

March 3, 2023



Ms. Petra Hielkema  
Chairperson  
European Insurance and Occupational Pensions Authority (EIOPA)  
Westhafenplatz 1  
60327 Frankfurt am Main  
Germany

Re: Discussion Paper: EIOPA Consultation on the Prudential Treatment of Sustainability Risks

Dear Ms. Hielkema:

The Institute of International Finance (IIF) and its insurance members are pleased to respond to EIOPA's consultation on the Discussion Paper on the prudential treatment of sustainability risks (Discussion Paper). The IIF has been actively engaged in thought leadership and advocacy on climate change issues that affect the financial services sector for several years and we recognize the importance of active dialogue on these subjects.

We appreciate EIOPA's ongoing work on sustainability risks and agree that the prudential analysis of these risks needs to be risk- and evidence-based. We support the statement in EIOPA's 2019 Opinion on Sustainability within Solvency II<sup>1</sup> that any change to Solvency II capital requirements must be based on a proven risk differential compared to the status quo. That Opinion found that the medium to long term impacts of climate change cannot fully be captured in the Solvency II capital requirements, which are designed to reflect the risks that undertakings are exposed to over a one-year time horizon. Scenario analysis embedded in risk management, governance and the own risk and solvency assessment (ORSA) allows an insurance undertaking to consider the impact of sustainability risks over longer time horizons that are subject to greater uncertainty around risk pathways as well as the potential impacts of mitigating actions taken by various public and private sector actors. We also welcome EIOPA's emphasis in the Opinion on materiality and proportionality and its recognition of the need to adapt scenario analysis parameters to the specificities of the undertaking.

**Difficulties Associated with Isolating Transition Risks.** We note that a number of risks captured under Solvency II incorporate climate-related transition risks, and that isolating transition risks (especially from spread risks<sup>2</sup>) can be extremely difficult and may contain fundamental limitations. These include the limited data surrounding transition risk and the model bias that could arise when attempting to isolate

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<sup>1</sup> [https://www.eiopa.europa.eu/sites/default/files/publications/opinions/2019-09-30\\_opinionsustainabilitywithinsolvencyii.pdf](https://www.eiopa.europa.eu/sites/default/files/publications/opinions/2019-09-30_opinionsustainabilitywithinsolvencyii.pdf)

<sup>2</sup> Climate transition risks are a driver of spread risks (among other drivers), which are difficult to entangle and isolate.

transition risk from other drivers using traditional methods such as bivariate and multivariate regressions.<sup>3</sup> The future pathways of transition risks are difficult to predict as they depend upon changing political, economic, social, technological and regulatory developments, which will differ across jurisdictions in terms of both scope and timing.

**Potential Negative Impacts of Assumptions and Estimates Given Uncertainties.** We are concerned that, given the inherent uncertainties regarding risk pathways, some of the assumptions and potentially inaccurate estimates underlying Pillar 1 charges could have an impact beyond the prudential capital charges for individual insurers. Specifically, they could contribute to herding behavior (i.e. fire sales or asset bubbles), and a disorderly transition. There may be a negative impact as well on insurers' incentives for investment or product development.

**Existing Tools Are Better Suited to Address Climate-related Risks.** As EIOPA has acknowledged, climate change is a driver of transition risks related to the decarbonization of the real economy and a driver of acute physical risks, relating to natural catastrophes and extreme weather events, as well as chronic physical risks. The insurance industry has long been managing climate-related risks through a variety of tools, including through reflecting material climate-related risks in the ORSA.<sup>4</sup> The ORSA is better suited to a consideration of the material impacts of climate-related changes on an insurer. By its nature, the ORSA is forward-looking and allows for multi-year scenarios at different confidence levels (as contrasted with the one-year, 99.5% confidence level under Solvency II), which is critical to an assessment of climate-related risks which materialize over time along uncertain pathways. Insurers are considering the impacts of technology, government policy and regulatory changes on investment portfolios. These changes are reflected in plans to mitigate transition risks, which the industry is developing with input from scientific experts.

**Insurers Are Already Including Adaptation in Their Underwriting and Pricing.** Insurers are actively engaged in reflecting adaptation measures in their underwriting policies and risk-adjusted pricing. From a risk management point of view, the availability and effectiveness of adaptation measures is reflected in business strategy, risk appetites, reserves and internal capital allocations. Better input from the real economy in addressing significant data gaps and data expected to be generated as corporates comply with the EU Corporate Sustainability Reporting Directive and other similar legislation should help to continue to improve the incorporation of adaptation into policies and pricing.

**Pillar 1 is Not Well Suited to Address Climate-related Risks.** The above considerations raise a threshold question for EIOPA, which could be considered more fully in connection with this consultation: is a backward-looking solvency measure based on a one-year value-at-risk a necessary and correct tool for responding to longer-term climate-related transition and underwriting risks and social risks? We have

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<sup>3</sup> For example, EIOPA notes that using a transition risk measure and sector as independent variables to test against a suitable equity risk measure would likely result in the transition risk measure (e.g. GHG emissions) being highly correlated with the sector. We believe that the use of GHG emissions (or other factors) as simplified proxy variables for transition risk could oversimplify the underlying economic dynamics of the energy transition, which have shifted and will continue to shift over time.

<sup>4</sup> The IAIS notes in its 2021 Application Paper on the Supervision of Climate-related Risks in the Insurance Sector that supervisors should expect insurers to consider all material risks arising from climate change in the ORSA process and adopt appropriate risk management actions to mitigate identified risks. <https://www.iaisweb.org/uploads/2022/01/210525-Application-Paper-on-the-Supervision-of-Climate-related-Risks-in-the-Insurance-Sector.pdf>

identified an emerging consensus among technical climate practitioners that Pillar 1 prudential capital requirements are not an ideal response to climate-related risks. This is based on the view that a material, steady and market-based climate differential that would underpin a risk- and evidence-based climate risk capital charge in Pillar 1 has not yet been identified and a recognition that the time horizons of climate-related risks are poorly matched with the one-year time horizon underlying prudential capital frameworks.<sup>5</sup> As noted above, the flexibility and proportionality of the ORSA make it a substantially better tool for analyzing material climate-related risks.

**We Generally Support EIOPA's Proposed Approach to Social Risks.** We support EIOPA's approach to social risks through a focus on governance, risk management, reporting and disclosure. These risks are increasingly reflected in insurers' risk management and governance tools, including the ORSA and internal capital allocations and we encourage EIOPA to refrain from prescriptive new risk management and governance requirements absent a material gap in the implementation of these tools. We also note that the macroeconomic impacts of certain social risks should already be embedded in the data underlying the calibration of market risk shocks in Solvency II.

We appreciate the opportunity to respond to this important consultation and welcome avenues for dialogue on these issues, which are of critical importance to the IIF's global insurance members.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Jeff Munn", with a long horizontal flourish extending to the right.

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<sup>5</sup> <https://www.iif.com/Publications/ID/5018/Climate-and-Capital-Views-from-the-Institute-of-International-Finance>.