

# Questions for public consultation on draft application paper on climate scenario analysis in the insurance sector

Thank you for your interest in the public consultation on draft application paper on climate scenario analysis in the insurance sector. The Consultation Tool is available on the IAIS website.

**Please do not submit this document to the IAIS. All responses to the Consultation Document must be made via the [Consultation Tool](#) to enable those responses to be considered.**

## Consultation questions

<p>1</p>	<p>General comments on the draft application paper on climate scenario analysis in the insurance sector</p> <p>For the financial soundness of an industry for which risk is foundational, it is essential that risks—including climate change risk—are assessed, quantified, and managed on an impartial basis. The American Academy of Actuaries Prudential Regulation Committee believes that the extensive scenario analysis that is suggested may not be appropriate for every insurer, because the relative importance of an insurer’s risk exposures will vary depending on individual facts and circumstances. An overemphasis might lead to the neglect of more impactful marketplace or risk phenomena, because company management, the board, and regulatory bodies have a finite ability to evaluate and manage risks. We encourage a balanced approach that would caution stakeholders about the perils of either a neglect of or overemphasis on any particular risk phenomenon, including climate change risk.</p> <p>The paper recommends that supervisors and insurers place heavy reliance on a tool that the paper itself deems unreliable. Climate scenario analysis is suggested for an array of core insurance functions, including risk assessment, investment portfolio management, pricing, business strategy, and capital management. It further recommends that supervisors employ climate scenario analysis in the context of financial stability. Yet paragraph 34d of the paper observes: “Caution should be used when determining the impact to capital, given the high degree of tracking error, use of subjective assumptions, numerous variables, varying time horizons, range of possible outcomes associated with each scenario and overall uncertainty of scenarios.” This “overall uncertainty” would limit the utility of climate scenario analysis for all suggested uses, not just capital management. As currently drafted, it seems imprudent for the IAIS to suggest the extensive use of a tool that could produce unreliable results. Two potential options for revision of the current language include positioning the recommended uses as aspirational (subject to better data and modeling), or a more cautious or narrow scope regarding the suggested uses of scenario analysis. There is a risk of improper supervisory expectations and application, such as the proposed use of scenario analysis to assess protection gaps and risk concentrations (Box 2).</p> <p>Overall, the paper does not appear to give significant attention to the differences between life insurers and property and casualty insurers (P&amp;C). For example, P&amp;C insurers are mostly exposed to physical risk, and scenario analysis may not consider impacts on investments. P&amp;C business is subject to frequent repricing and reunderwriting (with policy terms of only 12 months or shorter in most cases). P&amp;C investments are aligned with these shorter durations, which limits the usefulness of projections for longer time horizons. Life insurers, on the other hand, will be most exposed to investment risks, which are longer term. These differences and their implications for scenario analysis merit a fulsome discussion within the paper.</p> <p>The paper appears overly prescriptive and detailed in its recommendations. Given the nature of climate scenario analysis, a principles-based approach would be more effective for supervisory oversight and insurer risk management, with the following points of emphasis:</p> <p>1.1. <u>Materiality</u>. The paper does not sufficiently approach this risk topic with the principles of proportionality and materiality (see par. 10 and 16). Thus, it does</p>
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	<p>not place any reasonable use case restrictions or limits on climate scenario analysis, such as if it is deemed to be immaterial for an insurer or duplicative to other risk factors (as a driver of other risks that are already identified, assessed, and managed). Instead, the paper expects continued escalations of scenario analysis (e.g., section 4.2).</p> <p><u>Recommendations.</u> The recommendations related to the Enterprise Risk Management framework, investment policies, Own Risk and Solvency Assessment, risk policies like Asset Liability Management, and board accountability overstate how climate scenario analysis can reasonably inform those risk practices (see section 5).</p> <p>1.2. <u>Best Practices.</u> For an emerging, jurisdiction-specific, and uncertain risk, “best practices” are often unclear. As drafted, the paper conveys an authoritative and prescriptive perspective that goes beyond recommending. We strongly encourage the use of “may consider” in place of “should” throughout this section and the broader draft.</p>
2	General comments on section 1 Introduction
3	Comments on section 2 Scenario analysis versus stress testing
4	Comments on section 2.1 Identifying and applying climate change risk drivers
5	Comments on section 3 Scenario analysis objectives and scenario design (ICP 24 and 16)
6	Comments on section 3.1 Objectives of climate-related scenario analysis exercise
7	<p>Comments on section 3.2 Scenario design</p> <p>As currently drafted, the paper contains an inconsistency between the recommended climate scenarios and the proposed uses of scenario analysis. Many current climate scenario sets vary by policy choice. For example, the NGFS scenarios, which the paper references repeatedly, are broadly categorized into three transition types: orderly transition, disorderly transition, and no transition (“hot house world”). Accordingly, if all the underlying assumptions were to perfectly forecast the future of various policy choices, the NGFS scenarios would demonstrate which policy choice would be best for the insurer and which policy position the insurer should support. Yet, the paper does not mention this conclusion from the NGFS scenarios; instead, it recommends using scenario analysis to answer questions that the scenarios themselves are not necessarily designed or intended to answer. The paper would benefit from linking potential climate scenarios to the intended uses of the analysis.</p> <p>We are also concerned that the paper fails to sufficiently address the weaknesses of static approaches and the use of longer-term time horizons when evaluating individual insurers or the insurance industry. Any change in the underlying risk environment will lead to management actions from insurers. The speed with which this happens is a function of the business model. Specific examples follow:</p> <ol style="list-style-type: none"> <li>1. For general insurers covering property risk from weather events, these management actions will take place every year the environment changes. As a result, even a 5-</li> </ol>

