

Response to EIOPA’s consultation paper on the prudential treatment of sustainability risk

Our reference:	ECO-SLV-24-084	Date:	21 March 2024
Referring to:	EIOPA consultation paper on the prudential treatment of sustainability risk		
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Pages:	7	Transparency Register ID no.:	33213703459-54

General comments:

- **Industry's commitment to sustainability and current Solvency II Framework** - European insurers affirm their commitment to sustainability, aligning with the EU Green Deal. Sustainability is a fundamental aspect of the 2020 Solvency II review and elements such as plans addressing the risks arising from sustainability factors and climate scenarios in the own risk and solvency assessment (ORSA) will further enhance reflection of sustainability-related risks, which are currently already explicitly covered in Solvency II.
- **Option 1, no change is the appropriate policy option** - While the industry welcomes EIOPA’s acknowledgement of the need for a risk and evidence-based approach, at this stage, the industry does not consider there to be sufficient evidence provided in the current analysis to support a change to justify a dedicated prudential treatment of sustainability risks in SII. EIOPA’s mandate to reassess the standard formula calibrations on a 5-yearly basis will allow for adjustments to the calibrations if more evidence is found. In addition, EIOPA’s preliminary findings are considered to be potentially useful for insurers e.g. for their assessment of the climate change scenarios in the ORSA.
- The industry highlights the following key views on the analysis and policy options:
 - **Insufficient evidence for change**
 - The analysis and evidence currently put forward is not sufficiently conclusive in enabling a thorough assessment of how effectively the current standard formula calibrations would capture transition risk.
 - Insurers' limited exposure to fossil fuel assets (1% of total direct investments¹) and the portfolio-level approach to capital requirements suggest that existing calibrations are sufficient. EIOPA's analysis indicates a portfolio-level risk of 14.5%, significantly lower than the existing 39% calibration. A more granular breakdown of asset classes in the standard formula would only make sense if certain assets were both riskier and disproportionately invested in.

¹ See EIOPA consultation paper p.8

- **The distinction of prudential instruments in pillar 1 and 2 must be respected:** Pillar 1 sets hard capital requirements based on evidence on quantifiable risks in a backward analysis, while the corresponding own funds are designed to cover losses of all kinds, irrespective of whether known or unknown risks materialise. The conservatively calibrated capital requirements indirectly cover new or emerging risks with insufficient data. Pillar 2 risk management addresses these risks, for instance through forward-looking scenario analyses.
- **Challenges in isolating transition risks**
 - The analysis fails to clearly isolate the impact of transition risks on spread movements or equity prices, as these risks are intertwined with broader trends and materialise in the already recognised sub-risk types. For example, geopolitical tensions which can significantly affect energy prices, make it challenging to isolate climate impact only.
 - Furthermore, EIOPA assumes the identification of transition risks in bonds and equities in the portfolios analysed, rather than observing them through data. While additional volatility in fossil fuel assets is attributed to transition risks, other factors likely contribute to this as well.
 - EIOPA's supplementary forward-looking analysis, used to reinforce its backward-looking analysis, relies on assumptions about the impact of transition risks on equity, bonds and property, drawn from scenarios designed in the context of prospective climate scenarios. Alterations in scenario parameters and probability of occurrence could lead to varied outcomes.
- **The industry does not agree that EIOPA's proposed policy options II and III are risk-based.**
 - Given the assumptions of the standard formula, a dedicated treatment of fossil fuel assets is considered unnecessary and not sensible at this stage.
 - The standard formula assumes insurers invest in well-diversified equity portfolios, making the risk of any arbitrary sub-portfolio irrelevant. Only the risk of the entire diversified portfolio is of relevance.
 - Simply adding a 17% additional capital charge for fossil fuel assets not based on a consistent scenario/data set compared to the underlying (e.g. 39%/49%) capital charge is not technically robust.
 - Credit ratings already incorporate relevant information on counterparties' debt repayment capacity. While transition risks may not have been fully captured in past ratings, they are expected to be accounted for now and in the future. Therefore, artificially downgrading the standard formula would lead to a systemic overestimation of risk due to double counting.
- **Contrasting perspective from the European Banking Authority (EBA):**
 - In a similar [assessment](#) to EIOPA's, the EBA drew very different conclusions, noting many reasons – although the regulatory context is different in the banking sector – that are also partly relevant for the insurance sector, **including**:
 - Lack of risk sensitivity, leading to miscalibrated requirements
 - Risk of double counting
 - Suboptimal policy measure
 - Questionable effect
 - May not support effective and just transition

Q1. What are your views regarding the analysis of equity and spread risk?

