Management of climate- and other nature-related financial risks for Swiss Insurers

May 2024

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On 1st February 2024 FINMA has released the draft for its new Circular on nature-related financial risk. This report analyzes the proposed requirements, illustrates how it ties into existing requirements for Swiss insurers around climate change, highlights key success factors and explains how KPMG can support you to ensure compliance with the new requirements.

1.1 Background

The circular specifies existing requirements on the governance, risk management and the associated internal documentation pursuant to the Insurance Oversight Act.

It applies to all insurers (including Branches of foreign insurers), insurance groups or insurance conglomerates pursuant to the Insurance Oversight Act. Exempt are small insurers pursuant to Art. 1c of the Insurance Oversight Ordinance and Reinsurers of supervision category 4 and 5 pursuant to Art. 1d of the Insurance Oversight Ordinance. However, FINMA recommends such institutions to consider the requirements of the Circular, should they be exposed to material nature-related financial risks.

Nature-related financial risks relate to direct or indirect financial losses or other negative effects on an institution, in the short, medium and long term, resulting from its exposure to nature-related risks. As such, they encompass a broader scope than climate risk, such as the loss of biodiversity, air-, water- and soil pollution, water scarcity and deforestation. Nature-related risks can be seen as drivers that can be reflected in existing risk types through various transmission channels. They impact in insurance risk, credit risk, market risks, liquidity risks and operational risks (including legal and compliance risks).

Generally, the requirements of this circular must be implemented by institutions depending on their size, complexity and structure as well as their risk profile and business model. As such, the materiality assessment procedure described in the Circular (see below for further details) will be a key step in determining the scope of application of the Circular.

	By 1 January 2025	By 1 January 2026		By 1 January 2027
Who	Institutions in categories 1 and 2	Institutions in categories 1 and 2	Institutions in categories 3, 4 and 5	Institutions in categories 3, 4 and 5
What	• Risk identification, materiality assessment and scenario analysis • Consideration of nature-related risk in the institutions business objectives, strategy and financial planning • Corresponding reporting to the Executive Board and the Board of Directors	• Governance • Integration of nature-related financial risk into risk management system • Stress Testing	• Risk identification, materiality assessment and scenario analysis • Consideration of nature-related risk in the institutions business objectives, strategy and financial planning • Corresponding reporting to the Executive Board and the Board of Directors	• Governance • Integration of nature-related financial risk into rist management system • Stress Testing

1.2 Relation to other requirements

FINMA-Circular "Nature-related financial risks"

Governance and Strategy

- Appropriate allocation of oversight and management responsibilities
- Business objectives and strategies → CPIA
- The role of the Board
- Duties of Senior Management
- Duties related to remuneration

Risk Management and internal control

- Integrating climate-related risk and impacts into the scope of the risk management system
- Consideration of climate-related risks and impacts by the Contol Functions
  - Risk Management function
  - Compliance function
  - Actuarial function
- Internal audit function Fitness and propriety of Control Functions on climate-related issues
- Integrating climate-related risks and impacts in outsourcing decisions

Investment

- Climate-related risks for investments
- Asset liability management (ALM)
- Risk Assessment of Investments
- Impact of investments on climate change

Insured Risks

- Underwriting policy
  - Consideration of climate-related risks and impacts in the underwriting policy
  - Consideration of climate-related risks and impacts in the underwriting assessment
  - Monitoring of underwriting exposure to climate related risks and impacts
- Own Risk and Solvency Assessment (ORSA)
  - Stress testing and scenario analysis of climate-related risks

Ordinance On Climate Disclosure

Public Disclosure

- Corporate governance framework
- Strategy
  - Climate transition plan
- Risk Management
- Metrics and Targets
  - Quantitative climate goals
  - Carbon emissions
  - Forward-looking, scenario-based climate compatibility analyses → CPIA

The FINMA Circular corresponds to the IAIS Application Paper on the Supervision of climate-related financial risk (dated May 2021) along the main topics Governance and Strategy, Risk Management and Internal Control, Investments and Solvency. As such, it provides guidance on the methodological foundations of the information that should be disclosed to external stakeholders in accordance with the Ordinance on Climate Disclosures. In addition, both the FINMA-Circular and the Ordinance on Climate Disclosures link with the Climate Protection and Innovation Act (CPIA). It enshrines the Swiss climate goals that serve as the basis for firms' climate transition plans and foresees[1] biannual voluntary climate compatibility analyses for financial institutions that could feed into the disclosure requirement on forward-looking, scenario-based climate compatibility analyses.

