

framework for managing climate risk⁵ and reports on macroprudential instruments in the insurance sector.⁶ The remainder of the document will use the term *sustainability risks* to cover both environmental and social risks.⁷

Sustainability risks requiring a forward-looking approach

The increasingly disruptive impacts of climate change create a more uncertain environment to which the financial system must adapt. Severe weather and climate-related events are becoming increasingly frequent and severe, meaning that the impact of such shocks is no longer confined to relatively small geographical areas. Such events will become ever more disruptive for society and the economy: droughts causing crop failures or disrupting transport and energy production, large wildfires and severe floods. Climate change is also making vast areas of the planet unsuitable for agricultural or other forms of production (including tourism), or even uninhabitable. Such supply-side shocks will be particularly difficult to handle, particularly if fiscal and monetary policies are constrained.

Events related to climate change do not occur in a linear manner and will therefore increase levels of uncertainty and instability. Such instability can also result from, or be amplified by, social and political crises within countries, as well as geopolitical conflicts and migratory pressures. Policies aimed at tackling climate change and its consequences may add to this uncertainty to the extent that such policies are not implemented in a reliable and consistent way, not least because of political backlashes. Notably, this is already happening, although the dynamics could become far worse as and when certain expected or unexpected climate tipping points are reached or major social crises occur. Financial services will thus have to be provided in a far less predictable environment.

The ESRB, along with other European and international institutions⁸, has emphasised the potentially significant systemic dimension of climate risks. Transition and physical risks may simultaneously affect a large number of financial institutions across sectors and/or countries, thereby threatening the stability of the financial system as a whole.⁹ Climate-related risks may become systemic due to their inherent characteristics, such as their irreversibility, the simultaneous occurrence of natural hazards (for instance, heatwaves and wildfires), the amplification between transition and physical risks (delayed action increasing both transition and physical risks) or their concentration within specific sectors or regions. Climate-related risks can also be amplified through classic systemic risk channels, including contagion and spillovers across banks, insurers, investment firms and other parts

⁵ See ECB/ESRB (2023), **Towards macroprudential frameworks for managing climate risk**, December.

⁶ See ESRB (2018), **Macroprudential provisions, measures and instruments for insurance**, November, and ESRB (2020), **Enhancing the macroprudential dimension of Solvency II**, February.

⁷ See Recital 41c of the revised Solvency II Directive, where *sustainability risk* means an environmental, social or governance event or condition that, if it occurs, could cause an actual or potential negative impact on the value of the investment or on the value of the liability.

⁸ Like the ECB, the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), the European Environmental Agency, EIOPA, the IAIS and the FSB.

⁹ See NGFS (2019), **A call for action – Climate change as a source of financial risk**, Network for Greening the Financial System, April; ECB/ESRB (2020), **Positively green: Measuring climate change risks to financial stability**, June; and FSB (2022), **Supervisory and Regulatory Approaches to Climate-related Risks, Final report**, Financial Stability Board, 13 October.

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of the financial system. Thus, shocks can propagate well beyond the entities that are directly exposed to these risks. In addition, transition and physical risks may be amplified by feedback loops between the real economy and the financial system.

Insurers are exposed to physical and transition risks through several channels. Transition risks can include policy and regulatory risks, technology risks, reputational and legal risks, and market risks. Transition risks commonly manifest as a direct financial loss on the insurer, such as when assets exposed to sustainability risks drop sharply in value. Such price falls would reduce the value of the investment portfolios of insurers and reduce their own funds. Physical risks manifest through an increased frequency and severity of climate change-related events. They can also affect the value of the assets that insurers have invested in. However, the solvency position of the insurance sector may also be affected by increased claims linked to extreme weather events and other consequences of climate change. This could then lead to an increase in premiums for policy holders as insurers attempt to restore their solvency position and profitability, which could in turn lead to a drop in demand for insurance, as it would become less affordable.

As natural catastrophes become more global and systemic, insurers' capacity to diversify risks becomes compromised. In particular, reinsurance costs and reinsurance capacity may be adversely affected, reducing the insurability of private losses. This could also amplify social risks. Ultimately, higher insurance costs and reduced risk diversification capacity could result in a large increase in uninsured losses, also known as the protection gap.¹⁰

The uncertainty generated by climate change calls for a forward-looking precautionary approach. As ever more severe climate-related events can occur at any time, regulators and supervisors cannot rely solely on historical data to recalibrate prudential requirements or design new prudential tools. Such reliance would lead to an underestimation of the impact of sustainability risk on the financial system.¹¹

A forward-looking approach needs to build on scenario analysis that can capture the systemic dimension of sustainability risks. Conventional risk metrics used by financial institutions and supervisors applying microprudential requirements will not fully capture the range and systemic dimension of climate-related financial risks. A backward-looking approach applied at the level of individual institutions, while capturing the recent increase in climate-related events, would fail to reflect the growing frequency and severity of such events. Advances in climate modelling may provide a better understanding of where and how climate risks may materialise. Yet they will still be random events, albeit of increasing severity and with wider ramifications and far greater potential for disruption, including the financial sector. Non-linearities and tipping points associated with climate change, as well as the uncertainty, complexity and largely irreversible nature of climate risks and their multiple interactions with other sustainability risks, reinforce the need for tools that are calibrated on the basis of severe and plausible scenario analysis, as opposed to an approach based solely on observed past patterns.

