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Transition Risk: Portfolio Considerations Amid Increasing Carbon-Emission Controls and Climate-Related Regulations

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Potential business exposure to the growing concerns of climate change is becoming an issue for more insurers, and regulators are picking up the mantle as well. Regardless of how this affects an individual insurer's business practices, for all insurers it creates a need to understand transition risk, i.e., the investment risks - and opportunities - that may arise in response to how efforts to reduce carbon emissions may affect market conditions.

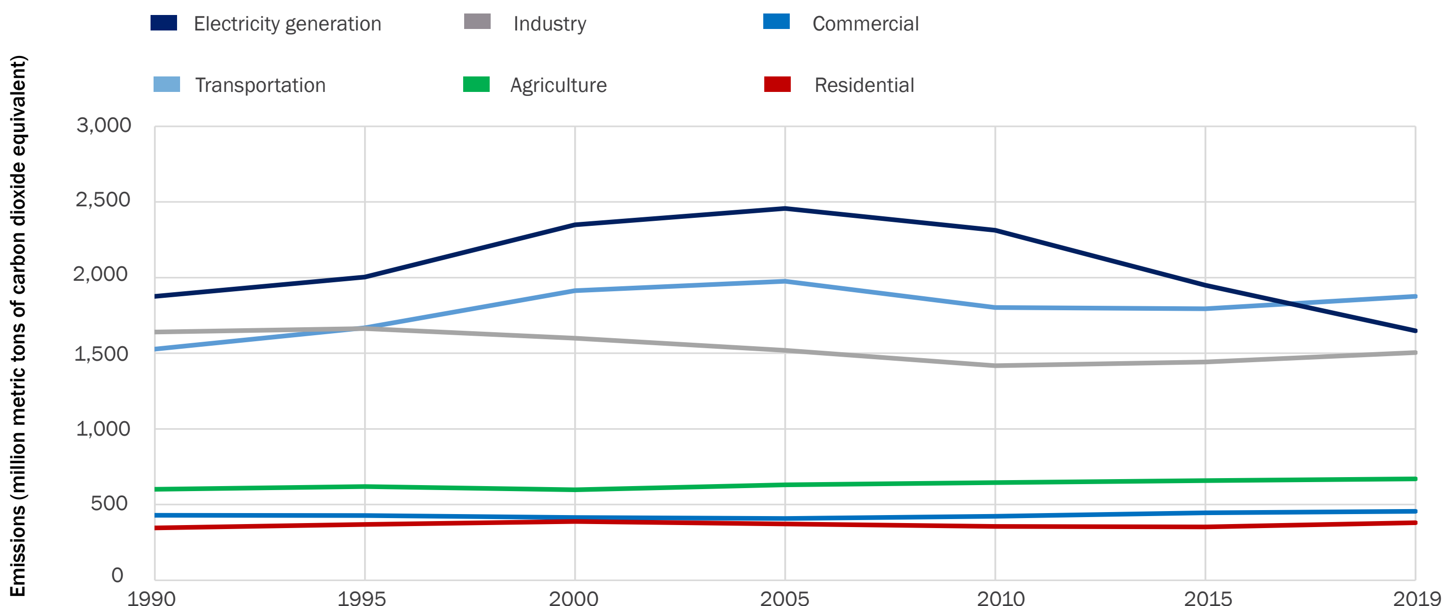
Momentum has clearly risen globally to address climate change concerns, and Conning anticipates that the path ahead will include more changes related to carbon emissions in both public policy and insurance industry regulations. From an investment perspective, Conning believes insurers should consider transition risk and the potential impact on both credit fundamentals as well as valuations.

Conning believes its credit analysis is more robust when it includes potential climate impact as it provides a longer-term view of how a credit may perform. Efforts to lower carbon emissions may impact some industries more than others and may not affect all companies in an industry equally. Identifying better-performing securities will remain our goal, and this deeper understanding may help insurers enhance the long-term value of their investments.

Regulations Grow with Climate-Change Concerns

Awareness continues to grow regarding climate concerns and the broader context of environmental, social and governance (ESG) activities. Several recent events suggest more formalized actions may be coming to the insurance industry regulatory environment in response.

