International Association of Insurance Supervisors
Climate Risk Steering Group
Bank for International Settlements
CH-4002 Basel
Switzerland

May 15, 2023

Re: IAIS Public Consultation on Climate Risk Supervisory Guidance

To the Climate Risk Steering Group,

Public Citizen, a public interest advocacy group with more than 500,000 members and supporters, welcomes the opportunity to respond to the first IAIS public consultation on climate risk supervisory guidance. We appreciate IAIS's leadership in establishing global best practices for insurance supervisors and believe these are highly relevant to U.S. supervisors. As climate risks present an increasingly intense and urgent threat to insurance markets, we hope that IAIS will see this as the first step in a broader, ongoing effort to develop best practices on climate-related risk.

While the insurance industry often touts its expertise in understanding weather and climate-related risks, this understanding has not translated into sufficient action. Insurers continue to invest in and underwrite fossil fuel expansion and delay efforts to address climate-related risks. At the same time, insurers are shifting more costs to consumers and withdrawing from communities vulnerable to physical climate risks. In doing so, these insurers are effectively eroding their own markets in the pursuit of short-term profits.

Insurers have made little effort to hide their emphasis on short-term thinking. Property insurers rely on one-year contracts that allow them to both quickly end contracts with fossil fuel companies and cut off homeowners vulnerable to extreme weather. This strategy underestimates not only the transition risks from fossil fuels but also the devastating impact of withdrawals on insurance markets, local and regional economies, and ultimately the financial system as a whole. Supervisors should require insurers to develop long-term risk management strategies that protect policyholders, individual insurers, insurance markets, and the financial system.

As insurance supervisors consider how to respond to climate-related risks, they should recall two lessons from the 2008 financial crisis. The first is that even supposedly sophisticated risk managers can contribute to massive systemic threats when their pursuit of short-term profits blinds them to complex, correlated risks. The second is that supervisors who focus too narrowly on individual aspects of a company or an economy will be unequipped to recognize and act on interconnected risks.

We urge IAIS to apply these lessons as it reviews and expands materials on climate-related risks. IAIS has stated that a good supervisory response to climate risks will protect policyholders, contribute to financial stability, and promote fair, safe, stable insurance markets. To address insurers' blind spots, IAIS should use this consultation process to strengthen its existing materials on financial stability in line with a precautionary approach. To address the interconnected nature of climate risks, IAIS should also expand its current scope to provide best practices on protecting policyholders and promoting fair insurance markets.

IAIS should recommend supervisors adopt a precautionary approach to climate-related risks.

Insurers' traditional approaches to risk management, including modeling, hedging, and reinsurance, are insufficient to manage the unique aspects of climate risk. As New York's climate risk guidance for insurers states, climate risks are "non-linear, correlated, and irreversible," and climate impacts have consistently emerged sooner than scientists have expected. The failure of Merced Property & Casualty Company after the Camp Fire in California in 2018 shows that even well-capitalized companies may be unprepared for physical climate-related risks. And along the Gulf Coast, major insurers have rapidly withdrawn, leaving behind smaller and weaker insurers. A series of insolvencies among these insurers and a resulting access crisis shows that intervention may be too little, too late if supervisors wait to act on correlated, irreversible risks until they have perfect visibility.

To address risks that are difficult to quantify, a precautionary approach requires establishing large margins of error, eliminating risks that cannot be modeled, rejecting the assumption that risks can be hedged adequately, and evaluating every part of the business for risk. We appreciate that the guidance already includes some aspects of a precautionary approach, such as recommending a whole-of-business approach, cautioning insurers about over-relying on historical data, and recommending that insurers analyze risks over long time horizons. However, IAIS should acknowledge the inherent limitations of risk management via modeling and quantification and encourage supervisors to focus on actions they can take now to increase their margin of safety.

IAIS can start by integrating a precautionary approach into existing materials on scenario analysis. Several factors can enhance the effectiveness of scenario analysis, including the use of short and long-term time horizons, qualitative and quantitative data, realistic assumptions, and an expansive range of stressors. However, even with these best practices, scenario analysis remains a limited tool that likely understates risks.

Moreover, the unique nature of climate-related risks make them ill-suited for management through quantification and modeling. IAIS should direct supervisors to focus on actions they can take now to reduce risk, including risk-based capital requirements. Increasing capital can be an important strategy for individual insurers who are particularly exposed to carbon-intensive assets. Given the pervasive misalignment with science-based targets, however, IAIS should also provide best practices on increasing system-wide levels of capital to maintain financial stability.

IAIS should recommend supervisors use transition plans as a tool to monitor the stability of individual insurers and insurance markets.

The most effective way to reduce climate-related risks in line with a precautionary approach is to direct insurers to engage in a managed draw-down of fossil fuel finance and underwriting. While voluntary insurer net-zero commitments have proliferated, the weak standards of voluntary initiatives like the Net-Zero Insurance Alliance, as well as the recent departure of several key NZIA members shows that voluntary associations will be ineffective in generating credible commitments and will not be able to hold insurers accountable. Supervisors must take action to ensure that insurers create credible transition plans and adhere to them.

IAIS should provide best practices for transition plans that facilitate supervisors using them as a forward-looking tool to assess the stability of individual insurers and insurance markets. Because insurers are using net-zero announcements to influence consumers and investors, IAIS should also provide best practices on evaluating the risk of greenwashing as a market conduct issue.

To be credible, transition plans must include short, medium, and long-term goals for meeting science-based targets and provide transparent metrics for evaluating those goals. Credible plans must include absolute reduction goals, a commitment not to finance new fossil fuel projects, and significant limits on carbon offsets and negative emissions technology.

