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Finance Watch Response: IAIS Public Consultation on draft Application Paper on public disclosure and supervisory reporting of climate risk

Brussels, 28 October 2024

General comments - draft Application Paper on public disclosure and supervisory reporting of climate risk

Finance Watch welcomes the draft Application Paper and the ongoing work of the IAIS to progress on capturing climate risk. There is a risk of inconsistencies when assessing materiality of climate risk in disclosures, which might result in disclosures being not comparable. The IAIS should consider whether further materiality assessment guidance is needed here.

The link between climate disclosures and financial statements is welcome, but the time horizon of financial statements is usually much shorter, meaning they have a limited ability to reflect climate risk considerations.

However, the draft Application Paper should explicitly highlight that transition plans are an important source of data and information on climate-related risks for the insurance sector. The draft Application Paper should refer to their role in relation to ICPs 9 and 20. In particular it should also look further into transition risk as 'deviation risk'- the risk that deviating from a Paris-aligned trajectory creates a higher level of financial risk.

Caution should be taken over the use and presentation of results of scenario analyses (CSA), as these remain subject to significant model limitations. Alternative approaches to scenario analyses can be used to make information from climate scenario analysis realistic and decision-useful. As a key starting point the assessments of the economic consequences of climate change in the scenarios needs to be realistic. The most notable improvements, which are needed, include:

- 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

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We refer to the Finance Watch report "Finance in the Hot House world" and our response to the IAIS consultation on climate scenario analysis for more detail.

Comments on section 1.2 Scope and paper structure

The draft Application Paper should also cover ICP 9.2 and ensure that supervisory plans make explicit provisions to take into account climate risk. This is particularly important given the reference in ICP 9.2.3 to the variety of inputs referred to that could be used to help develop supervisory plans. In particular reference to transition plans could be made here, along with climate scenario testing.

Comments on section 1.4 Proportionality

The proportionality principle should be strictly based on the risk profile and complexity of the undertaking. The cost of disclosure cannot be a reason to waive reporting a material risk.

Comments on section 2.1 Climate-related risk financial disclosures: materiality and relevance

Please refer to our comment in the response to question 1. Due to uncertainties and lack of commonly recognised or harmonised methodologies for assessing climate-related risks, application of the materiality principle to disclosures might impact reliability and comparability of disclosures. The IAIS should therefore consider additional guidance on materiality assessment.

The draft AP rightly recognises climate change as a source of financial risk and the increasing likelihood of a delayed and divergent transition. There should, however, be an explicit mention of the fact that insurers' underwriting and investments have an impact on climate change itself. These investments should be disclosed, for example through disclosure regimes linked to transition planning.

Comments on section 2.2 Link to international standards

When considering the work of international standards, it is important for the IAIS to consider what is most relevant for insurers to disclose to ensure that there is a view on their risk profile. Cross-sector standards may not cover information that is relevant for insurers to disclose or may not provide sufficiently granular detail on how to disclose if the rules are principle-based in line with the considerations in Box 1. It is therefore important to require the disclosure of insurance-specific information and for supervisors to consider common guidance around the use of transition plans for example.

Comments on section 2.3 Fundamental principles of a climate-related risk disclosure framework

This section rightly looks at how medium and long term horizons can be captured. Whilst forward looking disclosure is extremely important, caution is needed around forward-looking methodologies. These methodologies are an important way to assess climate risks, but over-reliance on historical data and calibrations, unadapted economic models of climate change damages to make forecasts should be stressed. A focus can rather be put on transition planning and expanding time horizons for scenarios to go up until 2050 and linking to the objectives of the Paris Agreement. The key here will also be to revisit and review methodologies regularly.

