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INSTITUTE OF INTERNATIONAL FINANCE

Dr. Victoria Saporta
Chairperson
Mr. Jonathan Dixon
Secretary General
International Association of Insurance Supervisors (IAIS)
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Application Paper on the Supervision of Climate-related Risks in the Insurance Sector (Application Paper)

Dear Dr. Saporta and Mr. Dixon:

The Institute of International Finance (IIF) and its insurance members are pleased to respond to the IAIS's public consultation on the supervision of climate-related risks in the insurance sector. We appreciate the IAIS's focus on the development of a consistent approach to the supervision of climate risks, which we believe should be aligned with, but not identical to, the supervisory approaches used in other sectors of the financial services industry. We also believe that there is value in striving for alignment in approaches to climate risk between the global and national levels. This work should be refined over time in an iterative fashion in close consultation with industry and academic experts, who are also working to address these important issues. We note that significant work on climate risk is being conducted at companies and in universities and think tanks, as well as by national supervisors. We believe that this work should inform the work at the IAIS as it continues to consider the risks and opportunities that climate change will present for the insurance sector.

We appreciate that, absent robust risk management, climate risk may be a significant source of financial risk that negatively impacts the interests of policyholders and the maintenance of fair, safe, and stable insurance markets. We also acknowledge the concerns raised by the Financial Stability Board regarding the potential for mechanisms within the financial system to amplify climate risks or the cross-border transmission of those risks.[1]

The IIF has conducted a significant amount of work on the topic of climate risks. We have recently shared with you an IIF Discussion Draft Paper, *Prudential Pathways: Industry Perspectives on Supervisory and Regulatory Approaches to Climate-related and Environmental Risks* (the IIF Prudential Pathways Paper). While this Paper reflects the perspectives of the IIF's broader membership of financial services firms, we believe that there are elements of the IIF Prudential Pathways Paper that may be appropriate for the IAIS to consider and discuss with stakeholders as it advances its work on climate change. We look forward to an opportunity to discuss this Paper and its particular relevance to the work of the IAIS.

[1] https://www.fsb.org/wp-content/uploads/P231120.pdf.

Overarching Comments on the Application Paper

The IAIS's Overall Climate Strategy

As an overarching, foundational comment on the draft Application Paper, we would like to better understand the IAIS's overall climate risk strategy and how this strategy will be reflected in the IAIS's ongoing work program, in particular with respect to the Holistic Framework for Systemic Risk in the Insurance Sector (Holistic Framework) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). We appreciate the importance of identifying and appropriately managing climate-related risks and we look forward to engaging with the IAIS on how climate risk considerations will be reflected going forward in IAIS standards and guidance.

Industry/Supervisor Information Sharing

Given the evolving nature of climate risks, industry/stakeholder/supervisor information sharing and collaboration are critical.[2]

We note that insurers are subject to expectations for greater information and disclosure from a wide range of stakeholders, including insurance and non-insurance regulators and supervisors, listing authorities for publicly traded companies, rating agencies, investors, customers and prospective customers. It may be appropriate for the IAIS to conduct a stakeholder dialogue on this topic, as well as on the topic of the IAIS's overall climate strategy, in early 2021. The IIF would be pleased to help organize such an event.

Supervisory Responses to Public Policy Goals

Consistent with the principle of proportionality, any supervisory response to climate-related risks should focus on material risk exposures, begin with the least invasive tools that can be used to achieve the supervisory objectives of policyholder protection, fair, safe and stable insurance markets and financial stability, and promote sound risk management practices. Ultimately, the development of enduring, sustainable responses to climate change will depend on broader national and societal efforts to transition towards lower-carbon economies. While the insurance sector can contribute to these efforts, supervision of the sector should remain risk-based and focused on protecting policyholders, maintaining fair, safe and stable insurance markets, and contributing to financial stability.

While regulatory capital responses to climate risks are not within the scope of the Application Paper, we understand that they are the subject of supervisory discussions and are discussed in the IIF Prudential

[2] One area in particular that would benefit from industry/supervisor collaboration and information sharing is with respect to expectations related to closing climate protection gaps (see e.g. Paragraph 11 of the Application Paper). The development of climate resilience through inclusive insurance is a laudable goal, but one that raises complex pricing and underwriting issues that need to be fully understood and reflected in any proposed solutions, including public-private partnerships.

