Contribution ID: 13817093-1b9b-4834-a579-5aaa86a634c9
Date: 20/03/2024 15:48:20

Public Consultation on Prudential Treatment of Sustainability Risks

Fields marked with * are mandatory.

European Insurance and Occupational Pensions Authority

Responding to the Paper

EIOPA welcomes comments on the consultation paper: “Prudential Treatment of Sustainability Risks”.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale and provide evidence; and
- describe any alternatives EIOPA should consider.

EIOPA welcomes comments on all parts of the consultation paper, and in particular on the specific questions raised.

Please send your comments to EIOPA using the EU Survey Tool by Friday, 22 March 2024, 23:59 CET. Contributions not provided using the EU Survey Tool or submitted after the deadline will not be processed.

Publication of responses
EIOPA may publish your responses on the EIOPA website unless: you request to treat them as confidential, or they are unlawful, or they would infringe the rights of any third party. Please, indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. EIOPA may also publish a summary of the survey input received.

Please note that EIOPA is subject to Regulation (EC) No 1049/2001 regarding public access to documents and EIOPA's rules on public access to documents.

By sending your contribution to EIOPA you declare that nothing within your response is unlawful or would infringe the rights of any third party in a manner that would prevent the publication.

Data protection
Please note that personal contact details (such as names of individuals, email addresses and phone numbers) will not be published. They will only be used to request clarifications, if necessary, on the information shared.

EIOPA, as a European Authority, will process any personal data in line with Regulation (EU) 2018/1725. More information on how personal data are treated can be found in the privacy notice and on EIOPA's website.

* **Declaration by the contributor**

- (●) I consent to the publication of all information in my contribution
- ( ) I consent to the publication of specific parts of information in my contribution as clearly indicated in the respective responses
- ( ) I do not consent to the publication of any information in my contribution

About the respondent

* Stakeholder name

ShareAction

* Type of Stakeholder

- (●) Association
- ( ) Industry
- ( ) Ministry
- ( ) Supervisor
- ( ) EU Organisation
- ( ) Other

* Contact person (name and surname)

Marika Carlucci

* Contact person email address

marika.carlucci@shareaction.org

Questions to Stakeholders

1. What are your views regarding the analysis of equity and spread risk?

ShareAction positively receives EIOPA's analysis and welcomes it as an important first step in the right direction to assess and account for the higher risks to which certain assets, and particularly investments in industries dependent on fossil fuels, are exposed to during the ongoing, unprecedented and radically uncertain climate transition. Data from a soon to be published benchmark by ShareAction covering 65 insurers, many of which are European or operate in the EU, found that none of their climate-related policies are aligned with efforts to limit temperature rise to 1.5 degree Celsius. Hence, the importance of tackling this issue through science-based policies that rely on a combination of historical data with a forward-looking analysis to overcome the limitations posed by a pure backward-looking approach in terms of accuracy and reliability to capture transition risks.

Climate scenario analysis is a good starting point to assess and quantify such risks, and we support EIOPA's approach with regards to the choice thereof. However, climate scenario analysis is based on specific assumptions. As such, we would like to point out some considerations that have not been adequately reflected in the scenarios used in EIOPA's analysis, and therefore could have led to different results had they been integrated therein. As highlighted at https://theiafinance.org/wp-content/uploads/2023/12/1in1000_finstab_final_v0.pdf , the NGFS "Hot House" scenario typically disregards the most pessimistic economic outlooks, does not consider the additional effects of climate tipping points as well as those posed by wider shocks in the ecosystem, among other factors. Additionally, the role played by regulation in increasing the risks of assets becoming stranded and the impact of the growing number of climate litigations may have also been overlooked in this forward-looking analysis. We have recently seen examples of the former in other jurisdictions (https://www.rigzone.com/news/chevron_recognizes_up_to_4b_in_impairments_losses-03-jan-2024-175247-article/), and solid evidence for the latter in newly published research (https://www.science.org/doi/10.1126/science.adj0598). We believe that considering such factors in EIOPA's forward-looking analysis could bring in additional elements to ensure climate-related financial risks are not underestimated, and the financial sector remains healthy and stable. For the same reason, we also recommend EIOPA does not evenly weight the scenario used in the calculations through the Monte Carlo method: greater consideration should be given to worse case scenarios to fully ensure the precautionary principle is properly applied.

