Insurance sustainability risks: prudential frameworks needed at the global and EU levels

1. Global sustainability risk impact on the insurance sector

1.1 The increase in frequency and severity of national hazards and the potential economic and societal may impact asset and insurance companies' liabilities values: the resulting challenge is the availability and the affordability of coverage for consumers

An official stated that the United States is exposed to many climate, catastrophic and sustainability risks which do not recognise borders. Sustainability risk is like other systemic risks insurance faces as an industry, and mostly comes down to physical risks such as the increasing frequency and severity of property loss from national hazards and transition risks, or how economic and societal shifts may impact asset values and the cost of doing business. The most prominent challenge that is faced is increasing property loss, degrading the affordability and the availability of insurance coverage. These extreme loss events often result in immediate market disruptions that extend for several years, and repeat losses only exacerbate this effect.

An official added that it is still not widely known how transition risks will impact investment pricing in the long term, but there appears to be more interest from investors for environmental, social, and corporate governance (ESG) disclosure. There is also potential for insurers to encounter liability issues due to climate-related impacts. These factors could impact the solvency position of insurers, particularly if they are heavily concentrated in certain markets or have a niche in particular industries. A significant challenge for state regulators is balancing the solvency risk to insurers with the availability and the affordability of coverage for consumers. There are also opportunities for insurers to take a proactive role in risk management, as well as offer products and services that support mitigation and adaption, including using innovative technologies.

1.2 Insurance companies and states have to partner to make sustainability risks insurable

The Chair stated that the uncertainty of what is or is not green and the uncertainty in putting the taxonomy into practice are challenges that insurance companies are facing. The sustainability risk case is multifaceted. The measurement of sustainability risk also includes disciplines that are not usual for finance. Assets and liabilities are fully exposed to sustainability risk, but even more because of the role of insurance in driving toward the path of sustainability by using its own professional activity, the release of protections. Special focus should be given to the regulation, as it should not limit the ability of insurers to provide protection.

A market expert observed that the financial sector is essential to the financing of the rising climate risk. Europe has €10 trillion of assets in insurance and is a very important investor. The risks insured by the insurance sector are diverse, both in nature and frequency. The main risk is drought. Marine submersion is a very long-term threat, but where the state and the public authorities are first concerned. The most important sector where insurance has historically intervened is natural catastrophes like floods, hurricanes, and typhoons when a company is multinational. Insurance has a very important role in evaluating and pricing the risk. The knowhow of insurers regarding risk pricing is a tool that authorities should use because it is a way to gradually face the challenges of the emerging and growing risks.

A market expert added that insurance is an educational tool and helps to create a green client. If Europe wants to have a green economy in the future, then corporates and households need to take the sustainability risk into account and understand the positives of the propositions of the insurance companies. Insurance is a commercial activity. Insurers try to attract potential clients by interesting devices, but at the same time they educate the client and help them to understand the preventative need. However, care is needed regarding the balance between public intervention and the insurers.

A market expert explained that the contribution of insurers is also necessary, as they have the possibility through their networks to evaluate the risks on a very local basis. Most of those risks have local or regional dimensions; different locations on earth do not suffer from drought at the same rate, so it is important to take that into account when considering a risk. However, although a sound geological expertise is required, when such an expertise eventually increases the price of the premium then the potential policyholder could refuse to pay it, meaning the insurance company leaves those kinds of markets.

A market expert stated that the yearly cost of climate change for Europe is estimated at €180 billion per year. Studies from the France Assureurs evaluate the enrichment effect to half of the cost, meaning that the client should only accept paying half of the risk. The rest is paid by the taxpayer through various devices and state intervention. Conversely, if only the state intervenes and takes over these risks then it disincentivises clients paying for a premium and increases a protection gap. Insurance has already found a method to mix the intervention of state and insurance through reinsurance approaches. It is a system that France established in 1984, where the insurance costs and risks are partially financed through a tax on the premiums. In the sustainability risk context Europe must systematically manage to have an effective availability of insurance, and to preserve the affordability of insurance.

An industry representative noted that Covéa recently published a study that evaluates the impacts of climate change on natural catastrophe perils and claims based on the worst-case scenario such as the Representative Concentration Pathway (RCP) 8.5 until 2050. The study shows that underwriting based on informed granular elements can accompany new trends. We see no impact of climate change on storms in France for instance, this is an important result. The impacts are to be found on flood and drought. Non-life insurers are best placed to monitor the physical risks implied by climate change and Covéa has developed sophisticated and granular modelling capacities to inform on the actual perils' impacts on our liability exposures linked to our very large policyholder base. Hence also peril intensity will be more severe on drought than flood at global peril level in France, it will translate the other way on our portfolio due the precise location of our exposures. Insurers also need to be mindful of possible second-round effects. Discounting premiums cannot compensate the cost of preventive measures. Preventive measures can be incredibly costly, so discounts can send a signal but will not make up for the cost of prevention measures. Insurers need to be mindful of not becoming socially unfair. Mutualisation needs to be maintained, and in cases where the risk is too intense, or hazard disappears then insurers might have to resort to private/public partnerships.

