennan welcomes the opportunity to contribute to the European Commission's Consultation on the Renewed Sustainable Finance Strategy. In addition to the responses submitted via the EUSurvey, we would like to expand on our submissions to questions 6 and 84 and provide references to Intellectual Capital developed by Marsh & McLennan Companies on these topics.

- *With regard to question 6 (What do you see as the three main challenges and three main opportunities for mainstreaming sustainability in the financial sector over the coming 10 years?)*

### Challenges include:

#### 1) The level of ambition

A challenge is the extent to which the current renewed strategy and EU budget and Work Programme for 2020 and stimulus can be implemented with ambition, climate governance and systemic risk management approaches.

For example, the continuation of fossil fuel subsidies, estimated at 55bln p.a., among Eurozone governments will reduce the ability of the EU to deliver on its sustainable aims<sup>2</sup>.

If stimulus packages tolerate higher emissions as a 'necessary evil', Member States, governments and companies could lose competitive disadvantage in the global transition to a low-carbon economy, leave the Eurozone more vulnerable to systemic transition risks and slow sustainability mainstreaming through the finance system.

The ambition of the economic stimulus should be to create a stable financial system for "transformational investments", which we define as investments with an attractive risk-adjusted return, which also help mitigate or address one or more long-term systemic risks<sup>3 4 5</sup>.

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<sup>1</sup> <https://www.mmc.com/about.html>

<sup>2</sup> <https://www.euractiv.com/section/climate-environment/news/eu-countries-have-no-concrete-plans-to-phase-out-fossil-fuel-subsidies-report/>

<sup>3</sup> <https://www.mercer.com/our-thinking/wealth/converting-global-systemic-risks-into-sustainable-returns.html>

<sup>4</sup> <https://www.oliverwyman.com/our-expertise/insights/2020/apr/how-covid-19-can-help-fight-the-climate-battle.html>

<sup>5</sup> <https://www.weforum.org/agenda/2020/05/tackle-worlds-biggest-challenges-and-pursue-return/>

2) Partial execution examples include:

- The disclosure problem: insufficient transparency on climate-related and broader sustainability-related risks and opportunities to allow finance providers to make informed decisions. Currently addressed in Sustainability-Related Disclosures in the Financial Services Sector Regulation (EU) 2019/2088 ('The Disclosure Regulation') – challenges may arise if ESAs guidance and any potential future Delegated Act does not carry forward the ambition laid down in the Regulation and its preparatory work<sup>6</sup>.
- The data problem: differing reporting approaches among companies and investors, limited data availability from large-, mid-caps and SMEs; poor concordance of different ESG ratings data, lack of standards for different 'green' financial products. Currently addressed in Sustainability-Related Disclosures in the Financial Services Sector Regulation (EU) 2019/2088 ('The Disclosure Regulation'), Proposal on the Establishment of a Framework to Facilitate Sustainable Investment ('The Taxonomy Regulation'), Directive 2014/95/EU – Disclosure of Non-Financial and Diversity Information ('The Non-Financial Reporting Directive –NFRD') – challenges may arise if current consultations, technical standard drafting and any future Delegated Acts do not carry forward the ambition laid down in the Action Plan and by expert working groups.
- The accessibility problem: it is not easy to finance transition in brown sectors because of concerns about greenwashing and reluctance of investors to hold green bonds from 'brown' companies, yet achieving net-zero by 2050 demands that very significant transformation in brown sectors – where the majority of emissions originate – is financed. Mainstreaming must ensure adequate availability of financing for low-carbon investment in high-emissions sectors (with appropriate incentives for decarbonization) and avoid a two-tier financial system that provides green finance for green companies and 'brown' finance for 'brown' companies. Currently mainly addressed in the Proposal on the Establishment of a Framework to Facilitate Sustainable Investment ('The Taxonomy Regulation') – challenges may rise if technical standard-drafting, in particular as it comes "transition activities" and future Delegated Acts do not carry forward the ambition laid down in the Action Plan and the depth of the Taxonomy becomes limited (from green to 'so-called' brown taxonomy – to social taxonomy).

