

To: Solvency II WG, Corporate Reporting - Investments & Sustainable Finance WG, Sustainability WG
From: Prudential Team
CC:
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Subject: High level summary - Fit-for-55 Secretariat Review

Summary

On 19 November, the European Supervisory Authorities (EBA, EIOPA, and ESMA – the ESAs) together with the European Central Bank (ECB), released the results of the one-off 'Fit-For-55' climate scenario analysis. The analysis demonstrates that while **transition risks alone are unlikely to threaten financial stability**, their combination with macroeconomic shocks can increase losses for financial institutions and may lead to disruptions.

EIOPA's webpage [here](#) details the considerations for the insurance industry. The secretariat reviewed the documents and prepared this summary for members' information below.

Background

The climate stress test was conducted against **three scenarios** developed by the European Systemic Risk Board (ESRB), with the support of the ECB. The scenarios incorporate transition risks as well as macroeconomic factors, under the assumption that the Fit-for-55 package is implemented as planned.

- **A baseline scenario (B)** foresees the implementation of the 'Fit-for-55' package in an economic environment that reflects **June 2023 forecasts**.
- **A first adverse scenario (A1)** focuses on short-term climate-related risks that materialise in the form of asset price corrections triggered by a sudden reassessment of transition risk (the so-called 'run on brown' (RoB)).
- **A second adverse scenario (A2)** combines the same climate-related risks with other macroeconomic stress factors. The selection of non-climate-related stress factors represents a subset of the main financial stability risks considered in the **EU-wide EBA stress test 2023, including geopolitical risk**.

Results

- Under the **baseline scenario**, the financial system **remains resilient**, with limited overall losses.
- In **scenario A1**, losses from 'run-on-brown' shocks are **manageable**, affecting between 5.2% and 6.7% of exposures across sector.
- In **scenario A2**, combined transition risks and macroeconomic shocks result in substantial first-round losses (10.9% to 21.5% of exposures). However, mitigating factors such as banks' income, insurers' liabilities, and cash reserves in funds provide a cushion against these losses.

The insurance sector results (first-round losses) highlight:

- Losses are contained under the baseline scenario and A1, ranging from **2.2% to 5.2%** of investment in scope for insurers (insurers have the lowest losses compared to other sectors).
- Under scenario A2, insurers experience an **18.8%** decrease in the value of their investments in scope (vs **10.9%** for banking). The sharp rise in swap rates and credit spreads significantly reduced the market value of insurers' long-duration investments, particularly corporate and sovereign bonds, partially offset by reduced liabilities.

Table 1 (extract) - Results presented as total losses relative to exposures in scope in percentages

First-round losses (%) by sector	Baseline (B)	Adverse 1 (A1)	Adverse 2 (A2)
Banking	-5.8	-6.7	-10.9
Insurance	-2.2	-5.2	-18.8
IORP Sector	-3.0	-6.4	-21.5
Investment fund	-4.0	-6.1	-15.8
Total	-3.9	-6.0	-15.8

Further cross-sectoral amplifications are then considered combining first and **second-round losses** leading to further worsening, eg a 23.3% loss in scenario A2.

Caveats for Results

The report states:

- "Given the novelty of the methodological approaches and the data-related challenges, **the results are subject to a large margin of uncertainty.**"

There are **two key caveats** for the insurance sector highlighted in the summary of the report and detailed in the sector-specific chapter.

- Liabilities of insurers and IORPS (Box 2)
 - In the stress test, the liability-driven investment approach of insurers underscores the importance of considering both assets and liabilities for an accurate assessment of solvency and capital positions. **However, these liabilities were not recalculated in the test, limiting the interpretation of results.**
 - The Solvency II framework includes tools like the volatility adjustment and matching adjustment to mitigate the effects of short-term market volatility and reduce procyclicality.
 - Market risks vary by product type, with some, such as unit-linked contracts, transferring risks to policyholders. An illustrative scenario shows that a severe increase in interest rates could reduce insurers' liabilities by approximately 21%, partially offsetting a 19% decrease in asset values. This highlights the need to account for both sides of the balance sheet to fully understand insurers' resilience.
- Loss absorption by policyholders and beneficiaries in unit-linked (Box 3)
 - Within the insurance sector, unit-linked portfolios differ from non-unit-linked portfolios in the allocation of investment risk.
 - In unit-linked insurance, policyholders bear the investment risk, meaning losses on these assets do not impact the insurer's balance sheet but reduce the value of policyholders' units.
 - In the stress test scenarios, 20-30% of total losses in the insurance sector were absorbed by unit-linked products, illustrating the significant risk transfer to policyholders.

Data quality

- It is worth noting that the insurance sector has the **highest share of assets covered** in the exercise (see table below).
- Differences in data coverage across sectors may explain variations in first and second-round results.
- For the banking sector, major data quality issues included challenges in providing counterparty-level emissions data and the inability to supply identification codes for 70% of counterparties. Internal granular data from the ECB was used to address these gaps.

Table (based on report text) - The share of assets covered for each sector

Sector	Share of Assets
Banking (credit risk)	35%
Banking (market risk)	26%
Insurance	81%
IORP Sector	76%
Investment fund	77%

Considerations which may overstate impacts (not highlighted in the executive summary)

- **Relative vs total investments:** The reported impact (-18.8%) applies only to investments in scope. When considering total investments, the impact is reduced to -15.2%.
- **Hedging exclusion:** Unlike the banking sector, hedging mechanisms are not included for insurers, despite their relevance in mitigating risks.
- **Exclusion of management actions and reinsurance:** No reactive management actions or shocks to liabilities and reinsurance assets were considered, which could mitigate the estimated impacts.
- **Market risk methodology:** Shocks to bond prices are approximated using a linear formula based on modified duration, potentially overestimating impacts due to the simplification of convex price-yield relationships.
- **Scenario severity:** The swap rate shocks for scenario A2 are much more extreme than EIOPA's 2024 insurance stress test (as per FAQ 18 [here](#)) – The EUR 10Y swap rate shock in the adverse scenario (+219 basis points) is significantly higher than in EIOPA's 2024 stress test (+46 basis points). These extreme shocks apply only to assets, not liabilities, further inflating the estimated impact.