Market review: climate change risk for non-life insurers

October 2021

Introduction

We are delighted to share with you the results of our market review on climate change risk for non-life insurers.

The review will help you benchmark your firm's response to climate change risk against that of your peers.

Thank you to the 31 participating firms. These firms represent a wide range of classes, territories and areas of operation, with representation from smaller and larger firms.

Our results show that there is much work to be done by firms in addressing climate change risk. **The key is how best to target your efforts, as well as having a clear longer-term roadmap.**

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Key findings

40% of boards have had no climate change risk training. Of these, fewer than half have training planned.

60% of respondents have started to use metrics for monitoring climate change risk.

55% of respondents are not yet making an explicit allowance for climate change risk in their capital calculations, pricing, underwriting or reserving.

42% of respondents have not yet considered short-term climate change scenarios and ***65%*** have not considered long-term scenarios.

97% of respondents mention climate change risk in their ORSA.
More than ***40%*** have also included it in their annual reports and their SFCR.

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Strategy, governance and disclosures

First things first

The starting point in addressing any key risk is to get the Board’s engagement, agree priorities and determine an appropriate strategic response.

Given the high impact, long term nature of climate change risk, establishing the right governance around your strategic response is particularly important.

The stakes are high, both in terms of business opportunities and downside risks.

Also, views on the nature of climate change risk vary significantly between firms and even within firms.

Proactive response vs compliance-led response

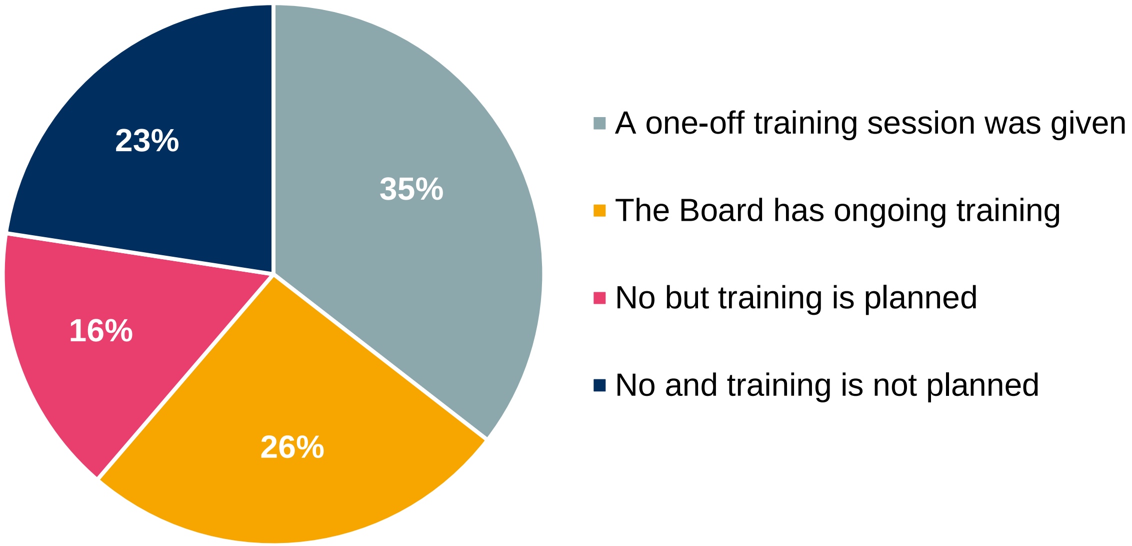
All of this points to the crucial role of a deliberate, planned response rather than a mainly reactive, tactical response.

Regulatory and disclosure requirements are of course ramping up steeply at present. A strong response to climate change risk should be designed to comfortably cover (and go beyond) these requirements.

Conversely, if you find that your climate change strategy is mainly being driven by compliance, this may be a warning sign that you need to rethink your approach.

Board training and governance structures

Has the Board been provided with training on climate change risk?



40% of boards have had no climate change risk training at all. Fewer than half of these have training planned.

All respondents have allocated the responsibility for managing and monitoring climate change risk to an existing Senior Management Function holder.

48% of firms have established a new working group or committee to consider climate change risk. Other firms are either making use of existing committees or have not yet decided on their approach.

LCP view

Board training is an essential early step in developing an appropriate response to climate change risk. Without it, there is a risk of an inconsistent "tone from the top", which can hamper efforts to coordinate strategic and risk management activities around climate change.

Impact of climate change risk on strategy

55% of respondents can point to strategic changes they have made as a result of climate change risk.

Examples include the following:

Underwriting

"Reducing exposure to certain physical risks."

"Seeking to write higher-up layers of certain insurance programmes."

"Reviewing product coverage to include emerging technologies."

"Developing climate-specific underwriting risk appetites."

Investment

"Developing a Responsible Investment policy."

"Monitoring ESG metrics as part of asset selection."

"Divesting from assets that are particularly vulnerable."

"Increased expectations of investment managers regarding ESG."

Operations

"Starting and Improving greenhouse gas reporting."

"Publicising targets."

"Considering Net Zero goals."

"Considering employer responsibility actions to reduce carbon footprint, eg flexible working arrangements and bike usage."