Pathways Paper. We believe that the use of regulatory capital is an ineffective approach to the management of climate-related risks, which may give rise to unintended consequences, including the mis-pricing of insurance products and investments. In turn, insurance mis-pricing could have deleterious impacts on the ability of insurers to provide the long-term, patient capital on which markets depend.

Practical, Proportionate and Sequential Approaches to Risk Management

Given that the science around understanding and managing climate risk is rapidly evolving, very specific, mandated risk management requirements would be premature at this time. Instead, prudential supervisory approaches to risk management should be practical, proportionate and sequential, driven by data and informed by relevant expert advice and judgment. Supervisory initiatives should be risk-based, science-based and reflect and leverage market-led approaches to the extent possible.

The insurance supervisory approach to climate risks should reflect the insurance business model and careful consideration should be given to the differences between the insurance sector and other financial services sectors. We support an approach that promotes alignment to the greatest extent practical and possible among financial services standard setters, including a common taxonomy that is aligned across the financial services sectors and that is designed to be dynamic in order to reflect the changing understanding of climate-related risks. While there will be a need for some sectoral and jurisdictional differences to reflect the nature and materiality of the risks to which companies are exposed and the different paths and manifestations of climate risks across countries and regions (as well as the resources and capacity available to address climate-related risks in some emerging or developing economies (EMDEs)[3]), we support efforts to align and integrate supervisory practices over time.

Specific Comments on the Application Paper

Section 2: Role of the Supervisor

We appreciate the focus on materiality in Paragraph 12 of the Application Paper and we would support a further clarification that, at present, the concept of materiality is defined as financial materiality. It is also important for supervisors to account for different levels of materiality of climate risks across firms and to refrain from applying a 'blanket approach' to climate-related risks. In the first instance, supervisors should consider the firm's consideration of the materiality of climate risks in its own risk and solvency assessment (ORSA). (These comments are further elaborated in our discussion of Section 4 of the Application Paper.)

With respect to supervisory review and reporting (Subsection 2.2), we encourage the IAIS to state that supervisors should be mindful of the burden of multiple, duplicative information requests or data calls to insurers and should leverage existing sources of information to the maximum extent possible. Any information requests should have a clear risk-based objective and purpose that is tied to specific supervisory needs or goals; this would also help insurers provide the most meaningful data in response to supervisory requests. Insurance supervisors and supervisory colleges should make use of company reporting to group-wide supervisors in order to avoid duplicative and burdensome requirements.

[3] In addition, with respect to challenges in EMDEs, it should be noted that climate risk may be significantly interrelated with sovereign, political and legal or reputational risks.

Supervisors should be encouraged to coordinate data requests, which would greatly reduce administrative burden, especially for companies operating with a global footprint.

Section 3: Corporate Governance

We note that this section shifts the focus from recommendations for supervisors to recommendations for the insurers themselves. Consistent with the purpose of an Application Paper, we recommend a refocusing of this Section to the supervisory response. Supervisors should assess the robustness of insurers' corporate governance practices and recommend improvements where needed.

We recommend that the IAIS delete Paragraph 33. It is appropriate to link the variable compensation of those key individuals with direct responsibility for the risk management framework to the prudent management of all material risks, including any potential impact that climate change may have on the way risks emerge. However, the Paragraph as drafted could be read in a much broader fashion to cover employees who have no responsibility for or control over climate-related risks. Further, the last sentence of this Paragraph is vague and open to a variety of interpretations. Climate risk considerations are an important part of a wide range of factors that are taken into consideration and balanced in making investment decisions that are in the best interests of policyholders and other stakeholders.

Section 4: Risk Management and Internal Controls

Again, in this Section, the focus should shift back to supervisory best practices, rather than best practices for insurers. Supervisory engagement and monitoring of climate risks should be a key focus and guidance to supervisors should be principles-based and recognize the need for flexibility given the evolving nature and understanding of climate risk.

Any guidance to insurers should be developed in consultation with the industry and, in particular, in conversation with insurance chief risk officers. Insurers are incorporating climate risks into their ORSAs and enterprise risk management frameworks and are assessing the materiality of these risks across business lines and activities. Firms should be provided flexibility to adapt their risk management frameworks to reflect the risks that are most material to the company. Firms' existing risk management frameworks can be leveraged as a baseline for assessing climate risks as they have for other risks over the years.

