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From COVID to climate – management of Black Swans and Grey Rhinos

The COVID-19 pandemic and resulting economic fallout shifted consumer and employee needs, habits, and expectations, while necessitating digitalization of insurers' operations practically overnight.

For most risk managers, the COVID-19 pandemic was exemplary of a Black Swan event — an extremely rare event that is (close to) impossible to predict, and typically with severe consequences. In order for insurers to prepare for such Black Swan events, they require established, solid, and resilient risk frameworks.

The 2021 half-year results of the largest Dutch insurers[1] showed great resilience from the insurance sector. In general, the underlying operating results and capital generation were very strong, combined with a healthy balance sheet and resilient solvency. A key question is whether this resilience is attributable to a strong risk management system — due to, amongst others, the introduction of the Solvency II framework in 2016 — or if resilience resulted from performance boosted by external factors like monetary easing by central banks (which lead to strong financial performance) and lockdowns (which resulted in fewer claims for the general insurance business and thereby better underwriting results). Likely it has been a combination of both, although it is fair to say that most insurers showed a quick and adequate response to the pandemic.

Besides Black Swan events, risk managers should also consider so-called "Grey Rhinos", which are slow-moving threats with a severe impact but, due to the seemingly slow speed of the threat, are sometimes not prioritized. A popular quote is, "Never let a good crisis go to waste". The current COVID-19 crisis has required insurers to rethink their business operations. Now can be a perfect time for insurers to also address the Grey Rhinos that are lurking in the near distance — but might be arriving sooner than expected. This could also answer the question posed in the previous section: how resilient are insurers in the face of a crisis?

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LOOMING GREY RHINOS AND HOW TO RESPOND

Environmental risk as an example of a Grey Rhino

Some relevant emerging risks at the moment can be categorised as geopolitical, technological, environmental and societal. In this article, we will focus on environmental risks, as this seems to be the most emerging "Grey Rhino" for insurers at the moment. As we have seen with the floods in North-West Europe and the wildfires in southern Europe during the summer of 2021, climate change has an increasing tangible and material effect. ASR (expected € 20-30 million), Achmea (expected € 50 million) and Nationale Nederlanden (expected € 70 million) have already indicated that these floods will have a financial impact for the second half year of 2021[1]. For risk management in the insurance industry, it is important to manage climate risk along with the entire risk continuum, from short-term extreme weather events (e.g. floods) to long-term changes (e.g. rising sea levels).

EIOPA recently announced its intention to require insurers to incorporate climate-related risk scenarios into their ORSAs. The DNB and PRA have specified similar expectations, and in its final recommendations, the Taskforce for Climate-related Financial Disclosures ("TCFD") presents scenario analysis as a key component of climate risk analysis.

As climate risk and other ESG-related risks are having a more prominent role in risk management, underwriting and pricing, insurers will need to shift from a reactive role to a more pro-active stance. Insurers have the position to incentivize consumers in becoming greener. This will help to make the overall business more sustainable — particularly when considering the shifting demands from consumers, employees and investors.

How to deal with a crisis: respond, adapt and thrive!

When managing a crisis, the following three-step approach could be used: respond, recover, and thrive.

Take the COVID-19 crisis for insurers as an example. When the pandemic first emerged, insurers **responded** by taking immediate steps to establish business continuity and help customers and their communities cope. As a next step, insurers needed to **adapt**, and some insurers already considered a mix of reactive and proactive actions in order to accelerate longer-term recovery efforts. After the required adaptation, insurers will (need to) pivot to the **thrive** phase, where sustainable profitability is reemphasized, despite challenging economic and social conditions.

As COVID-19 already demanded a change in how to approach an insurer's business operations, now is the right moment to also address the "Grey Rhinos" that are approaching in a fast pace — remember, never waste a good crisis. For example, insurers should move from delivering simple reactionary tactics to proactive ones, and become a more trusted business partner so that clients will want to stay loyal for years. This way, the business models for insurers will mature from "claims payers" to "partners in protection".
Improving a business to adhere to the shifted consumer and employee needs, habits, and expectations will ensure readiness for the final step of the abovementioned three-phase approach.

How to respond to environmental risk

Given that environmental risks are looming, the insurance industry is currently in the "respond" phase. There are still various uncertainties on the best approaches to tackle these risks, such as climate change, but it is clear that responding to these looming risks is needed. Below we will briefly highlight some of these responses.

A broad range of stakeholders (internal and external) are now driving change regarding business operations on climate change, which impacts executive KPIs and remuneration. This affects both board considerations and business considerations. Key risk (and performance) indicators could be supplemented with specific targets and should collectively adhere to external and internally-defined goals, such as a 1.5ºC warming goal for transition risk.

As the topic is evolving, transparency on climate-risk-related progress — plus the limitations and uncertainties insurers are facing — is essential to identify risk areas. It is important to identify the risks, establish the responsibilities and set up an approach, both for the short term and the long run. As climate change becomes more apparent, insurers should not only react to this increase in climate risk, but also take a proactive stance by addressing and mitigating against further warming by embracing Net Zero - in all of their businesses - and in incentivizing consumers to become "greener". As climate-related disasters are expected to occur in a higher frequency, playbooks for different scenarios should be available to respond to these disasters in much more effective ways.

It remains a challenge to be fully prepared for all Black Swans that might lurk in the future, but the Grey Rhinos are less difficult to identify and might appear faster than initially expected; the recent Sixth Assessment report[2] from the Intergovernmental Panel on Climate Change ("IPCC") once more confirmed the increasing speed at which some Grey Rhinos are moving. Insurance is shifting from its traditional roots — of providing customers with a product that protects against loss — towards an increasingly proactive, preventative focus. Firms are starting to offer a range of services, but it is to be expected that they have their sights set on more. As such, the "thrive" phase may not be far off here.

CONCLUSION

The insurance industry has shown great resilience in the COVID-19 crisis, as is evident in the 2021 half-year results of the largest Dutch insurers. This resilience may well be attributable to the adequateness of the risk management system, in combination with a performance boost caused by external factors that were out of control of the insurers. In the next crisis, external factors like financial stimulus will probably play less of a prominent role, so then the risk management framework of insurers will be more seriously tested.

With the recent experience of the COVID-19 Black Swan, insurers are in a good position to adapt to the emerging risks that loom on the horizon — such as environmental risks — and hopefully show that the resilience was indeed based on a strong risk management system. Insurers should therefore not forget the increased speed at which grey rhinos could come their way, nor sit back and think they are fully prepared for the next crisis. If they are alert, thriving results and real client impact may be close at hand. ■

1 – See e.g. https://www.nn-group.com/investors/financial-reports-1.htm
https://www.aegon.com/investors/press-releases/2021/2q-2021-results/
https://www.achmea.nl/investors/publicaties
https://www.asrnederland.nl/investor-relations/financiele-publicaties

2 – https://www.ipcc.ch/report/ar6/wg1/