Finance Watch
Making finance serve society

10 January 2022

Finance Watch response to the European Commission's proposals for a Solvency II Directive (2009/138/EC) and a Directive establishing a framework for the recovery and resolution of insurance and reinsurance undertakings

The proposals for a review of the insurance sector's prudential regulation feature a major inconsistency with respect to addressing the systemic risk dimension. On the one hand, they recognise the systemic nature of the sector by introducing, in a most welcome move, a directive establishing a framework for the recovery and resolution for insurance and reinsurance companies. At the same time, the proposals fail to impactfully address the insurance industry's climate-change related risks, which pose a major threat to financial stability. The proposals also lack ambition regarding macroprudential tools in the insurance sector.

Financial risks related to climate change are a major threat to the stability of the insurance sector and the whole financial system. Yet the measures proposed to address climate-related financial risks fall short in terms of their impact and timeliness. In order to protect taxpayers from having to bail out too-big-to-fail insurance companies, we not only need a recovery and resolution framework but also an adequate level of capitalisation. However, the measures put forward by the Commission will not achieve this objective. Climate scenario analyses remain exploratory exercises with numerous limitations related to the radical uncertainty of climate risks and their forward-looking nature. These limitations render quantitative modelling unable to lead to meaningful conclusions about capital adequacy of insurers (see the attached Finance Watch reports for the discussion). Data availability, too, remains a significant obstacle to measuring climate-related financial risk overall and to reaching credible conclusions via scenario analysis conclusions specifically, as pointed out by the Financial Stability Board (FSB) in its report dated 7 July 2021.[1]

The proposal on prudential rules for natural catastrophes, as in the case of scenario analyses, relies on climate risk modelling and measurement as well, which, as stated above, is faced with challenges and uncertainties. Even climate scientists confirm that the recent climate-related events could not have been predicted by climate models.[2]

The Commission deferred any further measures to the EIOPA's mandate on prudential treatment, due in 2023. This puts any potential regulatory changes years ahead, when climate-related physical and transition risks (delayed disorderly transition) will have increased significantly.

Precautionary, timely and risk-based measures should be prioritised. The European Parliament and Council review offer an opportunity to implement an available feasible solution to address the biggest climate-related financial risks to the insurance sector. Specifically, Pillar I capital requirements for fossil fuel exposures should be adjusted to reflect the risks associated with such assets - differentiating between the existing fossil fuel assets and exploration and production of new fossil fuels (see the attached proposals). Fossil fuel exposures represent a clearly identifiable set of assets, which are at a high risk of stranding

1 FSB, *The availability of data with which to monitor and assess climate-related risks to financial stability*, 7 July 2021.

2 See, for example, Jonathan Watts, *Health warnings as Death Valley scorches in 54.4C heat*, 12 July 2021; Michael E. Mann, *Opinion: It's not rocket science: Climate change was behind this summer's extreme weather*, Washington Post, 2 November 2018.

and which are also the main root cause of climate-related financial instability. Supervisory review process, including stress testing, can only be effective given strong Pillar I requirements, as only the application of "hard-coded" and thus consistent capital requirements across financial institutions can ensure their resilience and solvency in case of a financial crisis.

Article 191 of the Treaty on the Functioning of the European Union (TFEU) sets out the Union's policy on the precautionary principle and refers explicitly to the duty of combating climate change, requiring EU policy-makers to take preventive action in the case of risk.

With respect to the proposed macroprudential tools, we welcome the inclusion of many of them in the Commission's proposal. However, more ambition is needed to implement the ESRB recommendations for liquidity and capital-based buffers (ESRB report from February 2020).[3]

3 ESRB, *Enhancing the macroprudential dimension of Solvency II*, February 2020.

Finance Watch
Rue Ducale 67 b3
1000 Bruxelles

Contact us:
+ 32 (0)2 880 0430
contact@finance-watch.org

For more information,
visit our website:
www.finance-watch.org