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European Commission proposal for review of Solvency II Directive

ClientEarth feedback

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Top Lines

ClientEarth welcomes that the Commission is introducing enhanced rules on climate change scenario analysis, in its proposal for amendments to Solvency II (the "**Proposal**"). However, the Commission should use this opportunity to improve the management of climate-related risks in the Solvency II regime by making the following amendments to the Proposal:

- Scenario analysis: More detail is required on scenario analysis requirements. In particular: (1) insurers should be required to at least model scenarios based on assumptions of extreme warming (3°C or more), orderly transition limiting warming to under 2°C, and disorderly transition; and (2) the minimum duration to be modelled in climate scenario analysis should be specified (for example, 30 years).

- Double materiality: The Pillar 2 risk management system requirements should be amended to expressly provide for insurers to assess and manage the environmental and social impact of their underwriting activities (in addition to managing their exposure to environmental and social risks).

- Capital requirements & fossil fuels: The Commission should introduce rules to enhance capital requirements for investments and insurance liabilities related to fossil fuels as soon as possible, in view of the significant climate-related risks they are exposed to. At a minimum, the Proposal should be amended to direct EIOPA to fast-track an analysis of the capital treatment of fossil fuels (for example by June 2022), in order to accelerate the process for amendments to the capital regime.

Background

Scenario analysis requirements

1. Climate change scenario analysis is vital for insurers to assess their longer-term exposure to climate-related risks, and we therefore welcome that the Proposal includes a requirement for insurers to conduct such analysis. However, as currently drafted, the Proposal could allow insurers to conduct scenario analysis that does not fairly and accurately assess the climate-related risks to which they are exposed. In particular, more detail is required on the choice of scenarios and the minimum duration that must be modelled.

   Scenario choice

2. The Proposal provides for two scenarios: one where warming *"remains below two degrees Celsius"*, and one where it is *"equal to or higher than two degrees Celsius"*. This does not specify sufficient detail to ensure the scenarios are meaningful and reflect the range of climate-related risks that insurers are exposed to. In particular, it does not ensure that the scenarios reflect the risks of either extreme warming or disorderly transition:

a. The Proposal allows a scenario of just 2°C warming to be used as the warmer scenario, which would not reflect the risk of extreme warming. It is estimated, based on current policies and action, that the world will warm by between 2°C and 3.6°C by 2100.[1]

b. The Proposal does not specify any assumptions regarding the nature of the transition. A late and disorderly transition that involves delayed and sharper emissions reductions poses heightened transition risks, compared to an early, orderly transition.[2] These risks would not be reflected in scenario analysis, if only an early and orderly transition is modelled.

3. We therefore propose that the Commission at a minimum requires insures to model each of scenarios (a) to (c) below. These closely reflect the scenarios designed by the Network for Greening the Financial System,[3] as well as scenario analysis requirements that are already being introduced by the Financial Conduct Authority for asset managers and owners in the UK in order to capture the risks of extreme warming and disorderly transition:[4]

   a. *Hothouse world*: assumes only currently implemented policies are preserved (and that current commitments, which are not yet reflected in policy, are not met) and emissions continue to rise, with high physical risks and severe social and economic disruption and failure to limit temperature rise, leading to 3°C or more of warming.

   b. *Orderly transition*: assumes that climate policies are introduced early and become gradually more stringent, reaching net-zero emissions around 2050 and likely limiting warming below 2°C.

   c. *Disorderly transition*: assumes climate policies are delayed or divergent, requiring sharper emissions reductions achieved at a higher cost and with increased physical risks in order to limit temperature rise to below 2°C.

Duration

4. The Proposal provides that scenario-analysis should be *"long-term"*, but does not specify what this means. This allows for insurers to set an inappropriately short timeframe for the scenario analysis, which would be ineffective to assess longer-term climate risks. For example, the Directive could clarify that long-term scenario analysis should model at least 30 years (which would cover the planned transition to net-zero emissions by 2050). We note that, in the UK, the Prudential Regulation Authority states that long-term climate-related scenario analysis should be *"in the order of decades"*.[5]

Double materiality

5. The Commission should amend the Pillar 2 risk management system requirements (under Article 44 of Solvency II) to expressly provide for 'double materiality' in relation to environmental and social matters. This would require insurers to assess and manage the impact of their activities (including

[1] Climate Action Tracker, Glasgow's 2030 credibility gap (November 2021).
[2] See Carbon Tracker, Handbrake Turn: The cost of failing to anticipate an Inevitable Policy Response to climate change (2020).
[3] NFGS, Climate Scenarios for central banks and supervisors (June 2020).
[4] See FCA, PS21/24: Enhancing climate-related disclosures by asset managers, life insurers, and FCA-regulated pension providers (December 2021) at Annex B page 17. See also PRA Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change (April 2019) which suggests that scenarios modelling both orderly and disorderly transition be modelled at page 7.
[5] PRA Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change (April 2019).

