

PRI RESPONSE

DRAFT APPLICATION PAPER ON CLIMATE RISK SCENARIO ANALYSIS IN THE INSURANCE SECTOR

February 2024

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To inform this briefing, the following investor group has been consulted: PRI Global Policy Reference Group. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.

PRI Association

Registered office: 25 Camperdown Street
London, UK, E1 8DZ Company no. 7207947
T: +44 (0) 20 3714 3220 W: www.unpri.org E: info@unpri.org



United Nations
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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the IAIS call for feedback on draft application paper on climate scenario analysis in the insurance sector.

ABOUT THIS CONSULTATION

The IAIS is seeking comments on the [draft application paper on climate scenario analysis in the insurance sector](#). The paper focuses on the use of climate-related scenario analysis as a tool used by both supervisors and insurers to understand the risks to which the insurance sector is exposed at a micro- and macroprudential level. The paper considers why and how climate-related scenario analysis exercises should be used and the extent to which they can overcome some of the shortcomings of existing methods for assessing risks.

For more information, contact:

Margarita Pirovska
Director of Global Policy

margarita.pivovska@unpri.org

Daniel Gallagher
Head, Climate Technical Guidance

daniel.gallagher@unpri.org

KEY RECOMMENDATIONS

The PRI welcomes efforts by the International Association of Insurance Supervisors (IAIS) to develop guidance on the use of climate-related scenario analysis in the insurance sector, focusing on how scenario analysis may be used by both supervisors and insurers to understand the risks to which the insurance sector is exposed at a micro- and macroprudential level.

The PRI's key recommendations are set out below:

- Supervisors should work to develop a comprehensive global understanding of the systemic impact of climate change on the insurance industry as a whole.
- In addition to promoting transparency of scenario analysis exercises, it is important to clarify a number of conceptual issues in addition to quantitative assumptions and data sources. To ensure wide public and industry appreciation of the meaning and value of climate-related scenarios, supervisors should ensure that these issues are clearly communicated and understood.
- Insurers should be encouraged to explore harmonizing the risk analysis approaches used in the context of underwriting with those used for investment.
- Risk analysis should integrate physical risk, tipping points, and second-order effects.
- Insurers should engage with investee companies to understand the steps they are taking to reduce their exposure to climate risk, and insurers should use proxy voting and sector collaboration to positively shape investees' transition to more sustainable business practices.
- Insurers should assign specific board committees responsibility for the oversight of climate change issues.

DETAILED RESPONSE

QUESTION 9. COMMENTS ON SECTION 4.1 ASSESSING SYSTEMIC IMPORTANCE (ICP 24.3)

The PRI welcomes and supports the recommendation for supervisors to analyse climate-related factors as systemic risks and to coordinate with other supervisors across jurisdictions and with regional or global insurance standard setters. Although the first approaches to climate risk in the insurance sector focused on potential impacts on single-location assets such as real estate or infrastructure, it is increasingly clear that climate impacts are occurring in every industry across the economy. Rising temperatures are altering weather patterns, water availability, and biodiversity across regional and national boundaries and in ways that affect the entire context of economic activity. For example, in recent years, low water levels in many rivers around the globe have led to increases in the cost of transport and decreases in hydropower production. While the specific impact of each of these phenomena on any particular insurer's business will be challenging to evaluate, **it is essential that supervisors work to develop a comprehensive global understanding of the systemic impact of climate change on the insurance industry as a whole.**

QUESTION 11. COMMENTS ON SECTION 4.3 TRANSPARENCY (ICP 24.5)

The PRI supports the emphasis on the importance of transparency regarding climate scenario models. We recommend that, in addition to promoting transparency around quantitative assumptions and data sources, it is important to clarify three key conceptual issues. One, whether a given scenario incorporates transition risk, physical risk, or both; two, the probability levels assigned to model outcomes; and three, the extent to which a scenario extrapolates from current conditions, and assumes dramatic future changes such as new technology development, or begins from a desired temperature outcome and works backward to model a required trajectory. Currently, a wide range of scenarios is in use that differ in these respects and whose outcomes are therefore not directly comparable. To ensure wide public and industry appreciation of the meaning and value of scenarios, supervisors must ensure that these issues are communicated and understood.

