

Response to EIOPA consultation on the application guidance on climate change risk scenarios in the ORSA

Our reference:	ECO-SLV-22-064	Date:	10-02-2022
Referring to:	Consultation paper on Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA		
Related documents:			
Contact person:	Prudential Team	E-mail:	prudential@insuranceeurope.eu
Pages:	5	Transparency Register ID no.:	33213703459-54

Key messages

- The insurance industry welcomes the consultation paper on EIOPA's guidance, while noting that it could be enriched with further explanations for stakeholders. However, there is **a risk that the EIOPA guidance creates a de facto standard** ("best practice") and supervisors could request justifications in cases where insurers deviate from the guidance. This would contradict the meaning of the own risk and solvency assessment (ORSA).
- **An ORSA is a company's own analysis and should remain that way.** Therefore, the decision on how to perform the forward-looking analysis on climate change risks in the ORSA in practice should remain at the discretion of the specific insurer. This includes the ORSA structure and the guidance should therefore neither impose constraints nor prescribe an ORSA structure.
- **The alignment of the ORSA time horizon with the strategic and business planning time horizon** (ie 3 to 5 years) **should be preserved, to ensure the ORSA remains a decision-useful tool.** The ORSA is not always the best tool/reporting instrument to operate an insurer's climate scenario analysis framework. On the one hand there are climate change risks that may materialise quicker and if they can have a potential material impact over the business planning horizon these risks need to be considered in the ORSA. On the other hand, the long-term impact of climate change scenario (ie >5 years) would necessarily include strong limitations which would prevent most companies to use them in the business decision-making process. This seems in contradiction with the purpose of the ORSA to be an actionable tool for boards and senior management
- EIOPA's guidance **lacks clear reference to management actions.** This is probably due to the fact that the scenarios described in the document are for further development and are for information purposes only. **EIOPA should mention this clearly in the document.**
- While the materiality assessment process is crucial, the described approach is quite complex. In fact, it requires the wide availability of detailed exposure data of an appropriate level of quality and the implementation of a framework for setting the thresholds, although on a qualitative basis.
- The **proposed scenario analysis might be onerous for small and mid-sized insurers**, and even for larger undertakings. Having a **simplified approach for SMEs would therefore be appreciated.** **Proportionality aspect:** EIOPA should refer to the EC proposals in the context of the 2020 Solvency II review, which exempt Low Risk Profile Undertakings (LRPU) from specifying climate change scenarios and the requirement to assess their impact on the business of the undertaking.

1. Do you agree that the first two chapters provide a clear picture on the inclusion of climate risk scenarios in the ORSA to a high-level reader?

