Commentary

Italian Non-Life Insurance — Incorporating Climate Change into Risk Management

DBRS Morningstar
17 May 2021

Tomasz Walkowicz
Vice President
Global Financial Institutions Group
+44 20 7855 6643
tomasz.walkowicz@dbrsmorningstar.com

Marcos Alvarez
Senior Vice President, Head of Insurance
Global Financial Institutions Group
+1 416 597-7553
marcos.alvarez@dbrsmorningstar.com

Key Highlights:

- Italy is considered one of the countries in Europe with the highest exposure to climate change risks.
- In managing physical risks of climate change, Italian insurers are concentrated on evaluating their potential impact on underwriting risk.
- Some of the leading insurers indicated that climate change impacts have been incorporated into their Own Risk and Solvency Assessment processes and affected their reinsurance strategies.
- Insurers' substantial expertise in mitigating natural catastrophes risk developed over many years of operations in Italy positions them well to deal with climate change risks in the long term.

Overview

Italy is considered one of the countries in Europe with the highest exposure to climate change risks, which manifests itself through increased frequency and intensity of extreme weather events. According to a recent research study[1] on the impact of climate change on Italy, five areas were identified as most at risk from climate change: urban environment, geo-hydrological risk, water resources, agriculture, and forest fires.

The largest insurers in Italy, including Unipol Gruppo[2] (rated by DBRS Morningstar at BBB/Negative) and Generali, provide extensive disclosure specifically dedicated to climate change. Their reporting gives a good insight into how the Italian insurance sector is incorporating climate change into its risk management systems and positioning itself to deal with its long-term effects. In managing physical risks of climate change, insurers are concentrated on identifying changes in the frequency and intensity of catastrophe events and recognizing their potential impact on underwriting risk. Some of the leading insurers indicated that climate change impacts have been incorporated into their Own Risk and Solvency Assessment (ORSA) processes and affected their reinsurance strategies. With regards to transition risks of climate change, large Italian insurers are focused on minimising potential for losses in their investment portfolios, which could arise from exposures to entities not meeting expectations with regards to repositioning towards greener economies.

DBRS Morningstar notes that insurers' substantial expertise in mitigating natural catastrophes (Nat Cat) risk developed over many years of operations in Italy positions them well to deal with climate change risks in the long term.

Relatively High Exposure to Climate Change Risks in Italy

Climate change risk is associated with increases in average temperature, changes in rainfall patterns, and increased frequency and intensity of extreme weather events such as floods, droughts, heat waves, cyclones, storms, or longer-term phenomena such as rising sea levels. As such, it has the potential to substantially affect the non-life insurance sector, which covers customers from losses resulting from such events.

A recent research study[1] focused on the impact of climate change in Italy identified five areas that are most at risk from climate change: urban environment, geo-hydrological risk, water resources, agriculture, and forest fires. Urbanised areas could suffer from climate change through heat waves and intense precipitation. Intense heat presents a health risk for the population, and children, the

1 Centro Euro-Mediterraneo sui Cambiamenti Climatici " Risk Analysis - Climate Change in Italy - ", 2020

2 UnipolSai Assicurazioni S.p.A., the main operating entity of Unipol Gruppo, is rated by DBRS Morningstar at A (high)/Negative

elderly, and people with disabilities are the likely primary victims of the most negative effects. Geo-hydrological risks reflect the danger that rising temperatures and intense precipitations could lead to the overflow of basins and landslides. Climate change, through extended periods of drought and changes in the rainfall regime, also presents a risk to the quality and availability of water resources in Italy. In agriculture, climate change could have an adverse impact on the productivity of the sector as the increase in average temperatures can alter the growing seasons and lead to potential shifts of cultivation areas. Further exacerbation of fire risks is expected due to the increase in mean temperatures and the intensification of dry periods combined with the decrease in average precipitation.

Incorporating Climate Change Risks into Risk Management

The largest insurers in Italy, including Generali and Unipol, provide extensive disclosure that is specifically dedicated to climate change. Their reporting gives a good insight into how the Italian insurance sector is incorporating climate change into its risk management systems and positioning itself to deal with its long-term effects. DBRS Morningstar views positively that the leading Italian insurers have implemented comprehensive frameworks to reduce the risks related to climate change. This reflects a relatively early implementation of environmental, social, and governance (ESG) frameworks and good advancement in creating procedures mitigating climate change and other ESG risks.

The risks stemming from climate change are categorised into physical risks and transitional risks. The main physical risk is the technical and credit risk due to increased frequency and severity of claims related to the consequences of climate change. The risks of transition involve potential losses in the investment portfolio due to exposures to companies not meeting expectations with regards to the transition path to a low-CO_2-emitting economy. They also include reputational risks stemming from undertaking business with companies whose path towards a low-carbon economy is considered insufficient.

Insurers' effort in incorporating climate change into the management of their underwriting risk management is concentrated on identifying changes in the frequency and intensity of catastrophe events and recognising their potential impact on underwriting risk. In order to achieve this, Italian insurers monitor physical risks and collect statistics that are later incorporated into actuarial models and used to estimate potential losses related to climate change and enhance underwriting. One challenge faced in the statistical data analysis is isolating the impacts of climate change from the effects of natural climate variability.

ORSA processes have also begun incorporating emerging climate change impacts. Unipol reported that specific stress testing focused on the impacts of climate change was incorporated into its 2019 ORSA. The stress testing was specifically focused on severe convective storm projections linked to damage from hail, wind, and lightning over the medium and long term (2020–2050). On this basis, additional average losses were estimated under various climate scenarios.

Risks related to climate change are incorporated also into Italian insurers' reinsurance strategies. Unipol reported that, in recent years, it increased its reinsurance coverage for Nat Cat events by adopting "annual aggregate" type coverage on medium-size natural events. Both Unipol and

Generali, in addition to reinsurance contracts, have accessed alternative risk transfer instruments such as cat bonds.

With regards to transition risks of climate change, large Italian insurers are focused on minimising potential for losses in the investment portfolios, which could arise from exposures to entities not meeting expectations with regards to transitioning towards greener economies. Generali indicated that it has been reducing investment portfolio exposures to certain issuers in the coal and tar sands sectors, including those with more than 30% of revenue or power generation from coal or with more than 5% of revenue from tar sands, and to projects for construction of new coal-fired power plants. Generali reported also that it seeks to minimise its underwriting exposure to this sector and, since 2018, it is no longer offering property and engineering insurance coverage for the construction of new coal-fired power plants and mines. In addition, it does not undertake the coverage of existing coal-fired power plants belonging to new customers. It also does not provide insurance coverage to companies operating in the tar sands sector.

Significant Expertise in Mitigating Nat Cat Should Support Dealing with Climate Change

DBRS Morningstar notes that the insurers are well positioned to deal with climate change risks, given their substantial expertise in mitigating Nat Cat risk, developed over many years of operations in the Italian market. The expertise covers managing a broad range of risks prevalent in Italy. The impact of Nat Cat perils on Italian insurers has been evident in recent years' technical results. In 2019, Unipol incurred losses due to weather-related events of considerable impact in the Fire and Other damage to property business and in Land Vehicle Hulls lines as a result of hail storms that hit numerous towns and cities in Italy. In 2018, Unipol was affected by losses in relation to damages caused by storm “Vaia”. Cattolica Assicurazioni incurred impact from weather events that affected the agricultural crop sector in 2019. Despite substantial scale, the overall impact was well managed. Italian insurers' exposure to climate change risks is mitigated also by the annual renewal of insurance policies, which allows them to incorporate evolving loss assumptions and mitigate the uncertainty inherent in climate change impact projections.

ESG Factors in DBRS Morningstar Rating Analysis

DBRS Morningstar has developed an ESG assessment framework that encompasses up to 17 ESG risk factors that are currently considered in DBRS Morningstar’s rating analysis and can potentially affect an issuer's creditworthiness. Further details of DBRS Morningstar’s approach to ESG risk factors in ratings and their disclosure can be found here.

The assessment of environmental risks is a major component of the analysis for the property and casualty (P&C) insurance business. This includes the impact of insured catastrophes on an insurance company’s financial strength, as well as considerations regarding claims predictability, frequency, and severity. P&C insurance and reinsurance companies have made progress incorporating environmental factors into their strategic planning and risk management processes.

Related Research

- Italian Non-Life Insurance - On a Path to Post-Pandemic Recovery in 2021, 3 March 2021
- Expected Busy Hurricane Season Likely to Add to U.S. P&C Insurers' Woes in 2020, 5 August 2020
- Severe Weather-Related Losses Compound Canadian P&C Insurance Companies' Challenges in 2020, 20 July 2020
- P&C Insurance: Regulatory Oversight Essential for Broad Adoption of ESG Reporting Principles, 27 April 2020
- Wildfire Challenges Manageable for Australian P&C in Q1 2020, 27 January 2020

Note:
All figures are in euros unless otherwise noted.

About DBRS Morningstar

DBRS Morningstar is a full-service global credit ratings business with approximately 700 employees around the world. We're a market leader in Canada, and in multiple asset classes across the U.S. and Europe.

We rate more than 3,000 issuers and nearly 60,000 securities worldwide, providing independent credit ratings for financial institutions, corporate and sovereign entities, and structured finance products and instruments. Market innovators choose to work with us because of our agility, transparency, and tech-forward approach.

DBRS Morningstar is empowering investor success as the go-to source for independent credit ratings. And we are bringing transparency, responsiveness, and leading-edge technology to the industry.

That's why DBRS Morningstar is the next generation of credit ratings.

Learn more at dbrsmorningstar.com.