June 19, 2024

INSTITUTE OF INTERNATIONAL FINANCE

Mr. Shigeru Ariizumi
Chair, Executive Committee
Mr. Jonathan Dixon
Secretary General
International Association of Insurance Supervisors (IAIS)
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: IAIS Climate Risk Consultation Package 3 – Proposed Changes to ICP Guidance to reflect climate risk

Dear Messrs. Arizumi and Dixon:

The Institute of International Finance (IIF) and its insurance members are pleased to comment on the IAIS's *Climate Risk Consultation Package 3 – Proposed Changes to ICP Guidance to reflect climate risk* (Climate Package 3). The IIF has been leading and supporting efforts within the broader financial services industry to advance sound risk management practices for climate-related financial risks and we support the efforts of financial services standard setters to address these important concerns. Indeed, the interests and goals of supervisors and the insurance sector in managing climate-related risks are well aligned and the insurance industry continues to develop expertise in the management of these risks. Addressing these novel and complex risks requires a collaborative approach that includes supervisors and standard setters, insurers and climate experts. The IIF and its insurance members support greater coordination and collaboration across the wide range of insurance stakeholders and the IIF stands ready to help facilitate these efforts.

The IIF has responded to several climate-related consultations from the IAIS, including a response to the IAIS Draft Application Paper on climate risk scenario analysis in the insurance sector, and many of the points raised in those responses are relevant to a discussion of Climate Package 3.

Overarching Comments

The need for an iterative approach to the development of new guidance and supporting material on climate-related financial risks. We encourage the IAIS to take an iterative approach to the development of ICP guidance and supporting material that takes into consideration stakeholder comments on prior consultations before advancing new consultations. The development of supervisory guidance and supporting material related to climate-related financial risks requires careful consideration of the views of a wide range of stakeholders and experts in order to produce appropriate and proportionate guidance that avoids a number of potential unintended consequences. An iterative approach to the development of new guidance and supporting material can facilitate dialogue among IAIS members and stakeholders and reflect in subsequent consultations stakeholder views on prior proposals.

The need for supervisory coordination. Relatedly, we encourage the IAIS to recommend to its members the enhanced coordination of the plethora of guidance, data calls, and supervisory exercises designed to address climate-related financial risks. Inadequate coordination and communication among supervisors lead to multiple, duplicative and even conflicting guidance and requests for information and data that create serious resources issues for both supervisors and the industry and detract from industry efforts to address climate-related financial risks.

The importance of a clear linkage to supervisory mandates. Consistent with our comments on other sustainability-related topics, we encourage the IAIS and its members to consider carefully how their sustainability efforts tie to their supervisory mandates. We encourage a focus on climate-related financial risks that reflects the key role of the insurance supervisory community – that of requiring sound risk management and adequate levels of financial resources in order to provide for a safe and solvent insurance industry and for the protection of policyholders.

Climate Package 3 has a strong emphasis on insurers' investment practices and reflects a double materiality concept. The second prong of double materiality, i.e., the impact of an insurer's activities on the climate, does not advance the supervisory mandate of sound risk management and policyholder protection (see our specific comments under ICP 15 below). The supervisory focus should be on financial materiality and financial risk management and this focus should be reflected throughout the ICPs, ComFrame and the supporting material.

Insurers must structure their investment portfolios to meet a number of important goals. It is the responsibility of the senior management of an insurer to decide how the assets of the company should be invested in order to advance sound asset/liability management that positions the insurer to meet policyholder claims and other obligations. Consistent with their prudential mandates, supervisors have an important role to play in the event that they have concerns about excessive risk taking or other inappropriate practices. Absent those concerns, the responsibility for appropriate investment practices (which will vary from insurer to insurer) lies with company management. In general, given the importance of the insurance sector as a long-term institutional investor, supervisors should avoid using micro-prudential instruments to either encourage or discourage the integration of sustainability criteria in investment decisions. Capital requirements should remain risk-based; the introduction of non-risk-based factors could give rise to destabilizing impacts on the financial sector and real economy, including through potential herding behavior.