[1] Consultation Draft of the Ordinance on Climate Protection and Innovation:
Bundesrat eröffnet Vernehmlassung zur Klimaschutz-Verordnung (admin.ch)

Governance and Strategy

Summary of key requirements

Key requirements of the new Circular:

- The institution defines tasks, competencies and responsibilities for the identification, assessment, management and monitoring of nature-related financial risks as well as reporting across the organization, including Board of Directors, Executive Board and independent control functions.
- The members of these bodies and units must have sufficient knowledge and experience in dealing with nature-related financial risks.
- The senior management body or the Board of Directors reviews the institution's remuneration system and adjusts it where necessary to support the institution's risk strategy regarding nature-based financial risks.

Additional requirements to be considered with regard to climate risk only:

- The **Climate Disclosure Ordinance** also requires disclosure of information on the impact of climate-related risk and opportunities on the institution’s business, strategy and financial planning as well as the resilience of its strategy under different climate-related scenarios.
- A key aspect represents the disclosure of information on a transition plan that is in line with Swiss climate goals. The **Climate protection and innovation act** contains further details regarding these goals. While the general reduction targets will also apply to the Scope 1 and 2 emissions of insurers, the sectoral reduction targets will be more relevant from the perspective of their investment portfolios and underwritten risks.

Success factors

- **Leverage existing governance wherever possible:** Although it tends to take more time to effectively embed within an organization, responsibilities for environmental risk (or any sustainability matter) should allocated along existing governance structures, with the sustainability function remaining a relatively small group of subject matter experts supporting the rest of the organization with specialist knowledge. More time will be required to upskill staff and revise policies and processes, but in the long run a more effective management of environmental risk will be ensured.
- **Bespoke training:** External trainings have their role to play to ensure sufficient knowledge of the management and the control functions on sustainability matters. However, to ensure function-specific knowledge that is relevant to the role of the staff, this should be complemented with internal trainings that is specific to the business nature and processes of the institution. Also, boards and senior management should be trained to properly interpret and understand the reporting they receive on environmental risk and other sustainability matters.
- **Link remuneration only to mature environmental risk and sustainability management systems:** Linking remuneration to environmental risk management or sustainability-related goals can be very effective, however, if the remuneration mechanism is ill-conceived there is a real risk of damage to the firm. Therefore, linking ESG-matters with remuneration should only be contemplated if the underlying business is subject to a robust control environment.
- **Transition plans – focus on data and client engagement:** There is no doubt that a financial institution’s transition plan is a matter of strategic importance. However, to design effective and reliable measure and design robust goals, granular information needs to be available. Therefore, any transition plan should start with a long-term plan to obtain the necessary information to help the firm identify its current positioning and understand what measures will be the most effective to achieve its net zero goals.

Risk Management and Internal Control

Summary of key requirements

Risk identification, materiality assessment and scenario analysis

- The Insurer regularly identifies and assesses nature-related financial risks to determine their materiality profile.
- Possible interactions between these risks and the business strategy are considered as well as their impact on equity, customers, stakeholders and the environment.
- Risk identification and materiality assessment include the use of internal and external information, the consideration of influences and dependencies of the institution on nature as well as the definition of quantitative indicators and materiality thresholds.
- Scenario analyses are carried out to assess the impact of nature-related risks on the risk profile under various assumptions, including low probability and high impact events.
- The results are documented and integrated into reporting to the Executive Board and the senior management body, where the periodicity of identification and assessment depends on new findings and changes

General requirements on Risk Management

- Institutions integrate the management, monitoring and reporting of nature-related financial risks into their institution-wide risk management and internal control system.
- This includes the consideration of possible cluster risks, such as concentrations of business activities or portfolios in certain sectors, industries or regions.
- Based on the risk strategy, institutions define suitable risk indicators, warning thresholds or limits and integrate their monitoring into existing processes. They periodically adapt their methods and sources of information and check that their business strategy, business model and risk management comply with public statements and legal obligations. Any anomalies are reported to the Executive Board and the senior management body.

Operational risk management (including Compliance-, Reputational- and Legal Risks)

- Insurers evaluate the impact of natural events on business continuity, analyzing risks to personnel, processes, infrastructure, IT systems, and outsourced services.
- It also assesses compliance, reputation, and legal risks arising from handling nature-related risks, including potential financial losses.
- If deemed significant, the company integrates risk management into relevant processes and controls, ensuring compliance with regulations and commitments.