¹⁰ See also Chapter 4.2.2.1. of ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

¹¹ See Chapter 4.1. of ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

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General considerations on the prudential approach

Prudential policy should be risk-based and should not be used to achieve broader policy objectives such as the transition to a low-carbon economy and the necessary adaptations to climate change. Prudential policies need to look at all risks (which increasingly includes sustainability risks) that affect the resilience of financial institutions, including insurers. This includes the impacts on these institutions' assets, liabilities and cash flows so that authorities have a comprehensive view of the implications for solvency and liquidity. This will ensure that the financial system is able to fulfil its role in supporting the real economy, including its transition to a low-carbon economy and the necessary adaptations to climate change.

Prudential policy must ensure that the insurance sector remains resilient in the face of sustainability risks. Insurers play a pivotal role in managing sustainability risks to the benefit of businesses and households. The pooling and transfer of risks are central to insurance, and insurers contribute to climate change mitigation and adaptation by providing insurance-based solutions. Prudential requirements need to ensure that all associated risks and potential unintended consequences are covered by the regulatory framework. Sustainability risks should therefore be considered in a comprehensive way, particularly in the risk management framework, taking into account the business models of insurers. Furthermore, the increasing severity and systemic dimension of sustainability risks calls for a macroprudential perspective.

A prudential approach to sustainability risks in the insurance sector needs to reflect the fact that insurers are exposed to risks through channels that differ according to their lines of business. The portfolio composition of an insurer determines the extent to which it can experience losses on its financial and real assets that are affected by transition or physical risks or wider economic and political instability resulting from climate change. Depending on their line of business, insurers may also be affected to varying degrees through their underwriting activities, which may expose them to increasingly severe natural catastrophes. Some insurers may also be confronted with costly litigation claims, either as a result of their underwriting activity or their own business conduct and investment decisions.

The increasing severity and systemic dimension of sustainability risks calls for a macroprudential perspective.¹² These risks will not affect just individual insurers, but the entire financial sector by becoming key drivers of the different categories of risks (e.g. credit risk, market risk, liquidity risk, operational risk) that financial institutions must manage. A wide range of scenarios are possible, all with complex interactions between types of risk, other financial institutions and sub-sectors of the financial system, and the wider economy and society. A macroprudential perspective is therefore crucial to ensure that the disruptive potential of sustainability risks is adequately addressed by the prudential requirements imposed under the three pillars of the prudential framework.

¹² See Chapter 4 of ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

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It is therefore important that supervisory authorities consider the disruptive potential of sustainability risks and spillovers and amplification across the financial system and the wider economy.

The prudential treatment of sustainability risks should also be consistent, where possible, across sectors of the financial system. There are large differences in the prudential frameworks for banks, insurers and other non-bank financial intermediaries, reflecting their different risk profiles. Differences between banks and insurers in the prudential treatment of assets that are particularly exposed to sustainability risks could result in such assets moving to other financial sectors with less stringent capital requirements. Legislators must ensure that there is a consistent, risk-based treatment across sectors and jurisdictions while acknowledging and addressing the specificities of each sector. This includes indirect exposures to sustainability risks through assets held by investment funds.

Assessing the suitability of the prudential framework in the face of increasing sustainability risks is a continuous process. The response to the question of whether a dedicated prudential treatment for sustainability risks is needed, and how best to deal with these risks in the existing framework, may evolve over time. The immediate priority is to make the most effective use of the existing micro- and macroprudential tools amid this highly uncertain environment, but without this precluding further work on new and complementary tools. This will be a continuous learning process as new data on risks and exposures to risks become available and as authorities gain a better understanding of the vulnerabilities and how best to address them.

Considering a dedicated prudential treatment under Pillar I

The Solvency II Directive¹³ makes insurers more resilient by adopting a market-consistent and risk-based approach. The regulatory framework comprises three pillars: Pillar I sets out the *quantitative* requirements and in particular the calculation of technical provisions (insurance liabilities) and a Solvency Capital Requirement (SCR). Insurers' own funds need to cover their SCR. Pillar II sets out the *qualitative* requirements on governance and risk management, including the Own Risk and Solvency Assessment (ORSA). Pillar III defines requirements for supervisory reporting and public disclosures. The three pillars of Solvency II ensure a risk-based approach to capture insurers' individual risks in the prudential requirements.

¹³ **Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance** (OJ L 335, 17.12.2009, p. 1).