In addition to this, and being aware of the mandate received by the ESAs, the ECB and the ESRB to undertake the "EU fit-for-55 one-off exercise" by end of 2024, we would recommend cross-checking the two analyses to ensure coherence across assessments looking at the future and avoid looking at transition risk in isolation, that is with no consideration of knock-on effects on other sectors.

Concerning the rest of the choices underpinning the analysis, ShareAction supports the agreed timeframe, as well as the decision to undertake a sectoral, rather than firm-level analysis. We also support the use of NACE codes over one based on firm characteristics such as the existence of a transition plan, since the mere development of a transition plan does not mean it will be implemented, so financial climate-related risk could still materialise and remain significant. However, NACE codes have limitations, including their failure to identify companies involved in new fossil fuel projects. For this reason, we suggest a NACE code approach is complemented by alternative public datasets that include this information, such as the Global Coal Exit List and the Global Oil & Gas Exit List compiled by the NGO urgewald. However, for the time being we see merit in preferring a NACE-code approach to one based on firms' characteristics such as the existence of a transition plan. The mere development of a transition plan does not mean it will be implemented, so financial climate-related risk could still materialise and remain significant.

In summary, ShareAction welcomes the analysis and recommends EIOPA to:
-Integrate additional factors into the analysis to reduce the current likely underestimation of risk;
-Adequately weigh scenarios to ensure the precautionary principle is properly implemented;

-Cross-check this analysis with the “EU fit-for-55 one-off exercise”;
-Consider alternative datasets to complement its sectoral analysis.

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

ShareAction is not surprised that the results of the analysis undertaken by EIOPA show significantly higher level of transition risk for fossil fuels-related assets when compared to the assets of other economic sectors and to the market. There is extensive scientific literature available on the danger fossil fuels represent for the planet and society given their existential inability to become sustainable. In turn, running or financing this type of business activity without proper consideration of the risks it entails has meaningful implications on the economy, and ultimately, on financial stability. Equities and bonds related to these activities, and de facto enabling the continuation thereof, foster capital misallocation in a context where new requirements and increasing demand push firms towards sustainability, thereby creating additional risk building on already existing fat tail risks (see https://www.actuarialpost.co.uk/downloads/cat_1/IFoA%20Climate%20Report%201403241.pdf).

We are pleased to see EIOPA's analysis confirming the financial risk materiality of fossil fuels through quantitative data. This is particularly helpful to counteract arguments from the industry that dismiss previous considerations and preliminary discussions as not being evidence-based. This analysis is also extremely important to consolidate European leadership on the topic while sending a strong signal to other jurisdictions, and insurers themselves, about the urgent need for macroprudential action to avoid spillovers of climate-related risks and their transfer across the financial system, as mentioned in the ECB/ERSB report published in December 2023. The results of this analysis are thus key enablers of change, namely because they further underline the close climate-finance interaction while providing hard evidence to support the necessary regulatory measures to ensure risks are adequately capitalised.

That is why we would recommend EIOPA does not put unnecessary emphasis on the limitations of the findings in the backward- and forward-looking analysis (point 166). All studies have limitations, and it is important to acknowledge them from a methodological perspective. However, they should not be framed in a way that could be manipulated to undermine the validity of the results or question the need for targeted policy options.

Additionally, the section on limitations would have been more comprehensive and balanced if it had included a reference to the high possibility for the results to still underestimate the magnitude of the differentiated and elevated loss potential of fossil fuel-related stocks and bonds, as well as the implications this could have on other sectors. In fact, had the analysis taken into account some of the considerations shared in our answer to Q1 (see above), the results might have looked different – and most likely even more concerning. We have seen in the past, and notably during the financial crisis of 2008, how the detected VaR did not fully match the magnitude of the actual risk, which caused major disruptions in the real economy. We believe we should learn from what has happened to be better prepared in case this is the case also for transition-related financial risk.

Therefore, ShareAction:
- Agrees with EIOPA's results and welcomes them as enablers of the development of an adequate policy framework;
- Invites EIOPA to acknowledge that such results still underestimate the magnitude of the risk, with implications that go beyond financial stability to affect additional sectors.

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

ShareAction welcomes EIOPA's acceptance of the principle supporting a dedicated prudential treatment of riskier fossil fuel-related stocks, and is pleased with EIOPA's decision to move forward with prudential policy recommendations.

Despite EIOPA's encouraging decision, ShareAction finds all developed policy options to be suboptimal if compared to the ambition shown by EIOPA's analysis. In order:

Option 1 (the “no change”-option) is unrealistic, and ultimately harmful for both the financial system and the planet. We are aware that it is common practice at the European level to inform policymakers about the consequences of choosing not to act. However, we believe that in light of the results of the analysis undertaken by EIOPA, the inclusion of this non-evidence-based option could mislead policymakers into thinking that inaction would be acceptable, with severe risks for financial stability and the state of the planet.

Option 2 (envisaging treating fossil fuel-related stocks as Type II equity, that is with a capital charge of 49% rather than the 39% foreseen for Type I equities) is inadequate, and potentially misleading. Similarly to option 1, but to a lesser extent, policy option 2 is not based on the evidence produced by EIOPA's analysis as the 49% risk charge for Type II equities is lower than the empirically estimated VaR of 56%. In addition to not effectively tackling the problem, option 2 could also lead to a discrimination of type I assets (EEA/OECD) against type 2 assets, which would in turn likely undermine other considerations justifying the differentiated treatment in place.

Option 3 (envisaging a dedicated supplementary capital charge of 17% to the current equity risk calibration) matches the average empirically determined historic VaR (56%). This makes it an unambitious option, despite being linked to evidence, since it risks being ineffective should this be an underestimate, as we suggest in our answer to Q1. Despite representing the only acceptable and supportable option among those presented, we at ShareAction believe that it is still insufficient to establish an adequate risk-based solvency capital allocation and implement the precautionary principle enshrined in the treaties. Findings suggested by EIOPA's own forward-looking analysis in fact point at the need for up to 39% in supplementary capital charges to fully match the levels of risks assessed, which would entail the application of a 78% capital charge for fossil fuel assets at the very least. This would be appropriate and feasible, especially when considering the “overall very limited” impact of option 3 on the solvency ratios, according to EIOPA's impact assessment (point 191).

Inaction is costly, and as mentioned the joint ECB/ESRB mentioned in Q2 "policy responses need to weigh the cost of early action based on imperfect information, against the risk of acting too late". The 78% capital add-on represents the imperfect information currently available to EIOPA, and considering that climate risks only worsen over time, we believe it should represent the baseline option. EIOPA should not shy away from its own forward-looking analysis.

Building from there, an optimal and precautionary policy option would then envisage the application of a 100% capital charge on new fossil fuel-related equity. This would be reasonable and justified by scientific evidence, the limited impact of higher capital charges on solvency ratios proved by EIOPA's analysis, and the need to set up a proportionate buffer to respond to the possible underestimation of risk levels. Policymakers have already taken a similar stance with regards to the prudential treatment of crypto assets in the framework of the Solvency II review. Hence, we call on them to be as cautious with regards to climate-related financial risks as they have chosen to be with other risky assets, and to acknowledge that adopting a 100% capital add on to financially risky fossil fuel-related assets is not only compatible with achieving the green transition in an increasingly uncertain and competitive global geoeconomic scene, but also needed to ensure financial instability does not undermine such transition and taxpayers do not pay for the risks it entails.

Finally, we believe a three, rather than five, years review clause would be more adequate to assess the effects of the chosen policy option whilst allowing for new evidence to be swiftly integrated into the policy framework.

In summary, ShareAction:
- Identifies option 3 as the closest to acceptable of the presented options, preferring a higher capital charge based on EIOPA's forward looking analysis;
- Recommends the development of a policy option envisaging the application of a 100% capital charge on new fossil fuel-related equity;
- Supports a three-years review clause.

4. What is your view on the proposed polity options on introducing a dedicated prudential treatment regarding spread risk?

ShareAction's view on the policy options proposed by EIOPA on the introduction of a dedicated prudential treatment regarding spread risk associated with fossil fuel-related bonds is aligned in principle with the considerations made with regards to equity risks. We are supportive of EIOPA's decision to recommend action is taken at the regulatory level, and share EIOPA's concerns about the current ability of credit ratings to appropriately reflect transition risk exposures from a prudential perspective, given also the lack of clarity around how credit rating agencies integrate sustainability factors in credit ratings methodologies.

However, as for spread risk, ShareAction regrets the formulation of two suboptimal policy options that are not effective in fully addressing the assessed levels of financial transition risk. In order:

Option 1 (the “no change”-option) does not represent a valid and effective policy tool to tackle the higher risks level of fossil fuel-related bonds assessed through EIOPA's analysis. Hence, we believe that it should not appear among the policy options, which should build on the data collected and aim at ensuring financial stability.

