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Public Consultation on Prudential Treatment of Sustainability Risks

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eiopa

European Insurance and Occupational Pensions Authority

Responding to the Paper

EIOPA welcomes comments on the consultation paper: “Prudential Treatment of Sustainability Risks”.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale and provide evidence; and
- describe any alternatives EIOPA should consider.

EIOPA welcomes comments on all parts of the consultation paper, and in particular on the specific questions raised.

Please send your comments to EIOPA using the EU Survey Tool by Friday, 22 March 2024, 23:59 CET. Contributions not provided using the EU Survey Tool or submitted after the deadline will not be processed.

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About the respondent

* Stakeholder name

Actuarial Association of Europe

* Type of Stakeholder
  - (●) Association
  - ( ) Industry
  - ( ) Ministry
  - ( ) Supervisor
  - ( ) EU Organisation
  - ( ) Other

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Questions to Stakeholders

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

Summary:

The AAE is of the view that capital requirements should always consider risks adequately. The overarching principle is that same risks should require same capital.

We would like to emphasise that we recognise the necessity of considering sustainability risks appropriately into the risk management of undertakings.

In our opinion, the most appropriate approach to address these risks would be to continue inciting and facilitating the integration of forward-looking climate risk analysis into the ORSA framework of Pillar II. Already materialized and observed climate risks need to be considered in the capital model of Pilar I, though.

From the responses received from our member associations, although no consensus was reached with respect to the preferred approach, the majority have indicated the need for a more balanced direction that accounts for the dynamic nature of transition risks, with preference for leveraging the ORSA process under Pillar II for incorporating forward-looking simulations and climate risk analysis.

There are certain concerns with respect to the data and methodology used, and the section below provides more detail.

Specific data comments:

The overall analysis is interesting from an application guidance perspective, although EIOPA acknowledges that the data used for this exercise is insufficient in volume and potentially biased, so there are concerns that results may lack robustness.

It is noted that the historical data used are largely influenced by changes in macroeconomic variables with no direct link to the energy transition, such as the Covid-19 crisis, the price of energy or, more specifically, the price of a barrel of oil. The calculated Value-at-Risk (“VaR”) is consequently likely to reflect a risk linked to these latter phenomena rather than to energetic transition. These limitations could pose significant challenges in arriving at meaningful conclusions from a Pillar I perspective.

General remark concerning the change of any of the SCR parameters: the amended Solvency II Directive asks in recital 83a for a review of the underlying assumptions in the standard formula to assess the impact of a removal of UK data from the relevant data sets. This would offer the opportunity for a comprehensive analysis including the affected correlations.

Specific methodology comments:

The scenarios incorporate an evolution characterised by a long-term deterioration trend, which is very different from, and could even be in contradiction with, a sudden shock, which is the approach inherent to Level I. It seems that the approach of aggregating them to obtain a single, stable, one-year shock could be counterintuitive.

Moreover, EIOPA notes the uncertain nature of the link between the credit rating and the risk studied, making the option of credit rating downgrade difficult to substantiate and to avoid double counting.
The approach adopted itself remains largely dependent on expert judgement and sensitive parameters (e.g., probability of a "disorderly" transition) while the calibrations reflect the intrinsic market fluctuations from global equity indices and credit spreads including fossil fuels.

Options 2 and 3 proposed by EIOPA would lead to an equivalent level of equity shock between types 1 and 2, even though their impact on the financing of the economy and their intrinsic risk could differ widely.

Forward-looking simulations, based on expert judgment and prospective scenarios, could prove difficult to be integrated into Standard Formula SCR calculations (Pillar I). The risks associated with the energy transition are expected to change over time. As such, a reconciliation with the definition of a single shock parameter that is stable from year to year may not be possible.

In general, the proposed methodology, including the increase in the capital charge for assets exposed to the energetic transition, could prove punitive if it does not recognise the efforts made by insurance companies and/or issuers of the assets, to promote better practices. In particular, the classification used may penalise investments targeting the oil sector, even though it could involve green bonds and their business may not be adversely affected by the energy transition.