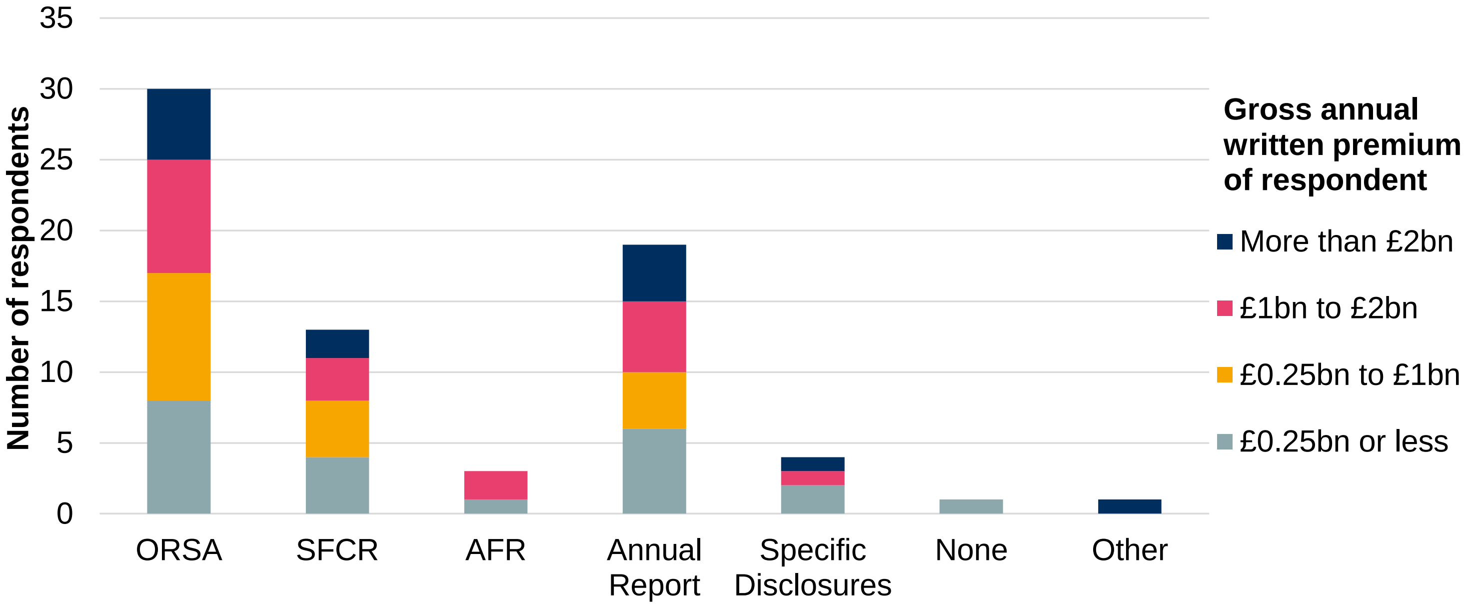
LCP view

Whilst it is encouraging to see some firms making a start on building climate change risk into strategic decisions, many of the above examples are relatively basic and would need to be developed significantly over the coming months and years.

45% of firms have not yet made any strategic changes in response to climate change risk. A common reason given is "waiting for further guidance from the government". Firms who leave this too long may be exposing themselves to unforeseen risks and also missing out on opportunities associated with climate change.

Disclosures

Which of the following documents now explicitly reference and address climate change risk?



Nearly all firms mention climate change risk in their ORSAs.

A third of respondents reference climate change risk in their ORSAs but not in other documentation.

LCP view

Appropriately articulating your climate risk appetites and management plans to external stakeholders is critical. Saying nothing is not a low risk option, and such firms may rapidly find themselves out of step with the market, risking lost business opportunities and reputational impacts.

TCFD recommendations

No respondents are currently meeting TCFD recommendations.

However, ***52% plan to do so in the next year*** and ***35% plan to in the longer term.***

13% don't have any current plans to do so.

Risk management

What does good look like?

Climate change risk management was highlighted in the PRA's July 2020 Dear CEO letter as a key area needing improvement.

We were keen to understand how firms' climate change risk management plans and processes have evolved since then.

We also investigated what risk metrics firms were using (or developing) to help with climate change risk management.

Above all, we wanted to get a sense of who is leading the way in defining "what good looks like" in this area – insurance firms or regulators?

Ongoing climate change risk management

Following the PRA's July 2020 Dear CEO letter, what practices have you put in place to help with ongoing climate change risk management?

LCP view

Most climate change risk management processes remain very much a work in progress. This lack of progress may prompt more intervention and rule setting from regulators. This would be a missed opportunity for the climate change response to be industry-led, rather than regulator-led.

Risk metrics

42% of respondents are not yet using any risk metrics for monitoring and measuring climate change risk in their assets and liabilities or to monitor progress against their overall business strategy.

Examples of the most common risk metrics being used include the following:

	Physical risk	*Transition and liability risk*
Underwriting	The proportion of UW activities exposed to key indicators of physical risk eg PML of insured products from weather-related natural catastrophes.	Monitoring eg climate-related class action lawsuits and policies exposed to renewable energy and fossil fuels.
Investment	Monitoring ESG ratings of key investments.	Monitoring the proportion of investments in sectors exposed to climate change, eg fossil fuels.
Operational		Monitoring scope 1 and 2 emissions arising directly from the firm's own operations.

LCP view

For most firms, risk metrics are still relatively unsophisticated. Although data may be limited, it is important to start measuring and monitoring key climate change metrics now, even if you need to rely on proxies.

Scenario analysis

Best practice, data sources and methodologies

Scenario analysis is an essential tool for informing a firm's strategic response to climate change.

