Sustainability factors: Update to Solvency II Delegated Regulations

Introduction

In April 2021 an amendment to the Solvency II Delegated Regulations[1] was published that integrates sustainability risks and Environmental, Social and Governance (ESG) considerations into the Solvency II risk management framework. The amendments will come into effect from 2 August 2022 and will apply to all (re)insurers in Europe that are subject to the Solvency II regime. At a high level the amendments add sustainability considerations to a number of requirements that are already in place under Pillar 2 of the Solvency II framework. The changes will require (re)insurers to update risk management policies and processes, including the own risk and solvency assessment (ORSA) process, investment decisions and the product approval process, to incorporate sustainability risk and ESG considerations.

This short briefing note aims to summarise the amendments. It includes links to other relevant papers that explain how (re)insurers can address the changes.

Definition of sustainability risk

The Delegated Regulations have been updated to include the following definition of "sustainability risk":

> 'sustainability risk' means an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential negative impact on the value of the investment or on the value of the liability

The amendment also introduces the definition of "sustainability factors," which is consistent with the definition under the Sustainable Finance Disclosure Regulation (SFDR):[2]

> 'sustainability factors' mean environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

The definition of "sustainability preferences" is also introduced, consistent with the SFDR requirements, relating to a customer's or potential customer's preference for environmentally sustainable investments, sustainable investments or investments that consider principal adverse impacts on sustainability factors.

Risk Management Framework

Under the amendment, the identification and assessment of sustainability risks has been formally added to the tasks of the risk management function as defined under Article 269 of the Delegated Regulation. In addition, a number of changes have been introduced to integrate sustainability factors into the risk management framework, in particular into the policies and processes to manage investment risk and underwriting and reserving risk. Other risk policies will also need to be updated where relevant.

Investment risk policies should be updated to consider actions *"to ensure that sustainability risks relating to the investment portfolio are properly identified, assessed and managed."* This means that (re)insurers will need to take action to identify sustainability risks inherent in their investments and to assess and manage these risks in line with their risk tolerances. In order to do this, (re)insurers may need to define an overarching strategy in relation to sustainability factors to better understand and articulate their risk appetites and define risk tolerances.

Sustainability risks should be considered in the underwriting and reserving policy. Insurers should assess and manage the risks of loss or change in liabilities resulting from inadequate assumptions used in pricing or reserving *"due to internal or external factors, including sustainability risks."* This means that, going forward, sustainability risks should be considered in the assumption-setting process for both pricing and reserving.

The amendment also adds a new paragraph to Article 269 that explicitly states that emerging risks and sustainability risks identified by the risk management function should form part of the risks included in the overall solvency needs assessment in the annual ORSA process. This includes emerging risks and sustainability risks that the (re)insurer is or could be exposed to, taking into account potential future changes in its risk profile due to the undertaking's business strategy or the economic and financial environment. This effectively formalises the requirement to include scenario analysis of sustainability risks, including climate-related risks, in the ORSA. This had already been flagged by the European Insurance and Occupational Pensions Authority

[1] See the full text of the amendment at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R1256&from=EN.

[2] See the full text of SFDR at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN.

(EIOPA) in its opinion on the supervision of the use of climate change risk scenarios in the ORSA.[3]

Prudent Person Principal

A new article has been added to the Delegated Regulation that specifically integrates sustainability risk into the prudent person principal under Solvency II. Article 275a states that (re)insurers should take sustainability risks into account when identifying, measuring, monitoring, managing, controlling, reporting and assessing risks arising from investments within their asset portfolios.

The article also states that (re)insurers should take into account the potential long-term impact of their investment strategies and decisions on sustainability factors and, where relevant, those strategies and decisions of an insurance undertaking shall reflect the sustainability preferences of its customers taken into account in the product approval process (as required under the Product Oversight and Governance Delegated Regulation[4]).

The reference to sustainability preferences links to SFDR, which requires companies to consider the principal adverse impacts of investment decisions on sustainability issues. This introduces the concept of "double materiality" to Solvency II; whereby (re)insurers need to consider the impact of climate-related risks on their investment portfolios and also the impact their investment choices have on climate and sustainability factors.

Actuarial Function

In addition to the changes introduced for the risk management system, the amendments also include changes to the requirements of the annual opinion on the underwriting policy provided by the Actuarial Function. Going forward, the Actuarial Function will need to consider the effect of sustainability risks when providing an opinion on the (re)insurer's underwriting policy.

This places an onus on the Actuarial Function to ensure sustainability risks are considered as part of the underwriting and pricing process.

Remuneration

Finally, the amendment also includes a change to the requirements of the remuneration policy. It states that *"the remuneration policy shall include information on how it takes into account the integration of sustainability risks in the risk management system."*

How to address the new requirements?

The amendments reflect the latest direction of travel for sustainability and climate-related issues and are consistent with other developments across Europe. While sustainability risk encompasses more than just climate-related (environmental) risk, the requirements are consistent with recent regulatory communications on expectations in relation to climate risk such as in the UK and Ireland.

We have produced a number of recent papers on how companies can update their risk management frameworks to include consideration of climate-related risk and the same process can be expanded to consider ESG and sustainability issues more broadly. Relevant papers include the following:

- ESG Investments – regulatory requirements and investment strategies in Europe and the United States
- Climate change and the Prudent Person Principle
- Climate risk management and opportunities for life insurers
- Application guidance on running climate change materiality assessment and using climate change scenarios in the ORSA

The papers should provide practical information and guidance to companies on how to update polices and processes in order to comply with the latest amendments.

At Milliman, we have worked with a wide variety of clients on climate-related risk, ESG investment and sustainability issues. Please contact the authors of this report or your usual Milliman consultant if you would like to know more about best practices in meeting these requirements or would like any support in this area.

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[3] EIOPA (19 April 2021). EIOPA issues Opinion on the supervision of the use of climate change risk scenarios in ORSA. Retrieved 31 May 2022 from https://www.eiopa.europa.eu/media/news/eiopa-issues-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa_en.

[4] The full text of the Commission Delegated Regulation (EU) 2017/2358 is available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R2358.