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Insurers need to be strategic about integrating ESG into their investment decisions

There is very little in the way of harmonised ESG reporting standards, which makes balancing ESG metrics against financial data a challenging exercise for investors

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There is no doubt the post-Covid environment will test the resolve of insurers on the underwriting as well as the investment front.

It is also clear that whatever challenges carriers ultimately confront, these will be made more difficult by environmental, social and governance (ESG) considerations, as regulators and governments continue to intensify their scrutiny of the way in which companies, including insurers themselves, address these issues.

For example, regulation is having an increasing effect on what are considered acceptable investments. For instance, the California Department of Insurance's thermal coal test is restricting investment in businesses deriving more than 30% of revenue from thermal coal. And the New York Department of Financial Services (DFS) is looking at how it can best support insurers' efforts to manage the financial risks from climate change.

Meanwhile, the UK's Prudential Regulation Authority (PRA) published its influential supervisory paper in March 2019, which encouraged the enhancement of banks' and insurers' approaches to managing the financial risks from climate change.

The PRA paper, which served as a model for regulators in other jurisdictions, set out a system for financial institutions to identify, measure, monitor, manage, control and report on ESG issues and climate risks. At the end of 2020, the Corporation of Lloyd's published its ESG report and committed to phase out investments in thermal coal-fired power plants, thermal coal mines, oil sands and Arctic energy exploration.

But while the insurance industry has something of an advantage over other industry sectors when it comes to ESG – an area in which the industry has a long track record of expertise – the terrain insurers have to navigate, particularly in a post-Covid operating environment, is constantly changing and becoming more complex.

Core competency

Managing ESG issues is a core competency for insurers on both the underwriting and corporate side of the business and they are now extending that expertise more explicitly to the management of their investment portfolios. But financial performance, rather than a high ESG orientation, is what ultimately determines the value of an asset within an investment portfolio, according to Russell Büsst, chief executive and chief investment officer at asset manager Conning Europe.

"There's a growing perception that companies with high ESG orientation also have high financial metrics, but that is not always the case – if an investment scores very well on ESG metrics, but the

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business is not sustainable, that's problematic," Büsst says.

It is also important to consider a company's trajectory. "A company may score poorly on ESG metrics at the moment but have a positive long-term outlook, which may be a good place to allocate capital. Companies strong in ESG but also strong from a financial objective tend to get a lower risk profile and better risk performance," he adds.

While strong financial metrics frequently have a high correlation with strong ESG focus and metrics, this is more likely driven by the tendency of high-performing firms to embrace good governance and other aspects of ESG as a means of ensuring their long-term sustainability, according to Büsst. "Financial metrics remain the key drivers behind creditworthiness, while a focus on ESG gives an indication of whether and how this can be maintained in the long term. In our experience, one does not necessarily beget the other," he says.

He cites the example of Volkswagen, which was found guilty of installing emissions cheat devices to beat environmental tests. The group had one of the largest and most financially robust balance sheets in the sector. It also received numerous environmental plaudits. "In that instance, the strength of its balance sheet and franchise meant it was able to sustain its business and protect its franchise. Other business cases, such as the outright asset fraud at Wirecard, resulted in the company's financial demise from being a European tech superstar," Büsst adds.

The view within Conning is that financially healthy companies that score highly across ESG factors are likely to preserve their position, while those that ignore them are likely to lose ground to competitors over the long term. "There is little evidence to suggest companies that score highly across ESG factors are immune to failure, much as many that do not are doomed to failure," Büsst says. "But we do believe changes in investor behaviour towards more ESG-focused objectives will make it increasingly difficult for weak ESG-scoring businesses to remain financially competitive."

In addition, insurers may suffer reputational damage by not adopting an approach to risk that accounts for ESG and climate risks explicitly, thereby creating a perception they are lagging behind their competitors. The big challenge for insurers, therefore, is how they can integrate ESG risk factors directly into the investment selection process when they assess an opportunity.