An industry representative observed that adaptation is a manageable challenge. Non life insurers are well placed for that with the prevention measures. Insurers can help prevent damage and help limit the damage once it has occurred. The less manageable aspect is the mitigation of climate change, which is deemed beyond reach of the connection with real risk drivers. Underwriting must remain risk based, and there might be a risk in reducing the availability of insurance covers for traditional activities.

2. Sustainability risk is a key risk that has been monitored for a while in the EU, and many areas for further investigation are identified

The Chair noted that the challenges outlined in North America are also very common in Europe. The Chair asked a regulator for his assessment of the extent and the way in which EU insurers manage sustainability risk, based on the monitoring activity of EIOPA.

A regulator stated that sustainability risk is a key risk that has been monitored for a while. EIOPA has already included ESG risk in its 2021 risk dashboard because it is becoming more and more relevant. The 2018 stress test already included natural catastrophe scenarios. The outcome of that stress test was that the sector can manage the risk, and there was a strategy to absorb losses as envisaged in the scenario that EIOPA put forward.

A regulator added that EIOPA has also performed some vulnerability analyses, detecting the holding of equity and corporate bonds that can be affected by climate risk such as fossil fuel, which is another industry that is sensitive to this risk. The scenario that was being tested is still manageable. Losses may be significant but there is diversification of the portfolio of investment in the insurance sector. The tendency to increase the investment in more sustainable topical assets can counterbalance the negative impact of this kind of scenario. The risk must be monitored continuously, and this year will see further investigation. Data analysis will take place going forward. EIOPA will detect more in the case of enhancing the frequency and severity of natural catastrophes, and what the impact on the underwriting risk can be.

3. Sustainability risks have systemic relevance, and analytical tools need to be developed to translate these issues into financial risks

The Chair noted that Europe is at the beginning of a long journey and asked an official to give her assessment on the systemic relevance of sustainability risk.

An official stated that in 2021 the IAIS published an analysis that assesses the consequences of climate change for investment exposures of the insurance sector under the three NGFS-based scenarios: an orderly transition, a disorderly transition, and a too little, too late scenario. The IAIS collected data from more than 30 members and concluded that 35% of investments could be exposed to climate risk. In the orderly transition scenario, the risks are manageable. In the disorderly scenario the insurance sector loses more than 14% of its solvency ratio, and in the too little, too late scenario it can lose up to 50%, but even in that scenario the insurance sector in aggregate remains financially sound, given the good pre-stress solvency levels. The IAIS is not complacent. Much of the analytical toolkit needs to be further developed to translate these issues into financial risks. Also, the 2021 analysis was only concentrated on the asset side. There are also risks on the liability side, which will be further examined through the IAIS' annual Global Monitoring Exercise in 2022.

4. Double materiality and risk assessment challenges

4.1 Addressing incurred risk and the risk that is generated by companies points to data and financial metrics challenges, and measuring sustainability risk of sovereigns is challenging

An industry representative stated that investor's view climate risk from two perspectives: the incurred risk and the risk that is generated. The concept of double materiality is relevant and represents the compass insurers should adopt. The first main challenge is data availability and standardisation. The second is how to integrate it with pricing and the financial metrics, because companies have a fiduciary duty towards their policyholders and need to generate sufficient return for shareholders and life clients. It is important to ensure the ESG angle is fully integrated with the traditional financial metrics. More than 85% of insurers' portfolios are comprised of fixed income securities bonds while ESG scores are at issuer level, and there is relatively little research on the difference between ESG metrics in valuing bonds vs equities.

4.2 The way to combine the time horizons of insurers' assets and liabilities and sustainability risk is not yet defined, and more is to be done in the S&G part of the ESG

An industry representative noted that the second question pertained on how to deal with sovereign bond exposure. In continental Europe around 50% of insurer assets are invested into government bonds. Regarding carbon footprint, as an example, there is still no consensus on how to measure the risk if looking at consumption based metrics, production based metrics, or if it is weighed on gross domestic product (GDP) or population. When looking at climate risk investors need to make projections over 20 or 30 years. However, in 20 or 30 years most of the bonds in the portfolio will have already matured.

