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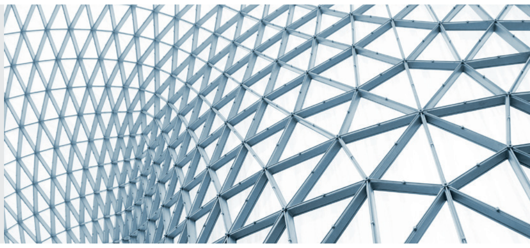

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Insurers: the ESG regulation challenge

Global rule-making for sustainable investments is expanding and converging

Key Takeaways:

- With the EU, the UN, the G7, IOSCO and the OECD all integrating ESG guidance into their long-term strategy planning, convergence between policymakers is taking place. Amid this regulatory upheaval and a shift in investor preferences, a simple risk-return approach is no longer sufficient for insurance portfolios.
- Framing a climate change investment policy and implementing it is a challenge for insurers. There is no accepted blueprint and, even with growing regulations, no single set of rules. But some general principles can be applied to all companies.
- Few entities apart from governments or research institutions have the risk-modelling capabilities of insurers. While creating a sustainable investment framework is no simple task, the insurance industry is uniquely well-placed to deal with the complexities of climate change and its impacts.

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As very long-term custodians of assets, insurers are more exposed to sustainability issues than most other classes of investor. While some investors can afford to give lip service to managing ESG exposures, for insurers it is an existential issue. Their long-term survival and success depend on it.

That insurers are at the bleeding edge of ESG efforts is increasingly recognised by policymakers. Governments and regulators are explicitly focusing their ESG edicts on long-term investors such as insurers. From idiosyncratic efforts led by a handful of early-mover countries, the regulatory push has started to go global. So not only are insurers exposed to actual ESG risks, but to regulatory risk too.

How are insurance groups around the world impacted and how are they responding to the challenge?

Europe leads the way in ESG rule-making

Given that insurers globally control around $30 trillion of global assets[1] and that some of these assets are held for decades, it is intuitive that ESG regulations should impact the insurance industry more than others.

The first wave of ESG regulatory activity occurred primarily in Europe. France, a leader in ESG rule-making, introduced its ground-breaking Article 173 in the wake of the 2015 United Nations Climate Change Conference (COP 21). The French legislation requires investors to publicly report how they assess ESG risks, with a specific focus on climate issues. Other regulatory and marketplace actions focused on ESG or merely green finance have emerged in different EU countries, for instance in the Netherlands and in the UK, in the aftermath of COP21.

These initiatives seem to have galvanised pan-European policymakers, with the EU taking on the mantle of standard-setter in green finance. The European Commission's action plan to promote sustainable finance, launched in 2018, will be the first time a supranational regulator has attempted to write standards for sustainable products and investments. The ultimate aim is a climate-neutral Europe by 2050.

Some of these regulations like the one on sustainability disclosure will apply to financial institutions with more than 500 employees. This captures all major insurers and demands that they provide reliable information to assess the impact of their activities on on sustainability in

1 https://www.actuarialpost.co.uk/article/what-role-can-insurers-play-in-the-climate-change-crisis-17418.htm

general including on social issues, and also the impact of climate change on insurers' development and performance., as investors.

The rules have been fully scoped. For instance, disclosure on a commonly agreed definition of green activities through the upcoming EU taxonomy (listing what can be considered a green activity) have helped to debate some questions such as should they only apply to investors who focus on offering green funds. The definition of green through the taxonomy regulation has become a major policy and economic stake. No-one should doubt the intent of the EU to launch the new rules. EU commission vice-president Valdis Dombrovskis said they represent the "single most important piece of legislation"[2] helping to meet global emission targets.

The European Commission also introduced (in June 2019) its concept for an EU Green Bond Standard, a voluntary standard that will follow the principles of the action plan. The standard will require an auditor approved by the European Securities and Markets Authority to review the framework, and this framework to be based on the EU taxonomy to ensure that it is indeed financing green projects.

The UK is making moves too. The Prudential Regulatory Authority (PRA) in 2019 set out its expectations regarding investors' approaches to climate change risk. The Climate Financial Risk Forum has worked with investment firms for investors to embed climate risks into their process and to develop their own disclosure frameworks. New ESG disclosure rules relating to UK pension funds were also introduced in 2019.

