Sustainability risks in the EU insurance sector

1. A complex and dynamic issue encompassing dramatic changes in many dimensions

A regulator indicated that the panel would discuss sustainability risk in terms of sector resilience and the contribution insurers can make to a smooth adaptation of the EU economy. The framework involved in analysing these issues is complex and very dynamic. Risks and the way they are measured are evolving. The business model is evolving. Regulation is also evolving, and a great deal of regulation is being produced in this field. The management of a company considers the sustainability risk borne by the insurer, but also what the insurers could do to contribute to a more sustainable world. The term 'sustainability risk' will be used, although much of the work has been done on environmental, in particular climate risk.

2. In the US climate change presents various risks in relation to underwriting and investments of insurance undertakings

A regulator stated that the level of preparedness is evolving in the US and globally. The National Association of Insurance Commissioners helps state insurance supervisors foster a degree of uniformity and coordination, while also enabling differences from state to state. While some may see these differences as a weakness, we see this as a strength of the US system as it allows for innovation among the states but within a well-developed supervisory and regulatory framework.

2.1 A wide variety of physical environments in the US

The NAIC recognises that climate change is an existential risk to the US and its financial system. There are three approaches to addressing climate risk: mitigation, adaptation and, at some point in the future, migration is expected. Given the wide variety of its physical environments, the US is an ideal place to study the impact of climate change. Connecticut has a relatively high income and a significant portion of insured property along the coast, which is threatened by climate change. Risks faced by California and Colorado include wildfires and lack of water. An integrated solution is essential.

2.2 Supervisors require insurance companies to provide climate related adaptation plans

Regulators of insurance companies have two primary considerations: underwriting and investments. At supervisory colleges and annual meetings, companies are requested to provide their plans on addressing the impact of climate change.

2.3 Making accurate and understandable information available is the most important focus of supervisors to accelerate adaptation and mitigation

Information is the most important focus. In April 2022, the NAIC adopted an updated disclosure survey based on the Task Force on Climate-Related Financial Disclosure (TCFD) template. This aims to ensure that the disclosures are accurate and comparable across jurisdictions. Currently, 80% of the premiums in the U.S. are subject to this disclosure. Also, the NAIC has created a new Catastrophe Modelling Center of Excellence within its Center for Insurance Policy and Research. This aims to provide supervisors with the information that is needed as the system evolves.

2.4 The American Risk-Based Capital system risks have been adapted to properly reflect risk to regulators and inform consumers

The US system avoids being prescriptive with the focus on consumer protection. Ultimately, the aim is to ensure that an insurer can pay the claims and fulfil its contract when a qualifying event occurs. The Risk-Based Capital (RBC) system recognises the threat to capital that certain investments or underwriting will cause and is the need to evolve as new risks emerge. For instance, supervisors recently recommended that an RBC charge for wildfires be added to the RBC framework for catastrophe risk exposures. s The data is for informational purposes now as supervisors consider how best to levy RBC charges.

3. In the EU insurance supervisors have started to assess insurance undertakings' sustainability risks and are considering whether the regulatory framework should evolve

3.1 EU reinsurance arrangements help the industry to mitigate risks

A regulator stated that underwriting investment is a key point of attention. An analysis of physical climate change risk was performed. Considering the recent tragic events, it can be said that the European system is well-placed to handle the risk, thanks to reinsurers.

3.2 Many undertakings should further integrate these increasing risks in their Own Risk Solvency Assessment (ORSA)

The European system has an important tool for starting the dialogue between industry and supervisor, the ORSA.

However, it has been discovered that only a minority of groups in the industry measure the risk in the wholesale in their own risk assessment.

3.3 The development of sustainability risk will improve customers' knowledge and awareness to prevent possible insurance gaps

The European Insurance and Occupational Pensions Authority (EIOPA) explored best practices and issued an application guidance to improve the self-assessment analysis. The increase of the risk and of prices can lead to exclusion and other issues. The consumer and their needs must be considered. Information, analysis, and risk management are of primary importance. Other measures relate to the disclosure of this information and the clarity of the contract with the policyholders.