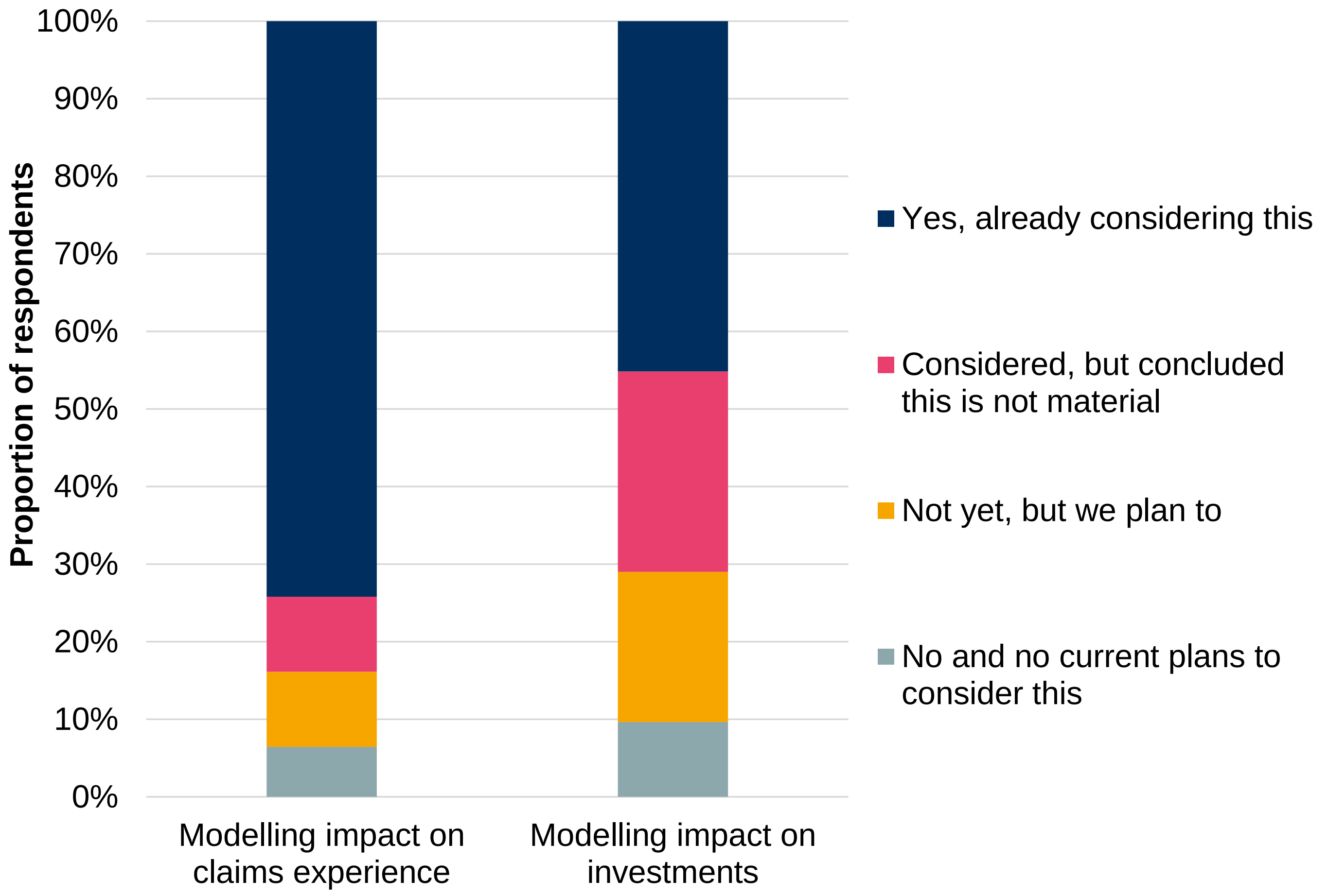
This is an area in which we provide a lot of support for firms.

We wanted to examine how best practice is evolving and what data and modelling approaches firms are using.

We were also keen to see how firms are progressing towards meeting specific regulatory requirements in this area.

Scenario analysis

Which of the following are you considering in your climate change scenarios?



More respondents are modelling the impact of climate change risk on their claims experience than on their investments.

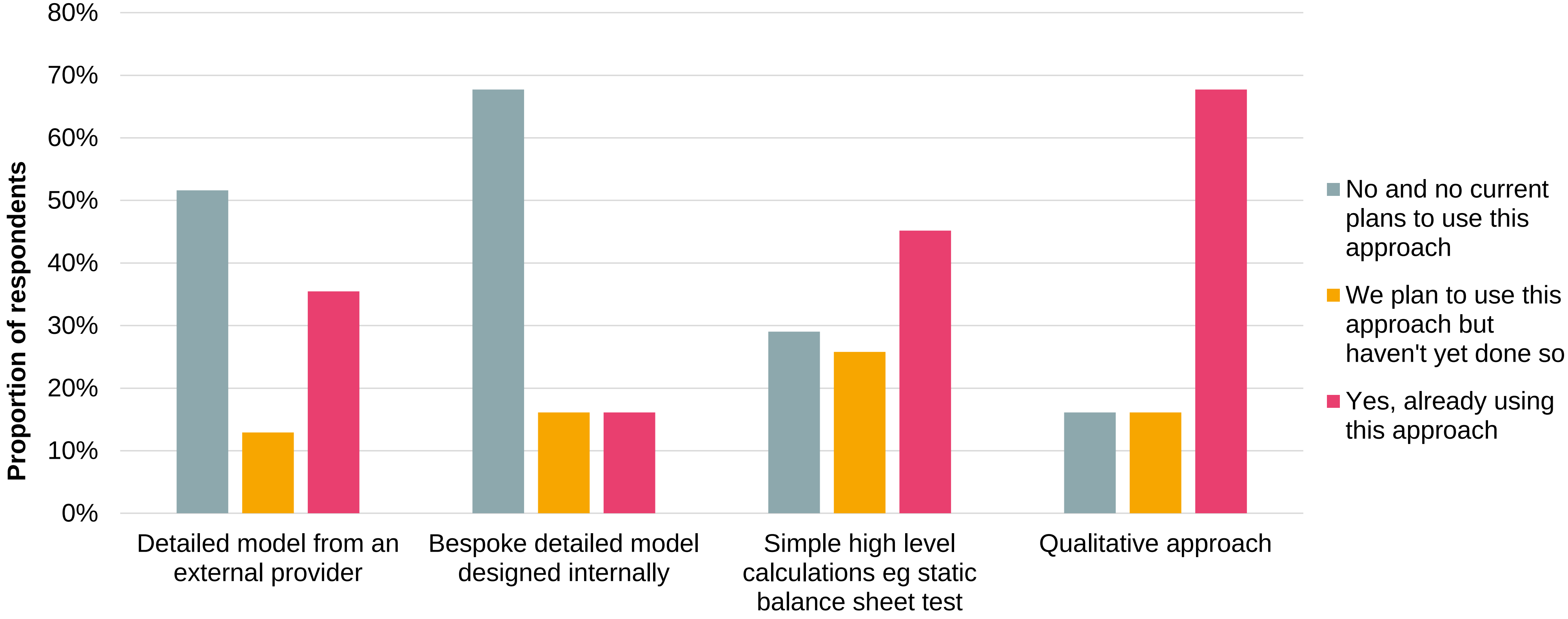
26% of firms have concluded that the impact on their investments is not material.

