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IMPACT OF CLIMATE RISKS ON THE DEFINITION OF INSURANCE PREMIUMS

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Introduction

As is well known, the insurance sector plays a very special role in two complementary areas. In fact, first of all the insurance company carries out the systematic assumption of risks potentially capable of determining future and uncertain damage on the part of the insured (physical damage) or their assets. Risk transfer takes place through the stipulation of a “policy” in which the insurer commits to compensate damage suffered for an event, against payment of an economic fee. In the same time, the insurers are institutional investors with a long run view: as risk managers, risk carriers and investors, insurers have a fundamental interest in sustainable economic and social development. By insuring crucial infrastructure and buildings against natural catastrophes made worse by climate change, insurers already contribute significantly to the EU’s sustainability agenda.

The EU Sustainable Taxonomy

While many insurers already have or have started sustainability related initiatives consistent with objectives of the EU sustainable Taxonomy, new processes and data will be needed to comply in full to the new regulation. First of all, insurance companies should integrate sustainability in their corporate governance framework, intended to address evolving risks and take into account that materiality of climate risks differs across countries, entities and may change over time. The fast emerging and evolving nature of climate-related risks warrants an approach that ensures the framework fits markets that are different in nature and are at different levels in developing policy relevant to climate-related risks. For these reasons consideration of climate-related risks in underwriting policies should be supported as long as there is a right balance between all risks, and no excessive focus is put on climate risks at the expense of other risks. Consideration of the effect of sustainability risks including climate-related risks is dependent on the company-specific strategy and risk assessment and should be included in the Own Risk Solvency Assessment (ORSA) as long as these risks are financially relevant and material for the undertaking

Whilst the underwriting process differs from one insurer to another, sustainability factors are at the core of the underwriting process of all insurers. In this contest, the importance of flexible approach based on strong stakeholder engagement is crucial for investment policies and in developing effective frameworks for innovation and insurability especially in uncharted areas as climate-related risks. In the past, only 35% of the total losses caused by extreme weather and climate-related events across Europe were insured. Losses to properties and businesses are expected to grow due to climate change. It is necessary to formalise the approach used to assess the so-called Natural Catastrophes (NatCat) or, in a wider range, climate-related risks parameters.

The climate-related risks parameters

The CatNat Risk calculation is generally carried out on a factor-based model and in response to increasing climate-related risk, the price of insurance will increase. Over the medium-to-long term, this can lead to insurance being unavailable or unaffordable for citizens and businesses, leading to a further widening of the insurance protection gap. For these reasons the factor used in the calculation should be confirmed and if necessary, updated in a fixed and well-defined time horizon by a standard process defined by Supervisors. This time horizon could be different for each factor in order to grasp the differences and peculiarities of the specific risks. In any case, it is imperative that the process is consistent, comprehensible and transparent. In all roles the insurance business necessarily requires a sufficient set (or rather, the widest possible) of available information insurance industry fully supports the assessment of the materiality of climate-related risks. Having more and more concrete, relevant, accurate, reliable and comparable information on the ESG impact of companies guarantees greater transparency and knowledge of risks for both consumers and investors, thus ensuring a greater stability and reliability of the entire economic and financial system. There are some criteria to improve this process and the parameters used should consider the variability captured and evaluated by historical data and by probabilistic models. The re-calibration every 3-5 years of these parameters should also consider the expected possible changes that could occur during the time horizon where the same parameters are defined.

The assessment should ensure that climate-related risks recalibrations are only undertaken where material changes have occurred to avoid unjustified volatility in the parameters. The materiality approach for recalibration is necessary in order to not include artificial volatility, but this does not exclude a regular reperforming of the parameters. The process should be transparent with respect to the data used and the methods applied and recalibration should also take into account the proportionality principles of Solvency II. Representatives of model vendors, academics, insurance and reinsurance companies as well as scientists can all provide valuable insights into the process. In this contest, adaptation and prevention measures are an essential component for insurance business and, thus, should be taken into account for future calibrations. In fact, the adaption measures can reduce the losses and the calibration of the parameters should consider the real effects of the catastrophic events.

The calculation of premiums is actually based on the risk level by definition: since pricing is based on actual risks, existing prevention and/or protection measures are necessarily taken into consideration. Insurers will even refuse to offer cover for a highly exposed risk if the customer refuses to take preventive measures. It is important to clarify, as previously stated, that not taking prompt adaptation measures could bring impacts not only on the estimates, but also on a broader economical and human level, with “snowball” effects that

could be very significant. Risk-based premiums' calculation should be extended to include all prevention or protection measures put in place by the insurer, whether individual or collective, immediately linked to the product or not. Indeed, such measures contribute to climate risk awareness and the implementation of adaptation actions. Even measures that do not result directly from the policyholder's actions should be included: e.g. the level of the insurance deductibles for natural catastrophes are linked to the prevention plans implemented by municipalities.

Need of high-quality sustainability-related data

As stated before, insurance companies need for high-quality sustainability-related data, ratings and research for sustainable investment and underwriting strategies. For a comprehensive approach, insurers should consider, at least:

i. state of play of sustainability-related products and services market (e.g. trends, regulation, standards, sustainable investment, SRI strategies, market participants, data and information flow)
ii. classification of providers and products (e.g. product types/use, provider business models, ratings, research, screening tools, benchmarks, advisory services, conflicts of interest, competitive dynamics)
iii. processes and data (e.g. data directly from the company covered, unstructured company data, third party data, quality assurance, estimation)
iv. data assessment process and transparency of sustainability-related rating methodologies (rating methodologies, methodology and scoring, transparency, accessing ratings, bias, ratings correlation, divergence of sustainability-related ratings)
v. use of sustainability-related products and services (e.g. use by investors and benchmark administrators, considerations of companies assessed).

Today, only around 6,000 large companies are subject to the Non Financial Reporting Directive (NFRD). SMEs, non-listed companies and non-EU companies will not be obliged to report climate-related risks. In any case Taxonomy eligible underwriting should be based on the nature of the product sold and not on the nature of the customers' economic activities. A different approach requiring insurers to verify whether their customers are aligned or not with the Taxonomy, which is out of insurers' control. Most insurance policies in Europe are contracted by individuals or micro and small businesses that are not under the scope of the Taxonomy regulation and therefore not required to disclose the 'green share' of their activities. For all these reasons, insurers welcome the recent EU Commission initiative to establish a European single access point (ESAP) for financial and non-financial information publicly disclosed by companies in order to ensure a fair

and transparent evidence and views, including the scope of data (and whether it could be broadened to non-mandatory information), cost-benefits, how to address SMEs, etc..

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