PRI FEEDBACK

SOLVENCY II REVIEW

13 January 2022

This consultation response represents the view of the PRI Association and not necessarily the views of its individual members.

INTRODUCTION

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has now over 4,500 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US $120 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

The PRI welcomes the opportunity to respond to the European Commission's call for feedback on the Solvency II review. Over 100 EU-based insurance companies have signed the PRI, thereby committing to align their investment practices with the six Principles. Many of these signatories are working collaboratively and leading efforts to achieve real-world outcomes through their investment and stewardship activities (eg. via the UN-Convened Net Zero Asset Owner Alliance).

ABOUT THE SOLVENCY II REVIEW

In September 2021, the European Commission published its review of Solvency II, which aims to strengthen European insurers' contribution to the financing of the Covid recovery, progressing on the Capital Markets Union and the channelling of funds towards the European Green Deal. The review targets important elements in the existing regime, including sustainability risks.

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KEY RECOMMENDATIONS

The PRI welcomes the review's focus on addressing long-term sustainability risks in the insurance sector. However, more ambitious measures will be needed to align financial flows with the EU's new sustainability objectives.

- The reform's aim to strengthen insurers' management of climate risks is particularly welcome. The new requirements should help further embed forward-looking climate scenario analysis into insurers' risk assessment practices. **We recommend that further guidance is provided on how the scenario analysis should be conducted, in alignment with new guidance from the TCFD.**
- **The PRI supports the mandate to explore by 2023 a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives and encourages EIOPA to explore how the EU Taxonomy can be used as a basis for this assessment.** Higher capital requirements for exposures to new fossil fuel investments could be added as part of the current Solvency II review, subject to an impact assessment.
- To help meet the EU's sustainability objectives, insurers should assess not only the impact of climate and sustainability issues on their investments, but also the impact that their own investment activities have on sustainability factors. The PRI therefore recommends that the Commission or EIOPA further clarify how inside-out risks (or sustainability outcomes) should be considered as part of the prudent person principle.

SUSTAINABILITY RISKS FOR INSURANCE COMPANIES

CLIMATE SCENARIO ANALYSIS REQUIREMENT

The Solvency II amendment introduces a requirement for insurers to identify any material exposure to climate change risks and, where relevant, to assess the impact of long-term climate change scenarios on their business. This involves specifying at least two long-term climate change scenarios, one where global temperature increase remains below two degrees Celsius, and one where the temperature increase is equal or higher than two degrees. Insurers will then be required to include an analysis of the impact on their business of the long-term climate change scenarios.

The PRI welcomes this requirement, as it should help further embed forward-looking climate scenario analysis into insurer's risk assessment practices. Many insurance companies are already undertaking long-term climate scenario analysis.

We recommend that the European Commission or EIOPA provide additional guidance on how the scenario analysis should be conducted. This guidance should be aligned as much as possible with leading market practice (for example, work by the Net Zero Asset Owner Alliance), and the recent guidance by the Task Force for Climate Related Financial Disclosures (TCFD) on scenario analysis for forward-looking metrics, targets and transition plans. An industry working group could be convened by EIOPA to develop common metrics and methodologies for climate alignment assessments.

The Commission should also ensure that these new requirements are coherent with upcoming sustainability disclosure standards related to forward-looking climate analysis (particularly the sustainability reporting standards under development by EFRAG relating to the CSRD proposal).

Climate risk scenarios should be adopted to consistently evaluate both liabilities and assets, as different portfolios can bring different risk contributions depending on liabilities and risk models. Climate risk scenarios should also ideally be centrally developed and made publicly available, to ensure both consistency across the industry and to allow smaller companies to comply.

In the future, the scenario analysis requirement could be broadened to wider environmental issues, such as biodiversity risks. A growing number of initiatives, such as the Task Force on Nature-Related Financial Disclosures, are working to develop a risk management and disclosure framework for organisations to report and act on nature-related risks.

DEDICATED PRUDENTIAL TREATMENT FOR SUSTAINABILITY RISKS

The Solvency II review also introduces two mandates to EIOPA as regards sustainability risks:

- EIOPA is mandated to explore by 2023 a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives; and to
- review regularly the scope and the calibration of parameters of the standard formula pertaining to natural catastrophe risk.

The PRI supports this mandate and encourages EIOPA to examine how the EU Taxonomy can be used as a risk-based tool to measure exposures that substantially contribute to sustainability objectives or cause significant harm. The climate delegated act adopted in December 2021 contains technical screening criteria that embeds both “substantial contribution” and “do no significant harm” criteria to specific environmental objectives.

Although the EU Taxonomy is typically seen primarily as a tool for understanding environmental performance, exposure to significantly harmful assets can also be used as a proxy for transition risk. The Taxonomy takes a sophisticated and technology neutral approach to identification of these activities and should be studied for use in this way, particularly in light of the potential extension of the Taxonomy, as suggested in preliminary report from the Platform on Sustainable Finance[1].

In the meantime, considering the International Energy Agency’s announcement that new fossil fuel investments are incompatible with a transition to net zero by 2050[2], exposures to new fossil fuel investments could be given a higher capital charge (equivalent to the treatment for highly risky equities and bonds under Solvency II). This measure should be risk-based and would help mitigate the most immediate risks of stranded assets in the insurance sector. It could be adopted as part of the current Solvency II review, subject to an impact assessment.

[1] See Public Consultation Report on Taxonomy extension options linked to environmental objectives (PSF, 2021) : https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-platform-report-taxonomy-extension-july2021_en.pdf

[2] See Net Zero by 2050 (IEA, 2021): https://www.iea.org/reports/net-zero-by-2050

FURTHER CLARIFYING THE PRUDENT PERSON PRINCIPLE TO ACCOUNT FOR SUSTAINABILITY IMPACT

In April 2021 the Commission made an amendment to the Solvency II Delegated Regulation[3] to introduce obligations for insurers to consider and manage sustainability risks – including as part of the prudent person principle.

The prudent person principle includes provisions on how insurers should invest their assets and ensures that they only invest in assets that they can "*properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs*". The April 2021 modification clarified that this should include considering both sustainability risks to portfolios and long-term impacts of investment decisions on sustainability factors.

Although this is a welcome development, more guidance is needed as to what this principle means and how it should be applied in practice, as Member States can interpret it differently due to its high-level nature and lack of clarity on how to consider sustainability risks. Therefore, we recommend clarifying that the prudent person principle requires consideration of double materiality and explore ways to include inside-out impact beyond long-term impact (i.e., consider short/medium impact as appropriate).

The PRI also recommends the development of further guidance on application of the prudent person principle. It would be helpful to clarify:

- whether the requirement to take into account inside-out risks refers to the procedure of making the investment decision or it also concerns the outcome of the investment decision and[4]
- how investors should assess sustainability risks and impacts, if/how they may set and pursue sustainability impact goals and how these relate to financial goals and duties.

Considerable voluntary investor action, such as the UN-convened Net Zero Asset Owners Alliance (which includes over 40 European insurance companies), demonstrate that investors do already take firm action on impact and align with the Paris Agreement. However, expectations to minimise harms and substantially contribute to environmental and social goals through capital allocation are ever increasing.

The PRI, together with the UN Environment Programme Finance Initiative and The Generation Foundation, have commissioned legal analysis to determine the extent to which investor duties currently enable investors to incorporate sustainability impact in their investment decision-making[5]. This project, Legal Framework for Impact, provides options for policy change to remove legal impediments to accounting for sustainability impact as a core part of investment.

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[3] See 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

[4] Procedural duty versus duty to invest (or to consider investing) in a certain manner.

[5] A legal framework for impact | PRI Web Page | PRI (unpri.org)

This research looks across 11 jurisdictions, including the EU, to answer the question: *are investors permitted, required or prohibited to incorporate sustainability impacts in investment management and decision making*? It finds that investors will likely have a legal obligation to consider investing for sustainability impact where it can help in pursuing their financial objectives, and, in some circumstances, investors can pursue sustainability goals for reasons other than achieving financial return goals (i.e. in parallel to them). **The PRI encourages the European Commission and the European Supervisory Authorities to draw on the project's analysis when assessing potential obligations to consider sustainability impacts as part of the legal framework for insurers and other institutional investors.**

The PRI has experience of public policy on sustainable finance policies and responsible investment across multiple markets and stands ready to further support the work of the European Commission to ensure a sustainable financial policy framework in the EU.

Any question or comments can be sent to policy@unpri.org.