August 2021

Insurers' Guide to Sustainable Investing: What, Why, and How ?

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25 years of ESG

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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.

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Introduction: Sustainable Investing Becomes Key for Insurers

#SpeedRead	
	• Our world faces significant Environmental and Societal issues. • Insurers are being called upon to play a key role in alleviating these issues by investing sustainably. • This challenge comes on the heels of a very tricky decade insurance investments -- low interest rates, geo-political uncertainty and new regulatory and accounting constraints. • Insurers must examine how they can turn Sustainable Investing into investment opportunity.

Insurers must embrace the new Sustainable Investing paradigm...

Sustainable Investing has become inevitable. Few topics have featured as prominently in recent years across both mainstream media and on the agendas of insurance investment decision-makers. At the root is the urgency of the Environmental, Societal and Economic issues the world faces.

It is estimated that climate change alone could cost the world economy 3% of GDP by 2050.[1] Not only does global warming cause environmental destruction and economic costs, it has also become the "ultimate risk multiplier" for society, causing economic disparity, broad damage to health, unmanageable migration and tensions between nations.

Insurers and other institutional investors are increasingly being called upon to play their part in the efforts to alleviate these issues through a more sustainable investment paradigm. National and supranational regulators are accelerating this imperative. One way is by implementing guidelines meant to channel investments towards activities designed to either mitigate climate change or foster our adaptation to its consequences. This creates new and near-term obligations for insurers in an already-challenging investment environment.

1. The Economist Intelligence Unit, Global economy will be 3 percent smaller by 2050 due to lack of climate resilience, 20 November 2019, https://www.eiu.com/n/global-economy-will-be-3-percent-smaller-by-2050-due-to-lack-of-climate-resilience/.

... on the heels of a complex decade, and in the midst of a crisis without precedent...

For the last decade, insurers have grappled with the need to generate investment returns in a low-rate environment. The uncertainties that plagued the global economy not only hindered visibility, but also impeded returns. Investor sentiment often swung between worst-case scenarios and optimism in mere days. Issues between the United States and China, Brexit, tensions with Iran, and social issues in several European countries generated volatility for many of the riskier asset classes, with stronger spikes occurring ever more rapidly.

Insurers juggled tightening regulation and changing accounting standards as well. The integration of Solvency II requirements into their asset management decisions and operations required significant resources. New requirements made certain performance-enhancing asset classes more costly in terms of regulatory capital. Listed European insurers became subject to IFRS 9, the new accounting standard for financial instruments. The likely result will be stronger linkages between the volatility of their investments and the volatility of their reported income.

These challenges placed further pressure on pricing and margins in many insurance segments, leading to industry consolidation in many countries.

The Covid-19 pandemic has few if any precedents in recent history in its repercussions on the economy and financial markets. While the prospects for the world economy have improved, the speed of recovery is likely to be quite uneven across geographies and sectors. Uncertainty remains high, notably with regards to the duration of accommodative monetary policies and interest rate levels.

A Constraint, or an Opportunity?

Against this complex backdrop, how can insurers best meet the challenge of Sustainable Investing? Is it another portfolio constraint? Or can Sustainable Investing be a source of opportunity and added value?

We offer a Guide to navigating the issues. Our Guide first clarifies ***What*** Sustainable Investing is, and defines key terminology. We then examine ***Why*** it makes sense for insurers to integrate sustainability criteria into their general account investments and unit-linked policies. Next, we analyse ***How*** Sustainable Investing can be implemented in insurance asset management. We will follow these with a chapter offering specific examples of the impact of Sustainable Investing on risk/return profiles. In the final section, our Guide offers a first look at Sustainable Investing results during the Covid-19 crisis.

1. What? - Defining Sustainable Investing

#SpeedRead	
	• *'Sustainability' in asset management is characterized a plethora of buzzwords and acronyms.* • *An essential first step is to create a clear understanding within your own organization of how you define a few key concepts.* • *'Responsible Investing' aligns investment decisions with ethical, religious or cultural considerations.* • *'Sustainable Investing' adds another step -- the analysis of Environmental, Social and Governance-related risks and opportunities.* • *'Impact' has as its primary objective a positive, measurable effect on the Environment or Society.*

Sustainable Investing, Responsible Investing, ethical portfolios, ESG, green financial products – in recent years, few topics have generated as much jargon as we have seen for Sustainability in asset management. This baffling array of terminology and the resulting lack of clarity has contributed to a certain degree of scepticism. Clarifying concepts and agreeing terminology is an important first step in tackling Sustainable Investing. Creating a common and workable understanding across your organisation is vital to coherent policies and efficient implementation.

Responsible Investing, Sustainable Investing and Impact are particularly fundamental concepts to clarify. These concepts and their key characteristics, as well as the various expressions used, are outlined in Figure 1. More detailed descriptions follow in the text.

Overview of key concepts and terminology

Concept	Responsible Investing	Sustainable Investing	Impact
Terminology	• Responsible Investing • Ethical Investing • Socially Responsible Investing	• Focus on moral responsibility and accountability • Alignment of investment decisions with certain values, such as ethical, religious or cultural considerations	• Impact • Impact Investing
Core Elements	• Sustainable Investing ("in the narrower sense")	• Focus on sustainability • The assessment of environmental, social and governance (ESG) risks and opportunities is part of investment decisions in order to generate better long-term risk-adjusted returns • Corporate stewardship	• Investing with the explicit intent of generating positive, measurable social and/or environmental effects

Concept	Sustainbale & Responsible Investing
Terminology	• Sustainable & Responsible Investing • Sustainable Investing ("in the broader sense")
Core Elements	Combination of the two concepts described above, i.e.: **Responsible Investing** + **Sustainable Investing** "in the narrower sense" = **Sustainable & Responsible Investing,** also known as **Sustainable Investing** "in the broader sense"

Throughout this Guide, we use the term of Sustainable Investing to refer to this concept, in the sense of Sustainable & Responsible Investing.

1.1. Responsible Investing

Some investors focus on the notion of 'Responsibility' and align their investment decisions with ethical, religious or cultural considerations and principles. They feel morally responsible and accountable for their actions when investing. Responsible Investing is also known as Ethical Investing, or Socially Responsible Investing.

In Responsible Investing the starting point is not sustainability as the primary objective. Put another way, the main objective is not to pursue Environmental, Social and Governance (ESG) opportunities. Rather, the goal is to align investments with certain values. Of course, these values may also help achieve positive Environmental or Social impact. It is just that this is not the primary objective of Responsible Investing.