QUESTION 14. COMMENTS ON SECTION 5.2 INVESTMENT POLICIES (ICP 16.6)

The PRI strongly agrees that investment policies must incorporate an awareness of climate risk. We support the recommendations that **insurers engage with investee companies to understand the steps they are taking to reduce their exposure to climate risk, and that insurers should use proxy voting and sector collaboration to positively shape investees' transition to more sustainable business practices.** Across the financial sector, asset owners and asset managers of all sizes and types are taking these steps in an effort to protect both their own portfolios and their ability to continue to invest profitably in perpetuity. There is a widespread understanding that because

the systemic nature of climate risk makes it impossible to insulate a portfolio from climate risk over the long term, engagement aimed at managing risks in the real economy is the best way to protect investor interests.

QUESTION 19. COMMENTS ON SECTION 5.7 BOARD ACCOUNTABILITY (ICP 16.11)

The PRI welcomes and supports the recommendations that boards explicitly consider how climate-related scenario analysis is integrated into existing governance frameworks. We particularly agree with the recommendations that boards should explore management actions to be taken in adverse scenarios, that boards should dedicate time to discussing the results of scenario analysis and their implications for strategy, and that board subcommittees may be particularly useful for discussion of detailed findings. At many asset managers and asset owners around the world, it has been found useful to **assign specific board committees responsibility for the oversight of climate change issues**. Periodic examination of climate scenario results may be a useful tool for the implementation of such oversight.

QUESTION 21. ARE THE DIFFERENT DIMENSIONS OF CLIMATE RISK FOR INSURERS NAMELY (I) TRANSITION (II) PHYSICAL AND (III) CLIMATE-RELATED LITIGATION RISKS EFFECTIVELY COVERED IN THE APPLICATION PAPER TO BOTH SIDES OF INSURER BALANCE SHEETS?

The PRI welcomes the discussions of transition, physical, and litigation risks. We would suggest that the following be considered when supervisors undertake to address these risks, evaluate their relative importance, and understand the interactions among them from the perspective of both sides of insurer balance sheets.

While the type of risk analysis done in the context of underwriting has traditionally been quite different from that used for investment, addressing the climate crisis may necessitate a greater harmonization of approach. Risk analysis for underwriting has often focused in significant part on the worst possible outcomes an insurer might experience, in order to assess maximum possible claims. Investment planning, meanwhile, has been more likely to take an approach that projects an expected outcome as a weighted average, in which the high impact of a worst-case outcome can appear muted by its low probability. In some cases, this may produce a disjunction between an underwriting team's increasingly dire projections of climate change's catastrophic impacts and an investment manager's relative sanguinity about the topic.

To bring the two sides into better alignment, insurers may wish to request that investment managers focus on assessing downside risk specifically, rather than variation in general. This could be done using a variety of methods that focus on the risk of loss, rather than simply standard deviation of returns. Investment staff should also be encouraged to explore narrative scenarios (like those created by [Business for Social Responsibility](#) on the basis of the quantitative ones developed by the Network for Greening the Financial System). These types of scenarios can help investment professionals to

consider climate risk as an investment theme that will alter the entire context of their activity, both through direct impacts and through second and third-order effects such as supply chain disruptions and geopolitical conflict. Seen in this way, the scope of the climate crisis as a financial issue may become more apparent than it does in scenarios that focus solely on transition risk. (The latter may in some cases project relatively minor impacts to portfolios, as expected losses in some sectors are nearly offset by gains in others.) Finally, in some cases, it may be possible for insurers to share the catastrophe models developed by their underwriting teams directly with the investment professionals responsible for their portfolios. Expanding the intellectual tool kit of investment managers in these ways may serve to better align the conceptual approaches being taken by the two sides of insurers' businesses and may thus better protect their long-term prosperity.

Modelling to date has emphasized transition risk, particularly in the short term; but physical risk, tipping points, and second-order effects are increasingly being recognized as central to adequate scenario planning. In summer of 2023, the University of Exeter and the Faculty of Actuaries released a report entitled [The Emperor's New Climate Scenarios](#), which argues that the severity of climate risk has been underestimated because of inadequate attention to potential tipping points and second-order effects. At COP 28, the [Global Tipping Points](#) report released by Exeter's Global Systems Institute provided more detail on some of these issues, including evidence that five of eight key tipping points are already at risk of being breached. The Intergovernmental Panel on Climate Change, moreover, has noted that the physical changes our planet is already experiencing as a result of climate change may be approaching the [limit](#) of humanity's ability to adapt to them. Given this reality, it is no longer prudent for scenarios to assume that physical risk will become significant only in the medium to long term, or that it will grow in a linear fashion. Rather, modelers and users of scenario analysis must grapple with the fact that extreme negative effects could appear quite suddenly and have an impact in the short term.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of IAIS further to enhance the regulatory framework for insurers to address sustainability related risks and opportunities at the global level.

Please send any questions or comments to policy@unpri.org.

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