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HM Treasury Consultation on Review of Solvency II

ClientEarth Response

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Top Lines

1. HM Treasury's review of Solvency II provides an opportunity to reassess the fitness of all areas of insurance prudential regulation and set the direction for the UK prudential regime for the near future. We note that the Treasury's consultation on Solvency II (the "**Consultation**") does not introduce any measures to better reflect climate risks in the prudential regime, nor to ensure that the insurance sector supports the UK's legally binding climate targets. We consider this to be a missed opportunity to ensure that the UK insurance sector is resilient to long-term climate risks.

2. In order to ensure that the prudential regime properly reflects climate-related financial risks, including both risks to individual insurers and the systemic risks posed by climate change to the sector, we propose that the Treasury make the following changes to the proposals:

   a. Matching adjustment & capital requirements: Investments in assets related to new exploration, expansion or development of fossil fuel projects and related infrastructure face significant climate-related transition risks, included the risk of becoming stranded assets, as those activities are fundamentally incompatible with limiting global warming to 1.5°C pursuant to the Paris Agreement. They should therefore be ineligible for the matching adjustment (in particular given that matching adjustment assets are intended to be held long-term, and are therefore particularly exposed to longer term climate risks) and insurers should be required to hold capital equal to 100% of the investment exposure (so that there is sufficient capital to absorb a full write-off of the asset).

   b. Transition plans: Insurers need to adopt credible transition plans aligned with limiting warming to 1.5°C, in order to mitigate the risks posed to their businesses by the global transition to net-zero. The UK Government has committed to mandating the disclosure of transition plans for financial institutions and listed companies. The prudential framework should require that such transition plans are embedded in governance, risk management and audit systems.

   c. Double materiality: Insurers should be required to identify and manage the impact of their businesses (including the impact of the companies and activities which they finance and underwrite) on society and on the environment within their risk management systems (sometimes referred to as 'double materiality'), in addition to managing the material risks to their own businesses.

   d. Scenario analysis: Treasury should introduce Pillar 2 requirements in the PRA Rulebook requiring insurers to conduct long-term climate change scenario analysis as part of their Own Risk and Solvency Assessment, taking into account the climate scenarios outlined by the Network of Central Banks and Supervisors for Greening the Financial System ("**NFGS**"). This would formalise the expectations set by the PRA in relation to scenario analysis in its Supervisory Statement 3/19.

   e. Lloyd's of London: The Society of Lloyd's has extensive powers to regulate the Lloyd's market and, in that capacity, should play a critical role in supervising climate risk within the market and setting the market's approach to transitioning to net-zero. Given that it fulfils this important regulatory role, it should be subject to duties to: (1) actively support the achievement of the UK's climate targets; (2) have regard to the desirability of protecting nature and biodiversity; and (3) publish its plan for the Lloyd's market to transition to net-zero by 2050, and its polices in relation to the management of nature and biodiversity related risks and impacts.

Matching adjustment & capital requirements

Question 4.1: What would be the impact of these reforms on insurers' use of the matching adjustment and investment:
• in economic infrastructure, such as clean energy, transport, digital, water and waste;
• to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and
• in any other asset classes.

Question 4.3: What safeguards are appropriate to protect policyholders from the risks posed by allowing a wider range of assets into matching adjustment portfolios?

3. The Solvency II review provides an opportunity to enhance Pillar 1 capital requirements to better reflect the climate-related transition risks inherent in investments in carbon-intensive activities that are not aligned with the global transition to net-zero. In particular, investments in new exploration, expansion or development of fossil fuel projects and related infrastructure ("**New Fossil Fuel Activities**") involve significant transition risks, as they are fundamentally incompatible with the goals of the Paris Agreement including limiting warming to 1.5°C above pre-industrial levels (the "**Paris Goals**"),[1] as well as the UK's legally binding climate goals.[2] For the reasons set out below, investments in such activities should be ineligible for the matching adjustment, and insurers should be required to hold capital equal to 100% of the investment exposure. In addition, Treasury and/or the PRA should conduct a review to assess whether capital requirements should be similarly enhanced for investments in other carbon-intensive sectors that also involve significant transition risks.

