

Regulatory Alert

Regulatory Insights



June 2021

Supervision of climate-related risk in the insurance sector

The IAIS paper sends a clear message to the insurance industry that climate risk needs to be embedded across all facets of risk management. The US NAIC and individual state insurance supervisors are likely to be influenced by these recommendations and may adopt components going forward as they continue efforts to understand the financial and nonfinancial risks posed by climate change. NAIC's Climate and Resiliency Task Force is currently looking at regulatory approaches to climate risk and resiliency, climate risk disclosures, and predictive modelling to better assess and evaluate climate risk exposure.

Key points

- Recommendations are directed toward supervisors in the insurance sector to guide integration of climate-related risks into supervisory and regulatory expectations, with a goal of promoting global consistency.
- Supervisors should expect individual insurers to fully integrate climate-related risks into their corporate governance frameworks, including risk management and internal controls systems across all risk categories.
- IAIS recognizes that climate-related risk assessment methodologies are evolving, data availability is limited, and disclosure requirements will be iterative over time; IAIS encourages supervisors and insurers to share information in an effort to build relevant data stores and metrics as well as to use external resources (e.g., FSB TCFD).

The International Association of Insurance Supervisors (IAIS), in partnership with the Sustainable Insurance Forum (SIF – convened by the United Nations), released an Application Paper on the [Supervision of Climate-related Risks in the Insurance Sector](#). The paper provides recommendations and examples of good practice, consistent with the IAIS Insurance Core Principles (ICPs), on how IAIS supervisory material can be used to manage both the challenges and opportunities arising from climate-related risks; it does not include new standards or requirements but IAIS suggest it is aiming to promote a globally consistent approach within the insurance sector.

The IAIS states that “climate-related risks are material for the insurance sector as they impact the insurability of policyholder property and assets as well as insurers’ operations and investments.” As such, supervisors are encouraged to “identify, monitor, assess, and contribute

to the mitigation of the risks from climate change.” The IAIS further suggests that the insurance sector has opportunities to play a critical role in the management of climate-related risks in its capacity as an investor as well as an assessor, manager, and carrier of risk. The IAIS adds that insurers also provide critical economic signals regarding the changing risk environment through risk-based pricing.

The paper is focused on providing guidance to supervisors in implementing ICPs in the following five areas: 1) Supervisory review and reporting (ICP 9); 2) Corporate governance (ICP 7); 3) Risk management (ICPs 8 and 6); 4) Investments (ICP 5); and 5) Disclosures (ICP 20). The IAIS recognizes that climate-related risks are rapidly evolving and, as such, risk management efforts will evolve and adapt over time with “the science and

improvements in data quality.” Highlights and key points of the IAIS recommendations follow.

Supervisory review and reporting.

Climate-related risks are a source of financial risk, which may translate to prudential risks to insurers.

- Supervisors should assess the extent to which climate-related risks are likely to impact insurers operating in their jurisdiction and determine how these risks may be transmitted to their economies and financial sectors more broadly.
- Development of supervisory practices related to climate risks and sustainability may be influenced by whether certain preconditions and resources are in place, such as macroeconomic and financial sector policies (e.g., carbon pricing); public infrastructure (e.g., levee system); financial markets efficiency (e.g., adoption of a standards framework); or financial market discipline (e.g., use of disclosures and/or sustainability ratings); and availability of sufficient training and resource materials.
- At present, supervisors commonly assess climate change in the context of its impact on other prudential risk classes (including investment risk; liquidity risk; operational risk; reputational risk; strategic risk; and underwriting risk) rather than as separate risk category. To understand and assess climate-related risks, supervisors should:
 - Obtain quantitative and qualitative information; supplemental information may be needed initially to address limited data availability.
 - Encourage two-way communication with supervised entities and engage with other supervisors through information sharing and cooperation agreements.

