



ESTABLISHING CHINA'S GREEN FINANCIAL SYSTEM

Detailed Recommendations 12: Create a Compulsory Green Insurance System



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Detailed recommendations 12:

Create a Compulsory Green Insurance System

The Third Plenum of the 18th CPC Congress has included the development of an ecological civilization in the overall arrangements for the social cost with Chinese characteristics and with emphasis on green, circular and low carbon development. China still has frequent environmental pollution incidents, with numerous pollution hazards and serious situations of ecological degradation. In recent years, the number of environmental incidents in China has been growing rapidly with serious impacts on economic and social sustainability and people's health. According to statistics, a total of 712 environmental incidents erupted in China in 2013, or 1.95 incidents per day. In the face of growing environmental pollution challenges, government departments and administrative resources alone are not sufficient and efforts must be made to create an environmental governance mechanism with public participation and a market-based operation.

As a market-based risk governance mechanism, insurance can help prevent the risks of environmental pollution and share the responsibilities of damage compensation. From a broader perspective, compulsory requirements for environmental pollution liability insurance (otherwise referred to as 'green insurance') for polluting companies will reveal future pollution costs and thus restrain the impulse of shareholders to invest in high environmental risk products. Hence, green insurance should become an important element of the green finance system and leverage its role in the development of an ecological civilization.

(1) Functions of pollution liability insurance

Environmental pollution liability insurance covers the economic compensation liabilities arising from the personal injuries, fatalities or property losses caused to third persons by corporate pollution incidents. Originating from the developed countries of Europe and North America, environmental pollution liability insurance has become a major means for the social pooling of environmental damage compensation liabilities. As a market-based environmental risk governance mechanism, environmental pollution liability insurance plays an important role in preventing the emission of pollutants and perfecting environmental pollution damage compensation system:

First, share the environmental pollution damage compensation liabilities and safeguard the smooth operations of market entities. Among various liabilities for incidents, liabilities for environmental pollution compensation may cause heavy and even devastating financial burdens to companies. An insurance mechanism can transfer the risks of environmental pollution damage compensation liabilities to insurance companies, which enables companies to convert any exorbitant compensation liabilities that may arise from potential environmental pollution risks into fixed premium spending. In the event of the occurrence of environmental pollution incidents, the

insurance compensation mechanism can avoid the major impacts of exorbitant indemnities and enable companies to resume their business operations early.

Second, prevent excessive or misguided investments in polluting projects, enhance the ex-ante and interim management of environmental pollution risks, and enhance corporate capabilities to prevent and avoid environmental pollution incidents. As an environmental risk management mechanism, compulsory environmental liability insurance can reveal future provisional environmental costs in the form of premiums and force investors to re-evaluate cost and return ratios, which helps restrain excessive investments in polluting projects. In addition, insurance companies will oversee corporate compliance with environmental standards through proactive accent intervention and process control in order to minimize the probability of environmental pollution incidents. Specific activities of ex-ante and interim management include: first, set preconditions for underwriting environmental pollution liability insurance, evaluate corporate environmental pollution risk level, and require the compliance of corporate manufacturing processes or equipment with specific environmental standards as the precondition for underwriting insurance. Second, put into place a premium rate adjustment mechanism pegged with corporate environmental pollution risk levels, leverage premium rates to incentivize corporate improvement of manufacturing processes, pollution management levels and improvement of resource and energy efficiency. Third, create an environmental pollution risk supervision and inspection mechanism, timely identify potential risks through process monitoring and propose recommendations for improvement, and urge the continuous improvement of environmental management capabilities of insured companies. Based on contract relations and economic interests, insurance companies have become a strong supervisory force for the environmental performance of the insured companies. In a nutshell, environmental pollution liability insurance, a market-based environmental risk management mechanism and coordination between insurance premium rates and corporate environmental management levels will significantly enhance corporate awareness and intrinsic pressures of environmental responsibilities, incentivize companies to carry out proactive risk and hazard identification, enhance pollution prevention and treatment capabilities on all fronts, and fundamentally reduce the probability of environmental pollution incidents.

