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REPORTING THE TRANSITION
(RISK)

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With the passing of the European Green Deal, the EU set its ambition to become the world's first climate neutral continent by 2050. While this this target date is still three decades away and therefore may seem to give insurers ample time to assess the impact of climate change risks, supervisory authorities are increasingly classifying climate change risks as the new financial risks that may have a significant impact on insurers' balance sheet.

For the Own Risk and Solvency Assessment (ORSA) the Dutch Central Bank (DNB) expects insurers to include both physical and transition risks[1] related to changing climate in 2020. While physical risks are increasingly included, for most insurers transition risks are not yet reflected in their risk models. Requiring granular details of the exposure and vulnerabilities of companies' and value chain counterparties' facilities, transition risks are subject to a more detailed analysis and reporting effort than physical risks. As these granular details are currently not comprehensively available and limited guidance exists to this day, insurers are having trouble estimating transition risks and reporting on their resilience to climate-change risks and the impact of their strategy on the environment.

EUROPEAN INSURANCE REGULATORS RAMP UP FOCUS ON CLIMATE CHANGE RISKS BORN BY INSURANCE COMPANIES

Given that the transition to a carbon-neutral economy may give rise to shocks that could be disruptive for the financial system, supervisory authorities such as EIOPA will focus their regulatory efforts in the coming years on climate-related risks. Whereas European companies were granted significant flexibility in disclosing relevant information regarding climate-related information in 'a way they consider most useful' initially, the European Commission recently reviewed the Non-Financial Reporting Directive (NFRD) as part of their strategy to strengthen the foundations for sustainable investment. These more stringent regulations will have to be incorporated and integrated in the reporting processes and systems of insurers and will be added to the increasing burden of reporting requirements that is carried by financial institutions.

THE NATURE OF TRANSITION RISKS LEADS TO NASTY CHALLENGES FOR RISK MODELERS

Research shows only a small number of companies disclose climate change risks, if at all[2]. Reporting seems more mature among large cap companies, where carbon-intensive and financial sectors demonstrate a more sophisticated approach compared to other sectors. Yet even these frontrunners face difficulties reporting on transition risks as a disconnect exists between the time horizon of potential impacts of transition risks – which is often beyond five years – and the time horizon that companies use for business planning and strategy definition purpose – which is often less than five years. Up until now regulators have merely given some exploratory guidance and requests for disclosures on how to treat transition risk[3] and have provided only limited tangible standards and policies. Without clear guidance on calculated probabilities and potential loss estimates beyond a five-year horizon even the existence of hard regulatory directives would not provide much concrete guidance to insurers on how to reflect transition risk beyond a few years.

An additional unfavorable characteristic of transition risks is that its impact is difficult to assess for a company, let alone a third party. The required information is scarce, uncertain and challenging to connect to either companies' financial information or business models. Many organizations might have already analyzed a potential impact of a carbon-neutral world, but as it potentially impacts their entire existence, they are not likely to share any details regarding their strategy or assessment outcome. An external party can still estimate physical risk relatively well (e.g., extreme whether event X will happen with probability p and insurance claim given event is €20-25 million), but it is much more difficult to calculate the indirect impact of climate risk in the form of transition risks due to non-visibility of investment strategies. So, insurers face the daunting task to assess these unknown and difficult parameters.

As with every paradigm shift (which is expected when moving to the carbon-neutral world[4]), entire industries are expected reinvent themselves. And while companies may have the best internal data and experts, they can still completely misjudge how and when their core business will change. Considerable uncertainty persists about how public policies will develop in the years to come, making it rather difficult for risk modelers to set reasonable assumptions. Hence, this raises the question: how can insurers be expected to accurately reflect transition risks in the risk calculations and reporting

1 ECB definition: **Transition risk** refers to an institution's financial loss that can result, directly or indirectly, from the process of adjustment towards a lower-carbon and more environmentally sustainable economy. **Physical risk** refers to the financial impact of a changing climate, including more frequent extreme weather events and gradual changes in climate, as well as of environmental degradation, such as air, water and land pollution, water stress, biodiversity loss and deforestation

2 *"Ready or not: Are companies prepared for the TCFD recommendations?"* Carbon Disclosure Project and Climate Disclosure Standards Board, 2018 & *"Sustainability Practices 2017 Key Findings,* The Conference Board, 2017

while it is not even sure whether the impact will be positive or negative for specific companies and entire sectors? One of the possibilities might be to "outsource" this to asset managers, which is simply deferring the problem.

Here, insurers can learn from banks in their on-going efforts to incorporate transition risks to reporting requirements. First, a robust framework is established with clear governance that integrates transition risks into their risk appetite framework. Techniques to cope with these risks such as transition risk heatmapping, scenario analysis and stress testing are introduced. Multiple applications of scenario analysis are employed to better understand the impacts of transitioning towards a carbon-neutral economy as well as to meet the growing list of requirements from regulators. Regarding stress-testing, banks tend to assess transition risks on global scale rather than countries specific[5]. In addition, some banks use sector-specific assessments as well as analysis at the transaction and counterparty level in iterative processes.

INSURERS MUST ACT NOW

In terms of risk modelling, insurers are faced with a gargantuan challenge. The push to a more carbon-neutral world will result in organizations being exposed to shifting asset values and higher costs of doing business. Insurers have to reflect these developments in their risk models for their business as a whole, which means they have to model a high-impact event that will likely happen somewhere in the (near) future but the gravity, expected loss, and time frame of which will be unpredictable. And while transition risks are increasingly being recognized as financial risks by supervisory authorities, their lack of clear guidance cause insurers to face considerable challenges in reporting, monitoring and managing transition risks. Here insurers do not have the luxury to see where the wind blows, but rather ensure that whenever the inevitable regulatory avalanche is coming, they are ready to act instantly. This can only be done by already assessing the potential impact of a carbon-neutral world on their investments, as only acting when the need arises will guarantee insurers will be playing perpetual catch-up.

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06-031.20

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