ClientEarth

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The Joinery
34 Drayton Park
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United Kingdom

The Insurance and Pensions Unit of the European Commission

For the attention of Didier Millerot (Head of Insurance and Pensions Unit)

By email

Dear Sir/Madam,

Review of Solvency II: reflection of climate risks in capital requirements

1. ClientEarth is a charity that uses the power of the law to protect people and the planet. We are international lawyers finding outcome-focused 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.

2. The purpose of this letter is to highlight to the European Commission relevant aspects of the UK Government's review of Solvency II. In particular, indications of the UK Government's position from its Call for Evidence in relation to its review of Solvency II suggest that UK capital requirements for insurers will be amended to better reflect climate risks as part of that review. We urge the European Commission to similarly enhance its reflection of climate risks in EU Solvency II capital requirements. We note that Finance Watch sent a letter to the European Commission dated 4 May 2021, which enclosed Finance Watch's proposals for amendments to Solvency II and the Capital Requirements Regulation (the "**FW Letter**").[1]

Climate risks posed to the insurance sector

3. It is widely recognised that climate change poses significant risks to the insurance sector.[2] In particular:

    a. The transition to a lower carbon world poses significant risks to insurers' asset portfolios.[3] Investments in fossil fuel assets are particularly vulnerable to transition risks, including the risk of stranded assets,[4] falling demand for fossil fuels and falling investor confidence in fossil fuels.[5] Investments in new fossil fuel projects (and in companies that are expending capital on new projects) face the highest transition risks, as such projects are incompatible with the goals of the Paris Agreement ("**Paris Goals**").[6] The International

[1] See the FW Letter on Finance Watch's website.
[2] See for example, PRA 'Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change' (2019), PRA 'The impact of climate change on the UK insurance sector' (2015), and Bank of England 'Quarterly Bulletin 2017 Q2: The Bank of England's response to climate change'.
[3] See for example analysis in PRA, 'The impact of climate change on the UK insurance sector' (2015).
[4] Stranded asset risks are already materialising. For example, 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, as reported in the Guardian.
[5] BloombergNEF, 'New Energy Outlook' (2020).
[6] 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*

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Energy Agency ("**IEA**") has assessed that, in a pathway aligned with limiting warming to 1.5°C: no further capital expenditure on new fossil fuel supply (beyond projects already committed as of 2021) is possible; the energy sector must be net-zero globally by 2040 and in OECD countries by 2035; and all unabated coal and oil plants (and the vast majority of unabated gas plants) must close by 2040. Energy majors will be subject to increasing legal and regulatory requirements to rapidly reduce emissions on a pathway consistent with Paris Goals (including meeting the IEA's targets set out above), as demonstrated by the recent judgment in *Milieudefensie*, *Greenpeace Netherlands and others v Royal Dutch Shell*,[7] in which Shell was ordered to reduce scope 1 to 3 emissions by 45% (compared to 2019 levels) by 2030.

b. Warming in excess of the Paris Goals poses significant macro-economic and financial stability risks to insurers' asset portfolios that cannot be effectively managed through portfolio construction and asset allocation (referred to as *"disruption risk"* in the FW Letter). Such macro-economic impacts will be irreversible and far-reaching in breadth and magnitude, causing a substantial reduction in global GDP compared to a Paris-aligned scenario.[8]

c. Climate change may lead to certain types of risk becoming uninsurable, as a result of either: (1) consumers being unwilling or unable to pay the increased level of premium that insurers require to accept the risk transfer (including as a result of increased reinsurance costs); (2) insurers being unwilling or unable to accept the maximum possible losses arising from risks for solvency capital requirement reasons; or (3) insurers being unable to accurately estimate the frequency and severity of risks in order to price premiums and ensure they have the right amount of technical provisions in place to meet insurance obligations arising from these risks, due to unpredictable and rapidly changing risks.[9] This poses a fundamental risk to the insurance industry, as it has been forecast that extreme warming will lead to a world that is largely uninsurable.[10]

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"*.

[7] Case number / cause list number: C/09/571932 / HA ZA 19-379.

[8] See Network for Greening the Financial System, 'Technical supplement to the First NGFS Comprehensive Report' (2019), Mercer, 'Investing In A Time Of Climate Change — The Sequel' (2019) which finds: *"for nearly all asset classes, regions and timeframes, a 2ºC scenario leads to enhanced projected returns versus 3ºC or 4ºC and therefore a better outcome for investors"*, Swiss Re, 'The economics of climate change: no action not an option' (2021) which finds that global GDP could be 10% lower if the Paris Goals are not met, and 'Bank for International Settlements, 'The Green Swan: Central banking and financial stability in the age of climate change' (2020).

