August 2021

Insurers Guide to Sustainable Investing: What, Why, and How ? - Ch. 3

CANDRIAM

A NEW YORK LIFE INVESTMENTS COMPANY

25 years of ESG

About the authors

Marie Niemczyk

Head of Insurance Relations

Marie Niemczyk is Head of Insurance Relations at Candriam. In this role she monitors the factors impacting insurers' asset management - including market, regulation and accounting-related matters – and works to ensure these insurance-specific requirements and objectives are integrated into investment solutions and strategies.

Prior to joining Candriam in 2018, Marie was Insurance Strategy & Development Director at AXA Investment Managers in Paris. Previously, Marie held several positions with Fidelity in London, Frankfurt and Paris. Before that, she was an Economist with EY in London. She started her career in 2004 as a Research Associate with The Advisory Board Company in Washington D.C..

Marie has an M.Sc. from the London School of Economics, a B.A. from Swarthmore College, and holds IMC and SII qualifications.

Kristof Woutters

Global Head of Pension and Insurance Relations

Kristof Woutters is Global Head of Pension & Insurance Relations at Candriam. In this function, Kristof is responsible for giving strategic advice to pension funds and insurance companies. This often involves the design of advanced investment solutions that take into account specific client needs and respective regulatory frameworks, such as SFDR, SRD II, IORP II, Solvency II, IFRS, etc. Kristof has over 25 years' of experience in the investment management industry. He is a regular speaker on various investment or pension & insurance topics at seminars and events and he is an active member of numerous associations in this field.

Prior to joining Candriam Investors Group in 2000, he worked as Senior Consultant at Pragma Consulting, an independent institutional investment consulting company specialised primarily in advising pension funds and financial institutions world-wide.

Kristof earned a master's degree in commercial engineering at the University of Leuven (KUL, Belgium) and an additional master's in economics from the University of Groningen (RUG, the Netherlands).

David Czupryna

Head of ESG Development

David holds the position of Head of ESG Development at Candriam. David's role is to deliver Candriam's unique blend of sustainability credentials and market wisdom to investors and market participants. Before that, David led the growth of sustainable investment strategies in several European countries at Sycomore Asset Management and in Northern Europe at Erste Asset Management. David started his career in finance with BNP Paribas in London on the equity derivative structuring desk in 2007.

David holds an MBA from the University of Cambridge specializing in finance and strategy as well as Masters degrees in political science from the Free University of Brussels and the Catholic University of Louvain.

3. How? Implementing Sustainable Investing in an Insurance Portfolio

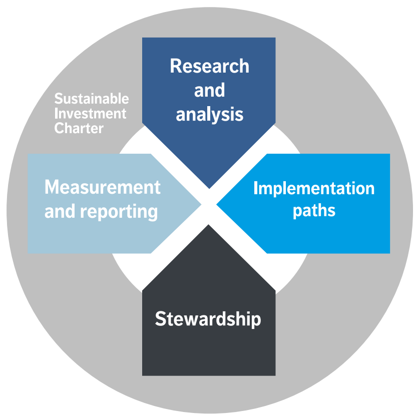
#SpeedRead	
	• *Implementing Sustainable Investing should be adapted to the needs of the individual insurer, the make-up of its portfolio of assets and its objectives, regulatory requirements and accounting constraints, and of course the culture of the firm..* • *There are a few generally applicable cornerstones of Sustainable Investing that can help insurers structure their approach -- producing a Sustainable Investment charter can provide a company-relevant base.* • *Thorough research and analysis of both companies and countries is the foundation of effective Sustainability risk management and opportunity identification.* • *Implementation often begins with exclusions, but many insurers add positive screening methods in order to capture Sustainability-related opportunities.* • *Stewardship, via voting and engagement, is an important lever for insurers to advance the Sustainability of their investments.* • *Clear reporting is key for the insurer's own understanding of the impact of Sustainable Investing on the portfolio, as well as in communications with regulators and end clients.*

How can insurers concretely implement Sustainable Investing? There is no one-size-fits-all formula. This is where the development of a Charter or roadmap can be helpful. What is important is the relevance between how Sustainable Investing is implemented, and the insurer's specifics, including the make-up of its assets and its corporate values. The Sustainable investment strategies should be aligned with respect to (other) regulatory frameworks, such as Solvency II, and to fit specific accounting conventions. The objective is for the Sustainable Investing approach to go beyond regulatory compliance, and functions as a potential source of added value.

