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REGULATION

Insurance and the journey towards carbon net-zero

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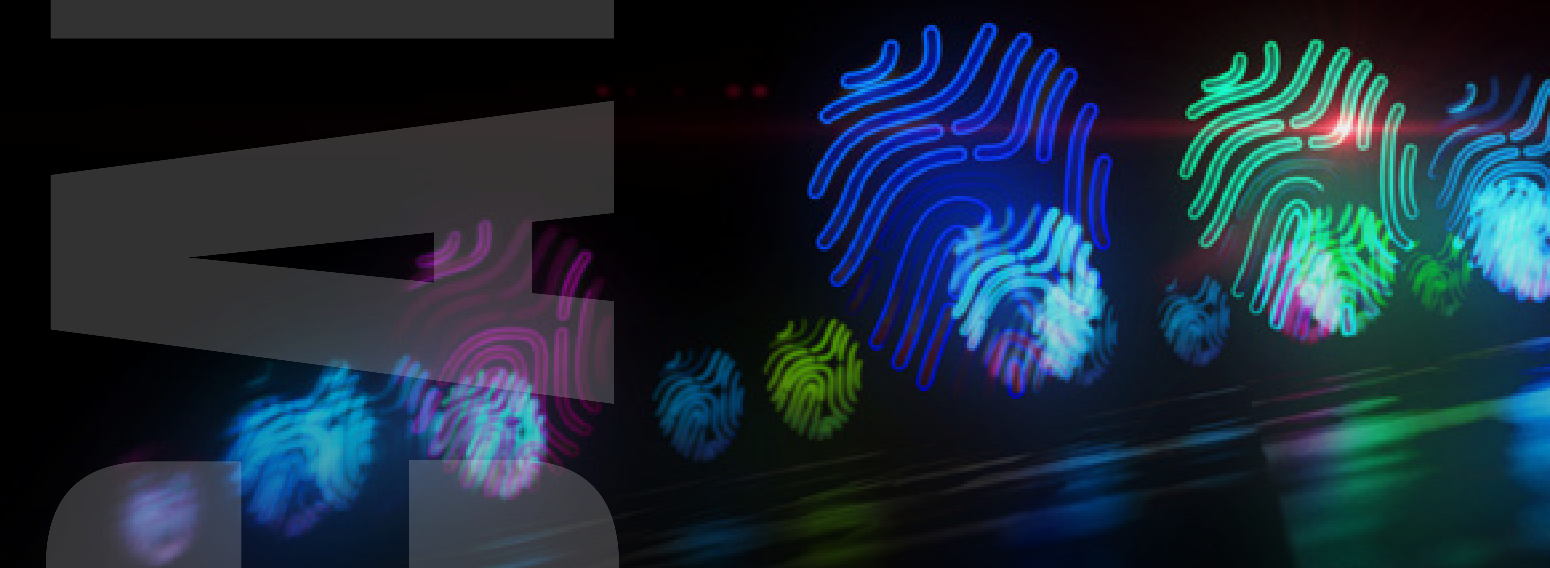

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DEAR READER,

Welcome to edition 54 of the Capco Institute Journal of Financial Transformation.

In this edition we explore recent transformative developments in the insurance industry, through Capco's Global Insurance Survey of consumers in 13 key markets, which highlights that the future of insurance will be personalized, digitalized, and connected. Other important papers cover topics high on global corporate and political agendas, from ESG and climate change to artificial intelligence and regulation.

The insurance industry has been undergoing transformation in recent years, with insurers responding to the needs and expectation of tomorrow's customers, for products that were tailored, flexible, and available anytime, anyplace, and at a competitive price.

COVID-19 has accelerated such change, forcing insurers to immediately implement programs to ensure they can continue selling their products and services in digital environments without face-to-face interaction. New entrants have also spurred innovation, and are reshaping the competitive landscape, through digital transformation.