1.2. Sustainable Investing

Some investors focus more on the concept of 'Sustainability', by assessing Environmental, Social and Governance (ESG) risks and opportunities to enhance long-term risk-adjusted expected returns. Put simply, Sustainable Investing is the integration of ESG dimensions into company and country analysis and investment decisions so as to better manage risks and/or generate consistent long-term returns.

Sustainable Investing is about maintaining and preserving capital in the long run. It fosters sustainable economic development and growth. This relationship with financial performance suggests that incorporating sustainability dimensions into investment decisions can be pursued even by those investors whose sole purpose is financial performance.

#InFocus: ESG dimensions

A brief overview of ESG dimensions is included below, using the example of company analysis:

- ***Environmental***
  Environmental criteria evaluate a company's energy use, waste, pollution, natural resource conservation and treatment of animals. Examination of environmental risks and understanding how the company manages these risks may improve projections of future company income. For instance, a company might face environmental risks related to ownership of contaminated land, an oil spill for which it was responsible, for disposal of hazardous waste, management of toxic emissions or non-compliance with environmental regulations.

- ***Social***
  Social criteria consider the business relationships of a company. Do its suppliers adhere to the same values that the company itself claims to hold? Does the company consider its effect on the surrounding community, and take steps to make the community a true stakeholder? Do working conditions show a high regard for the health and saftey of employees? Are interests of multiple stakeholders considered?

- ***Governance***
  Investors want accurate and transparent accounting. They want common stockholders to vote on important issues. They also want companies to avoid conflicts of interest in their choice of board members. Finally, they prefer not to invest in companies that engage in illegal behaviour or use political contributions to obtain favourable treatment.

1.3. Sustainable and Responsible Investing

The principles of Responsible Investing, and of Sustainable Investing, can be combined and thought of as **Sustainable and Responsible Investing.**

Sustainable and Responsible Investing is nowadays often simply referred to as Sustainable Investing. Moving beyond the original definition we offered in section 1.2 above, the more current definition of Sustainable Investing is somewhat broader, now often including elements of Responsible Investing.

From here on in this Guide, when we say Sustainable Investing, we will be using this broader and now more –widely used definition. We will simply say Sustainable Investing to encompass both Sustainable and Responsible Investing. We will use the phrase 'Sustainable Investing' to refer to the various ways in which investors integrate ESG considerations into their investments. Thus, in this Guide when we say Sustainable Investing, we also mean to include the more ethical approach we referred to as Responsible Investing.

1.4. Impact investing

Impact Investing has the explicit objective of generating positive, measurable, social and/or environmental effects. As a new investment category, the definition lacks consensus.

There are several types of Impact Investing. In many cases, the objective is to achieve positive impact while also generating competitive financial returns. Examples include private equity impact funds, green bonds and social bonds. There are also variants of impact investing in which below-market financial returns are deemed acceptable.

While impact investing represents a relatively small portion of the global investment universe, it is a rapidly growing area of interest for investors.

2. Why? - Identifying Risks and Opportunities

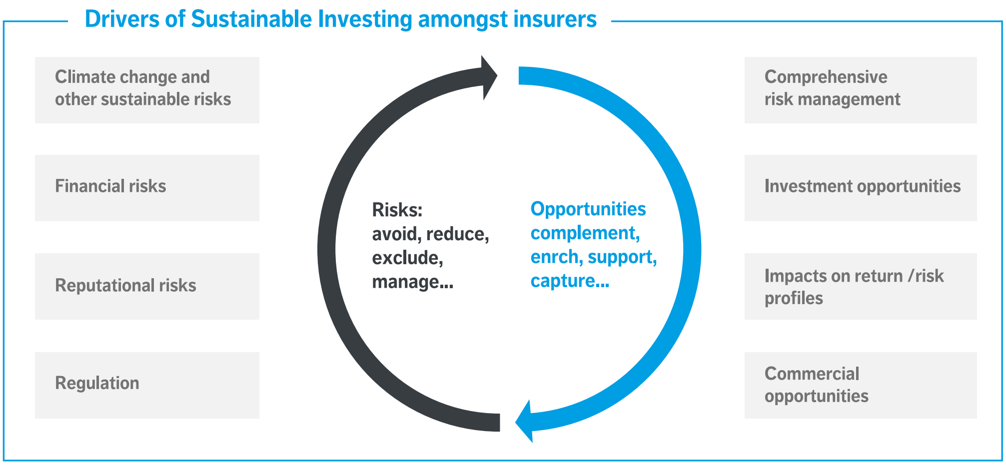
#SpeedRead	
	• *Insurers have several business-performance-related reasons to adopt Sustainable Investing.* • *Risk frameworks for insurers can be enhanced, to help mitigate Sustainability risks, including the potential financial and reputational consequences of these risks.* • *Growing regulatory constraints on insurers are another element, as they impact reporting obligations and product distribution.* • *Sustainable Investing offers insurers other opportunities, both in terms of investments with long-term growth potential as well as commercial opportunities.*

It is widely agreed that urgent action is needed to face emergencies such as climate change and biodiversity challenges. Additional considerations are pushing insurers to adopt Sustainable Investing, many of which benefit individual insurers themselves – 'doing well by doing good', one might say. Secondly, insurers are increasingly seeking out the investment and commercial opportunities that Sustainable Investing can develop.

Sustainable Investing offers insurers a richer framework for identifying, measuring, and managing risks. After all, insurers' core business is to insure risks. Therefore, they have a particular incentive not to contribute to the escalation of new and unmeasurable types of risks. Investing Sustainably can help reduce financial and reputational risks and manage new regulatory obligations.

The risks and opportunities linked to Sustainability in Investing are summarised in the Figure 2-A.

Figure 2-A.



Source: Candriam; for illustrative purposes only.

2.1 Risks

It is increasingly clear that failure to fully consider Sustainability represents risks for insurers and their assets, including the components of unit-linked policies. The first set of drivers motivating insurers to adopt Sustainable Investing is the management of these risks.

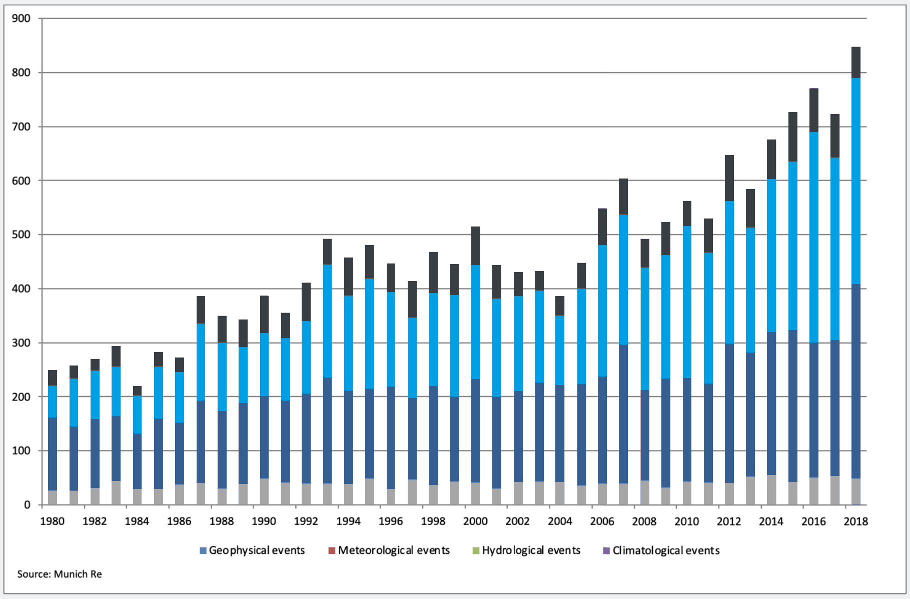
2.1.1. Sustainability Risks

Insurance portfolios that invest in equities, bonds and other assets are not immune to the increasingly significant Sustainability risks of the global economy. If the issuing companies and countries are not analysed in terms of ESG factors, it is increasingly likely that unwanted risks are unknowingly taken on in the insurer's investments.

#InFocus: Climate-change related risks

The key issue of climate illustrates the extent to which Sustainability risks can impact the investments of insurers. In the World Economic Forum's Global Risks Landscape, the three risks with the highest likelihood are all environmental risks: **Extreme weather**, **climate action failure**, and **human environmental damage.**[1] The number of natural catastrophes has grown at an accelerating rate over the past years, as shown in the chart.

Figure 2-B
Natural Catastrophes by Type



Source: Munich Re

Climate-related investment risks in the general account and in the funds held by the unit-linked insurance products can appear in two ways.

- **Physical Risks** -- Specific events or long-term changes to climate patterns that cause material damage to assets or supply chains.
- **Transition Risks** -- Risks associated with the economic and social effects of gradually transitioning to a low-carbon economy. It is important for insurers to understand whether and to what extent the companies and countries held in their portfolio are equipped for the energy transition.

1. World Economic Forum, Global Risks Report 2021, 16th Edition.

2.1.2. Financial Risks

Sustainability risks can represent significant financial risks for insurers. One study projected potential expected losses due to climate change of $4.2 trillion for assets held by non-bank financial institutions between 2015 and 2100.[2] In other words, the study estimated a Value-at-Risk to 2100 as a result of climate change for the global stock of manageable assets. The $4.2 trillion represent the average (mean) expected loss calculated in discounted, present value terms.

These types of estimates demonstrate why it is vital that insurers have a comprehensive understanding of ESG factors. Portfolios must be resistant to Sustainability risks in order to preserve assets and fulfil obligations over the long term.

2.1.3. Reputational Risks

Preserving the reputations of insurers is another driver of Sustainable Investing. In recent years, it is not just companies that committed serious Environmental, Social and Governance offences which have faced public scrutiny. Institutional investors, including insurers, are increasingly confronted directly about the Sustainability of the issuers of the securities held as investments.

2.1.4. Regulation

States and supranational entities have significantly increased regulations and guidelines designed to foster Sustainability in investing. Since the mid-2000s, the number of new regulations has increased exponentially, from less than 25 interventions globally in 2000, to around 150 in 2010 and approximately 450 in 2019.[3]

New regulation is an important driver of Sustainable Investing amongst insurers. For example, since 2015 the French Article 173 of the Law on Energy Transition has required institutional investors to communicate on whether and how they consider ESG factors in their investment processes. Even in countries in which sustainability guidelines are not (yet) legally binding, the desire to avoid potential regulatory shocks has been an important motivation.

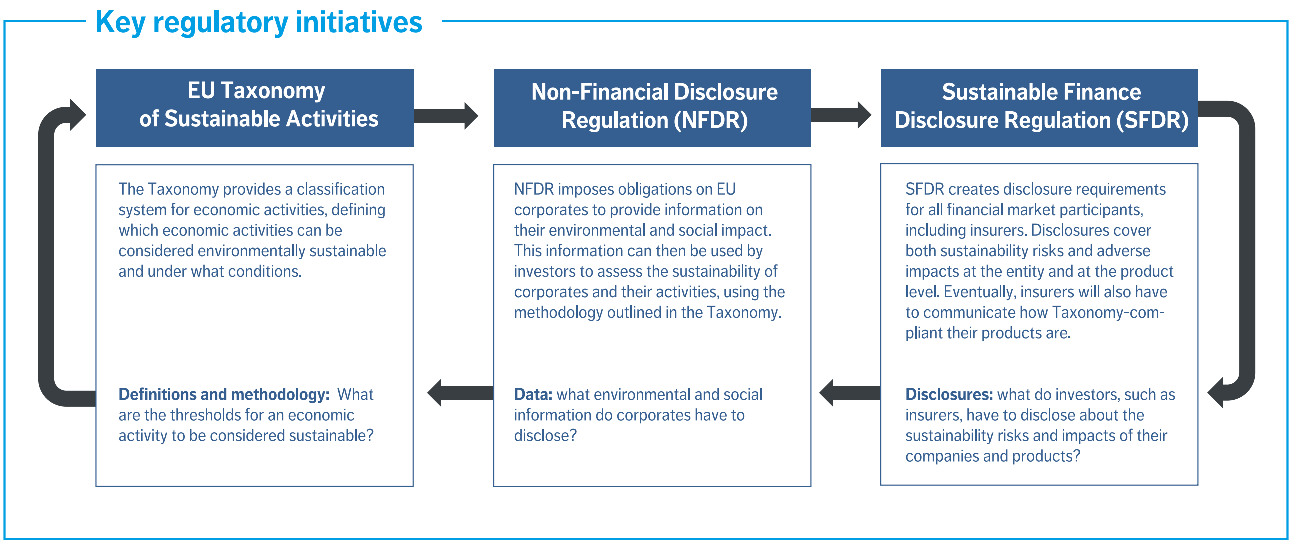
In recent years, the COP 21 in 2015 and the resulting Paris Agreement are among the most consequential initiatives at the international level. The Paris Agreement set the goal of holding the increase in global temperature below 2 degrees Celsius above pre-industrial levels. Under any scenario – and the IPCC has offered several roadmaps -- this will require major shifts in economic activities.

2.The Economist Intelligence Unit; "The cost of inaction: Recognising the value at risk from climate change; 2015." The value for the stock of manageable assets is the total stock of assets held by non-bank financial institutions, as estimated by the Financial Stability Board. Bank assets are excluded. Accesssed 16 February, 2021.
3. UN PRI Responsible Investment Regulation Database. Interventions include regulations, guidelines, directives, etc. Accessed January, 2020.