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Pillar I requirements under the Solvency II Directive¹⁴

The SCR aims to reflect the risk sensitivity of an insurer. Each insurer's SCR is intended to reflect its specific risk profile and all quantifiable risks that the insurer is exposed to from its activities.¹⁵ For that purpose, the SCR is calibrated by applying a defined set of shock scenarios to relevant parameters affecting the insurer's lines of business and asset exposures (e.g. natural catastrophes, lapse risks). The combination of individual risk modules (market risk, counterparty default risk, underwriting risk) determines the Basic Solvency Capital Requirement (BSCR).¹⁶ After applying adjustment terms and introducing operational risks, the SCR is calculated as the amount of own funds that insurers need in order to absorb losses.¹⁷ The SCR calculation, using either the standard formula or internal models, aims to capture all quantifiable risks that each insurer is exposed to, including sustainability risks. In addition, the insurer compares its SCR against its own solvency needs as part of their ORSA.¹⁸

As Solvency II aims to be a market-consistent framework, transition and physical risks should in principle be reflected already in the Pillar I calculations of the SCR, own funds and technical provisions. Valuations on the total balance sheet follow a market consistent approach as a general principle, albeit with certain dedicated rules relating to technical provisions.¹⁹ Assets valuations based on market prices thus include market expectations and sentiment on risk differentials on sustainability risks. However, given the growing severity and complex interactions of sustainability risks, markets may be unable to price in future sustainability risks²⁰. Supervisors should also monitor that insurers' technical provisions factor in changes in physical and transition risks related to their underwriting activities.²¹

¹⁴ No legislative changes are made to Pillar I regarding sustainability risks in the revised Solvency II Directive. Hence, for the purpose of Pillar I discussions, we refer to the Solvency II Directive in the above text.

¹⁵ See Article 101 of [Directive 2009/138/EC \(Solvency II\)](#).

¹⁶ See Article 104 of [Directive 2009/138/EC \(Solvency II\)](#) and Article 83 of the [Commission Delegated Regulation EU 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC](#).

¹⁷ See Recital 62 of [Directive 2009/138/EC \(Solvency II\)](#). The SCR should reflect a level of eligible own funds that enables insurers to absorb significant losses and that gives reasonable assurance to policy holders and beneficiaries that payments will be made as they fall due.

¹⁸ The ORSA is a Pillar II requirement which also covers several other risk factors. It is a valuable tool for insurers in which they compare their own solvency needs against the Pillar I capital calculation. See Article 45 of [Directive 2009/138/EC \(Solvency II\)](#) and [EIOPA Guidelines on ORSA](#).

¹⁹ See Articles 75 and 76 of [Directive 2009/138/EC \(Solvency II\)](#).

²⁰ See Eren, E., Merten, F. and Verhoeven, N. (2022) "[Pricing of climate risks in financial markets: a summary of the literature](#)", *BIS Papers*, No 130, Bank for International Settlements, December.

²¹ See EIOPA (2023), [Guidelines on Valuation of Technical Provisions – Consolidated Version with Explanatory Text](#), p. 19.

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EIOPA's findings regarding a dedicated prudential treatment under Pillar I

The revised Solvency II Directive requires EIOPA to look at the treatment of exposures related to assets or activities substantially associated with environmental or social objectives, including fossil fuel-related assets.²² In response, EIOPA conducted empirical analysis on three areas²³: (i) risk differentials for certain asset classes of insurers' investment portfolios due to transition risk; (ii) risk differentials between climate-related risk adaptation measures and prudential underwriting risks for non-life insurers; and (iii) links between social risks and prudential risks, including market risks and underwriting risks.

Addressing sustainability risks through a dedicated prudential treatment of certain assets under Pillar I

Fossil fuel-related assets are more exposed to transition risks than other asset classes and should therefore receive special attention from a risk management perspective. In February 2024, the European Commission recommended that, by 2040, the EU's greenhouse gas emissions should be reduced by 90% compared with 1990, with complete carbon neutrality to be achieved by 2050.²⁴ This will only be possible if accompanied by a substantial and swift reduction in fossil fuel consumption, as carbon capture, storage and use will account for only a small portion of the required emissions reduction. Current high prices for fossil fuels, driven by geopolitical crises, may temporarily sustain high asset valuations. However, such valuations are highly vulnerable to changes in supply (as these political crises are resolved, or where new producers enter the market) and demand conditions (recession, warm winters), as well as increases in carbon pricing.

EIOPA's consultation paper focuses on the potential impact of transition risks on insurers' investment portfolios and finds some empirical evidence on fossil fuel-related assets. EIOPA's risk-based analysis applies a backward- and a forward-looking approach to different asset classes that may be affected by climate change. EIOPA's analysis on equity and spread risks shows evidence of a differentiated and elevated risk profile for fossil fuel-related assets (equities and bonds), which would be consistent with the expectation that these assets may become stranded. EIOPA's consultation identifies policy options for a dedicated treatment of fossil fuel-related assets when calibrating the SCR in the form of a supplementary risk charge for equity and spread risks. EIOPA does not, however, express a preference for any of the proposed policy options. Moreover, EIOPA notes that any dedicated treatment in this area would have only a low impact on insurers' solvency ratios due to their small exposure to directly held fossil fuel-related assets. However, EIOPA also acknowledges that the introduction of a differentiated prudential treatment may have an impact on the transition efforts of affected fossil fuel-related

²² See Article 304a as set out in **Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU**, 19 January 2024.

