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Climate counts – the status of climate adoption into insurance risk management and reporting

Introduction

2022 will be remembered as a year of unprecedented progress in climate reporting regulation around the world. The emerging trend is clear – reporting on climate risks and impacts will no longer be voluntary or on a purely 'best effort' basis. The significant developments in the last year mean that climate reporting will soon become mandatory in many jurisdictions. In the European Union, the requirements will take the shape of the European Sustainability Reporting Standards (ESRS). In the US, the Securities and Exchange Commission's (SEC) proposed Climate Change Disclosures will form the requirements. In the UK, the first wave of companies has started to report under the Task Force on Climate-Related Financial Disclosures (TCFD) framework, which will also eventually become mandatory in other jurisdictions.

Beyond reporting compliance, insurers have begun to understand the impact climate could have on risk management, strategy, and their overall business. Many have already been working on developing, implementing, and improving their climate and ESG-related data, models, systems, and processes.

Moody's Analytics recently conducted one to one interviews and a survey of 30 insurers from Europe and North America, with some response from Asia and Australia. The aim of the survey was to determine the current level of climate integration into their risk management and reporting processes. We also wanted to learn more about insurers plans in this area. Our respondents came from a range of insurance businesses including Life, Health, P&C, Reinsurance, and other related financial institutions.

This report shares our learnings from the survey, covering current insurance market trends in developing climate capabilities, adopting climate scenarios, and addressing data gaps. We also share the insights and feedback from recent one-to-one discussions with insurers on the same topic. The report complements the findings from our survey published in September 2022 'Life Insurers: Climate Risk Modelling and Risk Assessment Process'[1].

[1] https://www.moodysanalytics.com/landing/2022/life-insurer-survey-report_climate-risk-in-the-orsa

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Key lessons learned

Many large insurers have begun climate reporting in the last few years. Not surprisingly, the most popular voluntary framework has been the TCFD. Insurers are also able to join the climate-related industry organizations such as the Net-Zero alliances (Net-Zero Asset Owners Alliance or Net-Zero Insurance Alliance). Perhaps due to the awareness that regulatory changes will soon mandate the reporting standards developed by the International Sustainability Standards Board (ISSB), SEC, and the European Financial Reporting Advisory Group (EFRAG).

One of the most difficult, but useful climate exercises is scenario analysis. Insurers plan to use, or are already developing, multiple scenarios, which often require customization, and consideration for changes such as portfolio mix over time. After its implementation, climate scenario analysis can serve several important needs; reporting compliance, but also regulatory stress testing, strategic asset allocation, and the Own Risk and Solvency Assessment (ORSA).

There are gaps in key data availability. In particular around Scope 3 Greenhouse Gas (GHG) emissions, which relate to emissions from sources that are not owned or controlled by the reporting entity. Insurers are currently unable to completely assess emissions from their investments, in particular from alternative assets. While this part of the balance sheet remains a challenge, P&C insurers are starting to turn their attention to underwriting emissions from their insurance contracts.

Integrating climate into risk management, strategy, and reporting will require significant changes to existing data, systems, and processes. Some insurers indicated that they might need to build new tools and models. The majority plan to use their existing systems. However, this will still require significant enhancements; such as emission data collection, or stress testing their strategy's resilience to various climate shocks, over the short-, medium-, and long-term.

Climate risk management and reporting are already starting to shape insurers' organizational structure. Many have created sustainability functions to lead the process. Groups are also starting to involve their subsidiaries, as more detailed climate data is required for granular analysis.

Reporting frameworks shape adoption of climate risk assessment

Many of the respondents already report under the TCFD framework, and many are members of the Net-Zero alliances. As a result, they represent the most experienced group of climate reporting adopters who are setting the pace and breaking new ground. Their views represented in the survey, may be helpful to inform the decision-making of insurers who are at an earlier stage in their journey to Net-Zero and climate risk response.