The contributions in this edition come from a range of world-class experts across industry and academia in our continued effort to curate the very best expertise, independent thinking and strategic insight for a future-focused financial services sector.

As ever, I hope you find the latest edition of the Capco Journal to be engaging and informative.

Thank you to all our contributors and thank you for reading.

Lance Levy, **Capco CEO**

INSURANCE AND THE JOURNEY TOWARDS CARBON NET-ZERO[1]

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ABSTRACT

In this article, we consider current sustainability practices, future objectives, and the views of key decision-makers from a wide range of European insurers. Given their long-term investment horizons, risk-management capabilities, and stringent regulatory framework, insurance companies are both highly exposed to ESG (environmental, social, and governance) challenges and, potentially, well equipped to turn some of those risks into opportunities. We discuss the key themes that arose from our research, including an overwhelming focus on environmental factors driven by risk management considerations and regulation. We go further to assess the practical challenges associated with developing and adopting decarbonization targets for insurers' investment portfolios. These challenges are not insurmountable, but they will require insurers, asset managers, policymakers, and regulators to work together to find practical and scalable solutions.

1. INTRODUCTION

In late-2020, abrdn commissioned a survey in partnership with Indefi. This involved more than 60 chief investment officers and heads of sustainable investment across Europe's five largest insurance markets: U.K., Germany, France, Italy, and Switzerland. The insurance sectors covered were property and casualty, life insurance, and reinsurance. At abrdn, we manage £221 billion of assets under management for insurers globally.[2] The aim of our research was to investigate how insurance investors are responding to environmental, social and governance (ESG) challenges, and their plans for the future. In this article, I will summarize the themes emerging from this research and also some of the practical challenges for our clients in moving towards carbon net-zero investment portfolios.

Insurers are becoming increasingly aware of the risks that climate change poses to their business in terms of assets and liabilities. As part of their efforts to consider and act on climate-change risks, the insurance industry is increasingly committing to net-zero targets for their own operations and their investment portfolios and strategies. There is an increasing recognition within the sector of the risks that climate change will bring for insurers, both directly but also through their investments. Increasingly, regulators require insurers to assess the potential climate risks to which they are exposed. These regulations do not require net-zero targets to be set for insurers, however, similar to other businesses, insurers are under increasing pressure from their own shareholders, customers, employees, non-profit organizations, and policymakers to commit to net-zero targets. Consequently, net-zero commitments have been made by many insurers

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[2] As at June 30, 2021

and pension funds. Given the uncertainty of the regulatory landscape, that will be essential to help move to a net-zero world. Membership of the Net Zero Asset Owners Alliance (NZAOA) now covers around U.S.$6.6 trillion of assets and is growing constantly.

2. CURRENT PERSPECTIVE ON THE EUROPEAN INSURANCE INDUSTRY

While our recent ESG research focused on the five largest European markets, we have frequently observed the same themes emerging to varying degrees from clients in North America and Asia.

Our research highlighted five main emerging themes:

2.1 Theme 1: Climate change a driver of innovation

In terms of the concrete ESG portfolio objectives set by insurance companies, almost all focus on climate change. These include carbon-footprint reduction, allocation to green assets, and net-zero commitments. This focus is driven by regulation, which has emphasized climate change as central to sustainable finance. Regulators have also facilitated climate action by providing investors with the necessary tools to measure risk and their contribution to the energy transition. This emphasis has yielded an array of increasingly sophisticated analytical tools and methodologies. It demonstrates the industry's innovative capabilities and its vast potential to address the rest of the United Nations' Sustainable Development Goals (UN SDG) in the same way.

2.2 Theme 2: Drivers for adopting ESG

While there are a number of reasons for adopting ESG strategies – including values, ethics, and regulation – risk management was the main driver. Around 81% of respondents cited this as the main reason why they were considering ESG in their investment strategies. Only 33% of respondents saw ESG as a business or marketing opportunity, which emphasizes that ESG integration is seen as a risk mitigator rather than a value creator.

