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Guidance Notice 1 of 2024

Guidance on climate-related governance and risk practices for insurers

Objectives of this Guidance Notice

A Guidance Notice is a regulatory instrument aimed at assisting insurers in complying with the requirements outlined in the relevant Governance and Operational Standards for Insurers (GOI). Standards enjoy legal standing and are intended to establish minimum requirements with which insurers must comply. Guidance Notices, whilst having no legal standing nonetheless provide clarity on the application of the respective Standards.

This Guidance Notice sets out guidelines aimed at assisting insurers in complying with the requirements of GOI 3 (Risk Management and Internal Controls for Insurers) and GOI 3.1 (Own Risk Solvency Assessment (ORSA) for Insurers) as these prudential standards apply to climate-related risk for insurers. This Guidance Notice aims to illustrate approaches that should be considered in managing an insurer's climate-related risks.

This Guidance Notice may reference specific provisions within GOI standards and, as such, must be read in conjunction with the respective standards cited.

The Guidance Notice provides guidance to insurers on integrating climate-related risks into their governance and risk management frameworks, including guidance on the insurer's own risk and solvency assessments (ORSAs).

1. Introduction

- 1.1 Climate change may result in physical¹ and transition² risks that could affect the safety and soundness of insurers and have broader financial stability implications for the financial sector. To this effect, it is imperative that insurers take active steps to address climate-related risks.

¹ Physical risks can be categorised as either acute – if they arise from climate and weather-related events – or chronic – if they arise from progressive shifts in climate and weather patterns. Physical risks include the economic costs and financial losses resulting from the increasing severity and frequency of extreme climate change-related weather events (such as heat waves, droughts, landslides, floods, wildfires and storms), as well as longer-term progressive shifts in the climate (such as ocean acidification, rising sea levels and average temperatures).

² Transition risks are financial risks which can result from the process of adjustment towards a lower-carbon and more circular economy, prompted, for example, by changes in climate and environmental policy, technology, or market sentiment.

1.2 The Prudential Authority (PA) has developed this guidance notice to strengthen and improve the risk management practices related to climate-related risks with the purpose of enhancing the financial soundness and stability of insurers. This guidance note is intended to be applied on a proportionate basis considering the size, nature and complexity of the institution and the overall level of risk that each institution is willing to accept.

2. Governance

2.1. General

2.1.1. Good governance is the foundation of prudent business management. Strong governance arrangements provide effective oversight of the way an insurer conducts its business and manages its climate-related risks. To ensure effectiveness, the insurer's governance arrangements need to be supported by the insurer's corporate culture.

2.2. Roles and responsibilities of the Board of Directors

2.2.1. The Board of Directors is responsible for the effective governance of climate-related risks. In exercising that responsibility, the Board of Directors should:

2.3.1.1 Ensure that the insurer's risk appetite framework incorporates exposure limits and appropriate thresholds for climate-related risks that the insurer is willing to assume;

2.3.1.2 Review, approve and oversee implementation of climate-related business objectives and strategies in consultation with senior management for achieving those objectives;

2.3.1.3 Review and oversee the design and implementation of climate-related risk management and internal control systems in consultation with senior management;

2.3.1.4 Review and oversee effective implementation of climate-related policies;

2.3.1.5 Have an adequate understanding of climate-related risks and be equipped with the appropriate skills and experience to manage these risks. Insurers should build capacity and train the Board of Directors and senior management on climate-related topics relevant to the insurer.

2.3.1.6 The Board of Directors may delegate the management of climate-related risks but retains the responsibility to monitor the exercise of the delegated functions and activities.

2.3.1.7 The delegation arrangements should include a clear assignment of the delegated responsibilities, and mechanisms for monitoring the exercise of the delegated authority.