There is no universal user manual for implementing Sustainable Investing. Practical experience offers cornerstones for insurers to structure their individual approaches. These are outlined in Figure 3-A.

Figure 3-A

Cornerstones of implementation



Source: Candriam

Research and practical experience offer important considerations and critical success factors for insurers to consider when building these cornerstones internally or selecting external service providers.

3.1 Starting Out, and Developing a Sustainable Investing Charter

Insurers are at varying levels of advancement in their adoption of Sustainable Investing. These differences are due in part to different regulatory histories in different jurisdictions, in part to insurer type and size, and of course to individual circumstances. Some insurers are actively contributing to the advancement of Sustainable Investing through ambitious programmes or innovative approaches, and may have been doing so for several years. Others have been taking on the topic more recently and are in the initial stages of implementing Sustainable Investing. This is perfectly understandable given that the past decade has been marked by many other regulatory requirements and financial market challenges that kept insurers busy.

#*InFocus:* Candriam Academy

Getting a grasp on Sustainable Investing can be quite resource-intensive. The absence of universal definitions, standard indicators and easily accessible homogeneous data can contribute to a steep learning curve when first taking on the topic. To support insurers, their teams and distribution networks in the development of their Sustainable Investing know-how, Candriam created the Candriam Academy. The Candriam Academy is the world's first free-to-access training platform for Sustainable Investing. It is knowledge-based and ad-free and brings together subject matter experts from around the world. To guarantee quality, the course has been accredited to the highest educational standards. The training is delivered through an immersive digital experience with video, graphics and tests and participants receive a certificate upon completion.

How can insurers in these early stages tackle Sustainable Investing? A useful first step is to 'take inventory' and develop a Sustainable Investing Charter. By 'taking inventory' we mean analysing the investment portfolios by asking such questions as,

- What ESG risks are currently present in the portfolio?,
- How are ESG risks and opportunities currently being managed, if at all?, and
- What stewardship practices, such as engagement and voting, are in place?

These issues can be examined by asset class for both internally-managed assets as well as for externally-delegated strategies.

Using the inventory, the insurer can develop a Sustainable Investing Charter to define its own relevant Sustainable Investing objectives and strategies to achieve them. A useful structure for such a charter might be as follows:

- Negative Selection
- Positive Selection
- Impact
- Engagement
- Voting

Organizing by these five topics makes it easier to map the charter to the insurer's regulatory considerations. For example, for a European insurer, Negative Selection will cover the risk management requirements set out in SFDR. Positive Selection and Impact can be linked to SFDR's classification of Article 8 and 9 products. Engagement and Voting address the requirements of SRD II, which requires greater transparency from institutional investors regarding how they engage with investee companies.

The preparation phase of taking inventory and developing a Sustainable Investment Charter not only lays a foundation for implementation, is also facilitates internal buy-in to the Sustainable concept. Studies show that support from top management through operational functions is a key success factor for insurers to successfully implement Sustainable Investing.[1]

3.2 Research and Analysis

The underlying research and analysis is the basis for understanding and evaluating ESG opportunities and risks. If the ESG assessments and ratings that underpin investment decisions are not thorough and of quality, the insurer could unwillingly maintain unwanted ESG risks in the portfolio and miss out on ESG opportunities. While regulatory measures and the general trend towards Sustainability are improving the transparency of investee companies and countries, ESG data availability and heterogeneity remains such that thorough research and analysis are needed to properly understand and interpret ESG factors.

This requires experience, expertise and resources. Some insurers have built these in-house. Many are turning to external asset managers or research providers specialised in Sustainable Investing. We outline some of the elements that deserve the attention of insurers when evaluating how external providers conduct their research and analysis.

1. Candriam and Versicherungsforen Leipzig, 2020. "Anforderungen bei der Implementierung von ESG in die Kapitalanlage deutscher Versicherer."

3.2.1 Company Research and Analysis

What is important to assess the ESG performance of a company? Norms-based analysis, for example the monitoring of controversies related to UN Global Compact Principles, and the analysis of controversial activities allow investors to filter out certain risks in accordance with the principles and exclusion lists that they have established. However, these steps are not sufficient to fully assess the risks, and especially opportunities, of companies. At Candriam, we believe that two other elements are crucial to understanding these risks and opportunities and to respectively minimize and capture them.

• Stakeholder Analysis
Firstly, thorough research into and analysis of the Sustainable behaviour of a company using ESG factors, meaning a company's ability to manage its relationship with its stakeholders. These stakeholders include the environment, society, employees, customers, suppliers and investors.

• Business Activities Analysis
Second, it is our conviction that the exposure of a company and its business activities to global sustainability trends should be analysed as well as the opportunities and risks that arise from this exposure.

3.2.1.1 Sovereign Research and Analysis

ESG research and analysis for countries is also of particular importance to insurers, as a significant portion of the core investments of their general accounts remain in sovereign bonds. Moreover, it is becoming increasingly evident that ESG factors play an important role in the ability and willingness of a country to fulfil its debt obligations.

How can the Sustainability and ESG performance of a country be assessed? A first step to systematically avoiding high-risk exposure can be to screen out countries classified as 'Not Free' by Freedom House, exclude oppressive regimes, and eliminate those on the Financial Action Task Force's 'Call-to-Action' list, as well as avoiding nations which do not participate in certain international conventions.

To differentiate Sustainability levels among the remaining countries requires more in-depth analysis. Analysis aids in determining how countries are likely to utilise the new opportunities that may arise from sustainability trends. This helps investors set prices for those risks chosen to include in the portfolio to generate return.

We propose three criteria for insurers to consider in Sovereign Sustainability analyses, whether internal or externally-sourced.

• Sovereign Capital and the Central Role of Natural Capital

The starting point for sovereign ESG research and analysis is an assessment of the ability of countries to sustainably manage and develop their four forms of capital: Natural Capital, Human Capital, Social Capital and Economic Capital. For example, the ability of a nation to sustainably managed its Human Capital, or productivity potential based on knowledge, skills, labour and health, influences its ability to service its debt, and therefore the quality of its sovereign bonds. Consider the concept of sustainably developing Human Capital – in the short run, building housing improves Human Capital, but some housing can permanently and irrevocably impair Natural Capital.

***#InFocus:* "Weak Sustainability" vs "Strong Sustainability" in sovereign analysis**

When selecting ESG research providers or sovereign debt investment solutions with an ESG component, insurers should ask, "Has Natural Capital been adequately considered in the underlying research and analysis?"

Many sovereign ESG research approaches assume that the four forms of sovereign capital -- Natural Capital, Human Capital, Social Capital and Economic Capital, are substitutable. This implies that Natural Capital and Manufactured Capital are freely interchangeable, inferring that Natural Capital is unlimited. Under this traditional model, the Sustainability of a country is often scored as an average of the four types of capital. This results in what some scholars refer to as 'Weak Sustainability'. We think 'Weak Sustainability' is a misleading description. Natural Capital is finite and cannot simply be replaced with other forms of capital.

Insurers may prefer an approach to sovereign ESG research in which it is recognised that Natural Capital can not be replaced. A mining-based national economy, for example, is unsustainable after the mineral deposits are exhausted, and this should weight more heavily in its sustainability ranking. Such an approach provides insurers with a view of 'Strong Sustainability.