<u>Risks of New Fossil Fuel Activities</u>

4. New Fossil Fuel Activities are not compatible with limiting warming to 1.5°C. Almost 40% of *existing* global 'developed' fossil fuel reserves (from existing and under construction oil and gas fields and coal mines) need to be left unextracted in a science-based pathway aligned with 1.5°C,[3] so the exploitation of *new* reserves cannot be permitted in any reasonable science-based pathway. For example, the International Energy Agency's landmark publication on net-zero pathways indicates that, in order to limit warming to 1.5°C, there must be no new oil and gas fields approved for development and no new coal mines or mine extensions (beyond projects already committed as of 2021).[4] This means that investment in oil and gas must be limited to existing production facilities or those already approved

[1] Articles 2(1)(a) and (c) of the Paris Agreement under the United Nations Framework Convention on Climate Change commit signatories (including the UK) to pursue efforts to limit warming to 1.5°C, as well as to aim to make finance flows consistent with a pathway towards low emissions.
[2] The UK has set a nationally determined contribution under the Paris Agreement to reduce emissions by 68% (compared to 1990 levels) by 2030 (see the Government's UK Nationally Determined Contribution (2020)). In addition, the UK Government has statutory obligations to reduce emissions by 78% (compared to 1990) by 2035 and to net-zero by 2050 (see sections 1 and 4 Climate Change Act 2008 and section 2 Carbon Budget Order 2021). These targets are intended to limit warming to 1.5°C, in line with the IPCC's findings in its Special Report on Global Warming of 1.5°C (2018) that limiting warming to 1.5°C requires a pathway to net-zero emission by 2050.
[3] Kelly Trout et al, Existing fossil fuel extraction would warm the world beyond 1.5 °C, 2022 Environ. Res. Lett. 17 064010. See also Carbon Tracker, Unburnable Carbon: Ten Years On (2022) which found that 90% of all known (or 'proven') fossil fuel reserves must remain unextracted in order to limit warming to 1.5°C.
[4] International Energy Agency, Net Zero by 2050: A Roadmap for the Global Energy Sector (2021).

for development.[5] Climate goals require an end to new development of oil and gas fields and coal mines.

5. As a result, investments in New Fossil Fuel Activities are exposed to significant climate-related transition risks that are not adequately reflected in current capital requirements. New Fossil Fuel Activities will lock in fossil fuel infrastructure for decades to come, and are based on the assumption that the assets will be economically viable throughout their projected lifetime. However, many of those assets will become stranded during their lifetime due the substantial transition risks they are exposed to:

   a. New Fossil Fuel Activities may become economically unviable due to the increasing impact of new laws and regulation, as national transition policies inevitably accelerate globally in order to meet the Paris Goals. For example, carbon prices are expected to rise significantly.[6] These risks are even greater if policy action is delayed, and is therefore introduced in a more sudden and disorderly manner, in order to make up for lost time.[7]

   b. New Fossil Fuel Activities are exposed to the risk of falling (and volatile) fossil fuel prices, in light of falling market demand as companies increasingly recognise the financial and reputational imperative to align their business models with Paris Goals, as well as competition from clean energy as technological developments reduce the cost of renewables and electricity storage.[8]

6. It is estimated that over $1 trillion of oil and gas assets are at risk of becoming stranded,[9] and energy majors have already had to write down significant amounts of assets due to these risks.[10] The potential for such write downs not only poses risks for insurers investing in such assets, but also leads to the accumulation of systemic climate risk in the financial system.