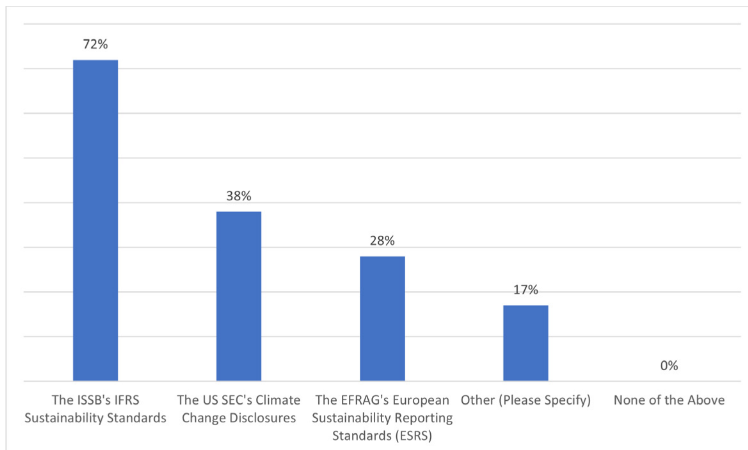
Looking forward, the IFRS Sustainability Disclosure Standards being developed by the ISSB are the most common sustainability and climate reporting framework insurers are likely to adopt. 72% of the respondents plan to adopt these after the first two standards on climate and general rules are finalized in 2023. It is expected that many jurisdictions will implement these standards as part of the financial reporting requirements.

For the US reporters, the SEC Climate Change Disclosures are the most likely to be adopted. Similar to the ISSB's standards, the work by their US counterparts is still ongoing.

Finally in Europe, more than half of the respondents are planning to adopt the ESRS that EFRAG published the first wave of in November 2022. It is worth noting a few points on ESRS that could indicate that uptake of these standards may turn out to be higher than our numbers suggest:

- As a delegated act of the new Corporate Sustainability Reporting Directive, ESRS reporting will apply to all large companies globally, with EU operations. Not just to European businesses.
- Reporting under ESRS will not only be mandatory for companies in scope, but the disclosures will also be subject to assurance.
- The effective date of these standards is already known; periods starting on or after 1 January 2024 for most companies. This leaves little time to adopt them.
- The scope of this framework is wider than some others, covering many ESG topics and requiring dual materiality assessment. This means also considering the impact that a company has on the outside environment, society, and the economy.

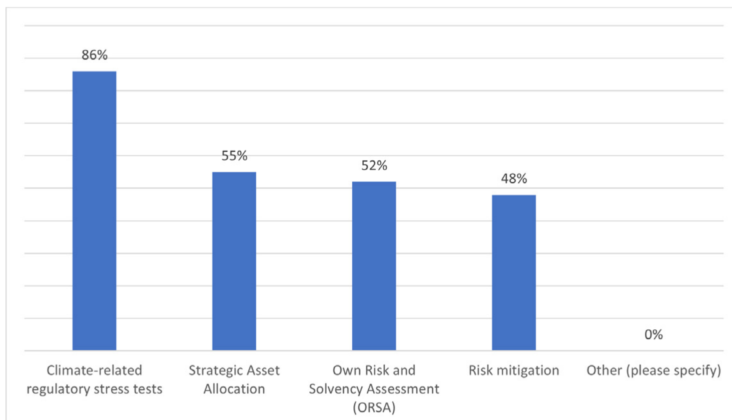
Figure 1 What new climate or sustainability reporting frameworks are you planning to adopt?



Climate scenarios require multiple, often customized pathways

Many of the frameworks mentioned before, require strategic resilience assessment and identifying the financial impacts of climate-related risks and opportunities over the short-, medium-, and long-term. Preparing this type of disclosure requires climate adjusted scenario analysis. The majority of respondents (86%) are planning to use analysis developed for climate-related regulatory stress-tests. Many companies have participated in exercises such as the Bank of England's 2021 Climate Biennial Exploratory Scenario (CBES), and used the results in their TCFD reporting. Other respondents said that they will report climate disclosures based on analysis developed for other purposes, such as strategic asset allocation (55%), the ORSA (52%), and risk mitigation (48%).

Figure 2 In your climate reporting, do you expect to use climate scenario analysis developed for other purposes?