LCP view

It is important to consider both sides of the balance sheet when conducting scenario analysis, including potential correlations between assets and liabilities in stressed conditions.

Different approaches

What approach are you taking to model climate change scenarios?

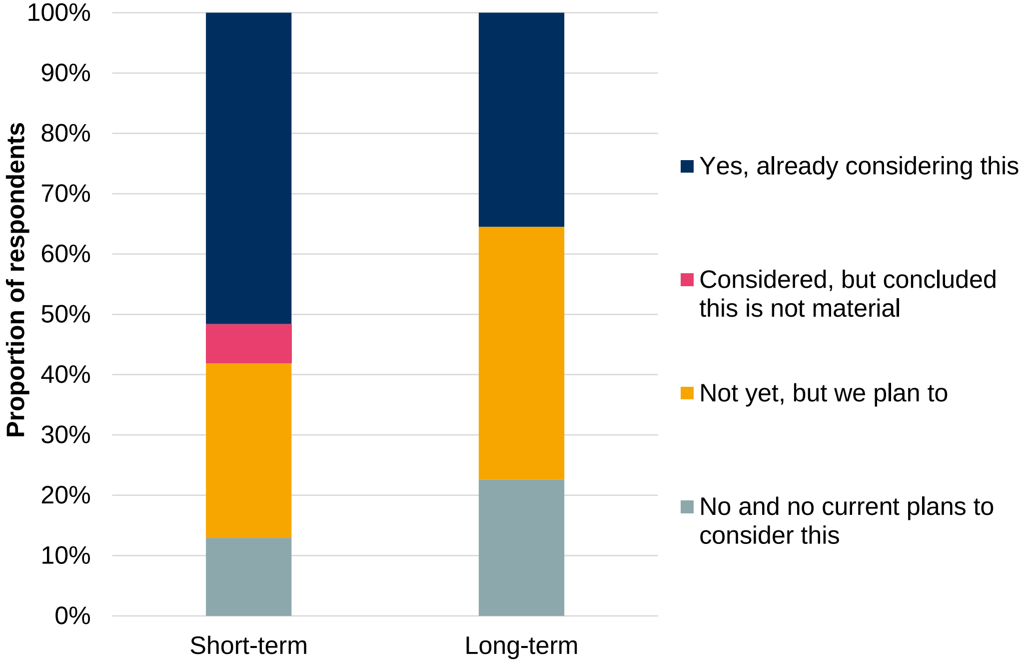


The approach taken to model climate change scenarios varies between firms. ***2 out of 3*** respondents are using a qualitative scenarios as at least one of their approaches.

A bespoke, detailed model designed internally is the least common approach. ***10% of firms*** are using all four approaches. On the other hand, ***20% of firms*** are not yet using any of these approaches.

Short-term and long-term scenarios

Which of the following are you considering in your climate change scenarios?



The PRA expects scenario analysis to include a short-term assessment, within the existing business planning horizon, and a longer-term assessment, in the order of decades, considering different climate pathways. ***52% of respondents*** are considering short-term scenarios. ***Only 35%*** have considered long-term scenarios yet.

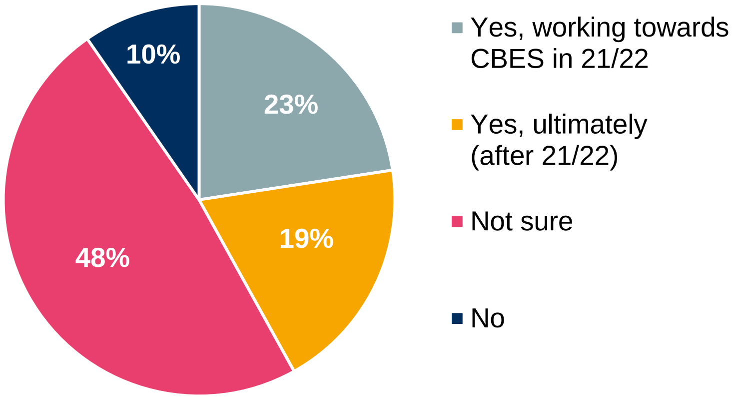
LCP view

It is a concern that most firms are not yet considering long term scenarios. Despite the obvious uncertainties involved, long-term scenarios can be very instructive in shaping your climate change risk appetite and strategic response.

Certain firms are required to complete the Bank of England's (BoE's) 2021 Climate Biennial Exploratory Scenarios (CBES), including 6 general insurers and 10 Lloyd's syndicates.

We asked participants whether they were planning to mirror the CBES approach in their own work. ***42% of firms*** are working towards CBES either in 21/22 or ultimately, but ***48% of firms*** are still "not sure".

Do you plan to run the CBES?



Business as usual (BAU)

To date, the regulation on climate change has focused on governance and strategy, risk management, scenario analysis and disclosures.

Firms are still focusing on implementing the PRA's expectations in these areas ahead of the 2021 year-end deadline.