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, which has 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"*.[11]

8. In addition, warming in excess of the Paris Goals gives rise to systemic risks for the insurance sector which pose a threat to the sector's long-term resilience. The capital regime should reflect that investments which are incompatible with Paris Goals (such as investments in New Fossil Fuel Activities) contribute to such systemic risks. For example, extreme warming can give rise to the following risks:

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[5] University of Oxford, Implications of the International Energy Agency Net Zero Emissions by 2050 Scenario for Net Zero Committed Financial Institutions (2022).
[6] See the Principles for Responsible Investment, The Inevitable Policy Response 2021: Policy Forecasts.
[7] See the Late Action scenario in the Bank of England, Results of the 2021 Climate Biennial Exploratory Scenario (2022). See also Carbon tracker, Handbrake Turn (2020).
[8] See BloombergNEF, New Energy Outlook 2021.
[9] Carbon Tracker, Unburnable Carbon: Ten Years On (2022).
[10] 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/seventop-oil-firms-downgrade-assets-by-87bn-in-nine-months.
[11] PRA Policy Statement PS14/20 Solvency II: Prudent Person Principle. See also the PRA's The impact of climate change on the UK insurance sector (2015) and Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change on the risks posed to insurers from climate change.

a. 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), such as homeowners who may be unable to afford the increased costs of cover in areas increasingly affected by extreme weather events;[12] (2) insurers being unwilling or unable to accept the maximum possible losses arising from risks for solvency requirement reasons; or (3) insurers being unable to accurately estimate the frequency and severity of risks in order to price premiums, due to unpredictable and rapidly changing risks.[13] This poses a fundamental risk to the insurance industry, as it has been forecast that extreme warming would lead to a world that is largely uninsurable.[14]

b. Warming in excess of the Paris Goals poses significant macro-economic risks to insurers' asset portfolios that cannot be effectively managed through portfolio construction and asset allocation. 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.[15]

Matching adjustment eligibility

9. As set out above, investments in New Fossil Fuel Activities are exposed to significant risks that could give rise to unpredictable losses. Allowing such assets to benefit from qualifying for the matching adjustment would therefore leave insurers with insufficient capital to cover the associated risks. Investments under the matching adjustment are intended to be held as long-term assets, and are therefore particularly exposed to longer term climate-related risks. The objectives of the matching adjustment (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 New Fossil Fuel Activities. We note that Treasury's Call for Evidence in relation to

[12] For example, the Australian Climate Council estimates that 1 in 25 homes in Australia will be uninsurable by 2030, due to the increased risks from extreme weather events (including flooding and wildfires) making cover unaffordable. See its media release, Climate Council Launches Cutting Edge Digital Climate-Risk Map (2022).

[13] 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 climate-related physical risks, as the risks can change in non-linear ways. See 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.

[14] 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 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.

[15] 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).

the Solvency II review recognised 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 noted the risk of stranded assets.

10. Furthermore, the Consultation proposes amending the eligibility requirements for the matching adjustment to make it easier for projects with construction phases to qualify as eligible, which risks making it easier for risky investments in New Fossil Fuel Activities to qualify for the matching adjustment, unless specific regulation is introduced making them ineligible. The Consultation states that the amended eligibility criteria are intended to make it easier for investments in *"long-term productive finance"* to qualify. However, investments in New Fossil Fuel Activities do not contribute to long-term sustainable and productive growth (given the risks outlined above and the likelihood of stranded assets) and so there are no grounds to make it more attractive to invest in them by allowing them to qualify for the matching adjustment.

11. We therefore propose that investments related to New Fossil Fuel Activities should be ineligible for the matching adjustment. This should include both direct investment in such activities, as well as investment in companies which generate revenue from such activities. We note that the definition of assets related to New Fossil Fuel Activities in the regulation will need to be sufficiently broad to ensure that investments in relevant companies and activities are caught within scope, and cannot be circumvented through portfolio construction.

Solvency capital requirement

12. Excluding New Fossil Fuel Activities from the matching adjustment is not sufficient to ensure that the risks of such activities are properly reflected in the capital regime. As noted above, climate-related transition risks are unpredictable and can manifest in a short timeframe. As a result, all investments in New Fossil Fuel Activities (including shorter term investments) are at risk of incurring unpredicted losses (and becoming stranded assets).