■ No

- It is important to stress that the structure of the ORSA reports should be tailored to best present a company's risk profile and to provide the administrative, management or supervisory body (AMSB) and other interested parties with useful forward-looking analyses to define the company strategy. Therefore, the paper should neither impose any constraints nor prescribe any document structure. Indeed, companies' ORSA reports are already well structured and understood by AMSBs and stakeholders. In fact, some supervisors, including the Italian supervisor, already prescribe an ORSA report structure, so any prescriptions regarding the ORSA structure may interfere with these and cause unnecessary additional operational burdens.
- The **alignment of the ORSA time horizon with the strategic and business planning time horizon** (ie 3 to 5 years) **should be preserved, to ensure the ORSA remains a decision-useful tool**. The ORSA is not always the best tool/reporting instrument to operate an insurer's climate scenario analysis framework. On the one hand there are climate change risks that may materialise quicker and if they can have a potential material impact over the business planning horizon these risks need to be considered in the ORSA. On the other hand, the long-term impact of climate change scenario (ie >5 years) would necessarily include strong limitations which would prevent most companies to use them in the business decision-making process. This seems in contradiction with the purpose of the ORSA to be an actionable tool for boards and senior management
- Furthermore, there should be no requirement to explain why a climate risk is not material. This does not exist for any other risk and is inconsistent with general ORSA requirements.
- EIOPA's guidance lacks clear reference to management actions. This is probably due to the fact that the scenarios described in the document are for further development and for information purposes only. EIOPA should mention this clearly in the document.
- There are several initiatives ongoing in the area of climate risk and these initiatives should not lead to duplication or in an increase in operational burden for undertakings.
- The insurance industry appreciates EIOPA's efforts to show how the climate topics may be evaluated from several perspectives and therefore represented in the most appropriate section of the ORSA report. And while the intention of the document is mostly clear, it could benefit from more explanations. For example:
 - In Chapter 2, the steps to conduct a climate scenario include "Transform climate change risks into financial losses". There is, however, no further guidance on that step. This is an area in which most companies may struggle and further explanations would therefore be helpful.
 - Regarding the integration of climate risk in a more holistic way into the ORSA, currently the guidance reads as though climate risk is a stand-alone risk separate from the rest of the ORSA.
- On **pp.14-15** of the consultation paper, EIOPA highlights the difference in the business horizons between the ORSA/business planning and climate planning. It should be noted that the "short-term risk" as described in the climate context is longer than most "normal" business horizons (short/mid-term). This is particularly important for those companies that consider one year as short term and three years as mid-term.
- On **pp.15-16** of the consultation paper, risk appetite is mentioned as short term (p.15), while in Table 1 (p.16) it is mentioned as mid/long-term.
- On **p.17** (Figure 5 – examples of materiality matrices):
 - The industry wishes to draw attention to the following point: regarding the assignment of the probability of occurrence for the initial main vulnerabilities' identification, it is not clear what the assumptions are for defining the probabilities. It would be useful to receive additional indications of how to determine the probability of occurrence of the different scenarios when performing the materiality assessment.

- These high-level heatmaps do not give any concrete view on what risks are material. They lack specifics to make the assessment relevant. It is noted that for emerging risks focus should be put on impact, rather than on probability, so as to further develop scenarios and actions.

2. Do the examples in "Chapter 3 – Materiality assessment" address the main transition and physical risks to which undertakings may be exposed?

■ Yes

- It is agreed that the **main transition and physical risks are addressed** in Chapter 3. However, the industry disagrees with the assessment of the technical provisions (TP) for non-life undertakings. These analyses are not considered proportionate for the following reasons:
 - The provisions for claims take into account losses that have already occurred and for which the claims are estimated on the basis of past settlement data. It is not expected that climate change would affect loss settlement significantly. For the calculation of the claims provisions, whether the losses or events were caused by climate change does not play a role. In addition, P&C insurers generally monitor the exposures to climate risk for non-life liabilities closely and as such they are well placed to identify existing and observable trends in the data they collect. Against this background, studying the impact of climate change on the claims provisions does not seem reasonable for proportionality reasons.
 - Premium provisions are determined from future cash flows. The main factor of the premium provisions is the combined ratio. This ratio includes the expected average claims expenditure for natural catastrophe events. The insurance cover period is key for the premium provisions and sets a limit on the timespan that needs to be considered. Generally, the term of insurance contracts is one year. The effect of climate change within this short period of time is expected to be minor and small in comparison to other effects. Thus, the analysis of the impact of climate change on premium provisions seems to be disproportionate.
- While the **materiality assessment process** is crucial, it could be perceived as being quite complex, as it requires the wide availability of detailed exposure data of an appropriate level of quality and a framework for setting the thresholds, although on a qualitative basis.
 - For example, for a unit-linked company providing a broad choice of investment funds for its customers, the number of individual underlying instruments after look-through could easily total more than a thousand. In such cases, the suggested approaches to assessing the materiality of transitional and physical risk would not be feasible, at least not without disproportionate efforts and costs.
- The **examples in the consultation paper are a good start** and appear to cover the main risks. However, as EIOPA points out, there are important limitations, eg to the Nomenclature of Economic Activities approach, ie the NACE approach, as it does not identify the source of energy used and its link with greenhouse gas (GHG) emissions (eg, investments in renewable energies will be considered climate-related, even if the level of emissions is very low). This makes the method less meaningful and EIOPA should analyse the implications further before the final version. Also, the paper could benefit from more explanations of the examples given. Furthermore, the various references to external sources, potential approaches, etc. are appreciated, and it would be beneficial if these sources were free of charge as far as possible.
- Physical and transition risks are considered to be comprehensively addressed in the paper. A common framework is deemed very important in order to achieve clear and comparable reporting in the market. The industry notes that there should be a consistent classification for climate risks, including litigation risk, across different frameworks, such as the TCFD.
- As far as assets are concerned (common topic for life & non-life insurers), it is important to allow to take into account information required to be provided under CSRD, SFDR and Taxonomy reports. This information will provide tangible elements to identify the (potential) impact of climate change on the value of assets.