Given the evolving nature of the science around understanding and managing climate-related risks, we recommend that the IAIS include in this Section language acknowledging that existing risk management frameworks, tools and capabilities will naturally and appropriately need to be developed and evolved in parallel. A phased approach to guidance, reporting and disclosure requirements would reflect this need for the further development and evolution of climate-related risk management frameworks.

We agree with the statements in Paragraph 38 that insurers should develop tools to collect reliable data in order to perform aggregated analyses of climate-related risks but this Paragraph should be restated in terms of what supervisors should expect to receive in terms of output from insurers. This Paragraph appropriately recognizes the value of a qualitative analysis of climate-related risks, especially in light of current shortcomings in available quantitative data. Given data shortcomings and the evolving nature of climate risk management, an overemphasis on quantitative analysis could result in a false sense of precision and security in the results. Further, at this time, we believe that scenario analysis should be exploratory in nature and focused on understanding how climate risks may emerge, rather than on developing responses to climate risks that may not be based on a comprehensive understanding of the multitude of factors that can influence or be influenced by climate considerations and, thus, may give rise to unintended consequences.

As further elaborated in our comments on Section 5, we encourage the IAIS and insurance supervisors to recognize the important differences between stress testing and scenario analysis and focus supervisory attention on the latter. Mainstream stress tests are near-term assessments of whether a firm has sufficient resources to weather macro-financial shocks. Climate scenario analyses, whether quantitative or qualitative, are designed to take a longer-term view of a range of potential pathways for climate-related risks and to understand how those risks would affect an insurer and how an insurer could respond to those risks.

Paragraph 50 should note that a number of jurisdictions have specific requirements relating to control functions. For those jurisdictions that are developing guidance in this area, flexibility should be granted to firms to reflect existing organizational structures.

We agree with a focus on climate-related risks in outsourcing decisions (Subsection 4.4), but we believe that Paragraph 51 should reflect that insurers may address the risks and potential consequences of vendor failure and other outsourcing risks in their operational resilience plans. We encourage the IAIS to adopt an outcomes-based approach that specifies the desired supervisory outcome and provides firms with the flexibility to choose in a principled and disciplined manner how to deliver that outcome. Outsourcing arrangements generally do not transfer control of key activities to third parties, which remains in the control of the insurer.

The need for proportionality is particularly important when supervising intragroup outsourcing arrangements. When developing supervisory expectations around exit strategies for intragroup outsourcing arrangements, supervisors should acknowledge that financial risk remains within the group.

Section 5: ERM for Solvency Purposes

We are in agreement with the statement in Paragraph 60 that the unique business strategy, investment portfolio and risk profile of each insurer will affect the degree of impact arising from climate-related risks. We encourage the IAIS to include this statement in the Introduction to the Application Paper.

Given the longer-term, forward-looking focus of scenario analysis relative to stress testing, we reiterate the comments raised above with respect to the need for supervisory focus on climate scenario analysis. A focus on forward-looking scenario analysis also reflects the longer-term focus of Paragraphs 61 and 62 of the Application Paper, in particular, the statement in Paragraph 62 that an insurer is required to perform a continuity analysis to assess its ability to manage its risks and meet its capital requirements under a range of plausible adverse scenarios with a forward-looking perspective in mind. The comments that follow are focused on scenario analysis, as we view scenario analysis as the better tool for assessing the potential impacts of climate-related risks, but many of these comments apply as well to stress testing.

With respect to the appropriate time horizon for the consideration of climate risks in scenario analyses (see Paragraph 61), we believe that this is a decision best made by the company's senior management based on the activities and risk profile of the firm and the types of assessments and scenarios that are the most decision-useful for the board and senior management. Climate risks do manifest over longer time horizons than many other risks but the decreasing reliability of results over a longer time horizon should be acknowledged.

Supervisors should also consider that robust scenario analysis may rely on data which is not currently available, such as data from counterparties. Consultation with the industry on the parameters and assumptions used in scenario analysis exercises can be useful in identifying data gaps and avoiding unrealistic expectations regarding the results of these exercises.

More generally, the design of scenario analyses should be industry-driven, providing firms with the flexibility to develop scenarios that best reflect their business models and particular risk profiles. An industry-driven approach to scenario design would help to develop effective and decision-useful tests. Supervisors and supervisory colleges have an important role to play in assessing the robustness of firms' analyses as well as the output of scenario analysis exercises.

At this time, given the early stage of development of climate scenario analysis, these analyses should be focused on understanding potentially material climate risks, exploratory in nature, and balanced between quantitative and qualitative data and observations, in order to produce reasonably reliable outputs that are decision-useful and avoid creating a false sense of precision in the results. This focus would also promote the efficient management of firms' resources.