Additional requirements to be considered in the same context:

- The **Climate Disclosure Ordinance** requires disclosure on how an organization identifies, assesses and manages climate-related risks. Also, financial institutions should report on forward-looking, scenario-based climate compatibility analyses.
- The current draft of the **Climate Protection Ordinance** foresees biannual voluntary climate compatibility analyses for financial institutions that can provide insight for financial institutions that are of relevance for the compliance with the FINMA Circular as well as feed into the disclosures pursuant to the Climate Disclosure Ordinance.

Success factors

- **Focus on material parts of the book and material risk drivers:** Given the potentially vast universe of risks, it is important to focus on the most material risks. For most Swiss insurers this is likely to include transition risk for corporates (on the investment side), physical risks for non-life insurance as well as reputational risks
- **Consider impact as well as probability:** When considering the materiality of different ESG risks, it is important to go beyond exposure and event probability, and look at the financial impact of possible events.
- **Design scenario analysis to be proportionate and transparent:** Scenario analysis quickly becomes complex, often without significant additional insight being generated. So it is necessary to develop a pragmatic approach balancing granularity with explicability. It may be helpful to deep dive on a smaller number of material exposures.
- **Always run a base case:** Scenario analysis is of limited value if results cannot be compared to some kind of base case to isolate the impact of the scenario idiosyncrasies
- **Establish a greenwashing framework:** Institutions should identify and assess material greenwashing risks across a firm- product and client-perspective enhance their existing (reputational-) risk frameworks and implement additional controls as necessary.

