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IT'S TIME

For insurers to embrace climate risk disclosure

This spring, the climate regulatory landscape changed dramatically for any insurer, domestic or foreign, that is subject to US regulation. On the same day — March 21st — the Securities and Exchange Commission (SEC) and the National Association of Insurance Commissioners (NAIC) both published new proposals with far reaching consequences for how insurers will need to assess, manage, and disclose climate-related risks. But while this double dose of climate regulation may feel like an unwelcome burden for many insurers, it is also an opportunity to develop the toolkit they will need to profitably navigate the transition to a low-carbon, climate resilient future.

TASKFORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

A common standard

Time is short. The NAIC's climate reporting standard means 80 percent of the US insurance market needs to provide reports aligned with the guidance of the Taskforce on Climate-Related Financial Disclosures (TCFD) by November 2022. The SEC's proposal, as outlined, would require SEC registrants to disclose climate risks and details of how these are managed, alongside details of their greenhouse gas (GHG) emissions from 2024 (for fiscal year 2023).

The TCFD has become the de facto global standard for climate risk disclosure so it is welcome that both the NAIC and SEC used it as the basis for their proposals. TCFD provides guidance on how companies should disclose climate-related risks and opportunities, how these are incorporated into risk management, risk governance and strategy, and the metrics and targets used. This common basis mean insurers can realize significant synergies between NAIC and SEC compliance and provides a head start for those which have already begun to make TCFD disclosures. But even for the early adopters, these requirements represent a step change in effort, not least because a regulatory requirement demands a particular standard of rigour. So whether an insurer is at the beginning of their journey or some way down the TCFD road, there is still a lot to do.

These climate requirements represent a step change for insurers — but also, a commercial opportunity

FULL SPECTRUM RISK

The foundation for any TCFD disclosure is a climate risk assessment and this needs to capture the wide range of climate risks insurers face. To understand why, let's consider underwriting (accepting that significant climate risks exist in the investment portfolio as well). Beginning with transition risks, some lines of business may see changes in claims patterns as government policy and regulation relating to carbon emissions evolve. For example, new green building regulations might increase reinstatement costs for property insurance, or a higher carbon price might increase default risk for credit insurance in high carbon sectors. Furthermore, the profitability of some books may shift as the transition unfolds and incumbent technologies are displaced by new technologies with poorly understood risks or less attractive claims performance. Within sectors, the relative profitability of different clients will vary depending on the different transition strategies they take.

Physical risks are already crystallizing for wildfire and flood and will worsen as climate change continues. Insurers need to understand how these risks are likely to evolve under different climate change scenarios to identify where they have risks that may become unattractive, or even uninsurable, in the future. Historically calibrated models are, by definition, not fit for this purpose.

Insurers also face increasing claims from climate-related litigation against their clients. The number of climate litigation cases is rising and spreading from energy to other sectors including mining, financial services and food and agriculture.

We are helping insurers develop strategies to navigate the fast-evolving risk landscape

Cases are also becoming more diverse in nature, ranging from claims for climate damages to allegations of securities fraud, breach of duty of care and greenwashing; targets include companies and individuals.

The full spectrum of climate risks that insurers face necessitates an approach to risk assessment that is both comprehensive and practicable and which applies a strategic horizon that extends well beyond the next 12 months. As a first step, insurers can use a heatmapping methodology to evaluate their climate risk exposures across the portfolio and identify key risk concentrations. However, ultimately, they will need a modelling infrastructure that allows them to stress test their portfolios against different scenarios and understand the implications by sector, geography and product line.

EMISSIONS IN SCOPE

The SEC proposals also require the disclosure of companies' greenhouse gas emissions (GHG) according to the Greenhouse Gas Protocol, which categorizes emissions according to Scope 1 (from owned assets), Scope 2 (from purchased power, heat and cooling) and Scope 3 (relating to a company's value chain). For insurers, Scope 3 will invariably pose the biggest challenges. Specifically, category 15 requires insurers to estimate the emissions attributable to their investment activities. Accepted methodologies for calculating investment emissions on both an absolute and intensity basis are available, but require non-trivial levels of investment in time, people, and data if they are to be adapted and applied appropriately.

Category 15 was written with banks and investors in mind so is unhelpfully silent on arguably the most important part of the insurance value chain: underwriting. Consequently, insurers will need to decide whether, and how, to disclose emissions attributable to their underwriting activities in the absence of clear guidance.

Some members of the insurance industry are working through the Partnership on Carbon Accounting in Financials (PCAF) to develop a methodology to attribute client emissions to an underwriting portfolio; in the meantime, more advanced carriers are piloting emissions intensity measures. Understanding underwriting emissions is a key step towards managing transition risk.

FROM RISK TO OPPORTUNITY

If all the above sounds like a lot of work, it is! But insurers can make it worthwhile if they approach these incoming regulations not as a “tick box” disclosure exercise, but as an investment in strategic risk management. Armed with the tools outlined above, insurers can begin to understand how different climate change and transition scenarios will play out for their business, develop strategies to navigate the fast-evolving risk landscape, and seize the commercial opportunities associated with the transition. Opportunistic firms will recognize this a true commercial opportunity to create targeted products and services that address climate change and the energy transition.

Get started with Oliver Wyman

Oliver Wyman is helping insurance leaders navigate the transition to a low-carbon, climate resilient economy. We are the knowledge partner for the Glasgow Financial Alliance for Net Zero, which includes the Net Zero Insurance Alliance and Net Zero Asset Owners Alliance and we support both the Task Force on Climate-related Financial disclosures (TCFD) and the Task Force on Nature-related disclosures (TNFD). Most recently, we have worked with leading insurers on all aspects of sustainability strategy, including net zero and portfolio steering, new product strategy, integrating sustainability into underwriting etc.

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