EIOPA-BoS-18/483
26 November 2018

Consultation Paper

on Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD

Responding to this paper

EIOPA welcomes comments on its draft technical advice regarding possible amendments to the delegated acts under Solvency II and IDD concerning the integration of sustainability risks and factors.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale; and
- describe any alternatives EIOPA should consider.

Please send your comments to EIOPA by 30 January 2019 responding to the questions in the survey provided in the following link:

https://ec.europa.eu/eusurvey/runner/CP_Sustainability_Risks.

Contributions not provided using the survey or submitted after the deadline, will not be processed.

Publication of responses

Contributions received will be published on EIOPA's public website unless you request otherwise in the respective field in the template for comments. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure.

Please note that EIOPA is subject to Regulation (EC) No 1049/2001 regarding public access to documents and EIOPA's rules on public access to documents[1].

Contributions will be made available at the end of the public consultation period.

Data protection

Please note that personal contact details (such as name of individuals, email addresses and phone numbers) will not be published. They will only be used to request clarifications if necessary on the information supplied.

EIOPA, as a European Authority, will process any personal data in line with Regulation (EC) No 45/2001 on the protection of the individuals with regards to the processing of personal data by the Community institutions and bodies and on the free movement of such data. More information on data protection can be found at https://eiopa.europa.eu/ under the heading 'Legal notice'.

[1] Public Access to Documents

1. Introduction

1. On 24 May 2018, the European Commission (Commission) adopted a package of measures on sustainable finance. The package included proposals aimed at establishing a unified EU classification system of sustainable economic activities ('taxonomy'); improving disclosure requirements on how institutional investors integrate environmental, social and governance (ESG) factors in their investment and advisory processes; and creating a new category of benchmarks which will help investors compare the carbon footprint of their investments.

2. On 1 August 2018, the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) received a formal request (mandate)[2] from the Commission to provide technical advice supplementing the initial package of proposals and to assist the Commission on potential amendments to, or introduction of, delegated acts under Directive 2009/65/EC (UCITS), Directive 2009/138/EC (Solvency II), Directive 2011/61/EU (AIFM), Directive 2014/65/EU (MiFID II) and Directive 2016/97/EU (Insurance Distribution Directive- IDD) with regard to the integration of sustainability risks and sustainability factors.

3. The Commission invited both EIOPA and ESMA to closely liaise with and consult each other in the preparation of their technical advices to ensure consistency across sectors and requested EIOPA and ESMA to provide technical advice by no later than 30 April 2019.

Background

4. Sustainability has long been at the heart of the European project. Following the adoption of the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development, the Commission has expressed in the Action Plan: Financing Sustainable Growth its intention to clarify so-called fiduciary duties and increase transparency in the field of sustainability risks and sustainable investment opportunities with the aim to:

    - reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;

    - assess and manage relevant financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and

    - foster transparency and “long-termism” in financial and economic activity.

5. Consequently, the Commission adopted several legislative proposals on sustainable finance of 24 May 2018, including a proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and targeted amendments to Commission Delegated Regulation (EU) 2017/565 and Commission Delegated Regulation (EU) 2017/2359 to increase disclosures of environmental, social and

[2] Request from DG FISMA to EIOPA and ESMA for technical advices with regard to the integration of sustainability risks and sustainability factors: https://eiopa.europa.eu/Publications/Requests%20for%20advice/20180724-Letter%20to%20EIOPA-ESMA-St.Fin.pdf

governance-related (hereafter, ESG) information and to integrate ESG-related preferences into the suitability assessment under IDD and MiFID II. The Commission launched public consultations to seek stakeholders' feedback on amendments to Commission Delegated Regulation 2017/565 and Commission Delegated Regulation 2017/2359 to include ESG considerations when investment or insurance advice is provided. Following the public consultations, the Commission intends to adopt the amendments.

6. During the preparation of the CP, EIOPA has liaised closely with ESMA to ensure consistency across sectors when preparing the draft technical advice.

Structure of the technical advice

7. EIOPA has structured its technical advice in two parts: a section related to those issues affecting the provisions of delegated acts under Solvency II and another section related to those issues affecting the provisions of delegated acts under IDD.

8. The structure of the technical advice also reflects the specific issues referred in the Commission's request:

   - organisational requirements;

   - operating conditions;

   - risk management; and

   - target market assessment.

9. The Solvency II section covers the first three mentioned issues. The IDD section covers conflict of interests (related to organisational requirements) and product oversight and governance (related to the target market assessment).

How does EIOPA understand sustainability in the context of the call for advice?

10. The call for advice refers to "sustainability risks and sustainability factors", in respect of the investment decision and insurance distribution processes. What is meant by "sustainability" and "sustainability risks"?

11. The Commission proposal "on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341"[3] defines, in Article 2(o) "sustainable investments":

'sustainable investments' mean any of the following or a combination of any of the following:

(i) investments in an economic activity that contributes to an <u>environmental objective</u>, including an environmentally sustainable investment as defined in Article 2 of [PO: Please insert reference to Regulation on the establishment of a framework to facilitate sustainable investment];

(ii) investments in an economic activity that contributes to a <u>social objective</u>, and in particular an investment that contributes to tackling

[3] https://ec.europa.eu/info/law/better-regulation/initiative/1185/publication/238004/attachment/090166e5baea374d_en

inequality, an investment fostering social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities;

(iii) investments in companies following good governance practices, and in particular companies with sound management structures, employee relations, remuneration of relevant staff and tax compliance;

12. The definition relates to the proposal on "the establishment of a framework to facilitate sustainable investment", i.e. the taxonomy[4]. Its Article 2(a) defines an "environmentally sustainable investment" as *"an investment that funds one or several economic activities that qualify under this Regulation as environmentally sustainable"*. Please note that further work at the European Commission level on the taxonomy is on-going.

13. Recital 58 of Directive (EU) 2016/2341 (the "IORP II" Directive) cites the relevance of environmental, social and governance factors, as referred to in the United Nations-supported Principles for Responsible Investment, for the investment policy and risk management systems of IORPs.

14. The impact assessment of the Commission legislative proposals of 24th May operationalises the concept of sustainability by referring to the so-called environmental, social and governance (ESG) factors. They write:

    Although there is no definitive list of which issues or factors are covered by the terms "ESG", they are - according to UNEP Inquiry and the PRI, broadly defined as follows: (i) Environmental (E) issues relate to the quality and functioning of the natural environment and natural systems; (ii) Social (S) issues relate to the rights, well-being and interests of people and communities; and (iii) Governance (G) issues relate to the governance of companies and other investee entities.

15. For the purpose of this consultation paper and this advice, EIOPA has chosen to refer predominantly to sustainability risks. These sustainability risks are operationalised via/stem from the concepts of environmental, social and governance risks. Sustainability risks could affect both the investments and the liabilities of insurance and reinsurance undertakings. EIOPA acknowledges that currently the assessment of environmental factors, in particular climate change, is most advanced in theory and practice. Please also refer to the final report from the Financial Stability Board "Task force on climate-related financial disclosures"[5], which divides climate-related risks into "two major categories: (1) risks related to the transition to a lower carbon economy and (2) risks related to the physical impacts of climate change".

16. Where the analysis and advice particularly aim to point out to the risks and opportunities brought by sustainability considerations, the term "sustainability factors" is used. In the analysis and advice on IDD the term "ESG preferences", as this is the term currently employed by the Commission in their proposed amendments to IDD and MiFID II delegated acts on the suitability assessment.

17. Sustainability risks, in the same way as legal or emerging risks, tend to materialise through existing risk categories such as credit risk or property risk. In EIOPA's

[4] https://ec.europa.eu/info/law/better-regulation/initiative/1185/publication/238025/attachment/090166e5baea4e23_en

[5] https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf

advice, sustainability risks are explicitly mentioned as risks that will affect the undertaking's risk profile. EIOPA does not consider sustainability risks to be a sub-category of emerging risks. Some sustainability risks may still be emerging, but some are already having an impact, such as physical damage to assets caused by environmental risks.

Approach to the Commission's request

18. The Commission's request for integration of sustainability factors and risks in investment decision and insurance distribution processes is detailed. As EIOPA reads it, this is a request for granular requirements, both from the prudential and the conduct of business points of view. For instance, the Commission requests EIOPA, on organisational requirements, to advise on "*steps of procedures and processes to ensure the effectiveness and adequacy of sustainability risk integration*".

19. The Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 (Solvency II Delegated Regulation) usually does not provide procedural requirements with that level of granularity on specific risks. In fact, such an approach would lead to disproportionate regulation, which would be more appropriately addressed in guidelines.

20. Therefore, EIOPA is proposing be consistent in the way the requirements for sustainability risks are expressed, when compared with other risks in the Solvency II Delegated Regulation.

21. Furthermore, the call for advice targets life insurance products and, therefore, life insurance undertakings. From a prudential point of view, sustainability risks and factors would affect the investments of life and non-life insurance and reinsurance undertakings. In Solvency II, usually the requirements are not for one or another type of undertaking, but for all insurance and reinsurance undertakings. EIOPA has chosen to follow this approach and is proposing that the requirements apply to all undertakings. EIOPA also notes that non-life insurance undertakings could also have long-term liabilities and hence hold assets over the long-term.

22. Finally, the call for advice focuses on integrating sustainability factors and risks in the investment decision process of undertakings. As explained below, this would affect the key functions and in particular the risk management function, the prudent person principle, the written policies on risk management and the ORSA. In particular for non-life insurance and reinsurance undertakings, sustainability risks will affect first their liabilities. EIOPA finds that it would be unbalanced to introduce changes in the Solvency II Delegated Regulation on the asset side and not on the liability side. Therefore, this consultation paper reflects proposals on both sides of the balance sheet in all the areas assessed as relevant by the Commission: organisational requirements, operational conditions and risk management.

