

# Task Force on Climate-related Financial Disclosures

## Introduction

We welcome the reporting framework established by the Task Force on Climate-related Financial Disclosures (“TCFD”). The framework continues to enhance our reporting as we make further progress on our approach to evaluating and managing climate-related risks and opportunities and as we strengthen our strategic response to one of the biggest challenges facing the world today.

The Group has complied with the requirements of Listing Rule 9.8.6R by including climate-related financial disclosures consistent with the TCFD recommendations and recommended disclosures including the supplemental guidance for all sectors and insurance companies (see pages 76 to 87).

## Governance

### Our approach

The Group’s approach to the governance of its sustainability strategy is underpinned by our Vision and Purpose (see page 23) and a clear commitment from the Board and senior management to align sustainability goals with the Group’s strategy and encourage accountability across the business.

Our five-pillar sustainability strategy, endorsed by the Board, aims to foster the highest standard of Environmental, Social and Governance practice and deliver long-term sustainability for all of our stakeholders. The Planet pillar takes the lead on climate-related issues and is sponsored by our Chief Risk Officer (“CRO”).

### Boards and Committees

The potential impact of climate change on the business (“inbound”), as well as the Group’s impact on the environment (“outbound”), are issues requiring robust governance to empower business areas in the management of climate-related risks and opportunities.

It starts with the Group’s Board, which seeks to underpin all of the Group’s activities with the highest standards of corporate governance. The Board has oversight on two key aspects of the Group’s approach:

- The Board reviews and approves the Group’s Own Risk and Solvency Assessment (“ORSA”), which includes an analysis of the climate change-related risks to the business.
- The Board oversees the Group’s sustainability activity through its Committees, which scrutinise and provide appropriate challenge on the Group’s five pillar sustainability strategy. The Chair of each Committee reports to the Board after each Committee meeting.

### 2021 highlights

- **Joined the Race to Zero**, committing to set Science-Based Targets that reduce our emissions based on a 1.5°C pathway.
- **Launched our first electric vehicle insurance package**, supporting the transition to a low-carbon economy and making it easier for customers to insure electric vehicles.
- **Announced our Supply Chain Sustainability Programme**, outlining our plan for the next ten years to engage and influence suppliers so we can make the transition to a pathway consistent with a 1.5°C scenario.

### Committees

- The **Audit Committee** meets a minimum of four times a year and is responsible for overseeing the Group’s financial statements and non-financial disclosures, including any climate-related financial disclosures.
- The **Board Risk Committee** oversees all aspects of financial, regulatory and operational risk, including the long-term risk to the Group from climate change. It meets a minimum of four times a year and receives reports on stress testing of long-term climate change scenarios, discusses strategies for managing the associated risks and considers emerging risks twice a year, recently involving a review of climate change.
- The **Sustainability Committee** supports the strategy by scrutinising progress against the plan to ensure that our Planet, People and Society pillars’ activity continues moving forward. It meets a minimum of four times a year.
- The **Investment Committee** meets a minimum of four times a year and considers the strategy for incorporating ESG factors into the Group’s investment management which has seen our credit portfolios tilted to issuers with higher sustainability weightings.
- The **Nomination and Governance Committee** meets a minimum of three times a year, monitoring the Board’s overall structure, size, composition, and balance of skills. This Committee also works to understand and integrate investors’ ESG expectations.

The Group's **Sustainability Committee** considers the work of the Planet pillar, alongside the Group's wider sustainability strategy. The Committee has taken a keen interest in the process towards setting Science-Based Targets, external activity undertaken by the Group to influence climate debates including the ABI's Climate Change Roadmap and the Sustainable Markets Initiative Insurance Task Force. The Committee has also discussed prominent public policy challenges such as flooding and accelerating the transition to electric vehicles.

### Management's role

There are three primary management roles designed to assign responsibility for the delivery of the Group's assessment and management of climate-related issues:

- the CEO has overall responsibility for climate change and environmental matters;
- the CRO is responsible for overseeing the management of climate change-related financial risk and sponsors the Planet pillar of the Group's sustainability framework. The CRO is also the senior manager with responsibility for assessing and monitoring climate change-related risk. In that capacity, the CRO oversees the work of the Risk function in analysing and stress testing the potential future impact of climate change on the business. The results of these stress tests are submitted to the Risk Management Committee, the Board Risk Committee and the Board, including as part of the ORSA; and
- the CFO is responsible for overseeing the implementation of the Group's investment strategy and is advised by the Investment Committee on the application of ESG weightings, including those related to climate change, to the relevant portfolios. The CFO is a member of the Investment Committee and the CEO, CRO and the Director of Investment Management & Treasury are attendees.

To support the Sustainability Committee's oversight and in recognition of the Group's increased focus on climate-related activity the Group formed a **Climate Executive Steering Group** which reports into the Sustainability Committee. Chaired by Tim Harris, our former CFO, the Climate Executive Steering Group consists of members representing various teams from across the business to assess potential impacts of climate change with the aim of ensuring risks are identified and managed effectively. The Steering Group's responsibilities include:

- prioritising the Group's focus on preparation for submitting Science-Based Targets;
- overseeing input in the Group's business development and strategic processes to make sure climate is given appropriate consideration in long-term strategy and planning; and
- considering the risk management challenges presented by climate change including financial risk related to underwriting and investments.

### Group Audit

Group Audit provides an independent and objective view of the adequacy and effectiveness of the Group's risk management, governance and internal control framework. The Group Audit Plan includes climate-related reviews.

## Strategy

There is strong empirical evidence and scientific consensus that human activity is causing an increase in global temperature. The impact has far-reaching implications for economies and societies around the world. If further warming was to continue the physical and economic impacts that could result may be significant, with the extent of these impacts dependent on the action taken to tackle climate change.

The insurance industry is not immune and for general insurers there are specific risks and opportunities at play. We want to contribute to a long-term sustainable future and know that through our actions as a business we can contribute to climate risk mitigation.

As a major motor insurer, we recognise our position in the motor eco-system and that we have a part to play in reducing the impact motor vehicles have on climate change.

The adoption of electric vehicles continues to increase and we are providing our customers access to insurance solutions that support this transition. In 2021, we released our first ever electric vehicle insurance package for new Direct Line policyholders (see page 81), a proposition that makes it easier for customers to insure electric vehicles, while aiming to fix them in the most energy-efficient repair network in the UK.