Moreover, it is pointed out that the approach should not disproportionately penalise specific sectors or discourage investments in transition activities. The integration of transition risks should also consider broader economic factors, such as inflation.

There are some concerns regarding the methodology's data limitations and regarding the potentially unintended consequences that punitive measures could have on investments, especially those directed towards sectors which are currently undergoing transition towards greener practices but may still require time to adapt.

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

While there is recognition of the material risks posed by high-transition sectors, notably fossil fuels, the methodologies employed, including backward-looking analysis, have their limitations (Paragraph 166 of the consultation contains a good summary of the limitations of the analysis completed). These include challenges in accurately attributing historical Value at Risk (VaR) to specific drivers and the relevance of such analysis given the impact of broader economic and geopolitical factors on market volatility, such as the pandemic and the war in Ukraine.

Prudential treatment should consider the specificities of different sectors and their transition paths. There is a concern regarding the broad definition of fossil fuels and the consistency of this classification with existing regulations. Furthermore, the exclusion of recent data and the potential distortion introduced by the current methodological framework suggest a need for revisions to ensure the analysis accurately reflects the market realities and regulatory objectives. For example, backward-looking analysis on MSCI World Index excludes 2022-2023, which seems onerous, as the inclusion of inflationary periods could fundamentally change the outcome of the analysis.

In light of the above, the following section sets out some specific points in relation to data and methodology limitations that could be considered.

Specific Data and Methodology Comments:

- Enhancing the analytical framework to incorporate broader and more up-to-date data, including recent market developments and forward-looking scenarios, to ensure the findings are representative.

- We note that backward-looking analysis could have limitations or biases such as undue conservatism towards bonds. Also, in the backward-looking analysis, extracting a sector specific Value-at-Risk may not reflect the diversification benefits of a diversified portfolio of an insurance company.

- The introduction of sustainability-related capital requirements for fossil-fuel related investments needs the comprehensive consideration of the affected risk-modules including the relevant correlations. The amended SII directive requires (in recital of article 83a) the review of all calibrations that are input for the calculations of the SCR and the MCR and which are “unduly dependent” on UK data. Where applicable, UK data should be phased out from the relevant data sets, unless no other relevant data is available. This task should be done in an evidence-based manner for all relevant risk-modules and risk sub-modules. A piecemeal approach by starting with the sole consideration of fossil-fuel related risk should be avoided.

- Adopting a more granular approach in defining fossil fuels and related sectors, aligning with existing regulations and acknowledging the diversity within sectors in terms of business models, transition readiness, and risk profiles (e.g. gas is not considered as brown under the EU taxonomy).

- Considering the inclusion of these risks in the ORSA, ensuring that entities' exposure to transition risks is accurately reflected and adequately managed. Consider the development of specific stress tests or scenario analysis that specifically address transition risks, ensuring these are grounded in realistic assumptions and up-to-date data.

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

It is noted that, although there was no consensus between AAE members, with most advocating Option 1 while some others preferring Option 3, the majority supported an approach under Option 1. It is noted that, the choice of Option 1 does not mean “do nothing”. Rather, it supports the notion of including the treatment of sustainability risks within the ORSA, with suitable stress scenarios.

The AAE acknowledges the necessity of addressing sustainability and climate-related risks, highlighting the ongoing efforts of insurers to adapt investment portfolios towards more sustainable assets, alongside active engagement in stewardship activities aimed at promoting environmentally responsible corporate behaviour. These efforts reflect a broader recognition of the significance of sustainability risks, suggesting that the industry is not inert to the challenges posed by climate change and the transition towards greener practices.

Given the limitations on data availability and quality, the preference among the majority of AAE members is to utilise the existing Pillar II Own Risk and Solvency Assessment (ORSA) process as a more flexible mechanism for assessing and managing sustainability and climate-related risks. This approach would allow for a tailored analysis reflective of each entity's specific risk profile and strategic responses to sustainability challenges. Additionally, the risk management framework of the ORSA can be strengthened with specific stress testing and scenario analysis focused on sustainability risks.

