SLAUGHTER AND MAY

Insurance Newsletter

May 2019

CLIMATE CHANGE AND INSURERS

The Extinction Rebellion protests in central London have recently brought climate change to the front pages. A number of regulatory initiatives have highlighted the importance of financial institutions addressing the risks associated with climate change. Insurers are in some ways ahead of the curve on this, with participation in organisations such as ClimateWise promoting actions to tackle climate change risk. There are, however, specific actions which insurers will need to take in response to recent initiatives.

For financial institutions, and particularly insurers, climate change-related risks arise both from the physical impact of climate change and so-called "transition risks" arising from the move to a carbon neutral economy. To an extent there is a tension between these two risks, as a rapid transition would limit physical risks but might make transition risks more difficult to address.

What are the risks?

Physical risks	Climate change is giving rise to increases in extreme weather events such as hurricanes, flooding and droughts, which directly and indirectly impact financial institutions. For non-life insurers, increases in extreme weather events have a direct impact on claims. Insurers may need to adjust to the potential for significantly higher claims with an increase in premiums or a reduced risk appetite, given the potential impact on the profitability of insurers in relevant markets.
• Global insured losses from natural disaster events in 2017 were the highest ever recorded • The number of registered weather related natural hazard loss events has tripled since the 1980s • Inflation-adjusted insurance losses from weather related natural hazard loss events has increased from an annual average of around US$10 billion in the 1980s to around US$55 billion in the last decade	
Transition risks	Transition risks are more difficult to identify and to quantify. They arise out of changes implemented by governments to reduce carbon emissions. For example, changes in environmental standards applicable to housing could affect the value of buy-to-let properties, and consequently the default rate for associated mortgages. On a larger scale, there is a concern that some assets may become "stranded" as a result of technological advances and changes in regulation, for example if infrastructure has to be retired before the end of its useful life in order to meet emissions reduction targets.

All corporates need to consider their exposure to assets whose value could be affected by climate change and by the transition to a carbon neutral economy. It is of particular importance to insurers in view of the large amounts of assets under management they hold and their prudential requirements. As well as considering these risks in their risk management policies, many insurers are taking active steps to move investments out of carbon intensive sectors and to encourage best practice in the companies in which they are invested.

Financial disclosures

The Task Force on Climate-related Financial Disclosures (TCFD) is a Financial Stability Board task force which aims to "develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders". The TCFD issued a set of recommendations in June 2017 and its first Status Report providing an overview of current disclosure practices in September 2018. The Carbon Trust has estimated that 2/3 of the top 500 UK companies will be disclosing climate-related risks and opportunities in their 2019 annual reporting, but that fewer than a quarter will report fully in line with the TCFD recommendations.

Many insurers have been making disclosures of climate change risks for some time in a variety of environmental or climate change specific reports. ClimateWise was established in 2007 as an organisation with the mission statement to "support the insurance industry to better communicate disclose and respond to the risks and opportunities associated with the climate-risk protection gap". Members include the ABI, Aviva, Lloyd's, Prudential and RSA. ClimateWise has published a set of principles which include incorporating climate change into firm's investment strategies and reducing the environmental impact of business. From 2019, it has aligned its principles with the recommendations of the TCFD.

Regulatory initiatives

The Network for Greening the Financial System (NGFS)

The NGFS was established in December 2017 as a group of central banks and supervisors, currently consisting of 30 members and 5 observers, including the Bank of England. It published its first comprehensive report in April 2019.

The NGFS's April 2019 report sets out a number of recommendations, some aimed at central banks and supervisors and some aimed at policymakers. Key recommendations include promoting compliance with TCFD disclosures, sharing of data to bridge data gaps in analysing climate change risks, improving international consistency of disclosure frameworks and developing a taxonomy to better identify sustainable assets and those which are exposed to transition risks.

The NGFS recommendations are non-binding and implementation will therefore depend on the approach of individual jurisdictions. In Germany, for example, BaFin has announced that it plans to discuss the implementation of scenario analyses and climate stress tests in supervisory interviews with selected insurance undertakings only. In France, the ACPR is establishing working groups on the governance of climate-change related risks and risk metrics/ scenario analysis. In the UK, the PRA has published a supervisory statement on climate change risks for insurers (discussed on page 3 below) which is closely aligned with the recommendations of the NGFS.

FCA discussion paper

The FCA published a discussion paper in October 2018 (DP18/8 – Climate Change and Green Finance) considering various climate change issues, including the possibility of introducing a requirement for financial services firms to report publicly on how they manage climate risks which may affect their customers or operations. No feedback statement has yet been published.

