OPSG

OCCUPATIONAL PENSIONS STAKEHOLDER GROUP

Advice on Consultation Paper on Joint ESAs Guidelines on ESG Stress Testing

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European Insurance and
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Consultation Paper on Joint ESAs Guidelines on ESG Stress Testing

Preliminary considerations:

The ESAs Consultation on guidelines for the integration of ESG risks in supervisory stress testing consultation comes at a very unstable legislative time; all sustainable finance regulation has been given a new sense of direction since the announcement of the Omnibus simplification in February this year and there is so far no way to foresee how things will evolve for financial market participants and their relation to sustainability, ie. ESG. The European Banking Federation (EBF), recent communication on the European Banking Authority 'ESG Risk management Guidelines' which proposes a delayed application 'until the Omnibus amendments are finalized, as well as a revision of the EBA Guidelines in the spirit of the Omnibus simplification and for consistency with the final versions of the CSRD/ESRS1 and CSDDD', raises valid arguments that the OPSG can consider in its feedback to this consultation in point. Many of these considerations remain relevant for the integration of ESG risks in supervisory stress testing, because, as stated, the entire body of sustainable finance legislation has been heavily modified in the context, target scope and timeline, with consequences on the financial value chain which have yet to be processed and therefore fully understood. The main considerations would impact the way in which ESG risks are being considered in the medium to long-term future and the regulatory relevance they might continue to have in the future for prudential and capital requirements perspectives in the European political context.

Question 1 - Please add here any comments on "Title I - Subject matter, scope and definitions"

There should be somewhat more emphasis as to the 'why' of this exercise and it's benefits for entities in scope. Because of its nascent practice, ESG stress testing needs to be well anchored to the practice of assessing the good functioning of financial market participants (IORPs in our case). It is therefore worthwhile, including a paragraph explaining the importance of this practice and ambitions for the future, even if in an high level form; while adding further details on the nature of the risks assessed (climate and environment) as well as what might be coming next (social and governance) as highlighted in point 7 (Background and Rationale). Further clarity on the reasons for carrying out this type of stress test should be therefore provided.

Question 2 - Do you agree with the list of objectives? Do you have any additional suggestions (addition, removal, precision,etc.)?

The objectives under point 15) have been split between testing the resilience of capital and liquidity position, as well as the loss-absorption capacity of financial entities and testing the **resilience of**

financial entities' strategy and business model to a range of ESG related scenarios over medium to long-term. This latter objective focus clearly revolves around the fundamental governance of the financial entity in scope as well as its robustness to withstand a variety of ESG related risk-related scenarios. These in turn, can take many different forms, therefore the OPSG supports a clear high-level framework that can serve as basis for all NCAs in their work. This would improve clarity and comparability among the entities subject to the stress test. Experience and reference should be drawn from the 2023 Flagship Technical Support Project - Technical Support Instrument that was built to ensure the set-up of a Risk framework to meet the needs around ESG of NCAs across Member States, who could request support for one or more work packages. Similarly, than for banks, the considerations regarding strategies and business models (always related to ESG) should meet proportionality considerations be linked to a series of materiality considerations linked to understanding what is relevant and permits to increase its financial sustainability. The strategic role of NCAs in this context should be aiming to guiding pension funds to embed the sustainability considerations linked to their investment decisions through their stewardship role and grasp how that can be translated as part of the overall business strategy of the IORP.

To this end, NCAs can draw useful resources by the work EIOPA has already issued in 2019 - the **Opinion on the supervision of the management of ESG risks faced by IORPs** *which provides an illustrative mapping of how ESG risks may arise in traditional prudential risks.*

Question 3: Do you have any comments or suggestions on paragraphs 16- 18 on Materiality assessment"?

The OPSG strongly supports a risk-based approach starting with a materiality assessment having the goal to determine, which risks are most relevant for IORPs and other financial entities. From that it should be decided which risks should be contained in a stress test exercise and which should be left out (due to a too insignificant impact). For reasons of efficiency and practicability only the most relevant risks should be modelled in a stress test. Otherwise, the calculation gets too complicated and too burdensome – especially for smaller IORPs – without delivering any significant additional insight. Such materiality assessment and the underlying scenarios used in the context of ESG stress testing should avoid any speculative elements. They would have to be strictly based on scientific results and proven interrelations and mechanisms. These should be accepted by the majority of the scientific community.

When designing ESG stress tests for financial entities, it must be clear that - although the risk sources are stemming from ESG-related events (e.g. general warming, flooding, extreme weather, the necessity of an unorderly change in the business of an issuer of a security etc.) – from the view of a financial entity, ESG risk is not directly a risk category of itself. Instead, it is a separate and important category for well-established sources of risks affecting also financial entities. If these risks materialize, they transmit into the usual risk categories a financial entity is directly exposed to. Example: In case of a production site of a company, which is located on the shore of a river, an event of extreme flooding due to extreme weather conditions out of climate change (physical risk) could destroy important parts of the site, leading to interruptions of production and making additional unplanned investments for the reinstalment and future physical protection of the affected parts of the plant necessary, both leading to weaker earnings and in consequence a lower value of the company's issued shares and/or bonds – in extreme cases this could theoretically lead to corporate debt not being served. Hence, for a professional investor in this example the physical risk transfers into market and/or credit risk. A similar mechanism holds e.g. if as a consequence out of political or public pressure a company needs to do additional unplanned investments to improve its carbon footprint (transition risk) or loses its license to operate.