Given that scenarios will not only be used for compliance with reporting requirements, but also for risk management and strategy purposes, insurers are planning to make their climate scenario analysis thorough and detailed:

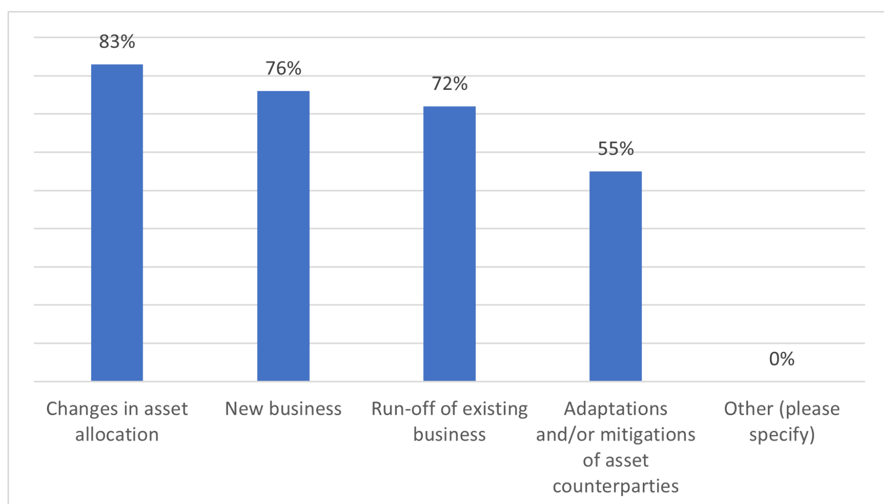
» Many respondents (52%) will use 3-5 climate scenarios. Only Health insurers (60%) and North American insurers (54%) are favoring a moderate number of 1-2 scenarios.

» Many respondents (55%) are planning to customize at least part of the scenarios used. The respondents most interested in customization were the ones associated with Health and Reinsurance, while half of our P&C respondents will be focused on fully standardized, industry-wide scenarios.

» When considering climate scenario impacts over time, the respondents plan to account for several changes in their asset and liability portfolios, including changes in asset allocation (83%), new business (76%), run-off business (72%), and climate

adaptations and mitigations (55%). North American respondents expect that the latter two will be less significant for their business.

Figure 3 When using climate scenario analysis, do you plan to account for the following changes in your asset and/or liability portfolios?



Given the amount of time and effort to include these sophistications in climate scenario analysis, it is not surprising that most respondents (76%) will only be able to perform them on an annual basis. Only 14% of respondents (mainly P&C and Health insurers) plan to run scenario analysis bi-annually. None of the respondents indicated quarterly frequency plans, although 7% of respondents would like to run the analysis monthly. From our discussions with insurers, it is clear that the frequency of analysis depends on their business type, and volatility of risks. Sometimes, scenario analysis may only have to be repeated every few years, whilst in other cases, insurers may decide to monitor development more frequently.

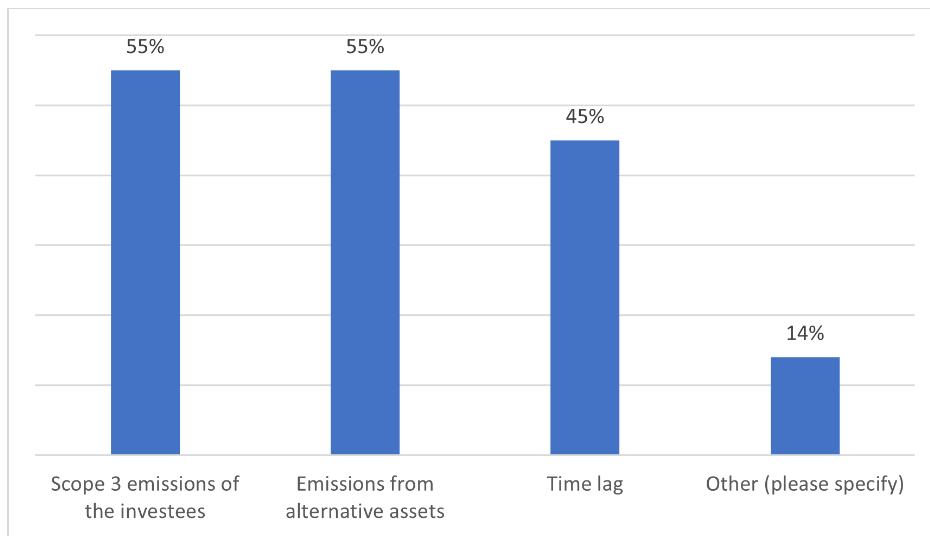
Many insurers are planning to use the climate scenario outputs in their existing asset (59%) and liability (55%) models. Nevertheless, around one third of respondents are planning to develop new models for assets, especially in their Reinsurance and Health business. Although the biggest group (45%), plan to model assets at an asset class level, the number of respondents planning to model assets at a sector (34%) or even individual instrument level (21%) is also significant.