Figure 1 U.S. Greenhouse Gas Emissions by Economic Sector, 1990-2019



Prepared by, Conning, Inc. Source: U.S. EPA's Greenhouse Gas Inventory Data Explorer, https://cfpub.epa.gov/ghgdata/inventoryexplorer/index.html#allsectors/allsectors/allgas/econsect/all

The U.S. has generally trailed Europe as well as Asia in addressing climate concerns. For example, the European Union (EU) has incorporated recommendations from the Task Force for Climate-related Financial Disclosure, and most European insurers soon will be required to demonstrate they have the systems and processes to understand and quantify the financial impact of climate change on the business, including investments. The EU has also committed to become carbon-neutral by 2050, which is expected to have a huge impact on businesses overall and may be transformative for certain industries.

President Biden appears committed to have the U.S. catch up. On his first day in office, he announced that the nation would rejoin the 2015 Paris Agreement of the United Nations Framework Convention on Climate Change, an agreement aimed to substantially reduce global greenhouse gas emissions that also commits the U.S. to becoming carbon neutral by 2050. Recently President Biden added to these measures, setting a target for the U.S. to achieve a 50-52 percent reduction from 2005 levels in economy-wide net greenhouse gas pollution in 2030. (U.S. net greenhouse gas emissions fell 13% between 2005 and 2019, according to the U.S. Environmental Protection Agency,[1] as illustrated in Figure 1.)

Meanwhile, in the U.S. insurance industry, a number of firms have reported that climate change is affecting their underwriting by driving up the costs of natural disasters like hurricanes and wildfires. U.S. insurance regulations are showing signs of requiring some type of recognition by insurers. The National Association of Insurance Commissioners (NAIC), along with the states of California and New York – both viewed as first-movers in state regulatory requirements - now require that insurers provide company-level climate-risk impact assessments.

From Education to Action

Regulatory action regarding climate-change risk appears to be generally following a process of education, information and then action.

The steps are intended to help insurers understand the issues and key metrics: what contributes to increased carbon emissions, what are the current levels, how do you track their movement, etc. As insurers monitor these factors over time, the figures become more meaningful and can help insurers identify the drivers to change.

Understanding climate-change risk factors may be a new step, but the process is similar to the "own risk and solvency assessment" (ORSA) that many insurers undertake under the guise of enterprise risk management. As with the incorporation of ESG factors into Conning's investment process, adding the climate-related focus puts more guidelines around the risk assessment, providing an enhanced framework to identify and monitor potential areas of concern.

"Once insurers understand the concepts and the risks, they then need to assess how and to what extent these factors will impact their business."

Once insurers understand the concepts and the risks, they then need to assess how and to what extent these factors will impact their business. How will they prioritize carbon emissions? How will this affect the management of their portfolios? Each insurer will likely need a custom solution for its business needs and objectives.

Identifying the Risk, Avoiding "Stranded" Assets

Many factors affect the level of climate-change risk an insurer faces today. Firms insuring against weather-related events may already be feeling the effects of higher claims, while those insuring lives may see little impact. However, life insurers may need to take a longer-term view of the risk climate change could play on investment assets given the longer-duration profile of their portfolios; P&C firms, with their generally shorter-duration portfolios, may have fewer concerns for the time being.

Conning's credit research includes proprietary ratings of ESG risk (Strong, Average or Weak) for each issuer. Our process continues to evolve and analysts are beginning to assess an issuer's CO2 intensity and its bearing on our ESG assessment in the context of the industry and relative to peers. From this analysis, we assign a Low, Medium or High transition risk factor to each issuer as well as industry. We pay particular attention to companies in the manufacturing, mining, energy, utilities and automotive areas given the carbon intensity of their industries.