An industry representative added that the S&G part of the ESG equation is also important, where there is even more to be done in terms of standardisation data and metrics. Engagement with issuers is critical. Certain topics like diversity and inclusion are very relevant when looking at companies in which investors invest.

An industry representative noted that the challenge regarding the release of protection in property and casualty (P&C) insurance is also applicable to risk management and supervision. The main challenge is to remain pragmatic, operational, and mindful of second-round effects. Companies cannot factor all the world's issues in an insurance underwriting process or business model, as the number of drivers and interactions are infinite.

An industry representative stated that climate is a very complex thing to model, particularly when associated with additional elements such as technology, science, geopolitics, and socioeconomic inputs. Insurers need to be prepared for the unforeseen and should refrain from single, dogmatic focuses and approaches. Insurers need to be reactive, adaptable, and resilient, and make use of their adequate management actions. Insurers are well placed to foster resilience and are best placed to assess climate risks, hazards, perils and trends when being a P&C insurer.

5. The journey toward embedding sustainability risk specificities in insurance companies is complex and lengthy

An industry representative stated that the sustainability risk journey posed three main challenges: a conceptual challenge, an execution challenge, and a leadership challenge. For the conceptual challenge the question was how to map and measure the risk in words that can be understood by stakeholders. Three dimensions were chosen: insurance activity, investment activity and internal operations. Three different forms were chosen: physical risk, transition risk, and responsibility risk.

An industry representative added that the conceptual challenge was in place because the risk had to be measured. Different metrics were chosen: the Solvency II balance sheet, income statements, and the valuation of the investment portfolio. The main impact is through the assets of the investment portfolio. CNP then made the decision to focus on financial risk related to its investment activity, which was the execution challenge.

An industry representative explained that the first part of the execution challenge was to choose the methodology to expose the facts and the reasoning. CNP chose the Task Force on Climate Related Financial Disclosures (TCFD) reporting, which is used by more than 3,000 companies over the world in more than 90 countries. The TCFD is a very good framework and worked extremely well. CNP also had a technical challenge, which was mostly a lack of data disclosed by companies in which it invested regarding climate-related exposures, a lack of harmonisation and a lack of audit.

An industry representative noted that the third challenge was the leadership challenge. It was important to look at the topic through many different eyes. CNP set up a committee comprising risks, investments, actuary, corporate social responsibility (CSR) and legal. Once started, continuous improvement is needed on the methodology, quality of data, perimeter, and key performance indicators (KPIs). CNP also decided to include biodiversity in its 2022 perimeter, as if it is not examined then some aspects are missing. When that happens the company's reputational risk is at stake, because if they are inconsistent their reputation can be destroyed.

6. Expected improvements in the prudential framework in the EU and globally

The Chair observed that disclosing specific risks is potentially even as complex as managing them, and asked industry representatives what they want to see in an ideally improved prudential framework.

6.1 Fully leveraging appropriate stress testing requires further refining related methodologies

An industry representative stated that stress testing is very important. It is essential to create a standardisation, but also to increase the awareness of both industry players and regulators. What is important is also to be mindful of potential and unintended consequences. When looking at climate, insurers should avoid cutting-off certain economic activities in sectors or countries embracing a credible energy transition. It is also important to avoid incentivizing 'brown spinning', where companies divest from certain brown activities towards investors with weak or absent ESG policies, but those activities are still there and generate negative impact on climate or society. Engagement with issuers is key in this respect. It is also important to look forward rather than backward, and to reward those who are best in class.

The Chair noted that the reward question could be posed to EIOPA.

6.2 Existing risk sensitive EU framework is mostly adequate

An industry representative noted that the framework is a good framework to welcome any new risk. Solvency II and the Insurance Capital Standards (ICS) are also very sensible. It can embed risk on the asset side and on the liability side. All the natural catastrophe perils have been identified. Within this framework, if focus remains on risks being risk based then insurers have a good chance to factor these issues.

6.3 The frameworks should encourage the diversity of business models, which is an essential tool for reducing systemic risk

An industry representative added that it is important to allow and foster the diversity of models, because they can be very sensitive to parameters and to their own intrinsic methodologies. It is important for the regulation to foster the diversity of models so that they do not have systemic failure in them. The diversity of the business models is a very good idea to enhance resilience. It is important not to impose a one-size-fits-all standard, as well as not to mix communication and risk awareness exercises with operational processes like the own risk and solvency assessment (ORSA) that insurers need to inform their business and governance decisions.