• Materiality

Whether developing their own sovereign ESG analyst teams or selecting external research providers, insurers are well-advised to focus on materiality. Integrating materiality into sovereign ESG research means that various ESG data points, issues and factors are weighted by their relevance and adequacy for each specific economy. For example, a data series on electric vehicles would be much more heavily weighted in the analysis of a country such as Norway. It tells us little about Uganda, however, where food security would be more material to the sustainability of the country.

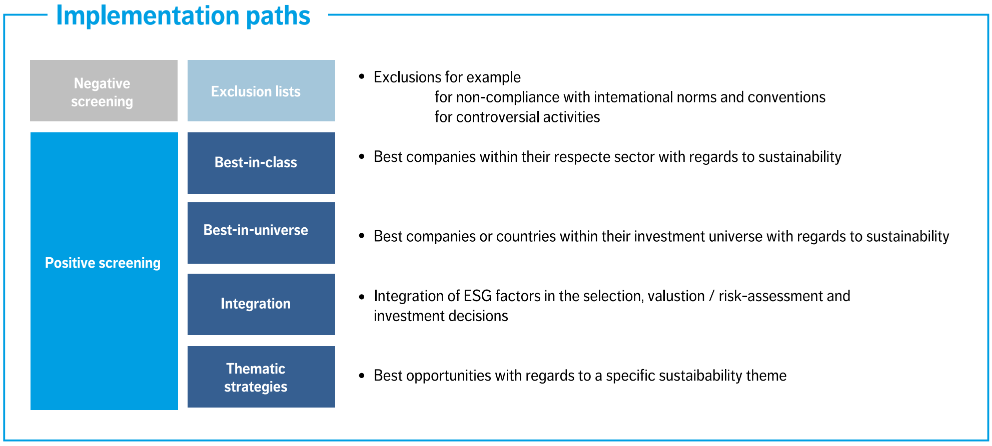
• Breadth and Depth of Data

A third element of particular importance is the breadth and depth of data on which the sovereign ESG analysis is based. Assessing the sustainability of a country is complex, and there are no global ESG disclosure requirements for governments. Data availability is growing, but the amount and quality of data used in ESG sovereign analysis greatly varies by provider

3.3 Implementation Paths

Sustainability and ESG factors can be integrated into insurers' portfolios through a number of methods. Several of these implementation paths can be combined to address the specific goals and constraints of the insurer and the specificities of the portfolio. An overview is shown in Figure 3-B.

Figure 3-B



Source: Candriam; non-exhaustive list; for illustrative purposes only.

3.3.1 Exclusion Lists

Negative Selection means excluding from the investment universe those companies and countries that fail to meet certain specific criteria. Often, the UN Global Compact Principles relating to human rights, labour rights, the environment and corruption, are used as guidelines. Ideally the analysis should also consider how companies and governments respond in the event of non-compliance. Taking sincere action to prevent a recurrence is obviously more Sustainable than one which just ignores a breach.

Controversial activities are another factor which can provide a screening tool. Companies or countries involved in the production, trade, testing or maintenance of certain controversial goods or services can either be excluded entirely or excluded above a percentage of sales volume or profit. Examples include controversial armaments, tobacco and certain types of energy production.

After these exclusions, the investment manager then selects stocks or bonds from the remaining investment universe based on financial criteria.

One limitation is that negative selection primarily focuses on risk avoidance. Opportunities related to sustainability are not exploited. Awareness of the limited effect of exclusion lists is growing. Many insurers are expanding into other implementation paths and/or using exclusion only as a first step.

3.3.2 Best-in-Class and Best-in-Universe

With a Best-in-Class approach, companies are assessed according to Sustainability criteria, i.e. ESG criteria. Each company is assigned an ESG rating so that all companies within the same sector can be ranked in relation to one another. A band can be chosen so that only the top x% of each sector, ranked by ESG rating, are permitted in the ESG universe. Examples would be to include only the best 50% or the best 70% of a given sector. The portfolio manager then uses financial analysis to select investment opportunities amongst these top x%.

