ClientEarth

February 2021

ClientEarth Consultation Response

HM Treasury Call for Evidence

Review of Solvency II (October 2020)

ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding practical solutions for the world's biggest environmental challenges. From our offices in London, Brussels, Warsaw, Berlin, Madrid, Beijing, Luxembourg and Los Angeles, we work on laws throughout their lifetime, from the earliest stages to implementation and enforcement.

1 Introduction

1. ClientEarth welcomes the fact that the Call for Evidence recognises that the *"prudential regulatory regime should help the insurance sector support the Government's objectives in relation to climate change"* and that, in particular, it seeks input on ways to better reflect climate risks in both the matching adjustment ("**MA**") and solvency capital requirement calculation ("**SCR**"). We set out below our response to questions in the Call for Evidence in relation to the MA and SCR.

2. In addition, the Call for Evidence invites comments on areas of Solvency II not specifically covered in the paper. Urgent action is needed to ensure that private sector financial flows are

aligned with environmentally sustainable growth (in line with the objectives of the Government's Green Finance Strategy) and with a pathway towards low greenhouse gas ("**GHG**") emissions (in accordance with the Paris Agreement). Accordingly, as set out below, we urge the Government to use the opportunity of the Solvency II review to introduce new requirements for insurers to adopt and implement strategies in line with the goals of the Paris Agreement[1] ("**Paris Agreement Goals**") and to take into account the impact of their activities on sustainability factors (including climate change) in their risk management systems.

3. We recognise that the Treasury is in the process of developing proposals for amending Solvency II and that they may be subject to further consultation. We would welcome the opportunity to input further into the development of the proposals, in advance of any further consultations. Please contact Dan Eziefula at DEziefula@clientearth.org if you would like any further input from us.

2 Matching adjustment

Question 4 - What changes, if any, should be made to the eligibility of assets for the matching adjustment?
Question 5 – What changes, if any, should be made to the calculation of the matching adjustment?
Question 8 – What changes, if any, to the matching adjustment could be made to better reflect climate change-related risks arising from investments and contribute to sustainable investment?
Question 9 – What are the costs and benefits of any changes proposed in response to the above questions? How should any risks to the safety and soundness of insurers and/or to policyholder protection be mitigated?

4. In ClientEarth's view, investments in fossil fuel or GHG intensive projects and companies should be ineligible for the MA, for the reasons set out below.

5. The Call for Evidence recognises that *"Insurance firms that hold assets for a long period may be exposed to increased levels of transition risk arising from climate change"*, and in particular notes the risk of stranded assets. We agree with this assessment, and support the development of proposals that would better reflect climate transition risks in the MA.

6. While transition risks will affect a variety of asset types, investments in fossil fuel projects and companies will likely face the most significant transition risks. They are exposed to the risk of falling prices in fossil fuels (in light of both future regulatory developments, and falling market demand as companies increasingly recognise the financial and reputational imperative to align

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[1] In particular, Article 2.1.a of the Paris Agreement under the United Nations Framework Convention on Climate Change sets the goal of *"Holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels"* and Article 2.1.c sets the goal of *"Making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"*.
See https://unfccc.int/sites/default/files/english_paris_agreement.pdf.

their business models with Paris Agreement Goals) as well as the risk of stranded assets.[2] These risks are particularly high for investments in companies expending capital on new fossil fuel projects, which will likely need to continue production for a significant period in order to be economically viable. In addition, companies outside the fossil fuel sector that also have high GHG emissions will also face significant transition risks, as they will need to reorient their business models to align with the necessary significant emissions reductions.

7. Such transition risks are by their nature complex and unpredictable, and yet can manifest in a short timeframe. This is recognised by the PRA. In its Policy Statement PS14/20 *Solvency II: Prudent Person Principl*e, it stated*: "The PRA notes that some risks (such as climate transition risk and political risk) are complex and poorly understood and, therefore, will be more difficult to manage. The PRA expects firms to pay particular attention to such risks in their investment risk management policies"*.[3] The objectives of the MA (which seeks to recognise that matching long-term assets to long-term liabilities reduces risk) are fundamentally incompatible with the kinds of complex and unpredictable risks faced by long-term investments in fossil fuel or GHG intensive projects and companies. Applying the MA to such investments may therefore result in insurers having insufficient technical provisions, in view of the climate transition risks they are exposed to.

