Sustainable Finance and Climate Change Risk in Financial Services: For Insurers

An update on the key global, European, and UK regulatory developments applicable to the insurance sector.

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LATHAM & WATKINS

Introduction

In a July 2020 speech on climate action in the financial industry, Sarah Breeden, executive director for UK Deposit Takers Supervision, said the industry is "at the start of a critical decade for climate action where the decisions we take today will shape the future of our planet for decades to come". Accordingly, UK regulators now expect the industry to take action.

This briefing provides an update on the key global, European, and UK regulatory developments in this area applicable to the insurance sector.

Specific developments in the insurance sector

As described in Latham's regulatory overview note in March 2020, there are a number of global, European, and UK-specific developments relevant to the insurance industry that, together, make up a substantial body of principles, guidance, and developing rules.

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Global developments

PCAF Global Carbon Accounting Standard

In June 2020, the Partnership for Carbon Accounting Financials (PCAF) published the draft Global Carbon Accounting Standard for public consultation. PCAF is an industry-led partnership that aims to establish a common global standard for financial institutions, including insurance companies to address this point, to assess and disclose greenhouse gas (GHG) emissions from their loans and investments (Scope 3 emissions) through carbon accounting. Carbon accounting enables financial institutions to disclose GHG emissions at a fixed point in time and in line with financial accounting periods.

These emissions disclosures are crucial for allowing stakeholders to understand how a financial institution's loans and investments are contributing to, or inhibiting, the transition to a low-carbon economy. Through the Global Carbon Accounting Standard, PCAF aims to provide a globally accepted methodology for the measurement and disclosure of Scope 3 emissions. Previously, the absence of harmonised methodologies and reporting rules has led to the poor uptake of carbon accounting of Scope 3 emissions and inconsistent disclosures across financial institutions. The Global Carbon Accounting Standard is due to launch in November 2020.

NGFS — Guide to Climate Scenario Analysis for Central Banks and Supervisors

The Network for Greening the Financial System (NGFS), a group of representatives from 66 central banks and supervisors, has played a role in developing climate stress-testing scenarios. In June 2020, the NGFS published a Guide to Climate Scenario Analysis for Central Banks and Supervisors along with a number of reference scenarios developed primarily for use by central banks and supervisors but published to assist the wider financial community.

In its reference scenarios the NGFS uses three main representative scenarios, which are similar in concept to the three identified by the Bank of England for the BES 2021. These are: (i) an orderly scenario (implementing policies in good time to achieve net-zero C02 by 2070); (ii) a disorderly scenario (late adoption of policies in the 2030s and a sharp reduction in GHG emissions); and (iii) a "hot house world" scenario (only current policies continue and GHG emissions continue to grow until 2080). Additionally, five alternate scenarios reflect different assumptions, e.g., in relation to temperature targets and the adoption of negative emission technologies. Taken together, the reference scenarios provide a harmonised set of high-level climate scenarios to the public for the first time. The NGFS is likely to continue developing the reference scenarios following feedback.

Through the Global Carbon Accounting Standard, PCAF aims to provide a globally accepted methodology for the measurement and disclosure of Scope 3 emissions.

EU measures

Latham's regulatory overview note in March 2020 considered the legislative proposals flowing from the European Commission's Sustainable Finance Action Plan (the Plan), which seeks to clarify the duties of financial institutions in helping to shift capital flows away from activities that have negative social and environmental consequences and, instead, direct finance towards economic activities that have genuine long-term benefits for society. The Plan will achieve this through:

- The implementation of new legislation directed at EU financial institutions
- Amendments to existing legislation, including Solvency II and the Insurance Distribution Directive (IDD).

Implementation of new sustainability-related legislation

On 23 April 2020 the European Supervisory Authorities (ESAs) published a joint consultation paper in relation to the draft regulatory technical standards for the disclosures required under the Sustainable Finance Disclosure Regulation (EU) 2019/2088 (Disclosure Regulation), which aims to improve transparency in relation to ESG matters through sustainability-related disclosures in the financial services sector, addressing the following obligations:

Principle of "do not significantly harm": Details of the presentation and content of the information in relation to this principle, including a mandatory reporting template to use for the statement on considering principal adverse impacts of investment decisions on sustainability factors.

