Finance Watch

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CONSULTATION RESPONSE | EIOPA Consultation on the Prudential Treatment of Sustainability Risks

Brussels, 22 March 2024

Q1: What are your views regarding the analysis of equity and spread risk?

Finance Watch welcomes EIOPA's addition of forward-looking methodologies in the analysis of equity and spread risk. This approach aligns with the nature of climate-related financial risk, which cannot be measured using backward looking data analysis alone, as the transition has not yet occurred (at the scale which is required in the future) and, thus, transition risk is not captured in historical data. The use of forward-looking methodologies marks a significant advancement in how environment-related financial risks, particularly those related to climate change, are assessed, and is essential for capturing their impact on asset prices. Finance Watch had previously advocated for the use of forward-looking information in climate risk analyses, we refer to our response to the previous EIOPA consultation. There is no evidence that market prices reflect climate-related information (both transition-related as well as information related to likely future physical disruptions). This is due to the specific features of climate-related physical risks (which were extensively elaborated upon in the "Green Swan" book by the BIS), uncertainties associated with the transition and inability of the existing pricing models to account for these specifics.

Furthermore, we support the use of NACE codes to identify high-risk assets for dedicated capital requirements. This approach not only targets investments with higher climate-related transition risks but will allow companies that have been leading in the transition towards sustainability, and transforming their primary business, to move into a different NACE category faster than entities which have not made similar efforts. Aiming to enhance the approach in the future, we welcome EIOPA's recognition of the importance of considering firm-level data for the transition risk analysis, which should become gradually more available as mandatory and comparable transition plans are mainstreamed. Firm-level data will offer a detailed view of individual companies' greenhouse gas emissions and use of fossil fuels, which the paper rightfully links to transition risk.

We recognize that forward-looking methodologies hinge on certain assumptions and models, in particular those used in the analyses of different transition scenarios, which can greatly influence the results. Finance Watch has drawn the attention to the current modelling limitations and

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modelling flaws in the current scenario analyses in its report "Finance in a hot house world". Given the complexity of climate change and other factors adding to transition risk, we urge EIOPA to dedicate special attention to future developments in these forward-looking methodologies. This is especially important as scenario analyses are developed to better capture the possible cost of climate change (for delayed or absent transition scenarios) and also as more granular data becomes available through the publication of CSRD-mandated transition plans, which should result in more reliable scenario-building.

Recognising the forward-looking nature of climate-related transition risk and only small steps made towards transitioning the real economy to date, we emphasise the fact that this risk is likely to only grow bigger in the future, as the pace of the necessary economic transformations to achieve the net zero objective needs to be faster than the transformations that have already happened. Hence, we strongly support that at this stage more weight is given to the forward-looking methodologies and their development rather than relying on historical data, which is only likely to perpetuate the failure of the current prudential rules to price in climate-related risks. Yet, recognising the need to gradually evolve the framework, which is largely based on calibrations using historical data, we support the current approach chosen by EIOPA to combine the empirical analyses using historical data and forward-looking scenarios.

The gradual implementation of transition policies in the real economy and transition planning for both the financial as well as the non-financial sector should drive the actual transition of the economy, so that the transition risks will, in time, be more reflected in the historical data. Therefore, in the next iterations of the risk charge calibrations, EIOPA should balance forward- vs backward-looking analysis taking into consideration the economic transformations which will have happened by then compared to the required transformations to achieve the EU and global climate objectives.

Q2: What are your views regarding the results, and in particular regarding the findings concerning fossil fuel-related stocks and bonds?

We acknowledge, as does EIOPA, the existence of data limitations and the influence of factors beyond transition risk that may drive potential loss of asset values. Tackling all kinds of different risks is a challenge intrinsic to the nature of financial risk assessment, particularly within the context of the Standard Formula's perspective on risk measurement. Despite these limitations in data, a clear risk differential associated with fossil fuel-related investments remains evident throughout the analysis. This differential underlines the heightened risk these assets pose to the insurance undertakings in the context of climate change and the transition towards a low-carbon future.

The acknowledgment by EIOPA of this risk differential is a significant step forward in aligning financial regulation with the realities of climate change and transition. It underscores the need for the financial sector to adapt its risk assessment and management frameworks to more accurately reflect the true risk profile of assets in a rapidly changing environmental landscape. This adaptation is essential for ensuring the resilience and sustainability of the financial system in the face of climate-related risks.

