DOI https://doi.org/10.30525/978-9934-26-390-3-11

ESG RISKS FOR NON-BANKING FINANCIAL INSTITUTIONS

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INTRODUCTION

In recent years, the level of attention to sustainability and social responsibility in business is significantly increasing. Investors, clients and the public are monitoring how individual business structures, including non-bank financial institutions, respond to ESG risks. Non-bank financial institutions that do not consider these risks often face financial difficulties and financial sustainability issues.

On the other hand, non-bank financial institutions that offer sustainable financial solutions can gain a competitive advantage, as there is currently an increasing interest of consumers in services and products that were creating with the accounting of ESG principles. In this way, taking into account ESG risks can serve as a source of innovation and new opportunities for the development of financial business.

Taking into account ESG principles contributes to increasing the trust of customers, investors and the public, allowing non-bank financial institutions to develop a positive reputation and be considered as socially responsible market participants. Awareness of ESG risks contributes to the consideration of social and environmental aspects in the business strategy of non-bank financial institutions, that will promote sustainable development.

At the same time, in many European countries, the activity of regulators and government bodies has increased as for defining reporting standards and requirements in the field of ESG risk management. Non-bank financial institutions must comply with these requirements to avoid legal risks and ensure compliance with standards. As a result, ESG risk management is currently a necessary component of the management of non-banking financial institutions. The importance of this issue is confirmed by the increased attention paid to it by international organizations and companies. The reports of these institutions were taken into account during this investigation.

However, this issue for non-banking financial institutions needs more attention. This necessitates a study of ESG risks for non-banking financial institutions, an analysis of positive European experience in this area for generalization of recommendations as for ESG risk management of non-banking financial institutions in Ukraine.

1. What is the concept ESG risks and why are they important for non-bank financial institutions?

Nowadays ESG risks are in the focus of financial institutions, as many companies are starting to make significant efforts to comply with ESG principles in order to integrate sustainable development practices into their activities, because it is a today's requirement.

In general, ESG risks are derived from ESG factors. It is worth noting that the concept of ESG appeared in the 90s and is an abbreviation of the such English words as "Environmental, Social and Governance" (Table 1) and means environmental, social and governance factors. All these factors should be taken into account by financial institutions in their activities, because along with financial indicators, more and more attention is being paid to these non-financial indicators[1].

Table 1

ESG factors

Factors	Essence	Example
Environmental	potential or real changes of the physical or natural environment	environmental pollution, impact on biodiversity, carbon emissions, use of natural resources, climate change
Social	potential or real effects affecting the population and, in particular, the workforce	occupational health and safety, supply chains, diversity and inclusion
Governance	the structure and processes of corporate governance, by which companies are managed and controlled	structure and diversity of the supervisory board, ethical conduct, risk management, information disclosure and transparency

Source: compiled by authors based on[2] [3]

Thus, ESG risks are risks associated with social, environmental, and governance factors that can negatively impact a financial institution or, conversely, have a positive effect. However, in practice, more attention is paid to ESG risks precisely from the position of threats.

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[1] Моташко Т. П. ESG та страхова індустрія. *Страховий ринок України у світлі євроінтеграції: новітні виклики та тренди* : збірник тез доповідей VI Міжнародної науково-практичної конференції. Київ, 2023. С. 115–116.

[2] Там само

[3] Політика щодо розвитку сталого фінансування на період до 2025 року. НБУ. URL: https://bank.gov.ua/ua/file/download?file=Policy_rozvytok-stalogo-finansuvannja_2025.pdf

Therefore, three groups of ESG risks can be distinguished for non-banking financial institutions:

Group 1 – environmental risks, those related to the specifics of the financial institution's interaction with the environment.

Group 2 – social risks are concerned with social relations and arise from financial institution interaction with staff, consumers, etc. Examples of social risks are the risk arising from violation of applicable labor laws or standards, that can lead to legal problems, fines, and reputational losses; the risk associated with the inconsistency of salary level with industry standards or workers' demands, that can lead to employee mistrust, conflicts and a negative impact on corporate culture; the risk associated with non-compliance with norms and standards regarding occupational safety and health, that may lead to injuries and other negative consequences for employees and the financial institution; the risk arising from non-compliance with product quality standards, that can lead to danger or consumer dissatisfaction, legal problems and reputational losses.

Group 3 – governance risks, that related to the governance of financial institution. Examples are the next:

– the risk of liabilities non-compliance with tax law, that can lead to financial penalties, lawsuits and reputational losses;

– the risk of abuse of power or attempts to obtain improper benefits through corruption or bribery, that can lead to legal consequences and negative impact on reputation;

– the risk of setting excessive or unacceptable levels of remuneration for senior management, that can lead to distrust of shareholders, conflicts with the public and impact on the financial stability of the company;

– risk of insufficient protection of confidential information and data, that can lead to breach of confidentiality, loss of trust of consumers, as well as legal consequences in connection with violation of regulatory requirements[4].

It is worth to note that ESG risks should be considered from two positions:

– firstly, from the standpoint of the influence of stakeholders (consumers, employees, the regulator, etc.) and the environment on the financial institution;

– secondly, from the perspective of the influence of the financial institution itself on the environment and stakeholders (Figure 1).

[4] ESG-ризики у банківській сфері. KPMG. 2022. URL: https://assets.kpmg.com/content/dam/kpmg/ua/pdf/2022/01/esg-risks.pdf

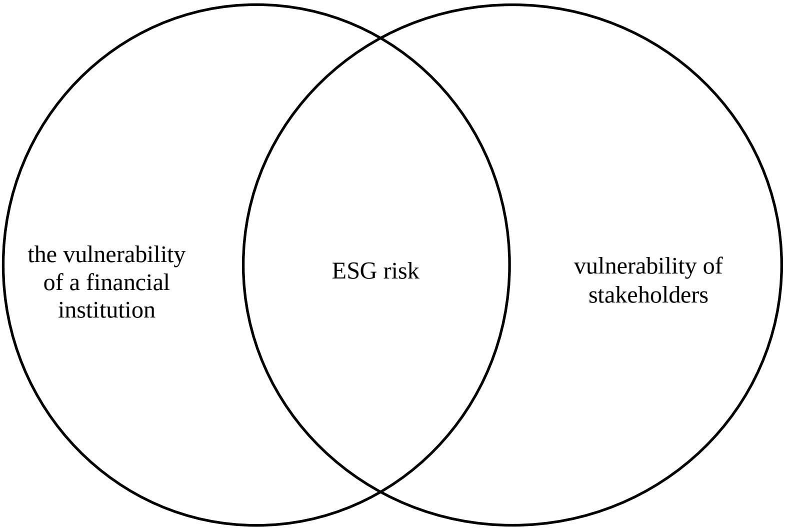

Figure 1. Types of ESG risks depending on the entity of influence

Source: compiled by the authors based on Moody's[5]

Thus, focusing on ESG risks is strategically important for financial institutions, because of a number of factors. First of all, it is the possible impact on the reputation of the financial institution. After all, if, for example, a financial institution has a negative environmental impact, it can become much more difficult to attract new and retain existing clients, and the financial institution can face an outflow of clients due to reputational risk. Along with the above, reputational risk depends on the available information about the environmental performance of financial institutions. Overall, any reputational damage can potentially hinder investment flows in the future, leading to financial losses[6]. Or the reverse effect can be observed: a significant level of social and environmental responsibility can strengthen the reputation and become a competitive advantage for the institution.

Another important factor that encourages financial institutions to pay attention to ESG risks is the availability of capital. Financial institutions that actively implement ESG approaches can have a better access to funds and

[5] ESG Insurance Underwriting. URL: https://www.moodysanalytics.com/solutions-overview/insurance/esg-insurance-underwriting

[6] Yawar Herekar Report on ESG disclosure standards for nonbank financial institutions with recommendations UNDP. 2022. URL: https://www.undp.org/ukraine/publications/report-esg-disclosure-standards-nonbank-financial-institutions-recommendations

capital in markets where investors increasingly pay attention to the non-financial aspects of the institution's operations.

The regulatory factor cannot be ignored. The increased attention to ESG factors from regulatory authorities leads to the emergence of new standards, legislative changes, their inclusion in regulatory requirements, that can have an impact on the activities and strategies of financial institutions. In addition, the abundance of disclosure standards and differences in how companies measure their ESG exposures led to confusion about actual ESG performance[7].

In addition to the above, environmental crises, social conflicts and governance issues can generally affect the financial stability of the financial institution.

Accounting these factors, financial institutions recognize the importance of incorporating ESG risks into their strategies and business practices to ensure long-term sustainability and success.

Therefore, if financial institutions do not pay attention to their ESG risks, this will lead to a lack of interest from future investors, the loss of loyal clients who are more aware of social and environmental issues, and the potential ignoration as for compliance with current environmental regulations requirements, that can lead to large fines and further affect the financial position of the company[8].

2. ESG risks for insurance companies: a European approach

ESG factors have a significant impact on the insurance industry. ESG requirements increased the need of insurers business processes integration, automation and optimization[9]. On the one hand, taking care of ESG assessments, insurance companies are working on creating new or modifing existing products for consumers. On the other hand, they change or limit objects of investment. In general, the impact of one or another ESG risk on an insurance company is depicted on the heat map of risks (Table 2).

Investigating the outlined issues, it is advisable to focus on the issues of environmental risks, namely climate change, as the biggest environmental problem.

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[7] Yawar Herekar Report on ESG disclosure standards for nonbank financial institutions with recommendations UNDP. 2022. URL: https://www.undp.org/ukraine/publications/report-esg-disclosure-standards-nonbank-financial-institutions-recommendations

[8] ESG Risks: Definition, Examples and Assessment Method. URL: https://greenly.earth/en-us/blog/company-guide/esg-risks-definition-examples-and-assessment-method

[9] Sustainable underwriting: how insurers can account for esg risks and enable dynamic pricing. URL: https://www.capgemini.com/insights/research-library/sustainable-underwriting-how-insurers-can-account-for-esg-risks-and-enable-dynamic-pricing/

Table 2

Heat map of ESG risks of non-life insurers

Factor	Subfactor	Level of risk
Environment	Climate change	
	Carbon emissions	
	Energy consumption	
	Waste disposal	
	Renewable energy	
	Resource depletion	
	Pollution	
Social	Occupational health and safety	
	Human resources management	
	Cooperation with partners and clients	
	Financial inclusion	
Governance	Information disclosure	
	Corporate culture	
	Product quality	
	Risk management	

Red color – maximum risk level, green – medium risk level, blue – minimum (potential) risk level

Source: created by the authors

The risk of climate change does not exist by itself and has a negative impact on the financial condition of insurers and other stakeholders. For example, according to Deloitte, severe weather events across Canada led to $2.1 billion in insured losses in 2021, making it the sixth-highest loss year on record. The impact of climate change on property and casualty insurance business models is a growing concern for insurers, because extreme weather claims have more than doubled every decade since the 1980s, leading to a significant increase in Canada's natural disaster coverage gap[10].

In addition to financial risks, special attention should be paid to the impact of environmental factors of ESG risk on reputational and regulatory risks. Regulatory risk in the insurance sector arises as a result of changes in legislation and regulation related to climate change. According to the PwC study "Understanding ESG-related regulations and guidelines"[11] is the main challenge for insurance companies in the process of implementing ESG in their activities.

[10] The insurance industry's path to ESG impact. 2023. URL: https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/financial-services/EN_FSI_Insurance_ESG_POV_V6_AODA.pdf

[11] ESG: A growing sense of urgency. URL: https://www.pwc.com/us/en/industries/financial-services/library/next-in-insurance-top-issues/esg-insurance-industry.html

With increased attention to environmental issues, regulatory requirements for insurance companies are becoming stricter and more specific. This leads to new disclosure and reporting challenges of insurers. An example is the new EU Corporate Sustainability Reporting Directive[12] (CSRD), that forms significant challenges affecting not only European insurance companies, but potentially also their subsidiaries located outside the EU[13]. Insurers face a transition from existing voluntary climate-related risk disclosures to mandatory requirements that potentially increase legal liability[14].

Thus, in the context of the above, insurers are forced to take a number of steps to adapt to climate change and mitigate its consequences. In this aspect, a significant role belongs to preventive measures, that are the basis of improving adaptation and resistance to climate change. Therefore, it is necessary to consider the experience of European countries, that took significant steps in this direction, including information and educational measures, insurance literacy measures, tools and solutions for consumers, tools and solutions for insurers (Table 3).