Journey

ESG is a journey for both companies and their investors, according to Büsst. In this regard, Conning prefers to identify a best-in-class group of leaders within an industry to identify the stronger ESG companies, rather than screening out entire industries that have significant potential to improve.

One of the key components of ESG under the banner of climate is transition risk, which measures a company's preparedness to move towards a low-carbon economy. "The best examples of these are in the higher CO_2-emitting industries like utilities, manufacturing and basic materials, and energy," Büsst says.

These industries have the most scope to improve and can potentially have the biggest impact on reducing global emissions. "Improving ESG strength does not come at the expense of financial strength; we prefer to view an ESG focus as a means to preserving financial strength," he says.

Identifying credible strategies, he argues, comes from assessing a combination of a firm's statement of intent, as well as its actions. "Clearly, if they do not signal intent, action is unlikely to follow. The next part of the analysis looks at meaningful steps towards achieving a strategy aligned with a low-carbon economy and determining whether we consider it to be achievable, as well as whether it could make a difference," Büsst says.

Among the key challenges for integrating ESG factors into the investment selection process are data availability and data quality. The data is improving, according to Büsst, but availability and quality vary by asset class and there is at present no harmonised approach to measuring ESG risks, "so trying to ensure consistency across insurers' asset managers can be challenging", he says. Like most large asset managers, Conning employs both proprietary and third-party ESG/climate data and assessments.

A good example of how challenging it is to select "appropriate" data is that of carbon-related climate risk, according to Büsst. "A relatively definitive data point, available from most companies is a company's carbon intensity measured as tonnes of CO_2 produced per unit of revenue. This piece of information is helpful in identifying companies and sectors that are responsible for emitting the most CO_2, but does little to help an investor decide whether a company is making meaningful inroads into increasing the thermal efficiency of its business, or investing in 'clean' energy, for example," he says.

In addition, there is little by way of harmonised reporting standards, unlike the data that is available to measure a company's financial metrics, so balancing financial versus ESG metrics remains highly nuanced, he says. "It is dependent on a range of factors including, sector, geography and, frankly, opinion of the impact of factors such as carbon emissions and will remain so until more harmonised reporting is available."

In this regard, Conning supports the Taskforce for Climate-related Financial Disclosures, which is one of the organisations promoting better and more homogenous reporting on climate-change related risk.

Increasing pressure

Looking ahead, Büsst says regulators and policyholders will place increasing pressure on insurers to demonstrate their ESG credentials and that this is likely to develop through an engagement process, rather than a box-ticking compliance exercise.

"To add value to an insurer, ESG needs to be integrated across the organisation. We expect convergence regarding the language used and the metrics used to measure ESG risk factors for it to become a meaningful risk management tool on both sides of the balance sheet," he says.

In the short term, Büsst finds it hard to see ESG factors meaningfully "trumping" financial outcome as an investment objective if they are deemed mutually exclusive, so the challenge of managing the risk/return metrics will continue to dominate. "Having said that, as more evidence of the link between good ESG-related practices and financial outcomes and stability emerge, driven by regulation and market forces, the balance of the decision-making process will, in our opinion, increasingly shift towards those factors," Büsst adds.

But that is to assume, he says, the focus remains on avoiding the "losers" in a changing and increasingly environmentally aware investment environment. "That is an appropriate place to be. But while the move to a lower carbon-emissions environment does have costs, it also has opportunities, so we believe over time the emphasis will shift towards picking the 'winners' – businesses able to develop technological solutions to climate issues, harness consumer demand for more sustainably produced products, and profit from financing these businesses," Büsst says.

Encouragingly, there are already a significant number of these "niche" players (companies for which ESG and climate considerations form part of their operating models, rather than as a factor that detracts from their financial strength) doing just that, he argues. "It is our belief that this 'niche' approach will become more mainstream and will filter across the industry over time." ■