	<p>year projection using static projections of the exposure of the insurer may produce unreliable (and unrealistic) projections. For example, in property insurance, it is expected that 10% - 20% of insured properties will exit the portfolio annually. For medium- or longer-term time horizons, material changes in the portfolio of insured properties are to be expected. Consequently, catastrophe model projections using static projections as to the mix of insured properties produce largely meaningless results for longer-term time horizons.</p> <p>2. A similar problem exists regarding investment risk for all types of insurers. Nearly all insurers have limits on the portion of their investment portfolio that is allowed to be in non-investment-grade assets. These limits will likely be a combination of internally set limits and statutorily or regulatorily set limits. As transition risks cause investments in certain asset categories to be rated lower and lower, those limits force the investment portfolio to change. A static set of assumptions regarding investment portfolios will therefore give an invalid projection of individual insurer's and the insurance industry's investment risks.</p> <p>The use of static approaches has value only if applied to a particular region's total exposures, serving as an indicator of where the overall market in that region would need action, such as stronger building codes or new infrastructure regarding physical risks.</p>
8	Comments on section 4 Macprudential considerations for supervisors (ICP 24)
9	Comments on section 4.1 Assessing systemic importance (ICP 24.3)
10	Comments on section 4.2 Supervisory response (ICP 24.4)
11	Comments on section 4.3 Transparency (ICP 24.5)
12	Comments on section 5 Scenario analysis to inform assessment of insurers' risk management and governance (ICP 16)
13	Comments on section 5.1 ERM framework review (ICP 16.16)
14	Comments on section 5.2 Investment policies (ICP 16.6)
15	Comments on section 5.3 Underwriting policies (ICP 16.7)
16	Comments on section 5.4 Insurer ORSAs (16.12) (16.14)
17	Comments on section 5.5 Integrating scenario analysis into risk policies (ICP 16.5, 16.6 & 16.7)
18	Comments on section 5.6 Risk appetite statement (ICP 16.4)
19	Comments on section 5.7 Board accountability (ICP 16.11)
20	<p>Does the draft application paper provide sufficient detail to be a useful tool for supervisors and insurers?</p> <p>We don't believe that the scenario analysis as described will be a useful tool for the reasons described above.</p>
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?

	These are well covered in general, but as described above we don't believe the recognition of differences between life and P&C insurers is sufficient.
22	<p>Are there concepts or approaches which should be added to the application paper?</p> <p>We believe that consideration of management actions and other likely changes over time (versus a static approach) are critical to consider.</p>
23	Does the application paper cover all relevant issues for scenario analysis from a macroprudential perspective (see section 4)?
24	Does the application paper cover all relevant issues for scenario analysis related to Enterprise Risk Management and governance (see section 5)?
25	Is there any additional work the IAIS should be undertaking in the area of climate-related scenario analysis?