Our new electric vehicle proposition is only one of a number of initiatives that are now underway across the organisation, supporting our aim of protecting our business from climate change and giving back more to the planet than we take out.

### Climate change risks and opportunities

We recognise that the long term and forward-looking nature of climate-related risk is complex to manage, and that the risk the Group is exposed to could vary in materiality depending on product, business area or investment. The specific impacts of climate change on our business fall into three broad categories:

- **physical risks and opportunities** resulting from the physical effects of climate change;
- **transition risks and opportunities** arising from the transition to a lower-carbon economy; and
- **liability risks** arising when parties who have suffered losses from climate change seek to recover them from those they believe may have been responsible.

In general, transition risks are likely to materialise more rapidly than physical risks, which are likely to be gradual and materialise in the longer term.

The timing of liability risks is less certain due to the nature of the exposure.

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Whilst such risks can create uncertainty that we must continue to manage, we also recognise the transition to a low-carbon future creates opportunities to help accelerate the transition and contribute to a sustainable economy. For more information on how we are mitigating risks and harnessing opportunities across our underwriting, operational and investment activities see pages 81 to 83.

During 2021, we took action to examine how we define the time horizons relating to climate risk and opportunity. We consider the following to broadly describe the climate-related risks and opportunities impacting the Group over the short, medium and long term. We have aligned the time frames closely to pathways representing possible future climate-related scenarios over a thirty-year plus time horizon. Specific issues alongside the associated time horizons are discussed throughout the TCFD disclosure.

**Short (1 – 10 years)** The frequency and severity of natural catastrophes and other weather-related events in the UK could increase, adversely impacting insurance liabilities. The speed of transition to a low-carbon economy could also increase, supported by changes in technology and policy, including the planned ban of new petrol and diesel car sales in the UK from 2030, as announced by the UK Government in November 2020. Throughout these initial stages of transition, we intend to ensure product offerings and capabilities provide insurance solutions that best meet our customers' evolving needs, for example, as seen through the launch of our electric vehicle insurance package for new Direct Line customers in November 2021. On page 81 we report the key risks and opportunities relating to our underwriting activities which includes how we view the potential impacts the transition to electric-powered vehicles could have.

**Medium (10 – 30 years)** The transition towards a low-carbon economy continues to prompt a strategic and operational response. As consumers become more widely impacted by the transition and further changes in policy and technology are implemented we may see changes to risk nature and profile, and more acute weather-related events in the UK could occur if global temperatures were to continue rising (see page 81 for more information). We aim to enable consumers access to insurance that supports low-carbon choices and that reflects the green transition shift by utilising data and capability generated in the earlier stages of transition. We also plan to reduce climate-related risk exposure in our investment portfolio, which includes the target of ensuring our entire investment portfolio is net zero emissions by 2050 (see pages 83 and 86).

**Long (30+ years)** If further warming was to continue and no action taken to curb the longer-term impacts of climate change on our planet, the physical impacts could intensify. If chronic risks such as changes in precipitation patterns and extreme variability in weather-related events were to occur, we could see significant changes in the Group's underwriting criteria to maintain risk appetite. We may also see a shift in dynamics within the markets we operate and invest in, creating both risk and opportunity.

### Financial planning

We acknowledge that there are risks posed by climate change that could potentially have impacts on financial performance and financial position.

As an underwriter, we actively measure climate-related risk through climate risk modelling due to the nature of the Group's products (see page 84). Climate risk is also integrated into the Group's overall approach to risk management (see page 84). We also undertake scenario analysis to enhance management of longer-term climate-related financial risks (see pages 79 and 80).

We recognise our prices, products and operations will evolve as climate change influences manifest themselves through changing loss patterns, however, a failure to understand the scale of change in market demand for products and services due to climate-related policy, technology and consumer preference, could have adverse impacts on revenue.

We are already experiencing increased climate-related operating costs and capital expenditure, seen, for example, through the ongoing investments we make to reduce the overall GHG emissions in our office estate and repair centres. We are aware, however, of the longer-term benefits such investments can bring in enhancing operational efficiency and resilience whilst also reducing impact on the environment.

Our financial investments represent one of the largest assets on our balance sheet. The impacts of potential physical and transition risks arising in the wider economy could have an impact on our investment portfolio, through their influence on the value of assets. See pages 83 and 86 for further information on how we are integrating climate-related considerations into our long-term investment management strategy to develop resilience against this risk.

As the potential for increasing adverse physical impacts due to climate change exists, we, as a general insurer, are aware that insurance liabilities could be impacted as more acute, and potentially more chronic, weather-related events are experienced in the UK. Approaches to understand this impact further are discussed throughout the TCFD disclosure.

### Establishing Strategic Management Actions

Alongside science-based target setting we have also established Strategic Management Actions which business areas are now prioritising. These include actions on electric vehicles, our supply chain, flood resilience and underwriting footprint. For more information please see page 71.

### Stress test

During 2021, we considered the financial impacts from three distinct climate scenarios at a ten- and thirty-year time horizon. The analysis was applied to the Group's Solvency II balance sheet as at 31 December 2020. Two of the scenarios represent routes to net zero greenhouse gas emissions and primarily explore transition risk from climate change:

- **Early Action** The transition to a net zero emissions economy started in 2021 so carbon taxes and other policies intensify relatively gradually over the scenario horizon. Global carbon dioxide emissions are reduced to net zero by around 2050. Global warming is limited to 1.8°C by the end of the scenario (relative to pre-industrial levels). Some sectors are more adversely affected by the transition than others, but the overall impact on GDP growth is muted, particularly in the latter half of the scenario once a significant portion of the required transition has occurred and the productivity benefits of green technology begin to be realised.
- **Late Action** The implementation of policy to drive transition is delayed until 2031 and is then more sudden and substantial. Global warming is limited to 1.8°C by the end of the scenario (relative to pre-industrial levels). The more compressed nature of the transition results in material short-term macroeconomic disruption, which is particularly concentrated in carbon-intensive sectors. Output contracts sharply in the UK and international economies. The rapid sectoral adjustment associated with the sharp fall in GDP reduces employment and leads to some assets being stranded, with knock-on consequences for demand and spending. Risk premia rise across multiple assets.  
  
