ADVANCING SUSTAINABILITY & INCLUSIVITY

SUSTAINABLE FINANCE

Seeing the wood for the trees

Why the EC's many sustainability-related initiatives must focus on the areas of most impact

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The European insurance industry is committed to the goals of the UN's Paris Agreement on climate change and the European Green Deal, as well as the EU's ambitious targets to reduce its greenhouse gas emissions by 55% by 2030 and achieve a net-zero economy by 2050. As Europe's largest institutional investor with over €10.6trn of assets under management, insurers have the potential to play a very significant role in helping to finance the transition to a more sustainable economy.

Insurers were among the first businesses to raise the alarm about climate change, and the industry has supported the objectives of the European Commission's sustainable finance agenda since its inception. While many insurers started their internal push towards sustainable investment years ago, actions are now being taken across the industry and more is planned for the coming years. In the past, the pressure for these changes came largely from within — from insurers' own management — but in recent years that pressure has been amplified greatly by EC policy initiatives.

The comprehensive environmental, social and governance (ESG) reporting framework that the EC is finalising is intended to provide the data that will allow investors, including insurers, to fully implement their sustainable investment strategies. It will also create the transparency about companies' activities and impact that will put yet more pressure on companies to meet their sustainability objectives.

While the industry is supportive of the Commission's many sustainability-related policy initiatives, it is vital that they are designed and implemented in the right way if they are to achieve their aims. This includes avoiding excessive requirements, focusing on the key obligations and reporting that will have the most impact and taking a phased approach to development and implementation. Policymakers must recognise the huge amount of work involved in applying all this new regulation, especially as sustainability regulation is only part of the very extensive set of regulatory and reporting projects with which European insurers have to cope.

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Taxonomy Regulation and Sustainable Finance Disclosures Regulation

Under the Taxonomy Regulation, from 2024 insurers have to disclose two Key Performance Indicators — one covering to what extent underwriting revenue is aligned with the Taxonomy and one covering the alignment of their investments with the Taxonomy.

Under the Sustainable Finance Disclosures Regulation (SFDR), from June 2023 insurers have to report on up to 18 mandatory and 46 optional indicators, which cover all three elements of ESG. These indicators are intended to shine a light on insurers' activities and impacts on sustainability.

There are two types of challenges for insurers here. One is that it is far from clear how some of these indicators should be calculated and reported, so the industry has sought clarifications from the EC. The other is that, to report some of these indicators, insurers need data from the companies in which they invest. That information is due to come from the Corporate Sustainability Reporting Directive (see below) but this will only be reported from January 2025 and will only be available in an easy to access form in a in a central database from 2026 at the earliest.

Key messages to policymakers

- On Taxonomy indicators: address insurers' questions as soon as possible and well before reporting is due to start.
- On SFDR indicators: recognise that where there are problems with the timing of data availability, insurers will have to report using best efforts, estimates and proxies.

Corporate Sustainability Reporting Directive, European Sustainability Reporting Standards and the European Single Access Point

The Corporate Sustainability Reporting Directive (CSRD) requires over 50 000 large European companies to disclose a very significant set of ESG data from 2024. The specific data that companies will have to report is set out in the European Sustainability Reporting Standards (ESRS), which are proposed by the Commission based on proposals developed by the independent European Financial Reporting Advisory Group (EFRAG).

The first set of standards, on which all companies within the scope will need to report, are due to be published by the EC in June 2023 and will contain up to 1 000 data points. A second set of standards covering additional sector-specific reporting requirements for 40 different sectors will follow. Other sets, including standards for listed SMEs and voluntary standards for unlisted SMEs and for non-European companies active in Europe, are also required by the CSRD.

All of this data will be available directly from each company within the scope but, to allow efficient access to the thousands of companies, the EC has launched the European Single Access Point (ESAP) project. This will be a huge database containing all the ESG data from the CSRD and many other datasets, including financial accounting information. The ESAP regulation is still being finalised by the Council of the EU and the European Parliament but is now expected to go live by 2026.

In principle, the development of ESRS is very positive because — if they work as planned — they will address the current lack of consistent, comparable and efficiently accessible ESG data. In particular, the industry is pleased some of its key concerns have been addressed. These were to include all the data needed to comply with the SFDR and Taxonomy reporting, to have a clear objective of achieving interoperability with the standards being developed by the International Sustainability Standards Board (ISSB) and to take a phased approach to developing and implementing the standards. On the last point, the EC's request in March to EFRAG to delay development of the second (sector-specific) set of standards and instead focus on providing implementation guidance and support for the first set was welcome. Implementation of the first set will already be a huge challenge and it is vital that this is successful.

Key messages to policymakers

- Provide clarity on certain aspects of how the first set of ESRS should be implemented and, in particular, ensure the value-chain concept (see side box below) is appropriately tailored for insurers.
- Limit and prioritise any additional sectoral reporting requirements, recognising that every new reporting requirement can incur significant costs and diverts scarce resources from other activities, such as risk management, sustainable transition and customer service.
- There is an urgent need for ESG data to be made available via the ESAP; preparatory work needs to start now.
- The EC needs to urgently provide increased funding to EFRAG, which has been given extensive new responsibilities on the ESRS but has not been granted adequate funding to fulfil its new responsibilities.