The proof of a clear risk differential for fossil fuel-related assets should serve as a foundation for policy development and regulatory adjustments. It highlights the importance of integrating forward-looking analyses into financial risk assessment practices. By doing so, policymakers and regulators can ensure that the prudential regulation aligns with the rest of the transition policies and that the financial system is resilient against future materialisation of climate-related risks and, thus, better equipped to support the transition towards a sustainable economy while safeguarding financial stability.

In conclusion, while acknowledging the challenges posed by data limitations and other influencing factors, the clear risk differential associated with fossil fuel-related investments cannot be overlooked.

Availability of data is a point of concern: EIOPA's analysis of possible impacts of the proposed capital requirements on the solvency capital ratios do not take into account indirect asset exposures, i.e. exposures via holdings in investment funds due to "existing data limitations in the look-through approach", whilst "indirect exposures make up a substantial portion of the total assets in certain markets". Whilst this fact has no bearing on the validity of the risk differential analysis, it offers concerns in regards to the ability of EIOPA, as the EU supervisory authority, to have a full picture as to the risks in the insurance sector as a whole, which is a necessary precondition to deliver on its supervisory mandate.

Q3: What is your view on the proposed policy options on introducing a dedicated prudential treatment regarding equity risk?

We appreciate EIOPA's recognition of the heightened risks associated with fossil fuel-related equities, which marks a significant milestone in aligning financial regulations with the realities of climate change. This acknowledgment that such assets warrant higher capital requirements for holders is a testament to the evolving understanding of financial risks in the context of environmental sustainability.

The fact that EIOPA has identified fossil fuel-related assets as carrying considerably higher risks is an important acknowledgment that supports the call from many civil society and academic advocates and forward-thinking financial stakeholders for timely precautionary regulatory measures (see for example our joint press release calling for "one-for-one" prudential capital

requirements on fossil fuel financing to prevent an economic crisis and Climate Safe Lending Network's Aligning Finance for the Net-zero Economy). Finance Watch has been at the forefront of voicing these concerns, having called for higher capital requirements for fossil fuel-related assets in our 2021 report "Insuring the uninsurable".

Regarding the proposed policy options, we stress that option 1 is not neutral, as it disregards the empirical findings and prevents the effective pricing of risk. This leads to continued misalignment of the insurance sector with climate objectives, effectively making it an impediment to the transition. In contrast, option 3 is aligned with empirical findings and, despite the small overall projected impact on the actual capital requirements, it makes a first step towards recognizing the risk in the prudential framework. Thus, it sends a critical signal to financial institutions to properly consider the risk. The choice of option 3 is not just a matter of regulatory preference but a necessary alignment with the empirical evidence. This option is also most aligned with the risk-based and forward-looking nature of the Solvency II framework.

As only a small percentage of insurers' asset portfolios will be directly impacted by the proposed prudential treatment, option 3 also appears very feasible in terms of implementation and is not likely to lead to cliff effects in terms of asset portfolio allocation by insurers. Overall, the approach chosen by EIOPA not only reflects the immediate need to address the risks associated with fossil fuel investments but also paves the way for more comprehensive measures to address transition-related risk that could influence a broader range of assets and sectors in the future.

However, we would like to add the following remarks regarding the policy options for equity risk, as well as those regarding spread risk:

Firstly, we urge further consideration of how the results might be impacted by the assumed probabilities of transition in the selected scenarios. Given that in accordance with the IEA net zero scenarios, 77% of the known fossil fuel reserves should be abandoned, the future transition risks associated with exposures to such reserves, can be assumed to be much higher than EIOPA's analyses revealed. The Finance Watch report "Finance in a hot house world" proposed a way forward to calibrate capital requirements in a forward looking manner (the report deals with the banking rules; however, the logic can be applied to calibrating asset portfolio requirements for insurers as well). We also draw attention to the requirement of a 100% capital charge for the fossil fuel exploration activities, which are incompatible with net zero scenarios—the so-called one-for-one rule that Finance Watch, together with many other civil society organisations, has been advocating for.

Secondly, we stress that these policy options for the Standard Formula should be equally reflected when internal models are being used by the insurers, in particular as the use of internal models is much more prevalent among major insurance undertakings in the EU.

And lastly, honouring the urgency to address climate change-associated risks, we ask EIOPA to initiate a review of the prudential treatment/calibrations of transition risks three years after implementation, instead of the proposed five years.

Q4: What is your view on the proposed policy options on introducing a dedicated prudential treatment regarding spread risk?