Table 3

Experience of European countries in the field of adaptation to climate change and mitigation of its consequences

Type of measure	Country/Organization	Characteristic
Informational and educational activities	Germany	The main purpose of such activities is to raise awareness as for the effects of climate change, the benefits of preventive measures and the best practices of building resilience to natural disasters, etc. They are implemented in collaboration with state bodies, organizations of the protection of consumer rights and other stakeholders

[12] Directive (EU) 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, as regards corporate sustainability reporting (Text with EEA relevance). URL: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464

[13] ESG in insurance: Sustainability reporting. URL: https://kpmg.com/xx/en/home/insights/2023/03/esg-in-insurance-sustainability-reporting.html

[14] ESG: A growing sense of urgency. URL: https://www.pwc.com/us/en/industries/financial-services/library/next-in-insurance-top-issues/esg-insurance-industry.html

	Sweden, Insurance Sweden	Insurance Sweden is working with its members on a common methodology for calculating carbon dioxide emissions during building renovations. The aim of such activities is to raise awareness of the impact of recovery on CO_2 emissions after post-fire, and therefore the importance, from this perspective, of preventing such damage
Measures on insurance literacy	Insurance Europe	Insurance Europe publishes information on its website as part of its "InsureWisely" financial education initiative for consumers. Such publications contain information on various insurance topics, including how to limit the effects of natural disasters
	France Assureurs	France Assureurs developed a series of educational booklets to help users to understand better how insurance works and what insurance products are available
Tools and solutions for consumers	Germany, Sweden, Austria, France, etc	Tools or applications to inform consumers about extreme weather events and possible risks
Tools and solutions for insurers	Germany	An online zoning tool allows insurance companies to calculate different types of flood risk with high accuracy and, take this into account during determination of the volume of the insurance premium

Source: compiled by the authors based on [15] [16] [17] [18]

[15] Sustainability hub. URL: https://sustainability.insuranceeurope.eu/s/7/index
[16] INSURANCE SWEDEN. URL: https://www.svenskforsakring.se/en/
[17] Insurance Europe. URL: https://www.insuranceeurope.eu/
[18] Sustainability hub. URL: https://sustainability.insuranceeurope.eu/s/7/index

In addition to the above, it is possible to add that insurance companies as the powerful institutional investors finance projects on renewable energy, energy-efficient and affordable housing, etc., and also use such financial instrument as "green bonds".

Thus, insurance companies, in order to have a low level of ESG risk and, as a result, "to be interesting" to investors (according to research of PwC, "80% investors say how a company manages ESG risks is an important factor in investment decision-making")[19], have to make a lot of efforts. After all, investing in a company with poor ESG standards can expose the investment portfolio to various risks that the company faces, such as labor strikes, lawsuits and negative publicity, that will lead to a decrease in future earnings[20]. However, quite often, the insurer with the high market capitalization can have low ESG scores, indicating the high level of ESG risks (Table 4).

Table 4

The level of ESG risk of the world's largest insurance companies*

Rating	**Insurance company**	**Head-quarters**	**Market Capitalization, mln. US $****	**ESG*****
1	Berkshire Hathaway Inc	The USA	778,368	18
2	UnitedHealth Group Inc	The USA	472,508	66
3	China Life Insurance Co Ltd	China	115, 014	
4	Ping An Insurance (Group) Company of China Ltd	China	113,864	50
5	Elevance Health Inc	The USA	105,401	63
6	Allianz SE	Germany	96,217	82
7	AIA Group Ltd	Hong Kong	93,930	54
8	Chubb Ltd	Switzerland	87,187	35
9	Group Cigna	The USA	85,929	64
10	The Progressive Corp	The USA	82,154	26

* The information as for risk level is provided at November 24, 2023

** The information is provided at September 30, 2023

*** The closer is the ESG value to 100, the better is the ESG score and the lower is the ESG risk level

Source: compiled by the authors based on GlobalData[21] and S&P Global[22]

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[19] Next in insurance ESG: A growing sense of urgency. PwC. 2022. URL: https://www.pwc.com/us/en/industries/insurance/library/assets/pwc-next-in-insurance-esg.pdf

[20] Yawar Herekar Report on ESG disclosure standards for nonbank financial institutions with recommendations UNDP. 2022. URL: https://www.undp.org/ukraine/publications/report-esg-disclosure-standards-nonbank-financial-institutions-recommendations

[21] Top 10 Global Insurers by Market Capitalization. URL: https://www.globaldata.com/companies/top-companies-by-sector/financial-services/global-insurers-by-market-cap/

[22] S&P Global ESG Scores. URL: https://www.spglobal.com/esg/solutions/data-intelligence-esg-scores

Thus, the colossal impact of ESG factors on the insurance industry can be observed today, that can manifest itself in the realization of the relevant risks outlined in paragraph 1. However, in order to direct it in a positive scenario as much as possible, it is advisable to create an appropriate environment that should include regulatory and legal component, and the appropriate level of support for participants in the insurance industry.

