

ESG in the Insurance Sector: Growth, Opportunities and Risks

6 January 2021

With the recent news that Apollo Lloyd's will no longer underwrite Adani's Carmichael coal mine in Australia following the expiry of the policy in 2021, it has never been more apparent that (re)insurers around the world are displaying a deep interest in environmental, social and governance ("ESG") factors. For example, in December 2020, Lloyd's published its first ESG report, in which it announced that for the first time they would be setting targets for responsible underwriting and investment, in particular by asking managing agents, from 1 January 2022, to stop accepting new business on certain coal and oil activities and to phase out existing coverage by 1 January 2030. ESG risks have resulted in increasing numbers and quantum of insured claims, and therefore losses to carriers, and are also linked to other legal and, crucially, reputational concerns. The ongoing activity of governments and the spotlight being shone by activists on these issues has led to an increasing amount of ESG-related legislation (largely focused on disclosure of risks and other ESG factors).

Although adapting to ESG risks is expected to reduce costs for companies in the longer term, in the short term, this greater regulatory burden represents a cost to all firms, including (re)insurers. This compliance burden is significant for international (re)insurance groups subject to standards that diverge between jurisdictions, such as the marked contrast between the relatively and increasingly stringent requirements of the European Union (the "EU") and the lack of any standardised ESG disclosure regime in the United States.

However, compliance with ESG reporting requirements and foregrounding ESG within investment strategies may also offer opportunities for insurers, such as attracting the growing number of ESG-minded consumers, as well as having the potential to enable positive financial returns on investments (see, for example, Blackrock's announcement of its commitment to assessing ESG "with the same rigor that it analyses traditional measures such as credit and liquidity risk"). By successfully integrating ESG factors into their risk assessment and underwriting processes, (re)insurers may be able to mitigate their losses from the growing number and range of ESG risks. To ensure the success of their businesses going forward, (re)insurers must prioritise consideration of ESG factors, both in their roles as investors and as (re)insurers.

Impacts of ESG Issues

The number and type of ESG risks are growing. Perhaps the most obvious manifestations of these are the risks posed by climate change to (re)insurers. S&P Global Ratings' research estimates that 60% of S&P 500 companies own assets at a "high risk" from the physical impact of climate change. With the intensification of natural catastrophes and weather-related events, at least in part due to the impact of climate change, property losses from U.S. catastrophes have increased from \$16.7 billion in 2010 to \$50.9 billion in 2018; the figure for 2017 was even higher, at \$111 billion, due in part to hurricanes Harvey, Irma and Maria.¹ These events also cause significant disruption to businesses and the market, as well as climate-related migration, which in turn leads to lower property values and therefore associated revenues for (re)insurers in the areas people are abandoning.

While the 'E' of ESG is important, it is not important to the exclusion of other risks. Indeed, in the EU Regulation on Sustainability-Related Disclosures in the Financial Services Sector (the "Disclosure Regulation"),² it is made clear in the definition of "sustainable investment" that the three branches of ESG are interrelated.³

In AM Best's recent survey of 97 (re)insurers on ESG factors ("AM Best's Survey"), corporate governance and product liability including cyber security were cited as the most relevant ESG issues for the insurance industry, alongside climate risk. A study by the Allianz Global Corporate & Specialty and The Value Group has shown that, in terms of "social" risk, "health and safety trainings, employee wellbeing and investments in employee safety [...] have measurable and positive effects on employee accident and fatality levels".⁴ A lack of respect for human rights can also cost companies on account of disruption to their work through community protest. To take just one example, local communities have been angered by the actions of the owner of the Las Bambas copper mine in Peru MMG Ltd, in particular its decision to use trucks to transport materials to and from the mine, which allegedly generate significant levels of pollution, and the alleged failure to consult with local communities about the building of the road on their

¹ Facts + Statistics: U.S. catastrophes, accessible at: <https://www.iii.org/fact-statistic/facts-statistics-us-catastrophes#2019%20natural%20catastrophes> (last accessed: 10 November 2020).

² Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

³ See Article 2, Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector ("sustainable investment" means an investment in an economic activity that contributes to an environmental objective ... or an investment in an economic activity that contributes to a social objective ... provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance").

⁴ *The predictive power of ESG for insurance*, accessible at: <https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/the-predictive-power-of-esg-for-insurance.html> (last accessed: 3 December 2020).

land. The ensuing protests has caused significant disruption to the mine, such that MMG Ltd has reduced its output guidance for the mine in 2020 by more than 10%,⁵ though the COVID-19 pandemic has been cited by the company as the cause, alongside community tensions.⁶

One major ‘social’ risk is the recent spate of diversity disputes, such as the shareholder derivative action filed against Facebook in 2020, alleging that the directors violated their fiduciary duties through their failure to take action on diversity and inclusion, and hate speech.

