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Insurers Guide to Sustainable Investing: What, Why, and How ? - Ch. 2

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25 years of ESG

About the authors

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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.

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.

2.Why? - Identifying Risks and Opportunities

#SpeedRead

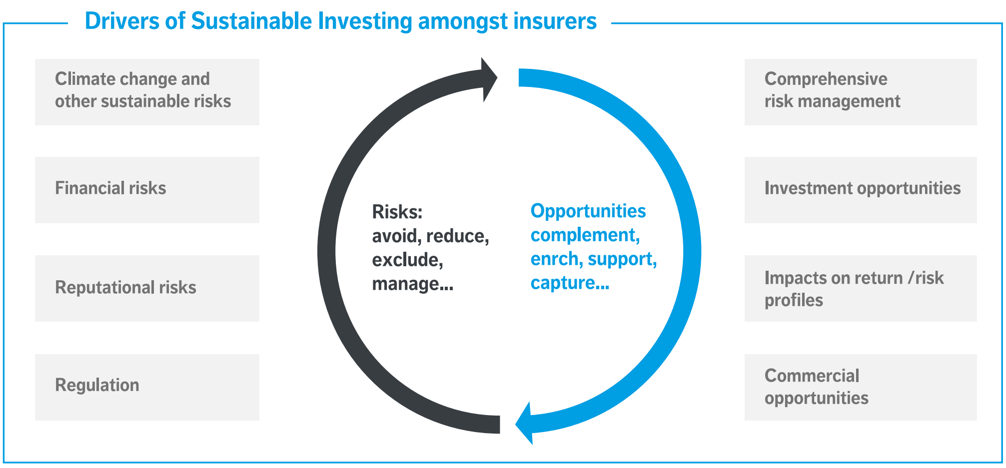
- *Insurers have several business-performance-related reasons to adopt Sustainable Investing.*
- *Risk frameworks for insurers can be enhanced, to help mitigate Sustainability risks, including the potential financial and reputational consequences of these risks.*
- *Growing regulatory constraints on 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.

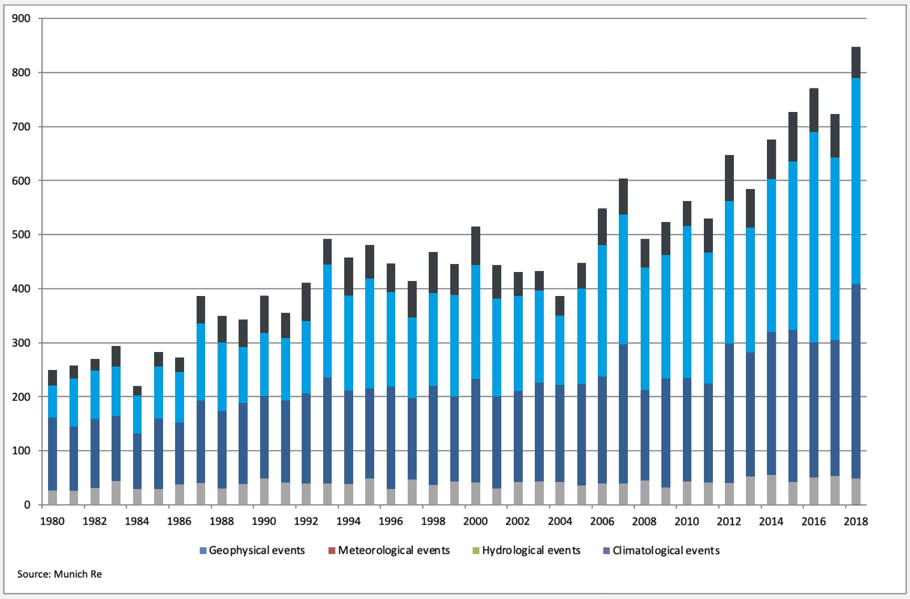
2.1.1. Sustainability Risks

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.

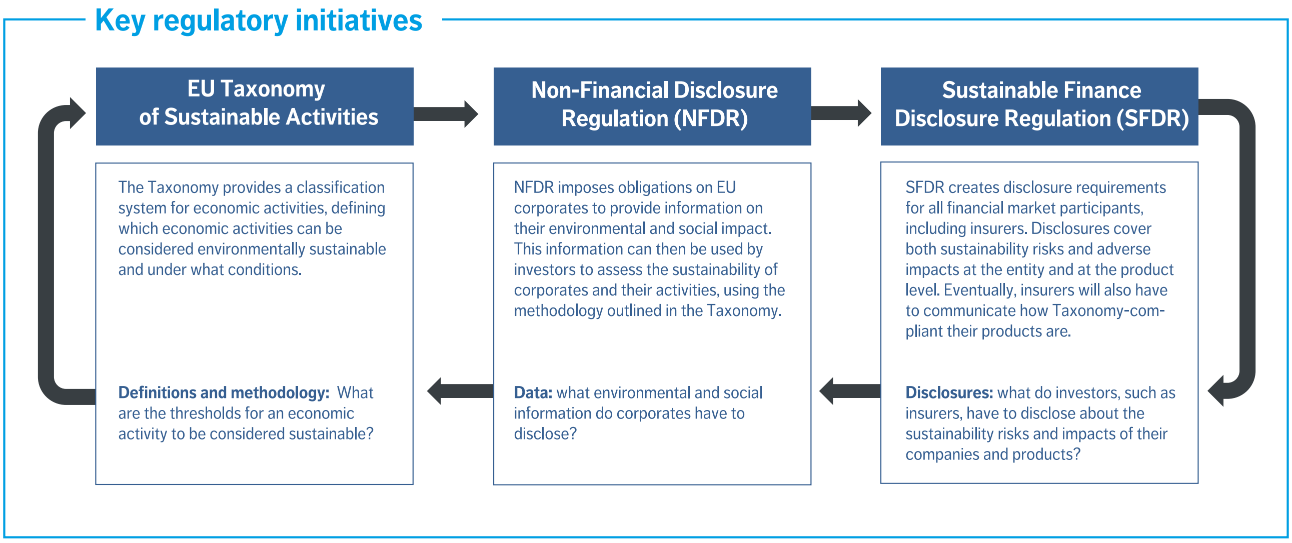
In recent years, the COP 21 in 2015 and the resulting Paris Agreement are among the most consequential initiatives at the international level. The Paris Agreement set the goal of holding the increase in global temperature below 2 degrees Celsius above pre-industrial levels. Under any scenario – and the 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)
	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.