2.3. Roles and responsibilities of senior management

2.3.1. Subject to appropriate delegation from the Board of Directors, senior management is responsible for and should:

2.3.1.1 Promote strong internal risk management and internal controls relating to climate-related risks;

2.3.1.2 Implement policies and procedures in relation to climate-related risks;

2.3.1.3 Apply their risk management framework to assess and manage climate-related risk exposures and periodically review the effectiveness of the framework and policies;

2.3.1.4 Provide recommendations to the Board of Directors on the objectives, strategies and policies as they relate to climate-related risks;

- 2.3.1.5 Establish and use relevant tools, models and metrics to monitor climate-related risk exposures;
- 2.3.1.6 Set out information, options, and recommendations to the Board of Directors in a manner that enables the Board of Directors to make informed and timely decisions on climate-related risk issues; and
- 2.3.1.7 Ensure that the insurer has allocated adequate resources, skills and expertise to the management of climate-related risks, which includes the provision of training and capacity building amongst relevant staff.

2.4. Strategy

- 2.4.1. Insurers should manage climate-related risks within their overall business strategy and risk appetite, and the Board of Directors should be able to evidence its ongoing oversight of these risks.
- 2.4.2. Climate-related risks should be incorporated and assessed as part of the insurers annual business and financial planning process.
- 2.4.3. Insurers may either establish an internal risk committee or expand the scope of existing risk committees for identifying the changing risk landscape and responding to addressing climate-related risks.

2.5. Policies

- 2.5.1. Insurers should adopt and oversee implementation of robust governance policies that will identify, analyse, manage, monitor, report and mitigate climate-related risks impacting the insurer. The insurer's policies and procedures should:
 - 2.5.1.1. Make provisions for the identification, analysis, management, monitoring, reporting and mitigation of climate-related risks;
 - 2.5.1.2. Be commensurate with the risk profile and aligned to the climate-related risk appetite of the insurer; and
 - 2.5.1.3. Be regularly reviewed to ensure that the insurers policy framework is developed in line with the evolving nature of climate-related risks.

3. Risk Management

3.1. An integrated approach

- 3.1.1. The multifaceted nature of climate-related risk requires that insurers incorporate and integrate this risk into their established risk and governance frameworks.
- 3.1.2. The nature, extent and impact of climate-related risks warrants an integrated and holistic approach that is not restricted to reputational risk considerations but a sustained focus on the impact of climate-related risks as it relates to assets, liabilities and the insurer's business model and strategy.
- 3.1.3. Climate-related risks may have a potential impact on the solvency position of an insurer, as such insurers should actively consider the risk within existing risk categories as part of the broader Enterprise Risk Management (ERM) framework.
- 3.1.4. Climate-related risks may affect the valuation of assets and liabilities in both life and non-life insurers from the perspective of both physical and transition risks that are inherent with the impact of climate-related risks.

- 3.1.5. The specialist nature of climate-related risks, its interplay with other risk archetypes and its potential impact on the solvency of insurers may require the development of specialist tools³ in the assessment of the quantitative and qualitative impact of the risk. Climate risk management may also impact on the insurers ability to raise capital.
- 3.2. Risk Management function
 - 3.2.1. The risk management function should ensure that climate-related risks are accounted for adequately in the Board-approved risk management framework. The risk management function should monitor and enable resourcing requirements across the insurer to identify, monitor and assess climate-related risks. The resources should have the appropriate skills in line with the specialist nature of climate-related risk.
 - 3.2.2. Appropriate quantitative and qualitative methods and metrics should be identified and utilised in monitoring the insurers' progress relative to its strategy and risk appetite as this relates to the assessment of climate-related risk. Insurers should be acutely aware of portfolio exposures to climate-related risks, and where such exposures have a material impact on decision making.
 - 3.2.3. The risk management function should ensure that insurers and their Board of Directors remain cognisant of direct legal action against insurers for failing to manage climate-related risks. The risk management function should maintain a register tracking climate-related litigation and continually test the insurers resilience to such litigation risk. The risk management function should ensure that climate-related litigation drivers are well understood within the insurer and adequately captured in the risk management framework.
- 3.3. Compliance function
 - 3.3.1. The compliance function should in the discharge of its mandate ensure that climate-related risks are identified and accounted for in the compliance risk management framework.
 - 3.3.2. The compliance function should ensure that internal policies and controls are compliant with relevant regulatory and supervisory frameworks and as these relate to climate-related risk. International frameworks should be considered where the insurer conducts business within international jurisdictions.
 - 3.3.3. The compliance functions should on a continual basis assess compliance related climate risk drivers.
- 3.4. Actuarial function
 - 3.4.1. The actuarial function is instrumental in providing assurance over the quantification of climate-related risks in terms of the valuation of assets and the calculation of insurance liabilities with concomitant capital requirements. In providing this assurance, the actuarial function should express an opinion to the Board of Directors on:
 - 3.4.1.1. The appropriateness of methodologies and models used to assess climate-related risks;
 - 3.4.1.2. The assumptions made and approximations and judgments used in the assessment of climate-related risks; and
 - 3.4.1.3. The sufficiency and quality of data used in the assessment of climate-related risk, in particular in the calculation of technical provisions and capital requirements.

