Feedback Statement

Public Consultation – Prudential Treatment of Sustainability Risks

EIOPA-BOS-24/383
07 November 2024

European Insurance and Occupational Pensions Authority

1. INTRODUCTION

Sustainability risks are of growing relevance for the investment and underwriting activities of insurers, as they can materialize, for example, through investment losses related to stranded assets or insured losses due to climate change.

EIOPA's work on sustainable finance reflects the important role of insurers as long-term investors and risk managers, ensuring that the prudential framework reflects sustainability risks in the areas of solvency, consumer protection and financial stability in an adequate and risk-based manner.

The Solvency II framework has made a lot of important progress to address sustainability risks over the last years. However, as the understanding about sustainability factors and their risk-based transmission channels regarding the insurance sector is continuously evolving, it is essential that Solvency II as forward-looking and risk-based framework also continues to evolve to ensure that future sustainability challenges are appropriately captured.

EIOPA received a mandate under Article 304a of the Solvency II Directive to assess the potential for a dedicated prudential treatment of assets or activities associated substantially with environmental or social objectives, or harm to such objectives, and to assess the impact of proposed amendments on insurance and reinsurance undertakings in the European Union. EIOPA is required to submit a corresponding report to the European Commission by September 2024.

In response to this mandate, EIOPA has been following a step-by-step approach. EIOPA first published a discussion paper outlining the scope, methodologies, and data sources for the analysis in 2022, and then this consultation paper focusing on the findings and prudential implications. The public feedback received, together with the feedback received from the Platform on Sustainable Finance and the European Banking Authority (EBA) as well as the advice of the European Systemic Risk Board (ESRB), will form the basis for EIOPA's final report to the European Commission.

EIOPA would like to thank all the participants in the public consultation for their comments. All the comments submitted were given careful consideration by EIOPA, and the input received provided important guidance for EIOPA to finalise the report. The individual comments received and EIOPA's respective responses will be published as a separate document except those explicitly marked as confidential from stakeholders.

2. MAIN COMMENTS RECEIVED AND HOW EIOPA ADDRESSED THEM

RISK PROFILE OF FOSSIL FUEL-RELATED STOCKS AND BONDS

Most stakeholders welcomed the analysis conducted. In the responses, the stakeholders presented materially different views on the suitability of backward- and forward-looking risk assessments for determining policy implications, but there was overall support for the presented findings considering fossil fuel-related assets to have elevated transition risk levels.

One group of stakeholders emphasized the importance to rely on backward-looking risk assessments using historical data to determine quantitatively the risk profiles of assets and respective implications on solvency capital requirements. It was mainly mentioned that forward-looking assessments are based on technical assumptions that could bias the findings. In contrast, a second group of stakeholders emphasized the importance to rely on forward-looking risk assessments, since historical data would not sufficiently capture the dynamics of climate-related financial risks such as transition risks. It was also noted that transition risk exposures are expected to increase in future given the currently increasing potential for a disorderly transition scenario of the economy.

THE PROPOSED POLICY OPTIONS ON FOSSIL FUEL-RELATED STOCKS AND BONDS

The stakeholders presented materially diverse views on the prudential implications of the presented findings. While there was a general acknowledgment of the importance of reflecting sustainability risks such as transition risks properly under Solvency II, opinions varied materially on the relevant approaches, resulting in two general groups of stakeholders: One group supporting the introduction of a capital surcharge for equity and spread risk, and one group rejecting it.

Several stakeholders emphasized to reflect sustainability risks in general, and more specifically the elevated risk profile of fossil fuel-related stocks and bonds, in the ORSA (Pillar II) instead of the Pillar I capital requirements. Other stakeholders emphasized the need to explicitly reflect sustainability risks and the elevated risk profile of fossil fuel-related stocks and bonds in the Pillar I capital requirements by means of the proposed policy options. Some stakeholders suggested capital surcharges at levels going even beyond the proposed policy options. Among the stakeholders supporting the policy options proposed in this consultation paper, the option to introduce a capital surcharge was favored.

CREDIT RATINGS AND TRANSITION RISKS

A particular consultation question was raised on the capability of credit ratings to capture transition risks. Credit ratings are a central element to determine the spread risk capital charge under Solvency II's Standard Formula. As regards the proposed spread risk options, the transition risk-related effects intended to be captured by the specific policy options might overlap with the effects potentially already captured by credit ratings. On this, stakeholders were mainly separated in two contrary groups: One group argued transition risks are fully captured by credit ratings, while the other group argued for the opposite.

PROPERTY RISK AND ENERGY EFFICIENCY

There was large support by stakeholders for EIOPA's conclusion on the findings and respective recommendation to repeat the analysis in future under the condition more and better data would be available (e.g., in the context of developments around the Energy Performance of Buildings Directive (EPBD)).