8. In addition, the MA incentivises insurers to invest in eligible long-term assets. However, incentivising investment by insurers in fossil fuel and GHG intensive assets could undermine the objectives of the Government's Green Finance Strategy (including the goal of *"Aligning private sector financial flows with clean, environmentally sustainable and resilient growth"*).

9. In view of the above, we urge the Treasury to determine that bonds and other investments which are issued by or linked to fossil fuel or GHG intensive projects or companies should be ineligible for the MA.

10. Fossil fuel or GHG intensive projects and companies will need to be defined for these purposes. Fossil fuel or GHG intensive projects should be framed broadly, and should include any investment (including project bonds) in any projects, plants or infrastructure related to the extraction or production of fossil fuels (for example, including related transport infrastructure), as well as any non-fossil fuel projects that are projected to emit over a threshold amount of GHG over their lifetime. Fossil fuel or GHG intensive companies should also be framed broadly, for example including any companies that: (1) are planning any new fossil fuel projects or expansions to existing projects or capacity (in light of the particular risk of further capital expenditure on new projects, as outlined above); (2) derive over a threshold percentage of their revenues from fossil fuel extraction or production; (3) produce over a certain threshold

[2] Analysis by Carbon Tracker indicates that seven oil and gas firms wrote down assets totalling $87 billion within a nine month period in 2019-2020. See https://www.theguardian.com/business/2020/aug/14/seven-top-oil-firms-downgrade-assets-by-87bn-in-nine-months.

[3] See also: PRA *'Supervisory Statement SS1/20: Solvency II: Prudent Person Principle*, which also makes the same point, at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2020/ss120.pdf; and PRA *'Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change'* which outlines some of the risks posed to insurers from climate change.

amount of energy from fossil fuels; or (4) emit over a threshold amount of GHG globally. The applicable thresholds should be set following further consultation.

11. The approach outlined above relates to investments in fossil fuel or GHG intensive projects and companies. Other types of asset are also exposed to long-term climate transition risks. For the avoidance of doubt, we would welcome other amendments to the MA that serve to better reflect the exposure of other types of asset to long-term climate transition risks. For example, we would support the development of proposals in respect of assets in other sectors that are exposed to significant climate risks, in particular in respect of investments in companies that do not have credible transition strategies.

3 Calculation of the solvency capital requirement

Question 16 – What changes, if any, should be made to the SCR calculation to promote better measurement and capitalisation of climate change-related risks?

12. The Call for Evidence recognises that *"the one-year time horizon on which the SCR is based may not be well suited for long-dated risks such as those arising from climate change, which may not become apparent for many years"*. ClientEarth welcomes this acknowledgement and supports the development of proposals to better reflect climate risks in the SCR.

13. We suggest that any proposals should look at better reflecting both: (1) the impact of climate risks on liabilities; and (2) the exposure to climate risks of the assets used to cover liabilities.

14. On the liability side, we would suggest that the Treasury considers ways to better reflect the impact of climate change on natural catastrophe risks in the SCR. For example, see EIOPA's recent discussion paper on amending the natural catastrophe standard model to reflect climate risks.[4]

15. On the asset side, as noted above, climate transition risks are complex and unpredictable. We would therefore suggest that the Treasury considers ways to increase capital requirements for insurers with portfolios weighted towards asset types with higher climate transition risks. As outlined above, fossil fuel or GHG intensive projects and companies are particularly exposed to such risks, and we would support the development of proposals to reflect this in the SCR.

[4] EIOPA '*Discussion Paper on methodology on potential inclusion of climate change in the Nat Cat standard formula'* BoS-20/666 dated 2 November 2020 at https://www.eiopa.europa.eu/content/discussion-paper-methodology-potential-inclusion-of-climate-change-nat-cat-standard-formula.

4 Paris-aligned strategies

Question 29 – What, if any, areas of Solvency II not covered elsewhere should be considered for review?

16. The review of Solvency II provides an opportunity to expand the existing Pillar II risk management requirements to mandate that insurers adopt strategies to align their businesses with Paris Agreement Goals and, in particular, to achieve net-zero emissions (including emissions from the companies and activities which the insurer underwrites and invests in) by 2050.[5] The Government's Green Finance Strategy states that the Government is committed to *"Exploring initiatives to accelerate the alignment of financial flows to the Paris Agreement's objectives"* and to *"Aligning private sector financial flows with clean, environmentally sustainable and resilient growth"*. Furthermore, as a signatory to the Paris Agreement, the UK is committed to *"making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development"*.[6] However, this commitment in respect of private sector financial flows is not yet adequately reflected in national legislation.

