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

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About
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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..

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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

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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.

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 for 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 both across 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 these 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 by 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	• Sustainable Investing (“in the narrower sense”)	• Impact • Impact Investing
Core Elements	• Focus on moral responsibility and accountability • Alignment of investment decisions with certain values, such as ethical, religious or cultural considerations	• 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.

Investment approaches vary in terms of the specific ESG indicators considered, the way they are incorporated and the outcomes they create for insurance portfolios. However, the inclusion of these extra-financial considerations, together with corporate stewardship, forms the bedrock of any Sustainable Investing approach.

#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.

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