As already discussed in Q1, there are certain methodology and data limitations that make it challenging to quantify risks and draw conclusions, at this stage. Furthermore, the calculation of Solvency requirements should not be based on static rules but rather adjusted appropriately during the strategic planning period.

The inclusion of a dedicated framework such as example 3 and option 3 could complicate the Own Risk and Solvency assessment process. Furthermore, there is the risk that the special treatments/evaluation of sustainability risks could jeopardize the need for enhanced and continuous discussion on appropriate capital levels.

Any modifications to the regulatory framework, particularly concerning Pillar I solvency requirements, should be approached with caution. Moreover, it is important to provide adequate notice to insurers so that they can adjust their strategic asset allocations and manage transition risk exposures effectively.

Furthermore, the materiality and the potential impact of such a change should also be considered, and a balance should be struck between doing too much, which has very little effect. For example, the number of companies falling within equity risk target could be few (e.g., the number of companies with the applicable NACE code in the analysis is 47, which represents c. 3% of the overall universe by company count), and the general equity allocation of insurers are typically not that high.

A multi-tiered approach based on thresholds and exposures, such as the one described in our response to Question 4 could also be considered in the case of equity risk.

If a decision is made to select a new approach (e.g. Option 3), it is important to consider the robustness of the data that would underlie the methodology of the particular option, its availability and statistical significance, as well as the need to restrain additional complexity of the regulatory framework while ensuring consistency with the different components of Pillar I calculations. This complexity may not only add to the administrative burden for insurers but also complicate the overall risk assessment and the risk management process.

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

It is noted that, although there was no consensus between AAE members, with most advocating Option 1 while some others preferring Option 3, the majority supported an approach under Option 1. It is noted that, the choice of Option 1 does not mean “do nothing”. Rather, it supports the notion of including the treatment of sustainability risks within the ORSA, with relevant stress scenarios.

While recognising the importance of addressing emerging sustainability challenges, it is suggested that a balanced approach is considered.

We set out below our observations for consideration:

- Given the varying degrees of impact that dedicated prudential treatments for spread risk may have on insurers' Solvency Capital Requirements (SCR), a proportionality framework could be adopted. In particular, it could be the case that the impact on SCR is relatively benign unless an insurer is overweight in a particular asset.

- For regulatory reporting purposes and to maintain a clear focus on insurers' core solvency needs, a simplified approach akin to Option 1 could be considered, for undertakings where proportionality rules fall under a certain threshold. This would ensure that capital requirements remain straightforward and manageable.

- However, recognising the potential for material exposures to sustainability and climate-related risks to vary significantly across the industry, different capital requirements (Options 2 or 3) could be applied to insurers with substantial exposure levels. This targeted approach would necessitate clear thresholds for materiality and transparency in the application of proportionality.

- Any adjustments to the prudential treatment of spread risk should be grounded in robust data and risk

analysis. This entails a preference for incremental policy adaptations that can be scaled up as more conclusive evidence becomes available.

- It is important to provide adequate notice to insurers so that they can adjust their strategic asset allocations and manage transition risk exposures effectively.
It is important to incorporate new evidence as this becomes available and to consider the inclusion of relevant stress tests to ensure that the prudential framework remains responsive to sustainability risks.

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

It is recognised that Environmental, Social, and Governance (ESG) considerations, including those related to transition risks, are increasingly being integrated into the credit rating process. This integration reflects an evolving understanding within credit rating agencies of the importance of sustainability factors in assessing a company's financial health and risk profile. The consensus is that ESG factors, and by extension transition risks, are becoming integral to the credit assessment process, indicating a positive shift towards more comprehensive risk evaluations.

The existing credit rating system, which is beginning to incorporate ESG considerations more systematically, is on the right path towards adequately capturing transition risks. This evolution is seen as a natural progression of the credit rating agencies' methodologies to reflect the growing significance of sustainability issues in financial assessments.

