

**Finance Watch Response: IAIS Public Consultation on draft supporting material on macroprudential and group supervisory issues and climate risk**

Brussels, 28 October 2024

**General comments on the draft climate risk ICP 24 related supporting material**

Finance Watch welcomes the draft supporting material and the recognition that climate-related risks need additional guidance to be addressed as part of macroprudential supervision under ICP 24. The IAIS has made important progress on this subject in the past years. However, there is a further opportunity to strengthen the supporting material by mentioning the specific risks related to fossil fuel exposures. ICP 24.0.2 already acknowledges the importance of proper attention to outward risk to mitigate possible systemic risks.

Fossil fuel-related assets are well known to be subject to a higher degree of transition and stranding risk, as recognised by EIOPA in this year's Consultation on the Prudential Treatment of Sustainability Risks (see also [our response](#) to the consultation). The higher risk differential of these assets means they also carry a higher risk for systemic destabilisation. Systematic underpricing of these risks would lead to concentrations and in the case of abrupt risk materialisation in the case of a disorderly transition will cause knock-on, contagion or spillover effects.

A key point for the draft supporting material is that it should avoid the use of 'may' or 'could' when providing guidance and rather use 'do', 'will' or 'should'. A first example comes in the second paragraph of the paper, stating that the guidance provided may be implemented in the context of climate-related risk drivers. The draft supporting material needs to be clearer, using 'should' here- otherwise the value of the guidance in supporting more harmonised supervisory application is reduced.

**Comments on climate change and financial stability risks**

The recognition of higher impact of a delayed and divergent transition in the draft supporting material is important, as is the recognition of the need for supervisors to better understand climate-related risks.

The draft supporting material also rightly highlights disruption risk- outlining the situation where climate impacts on the financial system could also trigger reactions with other participants within



the financial system (including insurers) trying to mitigate the impact of the events on their balance sheet. The explicit acknowledgment that climate change is not only a financial risk to individual insurers but also has the potential to disrupt the wider financial system is a significant step.

The recognition in the draft supporting material of the heightened risks associated with a delayed and divergent transition is particularly important. As the transition to a low-carbon economy is delayed, the possibility of a disorderly transition increases, and with it the chance of severe disruption in financial markets. By emphasising this, the IAIS is supporting supervisors in taking timely measures to address these risks. As insurers and other financial participants react to a sudden transition, systemic risks will be amplified, potentially triggering broader macroeconomic effects. The focus on how these reactions may influence both the financial system and the real economy is a key consideration in macroprudential supervision.

In line with the recent work of EIOPA on the prudential treatment of sustainability risks, the supporting advice is right to point out that market pricing of investments is not taking into account climate risk. EIOPA investigated the specific area of fossil fuel exposures and found them to be underpriced from a risk capital perspective. This is an example and a result of the market not pricing in climate risk.

As it has been established that fossil fuel exposures carry a much higher risk differential (transition/ stranding and increasingly reputational), it would be important to see the draft supporting material on ICP 24 dive deeper into the specific risks of high-carbon industries, both for underwriting and assets. Supervisors should also pay special attention to the impact materiality of fossil fuel exposures, as is already embedded in ICP 24.0.2 (outward risks). Systematic underpricing of these risks would lead to concentrations and in the case of abrupt risk materialisation in the case of a disorderly transition will cause knock-on, contagion or spillover effects.

### **Comments on data collection for macroprudential purposes**

Finance Watch welcomes the guidance in the draft supporting material to use scientific physical risk projections for the risk assessment. This allows supervisors to make proper assessments of whether the data coming from insurers is leading to realistic conclusions on the impact of climate risks.

Given the current issues with climate risk data outlined in the supporting material, there is a need for advice on precautionary macroprudential measures to address systemic build-ups of climate risk.



As the supporting material rightly states, timely and high-quality data are essential to systemic risk assessment. Climate-related risks are inherently forward-looking, non-linear and radically uncertain. As the transition to a low-carbon economy has not yet occurred, the risks associated with that transition are not represented in the data, which is recognised by the supporting material.

To address this, the focus must shift as well to forward-looking data. As recognised by EIOPA in their Consultation on the Prudential Treatment of Sustainability Risks, forward-looking data is essential to any analysis aimed mitigating climate-related risks. (see also [our response](#) to the consultation). However, Finance Watch recognises that forward-looking methodologies hinge on certain assumptions and models, particularly models used in the analysis of different transition scenarios, which greatly impacts the results. We have previously discussed modelling limitations in current scenario analysis in our report '[Finance in a hot house world](#)'.