3.4 EIOPA launched a process to define whether a specific prudential treatment of sustainability risk is necessary and what the related methodology should be

EIOPA will be mandated to perform the capital charge. The Commission proposal for the review of Solvency II stated the need analyse if an exposure or an asset substantially associated with environmental risk requires a differentiated treatment in terms of potential capital requirement. EIOPA's analysis will first consider the methodology to measure the differential treatment that may be needed. Stakeholders will then be consulted. A great deal of debate is expected in this area.

3.5 The next stress tests will be driven by the European Systemic Risk Board (ESRB) in 2023

A regulator confirmed that a global stress test for the entire financial sector would be carried out in the following year, under the aegis of the ESRB.

4. At the global level the International Association of Insurance Supervisors (IAIS) is building a common doctrine from members' practices and leveraging ongoing monitoring to raise awareness and catalyse insurance supervisors' progress

An official commented that monitoring helps to raise awareness among the community of supervisors and stakeholders and to prioritise the many actions. A good platform for this is the Global Monitoring Exercise, one of the pillars of the holistic framework, which is two sets of data collection from a pool of insurers. It provides a very interesting perspective on risk in general and global risk.

4.1 The impact of climate risk on insurers' assets is being embedded in the Global Monitoring Exercise

The information required is not always available, so the exercise proceeds step by step. The Global Insurance Market Report (GIMAR), with a special topic on climate, was an important pilot exercise that aimed to produce a global assessment of the impact of the transition risk on the asset side.

4.2 The insurance sector globally can absorb the extreme stress scenarios involved in the Global Monitoring Exercise, which is reassuring regarding the solvency of the sector, although the cost of a disorderly transition is much higher

The exercise concluded that, in different scenarios, from an orderly transition to the climate target to a more extreme scenario of 'too little, too late', there is a huge difference in terms of the impact on the solvency of the insurers. The approach to achieving the climate target is going to make a huge difference. The exercise also considered the overall resilience of the sector and indicated that the insurance sector has the financial capacity to absorb even the extreme scenario, but this does not mean that the insurance industry should not continue this work. The liability risk is now included in the Global Monitoring Exercise.

4.3 Stress testing the creation of a tool kit and support to supervisors are key bedrocks of the IAIS action in the area of sustainability risk

A supervisory response and a sector response are needed. Stress testing is crucial. There are challenges in implementing stress testing in smaller jurisdictions. IAIS is providing support on implementation of stress testing. Supervisors should include this risk in their approach to supervision. The IAIS standards support the supervisors, because they are very principle-based, but there is also the possibility of providing concrete solutions and an adequate toolkit for implementation. Work is ongoing in this area.

5. Each undertaking has to fundamentally review its strategy since sustainability has profound and holistic impacts

An industry representative commented that sustainability must be a Copernican revolution. A Weltanschauung, a new view of the world, is needed.

5.1 Sustainability influences product design, investments, operation and management arrangements, business models and main human resources demands and interacts with undertakings' geographic footprint. It requires horizontal cooperation

Sustainability must be the foundation of any strategic activities. From an organisational perspective a proper setup is needed. The industry representative's organisation has defined a hierarchical set of committees, in addition to new ones dedicated to sustainability. Sustainability topics are also addressed in committees such as the risk and control committee.

An other industry representative commented that their group believes that it is very important to mainstream sustainability. The sustainability committee is co-chaired by the Group chief risk officer, the Group chief investment officer and the Group head of sustainability. This transversal view of the business and sustainability is at the foundation of climate leadership being one of the five pillars of the current strategic plan.

5.2 Investment strategy is influenced by the long-term nature of sustainability risk, possible subsequent impacts on nature, earth and society, and the interconnectedness and interplay of surrounding events

An industry representative outlined the three points that characterise these types of risk in relation to investment. The first is the long-term nature of the risks. The second is double materiality. The external impact of the stress test and the impact of the company on society must be considered concurrently. The third is interconnection.

