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CLIMATE CHANGE IN THE 2020s: THE DECADE FOR INSURERS TO LEAD

– THOUGHT LEADERSHIP

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Climate change is at the top of the agenda for policy makers, regulators and globally significant companies. It is an unprecedented risk and is under increasing scrutiny by shareholders and regulators. For insurers, climate change also presents opportunities for the industry to do what it does best – assessing and providing protection against risk – both in managing their own business and providing innovative products for policyholders to protect them against some of the economic implications. The 2020s will be a decisive decade in the race to deal with climate change and insurers may well play a key role in deciding the outcome of these efforts.

Climate change risks for insurers

Climate change affects insurers on both sides of their balance sheet, disrupting insurers' assets as well as their liabilities under the policies they write. Given the wide range of climate change risks, many regulators and industry bodies have adopted the helpful classification of the types of climate risks coined by the Governor of the Bank of England, Mark Carney[2]:

- Physical risks, the impact of the climate on physical assets which may lead to impairment of insurers' assets and/or the property which they underwrite.
- Transition risks, the risk in moving (and being required to move by laws, regulations and policy decisions) from the "brown" where we are now, towards the "green" world by adapting to the changing climate and seeking to stop further damage.
- Liability risks, the risk of increased liability resulting from litigation on climate change issues.

Liabilities

On the liability side, climate change will clearly have an impact on policies underwritten by general insurers. An increase in severe weather conditions will lead to an increase in claims under property and flood insurance policies, among others. It is also likely to result in an increase in demand for protection from adverse climate events.

Climate change is also universal, with its effects felt globally, not just in wealthy areas with high insurance penetration. Climate risks lay bare the insurance protection gap in developing countries where the effects of natural catastrophe is likely to be significant, whilst not having the benefit of comprehensive insurance protection. Innovative forms of alternative risk transfer, through for example parametric (re)insurance and insurance-linked securities (ILS) would be ideally placed to offer the protection so badly needed by the most vulnerable.

On the life insurance side, health and life insurers may also be impacted by changes in life expectancy and mortality, lifestyles and a shifting geographical spread of vector-borne diseases, alongside the effect on the assets backing these liabilities.

Assets

On the asset side, climate change may affect the value of investments, particularly in 'brown' industries, i.e. industries which have the most negative environmental and climate impact such as fossil fuel extraction and high carbon

1 Source: NDC Global Outlook Report 2019 (https://www.undp.org/content/undp/en/home/librarypage/environment-energy/climate_change/ndc-global-outlook-report-2019.html)

2 Source: Carney, M. (2015). Breaking the Tragedy of the Horizon (https://www.bankofengland.co.uk/speech/2015/breaking-thetragedy-of-the-horizon-climate-change-and-financial-stability)

emission transport companies. At the same time, new investment opportunities arise from these changes. Alternative asset classes, such as green bonds, green funds and environmental, social and governance (ESG) focused investments will continue to grow and will need to feature more prominently within insurers' portfolios in response to climate change. Indeed, as we discuss below, rules, regulations and to some extent voluntary initiatives, such as the Task Force on Climate-related Financial Disclosures (TCFD), and consumer pressures will drive insurers to make green investment decisions and ensure they have ESG compliant investment strategies. These are issues which all industries will be grappling with, but insurers with their expertise in risk assessment should be ideally placed to leverage this liability side expertise to manage their asset portfolios.

Legislative and regulatory initiatives

There is an increasing awareness of the urgency to address the challenges of climate change. Policymakers at international and national levels are working on imposing laws and regulations to ensure insurers consider climate change risks in their business. A complicated web of climate risk governance, risk management, stewardship and disclosure requirements is beginning to emerge globally, but particularly in the European Union and the UK.[3]

In addition to focusing on climate change simply because it is the right thing to do, insurers will also need to monitor legal and regulatory requirements as they begin to apply to them. In addition, decisions insurers make now (for example their investment strategies) are likely to have long term consequences, whilst climate change regulations are only now beginning to be formed. Therefore, insurers will need to monitor and scan the horizon for future developments in order to ensure they do not set themselves up to inadvertently fall foul of regulations.