The PRA supervisory statement

The PRA published a supervisory statement on "Enhancing banks' and insurers' approaches to managing the financial risks from climate change" (SS3/19) in April 2019. It covers four key areas:

Governance

Climate-related risks should be understood and discussed at board level and embedded into firms' investment strategies. The PRA expects firms to allocate climate change risk to a Senior Management Function holder by 15 October 2019.

Risk management

Climate change should be considered as part of the risk management system. UK firms will need to use scenario analysis and stress testing and to look at both short and long-term risks to their business model. The ORSA should consider all material exposures relating to the financial risks from climate change. Firms will also need to consider whether their exposure to financial risks from climate change in their investment portfolio is consistent with the prudent person principle, and take steps to mitigate where it is not.

Scenario analysis

The PRA emphasizes the importance of scenario analysis in consideration of financial risks from climate change. As well as asking firms to carry out scenario analyses, it intends to include consideration of physical and transition risk scenarios in its market-wide insurance stress test in 2019. In the policy statement accompanying SS3/19 the PRA acknowledges that there are challenges to carrying out scenario analysis such as lack of data and expertise. It hopes to issue further guidance on this in the future (see below).

Disclosure

The PRA encourages firms to engage with the TCFD recommendations, as well as requiring that they consider any further disclosures necessary to enhance transparency on their approach to managing the financial risks from climate change (over and above their Pillar 3 Solvency II requirements).

A framework for assessing financial impacts

The PRA published a practitioner's aide for the general insurance sector in May 2019 entitled "A framework for assessing financial impacts of physical climate change". The framework was developed by a working group of the PRA and industry experts and is intended to improve the ability of firms to respond to physical climate change risks and to increase levels of consistency across the market in assessing the financial impacts. The PRA also hopes that the framework could be adapted for use in other contexts, such as by asset managers seeking to identify financial impacts from climate risk to property.

What do insurers need to do?

For UK insurers, the most immediate actions are to ensure compliance with the PRA's requirements set out in SS3/19. For some insurers this may involve a shift in culture to recognise more fully the importance of climate change risk. For others, who already have climate change risk embedded in their risk management and disclosure procedures, it may be a simpler task to adjust current policies to align with the SS.

In the longer term, both the PRA and insurers themselves will need to do further work on data analysis and scenario modelling. The framework mentioned above is one contribution to this work. Models will need to be tested and updated on a regular basis to reflect actions taken by governments and the expected impact of those actions on both physical and transition risks. It is also likely that additional mandatory rather than voluntary disclosure requirements will be introduced in the future and insurers should be prepared for this.

Dated May 2019

A DUTY OF CARE FOR FINANCIAL SERVICES FIRMS?

In April the FCA published a feedback statement to its discussion paper on a possible duty of care for financial services firms (FS19/2 - A duty of care and potential alternative approaches). The headline conclusion appears to be that the FCA does not support the introduction of a new statutory duty of care. This does not mean, however, that no such new duty will be created - there is ample scope for a duty of care to be formulated in the FCA's rule-making.

The FCA plans to publish a further paper in autumn 2019 setting out possible options for change which are likely to include:

- introducing new or revised Principles to strengthen and clarify firms' duties to consumers
- introducing a private right of action for customers for breach of the Principles
- changes to how the FCA applies the regulatory framework, in particular how the Principles are used in supervision and enforcement.

Much of the feedback to the discussion paper appears to have focused on the perception that consumers are not adequately protected by current FCA rules. There is less clarity on how a new duty of care would improve the position of consumers and the FCA appear still to be grappling with this question. Those who were against the idea of a new duty of care have focused on:

- the risk of increased complexity
- concerns about how a duty would be interpreted, potentially leading to lack of clarity for firms
- fundamental issues regarding the extent to which a strict duty of care is appropriate - there will arguably always be some conflicts of interest between a financial services firm and its customers as an inevitable result of the commercial relationship.

The feedback statement does not suggest that respondents were particularly worried about the FCA relying more on Principles in its supervision of firms. This is, however, another aspect of the discussion paper which could give rise to concerns. Although firms already must have regard to the Principles at all times as well as the more detailed Handbook rules, extending the scope of the Principles or their use in enforcement may give rise to a significant lack of clarity for firms as to the extent of their regulatory obligations.