Option 2 (envisaging a rating downgrade of bonds related to fossil fuel activities) is inadequate, as it would lead to inaccurate capital charges that do not precisely reflect the magnitude of a potential shock based on the empirical findings, as acknowledged by EIOPA. As a consequence, choosing such a one-size-fits-all option 2 could fuel perceptions of higher capital requirements being a punishment for concerned bondholders rather than a proportionate instrument tailored to the assessed financial risk. There is also a risk that market participants recalibrate their evaluation of ratings for bonds issued by this sector. Additionally, in some cases downgrading bonds related to fossil fuel activities could result in their classification falling below investment grade to high yield or “junk” bonds, which in turn can suddenly create a large group of forced sellers if market players are only allowed to hold investment grade bonds, or no more than a set % of below investment grade.

As for option 3 (considering a dedicated supplementary capital requirement to the current spread risk calibration), we believe it appears more robust than option 2 as it is less artificial and/or open to abuse by participants, as well as more direct in managing risks. 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. However, we think that the proposed increased requirement to 17.5% is still inadequate to reflect the true magnitude of transition risk, which should not be considered in isolation and thus underestimated. That is why we support a 100% capital charge on new fossil fuel-related bonds, in line with equities. As the transition proceeds, the risk of stranded assets grows, as do spillover effects from physical risks, the damage from which could severely hamper asset values. As such, an adequate and precautionary prudential treatment of the risk requires quickly increasing capital requirements accordingly: these should not be narrowly focused on transition risk alone.

In summary, ShareAction:
- Identifies option 3 as the only acceptable option;
- Recommends the development of a policy option envisaging the application of a 100% capital charge on new fossil fuel-related bonds.

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

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

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

ShareAction welcomes EIOPA's analysis on the key role played by insurers in climate adaptation through impact underwriting, rather than solely through investment. The analysis acknowledges the current substantial insurance protection gap, which represents a real and increasing risk for communities in terms of degree of protection and affordability of insurance products, as well as for the health of the insurance sector and financial stability overall.

However, we find this question's exclusive focus on physical risk to be misaligned with the transition risk focus adopted thus far. Furthermore, we regret not seeing a complementary analysis on liability risks. Incorporating both would allow for a comprehensive picture of the options available to insurers to reduce climate-related financial risks.

Adaptation measures will be helpful to palliate the losses caused by climate change-related events, but by definition will not prevent such events from materialising less frequently or less intensely in the first place. As prescribed by the double materiality principle enshrined in the Solvency II regulation, insurers should take proactive measures to reduce the impact of their own activities on the planet and its people, which includes making the right choices when it comes to deciding what to insure. Therefore, by overlooking underwriting practices as a key transition tool through their role in climate mitigation, EIOPA’s analysis misses the opportunity to delve into the assessment of financial risks deriving from poor consideration of sustainability factors in underwriting decisions (ie providing insurance coverage to new fossil fuel projects). As a result, EIOPA only provides a partial examination of sustainability-related financial risks stemming from the transition towards more sustainable economies and of ways to limit the costs borne by governments and taxpayers in the future.

Despite this, we think that this analysis remains helpful to speed up discussions on how to future-proof the insurance sector and the legislation regulating it. Even though climate adaptation measures unfortunately remain at the inception stage and with limited data available, we regret EIOPA's caution in considering recommendations for a different prudential treatment for insurance policies adopting climate adaptation measures. We support EIOPA’s suggestion to undertake a new and extended analysis in the very near future when additional data will be available. Furthermore, given the importance, uncertainty, and urgency of the insurability crisis, we would recommend setting a clear and ambitious timeline for this exercise, which next time should better consider natural catastrophe risks given their increasing probability to materialise.

In the meantime, we also recommend not dismissing the preliminary results of the current analysis, but rather making the most of them to feed into ongoing discussions and advance the debate about suitable policy options to reduce climate-related financial risks in underwriting. For instance, these results made us at ShareAction believe that it could be more effective to eventually introduce higher capital requirements for policies without climate adaptation measures rather than lowering the capital required by those that do feature them. The rationale behind this is again that climate adaptation measures reduce the damage caused by climate change-related phenomena instead of reducing the risk for these phenomena to happen, which in turn means that although we might slightly improve the level of protection of physical goods, the overall risk level they are exposed to will continue to deteriorate if no complementary action is taken.