13. Investments in New Fossil Fuel Activities should therefore be given a significantly higher risk weight in the solvency capital requirement calculation. We propose that insurers should be required to hold capital equal to 100% of such investment exposures, which would provide for sufficient capital to absorb a full write-off. This would provide protection against the substantial risk that they may become stranded assets (and lose 100% of their value).[16]

Conclusion

14. The regulatory amendments proposed above would improve insurers' capital adequacy against climate-related losses and shocks, and drive behavioural change by disincentivising allocating financial flows to assets which exacerbate climate change and undermine financial stability. It would acknowledge the 'double materiality' aspect of climate change, in both strengthening individual firms and the whole insurance sector against climate-related risks, as well as helping to mitigate the impact that the sectors are having on climate change. It would also help to correct the mispricing of climate-related risks and prevent the accumulation of assets which may: (a) become stranded, thereby causing direct financial losses to the firms holding those exposures; or (b) contribute to exacerbating climate change, leading to the build-up of systemic risks in the financial system.

[16] See the open letters dated 27 October 2021 from a coalition of NGOs (including ClientEarth) sent in relation to the EU Solvency II review calling for 'one for one' capital requirements for New Fossil Fuel Activities, and the related legislative proposals for amending the text of Solvency II.

15. Importantly, it would be within each individual insurer's control whether and to what extent it will feel the consequences of this new regulation, as it would only apply to insurers that choose to continue investing in companies whose activities that are clearly not aligned with the Paris Goals.

16. We note that the PRA recognises that there may be gaps in the reflection of climate-related risks in the capital regime, and intends to undertake further analysis on this (including by issuing a 'Call for Papers' and host a Research Conference on the interaction between climate change and capital in Q4 2022).[17] We welcome that the PRA is undertaking this analysis, which we consider should include a review of whether the transition risks across key carbon-intensive sectors are adequately reflected within current capital requirements. However, action needs to be taken now in relation to investments in New Fossil Fuel Activities, given the clear risks to individual insurers and systemic risk arising from climate change outlined above. Time is of the essence; the Treasury should take a precautionary approach and use the opportunity of the Solvency II review to enhance capital requirements for assets related to fossil fuels now.

Transition plans

Question 2.5: How could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?

Question 4.1: What would be the impact of these reforms on insurers' use of the matching adjustment and investment:
• in economic infrastructure, such as clean energy, transport, digital, water and waste;
• to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and
• in any other asset classes.

17. We welcome that the UK Government committed at COP26 to introducing mandatory requirements for financial institutions and listed companies to adopt and disclose climate change transition plans as part of the upcoming Sustainability Disclosure Requirements ("**SDR**").[18] Mandatory transition planning is a crucial element of the Government's goal for the UK to become the first net-zero-aligned financial centre, and in addition will facilitate the UK in meeting its legally binding climate goals. The precise content and scope of the transition plans rules has not yet been set, but we infer that they will require insurers (or at a minimum, all listed insurers) to disclose transition plans.

18. Mandatory requirements for transition planning are necessary in order for the Government to meet its legally binding climate targets, as those targets cannot be achieved unless individual firms are properly incentivised to reduce their emissions accordingly and to align financial flows with the transition to net-zero. We note that Treasury's Call for Evidence in relation to the Solvency II review stated that the objectives of the review include *"to support insurance firms to provide long-term capital to underpin growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as **investment consistent with the Government's climate change objectives**"* (emphasis added).

[17] PRA, Adaptation Report 2021 at pages vii to x and 36 to 37.
[18] HM Government, Fact sheet: on net zero-aligned financial centre (2021).

