New ORSA Requirements:
Climate Change Risk Scenarios

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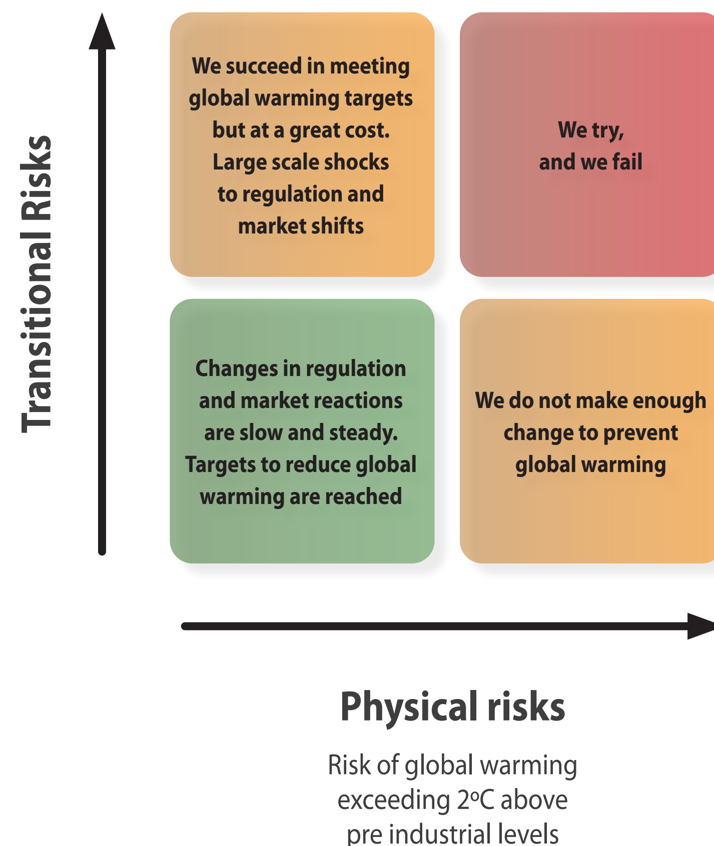
> *"the wide-ranging indirect impacts need to be considered"*

What's changing?
New EIOPA[1] guidance is being introduced which specifically requires (re)insurers to include climate change risk scenarios as part of their long term risk assessment and own risk solvency assessment (ORSA). Consequently (re)insurers will need to consider how to assess their business critically, to identify and measure material risks related to climate change.

What are climate change risk scenarios?
Risks related to climate change are typically classified as physical or transitional:

- Physical risks relate directly to the environmental impact of climate change, such as increased flood exposure.
- Transitional risks reflect the uncertainty and the potential for 'step-changes' which are experienced in the insurance industry and wider financial markets. These could arise due to policy and legislative changes as governments around the world take action to limit the impact of climate change.

Climate change scenario analysis is an evolving area; one method of choosing appropriate scenarios could be to consider the extent of physical and transitional risks as two ranges as shown in the chart. Different scenarios could then be generated by considering multiple positions on this two dimensional space.



For example, a scenario which considers high transitional risk / low physical risks (top left of the chart) might be:

- Transitional Risk (HIGH) A significant reduction in the market value of assets held in any investment which is not classified as green and/or sustainable, and
- Physical Risk (LOW) A moderate increase in flood risk exposure for property insurance.

(Re) insurers also need to reflect on the time horizon for climate change risk scenarios, as the timeframe may well need to be longer than that used in their current projections.

Are these risks already covered in the current Solvency II framework?
The short answer is "No".

The regulatory Solvency II assessment does prescribe stressing risks, such as market decline and natural catastrophe events. Individually these stresses could represent some of the impacts of climate change. However, combined scenarios specific to climate change are currently not prescribed.

Under current guidance, ORSA's should contain stress scenarios specific to each business. From a recent survey[2] by EIOPA only 13% of businesses had made reference to climate change risk scenarios in their ORSA.

What's the impact?
The risks caused by climate change will impact all (re)insurers, even if they are not writing risk which could be impacted directly by the extreme weather events. This is because the wide-ranging indirect impacts need to be considered as well. For example:

- Increased default risk on their reinsurance contracts based on their own reinsurer's direct exposure to climate change.
- Significant market changes caused by new technology or legislative changes which drastically reduce worldwide oil consumption.
- Increased operational risk from non-compliance with climate change-related legislation.

Timescale
The new ORSA requirements come into effect from April 2023. While this is nearly two years away, (re)insurers are encouraged to start work, as soon as possible, to ensure that their scenarios are as relevant as possible for their business.

When considering future risk, irrespective of jurisdiction, the EIOPA guidance provides a framework for considering climate change risk scenarios in ORSAs.

Please contact insurance@bwcigroup.com for further information on how we can help your business in designing climate change risk ORSA scenarios.

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[1] European Insurance and Occupational Pensions Authority

[2] Research conducted by EIOPA

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