underwriting) on environmental and social matters, including climate change (in addition to managing the risks they are exposed to from such matters). We propose this for the following main reasons:

a. Introducing double materiality for environmental and social risk management would reflect EIOPA's advice to the Commission in its Opinion on Sustainability within Solvency II,[6] which states that it is "*prudentially relevant to require undertakings to take into account the impact of their underwriting activity on sustainability factors"* and that insurers should *"contribute to adaptation to and mitigation of climate change"*.

b. Other regulation already requires insurers to take into account their environmental and social impact (in addition to environmental and social risks) in relation to their investment strategy and decisions,[7] as well as in the risk disclosures in their annual reports.[8] In our view, there is no good reason why a similar double materiality requirement has not been included for insurers' underwriting strategy and decisions.

c. Introducing an express requirement for insurers to consider the impact of their underwriting activities on climate change in their risk management systems will help mitigate the sector's contribution to climate change, and therefore mitigate the financial risks that climate change poses to the insurance sector. Extreme warming poses significant risks to insurers, including the possibility that certain risks could become uninsurable, as well as macro-economic and financial stability risks to insurers' asset portfolios.[9] In light of these risks, insurers acting prudently should in fact already be setting risk management strategies that seek to minimise their contribution to climate change.

d. The requirement for insurers to consider the impact of their underwriting activities on climate change would also help to achieve the Commission's 2030 Climate Target Plan and its aim for the EU economy to reach net-zero emissions by 2050.

Fossil fuel capital requirements

6. The Commission should amend the Proposal to direct EIOPA to fast-track an analysis of the capital treatment of fossil fuels (for example by June 2022), in order to accelerate the process for amendments to the capital regime.

7. Investments and insurance liabilities related to fossil fuels (and in particular, new fossil fuel projects) face significant climate-related risks. In addition, climate change poses macro-economic and financial

[6] EIOPA, Opinion on Sustainability within Solvency II (September 2019). See paragraph 4.16 to 4.19. See also EIOPA's Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD at paragraph 114.

[7] An amendment to the Solvency II Delegated Regulation provides that insurers should take into account the potential impact of their investment strategy and decisions on sustainability factors. See Commission Delegated Regulation (EU) 2021/1256 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings (which applies from 2 August 2022) at Article 275a.

[8] The Non-Financial Reporting Directive introduced a requirement for double materiality, which is clarified in the Commission's proposals for a Corporate Sustainability and Reporting Directive. See Directive 2014/95/EU amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups at Article 29a and the Proposal for a Directive amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting at Article 19a.

[9] See our letter to European Commission (9 July 2021) for further detail on these risks.

stability risks that impact the whole insurance sector, and may lead to certain types of risk becoming uninsurable. For further information on such climate-related risks, see our letter to the Insurance and Pensions Unit of the Commission on 9 July 2021 in support of enhanced capital requirements for fossil fuel-related assets and liabilities.[10]

8. We consider that current Solvency II capital requirements do not adequately reflect the risks of assets and liabilities related to fossil fuels. In a letter dated 27 October 2021 from a coalition of NGOs (including ClientEarth) to the President of the European Commission and others, we called for fossil fuel investments and underwriting to have the highest risk category under Solvency II, and for the financing and underwriting of new fossil fuel projects to be subject to a 100% capital requirement.[11]

9. The Proposal does not include any amendments to capital requirements to better reflect climate risk. Instead, it provides that EIOPA should submit a report by 28 June 2023 on the prudential treatment of exposures that relate to environment or social objectives, or harm to such objectives.

10. We welcome that EIOPA will conduct such a review. However, the timing of the report is too late to ensure that the insurance sector allocates sufficient capital to reflect climate risks during the upcoming transition. The next decade is crucial for climate action, as has been noted by the 197 state signatories to the Glasgow Climate Pact, and nations are increasingly setting ambitious targets for emissions reduction by 2030. However, if all proposals for enhancing the capital regime to better safeguard against climate risks are delayed until after the report is filed in June 2023, this will mean that any proposals are unlikely to be implemented until 2025 at the earliest (and possibly later). In the interim, the insurance sector will continue to invest in assets and insure liabilities related to fossil fuels that pose both risks to individual insurers and systemic risk arising from climate change.

11. We consider that the Commission should take a precautionary approach and enhance capital requirements for assets and liabilities related to fossil fuels now (in advance of EIOPA's report). However, if the Commission does not amend capital requirements in relation to fossil fuels at this stage, at a minimum it should bring forward the deadline for EIOPA's analysis of the capital treatment of fossil fuels (for example to June 2022) in order help accelerate future legislation on the issue. The remainder of EIOPA's review of the prudential treatment of exposures that relate to environment or social objectives (which deals with a much broader set of risks) could follow at the currently proposed date of June 2023.

[10] ClientEarth, Letter to European Commission (9 July 2021).
[11] https://www.finance-watch.org/campaign/climaterisk/.

Joanne Etherton

Acting Head of Climate

jetherton@clientearth.org

www.clientearth.org

Dan Eziefula

Lawyer, Climate Finance

deziefula@clientearth.org

www.clientearth.org

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