Figure 4 Are you planning to use existing Asset and Liability models with your climate scenario analysis?

Availability, completeness, and quality of GHG data remains one of the main constraints

Financed emissions (Class 15 of Scope 3 emissions) are one of the key data gaps for insurers. There are common issues around obtaining data about investees' Scope 3 emissions, and about emissions from alternative assets (each cited by 55% of respondents), as well as a data lag in receiving GHG data on the investments (45%).

Figure 5 What are the gaps in your measurement of financed emission?



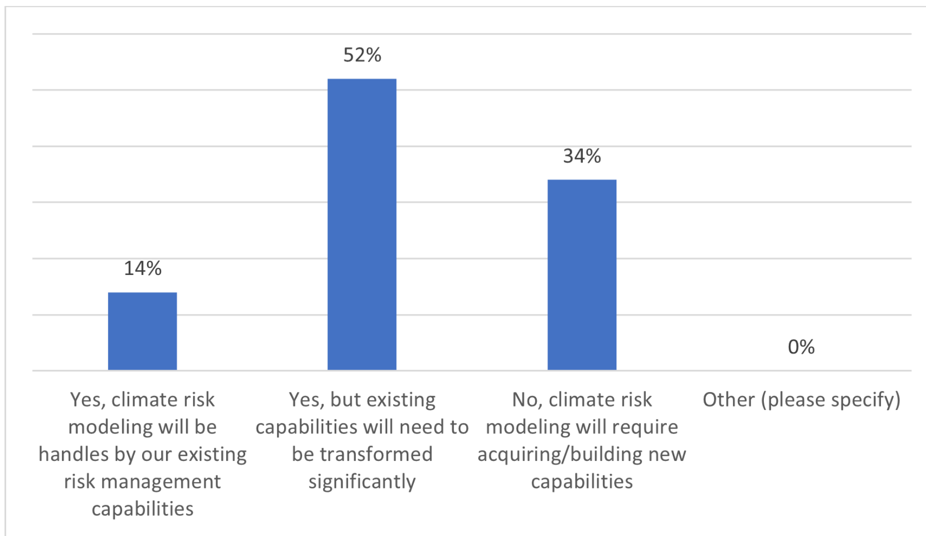
Data from third-party providers is commonly used to address these data gaps. Sometimes, insurers use this external data as a temporary measure while planning to develop their own capabilities in the future. In other cases, insurers plan to rely on external providers for the long term. The latter is more pronounced for respondents from small and medium size insurers with GWP up to $6B. Respondents from larger insurers most commonly plan to build their own methodologies to estimate financed emissions.

When measuring transition risk from the insurance side of the balance sheet, most respondents are planning to perform qualitative assessments of portfolios, covering most carbon-heavy industries. Alternatively, they will perform a high-level assessment of GHG emissions by geography, industry, or product type. Only about one quarter of respondents—mainly reinsurance companies—are planning a more granular assessment of underwriting GHG emissions. Relatively few P&C respondents said they are planning granular assessment. This might start to change as a growing number of P&C insurers have been engaging in self-regulation on measuring their Net-Zero progress. In November 2022, the Partnership for Carbon Accounting Financials (PCAF) industry group published its final standard on Insurance-Associated Emissions for personal motor and commercial lines. Members of the Net-Zero Insurance Alliance have committed to setting targets for these two business lines within six months. It is also expected that further business lines, including life and health, will become self-regulated in the future; resulting in a growing number of insurers assessing their underwriting emissions with more detail.

Systems and models will require significant updates

The survey has shown (as indicated by 52% of respondents) that significant changes are expected to current tools and models to incorporate climate risk impacts, or to make them 'climate risk aware'. In addition, 34% expect that climate change will result in acquiring or building new models. This view was common among Reinsurers. Only 14% of respondents plan to handle climate risk by using their existing risk management capabilities. The extent to which current capabilities will have to be modified is likely to have led to the fact that 62% of respondents would like to have a single system, able to support both quantitative and qualitative disclosures.

