Memo for information

To: Solvency II WG, Long Term Investments & Sustainable Finance PG, Sustainability WG
From: Prudential Team
cc:
Date: 18-04-2023
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Subject: Summary EIOPA Staff paper on nature-related risks and impacts for insurance

Summary

The secretariat has prepared a summary of the EIOPA staff paper on nature-related risks and impacts for insurance. In the paper, EIOPA explores how nature-related risks can affect (re)insurers and examines ways in which the insurance sector can meaningfully contribute to the conservation and restoration of nature through investments and underwriting activity.

At this stage, the secretariat does not consider that any immediate follow-up action is required, but a discussion on the topic in the future may be suggested by the secretariat. In the meantime, should members have any comments or views please write to prudential@insuranceeurope.eu.

Background

The EC and UN have highlighted the role of the insurance sector in nature restoration and conservation. This highlights the importance of the role of the insurance sector in restoring and conserving nature, through investing and underwriting activity, and to assess from a prudential perspective how nature-related risks can affect (re)insurer's balance sheet/business.

EIOPA aims to establish supervisory expectations for managing nature-related risks and impacts in a step-by-step approach. The staff paper provides a framework to identify key areas for addressing such risks, with EIOPA's upcoming initiatives focusing on identifying relevant data sets and tools for performing risk assessments.

TRANSMISSION OF NATURE-RELATED RISKS INTO SOCIETY AND ECONOMY

- The transmission of nature-related risks into society and the economy can occur through direct, indirect, or spill-over impacts, affecting citizens, businesses, and the economy at large.
- Economic activities that negatively impact nature are most likely to be exposed to nature-related transition risks, while activities highly dependent on intact nature are more likely to face physical risks.
- These risks can materialize due to changes in policy, technology, or legal requirements aimed at reducing or reversing damage to nature. Loss of natural capital and biodiversity can lead to impacts at the micro, meso, and macroeconomic levels, potentially creating systemic risks to the financial sector and financial stability.
- Nature-related risks are transmitted into society directly ('first-order'), indirectly (i.e. 'second order', for example through value chains,) or through spill-over impacts (contagion), affecting citizens, businesses and the economy at large.

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THE RELATION BETWEEN CLIMATE AND NATURE-RELATED RISKS

- Nature-related and environmental risks are sometimes used interchangeably but encompass different risks. Environmental risks include nature- as well as climate-related risks and encompass the interaction between nature losses and climate change
- The paper provides a table with similarities and differences between nature and climate related risks, in terms of risk characteristics/data, methodologies, metrics/insurability.
- Climate and nature-related risks are interconnected and exhibit self-reinforcing feedback loops. Climate change can pressure biodiversity and ecosystems, while biodiversity loss exacerbates climate change.
- While climate and nature-related prevention measures can have mutually mitigating effects through nature-based solutions, some mitigating actions for climate change may have negative impacts on nature, leading to unintended effects and trade-offs.

NATURE-RELATED RISKS FOR (RE)INSURERS' INVESTMENTS AND LIABILITIES

- (Re)insurers' direct impact on nature is limited as it has no heavy impact on nature and does not consume many natural resources.
- (Re)insurers may face **indirect nature-related risks** through their investments and liabilities.
- **Nature-related transition risks** can arise from misalignment of asset and liability portfolios with developments aimed at reducing nature damage, leading to counterparty defaults, declining asset values, and increasing claims.
- **Nature-related physical risks** can result in increased losses in investments or liabilities, including property and business interruption insurance, marine/aviation/transport insurance, crop insurance, and life/health insurance.
- Biodiversity and ecosystem disruption can lead to financial devaluations and/or default of (re)insurers' investees, which may not be covered by the SCR, resulting in a long-term decrease in financial returns and potential solvency risks for (re)insurers.
- (Re)insurers may also face **direct nature-related risks** to their own property and reputational risks from negative impact on nature by investees or policyholders. Insurers may also face legal risks, when failing to disclose adverse impacts or failing to perform due diligence on their investees/PH under regulatory requirements. This can in turn become an operational risk, when impacting the insurer's stakeholder/shareholder value.
- As nature-related risks increase:
    - availability of insurable as well as investable assets can reduce, affecting business opportunities more generally
    - Besides prudential risks, (re)insurers could suffer direct conduct risk, if insurance products are unclear about coverage of losses caused by nature-related risks.
    - Where nature-related risks are of increasingly systemic nature, diversification becomes more difficult and insurance may become less affordable for businesses and consumers, and economic losses may remain uninsured, negatively impacting the resilience of the economy. If proper risk management fails, the lower capitalised insurers can fail and when governments have to step in, this can lead to a spill over effect.

