ESG—A New Challenge for Insurers in Asia?

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Introduction

Environmental, social and governance ("ESG") considerations have recently risen to the top of the agenda in the insurance industry, including in Asia. As awareness of climate-related risks and other social issues grows across regions and sectors, insurance regulators have adopted rules and guidelines on ESG that are primarily based around three pillars: risk management, governance and disclosure.

Detailed ESG rules for insurers have been limited in the Asia Pacific region so far. The guidelines on environmental risk management for insurers issued by the Monetary Authority of Singapore ("MAS") in December 2020 and the practical guidance on managing the financial risks of climate change issued by the Australian Prudential Regulation Authority ("APRA") in November 2021 are notable. The principles stated in those guidelines are similar to those applicable to insurers in other countries, such as the United Kingdom. The MAS is currently consulting on a "transition planning" guideline that will impose more granular obligations in relation to insurers' transitioning towards climate risk mitigation. The Chinese banking and insurance regulator also issued green finance guidelines imposing certain risk-management and governance obligations in June 2022.

A number of jurisdictions, including Hong Kong, have seen rules or guidance issued to financial institutions such as banks but not yet to insurers. It is expected that many more insurance regulators in the region will issue their own ESG rules in the coming years. In the meantime. certain industry organisations have been working on guidance or other self-regulatory measures in relation to ESG. For example, the Hong Kong Federation of Insurers has recently launched a consultation on a draft climate charter for insurers.

Pressure on insurers to adopt ESG principles and governance is not only exerted by regulators. Investors in insurance companies may have their own ESG commitments and strategies that they apply across their investments, and ESG issues play a growing

role in the selection of insurance providers by customers. According to recent surveys, the vast majority of insurers across the region already have ESG frameworks.

While climate-related and environmental risks are at the core of ESG guidelines issued by regulators, the scope of ESG is wider and comprises a broad spectrum of issues such as social standards, prevention of corruption, diversity and human rights.

This article seeks to outline the challenges that are emerging for the insurance industry in implementing ESG regulation in a region whose countries vary widely in terms of economic development, political systems, environmental awareness and social views.

Risk Management—a Natural Fit for Insurers?

A key pillar of ESG guidelines (including those issued by the MAS and APRA) is the assessment and management of ESG risks. For some insurers this will be nothing new—general insurers that provide coverage against catastrophe risks have been assessing climate-related risks for a long time, and their analysis feeds directly into the pricing of their products.

Outside of such areas, however, the role played by ESG considerations in the risk management of many Asian insurers has traditionally been limited. This is changing now—all insurers will increasingly have to consider climate-related and other ESG risks with regard to their business, whether they focus on life insurance, travel insurance or home insurance.

Insurers in most jurisdictions already have risk-management systems through which they assess a variety of risks on an ongoing basis, such as market, insurance and operational risks. In that sense, ESG regulation simply adds another type of risk to be considered explicitly as part of such risk-management system.

Essential tools with regard to the assessment and management of ESG risks are scenario analysis and stress testing, i.e., the careful consideration of scenarios that may arise from ESG-related risks in the future and the quantification of their impact on an insurer's business through specific "stresses" such as a specified rise in sea levels, the occurrence of certain natural catastrophes or pandemics, or the transition to renewable energy sources within a defined period.

A major challenge for a meaningful implementation of scenario analysis and stress testing is the relative lack of reliable data in relation to many ESG risks, particularly in the Asia Pacific region. While the risk of a typhoon occurring in a particular area may be

straightforward to assess based on existing data, the risk to an insurer of the developing economies of South East Asia transitioning towards renewable energy on an accelerated timetable will likely be much harder to analyse and quantify.

As ESG-related risk assessments become commonplace, the quality of data will improve, and it is likely that industry organisations, regulators and commercial providers will play a role in the collection and analysis of ESG data. An example of such collaboration will be considered with regard to investments below.

ESG and Underwriting—a Challenge Specific to Insurers

While ESG risk management can be applied to all regulated entities in the financial services sector, risk management in relation to underwriting is specific to insurers.

As part of their ESG risk management, many insurers have already ceased to provide new cover to entities that raise particular environmental risks, such as those engaging in coal mining or certain types of oil exploration. Existing cover is also being phased out in relation to such entities.

Apart from the environmental risks created by such entities, insurers are also concerned about the reputational impacts of insuring "polluters" since investors in insurance companies and other stakeholders may oppose supporting such activities through provision of insurance, and negative press may have a significant adverse effect on new insurance business.