Third, provide economic indemnities for environmental pollution damages and ensure timely compensation for pollution victims. Due to inadequate environmental infringement relief measures and limited indemnities for responsible entities, many victims of environmental pollution cannot be properly indemnified for the losses. In many cases, failure to deliver timely economic compensation to victims after the eruption of a serious pollution incident may lead to mass protests that disrupt social stability. With the green insurance mechanism in place, insurance companies will be able to indemnify victims and support the proper solution for pollution incidents. In this manner, the disputes and protests caused by environmental incidents will be effectively reduced and fiscal risks on the part of government will be substantially abated.

(II) Problems facing China’s development of pollution liability insurance

Pilot programs under China’s environmental pollution liability insurance started with the *Guiding Opinions on Environmental Pollution Liability Insurance* (MEP [2007] Document No.189) jointly promulgated by the former State Administration of Environmental Protection and the CIRC in 2007. In order to further improve the environmental pollution liability insurance system and properly carry out its pilot programs, the Ministry of Environmental Protection and the CIRC jointly promulgated *Guiding Opinions on Implementing the Pilot Programs of Compulsory Environmental Pollution Liability* (MEP [2013] No.10 Document) in early 2013. Under the proactive efforts of the Ministry of Environmental Protection, CIRC and local governments, local environmental protection departments and insurance regulatory bureaus have promulgated a series of regulations and policies on the development of insurance products by insurance companies and compulsory insurance for companies with high environmental risks. After a few years of efforts, these pilot programs of compulsory pollution liability insurance have made headway but remain in the early stage of development with many problems and challenges.

First, implementation of environmental pollution liability insurance lacks vigorous legal support.

Since China’s launch of pilot programs for compulsory pollution liability insurance in 2007, the Ministry of Environmental Protection and local governments have successively introduced relevant policies and regulations, but a national level legislation and compulsory pollution liability insurance has yet to be promulgated. Article 52 of the Environmental Protection Law of the People’s Republic of China newly revised in 2014 stipulates that “The State encourages participation in environment pollution liability insurance”. Despite the inclusion of liability insurance in the Environmental Protection Law, the requirement for insurance stays at the level of ‘encouragement’. Without compulsory legally binding force, the local pilot programs of environmental pollution liability insurance have met significant constraints at the local level. Not only has local legislation been slow but also many restrictions exist in funding support and policy preferences. In recent years, promulgation of the law has preceded the rapid development of traffic accident liability insurance for motor vehicles, road passenger transport liability insurance and travel agency liability insurance. Therefore, explicit and compulsory requirements for environmental pollution liability insurance in the national level environmental legislation will be the key to promoting the development of green insurance and expanding coverage of green insurance.

Second, inadequate law enforcement for infringement liabilities has led to the low cost of environmental pollution violations and weakened corporate willingness to participate in environmental pollution liability insurance.

Improvement of the law is vital to the development of liability insurance, which covers the civil liabilities of indemnity. As a special type of infringement, environmental pollution damages are applicable to the principle of liability without fault. Article 65 of China’s Tort Liability Law stipulates that “polluters shall be responsible for the liabilities of infringement arising from damages caused by environmental pollution”. However, due to the lack of explicit definitions of tort liabilities on the part of entities responsible for environmental

pollution, inadequate law enforcement against tort and the low cost of violations, many companies are not motivated to participate in insurance. Under economic growth pressures, some local governments have relaxed their efforts on environmental protection and failed to hold polluters accountable for the consequences of environmental pollution. Due to insignificant civil indemnity liabilities for environmental pollution incidents, effective demand for environmental pollution liability insurance has been insufficient.

Third, unclear and inconsistent standards for indemnities for environmental pollution damages have affected the institutional design and product R&D of environmental pollution insurance.