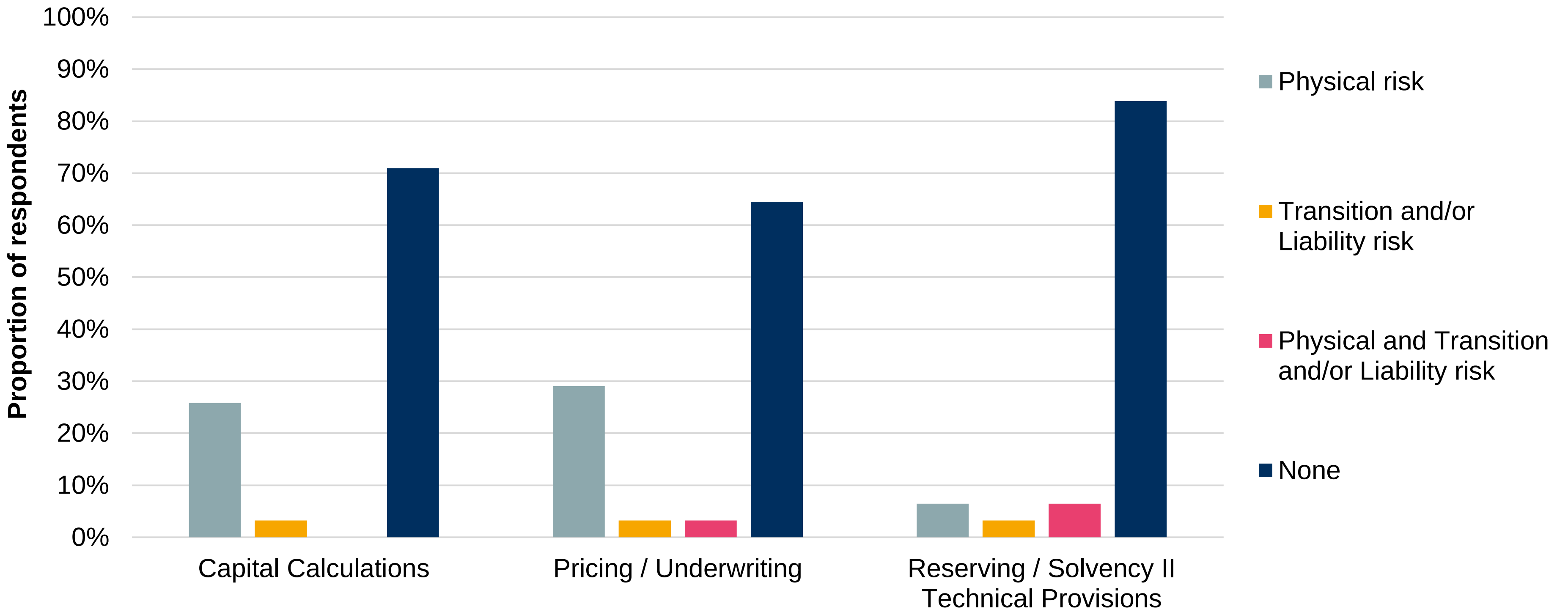
Embedding climate change risk management

Once a firm has a good understanding of their key exposures to climate change risk and has conducted scenario analysis, a natural next step would be to consider whether any explicit allowances for climate change are needed in existing practices.

We wanted to see how many firms were making explicit allowances for the financial risks of climate change in BAU practices, such as capital, pricing and underwriting, reserving and internal model validation.

Explicit allowances for climate change

Do you make an explicit allowance for climate change risk in the following areas?



55% of respondents are not making an explicit allowance for climate change risk in their capital calculations, pricing, underwriting or reserving.

Where climate change risk is explicitly considered, this tends to be limited to physical risks rather than transition and liability risks. The area where climate change risk is most commonly allowed for is pricing/underwriting, where ***35% of firms*** are allowing for at least one of physical, transition or liability risk.

Note some respondents have said that they make no explicit allowance in response to this question, but their responses to the questions on the following pages indicate that some adjustments have been made.

Capital calculations

If you do make an explicit allowance for climate change risk in your capital calculations, what approaches are you using?

71% of firms are not making any explicit allowance for climate change risk in their capital calculations. These firms are excluded from the chart.

Other firms use a variety of approaches.

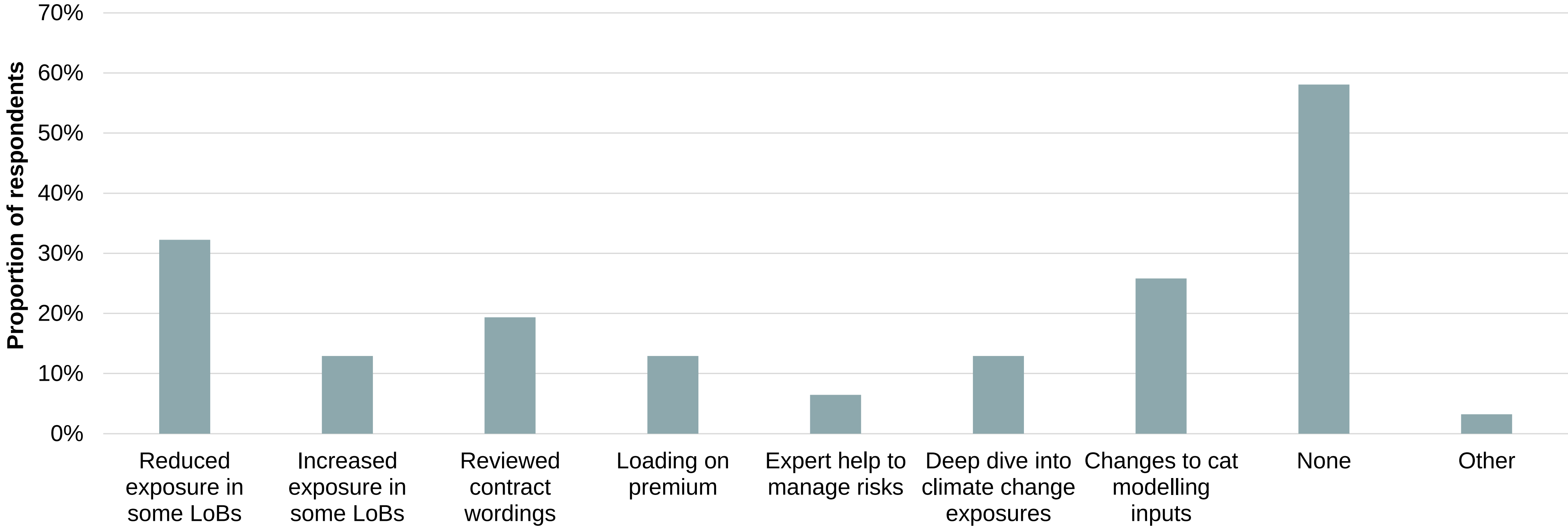
The most common area in which climate change risk is allowed for is ***catastrophe underwriting risk.***

The most common approaches are for climate change risk to be ***built into the stochastic modelling*** or to ***increase volatility assumptions*** in the model as a proxy.