The draft AP has a concerning view on the application of the proportionality principle. It seems to suggest that the disclosure cost could overrule the key foundation of the proportionality principle that proportionality is applied where the risks are proportionately lower- due to the size, scale and complexity of insurers. The draft AP suggests that this principle could now be overridden even where disclosure is effective, because costs are perceived to be too high. Costs in this case could also be measured against net profits and dividend payments to give context. The starting point should not be to assume that climate-related disclosures will be less effective due to the cost of compliance, it should be to ensure that they are effective in providing material risk information.

Comments on section 2.4 Recommendations

Please refer to our comment on section 2.1 on the application of materiality principle to disclosures.

The recommendations would benefit from the explicit mention of transition plans and their key role as part of a climate-related risk disclosure framework.

General comments on section 3 Public disclosure of decision useful climate information

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This section would again benefit from a reference to transition plans as a key way to fulfil climate-related disclosure requirements under ICP 20.

Comments on section 3.1 Climate information

An important point to recognise in this section is that it will not be sufficient to integrate climate-related risks into disclosures for existing categories. In many cases, for the reasons outlined in paragraph 25 specific disclosures will be needed to capture these risks and ensure that the information is decision-useful.

This section should also cover guidance on climate-related risk to ICP 20.9. Ensuring that a transition risk perspective is brought into considerations under 20.9.1 and 20.9.4 relating to both climate-related risk materialising on both the asset and liabilities sides would be important.

Box 4 outlines key indicators, but 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. Box 4 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. However, given the lack of commonly recognised or harmonised methodologies for measuring portfolio alignment (transition risk), disclosures would benefit from additional guidance on and transparency over the underlying methodologies and approaches for the disclosed metrics.

We refer to our response to the BCBS consultation on climate-related risk disclosures.

Comments on section 3.2 Disclosure of scenario analysis results

There is an apparent contradiction between the recognition in the paper that "Scenario analysis exercises are not intended to present a definitive assessment of the extent to which climate will be a driver for risks faced by insurers", and guidance on disclosure of the results of scenario analyses "where a scenario analysis is conducted and the conclusions from the exercise are material". Given that climate scenario analyses remain exploratory exercises subject to significant limitations, the materiality of their outcomes cannot be treated as an indicator of the materiality of climate risk to an insurance undertaking (including for the purposes of disclosure). Doing so will lead to the underestimation of risks and omissions of material information in disclosures.

The indicators suggested climate scenario-conditional projects should take into account key shortcomings of using past data. Indicators such as credit ratings and historic NatCat losses are two key examples that are included in the draft AP. More clarity needed over how the other indicators could be rendered decision-useful. This clarity would help to ensure further harmonisation of the scenarios used and by extension comparability of results.

Comply or explain clauses often receive complaints from the industry that they are de facto obligatory requirements. It would be better in this context and given the importance of these disclosures to provide more clarity that these are direct requirements. Where insurers use scenario analysis, the methodology, parameters and limitations should be very clear and publicly disclosed.

Comments on section 3.3 Key criteria to improve the decision usefulness of indicators

The key criteria outlined in the draft AP are consistent with ICP 14 and important to ensure the decision-usefulness of indicators. Caution is, however, to be taken on the forward looking perspective. It is important and right to include this perspective, but the results of the methodologies used must be checked for consistency against climate science and to include the impact of passing climate tipping points for example. These methodologies will also need to be regularly revisited and reviewed.

Please also refer to our response to question 10 on the application of the principle of proportionality and the cost-benefit analysis. A starting point should not be to assume that climate-related disclosures will be less effective due to the cost of compliance, it should be to ensure that they are effective in providing material risk information.

Comments on section 3.4 Climate adaptation

Climate adaptation measures are important, but should also be put into the context of their actual impact on reducing a risk to be relevant for disclosures. If insurers simply disclose that they have taken an action this would not be decision–useful information, as it needs to be put in the context of the impact it has had.