²³ See EIOPA (2023), **Prudential Treatment of Sustainability Risks**, *Consultation Paper*, 13 December.

²⁴ See European Commission (2024), **2040 climate target**, 6 February.

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companies and that fossil fuel-related activities are unlikely to become less environmentally harmful when it comes to mitigating climate change.²⁵

Addressing sustainability risks through a dedicated prudential treatment for non-life underwriting and climate change adaptation (Pillar I)

EIOPA analyses the potential risk differentials between climate-related adaptation measures and non-life underwriting risks but makes no policy proposals for a dedicated prudential treatment. EIOPA carried out a qualitative and quantitative assessment. Its findings indicate that adaptation measures might lead to a reduction in non-life underwriting risk of insurance companies. In EIOPA's view, data constraints and the mixed identified effects of private mitigation measures on insurers' key underwriting risks (i.e. premium and reserve risk and natural catastrophes) do not provide a sufficiently strong basis to justify a dedicated prudential treatment in the capital requirements. The ESRB welcomes EIOPA's intention to repeat the analysis as new evidence becomes available.

It is necessary to evaluate further the extent to which climate-related adaptation measures taken by policy holders (e.g. anti-flood doors) could influence non-life underwriting risks for insurers. Climate-related adaptation measures are valuable in managing physical risks. The effectiveness of such measures can reduce the impact of climate-related risks both on insurers and policy holders. Insurers can consider adaptation measures when underwriting and pricing insurance policies, while policy holders may be incentivised to improve adaptation measures, such as if they live in areas prone to flooding or wildfires. Consequently, adaptation measures could reduce the risk for the insurers, which could lead to lower premium costs for policy holders.²⁶ Affordability and accessibility of private insurance coverage remains a key aspect when monitoring this development since it could create negative externalities by increasing the protection gap.²⁷

Including adaptation measures in the company's product design and risk management framework can help reduce systemic risk. Considering adaptation measures when assessing sustainability risks is not only beneficial for reducing insurers' risk exposures and claims costs, but their effective implementation could also reduce systemic risk. The ESRB acknowledges EIOPA's efforts in this area and supports further analysis, which should also consider the macroprudential effects of implementing private adaptation measures, or the absence of such measures.

²⁵ See EIOPA (2023), **Prudential Treatment of Sustainability Risks**, *Consultation Paper*, 13 December, pp. 7-8 and, for supporting analysis, pp. 15-63.

²⁶ See also Chapter 4.2.2.1. of ECB/ESRB (2023), **Towards macroprudential frameworks for managing climate risk**, December.

²⁷ Although adaptation measures could lead to lower premiums, insurers must manage premiums adequately to ensure coverage of policy holders' claims.

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Addressing sustainability risks through a dedicated prudential treatment of assets/liabilities and social objectives

EIOPA's consultation paper analyses how social risks could potentially translate into prudential risks for investments and underwriting. EIOPA argues that all components of sustainability risks, such as climate and social risks, should be treated in a similar manner. EIOPA considers that the prudential treatment of social risks could, to a certain extent, be inspired by the prudential treatment of climate-related events. However, there are differences in how methodologies are applied between social risks and climate-related risks (e.g. scenario analysis). Furthermore, the lack of data and risk models limits the potential for a quantitative assessment. Thus, EIOPA does not conduct a risk-based analysis and does not provide advice on a dedicated prudential treatment. It also calls for further work on this subject and outlines the need for developing application guidance under Pillar II to support the social risks materiality assessment for the purpose of the insurers' ORSA.²⁸ The ESRB acknowledges the challenges faced by EIOPA and echoes the need for further guidance on how best to reflect social risks in the ORSA. Future analysis on social risks should also consider a macroprudential dimension.

Challenges in devising a dedicated prudential treatment under Pillar I

Developing a dedicated treatment of sustainability risks means dealing with a high degree of empirical uncertainty. Despite the observable and rapidly evolving nature of physical and transition risks linked to climate change, there is a lack of sufficiently granular data to reliably assess the need for a dedicated treatment of sustainability risks. Indeed, a general challenge with any empirical analysis of such risks is that patterns observed in the data are unlikely to hold given the unprecedented and accelerating rate of climate change.²⁹

EIOPA notes that it encountered data and methodological challenges in its empirical assessment of sustainability risks from a prudential perspective.³⁰ For instance, EIOPA's analysis on climate-related adaptation measures (physical risks) was affected by a lack of data. As a result, EIOPA did not draw policy implications on a risk-based dedicated treatment of underwriting. Thus, EIOPA recommends repeating this analysis once better data become available.³¹ In contrast, EIOPA found more empirical evidence on analysing potential risk differentials for fossil fuel-related assets. Reflecting this, EIOPA considers policy options only for fossil fuel-related assets.

²⁸ See EIOPA (2023), **Prudential Treatment of Sustainability Risks**, *Consultation Paper*, 13 December, pp. 109-113 and p. 120.

²⁹ See also ECB/ESRB (2023), **Towards macroprudential frameworks for managing climate risk**, 13 December, p.11.

