Understanding (re)insurers' first reporting of Taxonomy Regulation's Underwriting and Investment KPIs

Context

The EU's Taxonomy Regulation entered into force in July 2020 and aims to create a common classification system for environmentally sustainable economic activities. According to the regulation, through delegated acts, the European Commission (EC) identifies sustainable activities for each of the following six **environmental objectives** set by the regulation:

- climate change mitigation;
- climate change adaptation;
- sustainable use and protection of water and marine resources;
- transition to a circular economy;
- pollution prevention and control; and
- protection and restoration of biodiversity and ecosystems.

The qualification of **taxonomy-aligned** activity depends on whether all four **of the following overarching conditions** defined by the Taxonomy are met:

- substantial contribution to one or more of the six environmental objectives set by the regulation;
- comply with the Technical Screening Criteria (TSC) established through delegated acts;
- do no significant harm (DNSH) to any of the six environmental objectives of the regulation; and
- comply with minimum social and governance safeguards defined by the regulation.

An economic activity is therefore considered as **taxonomy-eligible** if it is covered specifically in the scope of the regulation. An economic activity is **taxonomy non-eligible** if it is not (yet) included in the list of activities covered by the regulation.

An economic activity is defined as **taxonomy-aligned** if it is taxonomy-eligible and meets all four overarching conditions defined by the regulation.

The EU Taxonomy covers only two insurance activities within the Climate Change Adaptation objective: **underwriting and the reinsurance of climate related perils**.

As from financial year 2021, under the EU Taxonomy Regulation insurers have to **report how much of their underwriting and investment is taxonomy-eligible**. From financial year 2023, insurers also have to report on their taxonomy alignment **through two key performance indicators (KPIs)**:

1) **Investment KPI**: aims to show the proportion of its total assets an insurer has invested in taxonomy-aligned activities.

The Investment KPI is currently calculated as follow:

$$\text{Investment KPI} = \frac{\text{Weighted average value of Taxonomy−aligned investments}}{\text{Total assets covered by the KPI}} = \text{X \%}$$

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2) Underwriting KPI: aims to show what proportion of their total non-life underwriting premiums are taxonomy-aligned.

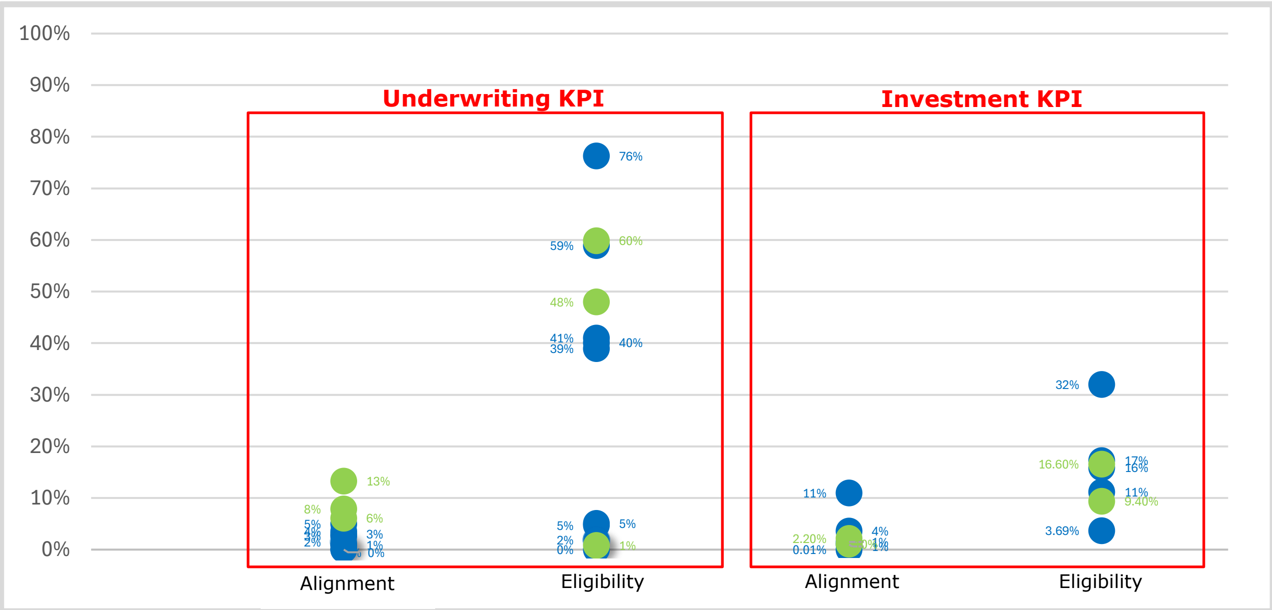
The Underwriting KPI is currently calculated as follow:

$$\text{Underwriting KPI} = \frac{\text{Premiums from Taxonomy aligned activity}}{\text{Total premiums from all non-life products (ie taxonomy eligible and non-eligible)}} = \text{X \%}$$

The EC issued draft Frequently Asked Questions (FAQs) in December 2023, 10 days before the closure of the financial year 2023, including details about how insurers should report these KPIs. This included an expectation that insurers should apply a split premium approach when calculating the Underwriting KPI. This means that for A.1 of the EU Taxonomy Regulation template, insurers should first determine if a product meets all the requirements to be taxonomy-aligned, and then for that product they must split the premiums they collect from customers to estimate what portion of the premiums relate to climate-related risks.

The guidance published very late, coupled with weaknesses and limitations in the taxonomy which we explain below, resulted in very inconsistent reporting. This was especially with regard to eligibility reporting, exemplified by the following reported figures for the financial year 2023 for a selection of insurers with similar insurance portfolios and similar data for financial year 2022 shown below:

EU Taxonomy Underwriting and Investment Alignment and Eligibility KPIs, FY 2023



*Reinsurers are shown in green, primary insurers are shown in blue.

