Sustainability within Solvency II: EIOPA Opinion

On 30 September 2019, EIOPA (European Insurance and Occupational Pensions) published its Opinion on Sustainability within Solvency II. The document was produced at the request of the European Commission, which wanted to know how sustainability, and specifically climate-related developments, are currently and could in future be integrated into the Solvency II framework. The European Commission was interested in the potential impact on insurance underwriting as well as the impact on investments.

During the past year, EIOPA has consulted with the insurance industry as well as the scientific community to develop the views it has expressed in this Opinion. Below, we discuss some of the key points from the Opinion, the responses provided by participants and the analysis performed by EIOPA.

Valuation of Assets and Investment practices

Solvency II is based on the principle of using fair values for assets – where possible, observable market prices are used. These prices are assumed to reflect all relevant risks, including sustainability risks. But the availability and quality of information on sustainability is currently limited, which inhibits the transmission into asset valuations.

Insurers as a group are important institutional investors and their investment practices can impact sustainability factors. EIOPA would like to see more transparency on sustainability risks, both from insurers and ESG ratings providers. This will help insurers to better take into account the longer-term risks in their portfolios and develop more sustainable investment strategies. Matching portfolios require specific focus on the insurer's ability to hold assets to their full term from a sustainability perspective.

Valuation of Liabilities and Underwriting practices

EIOPA believes that insurers should use the best available science to calculate best estimate liabilities. As a minimum, this should include historical loss data combined with scientific literature, and where appropriate insurers should use forward-looking models. The renewal cycle is an important driver of the modelling horizon: for business that renews every year, there is an annual opportunity for repricing and calibration, which should incorporate more sustainability-related information as this becomes available. For long-dated business, insurers should consider the longer-term impact of climate-related risks in calculating the best estimate. This is then updated periodically.

Insurers can also impact sustainability factors through their underwriting practices. The pricing of insurance products influences demand and overall coverage. Including ESG considerations in insurance pricing may have a positive influence on behaviour, but it may also render insurance for certain risks unaffordable. Improved data-gathering and sharing within insurance companies, across the industry and more widely, can reduce any protection gap.

Capital requirements

EIOPA believes that the key climate-related risk drivers on the market risk side are property risk, equity risk and spread risk. More granular data is needed to better quantify the property risk, for example by having standard and "sustainable only" property total return indices. For equities, there are "sustainable" versions of a number of large indices that have a certain history across which they can be compared to their standard equivalents. EIOPA found no significant difference in performance in the indices it analysed[1], which could be the result of lack of history, overlaps between standard and sustainable indices (for comparisons between indices), or the lack of a uniform taxonomy on sustainability[2].

For the calibration of the sustainability component of spread risk, EIOPA is pinning its hopes on green bonds. If a representative set of green bonds and a representative set of non-green bonds can be identified, the spread volatility of the two sets can be compared. The sets would need to be large enough and cover different industries, geographies, rating levels and maturity buckets.

On the liability side, the obvious climate related risk is natural catastrophe risk. To the extent that these risks are regularly re-calibrated on a forward-looking basis, insurers could prepare themselves adequately for climate-related changes to this risk. Current Solvency II capital requirements have been calibrated to historical data. EIOPA also recommends further investigation into whether risks such as drought or wildfires could be better captured in the natural catastrophe risk module.

1. MSCI World Developed (reference index), MSCI World All USD, MSCI Environmental USD, Dow Jones Sustainability World
2. The EU has established a Technical expect Group on Sustainable Finance, which produced a Taxonomy Technical Report in June 2019. https://ec.europa.eu/info/files/190618-sustainable-finance-teg-report-taxonomy_en

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The time horizon issue

One of the key issues insurers and regulators have to deal with when thinking about incorporating sustainability, is a difference in time horizon. This can be seen in three areas.