**Opportunities might include:**

1) Transformational investments

The opportunity for the finance sector lies in developing governance structures that enable a shift toward a net zero economy by 2050. This will enable the finance sector to position investment programs identifying transition and decarbonisation risks and investing in transition capacity and transformational

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<sup>6</sup> <https://www.esma.europa.eu/press-news/esma-news/esas-consult-environmental-social-and-governance-disclosure-rules>

solutions to facilitate capital investment where financing gaps exist and there are opportunities for positive externalities (e.g. public private partnerships)<sup>7 8 9</sup>.

## 2) The €1 trillion low-carbon investment opportunity

The financial services industry has a crucial role to play in the transition to a lower-carbon economy. Much has been done in the industry to increase the pace and scope of the response, but there is much more to do. The EU has a crucial position as accelerator and the global sustainability leader through regulation, diplomacy and innovation.

Examples include:

- Oliver Wyman estimates<sup>10</sup> the global market in sustainable finance to be \$100bn - \$150bn a year in new revenue potential, across investing, financing, data and advisory. Industry players are able to move fast, develop in line with the highest ambition of this Action Plan and work across any perceived boundaries to shape the evolving market are the best placed to benefit. European financial services companies reported almost €1 trillion of low-carbon opportunities to CDP in 2019<sup>11</sup>.
- Biodiversity, the EU Biodiversity Strategy 2030, and a broad, fundamental recognition of nature based solutions as an 'asset class' supporting green recovery. The financial sector capacity building in understanding nature dependency (half of global GDP EUR40trl) and the cost of inaction will catalyse sector innovation and investment<sup>12</sup>.
- Based on Oliver Wyman analysis of data reported to CDP in 2019, 882 European companies responsible for over 2.3 GtCO<sub>2</sub>e of emissions reported €124 billion of new low-carbon investments of which capital investments amounted to €59 billion. To reach the proposed new emissions targets for 2030 and 'climate neutrality' by 2050 Oliver Wyman analysis of this data found that the rate of low-carbon capital investment would need to more than double to around €122 billion a year. While this is a significant increase, in the context of overall capital expenditure, low-carbon investment would still remain a modest: growing from 12 percent to 25 percent of capex. This in turn would create significant opportunities for capital goods companies.
- More broadly, business opportunities from the low-carbon transition are immense, for example: European companies reported €1.2 trillion of opportunities to CDP – more than six times the cost to realise them<sup>13 14</sup>.
- In the insurance sector, government entities are beginning to take proactive steps to understand and manage the risks that they hold and implement processes designed to improve their financial resilience. They have a willing and able partner in the reinsurance

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<sup>7</sup> <https://www.mmc.com/insights/publications/2020/june/becoming-a-future-maker--from-shareholder-to-stakeholder.html>

<sup>8</sup> <https://www.mmc.com/insights/publications/2020/february/the-purpose-of-corporations.html>

<sup>9</sup> <https://www.mercer.com/our-thinking/wealth/navigating-a-pandemic-driven-market-crisis.html>

<sup>10</sup> <https://www.oliverwyman.com/our-expertise/insights/2020/feb/doubling-down.html>

<sup>11</sup> <https://www.mmc.com/insights/publications/2020/february/climate-change.html>

<sup>12</sup> <https://www.gov.uk/government/publications/interim-report-the-dasgupta-review-independent-review-on-the-economics-of-biodiversity>.

<sup>13</sup> <https://www.oliverwyman.com/our-expertise/insights/2020/feb/doubling-down.html>

<sup>14</sup> <https://www.mmc.com/insights/transformative-technologies.html>

industry. Governments are turning to the reinsurance market for innovative risk solutions and making important progress in quantifying the impact of climate change<sup>15</sup>.

### 3) De-risking of the financial system

“Failure of climate-change mitigation and adaption” was by far the number one long-term risk by impact and number two by likelihood, according to the World Economic Forum’s 15th annual “The Global Risks Report” completed in cooperation with Marsh & McLennan<sup>16</sup> (pre-pandemic). Governments, businesses and societies face an urgent and existential challenge of both mitigate and adapt to climate change in the coming decade.