ASSESSMENT OF RISKS

- Two main approaches for identifying and quantifying nature-related risks:
    - **Economic activity's dependency on biodiversity and ecosystem services**. Mapping production processes to biodiversity and ecosystem services and rating their degree of dependency can build indicators for assessing exposure to physical risk.
    - **Economic activity's impact on biodiversity and ecosystems** (biodiversity footprint). Combining data on economic sectors' dependency and impact on nature with data on insurers' exposure to these sectors can support materiality assessment for nature-related risk exposures.
- Various tools are being developed and tested to assess risk exposures and identify financial flows' contribution to nature-related risks.

APPROACHES TO MANAGING NATURE-RELATED RISKS

A. TARGETS AND TRANSPARENCY

- Managing nature-related risks requires targets and transparency at global and regional levels.
- The intricacies of ecological interactions make it challenging to devise a single target for nature-related conservation and restoration.
- The *Kunming-Montreal Global Biodiversity Framework* sets targets for a transition pathway to protect and restore biodiversity, with financing and monitoring crucial for achieving measurable progress.
- The *EU Biodiversity strategy* aims to ensure Europe's biodiversity will be on the path to recovery by 2030, with legal protection for a minimum of 30% of the EU's land and sea areas.
- The *EU Taxonomy* objectives and criteria need to integrate targets for nature-related objectives. Two of the six EU Taxonomy environmental objectives are related directly to the sustainable treatment of natural capital: the protection and restoration of biodiversity and ecosystems and the sustainable use and protection of water and marine resources.

B. NATURE-BASED INVESTMENT AND UNDERWRITING ACTIVITIES

- Nature-based solutions are a cost-effective way to achieve environmental, social, and economic benefits while building resilience. They support EU policy priorities such as the European Green Deal, EU biodiversity strategy, and climate adaptation strategy to promote biodiversity and increase Europe's climate resilience.
- (Re)insurers investment or underwriting strategies can contribute to funding or covering risks for nature-based solutions, which can reduce transition and physical risks on their balance sheets. (Re)insurers can target their investment or underwriting activity to nature-based solutions by assessing their investees or policyholders' nature-related footprint or dependency.
- Nature-based investment solutions - Investment activity can be directed towards supporting activities that reduce the risk of loss of biodiversity. Insurers can assess and disclose the biodiversity footprint for their investments to identify where mitigation or adaptation measures are appropriate.
- Nature-based underwriting solutions - Insurance activity can aim to underwrite losses for companies that have nature-positive impacts, and nature-aligned insurance products can serve as innovative underwriting practices.

C. PRUDENTIAL TREATMENT OF NATURE-RELATED RISKS AND IMPACTS

- Solvency II integrates ESG risks into (re)insurers' governance and risk management requirements. Nature-related risks should be treated similarly to other environmental-related risks if considered material.
- Pillar I: There is no explicit prudential treatment - and no capital requirements - for sustainability risk in Solvency II, including nature-related risks. EIOPA launched a discussion paper noting there are still important challenges to the measurement of the potential impact of nature-related risks on insurers balance sheets, mainly due to issues related to data availability, common risk indicators and absence of common scenarios. For this reason, a Pillar I-based prudential treatment of nature-related risks is unlikely to develop in the short term.
- Management of sustainability risks, including nature-related risks, is part of Solvency II Pillar II governance and risk management requirements (ORSA).
    - The materiality assessment of nature-related risks through quantitative scenario analysis is difficult, and work is underway to define applicable scenarios.
    - Undertakings are required to consider the impact of their investment strategy and decisions on sustainability factors, including nature-related factors.
- Pillar III - Solvency II does not require supervisory reporting or public disclosure on nature-related risks, but extensive corporate sustainability reporting is materializing under CSRD and SFDR.

ROLE OF SUPERVISORS AND REGULATORS

- NSAs will need to assess nature-related risks in the (re)insurance industry's portfolios to protect consumers and preserve financial stability, which will require integrating nature-related risks into prudential/conduct supervisory frameworks and establishing methodologies and guidance on macro-/micro-prudential for risk assessment of nature-related risks.
- Supervisors can promote transparency and risk-based prevention measures, including:
    - promoting disclosure on nature-related risks,
    - increasing risk awareness
    - consider addressing regulatory opportunities incentivizing conservation and restoration through investment and underwriting requirements,
    - and contribute to identifying public-private risk transfer solutions based on risk assessment and risk prevention analysis.

  This in order to prevent the rise of (insured) losses from causing protection gaps to the detriment of consumers and systemic risks from jeopardising financial stability.
- Scenarios and stress testing are necessary to provide insights on the consequences of different actions and identify vulnerabilities.
- Sharing knowledge and data across disciplines is essential for improving the assessment and management of nature-related risks.
- EIOPA aims to establish supervisory expectations regarding the management of nature-related risks and impacts for the insurance industry and will focus on identifying relevant data sets and tools for performing risk assessments. This will form the basis for conducting materiality assessments for nature-related risks and impacts, by supervisors as well as by undertakings through their ORSAs.