The Chair agreed that cooperation between supervisors is key and asked a regulator to outline what EIOPA is going to do, particularly regarding the request of the commission on the review of Solvency II.

A regulator noted that it is too early to see the outcome. EIOPA will work on the risk differential to understand if there is a need for a dedicated prudential treatment on the asset side, but also on the underwriting side, as that is part of the difference between the insurance sector and the others. The approach will be risk based. If the industry is not on the same page as EIOPA it is at least on an equivalent page. The difference between ORSA and the stress test is clear, and EIOPA welcomes the requirement to consider it in the ORSA.

6.4 A cautious, consistent, and holistic implementation of the Corporate Sustainability Reporting Directive will be an essential contribution to risk assessment

An industry representative stated that CNP supports the Corporate Sustainability Reporting Directive (CSRD) and the European Financial Reporting Advisory Group (EFRAG) standards project. The main features of a framework should be harmonisation of the definition of the KPIs, mandatory disclosure and mandatory external audit. Beyond those technical considerations it is important not to go too fast. Climate change is an area where Europe is in a hurry, but it is useful to take time to involve stakeholders and the actors of the industry.

An industry representative added that an integrated approach is preferred. It is better to have fewer KPIs covering all the scopes of climate, social, and biodiversity than a lot of KPIs dedicated to climate. If climate risk is managed without having the social impact of going too fast in the decarbonated investment portfolio in mind, then it could put a lot of people out of their jobs. It is better to think in a coherent way rather than going very deep in one direction because that way was calculated as the most important.

6.5 The NAIC has many initiatives underway, notably on risk disclosures, addressing additional perils within its risk-based capital framework, climate risk stress tests and scenario analysis

The Chair observed that this is the approach of regulators and asked an official to outline the top priorities for improving the framework in the US, if necessary.

An official stated that one of the NAIC's regulatory priorities in 2022 is the work of the Climate Resiliency Task Force (CRTF). The task force will focus on five topics, two of which are solvency and climate risk disclosure. Regarding solvency, the task force is looking at enhancements to its current existing regulatory solvency tools, as well as including a risk framework for addressing additional perils within its risk-based capital framework. The NAIC already has hurricane risk and earthquake risk captured in these capital models but is looking to add a risk of wildfire.

An official added that the NAIC is looking for modifications to its ORSA process, its financial analysis handbooks and its financial condition examiners handbooks. The NAIC is also looking to develop climate risk stress tests and scenario analysis of climate risk, including examining scenarios, assumptions, and parameters for the stress testing exercise. The NAIC is progressing on work to determine a methodology for quantifying insurers' exposure to climate-related investments.

An official explained that the Insurance Climate Risk Disclosure Survey has been collected by state insurance regulators for over a decade. It currently captures about 80% of the market by direct premiums in the US. The disclosure survey contains eight questions covering topics that include climate risk governance, management, modelling and analytics, stakeholder engagements and greenhouse gas management. Last year the NAIC undertook a review of this disclosure survey and in mid February it released a revised version of the survey which is more aligned with the TCFD framework.

6.6 Sustainability risk is material and should be disclosed through the TCFD framework, though IAIS is closely watching what the International Sustainability Standard Board (ISSB) is going to be doing

The Chair stated that an issue where both the industry and the supervisor have the same objective should be exploited, as it does not happen that frequently. The Chair asked an official for her thoughts on the global cooperation of a supervisor and the top priority of IAIS in the framework.

An official stated that, as highlighted in the IAIS' recent application paper, climate risk needs to be included in the ORSA if it is a material risk. The IAIS Insurance Core Principles (ICPs) also require that material risks should be disclosed and the IAIS has stated that that should be done through the TCFD framework because it is the only global framework available. The IAIS is closely monitoring the ISSB's development of standards and has publicly stated its support for this work, starting first with climate and then potentially broadening them to other priorities. This is going to be a global standard for disclosure across the corporate sector.

The IAIS is also working on three more workstreams on climate risk. The first is scenario analysis. The IAIS has just completed a stock take of the practices of its membership, with a view of potentially incorporating it into an application paper or other guidance in terms of possible best practice. The IAIS is also reviewing its standards (ICPs) whether there are any gaps. Lastly, it is looking at whether it can incorporate data collection on climate risk more systematically in its financial stability analysis. On other sustainability topics, the area that the IAIS is currently exploring is diversity, equity, and inclusion, and how that is reflected in strengthening decision making and governance by reducing groupthink in insurers.

The Chair summarised that there is a lot of work to do, but it is better to work together to mitigate the sustainability risk and make the insurance sector play its role in this context.