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Global insurance and ESG: rising to the challenge

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Global institutional investment is increasingly influenced by environmental, social and corporate governance (ESG) considerations. This paper considers how ESG factors may affect insurance companies, today and tomorrow. We consider not only the potential impact on both sides of insurance balance sheets, but also the broader impact on the insurance industry, including on its customers and its employees. We believe there are tremendous opportunities for insurance companies that plan and respond effectively to the fast-changing ESG environment.

This note is not about how ESG considerations can or should be integrated into active investment processes – a fascinating topic worthy of a dedicated paper.[1] Rather, this is about the business opportunities that ESG offers insurance companies to create better outcomes for everyone. How can this be done?

- By understanding the ESG-related changes that are happening around the world and in the insurance industry in particular
- By appreciating the impact that these changes will have on insurance businesses
- By recognising and realising the tremendous opportunities that exist for companies that plan and respond effectively.

How ESG factors affect insurance companies today

ESG-related themes are having an impact on more and more facets of human life and the physical world. This makes ESG factors increasingly important in the assessment of the risks to insurers' assets and liabilities – to the future value of insurance firms' investment portfolios and to the size of the insurance claims that the firms are subject to each year.

Environmental factors clearly have a major impact on property & casualty (P&C) insurance claims from one year to the next. But over the long term, they also affect the health of the population and therefore have an impact on the cost of health and sickness benefits and, ultimately, the value and cost of annuity policies. Hence, P&C claims (arising from floods, fires, pollution, etc.), health insurance claims, and mortality trends may all be materially affected by ESG factors – today, in the foreseeable future and beyond.

On the asset side, there is compelling research evidence to support the hypothesis that ESG factors can play an important role in long-term stock-selection success.[2] In general terms, corporations must try to be proactive in managing the emerging financial consequences of ESG risks. For example, moving from old practices and equipment to new, more environmentally friendly ones may entail significant investment and costs. And it is already clear that poor governance within firms increases the likelihood of mistakes and, in time, negligence claims.

How insurers choose to run their businesses in the face of these real risks may affect their competitive positions and reputations in the marketplace. It will also have an impact on the culture of the firm and may affect employee engagement and, ultimately, the ability to attract and retain talent.

In some parts of the world, ESG is starting to feature in insurers' regulatory regime. The Prudential Regulation Authority (PRA) in the UK and the European Union's EIOPA (European Insurance and Occupational Pensions Authority) have now made it explicitly clear that they expect insurance companies to model and quantify the impact of ESG factors (and climate change in particular) in their regular Solvency II stress-testing exercises and to report on the results.[3]

Climate change is clearly one of the most high-profile and politically topical ESG risks. It is often described as having three components of risk – physical, transition and liability. Let's briefly describe each of these in turn.

The physical risks from climate change are the most obvious and direct. These are the tangible risks, costs and losses from flood, fire, storms, etc. They are already having a major impact on the global insurance sector. 2017 was the worst year ever for insurance losses and 2018 was not far behind. Apart from the obvious impact on claims, these events hit asset prices and property valuations in general and cause credit risks to rise "further down the chain". In the light of this, the models that we use to evaluate both the asset and liability sides of the insurance balance sheet will need to evolve –to adapt not just to changing climate-related trends but also to long-term changes in, for example, morbidity and mortality, and also to cope with potentially rising correlations and falling diversification benefits.

The second component is transition risk. This refers to the costs and impact of the changes prompted by the new climate environment. Some of the numbers involved can become quite mind-boggling. The Bank of England's 2015 climate-change adaption report estimated that just under one third of the total value of global equity and global fixed-income assets is in carbon-intensive industries and hence is likely to experience significant change or disruption at some point in the future.

What will the triggers of change be? In some cases, regulators will force change. At other times, it will be prompted by a technology leap or physical events. But often, it will simply be changes in investor or consumer preferences that reduce demand for products, services and the assets of certain companies.

Finally, there is liability risk – the cost of claims for damages, etc. This affects some insurance companies directly as a result of underwriting exposures, but also, of course, as a result of its impact on the market price of their wider investments.

Why does it matter now?

Well, put bluntly, the demands from the marketplace for better and more detailed reporting are rising and cannot be ignored. The Task Force on Climate-related Financed Disclosure (TCFD) was established three years ago at the request of the G20 leaders and the Financial Stability Board under the leadership of Michael Bloomberg. Since then, there has been a step change in the level of financial institutions' climate-change reporting. Current supporters of TCFD include three-quarters of the world's globally systemic banks and all of the top 10 global asset managers, along with many of the top pension funds around the world, the major credit-rating agencies and the 'big four' accountancy firms.