Our response to this question echoes our perspective on equity risk in the previous question: We appreciate EIOPA's recognition of the unique challenges posed by fossil fuel-related assets. This acknowledgment is crucial for advancing a regulatory framework that is both robust and reflective of the environmental risks impacting the financial sector and vice versa.

An additional point of consideration is the current inadequacy of external credit ratings to reflect climate-related financial risks. This oversight in credit risk assessment further underscores the need for dedicated prudential treatment of transition risk within the spread risk sub-module under the standard formula of Solvency II. By adopting these measures, we move towards a regulatory environment where the financial nature of climate risk is recognised and more accurately reflected, thereby encouraging a more proactive and preventative approach to risk management in the context of environmental sustainability.

Similarly to the risks in the equity sub-module discussed above, we support the policy option 3, as it is the one most aligned with the empirical results of EIOPA's analyses. The proposed prudential treatment not only acknowledges the immediate risks associated with fossil fuel investments but also embeds the precautionary principle to prudential regulation, thus making the financial sector contribute positively to the transition towards a sustainable and resilient economy. This approach aligns with the view, recognised by the prudential supervisors, that timely and orderly transition is the best way to ensure financial stability.

Q5: What is your view on the current potential of credit ratings to capture transition risk?

At present, external credit risk ratings are falling short of integrating ESG risk factors. For example, ESMA highlighted in its 2022 study "Mining ESG disclosures in rating agency press releases" the inconsistencies in credit rating agency's (CRAs) approach to factoring ESG risks into creditworthiness assessments. The ECB working paper "Disclosure of climate change risk in credit ratings" (2022) also found a lack of transparency on ESG risk methodologies and their possible impact on rating assessments.

Within the existing methodological and regulatory framework, there is very little potential for credit ratings to capture transition risk. First of all, the discrepancy between the time horizon of credit ratings and the variable, often long-term time horizons for ESG risk materialisation—coupled with

radical uncertainty—poses significant challenges. Even if credit risk ratings aim to incorporate forward-looking outlook on the creditworthiness assessments, mathematically they are most of the time limited to 1-year probability of default of the rated entity. Yet, not accounting for transition and other climate-related risks in the short-term credit ratings inevitably leads to an accumulation of systemic risk.

An important impediment to the possible incorporation of transition risk into credit ratings is the existing legal framework. It imposes data and methodology requirements on credit rating agencies (CRAs), which are oriented towards traditional financial risks and prove inadequate when considering sustainability-related risks. In particular, provisions of the CRA Delegated Regulation EU 447/2012, Articles 4(b) and 7, require CRA methodologies to be "supported by statistical, historical experience or evidence" (Art. 4(1)8b), describe "the historical robustness and predictive power of credit ratings" (Art. 7(2)(a). These requirements cannot be satisfied for climate-related transition risk, which is of forward-looking non-linear nature, where required future transformations are not reflected in the historical data.

Q6: What is your view on the analysis of property risk and EIOPA's recommendation?

Q7: What is your view on the analysis of underwriting risk and EIOPA's recommendation?

We welcome EIOPA's reflections of the underwriting risk and support the general consideration of adaptation measures as risk-reducing under the non-life underwriting risk module. Yet, importantly, the analysis does not consider that the reduction of the frequency and severity of weather- and climate-related losses thanks to climate-related adaptation measures can be more than offset by the increase in the frequency and severity due to aggravating climate change. As climate change is a non-linear development and its pace will accelerate in the absence of timely and adequate mitigation measures, the benefits of risk reduction through adaptation measures may prove smaller than possible increase in the premium risk due to growing physical risk. This aspect should be taken into account in the future analyses.

It also emphasises the importance of risk mitigation measures—economy-wide, but also by insurers specifically as part of the aligned efforts to mitigate the systemic risk of climate change. In particular, mitigation measures should be mandated under the "prudential transition plan" requirements, which will be elaborated by EIOPA under its mandate as per the revised Solvency II Directive. Recognising that there are clear limits to risk adaptation in case of unabated climate change, risk mitigation measures are key and should apply to the insurers' assets and underwriting portfolios. Finance Watch is looking to provide further input and policy ideas on the topic in the future.

Further, we support the continued work on prudential treatment of natural catastrophe risk to explore possible revisions needed in response to the growing number and severity of natural

catastrophes. Strong link with climate science for the future developments of natural catastrophe models is paramount, as there is growing evidence that the existing models become increasingly inadequate as climate change accelerates and tipping points might be reached.

Q8: What is your view on EIOPA's proposed recommendation with regard to the prudential treatment of social risks and impacts?

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens.

For more information on our sustainable finance work, please visit our website.