[9] CRO Forum, 'The heat is on' (2019). These risks are recognised by regulators. See for example analysis in PRA, 'The impact of climate change on the UK insurance sector' (2015), EIOPA, 'Discussion paper on non-life underwriting and pricing in light of climate change' (2020), and IAIS and SIF, 'Issues Paper on Climate Change Risks to the Insurance Sector' (2018) which notes that insurers may face difficulty in accurately pricing physical climate risks. See also Swiss Re, 'Socio-economic developments and climate-change effects to drive rising losses from severe weather events' (2020) which finds that unmitigated climate change could jeopardise the insurability of weather risks.

[10] See CRO Forum, 'The heat is on' (2019) which finds *"The 3°C scenario creates real insurability challenges and could therefore challenge the sector"*. See also statements by Henri de Castries (at the time, CEO and Chairman of AXA) that 4°C warming would lead to most assets being uninsurable (reported in Environmental Finance (2015)), by Thomas Buberl (CEO of AXA) that a world warmed by 4°C is *"not insurable"* (One Planet Summit – CEO speech (2017)), and by Jacki Johnson (at the time Group Executive

d. Insurers are exposed through liability cover to the risks of litigation against energy majors in relation to climate change. An increasing number of proceedings have been issued against energy majors alleging liability for their contribution to climate change, as well as proceedings alleging deceptive practices and greenwashing. It is anticipated that liability cover for such proceedings could pose a significant risk for the insurance industry. By way of example, Moody's has warned insurers about liability risks arising from climate change litigation, and has indicated that it therefore views the reduction of cover for coal and other carbon-intensive industries as positive.[11] However, the UNEP Finance Initiative has found that insurers are not currently properly assessing such material litigation risks in a quantitative and scenario-based manner.[12]

4. We consider that these financial risks are not captured adequately by the current Solvency II Pillar 1 capital requirements, and would therefore support enhancing the capital requirements to better reflect climate risks (and in particular, the risks arising from fossil fuel assets and liabilities).

UK review of Solvency II

5. As you will be aware, the UK Government is currently conducting a review of Solvency II. HM Treasury ("**HMT**") issued a Call for Evidence in relation to this review, which closed in February 2021.[13] In that Call for Evidence, HMT recognised that climate change has *"profound implications"* for the insurance sector, and sought views on how to better reflect climate risks in the matching adjustment and solvency capital requirement ("**SCR**") calculation.

6. In particular, HMT recognised that long-term transition risks (including the risk of stranded assets) are relevant to the matching adjustment, and that the matching adjustment may need to be enhanced to better reflect those risks.[14] In addition, HMT noted that, whilst the SCR is the *"logical place"* for firms to allow for climate risks, the current SCR calculation is not well suited to reflecting long-term climate risks. We set out some relevant extracts from the Call for Evidence in the Annex to this letter. In light of these concerns, HMT asked two questions in relation to climate risks:

   a. 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?"*

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for People, Performance and Reputation at IAG) that 4°C warming entails that *"the world becomes pretty much uninsurable"* (reported in the Australian Financial Review (2018)). See also 'Bank for International Settlements, 'The Green Swan: Central banking and financial stability in the age of climate change' (2020) which warns that unmitigated climate change would lead to a systemic financial crisis affecting the financial health of the insurance sector, which would render climate risks uninsurable.

[11] Moody's, 'Research Announcement: Moody's – Insurers' retreat from coal is positive, reducing stranded asset risk, limiting liability risk' (2020).

[12] See UN Environment Programme Finance Initiative Principles for Sustainable Insurance, 'Insuring the climate transition: Enhancing the insurance industry's assessment of climate change futures' (January 2021) which found *"Climate change-related litigation risks are generally not yet assessed by the insurance industry in a quantitative and scenario-based manner"*. See also the Sabin Center for Climate Change Law's Climate Change Litigation Databases in respect of US litigation and non-US litigation.

[13] HMT, 'Call for Evidence: Review of Solvency II' (2020).

[14] See also the speech by Charlotte Gerken of the PRA, 'Developments in the PRA's supervision of annuity providers' (2021), which addresses potential changes to the matching adjustment to better reflect climate risks (in particular, reflecting the market pricing of climate risks).