³ These tools relate primarily to data collection and data assimilation.

3.5. Internal audit function

- 3.5.1. The risk management process that applies to climate-related risks should be reviewed by the internal audit function to ensure the adequacy and effectiveness of the process. Where climate-related risks are material, the internal audit function should assess the impact on the insurer's resilience and consider the appropriateness of risk mitigation measures, if avoidance of these risks are not possible. Material risks should be reported on and disclosed in the insurer's annual reporting.

3.6. Control Function competencies

- 3.6.1. The specialist nature of climate-related risk may require a unique skill set from the Control Functions. These skills may be procured through capacity building or through the insourcing of specialist skills adept at addressing the nuances of climate-related risk.
- 3.6.2. Insurers should therefore adapt their internal policies and implement appropriate training programs to ensure that there is sufficient understanding of the impact of climate-related risk on the risk profiles of the insurer. Control Functions to this end should ensure that persons performing such functions possess the necessary experience in understanding climate-related risk and exposures.
- 3.6.3. The insurer may designate specific persons or a specific dedicated unit within the relevant control function to maintain primary responsibility for climate-related aspects and to ensure that climate-related risks remain in scope and integrated into all relevant parts of the insurers business.

3.7. Outsourcing

- 3.7.1. Outsourcing material activities and functions is an inherent part of the activities of an insurer. An insurer should therefore ensure that there is continuity of the outsourced functions in the event of failure of an outsourcing service provider.
- 3.7.2. The insurer should ensure that business continuity plans account for physical risks that may disrupt the operations of the outsourced service provider.
- 3.7.3. Business continuity plans should therefore reflect climate-related risks where such risks are deemed material.
- 3.7.4. The insurer may consider utilising physical risk scenarios in assessing the climate-related risk associated with outsourced service providers.

3.8. Transition planning

- 3.8.1. Transition plans, and the process of transition planning, is an important tool to manage climate-related risks and achieve commitments to climate targets. There is an emerging consensus on the general concept of transition plans as an articulation of an insurers forward-looking approach to the transition to a low carbon economy and the increasing physical effects of climate change.
- 3.8.2. As part of climate-related risk management, insurers should undertake transition planning and consider compiling transition plans in proportion to their size, business model and complexity.
- 3.8.3. Transition planning should support practices to test the resilience of an insurers strategy and understand and manage the risks associated with various transition pathways and potential changes in business models. Transition planning should consider geopolitical considerations, government policy and the structural changes required in the real economy. International frameworks should be considered where applicable.

4. Own Risk Solvency Assessment (ORSA)

4.1. General

4.1.1. The unique business strategy, investment portfolio and risk profile of each insurer will affect the degree of impact arising from climate-related risks. The nature and materiality of the relevant insurance, credit, market, concentration, operational and liquidity risks will vary depending on the climate-related risk exposures of each insurer. The ORSA is therefore a particularly useful tool for insurers to assess the adequacy of its ERM and capital position relative to climate-related risks.

