ENVIRONMENTAL, SOCIAL AND GOVERNANCE RISK (ESG) INVESTING

An insurance perspective

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As ESG takes a more prominent role in investment many related terms and approaches have emerged. Usually when ESG is discussed the focus is on the wider benefits of building on ESG portfolios. Whilst these are numerous, there can also be ESG impacts on many types of investments and it is essential to take these into account when measuring the risks present in your portfolio. Increasingly, investors are finding that simply discussing ESG is becoming confusing and doing something about it is an even greater challenge. In this paper we briefly describe what is meant by ESG and Socially Responsible Investing (SRI) and describe the impact these issues can have on an insurer's business.

Defining ESG is confusing as the same terminology can mean different things to different people. In general, ESG refers to an approach to investing which focuses on addressing:

E

Environmental issues like carbon emissions, water scarcity, environmental pollution.

S

Social issues like discrimination, gender issues, equal-pay, wealth distribution.

G

Governance issues like executive pay, corporate responsibility, regulatory intervention.

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From an investment perspective, ESG is often linked to SRI (which has a narrower definition on focusing on investments which address social issues). That is, structuring investment decisions to directly, or indirectly, take ESG considerations into account. This may be referred to as responsible investing, sustainable investing, ethical investing or green investing - all of which can be used to refer to all or sections of ESG investing. Clarification of terms when discussing ESG and SRI is essential.

How is this relevant for insurers though? Well, when you cut through the jargon, insurers can be particularly sensitive to ESG issues, arguably more so than other institutional investors. ESG events tend to have an impact on insurance assets and liabilities. We've used a couple of simple examples below to illustrate the potential impact ESG can have on an insurer's balance sheet:

	EVENT	LIABILITY IMPACT	ASSET IMPACT	NET BALANCE SHEET IMPACT
E - Environmental	Global warming and climate change, specifically as a result of manmade greenhouse gases.	Increased frequency and severity of natural catastrophic events such as floods, hurricanes and drought.	Investment losses on assets impacted by catastrophe events (e.g. oil and gas companies operating in storm-prone areas – Gulf of Mexico).	Increasing liabilities and a fall in the value of investment assets leads to reduction in solvency and profitability.
S - Social	Data security and privacy in social media.	Theft of user data, or insecure data leading to a significant data breach, could be used in hacks against global targets. Insurers are increasingly providing cover for cyber security related risks so these incidents can have an impact on underwriting results.	Insurers invested in companies for whom they provide cyber-security cover may be exposed to portfolio losses following a cyber-event. Many insurers will also be directly or indirectly invested in social media companies. Trust is critical for their business model and so any misuse of customer data could have a fundamental impact on customer behaviour and share price.	Assets and liabilities are exposed to the same types of technology risks increasing balance sheet volatility and risk correlations. Increasing liabilities and a fall in the value of investment assets leads to reduction in solvency and profitability.
G - Governance	New regulation introduced to incentivise ESG aware business practices.	Certain types of insurance become commercially unviable as a result of regulation; for example providing insurance cover to coal miners.	Some assets currently held have increased regulatory capital requirements levied on them to discourage investment.	Reduced solvency as a result of higher capital charges and less risk diversification.

Clearly ESG is an issue for insurers. Certain types of business expose insurers to more ESG risk exposure than others but we believe this is an issue that should be evaluated by all insurers because;

- ESG risks may not be immediately obvious
- ESG risks can have a material impact on an insurer's balance sheet in a short space of time
- In many cases, ESG investment risks can be mitigated substantially by making simple changes to an investment portfolio

One of the key concerns we often hear from Clients is whether their expected return profile will change once they commit to ESG aware investing. It's a common misconception is that ESG investing must be done at the expense of investment returns. We would argue that ESG aware investing done correctly should enhance the long-term return profile of an insurance investment portfolio for the following reasons:

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- ESG is a risk factor to be considered for any asset - holding securities that are exposed to negative ESG events should result in losses in the long-run as these risks materialise
- Socio-economic and regulatory trends mean that early adopters of ESG aware investments should see value emerge as the world operates in a more ESG aware fashion (consider the growing popularity of electric vehicles and the increased regulation limiting diesel engines)
- Where ESG correlations exist for insurers between assets and liabilities, there is a meaningful risk of unexpectedly large losses as a result of ESG events. Investing with those correlations in mind provides for a more diversified risk profile across the business

Large insurers are already incorporating these ideas and practices into their businesses but how are small insurers affected? ESG issues may not be an obvious set of risks to these insurers which may leave them in a vulnerable position as these risks emerge. Insurers who have not systematically evaluated ESG exposures may find that unexpected ESG events could have an outsized, adverse impact on their business.

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We would encourage insurers who haven't developed a way to systematically evaluate ESG risks to start with the following questions:

SUGGESTED ESG RISK QUESTIONNAIRE	
1	How would we define ESG risk for our business?
2	What ESG risks impact our underwriting business and can we quantify the risks?
3	What ESG risk exposure do we have in our asset portfolio and can we quantify the exposure?
4	Which of the risks identified is above our level of comfort/risk exposure limits?
5	Are the risks above correlated in any way (i.e. can the same risk event negatively impact both assets and liabilities)?
6	If Yes to 5, can we quantify in some sense the potential impact of the combined risks and are we comfortable with this level of exposure?
7	What practical steps can we take to mitigate and/or monitor these risks? (This may include introducing exclusions of certain companies in the investment portfolio, reinsuring certain classes of business, limiting premium exposure to certain insureds etc)
8	How do we think the current environment will evolve in the long-run and are we positioned to capitalise on these changes? (this may be from a regulatory perspective and/or industry perspective)

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