The withdrawal of coverage is not without ethical issues. If major international insurers refuse to insure "polluting" projects, this may result in such projects being left with limited or no coverage. If the projects cause damage to the local environment or local communities, the lack of coverage may ultimately leave claimants without compensation. It is not realistic to expect that all "polluting" projects will be stopped for insufficiency of insurance coverage. Asia is a particularly problematic region in this respect given the comparatively low environmental and social standards in many countries and the lack of other compensation mechanisms.

Another issue for insurers is how to determine the most "damaging" or reputationally risky activities that should be denied coverage. Large chemical plants may be more polluting than coal mines; construction sites may have catastrophic social standards; large companies (whether state owned or privately owned) in developing economies may have high levels of corruption and low environmental and worker rights standards. Public opinion on particular sectors and ESG risks may shift over time.

It is therefore clear that "ESG conscious" underwriting is not an exact science but at least partly a response to prevailing views in particular societies. Asia is a challenge here given the disparity among applicable standards as well as social perceptions of relevant ESG issues.

Many insurers have adopted nuanced approaches to underwriting. Rather than rejecting coverage altogether, they may set underwriting conditions in relation to ESG standards that policyholders must meet or actively work with corporate customers to raise environmental or social standards to an acceptable level before coverage is provided. This approach enables insurers to be a catalyst for positive change, while reducing ESG risks for both the insurer and the policyholder. On the other hand, the approach requires significant ESG expertise within the insurer in order to be successful.

Examples of such an approach are a general insurer engaging in detailed assessments of the environmental impact and social standards of a sports stadium before it is built or working with a chemical plant on a checklist of environmental protections and standards.

ESG and Investment—Where to Draw the Line?

An area that is crucial in the context of ESG risk management (and disclosure) is investment. Insurers share the focus on investment with banks and other large institutional investors.

As with underwriting, many insurers do not invest in certain "blacklisted" industries, such as particular types of fossil fuels. Others have gone further and included, for instance, the tobacco industry in such blacklist. Potential drawbacks of blacklists should be considered—for example, over the last year many U.S. states have passed laws prohibiting the boycott of such industries by banks, asset managers, and other financial services firms. The insurance industry in particular has come under fire, with state Attorneys General opening investigations of certain insurance companies' participation in groups such as the Net Zero Insurance Alliance, pointing to potential antitrust concerns raised by the collaborative efforts of such initiatives.

A complementary approach pursued by some insurers is to issue "green bonds" or "sustainable bonds" whose proceeds are allocated to investments meeting certain ESG-based eligibility criteria. For instance, investments in renewable energy projects may be eligible, while investments in relation to oil, tobacco, alcohol, weapons or gambling may be excluded. "Green bond" investments are subject to additional governance, vetting and reporting mechanisms that provide further reassurance to investors.

A similar approach is being pursued by life insurers with regard to life policies with an investment element. “ESG savings” products are being sold to ESG-conscious policyholders with the promise that the monies received under the policy will be allocated to eligible “ESG-positive” investments such as green bonds. One challenge in this regard in the Asia Pacific region is the relative scarcity of investable “green” opportunities.

An important question is how “ESG-negative” and “ESG-positive” activities should be determined—e.g., are alcohol and sugar as damaging as tobacco? Are human rights or social standards as important as environmental risks? Again, industry consensus and public opinion may be a significant factor in such decisions in the foreseeable future, and Asia may be a particularly challenging region with regard to the identification of companies that should be added to investment blacklists or, conversely, included in “sustainable investment” programs.

The discretion insurers have in relation to the identification and management of ESG risks has two important implications, namely the need for reliable ESG data and the importance of internal governance.

It is crucial that insurers have reliable data in relation to the ESG risks arising from particular entities, whether in the context of underwriting or investment. Industry organisations and regulators can play an important role in this area.

For instance, the MAS has established several platforms for the financial services industry, including insurers, under its “Project Greenprint” umbrella. The framework includes a portal that aggregates sustainability data from several data sources such as major ESG data providers, utilities providers and sectoral platforms. It also includes an “ESG registry” that records and maintains the provenance of ESG certifications and data and a portal that allows conversion and comparability across different reporting frameworks.

The MAS has gone further and signed a memorandum of understanding with CDP, an international non-profit organisation that operates one of the prominent environmental disclosure systems for companies and other entities. Two areas of cooperation between the MAS and CDP are the exchange of ESG-related information between CDP and the Project Greenprint platform of the MAS and capacity building for financial institutions with regard to ESG disclosures.

Other Asian regulators have launched similar platforms, such as the ESG data source repository launched by the Hong Kong Insurance Authority together with other sectoral financial services regulators. Following the example of the MAS, the ESG steering group of Hong Kong financial regulators has also entered into a collaboration

with CDP in order to enhance ESG data availability and accessibility and build know-how with regard to ESG disclosures.

