PRUDENTIAL TREATMENT OF SUSTAINABILITY RISKS

Consultation Paper

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BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

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EXECUTIVE SUMMARY

Transition, equity and spread risks	EIOPA analyses sustainability risks using both backward-looking historical data and forward-looking model assessments to evaluate the need for specific prudential treatment of transition risks. The analysis focuses particularly on equity and spread risks in fossil fuel-related assets. For equities, three policy options were considered, where Option 3 states: implementing a supplementary capital requirement up to 17% on fossil fuel-related stocks. Similarly for bonds, among three options, Option 3 states: introducing a supplementary capital charge up to 40% for fossil fuel-related bonds. Both recommendations stem from evidence showing elevated risk profiles in fossil fuel-related assets compared to other sectors. However, the impact on insurers' solvency ratios is expected to be limited due to their relatively low direct exposure to fossil fuel assets.
Non-life underwriting risks and climate-related risk prevention measures	EIOPA conducted a study examining how climate adaptation measures, such as flood prevention installations, might affect non-life insurance premium risks. The research concentrated on private adaptation strategies that could be integrated into insurance products by either policyholders or insurers. The organization gathered data from non-life insurers in 2022, including both quantitative information and a qualitative survey exploring effects on reserve and natural catastrophe risks. While initial findings suggested potential reductions in premium risk, the limited data sample prevented definitive prudential conclusions. In order to justify specific prudential treatment for climate adaptation measures in premium risk capital requirements, EIOPA should revisit its analysis, when more data is available and consider including natural catastrophe risk assessment in future iterations.
Social risks	EIOPA examined how social risks could transform into prudential risks across both asset and underwriting domains. All sustainability risk components, including climate and social risks, should receive similar treatment in terms of identification and management. While social impacts are significant under the double materiality principle, EIOPA's qualitative analysis reveals that not all climate-related prudential measures and concepts can be directly applied to social aspects, particularly regarding scenario analysis and quantitative reporting requirements. Given that social risks are likely to evolve into prudential risks, and considering the limited practical guidance available for insurers in managing these risks, EIOPA recommends continuing work on developing guidance to help insurers assess social risk materiality within their Own Risk and Solvency Assessment (ORSA).

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Q1: What are your views regarding the analysis of equity and spread risk?

BETTER FINANCE recognises the importance of addressing prudential treatment of equity and spread risk by utilising a balanced approach based on both historical and forward-looking data. Climate scenarios are important elements for risk evaluation; however not all factors can be assessed in an equal measure as for example impact on price volatility could depend on the analysis of whether transition is expected to be different to those experienced in the past and whether markets are able to capture it in current prices. The use of NACE codes can support undertaking who lead in transition to change to a different NACE category, while those that do not make sufficient transition changes would not. Forward-looking methodologies rely on certain assumptions and transition scenarios can differ greatly depending on the method used. With the upcoming CSRD requirements for transition plans, more granular data can support an improved scenario-building and by extension any risk charge calibrations from EIOPA should reflect a balanced forward and backward-looking analysis, which takes into account the various transformations and transition factors.

Q2: What are your views regarding the results, and in particular regarding the findings concerning fossil fuel-related stocks and bonds?

It is evident that data limitations coupled with factors that go beyond transition risk can also drive losses in asset value. Fossil fuel sector investments may also be driven by specific economic circumstances or temporary policy decisions that are actually not reflective of transition risk. Capturing and responding to the multitude of risks is a persistent challenge, despite the fact that companies are already required to reflect sustainability risks in with their own risk and solvency assessment (ORSA) for example. Beyond fossil fuel-related stocks and bonds, the analysis shows other CPRS should be under increased supervision. While fossil fuel-related stocks and bonds logically fall under pillar I and II, a broader approach to the transition of bond and equity portfolios could be taken through pillar II.

Q3: What is your view on the proposed policy options on introducing a dedicated prudential treatment regarding equity risk?

Among the three policy options, Option 3 is the only one that fully encompasses EIOPA's empirical findings. Activities labelled as sustainable under the EU Green Taxonomy may still be subject to transition risk and as only a small percentage of insurers' asset portfolios will be directly impacted by the proposed prudential treatment, Option 3 also appears very feasible in terms of implementation.

Q4: What is your view on the proposed policy options on introducing a dedicated prudential treatment regarding spread risk?

Similarly to the risks in the equity sub-module discussed above, we support the policy Option 3, as it is the one most aligned with the empirical results of EIOPA's analyses, however it would also be important to consider any implications for the volatility adjustment (VA) which may follow from an amendment of spread risk treatment. Given the small percentage that fossil fuels take up in insurers' and reinsurers' bonds portfolios, the changes required to solvency ratios would be limited. We acknowledge that it would be reasonable to apply less stringent requirements on bonds compared to equities when purely considering transition risk in isolation, given the risk of an immediate total write off in this scenario is lower because (A) bondholders rank above equity owners in capital structure and (B) coupons provide ongoing compensation to investors.

Q5: What is your view on the current potential of credit ratings to capture transition risk?

The ECB working paper "Disclosure of climate change risk in credit ratings" (2022) also found a lack of transparency on ESG risk methodologies and their possible impact on rating assessments. An important impediment to the possible incorporation of transition risk into credit ratings is the existing legal framework. It imposes data and methodology requirements on credit rating agencies (CRAs), which are oriented towards traditional financial risks and prove inadequate when considering sustainability-related risks. In particular, provisions of the CRA Delegated Regulation EU 447/2012, Articles 4(b) and 7, require CRA methodologies to be "supported by statistical, historical experience or evidence" (Art. 4(1)8b), describe "the historical robustness and predictive power of credit ratings" (Art. 7(2)(a). These requirements cannot be satisfied for climate-related transition risk, which is of forward-looking non-linear nature, where required future transformations are not reflected in the historical data.

Q6: What is your view on the analysis of property risk and EIOPA's recommendation?

We support ongoing analysis in that area.

Q7: What is your view on the analysis of underwriting risk and EIOPA's recommendation?

There is insufficient data to change premium risk factors and ongoing analysis is likely to be valuable, especially in the context of natural catastrophe risk outcomes (continued work on prudential treatment of natural catastrophe risk to explore possible revisions needed in response to the growing number and severity of natural catastrophes).

Q8: What is your view on EIOPA's proposed recommendation with regard to the prudential treatment of social risks and impacts?

From a prudential perspective, social risks matter, but the lack of commonly agreed definitions of social risks as well as of social-related data, prevents an inclusive quantitative Pillar I analysis.

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BETTER FINANCE, the European Federation of Investors and Financial Services Users, was created in 2009 to give European consumers of financial services a voice. Supported by the European Union since 2012, BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since its constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other financial services users, BETTER FINANCE has the best interest of all European citizens at heart. It represents about 4 million financial users through 39 organisations in 26 countries. BETTER FINANCE believes that the financial system exists to serve the real economy.