It was also apparent that insurers with longer-term investment horizons, primarily life and pensions insurers, saw this as a key reason to consider climate-related risks.

2.3 Theme 3: Evolving the tools and techniques to support ESG integration

Innovations in ESG practices will come predominantly from two groups of market participants. Firstly, there are the pioneers of sustainable investment (chiefly large firms). These

Table 1: Main drivers of sustainable investment in insurance

MAIN DRIVERS OF SUSTAINABLE INVESTMENT IN INSURANCE BY COUNTRY					
	U.K.	GERMANY	SWITZERLAND	ITALY	FRANCE
Values and ethics	● (50%-75%)	● (25%-50%)	● (25%-50%)	● (>75%)	● (50%-75%)
Risk management	● (>75%)	● (50%-75%)	● (50%-75%)	● (>75%)	● (>75%)
Stakeholder management	● (>75%)	● (50%-75%)	● (>75%)	● (25%-50%)	● (25%-50%)
Regulation	● (50%-75%)	● (50%-75%)	● (50%-75%)	● (25%-50%)	● (>75%)
Investment opportunities	● (25%-50%)	● (25%-50%)	● (<25%)	● (<25%)	● (25%-50%)
Business opportunities	● (25%-50%)	● (25%-50%)	● (<25%)	● (<25%)	● (25%-50%)
MAIN DRIVERS OF SUSTAINABLE INVESTMENT IN INSURANCE BY BUSINESS LINE					
	LIFE	P&C	REINSURANCE		
Values and ethics	● (50%-75%)	● (25%-50%)	● (>75%)		
Risk management	● (>75%)	● (50%-75%)	● (>75%)		
Stakeholder management	● (50%-75%)	● (25%-50%)	● (25%-50%)		
Regulation	● (>75%)	● (25%-50%)	● (>75%)		
Investment opportunities	● (25%-50%)	● (<25%)	● (<25%)		
Business opportunities	● (25%-50%)	● (<25%)	● (<25%)		

Notes: ● (<25%), ● (25%-50%), ● (50%-75%), ● (>75%)

companies were the first to adopt ESG practices and remain at the forefront. Secondly, there are the potential innovators or “leap-froggers”. These are typically smaller firms that have only recently adopted ESG, but their late entry leaves them poised to exploit the maturity of the market. They innovate through new strategies or climate frameworks, and they are not constrained by processes that are embedded but potentially outdated.

Respondents highlighted that while some of the factors that impeded ESG integration a few years ago (such as the lack of reliable data) are now diminishing, more structural constraints persist. These include the search for yield to support investment-income requirements and constraints on the investable universe because of the need to meet capital requirements. This indicates that we are likely to see innovation in ESG-related investment solutions, such as measurement, stress-testing, and optimization tools in the future.

2.4 Theme 4: Juggling E, S, and G

The sustainable practices adopted by European insurance companies fall into four broad categories with significant overlap. These are exclusion, ESG integration, stewardship and impact, and thematic investing.

Although most respondents consider ESG as a single factor, nearly all recognize the drawbacks of this broad-brush approach. So far, the E in ESG has been by far the dominant factor. This is because it is the most quantifiable and material of the three elements in ESG. Environmental issues have attracted the overwhelming majority of attention from insurers, who employ all the elements in the ESG patchwork to address these issues (from coal exclusions, to engaging with companies on climate risk, to investing in climate solutions).

Undoubtedly the COVID-19 pandemic has led to a growing focus on social issues, particularly in the context of economic recovery and safeguarding jobs. But the S in ESG is seen as less material than environmental issues, and there is no consensus on how social issues should be measured. Nor is there any consensus as to how social indicators should be integrated into investment strategies. These issues are largely a result of poor reporting on social factors and a lack of consistency that comes with social reporting. But until they are addressed, we expect they will continue to impede government strategies that are using the longer-term investment capital of insurers and pension schemes to support post-COVID investment programs.

