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Review of Solvency II
HM Treasury
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Sent by email to SolvencyIIReview@hmtreasury.gov.uk

15 July 2022

Dear Solvency II Review Team,

Consultation response: Review of Solvency II

I am writing to respond to HM Treasury's consultation *Review of Solvency II*, on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. Among other activities, we work with the financial services sector, including insurance firms, to promote integration of sustainability factors in investment decisions, long-term stewardship of assets and the consideration of the views of clients, beneficiaries and pension scheme members.

Introduction

We have been greatly encouraged by the former Chancellor Rishi Sunak's ambition to make the UK home to the world's first Net Zero-Aligned Financial Centre. At a time where insurers, even those in the Net Zero Insurance Alliance, continue to underwrite and invest in new fossil fuel projects – disregarding warnings from the IEA and the IPCC – this could not be more urgent. As such, we were disappointed to see that the proposed review of Solvency II does not include mandatory sustainability requirements to streamline the insurance industry with the UK Government's climate ambition.

Edie recently reported that the UK is lagging behind the EU in terms of the proportion of market activity accounted for by green finance. Indeed, the Solvency II Directive is currently being reviewed in the EU, where sustainability requirements such as climate change scenario analysis, insurers' exposure to biodiversity loss, and a potential change to the prudential treatment of exposure to assets which are substantially environmentally and socially harmful, are being considered. Furthermore, in April 2021 an amendment to a Delegated Regulation on Solvency II brought in sustainability risks as part of the 'prudent person principle' i.e. the rules on how insurers invest. This will come into force in the EU in the Summer.

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It is vital that the UK keeps pace with the EU on sustainable finance. Not only is it impractical for companies to face divergent regulation in different jurisdictions, but it also puts the UK's aim to be the world's first Net Zero-Aligned Financial Centre in jeopardy. As the impacts of climate change become ever more severe, and the risks of catastrophic economic and financial outcomes grow, the UK cannot afford to continue to regulate insurance, and the wider financial sector, as if these risks did not exist.

We have therefore outlined recommendations below around what mandatory sustainability requirements should be included in the Solvency II review to ensure the UK's net-zero targets are reached.

Risk margin

Question 2.1 How would a reduction in the risk margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on:

- policyholders and their level of protection; and
- insurers and their reinsurance, investment and product pricing decisions.

We do not support reductions in risk margins for long-term life insurers without accompanying mandatory requirements that this 'freed up' capital be channelled into green investments. Otherwise, there is no guarantee that the tens of billions of capital previously set aside to protect policyholders will not be used to invest in and/or underwrite fossil fuel projects (or other socially and environmentally harmful assets) that expose both policyholders and insurers to greater risks.

ShareAction's latest policy briefing: *Going beyond insurers' voluntary initiatives: Why policymakers must embed mandatory insurance regulation in Solvency II* highlights the extent to which insurance companies – even those in the Net Zero Insurance Alliance – continue to underwrite and invest in new fossil fuel projects. There is no room for new oil and gas fields in the IEA's pathway for the global energy sector to achieve net zero CO2 emissions by 2050. But despite this, only 18 of the world's insurers have committed to end or restrict underwriting tar sands projects, 15 have committed to end or restrict underwriting for Arctic fossil fuel development, and just 10 have committed to end or restrict underwriting for O&G development. It is only on coal where the numbers look better, with 39 insurers having committed to end or restrict insurance services.

Major European insurers AXA (France), Allianz (Germany) and Aviva (UK) – some of the founding NZIA members – were among the top five insurance company investors in North Sea fossil fuels between 2019 and 2021, having invested a combined total of US $4.7 billion in O&G companies in the region. The overarching reality of the insurance industry's position on climate is grim.

If policyholder protections are to be weakened, HM Treasury must embed mandatory sustainability requirements in Solvency II regulation to funnel this capital into green investments. To this end, we recommend HM Treasury mandates:

1. Higher capital requirements accounting for high-risk assets such as fossil fuels

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Following a basic risk management logic, the Basel Committee on Banking Supervision (the global standard setter for the regulation of banks) has recommended that the one-for-one capital requirements be applied to certain cryptocurrencies' exposures. Applied to climate change exposure, such a rule would mean that for each euro/dollar/pound that finances fossil fuels, banks and insurers should have a euro/dollar/pound of their own funds held liable for potential losses.

Alternatively, a more sensitive approach might be to use an own funds adjustment linked to the extent of damage caused as measured by an objective, foundational taxonomy. So, for example, if an asset were considered to have a 5/10 sustainability rating, then insurers would hold 50p in the £, if it were rated as 8/10 then insurers would hold 80p in the £, etc.

This targeted and proportionate measure would thus only affect insurers that choose to invest in highly risky assets, such as fossil fuel-related assets. It is a financial stability measure that will allow insurers to have enough capital to absorb losses arising from the materialisation of climate change risks; this will therefore reduce the likelihood that taxpayers have to bail out insurers. At the same time, it will steer investments away from fossil fuels, as higher capital charges will effectively remove the artificial subsidy in the form of unwarranted low capital charges currently applied to fossil fuel assets.

As the European Economic and Social Committee recently stated, "sustainability goals must not be jeopardised by insufficient capital requirements that artificially turn highly polluting activities into profitable investments", and thus "where capital requirements are too low (for example, risks relating to climate change), they need to be increased to ensure the stability of the sector."

2. Mandatory net-zero transition plans and frequent regulatory scrutiny thereof

Voluntary initiatives alone cannot guarantee that all insurers are on the right path when it comes to combating climate change. It is high time that policymakers make it mandatory for insurers to publish detailed net-zero transition plans, making their underwriting and investment business models and strategies compatible with the limiting of global warming to 1.5°C with no or limited overshoot.

To be clear, no insurer can claim to be net zero-aligned unless:

- they implement **financing restrictions in relation to coal and oil & gas expansion**;
- their transition plans **phase down fossil fuels on timelines aligned with 1.5C pathways**;
- their transition plans lead to **absolute emissions reductions** (rather than emissions intensity reductions[1]).

[1] Emission intensity targets do not necessarily lead to reductions in absolute emissions. This is because companies can reduce intensity in two ways – through decarbonising or by increasing market share. For example, if a bank or a company increased its investments in low-carbon assets at a faster rate than it is investing in high-carbon assets, it would reduce its emission intensity. Yet it would not necessarily reduce its absolute emissions – as it might still grow the size of its high-carbon assets and/or keep it constant. In addition, an emission intensity metric does not capture the climate impact of large emitters.

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ShareAction recently published our response to the Call for Evidence on a Sector-Neutral Framework for private sector transition plans, which outlines our views on what best practice for transition plans should be.

In addition, policymakers must regularly publicly scrutinise transition plans. In the UK for the first time, we're seeing the Environmental Audit Committee question representatives from the Glasgow Financial Alliance for Net Zero on their progress to net zero – an important step in private sector accountability. Insurers should be brought before Select Committees and Ministers in the UK annually to explain why their transition plans are adequate and to evidence the progress they've made or targets they've missed, since this is in the public interest.

3. Streamlined 'double materiality' approach for insurers to assess their impact on climate

It is increasingly regarded as good practice for insurers to consider how environmental factors constitute financial risks e.g. through TCFD reporting. But holding global warming to well under 1.5 degrees will require insurers to also assess how their own business operations and investments are impacting people and planet.

Insurers' risk management systems and reporting practices should therefore take a double materiality approach, i.e. consider also the wider social and environmental impacts of their underwriting and investment activities. That way, insurers will be able to take adequate steps to mitigate any negative impacts, and external stakeholders will better be able to hold insurers accountable.

4. Rigorous stewardship policies for investment and underwriting

Evidence shows that one of the most impactful tools available to investors is engagement with investee companies, and that shareholder engagement requests tend to have good success rates. Yet as ShareAction's research shows, only a small minority of insurers have robust stewardship strategies to ensure engagement with investee companies and policyholders. General transparency on stewardship activities is also poor.

Insurers should be required to have an ambitious written stewardship policy (inclusive of an escalation strategy), to take reasonable steps towards its successful implementation and to regularly report on the outcomes of that stewardship policy, in line with the FRC's UK Stewardship Code.

5. Stricter reporting rules as per the obligations of TCFD and TNFD

TCFD and TNFD require businesses to outline the financial risks and opportunities provided by a warming climate and nature loss respectively. They mandate reporting around four key pillars: governance, strategy, risk management and metrics. Aligning insurers' reporting with these guidelines will allow for a better assessment of sustainability risks. This can result in better risk management and more informed strategic planning by financial stakeholders, as they seek to mitigate the financial impact of climate related and nature-related risks and maximise opportunities to safeguard the planet and their balance sheet.

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Question 2.2 How would a reduction in the risk margin for general insurers of 30% impact on:

- policyholders and their level of protection; and
- insurers and their reinsurance, investment and product pricing decisions.

See answer above.

Question 2.3 Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

No comment.

Question 2.4 Is there any further information about actual transfer values of insurance risk that should be taken into account when finalising the calibration of the risk margin reforms?

No comment.

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?

We agree that this is a risk, and as such would recommend that the Government mandate that:

a) a certain majority threshold of newly available resource is to be invested solely in green infrastructure and projects (for example, green taxonomy-aligned companies);
b) no resource is distributed to shareholders or used to increase remuneration to parties within the insurance firm (rather, executive pay and renumeration could be linked to insurance company progress towards their short-term climate targets, as outlined in their net-zero transition plans).

Increasing investment flexibility

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.

We are disappointed to see that these matching adjustment (MA) reforms miss an opportunity to redirect capital flows away from high-carbon investment to green alternatives. ShareAction's report *"Insuring Disaster: A ranking of the world's largest insurers approaches to responsible investment and underwriting"* finds that insurers' current approach to responsible investment and underwriting is insufficient to safeguard a 1.5C future. Almost half (46 per cent) of those surveyed received the lowest sustainability rating (E), with another 17 per cent receiving a D rating. No insurer received an

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AA or AAA rating. **As such, we are in agreement with [ClientEarth's view] that investments in fossil fuel or greenhouse gas (GHG) intensive projects and companies should be ineligible for the MA.**

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 market demand as companies increasingly align their business models with 1.5C, as well as the risk of stranded assets. Carbon Tracker finds that over $1 trillion of oil and gas assets risk becoming stranded due to policy action on climate and the rise in alternative energy sources.

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. Similarly, companies beyond the fossil fuel sector that have high GHG emissions will face significant transition risks, as they will need to rework their business models to align with 1.5C temperature pathways.

Incentivising (or failing to disincentivise) investment by insurers in fossil fuel and GHG intensive assets could undermine the objectives of the Government's Green Finance Strategy (see ShareAction's response to this consultation here), including the goal of *"Aligning private sector financial flows with clean, environmentally sustainable and resilient growth"*. 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 amount of energy from fossil fuels; or (4) emit over a threshold amount of GHG globally.

We urge the Treasury to revisit the MA to ensure that reforms specifically distinguish between high-carbon and low-carbon assets, with the former disincentivised for investment or underwriting by insurers.

Question 4.2 What are the additional risks that these reforms may pose to policyholder protection?

There is a risk that these reforms will not sufficiently tackle high rates of underwriting and investment in fossil fuels by insurers, thus exposing policyholders not only to all the extreme risks that come with global heating, but also related financial risks incurred by insurers operating in this context. Addressing climate risks first, these include but aren't limited to:

- Business risks:
    - Decreased productivity due to extreme heat;
    - Job losses, disruptions, and risks to business locations and infrastructure from coastal change from erosion, flooding and extreme weather events;
    - Risks to business from disruption to supply chains and distribution networks.
- Cultural heritage:

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  - Risks to cultural heritage e.g. waterlogging of archaeological sites, damp problems and water ingress issues at historic properties, changes in groundwater levels affecting historic gardens, new pest species threatening heritage landscapes, damage to assets caused by wildfires and flooding and heat risks to collections and archives;
  - Risks to people, communities and buildings from flooding.
- Health:
  - Injuries and trauma, heat-related illnesses, psychological distress;
  - Risk of food security crisis, given UK sources much of its food from countries already under significant climate stress.

Now turning to the financial risks a changing climate poses insurers (and by extension, policyholders): stranded assets. Insurers exposed to higher risk assets – such as fossil fuels – are not adequately prepared to face losses when these assets inevitably become stranded (hence, as discussed above, higher capital requirements are needed on such assets, as well as changes to the MA to reflect this). **According to Chief Economist at Finance Watch, Thierry Philipponnat, the *"value [of fossil fuel assets] is doomed regardless of the scenario that will prevail in the coming years."*** He goes on to note that in a stranded assets context, *"there is no scenario under which fossil fuel assets can prosper in the now near future with a planet carbon budget equal to 8 years, the insurance industry will be seriously threatened by climate change unless we get our act together now and adapt insurance companies' capital requirements linked to fossil fuel exposures."*

In the case of extreme losses and company failures, the UK Government – the public purse – would have to bail these companies out, just like in the 2008 financial crash. This could have significant repercussions for society and the wider economy. We urge the Treasury to reconsider their Solvency II reforms to avoid such devastating climate and financial risks to both insurers and policyholders.

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?

As we have expressed in our answer to Question 2.1, fossil fuel and other GHG intensive assets must be made ineligible for the MA. Furthermore, there is a need for higher capital requirements for high-carbon assets, mandatory net-zero transition plans and public scrutiny thereof, a mandatory double materiality approach to reporting alongside TCFD and TNFD obligations, and robust stewardship policies in line with the UK Stewardship Code.

Question 4.4 What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?

Unless underwriting and investment of high-carbon assets are not disincentivised, insurance companies face serious financial and reputational risks. Starting with financial (in addition to stranded assets as mentioned above), Swiss Re has estimated that climate change could lead to

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200% increase in insured losses due to flood damage in the UK, and add $183 billion to annual house insurance premiums globally in the coming decades.

As for reputational risks, ShareAction analysis shows fossil fuel expansion was firmly on the agenda at financial institutions' AGMs this year, and investors have started to push back on firms' inadequate Say on Climate plans. Campaign organisations such as ShareAction, InsureOurFuture and Reclaim Finance continue to scrutinise financial institutions not taking fast enough action on climate and are continually placing laggards in the spotlight – recent examples of this can be found in the Guardian, Reuters, Capital Monitor and Insurance Business.

Question 4.5 What changes to the matching adjustment approval process are necessary to ensure that applications to use the matching adjustment are approved more quickly?

No comment.

Question 5.1 What is the impact of these reforms on regulatory costs incurred by insurers?

No comment.

Question 5.2 What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?

No comment.

Question 5.3 What would be the impact of a new mobilisation regime for insurers and changes to thresholds at which Solvency II applies on:

- businesses currently considering whether to become an authorised insurer; and
- small insurers' ability to expand before Solvency II applies?

No comment.

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Thank you for taking the time to read this consultation response. Please do not hesitate to get in touch if you have any questions.

Yours sincerely,

Isabella Salkeld

Senior UK Policy Officer, ShareAction