The value at risk to 2100 is estimated at 43 Trill.<sup>17</sup> or between 2 percent and up to 10 percent of global financial assets being at risk by 2100. Such is the scale of the devastation that we need to accelerate our preparation in the sector now<sup>18</sup>.

De-risking the financial system through mainstreaming of TCFD, incorporation of climate-risks into regulatory and supervisory frameworks (for example strenuous stress testing) and widespread adoption of models that allow a financial institution to quantify climate risks and allocate capital appropriately is key for the preparation of the sector.

De-risking would also lead to value creation within the sector and broader society (see Oliver Wyman estimates for banking revenue opportunities discussed above, as well as Oliver Wyman - CDP estimates for banking and corporate opportunities). Mercer furthermore estimates in its seminal climate scenario analysis work that expected returns for Asset Owners are significantly better from investment portfolios leading to energy transition and lower global heating (in line with EU 2050 goals) than from portfolios allowing climate crisis level of heating to prevail. Mercer opines that transition investments are imperative, since, for nearly all asset classes, regions and timeframes, a 2°C scenario leads to enhanced projected returns versus 3°C or 4°C and therefore a better outcome for investors. Although incumbent industries can suffer losses in a 2°C scenario, there are many notable investment opportunities enabled in a low carbon transition that allows investors to capture “low carbon transition premium”<sup>19</sup>.

Transformational investments will convert global systemic risks into sustainable returns and provide system-level de-risking not only for the financial sector but for use of the financial sector as the engine for real-economy de-risking. We have identified six critical systemic risks that address an annual investment gap of \$6.27 trillion and a governance framework that enables the investment community to address risks related to water security, climate change, population growth, geopolitical uncertainty, negative interest rates and technology disruption<sup>20 21</sup>.

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<sup>15</sup> <https://www.mmc.com/insights/publications/2020/march/protecting-our-planet-and-the-public-purse.html>

<sup>16</sup> <https://www.weforum.org/reports/the-global-risks-report-2020>

<sup>17</sup> <https://eiuperspectives.economist.com/sustainability/cost-inaction>

<sup>18</sup> <https://www.mmc.com/insights/publications/2020/apr/climate-change-is-a-global-financial-risk.html>

<sup>19</sup> <https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html>

<sup>20</sup> <https://www.weforum.org/whitepapers/transformational-investment-converting-global-systemic-risks-into-sustainable-returns>

<sup>21</sup> <https://www.mmc.com/insights/publications/2020/apr/climate-change-is-a-global-financial-risk.html>

Today's more complex risk environment (with challenges ranging from cyber to climate) puts traditional national risk governance approaches under considerable pressure, demanding new behaviours, interactions, and solutions. We suggest how to frame the evolving macro-level risk landscape in a way that helps allocate resources to the most material concerns and how to review options for organizing and coordinating risk management activities within the government<sup>22</sup>.

- ***With regard to question 84 (Climate change will impact financial stability through two main channels: physical risks, related to damages from climate-related events, and transition risks, related to the effect of mitigation strategies, especially if these are adopted late and abruptly. In addition, second-order effects (for instance the impact of climate change on real estate prices) can further weaken the whole financial system. What are in your view the most important channels through which climate change will affect your industry?)***

As a professional services firm, Marsh & McLennan is primarily exposed to physical and transition risks indirectly, through the impacts on its clients. The Investment consulting and asset management industry is most affected by regulation and policy focussed on financial stability so that investors can deliver investment performance and meet risk objectives in the face of physical and transition risks. Through our work with asset owners, banks and insurance companies, helping them to assess their climate risk exposures, we would emphasise considerations around managing:

- Carbon pricing risk
- Capital adequacy and risk-weighted assets
- Liquidity risk
- Funding risk
- Insurance risk to address gaps in insurance protection
- Market risk
- Credit risk
- Policy and legal risk
- Operational risk
- Strategic risk flow on effects of systemic risk for the economy

### **Physical Risk<sup>23 24</sup>**

Increased frequency and severity of flooding in Europe is expected to increase average annual loss and 1-in-100 year loss for non-life insurers, particularly in scenarios with high-levels of warming.

Investors and insurers face significant investment risks from physical impacts. Research by Mercer found that expected portfolio returns could be 0.1% pa lower to 2100 on a 4C pathway compared to a 2C pathway.