Governance

From a climate-related risk lens, supervisors should expect insurers’ corporate governance frameworks to:

- Assign relevant roles and responsibilities to the Board, Senior Management, and the Control Functions; roles and responsibilities should be allowed to evolve as the understanding of climate risk evolves, especially with regard to information and reporting needs, resourcing, skill sets, and budgets.
- Incorporate climate change into existing risk assessments as well as the annual financial planning and long- and short-term strategic planning.
- Maintain effective Board oversight of climate-related risk management, including incorporating climate-related considerations into the insurer’s risk appetite, strategies, and business plans; consideration should be given to the insurer’s business risks, the fair treatment of customers, and the insurer’s duty to conduct business in a socially responsible manner.

- Board members should have sufficient understanding of, and training on, climate risks.
- Senior management should implement the Board’s policies and incorporate elements into relevant operational and business policies; senior management should provide the Board with advice on organizational objectives, plans, strategic options, and policies as they relate to climate risk, including tools, models, and metrics to monitor exposures.
- Remuneration tied to risk-taking should consider climate-related risks.

Risk management and internal controls

Climate-related risks should be integrated into supervisory expectations for insurers’ overall corporate governance framework, including risk management and internal controls systems.

- Climate-related risks should be fully integrated, including consideration of reputational risk as well as the impact on assets, liabilities, and the overall business model.
- Insurers should assess and document in their risk management policies how climate-related risks could impact each area of the risk management system, and in particular, in the investment and underwriting policies, taking into account potential risk mitigation measures and the speed at which risks may manifest over time. The potential impact on business continuity due to climate change should also be considered.
- The Control Functions should identify, measure, and report on the insurer’s risks, assess the effectiveness of the insurer’s risk management and internal controls, and determine whether the insurer’s operations and results are consistent with the Board-approved risk appetite statement.
 - Persons who perform Control Functions should have relevant experience in understanding the risks of climate change as appropriate to their respective duties.
- The risk management function should monitor and facilitate the proper identification, assessment and management of climate-related risks. Risk management areas that may be particularly affected by climate-related risks include asset-liability management (ALM), investment risk management, underwriting and reserving, reinsurance and other risk-mitigating techniques, operational risk, and reputational risk management.
 - The compliance function should ensure that internal policies and internal control procedures are compliant with the relevant standards, directives, charters, or codes of conduct related to climate

- change that the insurer is obliged or committed to respect.
- The actuarial function should consider the potential impact of climate-related risks on the valuation of assets, ALM, underwriting, risk mitigation, and the calculation of insurance liabilities and capital requirements.
- The internal audit function should review the risk management process to ensure it is adequate and effective and that all material risks are considered and mitigated.
- Insurers that outsource activities should preserve the ability to manage risks and ensure the continuity of their activities in case of a failure of the outsourcing provider.

Enterprise risk management for solvency purposes

Climate-related risks should be integrated into insurers' underwriting policies and processes as well as their Own Risk and Solvency Assessment (ORSA) process.

- Physical, transition, and liability risks arising from climate change can impact the business risk profile, underwriting strategy, and underwriting processes of insurers. How insurers consider the climate-related risks within underwriting risk is likely to be dependent on various elements (e.g., duration of the contract, frequency and severity of climate events, localization of the goods and persons covered, impact of perils on their policies, reinsurance agreements, terms and conditions). Supervisors should:
 - Require insurers to incorporate consideration of climate-related risks in the underwriting policy, as appropriate, given the exposure of their individual products to those risks.
 - Encourage insurers to include, as relevant, their climate risk assessment as part of their overall underwriting assessment for each policyholder (including the policyholder's commitment to managing and mitigating climate-related risks, duration of the policy, and conditions for certain types of higher risk products); higher-risk transactions should be escalated for approval.
 - Encourage insurers to develop appropriate tools and metrics to monitor their underwriting exposures to climate-related risks.
- Supervisors should expect insurers to consider all physical, transition, and liability risks arising from climate change in their ORSA process and adopt the appropriate risk management actions to mitigate the identified risks accordingly. Insurers may consider the risks on both a qualitative and quantitative basis, though quantitative capabilities should improve over time as data is improved.

- Stress testing and scenario analysis should include the identification and assessment of the direct and indirect impacts of climate-related risks.
- Parameters and assumptions for stress testing scenarios may be adopted from modelling work performed by meteorological agencies, regulators, or other external experts. Supervisors should encourage insurers to use models that are pertinent to their geographical scope and nature of business.