17. The imposition of such a requirement is supported by the Advisory Group on Finance for the UK's Climate Change Committee, which has recently recommended[7] that the UK should commit to being a net-zero financial system and that it be mandatory for all financial institutions to adopt targets and plans for net-zero emissions by 2050. It has advised that a shift in focus away from managing climate risks and towards net-zero goals is necessary in order to deliver on the UK's Paris Agreement commitments. A regulatory framework based on climate risk management (with each insurer focussing only on managing its own individual financial exposure) is not sufficient[8] to prevent insurers contributing to warming in excess of Paris Agreement Goals that would have significant consequences for the insurance industry as a whole, as well as system-level macro-economic and financial stability consequences which could harm the entire global economy.[9]

18. The insurance industry is uniquely exposed to the risks from climate change, being directly exposed to physical risks through insurable events, as well as being exposed to climate risks

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[5] The best available science indicates that, in order to limit warming to 1.5ºC above pre-industrial levels, global emissions must decline by 45% from 2010 levels by 2030 and reach net zero by 2050. See the Intergovernmental Panel on Climate Change (2018), *'Special report on global warming of 1.5ºC'* at https://www.ipcc.ch/sr15/chapter/spm/.

[6] See Article 2.i.c of the Paris Agreement under the United Nations Framework Convention on Climate Change.

[7] In its December 2020 paper for the Sixth Carbon Budget Advisory Group *'The road to Net-Zero Finance'*.

[8] Ben Caldecott (2020*), 'With the TCFD in its fifth year, it's time to make 'net zero' mandatory for financial institutions'*, Responsible Investor, at https://www.responsible-investor.com/articles/with-the-tcfd-in-its-fifth-year-it-s-time-to-make-net-zero-mandatory-for-financial-institutions.

[9] See for example: Network for Greening the Financial System (2019), *'Technical supplement to the First NGFS Comprehensive Report'* at https://www.ngfs.net/en/technical-supplement-first-ngfs-comprehensive-report.

through their asset portfolios.[10] Warming in excess of Paris Agreement Goals will increase the degree of risk and uncertainty for certain insured risks (in particular, natural catastrophe cover for extreme weather events) and could lead to them ultimately becoming uninsurable.[11] In addition, extreme warming and/or disorderly transition pose significant risks to insurers' asset portfolios.

19. Insurers running effective risk management systems (under the existing regulatory regime) should seek to mitigate these risks by setting net-zero targets and putting in place an effective strategy to meet those targets. Increasing numbers of insurers are recognising this reality and have voluntarily set net-zero emission targets for their direct emissions and asset portfolios.[12] However, in practice many have not yet done so, and in particular progress has been poor in respect of targeting net-zero emissions in underwriting portfolios. Furthermore, as there is no regulatory framework for setting net-zero emission targets, many firms have set net-zero targets without yet setting meaningful short and medium term targets, or without adequate measures for transparency and accountability. This runs the risk that some commitments could be greenwashing, rather than reflecting actual business imperatives, and could potentially mislead investors and customers as to their efficacy.

20. In view of the above, we consider that mandating Paris-aligned strategies is a fundamental step towards ensuring the resilience of the UK insurance industry and preventing the industry from contributing to system-level financial risks, and it will pave the way for the industry's sustainable, long-term growth. In addition, such an approach would encourage innovation within the UK insurance market and the development of new green insurance products. Furthermore, it would solidify the UK's reputation as a leader in green finance, in advance of COP 26 and following the UK's exit from the EU. It is imperative that this action is taken as soon as possible, as taking earlier policy action will result in a smoother transition and will make it easier for firms to plan for the impact of transition on assets.[13]

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[10] See for example: PRA *'The impact of climate change on the UK insurance sector'* at https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-impact-of-climate-change-on-the-uk-insurance-sector; PRA *'Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change'* at https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss; and Bank of England *'Quarterly Bulletin 2017 Q2: The Bank of England's response to climate change'* at https://www.bankofengland.co.uk/quarterly-bulletin/2017/q2/the-banks-response-to-climate-change.