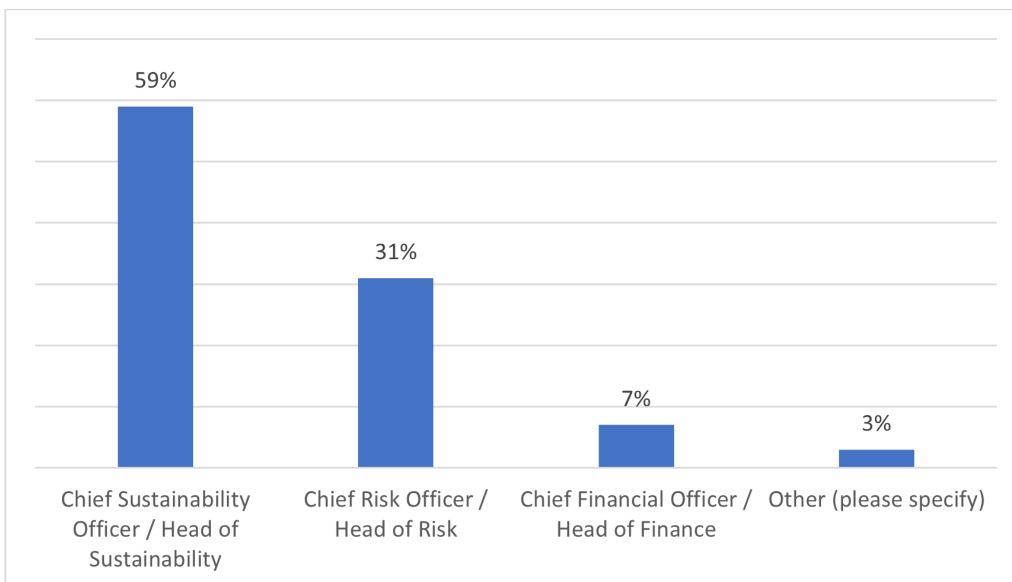
Figure 6 Will modeling climate risks impacts be handled by your existing capabilities (e.g., models, tools, and processes)?



Processes and resources become climate-specialized

Most respondents (59%) have created special sustainability functions responsible for climate and other sustainability reporting. The trend was high among P&C insurers. This shows the importance of climate reporting being seen as a separate process, requiring devoted tools and resources. On the other hand, 38% of respondents delegated climate reporting responsibilities to existing Risk or Finance functions. In these cases, it is their intention to integrate climate and sustainability as part of their 'business as usual' processes.

Figure 7 What function is primarily responsible for your climate reporting?



The majority (72%) of respondents told us that their group functions will be leading the climate reporting process, but their subsidiaries will play an important role in providing information. This shows the maturity reached by many respondents in their climate reporting. We observed that insurers who have only started to report on climate at a high level, do not involve their subsidiaries in the process. After the process gets more thorough, and more data is needed, subsidiary involvement becomes indispensable.

Conclusions

Insurers around the world cannot ignore the impact of climate change on their business, reporting, and strategy. We have observed in our interviews that some insurers in jurisdictions such as the USA, are more inclined to wait for the requirements to be finalized. They also seem to opt to follow the minimum compliance path. However, with the speed of recent global regulations and increasing investor pressure, they may soon find themselves in the scope of mandatory frameworks, such as from the ISSB, who are working on creating a global reporting baseline. Lack of adequate climate disclosures can also make their business look riskier to international investors. Aside from the external reporting pressure, climate change has quickly become one of the more important risks faced by insurers. Its appropriate internal measurement and management will be vital to ensure long-term business strategy resilience.

Many insurers choose to act as 'front runners' in the market. They understand that early adoption of voluntary frameworks gives them a few extra years to prepare and test their systems and processes before what may inevitably turn into mandatory reporting. As more data becomes available and models continue to get more sophisticated, climate risks and opportunities become better understood, and can be more integrated into insurers' strategic decisions. This gives them competitive advantage. Rapid integration of climate into all aspects of an insurers business, with climate scenarios being at the forefront, will give insurers operational advantage and better insights into the management of increasing physical and transition climate risks. It will also meet the increasing demands of investors around the world, looking for disclosures on approaches to climate risk and strategic actions taken to adapt or mitigate them, in the transition to a low carbon economy.

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