Too hot to insure – avoiding the insurability tipping point[1]

Executive summary

Climate change is accelerating, with an increasing likelihood of widespread disruptions to the financial sector, including the insurance sector. Global efforts to transition to net zero greenhouse gas (GHG) emissions, while commendable, are still uncertain in terms of their impact in slowing climate change. There is a chance that the global average temperature increase target under the Paris Agreement could be breached, pushing the world, the global economy and financial systems into uncharted territory. Efforts to facilitate a swift transition to a sustainable economy, including adequate risk adaptation, mitigation and coverage by economic agents, are therefore key.

Through their pricing and underwriting policies, insurers play an important role in both supporting climate risk mitigation efforts to transition to net zero, as well as in incentivising risk adaptation measures. An increasing number of insurers are publishing transition plans that set out how they intend to support climate risk mitigation, including adjustments to their underwriting policies. An orderly transition to net zero is essential to avoid economic disruptions and financial instability. Some insurers are pulling out from insuring GHG-intensive sectors, and they do so in a gradual manner, recognising that some high emitters are taking steps to reduce their emissions. At the same time, insurers can incentivise climate risk adaptation efforts through their pricing and underwriting policies by recognising risk reduction measures in terms of reduced premiums or more favourable policy terms. Nevertheless, the insurance industry alone cannot mitigate climate-related risks – other actors such as governments, households and businesses need to play their part.

Given the relevance of insurers' pricing and underwriting policies to their safety and soundness, the affordability and availability of insurance coverage and net zero transition goals, supervisors need to assess such policies. Based primarily on a survey of selected insurance supervisors and insurers, this paper examines insurers' pricing and underwriting approaches from those three different perspectives. Depending on their specific mandates, supervisors may place different weights on these considerations in their regulatory or supervisory approaches. Insurance supervisors have an interest in climate risk adaptation, as this has a direct impact on insurers' risk exposures as well as on the affordability and availability of insurance coverage for consumers. On the other hand, while adequate climate risk management should contribute to an orderly transition, the role of insurance supervisors in directly promoting climate risk mitigation is arguably less clear as this could eventually collide with core prudential objectives.

Insurers' approach to underwriting and pricing climate-related risks may have negative implications for financial stability. Underpricing and overly optimistic underwriting could lead to solvency or liquidity problems for insurers. In contrast, en masse withdrawals of coverage from economically significant sectors could cause unintended and disorderly economic dislocations. There could also be spillovers to other financial sectors – including the banking sector – if insurance is no longer available. For example, uninsurable properties may lead to credit becoming unaffordable or financial

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exclusion as banks refuse to lend. Such properties may be disqualified as eligible collaterals, thus increasing credit risk exposure to banks.

Although most of the surveyed insurers do not currently explicitly account for climate change impacts when pricing insurance policies, there is a noticeable trend of increasing premiums and reducing insurance coverage. It is important to acknowledge that the rising cost of certain insurance coverage is not due entirely to the increasing frequency and severity of the insured perils, but also to increased exposures from the concentration of assets in high-risk regions. The surveyed insurers consider that any climate change impact would emerge through insurance claims experience, which is taken into account in regular pricing cycles. Moreover, short-term contracts – mainly non-life insurance – can be repriced on an annual basis, reflecting any projected climate change impacts. The surveyed life and health insurers do not currently see an immediate, significant impact of climate change on the risks that they insure. As most of the surveyed insurers are not currently explicitly considering climate-related risks in their pricing or underwriting processes, it is difficult for supervisors to ascertain whether and to what extent products are under- or overpriced. Nevertheless, as insurers gain greater awareness and knowledge in incorporating climate-related risks in their pricing and underwriting approaches, it is reasonable to expect further reductions in the availability and affordability of insurance coverage.

Insurance supervisors have a critical role to play in promoting adequate premium pricing and sound underwriting approaches. While insurers may be well positioned to use their pricing and underwriting "powers" to influence or incentivise risk mitigation and risk adaptation measures, they should not do so at the expense of financial soundness. In other words, there is a limit to which the insurance industry can contribute to supporting climate risk mitigation and adaptation through favourable pricing and underwriting conditions. At the same time, at a broader policy level, supervisors and policymakers are becoming more concerned with how climate change is reducing the availability and affordability of insurance coverage. This trend, if left unabated, may lead to an insurance market failure for climate-related risks and ultimately force governments to become "insurers of last resort". One way to address this policy concern is for governments, regulators and the industry to work together to establish climate risk adaptation measures to contain insured losses from physical risks. However, not all supervisors have the mandate to support such policy objectives.

Within existing supervisory mandates, supervisors can address climate-related risks arising from pricing and underwriting processes through climate-related risk management requirements. In general, insurance supervisors expect insurers to adopt risk-based pricing and underwriting for any insurance products they offer. This applies similarly to products exposed to climate-related risks, though a major difference compared with other products is the high level of uncertainty due to unknown future climate change trajectories. Price increases and insurance coverage exclusions of certain climate-related perils are receiving greater supervisory scrutiny. A growing number of supervisors expect insurers to use scenario analysis to better understand the implications of climate change for their underwriting portfolios. Supervisors will need to collect the necessary data and rely on climate-related disclosures to assess insurers' underwriting exposure to climate-related risks. Nevertheless, technical (eg data issues) and capacity challenges need to be overcome if insurers are to properly address climate-related risks in pricing and underwriting. A major complicating factor is the uncertainty over future climate change impacts, which may unleash extreme events that have not occurred in the past for example due to climate tipping points.

One thing is clear – we cannot afford inaction. While there are many uncertainties in terms of how climate change might evolve or whether transition policies will be impactful, one thing is certain – without further measures and concerted efforts by insurers, regulators, governments and the public at large, insurance against climate risks will become less affordable and available. Eventually, the insurability tipping point could be crossed in different regions and for various risks, which will no doubt result in a lose-lose situation for all stakeholders.