Cost-benefit analysis

23. EIOPA has been requested by the Commission to support its Technical Advice with data and evidence on the potential impacts of proposals identified, including an assessment of the relative impacts of different options where this is appropriate. Where impacts could prove substantial, the Commission has requested, where feasible, that EIOPA provide quantitative data. The provision of such data and evidence will aid the Commission in preparing an Impact Assessment on the measures it shall adopt.

24. In order to gather feedback from market participants and interested parties, EIOPA has included a high-level assessment of possible impacts in Annex I. EIOPA has also included specific questions in this Consultation Paper related to the assessment of impacts. EIOPA acknowledges that the impact of the proposals may differ significantly due to different market structures and existing regulatory regimes in various Member States of the European Union. To enable a thorough assessment, respondents are invited to provide EIOPA with any data that they have, which is related to the possible impacts of the proposals outlined.

Questions to stakeholders

Q1: What would you estimate as the costs and benefits of the possible changes to the delegated acts under Solvency II outlined in this Consultation?

As far as possible, please link the costs and benefits you identify to the possible changes that would drive these. In relation to that, please provide, where possible, stating the assumptions underlying your calculations:

a) estimates of one-off and ongoing quantitative costs of change, in euros and relative to your turnover as relevant;

b) evidence on potential qualitative costs of change, please consider both the short and longer term;

c) evidence on potential benefits of the possible changes, please consider both the short and longer term.

Q2: What would you estimate as the costs and benefits of the possible changes to the delegated acts under IDD outlined in this Consultation?

As far as possible, please link the costs and benefits you identify to the possible changes that would drive these. In relation to that, please provide, where possible, stating the assumptions underlying your calculations:

a) estimates of one-off and ongoing quantitative costs of change, in euros and relative to your turnover as relevant;

b) evidence on potential qualitative costs of change, please consider both the short and longer term;

c) evidence on potential benefits of the possible changes, please consider both the short and longer term.

Next Steps

25. EIOPA will consider the responses it receives to this Consultation Paper, and will finalise the draft technical advice for submission to the Commission by end of April 2019.

26. EIOPA will monitor the issues raised in this technical advice and assess the need for issuing guidance to specify particular issues raised in this technical advice.

2. Technical advice on delegated acts under Solvency II

27.The Commission request refers to a wide range of aspects regarding system of governance of insurance undertakings which could be potentially affected by an amendment of the delegated acts under of Solvency II.

28.The relevant provisions of the Solvency II Directive are the following:

- Article 50(1)(a) and (b)

"The Commission shall adopt delegated acts in accordance with Article 301a to further specify the following:

(a) the elements of the systems referred to in Articles 41, 44, 46 and 47, and in particular the areas to be covered by the asset-liability management and investment policy, as referred to in Article 44(2), of insurance and reinsurance undertakings;

(b) the functions referred to in Articles 44, 46, 47 and 48."

- Article 135(1) (a) of the Solvency II Directive

"The Commission may adopt delegated acts in accordance with Article 301a specifying qualitative requirements in the following areas:

the identification, measurement, monitoring and managing of risks arising from investments in relation to the first subparagraph of Article 132(2);"

29.The table below lists the relevant articles of the Solvency II Delegated Regulation.

Empowerment	Solvency II	Delegated Regulation
Article 50(1)(a) Elements of system of governance	Article 41 General governance requirements	Article 258 General governance requirements Article 268 Specific provisions (functions) Article 273 Fit and proper requirements Article 274 Outsourcing Article 275 Remuneration policy
	Article 44 Risk management	Article 259 Risk management system Article 260 Risk management areas
	Article 46 Internal control	Article 266 Internal control system
	Article 47 Internal audit	

Article 50 (1) (b) Functions	Article 44 Risk management function	Article 269 Risk management function
	Article 46 Compliance function	Article 270 Actuarial function
	Article 47 Internal audit function	Article 271 Internal audit function
	Article 48 Actuarial function	Article 272 Actuarial function
Article 135 (1) (a)	Article 132(2) Prudent person principle	N/A

2.1 Organisational requirements

Extract from the European Commission's request for advice:

"EIOPA and ESMA are invited to provide technical advices on corporate governance mechanisms within the organisation of the financial market participants and investment and insurance advisors, including, where relevant, but not limited to:

- *The tasks and the role of the risk-management function or procedures for risk assessment, the compliance function, the internal control function or system, the internal audit function and/or the actuarial function in the system of governance and tasks or responsibilities of bodies that undertake the management and supervisory functions in the corporate governance in relation to sustainability risk limits and overseeing their implementation;*
- *steps of procedures and processes to ensure the effectiveness and adequacy of sustainability risk integration;*
- *skill, expertise and knowledge required for the assessment of sustainability risks;*
- *regular reviews of the mechanisms put in place to integrate sustainability risks and regular internal reporting;*
- *adequate support to (e.g. analysis, research and legal advice), and resources across, all relevant functions and where several functions are involved in the integration of sustainability risks, the requirements on cooperation with each other"*

30. With respect to organisational requirements the relevant articles of the Solvency II Delegated Regulation include: article 258 (general governance requirements), articles 268-272 (functions), article 273 (fit and proper requirements), article 274 (outsourcing) and article 275 (remuneration policy).

Analysis

31. Under Solvency II insurance and reinsurance undertakings are requested to have in place an effective system of governance which provides for sound and prudent management of their business. The system of governance should be proportionate to the nature, scale and complexity of the operations of the undertaking.

32. The requirements on the system of governance are irrespective of the business model or risk profile of undertakings, without unduly restricting them in choosing their own organisational structure.

33. EIOPA considers that the current Solvency II provisions regarding the responsibilities and tasks of the administrative, management or supervisory body (AMSB) and the key functions do not represent an obstacle for the integration of sustainability risks into the undertaking's investment decision process. On the contrary, already now all risks, and therefore also sustainability risks, should be taken into account both in the risk management (and in the ORSA) process and subsequently in the decision processes of the AMSB. However, due to the relative novelty of sustainability risks and the particular long time horizon and uncertainty of risks related to climate change, it seems advisable to more explicitly integrate sustainability risks in some aspects of the system of governance.

34. The AMSB of the insurance or reinsurance undertaking is responsible for the approval of the business strategy and the investment strategy. It is also responsible for the approval of the undertaking's written policies on the system of governance, including the risk management policy. Consequently, the AMSB is expected to have a crucial role in providing the adequate corporate framework to promote or, at least, to allow for a proper integration of sustainability risks in the investment decision process.

35. Although the concrete allocation of tasks within the undertaking will vary, the integration of sustainability risks in the investment decision process will have a direct and significant impact on the investment management tasks at operational level and will consequently affect the control over those by the key functions, in particular the risk management function.

36. As responsible for monitoring the risk management system, the risk management function should control the proper identification and assessment of sustainability risks.

37. Insurance and reinsurance undertakings, irrespective of their particular investment strategy and of their nature (life or non-life), are inevitably exposed to sustainability risks and they should, at least, assess the materiality of those risks. EIOPA considers that making explicit reference to sustainability risks as proposed will promote that insurance and reinsurance undertakings take proper consideration of sustainability risks in the future and allows sufficient flexibility considering that not all undertakings will be affected in the same manner.

38. EIOPA considers that other elements of the system of governance, such as the fitness requirements and the content of the remuneration policy, could be adapted for a better integration of sustainability risks in the undertakings' investment decisions. However, taking into account the current level of detail of the Solvency II Delegated Regulation, which does not contain specific organisational provisions for particular risk areas, EIOPA considers that a further explicit reference to sustainability risks would not be coherent. With respect to those elements, guidelines might be helpful to ensure common understanding, allowing for more flexibility.

39. With respect to fitness requirements, undertakings are already requested to ensure that AMSB members collectively possess the necessary qualifications, competency, skills and professional experience in the relevant areas of the business in order to effectively manage and oversee the undertaking in a professional manner. Insurance and reinsurance undertakings should employ personnel with the skills, knowledge and expertise necessary to carry out the responsibilities allocated to them. The assessment of whether a person is fit includes an assessment of the person's professional and formal qualifications, knowledge and experience not only within the insurance and financial sector but also in other businesses.

40. The assessment of sustainability risks requires deep knowledge of the undertaking's business, the external environment and the interaction between both. For such purpose, relevant knowledge may include a wide range of different areas such as ecology, law, sociology, financial markets, among others. In particular, risk managers and asset managers should be able to understand what "sustainability risks" means while being able to use relevant internal/external data.

41. EIOPA considers that under the current fitness requirements in the Solvency II Delegated Regulation, insurance and reinsurance undertakings could adapt their internal policy and implement training programs to ensure a sufficient understanding of sustainability risks by the AMSB and relevant functions within the company. Depending on their specific investment strategy, their risk profile and their size, the recruitment of dedicated experts may be needed for some undertakings. In any case, insurance and reinsurance undertakings should be requested to build-in the necessary expertise with particular consideration of the proportionality principle.

42. Consequently, a coherent regulatory action to reinforce fitness requirements regarding sustainability could be taken at the level of guidelines. That would be consistent with the recommendation of the EU High Level Expert Group on Sustainable Finance in January 2018 to modify EIOPA's guidelines on system of governance to include "*relevant long-term risks and opportunities linked to sustainability*" referring to the appropriate qualification, experience and knowledge which the members of the administrative, management or supervisory body should collectively possess [6].

43. Remuneration may also be used as a tool for the integration of sustainability risks in the investment decisions. Solvency II Delegated Regulation currently provides that the remuneration policy and remuneration practices shall be in line with the undertaking's business and risk management strategy, its risk profile, objectives, risk management practices and the long-term interests and performance of the undertaking. Therefore, changes in the undertaking's investment risk management policy to incorporate sustainability risks will have a subsequent impact in the undertaking's remuneration policy. Undertakings are also requested to take into account both financial and non-financial criteria when assessing an individual's performance. The consideration of sustainability risks is a good example of non-financial criteria that could be taken into account when assessing individual performance.

44. EIOPA considers that the current Solvency II requirements on remuneration do not need to be modified to promote the integration of sustainability risks. Nevertheless some guidance on how sustainability could be considered by undertakings in their remuneration policy and practices might be deemed useful.