The third scenario primarily explores physical risks from climate change in the event that there are no new climate policies introduced beyond those already implemented.
- **No Additional Action** The absence of transition policies leads to a growing concentration of greenhouse gas emissions in the atmosphere and, as a result, global temperature levels continue to increase, reaching 3.3°C relative to pre-industrial levels by the end of the scenario. This leads to chronic changes in precipitation, ecosystems and sea level. UK and global GDP growth is permanently lower and macroeconomic uncertainty increases.

### Relative Impact – No Action to Early Action

The following graph illustrates the potential adverse impact to the Group's Solvency II balance sheet value of investment assets and insurance liabilities at Year 30 under the Early Action, Late Action and No Additional Action scenarios. The financial impact of the Early and Late Action are shown relative to the impact of the No Additional Action scenario which is set at 100%.

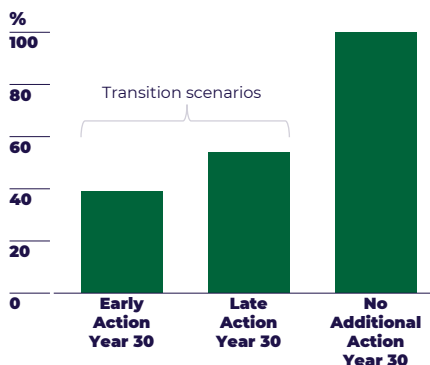


Figure 1: Year 30 impacts of scenarios relative to the largest No Additional Action scenario

In the Late Action scenario, the delay in policy implementation to transition to a low-carbon economy means there are no transition impacts over the initial ten-year time horizon. However, accelerated transition from 2031 results in greater impacts versus the Early Action scenario over the thirty-year time horizon. Whilst both of these transition scenarios saw material impacts on the investment portfolio, the most significant impacts on both investments and insurance liabilities arose from the physical risk effects of no transition in the No Additional Action scenario (where no additional actions are taken beyond those already announced).

At the thirty-year time horizon, financial impacts in the No Additional Action scenario are nearly double those in the Late Action scenario and physical risks also drove the largest impact on investment results in absolute terms. However, these impacts do not take into account the Group's long-term commitments within its investment strategy, which includes the target of holding a net zero emissions investment portfolio by 2050 (see pages 83 and 86).

All three scenarios would lead to a breach in risk appetite and the No Additional Action Year 30 scenario would also lead to a breach in SCR based on the Solvency II balance sheet as at year-end 2020. However, a set of clearly defined management actions could be deployed in each scenario to address the risks and allow the business to recover to above risk appetite.

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### Impact on insurance liabilities v investments

The graph below shows the potential adverse impact on the Solvency II balance sheet value of investment assets and insurance liabilities under the Early Action, Late Action and No Additional Action scenarios at Year 10 and Year 30. The total impact for each scenario is set at 100% and is split between the impact on investments and insurance liabilities.

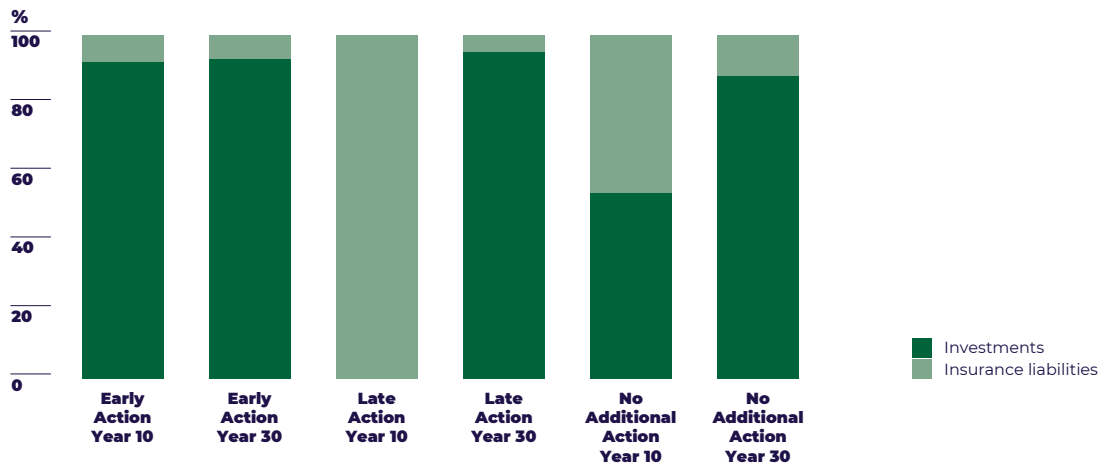


Figure 2: Share of impacts on insurance liabilities v investments

In all scenarios at the thirty-year time horizon, the impact on insurance liabilities was more limited than on investments. However, insurance liabilities were considered gross of reinsurance and in practice the short-term nature of the business, the ability to re-price annually and the risk mitigation provided by reinsurance arrangements is likely to limit the impact on general insurance liabilities further.

### Physical risk by peril

The following graph illustrates the potential adverse impact of physical risk on the Solvency II balance sheet value of insurance liabilities at Year 30 under the Early Action, Late Action and No Additional Action scenarios. The total impact is analysed by peril.

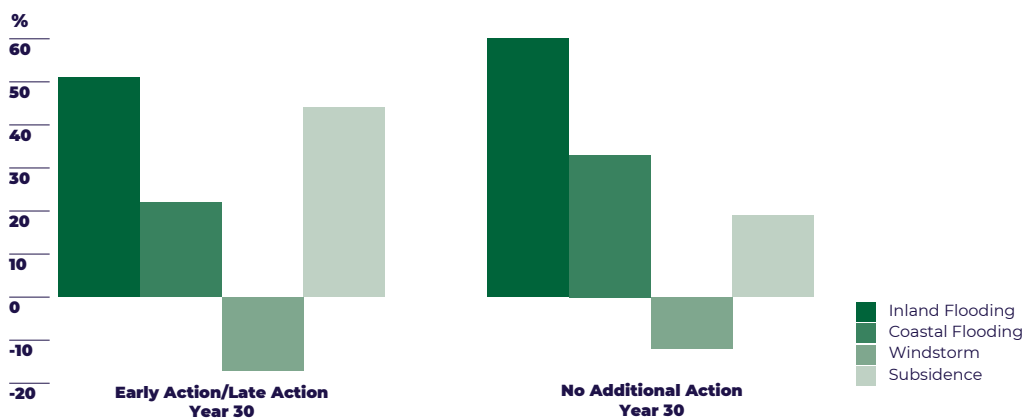


Figure 3: Split of physical risk impacts on insurance liabilities by peril

Figure 3 shows that, on a gross basis, the physical risk to insurance liabilities across all three scenarios was largely driven by inland flooding and coastal flooding which included storm surge due to a rise in sea levels. Windstorm was assessed to have a small positive benefit over all scenarios as a result of changing atmospheric conditions driven by complex interactions of a number of variables, ultimately caused by rising temperatures.