2.5 Theme 5: The role of asset managers

Most European insurance companies extend their ESG policies to outsourced assets and place ESG at the core of their discussions with asset managers. Asset managers have a pivotal role to play in the transition to a sustainable investment model. Lagging asset owners will look towards their managers for tools and support in navigating the sustainable investment landscape. Simultaneously, leading insurers will increasingly scrutinize managers in an effort to curb “greenwashing” and to find effective integration.

The rapid development of sustainable investment in the European insurance landscape presents a clear opportunity for asset managers to extend their role beyond asset management. They can help their clients manage extra-financial risks, contribute to SDGs (sustainable development goals) solutions, and warn that there is a risk of losing assets if managers fail to innovate with solutions to support their clients. One of the challenges is that the SDGs were set up by government and civil society to address world problems. They are not very investor-friendly and the transfer to companies/investments is proving challenging.

2.6 COVID-19 and insurers’ responses

While COVID-19 was not a specific focus of our survey, many respondents gave their thoughts on the impact of the pandemic on their approach to ESG. Only a few respondents saw the pandemic as an opportunity to start considering ESG, particularly in light of the strong performance of ESG products in the first half of 2020. In contrast, more advanced ESG players saw the pandemic as an opportunity to invest in social products and to increase their efforts towards sustainable investment.

3. SO WHAT NEXT? THE CASE FOR, AND THE CHALLENGES WITH, INTERIM TARGETS FOR NET-ZERO

Our research highlighted that while the target is to be carbon net-zero by 2050 or, in some cases, 2040, the magnitude of the issue and actions required warrant immediate attention. But there is significant uncertainty when looking over a 20-to-30-year horizon because of a lack of certainty as to how governments will regulate on climate change. This is particularly the case when the focus is on an area that could be exposed to significant policy changes and technological developments.

3.1 The practical challenges associated with adopting interim net-zero targets for insurers' investment portfolios

Insurers are not required by regulation to set or disclose interim net-zero targets, although NZAOA (Net Zero Asset Owners Alliance) requires members to set interim targets within one year of joining. Indeed, often corporate-level commitments are made externally ahead of insurers determining the detail of how to achieve the ultimate goals. One area of increasing focus is breaking down the target into manageable chunks, such as setting interim targets for the next 5-10 years, so that progress towards the long-term 2050 (or sooner) goal can be demonstrated.

Interim targets in themselves are not straightforward to set, but the focus is increasing on this area and progress is being made. NZAOA has published guidance on how firms should develop and set these targets. It says that emissions need to be reduced by 16-29% by 2025 to ensure a pathway to net-zero. These figures are informed by work from the Intergovernmental Panel on Climate Change (IPCC).

While insurers are not currently required to set net-zero targets, they are increasingly required by regulators to assess the climate risks to which they may be exposed. This assessment is typically embedded in requirements that relate to risk management and governance for an insurer. Many regulators globally have introduced requirements for insurers to develop scenario-testing to assess the impact on their portfolio of differing climate transition pathways. Insurers will, therefore, become increasingly familiar with climate-scenario testing. This is useful for a range of reasons, including net-zero target setting and the development of investment approaches to achieve the targets set.

But the reality is that each firm that commits to net-zero and sets interim progress targets will have a unique set of circumstances to consider. They also need an actionable investment strategy and there is no easy solution to this challenge. Some of the considerations for insurers include their investment management framework, new business growth, customer redemptions and claims across the medium-to-long term, different liability characteristics and related limitations, and the corporate appetite to adopt ESG practices for their funds and policyholders. The reality of committing to interim targets could necessitate changes to current practice.

