International Association of Insurance Supervisors

Climate Risk Consultation Package 3 - Proposed changes to ICP Guidance to reflect climate risk

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Background

The Insurance Core Principles (ICPs) were adopted on 1 October 2011. Since then, amendments have been made to various individual ICPs, the most recent being adopted in November 2019.

This document includes proposed additions to reflect climate risk in the guidance to ICP 15 and ICP 16. This document only contains the relevant standards and guidance paragraphs that have proposed changes. The changes are underlined and shown in blue font.

The full overview of the ICPs can be found on our public website.

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Proposed changes to ICP 15 Guidance to reflect climate risk

ICP 15 Investments
The supervisor establishes regulatory investment requirements for solvency purposes in order for insurers to make appropriate investments taking account of the risks they face.

15.1 The supervisor establishes regulatory investment requirements on the investment activities of the insurer.

15.2 The supervisor requires the insurer to invest assets so that, for its portfolio as a whole:

- **assets are sufficiently secure and are held in the appropriate location for their availability;**
- **payments to policyholders or creditors can be made as they fall due; and**
- **assets are adequately diversified.**

15.2.1 […]

15.2.2 […]

15.2.3 External credit ratings can assist the insurer in determining the credit risk of an investment. However, the insurer should be aware of the limits of using external credit ratings and conduct its own due diligence to assess credit risk. The insurer should also consider the extent to which various external risks (such as climate change) have been factored into the ratings and over what time horizon, and make adjustment to the ratings where necessary. The supervisor may establish requirements for the appropriate use of external credit ratings. The supervisor may also require the insurer to conduct a credit analysis independent of the external credit rating, which may help in assessing the security of an investment.

15.2.4 […]

15.2.5 […]

15.2.6 [NEW] Insurers should consider the potential effects of climate change in their investments through traditional risk categories (such as credit risk, market risk, reputational risk and strategic risk) and assess how such risks may affect their investments. Investment decisions, especially at a large scale, could in turn also negatively impact climate change, potentially leading to financial impacts on insurers' investments through the aforementioned traditional risk categories. Taking these risks into account, insurers could decide to take

appropriate steps, such as engage with investees, divest of certain assets or change their investment strategy. This could also help insurers address potential reputational risks following from negative views of policyholders and market participants on their investment activities.

[…]

15.3 The supervisor requires the insurer to invest in a manner that is appropriate to the nature and duration of its liabilities.

15.3.1 Assets that are held to cover policyholder liabilities and those covering regulatory capital requirements should be invested in a manner which is appropriate to the nature of the liabilities, as the insurer needs to use the proceeds of its investments to make payments to policyholders and other creditors when due. The insurer's investment strategies should take into account the extent to which the cash flows from investments match the liability cash flows in terms of timing, amount and currency, and how this changes in varying conditions. For example, the insurer should consider how climate-related risks may change conditions for asset-liability management, especially, but not only, when the liabilities have a long duration. In this context, the insurer should specifically consider investment guarantees and embedded options that are contained in its insurance policies.

[…]

15.4 The supervisor requires the insurer to invest only in assets where it can properly assess and manage the risks.

15.4.1 The insurer should have sufficient information about its investments, including those in collective investment funds, to ensure that its asset risks can be properly managed. For certain investments where there are information gaps (for example, a lack of historical or readily available market data related to climate-related risks), the use of quantitative or qualitative scenario analysis could be useful in managing such risks.

15.4.2 The insurer should understand the risks involved, and determine how material the risk from a proposed investment is, before undertaking any investments. Assessment of risks should take into account the maximum possible loss, including losses that may occur in situations where assets, such as derivatives, become liabilities for the insurer. The supervisor should assess how the insurer identifies, analyses, monitors, manages, controls, and reports risks arising from its investments. This assessment includes how the insurer considers varying time horizons (short, medium and long-term).

[…]

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15.5 The supervisor establishes quantitative and qualitative requirements, where appropriate, on:

- **the use of more complex and less transparent classes of assets; and**
- **investments in markets or instruments that are subject to less governance or regulation.**

Proposed changes to ICP 16 Guidance to reflect climate risk

ICP 16 Enterprise Risk Management for Solvency Purposes

The supervisor requires the insurer to establish within its risk management system an enterprise risk management (ERM) framework for solvency purposes to identify, measure, report and manage the insurer's risks in an ongoing and integrated manner.