Regarding the backward-looking analysis:

- Data
 - The data used in certain areas of EIOPA's analysis seems sparse and not sufficiently standardised. Extrapolating towards a 1:200 event is inappropriate as it would not meet the calibration and statistical standards (for example those needed to embed this in internal models).
 - The data contains a high level of noise and non-linearities. Market values are the result of the endless interconnections of numerous factors including monetary policies, inflation, geopolitics, technologies, demography, health, productivity, etc. which makes the isolation of the effect of different levels of potential transition impossible.
 - Past data already includes transitions like the internet-based economy and digitalisation, which are already reflected in the data series used for calibrating the standard formula. Two short time periods, the COVID period in particular, are used which do not allow for robust empirical evidence.
- Assumptions
 - EIOPA assumes the identification of transition risks in bonds and equities in the portfolios analysed, rather than observing them through data. While additional volatility in fossil fuel assets is attributed to transition risks, other factors likely contribute to this as well.
 - While EIOPA acknowledges the shortcomings of the NACE codes, it is highlighted that in terms of asset exposures and transition risks, the sectoral/NACE classification may not fully capture insurers' increasing consideration of environmental, social, and governance (ESG) factors in investment policies, potentially overestimating transition risk for well-performing companies and underestimating it for worse-performing ones.
 - Furthermore, to evaluate transition risk not only sectors' belonging is sufficient. Assessing issuers' specific decarbonisation plans and their robustness, as well as analysing more in detail the composition of entities' business across energy sources better allows to depict the transition risk of single counterparties.

Regarding the forward-looking analysis:

- The approaches used in the forward-looking analysis may lead to circular reasoning, as stress tests already assume the existence of transition risks. Consequently, the assumptions made in the context of the stress test serve as the foundation for assessing transition risk.
- EIOPA's supplementary forward-looking analysis, used to reinforce its backward-looking analysis, relies on assumptions about the impact of transition risks on equity, bonds and property, drawn from scenarios designed in the context of prospective climate scenarios. Alterations in scenario parameters and probability of occurrence could lead to varied outcomes.
- For the most part, those climate scenarios only provide a view of plausible possible future states – they are not intended to be accurate and reliable predictions of the future. Scenario analysis can be conducted for a variety of purposes, and it is worth noting that the assumptions selected in those contexts are not yet well established and will be refined on a continuous basis. In conducting scenario analysis, scenarios are selected according to the exercise's objectives, the advantages and disadvantages of each scenario, and the intended outcomes. However, outcomes vary depending on scenario settings. They may draw on quantitative data, but for the most part, the narrative and assumptions within a scenario reflects subjective judgements made today about future possibilities.

- Solvency II capital requirements are determined based on a 99.5% value at risk (VaR) measure over one year. Scenarios without a confidence level are part of the ORSA and should remain so. The ORSA is a much more suitable risk management tool to address transition risk concerns.
- It is important to note that the findings in the forward-looking analysis have limitations as sustainable finance is an emerging area for quantitative-based risk analysis.

Q2. What are your views regarding the results, and in particular regarding the findings concerning fossil fuel-related stocks and bonds?

- The results show that in the analysed period the realised overall equity risk was lower than the standard formula shock of 39% (VaR 99.5 estimated as equal to 14.5% - Table 1 on page 30). Based on this analysis, it is clear that the Type 1 Equity Shock is sufficient to capture the equity risks, including transition risks, in this period.
- The VaR of several sectors shows that Energy/Fossil Fuels had elevated market risk between 2010-2021. There are however empirical uncertainties, such as a limited sample size and as such, high market risk associated with fossil fuels might be just an idiosyncratic feature of given instruments.
- Similar uncertainties apply to bond portfolio and spread analysis.

Q3. What is your view on the proposed policy options on introducing a dedicated prudential treatment regarding equity risk?

- **At this stage, the industry believes keeping the status quo is appropriate and justified and option 1, no change is endorsed.**
- In particular, the industry notes the following:
 - Implementing policy options II and III would increase the complexity and burden of the standard formula. Given the minimal impact demonstrated in the accompanying impact analysis, EIOPA has not clearly demonstrated that these changes benefit policyholders or would help protect against financial instability, which is central to EIOPA's mandate expected to be given by the co-legislators ("*EIOPA shall assess the potential effects of a dedicated prudential treatment.....on the protection of policy holders and financial stability in the Union, including fossil fuel related assets*").
 - EIOPA fails to give due consideration to the assumptions underlying the standard formula calibrations (ref: EIOPA 14 322). EIOPA's key assumption underlying the type 1 equity calibration is that "*The undertaking holds a type 1 equity portfolio that is well diversified with respect to geography (developed market countries), stock size (large, mid, small, micro cap), sectors and investment style (growth, value, income, etc.)*."
 - Isolating specific sectors for a dedicated treatment undermines this assumption and suggests that a corresponding change should be considered for other types of issuers/sectors. Otherwise, the proposed overall market risk calibration may not align consistently with the one-year horizon 99.5% VaR. In particular, there might be double counting of risks (as noted by the EBA in its analysis).

Q4. What is your view on the proposed policy options on introducing a dedicated prudential treatment regarding spread risk?