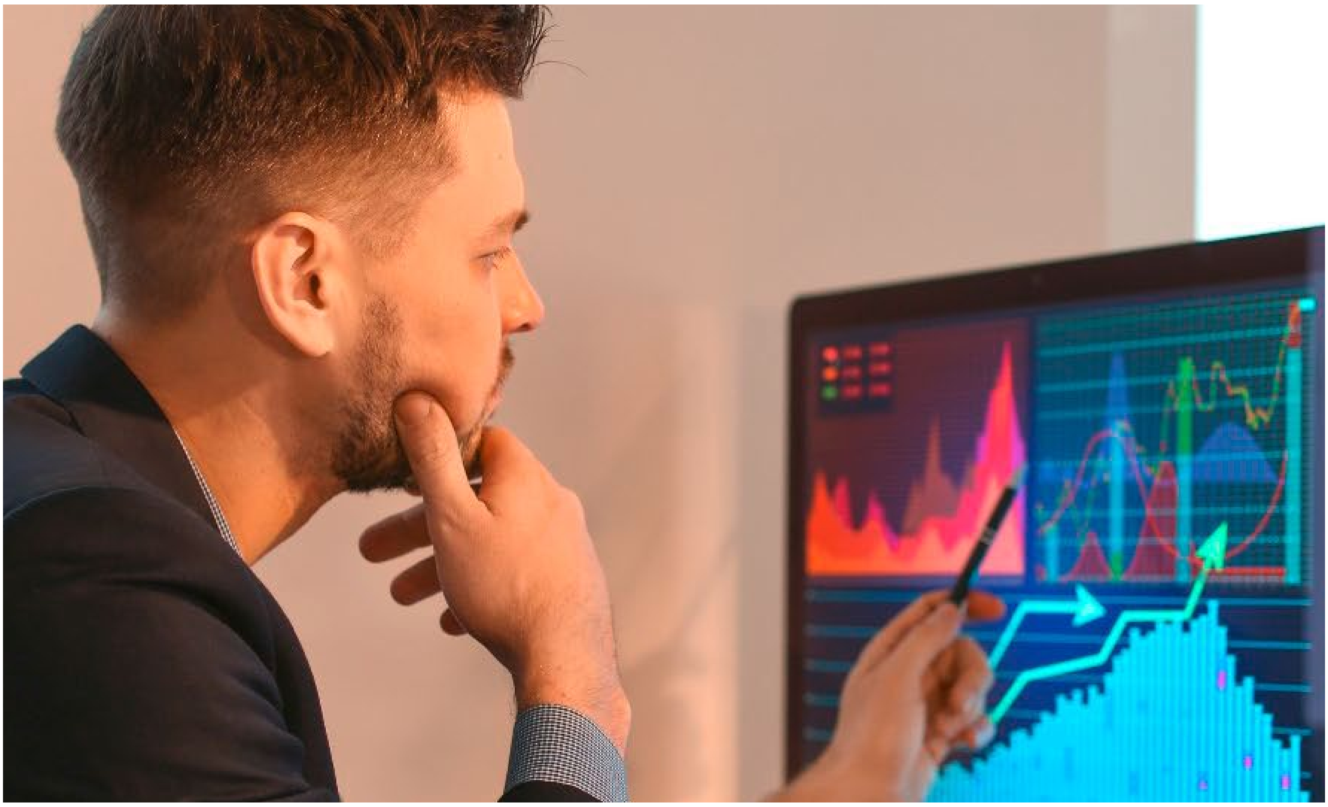
Investment

Summary of key requirements

- Insurers assess the significance of nature-related financial risks, considering impacts on market, credit, and liquidity risks, as well as asset liability management.
- The assessment evaluates direct and indirect effects of nature-related risks on asset values, probability of credit defaults, liquidity outflows, and availability of liquid funds for payouts.
- Insurers with significant nature-related financial risks incorporate these into processes, policies, and controls of asset management, credit and liquidity risk management, and asset liability management.

Success factors

- **Consider business risk:** Impacts on credit spreads (on the asset side) themselves can threaten revenues, so it is important not to neglect the revenue side when performing a wholistic risk review.
- **Consider upstream impacts:** If performing a deep-dive analysis on a specific corporate bond exposure, consider that the key physical risks may not lie with firm's own buildings but with upstream effects, such as the impact of drought on prices of agricultural produce.
- **Consider location data**: Particularly for corporate bond issuers, obtaining detailed data on site locations is critical for physical risk assessments.



Insured Risks

Summary of key requirements

- Insurers evaluate how their insurance lines and products may be impacted by nature-related financial risks, utilizing appropriate methods and data.
- Companies with significant nature-related financial risks integrate these into relevant processes, policies, and controls of insurance operations, covering aspects such as type and structure of insurance coverages, underwriting, pricing, risk management, and claims reserving.
- This integration includes managing risk concentrations, correlations, and accumulations, ensuring comprehensive oversight of insurance risks.
- Insurers with significant nature-related financial risks incorporate them into their Own Risk and Solvency Assessment (ORSA), considering their impact on overall risk profile, capital requirements, scenarios, and the need for risk mitigation measures.
- The appointed actuary of the insurers includes significant nature-related financial risks when fulfilling their regulatory duties and reports them in their report to the management.

Success factors

- **Insurance coverages:** when looking at the type and structure of the insurance coverages, insurers should consider both exposure to nature-related risks for existing products, and exposure from future risks and products based on the future business strategy. Both claim frequency and claims inflation can be impacted by nature-related risks.
- **Train the specialists:** the training of actuaries, underwriters claims managers and risk managers plays a key role for the understanding of nature-related risks, the exposure of the own portfolio and the implementation of concrete actions in the internal processes.
- **Design scenario analysis to be proportionate and transparent:** Scenario analysis quickly becomes complex, often without significant additional insight being generated. So it is necessary to develop a pragmatic approach balancing granularity with explicability.
- **Definition of scenarios:** when defining the scenarios, special attention should be paid on the selection of the most exposed geographical areas, on the impacted balance sheet elements, on the data limitations, the temporal horizon and the design.

Public Disclosure

Summary of key requirements

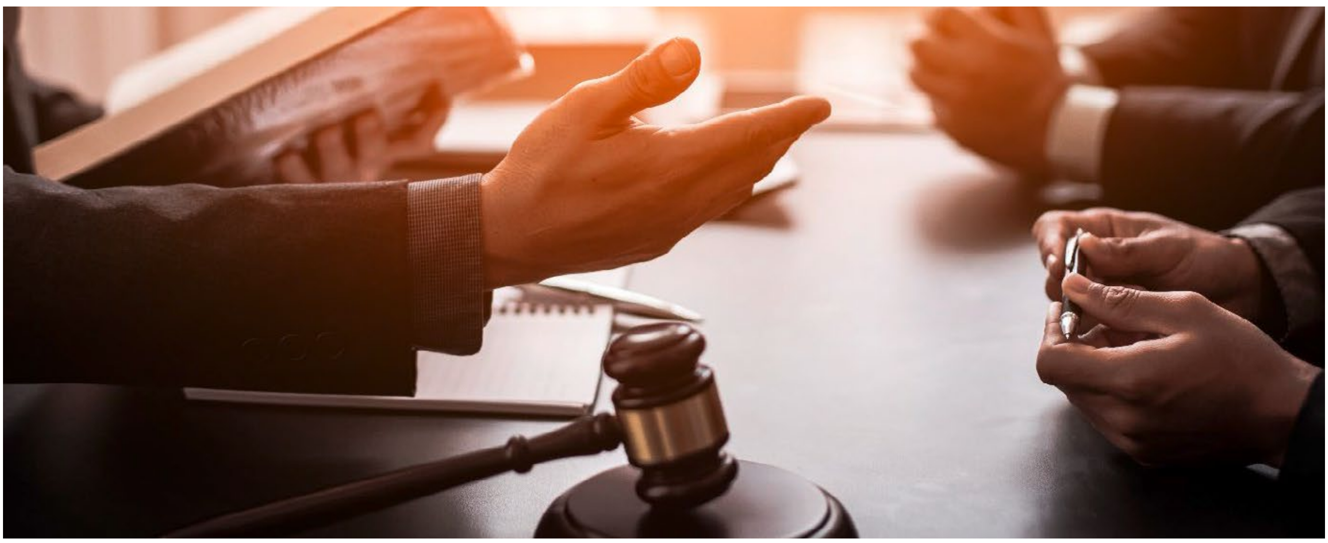
Financial institutions with 500 or more employees and at least CHF 20 million in total assets or more than CHF 40 million in turnover are obliged to report publicly on climate issues. Public reporting involves disclosures not only on the financial risk that a company incurs because of climate-related activities, but also on the impact of the company's business activities on the climate. In addition, the company must describe the reduction targets it has set for its direct and indirect greenhouse gas emissions, as well as how it plans to implement them.