The 2-degree goal serves as the framework for many regional and national regulations. The European Union's European Green Deal sets ambitious targets for 2030 -- Cutting greenhouse gas emissions by at least half compared to 1990, and increasing energy saving as well as the share of renewables in final energy consumption by a third. The EU's ambition is to be climate neutral by 2050. That is a fundamental change to an economy to reach net-zero greenhouse gas emissions.

The EU must invest an incremental €175 to €290 billion annually over the coming decades to meet these targets. The European Commission (EC) pledged to dedicate one quarter of the EU budget to climate action. Yet, public money will not be enough. This is why the EU Action Plan on Sustainable Finance and a number of other initiatives are in motion to re-orient the assets of institutional investors towards sustainable activities. Currently, the EU Taxonomy of Sustainable Activities, the update of the Non-Financial Disclosure Regulation (NFDR) and the Sustainable Finance Disclosure Regulation (SFDR) warrant particular attention from insurers, as shown in Figure 2-C.

Figure 2-C



These programs are at different stages of completion. The impact of these future regulations on insurers and their investments will vary. At this point, SFDR is among those with the most immediate and direct impact. This regulation, partially effective from 10 May 2021, impacts insurers via disclosure obligations and a classification system for insurance-based investment products (IBIP).

#InFocus: Sustainable Finance Disclosure Regulation

SFDR creates a framework for insurers to disclose how they integrate and manage sustainability factors. The framework is based on two pillars of “double materiality”:

- **Sustainability Risks** -- The material ESG risks to which an insurer and its products are subject .
- **Sustainability Principal Adverse Impacts** -- The potential negative repercussions of an insurer's activities and investments on Environmental or Social objectives.

SFDR requires financial market participants to disclose how these Sustainability risks and principal adverse impacts are managed at two levels:

- **Entity Level** -- The activities and investments of insurers as a corporate entity.
- **Product Level** -- The insurance-based investment products (IBIPs) promoted, marketed and sold by the insurer.

The requirements at each of these two levels are described in Figures 2-D and 2-E.

Disclosures at Entity Level

Insurers will have to report on Sustainability risks and principle adverse impacts at entity level. They will also have to communicate on the consistency of their remuneration policy with the management of ESG risks and adverse impacts. The goal to clarify whether the remuneration framework creates alignment with the principles of identifying and managing sustainability

Figure 2-D

Disclosures at entity level

Disclosures at entity level			
Subject matter		Required disclosures	Effectiveness date (subject to change)
Double materiality	Sustainable risks	Policy to identify, monitor and manage sustainability risks	10 Mar 2021 (Disclosure)
Double materiality	Principle adverse sustainable impacts	Policy & statement (reporting) < 500 employees: Comply or explain* > 500 employees: Mandatory	Policy by 30 June 2021 Reporting in 2022 annual report
Renumeration policy		Policy consistency with management of Sustainability risks & adverse impacts	10 Mar 2021 (Disclosure)

**At the time of publication of this Guide, the reporting requirement on PAI at the entity level applies to companies with more than 500 employees. For companies with fewer than 500 employees, the entity-level PAI reporting requirement applies on a comply-or-explain basis.*
Source: Candriam. Simplified view of the regulation, subject to change.

#InFocus: Sustainable Finance Disclosure Regulation (suite)

Disclosures at Product Level

From 10 March 2021 onwards, insurers see their IBIPs fall into one of three categories:

- **Article 9 Financial Products** -- Products that have Sustainable Investing as an objective.
- **Article 8 Financial Products** -- Products with ESG characteristics, but that do not have Sustainable Investing as an objective.
- **Article 6 Financial Products** -- Products that have neither Sustainability Objectives nor ESG characteristics.

The disclosure requirements for these three categories are outlined in Figure 2-E.

Figure 2-E

Disclosures at product level

Disclosures at product level					
	Subject matter	Required disclosures			Effectiveness date (subject to change)
		Article 9	Article 8	Article 6	
		How objectives are achieved + impact measure	How ESG characteristics are considered / attained ?		10 Mar 2021: Website & prospectus (01/01/2022: Annual report)
Double materiality	Sustainable risks	How ESG risks are taken into account and impact on investment process			10 Mar 2021: Website & prospectus
Double materiality	Principle adverse sustainable impacts	If and how adverse impacts are taken into account (Comply or explain)			10 Mar 2021: Website & prospectus (2022: Annual report)
	EU Taxonomy Alignment	Yes (% alignment) / No (why) (Comply or explain)			Jan 2022 – Jan 2023: Website & prospectus; Annual report

Source: Candriam. Simplified view of the regulation, subject to change.

For insurers, this product categorisation could potentially impact their distribution. One consequence of SFDR is that distribution directives such as the Markets in Financial Instruments Directive and the Insurance Distribution Directive are likely to integrate Sustainability suitability assessments. Depending on an insurance purchaser level of interest in sustainability, only Article 8 and/or Article 9 products might be pertinent.

It is of note that the regulatory technical standards, which provide details supporting the implementation of SFDR, were not yet finalised at the time SFDR became effective in March 2021. As a result, SFDR requirements are being phased in over time.

2.2 Opportunities

Sustainable Investing can represent opportunities. When considering Sustainability merely from a risk and regulatory perspective, it may appear to be an inevitable but burdensome constraint for insurers and their investments. The key is to understand the opportunities and to implement Sustainable Investing in such a way as to create this added value.

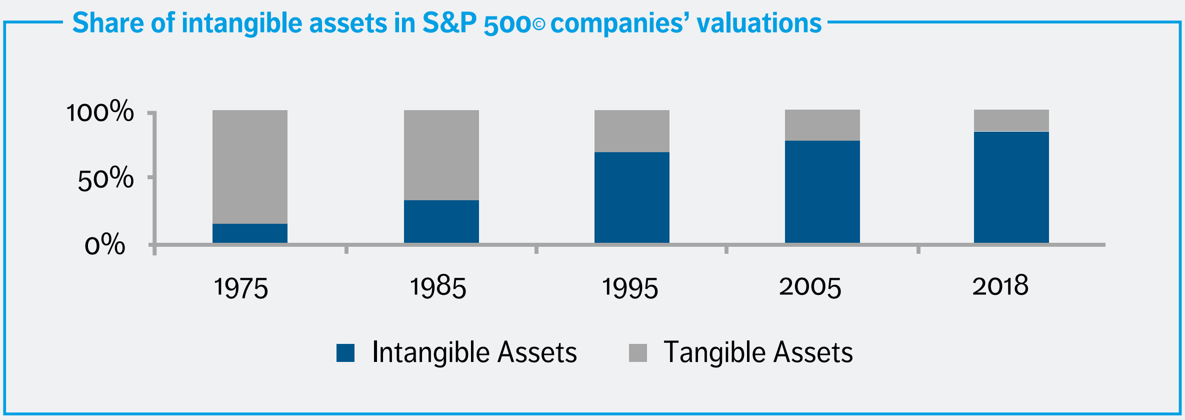
2.2.1. More Comprehensive Risk Management

Integrating Sustainability into asset management offers insurers an opportunity for more comprehensive risk management. While financial analysis and risk management typically touch on matters such as Governance, they generally do not thoroughly evaluate and price many of the extra-financial ESG risks inherent to companies and countries. A well-considered Sustainable Investing process can integrate these into risk management. In an environment where risk-free returns are minimal or negative, thorough risk identification and management is critical to investment returns.

