Comments

of the German Insurance Association (GDV)

on the proposal for a Commission Delegated Regulation amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings

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Insurance and reinsurance companies are one of the largest institutional investor groups. The German insurance association GDV therefore welcomes the opportunity to comment on the proposal for a Commission Delegated Regulation amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings.

- GDV welcomes the aim to integrate sustainability considerations into the governance of insurance undertakings, where this is expedient.
- Clarification of the definition of sustainability risks and factors, consistent with existing legislation is reasonable. However, clarifications should be limited to clarifications and should not introduce further restrictions that are not laid down in other regulatory projects, eg the Disclosure Regulation.
- GDV supports the consideration of sustainability aspects as part of all business processes, this means also in risk management. But the regulation should avoid any redundant elements. As the prudent person principle already requires consideration of sustainability risks, where relevant, there is no need for an additional reference in article 260. The argument of redundancy holds true for articles 269, 275 and 275a.
- Furthermore, we are of the opinion that the link between sustainability risks and the ORSA is critical. We agree that the "effects of sustainability risks" on the risk profile should only be taken into account if these effects are financially relevant and material for the undertaking. However, a compulsory analysis of sustainability risks would contradict the basic idea of a company-specific strategy and risk assessment.
- From a content perspective the underwriting processes in compliance with existing Solvency II legislation include the consideration of the impact of sustainability risk on the risk profile of the undertaking, as well as consideration of these risks in pricing and reserving. But there is a risk that additional explicit requirements for the actuarial function regarding the assessment of sustainability risks may be misinterpreted to signal additional reserving or additional risk capital needs, which in both cases is redundant. Therefore we don't see any reason to include the liability side.
- GDV is of the opinion that the implications of the first part of Article 275a (2), requiring undertakings "to take into account the potential long-term impacts of investment decisions on sustainability factors", are not made sufficiently clear. As the proposal is worded, it may result in an unintended contradiction to Article 133 of the Solvency II Directive.
- The objective of prudential regulation is the protection of customers' financial interests resulting from direct contracts with the undertaking. Therefore, GDV suggests to remove Art. 275a (2), as it seems that the proposed addition is out of scope of prudential regulation.

We welcome the aim to integrate sustainability considerations into the governance of insurance undertakings, where this expedient. There are, however, some points in the Commission's proposal which should be revised.

- **New definitions in Article 1 points 55c to 55e of Regulation 2015/35**

GDV welcomes that the EC provides clarity on the definition of sustainability risks and factors, consistently with existing legislation. But we want to point out, that the definition of sustainability preferences should refer to the existing categories of sustainable products in Article 8 and 9 SFDR without adding the further constraints proposed as sub-points (i) and (ii) of Article 1 point 55e (b). The legislator has devised Article 8 and 9 SFDR in order to take account of the variety of sustainable products available on the market (Recital 21 of the SFDR). Introducing a third (i) and fourth (ii) category of sustainable products under the Solvency II Regulation would, in our view, raise further legal uncertainties and inconsistencies without apparent benefit to the customer. For instance it would mean that a product may be advertised as promoting sustainable characteristics yet does not address sustainability preferences. It would, furthermore, mean that until December 30th, 2022 the customer's desire for a product which excludes certain investments from its portfolio (e. g. fossil fuels, child labour etc.) would not constitute a sustainability preference within the meaning of the Delegated Regulation.

- **Article 260 of Regulation 2015/35**

GDV is of the opinion: The consideration of sustainability factors should have its place via underwriting policy. They must neither interfere with the risk-based premium calculation nor counteract it.

While we support the consideration of sustainability aspects as part of all business processes, the proposed references introduce an element of redundancy. Where the proposal suggests changes to the underwriting and reserving related sections of the delegated Solvency II regulation, these do not relate to areas where a deficiency had been identified by the EU Commission and are duplicating requirements already implied by the Solvency II directive and regulation.

On the liabilities side of non-life insurers, effects of climate change are realising, if they occur, year after year. So if there appear trends in time series of technical provisions showing claims expectations to rise, insurers

normally react by means of premium adjustments or changing reinsurance programs, which is possible due to the short term contracts. The addition that sustainability risks must be taken into account in underwriting is therefore not necessary, because it is considered in the estimation and the way of handling risks anyway.

