



Ref.: 15/8/6/2

## Financial Sector Regulation Act, 2017

### Proposed Guidance Notice

#### Proposed Guidance on climate-related 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 physical and transition risks that could affect the safety and soundness of individual insurance institutions and have broader financial stability implications for the insurance sector. To this effect, it is imperative that insurers take active steps to address climate-related risks within the insurance sector.
- 1.2 The Prudential Authority has developed this guidance notice to strengthen the regulation and supervision of climate-related risk with the purpose of enhancing the financial soundness and stability of insurers.

## **2. Governance**

### **2.1. General**

- 2.1.1. Good governance is the foundation of prudent business management by an insurer.

Strong governance arrangements provide effective oversight of the way an insurer operates 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. Allocation and delegation of roles and responsibilities

- 2.2.1. The Board of Directors and senior management should clearly identify and assign responsibilities throughout the organisational structure for managing climate-related risks.
- 2.2.2. 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.
- 2.2.3. 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 the Board of Directors

- 2.3.1. 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 Assess and understand climate-related risks at Board and Board committee levels. Where appropriate, insurers should provide appropriate training to Board members to facilitate understanding and discussion of climate-related risks.
  - 2.3.1.2 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.
  - 2.3.1.3 Set, approve and oversee implementation of climate-related business objectives and strategies for achieving those objectives.
  - 2.3.1.4 Set and oversee the design and implementation of climate-related risk management and internal control systems.
  - 2.3.1.5 Set and oversee effective implementation of climate-related policies; and
  - 2.3.1.6 Allocate roles and responsibilities to senior management in the management of climate-related risks and hold senior management accountable for the responsibilities.

## 2.4. Roles and responsibilities of senior management

- 2.4.1. Subject to appropriate delegation from the Board of Directors, senior management is responsible for and should:
  - 2.4.1.1 Promote strong internal climate-related risk management and internal controls.
  - 2.4.1.2 Implement policies and procedures in relation to climate-related risks.
  - 2.4.1.3 Apply their risk management framework to assess and manage climate-related risk exposures and periodically review the effectiveness of the framework and policies.
  - 2.4.1.4 Provide recommendations to the Board on the objectives, strategies and policies as they relate to climate-related risks.
  - 2.4.1.5 Establish and use relevant tools, models and metrics to monitor climate-related risk exposures.
  - 2.4.1.6 Set out information, options, and recommendations to the Board in a manner that enables the Board to make informed and timely decisions on key climate related risk issues; and
  - 2.4.1.7 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.

## 2.5. Policies

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

## 2.6. Strategy

- 2.6.1 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.
- 2.6.2 Climate-related risks should be incorporated and assessed as part of the insurers annual financial planning.
- 2.6.3 Insurers may adopt an internal risk committee that is responsible for addressing climate-related risks and identifying the changing risk landscape.

## 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 corporate governance frameworks.
- 3.1.2. The nature, extent and impact of climate-related risk warrants an integrated and holistic approach that is not restricted to reputational risk considerations but a sustained focus on the impact of climate-related risk as it relates to assets, liabilities and the insurers business model.
- 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 risk.
- 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 tools<sup>1</sup> 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 in its functional mandate 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

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<sup>1</sup> These tools relate primarily to data collection and data assimilation.

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.

### 3.3. 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. Climate-related risks from the perspective of the compliance function relate in the main to legal risk (liability risk)<sup>2</sup> and legal change risk (disclosure risk related to the failure to disclose climate-related risk exposures).

3.3.3. 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 operates within international jurisdictions.

3.3.4. The compliance functions should on a continual basis assess climate-related legal liability risks.

3.3.5. Insurers and their Boards should remain cognisant of direct legal action against insurers for failing to manage climate-related risks. The compliance function should maintain a risk register tracking climate-related litigation and continually test the insurers resilience to such litigation risk.

3.3.6. The compliance function should ensure that climate-related litigation drivers are well understood within the insurer and adequately captured in the risk management framework.

### 3.4. Actuarial function

3.4.1. The actuarial function is instrumental in the quantification of climate-related risks in terms of the valuation of assets and the calculation of insurance liabilities with concomitant capital requirements.

3.4.2. Climate-related risk data should be of a sufficiently high quality in terms of the completeness and accuracy of data sets in the calibration of premium reserves to reflect the evolving nature of climate-related risk.

### 3.5. Internal audit function

3.5.1. The risk management process as this process applies to climate-related risk should be reviewed by the internal audit function to ensure the adequacy and effectiveness of the process. Where climate-related risk is material, the internal audit function should assess the impact on the insurer's resilience and consider the appropriateness of mitigation measures.

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<sup>2</sup> The risk of climate-related claims under liability policies, as well as direct actions against insurers, for failing to manage climate risks.

### 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.
- 3.6.4. In determining capacity building initiatives, the insurer should remain cognisant of principles of proportionality relative to the size, nature and complexity of the insurer.

### 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. Insurers may consider utilising physical risk scenarios in assessing the climate-related risk associated with outsourced service providers.

### 3.8. Transition plans

- 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.
- 3.8.2. There is an emerging consensus on the general concept of transition plans as an articulation of an institutions forward-looking approach to the transition to a low carbon economy.
- 3.8.3. As part of climate-related risk management, insurers should consider undertaking transition planning and compiling transition plans in proportion to their size, business model and complexity. 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. As part of the ORSA, an insurer is required to perform a continuity analysis to assess its ability to manage its risks and meet its capital requirements under a range of plausible adverse scenarios 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:

4.3.1.1 Physical risks use catastrophe modelling including 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.

4.3.1.2 Transition risks may include an assessment of how increases in carbon taxes, stricter environmental regulations and a low-carbon economy would impact both assets and technical provisions; and

4.3.1.3 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.

4.3.2. Parameters and assumptions for climate-related stress testing 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. If climate-related risks are assessed to be material by an insurer, the following should be clearly documented and explained in the ORSA documentation:

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; and
- 4.4.1.7 Details on the challenges identified in the process of assessing climate-related risks and how these could be addressed in future.
- 4.4.2. If climate-related risks are assessed as not material, this should be clearly documented and explained in the ORSA documentation to allow for a supervisory review.

## **5. Invitation for comments**

- 5.1 Insurers and other interested persons are hereby invited to submit their comments, using the template provided, on this proposed guidance notice to: PA-Standards@resbank.co.za for the attention of Mr Christiaan Henning and Mr Ashendran Padayachee, by no later than 13 September 2023.

Fundi Tshazibana  
**Chief Executive Officer**

Date: