ESG: The New Corporate Conscience for Insurers

A Practical Guidance® Practice Note by
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This practice note explains the concept of ESG and its components, discusses the impact that ESG is having on insurers, summarizes the insurance industry's initial responses to ESG, and outlines compliance initiatives insurers should consider when addressing emerging ESG statutory and regulatory requirements.

Prior to the pandemic, "ESG" was barely a whisper, let alone the buzzword that it has evolved into today. Yet, many companies still inquire as to whether ESG is a "thing." ESG is here, and yes, Virginia, it is definitely a "thing." As an acronym, "ESG" stands for its component parts:

Environmental

Social

Governance

ESG has as its underpinnings the confluence of the growing concern about climate change and its effect on businesses, and the changing predilections of the newer generations, such as Millennials (the generation born between 1981 and 1996), Gen Z (the generation born between 1997 and 2012), and even Gen X (the generation born between 1965 and 1980).

For more information about ESG, see Environmental, Social, and Governance (ESG) Resource Kit.

Environmental – Climate Change

Climate change was the initial driver of what we now know as ESG. A Munich Re report showed the dramatic rise in catastrophe losses due to climate change. See Hurricanes, Cold Waves, Tornadoes: Weather Disasters in USA Dominate Natural Disaster Losses in 2021, Munich Re (Jan. 10, 2022). Such losses were $16.7 billion in 2010, rose to $111 billion in 2017 (Hurricanes Harvey, Irma, and Maria), increased to $166 billion in 2019 (with only $57 billion insured), and incrementally increased to $210 billion in 2020 (with only $82 billion insured). This dramatic increase in losses caused all businesses to focus on the effect of climate change in their operations and plans as time has progressed. In the Global Risks Report 2022 by the World Economic Forum (Jan. 11, 2022), respondents to the report's survey identified climate action failure and extreme weather as the two most severe risks to be encountered by the world economy.

The insurance business world was already recognizing the need to address climate change before the pandemic. However, a number of insurance companies, international brokers, and ratings agencies recently have been pushing climate change initiatives. In 2019, Zurich Insurance Group signed up to the Business Ambition pledge to reduce global temperature increases to under 1.5°C and has recently pledged to reduce emissions from operations by 70% by 2029. In 2020, Aviva committed to reduce its carbon footprint to net zero by 2040. Swiss Re has committed to achieving net zero emissions for its own operations by 2030, and committed to reduce carbon intensity by 35%

for corporate bonds and its equity portfolio by 2025. In 2021, Lloyd's of London committed to attaining operational and attributable gas emissions to net zero by 2050 at the latest. Also in 2019, Chubb Ltd. initiated its coal policy by which it promised to end new policies for companies that generate more than 30% revenues from thermal coal mining and to phase out existing coverage for those companies in the next year or two. In 2021, Chubb ended coverage on a pipeline project, the Trans Mountain tar sands expansion project. In the same time frame, Liberty Mutual Group committed to cut 50% of its scope one and scope two greenhouse gas (based on 2019 levels) by 2030. Marsh & McClennan initiated a D&O insurance initiative that would reward clients who met certain ESG criteria with enhanced terms and conditions. At least four major carriers have joined the initiative, including AIG, Berkshire Hathaway, Sompo International, and Zurich North America. Finally, AIG announced that it would no longer provide underwriting services and investments for the construction of any new coal-fired power plants, thermal coal mines, or oil sands. These are just a few of many such examples.

Social – Investor and Customer Pressure

In addition to concerns about the effect on climate change, the rise of the Millennials and Gen Z / Gen X as investors and customers has also impacted the focus on ESG factors. These younger generations are already having an impact in the way that insurance is sold and delivered as confirmed by the proliferation of technology ("Insurtech") companies and products. The effect of these generational views is also a driving factor in the ascendency of ESG. A CNBC report shows that sustainable investments by Millennials grew ten-fold from 2015 ($5 billion) to 2020 ($51.1 billion). See Alicia Adamczyk, Millennials Spurred Growth in Sustainable Investing for Years; Now, all Generations are Interested in ESG Options (May 21, 2021). A related study also showed that close to one-third of Millennials often use ESG-related investments, as compared to 19% of Gen Z, 16% of Gen X, and 2% of Baby Boomers. See Millennials are a Driving Factor in the Growth Behind ESG Investments, EFT Trends and Nasdaq (May 25, 2021). Many Millennials and Gen Zs seem to have common views on issues such as climate change and race. Millennials comprised 72.1 million people in the United States in 2019. Gen Z totaled 25.9% of the U.S. population that year.