5.3 The insurance industry is dealing with the data challenge since defining its strategy and behaviour requires measuring many external parameters specific to each player, sector, and geography

Data is the key to carrying out a proper assessment. On the investment side the industry is in a much more mature state. Internal data is easy to identify but obtaining data on the carbon footprint of the investees relies on an external provider. Plans of these investees and how to distribute exposures across geographies and sectors must be considered. This is very similar to what happened in 1990 and 2000 for the catastrophe (CAT) modelling. Regarding internal data, a great deal of additional information, sometimes acquired while writing new business, has to be captured. This requires internal cooperation as well as a more transparent way of sharing the data. The value is not in owning the data but in how the data is used.

5.4 Developing tools and initiatives pooling data is urgently needed

An industry representative commented that there is a need for more platforms to capture and distribute data. Ensuring pools of data are publicly available to all the companies is fundamental. A massive request on the reporting side must be avoided, so progress should be measured.

6. Going beyond climate related challenges is a necessity globally given that S or G are essential performance factors for investment in addition to the material risk they represent

An industry representative noted that in an analytical assessment of the risks faced by insurers, sustainability is top of the list. ESG is not just E and E is not just climate. For instance, their organisation aims to promote good governance as a basis for sound investment. As an underwriter, when they sell a director and officers' liabilities policy, there is also an emphasis on good governance. More generally, the volume of insurers' business is correlated with GDP and so the state of their business is like a seismograph of society.

An official emphasised that insurance is embedded in real life. This is particularly relevant for the IAIS because it has a broader membership. It also has an emerging market jurisdiction, where the questions of financial inclusion and affordability are important topics. Social is a very broad topic. Diversity, equity, and inclusion is a key strategic theme for the IAIS, partly because it is socially desirable and morally right, but also because embedding diversity will deliver better outcomes for prudential and consumer protection. A consensus that this area is key to fostering and enhancing supervision is vital.

7. Addressing possible insurance gaps regarding climate risk

7.1 Risk prevention and retention must be developed, and clarification sought on whether threats are insurable or require state intervention when systemic

An industry representative stated that insurers are at the forefront of climate change, as clients are indemnified for natural perils such as drought and wildfires. Sustainability is therefore embedded in how risks are managed, and the design of products is considered.

Underwriting in insurance requires a series of criteria. The first one is a demand for the provision of insurance, which has been increased by recent events. The second criteria needed is an alignment of interest between customers and insurers to offer the appropriate cover: both prevention and retention – deductibles – are needed. Then, for insurance mechanisms to work, there must be some degree of uncertainty, with the hazard component being one of the drivers of climate change (besides vulnerability and exposure) on which we need to act. Finally, we need a pooling mechanism so that the risk does not become systemic. There needs to be a top layer where policymakers step in.

7.2 Protection gaps unveil unaffordable risk which demand first addressing root causes including behaviour or society choices

Insurers want to be tough on risks, but also on the sources of risks. Insurance reflects the underlying risks and choices of the society: insurance is a reflection of it, not the root cause of it.

8. The ongoing contribution of the insurance sector to the climate related transition of the economy

8.1 Role of the Net-Zero Insurance Alliance

An industry representative indicated that the Net-Zero Insurance Alliance (NZIA) was founded in the previous year. Members have committed to transitioning their underwriting portfolios to net zero by 2050, which involves helping clients to transition their business models, lower their emissions and improve their carbon footprint.

8.2 The insurance sector will play an increasing role in providing information and assisting particularly SMEs with prevention

An industry representative noted that the penetration of insurance premium into GDP is still relatively low, meaning that a major increase is possible. Rather than prevention, there is the logic of being paid ex-post. Advice is especially relevant when working with small and medium enterprises (SMEs). SMEs are supported in understanding risk areas through stress testing. Information on upcoming climate related events is provided, so policyholders can prepare and avoid damages that are paid ex-post.