Due diligence policy: The content, methodology, and presentation of information to be published on a firm's website about their due diligence policy on investment decisions which may have adverse impacts on: (i) climate and other environment-related matters; or (ii) social and employee matters such as respect for human rights, anti-corruption and anti-bribery.

Pre-contractual information: Details of the content and presentation of the product-level pre-contractual disclosures on: (i) how a product with environmental or social characteristics meets those characteristics; and (ii) how a product with sustainable investment objectives and a designated index as a reference benchmark aligns its index with those objectives.

Website disclosures: Details of where and how website disclosures must be published as well as details of their content.

Periodic reports: Details of the content, methodologies, and presentation of information to be disclosed in periodic reports, including a mandatory template for periodic disclosure.

The consultation closed on 1 September 2020. The ESAs will review the draft technical standards based on the responses received before submitting them to the Commission for approval.

Amendments to existing legislation to embed sustainability considerations

On 8 June 2020 the Commission published six draft Delegated Acts for consultation that amend MiFID II, AIFMD, the UCITS Directive, Solvency II, and the IDD. The aim of these proposals is to amend existing sectoral legislation in order to incorporate sustainability considerations within the EU-wide regulatory framework on a consistent basis. These proposals align with the standalone reforms flowing from the Plan, including the Taxonomy Regulation (EU) 2020/852 and the Disclosure Regulation.

The amendments will apply to re(insurance) companies and insurance firms and brokers.

(Re)insurance companies

The Commission's proposals include amending the Solvency II Delegated Regulation (EU) 2015/35 to further specify requirements on governance, conflicts of interest, and risk management for insurance and reinsurance undertakings. The Commission's goal is to ensure that the existing Solvency II regime remains consistent with the proposals in the Disclosure Regulation, in particular that the system of governance of insurance and reinsurance undertakings, and the assessment of those undertakings' overall solvency needs, reflects sustainability risks.

Risk management: Insurance and reinsurance undertakings should take into account sustainability factors as part of their duties towards policyholders. Insurance and reinsurance undertakings should therefore assess not only all relevant financial risks on an ongoing basis, but also all relevant sustainability risks that could cause an actual or potential material negative impact on the value of an investment. This includes the risk of loss or adverse change in the values of insurance and reinsurance liabilities resulting from inadequate pricing and provisioning assumptions due to internal or external factors, including sustainability risks.

Under the proposals, the identification and assessment of sustainability risks will need to be included in the tasks of insurance and reinsurance undertakings' risk management function.

Actuarial function: This function must take into account sustainability risks in its assessment of the uncertainty associated with estimates made in the calculation of technical provisions.

Remuneration policy: This policy should contain information on how it is consistent with the integration of sustainability risks in the risk management system.

Prudent person principle and product approval: The prudent person principle laid down in Solvency II requires that insurance and reinsurance undertakings only invest in assets the risks of which they can identify, measure, monitor, manage, control, and report properly. In order to ensure that climate and environmental risk are effectively managed by insurance and reinsurance undertakings, the implementation of the prudent person principle should take into account sustainability risks, and insurance and reinsurance undertakings should reflect in their investment process the sustainability preferences of their customers as taken into account in the product approval process.

Insurance and reinsurance undertakings should assess all relevant sustainability risks that could cause an actual or potential material negative impact on the value of an investment

Insurance firms and brokers

The changes consulted on by the Commission seek to modify the IDD framework in two ways:

1. Integration of sustainability factors into the suitability assessment

   Under the existing IDD framework, insurance intermediaries and insurance undertakings distributing insurance-based investment products are required to undertake a suitability assessment based on certain information that must be obtained in relation to the client.

   The Commission notes that currently information about investment objectives generally relates to financial objectives, while non-financial objectives of the customer, such as sustainability preferences, are usually not addressed. In particular, existing suitability assessments generally do not include questions on sustainability preferences of customers, while the majority of customers would not raise the sustainability issue themselves.

   As a result, the Commission considers that there is a need to ensure that insurance intermediaries and insurance undertakings distributing insurance-based investment products consistently give appropriate consideration to sustainability factors in the selection process. In order to facilitate this consideration, the Commission proposes amendments to Delegated Regulation (EU) 2017/2359, which supplements the IDD by specifying information requirements and conduct-of-business rules applicable to the distribution of insurance-based investment products, to embed sustainability preferences within the suitability assessment process.

   Notably, the sustainability preferences of the client or potential client will only be relevant to the extent that they have such preferences — the proposals do not make it mandatory for a client to have sustainability preferences. Additionally, insurance intermediaries and relevant insurance undertakings must differentiate between investment objectives and suitability preferences, as prioritising a sustainability factor over a client's personal investment objective could result in mis-selling. The Commission has therefore proposed the inclusion of a recital to clarify that sustainability preferences should only be addressed within the suitability process after the identification of the customer's investment objective.

   Once implemented, these measures will apply on a go-forward basis such that a new suitability assessment for existing contracts will generally not be necessary.

The Commission aims to modify the IDD framework by:

1. *Integrating sustainability factors into the suitability assessment*
2. *Integrating sustainability risks and factors into the organisational requirements and product governance and oversight structures*

2. Integration of sustainability risks and factors into the organisational requirements and product governance and oversight structures

The Commission proposes to amend the IDD framework to facilitate the integration of sustainability factors and preferences into the product oversight and governance requirements for insurance undertakings and insurance distributors and into the rules on conduct of business for insurance-based investment products. Specifically, the Commission proposes amendments to Delegated Regulation (EU) 2017/2359 (referred to above) and Delegated Regulation (EU) 2017/2358 (product oversight and governance requirements for insurance undertakings and insurance distributors). These amendments are based on technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD delivered by the European Insurance and Occupational Pensions Authority in April 2019.

Conflicts of interest: Under the proposals, insurance intermediaries and insurance undertakings distributing insurance-based investment products will be required to:

- Include conflicts of interest that stem from the distribution of sustainable insurance-based investment products or from insurance based investment products that promote environmental or social characteristics when identifying conflicts of interest that may damage the interests of a customer (including their sustainability preferences).
- Identify any conflict of interest that may arise in relation to sustainability factors and in the course of any distribution activity related to insurance-based investment products, even when customers have not specified their sustainability preferences.
- Implement appropriate arrangements to ensure that the integration of sustainability factors in the advisory process does not lead to mis-selling practices.

Product governance: The proposals require manufacturers of insurance products to consider sustainability factors in the product approval process of each insurance product and in the other product oversight and governance arrangements for each insurance product that is intended to be distributed to customers seeking insurance products with a sustainability-related profile.

As the target market is required to be defined at a sufficiently granular level, manufacturers of insurance products should specify which group of customers with specific sustainability preferences the insurance product is intended for, rather than rely on a general statement that an insurance product has a sustainability-related profile.

Additionally, the Commission proposes to amend the distributor obligations to reflect that the objectives, interests, and characteristics of customers, including any sustainability preferences, must be taken into account. In particular, if an insurance distributor becomes aware that an insurance product is not in line with the sustainability preferences of the target market, the insurance distributor will be required to promptly inform the manufacturer and, where appropriate, amend its distribution strategy for that insurance product.

> ***Manufacturers of insurance products should specify which group of customers with specific sustainability preferences the insurance product is intended for***

Sustainable Corporate Governance Inception Impact Assessment

In July 2020, the Commission launched the Sustainable Corporate Governance Inception Impact Assessment, which aims to ensure that sustainability is embedded in firms' corporate governance frameworks. In particular, the initiative is focused on helping corporate boards integrate sustainability risks into strategies, decisions, and oversight by establishing longer-term time horizons in corporate decision-making. As a result of the impact assessment, the Commission may modify the codified company law Directive (2017/1132) and the consolidated Directive on Shareholder Rights (2007/36).

The Commission notes that Member State action alone is unlikely to be sufficient, since sustainability problems are of a global dimension and have cross-border effects, and national intervention is likely to result in market fragmentation. Instead, this initiative aims to build a level playing field for EU companies to operate on sustainable terms. This aim is particularly relevant in the context of Brexit, the implications of which are discussed below.

Feedback on the impact assessment is due by 8 October 2020.

Brexit impact

When the Brexit the transition period ends on 31 December 2020, EU law will cease to apply in the UK. To prepare for this, the UK government has undertaken what is referred to as an "onshoring" exercise to incorporate into UK law existing EU legislation that would otherwise be lost when the transition period ends.

However, under the European Union (Withdrawal) Act 2018, the UK government only has the power to onshore EU legislation that is operative (i.e., both in force and applicable) before the transition period ends. Most of the EU sustainable finance legislation discussed here and in Latham's March 2020 regulatory overview note does not fall into this category and therefore cannot be onshored in the same way as other EU legislation. Instead, policy decisions will be taken on a file-by-file basis by the UK government to determine if and how the UK will incorporate these files into UK law.

Accordingly, the UK approach to EU sustainable finance legislation will be a key watch point for insurers. If the UK diverges from the approach taken in Europe, firms operating across the UK and the EU will need to reconsider their ability to follow a harmonised approach.

UK measures

The publication of the UK government's Green Finance Strategy in July 2019 marked a key milestone in the UK's journey to achieve its target of carbon neutrality by 2050. The strategy identified two objectives: (i) to align private sector financial flows with clean, environmentally sustainable and resilient growth, and (ii) to strengthen the competitiveness of the UK financial sector. The strategy clearly identified the role of financial services in tackling climate change.

Financial regulators and climate change

The PRA and the FCA have increasingly focused on the impact of climate change on the UK insurance sector and continue to embed climate-related financial risk into their supervisory approach. Following on from the Bank of England's Supervisory Statement (SS3/19) on banks' and insurers' approaches to managing the financial risks from climate change in April 2019, there have been a number of further publications. A Dear CEO letter from Sam Woods that was published in July 2020 builds upon the expectations set out in the Supervisory Statement and provides next steps for firms. It is clear that, despite the COVID-19 pandemic, the PRA expects firms to continue to work on their plans in relation to climate change.

Insurers had been expected to have an implementation plan in place by October 2019, but the PRA had not set a date for full implementation. The PRA has now confirmed that firms should have fully embedded their approaches to managing climate-related financial risks by the end of 2021. Whilst a proportionate approach is expected, this does mean that the expectations set out in SS3/19 should be fully implemented and embedded in the organisation by the end of next year.

The PRA's expectations require a firm's board to understand and assess the financial risks from climate change that are relevant to the firm, and a senior manager to be formally allocated responsibility for identifying and managing these risks. The PRA also expects firms to address the financial risks from climate change through their existing risk management frameworks, conduct scenario analyses to inform their strategic planning, and consider whether any extra disclosures are necessary to enhance transparency on their approach to managing climate-related financial risks.

Helpfully, the PRA recognises that some areas of implementation, including the availability of relevant data, may present challenges for firms. Nevertheless, the PRA expects firms to address any risk through the holding of adequate capital.

Feedback in relation to the thematic review of firms' SS3/19 implementation plans indicated that most firms were making good progress in their approaches to managing climate-related financial risks and to embedding them into internal governance and control structures. However, gaps were identified. For insurers, it is particularly noteworthy that the PRA acknowledged that the science, data, and tools were not yet sufficient to enable accurate estimation of the risks but that they should ensure that identified risks were appropriately recognised by using reasonable proxies. Also, risk management processes still required updating to include integrated policies, risk appetite statements, and monitoring capabilities. Disclosures were also hampered by a lack of capability, an area that most firms will need to invest in before full implementation can be achieved.

Firms should fully embed their approaches to managing climate-related financial risks by the end of 2021, per the PRA

SMF holders with responsibility for climate-related financial risk should expect regular engagement with the regulators, and boards should continue appropriate oversight as the process is embedded. Boards are responsible for setting climate-related financial risk appetite and ensuring that these risks are appropriately managed and controlled. Training has already been provided for some boards on how to enable them to oversee this risk appropriately.

The Dear CEO letter sets out the PRA's observations of "good practice" in firms' plans, which will no doubt inform the approach to be taken as insurers continue to develop and update their plans during the period to full implementation. This covers areas such as governance structures, oversight, risk management frameworks, and strategy. Insurers have started to demonstrate their exposure to, and management of, climate-related financial risk in their ORSAs and to embed scenario analysis, which the PRA considers to be an important planning tool.

In June 2020, the Climate Financial Risk Forum (CFRF), which is co-chaired by the PRA and the FCA, produced a written guide for insurers, banks, and asset managers on how to approach climate-related financial risk. Established in March 2019, the CFRF adopts an "industry for industry" approach through its working groups with various industry participants, including a number of large UK-listed insurance groups. The Climate Financial Risk Forum Guide 2020 provides detailed chapters proposing best practices on a range of topics, including risk management, scenario analysis, disclosure, and innovation. The innovation chapter explores the importance of mobilising finance to help achieve climate goals and the need for a "step change" in investing to move from "brown" to "green" assets. Such an approach would require a realignment of pools of capital with climate investment solutions and a change in capital allocation plans of financial institutions. Although not regulatory guidance, the CFRF is acknowledged by the PRA as a useful tool to assist firms in developing their strategies and pursuing best practices.

The Dear CEO letter also expressly refers to the Bank of England's biennial exploratory scenario (BES) on financial risks from climate change. Published in December 2019, the 2021 BES explores less well-understood risks that are not neatly linked to the financial cycle and assesses the financial risks posed by climate change.

In summary, the 2021 BES will test the resilience of the business models of banks, insurers, and the financial system to the physical and transition risks from climate change so that the UK financial system's exposures can be assessed. The discussion paper sets out the proposed framework for the 2021 BES, and insurers will participate through a BES-aligned Insurance Stress Test. Firms' resilience will be tested against three climate scenarios that will embody the risks of earlier and later policy action to achieve the Paris Agreement target in addition to a scenario in which the Paris Agreement target is not met at all.

Identified as a "pioneering exercise," the 2021 BES was expected to launch in the second half of 2020, but due to COVID-19 the launch has been deferred to the middle of 2021. The Bank is expected to issue additional guidance in the form of a roadmap and references scenarios prior to launch.

The Climate Financial Risk Forum Guide 2020 is a helpful tool firms can use as they develop strategies and pursue best practices

It should also be noted that, following FCA Policy Statement 19/30, on 6 April 2020 new FCA guidance relevant to investment-based life insurance products was introduced in SYSC 3.2.23. This guidance clarifies how firms should think about environmental, social, and governance (ESG) risks and consumer concerns in investment decision-making. The FCA distinguishes between financial and non-financial matters such that firms:

- Should always take into account financially material ESG risks, including climate change
- May take into account the non-financial concerns of relevant consumers, provided that those consumers generally share the concern and there is no significant risk to consumer outcomes

Conclusion

In recent years, ESG implementation has transformed from a niche activity to a mainstream one as policymakers and lawmakers have increasingly focused their collective attention and actions on sustainability and other ESG issues. The corporate world is also now questioning whether the prioritisation of shareholder value above all other objectives is appropriate, and whether a softer form of capitalism that equally prioritises social responsibilities (or stakeholder capitalism, as described by the organisers of the World Economic Forum at Davos) is needed.

The financial sector is playing, and will continue to play, a central role in this economic transformation, and the "winners" will be those firms that respond best to the opportunities and obligations that will be presented in the years ahead. The developments summarised in this briefing show that the EU and the UK are looking to lead the way on ESG issues globally. While ESG has not gained the same level of traction among policymakers in other jurisdictions, this position is now starting to change.

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