During 2021, we also participated in the Bank of England's CBES exercise which was designed to test the resilience of the UK financial system to physical and transition risks from climate change and to assist banks and insurers in enhancing their management of climate-related financial risk.

Going forward, we will continue to work towards developing scenarios specific to our own risk profile, that focus on the most material aspects of our business. This will enable us to more effectively make use of scenario-testing output to inform our strategic approach to mitigating these impacts.

## Underwriting

Climate change is a key risk facing the insurance industry. It has the potential to affect both the frequency and severity of natural catastrophes and other weather-related events in the UK which are key drivers in the Group's solvency capital requirements. The move to low-carbon vehicles, particularly electric-powered cars, also presents new challenges from which the Group could benefit, for example creating innovative products that enable consumers access to insurance solutions that support the transition to a low-carbon economy. We summarise a number of risks and opportunities in the table below relating to our underwriting activities, and highlight key action and assessment taken in 2021 against these.

### INBOUND

#### Impact of climate change on the Group

- The frequency and severity of natural catastrophes and other weather-related events could be affected by climate change and impact insurance liabilities.
- The way we price property underwriting risk due to changes in building codes or standards could be affected.
- Liability loss could arise as people suffer losses from climate change.
- The transition to electric-powered vehicles could have significant strategic and operational impacts, including fundamental changes to the profile of accidents and the nature of risks, supply chain and repair processes.
- Understanding the transition to electric-powered vehicles provides an opportunity to contribute to and benefit from the transition to a greener future. This will ensure optimum risk assessments influence pricing decisions, safeguard efficient repair process in our accident repair centres and help develop new products and propositions for our customers.
- Climate change creates an opportunity to enhance our risk-modelling expertise and help strengthen our pricing decisions.

### OUTBOUND

#### The Group's impact on the environment

- Remaining active participants in developing solutions to influence the debate on weather-related events provides an opportunity to enhance risk modelling and ensure commercial impacts are understood, particularly how claims and fulfilment operations function, for example flooding and resilient repairs.
- Issuing communications on preventative measures customers can take could reduce claims numbers.
- Developing further insight into electric-powered vehicles for pricing considerations, the nature of the risks involved, developing efficient repair practices and strengthening technical expertise in our accident repair centres are commercial opportunities.
- Integrating electric vehicles into our fleet of courtesy cars to support customer awareness of electric vehicle capability.
- Developing products and propositions that could encourage a reduction in emissions and open up potential commercial opportunities, for example our "Mileage MoneyBack" proposition.
- Monitoring consumer attitudes to green products and develop insurance solutions that best meet our customers' evolving needs and accelerate the transition to a low-carbon future.

#### Key Group action 2021

In 2021, we continued to explore the potential longer-term climate-related underwriting risk, and how we can support the transition to a low-carbon economy through underwriting activities.

As a participant in the Bank of England's 2021 CBES exercise, we gained extensive insight into the potential impact of modelled climate scenarios on our insurance liabilities over a thirty-year period; this has also expanded our capabilities to enhance in-house scenarios specific to our own risk profile and most material aspects of our business (see pages 79 and 80).

In our Motor business, we announced a new partnership with Motability Operations Ltd which is due to take effect from 2023 (see page 8). The Motability Scheme helps over 640,000 individuals gain access to mobility with lease terms on most vehicles being three years. Over the course of the 10-year partnership we expect the number of electric vehicles we insure to grow significantly, providing valuable underwriting data, insight and capability into the future of vehicle technology and repair, crucial for building long-term strategic resilience against key transition risks.

Demonstrating our commitment to developing insurance products that can support the transition to a low-carbon economy, in Q4 2021 we announced our first 'green' motor insurance solution, launching a fully electric vehicle insurance package to new Direct Line customers (see below).

### Making electric easy

Our Direct Line brand is working to make electric easy for our motor insurance customers, offering all new business customers access to a bundle of electric vehicle essentials as well as insurance that covers batteries and charging cables. The bundle includes discounted access to public and community charging, discounted home charger installation, help with grants and discounted parking for electric vehicles\*. Our customers also benefit from our repair expertise via our network of body shops.

\* One bundle per Direct Line motor policy, available to new customers only who buy between 28/10/2021 and 31/10/2022. Free bundle provided by Zoom EV for 12 months from activation and validation of Zoom EV account.



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### Operations

Given the scale of our operations we are all the more determined to ensure action is taken to reduce our impact on the environment. To support this, we are setting clear, transparent and science-based emission reduction targets, improving the way individual business areas operate and exploring the way we leverage our relationship with suppliers. Our operations are also exposed to physical and transition risks, such as possible disruption to direct operations due to the physical impacts of climate change, and we could also see a rise in operating costs through carbon cost increases and regulatory requirements designed to limit GHG emissions. We summarise a number of risks and opportunities in the table below relating to our operations, and highlight key action and assessment taken in 2021 against these.