The importance of recognizing climate risk as one of many drivers of financial risks. The IAIS's stated view is that climate risk is not a standalone risk category but, rather, one source of financial risk.[1] This is appropriate, as market price fluctuations incorporate all available information and reflect all of the different sources of risk (including transition risks) that could impact economic activities. However, Climate Package 3 does promote the concept of climate risk as a separate risk taxonomy in various instances, rather than properly recognizing that climate risk is one of several drivers of traditional financial risks. See, for example, Paragraph 32 of the *Proposed supporting material to reflect climate risk*, with respect to which we have proposed rewording in our Specific Comments.

As noted above, the ICPs and ComFrame encompass *all* material risks to which an insurer may be subject, including financially material climate-related risks. This suggests that there may a need for a more limited

[1] https://www.iaisweb.org/activities-topics/climate-risk/

scope of additional guidance and supporting material related specifically to climate-related drivers of financial risks. Throughout the ICPs, ComFrame and supporting materials, reference should be made to *financially material climate-related risks*.

Relatedly, climate-related risk drivers of financial risk should not be elevated over other risk drivers that impact an insurance enterprise unless a materiality determination provides evidence that climate-related drivers are in fact more dominant risk drivers to the organization than others. Elevating climate-related risk drivers over other more dominant risk drivers can distort supervisory judgment and firms' risk assessments and related business decisions, in conflict with the very objectives of prudential supervision. In making sound, risk-based business decisions, company management needs to consider climate-related financial risks in the broader context of the full range of risks that are material to the company. As well, the board has a fiduciary duty to ensure that strategic plans and key business decisions reflect the consideration of *all* material risks. This is a particularly important distinction to make in the context of the ICPs, which are the backbone of the global framework for insurance supervision and against which IAIS member jurisdictions are assessed.

The important concept of materiality needs to be reflected throughout the ICPs, ComFrame and supporting materials. For example, ICP 16.1 appropriately incorporates a materiality standard that should be included as well in the guidance and supporting material under that ICP.

The supporting materials related to the ICPs should provide further advice, information, recommendations or examples of good practice, as opposed to prescriptive requirements. As we have noted previously with respect to Draft Application Papers, the IAIS should go back to first principles and refrain from providing in guidance and supporting materials prescriptive requirements that do not reflect the important principles of proportionality and materiality. We remain concerned that the supporting materials related to the ICPs may be interpreted by supervisors as prescriptive requirements from the IAIS and, by extension, that failure to implement those requirements could give rise to negative assessments. For example, the supporting material related to ICP 15 in Paragraph 6 refers to divestment and other investment strategies, such as exclusions, positive and negative screening, integration of ESG factors, suitability-themed investments and impact investment. Whether these strategies are relevant and appropriate for a particular insurer depends on its business model and strategies. If supervisors interpret Paragraph 6 as establishing an expectation that a supervisor should or must require all insurers to adopt those strategies, it could result in the application of inappropriate standards to a particular insurer or group of insurers.

Specific Comments – Proposed changes to ICP Guidance to reflect climate risk

ICP 15.2: The inclusion of a double materiality concept in the guidance under ICP 15.2 (15.2.6) is inconsistent with the key focus of supervisors on material financial risks. We encourage the IAIS to better emphasize in its guidance to supervisors the primary role of supervisors in promoting the financial soundness of the insurance industry for the protection of policyholders, including through supervisory practices and guidance to the industry that helps insurers better manage climate-related financial risk drivers.

Consistent with our comments above, in Section 15.2.6, we do not support the IAIS's implication that supervisors should expect insurers to divest assets or change their investment strategies or investee engagement practices, as these actions are the purview of the board and senior management based on the company's strategic plan and business model. We propose the deletion of this Section.