These growing risks are relevant to (re)insurers in their roles as both investors and underwriters. From an underwriting perspective, a failure to integrate all ESG factors into the risk assessment and underwriting process will misunderstand the scope of the eventualities and the related risks that policy is covering. This will likely lead to increased claims on policies, which has the capacity to significantly reduce (re)insurers’ ability to derive underwriting profits on policies. A failure to consider ESG factors can also be detrimental to the value of (re)insurers’ investment portfolios. Companies’ revenues, profits and market values decline following ESG incidents such as oil spills and weather-related supply chain disruptions. If a (re)insurer invests in companies seeing a reduction in their share value, this may reduce investment returns. Taking a longer-term view, some companies may ultimately collapse in the face of risks stemming from long-term trends such as climate change. A failure to factor this in could impact the value of investment portfolios and underwriting profits (or extend underwriting losses), as well as the ability of the (re)insurer to attract investment itself, as institutional investors and consumers start to compare products and turn to those more aligned with their personal and institutional values.

Risks related to, and the approach generally to, ESG issues can also impact a company’s reputation. With the advent of viral social media, customers can easily express displeasure, with wide exposure, at how companies, particularly those that are public facing, have handled ESG issues. Returning to the example of the Adani mine, activists successfully targeted companies involved with a sustained social media campaign to #StopAdani. The #GoTransparent campaign calls on fashion brands to publish a list of the factories that make their branded products, and have targeted companies such as Armani and American Eagle Outfitters. There is an increasing normative expectation held by investors, courts, regulators and customers that (re)insurers should comply

⁵ UPDATE 1-MMG says Las Bambas copper shipments back to normal, cuts 2020 guidance, accessible at: <https://www.reuters.com/article/peru-copper/update-1-mmg-says-las-bambas-copper-shipments-back-to-normal-cuts-2020-guidance-idUSL1N2HH0NW> (last accessed: 14 December 2020).

⁶ Transport convoy from major Chinese-owned copper mine attacked in Peru – Reuters, accessible at: <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/transport-convoy-from-major-chinese-owned-copper-mine-attacked-in-peru-8211-reuters-59528047> (last accessed: 14 December 2020).

with ESG expectations and put ESG issues at the forefront of their decision-making. As discussed above, not doing so may damage (re)insurers' reputations and growth, from both an underwriting and investment perspective. Reducing reputational risk was the most-cited reason behind (re)insurers' integration of ESG factors in investing mandates by the respondents to AM Best's Survey.

ESG Disclosure Requirements

ESG legal frameworks are currently focused on diligence, disclosure and reporting obligations so as to allow investors and interested parties to bring pressure to bear on those who do not meet expected or mandated targets and/or requirements. Such laws can have a significant impact on furthering the consideration of ESG issues. Indeed, in AM Best's Survey, almost half of the respondents chose legislators or regulators as a source of high or significant stakeholder pressure for considering ESG risks and opportunities.

The UK

On 9 November 2020, the UK's joint Government-Regulator Task Force on Climate-related Financial Disclosures ("TCFD")⁷ announced its intention to make TCFD-aligned disclosures mandatory across the economy by 2025, alongside the publication of its Interim Report and Roadmap. The Roadmap sets out that (re)insurers will likely be subject to mandatory disclosures by the end of 2021. The Chancellor also announced that the UK would implement a green taxonomy, which would "take the scientific metrics in the EU taxonomy as its basis and a UK Green Technical Advisory Group will be established to review these metrics to ensure they are right for the UK market".

UK regulators also are pushing for more detailed disclosure on both investments and liabilities. The Prudential Regulation Authority has mandated insurers to pressure test their UK-based investment portfolios under different global-warming scenarios. The Bank of England has selected ten insurers, ten Lloyd's managing agents and Lloyd's to participate in a climate change stress test to be conducted in 2021 to assess their resilience to climate-related risks. The FCA has issued a policy statement confirming that the UK intends to use the TCFD as the basis for its ESG regulation, and requiring companies with premium listings in the UK to add TCFD disclosures to their annual

⁷ The organisations involved with the TCFD include HM Treasury, the Bank of England, the Prudential Regulation Authority, the Financial Conduct Authority, the Department for Business, Energy & Industrial Strategy, the Department of Work and Pensions, the Financial Reporting Council and the Pensions Regulator.

statements, or explain why they have not.⁸ These developments suggest the UK will remain committed to the development of ESG disclosure regulation despite its exit from the EU.