If ESG stress scenarios are defined, such transmission mechanisms must be taken into account in a way, which is science-based and to the biggest extent possible free from any subjective estimate or speculation. That means that the determination of thresholds for materiality and concrete stress parameters has to be based on scientific knowledge about how ESG-risk-events (short-term) or developments (log-term, e.g. a certain development in global warming) most probably would transform into financial risks.

Additionally, any ESG stress scenario has to be economically plausible and consistent in itself. Example: If a certain stress scenario results in an upwards shift of yield curves on the asset side, which are also used by the financial entity to value its liabilities, then also an upwards shift in yields for the liabilities has to be assumed in this scenario.

The OPSG shares the view, that materiality assessment and scenario definitions need to be dynamic, since risks as well as scientific results in this context are dynamically evolving.

Question 4 - Please add here any additional comments on "Title II - Requirements regarding consistency, long-term considerations and common standards for assessment methodologies in stress testing of ESG risks - 3.1 Objectives"

Interconnectedness should be at the core of the NCAs' focus. They should have a clear view on the requirements across regulations different stakeholders have to comply with. If correctly done, this step ensures heightened efficiency and avoids overlaps among similar regulatory requests, while avoiding blind spots, as enumerated under point 23 of this consultation. The entities in scope of the 'stress test' should not be obliged to apply breakdowns of assets and other stress test relating data going beyond their regular reported data.

Already in 2018 the HLEG recommendations promoted the practice of "extending the time horizons of investment and bringing greater focus on ESG factors into investment decisions", as well as "upgrading disclosures to make sustainability opportunities and risks transparent" to investors.

As a follow-up to that, in 2019, EIOPA issued an Opinion on the use of governance and risk assessment documents in the supervision of IORPs - a guidance – in which it referred to the monitoring of the SIPP (including ESG considerations) and of the policy and procedure for conducting the ORA.

The "follow-up report on peer review on supervisory practices with respect to the application of the PPR for IORPS" launched in 2023, did not yet reveal anything substantial in terms of the impact of ESG considerations in the SIPP. The next follow-up report is expected in the course of 2025 and should be duly monitored.

There should be univocity in the understanding of the different terms in scope under the acronym 'ESG', which could entail, for NCAs to refer to and make use of the same references and sources (ie. TCFD, PRI, OECD). Building up on common practice so far, in terms of disclosures on ESG risks and what can be expected from sustainability reporting, striking a good balance between, proportionality and availability of data, the OPSG agrees with the suggested scope being **primarily on climate risk, while introducing some guidance on other ESG aspects**. Also, the OPSG supports keeping the focus on the most material ESG risks, optimizing in this way cost/benefit balance for their supervisory stress testing framework.

Question 5: Do you have any comment or suggestion on paragraphs 27-28 on "scope" and paragraph 29 on "time horizon"?

On a pan-European level IORPs did already an ESG stress test exercise in form of the EIOPA stress test in 2022. Due to the toolbox-approach, which EIOPA intends to use for stress testing in the IORP sector, on a pan-European level also ESG risks can be assessed in coming EIOPA stress test exercises.

The OPSG supports the view, that a balanced and pragmatic approach regarding the coverage in terms of portfolios, sectors, geographies and economic activities should be taken. Sufficient coverage is necessary to derive a representative and fair picture regarding the resilience of financial entities and the financial sector against ESG risk. Hence, the majority of financial institutions should be covered. Smaller institutions, whose inclusion into ESG stress testing would not change the whole macro-prudential picture significantly, should be exempted for reasons of efficiency and proportionality. For cross-border financial groups all relevant entities having the defined minimum-size should be included in the assessment.

Regarding time horizon and depending on the objectives of the respective stress test exercise either a short-term shock or a long-term scenario can be modelled. In the latter case also the adaption of markets and financial entities with respect to ESG developments should be possible to build into the calculations as well as management actions in general (which of course must be plausible).

Question 6: Do you have any comment or suggestion on paragraphs 30-33 on scenario design and application?

Scenarios must be strictly based on scientific results and proven interrelations and mechanisms describing the transfer of ESG-risks into the usual financial risks. These should be accepted by the majority of the reputed scientific community. They should be to the biggest extent possible free from any subjective estimate or speculation.

In case ESG stress tests with a longer-term simulation horizon the use of too many distinct scenarios will be quite complex and work-loaded for IORPs. Especially medium-size to smaller IORPs might not be in the position to perform the necessary calculations for too many different scenarios at the same time. Hence, for long-term stress testing, one should focus on one (or maximum two) adverse stress scenarios, which should be in general pessimistic but still realistic, plausible and consistent in itself (for the latter please refer to the example at the end of the answer to question 3). The OPSG supports the view, that adverse stress scenarios should be the same for all participating IORPs. However, in exceptional cases an individual IORP should have the possibility to assume a different transfer of ESG-related shock events into shocks to the individual OPSG's portfolio if the general assumptions do not fit. In this case the respective IORP of course has the duty to prove, that the assumed transfer is correct and that assuming the designed standard transfer mechanism would lead to misleading results.