ICP 15.4: We question the reliability of climate scenario analysis (15.4.1) to manage risks in light of the significant lack of data. As noted in our response to the IAIS's *Draft Application Paper on climate risk scenario analysis*, data and methodological limitations constrain the ability of insurers to use climate scenario analysis (and particularly quantitative techniques) as an effective tool in decision making at the present time. In addition, some of the results of scenario analysis can be commercially sensitive and/or give rise to legal and reputational concerns. Supervisors should be mindful of these considerations when asking for disclosures to investors and other stakeholders and consider the provision of appropriate safe harbors.

We would redraft the second sentence of Section 15.4.1 as follows:

For certain investments where there are information gaps (for example, a lack of historical or readily available market data related to climate-related financial risks), a qualitative approach to scenario analysis is appropriate in assessing such risks.

Insurers should have the flexibility to define appropriate time frames for the assessment of climate-related financial risks, including through climate scenario analysis (15.4.2). The definition of short-, medium- and long-term time frames can vary depending on an insurer's business model and risk profile. However, any reference to time frames for capital and solvency assessments should explicitly reflect a short-term (e.g. one-year) time frame.

ICP 16.2: The guidance under this ICP in 16.2.19 refers to the use of scenario analysis to investigate the impact of climate-related risk changes over varying time horizons, including long-term horizons. Consistent with our prior comments on climate risk scenario analysis in the insurance sector, we caution against overly optimistic expectations regarding the reliability of climate scenario analysis over longer time horizons to inform firms' strategies, particularly for shorter-tail lines of business.[2]

We encourage the IAIS to consult with industry, climate scientists and modeling experts in order to better understand the current state of the art and limitations of climate scenario analysis, and to understand the limitations and uncertainties that arise in modeling over longer time horizons. As discussed in the IIF's Insurance Climate Scenario Analysis Report[3], most insurers report that they are only able to confidently model physical and transition risks over relatively short timeframes due to modeling and data challenges, as well as uncertainties regarding the future path of governmental and regulatory climate policies in various jurisdictions. Second-order effects of climate change, such as socio-economic impacts or the future direction of adaptation and mitigation efforts are also subject to substantial uncertainty. These uncertainties, as well as the necessary reliance on estimates and proxies, decrease the precision of climate modeling and call for a careful approach to interpreting the results of scenario analysis exercises that incorporate more qualitative insights.

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[2] Our comments regarding the exploration of longer time horizons for climate-related risks is also pertinent to the guidance in 16.6.6 and 16.12.9.

[3] https://www.iif.com/portals/0/Files/content/32370132_iif_insurance_climate_scenario_analysis_report_-_final.pdf

ICP 16.16: We reiterate our comments with respect to the own risk and solvency assessment (ORSA) in response to the guidance under this ICP. The ORSA should continue to be a qualitative and quantitative assessment that is owned by the company, tailored to fit its organizational structure and risk management system, actively used by the company in its own risk management, and reflective of the company's unique risk profile and the materiality of various risks to its business model. The ORSA should primarily cover near- to medium-term material risks, consistent with the three- to five-year strategic planning horizon. The IAIS should be mindful not to single out climate risk as a predominant risk driver, as the materiality of this risk driver may differ across insurers. In addition, caution should be taken not to double count climate-related risk exposures and traditional financial risk exposures.

Specific Comments – Proposed supporting material

Chapter 3 – Corporate Governance

Section 3.3: The role of the board: the composition of an insurer's board should reflect a broad range of skills, including individuals with a good understanding of climate-related risks and broader sustainability topics. We encourage the IAIS to emphasize the need for climate and sustainability expertise as one element of the needed diversity of backgrounds and talents on an insurer's board.

It is also helpful for the board to have a healthy diversity of views on the subject of climate-related risks and broader sustainability topics in order to reflect the range of views of stakeholders on these issues and to promote a healthy dialogue that can lead to better decision making. More broadly, corporate culture may differ among insurers, reflecting different business models, management styles and jurisdictional requirements and norms; diversity in corporate cultures and in corporate views on sustainability matters should not be perceived negatively by supervisors.