3. Recommendations as for ESG risk management for non-banking financial institutions in Ukraine

In order to effectively manage ESG risks and strengthen sustainability of non-bank financial institutions it is necessary to pay attention to a number of aspects. First of all, it is worth to develop the ESG strategy that will reflect the corporate values and goals of the institution. At the same time, the ESG strategy must be constantly updated. Accordingly, it is advisable to establish a systematic mechanism of monitoring and reviewing the ESG risk management strategy to meet new trends and regulatory requirements. Without it, the organization faces a triple threat: first, the loss of funding from ESG investors; secondly, the loss of some categories of clients; thirdly, the probability of receiving large fines due to violations of legal norms and established rules[23].

Considerable attention should be paid to the development of products and services during ESG risk management. In particular, it is necessary to develop products and services that reduce risk, have a positive impact on ESG issues and generally contribute to better risk management. In addition, ESG risk literacy and management programs should be developed or maintained (e.g., insurance)[24].

Work with personnel cannot be neglected. Non-bank financial institutions should integrate ESG issues into their recruitment, training and engagement programs. In addition, special attention should be paid to employees of the sales and marketing departments in the field of ESG risks.

Important attention should be paid to the issue of investment portfolio management. In particular, non-banking financial institutions need to consider ESG criteria during choosing and managing financial assets. It is worth to avoid investing in assets that may be associated with a negative impact on the environment, social issues, etc. It is better to invest in projects and companies that contribute to sustainable development and innovations in the context of environmental and social challenges coping. At the same time, non-banking

[23] Josh Palmer. What is ESG Risk? 2022. URL: https://www.onboardmeetings.com/blog/esg-risk/

[24] Managing environmental, social and governance risks in non-life insurance business. UNEP Finance Initiative. 2020. URL: https://www.unepfi.org/psi/wp-content/uploads/2020/06/PSI-ESG-guide-for-non-life-insurance.pdf

financial institutions should use monitoring systems to constantly assess the ESG profile of the made investments, identify changes and develop strategies for managing them.

Non-banking financial institutions should strive for a high level of transparency and reporting on ESG indicators, providing information to stakeholders. In general, interaction with stakeholders is also extremely important. Non-bank financial institutions should establish an active dialogue with stakeholders (eg, clients, investors, regulators, etc.) to jointly address environmental and social issues. Along with this, for example, considerable attention should be paid to the quality of clients service, and settlement of claims.

The issue of underwriting cannot be ignored. It is especially relevant for insurers, because traditional underwriting methods, that are based on conventional approaches to risk assessment, are becoming insufficient to identify and effectively manage the complex ESG risks. Accordingly, insurance companies should take into account an ever-increasing array of data from a variety of sources for more efficient underwriting and pricing. Additional sources may include more detailed climate and weather data, real-time information from IoT-connected sensors, and even unstructured data on call center interactions or claims settlement documents. Using artificial intelligence to process these expanded data sets will allow insurers to gain more precise insights as for diverse risk profiles of their customers, including climate-related risks as well as other types of risks[25]. Thus, in the process of making underwriting ESG decisions, insurance companies use indicators of the policyholder's performance as for environmental, social and governance aspects, that are now becoming vital for all participants in the financial sector.

In addition to the above, it is worth to conduct a systematic assessment of ESG risks in the entire activity of the institution, identifying important issues that may affect its stability and financial condition. Non-banking financial institutions should carry out stress tests (for example, climate stress tests, that make it possible to assess the vulnerability of non-banking financial institutions, in particular insurers, to climate risks) to find out how resistant is the non-banking financial institution to ESG risks and to develop a list of necessary measures to increase the resilience of a non-banking financial institution to such adverse events. The value of stress tests is also determined by raising awareness of ESG risks, as well as the ability to assess their potential impact on the financial sector in general. However, it is worth to remember that in the case of ESG risks, the risk management system must