INBOUND	OUTBOUND
<b>Impact of climate change on the Group</b> <ul style="list-style-type: none"> <li>– Operating costs could rise due to potential carbon cost increases, regulatory requirements designed to limit carbon emissions and as a result of failure to improve operational efficiencies. This would drive the need for more aggressive energy reduction measures across the Group.</li> <li>– Frequency and severity of natural catastrophes and other weather-related events could impact direct operations leading to business interruption.</li> <li>– Total Scope 3 emissions could either increase or reduce as a result of how we manage our supply chain, particularly the goods and services we purchase.</li> </ul>	<b>The Group's impact on the environment</b> <ul style="list-style-type: none"> <li>– A failure to set long-term emission reduction targets for business operations could see energy consumption increase.</li> <li>– Investing in energy-efficient features and equipment across our office estate and accident repair centres provides the opportunity to reduce energy consumption, which could otherwise increase.</li> <li>– Improving operational efficiencies can save on energy consumption particularly in our roadside rescue and recovery business and in our repair centres.</li> <li>– Encouraging employees to make environmentally conscious decisions can enhance education, increase recycling rates and save on consumption over the long term.</li> <li>– Once validated, our new Science-Based Targets will ensure we have a clear and transparent route to further reduce and monitor our Scope 1, 2 and 3 emissions.</li> </ul>
<b>Key Group action 2021</b> <p>In 2021, we remained committed to reducing the impact of our operations on the environment and continued to make progress to mitigate the impact physical and transition risk could have on our operations.</p> <p>At the end of 2020 we announced our commitment to set science-based reduction targets for our Scope 1, 2 and 3 emissions via the SBTi and in 2021 we continued to make progress against this. Working with environmental consultancy Carbon Intelligence, we plan to submit the targets to the SBTi for their independent validation in 2022.</p> <p>We also joined the Race to Zero in 2021, taking a leadership position as we reduce GHG emissions. It means we will set targets in line with a 1.5°C emissions scenario where we are aiming to achieve net zero emissions by 2050 at the latest.</p> <p>We have also continued to offset the carbon emissions from our operations we can't yet avoid, see pages 71 and 73 for further information.</p> <p>Throughout 2021, we continued to implement further operational efficiencies and improve long-term operational resilience against climate-related matters, key action included:</p> <ul style="list-style-type: none"> <li>– Launching our <b>Supply Chain Sustainability Programme</b>, which outlines our plan for the next ten years to support the reduction of Scope 3 emissions in our supply chain (see below); and</li> <li>– Embedding new solutions in our Auto Services repair centres by making use of alternative fuels, offering customers the option of choosing 'green' parts in vehicle repairs and moving away from reliance on gas powered repair processes (see page 74 for more information).</li> </ul>	

### Supply Chain Sustainability Programme

We are using our established relationships and purchasing capabilities through procurement to mitigate our risks by seeking to reduce the emissions in our supply chain. The Group's Ethical Code already sets out our expectations of suppliers that they should support a precautionary approach to environmental challenges, promote greater environmental responsibility and encourage the development of environmentally friendly technologies.

We have launched our Supply Chain Sustainability Programme which outlines our plan for the next ten years. We recognise this will be a gradual process but by acting now we can work with suppliers by signalling our expectations so that we can make the transition to a pathway consistent with a 1.5°C emissions scenario.

### Our approach means:

- Engaging with our largest emitting suppliers to encourage them to sign up to SBTi targets or an equivalent.
- Requesting information on what efforts firms have made to measure their carbon footprint across Scopes 1, 2 and 3 and their plans to reduce emissions, including targets.
- Changing our sourcing approach on appropriate contracts by introducing a sustainability rating that will increase over the next ten years, which could exclude prospective suppliers if they have no plans to reduce emissions.

## Investments

In recent years we have started to integrate more ESG considerations into our investment strategy, recognising this is a long-term process which will require assessment and challenge to inform future decision making. We know that the impacts of potential physical and transition risks arising in the wider economy will have an impact on our investment portfolio, through their influence on the value of assets. For example, our portfolio is exposed to physical risks through our investment in companies that are exposed to disruption from adverse weather events across their supply chain. It is also exposed to transition risks, where companies that we are invested in are not adapting their strategy to a low-carbon future. However, the transition to a low-carbon economy also creates significant investment opportunities.

We have committed to ensuring our entire investment portfolio is net zero emissions by 2050. In the table below, against the inbound and outbound impacts our investment portfolio brings regarding climate risk, we summarise key climate initiatives started in 2021.

<b>INBOUND</b>	<b>OUTBOUND</b>
<p><b>Impact of climate change on the Group</b></p> <ul style="list-style-type: none"> <li>– The impacts of physical and transition risks arising in the wider economy could have an impact on our investment portfolio, through their influence on the value of assets and the potential for certain carbon-intensive assets to become stranded.</li> </ul>	<p><b>The Group's impact on the environment</b></p> <ul style="list-style-type: none"> <li>– Working to ensure our climate strategy is aligned with the Race to Zero campaign on climate change, we can reduce the impact of climate risk on our financial assets. The transition to a low-carbon economy will require large scale public and private market investment. This creates opportunities for institutional investors like ourselves to ensure capital is directed to help with the transition.</li> </ul>
<p><b>Key Group action 2021</b></p> <p>At the beginning of 2021 we implemented our climate strategy for corporate bond portfolios which represent around two-thirds of assets held. The initiatives are summarised below:</p> <ul style="list-style-type: none"> <li>– We have committed that by 2030 the Group will have reduced by 50% the weighted average carbon intensity of corporate bond portfolios (from a 2020 base year).</li> <li>– Given the need for a phaseout of thermal coal power production (since it's one of the most carbon-intensive forms of energy generation), bond issuers that generate &gt;5% of revenues from thermal coal activity (mining or power production) have been divested unless the company is taking positive climate action<sup>1</sup>.</li> <li>– We do not invest in companies opening new thermal coal mines or thermal coal power plants.</li> <li>– Investment within corporate bond portfolios will increasingly be tilted towards companies evidencing they are taking the transition to a low-carbon economy most seriously. These will be companies that have committed to setting Science-Based Targets, or those with a 2°C or better carbon performance alignment from the transition pathway initiative.</li> <li>– The exclusion of companies with an MSCI Low Carbon Transition Category of "asset stranding".</li> </ul>	

The actions detailed in the table above form part of the ongoing development of the wider ESG framework underpinning investments. In terms of holding investments in other companies, those with higher reported ESG credentials have more sustainable practices which better align to our investment, environmental and social goals. As such, a requirement of all investment-grade corporate bond portfolios is that each portfolio must maintain a minimum MSCI ESG rating of 'A' or better.

Looking through the climate lens, we also have in place the following current initiatives:

- We actively encourage our investment managers to invest in green bonds. Green bonds are designated bonds intended to encourage sustainability and to support climate-related or other environmental projects. All our relevant corporate bond mandate guidelines now direct the portfolio manager to purchase a green bond where the risk return characteristics are similar to those of a comparable non-green bond.