Other examples include loadings for model error and stress testing. Certain firms make other subjective, qualitative allowances.

Pricing/underwriting

If you have made an explicit allowance for climate change risk in your pricing/underwriting, which of the following approaches have you used?

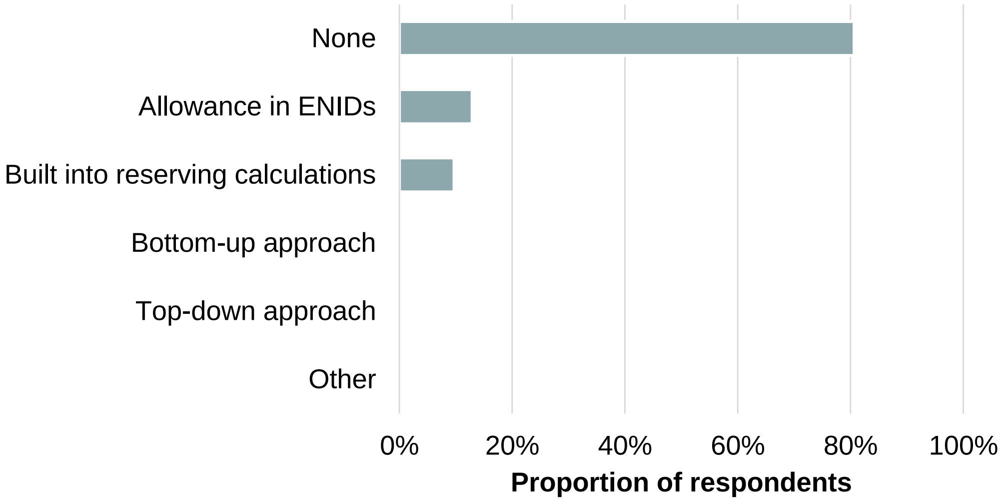


Approximately ***60% of respondents*** are not making an explicit allowance for climate change risk in their pricing and underwriting. For those who do make an allowance, there is a wide range of approaches.

The most common approaches are to ***reduce exposure in some lines of business***, and to make ***changes to catastrophe modelling inputs***.

Reserving and internal model validation

What approaches have you used to allow for climate change risk in your reserving/Solvency II TPs?

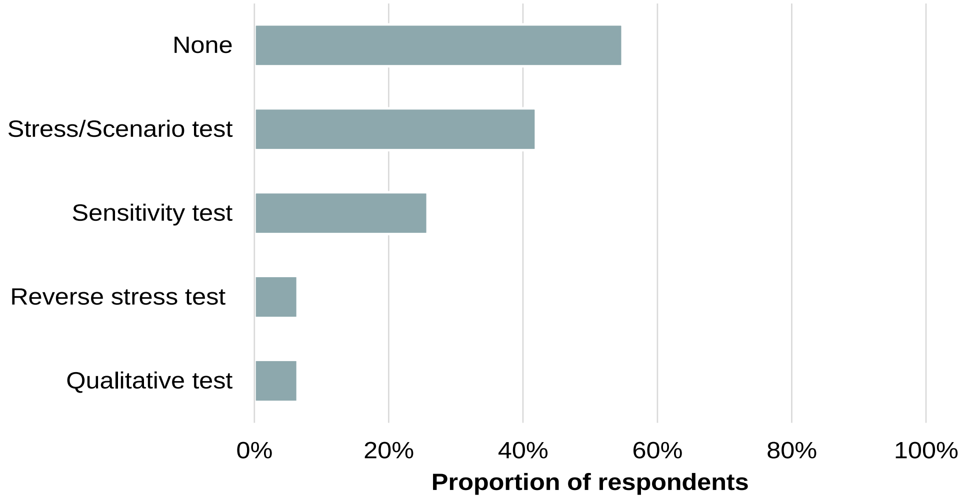


Most firms make no explicit allowance for climate change risk in reserving or Solvency II TPs.

10% of firms make an explicit allowance by adjusting assumptions such as initial expected loss ratios or frequency/severity assumptions.

13% of firms make an allowance via the ENID (Events Not In Data) adjustment.

What approaches have you used to allow for climate change risk in your internal model validation?



55% of firms do not explicitly consider climate change risk as part of internal model validation.

42% of firms use stress and scenario testing and ***26% of firms*** use sensitivity testing.

A small proportion of firms have considered reverse stress tests or a qualitative approach.

What next?

Key challenges

Responding to climate change risk is a marathon, not a sprint. Firms have shared with us the key challenges they are facing (see next slide).

Some of these challenges can be addressed right away with expert input and appropriate resourcing.

Other challenges are more deep-seated and may take years to address, especially the lack of appropriate data to monitor emerging risks.