In addition to their own wealth and investments, these two groups are likely to inherit approximately $30 trillion dollars from their older generation parents. Studies of Millennials have shown that:

- 86% are interested in impact investing
- 89% expect their financial advisors to vet a company's ESG factors and history before making an investment recommendation –and–
- 76% consider climate change to be a serious threat to society

Similarly, studies of Gen Z's show:

- 80% factor ESG into investment decisions
- Gen Z's are more likely to buy sustainable brands and are willing to pay more to do so –and–
- 28% see climate change as one of their greatest concerns

See Tiffany Robertson, Millennial and Gen Z Investors Grow to Embrace ESG Issues, The Impactivate (Dec. 7. 2021).

Given the potential impact of these potential investors and customers, it is therefore no surprise that the financial sector, including insurance companies, have begun to focus on the effect of ESG factors on their business.

The investment markets have mirrored the priorities of these younger generations. Another 2021 study found that:

- ESG assets under management could grow to $53 trillion—approximately one-third of all assets under management
- Europe accounted in 2020 for half of ESG assets, but the United States may overtake Europe by as early as 2022
- ESG exchange-traded funds would surpass $190 billion by the end of 2021 and could be as high as $1 trillion by 2025
- ESG debt market as of the end of 2020 was about $2.2 trillion, but was expected to grow to $11 trillion by 2025 –and–
- Organic growth of ESG debt is unlikely to slow and will be driven by companies, development projects, and central banks alike

See ESG assets may hit $53 trillion by 2025, a third of global AUM (Feb. 23, 2021).

As the younger generations attain more wealth, it appears that these trends will continue to develop.

Governance

An increase in the focus of governance is nothing new to the insurance sector. The initiation of the Corporate Governance Annual Disclosure Model Act (CGAD) and the Own Risk and Solvency Assessment Model Act (ORSA) as a part of the governance framework by the National

Association of Insurance Commissioners (NAIC) are only recent instances of an increased focus by regulators on the governance and forward-looking management necessary for insurance companies. While the "G" in ESG is not new, it does emphasize that the recognition of environmental and social factors in the business analysis is meaningless if it is not made a part of the fabric of a company's plans through adequate top-down governance.

See NAIC Model Laws, Regulations and Guidelines 305-1, §§ 1–10 and NAIC Model Laws, Regulations and Guidelines 305-1, State Adoption and NAIC Model Laws, Regulations and Guidelines 505-1, §§ 1–11 and NAIC Model Laws, Regulations and Guidelines 505-1, State Adoption.

For details about Corporate Governance Annual Disclosures and Own Risk and Solvency Assessments across the 50 states, see these topics in the drop down menu on the Insurance Practical Guidance **State Law Comparison Tool**.

Rating Agency Reaction

As these trends in climate change and generational shifts in investment focus were developing, rating companies also were endorsing ESG principles into their rating methodologies. In recent reporting, DBRS Morningstar announced that it is more formally including 17 ESG factors into its rating process:

> The assessment of environmental risks is a major component of DBRS Morningstar's analysis for the property and casualty (P&C) insurance business.

Five of those factors relate to the environment.

In that same report, the firm's head of global structured finance research further elaborated:

> What we're doing now is we're bringing these ESG factors forward and out so that they are identified and discussed [formally] in the ratings process. Where we find that one of these factors is involved and influential in determining our ratings, we will then be identifying that and detailing that in our press releases and ratings reports.

In an online letter directed to its clients, BlackRock Institutions announced its commitment to evaluating ESG "with the same rigor that it analyses traditional measures such as credit and liquidity risk."

At the end of 2020, AM Best reported that

> AM Best has refined its Best Credit Rating Methodology (BCRM) to enhance transparency as to how it contemplates ESG risks as part of the credit rating analysis. AM Best will continue addressing climate risk, innovation and enterprise risk management in the assignment of a rating.

See AM Best Clarifies How Insurers" ESG Risks Are Considered in Credit Rating Process (December 21, 2020).

Consistent with its prior announcement, in 2021 AM Best reported that ESG factors were considered one of the drivers of 13% of its global ratings for the 12-month period ending in March 2021. AM Best indicated that in the majority of those cases, environment factors were the ESG driver.

See Impact of ESG Factors on AM Best's Rating Actions, AM Best (July 14, 2021).

Further, while Milliman is not a rating agency, it noted in a 2020 whitepaper that

> ESG considerations cannot be overlooked by insurers in today's environment, given the growing prominence of such issues. As awareness of sustainability increasingly influences customer demand and as regulatory attention to this area grows, insurers must ensure their positions on ESG matters are clear and that management are aligned to them. This will be increasingly important not only in order to maintain brand and reputation, but also to remain competitive as customer demand evolves.