Regular mandatory disclosure of quantitative scenario analysis results is premature at present. Any call for scenarios that could potentially cause insolvency is especially premature and could lead to inappropriate supervisory action. We encourage insurance supervisors to consider an iterative approach to any quantitative reporting or disclosure requirements when climate risk measurement tools and techniques are at a more advanced state.

Importantly, climate scenario analysis is not well enough advanced to serve as a foundation for decisions on prudential regulation, particularly regulatory capital requirements. There are a number of important conceptual and practical challenges associated with using regulatory capital to respond to climate-related risks[4] and other tools are better suited to address these risks. In particular, firms' internal risk management processes are a strong tool for managing evolving risks such as climate-related risks.

Section 6: Investments

We agree that physical and transition risks could have complex and non-linear impacts on insurers' investments that need to be taken into account whether the insurer invests directly or through a third-party asset manager or investment advisor. Insurers need to understand the long-term suitability of their investments as part of prudent asset-liability management, the ultimate purpose of which is to meet policyholder obligations. Greater recognition of and incorporation of climate risk into financial asset prices over time should serve to help to mitigate these potential investment risks.

With regard to the last sentence in Paragraph 70, we request that the IAIS further clarify the impacts of climate risk on asset-liability management and, in particular, how the correlation of asset classes is directly related to asset-liability management.

[4] See Section 3.5 of the IIF Prudential Pathways Paper.

As mentioned in our comments at Section 2, Role of the Supervisor, while the insurance sector can contribute to the shift towards lower-carbon economies, the development of enduring, sustainable responses to climate change will require and be driven by the degree to which broader national and societal efforts to transition are pursued and effective. While insurers may consider the stewardship aspect of climate change as one of a broad range of factors when considering strategic decisions, the supervision of climate-related risks should be risk-based and remain focused on policyholder protection, the promotion of fair, safe and stable insurance markets and financial stability. Section 6 should also acknowledge that the promotion of strategies to avoid certain assets in favor of others could create or exacerbate financial risks by incenting large shift in portfolio composition across the industry or by eliminating sources of investment and financing that will be needed to facilitate the transition to a lower-carbon economy.

While capital and valuation issues are not within the scope of the Application Paper, we understand that the IAIS is discussing these issues, as are a number of supervisors and standard setters. As a general matter, supervisors' use of prudential tools should remain risk-based. Climate or environmental regulatory capital adjustments or other regulatory efforts to re-direct insurers' away from certain types of assets and towards 'green' assets – an investment class that is still ill-defined -- could potentially undermine the credibility and efficacy of risk-based prudential instruments. These efforts could also generate unintended effects that could actually hamper the transition to a low-carbon economy, including by producing destabilizing asset bubbles in 'green' assets. To the extent that rating agencies or market prices already factor in climate risk, climate-based prudential requirements could introduce a double counting effect.

Section 7: Public Disclosure

We encourage a more proportionate and less prescriptive approach to public disclosure at this point in time, with an emphasis on voluntary disclosure. Market-led responses to the need for public disclosure should inform supervisory expectations or best practices on public disclosure. In designing any disclosure guidance, due recognition should be given to the requirements arising from the rules of listing authorities.

Guidance on disclosure should be proportionate and focused on the financial risks that are material and decision-relevant for the insurer, recognizing that materiality is company-specific. Companies should be encouraged to highlight not only risks but also opportunities that arise from the transition to a low-carbon economy.

Any disclosure requirements should be imposed in an iterative manner, with an initial focus on qualitative measures (especially for longer-term exposures), until climate risk measurement tools and techniques are at a more advanced state. A careful approach to disclosure requirements would help to mitigate insurers' exposure to legal risks. As noted above, the disclosure of quantitative climate scenario analysis results in particular is premature at present.

Finally, a number of companies within the financial sector and beyond voluntarily issue TCFD-compliant reports. The IIF welcomes the IAIS reference to TCFD as an example of developing best practice as it is important that firms consider internationally recognized guidance where appropriate in an effort to better align disclosures.

We appreciate the opportunity to comment on the Application Paper and we look forward to continued industry/supervisor dialogue on climate-related risks in the insurance sector. We would be pleased to present to the IAIS and its members our views on these topics in greater detail.

Respectfully submitted,

MF Monroe

Mary Frances Monroe