

Good insurance business: can insurers save the world?

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During 2020, a substantial amount of material has been published that is important for insurers' handling of risks posed by climate change and the broader transition to a carbon neutral ('net zero') global economy. The material is a mixture of the advisory and the mandatory, with an emphasis on the latter set to increase going forward.

This article considers how the concepts in advisory and mandatory materials go hand in hand, focusing on "climate risk as a financial risk type" ('climate-related financial risks' – "Climate FinRisk"). It is notable that regulatory analysis tends to identify Climate FinRisk as being independent of "broader sustainability / ESG [environmental, social and governance] risks" (see the [Climate Financial Risk Forum](#) – "CFR Forum" – publications addressed below).

In managing their own Climate FinRisks, insurers are seen by regulators as playing a leading economic role by:

- being "in a strong position to encourage [third parties' Climate FinRisk disclosures] through
 - [insurers'] ownership of financial assets" (see the Supervisory Statement further below), and potentially
 - their insurance of those assets; and
- supporting "the transition to zero net emissions [as] a critical part of the [UK economy's] recovery" from Covid-19 and longstanding structural problems.

The above point was the conclusion of a 09.11.20 [speech](#) by Andrew Bailey, Governor of the Bank of England, in which he stated:

- "[the Bank's] goal is to build a ... financial system [that is]
 - resilient to [climate] risks ... and
 - supportive of the transition to a net-zero [carbon] economy ...
- The financial system has supported the real economy in the [Covid pandemic] ... Compared to the financial crisis and the pandemic, the risks from climate change are even bigger and more complex to manage ..."
- "progress [in this regard] is being made[:] ... five years ago climate change was considered more of a charitable cause ...
- progress has to focus on data and disclosure ... The [Taskforce for Climate-related Financial Disclosures](#) (TCFD) has led the way ...
- it is important that financial firms and their clients use the TCFD framework ... to measure, model and disclose the climate [related] risks and opportunities ["CRRs"] they are exposed to today and in different future climate scenarios ...
- Disclosure metrics force us to confront the question of where we are and where we want to be, and thereby drive different decisions today ..."

The TCFD is an international advisory body established by the [Financial Stability Board](#) in December 2015 "to develop a set of voluntary, consistent disclosure recommendations for use by companies in providing information to investors, lenders and insurance underwriters about their climate-related financial risks". Its "framework" contains "recommendations" that all types of business – especially financial services – publicly disclose ("in financial filings or other reports") information in respect of four areas of business operation (see eg [TCFD 'Overview' March 2020](#)):

- **'Governance':**

- “the board’s oversight of [CRROs], and
- “management’s role in assessing and managing [CRROs]”;
- **‘Strategy’**:
 - “the [CRROs that the] organization has identified over the short, medium, and long term”,
 - “the impact of [these CRROs] on the organization’s businesses, strategy, and financial planning”, and
 - “the resilience of the organization’s strategy, taking into consideration different climate-related scenarios ...”;
- **‘Risk Management’**:
 - “the organization’s processes for identifying ... assessing [and “managing”]” Climate FinRisks, and
 - “how [the above processes] are integrated into the organization’s overall risk management [systems and controls]”; and
- **‘Metrics and targets’**:
 - “the metrics used by the organization to assess [CRROs] in line with its strategy and risk management process”,
 - metrics for “greenhouse gas (GHG) emissions” within
 - “Scope 1 [eg direct usage by a business of vehicle fuel – description and categorisation as per The Carbon Trust],
 - Scope 2 [ie fuel as a direct power input or cost to a business], and ...
 - Scope 3 [eg supply chain and other indirect / associated emissions, such as employee commuting] and the related risks”, and
 - “the targets used by the organization to manage [CRROs] and performance against targets”.

The work of the TCFD is addressed in a CFR Forum guide from June 2020 (the “Guide”). The CFR Forum was established in 2019 by the Bank of England (Prudential Regulation Authority – “PRA”) and the Financial Conduct Authority; members include insurers, banks and asset managers.

The Guide includes a risk management (“RM”) chapter which seeks to supplement, but not modify, regulatory requirements:

- of particular importance here is the PRA’s Supervisory Statement (“SS”) 3/19 (“Enhancing ... approaches to managing the financial risks from climate change”);
- the guide’s RM chapter addresses climate change in the context of insurers’ RM compliance with ‘Solvency II’ (Directive 2009/138/EC - “S2”), and states that it “aligns well” with SS3/19’s section on RM.

SS3/19 includes PRA expectations for insurers’ response to Climate FinRisks, the latter being categorised as:

- “physical” – eg:
 - “heatwaves, floods, wildfires and storms” (described in the Guide as “acute” risks) and
 - “longer-term shifts ... in precipitation, extreme weather variability, sea level ... and ... mean temperatures” (described in the Guide as “chronic” risks); and
- “transition” - ie “the process of adjustment towards a low-carbon economy”, such as “developments in
 - [public] policy ...
 - technology ... and
 - legal [evidence and] interpretations”.

The areas of response can be summarised as:

- ‘Governance’
- [RM]
- ‘Capital management’ (‘Prudential’) and
- ‘Disclosures’.

The sections on RM address:

- RM policies
- Data, risk and scenario modelling and analysis,
- Metrics and monitoring, and
- Risk mitigation.

In relation to S2, SS3/19 identifies the need for insurers to include Climate FinRisks in their ‘Own Risk and Solvency Assessments’ (as per S2 Art 45 - “ORSA”). The Guide however identifies the need for a careful and sophisticated approach:

- “The ORSA time-horizon is typically shorter than the timespan over which climate risks will evolve ...”; and
- in relation to ‘Solvency Capital Requirements’ (as per S2, Ch VI, section 4 – “SCR”), the Guide notes that

- the “standard formula” (sub-section 2 on SCRs) “does not explicitly consider climate change risk [but]
- ... internal models [under sub-section 3] ... may cover environmental factors more appropriately”.

The 09.10.20 [speech](#) announced a launch date of June 2021 for the “biennial exploratory scenario [“BES”]” on Climate FinRisks. This S2 and climate-related stress test was covered in a [December 2019 PRA Discussion Paper](#), and the PRA’s [July 2020 Dear CEO letter](#) on “thematic feedback ... and clarification of expectations” as to firms’ response to SS3/19 – the letter’s upshot being that firms’ responses are at an “early stage”, with some way to go in meeting regulatory expectations.

The [speech](#) announced that the BES “will explore three different climate scenarios, testing different combinations of physical and transition risks ...

- to size the risks faced in these scenarios ...
- to understand how different ... insurance business models will be affected and how they might respond, and ...
- as a way of improving firms’ [RM] practices ...”

The BES will in particular address the prudential status of “capital” in the form of “Investments that

- [no longer] look safe ... given climate risks ... [or]
- might [once] have looked speculative [but now] look much safer in the context of a transition to net zero ...”

Insurance industry participants have argued that it could not have operated to respond to many, if any, of the global losses from the Covid pandemic. Are regulators expecting too much in requiring it to shoulder, or at least help ease, the greater burden of climate change?

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