16.1 The supervisor requires the insurer's ERM framework to provide for the identification of all reasonably foreseeable and relevant material risks and risk interdependencies for risk and capital management.

[…]

16.1.9 The scope of risk identification and analysis of risk interdependencies should cover, at least: insurance risk, market risk, credit risk, concentration risk, operational risk, liquidity risk. Other risks may be included, such as climate-related risk, conduct risk, legal risk, political risk, reputational risk, strategic risk, group risk, and other emerging risks.

16.1.10 […]

16.1.11 The insurer should also assess external risk factors which, if they were to crystallise, could pose a significant threat to its business. Particular consideration should be given to whether there are any new emerging risks or changes to sources of existing risks (for example, climate-related risks or geopolitical trends).

16.1.12 […]

16.1.13 […]

16.1.14 Sources of risks may include natural or other catastrophes, downgrades from rating agencies or other events that may have an adverse impact on the insurer's financial condition and reputation. These events can result, for example, in an unexpected level of claims, collateral calls or policyholder terminations and may lead to serious liquidity issues. The ERM framework should adequately address the insurer's options for responding to such events.

[…]

16.2 The supervisor requires the insurer's ERM framework to:

- **provide for the quantification of risk and risk interdependencies under a sufficiently wide range of techniques for risk and capital management; and**
- **as necessary, include the performance of stress testing to assess the resilience of its total balance sheet against macroeconomic stresses.**

16.2.9 […]

16.2.10 Different approaches to measuring risk may be appropriate depending on the nature, scale and complexity of a risk and the availability of reliable data on the behaviour of that risk. For example, a low frequency but high impact risk where there is limited data (such as catastrophe risk) may require a different approach from a high frequency, low impact risk for which there is substantial amounts of experience data available. Stochastic risk modelling may be appropriate to measure some risks (such as non-life catastrophe), whereas relatively simple calculations may be appropriate in other circumstances. For complex risks of a long-term and non-linear nature (such as climate-related risks), scenario analyses may be considered as an approach to measure, in a forward-looking manner, to what extent the insurer is at risk and whether the insurer is able to absorb possible shocks.

[…]

16.2.16 Where a risk is not readily quantifiable or one risk amplifies other risks (for example, some operational, climate-related or reputational risks), the insurer should make a qualitative assessment that is appropriate to that risk and sufficiently detailed to be useful for risk management. The insurer should analyse the controls needed to manage such risks to ensure that its risk assessments are reliable and consider events that may result in high operational costs or operational failure. Such analysis should inform the insurer's judgments in assessing the size of the risks and enhancing overall risk management.

16.2.17 […]

16.2.18 […]

16.2.19 Stress testing and scenario analysis should be carried out by the insurer to validate and understand the limitations of its models. They may also be used to complement the use of models for risks that are difficult to model or where the use of a model may not be appropriate from a cost-benefit perspective. For example, these techniques can be used to investigate the effect of proposed management actions or the impact of climate-related risk changes over varying time horizons (short, medium and long-term).

[…]

16.3 The supervisor requires the insurer's ERM framework to reflect the relationship between the insurer's risk appetite, risk limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk.

16.4 The supervisor requires the insurer to have a risk appetite statement that:

- **articulates the aggregate level and types of risk the insurer is willing to assume within its risk capacity to achieve its financial and strategic objectives, and business plan;**
- **takes into account all relevant and material categories of risk and their interdependencies within the insurer's current and target risk profiles; and**
- **is operationalised in its business strategy and day-to-day operations through a more granular risk limits structure.**

16.5 The supervisor requires the insurer's ERM framework to include an explicit asset-liability management (ALM) policy which specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.

16.6 The supervisor requires the insurer's ERM framework to include an explicit investment policy that:

- **addresses investment risk according to the insurer's risk appetite and risk limits structure;**
- **specifies the nature, role and extent of the insurer's investment activities and how the insurer complies with regulatory investment requirements; and**
- **establishes explicit risk management procedures with regard to more complex and less transparent classes of asset and investments in markets or instruments that are subject to less governance or regulation; and**
- **as necessary, includes a counterparty risk appetite statement.**

[…]

16.6.6 A number of factors may shape the insurer's investment strategy. For example, for insurers in many jurisdictions, concentration risk arising from the limited availability of suitable domestic investment vehicles may be an issue. By contrast, international insurers' investment strategies may be complex because of a need to manage or match assets and liabilities in a number of currencies and different markets. In addition, the need for liquidity resulting

from potential large-scale payments may further complicate an insurer's investment strategy. With respect to climate-related risks, insurers should consider: longer term time horizons (although within the maturity profile of their investment portfolio); the impact of material climate-related risks on their investments, and the impact of their investments on the climate; and their customers' known preferences in relation to sustainability considerations, where relevant.

