

Climate Change into the insurance boardroom



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The days of climate change being reserved for scientists, environmental lobbyists and politicians are long past. There is now much greater understanding of the impacts on us all and policymakers recognise that they need the support from financial market participants to redirect capital flows towards low carbon investments if they are to achieve the Paris Agreement targets to limit global warming to below 2 degrees Celsius. In our sector, boards of insurance companies are increasingly needing to understand the financial impacts of climate change on their business models arising from their underwriting and investment activities, both inside and outside of the organisation.

Climate change risks

There is now a general consensus that the main categories of climate change risks to insurers' balance sheets are:

Physical risks



While non-life insurers are able to adjust underwriting exposures to extreme weather events through annual contract re-pricing, the occurrence of uncorrelated events could result in an unexpectedly high claims burden. Life insurers also need to manage their mortality and morbidity exposures as extreme weather events could compound pre-existing health conditions.

Transition risks



Moving to a low-carbon economy could affect the value of investments and the costs of doing business. For example, several European reinsurers have made recent public commitments to stop investing in companies that generate more than 30% of their revenues from coal-related business.

Liability risks



The risk of litigation for not fully considering or responding to the impacts of current and future environmental risks, both by insurance company boards themselves or exposures arising from the companies to whom they provide D&O, PI or third party environmental cover.

Focus for regulators

Climate change is becoming increasingly relevant to financial regulation and supervision. Following a consultation with the UK market at the end of last year, PRA recently released Supervisory Statement 3/19 outlining its expectations on insurers (and banks) to manage the financial risks arising from climate change.. Insurers will need to embed climate change within the existing governance framework and assign board-level accountability for oversight. CROs will need to consider long-term scenario testing to inform the firm's strategic response to climate change and build climate change risk into risk management processes (such as the ORSA).

In March 2019, the Governor of the Bank of England, announced that the PRA will shortly ask UK insurers to consider the impacts of different climate change scenarios as part of a market-wide insurance stress test. Aside from allowing the regulator to improve its understanding of the impacts on insurers' solvency positions and key exposures to reinsurer counterparties and jurisdictions, this exercise is likely to reveal those firms that have already embedded climate change risk within existing risk management frameworks and those that might have much more to do.

While insurers are already required to disclose information on material risks in their regulatory reporting, and UK firms must disclose information on principal risks and uncertainties, it is not clear whether the regulators will seek to improve consistency of disclosures. Firms will also need to consider whether their existing disclosures are sufficient and whether to engage in wider initiatives such as the '[Recommendations of the Taskforce on Climate-related Financial Disclosures](#)' published by the FSB.

More broadly, the European Union is developing proposals for a taxonomy for environmental, social and governance risks and is considering additional disclosure requirements.

EIOPA has been tasked to develop recommendations on how existing regulatory frameworks might incorporate sustainability risks and factors and an opinion on the impact of Solvency II on insurers' sustainable investment and underwriting activities. For example, the assessment of sustainability risks within asset-liability management and investment policies under Solvency II as well as the inclusion of sustainability factors when designing and distributing insurance products and managing conflicts of interest under the Insurance Distribution Directive.

What boards should be considering

Boards should adopt an overall strategy in relation to climate change risks taking into account the expectations of regulators, investors and policyholders. This strategy should consider the investment approach over a range of time horizons to ensure that those are consistent with the firm's overall strategy and planning. For example, it might be more challenging to justify long-term sustainability goals to stakeholders who are not prepared to compromise on short-term profitability.

After defining a strategy and identifying relevant metrics to measure and manage climate change risks, the Board might look to define its risk appetite and tolerances recognising that these might change over time. Boards should also review their governance and risk management policies and consider whether and how these incorporate environment risks. It is important to assign clear responsibilities for assessing and monitoring these risks to individuals that have the appropriate skills and expertise to properly assess and manage them and who are able to produce effective management information to report to the board.

Where such risks are material, this should be fully explained within the firm's own risk and solvency assessment report and the risks should be subjected to appropriate stress and scenario testing.

Firms should be aware of the development of a number of different taxonomies for categorising potential risks across a broader spectrum of ESG (environmental, social and governance) risks. Firms will want to consider whether to reflect these emerging frameworks when developing their own objective criteria to help their risk teams reach consistent judgements. They will also need to consider whether their screening and monitoring processes obtain sufficient and robust evidence to form a judgement over the risk profile of any given policyholder or investment.

As supervisors obtain increasingly more granular data points about an insurer's risk universe, boards might wish to consider where they require independent assurance over their processes and controls as well as assurance over the information supplied as part of industry-wide reviews. Many boards will have already considered the extent and scope of climate-related financial disclosures and have been voluntarily including these within their financial statements. Such disclosures are likely to receive increasing attention from analysts and supervisors, especially around the appropriateness and results of scenario analysis.

Get in touch to discuss your climate change strategy



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