- **At this stage, the industry supports keeping the status quo as the appropriate and justified policy option and therefore option 1, no change, is endorsed.**
- Our views on the spread risk analysis are consistent with the reasoning outlined to equity risk, with heightened concern due to even less compelling evidence.
- As mentioned in the consultation paper, future developments in the area of credit ratings may further capture transition risk exposure of an undertaking and/or sector and there is no need for special adjustments to standard formula spread risk. Furthermore, rating agencies consistently consider probabilities of default across industries, leading to potential transition risks. In case an additional downgrade would be added for fossil fuel issuers this would likely result in double counting of the same transition risk.
- In addition, the industry highlights the following:
 - Despite the limited impact of the proposed policy options on the solvency ratio, the introduction of a differentiated prudential treatment may impact the transition efforts of affected fossil fuel-related companies. In addition, transition plan robustness shall be taken into consideration as well.
 - Moreover, there is no additional complexity and costs of implementing option I.

Q5. What is your view on the current potential of credit ratings to capture transition risk?

- In their assessment process, rating agencies are including all relevant information on companies, including their medium- and long-term strategies. This includes assessing probabilities of default consistently across industries, considering potential transition risks.
- Major credit rating providers recognise the increasing necessity of incorporating ESG characteristics into their products.

Q6. What is your view on the analysis of property risk and EIOPA's recommendation?

- **The industry supports EIOPA's recommendation to have no changes in Pillar I treatment of property risk in the context of energy efficiency.**
- EIOPA's backward- and forward-looking analysis of the real estate market and the influence of the level of emissions of buildings on their price do not clearly identify property risk. The studied subject exhibits a high level of complexity. Moreover, VaR analysis shows that very energy-efficient buildings with labels A/B have similar loss potential in terms of Value at Risk as energy inefficient properties labelled E, G or H. Forward-looking risk differentials were found only in case of the two least energy-efficient classes of buildings. Mixed results provide a rationale for no change of current prudential treatment of property risk.

Q7. What is your view on the analysis of underwriting risk and EIOPA's recommendation?

- Insurance Europe supports EIOPA's approach to the analysis and the proposed strategy for drawing conclusions and taking policy actions concerning adaptation measures and the prudential treatment of non-life underwriting risks.

- In particular, using the Undertaking Specific Parameter (USP) methodology to assess the potential for recalibrating non-life Solvency Capital Requirement parameters for premium risk in the Standard Formula (SF) appears to be a reasonable approach.
- According to EIOPA's analysis, incorporating climate-related adaptations into the model may result in a lower standard deviation of the loss ratio, thereby reducing premium risk. We broadly agree that adaptation measures could impact the SCR. Insurers' climate adaptation initiatives (e.g. through advice, incentives, and other services to policyholders) or measures taken by policyholders, such as concrete construction to enhance resilience against natural catastrophes, have the potential to reduce risks. However, it is important to recognise that incentives offered by insurers in their products and premiums are not the only steps necessary to guarantee future affordability and availability. This task involves all stakeholders, including governments, consumers, industry, and financial institutions. No single stakeholder can be exclusively held accountable for ensuring the affordability of insurance.
- At the same time, we support EIOPA's call for caution in drawing conclusions from the results of the conducted analysis, as at this stage the data collected is insufficient to draw such conclusions. Therefore, we agree with EIOPA's recommendation not to change the prudential treatment and advocate for further analysis when more data becomes available. If relevant and substantiated, an adapted prudential treatment may be considered for specific types of business lines.

Q8. *What is your view on EIOPA's proposed recommendation with regard to the prudential treatment of social risks and impacts?*

- The industry agrees with EIOPA's proposal not to recommend a Pillar I treatment and to work on providing guidance.
- For the time being, the analysis of social risks should remain at a prospective/identification stage, as a meaningful quantification is not feasible due to limited (standardised) data availability and studies on social risk and objectives. Therefore, the assessment of social risks should be of a qualitative nature.
- From a governance perspective, it is important to ensure that social risks are adequately managed. The SII requirements (i.e. internal controls, independent key functions) are considered important and sufficient.
- EIOPA emphasises the interconnectedness of social and environmental risk and recommends considering them jointly for prudential policy. This aligns with Solvency II Prudent Person Principle which requires inclusion of sustainability factors in long-term investment strategy. However, the specificity of each insurer's investment exposure, a global Solvency II adjustment focusing on social objectives is deemed unnecessary. Instead, EIOPA could conduct an information campaign to guide insurers on detecting social risks.
- Comparing climate change impact to social risks seems to suggest that a transition would similarly exist in both cases. However, looking at historical evolutions, social risks have always been present and are implicitly embedded in different risk measures used for prudential purposes. While not explicitly isolated in formulas, there is no need to do so as there is sufficient capitalisation to cover them.
- It is noted that social risks can also be caused by taking measures to lower environmental risks, as there is a trade-off between achieving environmental protection and social equity. For example, regarding fossil fuels, lower-income individuals may face challenges in adapting to greener alternatives due to financial constraints, such as the cost disparity between petrol and electric cars or gas heating and heat



pumps. Similarly, families with limited incomes may struggle to afford energy-efficient renovations in real estate. Policymakers and supervisors need to consistently weigh the trade-off between environmental (E) and social (S) factors in Environmental, Social, and Governance (ESG) considerations.

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