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Climate risk capital – a warning to insurers from the Bank of England

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According to a recent report from the Bank Of England ("BoE"), there is some degree of uncertainty as to whether insurers hold sufficient capital against future climate-related losses.

In particular, the BoE has warned of capability and regime gaps, which can create uncertainty as to whether insurers are sufficiently capitalised against climate-related losses.

The capability gap

In the report, the BoE identified a risk appetite challenge for prudential regulators when considering regulatory capital frameworks. Essentially, regulated firms with effective risk management controls may be in a position to reduce the amount of their capital requirements, whereas those firms with fewer controls will be less likely to be in a position to do so.

As a first step, the BoE has said firms should focus on addressing '*capability gaps*' within their organisations, with a view to improving the identification, measurement and management of climate risk.

The BoE has identified that regulators will need to develop frameworks that can inform capital requirements, and that those frameworks must take into account '*the unique characteristics of climate risks*', which necessitate a '*more forward-looking approach than used for many other risks*'.

Notwithstanding the BoE's comments, it did conclude that existing time horizons over which risks are capitalised by banks and insurers are sufficient and that accordingly '*there does not appear to be sufficient justification for regulators…to make a policy change to these time horizons*'.

A regime gap?

The BoE also discussed the need to undertake further work on the 'regime gap' in the macroprudential framework, adding:

"*Any use of macroprudential tools would need to be assessed carefully against how well they mitigate climate risks, their behavioural impacts and the potential for unintended consequences. Calibration of [such] tools would also be challenging given uncertainties around climate risks and the need for the to help facilitate an orderly transition to net zero*'.

The BoE has called for research papers into the challenges of incorporating climate risk into capital frameworks.

What should insurers do?

We can no doubt expect to hear more from the BoE on this topic in the coming months and years. In the meantime, insurers should review their own risk modelling in relation to climate risks and try to identify the extent of any capability gaps in their organisation.

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