45. Outsourcing is also considered as a topic where further guidance could be helpful, to clarify the expectations on the allocation of responsibilities between the insurance undertakings and assets managers in those cases where the investment activities are (partially) outsourced.

46. Consequently, EIOPA is proposing to add a reference to sustainability risks only in Article 269 of the Solvency II Delegated Regulation, on the risk management function. In addition, EIOPA is proposing to include reference to sustainability risks

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[6] See https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en

in Article 272 of the Solvency II Delegated Regulation, on the actuarial function; the rationale of such proposal is presented in the next section (see paragraphs 67-71).

Draft Technical Advice

Policy proposals for organisational requirements

Solvency II Delegated Regulation to be amended as follows:

Article 269 (1)

"The risk management function shall include all of the following tasks:

(a) assisting the administrative, management or supervisory body and other functions in the effective operation of the risk management system;

(b) monitoring the risk management system;

(c) monitoring the general risk profile of the undertaking as a whole;

(d) detailed reporting on risk exposures and advising the administrative, management or supervisory body on risk management matters, including in relation to strategic affairs such as corporate strategy, mergers and acquisitions and major projects and investments;

(e) identifying and assessing emerging risks **and sustainability risks**."

Questions to stakeholders

Q3: Do you agree with the proposed reference on the tasks of the risk management function?

Q4: Would you propose any other amendment to the organisational requirements in the Solvency II Delegated Regulation to ensure the effectiveness and adequacy of sustainability risk integration?

2.2 Operating conditions

Extract from the European Commission's request for advice:

"The Commission is […] seeking the EIOPA and ESMA technical advices on how and where financial market participants are to integrate relevant sustainability risks within their business models and relevant procedures in the areas of […]:

- operating conditions, in particular investment strategy and asset allocation […] taking into account the size, nature, scale and complexity of their activities.

Operating conditions in delegated acts adopted under Article 50(1)(A) of the Solvency II Directive do not establish the details of the integration of sustainability risks within the conduct of business or prudential person rules and due diligence requirements. Financial market participants therefore should (i) define an investment strategy, (ii) where relevant, identify a proper asset allocation which clarifies how client's money is allocated in accordance with the investment strategy, and, (iv) ensure that the portfolio remains in line with the investment strategy and, where relevant, the asset allocation, while integrating sustainability risks."

"EIOPA and ESMA are invited to also consider Article 135 (1) (a) of the Solvency II Directive for potential new level 2 measures."

47. With respect to operating conditions, it should be noted that the Solvency II Delegated Regulation does not currently foresee any specific provision related to the prudent person principle of Article 132 of the Solvency II Directive.

48. Following the approach set out in the introduction of the paper, EIOPA considers that "operating conditions" are being affected by sustainability in two aspects: first, the investment strategy and in particular the prudent person principle; second, the underwriting policy.

Analysis

<u>On the prudent person principle</u>

49. The overarching investment principle under Solvency II, according to Article 132 of the Solvency II Directive, is the prudent person principle. This principle requires that an undertaking only invests in assets and instruments whose risks it can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs. Furthermore, all assets shall be invested in such a manner to ensure the security, quality, liquidity, and profitability of the portfolio as a whole. In particular, assets held to cover the technical provisions shall be invested in the best interest of all policyholders and beneficiaries taking into account any disclosed policy objective.

50. It is the stated objective of the European Commission to reorient private capital flows towards more sustainable investments, defined as those that pursue either environmental, social and governance objectives. EIOPA needs to assess, from a prudential perspective, how this would affect the insurance and reinsurance undertakings' investment strategy and asset allocation.

51. It has become clear, over the past years, that sustainability risks and in particular climate-change risks will affect insurance and reinsurance undertakings. See for instance the 2015 report of the Prudential Regulation Authority "The impact of

climate change on the UK insurance sector"[7] or the 2017 report of the De Nederlandse Bank "Waterproof? An exploration of climate-related risks for the Dutch financial sector"[8].

52. Similarly to risks, the evolution of activities towards more sustainability may also create opportunities and increase the financial return of an investor's diversified portfolio.

53. Undertakings shall therefore, when investing according to the prudential person principle take into account sustainability risks, in line with the economic risk-based approach of Solvency II.

54. The prudent person principle allows for sustainability risks to be taken into account, in analogy with other risks. However, the principle as currently stated in the Solvency II Directive does not require explicitly undertakings to consider these risks.

55. There is a lack of evidence that undertakings across Europe effectively and consistently consider sustainability risks in their investment strategy. This can be explained by a lack of a clear taxonomy of sustainable ("green") / non-sustainable ("brown") investments, a lack of reliability and comparability on ESG information, a lack of experience and ESG skills among institutional investors and asset managers, or the impact on costs and risk-adjusted performance.[9]

56. By assessing the sustainability risks on their investments, insurance undertakings would act in the best interest of the policyholders and beneficiaries, as required by the prudent person principle. Undertakings should assess the extent to which sustainability risks would affect the undertaking's investments and its ability to meet its obligations towards the policyholder.

57. Therefore, EIOPA finds it appropriate to advise the Commission to use the possibility of the empowerment and to include a new article in the Solvency II Delegated Regulation on the prudent person principle, stating how sustainability risks need be considered.

58. Since the prudent person principle requires undertakings to consider the security, quality, liquidity, and profitability of their portfolio as a whole, a possibility would be to further require them to consider the sustainability of their portfolio. EIOPA believes this would not be a solution that would fit best the emerging practices on sustainability risks. Indeed, where sustainability risks materialise, they can affect the security and/or the quality and/or the liquidity and/or the profitability of the investment portfolio. Therefore, it would be operationally more appropriate and better in line with the Solvency II Directive to request undertakings to take account sustainability risks when assessing their investment portfolio.

[7] See https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf?la=en&hash=EF9FE0FF9AEC940A2BA722324902FFBA49A5A29A

[8] See https://www.dnb.nl/en/binaries/Waterproof_tcm47-363851.pdf?2018111417

[9] See COMMISSION STAFF WORKING DOCUMENT IMPACT ASSESSMENT Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment and Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 and Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks, Brussels, 24.5.2018 SWD(2018) 264 final.

59.As highlighted in several reports and analyses, sustainability risks may materialise themselves through a “transition risk”. For instance, the 2016 report of the Advisory Scientific Committee of the European Systemic Risk Board “Too late, too sudden: transition to a low-carbon economy and systemic risk”[10] highlights the risk of assets becoming unprofitable, leading investors to dis-invest in certain categories of assets, the so-called “stranded assets”.

60.Policymakers should be careful and address this risk. But more fundamentally, EIOPA strongly believes that the transition towards a sustainable economy cannot be achieved by simply implementing a binary approach between sustainable investments and non-sustainable investment.

61.Indeed, institutional investors such as insurance and reinsurance undertakings apply engagement strategies to steer the activities of the assets they are holding (where their shareholders’ rights allow). This is the principle of stewardship by which undertakings would act to influence the strategy and business of the firms in which they are investing in order to progress towards sustainable economic activities. This principle is already recognised in other regulatory action and initiatives[11] and EIOPA believes that the transition towards a more sustainable economy should also rely on this principle. From a prudential point of view, this can greatly contribute to the management of sustainability risks.

62.That is why EIOPA is not only proposing that sustainability risks be assessed in the investment portfolio of undertakings, but is also proposing to complement the prudent person principle with the requirement for undertakings to assess the potential long-term impact of their investments on sustainability factors, which would support undertakings’ active engagement with investees to achieve sustainable investment outcomes. In this respect, EIOPA’s proposal also considers the existing requirements posed by the IORPII Directive, where it is stated that “within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors”. By addressing both sides of the investment, the impact of the investments and the impact on the investments, a sustainable investment cycle would be implemented:

63.One last element considered by EIOPA in the prudent person principle is the link of sustainability between the designing of insurance products and investment decision

[10] See https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf?ea575bbcd2dd43ecebd545ea146f9710

[11] See Directive 2017/828 of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

processes. Later in this consultation paper, EIOPA further develops proposals to integrate sustainability in Product Oversight and Governance (POG) requirements in the Insurance Distribution Directive applicable for the design of insurance products. Given that the ESG preferences of policyholders and beneficiaries will be reflected in the product design of insurance contracts, these ESG preferences should also be reflected in the investment strategy and decisions of undertakings.

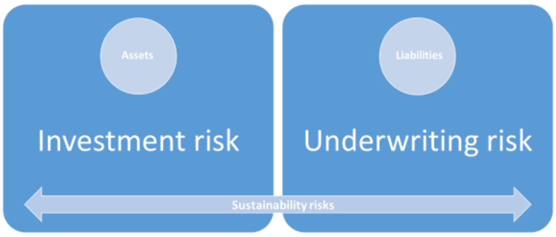
64.In terms of practical implementation, reflecting policyholders' and beneficiaries' ESG preferences in the investment portfolio may only be possible for certain types of products. Typically, if the insurance product provides that undertakings will share a part of their general portfolio investment return with policyholders, reflecting all policyholders' preferences would not be materially possible. However, in the case where the insurance-based investment product relies on funds and UCITS, the insurance undertaking will be able to participate in the selection of the fund reflecting the ESG preferences of the policyholder.

65.From the prudent person principle point of view, undertakings will still have the duty to monitor the ESG strategy of these funds to ensure it continues to reflect policyholders' preferences. Including explicitly this requirement in the Solvency II Delegated Regulation will also clearly provide the competent insurance supervisor with the legal hook to analyse how policyholders' preferences are reflected and how they are integrated in the investment strategy of undertakings.

66.To clarify this link between Solvency II and IDD, EIOPA proposes to include a recital. This recital should clarify the meaning of the term "where relevant", indicating that ESG preferences should be reflected in the investments where ESG preferences are expressed as part of product oversight and governance arrangements.

<u>On the underwriting policy</u>

67.If one considers that sustainability risks are relevant in analysing an asset in which an insurance undertaking is investing, then, symmetrically, these sustainability risks would also be relevant in analysing the terms under which an insurance contract are offered: the underwriting policy.



