EIOPA’s Discussion Paper on the Prudential Treatment of Sustainability Risks

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INSURANCE, SUSTAINABLE FINANCE AND REGULATION

Economic Perspective

- Sustainability risks become increasingly important for the investment and underwriting activities of insurers, e.g. climate change:
  - → Transition towards a low-carbon economy can materialize as transition risks in asset values, potentially leading to stranded assets
  - → Rise in frequency and severity of natural catastrophes already increasing physical risk exposures and claim payments

Prudential Perspective – Need for specific adjustments?

- Important that Solvency II – as a risk-based and forward-looking framework – reflects sustainability risks and insurers as long-term investors and society's risk managers appropriately
  - → EIOPA published its "Discussion Paper on the Prudential Treatment of Sustainability Risks"
    - Overview of methodologies and data sources for assessing the potential for a dedicated prudential treatment of assets and activities associated with environmental or social objectives under Solvency II (proposed Art. 304a Solvency II Directive)
    - First deliverable, in a step-by-step approach: First discussion paper, subsequently consultation paper on empirical findings and potential policy implications

DISCUSSION PAPER: OVERVIEW

Three main areas

I. Assets and Transition Risk Exposures

II. Underwriting Risks and Climate Change Adaptation

III. Social Objectives for Assets and Underwriting

I. Asset Side and Transition Risks

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I. ASSETS AND TRANSITION RISKS: OVERVIEW

Risk-based Rationale for the Analysis

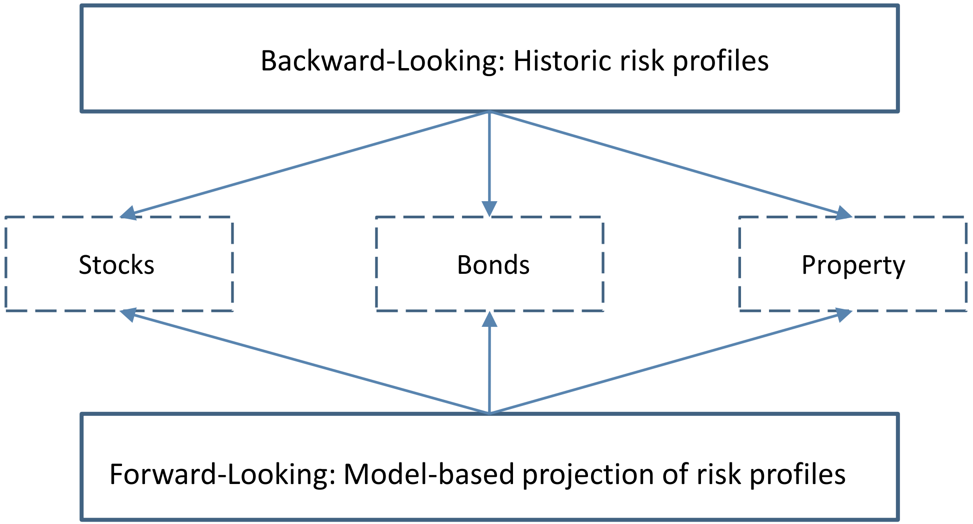
- Climate change mitigation as environmental objective requires substantial and quick decarbonization of the real economy

  → Potential materialization of transition risks in the market value of assets related to firms unable to adapt quickly to a low-carbon economy

- General improvements in definitions and data availability, as well as existing evidence in the literature:

  → Analysis of the solvency capital requirements for market risks

Conceptual Framework for the Analysis



RISK ASSESSMENT APPROACH

Bonds and Stocks

Two general approaches to assess transition risk exposures

Sectoral Approach:

- Sectoral characteristics as main determinant for transition risk exposure
- Risk classification of assets based on corresponding firm's NACE code level

Firm-level Approach:

- Firm characteristics as main determinant for transition risk exposure
- Risk classification of assets based on firm-specific variables, e.g. GHG emission levels

• Solvency II: Risk measurement and data sources

Property

• Building's Energy Efficiency as main determinant for transition risk exposure

• Risk classification based on Building's Energy Performance Certificate as indicator for transition risk

• Portfolio construction by means of label-specific house price indices: APLUS – H

• Solvency II: Risk measurement and data sources

II. Underwriting Risks and Climate Change Adaptation

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II. UNDERWRITING RISKS AND CLIMATE CHANGE ADAPTATION

Risk-based Rationale for the Analysis

- Climate change is expected to increase the frequency and intensity of climate- and extreme weather-related events (e.g. 2021 IPCC report)

  → Increase in risk-based premium levels, esp. for non-life insurance products with natural catastrophe coverage

  → Threat to medium- and long-term affordability and availability of these insurance products

- Already substantial climate-related insurance protection gap in Europe (EIOPA Nat Cat Dashboard), and
- Market frictions in terms of insurance stops in certain disaster-prone areas (e.g. California’s moratorium on non-renewals)

  → Climate Change Adaptation (risk prevention) as environmental objective: key tool to maintain the future affordability and availability of non-life insurance, and to reduce the natural catastrophe insurance protection gap

Prudential Perspective

- Do underwriting pools with and without climate-related adaptation measures show a different risk profile, and if so, is a dedicated prudential treatment justified?