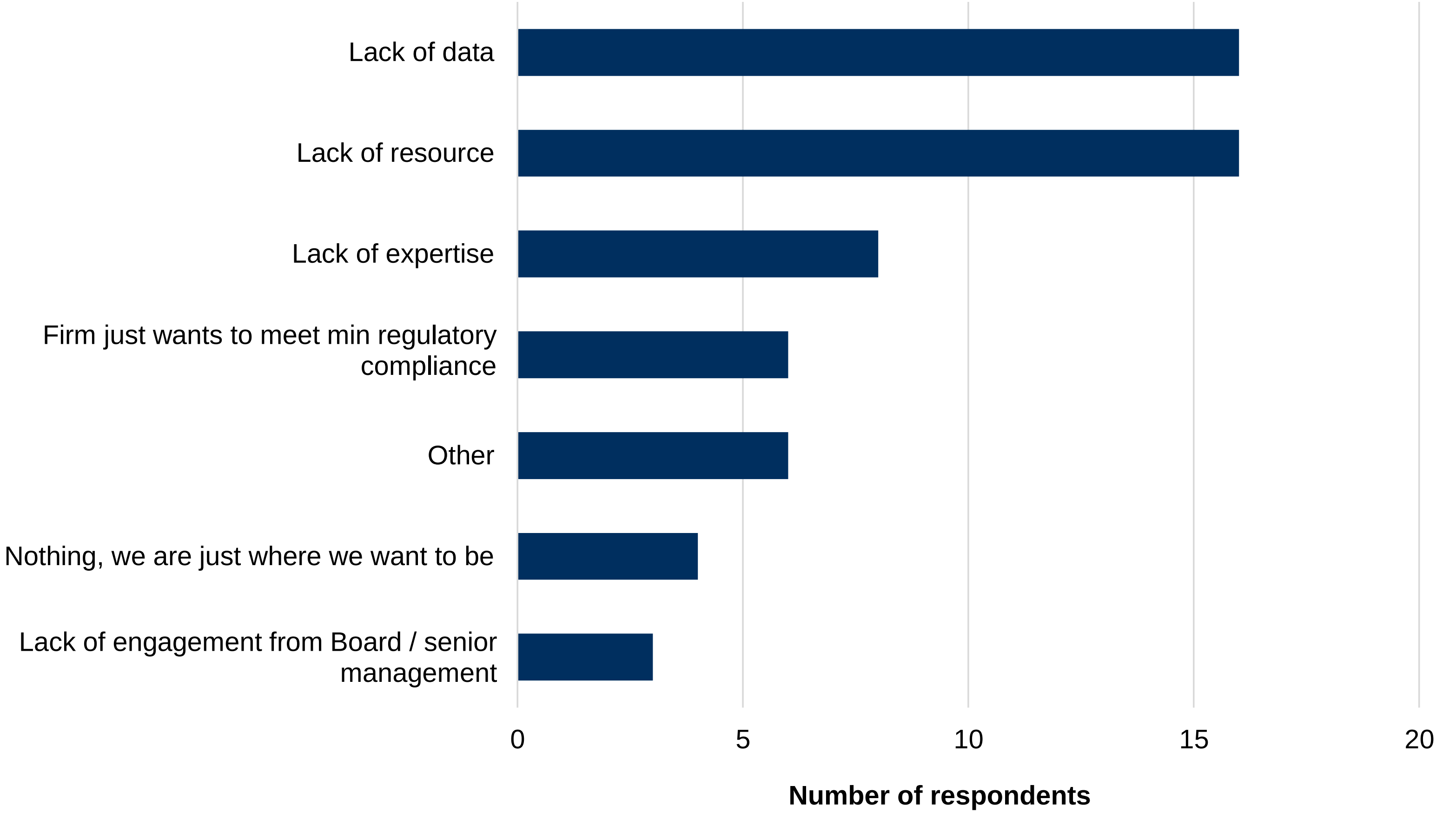
Best practice is evolving. Whilst many firms are not yet making explicit allowances for climate change in BAU practices, some firms are. We think there is a lot to learn from others in the market, and so we hope the results from this review provide useful benchmarking for your firm.

How we can help you

- **Scenario analysis** – modelling the impacts of future climate pathways on your assets and liabilities, using our state of the art methodologies developed in collaboration with Ortec Finance and Cambridge Econometrics.
- **Strategy** - facilitating a balanced debate at board level about managing climate change risks and capitalising on upside opportunities.
- **Training** – demystifying climate change risk requirements for the board and helping them put a clear structure around the firm's response.
- **Disclosure** – helping you design a disclosure plan that evolves over time and adds real value while encompassing emerging requirements and recommendations (eg SS 3/19 and TCFD).
- **Investments** – strategic review of your approach, to address climate change risk and to identify corresponding growth opportunities.

Challenges

What is holding you back from doing more on climate change risk?



The main challenges identified by firms are a lack of resource and a lack of data. Lack of expertise was also a common response. ***4 respondents*** said nothing was holding them back from doing more on climate change, as they are already where they want to be.

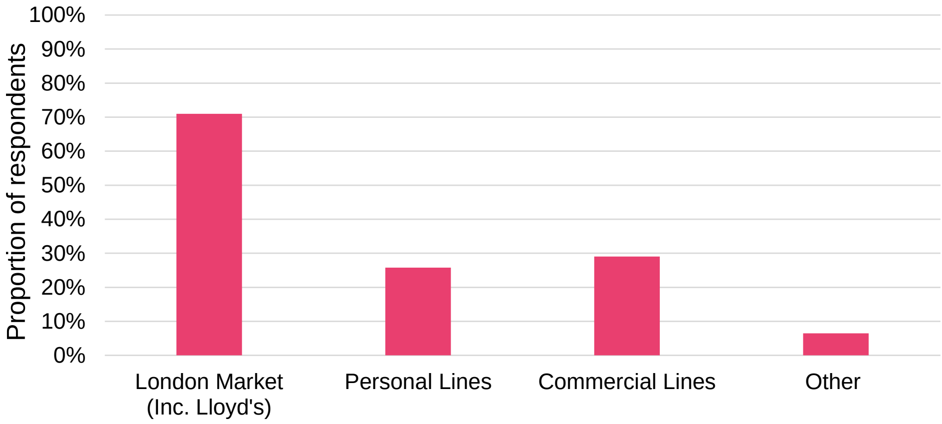
Other challenges mentioned by firms were the need for further government and regulatory guidance, and the need to focus efforts on other, more urgent risks to the business.

