

# Mind the climate-related protection gap – reinsurance pricing and underwriting considerations<sup>1</sup>

## Executive summary

**Climate change is increasingly breaking records.** From record breaking temperature highs to record breaking economic and insured losses from climate-related events in certain regions, climate change is contributing to adverse impacts in various sectors and amongst the general population. Since 2020, annual insured losses from natural catastrophes (NatCats) have exceeded the USD 100 billion mark globally. The impact of climate-related events on economic and societal resilience has increased attention amongst policymakers, standard-setting bodies and financial authorities. One of the areas of focus is on reinsurance, given the indispensable role it plays in global risk diversification and in supporting the underwriting ability of primary insurers including climate-related risks. In this context, insurance supervisors may have an interest in how reinsurance can contribute to the safety and soundness of financial institutions, the growing (re)insurance protection gap, as well as the role of (re)insurers in supporting climate risk adaptation and mitigation.

**From a safety and soundness perspective, retreating reinsurance coverage can impact the solvency of primary insurers.** To underwrite NatCat risks, primary insurers rely on affordable reinsurance to transfer part of the underwritten risks to reinsurers. However, a range of factors, from increasing costs of rebuilding or repair to expanding populations and properties in NatCat prone areas, are testing the limits of the availability and affordability of (re)insurance coverage. On top of this, climate change is contributing to increased uncertainties (and therefore risks) for certain NatCat events. As a result, insurers may pass on the higher costs to policyholders. Alternatively, as their risk appetite is affected by reinsurance availability, they may cease to underwrite certain risks altogether. Another potential consequence is that some insurers may retain greater volumes of underpriced risks, which may adversely impact their solvency position. Underpriced or inadequately underwritten insurance products may threaten their financial position.

**The reinsurance protection gap, which in this paper refers to the shortfall between reinsurable and actually reinsured losses, may contribute to financial stability risks.** NatCat events that result in the destruction of properties or the disruption of businesses may reduce property collateral values and borrowers' capacity to repay. As a result, there is increased risk of mortgage and business loan defaults, potentially adversely impacting the banking sector. Parts of uninsured losses, especially in terms of infrastructure damage, will need to be borne by governments, which may have fiscal implications. In some jurisdictions, especially emerging markets and developing economies (EMDEs), economically vital sectors such as agriculture and tourism may be particularly vulnerable, as local insurers may not be able to offer insurance protection for those sectors in the absence of capacity amongst global reinsurers. The lack of affordable access to critical insurance products such as home or flood insurance may also have other far-reaching economic and social consequences, further exacerbating financial stability risks. Provided that risks are reinsurable, the reinsurance sector can play a market stabilising role and support

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the availability of insurance – thus countering financial stability risks by absorbing extreme financial losses arising from climate change impacts.

**To counteract retreating reinsurance coverage for climate-related NatCat events, it is essential to make climate-related risks insurable at affordable – but risk-based – levels.** To contribute to the continued availability and affordability of reinsurance coverage, governments, the insurance industry and supervisors need to work together to support risk adaptation measures. Climate risk adaptation measures need to be pursued to bring risk levels down and to be taken into account explicitly in insurers' and reinsurers' pricing and underwriting practices, which may not currently be the case. The interests of primary insurers and reinsurers need to be aligned, in terms of underwriting adequately priced insurance products as well as properly acknowledging risk adaptation measures. Therefore, reinsurers' pricing can be an important signal to insurers, reflecting underlying risk levels.

**From an underwriting perspective, reinsurers are pursuing their own net-zero goals in various ways, including providing reinsurance coverage to support new green technology and the phasing down of underwriting carbon-intensive sectors.** Views are mixed as to whether insurance supervisors have a role to play in incentivising reinsurers to contribute to such risk mitigation efforts. Nevertheless, it is acknowledged that net-zero goals can contribute to slowing down or even reversing climate change, thus reducing the increase in both the frequency and severity of climate-related NatCat events. As a result, insured losses could be more contained, thus contributing to the safety and soundness of (re)insurers, which justifies the proactive approach taken by some supervisors in this regard.

**As private reinsurers may not be able or prepared to underwrite climate-related risks, public-private partnerships may become increasingly important to correct market failures and address risk accumulation.** Nevertheless, the extent to which public sector reinsurance schemes can cover increasing climate-related losses is limited. The policy options and trade-offs in establishing a public sector reinsurance scheme need to be weighed carefully. There might be unrealistic expectations that governments will continue to subsidise reinsurance premium rates despite mounting climate-related insured losses. In addition, there is a risk that moral hazard may prevent adaptation and mitigation measures from being implemented. As insured losses continue to mount, even well run public-backed reinsurance schemes may face losses due to underpricing and/or increasing claims.

**While highly relevant, reinsurance alone cannot resolve the issues of affordability and availability in the insurance market.** It can only be part of a wider policy response to the climate crisis and potential further climate change impacts. Climate scientists are clear that we are crossing a number of climate tipping points and the world looks set to exceed our carbon budget to limit global temperature increase to not more than 1.5 or 2 degrees Celsius. This implies substantially more property damage and business interruptions as physical losses become more frequent and severe. Even though climate change itself may not currently be the dominant factor in driving up insured losses, there might be high NatCat exposures in certain regions and therefore, careful monitoring of climate change-related developments is needed. The increasing uncertainty in loss patterns due to volatility caused by climate change can pose challenges for reinsurers' pricing and underwriting practices. Against this backdrop, additional multi-stakeholder collaboration is required, including across borders, to contribute to the transition to net zero. At the same time, risk adaptation measures need to be accelerated as an "insurance policy" against failed transition.