Finance Watch response to the EIOPA Consultation on Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA

Question 1. Do you agree that the first two chapters provide a clear picture on the inclusion of climate risk scenarios in the ORSA to a high-level reader?

Chapter 1 describes the different parts in the ORSA where undertakings have the possibility to address climate change risks – from insurance undertaking’s vision and strategy to risk assessment and management actions. Whilst we understand that the consultation document guidance only covers materiality assessment and scenario analyses components of ORSA, it should be highlighted that the listed components of ORSA are not alternative options to address climate-related risk, but should be viewed holistically, i.e. climate-related financial risks should be considered in all parts of ORSA, as are other financial risks.

Materiality assessment: The recognition that climate-related financial risks can impact both sides of the insurers’ balance sheet – market value of assets, technical provisions and solvency capital requirement – is most welcome. However, operationalisation of the generic guidance on materiality assessment represents a major issue, as there is significant level of uncertainty associated with climate-related risks, insufficient availability, as well as standardisation and consistency of data with which to analyse and measure these risks. Transmission channels between climate events and financial implications for the balance sheets of affected institutions require further exploration before these are fully understood. In its Application Paper on the Supervision of Climate-related Risks in the Insurance Sector, dated May 2021, the International Association of Insurance Supervisors (IAIS) stated: “The measurement of climate-related risks is an evolving science with challenges in the quality and availability of data. In some cases, there may be challenges to translating climate change (scenarios) into financial risks (e.g. translating a change in temperature into certain natural catastrophe risks).”

Furthermore, the radical uncertainty around climate-related risks complicates the view on the relevant time horizons of their materialisation. In particular, time horizons for acute physical risks cannot be modelled/predicted with any degree of precision due to the “green swan” nature of climate events and overall non-linearity of climate changes. In particular, green swans are characterised by: i) certainty of their arrival despite highly uncertain impacts and exact timing of climate risk materialisation; ii) wide-ranging and existential impacts on the economy and financial system; iii) high degree of complexity, including cascade effects and chain reactions in the environment, economy and society. Based on this, the statements provided in the Guidance with respect to time horizons for climate risk are inaccurate in that they do not account for the possibility of sudden risk materialisation: “the fact that the time horizon used in the context of climate change is much longer than the usual “business” time horizon used by undertakings in the ORSA” (page 15 of the Guidance).

Climate change scenarios: The overall principle of scenario application “define scenario – transform scenario into climate change risks – transform climate change risks into financial losses” is clear from the high-level perspective; however, subsequent scenario descriptions and transformations to arrive at financial losses require a substantial degree of expertise and specialised knowledge. Therefore, implementing the Guidance on scenario analyses will be a gradual process, where insurers will need to develop expertise and capabilities and ensure that they have appropriate resources allocated to these tasks.
This means that comprehensive conclusions and corresponding prudential measures on the back of such scenario analyses will not be in place in the foreseeable future.

**Question 2. Do the examples in “Chapter 3 – Materiality assessment” address the main transition and physical risks to which undertakings may be exposed?**

As mentioned in our response to Question 1, the Guidance does not appropriately account for the “green swan” nature of climate events and associated risks. This type of risk can be defined as disruption risk - the risk of large-scale disruption to the world, including to the economy and financial system. In its worst manifestation, disruption risk can lead to a world which is uninsurable due to prohibitive prices to insure certain risks, insurance companies going out of business due to extremely high and unforeseen payouts, as well as the economy, and with it the financial system, collapsing.

The proposed materiality assessment at the level of a single insurance undertaking also ignores the systemic dimension of climate-related financial risks, in particular the risk associated with fossil fuel finance. By continuing to invest into securities issued by fossil fuel companies and insure assets and projects related to fossil fuels, insurance companies not only expose themselves to the risk of stranded assets, but also enable climate change. This increases the systemic risk to the whole financial system, as climate-related events become more severe and frequent and inflict losses on financial institutions.

**Question 3. Do you consider the scenario analyses proposed in “Chapter 3 – Climate change scenarios” easy to apply for small and mid-sized insurers?**

As mentioned in our response to Question 1, application of scenario analyses on climate-related risks requires substantial expertise and specialised knowledge. It further involves challenges to obtain/gather necessary data with sufficient level of granularity, which is required for such scenario analyses. Therefore, it might be particularly difficult for small and mid-size insurers to implement the Guidance. On the other hand, small and mid-size insurers may have simpler asset and liabilities portfolios in terms of product and geography composition, which should make the scenario analysis simpler compared to larger institutions.

These aspects should be taken into consideration by the supervisors as part of their interactions with the supervised entities to ensure the insurers build the necessary expertise and knowledge to understand and manage their climate-related financial risks. The existing proportionality provisions of the insurance prudential rules allow for the consideration of the nature, scale and complexity of the risks inherent in the business of an insurance or reinsurance undertaking.

**Is there any relevant aspect not covered by the previous questions, with a particular focus on alternative methodologies / approaches?**

We welcome the EIOPA’s Guidance and consider it to be essential to help financial institutions build identification and risk management capabilities for climate-related financial risks, and embark on the process to explore and understand those risks going forward. However, the challenges discussed in our responses above make it unlikely that credible and reliable outcomes, which would be consistent across institutions, will be achieved in the near future. Without questioning the necessity to pursue the selected path of risk exploration, we are strongly convinced that more timely and impactful measures to manage climate-related financial risks should be prioritised such as introducing capital requirements to account for these risks. 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 (refer to Finance Watch’s legislative proposals [https://www.finance-watch.org/wp-content/uploads/2021/05/Breaking_the_climate-finance_doom_loop_Finance_Watch_amendments_proposal-2.pdf](https://www.finance-watch.org/wp-content/uploads/2021/05/Breaking_the_climate-finance_doom_loop_Finance_Watch_amendments_proposal-2.pdf)). Fossil fuel exposures represent a clearly identifiable set of assets, which are at a high risk of stranding and which are also the main root cause of climate-related financial instability.
Whilst we understand that Pillar I capital requirements are outside of the EIOPA remit, EIOPA’s support as a supervisory authority is important to achieve regulatory change in the current review of the Solvency framework. Further, EIOPA’s mandate as per the EU Renewed Sustainable Finance Strategy (Article 304a of the Commission’s proposal for the Solvency II Directive review) will also be crucial for the future prudential treatment of climate-related financial risks. It represents a major opportunity to implement an impactful solution to ensure resilience of the insurance sector against those risks.