- Within our investment property portfolio all assets must have an Energy Performance Certificate of 'D' or better, or a plan and funds in place to achieve that level. The property portfolio also has a tailored set of end 2022 ESG targets covering, inter alia, carbon, energy, water and waste.

A key objective to enhance further our climate objectives in 2022 is to submit Science-Based Targets for the investment portfolio. The setting and validation of investment targets will form part of our wider application with the SBTi.

### Using our influence

We are committed to using our influence to drive wider change. For example, we expect all of our investment managers to be signed up to the UN Principles for Responsible Investment. We also talk regularly to our external asset managers to understand (and where necessary, challenge) how they are using their global presence, size and leverage to engage and encourage corporations to tackle climate change.

Note:

1. Companies taking positive climate action are defined as those that are committed to setting Science-Based Targets or have a 2°C or better carbon performance alignment from the transition pathway initiative.



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# Risk Management

### Enterprise Risk Management Strategy and Framework

The Enterprise Risk Management Strategy and Framework sets out the Group's approach to setting risk strategy and for managing risks to the strategic objectives and day-to-day operations of the business. Further information can be found in the Risk management section of the Strategic report on page 89.

### Risk taxonomy

The effects of climate change are wide-ranging, affecting many risks across the risk universe. For this reason, the Group reflects the effects of climate change in the drivers of those risks which are defined in the Group Risk Taxonomy rather than adding climate change as a separate risk category. For example, the effects of climate change would be a driver of meteorology risk, which is a subset of underwriting risk.

### Risk impact

The impacts of all risks, events and action plans are rated using the Impact Classification Matrix which facilitates a consistent approach to the sizing and categorisation of risk across the Group. This includes those risks relating to climate change, and allows the Group to determine the relative significance of climate-related risks in relation to other risks.

### Climate-related risk identification process Annual risk identification process

Each year, the business is required to review all current and developing risks which could impact on the achievement of strategic objectives. This process includes assessing risk drivers, such as those due to climate change, and their potential impact and likelihood of risk crystallisation on both an inherent and residual basis, in addition to identifying the position which aligns with risk appetite.

### Regulatory monitoring

The Group monitors and reviews relevant outputs from the FCA, the PRA, European supervisory authorities (including the European Insurance and Occupational Pensions Authority ("EIOPA")), the European Commission and Her Majesty's Treasury, to consider existing and emerging regulatory requirements.

During 2021, this included reviewing:

- the PRA's launch of the 2021 Climate Biennial Exploratory Scenario on financial risks from climate change;
- the FCA's Policy Statement confirming the introduction of a new comply or explain listing rule requiring companies with a UK premium listing to include a statement in their annual report for accounting periods beginning on or after 1 January 2021 which sets out whether they have made disclosures consistent with the recommendations of the TCFD;
- the HM Treasury roadmap 'A new chapter for financial services', which confirms that the UK Government will implement an integrated Sustainability Disclosures Requirement which will require businesses to disclose their risks and opportunities from, and impact on, the climate and the environment; and
- the minutes of the PRA and FCA's joint Climate Financial Risk Forum.

We continue to monitor future developments and reviews are summarised and distributed to relevant stakeholders, and, where necessary, responses are co-ordinated and overseen by members of Second Line of Defence.

### Emerging risk process

In addition to the annual risk review process, the Group has in place an emerging risks process which facilitates the identification, management and monitoring of new or developing risks which are difficult to quantify or are highly uncertain. The Group records emerging risks within an Emerging Risk Register. An update on emerging risk is presented to the Risk Management Committee twice a year, and the Board Risk Committee annually, and is supplemented by deep dives on selected emerging risks.

Climate change is one of the Group's most prominent emerging risks and is owned by the Executive Committee with regular oversight provided by the Climate Executive Steering Group, consisting of First Line of Defence subject matter experts from around the business where the impact of climate change is the highest, in addition to Second Line of Defence subject matter experts who provide oversight and challenge of risk management activity relating to this.

Each emerging risk is owned by an Executive sponsor to help ensure alignment of how it is managed to the strategic objectives and priorities.

### Climate risk modelling

The predominant direct physical drivers of risk to the Group's capital position are major UK floods and windstorms. Whilst additional risks such as freeze and subsidence are less material to capital requirements, these are modelled within the Group's Internal Economic Capital Model and reviewed at least biennially.

The influence of climate change is difficult to isolate from the complex oceanic and atmospheric processes driving UK weather. The Group uses catastrophe models to capture these factors, and in turn these models are regularly reviewed against specific criteria including how they have considered latest scientific thinking, to ensure they appropriately capture the Group's risk profile. Responsibility for this work sits within the Capital Management function.

Our most exposed policies renew annually and are priced according to risk. Pricing algorithms use sophisticated rating engines to account for recent trends and are supplemented with views of catastrophic risk to seek to ensure sufficient pricing. These prices will evolve as climate change influences manifest themselves through changing loss patterns, and views of catastrophic risk develop because of rising sea levels, changes in precipitation rates and urban resilience.

Risk pricing models are built using historical data covering a multi-decadal time period for perils most likely to be influenced by climate change. This allows us to understand and incorporate long-term signals and past trends into our modelling. These models benefit from considerable amounts of internal and externally purchased data. External data is reviewed and updated regularly, and we maintain a relationship with data suppliers to understand the methodologies and assumptions in their work. Nevertheless, the underlying trends can be difficult to measure as they emerge through infrequent one-off catastrophe events and may have additional contributory factors (for example, deforestation increasing the pace of rainwater run-off upstream of a flood). Furthermore, future trends are likely to differ from past projections. As such, we recognise a range of uncertainty as to current and future impacts.

Increases in frequency and severity of large catastrophe weather events are mitigated by the Group's use of catastrophe excess of loss reinsurance. This reinsurance covers property (Personal Lines and Commercial) and Motor physical damage losses; in addition to significant capital benefits, it transfers the volatility of low-frequency, high-severity natural perils events away from the Group. The reinsurance purchase decision is a combination of catastrophe modelling, capital analysis, the Group's risk appetite, cost of cover and the overall income statement impact. Cover is purchased with an upper limit equivalent to a 200-year modelled loss and the retention will be based upon the amount that the Group is willing to sustain from such a loss. In addition, we purchase risk covers to protect against large individual commercial losses and we make extensive use of Flood Re to cede high flood risk residential properties.