Additionally, we believe that the role of supervision will be key when working with policies featuring climate adaptation measures to ensure they abide to the standards required to mitigate climate-related risk and they are effectively taken into account when assessing and pricing such risk. Upcoming insurance research conducted by ShareAction indicates that more than one third of major property and casualty insurers are not conducting scenario analysis in relation to their underwriting (8/29 insurers), and further, that a third of those that do the analysis are not currently using it to inform their approach to climate change (7/21 insurers). Therefore, it is important to ensure that insurers' underwriting activities are robustly evidence-based when it comes to climate-related financial risk in relation to adaptation measures and beyond.

In summary, ShareAction recommends EIOPA to:
- Complement its current analysis by looking at liability risks and fully capture the double materiality principle embedded in Solvency II;
- Set a clear timeline for the extended analysis of the different prudential treatment for insurance policies adopting climate adaptation measures;
- Ensure effective supervision of policies featuring climate adaptation measures.

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

ShareAction welcomes EIOPA's definitions of social risks and impacts and is pleased to see explicit references to life, health and well-being related risks as recommended by ShareAction in our response to EIOPA's previous consultation. ShareAction also appreciates the recognition and clear explanation of how a variety of social risks translates into prudential risks for insurers and can undermine insurers and systemic financial stability. This is particularly relevant in the current socio-economic context that demands social factors are increasingly considered alongside environmental ones when making investment or underwriting decisions. Social and climate considerations are indeed deeply interlinked, and the social dimension plays a pivotal role in enabling the transition towards more sustainable economies, as noted by the European Commission.

Despite such high-level acknowledgments, data from the already mentioned and soon to be published insurance benchmark undertaken by ShareAction shows that in practice insurers take inadequate (or almost inexistent) actions to address social risks such as human rights, labour rights, and public health. For instance, most benchmarked insurers, including a majority in the EU, continue to allow tobacco investment and underwriting, permit the underwriting of companies involved in the manufacture of controversial weapons, and do not have clear policies covering indigenous rights in relation to investment or underwriting client engagement. This suggests an almost complete lack of consideration by insurers for both social factors and the impact that certain harmful activities have on them, as well as a significant gap between risk assessment and practice. The Reputational Risk Projects database created by German NGO urgewald is extremely effective in tracking the social harm caused by projects from oil and gas companies (which require insurance to move forward), and is a powerful tool to shed light on the magnitude of the impact that certain investments or underwriting decisions by insurers have on communities. This data highlights the need for regulation to not be playing catch-up with insurers' practices, but rather lead the way for these to be developed in a coherent and harmonised fashion. Hence, our disappointment with EIOPA's decision not to analyse a prudential Pillar 1- related capital treatment for social risks, which would have a more meaningful impact in making sure insurers are mindful of social risks in their choices. However, we understand the operational and analytical challenges posed by the lack of commonly agreed definitions and the decision to prioritise climate risks, and we recommend that EIOPA kickstarts its work towards the differentiated capital treatment of assets exposed to social risks (Pillar 1) as soon as steps are taken by the European Commission to define social aspects further, for instance through the Social Taxonomy. In the meantime, EIOPA should highlight the existence of such bottlenecks to policymakers to urge action on this critical and yet delayed topic, and start collecting the increasingly available data on insurers' exposure (and contribution) to social risks, which will be provided by disclosures from requirements under other pieces of legislations (CSRD and SFDR, for instance). This would allow for EIOPA to explore possibilities to integrate this data in appropriate risk models. As for the treatment of social risks under Pillar II, ShareAction believes that the development of further guidance to support the social risk materiality assessment within the ORSA would be helpful, especially if it also includes recommendations on how to make sure such assessment adequately and meaningfully informs business decisions in line with the Prudent Person Principle. As shown by the data mentioned above, this currently does not happen. Finally, ShareAction regrets EIOPA's decision to not recommend the development of additional (prudential) disclosure under Pillar III at this stage, in response to businesses claims about being "overburdened'. Pending improved disclosure requirements, we recommend EIOPA to investigate how to use the information already disclosed for prudential purposes, or at least to identify what is missing there to inform the analysis of the prudential treatment of social risks in insurers assets and liabilities. This would avoid duplication and reduce costs while making progress and opening possibilities for further action.

In summary, ShareAction recommends EIOPA to:
-Urge policymakers to further define social aspects at the European level, for instance through the Social Taxonomy, and subsequently work towards the differentiated capital treatment of assets exposed to social risks (Pillar 1);
-Develop guidance to ensure social risk materiality assessments adequately inform business decisions;
-Identify missing information from existing prudential disclosure requirements to avoid duplication.

Privacy Notice

Contact

Contact Form