³⁰ See EIOPA (2023), **Prudential Treatment of Sustainability Risks**, *Consultation Paper*, 13 December, pp. 5-8 and p. 12.

³¹ See EIOPA (2023), **Prudential Treatment of Sustainability Risks**, *Consultation Paper*, 13 December, pp. 100-102.

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Data constraints should not discourage future analysis, but do call for making use of the legal provisions in the revised Solvency II Directive. Climate change affects the value of financial assets through the sudden materialisation of physical or transition risks, and regulators must ensure that exposures and resilience are commensurate with sustainability risks. While analysis should continue, empirical uncertainty should not curtail regulators and supervisors' ability to develop complementary forward-looking approaches to transition and physical risks.

EIOPA may want to consider alternative ways to broaden the Pillar I analysis to reflect the various ways in which sustainability risks can affect the business models of insurers. Both assets and liabilities will be affected by the transition to a low-carbon economy and by physical risks (including any risk mitigation measures that insurers can incentivise their policy holders to take). The impact on the balance sheet and cash flows differs from one (re)insurance company to another. A capital charge for specific assets would not be enough on its own to achieve the goal of making the insurance sector resilient to the systemic effects resulting from climate change. Furthermore, in its future analysis, EIOPA may also wish to assess whether a dedicated prudential treatment of sustainability risks should also be considered more broadly for Pillar I. Such analysis would ideally include a more granular assessment, to complement the sector-wide approaches pursued by EIOPA.³²

Making use of the revised Solvency II provisions beyond Pillar I

The tools and provisions provided for in the revised Solvency II Directive can help address sustainability risk. The revised Solvency II Directive has been strengthened to better reflect and help address sustainability risks, especially in relation to Pillar II (e.g. risk management including the ORSA) and Pillar III (reporting and disclosures).

Pillar II

Sustainability risks are an integral part of the Pillar II regulatory framework for governance and risk management, including the ORSA.³³ EIOPA has issued guidance on how to use forward-looking scenarios on climate risk in the ORSA.³⁴ Moreover, the current review of the Solvency II Directive further strengthens the requirement for sustainability risks to be taken into account by insurers as part of their risk management³⁵. For instance, the revised text specifies the need for insurers' risk management framework, including the ORSA, to

³² See ECB/ESRB (2023), **Towards macroprudential frameworks for managing climate risk**, December, p.81.

³³ See the ORSA macroprudential considerations in the section of the present report entitled "A macroprudential perspective on sustainability risks: applying the newly agreed provisions and exploring new tools".

³⁴ See EIOPA (2022), **Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA**, 2 August.

³⁵ See Article 44 (2) of the Solvency II Directive as set out in **Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU**, 19 January 2024

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explicitly take into account the short-, medium- and long-term horizon when assessing sustainability risks³⁶. Furthermore, the *prudent person principle* guiding the investment strategy requires insurers to consider both the impact of sustainability risks on their investments and the potential long-term impact of their investment decisions on sustainability.³⁷

The revised Solvency II Directive requires insurers to develop, and monitor the implementation of, specific plans to address their sustainability risks. Embedding sustainability risks in insurers' risk management frameworks and having dedicated prudential plans to address the risks associated with sustainability are a positive step to better understand insurers' exposures to climate-related risks. The revised Solvency II Directive requires insurers to consider "the financial risks arising in the short, medium, and long-term from sustainability factors, including those arising from the process of adjustment and transition trends".³⁸ This could become an important tool for helping insurers manage their sustainability risks and for disclosing their efforts.

Pillar III (and other disclosures on sustainability)

Public disclosures and supervisory reporting on how insurers deal with sustainability risks should lead to a better management of such risks through market discipline and public scrutiny. The revised Solvency II Directive will strengthen public disclosure requirements. In particular, insurers must ensure consistency between their public disclosures (e.g. public commitments) and their Solvency II sustainability plans. Moreover, where insurers disclose information on sustainability matters in accordance with their corporate sustainability reporting³⁹, the sustainability plans to be developed by them under the revised Solvency II Directive must be consistent with all applicable legislation on sustainability disclosures.⁴⁰

³⁶ See Article 45a of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024

³⁷ See amendment to Article 132 of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

³⁸ See Article 44 of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

³⁹ Articles 19a and 29a of [Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC](#).

⁴⁰ See Article 44 (2b) as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

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Insurers' exposures to sustainability risks will become more transparent over the medium to long term as a result of the Corporate Sustainability Reporting Directive (CSRD).⁴¹ The CSRD will require larger corporates to disclose more specific information on their environmental and social impacts. Companies will also have to present, in their management reports, their transition plans for aligning with the 1.5 degrees Celsius warming limit and with the goal of climate neutrality by 2050.⁴² The first reports containing such sustainability disclosures must be published in 2025. Enhanced corporate disclosures should enable insurers to direct their investments towards companies that are less risky from an environmental and social point of view, both in terms of their current and expected future impact.⁴³

Additionally, insurers, like other financial institutions, have had to become more transparent about the sustainability impact of their own activities. The Sustainable Finance Disclosure Regulation (SFDR) entered into force in 2021 and has since been specified in more detail through technical standards that bring it more in line with the Taxonomy Regulation⁴⁴ and provide more clarity to avoid greenwashing. By having undertakings disclose information on sustainability risks, the SFDR aims to increase comparability of sustainable finance disclosures across the Union.⁴⁵ Disclosure requirements help to ensure compliance among insurers with sustainability goals via market discipline, though they should also offer investors better insights into an insurer's exposure to sustainability risks.