68.Typically in the case of transport insurance, construction insurance or liability insurance, the policyholder and its claims may be affected by sustainability risks. Solvency II does not regulate the pricing of insurance contracts, but provides requirements on the role of the actuarial function with regards to the underwriting policy.

69.All risks and expected future developments would then be expected to be included in the best estimate calculation, as provided already by Article 29 of the Solvency II Delegated Regulation.

70.The actuarial function is required to express an opinion on the underwriting policy; this opinion shall include considerations on the effect of inflation, legal risk or change in the composition of the undertaking's portfolio, among other aspects.

71. EIOPA believes that due consideration should also be given to sustainability risks with respect to the underwriting policy.

Draft Technical Advice

Policy proposals on operating conditions

- New article in the Solvency II Delegated Regulation, Chapter IX, new Section 6:

Section 6 Investments

Article 275bis

Integration of sustainability risks in the prudent person principle.

"1. Within the prudent person principle, insurance and reinsurance undertakings shall take into account sustainability risks when assessing the security, quality, liquidity, and profitability of the portfolio as a whole.

2. Insurance and reinsurance undertakings shall take into account the potential long-term impact of investment decisions on sustainability factors and, where relevant, reflect the environmental, social and governance preferences of policyholders and beneficiaries."

- New recital in the Solvency II Delegated Regulation:

"**(xx) Insurance undertakings should reflect the environmental, social and governance preferences of policyholders and beneficiaries in their investment portfolio where these preferences are relevant for the product oversight and governance arrangements according to Directive 2016/97 and Commission Delegated Regulation 2017/2358, as indicated by the use of the terms "where relevant, reflect the environmental, social and governance preferences of policyholders and beneficiaries " in this Regulation**."

- Solvency II Delegated Regulation to be amended as follows:

Article 272

Actuarial function

(…)

6. Regarding the underwriting policy, the opinion to be expressed by the actuarial function in accordance with Article 48(1)(g) of Directive 2009/138/EC shall at least include conclusions regarding the following considerations:

(b)the effect of inflation, legal risk, **sustainability risks**, change in the composition of the undertaking's portfolio, and of systems which adjust the premiums policyholders pay upwards or downwards depending on their claims history (bonus-malus systems) or similar systems, implemented in specific homogeneous risk groups;

(…)

Questions to stakeholders

Q5: Do you agree with the proposed new article for the integration of sustainability risks into the prudent person principle?

Q6: Do you agree with the proposed amendment of the article for the actuarial function?

2.3 Risk management

Extract from the European Commission's request for advice:

"In line with the Delegated Acts adopted under Article 51(4) of the UCITS Directive, Article 50(1)(a) and (b) of the Solvency II Directive, Articles 15(5) and 19(11) of AIFMD and Article 16(12) of MiFID II risk management systems or procedures for risk assessment should be in place to monitor risks to which they are exposed. Financial market participants must employ risk-management processes which enable them to measure and manage at any time the risk of the positions and their contribution to the overall risk profile. Risk assessments should consider both financial and relevant sustainability risks. The valuation processes should therefore ensure a proper degree of consideration of relevant/material sustainability risks. The technical advices should describe the elements needed to ensure that financial market participants take into account sustainability risk effectively as well as the tasks to be fulfilled by the relevant functions, such as risk management function, in this respect."

72. With respect to risk management, the relevant articles of the Solvency II Delegated Regulation include: article 259 (risk management system), article 260 (risk management areas), article 262 (overall solvency needs) and article 269 (risk management function).

73. For the risk management function, please refer to the "organisational requirements" part of this consultation paper.

Analysis

Risk management system and areas

74. As part of the Solvency II requirements on governance, insurance and reinsurance undertakings are requested to have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report the risks to which they are or could be exposed.

75. The Solvency II Directive provides that at least the following areas should be covered by the risk management system: underwriting and reserving, asset-liability management, investment, liquidity and concentration risk management, operational risk management and reinsurance and other risk-mitigation techniques. The Solvency II Delegated Regulation specifies the content of the risk management policies in all these areas.

76. From a practical implementation point of view, EIOPA believes that undertakings should consider how sustainability risks could materialise within each area of the risk management system.

77. Furthermore, given the context of this call for advice, given that sustainability risks are to be included in investment decision and insurance distribution processes, it appears essential that the policy on investment risk management describes the actions to be taken by the insurance and reinsurance undertakings to ensure that sustainability risks relating to the investment portfolio are properly managed. This also ensures consistency with Article 25 of the IORP II Directive on the risk

management system according to which ESG risks shall be covered for the whole investment portfolio and IORPs are expected to manage these risks.

78. In particular in the case of climate-related risk, it would be expected that both physical and transition risks are considered. For instance, please refer to the Financial Stability Board "Task force on climate-related financial disclosures"[12], which divides climate-related risks into "two major categories: (1) risks related to the transition to a lower carbon economy and (2) risks related to the physical impacts of climate change".

79. Sustainability risks relating to the investment portfolio could also affect other risk management areas. For instance, one could assess that an investment in an asset with sustainable activities would be easier to sell, i.e. more liquid, due to market preferences towards sustainable investment. Another area where sustainability risks relating to the investment portfolio appear relevant is concentration risk management. There are different types of concentration: for instance on a group, on a sector, on a geographical area. There could also be concentration in investments that would all be particularly sensitive to sustainability risks. Therefore EIOPA is proposing to add a new paragraph so that all policies on other relevant areas than investment risk reflect as well sustainability risks.

80. As referred to before, sustainability risks could also affect the liabilities of insurance and reinsurance undertakings' balance sheets. For example, an increase in environmental risks may impact on losses, or would require additional data to be considered in the underwriting process. Therefore EIOPA also proposes to include sustainability risks under the "underwriting and reserving" risk management area.

81. EIOPA considers that the inclusion of reference to sustainability risks in the Article 260 "Risk management areas" is sufficient to allow the risk management system to appropriately consider these risks. Article 259 "Risk management system" refers to the risk management strategy and the written policies. It does not appear necessary to include a further reference in that article.

ORSA

82. The ORSA has become a key element of the risk management system of insurance and reinsurance undertakings. Article 45 of the Solvency II Directive provides that the ORSA shall at least include an assessment of the overall solvency needs, of the compliance, on a continuous basis, with the capital requirements and of the significance with which the risk profile of the undertaking deviates from the assumptions underlying the Solvency Capital Requirements.

83. The Solvency II Delegated Regulation further specifies the assessment to be conducted on the overall solvency needs. It provides that the assessment shall be forward-looking and a set of minimum elements to be included are provided.

84. Article 262 of the Delegated Regulation specifies, in particular, that the assessment due to changes in the risk profile should be analysed considering external risks to the insurance or reinsurance undertaking. The economic and financial environment is mentioned as an example.

[12] https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf

85. Paragraph 2 of Article 262 also refers to the "risks the undertaking faces in the long-term". There is no denying that this is relevant for sustainability risks. In particular, the development in the long term of climate change will have a material impact on insurance and reinsurance undertakings' business and risk profile.

86. Article 28 of the IORP II Directive on the "own-risk assessment" specifically mentions ESG factors and, in particular risks related to climate change, as an element to be considered in the own risk assessment (ORA) of IORPs.

87. Given the key role of ORSA in Solvency II and in insurance and reinsurance undertakings' risk management, given its forward-looking and long-term aspect and, given the objective to ensure cross-sectoral consistency, EIOPA believes that Article 262 of the Delegated Regulation should include a reference to sustainability risks.

88. The assessment of the overall solvency needs is expected to provide a quantitative estimation of these needs. EIOPA has noticed that science and financial institutions have, so far, focused their attention on climate-related risks and climate change risks. In this area in particular, scenarios and projections have been quantified. Of course, all sustainability risks may be relevant to a specific insurance and reinsurance undertaking. However, in EIOPA's view, climate-related risks and climate change risks are particularly relevant. Given the availability of scenarios for climate change risks, EIOPA has considered that mentioning this risk explicitly would make sense and help undertakings to quantify their overall solvency needs.

Draft Technical Advice

Policy proposals for risk management

Solvency II Delegated Regulation to be amended as follows:

Article 260

Risk management areas

"1. The areas referred to in Article 44(2) of Directive 2009/138/EC shall include all of the following policies:

(a) Underwriting and reserving:

(i) actions to be taken by the insurance or reinsurance undertaking to assess and manage the risk of loss or of 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**;

(…)(c) Investment risk management:

(…)

(vi) actions to be taken by the insurance or reinsurance undertaking to ensure that sustainability risks relating to the investment portfolio are properly identified, assessed and managed.

(…)

1.a The policies on the areas referred to in paragraph 1 shall include, where appropriate, consideration of sustainability risks.

Article 262

Overall solvency needs

"1. The assessment of an insurance or reinsurance undertaking's overall solvency needs, referred to in Article 45(1)(a) of Directive 2009/138/EC shall be forward-looking and include all of the following elements:

(a) risks the undertaking is or could be exposed to, including operational risks, taking into account potential future changes in its risk profile, due to:

i. the undertaking's business strategy,

ii. the economic and financial environment, **or**

iii. **the effect of sustainability risks, including climate change**~~, including operational risks~~ ;

(…)

Questions to stakeholders

Q7: Do you agree with the proposed reference to sustainability risks under the investment as well as the underwriting and reserving risk management policy?

Q8: Do you agree that other risk management policies may include reference to sustainability risks?

Q9: Do you agree with the proposed requirement to include consideration of the effect of sustainability risks in the overall solvency needs assessment of the undertakings'' ORSA?