Indemnity standards for environmental pollution damages constitute an important foundation for creating and implementing a green insurance system. Indemnity standards for environmental pollution damages must be justified by facts and therefore it is necessary to identify economic losses through a science-based evaluation of environmental pollution damages. The principal regulations of China's existing laws and regulations on the indemnities of environmental pollution damage mainly involve the elimination of tort and damage indemnities without specific indemnity standards for the measurement of economic value of environmental pollution damages. In the absence of reference standards, it becomes difficult for insurance companies to make incident investigation, loss evaluation and liability identification. As a result, the risks of disaster losses are difficult to manage, which affects the determination of premium rates and product development of environmental liability insurance.

Fourth, supporting policies for environmental pollution liability insurance are inadequate and an effective incentive mechanism is not in place.

Some foreign countries have established a policy support system for environmental pollution liability insurance encompassing fiscal subsidies, tax exemptions, government guarantee, third-party risk evaluation and dispute settlement mechanism. In comparison, the lack of policy support has dampened the enthusiasm from both companies and insurance companies in China. Judging by the implementation of local pilot programs, the penalty mechanism of environmental pollution is incomplete and polluters are only subject to administrative penalties; although some regions have introduced fiscal subsidies for green insurance premiums and required insurance as a prerequisite in the certification of corporate qualification, these measures have failed to achieve desirable results. In some regions, the implementation of a green insurance system remains at the level of document forwarding without raising any compulsory requirements on polluters or putting into place any effective support policies and measures. As a result, companies are not under external and internal pressures to participate in environmental pollution liability insurance and most companies still have a wait-and-see attitude.

Fifth, major problems involving moral hazard and adverse choice exist in the area of environmental pollution liability insurance.

While most companies are not motivated to participate in pollution liability insurance, the insurance participation by only a few high-risk companies has led to the failure of the law in terms of numbers, presenting significant risks to insurance companies. With the limited number of insured companies and the limited coverage of insurance, insurance companies are not able to develop a sufficient number of clients for effective

risk dispersion, which results in the failure of the law and undermines the sustainable development of environmental pollution liability insurance services.

(III) Recommendations on establishing a compulsory insurance system for pollution liabilities

Opinions of the State Council on Accelerating the Development of Modern Insurance Services (the State Council [2014] No.29) has called for the strengthening of liability insurance development with government guidance, market-based operations and legislative assurance, priority development of liability insurance in areas of immediate concern to public interests, such as environmental pollution, and exploration of pilot programs of compulsory liability insurance. We believe that efforts must be made to develop and improve the compulsory system of environmental pollution liability insurance to build ecological civilization and beautiful China.

First, efforts must be made to expedite the development of a national compulsory insurance system for environmental pollution liabilities and promulgate *Regulations on Compulsory Environmental Pollution Liability Insurance*. The Environmental Protection Law serves as the Basic Law in China's environmental regulatory system. The newly revised Environmental Protection Law to be effective in 2015 has, for the first time, prescribed a clause on the participation of environmental pollution liability insurance. However, the clause only 'encourages' companies to participate in pollution liability insurance, which falls short of the expectations from the environmental and insurance communities. Nevertheless, the Environmental Protection Law has been recently revised and will not likely to be revised again soon. By now, out of a total of 31 provinces, autonomous regions and municipalities (including Jiangsu and Shanxi) that have in place pilot programs for liability insurance, 18 (including Shanxi and Dalian) have implemented pilot programs for compulsory liability insurance. It is suggested that the State Council Legislative Affairs Office take the lead with the joint participation of the Ministry of Environmental Protection and the CIRC to *promulgate Regulations on Compulsory Environmental Pollution Liability Insurance* pursuant to China's Insurance Law, the Environmental Protection Law, the Tort Liability Law and the Guiding Opinions on Implementing the Pilot Programs of Compulsory Environmental Pollution Liability (MEP [2013] No.10 Document) released by the Ministry of Environmental Protection and the CIRC to expedite the development of a national compulsory insurance system for environmental pollution liabilities. The *Regulations on Compulsory Environmental Pollution Liability Insurance* should prescribe explicit provisions on the participation and underwriting of environmental pollution liability insurance, insurance clauses, insurance premium rates, service accounting, a premium rate adjustment mechanism, an information sharing mechanism, compensation, penalty rules and supervision and management.