The 2015/6 Paris Agreement on climate change and the UN 2030 Agenda for Sustainable Development have prompted the European Commission to put in place a package of measures on financing sustainable growth. These reflect three key objectives that were expressed in an action plan published in March 2018: [4]

- Reorienting capital flows towards sustainable investment, in order to achieve sustainable and inclusive growth;
- Managing financial risks stemming from climate change, environmental degradation and social issues; and
- Fostering transparency and long-termism in financial and economic activity.

In August 2018, EIOPA and the European Securities and Markets Authority (ESMA) were asked by the European Commission to work out how these objectives should be incorporated into the regulatory environment for financial services.

Insurance firms' senior management and boards are expected to understand, address and oversee all the risks that can arise from long-term ESG trends – including those well beyond the standard business-planning horizon of four or five years. There is a need to improve stress and scenario testing and develop a fuller appreciation of the sensitivity of the balance sheet to changes in key ESG risk drivers. These results need to be communicated to the outside world, and this represents a positive marketing opportunity. Firms will need to develop and oversee revised investment policies and adapt underwriting and pricing techniques to ensure that risks are priced profitably.

All of the above is a reaction to external pressures. But, as well as improving the insurance firm's risk management, a proactive ESG strategy may create opportunities for the firm to benefit competitively from such a position. The firm's response to ESG may create marketing and brand-positioning opportunities. It may help with employee engagement and business culture. And it may support the development of relevant new products and the identification of new profitable business.

Financing sustainable growth opportunities

We noted above that the EU has identified three key priorities for financing sustainable growth. Let's consider each of these in turn.

The first is the objective of directing capital flows to achieve sustainable and inclusive growth. The move to a low-carbon economy will offer huge rewards for companies that participate effectively. In a 2017 paper,[5] the International Energy Authority (IEA) estimated that the transition to a "2-degree world" could require US$3.5 trillion in energy-sector investments per annum for decades (more than twice the current rate). Globally, US$90 trillion of infrastructure investment is expected between 2015 and 2030 (this is five times US GDP).

Insurers can develop new products and direct long-term capital flows to participate in this sustainable and inclusive growth. But there are challenges. At present, there is no common, globally accepted definition of sustainable investment. This leads to the potential risk of 'greenwashing' investment products, where investment firms overstate new products' ESG-related qualities. It is essential that regulatory and accounting frameworks around the world do not unduly discourage the deployment of capital to meet sustainable investment requirements – for example, in the setting of liability discount rates and the calibration of capital charges for investment risk.

The second objective is to assess and manage the financial risks of climate change, resource depletion, environmental degradation and social issues. There is a view that, historically, banks and insurers have not given sufficient consideration to long-term risks. Mark Carney, the governor of the Bank of England, recently referred to this as the "tragedy of the horizon", given that the impact of these changes far exceeds the traditional length of financial institutions' business-planning cycle. The financial modelling of the impact of ESG factors on the risks for assets and liabilities is currently underdeveloped. And insurance, as an industry, requires an operating environment that allows underwriting under suitable conditions.

The third and final objective is to foster transparency and 'long-termism' in financial and economic activity. Too little information is provided by companies on their sustainability-related activities. Insurers should challenge their asset managers to ensure that their ESG governance, expertise, reporting, risk assessment and stewardship practices are best in class and effectively integrated with the insurers' ESG policies.

Regulatory interest and involvement

As mentioned earlier, regulatory interest and involvement is rising, especially in Europe. We mentioned above the UK PRA's climate-change adaption report of 2015. This was followed by a Consultation Paper in October 2018 and a Policy Statement in April 2019. The European Commission established a High-Level Group (HLEG) on sustainable finance in 2016, which published a report in early 2018.[6] In August 2018, the EU made a very direct request to EIOPA and ESMA: "How should the risks and objectives be worked into the regulations?".

Why the focus on the financial risks associated with climate change? Regulators have been very clear and direct about this. They believe the trends underway now may be larger in magnitude than we have seen before, and they may be non-linear, correlated and irreversible. They will play out over uncertain, albeit extended, timescales, but they are to some extent foreseeable and very dependent on what we do now. So it is clear they expect a response; they expect insurers to do something.

Conclusions

For all of us, it is important to recognise these long-term trends and to try to understand their impact on the global insurance industry. The evolving business risks, reputational risks and regulatory risks all need to be proactively managed. The management of climate-change risk is emerging as one of our industry's highest-profile initiatives. The numbers are huge, and the impact is potentially pervasive – financially, across both the asset and liability sides of the insurance balance sheet, and operationally and culturally too. This is about challenging our industry to respond effectively. It is also about the opportunity for insurance firms to profit from trends that are already underway.

[1] https://www.aberdeenstandard.com/docs?editionId=639368e9-ffff-4931-ae22-a41ff17404aa

[2] https://www.msci.com/documents/10199/4a05d4d3-b424-40e5-ab01-adf68e99a169

[3] See PRA's Policy Statement 11/19 and EIOPA Consultation Paper 19/241

[4] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

[5] https://webstore.iea.org/world-energy-outlook-2017

[6] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en