Most importantly, a credible plan for an insurer must rely on reducing *financed and insured* carbon emissions. Insurers' direct emissions represent just a small fraction of overall emissions. Allowing insurers to announce net-zero commitments exclusively for their operations, omitting the vast majority of their emissions, guarantees that supervisors and consumers miss the forest for just a handful of trees. Additionally, while insurers may rely on a client engagement strategy for reducing emissions, a credible client engagement strategy requires the ability to say no. If insurers plan to reduce financed or insured emissions through client engagement, supervisors must require insurers to produce and follow realistic plans to deal with clients who do not make progress on emissions reductions.

Supervisors must also continually monitor insurers' adherence to their stated commitments. IAIS should highlight that if the supervisor believes insurers have made genuine commitments, a lack of progress should trigger concerns about whether management is capable of understanding and addressing the climate-related risks and its own commitments, as well as capable of operationalizing its plans effectively. IAIS should also highlight that if commitments appear insincere, insurance supervisors must protect consumers from "greenwashing" claims that obscure insurers' actual approach to climate change.

Recognizing that these risks are interconnected, IAIS should provide best practices on maintaining access to affordable insurance, with a focus on equity.

Instead of managing climate risks, insurers have been quietly transferring the costs to policyholders. Even as the costs from climate-related disasters grow, insurers have protected their profits by raising homeowner insurance premiums and deductibles, cutting out coverage for climate-related hazards, delaying, denying and underpaying post-disaster claims, and in some of the most vulnerable communities, simply withdrawing. It is unconscionable for insurers to contribute heavily to climate harms by supporting fossil fuel production wildly in excess of climate targets and then raise prices and abandon policyholders as a result of climate harms that the insurers have helped cause.

Due to a history of redlining and underinvestment, climate risks like flooding and wildfires disproportionately impact marginalized and low-income communities. As insurers withdraw, they will transform formerly redlined communities that previously could not access the financial system into "bluelined" communities that now cannot access insurance and, by extension, home ownership.

Patterns of delay, denial, and underpayment will also be particularly challenging to vulnerable communities that already lack the credit access to fund repairs or the funds to pay for both a primary residence and a temporary one while they wait for their claim to be approved and paid. Multiple studies have shown that communities of color face additional hurdles and longer waits on claims payments, and insurers responses to climate change will likely reinforce those trends.

In some regions, insurance withdrawals could reach tipping points that trigger devastating harm to local, regional, or even national economies. For example, in the U.S., rising insurance costs and falling availability could lead to a foreclosure crisis, which could in turn threaten the tax base needed to fund basic mitigation and increase risks for community and regional banks. In New York City, officials have already warned about the risk of a foreclosure crisis in the community of Canarsie. In 2020, a report from an advisory committee to the U.S. Commodity Futures Trading Commission warned that "sub-systemic" shocks like this one could create a "systemic crisis in slow motion."

Just as insurers must evaluate climate risks in every part of their business, supervisors must evaluate every part of insurance markets and their connection to the broader financial system. Rather than viewing a growing gap in insurance access as an isolated issue, IAIS should recognize that risk supervision and access to insurance are closely intertwined. We appreciate that IAIS has recently established a natural catastrophe protection gap workstream, and we encourage the Climate Risk Steering Group to coordinate with this new workstream on the unique climate-related factors increasing the protection gap. We also urge the Climate Risk Steering Group to explicitly address best practices on access to insurance, with a focus on equity, into materials on climate risk supervision.

To prevent insurers from simply transferring risk throughout the economy, IAIS should help supervisors take proactive steps to protect policyholders. IAIS can start by integrating these concerns into materials on climate risk supervision. IAIS can look to guidance from New York State, which acknowledges the potential for climate risk management to harm vulnerable communities and encourages insurers to contribute to just transition and climate adaptation efforts, and not to abandon communities who will become even more vulnerable to climate harms if insurers stop covering them. Specifically, IAIS should recommend that supervisors require insurers to disclose the impacts of particular risk management strategies on access to insurance, particularly for vulnerable communities, in both their scenario analyses and their transition plans.

IAIS should also address the unique climate-related impacts on market conduct and provide best practices for proactively protecting policyholders. Insurers that have failed to prepare for climate risks may be tempted to maintain their solvency or protect their profits by cutting coverage or disputing whether damage is covered. Insurers may also seek to delay, deny, or underpay claims. In California, insurers introduced illegal coverage limitations on smoke damage to avoid paying for increasing wildfire claims. In Florida, insurers illicitly rewrote adjusters' descriptions of hurricane damage to cut payments by more than 80%.

Protecting policyholders and ensuring fair access will require more proactive action from supervisors. IAIS should also highlight that climate change is dramatically increasing the category of potentially vulnerable insurance consumers for whom consumer education will be an ineffective solution for a rapidly changing environment. IAIS should highlight that the concurrent and increasingly intense effects of climate disasters will require more resources for reviewing policy language and potential insurer misconduct, and supervisors should act proactively to ensure they have sufficient tools and resources to meet the scale of the problem.

Conclusion

Existing work from IAIS on climate risk represents an important step towards the development of global best practices on climate-related risk, but IAIS should see it as one step in a broader, ongoing effort. To meet the scale and complexity of the crisis, IAIS should use this consultation process to strengthen its existing work in line with a precautionary approach and expand its scope to help supervisors protect policyholders and promote fair and stable insurance markets.

We look forward to engaging with IAIS as part of the ongoing consultation. If you have questions, please contact Carly Fabian at cfabian@citizen.org.

Sincerely,

Public Citizen