The EU

Companies operating in the EU have a dual burden of complying with both local and EU ESG-related legislation. For example, (re)insurance companies established in France must comply with the “*Loi de Vigilance*”,⁹ which requires them to establish, implement and publish a plan to prevent violations of human rights and the environment in their supply chains;¹⁰ and the Netherlands has enacted a law that aims to tackle modern slavery, which companies must comply with.

Currently, the Non-Financial Reporting Directive (the “NFRD”) requires (re)insurance companies with more than 500 employees to publish reports on the policies they implement in relation to:

- environmental protection;
- social responsibility and treatment of employees;
- respect for human rights;
- anti-corruption and bribery; and
- diversity on company boards (in terms of age, gender, educational and professional background).¹¹

In addition, European (re)insurance companies¹² offering insurance-based investment products (“IBIPs”), as well as insurance intermediaries providing insurance advice with

⁸ *Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations*, accessible at: <https://www.fca.org.uk/publication/policy/ps20-17.pdf> (last accessed: 24 December 2020).

⁹ LOI n° 2017-399 du 27 mars 2017 relative au devoir de vigilance des sociétés mères et des entreprises donneuses d'ordre.

¹⁰ For an example of an insurance company complying with the *Loi de Vigilance*, see *Our commitment to Human Rights*, accessible at: <https://www.axa.com/en/about-us/our-commitment-to-human-rights> (last accessed 8 December 2020).

¹¹ Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

regard to IBIPs must comply with the Disclosure Regulation, which comes into effect on 10 March 2021.¹³ In-scope entities will need to report (on a “comply or explain” basis) on three distinct disclosure areas:

- the integration of sustainability risks in the investment decision-making process;
- for certain types of products, companies must comply with the pre-contractual disclosure principles set out in Articles 8 and 9. For example, where a company offers a financial product with sustainable investment as its stated objective:
 - if they have designated an index as a reference benchmark, they must include information on how the index is aligned with that objective and give an explanation as to why and how that index differs from a broad market index; or
 - if they have not designated an index as a reference benchmark, they must explain how the fund’s sustainable investment objective is going to be met; and
- their due diligence policies with respect to the adverse impacts of their investment decisions on sustainability factors (although this requirement will be “opt-in” for in-scope entities with fewer than 500 employees themselves or on a consolidated basis where they are parent undertakings of a large group).¹⁴ Participants who comply with the NFRD standards or international standards could use that information for this requirement.

In April 2020, the Joint Committee of the European Supervisory Authorities published a consultation paper on proposed regulatory technical standards (“RTS”) relating to the content, methodologies and presentation of ESG disclosures under the Disclosure Regulation. In late October 2020, the European Commission published a letter extending the deadline for the RTS consultation. The consultation was previously intended to end in December, with the ESAs scheduled to publish the RTS by 30 December 2020. The Commission has not provided an updated date for the consultation’s closing or the RTS publication.

Without the finalised RTS, entities which are required to comply from 10 March 2021 have been left in the dark as to how to formulate these disclosures.

¹² Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector will not be applicable in the UK as a result of the UK’s withdrawal from the EU.

¹³ Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

¹⁴ For these “smaller” in-scope entities, there is the option instead to provide “clear reasons” why they do not consider adverse impacts of investment decisions on sustainability factors.

The consultation paper on the draft RTS has garnered criticism. Insurance Europe has stated that the RTS are too prescriptive and inflexible. The Financial Markets Law Committee has expressed concerns that there are diverging sustainability-related disclosure requirements both with other jurisdictions globally and within EU legislation itself.¹⁵

For further information on the Disclosure Regulation please see our recent webinar series [here](#) and previous client updates [here](#) and [here](#). EIOPA's fourth roundtable on sustainable finance took place on 16 December 2020 and discussed their efforts to integrate ESG risk assessment into the regulatory and supervisory framework for insurance.

The EU's Regulation on the Establishment of a Framework to Facilitate Sustainable Investment ("Taxonomy Regulation")¹⁶ also applies to European (re)insurers offering IBIPs and insurance intermediaries providing insurance advice with regard to IBIPs. The Taxonomy Regulation sets out four overarching conditions that an economic activity has to achieve to qualify as "environmentally sustainable", in order to assist investors in identifying sustainable economic activities and prevent greenwashing. On 9 March 2020, the Technical Expert Group on sustainable finance published its final report on EU taxonomy,¹⁷ which, alongside the technical annex, contained recommendations relating to the overarching design of the EU taxonomy, and guidance on how in-scope entities can use and disclose against the EU taxonomy. For further information, please see our previous client update available [here](#).