Participating firms

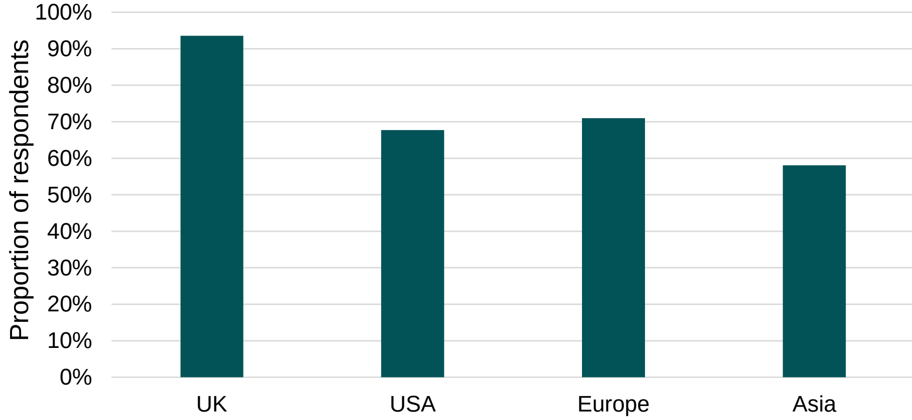
The next slide provides a profile of the 31 firms who took part in our review, by area of business, territory, premium volume and class of business

Profile of participating firms

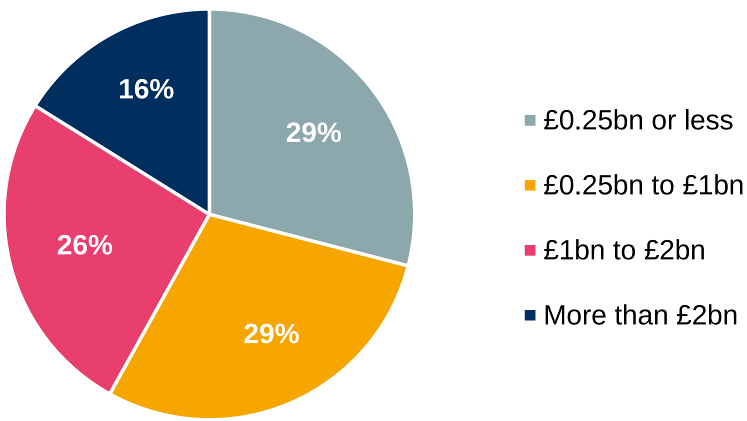
Area of business



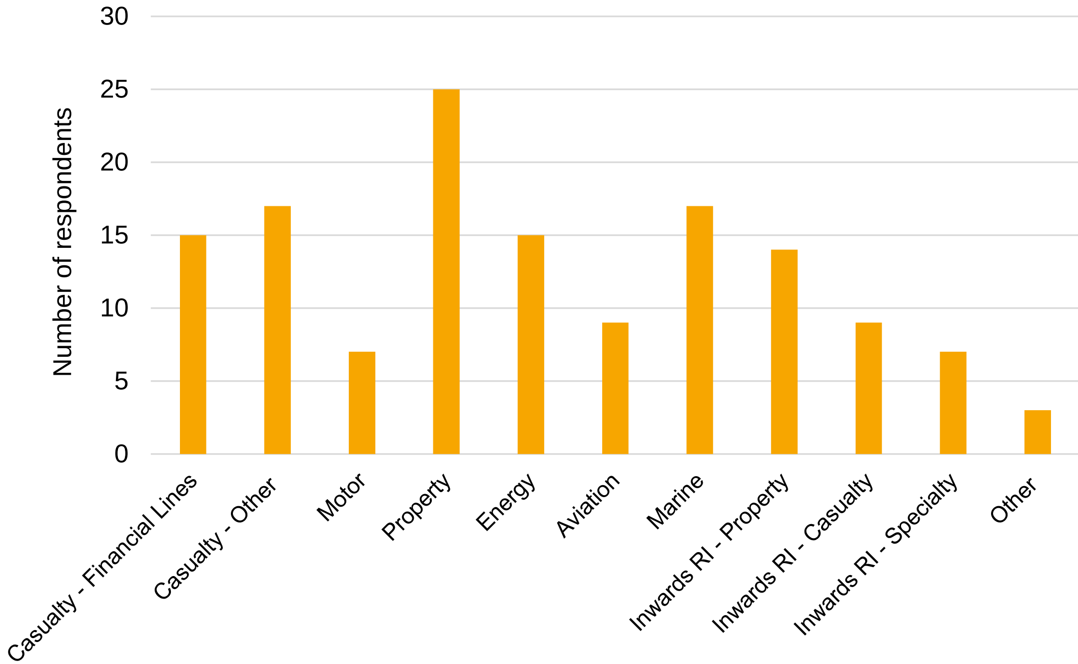
Territories



Annual gross written premium



Lines of business



Other insights from LCP

Insurance insights

The Virtuous Cycle examines how insurance boards can work together more effectively with the actuarial function.

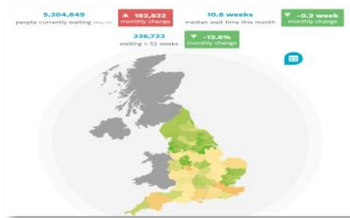
Change on the horizon is our analysis of Solvency II reporting for the top 100 general insurance firms in the UK and Ireland.

Our 2021 London Market capital survey provides benchmarks your most material capital modelling assumptions. Contact Richard.Holloway@lcp.uk.com to find out more.

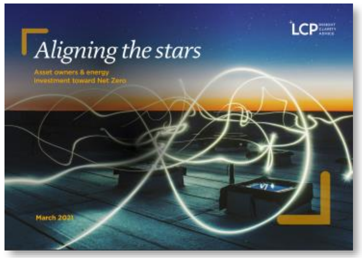
Our 2020/21 actuarial and risk team size survey provides valuable data to help you with your resourcing plans. Contact matthew.pearlman@lcp.uk.com to find out more.

Other insights

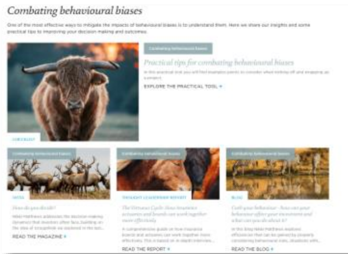
Our Climate change and sustainability insights hub helps you keep up-to-date with the risks, impacts and opportunities of climate change and ESG issues.



Our NHS waiting list tracker is helping to inform debate and decision making on health resourcing in the UK.



Aligning the stars - asset owners & energy investment toward Net Zero looks at how the sea-change in energy policy and infrastructure will create opportunities for energy firms and investors over the coming years



Our Behavioural Insights Hub provides tools to help you address cognitive biases in your key business decisions.

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