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National Australia Bank

A world of INSIGHT

Integrating ESG in the insurance industry: two sides of the ESG coin

June 2019

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INTEGRATING ESG IN THE INSURANCE INDUSTRY: TWO SIDES OF THE ESG COIN

Environmental, social and governance ("ESG") considerations are fast becoming incorporated into mainstream practice across all sectors of business. They have become particularly important for the insurance sector as insurance companies must consider both the asset and liability side of their balance sheet in their role as managers of risk as well as their role as investors in large asset portfolios.

In addition, the quality of a company's integration of ESG principles increasingly influences whether they can attract and maintain both their customer and investor base. To help our insurance customers build ESG strength and resilience, NAB recently brought together a group of insurance professionals with ESG market experts and practitioners to explore risk, operations, reputational and investment issues.

Part 1: ESG in risk, operations and reputation

The ESG risk landscape

To date much of the ESG focus in the insurance industry has been on the "e" of ESG in the form of climate change risk. Climate change risk often manifests in the form of more extreme weather events which can heavily impact general insurers and re-insurers as well as communities. However, it is not just environmental risk over the long term that can have a significant impact. That is, it's not just the impact of the physical risk that is the issue. "The Paris Agreement has turned climate change into an economic transition risk. It is a pure financial risk as well as a physical risk." says Sarah Barker, Special Counsel at Minter Ellison. "The Agreement targets a global economy that is net zero greenhouse gas emissions by 2050. This is the basis for the change to the global economy over the next 30 years".

There is regulatory guidance as well as voluntary frameworks that reinforce the financial risk of climate change impacts. These include the Task Force of Climate Related Financial Disclosures (the "TCFD"), currently a voluntary framework which was borne out of the G20 Financial Stability Board. It seeks to provide forward looking stress testing and scenario planning under plausible climate futures. Compliance with the TCFD may not be mandatory today however there are strong indicators that all financial institutions including insurers will need to participate. "The weight of investor money will mean that the TCFD is not elective. For example, the UN Principles for Responsible Investment which represents US$80 trillion of assets has made it mandatory for its members to have regard to the strategic components of the TCFD from 2020. We also see bodies like Climate Action 100+ who represent US$30 trillion of assets. They are committed to engaging companies to disclose in accordance with the TCFD," comments Sarah.

Our regulators and prudential bodies are also acknowledging climate related financial risk and participants from the financial and insurance community are committed to take action through initiatives such as the Australian Sustainable Finance Roadmap which was launched in April 2019 to set out a roadmap for realigning the finance sector to support greater social, environmental and economic outcomes for the country.

However, it is not just climate risk that insurers need to consider. Financial insurance such as Directors and Officer's insurance is increasingly coming under scrutiny through the lens of both social and governance factors. Sarah notes, "Directors who allegedly fail in their oversight of ensuring their company identifies, manages and discloses risk can be exposed. This includes emerging trends such as the #MeToo movement as well as cyber security breaches. Furthermore, whilst social and governance issues may be the catalyst, we need to consider how these issues impact on secondary risks like health and longevity outcomes."

How well does the insurance sector stack up?

In practice, there is a variance in how well insurers are integrating ESG principles into their operations, however, there is evidence of both rapidly evolving processes as well as increasing engagement. Pablo Berrutti, Head of ESG at Colonial First State Global Asset Management notes some of the changes particularly in the general insurance sector. "ESG has become better integrated over the past decade, most strikingly over the past couple of years. On the underwriting side, some insurers still view climate change as a one year policy risk where premiums can be adjusted to adapt or hope that weather related losses will improve in the future; neither approach indicates a long term strategic approach to the issue. While most have moved on from there, there is still a long way to go". Brendan Baker, MSCI, agrees there is a variance in how companies stack up from an ESG perspective with some managed well according to the MSCI ESG model and others less so, with peers overseas being somewhat ahead on how they score on management policy. What is evident however is the increased level of engagement. "We have noticed that engagement with our ESG rating process has increased considerably over the past couple of years and that Australia's insurers are quite engaged", comments Brendan.

There are a number of drivers for this increase in awareness and engagement including stakeholder activism and customer expectations. "Stakeholders including customers, shareholders, institutional investors and NGOs are now asking financial institutions how we are managing ESG risks and directors need to be able to answer those questions when asked", adds Rosemary Bissett, Head of Sustainability Governance and Risk, National Australia Bank.

PARTICIPANTS IN THE NAB ESG INSURANCE EVENT

Special guest speakers

Sarah Barker
Special Counsel, Minter Ellison

Simon O'Connor
CEO, Responsible Investment Association Australasia (RIAA)

Panelists

Pablo Berrutti
Head of ESG, Colonial First State Global Asset Management

Brendan Baker
MSCI ESG Ratings Analyst, MSCI

Rosemary Bissett
Head of Sustainability Governance and Risk, National Australia Bank

Max Cappetta
CEO, Redpoint Investment Management

Mark Kiely
Antares Fixed Income

Ian Woods
Head of ESG, AMP Capital

David Jenkins
Head of Sustainable Finance, Corporate Finance, National Australia Bank

Moderators

Leanne Bloch-Jorgensen
Head of Thought Leadership and Insights, Client Coverage, National Australia Bank

Clive Johnston
Head of Financial Institutions, Client Coverage, National Australia Bank

> "The Paris Agreement has turned climate change into an economic transition risk."
>
> **Sarah Barker,** Special Counsel, Minter Ellison.

Integrating ESG into risk and strategy

Whilst climate change vulnerability continues to be a significant risk, new risks continue to evolve such as data security, privacy and human rights. Rosemary notes, "Boards have become more skilled at considering risks from a climate perspective, however, constant vigilance to understand evolving ESG risks is required. Connecting an organisation's risk, corporate responsibility and front line teams to share and integrate knowledge can help this process". Moving beyond risk management, there is a significant opportunity to integrate ESG considerations into strategy and indeed for ESG to be viewed as an opportunity. "Leading management teams look at ESG strategically. ESG can be a headwind but it can also be a tailwind. As investors, we very much view a company's approach as a proxy for the quality of management", notes Pablo.

Part 2: ESG in investment portfolios

The role of ESG in the insurance investment portfolio

As large holders of investment portfolios, ESG considerations play an important role in the investment decisions of insurers – whether they manage investments themselves or whether they engage asset managers to undertake their investments on their behalf. Increasingly ESG has been lifted to the fore in the insurance industry.

A recent Blackrock survey of senior insurance executives representing US$7.8 trillion globally found 83% of respondents rated having an ESG policy as either extremely important or very important to their organisation, with 53% already having adopted an ESG investment policy and a further 27% expecting to adopt one within the next year.[1]