8.3 Services embedded in insurance contracts will accentuate insurers' added value and the contribution of the sector to risk mitigation and prevention, as well as the transition of customers

Technology can assist with spatial analyses. Real-time imaging of an event will enable a better understanding of the damage and support the rescue. The product is not only an insurance policy, but a set of services provided to the policyholder. Agriculture businesses are helped to understand how to better use biotechnology and artificial intelligence. This is relevant to how the crops are insured and reduces the weather dispersion and use of fertilisers that are one of the key elements for CO2 emissions.

The basis of any correct risk assessment is the data and scarcity of data means that the assessment can be improved. Insurers should not stop giving the right pricing. Different products should be used, like the parametric insurance that can be more tailored to a need. The aim should be to produce a sustainable balance sheet where pricing is adjusted over time with the data. A private-public schema or pool and conversations around data availability are needed.

8.4 The profitability of products must be combined with their ability to mitigate risks which is beneficial in the long term

A regulator commented that insurance can mitigate climate risk and help with adaptation to climate risk. A trade-off could be identified between profitability in the short term and the ability of products to mitigate the climate risk. An industry representative commented that, when insurers are faced with a trade-off between the short term and the long term, they opt for the latter. An industry representative commented that it is not possible to be sustainable if the long term is ignored in order to focus on the short term.

9. Cooperation between public and private sectors will improve insurance coverage

A regulator stated that the US perception is that risks must be addressed holistically. Reporting requirements, the ORSA, governance disclosures, climate disclosures and net zero involvement can be considered together. Supervisors collectively must be committed to addressing these risks. Products, including the micro-insurance and parametric products, must be available for consumers.

9.1 Transition and mitigation may require deep investments, made affordable by combining and coordinating financing and premium incentives, requiring the participation of life insurers as long term investors, public banks, foundations etc, in addition to insurance undertakings

The effects of climate change will be disproportionately felt by communities that are least able to address them. In response, US state supervisors are working with industry on select initiatives to help mitigate damage in those communities, including the Strengthen Alabama Homes programme, and the Connecticut Green Bank's leveraging of private investment, including from the insurance companies.

9.2 Insurance regulators must also adjust their practices

In the US, the American Council of Life Insurers (ACLI) is working to bring large-scale impact investing to traditionally underserved communities. This will require regulators to be flexible in their approach because impact investing is different to a normal investing profile. The investment partnership enables smaller insurers to invest and pool their money, as many larger insurers have already started to do, to ensure that communities that cannot finance mitigation of and adaptation to climate change and to environmental damage are able to do so.

9.3 In addition to improving insurers' ability to underwrite, better insurance coverage stems from monitoring developing risk and related insurance gaps, pricing issues etc.

A regulator stated that regulators should be self-critical. The drive is currently towards enhancing sustainability. Sustainability touches all the different areas at EIOPA: policy, oversight, consumer protection. Regulators need to help and sometimes could do better. The concept of the impact on underwriting was developed some time ago to assist the insurance sector to collect from an underwriting point of view. Regulatory barriers to proper assessment in a risk-based system like Solvency II, with any adaptation to climate risk, must be reflected in the technical provision in the capital requirement. In the future, there should not only be a focus on the capital requirement.

Information is key to improving insurance penetration. In EIOPA have developed a dashboard to enable the government and all the stakeholders to identify where the risks are. Affordability and pricing of the product is also important. The shared resilience solution was introduced some time ago. There are some systemic risks that the sector itself cannot afford and where it therefore cannot play its proper role as the risk manager for society. It is good that the Commission has set up the roundtable on climate resilient dialogue. A clear understanding of consumer engagement on this difficult topic will be important. Raising awareness and financial education has a role, but it is maybe too long term an objective. An understanding of how to help consumers buy these products is essential.