We focus here on some key initiatives relevant to insurers (with a focus on the UK):

International Association of Insurance Supervisors (IAIS)

The IAIS has been working with the Sustainable Insurance Forum and insurance regulators globally in responding to climate risks. Initiatives on climate change in many jurisdictions are being developed and the IAIS is keenly aware of the need for insurance supervisors to give climate change their full attention and that supervisory requirements will need to be scaled up. As an indication, the focus of this year's IAIS annual conference will be climate change.

In addition, the IAIS has noted the impact of climate change and the insurance protection gap and the role that parametric/ index linked (re)insurance could play to plug the gap. An example of this is the $225 million ILS issuance by the government of The Philippines in November 2019 seeking to close the country's gap in protection against earthquakes and tropical cyclones.

The IAIS has also focused on disclosure requirements and is supportive of insurers complying with the TCFD Recommendations. It has found that whilst insurers (particularly in the general insurance sector) show good awareness of climate risks, progress in complying with TCFD disclosure standards has been slow for insurers especially compared to banks and other financial institutions.[4] Whilst the TCFD Recommendations are voluntary, in the IAIS' view, climate risk disclosure could be assumed to already be required under the IAIS' Insurance Core Principle 20 (Public Disclosure) which requires firms to disclose "relevant

3 We refer to our Thought Leadership page on climate, sustainability, green finance and renewables which sets out a broader summary of the various initiatives on climate change and our publication Growing the Green Economy which is a collection of articles focusing on sustainability issues globally but with a particular EU and UK focus

4 See IAIS Issues Paper on the Implementation of the Recommendations of the Task Force on Climate-related Financial Disclosures, 19 December 2019.

and comprehensive information on a timely basis in order to give policyholders and market participants a clear view on their business activities". This view is also taken by the Financial Stability Institute and a majority of insurance regulators, including the PRA.[5] The IAIS now aims to publish an Application Paper on climate risks in collaboration with the Sustainable Insurance Forum later in 2020 to assist insurance regulators in developing their regulatory frameworks in respect of climate risk disclosure.

European Insurance and Occupational Pensions Authority (EIOPA)

On the back of the EU's Sustainable Finance Action Plan (SFAP)[6], EIOPA has published its proposals on how sustainability risks should be included within the Solvency II framework. In particular, it has proposed that sustainability risks will expressly need to be taken into account in the Prudent Person Principle, risk management and solvency capital requirements. EIOPA is also encouraging insurers to use qualitative scenario analysis and testing to examine the impact of climate change, with scenarios tailored to the insurer's risk profile. These proposals echo the UK PRA's proposals as described below.

Prudential Regulation Authority (PRA)

The PRA has been at the forefront of addressing climate change within the financial institutions sector. It was among the first regulators to have published its assessment of the impact of climate change on the insurance sector with its Supervisory Statement SS3/19 and Policy Statement PS11/19 being issued in April 2019[7]. The PRA has made it clear that boards must understand, assess and address financial risks arising from climate change. In addition, they must allocate responsibility for managing climate risks to the most suitable existing Senior Management Function. Whilst one individual will have responsibility, insurers will need to ensure that taking climate change risks and ESG matters into account must form part of the overall culture of the firm.

The PRA also expects firms to manage climate risks within their existing risk management framework and firms will need to demonstrate that they understand the resulting financial risks and how their business models will be affected.

In addition it has started working with firms on in-depth scenario and stress testing on climate change to identify the risks so as to inform firms' decisions. Similar to the EIOPA proposals, the PRA expects firms to consider financial climate change risks in their ICAAP or ORSA assessments under the Prudent Person Principle. The Bank of England has also announced that it will focus on financial risks resulting from climate change in its 2021 biennial exploratory scenario to test the resilience of financial institutions, including insurers, to climate risks.

Insurers are also expected to consider further disclosure on climate risks, governance and risk management as part of their financial reporting. This enhances and builds on disclosure requirements which affect other companies such as the FRC's UK Stewardship Code for investors and the requirement for large companies to report on how directors have considered their various duties under section 172 of the Companies Act 2006. This includes the duty to consider the impact of the company's operations on the community and the environment, which requires boards to take into account the environmental, social and governance impact of decisions made by the company.