3. Do you consider the scenario analyses proposed in "Chapter 3 – Climate change scenarios" easy to apply for small and mid-sized insurers?

■ **No**

- The scenario analysis set-up might be quite onerous for small and mid-sized insurers. Having a simplified approach for these undertakings would therefore be appreciated. For example, for such undertakings, stress levels could already be given to facilitate implementation.
- Proportionality aspect: EIOPA should refer to the EC proposals in the context of the 2020 Solvency II review, which exempt LRPUs from specifying climate change scenarios and the requirement to assess their impact on the business of the undertaking. (Directive Article 45a (5) "By way of derogation from paragraphs 2, 3 and 4, insurance and reinsurance undertakings that are classified as LRPUs shall neither be required to specify climate change scenarios nor to assess their impact on the business of the undertaking.")
- One of the difficulties of the exercise is to translate the simulations into operationally exploitable scenarios with increases in global temperature above and below 2°C. This part (Chapter 3) has the advantage of offering an overview of the tools available to simulate these risks. Against this background, it would be helpful if EIOPA could provide a concrete example of material exposure to climate change risk for the two scenarios proposed by the EC in Art 45a(2) (ie, a long-term climate change scenario where the global temperature increase remains below 2°C and a scenario where the increase is equal to or higher than 2°C), and how this would work out for SMEs (in particular for non-LRPU) and for bigger insurers. And, at the very least, in each of the tools, the link with the scenarios (>2°C or <2°C) could be further explained.
- Advances have been made in defining physical scenarios. However, for transitional scenarios the paper is not sufficiently clear and the development of further examples and explanations would be useful, especially for life business as there is not much explanation on this.
- It would also be useful to have more examples of how the different decarbonisation scenarios are associated with macroeconomic variables.
- The guidance, especially in Chapter 3, is not well structured and partly redundant. For example, it is unclear why a distinction is made between life and non-life on the asset side. The approach is analogous, regardless of the investment horizon. A differentiation by asset class would make more sense here (as is partially implemented in the quantitative analysis).
- Furthermore, the industry wishes to highlight that as uncertainties with respect to climate, exposure and vulnerability are larger in the very long run (eg, the affordability of insurance premiums can change greatly over time), quantitative scenarios longer than five to 10 years are less useful and may result in higher costs than benefits. The longer the time horizon, the more qualitative in nature this should be. Against this background, the use of qualitative analysis for longer term horizons is supported.
- Although PACTA is open software that provides several scenarios in different sectors, it is necessary to spend time to generate the database and to get to know the program, which would not be easy for SMEs.

4. Is there any relevant aspect not covered by the previous questions, with a particular focus on alternative methodologies / approaches?

■ Yes

- EIOPA should make it clear that the climate change scenarios in the guidance are examples and are not binding. The guidance should also highlight the fact that climate change is a risk driver and not a stand-alone risk type.
- The introduction of a framework and proposed approaches is appreciated, given the increasing importance of embedding climate change topics in the overall risk management framework.
- Most importantly, the proposed approach should be robust and easy to understand and implement, in order to have a tool to support insurance undertakings that is fit for purpose.
- To give the users more options and variety, reference could also be made to the recommendations of the TCFD in the ORSA. These provide a good basis for the identification, assessment, management and integration of climate-related risks into a company's risk management systems.
- Further examples of how to develop scenarios for life business would be helpful.
- The assumptions used in the open-source tools should be explained, in order to avoid the described tools being a black box.
- Furthermore, the simulations should be linked to the main indicators (in particular result).

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