See Claire Booth, Amy Nicholson, and Natasha Singhal, ESG Considerations in the Insurance Industry, Milliman (July 15, 2020) at page 8.

Regulatory Actions

An overview of the actions of insurance regulators around the world is really a tale of two cities. In the United States, regulator reaction has been slow to develop. In the European Union, the regulator activity has been very robust and world-leading.

U.S. Regulatory Actions

The U.S. regulatory reaction has been slow and primarily exploratory in nature. The Securities and Exchange Commissions has begun reviewing these issues and has:

- Requested comment on climate disclosure
- Enhanced its focus on climate-related disclosure in public company filings –and–
- Created an enforcement task force focused on climate and ESG issues

See SEC Response to Climate and ESG Risks and Opportunities (Oct. 26, 2021).

In a speech to the 2021 Society of Corporate Governance National Conference, SEC Commissioner Allison Herren Lee commented:

> We should consider whether public pledges on ESG issues are actually backed up by corporate action. That's part of my message . . . that substantive consideration of ESG should be meaningfully integrated into board oversight . . . [a]nd why I've previously suggested that our disclosure regime should provide investors with adequate information to test public pledges like these.

See A changing boardroom climate: insurance planning with ESG in mind (Sept. 24, 2021).

However, the SEC has not taken any formal action with regard to ESG principles.

Similarly, the National Association of Insurance Commissioners does not appear to have taken any action regarding ESG principles than to seek data from insurers on their disclosure of climate change risks. However, at least one state—New York—through its Department of Financial Services, has required that financial institutions, including insurers, must "start integrating the financial risks from climate change into their governance frameworks, risk management processes, and business strategies." Further, the department requires that such institutions

> conduct a risk assessment of the physical and transition risks of climate change, whether directly impacting them, or indirectly due to the disruptive consequences of climate change in the communities they serve and on their customers, such as business disruptions, out-migrations, loss of income and higher default rates, supply chain other disruptions, and changes in investor and consumer sentiments, and start developing strategic plans, including an outline of such risks, the impact on their balance sheets, and steps to be taken to mitigate such risks.

See New York Department of Financial Services Industry letter, Climate Change and Financial Risks (Oct. 29, 2020).

It is not clear what, if any, action the New York Department of Financial Services has taken to date to enforce this industry directive.

European Union

Unlike the United States, the European Union and such countries as United Kingdom have taken robust regulatory action. As it did with data security and privacy, the European Union has taken a leading role in setting standards for financial institutions to analyze and report ESG factors affecting their businesses. While it would take a practice note far longer than this to effectively describe in detail the specifics of the European Union regulatory scheme, a summary of the critical elements follows.

The Sustainable Finance Disclosure Regulation (SFDR) became effective on March 10, 2021. See Regulation EU 2019/2088. The regulation set forth the basic standards for sustainability-related disclosures in the financial services sector, which includes insurance companies. The aim of the SFDR is to provide investors with "accurate, fair, clear, not misleading" ESG information about products in the financial services sector. The SFDR complements the previous Non-Financial Reporting Directive (NFRD), (see Regulation 2014/95/EU), which required large companies to report on how their business affects the environment and the people they employ, as well as their customers. The NFRD was replaced and updated by the Corporate Sustainability Reporting Directive (CSRD), (see COM/2021/189) which introduces tougher reporting requirements and audits of ESG-related information. This group of regulations is supplemented and amended by the EU Taxonomy Regulation, Regulation 2020/852/EU, which provided the conceptual framework and vocabulary for the reporting requirements. To provide further clarity to the regulations, the Taxonomy Regulation permitted European Supervisory Authority (ESA's) draft regulatory technical standards (RTS) for additional disclosures on products using "environmental" taxonomy. Several draft RTS have been circulated for discussion, with the latest and proposed final RTS in October 2021. The RTS were expected to have an application date of July 1, 2022, but that date was later moved to January 1, 2023.

The SFDR imposed three types of disclosure requirements:

- Entity-level principal adverse impact assessments
- Pre-contractual and website product disclosure –and–
- Periodic product disclosure

As to the entity-level principal adverse impact assessments, companies are required to measure the adverse impact against certain core environmental (e.g., carbon emissions, energy consumption from nonrenewable sources) and social (e.g., gender pay gap, board gender diversity) indicators. Companies must compare the indicators against the prior year's assessment and identify the policies used to identify and prioritize the adverse impacts. The RTS initially contained 32 mandatory indicators and 18 additional indicators of which companies must report as against at least two.