More recently, on November 9th, 2020, the UK sets out ambition for future of UK financial services, with the objective to extend its global leadership in green finance[3] . Announcements include the issuance of the first Sovereign Green Bond in 2021 subject to market conditions, with a series of further issuances to follow, the introduction of more robust environmental disclosure standards. The Task Force on Climate-related Financial Disclosures (TCFD) aligned disclosures will also be fully mandatory across the economy by 2025 for listed commercial companies, UK-registered large private companies, banks, building societies, insurance companies, UK-authorised asset managers, life insurers, FCA-regulated & occupational pension schemes. The UK will also implement a green taxonomy, taking the scientific metrics in the EU taxonomy as its basis; a UK Green Technical Advisory Group will be established to review these metrics to ensure they are right for the UK market. The UK also intends to join the International Platform on Sustainable Finance.

Global regulation starting to converge

Meanwhile, in Canada, an Expert Panel report has made 15 recommendations to support the growth and development of sustainable finance in Canada amid concerns that climate change is damaging the Canadian economy. It is estimated that climate change will cost Canada between C$21 billion and C$43 billion a year by 2050[4] . Since 2009, Canadian insurers have paid out C$1.8 billion a year in claims, compared to C$400 million through the 1990s.

In Japan, the market for green bonds is accelerating. Likewise, in Australia, the private market is driving climate change initiatives rather than government edict. In the US, despite the government's withdrawal from the COP 21 agreement and very conservatives stances taken on ESG, the ESG agenda still moves forward, driven by individual states the courts and internal debates at the SEC.

Mexico launched a national carbon market pilot program in late 2019 as part of its Energy Reform and National Climate Change Strategy. From 2021, participants in the pilot program must report their emissions and have them certified by an accredited verification entity.

Circling back to France, Paris has doubled down on Article 173, adopting the "PACTE" law on companies' growth and transformation. It integrates, among others, the obligation for life-insurance products to offer solidarity-based, SRI and green life-insurance products by 2022.

With the UN, the G7, IOSCO and the OECD all integrating ESG guidance into their long-term strategies, convergence between policymakers is starting to take place. Globally, policymakers are far from united in their ESG positions. But the direction of travel is clear and further convergence of standards and regulation can be expected in the near future.

Insurers aware of growing ESG risk

Most insurance groups do not require regulators to make them aware of ESG risks. Many insurers are taking steps to comply with current and likely future regulation and are also tackling ESG risks in ways that enhance their own business. "In some cases, they are going way beyond regulation, positioning their investment portfolios and product ranges to reduce their carbon impacts and positively impact the environment," says Estelle Castres, Head of Key Insurance Clients Group at Natixis Investment Managers. In doing so, they seek to protect against the downside risks to their business models and potentially increase returns from their long-term investments.

The downside risk includes a greater risk of natural disasters against which insurers are required to write premiums. The risks are rising. Insured losses totalled some $227 billion in 2017 and 2018[5]. In 2018 alone, catastrophe losses were $90 billion, with hurricanes such as Michael and Florence and Typhoon Jebi accounting for most of the losses. Historically insurers have used catastrophe or cat models to estimate the frequency, intensity and damage footprint of a natural disaster. But cat models are powerless when events become far more extreme or happen in places where they have never occurred before.

Insurance companies which cannot adapt their models and investment portfolios are exposed to double danger: rising risks to insured assets and to their investment portfolios. Mark Carney, governor of the Bank of England, outlined the task ahead[6] for insurers. Carney warned that general insurers and reinsurers are on the front line of managing the physical risks from

2 https://www.theparliamentmagazine.eu/articles/interviews/greening-economy - 3 https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services - 4 https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=12281113 - 5 Source: Aon climate change. He said: "Insurers have responded by developing their modelling and forecasting capabilities, improving exposure management, and adapting coverage and pricing. In the process, insurers have learned that yesterday's tail risk is closer to today's central scenario."

Building sustainable portfolios

According to the 2019 Natixis Insurance Survey, more than two-thirds of insurers now consider climate change as a core business issue or are starting to consider it a core business issue[7] . Some strategies include exclusion policies, "best-in-class" stockpicking and a core-satellite approach. In the core-satellite approach, ESG scoring is used for the portfolio's core holdings, while solutions with positive social or environmental impacts form a satellite allocation.