5 See FSI Papers No 20 of 6 November 2019 – Turning up the heat – climate risk assessment in the insurance sector.

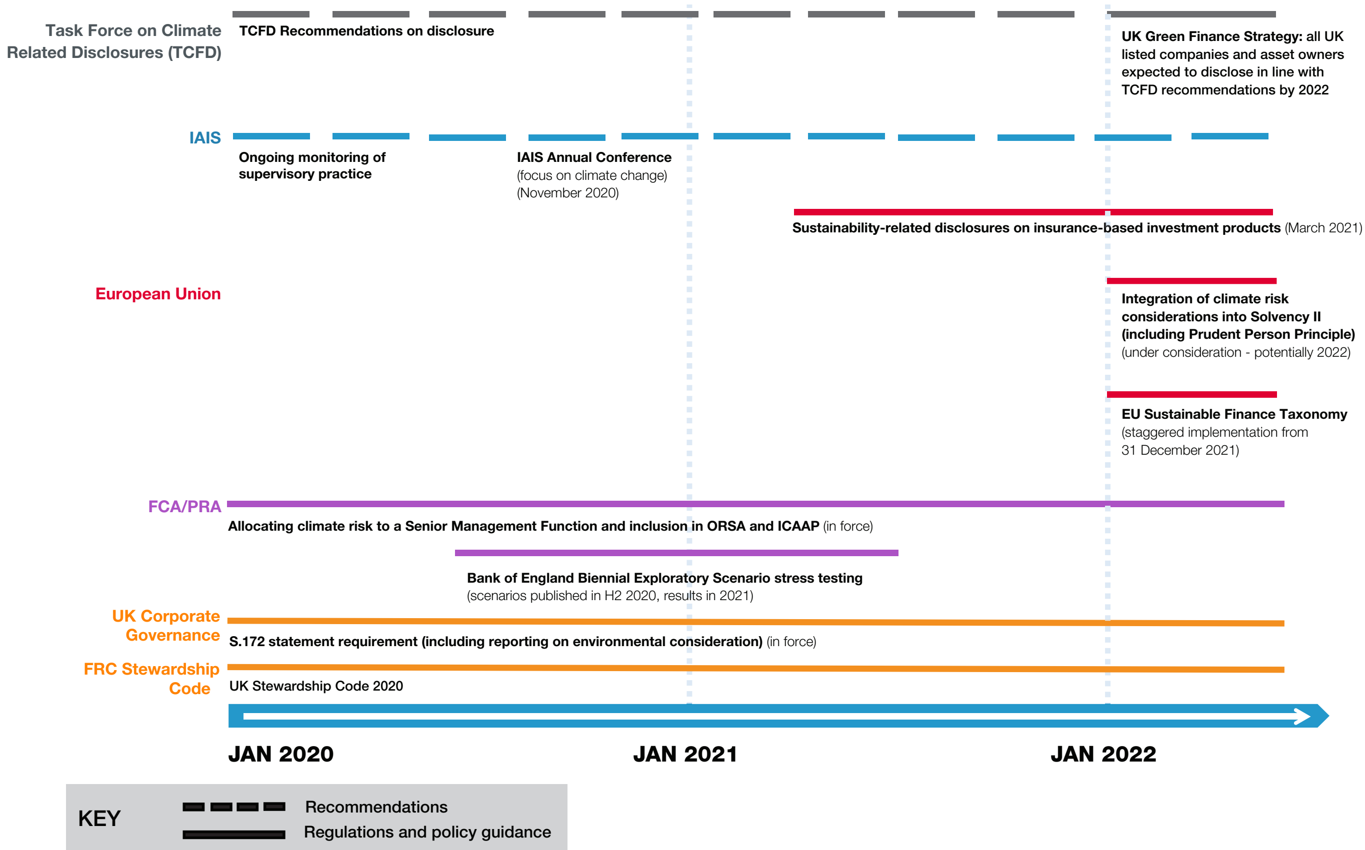
6 See our October 2019 briefing EU Sustainable Finance Action Plan: Status Table.