#InFocus: Sustainable Finance Disclosure Regulation

The potential financial consequences of realising an ESG risk are increasingly significant. With a large proportion of corporate market value now based on intangible assets, including brand and reputation, this intangible value can be rapidly and dramatically impaired. Consider a company that has to close one of its factories because of a Governance issue, such as violating local lobbying regulations. Market value could be reduced not only by the tangible decrease in production capacity, but also by the reputational damage.

Figure 2-F



Source: https://www.statista.com/statistics/1113984/intangible-tangible-assets-sandp500-largest-companies/

2.2.2. New Investment Opportunities

The integration of ESG factors by insurers into their investment management processes can also help identify new investment opportunities. In most regions, structural Sustainability trends such as the transition to a carbon-neutral and more circular economy are increasingly backed by regulation. These trends demand significant changes in economic activities.

An obvious example of regulation augmenting ESG opportunities is in the reduction of CO_2 emissions. It is estimated that more than a third of these reductions will arise from efficiency gains, and another third from the transition to renewables, as described by the IEA/International Energy Agency. Companies that innovate in these areas can offer insurers attractive investment opportunities both in new growth sectors, and via new investment instruments, such as green bonds. Sustainable Investing provides insurers with a framework for identifying and capturing these long-term trends.

2.2.3. Growing Insight into Risk/Return Profiles

Practical experience and academic research demonstrate that integrating ESG factors into investment processes does not necessarily have a negative impact on the risk/return profile. On the contrary, the experience of many institutional investors has been that the impact on returns is neutral or positive. This is another element driving the adoption of Sustainable Investing amongst insurers.

Academic and industry studies also show that sustainable strategies tend to perform in line with or better than conventional strategies. A comprehensive academic review[4] in 2015 analysed more than 2,000 empirical studies. More than 90% of the studies found that individual companies with strong ESG profiles tend to outperform their non-ESG counterparts. Along with such academic research, industry papers also debunk the idea that ESG strategies necessarily underperform conventional approaches. In February of 2019, Morningstar published data[5] showing that 63% of Sustainable funds finished 2018 in the top half of their respective categories.

As extra-financial factors, ESG descriptions of a given issuer may vary. This is an important factor in the academic studies of 'ESG' investment performance. While ESG strategies are varied and will not always outperform, both academic research and real returns suggest that investing Sustainably is often more likely to enhance the risk/return profile, rather than restrain returns.

2.2.4. Commercial Opportunities

Insurers may ask whether Sustainability helps capture new commercial opportunities in areas such as their unit-linked business. Surveys indicate that a growing number of end investors are interested in Sustainability when selecting financial products. This trend is particularly developed among 'Millennials'. A Morgan Stanley survey[6] found that 95% of individual investors in this age group are interested in Sustainable Investing. But don't rule out the Boomers – Sustainability considerations are growing in importance across all investor age groups.

This demand has taken a bit longer to crystallize for insurance products than for financial products associated with banks. Insurers are not always perceived as financial product providers and the link to Sustainable finance may be less obvious for some end consumers. Nevertheless, this trend is material and growing in the insurance space. Certain forward-thinking insurers are launching Sustainable insurance products. This offers the product management function of insurers the opportunity to differentiate the positioning of their product range.

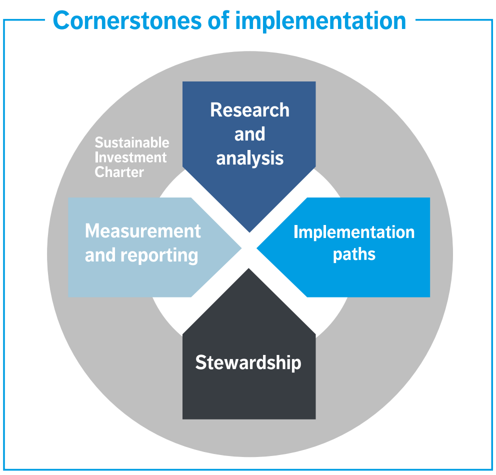
3. How? Implementing Sustainable Investing in an Insurance Portfolio

#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



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.

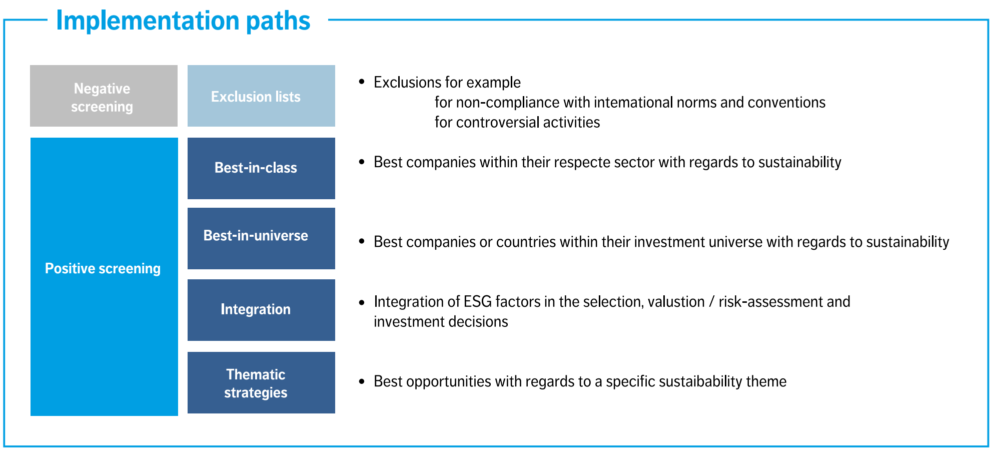
• Breadth and Depth of Data

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?

