Finance Watch
Making finance serve society

Finance Watch response to the IAIS public consultation on climate risk supervisory guidance – part one

Q1. Do you have any comments on the proposed text referencing climate-related risk within the ICP Introduction?

The inclusion of a reference to climate-related financial risks in the ICP introduction is a welcome development and step towards tackling these risks. There is a potential issue with the way that climate-related risks and emerging risks are referred to in the additions to the introduction, as the proposed text assumes that the ICPs in their current form are already well-designed to address climate-related risks.

The new text could better recognise the need to assess how well the ICPs capture emerging risks. These risks, including climate-related financial risks, may pose new challenges to the existing principles and prudential frameworks. A recognition of the need to assess and adapt the principles where needed would be more appropriate than the suggested assertion that the ICPs in their current design can address all the risks related to insurance and its supervision, including when applied to emerging risks. In particular, the forward-looking non-linear nature of climate related risks, as well as a more fundamental radical uncertainty of climate change, require evolution of supervisory and prudential frameworks.

Q2. Do you have any comments on the location of the proposed text?

The additions to the introduction appear to be located in the most appropriate section, formerly on risk management and that covers risks.

Q3. The IAIS considers that the 2021 Application Paper material related to ICP 7 (Corporate Governance) and ICP 8 (Risk Management and Internal Controls) remain appropriate in the context of climate risk management. Are there any issues related to corporate governance and/or risk management and internal controls from a climate perspective that are not addressed in the 2021 Application Paper that would be helpful for the IAIS to develop?

Much of the 2021 Application Paper material remains an important first step towards addressing climate-related risks. There are certain further upgrades to the ICPs that would ensure these risks are properly addressed in a timely manner. In particular the guidance should provide advice on possible forward-looking precautionary measures to tackle climate-related risks rather than being limited to the generic application of traditional risk management principles, which is likely to be insufficient given the lack of reliable statistical data and universally accepted risk metrics and measurement methodologies to assess climate-related risks.

ICP 7 - Corporate Governance

An addition to the 2021 Application Paper guidance on ICP 7 should be to adjust section 3.5 to explicitly suggest linking variable remuneration with achieving objectives of managing climate-related risks, in particular with respect to alignment with climate targets. Refer to our response to Q5 below with regards to climate targets and transition planning as instruments to manage transition risk. Moreover, we suggest clarifying the expected transparency on remuneration practices with a clear statement in section 7.6.4 that disclosures to the supervisor and the public should describe how variable remuneration is linked with climate targets.

ICP 6 - Risk Management and Internal Controls

There is also room to improve the 2021 Application Paper guidance on ICP 8. Paragraph 38 in section 4.1 focuses heavily on directing insurers towards data collection for climate-related risks. It would be important to include a caveat here that some climate-related risks are unlikely to be fully captured through data collection and analysing historical data. Transition risks could be used as an example here (given that transition has not yet taken place), to then link to the additions we suggest to ICP to explicitly include transition planning under the supervisory remit. Physical risks related to major climate disruptions (so-called “green swan” events) and the risk of a disorderly transition could also be used as examples here. They are unpredictable risks as they are non-linear, but increasing over time. Therefore, an addition should also be made to paragraph 43 to direct insurers towards using forward-looking information to construct methods and metrics to monitor climate-related risks.

It would also be important to expand paragraph 39 of section 4.1 of the 2021 Application Paper to elaborate the potential ways that transition risk and physical climate risks can disrupt business continuity.

Paragraph 44 of section 4.2.1 of the 2021 Application Paper rightly outlines considerations around limiting climate risk through limiting investments in certain industries and incorporating environmental and climate change considerations when evaluating a proposed investment. If this advice is combined with engagement via transition plans and assessments of insurer’s exposure to the industries most impacted by climate change then it could allow a more sophisticated approach to tackling transition risk in particular. Rather than incentivising wide divestment that could lead to certain industries turning to less well-regulated entities than insurers to finance them. This leaves the risk these industries pose unchanged at a macro level in the financial system, whereas insurers can play a role in incentivising their transition through targeted engagement strategies, which should be part of transition plans of insurers.

The ultimate end of the transition pathway may still have to be divestment, but does not have to be if these industries transition or transform. It is important to ensure that transition risk management measures are accompanied by needed adjustments to capital requirements where transition risk for these industries is currently high and underpriced as it is not captured by the existing models (either internal models or by credit ratings).

Q4. Do you have suggestions on issues or themes to explore in the forthcoming consultations to improve the usability of the climate risk related Application Papers?

The 2021 Application Paper and the consultation paper cover a number important areas and suggest useful updates to both the guidance and potentially the ICPs. Further to the points made in response to question 3, particular attention should be given to how ICPs 9 and 16 should be adjusted to explicitly cover transition planning by insurers. Please refer to the response to question 5 for more points on how transition planning should be taken into account.