7 See our November 2019 Briefing Sustainable Finance: the impact for Banks and Investments

Financial Conduct Authority (FCA)[8]

The UK FCA has also set out its climate change priorities in its feedback statement FS19/6 published in October 2019. The FCA intends to publish a consultation paper in early 2020 proposing new disclosure rules aligned with the TCFD Recommendations on a 'comply or explain' basis. Such rules if implemented, would potentially accelerate the UK government's current plan to require certain listed issuers to start disclosing on climate risks from 2022. Given the focus consumers themselves have on sustainability, and the demand for "green" financial products, the FCA has also emphasised that it will take appropriate action to prevent consumers being misled by greenwashing, i.e. companies making unfounded or exaggerated claims regarding the environmental credentials or benefits of their products.

The below timeline provides an overview of the expected timing of various key initiatives coming into effect over the next two years.



Pressure groups

In addition to the legal and regulatory requirements on climate change and policyholders' expectations, various grassroots movements and pressure groups may also influence insurers' approach to climate change. These groups exert significant influence on public opinion and have the media's attention. Recent examples include BlackRock's decision to shift its business model towards green and ESG compliant investments following pressure from various activist groups including *Extinction Rebellion* and a coalition of groups co-operating under the slogan *BlackRock's Big Problem*. BlackRock itself has subsequently joined the pressure group *Climate Action 100+*. Siemens was similarly forced by the group *Fridays for Future*, among other groups, to put in place oversight arrangements in respect of sustainability issues in relation to the planned construction of a major coal mine in Australia.

The table below provides a high level overview of some key pressure groups relevant to (re)insurance firms.

8 See our October 2019 briefing Sustainability Snapshot: UK FCA signals next steps in its strategy on climate change and green finance

Pressure Group	Relevant goals	Actions
ClientEarth	Better disclosure of environmental and climate risks by companies	Reported several insurers to the FCA for failing to adequately disclose climate risks
Climate Action 100+	Ensuring the world's largest greenhouse gas emitters take action on climate change[9]	Pressuring greenhouse gas emitters to put in place better governance and disclosure through influencing their institutional shareholders
Asset Owners Disclosure Project	Engaging with the largest financial investors on responsible investing[10]	Calling out pension funds for lack of disclosure of their responses to climate change
Unfriend Coal	Stopping insurers from underwriting risks in relation to the coal industry[11]	Naming and shaming insurers underwriting coal projects Disrupted the 2018 Rendez-Vous de Septembre in Monte Carlo.
WWF	Protecting World Heritage Sites[12]	Currently producing a guide for insurers on how to prevent or reduce the risk of insuring and investing in companies or projects whose activities could damage World Heritage sites
Extinction Rebellion	Stopping biodiversity loss and reaching net zero greenhouse gas emissions by 2025[13]	Physical disruption and blocking of insurance offices to highlight the role of the insurance sector in the fossil fuel industry

What's next?

With the focus on climate change, insurers should and will be expected to take climate change risks seriously in all aspects of their business, on both sides of the balance sheet. Insurers will need to fully understand the impact of climate change on their business and to respond appropriately. Regulatory developments are likely to also impose the need for further scenario analysis and stress testing, as will additional disclosure and reporting requirements on firms' ESG policies. Whilst in the UK an individual senior manager will need to have responsibility for climate change, the need to focus and take climate change into account should not be ascribed to just one individual or team, but will need to form part of the insurer's culture and risk management framework. In addition, insurers should be aware of the impact pressure groups may have on their activities.

Insurers wield considerable power as some of the world's largest investors and asset managers. Their capacity to create innovative products which respond to climate change issues such as parametric reinsurance and ILS and their expertise in risk modelling make insurers ideally placed to have a significant impact in the fight against climate change. Policymakers, regulators and pressure groups are challenging insurers to embrace this role. The 2020s will be the decade for insurers to step up to this challenge and lead from the front.

9 Source: http://www.climateaction100.org/

10 Source: https://aodproject.net/

11 Source: https://unfriendcoal.com/

12 Source: https://wwf.panda.org/wwf_news/press_releases/?341718/UN-WWF-and-worlds-insurers-to-develop-pioneering-industry-guide-to-protect-World-Heritage-Sites

13 Source: https://rebellion.earth/the-truth/demands/

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