RISK ASSESSMENT APPROACH

Definition of Climate-Related Adaptation Measures

- Structural and non-structural measures and services that are implemented by policyholders or insurance undertakings ex-ante to a loss event, which reduce the physical risk exposures to climate-related hazards through lowering the frequency of climate-related losses or lowering the intensity of climate-related losses

Examples

- Anti-flood doors and shutters, sandbags, hail protection nets, early warning systems, etc.

  → Focus on private measures under the control of the policyholder or insurance undertaking, not on public measures like dikes

  → Risk-based link to actuarial insurance premium given (not necessarily the case for mitigation measures)

EIOPA's Discussion Paper sets out:

- Pillar I hypotheses on the potential impact of adaptation measures on non-life underwriting risk, with focus on premium risk
- Three external case studies by loss modellers on the general influence of risk prevention on climate-related loss exposures
- EIOPA's dedicated data collection on premium risk (Q2 2022) and risk measurement for estimation purposes

III. Social Objectives for Assets and Underwriting

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III. SOCIAL OBJECTIVES FOR ASSETS AND UNDERWRITING

Risk-based Rationale for the Analysis

- Social risks become increasingly important for the investment and underwriting activities of insurance undertakings

  → For example, misalignment of firms with social objectives like social and employee matters or respect for human rights (SFDR) could lead to financial losses in investment or underwriting portfolios (reputational losses, litigation expenses, etc.)

Prudential Perspective

- As part of sustainability risks, the prudential treatment of social risks should aim to be conceptually similar to climate-related risks, but consider conceptual differences (e.g. scenario analysis or quantitative prudential reporting)

- Ongoing public debate on the appropriate definition of social objectives and social risks, their measurement and disclosure as well as data availability

  → EIOPA intends to follow a gradual approach when assessing the potential for a dedicated prudential treatment of social risks and objectives under Solvency II

  → Focus on governance and risk management (Pillar II) as well as reporting and disclosure requirements (Pillar III)

MAIN APPROACH IN THE CHAPTER

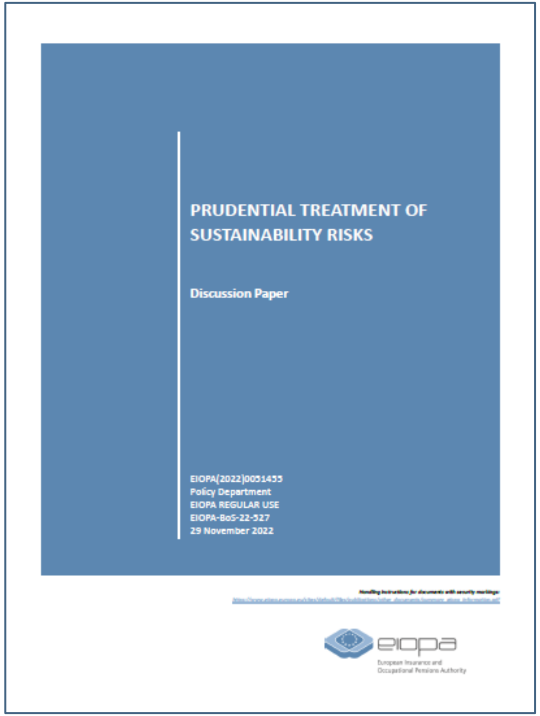
- A particular aim of EIOPA's approach is to initiate discussions on the appropriate prudential consideration under Solvency II and to identify potential areas for further analysis

EIOPA's Discussion Paper sets out:

- Working definitions for social risks and objectives,
- How social risks can translate into prudential risks on undertakings' balance sheets
- How insurers' governance and risk management can contribute to the identification and management of social risks
- Current disclosure requirements of social risks and objectives under current applicable regulation

Source: Own Figure.

HAVE YOUR SAY


PRUDENTIAL TREATMENT OF SUSTAINABILITY RISKS

Discussion Paper

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- Share with us your opinion, ideas and evidence until 5 March 2023
- EU Survey
- There are 82 specific questions – no expectation to stakeholders to answer all questions

THANK YOU!

For more information visit:
https://www.eiopa.europa.eu

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