ICAEW KNOW-HOW
FINANCIAL SERVICES FACULTY
INSURANCE

INSURANCE ROUNDTABLE – CLIMATE CHANGE RELATED FINANCIAL RISKS AND NATURAL CAPITAL

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INTRODUCTION

ICAEW gathered representatives of the insurance industry and independent experts to explore how the sector understands its relationship with nature. We wanted to hear how the language of 'capitals' resonated with insurers. We focused on climate change related financial risks as a starting point due to the prominence they have in financial services regulation.

Despite the regulatory attention the insurance sector gets a very low score (in the TCFD Status report in June 2019) for disclosing information on their management of climate change related financial risks. However, participants at the roundtable insisted that this does not mean that insurers are ignoring these risks. They are working to understand, manage and mitigate what they can. There is a reluctance to disclose until they have a complete story to tell. The lack of understanding of insurance outside the sector means disclosing now may not be helpful. (This is also a theme we have heard within the Natural Capital Coalition of business more broadly).

INHERENT DIFFICULTIES

Life and non-life (general) insurance have very different factors to consider.

It seems easy to accept that general insurance would have very little incentive to build climate change related financial risks into their models. These risks will take time to crystallise and general insurance contracts renew, re-price every year and are backed by reinsurance.

This means they lack the incentive to consider the long-term vision. But all general insurers accept that pricing out (making insurance unaffordable) is not a solution.

Life insurance does focus on the long term, but businesses still make money from taking risk; so insurers can't discard all risks. They look to model and understand them thoroughly and buy reinsurance. However, as uncertainty is growing new means of mitigation and adaptation will need to be created. Insurers can argue that these are public goods and benefits; not for them to pay for. This felt like a paradox at the centre of the conversation.

Passing the risks onto reinsurers is not the answer.

If reinsurers are not adequately covered and suffer huge losses everyone will suffer with them, leading to more and more risks becoming uninsurable. It could be argued that the insurance industry, unlike banking, does not have the benefit of an implicit guarantee. Even where wider societal intervention has occurred (ie Flood Re) it is industry funded, rather than a state bail out.

Insurers have the technical expertise to model risks, including climate change related ones. However, full understanding of the nature and scale of the action to be taken to mitigate the risks and achieve the 1.5C world takes time and effort. The view now is that if the 4C world was properly modelled the truth would be unpalatable and insurers would probably go bust. The risk would be so vast that just the regulatory capital needed to held against it would wipe out the business.

Ignoring the subject, however, is not a solution. Public sentiment is changing fast, any business that does not consider the climate related financial risks and deemed not do their best to mitigate them could suffer huge financial losses as well as reputational damage.

REGULATION

The answer could lie in regulation. While regulation is a helpful tool, it will, in itself not solve the problem; it is only a 'top-down' mechanism for change. Companies, regulators and the public (policyholders) need to co-operate and find the tools that will help insurers come up with solutions. Regulators can and need to look to the "best in class" and base requirements on pragmatic real solutions. The best in class are normally the reinsurers who cannot pass the risks onto anyone else, so have a true business incentive to price accurately and profitably. They could do worse than look to natural capital solutions as the 'bottom-up' case for action.

The publication of the TCFD recommendations have been a real game changer in this space. They give a strong indication of the direction regulation is heading to, allow and encourage voluntary action. They also help to experiment and investigate how best practice could be established in driving the change not only in disclosure but decision-making too. This way when regulation finally acts as a catalyst it will not be in a vacuum. The best in class would already be ahead of the rest and will have potential plans for action.

EXPERIENCE TO DATE

Based on the frank discussion we have had with experts, our conclusion is that insurers need a safe space where they can collectively assess the risks and make others understand them before disclosing what their individual businesses face and how they plan to mitigate them. This is more difficult than it sounds as understanding and pricing risks is literally insurers' intellectual property, they can't "just share".

Property is a simple and understandable way to illustrate the issues. Insurance companies (especially life ones) are looking for long-term investments to match their assets and liabilities (claims/pensions payable in the future). Investing in housing to rent is an obvious investment proposition as rents receivable will cover (give or take) the liabilities crystallising in the future.

However, property is particularly vulnerable to climate related risks. The physical risks (flooding, excessive rainfall, inadequate air conditioning provisions for prolonged heat waves) are trumped by the transition risks. Due to government and regulatory (both national and international) directives, the conditions of doing business could change very quickly (e.g. emission restrictions, standard changes around building and renting) – adjustment and adaption could be incredibly expensive. These risks could crystallise very quickly and, unlike physical risks, will not take until the middle of this century.

If an insurer decides that they would do the responsible thing, for example building flood defences, other companies will benefit, notwithstanding their own lack of investment. This underlines how a collective approach is very important for credible action.

AFTER CLIMATE CHANGE

These concerns are valid for other sectors as well as beyond climate change. Eventually we need to value the services nature provides us with. The questions there are even harder. How do you make businesses value benefits that are not even private but public? For example water and biodiversity? Markets tend to value goods (although usually under-price) like timber but undervalue benefits (like flood prevention). Dependencies on natural capital instead of public property available for all would be a more comprehensible proposition for businesses to consider and translate into risks and opportunities. The Natural Capital Protocol can provide a framework for this.

COLLECTIVE ACTION

We need insurers to educate the public about how insurance will become unaffordable or impossible without proper understanding and pricing of these risks. The most vulnerable would be the first to become uninsurable, with consequences for society as a whole. Climate risks are not

"only" 1 in 200 years (the horizon and worst-case scenario insurers understand and prepare for) but are here, but with a lot of unknowns.

Insurers need to be part of the public conversation and point out the risks – using the property example again: what happens after Flood Re runs out in 2039? What do they need to be able to insure our lives and property?

Governments need to co-ordinate between the markets and the public. Regulation can be the catalyst and push businesses, but there needs to be at least an understanding, if not acceptance of why the changes are necessary. For example no one wants extra premium taxes but if we know and can be certain that they will go towards insurers' long-term resilience and our long-term protection there might be more tolerance. Stricter and more expensive building and planning regulations could serve the same purpose.

Government can also provide insurers with long-term investments. Green bonds issued to build the right infrastructure will help provide not only the funds for it but the crucial match for the long-term liabilities – our future claims and pensions. They can also help find nature-based solutions and eventually translate natural capital into visible source of benefits that requires appropriate valuation.

The government can also ensure that all the necessary agents are involved in the collective action. Going back to property the construction industry and their standards are crucial. We need more granular data on everything. Regulation and its fine tuning must be based on the best available solution from the best in class before it becomes best practice. We also need policies that reward the right stewardship and at the same time allow to find the business incentive that will make not only insurers, but others do "the right thing".

ICAEW'S ROLE

ICAEW is here to help insurers find the vital platform and the safe, non-compete space to share what they are willing to share about their own experience. We are ready to help regulators understand what businesses are doing and can do to work towards collectively mitigating the climate change related financial risk and value nature as it must be valued. Insurers have knowledge and experience to bring to policymaking and we do need to listen.

ICAEW can also play an educational role. Helping both the public and regulators understand how insurance works and what risks must be considered will contribute to credible action. Partnering with other projects (e.g. We value Nature) will assist insurers in finding the right tools they need to value nature in their decision making.

Understanding 'dependencies' goes some way to addressing the issue of public goods and benefits. Businesses that recognise the specific dependency pathways for their businesses have begun to recognise that they can't just see those public goods as someone else's problem.

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