## Metrics and targets

We use a variety of indicators across the different lines of our business to assess, monitor and manage our climate-related risks and opportunities.

### Underwriting

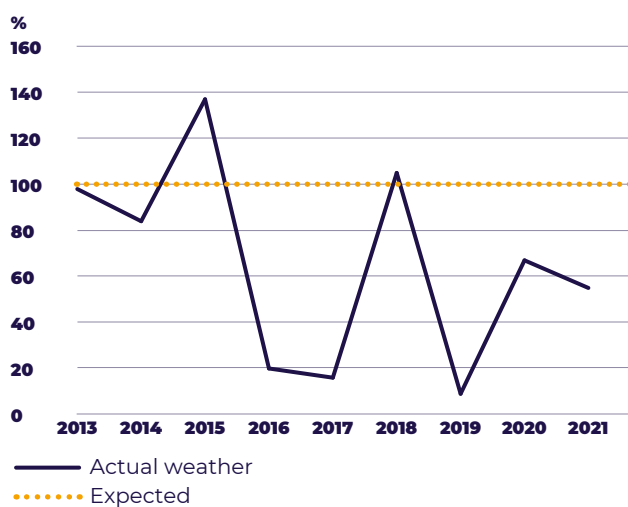
#### Weather-related loss impact

The predominant direct physical drivers of catastrophe weather risk from a capital perspective are major UK floods and windstorms. The last peak of windstorm activity was in the late 1980s and early 1990s; the last decade being particularly benign in comparison, by contrast, flood has seen more elevated activity.

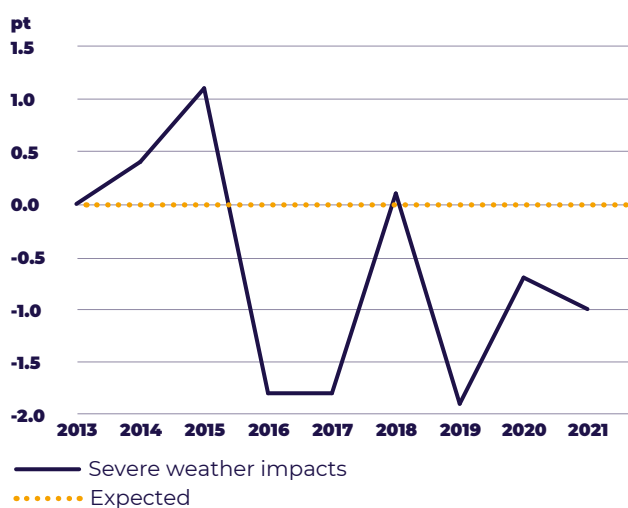
Catastrophe reinsurance is purchased annually to protect against event losses greater than £150 million and additional reinsurance cover protects against large individual commercial losses (see page 43). Use of the Flood Re scheme mitigates against the highest individual residential flood risks.

The Group uses sophisticated modelling techniques to determine the expected losses from severe weather events and uses these to set a weather load for budgeting purposes. The following graph shows the impact of severe weather events relative to the weather load; the trend is downwards reflecting recent benign activity, although there is significant variability. The 2018 peak was driven by the 'Beast from the East' freeze event whilst the 2015 peak was a result of a number of weather events in December which caused severe flooding across the UK.

#### Severe weather losses (actual % of expected loss)



#### Impact of severe weather on combined operating ratio (pt)



These results can be translated to impacts on the Group's combined operating ratio<sup>1</sup>; the relatively benign 2019 year for example improved the Group's combined operating ratio by nearly two percentage points against plan.

The frequency and severity of extreme weather events will be affected by climate change, which in turn will affect our view of risk, how we price severe weather risk, and the type and level of reinsurance we purchase to protect our balance sheet.

### Home

Key risk indicators are produced by Underwriting and reviewed quarterly through relevant business forums. The key climate change-related activities are flood, subsidence and weather incidents. For flood and subsidence perils, we monitor the Group's market share for risks deemed to be in the high- or very high-risk segments. We also monitor and review the proportion of policies ceded to Flood Re. Each peril is monitored against set tolerances, with movements in amber or red ratings generating investigation and action as required. We maintain a view of trends and look to take action where a trend is likely to result in a breach of tolerance.

Note:

1. See glossary on page 248 for definition.

## Task Force on Climate-related Financial Disclosures *continued*

### Subsidence

Subsidence as a peril is a relatively low overall cost, however a subsidence event can be very costly. We monitor this risk via our subsidence market share by geo risk classification. This risk classification aims to give a market view of geographic risk of having a subsidence claim. This enables us to understand the proportion of subsidence risk that we write compared to our estimate of the total in the market.

The classifications take the geographic factors in the subsidence buildings models and not the individual property estimated sums insured.

### Flooding

Governments have been working with insurers since 2000 to help make flood risk insurance more affordable. In 2016, a previous solution was replaced with a longer-term plan, called Flood Re. Every insurer that offers home insurance in the UK, the Group included, must pay into the Flood Re scheme. This levy has raised £180 million every year which is used to cover the flood risks in home insurance policies.

To ensure the Group and its customers benefit from the levy and guard against the highest of flood risks, we monitor the volume and proportion of policies we are ceding to Flood Re. Properties are eligible to be ceded to Flood Re when they meet certain criteria. Since early 2019, the cost to cede policies to Flood Re has dropped, driving an increase in ceded volumes.

### Motor

The Group's motor market is diversified throughout the UK, and weather-related claims make up a very small part of total motor claims. As such we do not currently consider there to be any valuable climate-related risk indicators that can be tracked for this portfolio.

In order to track the transition towards electric and alternatively fuelled vehicles (such as hybrids), we monitor both the number and proportion of policies we underwrite for these types of vehicles as well as electric vehicle and alternatively fuelled vehicle registration data from The Society of Motor Manufacturers and Traders.