In practice, many insurers have outsourced at least part of their investment management to external managers. Internal application of ESG guidelines and procedures is therefore insufficient. Where asset management has been outsourced, insurers will typically assess the asset manager's approach to ESG, including the assessment of ESG factors as part of investment decisions and potential engagement with issuers, as part of their selection process. Compliance with the insurer's "blacklists" and ESG-investment principles will also typically be monitored on an ongoing basis.

ESG Governance—at the Core of Insurers' ESG Initiatives?

It is clear from the above that ESG-based risk management, underwriting and investment all require significant ESG expertise and resources. Governance is therefore a key focus area of existing regulatory guidance issued with regard to ESG in the insurance industry.

Key principles of governance are sufficient expertise and oversight of the board and senior management in relation to ESG matters, together with appropriate staff expertise and training.

While many insurers may quickly achieve a "superficial" level of ESG compliance (such as publishing ESG principles and making certain disclosures), sophisticated ESG risk management requires staff with the expertise to collect and evaluate ESG data, including with regard to underwriting and investments. Directors and senior managers will increasingly be expected to make (and challenge) strategic decisions based on ESG considerations.

Insurers in Asia are at different stages of development with regard to ESG risks. Some have had sophisticated ESG governance, including a board-level ESG committee, for several years. Others are taking their first steps towards ESG governance, such as recruiting specialist staff and providing training for employees involved in relevant activities.

A particular challenge for ESG risk managers in Asia will be to make their voices heard in organisations that compete in developing markets where ESG risks may be regarded as secondary considerations. The challenge may be more acute for local insurers that are not part of larger international groups with sophisticated ESG guidelines or processes.

Another challenge for directors and senior managers in Asia will be how to navigate sensitive issues such as social or environmental standards and human rights as part of an ESG framework in jurisdictions where the discussion of such issues is discouraged by the government or other powerful actors. Large international insurance groups—who are often subject to global ESG guidelines—will have to approach such issues carefully.

ESG Disclosures

ESG-related disclosures complete the regulatory regime since such disclosures permit investors, policyholders and other stakeholders to understand an insurer's approach to ESG, including governance and specific targets.

A number of financial services regulators who have issued guidelines on ESG (including the MAS and APRA) currently encourage insurers to follow the disclosure regime recommended by the Task Force on Climate-Related Financial Disclosures ("TCFD") or similar international standards.

The TCFD recommendations revolve around four themes, most of which have been discussed above: governance, strategy, risk management, and metrics and targets.

Metrics and targets are a key area since they demonstrate the sophistication of an insurer's ESG assessments and the ambition of their corresponding targets.

A key part of the TCFD recommendations is that companies should disclose their Scope 1, Scope 2 and (if appropriate) Scope 3 greenhouse gas emissions. While many companies assess and disclose their Scope 1 and 2 greenhouse gas emissions, which include direct emissions resulting from their operations and the generation of the energy consumed by them, Scope 3 emissions are more difficult to quantify and include the indirect emissions resulting from, e.g., business travel, purchases of goods and services, and investments. Insurers with more sophisticated ESG governance increasingly assess their Scope 3 emissions or at least specific types of such emissions.

The TCFD disclosures are only a minimum standard with a focus on climate-related disclosures. In practice, many of the larger international insurers go beyond those disclosures in their ESG reports and include information on broader sustainability issues. Disclosures that may be made in such reports include those by reference to the Global Reporting Initiative standards, the Ten Principles of the United Nations Global Compact and the UN Sustainable Development Goals. Many ESG reports also include statements from independent auditors in relation to certain aspects of the report.

ESG reports are often a glossy marketing tool as well as a source of detailed ESG-related information. It is generally expected that ESG disclosures under a specified standard (such as TCFD) will be required rather than encouraged in the near future, including in Asia. For example, the financial regulators in Hong Kong are working toward the goal of making such disclosures mandatory no later than 2025. However, the exact scope and detail of such disclosures will remain under discussion and can be expected to evolve as awareness of ESG issues increases.

Conclusion

Climate and other ESG-related risks are particularly acute in Asia. At the same time, Asia is gearing up to be the largest insurance market in the world. Insurers in the region are faced with the challenge of growing their business in a competitive environment while at the same time performing their role in upholding environmental and social standards.

Successfully navigating such competing demands is a challenge that insurers in the region can only meet by having sufficient ESG expertise at the relevant levels and truly embedding ESG assessments in their risk management and decision-making.

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