The United States

In contrast to the increasingly stringent EU framework, in the United States under the Securities and Exchange Commissions' (the "SEC") rules, there is no standardised ESG disclosure regime. Indeed, the SEC, in January 2020, proposed amendments to the Management's Discussion and Analysis rules, which, despite proposals from various U.S. federal lawmakers, did not include ESG disclosure requirements.

¹⁵ *Joint Consultation Paper concerning ESG disclosures*, accessible at: <http://fmlc.org/wp-content/uploads/2020/09/FMLC-Letter-on-ESAs-SFDR-Consultation.pdf> (last accessed: 3 December 2020). The FMLC demonstrated divergences between the Disclosure Regulation and the Taxonomy Regulation, and the RTS and the Disclosure Regulation.

¹⁶ Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

¹⁷ *Taxonomy: Final Report of the Technical Expert Group on Sustainable Finance* (March 2020), accessible at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf (last accessed: 3 January 2020).

While the National Association of Insurance Commissioners (the “NAIC”), an industry group governed by the insurance regulators of various states, has expressed some interest in ESG concerns, so far NAIC action has been limited to a survey of insurers gauging the level at which insurers currently disclose climate-change-related risks and incorporate such risks into their risk management policies. There is also divergence at a state level. In September 2020, the New York State Department of Financial Services published its Insurance Circular Letter No. 15, in which they stated their expectation that New York based (re)insurers should integrate climate-related financial risks into governance frameworks, public disclosures and business strategies, being the first state to do so. For further information on Circular Letter No. 15 please see our previous client update [here](#). It is reasonably likely that other states will follow the example of New York in the near future and begin requiring insurers to incorporate climate change risks in disclosure and risk management. This has been the case previously with other areas of regulation where New York was the first jurisdiction to act (*e.g.*, cybersecurity).

Other Likely Initiatives

Major players, including federal government agencies, state governors and insurance regulators, are considering the implementation of various initiatives as part of a wider re-evaluation of the significance of ESG factors in the insurance industry. Among the topics under consideration are:

- **Underwriting.** Legislation has been introduced in the Senate that would prohibit U.S. insurers from considering a number of factors (at least 20) in the underwriting of insurance risk. For example, the use in underwriting of facially neutral standards or algorithms that have a disproportionate impact on a protected class would be prohibited. The proposed legislation also provides for a private right of action where there are violations.
- **General Account Investments.** Non-U.S. regulators have allowed or required insurers to invest general account assets in areas deemed socially desirable. U.S. regulators may adopt this principle and thereby allow insurers to invest general account assets in such socially desirable investments. U.S. regulators may also follow the lead of certain other jurisdictions and *require* insurers to invest a certain amount in such investments.
- **Advertising and Distribution.** There is an emerging discussion about whether insurance companies can use advertising or distribution channels that target or seek to exclude specific groups.

- **ESG Investments Funds.** Tobacco and energy companies are often excluded from socially responsible investment funds. These funds may at some point begin to exclude insurance companies that insure socially undesirable risks.
- **Disclosure of Risks.** The SEC may require insurance companies to disclose in their regulatory filings socially undesirable risks that they cover. Regulators may also sanction insurance companies for over-promising on their ESG policies.
- **ERISA Funds.** Under the U.S. Department of Labor’s “Scalia Rule”, Employee Retirement Income Security Act (“ERISA”) plans must offer investment options based solely on economic performance. Under a new administration, this rule could be overturned to allow ERISA plans to market socially responsible investment options to plan investors.

General Considerations Regarding Disclosure Liability

In response to this wider re-evaluation, as well as investor demand, most companies are now reporting ESG metrics on their own operations that go far beyond what is required by law. The standards used vary widely, as do the standards considered by the “ESG rating agencies”. The lack of a standardised global disclosure regime presents various risks. It increases the financial and temporal burden of compliance on (re)insurers, as well as the threat of companies’ failing to comply with the regulations, which in turn poses a reputational risk.

There is also a risk of disclosure liability arising, either where a company states that it has accomplished an ESG target, which is deemed misleading because the measurement standards were poor, or where a company states its general future intentions regarding ESG practices which are then allegedly not followed. Finally, there is a risk that a statement by a parent company may create liability that would previously have been contained at the subsidiary level.

