A proper understanding and integration of ESG factors is seen as increasingly critical to the long-term viability of (re)insurers’ business.

Insurers and Reinsurers: Ignoring ESG Factors Poses Reputational Risk

AM Best surveyed (re)insurers in Europe and the Asia Pacific region to seek their feedback on how the industry considers environmental, social and governance (ESG) factors. The survey found widespread recognition among respondents that the insurance industry has a pivotal role to play in the ESG arena, and that understanding ESG factors is crucial to the industry’s long-term viability (see Exhibit 1).

Principal Takeaways: Findings from AM Best’s ESG Survey

- Insurance companies in Europe and Asia Pacific generally recognise the importance of ESG factors to the long-term viability of their businesses, although risk carriers are at different stages of their ESG journey.
- Overall, there is a marked lag between recognition of ESG risks and action being taken to mitigate those risks.
- Larger (re)insurers with an international focus are typically more engaged and more active in the ESG arena than their smaller peers.
- In the main, investment activities are the primary focus of ESG integration, with only a few respondents highlighting underwriting initiatives.
- Corporate governance, product liability including cyber security, and climate risk are cited as the most relevant ESG issues for the insurance industry.
- Lack of transparent and comparable definitions and data is stifling greater application of sustainable investing practices.

Awareness of ESG factors has increased significantly, along with an acknowledgement that these factors require special attention. However, fresh research from AM Best shows a lag between awareness of ESG risks and the actions taken to assess and manage them.

The Insurance Industry’s Unique Perspective

Insurers and reinsurers occupy a unique position in the ESG space, as both risk carriers and institutional investors.

Therefore, ESG factors have the potential to affect both sides of their balance sheets and impact their results, throwing the spotlight on the importance of integrating them in underwriting and investment activities.

Survey respondents recognised that the (re)insurance industry has a pivotal role to play in steering the ESG agenda. However, the feeling...
was not unanimous. Slightly, over a fifth of respondents were agnostic about this statement, though none disagreed with the fact that the industry has role to play (see Exhibit 1).

Support for the importance of the industry’s role was particularly strong among the larger respondents, substantially all of whom either agreed or strongly agreed with the proposition.

AM Best expects the level of insurance industry involvement with ESG to continue to grow as regulators, rating agencies, investors and other stakeholders refine evolving definitions of ESG and adjust their approach to ESG. Regulators in particular are expected to set further disclosures and reporting requirements for the industry. This is reflected in the survey, where 48% of respondents chose legislators/regulators as a source of high or significant stakeholder pressure for considering ESG risks and opportunities (followed by investors and then rating agencies) (see Exhibit 2).

AM Best notes that the growing focus by regulators on ESG risks has some parallels with the evolution of Enterprise Risk Management (ERM) when regulators across the world started demanding insurers improve corporate governance and prepare their own risk and solvency assessments (ORSA).

Insurers identified corporate governance, product liability including cyber security, and climate risk as the most relevant ESG issues (see Exhibit 3). In particular, corporate governance (flagged by 78% of respondents as of high or significant relevance) continues to be scrutinised by regulators and investors. Linked to corporate governance, social movements such as #MeToo and racial injustice concerns have led to demands for diversity in employee composition and board make-up. Executive compensation has been a major concern for investor activism as well.

Product liability including cyber security was cited by 76% of respondents as a factor that was of high or significant relevance for the insurance industry. Some insurers possess huge amounts of personally identifiable information from their clients, which makes cyber security and data privacy a key social issue that needs to be managed from an operational risk management perspective. Insurers also underwrite cyber insurance and provide risk management services that enhance their customers’ cyber hygiene practices (thereby improving their resilience as well).
Given (re)insurers’ exposure to property risks across the world, it was no surprise that climate risk was considered a significantly or highly relevant ESG issue by 76% of respondents.

Clearly, dealing with climate risk is increasingly important on the underwriting side, whether it comes from insuring properties that are exposed to the consequences of climate risk or making decisions about whether to provide cover to high-polluting industries.

It is also relevant on the investment side, where ignoring the associated transition risks could lead to exposure to so-called “stranded assets”. Transition risks refer to financial risks that could result from significant policy, legal, technology, and market changes as countries transition to a low-carbon global economy and climate resilient future.

**Growing ESG Awareness**

AM Best’s ESG survey received responses from a total of 97 companies, including non-life, life and composite (re)insurers, from 37 jurisdictions across Europe and Asia Pacific. An overwhelming majority acknowledged that stakeholders have increasingly been demanding (re)insurers undertake explicit consideration of ESG factors. While high awareness of the topic is a sign that the industry is taking those expectations seriously, the survey highlighted that the degree of engagement varies considerably among respondents.

The survey notes that larger (re)insurers – and those with a wider geographical scope – are further advanced than their smaller peers and are typically considering ESG factors in both their investment and underwriting activities. Other insurance companies are at an earlier stage of the journey, suggesting that (in some cases) there is a lack of urgency in coming up with solutions.
Only a little over half of the respondents described their company as “actively engaged” on ESG matters. The balance said they were “somewhat engaged”, and one respondent admitted to having no engagement with ESG at all. However, looking at the largest respondents, all reported being “actively engaged”.

In general, respondents acknowledged that failure to act on stakeholder pressure around ESG issues could lead to long-term reputational challenges for their organisation and the insurance
industry at large. Larger respondents were more likely to make the link between failure to act and the longer term reputational consequences. Reducing reputational risk was the most-cited reason behind integrating ESG factors in investing mandates by survey respondents.

The focus of the stakeholder pressure to address particular ESG risks varies by stakeholder. Among the public there has been a sharp focus on those risks relating to the environment, as people can clearly see and feel the impact of changing climate trends through the increased frequencies of heatwaves in Europe, or the wildfires in Australia, California and Oregon. At the same time, regulators and central banks are also looking to impose new regulatory requirements, particularly through climate-related stress tests and non-financial disclosures. AM Best expects these developments to be just the first of a series, with more on the horizon.

Increased focus by regulators on environmental risks tallies with the expectations of the survey respondents. In general, they believed that regulators and lawmakers are taking the lead in applying pressure on (re)insurers to consider ESG factors. In addition, the survey found that investors and employees have been involved in pushing the ESG agenda. Conversely, none of the respondents reported feeling highly pressured by customers to embrace ESG, although AM Best thinks this might change as their customer base shifts towards demographic cohorts that are more sensitive to the topic (such as “Millennials” and “Generation Z”).

There was some consensus among respondents that rating agencies are exacting pressure on (re)insurers to consider ESG risks and opportunities. Respondents identified governance as the most relevant of ESG factors for insurers. AM Best has long been considering the impact of natural catastrophe and governance in its ratings.

**Insurers Demand More Clarity on ESG-Related Reporting Requirements**

Although not considered the most relevant ESG issue by all respondents, environmental risks remain at the top of lawmakers' and regulators' agendas for measurement and management. Public pressure has grown in support of environmental causes in the face of growing scientific evidence and high-profile campaigns. Across the world, central banks and financial regulators have imposed environmental reporting requirements and stress tests as they strive to get a handle on the likely economic impact of climate risks. Insurers and reinsurers have found themselves in the front line. Examples include:

- France – insurers have been required by law to disclose climate risks since 2016 under the so-called French energy transition law. In 2020, French insurers will also face climate stress tests, according to the supervisory authority, Autorité de Contrôle Prudentiel et de Résolution (ACPR).
- United Kingdom – the Bank of England’s climate stress tests will encompass insurance companies and are designed to analyse the impact on balance sheets of more frequent severe weather events such as floods and subsidence. These tests are now scheduled to come into force in 2021.
- Singapore – The Monetary Authority of Singapore (MAS) is taking active steps to promote sustainable financing in the financial sector, including engaging financial institutions to consider ESG criteria in their decision-making processes, supporting the adoption of industry standards and guidelines, encouraging industry-led capacity building efforts, and developing the domicile’s green bond market. It is also collaborating with local stakeholders and international counterparts to distil best practices.
- Australia – In February 2020, the Australian Prudential Regulation Authority (APRA) wrote to all APRA-regulated institutions outlining its plans to develop a prudential practice guide focused on climate-related financial risks, as well as a climate change vulnerability...
assessment. APRA also intends to update its Prudential Practice Guide on Investment Governance to enable licensees to comply with requirements that include ESG investments.

- New Zealand - The domicile aims to become the first country in the world to mandate climate risk reporting for its financial sector companies.

Respondents to the AM Best survey conveyed a need for more clarity from regulators to identify, measure and report ESG factors on a consistent basis globally. Notably, more than 70% of the respondents called for more, or significantly more, direction from the authorities. Only 3% felt there was no need for further regulatory clarity around ESG – those respondents were overwhelmingly from the Asia Pacific region, whose regulators are in the process of introducing stringent ESG reporting measures.

It is clear that regulators are increasingly concerned with climate risks, and while insurers remain focused on corporate governance, climate risks are rising up the agenda. Companies typically need good corporate governance to ensure they can run their businesses well today, as well as into the future. Lawmakers and regulators will take a long-term approach and think about potential threats to financial stability. Many of the environmental risks in scope may only manifest themselves in the longer term.

**ESG and the Industry’s Role as Institutional Investors**

More than half the respondents to AM Best’s survey said they were already integrating ESG factors into their investment strategies. A further 15% indicated their intent to start considering ESG criteria in their investment approach in the next 12 months. Around 11% do not currently expect to incorporate ESG factors into their investment approach within a year.

The most popular approach in integrating ESG in investment strategies among the respondents was negative screening – whereby companies or sectors may be excluded from an investment portfolio based on specific ESG criteria. In general, this approach indicates that the respondents have plans to reduce their exposure to certain industries such as coal mining, nuclear energy, or tobacco production.

When embarking on an ESG-integrated investment strategy, survey respondents were most likely to cite the desire to reduce reputational risk as the main incentive. However, preservation of investment value and regulatory requirements were also high on the list of rationales. AM Best believes that it is important to recognise that these three considerations may be linked. As governments around the world seek to meet carbon reduction targets set as part of the United Nations Framework Convention on Climate Change’s 2015 Paris Agreement, new regulations may introduce fines, carbon taxes and possible restrictions on emitters. This would present challenges to the business models of some companies and industries, directly impacting their creditworthiness and valuation. That, in turn, could leave investors – including insurance companies – with stranded assets related to toxic industries that become largely worthless and may need to be written-off.

Just over two-thirds of the respondents cited the biggest hurdle to greater engagement with sustainable investing was the lack of transparent and comparable definitions and data (see Exhibit 4). A number of organisations, including the European Commission, Sustainability Accounting Standards Board (SASB) and The Task Force on Climate-related Financial Disclosures (TCFD) are promoting initiatives to address this challenge. However, some issues remain. The data largely feature unaudited or self-reported information, and there can be inconsistencies in reporting and/or disclosure. Respondents also cited the limited pool of sustainable assets as a central challenge to the wider integration of ESG investing.
ESG Underwriting Remains a Secondary Consideration, Although Expected to Take on Growing Importance

While survey respondents generally acknowledged the central importance of integrating ESG considerations in their investing activities, there was less consensus about the role of ESG factors in underwriting (see Exhibit 5).

The greatest proportion of the survey’s respondents – just over a third – felt that the importance of ESG factors within the underwriting process was “moderately important”. Only 14% of respondents felt it was “extremely important”, with nearly 10% replying that it was “not important” for insurers to factor ESG into their underwriting.

Nonchalance towards ESG integration in the underwriting process may stem from insurers’ general ability to reprice policies on an annual basis, at which point they can factor in loss experience. However, among the larger respondents, there was resounding recognition of the importance of factoring ESG into underwriting.

Those respondents deeming ESG unimportant to underwriting were more likely to be life insurers, even though life insurers would be directly impacted by changing demographics which underpin mortality and morbidity assumptions. Life insurers would find it more difficult to reprice policies to reflect these changes.

The survey highlights that respondents, by a significant majority of 66%, felt insurers were not yet fully factoring the future costs of climate uncertainty into policy pricing and technical provisions. Only a third of the survey participants said their company had taken meaningful underwriting action in relation to ESG risks, such as exiting certain lines of business or not renewing contracts. Another 7% indicated they intended to do so in the next 12 months, while, 44% said they had not exited, nor non-renewed contracts for ESG reasons, and had no intention of doing so over the next 12 months.

There was little consensus among respondents as to the challenges companies face integrating ESG factors consistently across both their investing and underwriting activities. Although 58% of respondents said consistent integration was a challenge, 43% were ambivalent or had experienced no such challenges.

Exhibit 4
Challenges (Re)Insurers Face When Integrating ESG Factors into Investing Activities (%)

- Lack of Transparent and Comparable Definitions/Data on Sustainable Assets: 68.1%
- Limited Pool of Sustainable Assets: 47.9%
- Human Capital/Specialised Talent: 22.3%
- Organisational Culture: 10.6%

Notes:
Results show the percentage per ESG issue where respondents to AM Best’s ESG Survey indicated challenges integrating ESG factors into their investing activities. Respondents could select all that applied, so percentages shown are not expected to add up to 100% in this instance. Not shown: Other (20.2%) and Funding (5.3%). Source: AM Best data and research.
Untapped Opportunities Remain

Amid the talk of ESG challenges, AM Best’s survey found that there was almost unanimous agreement among respondents that ESG is not just about identifying and measuring risk, but also about identifying opportunities. However, in many instances that opportunity is untapped.

Only 48% of participants reported having identified and capitalised on an ESG opportunity, such as developing new products that incorporate social and environmental values. As the insurance industry has long realised the value of innovation, it is expected that products may evolve to address these values, while other products may be customised (either through price or other strategies) in ways that balance long-run positive/negative externalities while maintaining current levels of profitability. Likewise, as demonstrated by the increase in green bond issues in recent years, AM Best expects more insurers to find a way, through ESG integration, to remain attractive to investors and maintain solid financial flexibility.

The events of 2020 have clearly illustrated the unpredictability, speed and impact of the challenges facing (re)insurers in 2020 and beyond. Insurers and reinsurers that fail to take action in a timely way may quickly find themselves left behind and looking increasingly irrelevant in a marketplace where words, phrases and statements like those in Exhibit 6 are commonplace.

Exhibit 5
Importance of ESG Factors in the Underwriting Process (%)

<table>
<thead>
<tr>
<th>Importance</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extremely Important</td>
<td>13.8</td>
</tr>
<tr>
<td>Very Important</td>
<td>31.9</td>
</tr>
<tr>
<td>Moderately Important</td>
<td>34.0</td>
</tr>
<tr>
<td>Somewhat Important</td>
<td>10.6</td>
</tr>
<tr>
<td>Not Important</td>
<td>9.6</td>
</tr>
</tbody>
</table>

Source: AM Best data and research

Exhibit 6
ESG Survey – Words and Phrases Used by Respondents

Source: AM Best data and research
Published by AM Best

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