Best-in-Universe similarly evaluates companies and countries on ESG criteria. However, they are not ranked separately for each sector. Rather, there is a single common ranking for the entire initial universe. Again, a chosen percentage of that investment universe -- for example the 50% best-ranked-names – constitutes the investable universe, from which the portfolio manager can select opportunities.

3.3.3 Integration

The previous approaches (Exclusionary, Best-in-Class/Best-in-Universe) are two-step processes -- first, defining a sustainable investment universe, followed by traditional financial analysis and selection within that universe.

By contrast, Integration folds ESG criteria into the analysis and selection. That is, traditional financial analysis is combined with ESG analysis. This means that both the financial and ESG-related risks and opportunities of each individual stock are investigated and assessed in the same step, permitting an integrated analysis of risks and opportunities which spans both ESG and traditional financial considerations.

When investigating and selecting external investment strategies that take an integration approach, it is important for insurers to keep in mind that 'integration' is interpreted in a wide variety of ways. The level and depth of integration can differ considerably. Close attention should be paid to clear sustainability indicators that measure the depth and effect of the integration.

3.3.4 Thematic Strategies

Thematic strategies allow insurers to invest in specific sustainability-related issues, themes, or industries. The aim of climate change strategies, for example, is to identify companies that offer solutions for minimising and adapting to climate change and that are profiting from the energy transition.

3.4 Stewardship

Another important cornerstone of Sustainable Investing for insurers is stewardship. This is composed of two pillars:

- **Voting**

Actively exercising shareholder rights through voting or supporting shareholder resolutions is an important means for contributing to improvements by investee companies. Ultimately, such improvements reduce the sustainability risks in the insurer's portfolio.

Voting is encouraged by the recent update of SRD II. Insurers working with external managers should examine the proxy voting policies and track records of their managers.

- **Engagement**

Engagement can take the form of direct, bilateral dialogue with investee companies or of dialogue through collaborative initiatives that bring together a number of institutional investors and their asset managers. Dialogue with companies not only contributes to pushing them towards desirable improvements. Through close communication and by listening intently and critically, investors and other stakeholders can better understand why a company is performing in a particular way when it comes to specific ESG factors. This is not always fully apparent from publicly available information. It can also be an information-sharing process among stakeholders including managements, shareholders, employees, customers, not-for-profits, etc.

Engagement processes are lengthy and resource-intensive. When developing a Sustainable Investment Charter, insurers might consider defining particular focus areas to make sure Engagement resources are effectively focused.

3.5 Measurement and Reporting

The final cornerstone, Measurement and Reporting, has three objectives:

• Reporting should ensure that the insurer can quantify, track, and understand the impact that Sustainable Investing has on the portfolio, the sustainability risks to which the portfolio is subject and the potential repercussions of its investments on the environment, society, or other specified elements.

• Measurement and reporting is a key element of major regulatory initiatives. SFDR, for example, requires transparency on ESG risks and potential adverse impacts and will in future require communication of alignment with the Taxonomy. Establishing a set of indicators and a solid reporting infrastructure facilitates preparation for, and compliance with, current and future regulation.

• Reporting should help insurers need to consider the perspective of their end clients, the insurance-takers. End-client demand is growing for products which integrate Sustainability. Easy-to-understand reporting is an important element when positioning sustainable products. For example, insurers offering Sustainable funds in unit-linked policies may ask how Sustainability performance is expressed in client-facing reporting. Are carbon emissions savings expressed only in terms of tons of CO2? Or does the reporting make such figures more tangible, for example by translating them into the corresponding numbers of roundtrip flights from Paris to New York, or cars on the road?

€140 B
AUM as of
31 December 2020

570+
Experienced and
committed professionals

25 years
Leading the way in
sustainable investing

CANDRIAM. INVESTING FOR TOMORROW.
WWW.CANDRIAM.COM

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY