TRANSCENDENT GROUP INSIGHT

## ESG Regulation in the insurance industry

The EU Sustainable Finance Action Plan (SFAP) has already had considerable implications for several financial industry participants. The imminent entry into force of the taxonomy legislation and sustainability linked financial disclosures regulation (SFDR), has forced several financial market participants – particularly asset managers and financial market advisors - to review their ESG strategy and ESG risk management processes.

One would however be ill-advised to assume that asset managers and financial market advisors will be the only actors impacted by the SFAP. While integration of ESG risks within the insurance industry may be at an earlier stage than in asset management, the effects of climate change will pose considerable threats and opportunities for the insurance and reinsurance companies.[1] As such, EIOPA have initiated a variety of activities aimed integrating climate risks into insurance products and risk management frameworks.

In this iteration of GRC insights, our colleagues Nezik Keshto and Fredrik Fogde give a brief overview of some of the latest regulatory developments affecting the insurance industry.

## Action Plan and Opinion Paper on ESG integration in Solvency II

EIOPA contributes to the EU "Green Deal", and to the SFAP through a variety of channels, and have been implementing a strategy with the following key objectives:[2]

1) Insurers should manage and mitigate ESG risks through their underwriting activities.
2) Insurers and pension funds should reflect policyholder and pension scheme member preferences for sustainable investments, where relevant.
3) Insurers and pension funds should adopt a sustainable approach in their investments based on principles of stewardship.

One of the first results of this action plan was to launch a consultation on the potential integration of sustainability within Solvency II. Opinions were published in 2019 concerning the suitability of integrating sustainability topics in the following areas:

- Valuation of assets.
- Valuation of liabilities.
- Investment practices.
- Underwriting practices.
- Capital requirements.
- Internal models.

[1] https://www.unepfi.org/psi/wp-content/uploads/2021/01/PSI-TCFD-final-report.pdf

[2] https://www.eiopa.europa.eu/browse/sustainable-finance_en

Key take-aways from the report included an acknowledgement that medium to long-term impacts of climate change cannot be fully captured in Solvency II capital requirements. However, these risks can instead be captured by scenario analyses and stress-testing tools, and should be embedded in risk management, governance and ORSA.

**Climate Risk Integration ORSA**

The EIOPA consultation on the draft opinion on the supervision of the use of climate change risk scenarios in ORSA ended on 5 January 2021. The consultation provides expectations to national authorities, on the supervision of the integration of climate change risk scenarios in ORSA processes. Key suggestions include:

- Authorities should require undertakings to integrate climate change risks (Physical and transition risks) in their system of governance, risk-management system and ORSA, including both short-term and long-term risks.
- Authorities should expect undertakings to identify the materiality of exposures to climate change risks through a combination of quantitative and qualitative analyses.
- A quantitative analysis could be used to assess the exposure to transition risks and physical risks.
- Authorities should expect undertakings to subject material risks to at least two climate-scenarios, one scenario where global temperature increase remains below 2°C, and one where global temperature increase exceeds 2°C.

Data should be collected through the regular supervisory reporting, most notably the ORSA supervisory report. EIOPA will start monitoring the application of the opinion by the competent authorities two years after its publication.

**Including Climate Change in the Nat Cat SCR calibration**

A second follow up to the opinion paper on Solvency II integration, is a consultation that launched in December 2020, with an end date of 26 February 2021. The Discussion Paper examines if and how to include climate change in the Nat Cat SCR calibration in the standard formula. A few notable take-aways include:

- Recalibrate the natural catastrophe standard formula parameters using models that explicitly consider climate change.
- Add a loading factor for specific perils or regions.
- Capture climate change in the spatial and peril correlation.

Following aggregation of feedback, a final report will be published in the spring of 2021.

**Sustainability preferences in IDD**

In June 2020, the EU commission published draft legislative proposals to amend the IDD regime, which are yet to be finalized and adopted. The amendments modify the IDD in two key ways:

- Sustainability factors must be integrated into product suitability assessments.
- Sustainability risks must be integrated into product oversight and governance requirements and into the rules on conflicts of interest.

**Insurer's key performance indicators in Non-Financial Disclosure Directive**

On 1 March 2021, EIOPA published it's advice to the European Commission on the mandatory sustainability disclosure of insurers' and reinsurers' key performance indicators within the scope of the Non-Financial Disclosure Directive (NFRD) and the Taxonomy regulation. Article 8 of the Taxonomy requires companies that meet the criteria of a "large organization" in the NFRD, report activities that are aligned with the technical screening criteria of the Taxonomy.

Here, EIOPA proposes requiring two key performance indicators, that depict the extent to which

- The insurer or reinsurer carries out taxonomy-aligned activities (According to RTS for Non-life insurance activities) - in terms of non-life gross premiums written
- The insurer or reinsurer is funding or financing taxonomy-aligned economic activities – in relation to total investments

**Summary**

The potential changes suggested are far-reaching, and like we have seen in asset management's reactions to the SFDR, can have long-term strategic implications. Moreover, both transition risks and physical risks are likely to impact the insurance industry in the mid-term future,[3] and should be considered material risks for most practitioners. The integration of sustainability aspects thus needs a holistic approach, affecting several business-critical areas, including compliance, risk management, sustainability & strategy. It is recommended that insurance companies begin to explore potential pathways already today.

If you need help navigating this jungle of expectations, please reach out to us at Transcendent Group.


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| Nezik Keshto, Senior GRC Consultant | Fredrik Fogde, Senior ESG Consultant |
| nezik.keshto@transcendentgroup.com | fredrik.fogde@transcendentgroup.com |
| +46-70 275 77 51 | +47-929 864 55 |


[3] "Climate change could make premiums unaffordable: QBE Insurance" https://www.reuters.com/article/us-climate-change-qbe-ins-grp-idUSKBN20B0DA