4. Who Can Benefit? Sustainability and Financial Performance

#SpeedRead	
	• *There is extensive evidence, both academic and practical, that investing Sustainably does not necessarily sacrifice financial performance.* • *Many studies at the individual security level and at the fund level have shown that Sustainability can often potentially improve return/risk profiles.* • *Sustainable investment strategies are diverse, and insurers must be careful in their selection.*

Research and practical experience have refuted the myth that Sustainable Investing inevitably means sacrificing performance. Many empirical studies have been conducted; a 2015 review[1] analysed more than 2,000 such studies. More than 90% of the studies demonstrated that ESG-friendly stocks perform in line with or outperform non-ESG stocks. The authors of this comprehensive review of the academic evidence concluded that sustainable strategies that focus on companies with good ESG practices were investing in "better" companies. They remarked that "the business case for ESG investing is empirically well-founded" and stated, "We clearly find evidence for the business case for ESG investing."

At the fund level, a study[2] examining how funds behaved in 2018 showed that 63% of sustainable funds concluded the year in the top half of their respective categories. Looking specifically at sustainable equity funds, the study found that this category performed better than their conventional equity counterparts in the volatile and negative stock market of 2018. We will devote a separate section to ESG performance in meeting the investment challenges of Covid.

It is important to examine the methodology of a strategy, and not to generalize. Of course, Sustainable Investing strategies are as diverse as other approaches. Not all will perform the same, nor will they always outperform. But across the board, they have proven their potential to enhance return/risk profiles. This generally applies across investment geographies and market capitalisations, as illustrated by the case study on Sustainability in emerging markets presented in the Box.

1. Gunnar Friede, Timo Busch, and Alexander Bassen (2015), "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," Journal of Sustainable Finance & Investment, 5:4, 210-233.
2. Morningstar, "Sustainable Funds U.S. Landscape Report," February 2019.

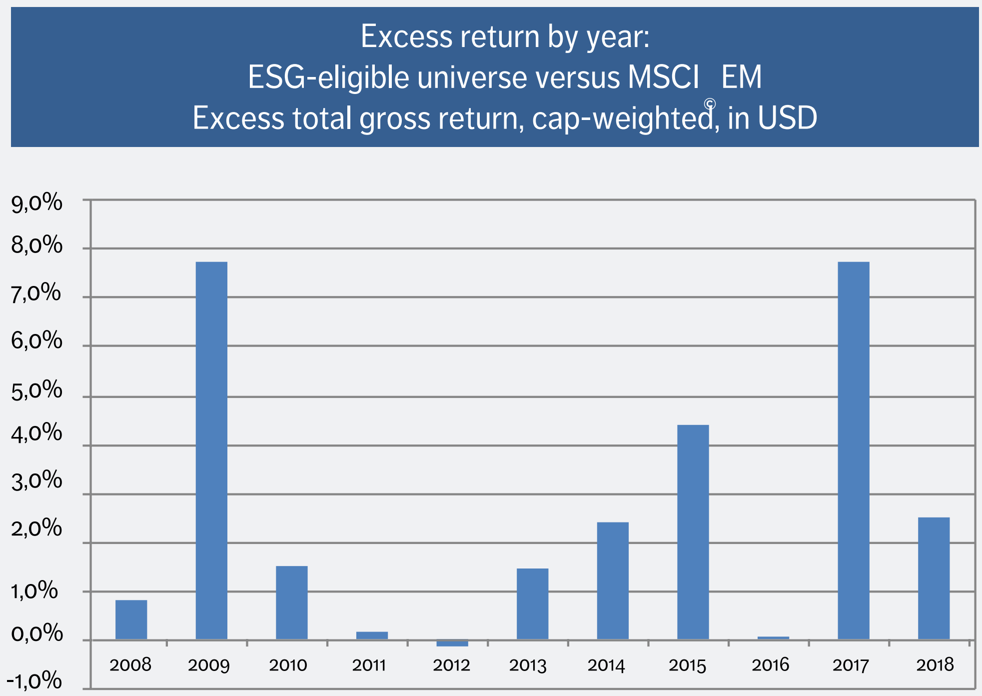
#InFocus: Sustainability and Performance in Emerging Market Equities

Emerging Markets are particularly interesting when examining Sustainability and investment performance. If ESG risks, particularly poor governance, are more pronounced in Emerging Markets, then correctly avoiding these risks should lead to significant improvements in risk-adjusted performance. Meanwhile, these higher ESG risks, plus reduced access to data, make Sustainable Investing more complex in Emerging Markets. The key question remains: can incorporating ESG factors in Emerging Markets investing pay off in practice?

We conducted a long-term study of ESG factors in Emerging Market equities. Given that ESG ratings vary by provider and investor, recognize that this study covers one specific approach. The Candriam engineering team compared the performance of the Emerging Markets ESG-eligible universe (approx. 700 stocks), as determined by Candriam's in-house ESG analysts, to the MSCI© Emerging Market Index (approx. 1,150 stocks) between 2008 and 2018. The universe of ESG-eligible Emerging Market stocks outperformed the MSCI© EM Equity Index by an average of 2.4% p.a. on a gross basis – with a similar risk.

Figure 4-A

ESG-eligible universe versus MSCI© EM



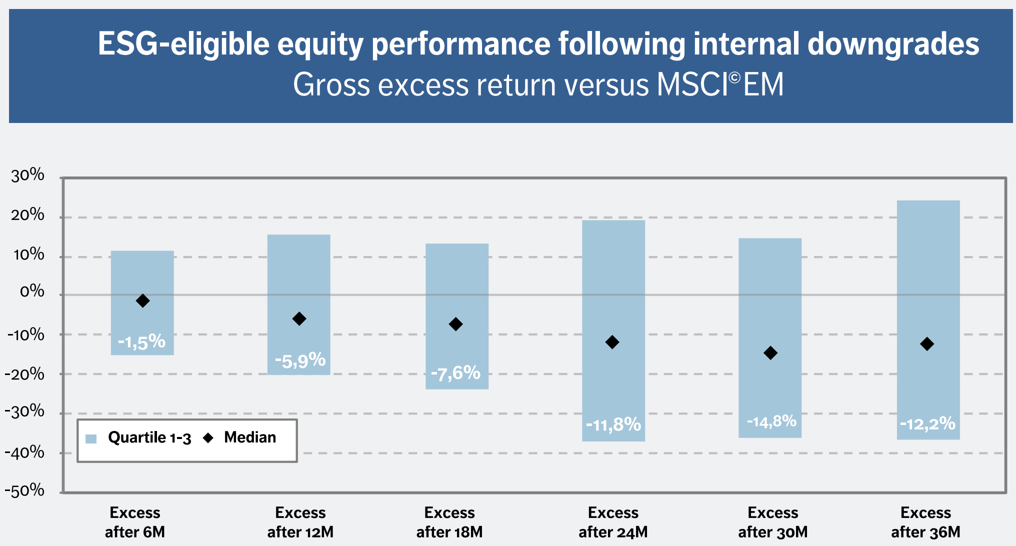
Sources: Candriam ESG Team and Financial Engineering Team, MSCI (Weight) © 2019 MSCI Inc. All rights reserved; Factset Prices (Gross Total Return). Data from April 2008 to October 2018. Past performances of a given financial instrument or index or an investment service, or simulations of past performances, or forecasts of future performances are not reliable indicators of future performances. Gross performances may be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact. The MSCI EM Index is mentioned for informational purposes only. The strategy does not consist of replicating this index.be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact. The MSCI EM Index is mentioned for informational purposes only. The strategy does not consist of replicating this index.