Comments on section 3.5 Recommendations

The recommendations cover key points for insurance supervisors and insurers to improve climate-related disclosures. In particular, the recommendation for supervisors to "encourage

development and adoption of standardised indicators and disclosure formats for climate-related risk" is welcome. However, this should not only happen at the jurisdictional level, but through a coordinating role of the IAIS that would promote credible and globally compatible/interoperable climate-risk disclosures.
A key missing element remains a reference to transition plans, which are a legislative requirement in certain jurisdictions like the EU and should be a key part of effective climate-related disclosures under the ICPs.

General comments on section 4 Considerations for supervisory reporting of climate-related risks

The draft AP should explicitly highlight that transition plans are an important source of data and information on climate-related risks for the insurance sector. The draft AP should also cover ICP 9.2 and ensure that supervisory plans make explicit provisions to take into account climate risk, as mentioned in the response to question 4.

Comments on section 4.1 Understanding different climate-related risks

The focus of this section on impact on policyholders and conduct risk is welcome, in particular on loss trends. This is crucial information to inform considerations on the NatCat protection gap in particular.

Again there is a missing reference to transition plans in the prudential bullet point section, as already outlined in the response.

Comments on section 4.3 Supervisor-level data issues

This section should look at the preventative role that supervisors have under ICP 9, not just the corrective role when it comes to data issues. The key example would be in relation to historical data being considerably less reliable, as outlined in table 3. Rather than only ensuring that uncertainties and gaps are communicated by insurers, supervisors should work on developing common approaches to assessing and measuring climate-related financial risks. Finance Watch's policy brief published on 17 October proposes a possible concept to assess climate-related transition risk as a "risk of deviation" from the Paris-compatible transition path. This concept should be further developed and elaborated on to design common risk assessment methodologies.

Supervisors should also look at taking a precautionary approach to high-stranding risk sectors for example. There are cases, as outlined in the latest work by EIOPA on the prudential treatment of sustainability, where high carbon industry risks are currently underpriced.

Comments on section 4.6 Recommendations

As outlined in the responses to questions 21 and 19 the recommendations should cover the use of transition plans, the development of harmonised methodologies for climate risk assessments and a precautionary approach by supervisors faced with data issues in particular.

Finance Watch supports explicit integration of climate-related risks into insurers' ORSAs.

The recommendations to undertake gap analysis, ensure agile and adaptable frameworks and supervisory training are key to keep pace with climate-related risk developments.

Comments on section 5.1 Setting regulatory governance expectations and exploring governance structures

In this section and in the recommendations the draft AP should also refer to remuneration of the board and senior management. It should recommend that insurers disclose whether or not their remuneration is linked to ensure the integration of climate-related risks and the achievement of climate targets, commitment or policies set by the insurer.

General comments on section 6 Data issues and limitations in climate-related risk disclosures

Whilst this section outlines key data issues and limitations in climate-related risk disclosures, it focuses heavily on providing grounds for supervisors to accept limited disclosures from insurers without providing precautionary measures for supervisors to implement until data issues are resolved. It is crucial to make the link with precautionary action where minimum thresholds of potential risk are met and data uncertainty are present. Please also refer to the response to question 21.

Comments on section 6.2 Insurer-level data issues

Where data from counterparties and public sources is not available or has shortcomings, the guidance institutions should require insurers to assess these gaps and their potential impacts. The draft AP should require insurers to take and document remediating actions in these cases, including using estimates or proxies as an intermediate step, and seeking to reduce their use over time as data availability and quality improve.

Comments on section 6.4 Possible actions from supervisors to address data issues

Finance Watch strongly supports the recommendation to standardise scenarios and timeframes of climate-related risk analysis, which will provide certainty for insurers when analysing these risks and also contribute to credibility and comparability of disclosures across jurisdictions.

Comments on section 6.7 Recommendations

The recommendations in this section should include a reference to transition plans as an important source of data and information on climate-related risks. Supervisors should develop harmonised methodologies for climate risk assessments and provide guidance on climate scenarios to be used. They should also outline how supervisors can implement a precautionary approach where data issues are present.

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