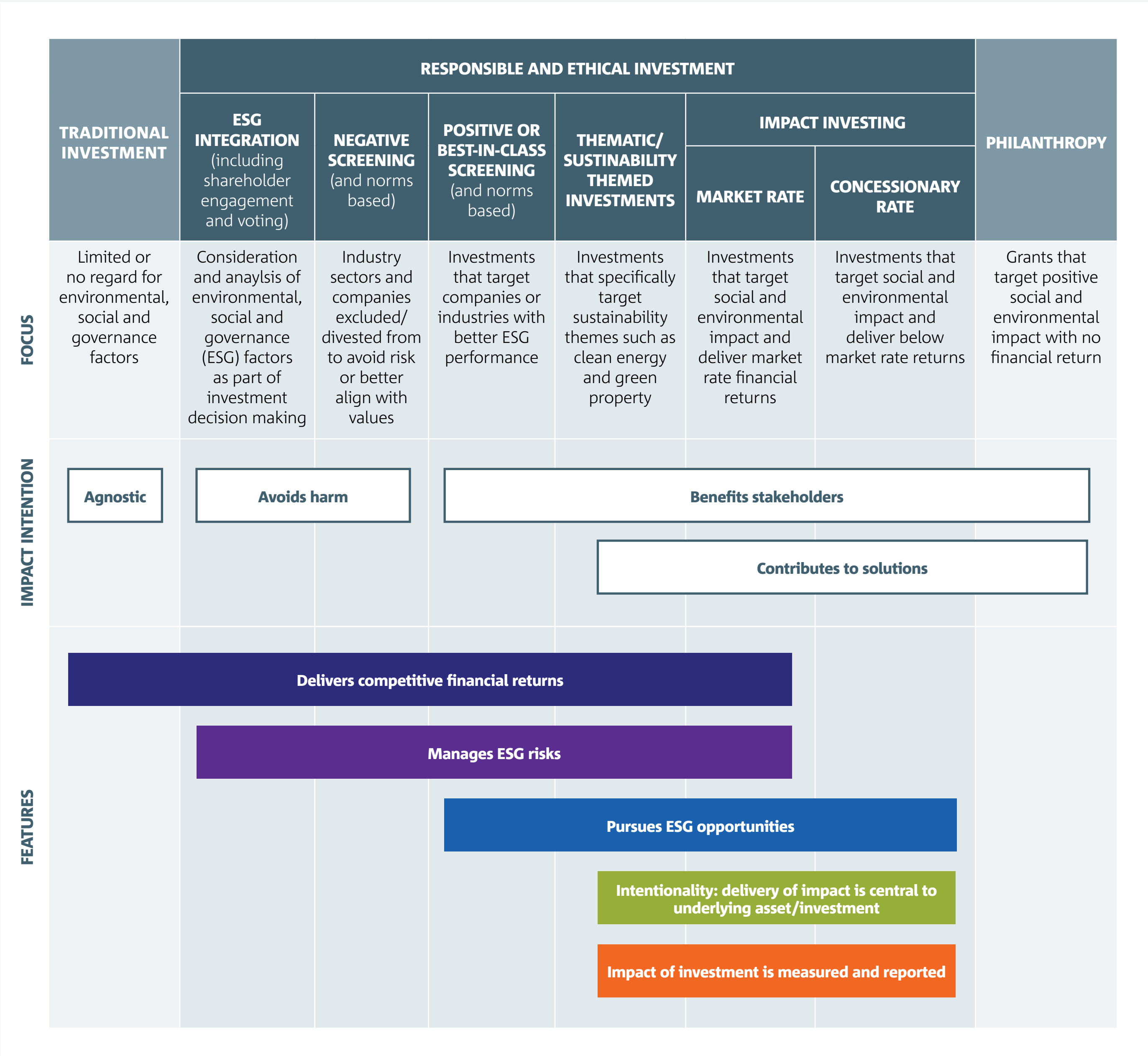
The ESG investment spectrum

ESG investment choices and strategies can appear complex and there isn't one approach to guide choices. ESG investing is often linked to the umbrella term of responsible investment with the spectrum spanning basic ESG integration which considers and analyses environmental, social and governance factors as part of investment decision making, through to impact investment which actually targets positive social and environmental impact. "There isn't one way to do responsible investment. There is a spectrum of approaches. However, global policy developments would suggest that the absence of consideration of ESG factors will rapidly be deemed to be non-compliant, breaching investor duties by failing to consider investment risks that are foreseeable and material", notes Simon O'Connor, CEO, Responsible Investment Association Australasia.

1. Blackrock Global Insurance Report 2018

Responsible Investment Association Australasia

RESPONSIBLE AND ETHICAL INVESTMENT SPECTRUM



Source: Responsible Investment Association Australasia (RIAA)

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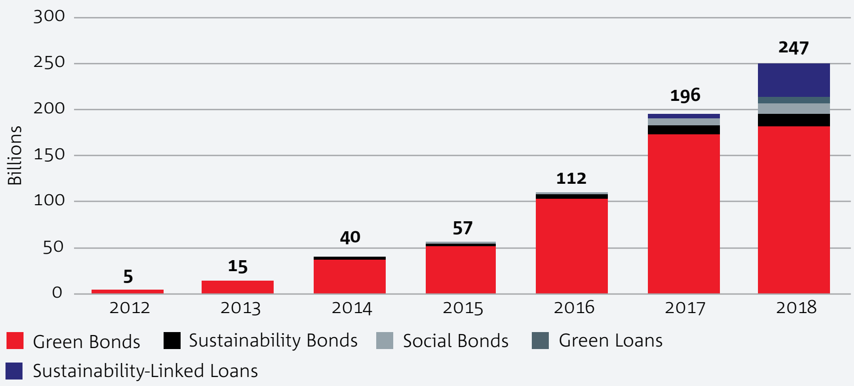
Pablo Berrutti, Head of ESG, Colonial First State Global Asset Management.