We analysed the consistency of the gross excess returns of the ESG-eligible universe across sectors, regions and sizes. In terms of sectors, ten of the 11 sectors generated a positive excess return. The ESG-eligible universe achieved a positive excess return in all four geographical regions. ESG-appropriate companies also outperformed the index in all three market cap categories.

We also asked what it means for the future performance of a company if it is no longer considered ESG-eligible. The study showed that when a company fell out of the ESG-eligible universe, this was followed by negative excess returns for time horizons beyond one year and up to three years after the company concerned has been removed from the list of sustainable companies. The lowest point was reached in the 30th month, with a (median) excess return of -14.8% (gross). The effects of an ESG-downgrade lessen beyond this time horizon.

Figure 4-B

Performance following ESG downgrades from ESG-eligible to ESG-excluded



Sources: Candriam ESG Team, MSCI (Weight) © 2019. All rights reserved; Factset Prices (Gross Total Return). Past performances of a given financial instrument or index or an investment service, or simulations of past performances, or forecasts of future performances are not reliable indicators of future performances. Gross performances may be impacted by commissions, fees and other expenses. Performances expressed in a currency other than that of the investor's country of residence are subject to exchange rate fluctuations, with a negative or positive impact. The MSCI EM Index is mentioned for informational purposes only. The strategy does not consist of replicating this index.

5. What About Covid-19? – The Potential Impacts for Sustainable Investing

#SpeedRead	
	• *It is too early to draw definitive conclusions on Covid-19 and Sustainable Investing. However, we can take inventory of the evidence so far.* • *Several studies show that during the crisis, Sustainable Strategies have been relatively resilient.* • *Sector allocation may explain part, but not all, of this resilience.* • *The attributes of companies with strong ESG characteristics, notably good stakeholder management, strong governance, capacity for innovation, and adaptability, likely also played a role.*

With the Covid-19 crisis still underway, it is too early to draw definite conclusions regarding its long-term impacts on Sustainable Investing. It is nevertheless informative to take an initial look at the performance of ESG strategies during the crisis so far, and at what the crisis has taught us so far about Sustainability as a predictor.

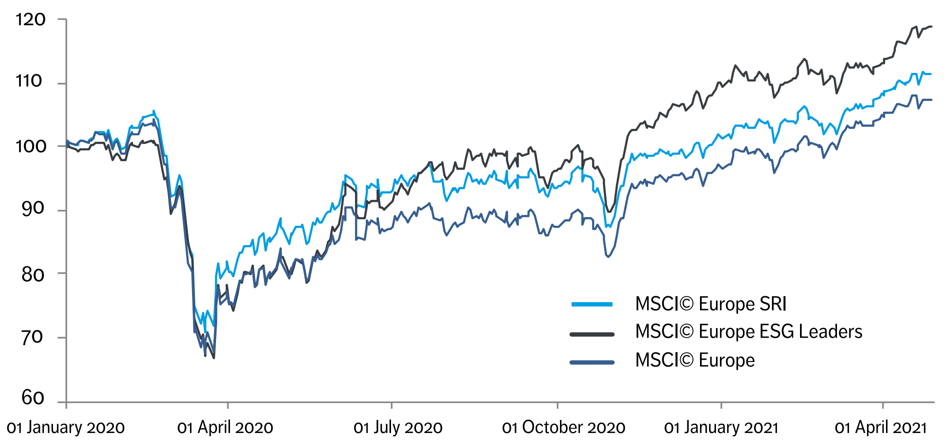
5.1. Performance During the Crisis

The effect of Covid-19 on companies and securities is particularly intriguing because it can be considered the first global, large-scale test of Sustainable Investing. While many Sustainable Investment Strategies demonstrated resilience during the 2008-2009 Global Financial Crisis, at the time they were more of a niche investment. Sustainable Investments have grown threefold since then.

Broad market indices and fund returns show that the performance of Sustainable Strategies during the Covid crisis has, on average, been more robust.

Figure 5-A

Comparative performance of European indices



Sources: Candriam, Bloomberg, 29/01/2021.

Figure 5-B

ESG fund performance in the depth of the crisis

Performance-ranking of 203 ESG Fonds in their respective Morningstar categories	
	13/02/2020 - 12/03/2020
1st quartile	39% of ESG funds rank in the 1st quartile of their Morningstar category
2nd quartile	27% of ESG funds rank in the 2nd quartile of their Morningstar category
3rd quartile	23% of ESG funds rank in the 3rd quartile of their Morningstar category
4th quartile	11% of ESG funds rank in the 4th quartile of their Morningstar category

Source: Morningstar

5.2. Drivers of ESG Performance During the Crisis

What explains the relative resilience of Sustainable strategies so far in the crisis? It is certainly too early to conduct a formal attribution analysis. However, what appears clear is that Sustainable strategies tend to display a number of characteristics that are logically sought-after attributes in times of stress.

A first factor that is often mentioned when trying to explain the performance of Sustainable strategies in the crisis is sector allocation. A sector that is often pinpointed in this argument is energy – indeed, it is often argued that strategies that take into consideration ESG factors have performed relatively well because they underweight energy. And in fact, the energy sector did suffer significantly during the early Covid financial market crisis.

Analyses show that the average outperformance of Sustainable investments on an aggregated basis is still material even after adjusting for sectors. It is not as simple as avoiding the energy sector. Many sustainable strategies still invest in energy forms such as natural gas and lower-emitting fossil energy. In many sectors there are dispersions within the industry, between companies with good versus unsustainable ESG ratings. Further, the weight of energy in most indices is actually not that high. The energy sector is less than 3% of the MSCI World index.[3] Sector allocation does not explain the overall performance of Sustainable strategies.