EIOPA'S FEEDBACK STATEMENT REGARDING THE COMMENTS ON ASSETS AND TRANSITION RISK EXPOSURES

EIOPA, as outlined in its discussion paper in 2022 and in its consultation paper in 2023, considers it important to combine both, the backward- and forward-looking perspective, concerning its analysis of the materialization of transition risk exposures in market risks:

- Focusing on older time series of data might not sufficiently capture the materialization of transition risk exposures in asset prices, since commonly supported climate objectives, such as the 2015 Paris Climate Goal, which are relevant for a materialization of transition risks, occurred only in rather recent time periods;
- Focusing on younger time series of data is better able to capture the materialization of transition risk exposures in asset prices, but limits the number of available data points for an empirical analysis

EIOPA considers the combination of both backward- and forward-looking perspectives to raise the robustness of the findings. However, it is important to note that EIOPA acknowledges that technical assumptions are necessary to conduct a forward-looking analysis and therefore uses the respective findings to cross-check and to validate the backward-looking findings as regards the policy implications.

Regarding the role of transition risks for credit ratings: The main CRAs indicate in their rating methodologies that considerations are given to sustainability risks such as transition risks, but also mention a certain level of own discretion whether sustainability risks can trigger a change in a bond's rating. Specifically transition risks (ESG) is one factor among other factors in the rating methodologies of some CRAs, and there is already some indication from recent cases that some of the main CRAs have downgraded the rating of specific firms particularly due to transition risks.[1] Moreover, there is also an indication that the relevance of ESG factors in the CRAs rating methodologies has increased.[2]

EIOPA has reviewed the literature shared by several stakeholders in the public consultation and agrees that those papers outline that challenges exist to capture transition risks appropriately in the credit rating methodologies assessed, e.g. regarding transparency and coherence.

Overall, whilst acknowledging that some CRAs do incorporate transition risks, EIOPA has not found clear evidence that, at this stage, credit ratings capture transition risks in a transparent, coherent and systematic manner. From a prudential perspective, the risk arises that the current methodology in Solvency II's Standard Formula to determine the solvency capital for spread risk could underestimate the transition risk exposure of fossil fuel-related bonds. Hence, EIOPA considers it in the context of the mandate appropriate to provide advice to the European Commission on a dedicated spread risk option.

UNDERWRITING RISKS

The stakeholders emphasized the importance of the environmental objective of climate change adaptation for underwriting activities, and supported the analysis conducted as well as EIOPA's overall conclusion on the findings and respective recommendation to repeat the analysis in future under the condition more and better data would be available. Several stakeholders suggested to also consider the objective of climate change mitigation focusing on reducing greenhouse gas emissions in the context of underwriting activities.

EIOPA'S FEEDBACK STATEMENT REGARDING THE COMMENTS ON NON-LIFE UNDERWRITING AND CLIMATE CHANGE ADAPTATION

EIOPA, in its work on sustainable finance, continues its work on the objective of climate change adaptation, since further progress is important to maintain affordable and available insurance coverage in the context of climate change in the EU. EIOPA sees merit in repeating the analysis conducted as regards the impact of climate-/nat cat-related risk prevention measures on prudential premium risk if further progress on the availability of data has been made, and to broaden the scope of the analysis to look at natural catastrophe risk as well.

In relation to the objective of climate change mitigation focusing on reducing greenhouse gas emissions in the context of underwriting activities: EIOPA considers it important that prudential

[1] Institute for Energy Economics and Financial Analysis (2023): Can credit rating assessments and sustainability coexist?

[2] ESMA (2022): Text mining ESG disclosures in rating agency press releases.

conclusions are risk- and evidence-based. EIOPA is not aware of existing evidence outlining a causal and risk-based link between an insured object's level of greenhouse gas emissions and the insured object's respective level of insured claims. Therefore, at this stage, the described aspect has been considered not relevant for the analysis under EIOPA's mandate.

SOCIAL RISKS AND IMPACTS FROM A PRUDENTIAL PERSPECTIVE

The stakeholders supported the importance of social factors for investment and underwriting activities of insurers and supported EIOPA's principle-based approach to assess social risks and impacts from a Pillar II and III perspective, instead of a Pillar I perspective. Most stakeholders welcomed EIOPA's conclusion and recommendation to potentially provide future ORSA guidance on a respective materiality assessment.

EIOPA'S FEEDBACK STATEMENT REGARDING THE COMMENTS ON SOCIAL RISKS AND IMPACTS FROM A PRUDENTIAL PERSPECTIVE

EIOPA agrees with the importance of social factors for investment and underwriting activities of insurers and notes the support by stakeholders for working on a potential ORSA guidance.