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

7. We submitted a response to HMT's Call for Evidence in February (see enclosed),[15] in which we proposed that fossil fuel assets should be excluded from the matching adjustment and that the SCR calculation should be enhanced to better reflect climate risks. HMT has not yet issued its proposals for amending Solvency II, and has indicated that it will consult on a package of reforms in early 2022. In light of the concerns raised around climate risks in the Call for Evidence, we anticipate that HMT's proposals will include enhancements to better reflect climate risks in capital requirements.

8. HMT has published a summary of the responses it received to its Call for Evidence.[16] In that paper, HMT noted that the UK Government wants the revised prudential regime to provide a foundation for insurance firms to provide *"investment consistent with the Government's climate change objectives"*. In particular, it noted that the eligibility of assets for the matching adjustment serves an important role in determining whether insurers provide capital to *"assets that are consistent with helping to combat climate change"*, and stated that reforms should support *"investment consistent with the Government's climate change objectives"*.

9. We note that the European Commission has not yet indicated that it will enhance the reflection of climate risks in Pillar 1 capital requirements in its review of Solvency II. We consider that it would be a missed opportunity to fail to do so. Enhancing capital requirements would help ensure the resilience of EU insurers to climate risks, and (given the current indications from the UK government regarding enhancing UK capital requirements in respect of climate risks) would result in a level playing field between EU and UK insurance capital requirements.

10. We hope that the above is useful for the European Commission in developing its proposals for amending Solvency II, and in considering the proposals in the FW Letter. We would be happy to meet with you to discuss any of the above issues in further detail.

Yours faithfully,

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[15] ClientEarth, 'Response to HMT Call for Evidence: Review of Solvency II' (2021).
[16] HMT, 'Review of Solvency II: Call for Evidence – Response' (2021). See paragraphs 1.10 to 1.15.

Annex – Extracts from HMT Call for Evidence

Extracts on implications of climate change for insurance sector

Paragraph 1.20:

> *"Changes in climate have profound implications for the economy, including the insurance sector, and the costs of climate change are already affecting the insurance sector's underwriting strategies and pattern of claims. In the long term, increasing levels of physical risk due to climate change could present significant challenges to general insurance business models and some insurance firms' long-term assets could be affected by the transition to a low carbon economy."*

Paragraph 1.21:

> *"The Green Finance Strategy sets out a comprehensive approach to aligning private sector financial flows with clean, environmentally sustainable and resilient growth and, in the process, strengthen the competitiveness of the UK financial sector. Reflecting their long-term investment horizon, insurance firms, and life insurance firms, in particular, can play an important role in contributing to these outcomes."*

Extracts on matching adjustment

Paragraph 3.2:

> *"the Government seeks views on the role that the matching adjustment could play to better support delivery of its climate, 'levelling up' and long-term investment objectives, including in appropriate infrastructure or other long-term productive assets."*

Paragraph 3.11:

> *"Insurance firms that hold assets for a long period may be exposed to increased levels of transition risk arising from climate change. One key risk is that assets may become 'stranded' (that is, unexpectedly or prematurely devalued or written down) because of environmental and political developments. For example, present or future climate commitments may cause some fossil fuel reserves to be left permanently unexploited, resulting in an unexpected downgrade (and potentially defaults) for assets of companies that rely on the exploitation of these resources. Transition risks are longer-term risks and, therefore, are especially relevant to insurance firms that use the matching adjustment. The Government seeks views on how the matching adjustment could be amended to recognise these emerging risks and better enable insurers to contribute to sustainable investment."*

Paragraph 3.12:

> *"The Government seeks views on whether the matching adjustment is operating optimally and whether reforms are required so that it can better meet its objectives. The Government wants to ensure that it operates to better enable insurance firms to play an appropriate role in the provision of long-term, productive finance to the economy and the provision of sustainable finance, consistent with the Government's 'levelling up' priorities and its objectives to address climate change."*

Extracts on solvency capital requirement

Paragraph 4.2:

> *"the Government seeks views as to the role that the determination of the SCR could play to support delivery of its climate change objectives, the delivery of its Green Finance Strategy and to address the risks posed by exposure to 'stranded assets'."*

Paragraph 4.9:

> *"The SCR is a primary means by which an insurance firm provides for adverse risk, that is, experience being worse than expected. It is intended to capture all material risks to which an insurance firm is exposed. Therefore, it is a logical place for insurance firms to allow for climate change-related risks. However, 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."*

Paragraph 4.12:

> *"the Government seeks views as to the role that the determination of the SCR could play to support delivery of its climate change objectives, the delivery of its Green Finance Strategy and to address the risks posed by exposure to 'stranded assets'."*