With respect to Paragraph 32, when an insurer's board retains external expertise, the relevant board committee should conduct appropriate due diligence, but it cannot be expected to 'demonstrate the competence of the experts' or 'assess that the information and guidance is appropriate'. Rather, the board committee should be expected to review the qualifications and background of proposed experts and make an informed decision as to whether their retention would benefit the firm.

We propose the following rewording of Paragraph 32:

Accordingly, insurers should demonstrate that the board has adequate information and analysis in order to understand how climate-related risk drivers could impact the business activities and financial condition or performance of the insurer. The board may consider obtaining external advice consistent with the materiality of climate-related financial risks to the company.

Section 3.4: Senior management has the responsibility for the management of all material risks, including climate-related- financial risks, and for reflecting those risks in relevant operational and business policies. Senior management should advise the board on how material climate-related financial risks can impact strategic and organizational objectives, and should explain the tools, models and metrics that they and/or external experts employ in monitoring exposures to material climate-related financial risks. The board should be permitted and expected to rely on the advice of senior management with responsibility for material climate-related financial risks.

We would restate Paragraph 34 as follows:

Senior management should be responsible for implementing policies related to the management of material climate-related financial risks and/or incorporating these risks into relevant operational and business policies. Senior management should provide information and advice to the board on how climate-related financial risks may impact strategic and organizational objectives.

Section 3.5: We propose to rename this section 'Alignment of remuneration'. Management remuneration should be aligned with the management of *all* material risks. Specifically, climate risk drivers will be reflected in the management of traditional financial risks, such as credit and market risks. Only those individuals with responsibility for risk management should be subject to negative remuneration consequences for poor outcomes.

When considering the design of remuneration frameworks to reflect climate-related risks, it should be recognized that the long-term time frame for climate-related risks is at odds with the much shorter time frames for most long-term incentive plans (approximately three years). We would retain the words 'as appropriate' in Paragraph 35.

The remuneration framework should be a matter for the board to design and for senior management to implement (subject to shareholder oversight and the ability to reject remuneration plans). This section in general, and Paragraph 36 regarding variable remuneration in particular, is overly prescriptive. We propose the deletion of Paragraph 36.

Section 4 – Risk management and internal controls

Paragraph 41 reiterates the double materiality concept referenced above. We would revise the final sentence of this Paragraph to read: *Insurers should consider the extent to which their investment strategy and business models could be materially impacted by financial risks, including those arising from climate risk drivers, and take into account in their analysis the expected timeline and path for transition in their major markets.*

Paragraph 42 should reference climate risk *drivers* rather than climate risks.

Proposed new climate risk-related supporting material related to ICP 15

We agree with the need for insurers to consider the potential impacts of climate change on the insurer's investments and insurers generally do conduct these assessments. However, despite the development of various methodologies to assess, categorize and disclose financial institutions' exposures to climate transition risk, there remains little formal consensus as to the most suitable and relevant data and metrics through which to do so.[4] The metrics that are most useful may differ by business line. Moreover, some commonly used metrics, such as GHG emissions, are not pure risk metrics but, rather, impact metrics. Conceptually and empirically, emissions-based metrics do not provide a comprehensive indication of a company's overall exposure to transition risk and therefore financial risk. For example, an investee with a higher starting level of GHG emissions and a credible transition plan may be less exposed to transition risk over the medium- to long-term than an investee with lower starting GHG emissions and no transition plan. More generally, while transition and physical risk drivers may be relevant inputs into an insurer's risk

[4] https://www.iif.com/portals/0/Files/content/32370132_iif_wtw_99786_emissions_impossible_whitepaper_v6-final.pdf

management framework, they do not necessarily equate to the risk of financial loss (e.g. market risk to the investment portfolio).