Additional requirements to be considered in the same context:

Financial institutions should disclose the result of forward-looking, scenario-based climate compatibility analyses. To support the Swiss financial industry with these complex matters, the draft Climate Protection Ordinance requires the Swiss government to organize bi-annual voluntary climate compatibility analyses for financial institutions. These insights will not only help financial institution comply with their disclosure requirements but will also provide valuable data on the progress of its portfolio-level decarbonization plans.

Success factors

- **Accuracy and Transparency:** Accurate data and transparent reporting are fundamental. This involves thorough research and analysis to identify and quantify climate-related risks relevant to the organization's operations, supply chains, and stakeholders. Transparent reporting means clearly communicating methodologies, assumptions, and limitations of the data and analysis presented. This builds trust with stakeholders and ensures informed decision-making.
- **Forward-looking Approach:** Excellent climate risk reporting goes beyond historical data and considers future scenarios and projections. It involves scenario analysis to assess potential impacts of different climate scenarios on the organization's business model, financial performance, and reputation. By adopting a forward-looking approach, organizations can better anticipate and adapt to changing climate conditions and regulatory environments, enhancing resilience and sustainability.
- **Stakeholder Engagement and Communication:** Engaging with a wide range of stakeholders is crucial for effective climate risk reporting. This includes investors, customers, employees, regulators, and local communities. Actively seeking input from stakeholders helps to identify their priorities, concerns, and expectations regarding climate risks and resilience efforts. Moreover, clear and tailored communication of climate risk information ensures that stakeholders understand the potential impacts on the organization and can make informed decisions. Regular dialogue and feedback mechanisms also demonstrate the organization's commitment to transparency and accountability in addressing climate-related challenges.



1.3 How KPMG supports insurers

Risk Identification

- **Exposure assessment:** Identifying key climate and nature risk drivers and sensitivities for a portfolio
- **Scenario analysis:** Assessment of an institution's vulnerability to hypothetical climate scenarios

Risk Integration

- **Risk mapping:** Identification and prioritization of ESG-related risk drivers and mapping to existing risk taxonomy
- **Greenwashing TOM:** Design effective control framework to address greenwashing risks on firm, product and service level
- **Climate transition plans:** Design firm- or portfolio level decarbonization plans across sectors and asset classes in line with best practice

Stress Testing & Scenario Analysis

- **Scenario selection** based on regulatory requirements and KPMG proprietary methodology where appropriate
- **Physical risk analysis** making of appropriate external data
- **Transition risk analysis** focusing key economic drivers
- Assessment of the **impact on capital requirements**

Disclosures

- **Gap analyses and interoperability assessment** for climate and nature reporting under various standards (TCFD, TNFD, GRI, ESRS, ISSB, etc.)
- **Reporting TOM:** Definition and implementation of robust processes and controls for non-financial reporting

Governance

- **Health Check:** Assessment of the institution's extent of ESG integration across entire business
- **ESG (Board) Trainings:** Design and deliver ESG trainings tailored to the needs to the institution
- **ESG Governance Target Operating Model:** Detailing the composition of the management bodies and overall ESG organizational structure
- **Goals and compensation alignment:** Benchmark approach to identify and compare incentive schemes and remuneration policies linked to sustainability matters

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