1. Capital requirements in Solvency II are calibrated based on a one-year time horizon, while sustainability risks – especially climate change risks - are generally considered to be longer-term risks.
2. The renewal cycle for much of the non-life market is typically 12 months, which creates regular opportunities for the repricing of risk based on newly accumulated experience.
3. Many insurance investors believe that since climate change risk is still (and slowly) emerging, they will have time to adapt their investment strategy over a number of years.

EIOPA believes that this difference in time horizon should not stop insurers from analysing the risks and getting prepared. Solvency II will continue to operate on a one year horizon, but insurers can complement the SCR calculation with scenario analysis and stress testing. The Own Risk and Solvency Assessment (ORSA) is the natural place for this. Whilst EIOPA acknowledges that different insurers can have very different risk profiles, it believes that the industry would benefit from a consistent set of quantitative parameters to apply in these analyses. EIOPA supports the idea of mandatory public disclosure of sustainability risks.

Some insights from participant responses

Overall, European institutional investors are known to be leaders in ESG integration, but judging from the responses to EIOPA's consultation, European insurers do not appear to be consistent contributors to this leadership. Whilst 70% of respondents to the consultation state they have implemented sustainability in their investment practices or are planning to do so in the next few years, over 75% of respondents say they are currently not explicitly taking climate risk into account in their best estimate liability calculations. There are also significant differences across types of insurers. According to a survey by the French prudential regulator ACPR in 2018[1], 93% of insurers with natural catastrophe risk on the liability side of their balance sheet also take physical climate related risks into account on the asset side, whilst for all surveyed insurers the percentage is only 38%. Whilst this is not surprising, it does point to significant room for improvement.

Practical implications for insurance companies

Whilst this Opinion does not contain any impending changes to the regulatory framework of Solvency II, there is a clear direction of travel: insurance companies should expect increasing regulatory scrutiny of the extent to which they incorporate sustainability factors into their investment and underwriting policies and practices. Given the time horizon issues and the lack of hard quantitative evidence to support the calibration of sustainability factors in the SCR calculations, EIOPA guides insurers towards scenario analysis and stress testing to be executed and published as part of the ORSA. There is no reason why insurers cannot start with this work now, although EIOPA acknowledges the possible difficulties in comparing results across insurers given the lack of a uniform taxonomy for sustainability factors.

EIOPA also makes the point that there is no excuse for incorporating sustainability analysis on one side of the balance sheet but not the other. Again this is an area where insurers can take steps now, in the knowledge that their regulator will start focusing on it in the future.

In terms of investment strategy, the preponderance of available sustainable investment products stands in stark contrast to the lack of consensus on taxonomy and the lack of "open source" sustainability information. Insurers will need to develop their own ESG policies and develop or amend their investment strategies to bring them in line with these policies. When the taxonomy and data work starts resulting in a degree of convergence, it should become easier to select appropriate investment strategies.

Fixed income is the dominant asset class for most insurance companies, and EIOPA has not provided the results of any quantitative analysis for this asset class in its Opinion. It gives some guidance on how green bonds could be used for calibration, but it is unclear how the results of such calibration would translate to the ever-increasing proportion of illiquid credit assets (e.g. residential mortgages, credit cards or trade finance) on the balance sheets of many insurers. Another issue not addressed in this Opinion is the impact on buy-and-hold portfolios such as Matching Adjustment portfolios.

For equities, the lack of differentiation between the risk/return profiles of the main indices and their sustainable equivalents has complicated EIOPA's efforts to identify a sustainability risk premium or risk factor. But it does not stop insurance investors from making sensible investment decisions around sustainable equities. Insurance investors are not tied to indices in the way EIOPA is, and this creates an opportunity to escape the vagaries of their rules of constitution. For example, an insurer could invest in a multifactor equity strategy that is benchmarked to the MSCI World or a similar global index, but achieves 40%-60% reduction in carbon intensity using only a fraction of the benchmark index universe. Whether such a strategy should be benchmarked to the standard MSCI World or its sustainable equivalent with the same return distribution remains a point for discussion for now.

1. https://acpr.banque-france.fr/sites/default/files/medias/documents/as_102_climate_change_insurers_en.pdf

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