[25] Sustainable underwriting: how insurers can account for esg risks and enable dynamic pricing. Capgemini. URL: https://www.capgemini.com/insights/research-library/sustainable-underwriting-how-insurers-can-account-for-esg-risks-and-enable-dynamic-pricing/

take into account new perspectives, for example, their impact not only on the organization itself, but also on stakeholders, as well as the impact of stakeholders on the non-banking financial institution and the state of the environment due to its activity[26]. For example, among the risks of consumers of insurance services may be financial ones, that will be the result of an increase in the cost of insurance services and a narrowing of the list of risks that will be covered by an insurance policy (some risk aspects related to changes in the climate or social responsibility may become the object of restrictions or exclusions from insurance policies). In addition, policyholders may face the challenge of disclosing information on ESG practices, which may be required by an insurance company to assess their risks.

Thus, the consideration of these recommendations by non-banking financial institutions in the process of implementing ESG issues in their business processes and risk management system will allow to use them as opportunities and to gain an advantage over competitors in the market. However, this will only be possible if a coordinated approach is taken by all stakeholders. For example, regulators should develop relevant documents on the implementation of ESG factors by non-banking financial institutions (for instance, detailing the existing Roadmap on the implementation of ESG by non-banking financial institutions; recommendations on disclosure of information by non-banking financial institutions on ESG risks and their management, etc.).

It is worth to note that the implementation of ESG criteria and the proper management of the risks caused by them is possible only if all stakeholders work together. In the context of the mentioned, regulator has to pay a lot of attention to the outlined issues: conducting educational activities and explanatory work, including among non-banking financial institutions; develop uniform standards for determining ESG rating and information disclosure by non-banking financial institutions.

CONCLUSIONS

It was found that ESG risks are currently in the focus of attention of non-banking financial institutions. In general, ESG risks are related to social, environmental and governance factors that can negatively affect a financial institution or, conversely, have a positive effect. However, in practice, more attention is paid to ESG risks precisely from the position of threats.

There are three groups of ESG risks for non-banking financial institutions as for other institutions, namely: environmental, social and governance. It is possible to consider ESG risks from two points of view: from the standpoint

[26] ESG-ризики у банківській сфері. KPMG. 2022. URL: https://assets.kpmg.com/content/dam/kpmg/ua/pdf/2022/01/esg-risks.pdf

of the influence of stakeholders and the environment on the financial institution; from the point of view of the influence of the financial institution on the environment and stakeholders.

It is strategically important for non-bank financial institutions to focus on ESG risks, given a number of factors: the impact on the reputation of the financial institution; access to capital; strengthening of regulatory requirements and responsibility for their compliance, etc.

Particular attention is paid to ESG risks of insurance companies, as important representatives of non-bank financial institutions. A heat map of ESG risks of non-life insurers is created. It is clear that climate change, cooperation with partners and clients, financial inclusion, disclosure of information, product quality, risk management can lead to the maximum level of risk. The experience of European countries in the field of adaptation to climate change, as an important environmental problem, and mitigation of its consequences is considered. Insurance companies can play an important role in this area.

It is substantiated that ESG risk management of non-banking financial institutions should include: development of the ESG strategy; development of products and services that reduce risks, have a positive impact on ESG issues, etc.; improvement of professional skills of personnel; increasing the level of openness and reporting as for ESG indicators; integration of ESG criteria into portfolio risk management; carry out a systematic assessment of ESG risks; It was determined that taking into account the above mentioned recommendations by non-banking financial institutions in the process of implementing ESG factors into their business processes and risk management system will allow them to be used as opportunities and to gain an advantage over competitors in the market, only if all stakeholders have a coordinated approach.

SUMMARY

ESG risks relate to social, environmental and governance factors and they are currently in the focus of non-banking financial institutions mostly from a threat perspective. The nature and types of ESG risks have been clarified. It is generalized that ESG risks can be considered from two points of view: from the standpoint of the influence of stakeholders and the environment on the financial institution; from the point of view of the influence of the financial institution on the environment and stakeholders. Special attention is paid to ESG risks of insurance companies, as important representatives of non-banking financial institutions. A heat map of ESG risks of non-life insurers is created. The experience of European countries in the field of adaptation to climate change, as an important environmental problem, and mitigation of its

consequences is considered. It has been established that insurance companies can play an important role in this area. The recommendations for improvement of the ESG risk management of non-bank financial institutions in Ukraine are generalized.

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