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Managing climate risk while balancing calls for regulatory simplification

Climate change poses multifaceted risks to insurers, including physical risks from extreme weather events and transition risks form the shift to a low-carbon economy. In light of this, EIOPA encourages a forward-looking management of these risks to ensure the solvency and viability of the industry.

One way to do this is through the Own Risk and Solvency Assessment, or ORSA. EIOPA's Opinion on the supervision of the use of climate change risk scenarios in the ORSA marked a key milestone in EIOPA's sustainability activities, supporting the integration of climate-related risks into insurers' risk management practices in a structured and forward-looking way.

The results of the monitoring exercise show a clear and very positive shift in the undertakings risk management of climate change risk, which is increasingly being integrated into insurers' risk management processes. Contrary to the situation observed in 2021, most insurers in the scope of the exercise now include climate change scenarios in their ORSA, considering both transition and physical risks, and scenario analysis has become a key element in assessing the financial impact of these risks.

Stress testing is also a valuable tool in assessing insurers' resilience to climate related risks. EIOPA incorporated a natural catastrophe scenario in the 2018 EU-wide insurance stress test and has published a paper setting out methodological principles that can be used to design bottom-up stress test exercises that aim to assess the vulnerability of insurers to climate risks. More recently, EIOPA participated in the one-off "Fit-For-55" climate scenario analysis, a joint exercise with the European Banking Authority, the European Securities and Markets Authority, and the European Central Bank. This exercise, at the invitation of the European Commission, showed that under the scenarios examined, transition risks alone are unlikely to threaten financial stability. However, when transition risks are combined with macroeconomic shocks, they can increase losses for financial institutions and may lead to disruptions. These findings underlined the need for financial institutions to integrate climate risks into their risk management in a comprehensive and timely manner.

One challenge for supervisors and the insurance industry to assess and manage sustainability risks relates to the availability of data and loss models. Comprehensive open-source data is needed to improve the accuracy of the risk assessments, in conjunction with open-source models integrating forward-looking climate considerations. EIOPA is addressing this challenge through knowledge-sharing initiatives, workshops. For example, EIOPA developed the "CLIMADA-app", a user interface to facilitate the use of the CLIMADA open-source catastrophe model.

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There are of course always areas for improvement. Within the Solvency II framework, there is scope to better reflect climate sensitivity. For example, there is room within the ORSA to strengthen guidance on incorporating long-term climate scenarios, particularly those related to the causes of global warming. There is also the potential to refine stress testing practices to capture the financial impacts of both physical and transition risks at a granular level.

Given growing calls for reducing regulatory burdens, it is important to find a pragmatic approach in striking the right balance between simplification and sustainability. Overall, EIOPA's view is that a more efficient and proportionate regulatory framework will enable insurers and pension funds to focus on what matters most: providing innovative, affordable, and sustainable financial solutions to European citizens and businesses. Cutting red tape and eliminating unnecessary complexity can provide opportunities for growth, investment, and job creation.

However, simplification cannot be at any cost, nor can it undermine financial stability or high standards of consumer protection. This is also true of sustainability targets and economic ambition must always be aligned with environmental and social responsibility. As a supervisor, EIOPA has a critical role to play in promoting sustainable finance, mitigating climate risk, and ensuring that our industries contribute to a more resilient and equitable future.

EIOPA therefore aims for a balanced approach to simplify rules where possible while ensuring that EU (re) insurers and occupational pension funds continue to have sufficient access to high-quality, standardized and consistent sustainability data. Especially in the context of mounting climate risks, such sustainability data are important reference points that allow for a sound assessment of sustainability-related risks and the provision of reliable information to consumers and investors.

As the insurance sector navigates the complexities of climate change, EIOPA will continue its work to build up sustainable insurance and pensions, including by addressing protection gaps, for the benefit of EU citizens and businesses.