European Green Bond Standard

The lack of suitable green and transition investments is a major barrier to insurers making full use of their investment capacity to support the European sustainability objectives. The EU Green Bond Standard (EUGBS) can help address this shortage. Insurers have therefore welcomed the fact that political agreement has been reached and look forward to the issuance of the first bond under this new legislation. While it is very difficult for a company to generate fully green revenues and thus issue green equity, many companies can identify transition projects and use an EUGBS to fund them.

Key messages to policymakers

- The industry identified a number of key features that are instrumental to the success of the EUGBS and is pleased that these have been incorporated into the final texts. These were that the bond proceeds be aligned with the EU Taxonomy, that use of the standard be voluntary, that there should be a “flexibility pocket” to allow for areas not (yet) covered by the Taxonomy and that there should be grandfathering to allow for tightening of the EUGBS without jeopardising existing green bonds.

Corporate Sustainability Due Diligence Directive

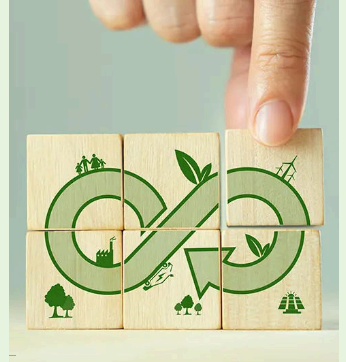
The EC published in February 2022 a proposal for a Directive on corporate sustainability due diligence (CSDDD). This would require the companies within its scope to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities throughout their global value chain. This would include adverse impacts on human rights, such as child labour and the exploitation of workers, and on the environment, such as pollution and biodiversity loss.

National administrative authorities appointed by EU member states will be responsible for supervising these new rules and may impose fines in cases of non-compliance. In addition, the Directive introduces a civil liability regime, as victims would have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures. Companies also need to have a transition plan to ensure that their business strategy is compatible with limiting global warming to 1.5°C, in line with the UN Paris Agreement.

European insurers agree that economic activities must not cause or contribute to adverse impacts on human rights and the environment. They also support the requirement for the more than 11 000 companies within the intended scope to have net-zero transition plans in place because this can help deepen and accelerate change across all sectors and generate transition products that insurers can help finance through their investments. However, there are a number of major improvements needed to the EC's proposals if they are to work in practice for insurers.

Key messages to policymakers

- The scope of business relationships that insurers have to assess needs to be limited to direct corporate customers. Insurers should be allowed to exclude customers of reinsurance mandated by law, as such insurance is typically there to protect third parties and not the company buying the policy.
- The requirements should be risk-based and so depend on whether a company is causing, contributing to or only being linked to adverse impacts. Insurers are only linked to (potentially) adverse impacts in their downstream value chains given their specific characteristics and relationship with customers and investments.
- Care must be taken to avoid unmanageable liability risks. If liability is to remain in the Directive then it is crucial that there are clear criteria defining where a company can be held liable.
- Insurance should not be considered a high-risk sector.
- Groups need to be able to apply the requirements at group level, on behalf of their subsidiaries.



Value chain: why it matters

Greenwashing

In May 2022, the EC sent a call for advice to EIOPA and the other European supervisory authorities (ESAs) on greenwashing. It asked each ESA to provide input — separately but in a coordinated manner — on:

- definition, cases and risks of greenwashing;
- the supervision of greenwashing and relevant sustainable finance requirements; and,
- proposals to improve the regulatory framework

It requested a progress report by May 2023 and the final report by May 2024.

Although the EU Taxonomy and other policy initiatives are intended to prevent greenwashing, they are still in the process of development or implementation, so the industry recognises that there are strong concerns over greenwashing and that an early assessment can be of value. The current lack of clarity and inconsistencies in some of the new EU rules and definitions, the lack of reliable data and the lack of maturity of the metrics and methodologies may lead to unintentionally flawed information being reported by insurers. It is important that this is not labelled as greenwashing.

Key messages to policymakers

- Greenwashing should be defined as “misleading intentionally” or “misleading through negligence”. It should not include accidentally incorrect reporting of flawed information.
- The industry needs clear and timely guidance on the questions it raises on regulatory requirements so that it can avoid accidentally flawed information.
- Before considering additional requirements, time must be allowed for the extensive existing EU sustainable finance framework to be applied. If designed and implemented correctly — and putting aside data and sequencing problems — it has the potential to address greenwashing.

Value chain: why it matters

The European Sustainability Reporting Standards (ESRS) introduce a number of reporting requirements under which companies will have to report impacts and data not just for their own operations but also for their value chain. The value chain is currently defined very broadly by the ESRS as "the full range of activities, resources and relationships related to the undertaking's business model(s) and the external environment in which it operates. A value chain encompasses the activities, resources and relationships the undertaking uses and relies on to create its products or services from conception to delivery, consumption and end-of-life".

This definition can be relatively easy to understand and apply for a company whose core business is, for example, to manufacture furniture. It has to consider how its raw materials, such as wood, are sourced from the original suppliers and travel through the various intermediaries, its own manufacturing processes and then how the goods are delivered to and used by the customer.

However, the application of the value chain concept is less clear and linear for insurance companies. For example, we do not think that insurers should be required to report on their customers' customers. Therefore, careful thought is needed about how to apply the concept of value chain for insurers because this will have a significant impact on how insurers report and the usefulness of the information provided.