19. In addition, transition plan regulation is essential for prudential and financial stability purposes. Insurers need to adopt a credible plan to mitigate the risks posed to their business by the global transition to net-zero.[19] An increasing number of countries are setting ambitious emissions reduction commitments under the Paris Agreement and implementing domestic policies to achieve them.[20] Insurers whose business models do not incorporate emissions reductions consistent with the Paris Goals will inevitably face material risks as new law and regulation is introduced by countries across the world to align the economy with global climate targets. We note that the PRA recognises that transition plans are relevant for prudential purposes, noting that they *"will be of interest to the PRA, particularly where they set out how firms intend to manage their activities in line with transition pathways"*.[21]

20. The SDR is expected to introduce requirements for firms to *disclose* transition plans. However, in order for transition plan regulation to be fully effective and capable of supervision by regulators, firms must also be required to *embed* transition planning in their internal processes. The Solvency II review provides an opportunity for the UK Government to introduce gold-plated transition plan requirements for the insurance sector by amending the existing Pillar 2 requirements to ensure that insurers adopt transition plans and embed them in their governance, risk management and internal audit processes.

21. Such regulation will help protect insurers from transition risks by ensuring that transition plans are not only disclosed, but are acted on. In addition, the implementation of credible transition plans by UK insurers will underline the integrity and resilience of the UK's insurance sector and foster trust around the sector's real world impact and sustainability. Furthermore, incorporating transition planning within the PRA's Rulebook will enable the PRA to supervise the implementation of transition plans by insurers and, where appropriate, to take enforcement action.

22. Transition plan requirements are also needed to ensure that the funds released by the Treasury's proposed reduction in capital requirements, as well as the relaxation of eligibility requirements for the matching adjustment, are not directed to activities that undermine the transition to net-zero and which do not contribute to sustainable, productive long-term growth. The PRA's Discussion Paper states that the proposals *"would make it easier for insurers that wish to place these new assets or redeploy their existing assets into investments which support growth, infrastructure and the transition to net-zero"* and the Consultation states that the proposals will *"unlock tens of billions of pounds for long term productive investments, including infrastructure"*. However, insurers may choose to use the reduced capital requirements to distribute funds to shareholders or increase remuneration within the organisation. In addition (absent transition plan requirements), even where insurers *do* use the released funds for investments, there is nothing to prevent those funds being directed towards unsustainable activities, such as New Fossil Fuel Activities that will ultimately become stranded assets.

23. We therefore propose that Pillar 2 requirements are amended as follows:

    a. *Adoption of transition plan*: Insurers must be required to adopt a written climate change transition plan aligned with the Paris Goal of limiting warming to 1.5°C. This must set out how the insurer will adapt its business model and strategy to reduce its emissions consistently with global transition pathways necessary to achieve the Paris Goals. The plan must cover all of the insurer's scope 1-3 emissions from its operations and value chain, including its financed and

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[19] See for example analysis in PRA, The impact of climate change on the UK insurance sector (2015). See also paragraphs 5 to 8 above.
[20] 151 countries have set nationally determined contributions. See the UNFCCC's NDC Registry and the Energy & Climate Intelligence Unit's Net Zero Scorecard.
[21] PRA, Adaptation Report 2021 at page 22.

insured emissions (i.e. emissions associated with the companies and projects which the insurer both invests in and underwrites). The plan should include science-based short- and medium-term targets for absolute emissions reduction, actionable steps necessary to achieve those targets, and a mechanism for monitoring and reporting progress against the targets. In addition, transition plans must indicate what the insurer will do to accelerate transition in the real-economy (including through robust engagement, stewardship and voting based on policyholder/investee company transition commitments) and must include strategies for the financing and insuring of carbon-intensive sectors which are consistent with the applicable sectoral transition pathway.[22] Introducing the above requirements into Solvency II now (for example, as a new section of the Conditions Governing Business in the PRA Rulebook) will allow for transition plans to be embedded into Solvency II governance, risk management and audit requirements (as set out below). In setting the requirements, regard should be had to the work done by the UK's Transition Plan Taskforce ("**TPT"**) to establish a 'best-practice' standard for the content and presentation of transition plans under UK regulation. Please see ClientEarth's response to the TPT's recent call for evidence for more detail on the hallmarks of a robust transition plan.[23].