Figure 2 Sample Conning Transition Risk Reporting

	Market value (local curr.)	% of account with MSCI data	Green Bonds	MSCI Carbon Intensity (Tons CO_2/$mm sales)[1]	MSCI Transition Risk[2]
Company	2,130,557,194	68.4%	na	502.6	5.5
ESG Benchmark		97.7%	0.9%	290.4	5.8

MSCI Carbon Intensity[1]	Company	ESG Benchmark
0-10	35%	34%
10-50	28%	37%
50-100	7%	4%
100-500	15%	15%
500-1000	4%	4%
1000-10000	11%	6%
	100%	100%

MSCI Transition Risk[2]	Company	ESG Benchmark
8-10	0%	0%
6-8	61%	70%
4-6	18%	16%
2-4	17%	13%
1-2	1%	1%
0-1	1%	0%
	100%	100%

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We generally identify risks among the issuers in two categories:

- **Technology risk** is the risks and opportunities associated with the technological shift in products and energy consumption patterns in moving toward a low-carbon economy.

- **Policy risk** encompasses the regulatory and legal aspects that a firm will need to comply with as certain jurisdictions require behaviors consistent with climate-aware strategies, e.g., the California Thermal Coal Test.[2]

Within client portfolios, we also watch for potential "stranded assets," or assets that turn out to be worth less than expected as a result of changes associated with the energy transition. (As an example, in Australia there are coal-fired power plants that are no longer economically viable.[3])

Conning's analysis is not intended to be a moral view of an issuer or industry and is not intended to be an exclusionary endeavor. We are trying to enhance our assessment of the financial risks companies face from climate change, such as how many have patents that will support them in lower-carbon initiatives, and what that may mean for credit worthiness and valuations in the long term. We believe the process improves our overall view of a credit and use that to develop recommendations for our clients, who ultimately decide on the best strategy for their businesses.

Applying to Portfolio Management

A number of Conning's U.K. clients are considering incorporating new guidelines for their portfolios, such as maximum average carbon emissions among the securities in which they invest, or a limit on the amount of transition risk to include in the portfolio overall. Some have gone further. For example, at the end of 2020 the Corporation of Lloyd's ESG Report stated its commitment to phase out investments in thermal coal-fired power plants, thermal coal mines, oil sands and new Arctic energy exploration activities by 2025.

The U.S. is seeing movement as well. As an example, some U.S. insurers have begun efforts to add more climate-friendly securities to their portfolios. For example, "green bonds," i.e., debt funding for environmentally focused projects such as solar-panel farms, are growing in popularity. Moody's forecasts that in 2021 there will be $375 billion of green bonds issuance – a 39% increase from 2020 (which was up 32% from 2019-2020). Moody's also predicts issuance of $150 billion in "social bonds" (financing intended to effect positive social change) and $125 billion in "sustainability bonds" (financing or re-financing to continue and enhance environmental and social goals).[4]

Conning's analysis seeks to integrate all risk and opportunities related to an investment portfolio, including transition risk. Our effort includes helping insurers build an investment strategy that suits their business needs and tolerance for risk and helps them understand the regulatory environment and the evolving investment landscape. Additionally, Conning offers the necessary data and reporting tools to allow clients to customize investment portfolios for their unique preferences to reflect climate-specific goals (see Figure 2).

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FOOTNOTES

[1] U.S. Environmental Protection Agency, "Inventory of U.S. Greenhouse Gas Emissions and Sinks," accessed May 1, 2021, https://www.epa.gov/ghgemissions/inventory-us-greenhouse-gas-emissions-and-sinks

[2] California Insurance Commissioner Dave Jones calls for insurance industry divestment from coal," press release, Jan. 25, 2016, California Department of Insurance, http://www.insurance.ca.gov/0400-news/0100-press-releases/archives/statement010-16.cfm

[3] "Stranded assets in Australia – with reference to the coal industry," United Nations https://www.un.org/development/desa/dpad/wp-content/uploads/sites/45/2019LINK-Tuesday-Session6-E.pdf

[4] © 2021 Moody's Investors Services, Inc., Moody's Analytics, Inc., and/or their licensors and affiliates – used with limited permission. Research Announcement "Moody's – Sustainable bond issuance to hit a record $650 billion in 2021," https://www.moodys.com/research/Moodys-Sustainable-bond-issuance-to-hit-a-record-650-billion--PBC_1263479