Having a consistent approach to transition plans will be important for comparability and transparency across the EU's financial system. Technical standards and guidelines need to be specific to ensure a high degree of consistency and methodological coherence with other regulatory requirements in the field of sustainability (e.g. disclosure of transition plans under the CSRD⁴⁶). This will allow for enhanced assessment and quantification of climate risk exposures both for supervisors and market participants.

Making use of Level 2 and 3 provisions to support an effective implementation of the revised Solvency II Directive

The revised Solvency II Directive better reflects sustainability risks and should be consistently and swiftly implemented. As previously noted, the review of the Solvency II Directive has toughened the requirements for

⁴¹ Directive (EU) 2022/2464/EU of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

⁴² See Article 19a (2) lit. a (iii) of Directive (EU) 2022/2464/EU of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

⁴³ See **Corporate sustainability reporting**, European Commission.

⁴⁴ See **Sustainability-related disclosure in the financial services sector**, European Commission.

⁴⁵ See **Sustainability-related disclosure in the financial services sector**, European Commission.

⁴⁶ The European Sustainability Reporting Standards (following the CSRD) are found in Annex I to **Delegated Regulation EU 2023/2772**.

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sustainability risks to be taken into account in the microprudential framework. This applies in particular to Pillar II (risk management including the ORSA) and Pillar III (reporting and disclosures). Pillar II is key to ensuring that capital and disclosure requirements are complied with through a sound system of governance and an adequate risk management framework. Moreover, as risks evolve and become better understood, there is a constant need to ensure that the different tools in the regulatory framework consider the interlinkages between risks and their emerging systemic dimension.

The effectiveness of the new provisions on sustainability risks in Solvency II will depend crucially on their sound implementation. EIOPA will have to draft Regulatory Technical Standards (RTS) specifying “*minimum standards and reference methodologies for the identification, measurement, management and monitoring of sustainability risks*”⁴⁷ as well as elements to be covered in the insurers’ plans, including timelines and quantifiable targets. Consistent and comparable implementation will facilitate supervisory analysis on how insurance companies align their operations with sustainability risks.

It will be important to consider the systemic dimension of sustainability risks in future Level 2 and Level 3 provisions. The modalities for the application of several new provisions in Solvency II on sustainability risks and macroprudential considerations will need to be defined in regulatory technical standards and guidelines. When developing these provisions, the emerging and systemic dimension of sustainability risks should be considered in a way that anticipates the acceleration of such risks. Moreover, in the absence of sufficient empirical data, these provisions should focus on developing the forward-looking perspective that is necessary for dealing with sustainability risks.

A macroprudential perspective on sustainability risks: applying the newly agreed provisions and exploring new tools

The revised Solvency II Directive includes several provisions that better equip insurers and supervisors to address systemic risks, including those stemming from climate change. The revised Solvency II Directive introduces enhanced liquidity management and reporting schemes for insurance companies. This includes a stronger toolkit for supervisors to take institution-specific pre-emptive measures, which may go as far as restricting dividend distributions or suspending early redemptions.⁴⁸ Moreover, the ORSA will have to cover “*considerations and analysis of the macroeconomic situation, and macroeconomic and financial markets’ developments*”. These developments should include “*climate change, pandemics, other mass-scale events and other catastrophes*” that

⁴⁷ See amendment to Article 44 of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

⁴⁸ See Articles 144a to 144d of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

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may affect insurers. If requested by the supervisory authorities, the ORSA should also include macroprudential concerns specific to the risk profile and activities of the undertakings.⁴⁹ Additionally, supervisory authorities may require certain insurers to take macroprudential considerations into account in their investment strategies.⁵⁰ EIOPA is tasked with developing technical standards to define the criteria for identifying those insurers that supervisors may ask to take these considerations into account.⁵¹

However, the revised Solvency II Directive continues to rely mostly on microprudential instruments and provisions to address sustainability risks. The Solvency Capital Requirement is sensitive to the riskiness of individual insurers' investment exposures and business activities, applying dedicated stress factors to specific parameters. It therefore addresses the individual vulnerabilities of insurance companies on a microprudential level. The enhanced risk management and reporting framework provided for under the revised Solvency II Directive will make insurers and markets better prepared for sustainability risks. Increasing the resilience of individual insurers should make the wider sector more resilient to sustainability risks and thus support macroprudential objectives. However, targeting the risk profiles of individual insurers is not enough. This is because of transmission channels, amplifiers, or spillovers within the insurance sector and to the wider financial sector and economy.⁵²