Accordingly, we do not believe that supervisors need to establish prescriptive regulatory investment requirements that include the impacts of climate change, as suggested in Paragraph 1 in the proposed new supporting material related to ICP 15. Any prescriptive, one-size-fits-all requirements would be at odds with the principle of proportionality and could give rise to negative unintended consequences, including herding behavior, if applied to all insurers in a particular jurisdiction. It is also seriously at odds with the responsibility and duties of the insurer's board and senior management to decide an appropriate investment strategy and policies for the insurer and to manage the company's assets and liabilities, taking into consideration all material risks (as acknowledged in Paragraphs 3 and 7). Rather, we support the approach taken in Paragraph 17 under the proposed new climate risk-related supporting material related to ICP 16, which recognizes that the unique business strategy, investment portfolio and risk profile of each insurer will affect the degree of impact on the organization of climate-related financial risks. This Paragraph also properly assigns to senior management the role of identifying, managing and mitigating those risks.

Further, with respect to Paragraph 3, we would amend the third sentence to read that 'it may be relevant for *senior management of the insurer* to assess and take necessary action as to how the impact from climate change on the insurer's investment may affect the risk-return characteristics of a portfolio'. This assessment and any subsequent action should be taken by the senior management of the insurer rather than by the supervisor.

Insurers invest their assets in light of a number of important objectives, including compliance with existing regulatory requirements and asset-liability management being among the most important given insurers' obligations to policyholders.[5] As noted above, insurers and supervisors have a common goal of ensuring that all material risks are well managed, including material climate-related financial risks.

Supervisors should intervene in the event that senior management does not meet regulatory requirements or fails to adequately manage the risks of the investment portfolio (and particularly if risk management shortcomings could negatively impact policyholders).

We believe that the ability of insurers to consider the impact of climate change on investments would be greatly facilitated by the growth of credible, transparent and voluntary carbon markets. We encourage the IAIS to consider how it could advocate for greater development of voluntary carbon markets, coordinating the IAIS role with other public sector bodies such as finance and environmental ministries.

With respect to Paragraph 6 of this supporting material, we note that credit rating agencies are evolving their individual practices with respect to the consideration of climate-related risks. The major credit rating agencies are developing their own methodologies for the consideration of climate (and other ESG) factors in their credit ratings, and only account for them so far as they can materially influence the creditworthiness of a rated entity.

Moreover, insurance supervisors do not have oversight responsibilities for credit rating agencies, and they should not imply that insurers are tasked with these responsibilities as credit rating agency customers.

[5] It should also be noted that many asset classes traditionally held by insurers may be less susceptible to climate-related risks than other asset classes that are less prominent in insurance investment portfolios.

Apart from it being an inappropriate role for insurers to perform, insurers do not have the requisite information, skills, and background to perform these tasks, nor do they have access to the proprietary techniques and models employed by the rating agencies that would be needed in order to properly perform these tasks. We would delete the second and third sentences of Paragraph 6.

Similar considerations apply to the use of ESG data and ratings from external sources referenced in Paragraph 11. Insurers may not have access to the proprietary data and modeling that is used by external providers of ESG data and ratings. We would reword the final sentence of Paragraph 11 to read: *Insurers should engage with any third-party ESG ratings providers to better understand their ratings criteria.*

Proposed new climate risk-related supporting material related to ICP 16

Paragraph 18 of this supporting material calls for the ORSA to include appropriate scenarios that use a more extended time horizon. We do not believe that supervisory expectations for the ORSA should include scenarios beyond the three- to five-year business as usual horizon. An insurer's ORSA should primarily cover near- to medium-term material risks, consistent with the strategic planning horizon, which is considerably shorter than some climate physical and transition risk time horizons. The results of climate scenario analyses, particularly those based on longer time frames that involve highly uncertain climate pathways and other variables, are not useful for informing near- to medium-term risk management. Supervisors should expect that company perspectives related to the analysis of longer-term time frames will be qualitative in nature.

Moreover, the incorporation of the results of climate scenario analysis in the ORSA should be solely at management's discretion, informed by the materiality of climate-related financial risks to the company. The disclosure of climate scenario results should not be mandated in supervisory requirements. Climate-related risk drivers should not be elevated over other material insurance risk drivers and all risk drivers should be considered through the lens of materiality to the firm.

We appreciate the opportunity to comment on Climate Package 3. We would be pleased to discuss our views with you and the IAIS members involved in this work.

Respectfully submitted,

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