One important issue is missing from the analysis in the 2021 Application Paper and the consultation paper. Neither paper considers re-assessing ICP 17 and providing guidance on capital requirements. The 2021 Application Paper recognises that climate-related risks are a material source of financial risk and can have an impact on financial stability, however it highlights the difficulty of quantifying climate change and the limited availability of data. In fact it is unlikely that data will ever be sufficient to properly capture some climate-related risks, including transition risk and physical risk. Historical data cannot be used to assess transition risk as no transition has yet taken place and the risk expands while this remains the case.

Here there is a clear opportunity to use climate-related risks as an explicit example in ICP 17.7.5 and 17.7.6 (p.242), as an example of a risk that is difficult to quantify. Climate-related risks should be included in the first sentence of ICP 17.7.5 with the list of less readily quantifiable risks. An explanation could be further included to state that whilst climate risk will most likely manifest themselves via market, liquidity and natural catastrophe risks, the timing and scale of materialisation are unlikely to be measured with any degree of precision. Moreover, the materialisation strongly depends on the mitigation actions taken today, including by the insurers themselves. There is a strong case for taking a precautionary approach to applying capital requirements for climate-related risks and ensure that whilst these risks result as manageable with a one-year solvency view, they could materialise in the medium or longer term in unexpected and unpredictable ways. An addition to the last sentence of ICP 17.7.6 is important in this regard to ensure that insurers not only address material risk in their ORSA, but also through a precautionary approach to capital requirements.

Another key area to look at is how climate-related risks are covered by macroprudential supervision under ICP 24. The scope of data and analysis under 24.1 and 24.2 should be adjusted to ensure that it takes a forward-looking perspective, beyond historical trends and the current risk environment.

Q5. Should the IAIS' work and upcoming consultations on climate risk also cover considerations related to transition planning by insurers?

Given that regulatory requirements for insurers to have transition plans are being discussed in jurisdictions like the EU and that claims of mitigating transition risk through plans are being made by insurers, including them in the IAIS' upcoming work is needed. On top of this many of the world's largest and leading insurers have committed to create and disclose transition plans in the Net Zero Insurance Alliance. This work on transition plans and the commitments in this area from parts of the industry are welcome developments, but would benefit from a consistent global approach to have real value.

There is an key opportunity for insurance supervisors to capitalise on the transition plans that many insurers will compile and disclose. An important part of the exercise is an assessment of an insurer's exposure to sectors and industries impacted by the transition to meet climate targets. Supervisors should monitor this to understand an insurer's levels of transition risk exposure. By monitoring progress made towards achieving the targets set out in insurer's transition targets and implementing their plans, supervisors can assess their ability to manage their transition risks, effective implementation and impactfulness of the declared measures and, if deemed necessary, take appropriate supervisory action.

This can be done through additions to ICP 9 in the annex for 9.5 and 9.6 and in ICP 16. The 2021 Application Paper indicates that climate-related risks should be considered as evolving risks under 9.1.11 and that they would fall under 9.4 as being an area that should move from ad-hoc information requests to more frequently reported on. A structured process around the supervision of transition planning can help to provide a significant part of the information supervisors need. This can combine disclosure of progress made towards achieving transition plans with explanations in the ORSA on the insurers management of transition risk through their own transition plan and through assessment of the plans of at-risk of stranding exposures.

To help clarify these points, the scope of the ICP 9 annex should be extended to cover ICP 9.1 and 9.4, with the inclusion of a new section 'F' on supervision of insurers transition plans to ensure consistency of supervisory approaches on this emerging area of risk and regulation for insurers. This new section should also refer back to ICP 16.10, where additions are also needed to clarify how climate-related risk and transition planning are dealt with in the ORSA. The key aim of the section should clarify that supervisors can assess transition risk by analysing insurers transition plans, linked to the continuity analysis in the ORSA.

Here a first addition to 16.14.1 should be considered to include 'climate change' after 'innovations in the industry'. An addition should also be made to 16.14.6, to add a sentence at the end using climate-related risks as an example. The sentence should explain that certain

Finance Watch
Making finance serve society

risks, such as climate-related risks, require even longer time horizons for continuity analysis. It should explain that time horizons for this analysis can be based on transition planning.

Q6. Do you see anything missing from the current IAIS workplan on climate risk, as outlined in the IAIS 2023-2024 Roadmap?

The IAIS roadmap sets out 5 key events that directly address climate risk, with two consultations, the Global Seminar, the Annual Conference and the GIMAR. This focus on climate risk is important and all opportunities for stakeholder input around consultations in line with the usual IAIS procedures are welcomed. In particular, we support the work to revise certain ICPs in order to incorporate climate-related risk considerations. The IAIS could consider welcoming some external stakeholders to a part of one of its Climate Risk Steering Group meetings to present stakeholder views directly to IAIS members.