[11] See PRA (2015) *'The impact of climate change on the UK insurance sector'* at paragraph 3.39 and Swiss Re *'Socio-economic developments and climate-change effects to drive rising losses from severe weather* events' at https://www.swissre.com/media/news-releases/nr-20200408-sigma-2-2020.html.

[12] See for example the Net Zero Asset Owners Alliance, https://www.unepfi.org/net-zero-alliance/alliance-members/.

[13] See Carbon Tracker (2020), *'Handbrake Turn: The cost of failing to anticipate an Inevitable Policy Response to climate change'* at https://www.carbontracker.org/reports/handbrake-turn/.

21. We would urge the Government to use this opportunity to require insurers to:

    a. Adopt and implement a credible transition strategy to align their businesses with the Paris Agreement Goals and to achieve net-zero emissions (including Scope 1, 2 and 3 emissions) by 2050 at the latest.

    b. As part of that strategy, adopt short, medium and long-term emission reduction targets, including 2025 and 2030 targets.

    c. Seek annual shareholder approval for their transition strategy (including the interim targets), where publicly listed.[14]

    d. Disclose the insurer's transition strategy and targets (including the insurer's underlying methodologies for setting targets and measuring progress) and report annually on progress against them.

    e. Allocate responsibility for implementing the transition strategy to specific individuals within the insurer, and adopt a remuneration policy that incentivises senior managers to implement the insurer's transition strategy and to meet the targets.

22. ClientEarth's October 2020 position paper *'Principles for Paris-alignment'*[15] sets out further detail on the principles that we consider should underpin any net-zero emission targets. As noted above, the targets should include reductions in emissions from insurers' underwriting and asset portfolios. Such reductions can be driven by requiring counterparties to adopt credible and effective Paris-aligned strategies before providing coverage or renewals and through stewardship activities as shareholders. However, these must drive actual reductions in emissions (as monitored by the insurer and disclosed annually) and therefore cannot rely on long-term net-zero commitments made by companies which do not in practice result in short-term emission reduction. In addition, any transition strategy must include a specific strategy for reducing emissions associated with fossil fuel companies within the insurers' underwriting and investment portfolios, in view of the significant transition risks faced by such companies (as outlined at paragraph 6 above).

23. The above requirement for Paris-aligned strategies should also be applied to Lloyd's of London (including both the Society of Lloyd's and managing agents). Specific legislative provision may need to be made for Lloyd's. In particular, we suggest that the Society of Lloyd's be given a role in setting a mandatory overarching Paris-alignment strategy for the marketplace.

24. We consider that Paris-aligned strategies and net-zero targets should be mandatory for all types of financial institution (not just insurers), in line with the recommendation of the Advisory Group on Finance for the UK's Climate Change Committee. However, as set out above, insurers are particularly exposed to climate risks, and the review of Solvency II represents an opportunity to introduce this requirement for the insurance industry.

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[14] See the Say on Climate initiative at https://www.sayonclimate.org/.

[15] At https://www.clientearth.org/media/40omeroa/2020-10-16-principles-for-paris-alignment-position-paper-ce-en.pdf.

5 Integration of sustainability factors in the prudent person principle and risk management systems

Question 29 – What, if any, areas of Solvency II not covered elsewhere should be considered for review?

25. If the Treasury considers that a requirement for Paris-aligned strategies requires further time to develop and implement, we would urge immediate action as part of the response to this Call for Evidence to introduce a requirement for insurers to take into account sustainability factors, including insurers' impact on sustainability factors (such as climate change), in their investment and underwriting strategies.

26. Whilst the existing rules do not expressly state that insurers must take into account their impact on sustainability risks (including climate change), we consider that a correct interpretation of the rules requires this and would urge the Government to introduce a clarification to this effect. In particular:

    a. In order to have an effective risk-management system in compliance with existing Pillar II rules, insurers should set a risk management strategy that seeks to minimise their contribution (both through their underwriting and their investments) to climate change and the consequent risks that could materially harm their business.

    b. The existing prudent person principle requires insurers to manage the risks to their portfolios and ensure their profitability as a whole. To comply with this, insurers again should set an investment strategy that seeks to minimise their contribution to climate change and the consequent risks that could affect the returns from their portfolio.

    c. The European Insurance and Occupational Pensions Authority's ("**EIOPA**") *Opinion on Sustainability within Solvency II*[16] states that it is *"prudentially relevant"* to require undertakings to take into account the impact of their underwriting and investment activities on sustainability factors and also recommends *"the integration of ESG considerations in the underwriting strategy and decisions"* of insurers.