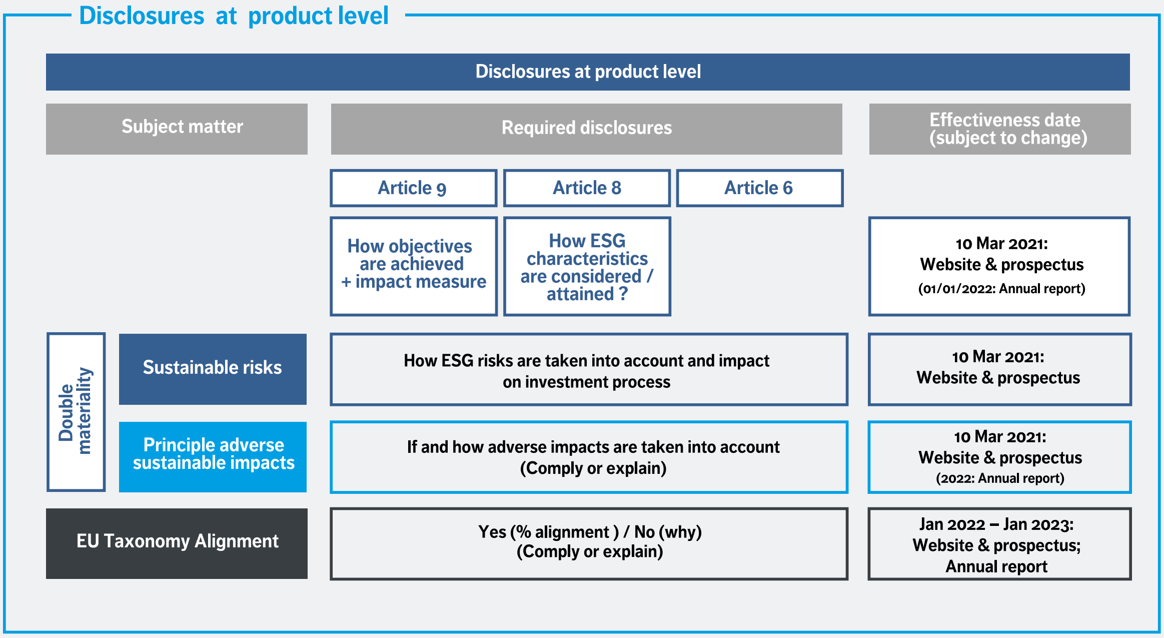
#InFocus: Sustainable Finance Disclosure Regulation (suite)

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



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.

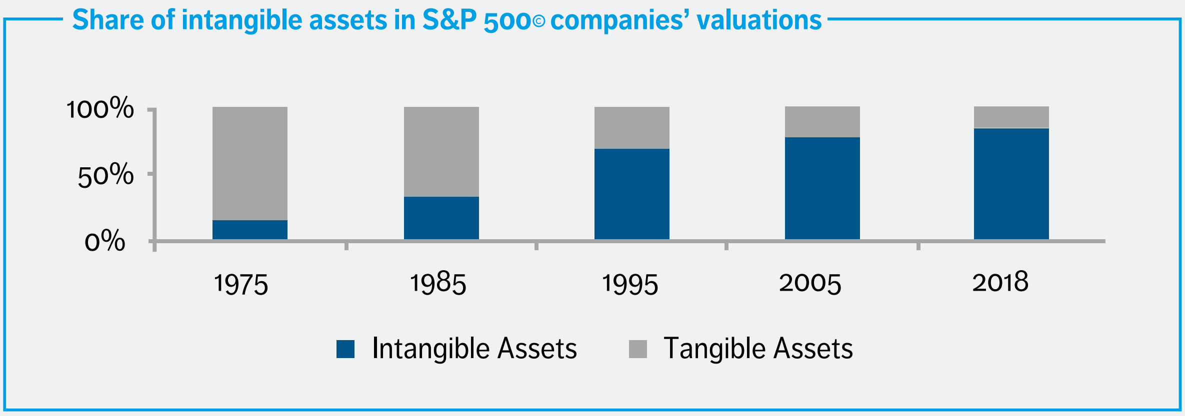
2.2.1. More Comprehensive Risk Management

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 CO2 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.

4. Friede, Gunnar; 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.
5. Morningstar, "Sustainable Funds U.S. Landscape Report," February 2019.

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.

6. Morgan Stanley Institute For Sustainable Investing, 2019. "Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice."

€140 B
AUM as of
31 December 2020

570+
Experienced and
committed professionals

25 years
Leading the way in
sustainable investing

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