Factors beyond sector allocation are demonstrably at work. Sustainability considerations at the company level are clearly relevant. The Covid crisis seems to point for example to certain Social, or S-factors, such as good management of employees and suppliers. Good long-term relationships with staff can support business continuity processes in times of crises. In sectors such as food distribution this can be a differentiator. Investors are increasingly pushing for greater transparency in these areas, especially with regard to working conditions and health insurance. Good relationships with suppliers, too, can be supportive in times of stress, notably to maintain supply chains.

The fact that investors have sought out companies with strong ESG ratings in the crisis also makes sense when thinking about the implications of good Governance. Companies with good Governance are often characterized by healthy balance sheets, financial caution and proactive risk management. In the eyes of many investors, these features help reduce risk, especially during market turmoil.

Companies with strong ESG elements frequently display adaptability and the capacity to innovate – both attributes which are particularly in demand in crises. Certain Sustainable companies develop new solutions, for example to mitigate climate change or facilitate the circular economy. Others evolved their processes to meet ESG criteria. This demonstrates innovation, flexibility and adaptability.

Hence, the crisis sheds light on the potential added value of analysing Sustainability risks and opportunities. It also illustrates why it is interesting to examine company's alignment with global Sustainability trends In fact, structural Sustainability trends such as digitalisation and the search for health and wellbeing have been further reinforced by this crisis.

3. Source: MSCI, January 29 2021

5.3. Peering into the Future

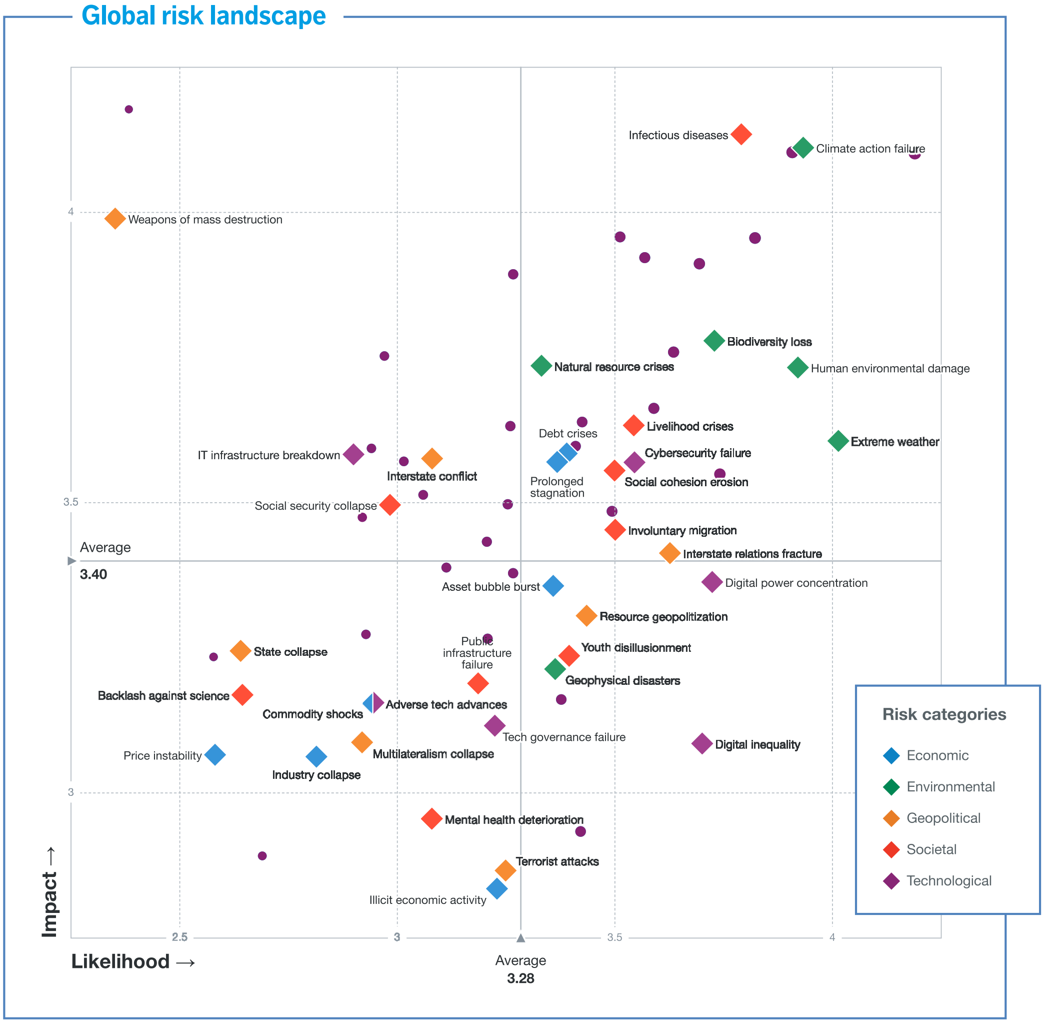
While it is too early to draw long-term conclusions on the impact Covid-19 will have on Sustainable Investing, we have gained insights from the crisis that should support the use of ESG in analysing investments.

So far, we are seeing that on average, issuers with good ESG ratings have been relatively resilient. The crisis illustrated the potential added value of exposure to structural sustainability trends. The evidence so far could also supports a more ESG-aligned perspective on what constitutes good, and financially successful, employee and supplier management. The international community is learning that massive, drastic remedies against exogenous shocks can be deployed relatively quickly, and that changes in human activity can have tangible consequences for the environment.

In the most recent World Economic Forum Global Risk Landscape, published after the onset of the crisis, climate action failure ranks almost as high as infectious diseases in terms of impact, and even higher in likelihood. These are followed by other environmental risks, such as human environmental damage, biodiversity loss and extreme weather. The fact that many environmental risks rank close to the risk of infectious diseases, may add to the growing understanding of the environmental urgency and further support regulatory initiatives to mitigate climate change and other environmental issues.

Figure 5-C

Global risk landscape



Source: World Economic Forum, Global Risks Report 2021, 16th Edition.

6. Conclusion: High Stakes

Sustainable Investing has become indispensable.

The stakes for insurers are high --- to ensure the resilience of investments in the face of rising Sustainability risks, align practices and portfolios with increasing regulation, and protect their company and brand against reputational damage.

Capturing the new opportunities offered by Sustainable Investing will be key to the long-term earnings potential of insurance assets and the competitive position of insurers. It is vital for insurers to build significant in-house know-how or to carefully select their external partners. For outside expertise, companies must carefully select partners that are both true Sustainable Investing experts to support the insurer in the implementation of Sustainable Strategies which fit their portfolio and individual circumstances.

The goal is simple -- to make Sustainable Investing a source of potential added value.

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