Scenario analysis applied to individual insurers and the insurance sector in its interactions with the financial system and the economy can play an important role in preventing systemic risks. As noted earlier, sustainability risks are likely to affect insurers in complex ways, and the impact can be very different from one (re)insurance company to another. Scenario analysis provides both insurers and supervisors with a better understanding of the possible impacts of new and emerging risks for which historical observations and probabilities are not representative. The key question will then be how any potential vulnerabilities of insurers and their systemic implications identified on the basis of scenario-based analysis can be addressed using the tools provided in the Solvency II framework. However, the recent ECB/ESRB report provides a framework for macroprudential tools used to manage climate risks that could be explored further for the insurance sector.⁵³

⁴⁹ See amendments to Article 45 of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

⁵⁰ See amendments to Article 132 of the Solvency II Directive as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

⁵¹ See Article 144d as set out in [Proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC as regards proportionality, quality of supervision, reporting, long-term guarantee measures, macro-prudential tools, sustainability risks, group and cross-border supervision and amending Directives 2002/87/EC and 2013/34/EU](#), 19 January 2024.

⁵² See Chapter 2 of ESRB (2018), [Macroprudential provisions, measures and instruments for insurance](#), November.

⁵³ See ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

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As we gain experience in applying the revised Solvency II Directive to sustainability risks, new macroprudential tools could be considered, such as a systemic risk buffer tailored to insurers. Ahead of the Solvency II review, the ESRB proposed in 2020 that a systemic risk buffer (SyRB) tailored to insurers could be used to target sectoral and sub-sectoral exposures that could lead to systemic risk. The ESRB suggested that such an SyRB could be added under the market risk module of the SCR standard formula so that insurance-specific risk-bearing capacities are reflected in the calculation. The ESRB considered how the SyRB could be used to address several types of systemic risk and suggested that it could also be applied, at a sectoral level, to exposures that are sensitive to climate change⁵⁴. In 2023, a joint ECB/ESRB report suggested that the SyRB could be a useful macroprudential tool to address risks to financial stability arising from climate change in the banking sector⁵⁵. However, it would need to be tailored to the specificities of insurance and it may be necessary to take into account exposures through both investments and underwriting.

An SyRB added under the market risk module would complement the concentration risk module in the Solvency II standard formula. The current concentration risk module of the SCR is limited insofar as it focuses on excessive exposures to individual issuers (“single name exposure”). It does not target sectoral or regional clusters of asset exposures, which are relevant in the context of transition and physical risks related to climate change. If a sectoral SyRB was available, authorities could define economic sectors and set suitable risk factors that would result in additional capital requirements being added to the overall market risk module for these insurance companies. As with the concentration risk module, for an SyRB no diversification effects would apply regarding other market risks. Being part of the market risk module, the diversification effects would, however, be considered relative to underwriting risk and counterparty risk. As part of the market risk module, an SyRB would also enter the calculation of loss absorbing effects applied to the SCR⁵⁶.

A sectoral SyRB would need to be applied with the right scope and granularity. As discussed in the recent joint ECB/ESRB report, SyRBs for addressing climate risks can be implemented either generally to all exposures, increasing overall resilience to the uncertain and far-reaching effects of climate change, or to specific exposures and/or sectors where climate risks can be expected to be most relevant. Moreover, an SyRB could be applied as a single rate or it could be more granular, with multiple and differentiated rates applied to different sub-sectors.⁵⁷

A major challenge for sectoral SyRBs would be calibrating them in such a way that they do not discourage insurers from financing companies that engage in decarbonisation processes. Even when applied at (sub)sectoral or regional level to insurers’ investments, an SyRB would take into account neither companies’ current and future emission levels nor their transition plans. Hence, it would be necessary to differentiate not only between sectors or activities that are more or less exposed to climate risks, but also between companies with credible

⁵⁴ See ESRB (2020), [Enhancing the macroprudential dimension of Solvency II](#), February.

⁵⁵ See ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

⁵⁶ See ESRB (2020), [Enhancing the macroprudential dimension of Solvency II](#), February.

⁵⁷ See Chapter 4.2.1.2 of ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

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transition plans and those that are poorly prepared for transition risks. An undifferentiated approach to a sectoral SyRB could become an impediment to financing an orderly transition to a climate neutral economy.⁵⁸ This calibration challenge would also arise for the policy options on a dedicated prudential treatment of fossil fuel-related assets considered by EIOPA.

By associating a sectoral SyRB with a concentration threshold, insurers' exposures to systemic risks could be limited, while also allowing them to invest in companies engaged in transition processes. A sectoral SyRB would then only apply above a certain level of exposure to sectors (or regions) that are expected to experience significant losses due to sustainability risks. However, the new sustainability requirements under Pillars II and III should ensure that insurers target their investments at companies that are engaged in reducing their transition risks. Thus, a concentration limit would enable insurers to support the transition to a sustainable economy. As the calibration of such sectoral SyRBs and concentration thresholds could incorporate new evidence and developments related to climate risks, it could prove to be more flexible and targeted than other ways of implementing some form of dedicated treatment for sustainability risks.⁵⁹

Conclusions

The ESRB welcomes EIOPA's work on the question of whether a dedicated treatment for sustainability risks would be justified for the insurance sector. Sustainability risks will become increasingly severe over the coming years, mainly as a result of climate change and the difficult transition processes needed to mitigate it. These risks are also becoming increasingly important drivers of other risk categories such as market risk, counterparty default risk and underwriting risk; and can be expected to aggravate these risks through different channels and interactions. The consequences are likely to be severe not only for individual insurers, but also for the insurance sector as a whole and for all economic sectors that rely on affordable and effective insurance services. The ESRB considers the question of whether a dedicated treatment would be justified from a macroprudential perspective, taking into account all three pillars of the regulatory framework.