The second SFDR reporting criteria, pre-contractual and website product disclosure, requires companies to show that their products promote environmental or social characteristics, or have sustainable investments or reductions in carbon emissions as their objective. The required disclosures include the planned proportion of sustainable investments (and the split between environmentally and socially sustainable investments), an explanation of how the investments comply with the "do not significantly harm" principle set out in the SFDR and Taxonomy Regulation, and a list of the indicators used to measure the attainment of the environmentally and socially sustainable investments. The final RTS is supposed to provide a template for the presentation of this information. Finally, the SFDR and RTS require certain information to be provided on a company or firm's website, including how environmental, social, and sustainability indicators are tracked during the life of a product, the methodologies used to measure the attainment of the environmental or social characteristics, the data sources used, and any limitations to the methodologies and data.

The third SFDR reporting requirement relates to financial products promoting environmental and social characteristics. The information required to be reported includes the degree to which attainment of social and environmental characteristics occurred during the period, a list of the largest investments of the financial product, a breakdown of total investments, and actions taken within the reporting period to achieve the social and environmental characteristics.

EU reporting companies not only have to deal with this very complex set of reporting requirements, but also a new set of vocabulary as well. EU firms now have to become conversant with a whole new set of terms. As noted above, the EU Taxonomy Regulation provided the reporting framework and vocabulary for the SFDR. One main reporting and vocabulary item was for companies to report on whether their activities were "environmentally sustainable."

The Taxonomy Regulation requires that the activity substantially contributes to one or more of 12 different environmental objectives, which include:

- Climate change mitigation (e.g., reduces greenhouse gas emissions, uses renewable or carbon-neutral fuels)
- Sustainable use and protection of water and marine resources (e.g., protecting or restoring the marine environment)
- Transition to a circular economy (e.g., reusability, recyclability, or prolonging use of products)
- Preventing/controlling pollution –and–
- Protecting/restoring biodiversity and ecosystems

In addition, in order to be environmentally sustainable, the activity must do no significant harm to the environmental objectives (DNSH) and comply with minimum social safeguards (e.g., relating to human rights and international labor standards).

While EU companies are still trying to understand the ground rules, reporting formats, and myriads of acronyms of the SFDR, NFRD, CSRD, and the EU Taxonomy Regulation, the European Commission continues to move forward with other ESG initiatives, which could extend the application of ESG principles. Proposals are on the table to add climate change mitigation and adaptation covering nuclear and gas activities, provide additional framework around sustainable use and protection of water resources, increased disclosure obligations under the SFDR, extension of the NFRD to smaller companies, strengthening the enforcement of environmental criminal law, and encouraging investment in green bonds. Moreover, the EU Commission has signaled that it plans to submit draft legislation in 2022 for a mandatory supply chain due diligence law that would require EU businesses to investigate and mitigate the risk of forced labor in their operations and supply chains.

The summary above of EU activity on ESG is a brief and high level view of a complex and evolving regulatory scheme. What is clear, however, is that the EU is taking a very proactive view of ESG and is making recognition, reporting, and mitigation of ESG issues mandatory and a part of the fabric of everyday corporate life.

What Are U.S. Companies Doing?

As is evident from the initial question as to whether ESG is a "thing," there is a substantial amount of confusion regarding what companies are doing and should do. A 2021 study by PriceWaterhouseCoopers (PWC) showed that 75% of companies were only at the beginning of consideration of ESG issues. However, approximately 90% of S&P 500 companies published sustainability reports in 2019. See Annual Corporate Directors Survey, PriceWaterhouseCoopers (2021). Further, a recent article about a September 2021 survey conducted by OCEG (a corporate governance advocacy nonprofit) reported that while 78% of the respondents (530 corporate executives) thought ESG will have an impact on brand and reputation, only 48% thought ESG would affect their company's financial outcome. Of those same executives, 28% had no confidence that their organizations had mature, well-documented ESG capabilities. Thirty percent felt that they had minimal confidence in their company's ESG programs. Only nine percent were highly confident in their ESG capabilities. Notwithstanding the lack of confidence in the ESG planning capabilities, over 50% of the respondents indicated that their companies already or will consider ESG factors in evaluating compensation for their executives. See Jessica DiNapoli, Most executives think their ESG programs fall short, survey finds (Sept. 15, 2021).