Second, include industries with high environmental risks in the scope of compulsory insurance and develop a name list for the compulsory participation of environmental pollution liability insurance. Countries including the US, Germany and Russia have adopted compulsory insurance for companies and equipment with high environmental risks. In the early development stage of environmental pollution liability insurance, Singapore and Chinese Taiwan have adopted the model

of compulsory insurance to expand insurance coverage and accumulate insurance funds for the growth of environmental pollution liability insurance market. As evidenced by the experience of the above-mentioned countries and regions, compulsory insurance can effectively address such problems as the lack of motivation for insurance coverage and the slow growth of the market. Countries and regions with compulsory insurance have all developed name lists for the compulsory participation of insurance, which include name lists for equipment, name lists for products and name lists based on environmental risk assessment according to the needs of environmental risk management. According to the *Guiding Opinions on Implementing the Pilot Programs of Compulsory Environmental Pollution Liability* (MEP [2013] Document No.10), *Regulations on Compulsory Environmental Pollution Liability Insurance* may first include companies with high environmental pollution risks in such areas as heavy metals into the scope of coverage (see Table 4).

Table 4: Enterprises with high environmental risks suggested to be covered by compulsory insurance for environmental pollution liabilities

No.	Enterprises	
1	Key industries for having metal pollution control	Enterprises of heavy non-ferrous metal ore mining (including associated ore); copper ore mining; lead and zinc ore mining, Ni-Co alloy mining, tin ore mining, antimony mining and mercury ore mining
2		Enterprises of heavy non-ferrous metal smelting: copper smelting, lead and zinc smelting, Ni-Co smelting, tin smelting, antimony smelting and mercury smelting
3		Lead storage battery manufacturers
4		Enterprises of leather and leather products: leather tanning, processing, etc.
5		Enterprises of chemical raw materials and chemical product manufacturing: manufacturing of fundamental chemical raw materials and manufacturing of ink pigment and similar products, etc.
6	Enterprises in such sectors as petroleum and natural gas mining, petrochemical engineering and chemical engineering	
7	Enterprises engaged in the manufacturing, storage, consumption, operation and transport of hazardous chemicals	
8	Enterprises engaged in the production, collection, storage, transport, utilization and disposal of hazardous wastes and enterprises with dioxin emissions	
9	Other enterprises with high environmental risks	

Third, establish and improve the system of regulations on tort liabilities of environmental pollution and tighten enforcement to create an effective legal environment for the promotion of environmental pollution liability insurance. The Fourth Plenum of the 18th CPC Congress has called for tighter legal systems for the protection of ecological environment, creating a legal system for ecological civilization that effectively governs development activities and promotes

green, circular and low carbon development, together with enhanced legal responsibilities of producers for environmental protection, and significantly increased costs of violation. Efforts must be made to enhance legislation and enforcement in the area of environmental protection and create a favourable legal environment for the promotion of environmental pollution liability insurance. First, relevant laws should stipulate the indemnity liabilities to be assumed by actors responsible for environmental accidents. According to international practice, these liabilities include: personal injury, property damage, eco-environmental restoration and relevant evaluation costs. Second, actors responsible for environmental incidents should be held more accountable for their criminal and civil liabilities in addition to administrative penalties that used to be the dominant form of punishment. Third, investigation and prosecution of liabilities should be strengthened and seen through in order for responsible actors to be fully aware of the severity of law and the compulsory execution of indemnities and thus understand the importance of preventing environmental pollution risks. Legislation and law enforcement must be enhanced for enterprises with high environmental pollution risks to be sufficiently aware of the risks and legal liabilities, assume relevant indemnity responsibilities, reverse the situation of ‘low cost of violations’ for environmental pollution, create pressures for responsible parties to participate in insurance, and inspire the spontaneous demand of companies for green insurance. Fourth, participation in environmental pollution liability insurance should be identified as a precondition for the issuance of pollution permits and such preferences as pollution fee exemptions or insurance premium deductions with pollution fees should be offered to enterprises that have participated in environmental pollution liability insurance.