The prudent person principle requires already today that financially relevant sustainability risks relating to the investment portfolio are taken into account. While we support the consideration of sustainability aspects as part of all business processes, the proposed reference introduces an element of redundancy, since where relevant, existing Solvency II legislation already requires sustainability risks to be considered in the risk management process. We would like to point out that with the requirement in paragraph (vi) to ensure that sustainability risks in the investment portfolio are properly identified, assessed and managed it is suggested that quantification of this sustainability risks is possible in a meaningful way. On the investment side one would have to look at the business models of each individual investment in the status quo as well as the business strategy/transition. And even then it is not said that this has any significance for financial risks, since questions such as the valuation of assets are more decisive in the medium term (example Solarworld).

Regarding Art. 260, new paragraph 1a we would welcome the inclusion of "where appropriate" in the first part of the first sentence, as this amendment allows for considering sustainability without putting too much focus on this specific risk at the expense of other risks. Provided, sustainability risks are financially relevant and material, we consider it to be acceptable if references to sustainability risks in risk management policies are made. However, we do not see a necessity to include sustainability risks into the risk governance / written policies as no deficiency had been identified by the EU-Commission in any other area but investment management. Therefore, if references to sustainability risks are made in risk management policies, it is important to strike the right balance of risk consideration in risk management practice and supervisory review.

- **Article 269 of Regulation 2015/35**

Already now Article 44 of the Solvency II Directive requires the risk management function to identify and assess all risks to which the undertaking is or may be exposed. As sustainability risks materialize through well-established risk factors, which are covered by existing legislation, financial material sustainability risks are already taken into account in risk man-

agement, ORSA and decision processes of AMSB. That is why we do not regard it as necessary to make an explicit reference on the tasks of the risk management in relation to the identification of sustainability risks. We agree that sustainability risks should be considered in view of their impact of the undertaking's risk profile as part of the risk management process, however, we do not see the need for an explicit reference, as this could also result in the identification and assessment of sustainability risks being overemphasized as it is one of many existing risks which may be relevant in the long-term (similar to, for instance, demographic change or longevity risk).

Further, we would like to point out that we consider related risk management activities as a main task of the first line of defence (1st LoD). The main task of the risk management function as a second line function is to oversee the 1st LoD-activities as defined in the Delegated Acts.

However, if the Commission insists on the explicit integration of sustainability risks in the legal provisions, we consider the proposed reference as acceptable. But we consider it essential, that an assessment of materiality of sustainability risks allows sufficient flexibility for undertakings so that they could integrate sustainability risks in a proportionate manner without changing their internal organisation.

In our view there is no need to propose any other amendment to ensure the effectiveness and adequacy of sustainability risk integration.

The link between sustainability risks and the ORSA is critical in our view. We agree that the "effects of sustainability risks" on the risk profile should be taken only in account if these effects are financially relevant and material for the undertaking.

However, a compulsory analysis of sustainability risks would contradict the basic idea of a company-specific strategy and risk assessment. Therefore, it should be made clear that a measurement and quantification of the effects of sustainability risks should only be necessary if these effects are financially relevant and material for the undertaking's ORSA. If the effects are financially relevant and material, then it should be sufficient to evaluate the material sustainability risks in a qualitative way.

- **Article 272 of Regulation 2015/35**

From a content perspective the underwriting processes in compliance with existing Solvency II legislation include the consideration of the impact of sustainability risk on the risk profile of the undertaking, as well as consideration of these risks in pricing and reserving. In contrast to the investment

related sustainability issues, the Commission has not identified deficiencies in the considerations of sustainability risks in the underwriting process. In fact, as far as sustainability risks are relevant for certain insurance coverages, for example environmental liability insurance or natural catastrophe coverages, dedicated expertise exists contributing to pricing and reserving. There is a risk that additional explicit requirements for the actuarial function regarding the assessment of sustainability risks may be misinterpreted to signal additional reserving or additional risk capital needs, which in both cases is redundant.

So we don't see any reason to include the liability side. As the models to calculate the best estimate are depending on long time data, undertakings are able to deal with changes and trends if there are any. This may lead to changes in prices, products or contracts if necessary, which is easy to do as contracts in non-life last mostly one year.

Art. 262 (1) (a) (iii)
As the actuarial function has to consider the whole underwriting policy we don't see the need to extend the duties. In case there are any management rules concerning sustainability one can assume that these surely will be implemented. In so far we believe it to be sufficient to refer to the management.

- **Article 275 of Regulation 2015/35**

While GDV understands and supports the Commission's ambition that climate and environmental risks are properly managed, we consider the proposed integration of sustainability risks in the remuneration policy redundant. Art. 275 para. 1 lit.(a) already requires the remuneration policy to be in line with the risk management practices, which are supposed to be amended by an explicit reference to sustainability risks. A particular emphasis on sustainability risks would suggest that other risk areas are less important for remuneration purposes. We fully agree with EIOPA's original draft advice which considered such an approach as incoherent. In its final advice EIOPA justified its change of mind by referring to a corresponding requirement included in Regulation on sustainability-related disclosures in the financial sector. However, alignment between Regulations (EU) 2019/2088 and (EU) 2015/35 is not a compelling rationale as they differ from each other both in terms of scope and regulatory objectives.

- **Article 275a of Regulation 2015/35**

Generally, we support the principle-based approach towards integration of sustainability risks in Solvency II. However, regarding Art. 275a (1) already now it is the task within the prudent person principle (ppp) to address sustainability risks in the assessment of investments, if they are financially relevant. Therefore, an explicit reference as part of the ppp is viewed as redundant. The ppp as defined in current legislation already requires to consider any factors that impact the security, quality, liquidity and profitability of the portfolio.

In the case that the explicit integration of sustainability risks in the legal texts is considered indispensable, we suggest to clarify the term as “financially relevant sustainability risks”. In this respect, we have the same understanding as EIOPA that sustainability risks are recognised within the existing ppp and not as another criterion alongside security, liquidity, profitability and quality. We furthermore agree with EIOPA that sustainability risks tend to materialise through the existing risk categories credit risk and property risk and that they can affect the existing investment principles.

The implications of the first part of Article 275a (2), requiring undertakings “to take into account the potential long-term impacts of investment decisions on sustainability factors”, are not made sufficiently clear. As the proposal is worded, it may result in a contradiction to Article 133 of the Solvency II Directive. The requirement to consider the impact of investment allocations on general sustainability factors is much broader than the current ppp (that focuses on impacts of risks on the financial situation of the company) and may entail a contradiction to the requirement to act in the best interest of existing stakeholders of the company (including policyholders).

While regulation in other policy areas may appropriately address general issues of “stewardship” and of directing macroeconomic capital flows, it seems inappropriately placed in prudential insurance regulation that addresses financial interests of stakeholders of the regulated company over the term of their underlying commitments. We suggest not to address broader macro-economic policy issues in prudential regulation and recommend to delete this part.

We view the binary approach as easier, better manageable and less costly for all insurers due to the following reasons:

- Engagement (in direct as well as indirect investments via funds) is very costly. Especially for small and medium sized insurers the on-

ly way to perform engagement within their portfolios is to outsource the necessary engagement activities, which entails considerable costs.

- The question arises as to the added value. We do not believe it is possible to provide the evidence about the effects of engagement activities in a reasonable manner

- Engagement is generally more effective and manageable in equity portfolios than in bond portfolios. However, insurers are mainly bond investors. Engagement is almost impossible with government bonds. Covered bonds might be regulated by special law.

- Generally, the overall effectiveness of engagement policies conducted by small and medium sized companies is questionable.

- An obligatory stewardship approach would create further legislation in order to clarify what stewardship means, in which cases it is appropriate etc.

We would suggest to remove Art. 275a (2), since the objective of prudential regulation is the protection of customers' financial interests resulting from direct contracts with the undertaking. It seems that the proposed addition is out of scope of prudential regulation.

If a stewardship principle is nevertheless followed for all insurers we would suggest to provide small and medium-sized undertakings with more time to gain experience in dealing with ESG concepts before introducing the obligation to implement engagement concepts or to introduce a threshold for small companies. Finally the proportionality principle should be mentioned here explicitly.

- **Article 2 of the proposal**

We welcome the implementation period of 12 months starting with the entry into force of the Delegated Act. Insurers need sufficient time to implement the rules once they are finalized.

Berlin, 6. July 2020