[…]

16.7 The supervisor requires the insurer's ERM framework to include an underwriting policy that addresses the:

- **insurer's underwriting risk according to the insurer's risk appetite and risk limits structure;**
- **nature of risks to be underwritten, including any material relationship with macroeconomic conditions; and**
- **interaction of the underwriting strategy with the insurer's reinsurance strategy and pricing.**

16.8 The supervisor requires the insurer's ERM framework to address liquidity risk and to contain strategies, policies and processes to maintain adequate liquidity to meet its liabilities as they fall due in normal and stressed conditions.

16.9 The supervisor requires, as necessary, the insurer to establish more detailed liquidity risk management processes, as part of its ERM framework, that include:

- **liquidity stress testing;**
- **maintenance of a portfolio of unencumbered highly liquid assets in appropriate locations;**
- **a contingency funding plan; and**
- **the submission of a liquidity risk management report to the supervisor.**

16.10 The supervisor requires the insurer to perform regularly its own risk and solvency assessment (ORSA) to assess the adequacy of its risk management and current, and likely future, solvency position.

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16.11 **The supervisor requires the insurer's Board and Senior Management to be responsible for the ORSA.**

16.12 **The supervisor requires the insurer's ORSA to:**

- **encompass all reasonably foreseeable and relevant material risks including, at least, insurance, credit, market, concentration, operational and liquidity risks and (if applicable) group risk; and**
- **identify the relationship between risk management and the level and quality of financial resources needed and available**
- **and, as necessary:**
- **assess the insurer's resilience against severe but plausible macroeconomic stresses through scenario analysis or stress testing; and**
- **assess aggregate counterparty exposures and analyse the effect of stress events on material counterparty exposures through scenario analysis or stress testing.**

16.12.9 The insurer should consider in its ORSA all material risks that may have an impact on its ability to meet its obligations to policyholders, including in that assessment a consideration of the impact of future changes in economic conditions or other external factors (such as the insurer's exposure to climate-related risks over short, medium and long terms). The insurer should undertake an ORSA on a regular basis so that it continues to provide relevant information for its management and decision making processes. The insurer should regularly reassess the sources of risk and the extent to which particular risks are material. Significant changes in the risk profile of the insurer should prompt it to undertake a new ORSA. Risk assessment should be done in conjunction with consideration of the effectiveness of applicable controls to mitigate the risks.

[…]

16.13 **16.13 The supervisor requires the insurer to:**

- **determine, as part of its ORSA, the overall financial resources it needs to manage its business given its risk appetite and business plans;**
- **base its risk management actions on consideration of its economic capital, regulatory capital requirements, financial resources, and its ORSA; and**
- **assess the quality and adequacy of its capital resources to meet regulatory capital requirements and any additional capital needs.**

16.14 16.14 The supervisor requires:

- **the insurer, as part of its ORSA, to analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements; and**
- **the insurer's continuity analysis to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements.**

16.15 The supervisor requires, as necessary, insurers to evaluate in advance their specific risks and options in possible recovery scenarios.

16.16 The supervisor undertakes reviews of the insurer's ERM framework, including the ORSA. Where necessary, the supervisor requires strengthening of the insurer's ERM framework, solvency assessment and capital management processes.

[…]

16.16.9 While insurers should carry out stress testing, scenario analysis and risk modelling that are appropriate for their businesses, the supervisor may also develop prescribed or standard tests and require insurers to perform them when warranted. One purpose of such testing may be to improve consistency of testing among a group of similar insurers. Another purpose may be to assess the financial condition of the insurance sector to economic, market or other stresses that apply to a number of insurers simultaneously (such as pandemics, major catastrophes or abrupt policy changes that can increase transition risk). Such tests may be directed to be performed by selected insurers or all insurers. The criteria the supervisor uses for scenarios for standard tests should reflect the jurisdiction's risk environment.