### **Comments on risk dashboard for monitoring climate-related vulnerabilities**

Finance Watch welcomes the proposal for climate-specific risk dashboards. This could also become a key activity of the IAIS at a global level.

Annex 1 outlines key indicators that could be used as part of the dashboard. These indicators must take into account key differences with the impact of climate change for physical risks in particular, such as accelerations when climate tipping points are breached and that the expectations for AAL and PML are likely to fall short in these cases. Annex 1 does, however, capture the key indicators for transition risks for assets and underwriting. In particular the portfolio alignment to the Paris Agreement, exposure to high-carbon industries and the analysis on different transition scenarios are essential. The suggestion to use exposure-based proxies could also be a useful avenue to explore. However, given the lack of commonly recognised/harmonised methodologies on measuring portfolio alignment (transition risk), additional guidance on transparency on the underlying methodologies and approaches for the disclosed metrics would be important.

We refer to [our response](#) to the BCBS consultation on climate-related risk disclosures.

### **Comments on data analysis for macroprudential purposes**

It is important for the IAIS to provide more guidance here in the supporting material, to address how climate-related risks can be captured under ICP 24.2. The IAIS should also consider building



on the important work of integrating climate-related data into the GME and conduct insurance-sector wide climate risk scenario analysis.

Additionally, explicitly referring to the role of climate scenario analysis with a forward looking perspective in view of ICP 24.2.7 would be important. Caution should be taken, however, to ensure that scenario analyses can support sector wide analysis.. As a key starting point the assessments of the economic consequences of climate change in the scenarios needs to be realistic. Scenarios must take account of the following points to achieve this:

- Ensure realistic scenarios are used
- Ensure that economic models account for the specificities of climate change, including its magnitude and irreversibility
- Ensure that the conclusions of economic models are compatible with the conclusions of climate science, including by rejecting the use of quadratic-only damage functions in loss assessments
- Conduct unbiased and rigorous analyses of the results
- Conduct sanity checks between the results of CSA and climate science

This section of the supporting material rightly points to the need to assess second-round effects, but should be clearer in requiring this as a key part of the analysis supervisors undertake. Given that consideration of second-round effects currently remains beyond reach of climate scenario exercises, the paper should be clear to recognise the limitations of climate scenario exercises and their implications in terms of the need for precautionary action. More work should also be done on outlining how supervisors can identify emerging threats to financial stability arising from climate-related risk drivers.

### **Comments on supervisory response**

The points raised in this section to confirm the application of ICP 24.4 in the case of climate-related risks from a macroprudential perspective are useful. More guidance on how supervisors should coordinate across jurisdictions to tackle vulnerabilities for the sector as a whole or originating from other jurisdictions is needed. This should cover in particular coordination over the application of microprudential instruments with a macroprudential perspective. ICP 25 provides options to structure the coordination between supervisors from different jurisdictions, such as supervisory colleges.

Addressing climate-related systemic risk by means of utilising the microprudential instruments under ICP 24 might raise a tension between the microprudential approach, which is primarily concerned with the safety and soundness of individual undertakings, and the macroprudential



dimension of climate risk. Given the primary objective of macroprudential intervention is to prevent the build-up of systemic risk that emerges when individual undertaking's actions contribute to the system-wide risk (which cannot be captured from the microprudential perspective), it is important to elaborate on the need to consider this systemic dimension when applying available microprudential instruments. Furthermore, design of dedicated macroprudential instruments is warranted. For example, in the EU, the European Systemic Risk Board [had elaborated](#) on the need for dedicated macroprudential tools for the insurance industry, which are particularly relevant in case of climate-related risk.

### **General comments on the draft climate risk ICP 25 related supporting material**

The considerations on the application of ICP 25 in context of the macroprudential dimension of climate risk is important, but should not be limited to the IAIGs and ComFrame standards.

As outlined in the response to question 6, there could be a need for more guidance on structured coordination of supervisors from different jurisdictions, such as supervisory colleges.

### **Comments on group considerations for data collection**

As highlighted in this section, particular attention should be drawn to cases where group-wide climate risk integration into the corporate governance framework, enterprise risk management and financial position may not be properly covering what is required of an individual insurance legal entity in a specific jurisdiction. The draft supporting material should provide more guidance on how this can be addressed.

In general the confirmation that climate-related risks should be a key area that is considered by group-wide supervisors, involved supervisors and in their cooperation through supervisory colleges is important.