Question 7 - Do you have any comment or suggestion on paragraphs 34-36 on "top-down vs. bottom-up approaches"?

As already stated, the inclusion of the full spectrum of ESG criteria as part of stress testing, is still in its infancy and the industry (target population) as well as the national competent authorities, are gradually adjusting to the new concepts and how they interact with each other. This learning phase should not be overly ambitious in terms of timelines or results. The OPSG would welcome a phased approach, with the start of a top-down strategy, where NCAs assemble the data, process it and deliver a series of results which can be then considered as the benchmark within and across member states. After this first 'incubation' phase, when data, (and data gathering) processes, impacts and initial methodologies and benchmarks, have been defined, at different national levels where there is an estimation of a satisfactory level of maturity attained, the exercise could be run on a bottom-up approach. In this phase a clearer quality and comparability level would be confirmed by financial entities, who have proficiently internalised ESG risk processes into their objective and overall modus operandi.

Question 8: Do you have any comment or suggestion on paragraphs 37-40 on "level of granularity"?

In order to make the participation in the stress testing practically possible for the majority of institutions, the granularity of the exercise should not be too high. For example, with regard to sectoral level, a too granular classification of certain shares or bonds will not lead to a clearer and fairer view within a stress test. In the 2022 EIOPA stress test exercise we could observe, that classifying companies according even to the highest level of NACE codes is often uniquely not possible, because some companies have several business lines and/or definitions of certain sectors may not be unique and/or overlapping, leading to the phenomenon, that different persons would sort the same company into different industries (Simple Example: Does a company producing dyestuffs for leather belong to the chemical industry or to the leather industry in this context? There may be good arguments for both positions.). Going even more granular would just be counterproductive. Furthermore, we should be clear, that within current Omnibus approach these issues should generally become simpler. When it comes to the geographical level, often the official place of business of a company does not coincide with the place, in which the production of the company's goods takes part. This can make it difficult with regard to correctly assessing certain physical risks. Therefore, a too high level of granularity often does not improve the quality of the stress test's results or might be practicably not possible to be taken into account in detail by the participants of the stress test (in case of production sites not being the official place of business a stress test participant would have to assess which products of the company are produced in which production site – this is in many cases definitely not possible for an outside-investor).

Question 9: Do you have any comment on paragraphs 41-44 on "balance sheet assumptions"?

In case of longer-term stress test scenarios it should be possible also to build management actions into the respective calculations. In any case, the national balance sheet (i.e. the balance sheet according to national law and accounting standards) should be modelled. A kind of "common balance sheet" can be used in addition in case of a pan-European stress test in order to provide for a certain level of comparability.

Question 10: Please add here any additional comments on "Title II – Requirements regarding consistency, long-term considerations and common standards for assessment methodologies in stress testing of ESG risks – 4.2. Principles and methodological considerations".

NCAs and EIOPA should use deterministic models for ESG stress tests, because at the current point in time it does not seem to be realistic to seriously develop (reliable and science-based) mathematical probability distributions for certain ESG risks and their transformation into financial risks. Furthermore, smaller financial institutions will not be able to cope with the requirement of stochastic modelling. The OPSG believes, that in light of the ability of ESG related data and its quality an additional benefit of stochastic modelling cannot be seen in this context anyhow.

Many financial entities (including IORPs) have to do stress testing with regard to financial risks regularly already today. In such cases, instead of creating burdensome additional ESG stress tests causing additional costs, one should integrate ESG risks into the already existing regular stress tests.

A coordination across jurisdictions to allow a harmonised approach to ESG stress testing for cross-border entities can be a very complicated process. In case of cross-border entities, the respective home member state should be identified and the respective NCA of the home member state shall apply its standards and definitions regarding stress testing to the respective cross-border entity. It has to be avoided, that one financial entity has to do ESG stress testing several times for different member state NCAs.

Question 11 - Please add here any comments on "Title II - Requirements regarding consistency, long-term considerations and common standards for assessment methodologies in stress testing of ESG risks - 3.3 Organisational and governance arrangements"

The OPSG concurs with the proposal for NCAs to increase their role in terms of data management responsibility (IT platforms) as well as acquiring a strategic base of competent and sustainable finance competent staff. It is essential to keep in mind that these still being relatively new topics in finance, therefore, it only makes sense that supervisory authorities help, guide and support the entities they supervise, enabling them to correctly accomplish their tasks while being able to jointly appreciate their results in the process. An open dialogue should also involve a two-way collaboration on the methodologies as well as the tools made available, where supervisory authorities can definitely have quite an important role to play.

EIOPA's Occupational Pensions Stakeholder Group

Westhafen Tower, Westhafenplatz 1

60327 Frankfurt – Germany

Tel. + 49 69-951119-20

Stakeholder.Groups@eiopa.europa.eu

https://www.eiopa.europa.eu