

## SUSTAINABILITY RISKS AND CHALLENGES IN INSURANCE



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### Main progresses expected from the Solvency II review on sustainability risks

In the context of the many works related to sustainability in insurance, the integration of sustainability considerations in Solvency II is certainly crucial. On the one side, the prudential regulatory framework should allow a satisfactory mitigation of the sustainability risks borne by the insurers (outside-in risks) and, on the other side, regulation itself could be a catalyst of the integration of sustainability considerations in the insurers' business model, and therefore a booster for insurers' positive impact on sustainability issues (inside out risks).

Even though at the moment the focus is almost exclusively on environmental risks, EIOPA, in the last few years, has produced a number of works in this area, starting from the (positive) assessment of

the capability of the overall framework to integrate sustainability risks and then covering all the three pillars.

The on-going review of Solvency II will provide, among other things, the opportunity to make any concrete adjustment to the Pillar 1 legal framework, based on the analysis done. The Commission's proposal includes two mandates for EIOPA: one on the periodic review of the calibration of NAT CAT capital charge and the other on the assessment of a possible dedicated prudential treatment of assets aligned with environmental objectives. EIOPA, on its own initiative, has also undertaken an assessment of the need for a differential treatment of insurance liabilities related to contracts that include climate-related adaptation measures.

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It is too early to discuss the expected results of these works. Certainly, EIOPA is facing challenges that could influence their outcome. Supervisors have always stated that capital requirements should be risk based and supported by clear evidence. Both criteria are difficult to apply in this case. The measurement of riskiness is challenged by the expected instability over time of sustainability risks; such instability limits the relevance of past evidence. At the same time, historical data are difficult to collect with enough accuracy, mainly due to the still incomplete implementation of the EU Taxonomy and the consequent lack of standardized reporting practices by companies.

More specifically, the work on NAT CAT consists in a new and – looking ahead – more frequent calibration of the parameters for this risk module, with the aim to consider the expected increase of the damages due to the climate change. Here the main challenge is to calibrate the parameters to capture the expected future dynamic of the frequency and intensity of the damages.

The analysis on assets faces the same type of problem, likely with increased complexity. Here there is the need to measure the expected risks (i.e. spread, equity and property risks) of the “green” (or alternatively “brown”) assets in the context of a very dynamic evolution of the market factors that can influence their value. For example, the financial characteristics of the markets where sustainable assets are traded could reasonably be expected to differ from the markets of other type of assets but, at the moment, it is probably difficult, if not impossible, to find clear evidence of that, as these markets could not yet be sufficiently defined and mature. In addition, the identification of the “green” assets itself is complex, due to the still persistent incompleteness and uncertainty of the taxonomy application.

The work on insurance liabilities aims at identifying the riskiness (i.e. the level of premium and reserve risk) of the subset of insurance contracts that include consideration of prevention measures in the definition of the contract performances. Here there is also the challenge to identify these contracts. A specific request has been addressed to the industry for this purpose.

Overall, the outcome of these works will be affected by the availability of data with sufficient quality to be used in the analysis as well as by the ability to properly extrapolate past data to predict a rapidly evolving future. The latter task will certainly leverage on advanced, forward looking model technics but, in my view, it will not be able to avoid supporting quantitative analysis with reasonable qualitative considerations, without abandoning the evidence-based approach.

Prudential regulation should remain risk based. However, balancing quantitative evidence with grounded qualitative considerations will likely be critical to design a prudential framework that supports sustainability risk protection, but also is conducive to the achievement of wider sustainability objectives. This also implies reviewing these considerations over time, in line with the evolutionary features of sustainability issues. As many other workstreams in the field of sustainability, also its integration in capital requirements is not a short term exercise.