### Operational

#### Our performance to date

We are proud of the progress we have made on reducing emissions and have a record of setting targets to hold the business to account. In 2013 we set two Group-wide environmental targets for our Scope 1 and 2 GHG emissions which we have tracked, reported against and successfully met in 2020. The two targets we set were:

- a 57% reduction in emissions (Scope 1 and 2) on a like-for-like basis by the end of 2020 against a 2013 baseline. In 2021, we saw a 61% reduction in energy-related emissions, which takes into account the impact of Covid-19 where mixed model working measures altered our energy usage; and
- a 30% reduction in energy consumption on a like-for-like basis by the end of 2020 against a 2013 baseline. This year we again delivered a 45% reduction in energy consumption, which takes into account the continued impact of Covid-19.

Overall, in 2021, we saw an increase in emissions under our direct control compared to 2020, which is explained by an increase in activity in vehicles being repaired in our Auto Services business as a result of Covid-19 restrictions being eased during the year. We have also for the first time this year calculated and included our homeworking emissions under the Scope 3 'Employee Commuting' category in recognition of more colleagues working from home.

#### Holding ourselves to account in the future: Setting Science-Based Targets across Scopes 1, 2 and 3

We are pleased with the success we have made in reducing our Scope 1 and 2 emissions having met the two targets we set as planned. We now want to go further because we believe transparency can guide the business in making targeted interventions as part of our carbon reduction strategy:

- We continue to break out our Scope 1 and Scope 2 emissions into separate performance figures across our office sites and accident repair centres and disclose a Scope 3 footprint, with greater clarity of the activities under our direct control, as well as our supply chain emissions. See page 72 for our 2021 emissions data.
- Throughout 2021, we continued to place an increasing focus on calculating and validating our emissions data across all areas of the business, including our Operations, Supply Chain and our Investments which are embedding plans to reduce carbon footprint.

We are undertaking this activity because we want to enhance our carbon reduction strategy. To go further we are committed to setting Science-Based Targets for Scope 1, 2 and 3 emissions via the SBTi and this year we joined the Race to Zero because we recognise our role in taking a leadership position as we reduce emissions. It means we will set targets in line with a 1.5°C emissions scenario where we are aiming to achieve net zero emissions by 2050 at the latest. We will submit our science-based reduction targets for validation by the SBTi in 2022.

#### Investments

More than 100 financial institutions have publicly committed to set emissions reduction targets through the SBTi. In 2018, the SBTi launched a project to help financial institutions align their lending and investment portfolios with the ambitions of the Race to Zero campaign. The project audience includes universal banks, pension funds, insurance companies and public financial institutions.

Our long-term goal is for our entire investment portfolio to be net zero emissions by 2050, in line with the aims of the Race to Zero campaign. To support this aim we have an interim target of a 50% reduction in weighted average carbon emissions intensity by 2030 (from a 2020 base year) within our corporate bonds portfolio, the largest asset class within the investment portfolio.

Carbon intensity is the GHG emissions intensity per \$1 million of sales. Normalising by sales allows the investor to compare carbon efficiency of different-sized firms within the same industry and has become a standard metric used in the investment industry.

We will continue to progress towards setting Science-Based Targets for the investment portfolio in line with SBTi's guidance and plan to submit these targets for validation to the initiative in 2022.

## Future Group Activity

We want to continue gaining a deeper understanding of how climate change might affect the business, and below we outline the future Group activity to support this.

<b>Governance</b>	<p>We plan to maintain strong Board oversight, ensuring the Planet pillar, as part of our sustainability strategy, continues to take a lead. We will also continue setting the Board's strategic debates in a climate change context, which will be supported by periodic debates on climate-related risks and opportunities.</p> <p>In 2022 we will also incorporate ESG-related metrics into executive management remuneration plans (see page 155).</p>
<b>Strategy</b>	<p>We intend to build further understanding around how we systematically consider climate-related issues from a risk and opportunity perspective across business areas and in our strategic decision making; a key part of how we can achieve this includes driving forward the Strategic Management Actions set in 2021 that business areas are already prioritising (see page 71).</p> <p>Alongside these actions, we also plan to enhance central scenario planning and testing by developing climate-related scenarios specific to our own risk profile. We are also considering how these scenarios could be incorporated into the development of the Group's business plan.</p> <p>We will also be taking part in a second round of the Bank of England's CBES exercise in Q1 2022. This is expected to further explore participants' strategic responses to the climate scenarios published as part of the first round and the associated implications for their business models.</p> <p>During 2022, the Climate Executive Steering Group will maintain its oversight into the Group's business development and strategic processes to make sure climate is given appropriate consideration in long-term strategy and planning. It will also continue to consider the risk management challenges presented by climate change including oversight of the modelling of climate change risk and financial risk related to underwriting and investments.</p>
<b>Risk management</b>	<p>We will continue our robust approach towards the management of physical risk and intend examining in more depth inbound and outbound impacts in order to enhance understanding of transition risks. This includes through the use of central scenario planning as discussed above. The ambition is for risk management processes to support the Group in conducting detailed analysis on each risk and applying monetary values to support the Group's overall strategy.</p>
<b>Metrics &amp; Targets</b>	<p>In 2022, we plan to submit our Science-Based Targets to the SBTi for their independent validation. The structured and measurable nature of the emission reduction targets will mean that, once validated, they will formulate the path we must take to ensure we meet our commitment of achieving net zero emissions by 2050 at the latest, which is in line with a 1.5°C emissions scenario.</p>

## Streamlined Energy and Carbon Reporting (SECR) regulations

The following table highlights where information can be found that supports the requirement to disclose how the Group manages its energy consumption and carbon emissions.

Requirement	Pages
Annual global GHG emissions (CO <sub>2</sub> e)	
– from activities for which the Company is responsible	70 and 72
– from buying electricity, heat, steam or cooling by the Group for its own use	70 and 72
Annual global energy consumption in kWh, being the aggregate of:	
– energy consumed from activities for which the Company is responsible	70
– energy consumed resulting from buying electricity, heat, steam or cooling by the Group for its own use	70
The proportion of GHG emissions and energy consumed relating to the UK and offshore area <sup>1</sup>	71 and 72
Methodology used to calculate emissions and energy consumption	72
At least one intensity metric in relation to emissions	73
Description of energy efficiency actions taken	75 and 86 (‘operational’ section)
Note:	
1. The offshore area is broadly defined as the sea adjacent to the UK, including the territorial sea, plus the sea in any designated area under section 1(7) of the Continental Shelf Act 1964 and section 41 (3) of the Marine and Coastal Access Act 2009.	