Response to the ECB-EIOPA discussion paper on policy options to reduce the climate insurance protection gap

Our reference:	GEN-SUS-23-043	Date:	15 June 2023
Referring to:	https://www.ecb.europa.eu/pub/pdf/other/ecb.policyoptions_EIOPA~c0adae58b7.en.pdf		
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Pages:	4	Transparency Register ID no.:	33213703459-54

Insurance Europe welcomes the discussion paper released by the European Central Bank and the European Insurance and Occupational Pensions Authority (EIOPA) on policy options to reduce the climate protection gap.

Over the past few years, climate change has exacerbated the severity and intensity of disasters from natural hazard events, leading to distressing loss of life and significant economic costs across Europe and worldwide. These climate-change effects, coupled with rapid urbanisation and increasing asset values, result in an increase in economic losses, a substantial portion of which are not insured, even though the situation varies sometimes significantly between member states. With the climate expected to continue changing for the foreseeable future, addressing this climate protection gap is more crucial than ever before.

The insurance sector plays a vital role as a tool for climate adaptation and effective disaster risk management, aiding individual policyholders and communities to recover more swiftly, as well as for managing risk integrally. Thus, Insurance Europe appreciates the recognition of the unique role of insurance and the benefits of high insurance penetration, but also the acknowledgement that the private insurance sector alone cannot handle climate change-related risks. Indeed, a protection gap cannot be solved solely by private insurance, and insurance only works as a capstone of good risk management.

Insurance Europe also appreciates the paper's presentation of several potential solutions for reducing the climate protection gap. With a view to contributing constructively to this important effort, we provide below our input on the solutions proposed in the discussion paper.

We note as well that the publication of the paper coincides with the European Commission's ongoing "Climate Resilience Dialogue", which brings together a broad range of stakeholders interested in addressing the climate protection gap, and in which EIOPA is also involved. The Climate Resilience Dialogue shares the goal of identifying ways to enhance climate resilience and so reduce the protection gap. Against this background, and given the importance of avoiding duplication of effort, we believe it would be highly beneficial to coordinate future discussions on this issue within the Climate Resilience Dialogue. We look forward to continuing to engage through this important dialogue.

1. Climate adaptation measures must go beyond insurance and "impact underwriting"

Insurance Europe supports the view that efforts to increase insurance penetration should complement ambitious mitigation policies aimed at combatting climate change, ie, urgently and significantly reducing emission of greenhouse gases. At the same time, to really be effective, mitigation policies must be coupled

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with equally ambitious adaptation measures. Insurers have a big role to play in this respect, but the public sector must also do its part in terms of adaptation policies. In fact, public authorities, be they at local, regional or national level, have a leading role to play here and must intensify and accelerate their efforts. If public authorities do not enact appropriate adaptation policies, including through spatial planning, building regulations and permit granting, certain risks may increase to the point of becoming difficult to insure at affordable prices, and thus contribute to the widening of the protection gap. However, when it comes to adaptation, the paper focuses mainly on the role of the insurance sector, particularly through "impact underwriting". In addition to overstating the role of insurance, this approach has further shortcomings:

- The focus on "impact underwriting" as the insurance sector's key contribution to climate adaptation is too narrow. In fact, the insurance sector is already contributing to adaptation through managing current and future climate risks and providing coverage and risk management advice — thus enabling rapid recovery, creating awareness, stimulating prevention and providing early warning — and it is willing to do even more in this respect.
- The paper suggests, for example, implementing premium reductions based on specific standards for flood-proofing and storm protection, as well as using real-time weather data for crop insurance. However, this approach may widen the wealth gap in Europe, as many homes will require substantial investment to meet these standards, leading to lower premiums for those who can afford it and higher premiums for those who cannot.
- The ability of insurers to offer premium reduction may be limited by the prudential framework. Indeed, under Solvency II proper modelling of the cash flows and the relationship between premiums and claims is required, and so unsubstantiated reductions in premiums would be criticised by the supervisor. Therefore, any incentive, in the form of reduced premiums, to policyholders to invest in climate adaptation measures with the aim of lowering future damages following a climate event, needs to be modelled in the best estimate and the capital requirements. Indeed, when setting prices for insurance products, insurers have to meet several standards and requirements. The setting of prices for insurance products is normally also part of the supervisory review process. Allowing for premium-related incentives without proper statistical evidence would be in contravention of those standards and requirements. Therefore, the industry stands ready to engage with the supervisory community to identify ways to remove any undue limitations on insurers' ability to apply premium reductions to policyholders investing in climate adaptation.
- The paper implies that impact underwriting would encourage policyholders to take proactive measures against climate-related risks. This argument, though, does not take consumer behaviour fully into account. Policyholders often prioritise short-term needs over long-term risks.

2. "One-size-fits-all" does not work

The insurance industry also believes that a "one-size-fits-all" approach to addressing the climate protection gap in Europe is impractical due to significant differences between member states, including their risk exposure, culture, history and existing schemes. Insurance Europe would recommend opening up a discussion on how the general structure proposed in the paper can be best adapted to the differences in national circumstances.

3. Bottom-up solutions should not be overlooked

There seems to be a lack of consideration of bottom-up solutions that specifically aim to narrow the protection gap for consumers. While the introduction of new, top-down, pan-European financial instruments is certainly important, it should not overshadow the potential of empowering individuals and households to actively participate in bridging this gap. In fact, contrary to what the paper implies, populations do not remain static in the face of disasters. They will adapt their practices to changes in their environment, leading to adaptive measures that ultimately reduce the impact of disasters. Through raising awareness, tailoring solutions to local contexts and fostering innovation, the insurance industry can facilitate this shift and unlock the potential for significant progress in closing the protection gap and enhancing financial resilience at the grassroots level.

4. Catastrophe bonds can bring additional capacity

Insurance Europe acknowledges the role, mentioned in the paper, of catastrophe bonds as part of a solution to reducing the protection gap. As correctly pointed out in the discussion paper, one of the advantages of catastrophe bonds is that they transfer the catastrophe risk to a wider set of investors. Capital market players investing in catastrophe bonds are able to knowingly inject capital into coverage for physical risk at higher layers, thereby ultimately expanding the total coverage available, while still needing to carefully monitor their exposure to natural disaster risks.

5. Existing and future public-private partnerships should be adapted to evolution of risks

Insurance Europe welcomes the focus of the paper on public-private mechanisms, which play an important role in a number of member states and may play a bigger role in the future. In connection to this, it is important to stress the need to review the existing public-private collaboration frameworks to incorporate or modify coverage for extraordinary risks given their foreseeable negative evolution.

6. EU-level instruments require effective governance

When considering EU-level measures, past experience in Europe has demonstrated that good intentions can sometimes have unintended consequences. While we recognise the value of a balanced European pooling approach, accompanied by effective governance that avoids moral hazard and other related concerns, the challenge lies in the practical implementation. Often only certain aspects are successfully implemented, with governance in particular struggling to effectively address "free rider" behaviour (ie, the risk of moral hazard).

Additional remarks

In addition to the more general comments above, Insurance Europe would like to provide the following remarks:

- There is a lack of data-backed evidence that clearly establishes how the widening of the protection gap in the face of climate change is directly contributing to financial instability. While the potential consequences of a widening protection gap are concerning, it is crucial to substantiate these claims with empirical data and robust analysis to better understand the extent of the impact on financial stability.
- Regarding Chart 1 on page 6, the interpretation of the data may not be accurate. While the share of insured claims related to weather events appears to be relatively low, it does not necessarily reflect insufficient coverage. For instance, it could be attributed to the presence of numerous claims paid out for other perils. In addition, ideally, the assessment and presentation of the protection gap should be based on estimates of current protection gaps, as opposed to historical data, which requires modelling and access to a range of data. Indeed, estimates of current protection gap rates are more representative of the protection gap challenge, thereby enabling the development of more suitable and focused solutions.
- Historical data is not always useful for defining a future protection gap. In the past many catastrophes occurred in a given region only once per decade or century, but they may occur more frequently in the future. Or there may be simply no claims/uninsured damage yet to measure.
- Regarding Figure 1 on page 17, the insurance and reinsurance blocks should be combined into a single one. Captives could also be included.
- The mention of climate change affecting randomness and correlation on page 6 seems to only consider an increase in the correlation and a reduction in the potential for diversification, while a decrease in

correlation is not necessarily unlikely. It appears that this perspective assumes the worst-case scenario when uncertainties exist, without any conditional considerations.

- The statement on page 6 about climate change generating higher than expected claims and increasing insurers' underwriting and liquidity risks, thus putting pressure on their solvency, appears to be based on an implicit, unsubstantiated assumption. Specifically, the paper appears to recognise that non-life insurance operates on an annual basis, allowing for rate adjustments to accommodate increased claims. While there may be more challenging years with a higher number of disasters, this is what has occurred in the past (though not always due to climate change). The only difference here would be if the magnitude of events exceeded expectations or if they occurred consistently for several years without adjusting rates or coverage limits. Given the existence of annual rate adjustments, the occurrence of claims that are higher than expected and the subsequent increase in insurers' underwriting and liquidity risks would only be possible under the (inaccurate) assumption that the capacity for such adjustments is finite and thus that excessive growth in the frequency or severity of disasters would lead to reduced coverage or losses for insurers.
- When considering "public" versus "private" costs, the paper seems to overlook the fact that the implementation of quasi-compulsory insurance is not in itself a solution that will reduce costs and the burden on all parties. This is why it is important that any solution has elements of risk-based underwriting and efforts are stepped up to reduce climate change and adapt to it. Having said this, insurance mechanisms with public support can function as a budgetary protection measure, as *ex-ante* costs for private and public insurance will be lower than the budgetary burden to pay for repairs afterwards.
- In line with the recommendation made recently to policymakers in the Global Federation of Insurance Associations' report on addressing climate protection gaps, it is crucial to secure a regulatory environment that supports open markets for (re)insurance to ensure that the maximum amount of capital is available to close protection gaps and support competitiveness and innovation.
- With regard to the role of reinsurance specifically, primary insurers will be in a better position to deepen their cover of natural catastrophe risks by transferring parts of the risks to better-equipped reinsurers. It is worth noting, however, that if losses become widespread across the globe, diversification benefit will decrease and major cross-border reinsurers will need to manage their global portfolios prudently to ensure that they are prepared to address situations in which climate-related natural catastrophes increasingly occur in different parts of the world simultaneously.
- Regarding the fiscal aspect, insurers contribute taxes that may decrease if the burden of natural events increases. Therefore, when mentioning a fiscal problem where uninsured companies bear the costs (leading to lower profits and reduced tax resources), it is important to acknowledge that the "insurance solution" to this fiscal problem only transfers it, at least partially, from one entity to another. While this transfer provides pre-event clarity about pay-out and recovery mechanisms post-events, it does not necessarily reduce the cost of the risk itself, which is why risk management remains essential.
- On risk reduction measures, there may be a middle ground between costly measures aiming to eliminate risk entirely and measures that reduce the impact. For instance, leveraging information technology could help limit costs without completely eliminating them.
- Establishing pan-European arrangements for smoothing tax results over extended periods could be useful for facilitating the coverage of catastrophic events that occur less frequently but generate significant losses.

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — it represents insurance and reinsurance undertakings that account for around 95% of total European premium income.