Fourth, create a professional risk evaluation mechanism and loss determination standards and improve the fundamental supporting conditions for implementing environmental pollution liability insurance. Evaluation standards for environmental pollution risks are the foundation of insurance product design and pricing and the basis for calculating the real economic losses of environmental pollution. Identification of environmental pollution risk evaluation and indemnity standards is the most critical technical condition for creating the environmental pollution liability insurance system. Indemnity standards should be created and improved to further refine premium rates and liabilities, increase the differentiated pricing power of insurance products, and achieve the differentiated burdens of ‘environmental costs’ through insurance. It is suggested that the resources of environmental protection authorities and professional private institutions be leveraged in creating mechanisms for environmental pollution risk assessment, incident investigation, loss assessment and liability identification; develop standards and guidelines for the assessment of environmental pollution incident losses and thus create standard claim procedures; develop independent third-party non-official evaluation agencies to coordinate for the settlement of tort disputes between polluters and victims and increase the objectivity and justice of risk loss assessment.

Fifth, establish a corporate environmental credit database supported by corporate environmental credit assessments to provide objective evidence for the determination of premium rates for companies participating in insurance and the entitlement of financial and tax

policy preferences. First, corporate environmental credit ratings should be carried out on all fronts pursuant to *Measures for Assessment of the Environmental Credit of Enterprises* to provide objective data support for the implementation of environmental pollution liability insurance. Second, a corporate environmental credit database should be put into place with the support of the Credit Information Centre of the PBoC, and make such data as corporate environmental credit information and ratings open to insurance companies as data support for the latter's product development and premium rate identification. Third, corporate environmental credit ratings should be pegged with the entitlement of policy preferences such as premium subsidies and corporate environmental credit ratings must reach certain standards in order to enjoy relevant policy preferences, so that companies will be motivated to improve their environmental management and compliance. For instance, differentiated premium subsidy program should be implemented according to corporate environmental credit rating. Fourth, such information as corporate participation in environmental pollution liability insurance and indemnities should be inputted into corporate environmental credit databases to provide information support for coordination between green insurance and other green financial services.

Sixth, create a mechanism for coordination between environmental pollution liability insurance and financial services such as green credit. A mechanism for coordination between insurance and financial institutions should be put into place and for enterprises identified in the list of polluting and energy intensive sectors, their coverage of environmental pollution liability insurance should be pegged with the entitlement to green financial services, so that “green financial services cannot be accessed without environmental pollution risk mitigation”. In order to acquire green credit or issue green bonds, companies must pass environmental assessments and purchase environmental pollution liability insurance. Mechanism of coordination between green insurance and green finance is favourable to promoting environmental investments by companies with financing demand and pursuing low carbon development, reducing the potential environmental legal liabilities on the part of financial institutions arising from financing for polluting and energy intensive projects, and restraining the expansion and low level repetitive construction of polluting industries through market-based means.

THE GREEN FINANCE TASK FORCE

The Green Finance Task Force was initiated by People's Bank of China (PBC) Research Bureau and the UNEP Inquiry into the Design of a Sustainable Financial System in 2014. The Task Force brought together leading Chinese financial policy and regulation experts together with experts from the private sector, academia and think tanks, as well as international experts.

A number of organizations have lent great support to this Task Force, chief among them are Chongyang Institute for Financial Studies of Renmin University, the Ecological Finance Research Center at the Renmin University of China, the Eco Forum Global, the International Institute for Sustainable Development, the Green Credit Special Committee of China Banking Association, and China Finance 40 Forum.

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Inquiry: Design of a Sustainable Financial System

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