

PRUDENTIAL TREATMENT OF SUSTAINABILITY RISKS

EIOPA-BoS-23-460

IRSG response final

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

While there are diverging views among IRSG members as to whether a different shock in Pillar 1 would be appropriate, the IRSG considers that the proposals put forward are not sufficiently well founded at this stage, for the following reasons:

- Given the limited exposure of insurers to these assets (EIOPA note that 1% of total investments are in directly held fossil fuel investments) and the portfolio-level approach to capturing capital requirements in the standard formula, the existing calibrations are considered sufficient. This is because the data sets used to calibrate the standard formula contain extreme idiosyncratic events which affected specific sectors eg. tech sector in 1999, financial sector in 2008
- The use of unreliable forward looking estimates
- Small sample sizes
- Different characteristics which apply for different “fossil fuel related” stocks meaning that a “one size fits all” differentiated shock would not be appropriate
- Unclear relationship between credit risk and transition risk
- There is a lack of consistency between EIOPA proposing to introduce a dedicated change to Pillar 1 which would depart from the current application of existing methodology, but indicating that the impact would be very limited
- We are also concerned that EIOPA should not put this work ahead of other important priorities following the Solvency II review

For equity and spread risks, it is important to acknowledge that financial markets, notably where deep, liquid and transparent, establish prices based on all the information and trends present in the economy. As sustainability issues become integrated in public and private agendas, they are necessarily informing market prices which in turn aim to factor in “transition risk” along with all the other general and company specific factors which are at play. The impact of sustainability factors is being integrated with that of other risks. Many other “transitions” are taking place every day in all sorts of ways, applying to sectors, geographies, technologies and other factors. Market values are the result of the interconnections of numerous factors, e.g. monetary policies, inflation, geopolitics, technologies, demography, geographies, health, productivity and, not least, innovation at large. An attempt to depart from a global approach to sector-differentiated equity risk calibration could risk producing limited results which could render the outcome fragile and questionable. In a practical sense, this is evidenced by the forward looking element proposed for the analysis. Although reliance on backward looking analysis would be inappropriate, the forward looking overlay does not appear to be reliable.

We may also observe fossil fuel companies steadily performing well, which can reflect idiosyncratic situations whereby such companies have worked out strategic plans engaging in paths with good prospects while still benefitting from the profits that fossil fuels may bring until their replacement is eventually achieved. This may also be reflective of the intertwined nature of renewable energies and fossil fuel investments that should not be overlooked or understated (see answer to question 2). We would not advocate application of a methodology which could direct firms away from investments which they may otherwise justifiably make in such companies.

Even if sustainability transition effects are part of the data series between 2015 and 2020 (together with all other transition types at work in the economy in different domains), it is possible that today's remaining transition impacts are reflected in market prices. Forward looking approaches based on pre-conceived paths could lead to potentially double-counting effects already encapsulated in the markets today. The question of whether or not there could be an impact on price volatility depends on the analysis of whether this transition is expected to be different to those experienced in the past and whether markets are able to capture it in current prices.

Concerning the sectoral shocks, one could argue that the average shock of the Standard Formula (SF) should be higher for some sectors which would be more prone to volatility, even if their prices may already include transition discounting. This would introduce a complexity in the SF aiming at allocating dedicated shocks per sector while maintaining an average global shock equal to the current one. Fundamentally, it does not seem consistent with the methodology used to apply a different shock to reflect the impact on one risk type while not doing so for other risk types.

We would suggest, as an extension of above, that any application of higher stresses to fossil fuel and potentially other sectors, should be accompanied by lower stresses for other sectors; otherwise, the aggregate stress would change from the current level.

The IRSG considers that rating agencies are integrating ESG factors in the credit assessment process. The role of rating agencies is core in assessing the credit quality of issuers on the basis of extensive information analysis. It may be more rational to work with agencies to ensure that ratings incorporate any identified elevated risk associated with activities of entities (fossil fuel related or other) as opposed to applying an artificial overlay to established Solvency II methodology.

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

It is paramount that the prudential Solvency II framework remains risk-based.

Other regulations are intended to prompt insurers to reduce their exposure to fossil fuels. There is already scrutiny of insurer risks and exposures through Pillar 2 and through various reporting requirements. There is a strong argument that these methods, which provide information on firm-specific exposures and the impact of different scenarios, are a more targeted method of assessing the risks operating on a specific firm than a differentiated stress in Pillar 1.

The volatility of fossil fuel sector investments may also be driven by specific economic circumstances or temporary policy decisions that are actually not reflective of transition risk. Again, a reason to be wary of separating out a single risk which may or may not apply in the way laid out in the proposal.

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

See above. There are diverging views among IRSG members as to whether a differentiated shock would be appropriate or not. The IRSG considers that the proposals put forward are not sufficiently well founded at this stage.

In addition to the arguments above, we note that, given the low percentage of the so called "brown portfolios" in insurance undertakings portfolios, a dedicated factor is not expected to have any material risk and solvency impact. We question the value of considering such a substantial deviation

from the Solvency II Pillar 1 framework for immaterial impact, and which would unnecessarily increase complexity and the operational burden for companies.

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

Our view is consistent with that set out above for equity risk. There are diverging views among IRSG members as to whether a differentiated shock would be appropriate or not. The IRSG considers that the proposals put forward are not sufficiently well founded at this stage.

In addition, future developments in the area of credit ratings may further capture transition risk exposure of an undertaking and/or sector to the point where a “brown downgrade” as contemplated by EIOPA in the standard formula would lead to double counting of the risk.

It would be important to consider any implications for the volatility adjustment (VA) which may follow from an amendment of spread risk treatment.

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

In their assessment process, rating agencies are including vast amounts of relevant information on companies, including their medium and long term strategies. We do not agree that the impact of one additional risk, i.e. transitional risk, can be effectively identified through statistical analysis of a small database in this way. Put another way, how could you separate what’s considered as transition risk from other risks? We are concerned that insistence on higher volatility of spread shocks for fossil fuel bonds based on this analysis does not properly demonstrate scientific objectivity.

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

We agree that the information available cannot be relied upon to alter the shock applied to property, which as an asset class reacts in a complex way to individual risks, and we support ongoing analysis of the area.

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

In its work, EIOPA needs to bear in mind the factors of, on the one hand the prudential requirements of insurers, and on the other the point of insurability / availability of coverage for customers. To draw this out a bit further, it would be regrettable if alteration of prudential requirements would as a consequence lead to fewer options for risk transfer for customers.

We agree that there is insufficient data to change premium risk factors, that ongoing analysis is likely to be valuable and that a particular focus on natural catastrophe risk outcomes is merited.

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

We consider that, given the current body of evidence, there is no justification for distinct treatment of social risks and impacts. We also consider that Pillar 2 analysis may be the appropriate place to deal with possible outcomes of social risks.