Weaknesses and limitations with the current insurance taxonomy KPIs

Insurers have been supportive of the EC's ambition to create a taxonomy which can be used to help direct investments to the economic activities most needed for the transition, in line with the European Green Deal.

However, there are a number of weaknesses which means that the insurance taxonomy KPIs cannot yet be used by others as a basis for investment decisions.

For the **Investment KPI**:

- The EU Taxonomy **currently only covers a very limited part of insurers investment portfolios**. The European Insurance and Occupational Pensions Authority (EIOPA) estimated that the taxonomy covers only about 15.5% of insurers assets. Notably, it does not cover sovereign exposures, infrastructure projects, exposures to Small and Medium sized Enterprises (SMEs), and investments in non-EU companies. The other 85% of assets may be important for sustainability or transition but they are not covered by the EU Taxonomy. These excluded asset classes are those that insurers want and need to invest in in order to provide customers a diversified portfolio with good returns for their savings and pensions; for the asset-liability matching that is core to the insurance business model; and to invest in the SMEs that the Capital Market Union (CMU) project has rightly identified as so important for Europe's growth and prosperity. Furthermore, the regulation is unclear regarding the definition of "investment portfolio" - whether it is aligned with the Sustainable Finance Disclosure Regulation (SFDR) and whether the guidance provided by the SFDR can be applied equally, as well as how total investments should be determined - whether derivatives should be set off against each other or not.

- The Taxonomy is focused on activities that are already green and sustainable, but it **does not cover transition investments well**. Companies which currently do not make significant contributions to environmental objectives, but which have transition plans to change their business models, can be the ones in most need of investment. For example, SMEs which are not covered by the taxonomy contribute to more than 60% of all greenhouse gas emissions by enterprises. Their transition is urgently needed for reaching net-zero. For insurers to be able to play their role in financing the transition, it is important that the EU Taxonomy appropriately recognises such investments.

Therefore, it is very hard for insurers to have an investment KPI above 10%. Besides, an insurer aiming to maximise its investment KPI may not be investing in the right way for its customers, for risk management, for the wider economy or even the green transition.

For the **Underwriting KPI**:

- A key problem arises because of the EC's decision in their FAQs to encourage insurers to **split the premiums** for a product such as house insurance, and to use only, as taxonomy aligned, the part of the premium related to climate risks such as floods, hail, windstorms etc. These climate-related premiums are typically a small part - between 2% and 10% - of the total premiums.
- Insurers need to bring different risks together to benefit from the **pooling effect** – combining climate risks with fire and theft risks for house insurance, for example. Insurers do not sell climate risk insurance alone, as this can lead to unreasonably high-risk concentrations, reduce the diversification which is key to the insurance business model, and create additional sales costs thereby rendering the product unprofitable or too expensive for the customer.
- In addition, the taxonomy-aligned premiums are compared to all non-life premiums to arrive at the percentage alignment. This includes premiums from products that are not relevant, such as pet or theft insurance. It would make more sense to compare the taxonomy-aligned premiums with the taxonomy-eligible premiums, which show the efforts insurers should do to increase their significant contribution to adaptation to climate change.
- The EU Taxonomy currently only recognises underwriting of climate-related perils within the climate change adaptation objective for insurers. Insurers' contribution to sustainability and environmental goals are much wider and the KPI is therefore a poor indicator of insurers' contribution to sustainable goals.

This means that in contrast to other industries, the underwriting taxonomy alignment KPI could not only never attain 100%, but it will rarely be able to exceed 5% for primary insurers even if they adapt their underwriting activities to fully satisfy the technical screening criteria. These limitations and weaknesses may jeopardise the ability of taxonomy data users to fully understand the effective contribution of insurers to adaptation and its ability to increase it, and create an unfair **competitive disadvantage for (re)insurers** compared to other financial market participants**.**

Other practical challenges

In addition to the weaknesses identified above, there are also a number of practical issues which mean that the KPIs insurers are reporting will not be as comparable or accurate as intended:

- There is a widespread **lack of data** on investee companies to meaningfully disclose on the Investment KPI. This may improve over time and with the availability of data on investee companies stemming from the Corporate Sustainability Reporting Directive (CSRD), which expands the number of companies obliged to report.
- **Appendix XII introduces extensive disclosure requirements** for which the information value is very low.
- The splitting of the climate risk related premiums from the total premiums charged to customers for each product can vary significantly across companies. There are different methods a company might use for making such a split and they will also depend on many company-specific factors such as which risks the company is exposed to, the location of the customers, how those risks diversify with other risks the company insures. Therefore, the **splitting of premiums can vary making comparisons across companies problematic.**
- The **draft guidance from the EC came too late**. In late December 2023, the European Commission published a notice with FAQs and answers on taxonomy-eligible and aligned activities (Taxonomy art. 8 reporting) aimed at helping implementation of the requirements for financial undertakings. Instead, the publication of very extensive FAQs, just tendays before the first mandatory reporting on EU Taxonomy Alignment started in 2024, came too late for adapting year-end data and reporting processes and created a lot of confusion. The final guidance has still not been published. As a result, different companies used different approaches for their first taxonomy alignment reporting and there remains a range of open questions about the reporting should be done.

Way forward

The first taxonomy alignment reporting has triggered significant discussion and analysis. and the insurance industry is, along with many other industries and policymakers, learning from the first reporting. The sector is currently considering how taxonomy reporting can be best improved to reach its potential as a tool to support the allocation of capital to achieve transition to a net-zero economy by 2050.