b. *Governance*: Insurers must be required to embed their transition plans in their governance systems (within the General Governance Requirements section of the Conditions Governing Business), in order to ensure there is adequate accountability for the design and implementation of the plan. In particular: (a) transition plans should be embedded in insurers' organisational structure with a clear allocation and appropriate segregation of responsibilities for delivering the transition plan; (b) the written transition plan should be subject to the prior approval of the insurer's governing body and subject to review at least annually; and (c) insurers' remuneration policies must promote the effective implementation of the transition plan and the sound and effective management of environmental and social risks and impacts, through incentives set at a level to influence behaviour.

c. *Risk management*: Insurers' risk management systems should incorporate the identification and management of risks to the successful implementation of the insurer's transition plan, as well as any risks to the insurer identified in the transition planning process (within the Risk Management Section of the Conditions Governing Business). Such a requirement would ensure that insurers properly embed their transition plans within their internal control systems and take steps to ensure that impediments to successfully delivering the plan are overcome.

d. *Internal audit*: Insurers' internal audit functions should be required to evaluate the adequacy and effectiveness of the insurer's governance arrangements and internal controls (including risk management systems) in relation to transition planning, including evaluating whether transition plan commitments are adequately integrated into those systems (within the Internal Audit section of the Conditions Governing Business). Review by internal audit is critical to ensure that the proposed new requirements in relation to transition plan are properly incorporated by insurers.

[22] In particular, as noted above at paragraph 4, there can be new investments in new oil and gas fields or coal mines in a pathway aligned with 1.5°C.
[23] ClientEarth, Response to the UK Transition Plan Taskforce Call for Evidence on a Sector-Neutral Framework for Private Sector Transition Plans (2022).

24. In addition, insurers should make public disclosures in relation to their transition plan arrangements in their solvency and financial condition report. This should include a summary of the insurer's transition plan, as well as an explanation of how their governance arrangements and internal controls (including risk management systems) are consistent with the delivery of their transition plan.

Double materiality

25. The current Pillar 2 risk management rules require insurers to identify and manage material risks to their own business. However, they do not require insurers to manage the impact of their business on society and environmental issues (referred to as 'double materiality'), including the impact of the companies and activities which they choose to finance and underwrite.[24] This is crucial to ensure that insurers act responsibly to mitigate their adverse impact on the environment and on social matters, and meet societal expectations of good business conduct.

26. If Treasury is not minded to introduce climate change transition plan requirements for insurers (as set out above), then introducing requirements to manage the impact of their business on society and environmental issues would help ensure that insurers reduce their contribution to climate change and the associated financial risks it poses (which would help to mitigate climate risks posed to the insurance sector, as well as system-level macro-economic and financial stability risks that could harm the wider economy). Furthermore, introducing an express double materiality 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.[25] It would also bring the UK closer to achieving its legally binding climate targets and its ambition to become a net-zero-aligned financial centre.

27. We therefore propose that Treasury should introduce a new requirement for insurers to take into account the potential long-term impact of their overall investment and underwriting strategies and individual decision-making on environmental or social matters, including on material system-level macro-economic and financial stability risks.

28. 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. In 2021, the European Commission amended the Solvency II Delegated Regulation to expressly require insurers to consider sustainability risks (including the impact of investments on sustainability risks, such as climate change) when investing in accordance with the prudent person principle.[26] In addition, EIOPA has stated that the impact of insurers' activities on sustainability factors is prudentially relevant, and recommends the integration of sustainability considerations in underwriting decisions.[27] The UK

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[24] See ClientEarth, Response to FCA discussion paper on Sustainability Disclosure Requirements and Investment Labels (DP21/4) (2022) on our proposals for disclosures in relation to double materiality.

[25] We note that, whilst the existing rules on risk management systems and the prudent person principle do not expressly state that insurers must take into account their impact on climate change, we consider that a correct interpretation of the rules requires insurers to manage their impact on climate change in order to mitigate their contribution to the systemic risks caused by extreme warming.

[26] European Commission Delegated Regulation (EU) 2021/1256 of 21 April 2021 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings.

[27] EIOPA, Opinion on Sustainability within Solvency II (2019). See also EIOPA, Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD (2019).

should be demonstrating leadership in prudential and environmental policy, but at a minimum should keep pace with positive enhancements to the EU regime.

Scenario analysis

29. The PRA has set supervisory expectations specifying that insurers should conduct climate change scenario analysis within their Own Risk and Solvency Assessment, in order to inform strategy setting and risk assessment and identification.[28] In addition, the FCA has set requirements for asset managers, life insurers and FCA-regulated pension providers and for standard listed companies to disclose scenario analysis.[29]

30. We agree that scenario analysis is a vital tool to help insurers identify and manage their exposures to both short and long-term climate risk. The review of Solvency II provides an opportunity for Treasury to formally bring long-term climate change scenario requirements into the PRA Rulebook. We note that the European Commission has proposed that an express requirement for climate scenario analysis requirements be added in the EU review of Solvency II (although that proposal is currently subject to amendment by the European Parliament).[30]

31. We therefore propose that Treasury introduces Pillar 2 requirements for long-term climate change scenario analysis, taking into account the NFGS climate scenarios.[31] At a minimum, this should include requirements to conduct long-term scenario analysis for an orderly transition (assuming warming is limited to 1.5°C through stringent and timely climate policies and innovation), disorderly transition (assuming climate policies are delayed or divergent, requiring sharper emissions reductions to limit warming to below 2°C) and a hothouse world (assuming only currently implemented policies are preserved, which would currently result in warming of 2.7°C).[32]

Lloyd's of London

32. As the world largest insurance marketplace, the Lloyd's of London market (the "**Market**") has a systemic impact on climate change and on nature and biodiversity. Lloyd's is particularly important in the energy sector, and is often the insurer of last resort for risky fossil fuel projects. In 2021, the Market generated £1.3 billion of gross written premiums within the energy sector.[33]

33. The Society of Lloyd's (the "**Society**") has substantial powers to act as a form of regulator for the market. It therefore plays a critical role in supervising climate risk within the Market and setting the Market's approach to transitioning to net-zero. We note that in October 2021, the Society issued guidance to Lloyd's managing agents asking them (on a non-binding basis) to set ESG strategies that

[28] PRA 'Supervisory Statement SS3/19: Enhancing banks' and insurers' approaches to managing the financial risks from climate change'.
[29] FCA Policy Statement PS21/23: Enhancing climate-related disclosures by standard listed companies, and FCA Policy Statement PS21/24 Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers.
[30] European Commission Legislative Proposal on Solvency II (2021).
[31] NFGS, Climate Scenarios for Central Banks and Supervisors (2021).
[32] Climate Action Tracker, Glasgow's 2030 credibility gap (November 2021).
[33] Lloyd's Annual Report 2021. In addition, Lloyd's invests a significant amount of funds, recording a total of £73 billion financial investments as at end of 2021.

take into account the Society's ambition for the Market to transition to net-zero by 2050 (the "**Guidance**").

34. However, the Society's legal duties in relation to the environment (under the Financial Services and Markets Act 2000, the PRA Rulebook and the Cooperation Agreement to the Cooperation Agreement between the PRA and the Society) are opaque. In a letter to Lloyd's in June 2021, we set out why we consider that the Society has a legal duty to manage the Market's exposure to climate risks, including by reducing the Market's contribution to climate change through its underwriting and investment activities.[34] In particular, the Society is responsible under its PRA Cooperation Agreement for *"the overall strategic direction of the market, control over how much (and what type of) risk to allow into the market as a whole, the marketwide control framework"*, which we consider includes controlling strategy on climate change and climate risk (see our letter for further detail). However, in its reply to our letter, the Society did not accept that it has legal duties in relation to managing the Market's impact on climate change, and therefore appears to be treating all action on managing the Market's climate impact as voluntary.

35. The Society's current policies in relation to climate change are inadequate to set the Market on a science-based transition to net-zero, or to mitigate the Market's climate risks and impacts. As set out more fully in our letter to Lloyd's in December 2021,[35] the Guidance: (1) makes a vague ask for managing agents to set an ESG strategy which *"supports Lloyd's ambition for the market's overall transition towards net zero"*, but provides no guidance or targets for making any interim emission reductions (neither for insured emissions, nor financed emissions); (2) contains no guidance or targets for phasing out investment in or underwriting of fossil fuels; (3) is not binding on managing agents; and (4) lacks provisions for transparency, as managing agents and syndicates will not be required to disclose their climate policies or targets, or to disclose their financed or insured emissions. As a result, managing agents can ignore the Guidance and Lloyd's net-zero 2050 ambition entirely (as they are not binding and there is no transparency on managing agent's individual action), and they could also comply with the Guidance by setting long-term 2050 targets whilst taking no meaningful action in the short-term.

36. In addition, the Society's approach to transparency in relation to its climate policies has, to date, been lacking. In particular:

    a. The Society issued its ESG Guidance (which, as noted above, set out its asks for managing agents in relation to transition planning) to managing agents in October 2021. However, it did not publish that Guidance at the time. The Society ultimately published the Guidance in December 2021 (following repeated calls for it do to so), only after a copy of the document was published online by a third party.

    b. The Society's approach to fossil fuel phase out has been unclear. It announced in its ESG Report 2020 in December 2020,[36] that it would be asking managing agents to phase out investment in and underwriting of coal, tar sands and Arctic oil, including stopping all new investments and underwriting from January 2022. The Society described this as a *"commitment"*, and as *"publicly accountable"* targets for the Market, and we note that these targets were subject to significant press coverage at the time. However, it now appears that the Society is rowing back from those targets. The subsequent Guidance did not ask managing

[34] ClientEarth, Letter to Lloyd's, 14 June 2021.
[35] ClientEarth, Letter to Lloyd's, 13 December 2021.
[36] Lloyd's ESG Report 2020.

agents to comply with those targets. Instead, it described them as merely a *"sensible and pragmatic ambition"*, stated that Lloyd's was *"not mandating"* that managing agents cease providing new cover for those fuels and specified that managing agents must *"decide their own ESG targets and policy"*. As a result, there is the potential for the public to misunderstand whether Lloyd's is in fact acting to phase out insurance and investments in coal, tar sands and Arctic oil.

37. Given its systemically important role, the Society needs to have express duties in relation to the environment, including both duties to manage the Market's climate impact and in relation to transparency on the action it is taking. This is because effective climate supervision by the Society is necessary in order to ensure that transition risks are effectively mitigated within the Market, and to support the UK in meeting its climate targets. We therefore propose:

    a. The Society should be given express duties in relation to the environment that reflect the duties that will be applied to the FCA and PRA following the Future Regulatory Framework review. In its consultation paper on the Future Regulatory Framework, Treasury proposed that the FCA and PRA are subject to a regulatory principle that requires them to take into account the UK's net-zero 2050 commitment. In our response to that consultation,[37] we proposed that the FCA and PRA should have: (1) a regulatory objective that requires them to actively advance all of the UK's climate targets (including the 2050 net-zero emissions target, interim carbon budgets, nationally determined contributions and the Paris Goal to limit global warming to 1.5°C above pre-industrial levels); and (2) a regulatory principle requiring them to have regard to the desirability of restoring and conserving nature and protecting biodiversity internationally in a manner that respects the rights of affected local communities and indigenous peoples. We propose that the Society should be subject to the equivalent duties to support the achievement of all of the UK's climate commitments, as well as to take into account the need to restore and conserve nature and biodiversity.

    b. The Society should be required to publish its plan for the Market to transition to net-zero by 2050 in line with the UK's interim emission commitments, and its policies in relation to the management of nature and biodiversity related risks and impacts. In addition the Society should update that plan annually, including a report on progress (including disclosing overall scopes 1-3 emissions for the Market and for individual syndicates).

[37] ClientEarth, Response to Treasury consultation on Future Regulatory Framework (2022).

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