

The AAE comments on the debate about whether to add additional text on climate change risks into the Solvency II framework

In the ongoing discussion on the Solvency II review of the trilogy parties we have noted that to reflect climate change risks to a greater extent than before has been challenged. We believe, however, that the version of the Solvency II reform as proposed by EIOPA and the European Commission was a good basis for addressing these challenges.

Whilst we acknowledge that some appear to consider that climate change risks are already implicitly covered within the Solvency II framework to an adequate extent, we believe that failing to incorporate such risks more explicitly within the framework would be a mistake at the present time. It would foster the public perception that the insurance industry does not take climate change seriously. It increases the likelihood of divergent supervisory practices developing in different member states. These might then require further legislation to address, whereas a clearer articulation of expectations now would help the insurance industry to prepare and adapt. And it could encourage some firms to ignore the issue or to push back on supervisory pressure to do otherwise, potentially leading to future policyholder detriment if these firms then pay insufficient heed to the risks involved.

The increasing frequency and severity of natural catastrophes linked to climate change is a scientific reality, well documented in the reports of the Intergovernmental Panel on Climate Change (IPCC) and countless other research institutions. The potential inclusion of climate change considerations in a future update of the Solvency II Standard Formula, as proposed by EIOPA in its Methodological paper from July 2021¹, is a necessary step towards integrating the latest scientific evidence into the Solvency II prudential framework. In particular, the AAE supports the conclusion from EIOPA that in order to ensure continuing policyholder protection and stability of the insurance market, the Solvency Capital Requirements (SCR) for natural catastrophe underwriting risk should be updated to reflect the expected impact of climate change.

In addition, the potential impact of climate risk on an insurance company's solvency position is not limited to short-term physical effects on natural catastrophes. Longer-term considerations and transition risks must be considered as well, which can and should be done in the Own Risk and Solvency Assessment (ORSA) as proposed by EIOPA in their Opinion on the supervision of the use of climate change risk scenarios in ORSA published in April 2021². As pointed out in the Opinion, only a minority of insurers currently assess climate change risks in the ORSA using scenario analysis, usually limited to a short-term time horizon. The AAE agrees that the inclusion in Solvency II's ORSA of climate-related risks not considered in the SCR follows the intent of the existing prudential regulation. Proportionality considerations are included in the Opinion through the need to first perform a materiality assessment for climate-related risks. For companies with limited expertise in this area, EIOPA has also published and consulted on (optional) guidance in December 2021³.

¹ https://www.eiopa.europa.eu/document-library/methodology/methodological-paper-potential-inclusion-of-climate-change-nat-cat_en

² https://www.eiopa.europa.eu/media/news/eiopa-issues-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa_en

³ <https://www.eiopa.europa.eu/document-library/consultation/consultation-application-guidance-running-climate-change-materiality-0>

Finally, the request from the EU Commission for EIOPA to analyse whether risk differentials between green and other assets may justify a different prudential treatment does not amount at this stage to a reform proposal, but merely highlights the urgent need for more research into an area which is fast becoming a global financial stability concern. Similar analysis work has been started by the Network for the Greening of the Financial System (NGFS, of which EIOPA is a member) since 2020⁴, and EIOPA's sister institution the European Banking Agency (EBA) is already consulting on this matter⁵.

Climate risk has become a top priority for the insurance industry in Europe and beyond, and the AAE considers it is a serious threat which should be carefully monitored and its adequate reflection in the Solvency II framework reviewed on a regular basis. Through insurers' roles as investors, underwriters and risk managers, the sector also has an important role to play in climate risk mitigation and climate change adaptation (notably to support the UN targets set at COP21 in Paris in 2015 and more recently at COP26 in Glasgow in 2021).

⁴ https://www.ngfs.net/sites/default/files/medias/documents/capturing_risk_differentials_from_climate-related_risks.pdf

⁵ <https://www.eba.europa.eu/eba-launches-discussion-role-environmental-risks-prudential-framework>