One of the critical issues facing companies is the lack of regulatory guidance and/or uniform reporting standards. This lack of uniformity and guidance was cited by companies as the top barrier to ESG reporting effectiveness in the PWC study. Similarly, over 70% of insurers and reinsurers in an AM Best survey called for more direction from regulators on ESG. See Best's Special Report: US Insurers Seeing Need to Adapt to Evolving ESG Demands, Survey Finds, Best's News & Research Service (Oct. 29, 2021). Indeed, the state attorneys general from New York and California have both written letters to the Securities and Exchange Commission asking for more guidance on ESG. This lack of uniformity is also an issue in the EU, where the final RTS purporting to provide a final framework and template to the SFDR are still under review and the implementation dates pushed off another year until 2023.

As with all corporate initiatives, companies must balance the initiative against growth and profitability targets. Quantification of potential return on investment of ESG goals is key and many companies are not confident in their forecasting ability. Adding to the potential inadequacy of forecasting is the lack of complete and consistent data. In the EU where the standards, while not finalized, are much more advanced and defined, data availability is incomplete and inconsistent. Data vendors do not have all the same data and vendor consensus is not very high. There is neither a great degree of standardization nor transparency to the methodologies used to score ESG elements. There are low levels of correlation due to individual and different calculation methodologies to determine ESG compliance. Compounding the problem is that ESG data providers are not regulated. See Adrian Whelan, SFDR Base Camp Reached: Now Comes the Hard Part, Brown Brothers Harriman (Mar. 29, 2021). With a near total lack of regulatory direction, the likelihood is that the issues of lack of data uniformity and scarcity is incrementally more problematic in the United States.

What Should U.S. Insurance Companies Do?

Notwithstanding the lack of action by U.S. regulators, ESG is clearly here to stay and must be dealt with by U.S. insurance companies. If the history of capital and privacy regulation repeats itself, the likelihood is that U.S. regulation ultimately will be closer to its EU counterpart than not. Even if U.S. regulation does not require material ESG disclosures, the competitive effect of European companies making such disclosures required by the EU, will effectively draft U.S. companies to make similar disclosures. Accordingly, U.S. companies should pay attention to the developments of ESG regulation in the EU.

Companies should start the process of developing ESG plans. Management should, if it has not already, reconsider its overall strategy and its view of the future to incorporate ESG principles and disclosure. A comprehensive analysis of ESG factors in the insurance business should be prepared. Law firms and consultants are available to assist in this process and consultants can be used to supplement company expertise. Many consultants and law firms are strengthening their bench strength to assist clients. For example, PWC announced that it intended to expand its ESG capabilities, hiring as many as 10,000 new personnel in this effort. Whether in conjunction with consultants and law firms, or not, insurance companies should incorporate ESG risk criteria in their underwriting and risk analysis.

It is not enough that companies begin to think about and incorporate ESG into their business plans. ESG targets have to be benchmarked, disclosed, and tracked over time and their success prioritized. The success of the business plans will be dependent upon the persistence and drive of senior management, who must dedicate adequate resources to the ESG initiatives. U.S. companies should begin to consider ESG-related disclosures and transparency. Companies should beware, however, of "greenwashing" (materially overstating or misrepresenting environmental or sustainability characteristics) as such statements will likely be heavily scrutinized by regulators. Consequently, any such disclosures will have to be backed by objective and reasonable information.

The evolution of ESG and its impact on the business plans and disclosures made by U.S. insurance companies is in its infancy and should be watched carefully by companies that do not want to be left behind or find themselves at a competitive disadvantage.

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Jim also drafts reinsurance agreements and handles reinsurance disputes. He is a certified reinsurance arbitrator. He advises clients on the drafting of life and property and casualty reinsurance agreements, structures securitized international financial transactions backed by insurance guarantees, and advises clients on structuring reinsurance transactions involving SPVs and backed by capital market investments. In his previous role as division general counsel, he was responsible for drafting and interpreting the reinsurance treaties placed annually by the division and was involved in the commutation of hundreds of reinsurance treaties.

Jim also previously served for nine years as senior counsel advising the rehabilitator of one of the largest insurance insolvencies in the United States - *Mutual Fire Marine and Inland Insurance Company, In Rehabilitation*. As a result of his substantial experience with insurance insolvencies and runoffs, he frequently represents clients who have issues with insurance companies in runoff and liquidation. He also has substantial international experience in the restructure of financially impaired, insolvent or bankrupt entities. Jim also handled substantial litigation in the United Kingdom, Japan, China, Argentina, Brazil and the Virgin Islands and brings more than 30 years of domestic litigation experience to the Insurance Practice.