Regulation and policy that supports decarbonisation and economic transition is critical to our industry to undertake management of portfolio assets on e.g. the range of potential temperature and economic

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<sup>22</sup> <https://www.mmc.com/insights/publications/2020/apr/national-resilience-report.html>

<sup>23</sup> <https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html>

<sup>24</sup> [https://www.mmc.com/content/dam/mmc-web/insights/publications/2019/apr/FINAL\\_Investing-in-a-Time-of-Climate-Change-2019-Full-Report.pdf](https://www.mmc.com/content/dam/mmc-web/insights/publications/2019/apr/FINAL_Investing-in-a-Time-of-Climate-Change-2019-Full-Report.pdf)

outcomes, the impact of climate on assets, asset classes and sectors and overall portfolio risk (for example, in terms of standard deviation or climate value at risk [CVAR] which shows how much a company may suffer an increase (risk) or decrease (opportunity) in business interruptions or asset damages from the physical manifestations of climate change. These include chronic hazards (gradual changes in temperatures, precipitation, snowfall and wind) and acute hazards (coastal flooding and tropical cyclones) and takes into account the specific locations of companies' facilities at an aggregated portfolio level and assessed via the key physical drivers.

Access to R&D and scientific evidence on physical damages for modelling and portfolio stress testing for real assets and alternative assets, agriculture, natural resources, timberland etc is key to the ability of the industry to construct and manage investment portfolios. Investors increasingly look to scientific sources of data and analytics to understand the trajectory of physical climate risks and limitations in current data sets, e.g. IPCC reports on physical damages typically excluding the high-uncertainty "feedback loops" that can create climate tipping points, such as permafrost melting and releasing methane.

### **Transition Risk**

As above, transition risk is material as companies, sectors, economies are decarbonised and transition. Key channels that impact on our industry are similar to the above – policy, regulation and adequate access to scientific data and research<sup>25</sup>.

Overall deterioration in economic outcomes will put a strain on the profitability of the finance sector and its ability to contribute positively to the sustainability of the finance system.

There may be parts of the industry that are unable to adapt to the new paradigm sufficiently and will as a consequence suffer commercially. Sudden transition may result in significant credit losses for banks with large exposures to high-carbon sectors. Oliver Wyman has estimated, for example, that the global implementation of a \$50 carbon tax could result in losses from energy sector lending totalling \$300 billion<sup>26</sup>.

Transition may also create significant investment risks for asset owners exposed to high-carbon sectors. Mercer has estimated that investments in coal, oil & gas and electric utilities could lose 58.9%, 42.1% and 39.2% of their value by 2030 on a 2°C pathway. Conversely, a 2°C scenario creates significant opportunities for investors with sustainable themed portfolios and, despite negative returns for high-carbon sectors, still leads to improved overall returns across nearly all asset classes, regions and timeframes versus a 3°C or 4°C scenario.

Transition risks may also suddenly crystallize if market expectations about the likelihood of rapid transition change and assets are repriced accordingly. Mercer has estimated that coal investments could fall 50% should market expectations align with a 2°C transition pathway, for example.

### **Second order effects**

The consequences of increasing flood risk is likely to extend beyond property damages and rising insurance claims in adversely affected areas, potentially leading to increased insurance premiums, reduced coverage, reduced local economic activity and falling asset values. In such cases, this will have

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<sup>25</sup> <https://www.mmc.com/insights/publications/2020/february/climate-change.html>

<sup>26</sup> <https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2020/February/Climate-Change.pdf>

second order consequences for exposed mortgage lenders and real estate investors. Mercer has estimated returns for property assets of -0.2% pa to 2050 in a 4°C scenario for example, although in practice price corrections are likely to happen rapidly as markets reprice flood risks following a period of loss events.

The coronavirus pandemic illustrates the potential for exogenous risks to strain the financial system. In the longer-term, climate change will increase the threat of destabilizing risk cascades or 'green swans' triggered by changes in the earth system<sup>27</sup>.

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<sup>27</sup> <https://www.greenbiz.com/article/these-are-climate-risks-finance-sector-should-be-planning>