Stakeholders will have another chance to give input to the FCA when the next paper is published later in the year and firms are strongly encouraged to engage with the regulator on this topic.

REGULATION IN A POST-BREXIT WORLD

Despite ongoing delays the assumption is that the UK will eventually leave the EU, although the nature of the future relationship remains very unclear. It is expected that little will change in terms of financial services regulation in the immediate aftermath of departure. The onshoring of the EU acquis means that prudential rules for insurers will be effectively the same after we leave save for adjustments to reflect the fact that EU27 member states will be third countries for the purposes of UK regulation.

Going forward, there are a number of possibilities for the evolution of insurance regulation. It is likely that the UK will wish to remain closely aligned with EU rules in order to take advantage of "equivalence" rules for group supervision, group solvency and reinsurance. Some increased flexibility is, however, expected which firms hope may be applied to address issues with the current rules such as the application of the risk margin. There are also concerns that future changes to the Solvency II regime may make it less desirable for the UK to stay aligned closely - once the UK has left, for example, the matching adjustment rules could be significantly amended or even removed from the regime. This would be particularly concerning if it happened during a transitional period within which the UK was obliged to comply with the full regime.

Some of these issues were discussed by Sam Woods, deputy governor for prudential regulation and CEO at the PRA, in a speech given on 16 May on the topic of "Stylish regulation". In it he outlined the key principles which he thought should form the basis of any future UK regulatory regime:

- robust prudential standards
- responsible openness based on international collaboration and standards
- proportionality and sensitivity to business models
- dynamism and responsiveness
- consistency
- accountability.

Mr Woods emphasized the importance of the UK contributing to international standard-setting processes, which he linked to maintaining the UK as a leading international financial centre. Once outside the EU, the UK's existing engagement with international bodies such as the IAIS is likely to take on greater prominence. He also suggested that the UK should be open to hosting cross-border business in the UK, provided it could be regulated properly.

Some interesting comments were also made about how future rules should be implemented. Mr Woods contrasted the way in which the SMCR has been introduced, involving core aspects being set out in legislation with the detail in rules developed by regulators, with the more prescriptive legislative approach adopted by the EU. The Solvency II Level 2 Delegated Regulation is a good example of this, containing as it does the level of detail which in the UK was formerly contained only in PRA rules. Although this contributes to EU harmonisation it is less flexible than allowing the regulators more control over rule-making.

The way in which the EU acquis is being onshored means that the provisions of the Level 2 Delegated Regulation will continue to be amendable only by Parliament and not by the PRA post-Brexit. Perhaps unfortunately, Mr Woods does not propose that this is changed but that a more flexible style is introduced for future regulations.

MODEL DRIFT

Sam Woods' speech on stylish regulation included the comment that "we should aim for a system in which the burdens on firms created by our regulation are no greater than they need to be to achieve the objectives set by Parliament". Anyone suspecting that this signalled a move towards a less onerous capital regime should, however, take note of David Rule's speech at the ABI seminar two days before focussing on the PRA's work to guard against weakening of capital requirements calculated from internal models (referred to as "model drift").

The PRA's concern around model drift in the insurance sector arises partly from the more extensive use of models by insurers than banks in terms of the scope of modelling allowed for under Solvency II. It is no doubt also conscious of the fact that the UK is by far the biggest user of Solvency II internal models, which puts a degree of additional pressure on the PRA to ensure that models are not misused and reduces the opportunities for peer review between regulators.

David Rule reports in the speech that during 2016 and 2017, standard formula capital and best estimates of liabilities rose considerably more than internal model capital, which could suggest significant model drift. The same trend was not apparent for non-life firms. For the time being the PRA recognises that legitimate factors may have caused these effects but Mr Rule warns that this is not a trend the PRA would expect to continue over time.

Other key concerns in the use of internal models highlighted in the speech include:

- quality of validation of proxy models
- inconsistency and lack of rigour in use of management assumptions in models
- level of understanding by management of the internal model and the associated risk of model misuse
- use of third party models.

Although no specific action is required of insurers in response to the speech, users of internal models should have regard to the issues raised and ensure that they have taken them into account in the way they construct, validate and use their models.

Insurance breakfast seminar – 13 June

We are holding an insurance breakfast seminar on the morning of Thursday 13 June (8:30-9:30) covering the following topics:

- *Insurers as investors – climate change, equity release mortgages and more*
- *Lessons learned from Brexit insurance business transfers*
- *The Solvency II review*

To register for this event or for more information please email events@slaughterandmay.com

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