3 Technical advice on delegated acts under IDD

89.The relevant provisions in the Insurance Distribution Directive are:

Empowerment	IDD	Delegated Regulation
Article 28(4)(a) and (b)	Article 27 Prevention of conflicts of interest Article 28 Conflicts of interest	Article 3 - Identification of conflicts of interest Article 4 - Conflicts of interest policy Article 5 - Procedures and measures under the conflicts of interest policy Article 6 – Disclosure Article 7 - Review and record keeping
Article 25(2)	Article 25 - Product oversight and governance requirements	Article 4 – Product approval process Article 5 - Target market Article 6 - Product testing Article 7 - Product monitoring and review Article 8 - Distribution channels Article 10 - Product distribution arrangements Article 11 - Informing the manufacturer

3.1 Organisational requirements

Conflicts of interest

Extract from the European Commission's request for advice

"EIOPA and ESMA are invited to provide technical advices on corporate governance mechanisms within the organisation of the financial market participants and investment and insurance advisors, including, where relevant, but not limited to:

- measures and policies specifically considering types of conflict of interest that might arise in relation to sustainability considerations and the steps to identify, prevent, manage and disclose them."

Analysis

90. Conflicts of interest are explicitly addressed as part of the organisational requirements in IDD. Insurance undertakings and insurance intermediaries have to maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its customers.

91. Within its mandate to EIOPA, the Commission clarified that its objective is to explicitly require the integration of sustainability risks i.e. sustainability risks, in the investment decision or insurance distribution processes as part of duties towards customers.

92. EIOPA considers that the integration of sustainability risks within the IDD requirements is better done through a high-level principle-based approach, similar to that already followed for all other relevant risks (e.g. credit risk, market risk, liquidity risk).

93. Detailed prescription would enhance the risk of regulatory arbitrage by firms and could result – at this stage - in regulatory errors, especially considering that there are still several ongoing legislative proposals in this area; for example the Commission's legislative proposals on:

- The establishment of a framework to facilitate sustainable investments;
- Disclosures relating to sustainable investments and sustainability risks; benchmarks; and
- The establishment of a unified EU classification system of sustainable economic activities ('taxonomy').

94. The expanding range of activities that many insurance intermediaries and undertakings carry on simultaneously has increased the potential for conflicts of interest between those different activities and the interests of their customers. It is, therefore, the aim of the IDD to ensure that such conflicts of interest do not adversely affect the interests of the customer. Customers not only pursue specific financial objectives, but may also have non-financial objectives, including ESG preferences that need to be considered by insurance intermediaries and insurance undertakings providing insurance distribution services. EIOPA has a broad understanding of what customers' interests may consist of, not limited to financial objectives, but also including interests linked to the ESG preferences which customers pursue when investing their money.

95. Accordingly, when identifying conflicts of interest, insurance intermediaries and insurance undertakings should also consider whether conflicts arise with regard to the ESG preferences of their customers. Situations where this could be the case, include defining the investment strategy for the customers' assets and the exercise of shareholder rights in companies in which the customers' assets with ESG preferences are invested. Another example is defining the investment strategy for underlying assets which may conflict with the ESG preferences of the customers, or different charging structures (such as different rates of commissions paid) for the underlying assets.

96. In the course of providing insurance distribution activities, distributors may face situations in which divergent customer interests arise from sustainability considerations. This can, in particular, be the case, if a customer has ESG

preferences which are not compatible with his own risk tolerance or his ability to bear losses due to his financial situation. Although these interests are divergent, the divergence is caused by the customer's own diverging interests, but not resulting from a conflict with the interests of another person, such as the insurance intermediary providing the insurance distribution activities. Therefore, these situations are not addressed in the context of the conflicts of interests regime, but within the context of the distributor's assessment requiring that the different objectives and interests of the customers are taken into account when recommending an insurance product which is suitable for the customer.

97. In addition to an amendment to the legal provisions of the IDD Delegated Regulation governing the identification of conflicts of interest, EIOPA also considers it useful to add a recital in the IDD Delegated Regulation on the topic of 'conflicts of interest', in order to clarify that when identifying the types of conflicts of interest whose existence may damage the interests of a customer, insurance undertakings and insurance intermediaries should include those conflicts of interest that stem from taking into account sustainability considerations. EIOPA believes that the addition of the recital is important to ensure that insurance undertakings and insurance intermediaries have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process does not lead to mis-selling practices and does not damage the interests of the customer. Finally, considering the relevance of these conflicts of interest, insurance undertakings and insurance intermediaries would be expected to include a clear reference in their conflict of interests policy on how they are identified and managed.

Draft Technical Advice

Policy proposals for conflicts of interest

IDD Delegated Regulation 2017/2359 to be amended as follows:

New recital 3 (bis) of the IDD Delegated Regulation to be introduced

When identifying the types of conflicts of interest whose existence may damage the interests of a customer, insurance undertakings and insurance intermediaries should include those that may arise in relation to sustainability considerations.

Insurance undertakings and insurance intermediaries should have in place appropriate arrangements to ensure that the inclusion of ESG considerations in the advisory process does not lead to mis-selling practices.

Article 3(1):

"1. For the purposes of identifying, in accordance with Article 28 of Directive (EU) 2016/97, the types of conflicts of interest that arise in the course of carrying out any insurance distribution activities related to insurance-based investment products and which entail a risk of damage to the interests of a customer**, including the interest in attaining ESG objectives (where relevant)**, insurance intermediaries and insurance undertakings shall assess whether they, a relevant person or any person directly or indirectly linked to them by control, have an interest in the outcome of the insurance distribution activities, which meets the following criteria:

(a) it is distinct from the customer's or potential customer's interest in the outcome of the insurance distribution activities;

(b) it has the potential to influence the outcome of the distribution activities to the detriment of the customer.

Insurance intermediaries and insurance undertakings shall proceed in the same way for the purposes of identifying conflicts of interest between one customer and another."

Questions to stakeholders

Q10: Do you agree that conflicts of interest may also arise with regard to the ESG objectives of customers of insurance undertakings and insurance intermediaries? Please give reasons for your answer.

Q11: Do you agree that conflicts of interest with the ESG objectives of customers may arise, particularly in regards to the investment strategy for the customers' assets and the shareholder rights in companies in which the customers' assets with ESG preferences are invested?

Q12: What other situations do you envisage might give rise to a conflicts of interest between the interest of customers in attaining their ESG objectives and an interest of another party?

Q13: What measures, if any, should be taken to address conflicts of interest arising specifically between the customers interest in attaining his ESG objectives and the interest of another party?

3.2 Product Oversight and Governance

Extract from the European Commission's request for advice

"The conditions to identify a target market in Commission Delegated Directive 2017/593 adopted under Articles 16(12) and 24(13) of MiFID II and Commission Delegated Regulation 2017/2358 adopted under Article 25(2) of IDD do not explicitly establish the details of the integration of sustainability factors by investment firms manufacturing financial instruments and their distributors and insurance undertakings, intermediaries manufacturing insurance products for sale to customers and insurance distributors referred to in Article 2 of Commission Delegated Regulation 2017/2358 respectively.

In order to ensure that products and, where relevant, the related services are offered in the interest of clients and that sustainability factors are taken into account in the target market assessment, EIOPA and ESMA should analyse the relevant changes to Commission Delegated Regulation 2017/2358, in particular Articles 5 to 11, and Commission Delegated Directive 2017/593, in particular Articles 9(9), 9(11), 10(2) and 10(5).

This approach should duly consider the existing ESMA Guidelines on MiFID II product governance requirements that already provide a good indication on how sustainability factors should be taken into account when identifying the target market. ESMA should ensure that changes to the definition of the target market do not lead to miss-selling practices, e.g. by clearly identifying investment objectives and ESG constraints. In addition, the possibility to identify a target market for clients without ESG preferences should be maintained. When establishing a requirement to consider sustainability factors under the client's objectives and needs, EIOPA and ESMA should also take existing practices for the identification of the target market into account.

The technical advices should be consistent with each other, while recognizing, where relevant, the difference in terminology used by IDD and MiFID II. The technical advices should list in mapping the provisions of delegated acts that should be amended."

Analysis

98. The objective of the IDD product oversight and governance requirements is to ensure that firms, which manufacture and distribute insurance products, act in the customer's best interests during all stages of the lifecycle of products or services.

99. The Commission's Call for Advice refers to the need to establish details for insurance undertakings and manufacturing insurance intermediaries to integrate sustainability factors when identifying the target market of the product. EIOPA notes that the Commission has published legislative proposals to create a common EU classification or taxonomy for products fulfilling ESG factors. However, taking into account that the finalisation of this taxonomy will likely occur after the amendments to the product oversight and governance arrangements will have taken effect, insurance undertakings will have to clearly specify which criteria they apply to define ESG preferences, while taking into account current market standards. Until the finalisation of the common EU taxonomy by the Commission, market participants

will be required to identify ESG classification standards they consider to be appropriate in the context of the product oversight and governance requirements.

100. It should also be noted that insurance undertakings are not required to consider ESG factors in the product approval process of any insurance product, but only if the insurance product is supposed to have an ESG profile. Hence, ESG preferences have to be considered only where they are relevant for the product design. This is clarified in the proposed wording by introducing the caveat "where relevant". A recital to be added to the IDD Delegated Regulation has also been included to better explain the purpose of the notion of "where relevant".

101. Furthermore, the Commission's Call for Advice states that the definition of the target market should not lead to mis-selling practices. For this purpose, it might be important to clearly define the investment objectives and constraints resulting from ESG considerations.

102. Sustainability factors may not only play a role in context of the target market assessment, but also with regard to related duties such as product testing and product monitoring and review, as well as with regard to distribution arrangements. For example, testing may require assessing whether the underlying assets of an insurance-based investment product with ESG objectives are eligible and whether and how changes of the underlying assets may influence or contradict the ESG objectives of the insurance product. Reviewing the insurance products with regard to the ESG factors may include the assessment whether the composition of the underlying assets is still in line with the identified target market or whether modifications are required to ensure consistency between the target market and these assets.

103. The Commission has also emphasised in the request for technical advice that the possibility to identify a target market for clients without ESG preferences should be maintained. This possibility should be distinguished from the question whether manufacturers of insurance products which are not designed for customers with ESG preferences should be similarly obliged to state that the respective insurance products do not pursue ESG objectives. However, considering that the taxonomy for the classification of ESG investment is still ongoing, EIOPA considers it as premature to require manufacturers of insurance products to do so.