Some insurers have developed more advanced strategies, making climate change a key focus of their investment policies and applying a climate risk approach across the entire portfolio. They seek assets that are emissions negative, such as forestry investments, or invest in new technologies which can extract carbon from the environment and transform it into renewable fuel.

As Carney notes, infrastructure investments will be essential to building sustainable portfolios. All countries, particularly emerging economies, will need to invest in new, climate-resilient infrastructure to adapt to a more volatile climate. Climate-resilient infrastructure assets are well suited to life insurers that need reliable returns over long-term horizons.

These types of assets are all the more compelling in an ultra-low interest rate environment. And there is evidence that infrastructure assets such as infrastructure debt could lower portfolio risk. A World Bank study[8] suggests that capital charges could decline significantly if infrastructure debt was classified as a separate asset class. The International Association of Insurance Supervisors (IAIS) is considering the case for a differentiated capital treatment for infrastructure.[9]

How to develop a sustainable framework

Framing a climate change policy and implementing it is a challenge for insurers. There is no accepted blueprint and, even with growing regulations, no single set of rules.

Insurers must first develop an ESG philosophy by establishing what climate risk means in the context of their business, says Hervé Guez, CIO of Equities & Fixed Income at Mirova, an affiliate of Natixis Investment Managers dedicated to sustainable investment.

Armed with a strong concept of what they want to achieve, measurement is a key first task. Methodologies exist to measure climate impact, even if they are evolving, so insurers can make informed attempts to report on the likely impacts of the economic sustainability of their investments and, conversely, how climate change may impact their investments and business model.

A second key step is to use these measurements to manage externalities, often by modelling various scenarios relating to the investment portfolio. Once externalities can be modelled, these models can be refined and retuned using the output data. Negative impacts can be reduced and positive impacts enhanced across the portfolio.

The industry is making progress, says Guez. "Things have changed," Guez says. "All insurers are now measuring what they do and assessing their ESG exposures. The twin regulatory and client agenda means this is the least they must do."
Regulatory demand for climate disclosures will expand hugely in the next two to three years, he says, and insurers will need to enhance their reporting and communication capabilities to meet this challenge.

From best-in-class to best-in-universe

The most ambitious insurers - those who seek to both meet the regulatory agenda and drive forward their business models - aim to "green" the whole organisation. This includes investing in green bonds and climate-friendly companies, to launching products that do no harm.

This advanced group tends to eschew best-in-class investments. After all, choosing a best-in-class oil major in preference to another oil major may not be the most efficient way to reduce climate change risk in the portfolio. Advanced strategies replace the best-in-class concept with a best-in-universe approach, which is sector or asset class agnostic. The investments are often high-conviction, high-impact assets.
These kinds of assets can be provided by specialist investment houses such as Mirova, whose portfolios all have a 2°C trajectory in line with the goals set out at COP 21. "We are dedicated to developing impactful solutions for clients," says Guez. "Using many asset classes, we offer investment strategies which finance projects and companies at any stage of maturity and which provide solutions to sustainable development challenges. And, of course, we look for financial performance."

Conclusion

Few entities apart from governments or research institutions have the risk-modelling capabilities of insurers. While adopting a sustainable framework is no simple task, the insurance industry is uniquely well-placed to deal with the complexities of climate change and its impacts.

"Natixis Investment Managers supports insurance companies in their structuring and implementing of ESG decisions," says Castres. Natixis Investment Managers can provide environmental advice and strategies which support these decisions and go beyond the scope of regulatory compliance, she adds.

What is certain, is that amid regulatory upheaval and a shift in investor preferences, a simple risk-return approach is no longer sufficient for the insurance industry.

Written in January 2021

6 https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/a-new-horizon-speech-by-mark-carney - 7 https://www.im.natixis.com/en-institutional/insights/insurance-survey-2019-regulatory-challenges - 8 http://documents.worldbank.org/curated/en/125511521722022110/pdf/WPS8373.pdf - 9 https://www.fsb.org/wp-content/uploads/P201118-1.pdf

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