27. Introducing an express requirement for insurers to consider their impact on sustainability factors (including climate change) would bring the UK closer to meeting its commitment to ensure that financial flows are consistent with Paris Agreement Goals. It would encourage insurers to reduce their contribution to the financial risks posed by climate change, including both the risks posed to the insurance sector (such as the possibility that certain risks could become uninsurable, and the risks posed to insurers' asset portfolios from disorderly transition) and system-level macro-economic and financial stability risks which could harm the

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[16] EIOPA-BoS-19/241 dated 30 September 2019 at https://www.eiopa.europa.eu/sites/default/files/publications/opinions/2019-09-30_opinionsustainabilitywithinsolvencyii.pdf. See also EIOPA *'Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD',* EIOPA-BoS-19/172 dated 30 April 2019 at https://www.eiopa.europa.eu/content/technical-advice-integration-of-sustainability-risks-and-factors-solvency-ii-and-insurance_en.

wider economy (and which undermine the PRA's statutory objective to avoid adverse effects on the stability of the UK financial system). Furthermore, introducing an express requirement would provide a clearer basis for the PRA to take action against insurers that do not have in place adequate strategies for reducing their contribution to climate change.

28. We propose the following amendments to the PRA Rulebook:

    a. The existing prudent person principle[17] requirements state that an insurer should *"only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of its overall solvency needs"* and should invest *"in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio of assets of the firm as a whole"*. These requirements should be amended to expressly include within their scope environmental, social or governance risks that could cause a negative material impact on the value of: (1) the asset; (2) other assets in the insurer's portfolio; or (3) any other business conducted by the insurer (including underwriting).

    b. A new requirement[18] for insurers to take into account the potential long-term impact of their overall investment and underwriting strategies and individual decision-making on environmental, social or governance matters, including on material system-level macro-economic and financial stability risks.

29. We consider that any such investment and underwriting strategy would, in order to be effective, need to include a specific strategy for reducing emissions associated with fossil fuel companies within the insurers' underwriting and investment portfolios (amongst other matters), in view of the significant transition risks faced by such companies (as outlined at paragraph 6 above).

30. The above requirements should also be applied to Lloyd's of London (including both the Society of Lloyd's and managing agents). As with our above submission in relation to Paris-aligned strategies, specific legislative provision may need to be made for Lloyd's. In particular, we suggest that the Society of Lloyd's be required to set a mandatory overarching investment and underwriting strategy for the marketplace that seeks to mitigate the market's impact on environmental, social or governance matters (including climate change).[19]

31. Failure to take further action on these issues now risks the UK falling behind the environmental protections within the EU insurance prudential regime, following the UK's exit from the EU. The European Commission has proposed a draft amendment to the Solvency II Delegated Regulation that would expressly require insurers to consider sustainability risks (including the impact of investments on sustainability risks, such as climate change) when investing in

[17] PRA Rulebook – Solvency II firms – Investments 2.

[18] As an amendment to PRA Rulebook – Solvency II firms – Conditions Governing Business – 3 (Risk Management).

[19] We note that the Society of Lloyd's issued its first Environmental, Society and Governance Report in December 2020. Amongst other matters, it proposes introducing targets for managing agents to phase out financing and underwriting of certain fossil fuel activities, but these will be on a non-binding basis. See https://www.lloyds.com/~/media/files/about/responsible-business/esg/lloyds_esgreport_2020.pdf.

accordance with the prudent person principle.[20] In addition, as noted above, EIOPA considers that the impact of insurers' activities on sustainability factors is prudentially relevant, and recommends the integration of sustainability considerations in underwriting decisions. The UK should be demonstrating leadership in prudential and environmental policy, but at a minimum should keep pace with positive enhancements to the EU regime. The review of Solvency II is an opportunity for the UK to do so.

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[20] See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/11961-Integration-of-sustainability-risks-and-factors-in-relation-to-the-business-of-insurance-and-reinsurance and https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=pi_com%3AAres%282020%292955224.