104. Whereas ESG preferences are above all relevant in relation to the target market assessment of insurance-based investment products, EIOPA is of the view, that ESG factors might also be considered in relation to other insurance products, including non-life products, e.g. long term insurance contracts such as occupational disability insurance products. This approach would allow manufacturers to consider the ESG preferences of their customers not only in the context of insurance-based investment products, but also, where relevant, with regard to other insurance products.

Draft Technical Advice

Policy proposals for Product Oversight and Governance

IDD Delegated Regulation 2017/2358 to be amended as follows:

New recital 5 (bis) of the IDD Delegated Regulation to be introduced:

Insurance undertakings should consider ESG factors in the product approval process of each insurance product and the other product oversight and governance arrangements if the insurance product is intended to be distributed to customers seeking insurance products with an ESG profile. For the sake of clarification, the wording states for that purpose "as well as the ESG profile of the product (where relevant)" and "including ESG preferences (where relevant)" in this Regulation.

Article 4(3):

The product approval process shall:

(a) ensure that the design of insurance products meets the following criteria:

(i) it takes into account the objectives, interests and characteristics of customers, **including ESG preferences (where relevant);**

Article 5(1), (2), (3) and (4):

1. The product approval process shall, for each insurance product, identify the target market and the group of compatible customers. The target market shall be identified at a sufficiently granular level, taking into account the characteristics, risk profile, complexity and nature of the insurance product, **as well as the ESG profile of the product (where relevant).**

2. Manufacturers may, in particular with regard to insurance-based investment products, identify groups of customers for whose needs, characteristics and objectives, **including ESG preferences (where relevant),** the insurance product is generally not compatible.

3. Manufacturers shall only design and market insurance products that are compatible with the needs, characteristics and objectives, **including ESG preferences (where relevant)**, of the customers belonging to the target market. When assessing whether an insurance product is compatible with a target market, manufacturers shall take into account the level of information available to the customers belonging to that target market and their financial literacy.

4. Manufacturers shall ensure that staff involved in designing and manufacturing insurance products has the necessary skills, knowledge and expertise to properly understand the insurance products sold and the interests, objectives, **including ESG preferences (where relevant),** and characteristics of the customers belonging to the target market.

Article 6(1) and (2):

1. Manufacturers shall test their insurance products appropriately, including scenario analyses where relevant, before bringing that product to the market or significantly adapting it, or in case the target market has significantly changed. That product testing shall assess whether the insurance product over its lifetime meets

the identified needs, objectives, **including ESG preferences (where relevant)**, and characteristics of the target market. Manufacturers shall test their insurance products in a qualitative manner and, depending on the type and nature of the insurance product and the related risk of detriment to customers, quantitative manner.

2. Manufacturers shall not bring insurance products to the market if the results of the product testing show that the products do not meet the identified needs, objectives, **including ESG preferences (where relevant)**, and characteristics of the target market.

Article 7(1):

Manufacturers shall continuously monitor and regularly review insurance products they have brought to the market, to identify events that could materially affect the main features, the risk coverage or the guarantees of those products. They shall assess whether the insurance products remain consistent with the needs, characteristics and objectives, **including ESG preferences (where relevant)**, of the identified target market and whether those products are distributed to the target market or is reaching customers outside the target market.

Article 8(3):

The information referred to in paragraph 2 shall enable the insurance distributors to:

(a) understand the insurance products;

(b) comprehend the identified target market for the insurance products;

(c) identify any customers for whom the insurance product is not compatible with their needs, characteristics and objectives, **including ESG preferences (where relevant)**;

(d) carry out distribution activities for the relevant insurance products in accordance with the best interests of their customers as prescribed in Article 17(1) of Directive (EU) 2016/97.

Article 10(2):

The product distribution arrangements shall:

(a) aim to prevent and mitigate customer detriment;

(b) support a proper management of conflicts of interest;

(c) ensure that the objectives, interests and characteristics of customers **including ESG preferences (where relevant)** are duly taken into account.

Article 11:

Insurance distributors becoming aware that an insurance product is not in line with the interests, objectives and characteristics of its identified target **market (including ESG preferences (where relevant)** or becoming aware of other product-related circumstances that may adversely affect the customer shall promptly inform the manufacturer and, where appropriate, amend their distribution strategy for that insurance product.

<u>Questions to stakeholders</u>

Q14: What current market standards or "labels" are you going to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or "labels"? Please describe.

Q15: Do you agree with the proposed amendments, in particular whether the ESG preferences of the customers should be considered in the assessment of the target market?

Q16: Do you agree that the identification of the target market should specify whether an insurance product is compatible being distributed to customers with ESG objectives or not?

Q17: Do you agree that the testing of the insurance product during the approval process as well as the monitoring and reviewing of the insurance product during its lifetime should comprise the ESG factors?

Annex I - Impact Assessment

1. Procedural aspects and consultation with stakeholders

The Commission has requested EIOPA and ESMA to provide technical advices on potential amendments to, or introduction of, delegated acts under Directive 2009/65/EC (hereafter, UCITS Directive), Directive 2011/61/EU (hereafter, AIFMD), Directive 2014/65/EU (hereafter, MiFID II), Directive 2009/138/EC (hereafter, Solvency II Directive) and Directive 2016/97 (hereafter, IDD) with regard to the integration of sustainability risks and sustainability factors.

According to the Commission's request, EIOPA and ESMA should justify the technical advice by identifying, where relevant, a range of technical options and undertaking an evidenced assessment of the costs and benefits of each. Where administrative burdens and compliance costs on the side of the industry could be significant, EIOPA should, where possible, quantify these costs.

In particular, EIOPA will provide technical advice on potential amendments to, or introduction of, delegated acts under Solvency II and IDD together with an analysis of costs and benefits, which is undertaken according to an Impact Assessment methodology.

EIOPA considered that, in view of the novelty of the topic, an early involvement of market participants and stakeholders is useful to build up a suitable "evidence base" for the thorough development of robust policy recommendations. For such purpose, an on-line survey was launched between 17th September and 3rd October 2018 seeking stakeholders' views and current approaches regarding the consideration of sustainability factors (i.e. environmental, social and governance factors)[13].

In addition, the draft technical advice and its impact assessment is subject to public consultation. Stakeholders' responses to the public consultation will be duly analysed and will serve as a valuable input for the revision of the draft technical advice and its impact assessment.

2. Problem definition

There has been a recent increase in emphasis on sustainable development, including its implication for financial markets, in particular the consequences of the adoption of the Paris Agreement on climate change. Several aspects of sustainable finance appear in particular relevant for insurers and for pension funds. Not only because of their weight in our economy, but also because they need to consider, by virtue of their long-term obligations, the environment in which they will operate in the distant future.

[13] https://eiopa.europa.eu/Pages/Surveys/Online-survey-on-the-integration-of-sustainability-risks-and-sustainability-factors--in-the-delegated-acts.aspx

In this advice and in line with Commission impact assessment[14], EIOPA has operationalised sustainability by referring to the so-called environmental, social and governance ("ESG") factors.

According to the Commission the integration of ESG factors in the investment decision and insurance distribution process in the EU financial market, is very low[15]. The Commission explains that "this seems to be partially due to insufficient legal certainty as to what is expected from relevant financial market participants and investment and insurance advisors. Some of these entities do not analyse sustainability risks and their impacts on returns either because they do not have the tools and the sustainability-related knowledge or because they confuse the integration of sustainability risks with ethical investing, which implies accepting lower risk-adjusted returns, which would not be in the best interest of their clients. In addition, certain investors have explicit ESG preferences that are not sufficiently addressed. For these investors, it is essential that their personal values are considered in the insurance distribution process and reflected in the investment product selection".

In its Call for advice, the Commission has identified specific areas in which market participants should adapt their procedures, which are:

- organisational requirements,
- operating conditions, in particular investment strategy and asset allocation,
- risk management, and
- target market assessment.

Baseline scenario.

When analysing the impact from proposed policies, the Impact Assessment methodology foresees that a baseline scenario is applied as the basis for comparing policy options. This helps to identify the incremental impact of each policy option considered. The aim of the baseline scenario is to explain how the current situation would evolve without additional regulatory intervention.

The baseline is based on the current situation of EU insurance and reinsurance markets.

The table below summaries the relevant provisions that have been considered as part of the baseline.

Solvency II	Articles 40-50, 132-135 of the Directive Articles 258-275 of the Delegated Regulation EIOPA Guidelines on system of governance
IDD	Articles 25 and 28 of the Directive

[14] See Impact Assessment Report accompanying the Commission legislative proposals on sustainable finance of 24 May 2018 (https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en)
[15] See Commission Impact Assessment Report

	Articles 4-10 of the Delegated Regulation on product oversight and governance requirements[16] Articles 3-7 of the Delegated Regulation on information requirements and conduct of business rules applicable to the distribution of insurance-based investment products[17]
Sustainable Finance	• Commission's proposals of 24th May 2018[18]: o Proposal for a Regulation of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment o Proposal for a Regulation of the European Parliament and of the Council on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 o Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks

3. Objectives

The main objective of the technical advice is to explicitly require the integration of sustainability factors and risks in the investment decision or insurance distribution processes as part of duties towards policyholders, customers and/or beneficiaries.

This objective is connected with the following aims stated in the Commission "Action Plan - Financing Sustainability Growth" [19]:

- reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth;
- manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and
- foster transparency and long-termism in financial and economic activity

Other relevant objectives, which have been considered by EIOPA in developing its advice include:

- coherence with current requirements under Solvency II and IDD provisions;
- proportionality, taking into account the size, nature, scale and complexity of insurers' activities; and

[16] Commission Delegated Regulation (EU) 2017/2358 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to product oversight and governance requirements for insurance undertakings and insurance distributors

[17] Commission Delegated Regulation (EU) 2017/2359 of 21 September 2017 supplementing Directive (EU) 2016/97 of the European Parliament and of the Council with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products

[18] See link: https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en

[19] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0097

- cross-sectoral consistency, in particular with respect to the target market assessment and with the IORP II Directive.