More than 70% of (re)insurers in AM Best’s Survey called for more direction on ESG from regulatory authorities. International (re)insurance companies, as well as all other companies, may benefit from more globally consistent regulation and frameworks on this issue.

Opportunities Arising from Considering ESG and the Insurance Industry's Response

Insurers that factor ESG issues into decision making, and make sustainability disclosures in line with regulatory requirements, are expected to derive significant benefits in the long term.

Various recent analyses show that ESG investments may offer higher returns as compared to more traditional investments. Research released by Imperial College London and the International Energy Agency, showed that over a five-year period, investments in renewables in the United States yielded 200.3% returns versus 97.2% for fossil fuels. Meanwhile, data from Arabesque found that S&P 500 companies ranking in the top 20% for ESG factors outperformed those in the bottom 20% by more than 25% between the beginning of 2014 and the end of June 2018; the data also showed that their stock prices were less volatile.¹⁸ Considering ESG factors can also mitigate portfolio risk, as referred to above. Insurers that integrate ESG risks into their investment processes may also be more competitive in winning third-party investment mandates.

While AM Best's Survey found that investment activities were the primary focus of (re)insurer's ESG integration, only a third of participants said they had taken significant underwriting action regarding ESG risks, such as exiting certain lines of business. However, there are additional options available to (re)insurers in integrating ESG risks into their underwriting business. For example, as well as considering whether to refuse to provide or renew coverage for high-risk or high-profile business (such as with the Adani mine discussed above), (re)insurers can price their coverage accordingly, to avoid or mitigate the large losses potentially associated with certain ESG risks. Models can help predict the frequency and severity of natural catastrophes. By incorporating the results of this data-drive approach into their decision-making processes, (re)insurers can continue to make better informed underwriting decisions.

Despite its concerns, in its response to the proposed RTS, Insurance Europe highlighted that greater access to ESG information is key to giving consumers the information necessary to make informed financial decisions in line with their ESG objectives. The information may also be useful for performance comparison against competitors for (re)insurers who have expressed their commitment to improving their business, operational and investment ESG credentials. (Re)insurers that comply with these requirements may be rewarded by attracting the growing class of consumers and investors concerned with ESG issues, who seek to use, or invest in, similarly minded companies.

¹⁸ *Doing Well By Doing Good: 5 Stocks to Buy for 2019*, accessible at: <https://fortune.com/2018/12/05/best-stocks-esg-2019-walmart-abbott-merck/> (last accessed: 14 December 2020).

Many key players in the (re)insurance industry have been vocal and proactive in highlighting how they are looking to tackle the ESG issues of the 21st century. Among the many statements, pledges and actions, Zurich has declared that “it avoids doing business with counterparties that may use child labour, forced labour, or conduct operations that could jeopardize health and safety, or offer unfair remuneration”.¹⁹ AXA has placed underwriting restrictions on the coal and oil sands industries and has developed “green/sustainable” products in both its Property & Casualty and Life & Savings ranges. Legal & General’s group CEO has recently come out in support of linking executive pay with ESG performance targets. As noted above, Lloyd’s published its first ESG report in December 2020, in which it announced that for the first time they would be setting targets for responsible underwriting and investment to help accelerate society’s transition from fossil fuel dependency, towards renewable energy sources. In particular, from 1 January 2022 Lloyd’s will ask its managing agents to accept no new business on thermal coal-fired power plants, thermal coal mines, oil sands or new Arctic energy exploration activities. Lloyd’s managing agents will also be asked to phase out existing coverage by 1 January 2030.

With the growth in the volumes of both ESG regulation and material ESG risks, (re)insurers can no longer afford to ignore ESG factors. It may be a slow progression, but the market is moving more steadily towards greater disclosure of ESG risks and issues and, as a result, investors, customers and regulators are coming to expect the same – whether required by the regulators or not. In addition, those that adapt and display a forward thinking attitude towards ESG issues may find they increase their customer base and profitability.

Debevoise’s cross-practice Business Integrity Group is closely monitoring ESG-related developments. Tools like the **Debevoise Business Integrity Screen** can help companies implement a systematic approach to business integrity risks to manage the rapidly evolving reputational, financial, political and legal consequences of such risks.

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Please do not hesitate to contact us with any questions.

¹⁹ *Corporate responsibility highlights 2017*, accessible at: <https://www.zurich.com/-/media/project/zurich/dotcom/sustainability/docs/corporate-responsibility-highlights-2017.pdf?la=en%20> (last accessed: 3 December 2020).

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