4.2. Time horizon

4.2.1. As part of the ORSA, the insurer assesses its risk management and financial resources over a longer time horizon than is used to determine its regulatory capital requirements. However, depending on the business mix, this time horizon will typically extend over a 3-to-5-year period. For some pure non-life insurers with short duration contracts, the time horizon may be shorter than 3 years. Some climate-related risks may however take longer to fully materialise, and insurers should ensure that the ORSA also includes appropriate scenarios with extended time horizon, where relevant.

4.3. Stress testing and scenario analysis

4.3.1. Scenario analysis and stress testing may serve numerous objectives and can be used as a supplementary risk and capital tool for risk identification, monitoring and assessment.

4.3.2. Scenario analysis may help the insurer understand the potential impact of climate-related risks on its business model and strategy and assist in determining and quantifying the potential exposure to physical and transition risks.

4.3.3. Whilst scenario analysis and stress testing in respect of climate-related risk is evolving, insurers are expected to align the objectives of these analyses with the insurer's risk appetite and risk management framework. This may relate to informing capital, underwriting and liquidity planning or to their role as an integral element of sound risk management.

4.3.4. Scenarios should be designed such that they are sufficiently severe but plausible with a forward-looking perspective in mind. When material, this analysis should include the identification and assessment of the direct and indirect impact of climate-related risks, including as part of the scenario analysis and (reverse) stress testing process. This would enable insurers to assess their resilience to financial losses with respect to climate-related risks. This process should incorporate an assessment of physical, transition and liability risks:

4.3.4.1. Physical risk assessments may use catastrophe modelling over a number of different scenarios (e.g., 1-100 to 1-500- or 1-1000-year events). This may also include the identification of a scenario that could potentially cause insolvency;

4.3.4.2. Transition risks may include an assessment of how increases in carbon taxes, stricter environmental regulations and a global transition to low-carbon economies would impact both assets and liabilities; and

4.3.4.3. Insurers offering claims-made policies should understand the potential impact on their insurance liability risks as a result of increasing pressure on Boards to manage their companies in a responsible manner, especially as it relates to the environment, and should consider appropriate exclusions and/or limits.

- 4.3.4.4. Stress-testing and scenario analysis should be designed such that the output can be used for decision-making at the appropriate management and strategic levels.
 - 4.3.5. Parameters and assumptions for climate-related stress testing and scenarios may be adopted from modelling work performed by meteorological agencies, regulators, or other external experts. Statistical models as an example can determine the frequency of flooding events and modified economic models to estimate the economic or financial impact of various climate shocks. Insurers are encouraged to adopt the relevant models that are pertinent to their geographical scope and nature of business. It is important for insurers to fully understand these models and their underlying assumptions and methodologies when deciding on their relevance.
- 4.4. Reporting requirements in respect of an ORSA
- 4.4.1. The following should be clearly documented and explained in the ORSA documentation to allow for supervisory review:
 - 4.4.1.1 The process followed to identify, assess, monitor, and report on climate-related risks;
 - 4.4.1.2 The climate-related risks identified including their transmission channels and how these would result in financial risk to the insurer considering traditional risk categories;
 - 4.4.1.3 The impact these identified climate-related risks could have on the insurer's strategy and business plan;
 - 4.4.1.4 The impact these identified climate-related risks could have on the insurer's solvency position, liquidity, and profitability;
 - 4.4.1.5 Risk management and risk mitigation strategies to mitigate and manage these risks;
 - 4.4.1.6 Details on the scenario analysis and stress tests used to assess the impact from these risks;
 - 4.4.1.7 Contingency plans to deal with divergence and unexpected events; and
 - 4.4.1.8 Details on the challenges identified in the process of assessing climate-related risks and how these could be addressed in future.

Fundi Tshazibana
Chief Executive Officer

Date: