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Climate Change and Insurance Regulation: Preparing for Challenges in 2025

Climate change is among the most significant challenges facing the insurance industry in 2025, transforming industry operating models and how insurers consider their risk assessments, pricing models, and claims processes.

The increased frequency and severity of climate-related events require insurers to continually adapt their practices to the evolving dynamics presented by these incidents. The financial impact on the sector has been substantial, with billions in losses attributed to weather-related incidents over recent years, and signs suggesting the trend is set to escalate.

The increased exposure has caused insurers to reassess their strategies, including their processes for predicting and underwriting the risks associated with climate change. This shift has implications for profitability and potentially affects the level of coverage available to policyholders and the premiums they need to pay to access it.

Climate Impacts

Global temperatures have been rising consistently since the late 19th century, but the last few decades have seen them increase at an unprecedented rate. Data from the Met Office and NASA highlight an increase in average temperatures alongside a rise in extreme weather events, such as floods, hurricanes, and droughts. 2024 was the warmest year on record globally, and the frequency of heatwaves has increased by more than 50% since the 1980s, representing a risk to agriculture, health, and infrastructure on a local, national, and international scale.

Climate projections suggest a range of serious consequences should current trends continue, with the Intergovernmental Panel on Climate Change (IPCC) suggesting that global temperatures could rise by 1.5°C to 2°C by 2100. Such changes will lead to intensified natural disasters and catastrophic impacts on the planet's biodiversity, with many species facing extinction as their habitats experience irreversible change.

Higher temperatures cause more moisture in the air, with the atmosphere able to retain 7% more moisture for every 1°C rise in temperature. The result is more frequent, heavier rainfall and changes to precipitation patterns, which can lead to intense flooding. In the UK, six of the ten wettest years on record have occurred since 1998, and the past ten years have been 10% wetter than 1961-1990.

The economic implications for the insurance industry are profound; the ABI reported domestic claims related to weather damage in 2023 reached £573 million, the highest total on record, with this number increasing to £585 million in 2024.

In addition to rising claims costs, regulatory pressures from the government and organisations such as the FCA and PRA require insurers to assess and report on their exposure to climate-related risk. Non-compliance represents the potential for further financial penalties.

Additionally, policyholders are increasingly environmentally aware and are known to select insurers with which they share values and who demonstrate an awareness of the impact their practices have on the environment. Insurers, therefore, need to adapt product offerings and integrate sustainable processes into their strategic decision making to remain competitive.

Insurer Response

Companies are utilising climate models to evaluate potential impacts on their portfolios and exploring innovative insurance products that support sustainability, such as coverage for renewable energy projects. Additionally, collaboration between insurers, regulators, and stakeholders is expanding, with initiatives such as ClimateWise encouraging companies to share knowledge and resources to co-develop frameworks for mitigating climate-related risks.

Insurers are also refining their risk assessment methodologies to account for climate-related factors, as traditional risk assessment models often fail to capture the complexity of climate risks, which can lead to inaccurate pricing and inadequate coverage.

To improve underwriting decisions, insurers are refining methodologies to incorporate advanced data analytics and climate modelling to allow for a more nuanced understanding of the risks posed by extreme weather events and changing environmental conditions.

Insurers are developing innovative policies tailored to address climate-related risks effectively. Among these is parametric insurance, a non-traditional product that pays out based on pre-defined conditions around climate-related events, such as rainfall levels or wind speeds, rather than the value of any loss. The increase in severe weather is likely to cause a rise in this coverage, given the need for speed and simplicity in managing the claims lifecycle.

Another example is green insurance, which encourages clients to adopt environmentally friendly practices, such as offsetting carbon emissions and promoting circular economies. Additionally, insurers are revising existing coverage to include climate-related exclusions or limits to ensure policies remain aligned with the evolving risk environment and to encourage proactive risk management among clients.

Regulatory and Policy Framework

A range of national and international agreements combine to shape the regulatory and policy environment, and these elements help guide insurers in managing climate-related risks and meeting their compliance obligations. The Paris Agreement, for example, establishes legally binding targets for limiting global warming aimed at reducing climate-related impacts and enhancing climate resilience.

Others, such as the Task Force on Climate-related Financial Disclosures (TCFD), make recommendations on disclosing information related to climate risks and opportunities, suggesting a series of measures companies can follow to embed these into core financial reporting. Compliance with these frameworks can help insurers mitigate risks and respond proactively to climate-related challenges.

Agreements such as the UN Sustainable Development Goals (SDGs) emphasise the important role insurance plays in sustainable development. Insurers are increasingly held accountable for their contributions to climate resilience, which includes investing in green initiatives and proactively fostering sustainable risk management practices.

UK Regulation

Following government reforms in 2013, oversight of the UK financial services sector has been delivered by the FCA and the PRA; referred to as the ‘twin peaks’ system. Together, they promote the stability of insurers, regulate their operations and ensure the protection of policyholders.

Recognising the implications for the insurance sector, both organisations have intensified their focus on climate change and enhanced the regulatory frameworks aimed at ensuring firms manage climate-related risks effectively and contribute to the UK’s wider sustainability agenda.

In January 2025, the FCA and the PRA published Climate Change Adaptation Reports in response to an invitation by the Department for Environment, Food and Rural Affairs

(DEFRA). These reports outline the key areas insurers should focus on to help them adapt to the challenges of climate change:

- **Risk Management Adjustments**: Insurers need to modify their risk management practices to account for climate-related risks, including adapting underwriting processes and investment due diligence and developing products that support adaptation in the wider economy.

- **Data and Modelling**: Quantifying and managing climate risks requires improved data and modelling capabilities, with enhanced data a critical element in enabling insurers to assess their exposure and resilience to climate-related events.

- **Sustainability-Related Reporting Requirements:** There are plans to consult on transitioning disclosure requirements to align with new standards developed by the International Sustainability Standards Board (ISSB) and the Transition Plan Taskforce (TPT) to standardise sustainability reporting and facilitate comparisons across the industry.

Furthermore, the PRA has set out its supervisory priorities in a 'Dear CEO' letter, emphasising the importance of embedding climate risk considerations into organisational governance and risk management frameworks through enhanced operational resilience, cyber security, and third-party risk management. By 31 March 2025, the PRA expects insurers to demonstrate their ability to remain within impact tolerances for critical business services during severe but reasonable disruptions, including those related to climate events.

Additionally, the PRA will consult on updates to Supervisory Statement SS3/19 to reflect the ever-changing risks and best practices in managing the financial risks from climate change. The focus will be on providing firms with guidance in areas including governance, risk management, scenario analysis, and disclosure practices to help them navigate the impacts of climate change.

In addition to the specific measures by the FCA and PRA, broader regulatory developments are anticipated to improve the adaptability of the UK's financial sector to climate change. The government will perform biannual performance reviews of regulatory bodies to ensure operations remain capable of effectively meeting emerging climate-related challenges.