These objectives are aligned with the aim of Solvency II to improve risk management of European insurers, with the aim of the IDD to mitigate the risk of customer detriment from unsuitable and/or poorly designed products and with the general common objective of both directives to ensure policyholder protection.

4. Policy options

With the intention to meet the objectives set out in the previous section, EIOPA has analysed different policy options throughout the policy development process. The section below reflects the most relevant policy options that have been considered in relation to different policy issues related to Solvency II and IDD respectively.

With respect to Solvency II, the following policy issues have been discussed:

1. Scope of the governance requirements
2. Organistional requirements
3. Reference to sustainability risks under the prudent person principle
4. Consideration of long-term impact of investments on sustainability factors
5. Consideration of policyholders and beneficiaries' ESG preferences
6. Risk management

With respect to IDD, the following policy issues have been discussed:

7. Conflicts of interest
8. Target market assessment- scope of products
9. Target market assessment- scope of POG

Policy issue 1- Scope of the governance requirements

Whether the amendments to the Solvency II requirements on system of governance for integration of sustainability risks in the decisions processes should only apply to life insurers or also to non-life insurers and reinsurers.

- Option 1.1 - New requirements applicable to life insurance undertakings
- Option 1.2 - New requirements applicable to all insurance and reinsurance undertakings

Policy issue 2- Organisational requirements

- Option 2.1 - Flexibility
- Option 2.2 - Detailed provisions

Policy Issue 3 –Reference to sustainability risks under the prudent person principle

Whether the prudent person principle should make explicit reference to sustainability risks.

- Option 3.1 – No explicit reference to sustainability risks in the prudent person principle
- Option 3.2 – Explicit reference to sustainability risks in the prudent person principle

Policy Issue 4 – Consideration of long-term impact of investments

Whether undertakings should take into account the potential long-term impact of their investment decisions on sustainability factors

- Option 4.1 – Undertakings should take into account the potential long-term impact of their investment decisions on sustainability factors
- Option 4.2 – Undertakings should not take into account the potential long-term impact of their investment decisions on sustainability factors

Policy Issue 5 - Consideration of policyholders and beneficiaries' ESG preferences

Whether the asset allocation should reflect the ESG preferences of policyholders and beneficiaries

- Option 5.1 - The asset allocation should policyholders and beneficiaries' ESG preferences where the target market is insurance products with ESG profile, only
- Option 5.2 – The asset allocation should reflect policyholders and beneficiaries' ESG preferences across all products - irrespective of the target market of the product
- Option 5.3 – The asset allocation should not reflect policyholders and beneficiaries' ESG preferences

Policy Issue 6 – Risk management

Whether undertakings should take into account sustainability risks related to their investments and also sustainability risks related to their liabilities

- Option 6.1 Consideration of sustainability risks for investments only
- Option 6.2 Consideration of sustainability risks for investments and underwriting

Policy issue 7 - Conflicts of interest

Measures and policies specifically considering types of conflict of interest that might arise in relation to sustainability considerations and the steps to identify, prevent, manage and disclose them

- Option 7.1 - introducing a reference to ESG considerations in a Recital of the Delegated Regulation, only
- Option 7.2 – introducing a reference to ESG considerations in Article 3 of the Delegated Regulation (EU) 2017/2359
- Option 7.3 – introducing a reference to ESG considerations in all provisions on conflict of interest of Delegated Regulation (EU) 2017/2359

Policy issue 8 - Scope of insurance products covered in the target market assessment

- Option 8.1 - Narrow scope of application including life insurance products and insurance-based products, only
- Option 8.2 - Broad scope of application including all insurance products

Policy issue 9 - Target market assessment- scope of POG applicable

- Option 9.1 - Narrow scope limited to Article 5 (Target Market) of Delegated Regulation (EU) 2017/2358
- Option 9.2. - Broad scope including all POG requirements laid down in Delegated Regulation (EU) 2017/2358

Analysis of impacts

Policy issue 1- Scope of the governance requirements

Option 1.1 - New requirements applicable to life insurance undertakings

Benefits:

- Consistency with the scope of the Commission's call for advice.

Costs:

- Compliance costs only for life insurance undertakings.
- The narrower the scope of the requirements, the lower the costs for supervisory authorities to assess the compliance by concerned undertakings.
- Non-life insurers and reinsurers may disregard relevant sustainability risks that could affect their investments portfolio.

Option 1.2 - New requirements applicable to all insurance and reinsurance undertakings

Benefits:

- Coherence with the current requirements on system of governance in the Solvency II Delegated Regulation, equally applicable to all insurers and reinsurers.
- Better risk management since sustainability risks are risks that could affect as well the investments of non-life insurance undertakings and reinsurance undertakings.

Costs:

- Compliance costs for all insurance and reinsurance undertakings
- The wider the scope of the requirements, the higher the costs for supervisory authorities to assess the compliance by concerned undertakings.

Policy issue 2 - Organisational requirements

Option 2.1 - Flexibility

Benefits:

- Proportionality aspects could be better considered.
- Lower compliance costs, allowing undertakings to consider sustainability risks without significant changes in their current organisational structure.

Costs:

- Possible uncertainty on the practical implementation of the requirements, both for undertakings and supervisors.

Option 2.2 – Detailed provisions

Benefits:

- More clarity on the practical implementation of the requirements, both for undertakings and supervisors.

Costs:

- Higher compliance costs for undertakings, which may be disproportionate for certain undertakings.

Policy Issue 3 –Reference to sustainability risks under the prudent person principle

Option 3.1 – No explicit reference to sustainability risks in the prudent person principle

Benefits:

- May limit the risk of imbalance in regulatory requirements caused by highlighting particular risks in an area which is still under development.
- May limit risk of promoting investments in particular assets and unintended consequences arising from it.

Costs:

- Undertakings would not be required to consider the sustainability risks and supervisors would not have the legal hook to assess the security, quality, liquidity, and profitability of the portfolio from an sustainability angle.

Option 3.2 – Explicit reference to sustainability risks in the prudent person principle

Benefits:

- Mandatory requirements could help to properly promote sustainable investments by insurers and reinsurers

- This could also enhance the industry's responsiveness to the ecological and social environment of the customer, promoting the stewardship role of insurers in the economy as institutional investors

Costs:

- Deviating from a high-level principle-based approach would inappropriately emphasise ESG factors/risks and would cause an imbalance in the regulatory requirements
- Strong mandatory requirements could increase the risk of stranded assets (those not considered sustainable), which would be to the detriment of financial stability.
- The requirement would go against the freedom of investment as stipulated in Article 133 of the SII Directive

Policy Issue 4 – Consideration of long-term impact of investments

Option 4.1 – Undertakings should take into account the potential long-term impact of their investment decisions on sustainability

Benefits:

- Consistent with the principle of stewardship recognised in other regulatory action and initiatives[20], including the IORP II Directive.
- Adopting a non-binary approach to sustainable investments would help to reduce the risk of creating stranded assets.

Costs:

- Difficult to assess the impact, up-front or after the investment was made.

Option 4.2 – Undertakings should not take into account the potential long-term impact of their investment decisions on sustainability

Benefits:

- The sustainability risk assessment would be a more proportionate, strictly prudential assessment limited to the risks posed by sustainability factors to the undertaking

Costs:

- Transition risks could materialise by leading to sudden disinvestment in assets which are considered not sustainable by undertakings

Policy Issue 5 - Consideration of policyholders and beneficiaries' ESG preferences

Option 5.1 - The asset allocation should reflect policyholders and beneficiaries' ESG preferenceswhere the target market is insurance products with ESG profile, only

Benefits:

[20] See Directive 2017/828 of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

- As the preferences of policyholders and beneficiaries will be reflected through the suitability assessment in the product design of insurance contracts, these ESG preferences should also be reflected in the investment strategy and decisions of undertakings

Costs:

- From a prudential perspective, in an economic-risk based framework, undertakings should consider ESG factors and risks across the undertaking where these are relevant and in line with the principle of proportionality, not limited to product characteristics

Option 5.2 – The asset allocation should reflect policyholders and beneficiaries' ESG across all products - irrespective of the target market of the product

Benefits:

- The assessment would be made in the general interest of all policyholders and/or beneficiaries, irrespective of the products' design

Costs:

- Assumptions on the preferences of the policyholders and beneficiaries would need to be made where these are not explicitly expressed.
- The requirement may be against (other) policyholders' primary interest in investment returns

Option 5.3 – The asset allocation should not reflect policyholders and beneficiaries' ESG preferences

Benefits:

- The assessment would be limited to a prudential risk assessment

Costs:

- Investments may not be made in the best interest of policyholders and/or beneficiaries, as requested by the prudent person principle.

Policy Issue 6 – Risk management

Option 6.1 - Consideration of sustainability risks for investments only

Benefits:

- Consistency with the scope of the Commission's call for advice.
- Lower compliance costs for undertakings compared with option 6.2.

Costs:

- Undertakings may disregard sustainability risks in their underwriting, potentially leading to inadequate pricing and reserving.

Option 6.2 – Consideration of sustainability risks for investments and underwriting

Benefits:

- Coherent with the total balance sheet approach of Solvency II, where assets and liabilities need to be valued in a market consistent manner.
- In particular relevant for non-life insurance and reinsurance undertakings, where sustainability risks will affect first their liabilities.

Costs:

- Higher compliance costs for undertakings compared to option 6.1.