There is a potential redundancy in introducing explicit supplementary measures, such as capital charges or rating downgrades specifically for transition risks. Such measures could lead to double counting of risks that are already factored into credit ratings through the integration of ESG considerations. This underscores the importance of ensuring that any new regulatory initiatives are carefully evaluated to avoid imposing unnecessary or duplicative burdens.

Consideration of credit ratings could be given within the ORSA in the context of credit risk.

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

We acknowledge the provisional nature of the current analysis due to the inherent uncertainties and the limited data available at this stage. There is a recognised need for an understanding that incorporates a wider array of risks, particularly physical risks stemming from climate change (e.g., floods, wildfires) which pose a significant threat to property values and insurability. These risks could be referenced more adequately in the future.

Moreover, the impact of government policies on property values, especially in relation to energy efficiency, presents a complex landscape across Europe and may influence any forward-looking analysis. The inclusion of energy efficiency as a predictive factor for property value volatility should be balanced with other tangible property characteristics, including location, size, and regulatory context.

While we appreciate EIOPA's efforts to address biases related to property location and age, concerns remain regarding potential residual biases and the overall reliability of conclusions drawn from the current dataset. The low volume and quality of data highlighted necessitate a cautious approach to future recommendations.

We support the recommendation of paragraph 256 to reiterate the analysis with more comprehensive data.

This could encompass both the direct and indirect effects of sustainability and climate risks on property values, in a diverse European context.

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

It is evident that there is an apparent shortfall of adequate data to comprehensively assess the impact of climate-related risks and adaptation measures.

We agree with EIOPA that the available data does not yet allow to reach a conclusion and that the analysis should be repeated once more data is available. Enhanced data collection, possibly through open-source databases (or even engineering studies where this is relevant), and further analysis will be essential to overcome this limitation.

The existence of adaptation measures is important—whether implemented by insurers, insureds, or public authorities, as these can significantly enhance risk profiles and, where appropriate, should be considered within the prudential framework.

Re/insurers with convincing evidence of efficient adaptation measures should be explicitly encouraged to take advantage of the existing USP mechanism.

It should be noted that, regarding the protection gap, adaptation measures may only be available to those that can afford them at the higher end of socioeconomic level. This concern was not explicitly addressed in the consultation.

The consultation should consider the economic and socio-economic implications of mandating adaptation measures for insurance eligibility and affordability. The potential burden on individuals to invest in such measures would potentially shift significant risk from insurers to the public.

Finally, within the consultation paper, the term “climate-related risks” has potentially been combined with natural catastrophe risks. Some differentiation could be applied here, noting the difference between risks which are exacerbated by climate change and already present natural catastrophe risks.

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

We support the decision to exclude social risks from Pillar I treatment for the time being, while recognising the importance of the continuing work to develop application guidance within the ORSA framework.

We note the usefulness of examples provided in the consultation document, such as those in Table 24, which aid the understanding of the potential impact of social risks on underwriting. Additionally, the differentiation between climate-related and social risks, as seen in Table 26, underscores the challenges in scenario analysis for social risks due to their qualitative nature. It is essential to approach the assessment of social risks within ORSA with a qualitative lens, given their emerging and complex nature.

Concerns regarding fairness and the avoidance of discriminatory exclusions in impact underwriting and services are valid and must be carefully considered in developing guidelines. The ongoing evolution of reporting requirements related to social risks is a positive step towards gathering the necessary evidence for future assessments. However, it is premature to set a specific timeframe for integrating social risks into Pillar I without a more developed evidence base.

Finally, clarity should be sought in the definition and scope of social risk that will be adopted eventually, with the aim of achieving consistency with established frameworks, such as the CSRD.

It is noted that the AAE has recently published a discussion paper titled Social Sustainability in Insurance (https://actuary.eu/memos/aae-discussion-paper-social-sustainability-in-insurance-what-who-and-how/) which touches upon the specific topic. (This paper is a discussion paper of the AAE. Any views expressed in this paper are intended to stimulate and inform further discussion and should not be read as being representative of the opinion of the authors' employers or professional organisations, or to be an agreed position of the AAE as an organisation.)

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