The ESRB takes note that EIOPA does not reach a firm conclusion as to whether a dedicated prudential treatment for sustainability risks would be justified at this time. EIOPA focused its empirical analysis on three areas: (i) risk differentials for certain economic sectors in terms of equity and spread risks as well as property exposures and related transition risks; (ii) risk differentials associated with climate-related risk adaptation measures and reflected in prudential underwriting risks for non-life insurers; and (iii) links between social risks and prudential risks, including market and underwriting risks. Given the methodological and data limitations, EIOPA concludes that – with the exception of equity and spread risks for one sector – there is insufficient evidence to consider policy

⁵⁸ See Chapter 4.2.1.2 of ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

⁵⁹ See Chapter 4.2.1.2 of ECB/ESRB (2023), [Towards macroprudential frameworks for managing climate risk](#), December.

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options for a dedicated prudential treatment. As regards equity and spread risks, EIOPA finds some evidence of risk differentials for fossil fuel-related investments which may support “a dedicated prudential treatment”.⁶⁰ EIOPA does not, however, express a view on whether a dedicated prudential treatment for equity and spread risk is justified.

The ESRB takes the view that it is important to act on sustainability risks as a matter of urgency. The assessment of whether a dedicated prudential treatment for sustainability risks would be justified is likely to evolve as new evidence comes to light, which will inevitably take time. Moreover, even once firmer conclusions can be reached, it will take time to reflect them in Solvency II. While improving the evidence base and capacity to model systemic risks related to climate change is important, the scale of the challenges stemming from climate change means that there is a need for urgent action. This time dimension would also apply to an SyRB adapted to the insurance sector, which this advice to EIOPA views as being a potential new macroprudential tool. This tool should be considered further and might, in the longer term, play a useful role in addressing climate risk. The priority for the near term must be for supervisors to make the best possible use of the new provisions available under the revised Solvency II Directive.

The ESRB believes that the tools and provisions in the revised Solvency II Directive can help address sustainability risks. The revised Solvency II Directive has been strengthened to better reflect and help address sustainability risks. This applies in particular to Pillar II (e.g. risk management including the ORSA) and Pillar III (i.e. reporting and disclosures). For example, under Pillar II insurers are required to develop plans, set targets and monitor financial risks related to sustainability. More precisely, insurers need to consider sustainability risks in both their ORSAs and their investment strategies. Moreover, strengthening disclosure requirements under Pillar III on how insurers deal with sustainability risks could contribute to a more transparent and ultimately better management of such risks.

The ESRB sees national supervisors and EIOPA playing an important role in ensuring that the tools and provisions under the revised Solvency II Directive are transposed and implemented consistently and swiftly. The effectiveness of the Pillar II and Pillar III requirements described in this advice to EIOPA will depend on how they are specified in the technical standards that EIOPA will need to draw up. Moreover, insurers’ compliance with climate change materiality assessments and their use of climate change scenarios in the ORSA will need to be monitored.⁶¹ There is also a need to assess whether the scenarios used by insurers are sufficiently severe and consistent across insurers and jurisdictions. This is an area where information gathering and supervisory convergence have a role to play.

⁶⁰ See EIOPA (2023), **Prudential Treatment of Sustainability Risks**, *Consultation Paper*, 13 December, p. 8.

⁶¹ EIOPA (2022), **Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA**, 2 August.

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The ESRB considers that scenario analysis could be particularly suited to better identify and help address sustainability risks. While it is evident that these risks will affect insurers in many ways, it is difficult to assign probabilities to their possible impacts because patterns observed in the data are unlikely to hold in the face of the unprecedented and accelerating rate of climate change. Therefore, the ESRB believes that it is important to take a forward-looking perspective. The one-off scenario analysis exercise that the European Commission has requested from the European supervisory authorities, the European Central Bank and the ESRB as part of the Fit-for-55 package is one example of such a forward-looking approach.⁶² This exercise may also foster the development of top-down stress-testing models that do not rely on the participation of insurers and that can therefore be deployed more flexibly and at less cost. This would allow authorities to test the impact of longer-term developments as well as possible impacts of sudden changes in the perceptions of how sustainability risks may materialise or how policy changes may become more disruptive. Stress-testing may also help detect interdependencies, including through risk sharing and transfer arrangements.

⁶² European Commission (2023), **Letter on the Assessment of the financial system's resilience to stress in the transition to the EU's 2030 goals for the reduction of greenhouse gas emissions"** .