Investments

Policies related to investments should consider the impact of climate-related risks on assets.

- Climate-related risks and investments - Physical and, especially, transition risks can have complex and non-linear impacts on insurers' investments. Risks must be taken into account regardless of whether the insurer invests directly or through a third-party asset manager or investment advisor.
 - Physical and transition risks have the potential to affect investments via credit/counterparty default risk, market risk, and liquidity risk. Second-order effects, such as indirect losses in insurers' investments due to the devaluation of financial counterparties or changes in market value due to changing investor sentiments, are also possible.
- Asset liability management - Climate change can negatively affect the matching of assets and liabilities, primarily through transition risk, as insurers with long duration products use longer-term bonds to match the liability cash flows. The time horizon is an essential component as the impact of climate change on insurers' investment portfolios may fully materialize over an extended period and therefore impact either the value or expected cash-flows from financial assets only in the long-term.
- Risk assessment - A forward-looking view with quantitative and qualitative data, as well as the use of scenarios, can help overcome potential limitations of historical and market data. External credit ratings may be used to determine the credit risk of an investment, but insurers should have enough information to fully understand the rating methodology and the extent to which climate risk has been factored into the rating.
- Impact of investments on climate change - Institutional investors, including insurers, that apply engagement strategies, or a stewardship approach, may steer the activities of the assets they are holding to progress towards sustainable economic activities, potentially contributing to a reduction in climate-change related risks and the risk profile of the investment.

Public Disclosure

Supervisors require insurers to disclose relevant and comprehensive information on a timely basis in order to give policyholders and market participants a clear view of their business activities, risks, performance, and financial position.

Supervisors that are considering the introduction of mandatory disclosure requirements on the risks from climate change may wish to consider a range of approaches, recognizing the iterative nature of disclosure processes and the early stages of certain aspects of climate risk assessment methodologies. Supervisors may also use the Financial Stability Board (FSB) Task Force on Climate-Related Disclosures (TCFD) Framework when designing best practices or as input for setting their own supervisory objectives.

Insurers' disclosures should describe the:

- Extent to which their risk profile exposes them to the impacts of climate-related risks; the metrics used to assess risks and opportunities; how the metrics are set, tracked and; the targets used by the organization to manage risks of climate change and performance against targets; and a description of the climate-related scenarios used, including the critical input parameters, assumptions and considerations, and analytical choices.
- Climate-related risks and opportunities the insurer has identified over the short-, medium- and long-term; the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning. The information should include supporting quantitative information, where available and relevant, on their core businesses, products, and services, including information at the business division, sector, or geography levels, and whether specific climate-related products or competencies are under development

- Board's oversight and Senior Management's role; the processes for identifying and assessing climate-related risks; and how processes for identifying, assessing, and managing climate-related risks are integrated into overall risk management.
- Process for undertaking scenario analysis and the rationale and limitations of the chosen approach as well as the actions taken in response to risks from climate change, such as new exclusion policies, an updated risk appetite statement, new underwriting targets and policyholder engagement efforts.
- Methodology for factoring climate-related risks and opportunities into relevant investment policies, either from the perspective of the overall investment policy or individual investment policies for various asset classes; how the current investment diversification and geographical asset allocation addresses climate risk; and efforts to diversify or divest against climate risk and any resulting financial impact.

The IAIS acknowledges that valuation and capital requirements, business conduct, and macroprudential supervision also have relevance for assessing and mitigating climate-related risks and states these areas may be covered in future work by IAIS and SIF.

Papers previously released jointly by IAIS and SIF include:

- [Issues Paper on Climate Change Risks to the Insurance Sector](#) (February 2018)
- [Issues Paper on the Implementation of the Recommendations of the Task Force on Climate-related Financial Disclosures](#) (February 2020)

For additional information please contact [Amy Matsuo](#) or [Mike Lamberth](#).

Amy Matsuo

Principal and National Lead

Regulatory Insights

E: amatsuo@kpmg.com

Contributing authors:

Amy Matsuo, Principal and National Lead,
Regulatory Insights

Karen Staines, Director, Regulatory Insights

kpmg.com/socialmedia



All information provided here is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the facts of the particular situation.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.