Practical approaches to investment – ESG as a pathway to value

How do ESG investment considerations translate into practice? The experience depends on the investment style and varies depending on the individual investor or asset manager. For Redpoint Investment Management, ESG has been integrated from the beginning and takes a "value seeking" rather than a "values driven" approach. However, underlying investors may view ESG differently with many investors focussing on a "values driven" approach; that is, the focus is on the investor's own ethics and principles which they are trying to embed in the investment approach rather than how one can seek out additional value add through ESG insights. Max Cappetta, the CEO of Redpoint Investment Management believes that taking a "value seeking" approach can unlock additional value add. "The data suggests that there can be stock selection outperformance by incorporating ESG in investment decisions. We see quality ESG incorporation as being aligned with the concept of company quality".

Ian Woods, Head of ESG, AMP Capital, echoes that the ESG strategy and approach very much depends on investment style and how you choose to integrate. However, irrespective of style, ESG is fundamental. "Our ESG integration process is all about helping our analysts answer questions about earnings growth, risk to earnings growth, and the level of confidence they can take in their assessments." A critical part of this process is understanding the external factors that shape the market in which a company operates, such as climate change. As well as understanding risk, this process helps to identify where the extra value of a company is coming from. "We believe the extra value lies in the intangible assets which can be 80% of a company's value. That's where ESG fits in." comments Ian.

Figure 1: Sustainable Finance issuance



Source: BloombergNEF, Bloomberg L.P.

"Successful companies manage ESG well and successful investors manage ESG comprehensively and systematically".

Simon O'Connor, CEO, Responsible Investment Association Australasia.

ESG in Fixed Income and other debt products

Whilst insurers invest in a variety of assets, liability profiles and regulatory capital considerations often mean that insurers have a very significant portion of their investments in fixed income. Historically, equities have led the way and have been somewhat more advanced in integrating ESG. Mark Kiely of Antares Fixed Income agrees, "Fixed income has been slower to respond, but it has become front of mind. There is not a client or investor meeting where the concept of ESG isn't discussed", notes Mark. He also points out that the concepts of ESG have always been incorporated into Antares' bond issuer analysis, credit research and investment decision making but the process has in recent years become much more structured and formalised.

Whilst it is expected that issuers of fixed income debt meet minimum ESG standards at a corporate level, increasingly, thematic or sustainability themed fixed income investments are becoming available and are in high demand. The most significant example is the green bond market which has grown rapidly from US$1.8 billion in issuance in 2007 to US$182 billion in 2018 and is expected to exceed US$200 billion globally in 2019. The data suggests that these bonds perform well and are generally issued in a quantum that ensures they are included in the relevant indices. Concerns around illiquidity frequently raised in earlier years have long been left behind.

David Jenkins, Head of Sustainable Finance at NAB notes, "Back in 2011, investors asked what additional premium they would get to compensate for the perceived lack of liquidity. Liquidity questions have been well and truly surpassed with a prime example being the recent Queensland Treasury Green Bond of A$1.25 billion. The discussion with investors has shifted to ask how the proceeds are being applied". The universe of these thematic bonds has broadened to include social and sustainability bonds, including bonds which are linked to the sustainable development goals, otherwise known as SDG bonds. We have also begun to witness growth in loan markets with green and sustainability linked loans being issued across industries (see Figure 1 for Sustainable Finance issuance to 2018). ESG ratings impact the cost of debt on $32 billion of these loans worldwide, up from just $3 billion in 2017.[2] This evolution tends to support the increased integration of ESG into a broad range of businesses which leads to expanded access to loan and capital markets as well as potential cost savings.

2. BloombergNEF

Contact us

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