Policy issue 7 - Conflicts of interest

Option 7.1 - introducing a reference to ESG considerations in a Recital of the Delegated Regulation only

Benefits:

- Explicit reference to ESG considerations in the context of conflict of interests minimise the risk of customer detriment resulting from conflicts not appropriately managed by distributors of insurance products
- Provides guidance on the application of the rules of conflict of interest in the context of the distribution of insurance products with ESG profile

Costs:

- Raising little awareness of addressees of regulatory requirements as reference would not be introduced in the legal text of the respective provisions in the Delegated Regulation
- No binding effect as Recitals are not mandatory, but aim to provide further explanation and back ground information setting out the purpose of the legal provisions, only
- Implementation costs for insurance undertakings and insurance intermediaries distributing IBIPs

Option 7.2 – introducing a reference to ESG considerations in Article 3 of Delegated Regulation (EU) 2017/2359

Benefits:

- Explicit reference to ESG considerations in the context of conflict of interests minimise the risk of customer detriment resulting from conflicts not appropriately managed
- Including the reference in the legal text as such introduces a mandatory and binding obligation for the addressees of the provision

Costs:

- Conflicts of interests arising in the context of ESG considerations are only one possible source, hence reference could overemphasise and unbalance the legal drafting

- Implementation costs for insurance undertakings and insurance intermediaries distributing IBIPs

Option 7.3 – introducing a reference to ESG considerations in all provisions on conflict of interest of Delegated Regulation (EU) 2017/2359

Benefits:

- Explicit reference to ESG considerations in the context of conflict of interests minimise the risk of customer detriment resulting from conflicts not appropriately managed
- Including the reference in the legal text as such introduces a mandatory and binding obligation for the addressees of the provision

Costs:

- Conflicts of interests arising in the context of ESG considerations are only one possible source, hence reference could overemphasise and unbalance the legal drafting
- Implementation costs for insurance undertakings and insurance intermediaries distributing IBIPs

Policy issue 8 - Scope of insurance products covered in the target market assessment

Option 8.1 - Narrow scope of application including life insurance products and insurance-based products only

Benefits:

- Lower risk of mis-selling of life insurance products and insurance-based products to customers with ESG preferences

Costs:

- ESG preferences of customers are not taken into account in the context of non-life insurance product
- Until the development of a common EU taxonomy, standards for classification would need to be developed by the market leading to inconsistent approaches and the risk of “Green washing” of insurance products in lack of uniform and binding taxonomy
- Implementation costs for insurance products manufacturers

Option 8.2 - Broad scope of application including all insurance products

Benefits:

- Lower risk of mis-selling of insurance products to customers with ESG preferences

Costs:

- Until the development of a common EU taxonomy, standards for classification would need to be developed by the market leading to inconsistent approaches and the risk of “Green washing” of insurance products in lack of uniform and binding taxonomy

- Higher implementation costs for manufacturers of insurance products

Policy issue 9 - Target market assessment- scope of POG applicable

Option 9.1 - Narrow scope limited to Article 5 (Target Market) of Delegated Regulation (EU) 2017/2358

Benefits:

- Legal framework for distributors of insurance products to consider ESC consideration in the context of product design and distribution promotes legal certainty and consistency
- Lower risk of mis-selling of insurance products to customers with ESG preferences

Costs:

- Lack of legal clarity and certainty about the application of POG requirements other than the target market assessment
- Implementation costs for manufacturers of insurance products

Option 9.2. - Broad scope including all POG requirements laid down in Delegated Regulation (EU) 2017/2358

Benefits:

- Legal framework for distributors of insurance products to consider ESC consideration in the context of product design and distribution promotes legal certainty and consistency
- Legal clarity and certainty about the applicability of other POG provisions than target market assessment
- Enhanced level of consumer protection

Costs:

- Higher implementation costs by manufacturers of insurance products

Comparing the options

Policy issue 1 - Scope of the governance requirements

EIOPA considers that the proposed amendments should be applicable to all insurance and reinsurance undertakings under Solvency II and not only to life insurance undertakings. This is considered the most effective option in view of the coherence with the current Solvency II requirements and considering that non-life insurers and reinsurers are also exposed to sustainability risks.

Policy issue 2 - Organisational requirements

EIOPA considers that sufficient flexibility should be allowed for undertakings to integrate sustainability risks without significant changes in their internal organisation. This options is also preferred in view of the proportionality principle.

Policy issue 3- Reference to sustainability risks under the prudent person principle

The mandatory requirement to consider sustainability risks would support the economic risk-based approach stipulated by Solvency II. The undertaking is required to take measures according to the nature, scale and complexity of the risk incurred, consistent with the principle of proportionality. The undertaking should ensure that the investment would not (materially) affect the ability of the (re)insurance undertaking to meet its obligations towards the policyholder.

Requiring undertakings to take into account sustainability risks in their investments does not amount to requiring undertakings to disregard investments that would not be considered sustainable. Neither does it require to invest only in so-called sustainable assets. Freedom of investment is not affected.

EIOPA expects that strategies for sustainable investment will further evolve and best practices will arise based on the experience that is being made. It may be relevant to keep taking stock and at some point, guidance may be developed to support undertakings to implement proportionate strategies.

EIOPA therefore considers that the explicit mention of sustainability risks and factors as part of the prudent person principle, while also consistent with ESMA advice, existing wording of the IORPII Directive and EIOPA's advice on the POG requirements, would be a proportionate measure.

Policy Issue 4 – Consideration of long-term impact of investments

The principle of stewardship of assets creates a general awareness for the impact of an undertaking's investment strategy on the sustainability of economic activities. Eventually, a the consideration of sustainability risks affecting its assets as well as the impact of its investments on sustainability factors would be mutually reinforcing and most effectively lead to more sustainable investments overall.

The promotion of investor's engagement to support long-term sustainability of European Union companies can be an important leverage in preventing risks, ultimately also preventing the risks of potential disinvestment and minimising the risk of stranded assets.

Policy Issue 5 - Consideration of policyholders' ESG preferences

The consistency with the Insurance Distribution Directive and the coherency between prudential and conduct proposals made by EIOPA require that where ESG preferences are relevant for the product oversight and governance arrangements, insurance undertakings should accordingly reflect the ESG preferences of policyholders and beneficiaries in their investment portfolio, in order to act according to the prudent person principle, in the best interest of policyholders and beneficiaries.

Policy Issue 6 – Risk management

EIOPA considers that the symmetric reflection of sustainability risks on the asset side and on the liability side is important to ensure the consistent valuation on both sides of the balance sheet. The holistic approach to risk management is in line with Solvency II's risk-based approach. Therefore, sustainability risks should be addressed in the underwriting and reserving area of the risk management system as well as in the investment risk area. This is mirrored by the proposal that as an operating condition, the opinion expressed by the actuarial function should include considerations on the effect of sustainability risks.

Policy issue 7- Conflicts of interest

When comparing the costs and benefits of the different options, it should be considered that the existing provisions of conflict of interest do no refer to any specific situation where conflicts of interest arise, but outline some general principles and criteria to be applied to assess and identify whether conflicts of interest arise in specific instances.

Taking into account that an explicit reference in a Recital would not have a binding effect and that a reference in all provisions on conflict of interest may unbalance the legal wording of the Delegated Regulation overemphasising the conflict of interest linked to ESG consideration, it is proposed to introduce the reference in Article 3 of the Delegated Regulation, only.

Policy issue 8 - Scope of insurance products covered

Whereas the COM is in particular referring in its mandate to insurance-based investment products, in EIOPA's view the scope of application should be extend to non-life insurance products. This follows the consideration that there are also many long-term insurance products in the Non-Life sector where ESG preferences of customers may also play a role, e.g. income protection insurance. Furthermore, it seems appropriate to include non-life insurance products as customers of non-life insurance products may also wish that their ESG preferences are considered when buying non-life insurance products.

Policy issue 9 - Scope of POG requirements applicable

Whereas the COM has primarily referred to the necessity of insurance undertakings to take into account of ESG considerations in the context of the target market assessment, it seems appropriate from a consumer point of view to amend the other POG requirements as well.

For example, insurance undertakings should also be required to test their ESG products under the scenario that the underlying assets of an IBIP do not longer fulfil the ESG criteria during the lifecycle of the product. In addition, the concept of "target market" pervades all aspects of the POG requirements so it seems very difficult to isolate any changes just to the target market assessment only.

Annex II - Summary of Questions to Stakeholders

Q1: What would you estimate as the costs and benefits of the possible changes to the delegated acts under Solvency II outlined in this Consultation?

Q2: What would you estimate as the costs and benefits of the possible changes to the delegated acts under IDD outlined in this Consultation?

Q3: Do you agree with the proposed reference on the tasks of the risk management function?

Q4: Would you propose any other amendment to the organisational requirements in the Solvency II Delegated Regulation to ensure the effectiveness and adequacy of sustainability risk integration?

Q5: Do you agree with the proposed new article for the integration of sustainability risks into the prudent person principle?

Q6: Do you agree with the proposed amendment of the article for the actuarial function?

Q7: Do you agree with the proposed reference to sustainability risks under the investment as well as the underwriting and reserving risk management policy?

Q8: Do you agree that other risk management policies may include reference to sustainability risks?

Q9: Do you agree with the proposed requirement to include consideration of the effect of sustainability risks in the overall solvency needs assessment of the undertakings' ORSA?

Q10: Do you agree that conflicts of interest may also arise with regard to the ESG objectives of customers of insurance undertakings and insurance intermediaries. Please give reasons for your answer.

Q11: Do you agree that conflicts of interest with the ESG objectives of customers may arise, particularly in regards to the investment strategy for the customers' assets and the shareholder rights in companies in which the customers' assets with ESG preferences are invested?

Q12: What other situations do you envisage might give rise to conflicts of interest between the interest of customers in attaining their ESG objectives and an interest of another party?

Q13: What measures, if any, should be taken to address conflicts of interest arising specifically between the customer's interest in attaining his ESG objectives and the interest of another party?

Q14: What current market standards or “labels” are you going to take into account or already taking into account for the consideration of ESG factors? Do you see any issues when relying on current market standards or “labels”? Please describe.

Q15: Do you agree with the proposed amendments, in particular whether the ESG preferences of the customers should be considered in the assessment of the target market?

Q16: Do you agree that the identification of the target market should specify whether an insurance product is compatible being distributed to customers with ESG objectives or not?

Q17: Do you agree that the testing of the insurance product during the approval process as well as the monitoring and reviewing of the insurance product during its lifetime should comprise the ESG factors?