We have recently assisted insurance clients in assessing how they can achieve their net-zero targets and we have found a two-step approach to be useful. In one instance, we applied this approach to an existing £4 billion global multi-asset portfolio, with a diversity of investment management styles. We worked with the insurer's investment management team to consider the practical implications of implementing specific net-zero interim targets:

- **Step 1:** Assessing the expected decarbonization trajectories of a benchmark (existing) portfolio: what is the trajectory for the market? For example, the carbon intensity of the FTSE 100 is likely to be lower in five years than it is today. Consequently, even a passive portfolio will exhibit a level of natural decarbonization because of the changing market. Assessing this is not straightforward. For a start, which climate transition pathway is assumed? Various pathways have been published by expert agencies, but placing undue reliance on any one example may not be prudent. There are different assumptions about policy uniformity across regions and sectors that consequently weaken their usefulness for investment integration. At abrdn, our climate-scenario approach tries to overcome this issue by considering a range of bespoke and off-the-shelf scenarios. We apply our judgment to assess the probability of each scenario occurring. We look at the economic shocks expected under a probability-weighted scenario on a stock-by-stock basis, rather than by sector or asset class. We can then aggregate for any given benchmark or fund. We recently published a white paper "Climate-scenario analysis: a rigorous framework for managing climate financial risks and opportunities" that sets out in detail our approach to climate-scenario analysis in our asset-management activities. A practical example of this involved working with a client where we estimated equity indices to reduce their carbon intensity by about 44% by 2030. Against their own target of a 55-66% reduction over that timeframe, this helped them assess how much further their portfolios must go to achieve that extra 11-22% reduction.
- **Step 2:** Assessing how much further your portfolio must go: once the reduction estimate is known, asset owners can have a good view of the expected level of decarbonization they will need to achieve through more active means. There are a whole host of approaches to consider, but two have proved popular with our clients:

- Identify how we can adjust the current portfolios to further decarbonize while being aware of the pre-existing mandate requirements. For example, we can try to minimize turnover, changes to tracking error, or volatility. Some have chosen to do this through allocations to climate-friendly passive funds. But the challenge here is that different funds will have different approaches and ways of measuring a low-carbon future.
- At the portfolio level, consider how climate considerations can be embedded within the strategic asset allocation process without losing sight of the traditional objectives of risk. This could be focused on investment return targets, solvency capital ratios, and asset-liability matching requirements. This approach also considers whether climate-tilted benchmarks are appropriate in the context of the overall investment objectives. It also assesses the cost of transitioning to these more climate-focused strategies.

3.2 Considerations beyond the target

The most significant aspect of our work with clients is currently on target setting and climate-scenario stress testing. But there are other considerations for insurers' investment teams and boards that are equally complex to address and solve:

- A scalable and consistent ESG measurement framework, as many insurers use a combination of internal and external asset-management teams. In the absence of industry-wide taxonomies and measurement methodologies, many insurers are developing and designing their own climate and impact-measurement frameworks. These can then be applied across their portfolios. This is a challenging exercise to design and implement, and it also requires continuous improvement and evolution over time.
- ESG integration and whether to take a common approach across all business lines. In our survey, we identified that 41% of life-insurance companies are trying to ensure a minimum standard of investment solutions are available to their clients. Mostly, insurance companies try to ensure that the unit-linked products they offer do not violate sustainability objectives pursued by general-account assets. But a potential exception is an insurer's approach to engagement with the underlying investment universe and whether this should differ between funds or business lines. How do you quantify and report the impact of this engagement to the relevant stakeholders in a meaningful and relevant way?
- When, and to what extent, do E, S, or G factors become the priority outcome before investment risk and return?

- Exclusions – should stock- or sector-specific exclusions in the investment universe also extend to exclusions in customer groups, underwriting, or other business interests?
- How quickly are portfolios to be transitioned and who should bear the transition cost? We have seen insurers contemplate this, particularly with regard to the life and pensions sector where policyholder engagement levels are traditionally low and policyholder consent is often problematic to attain.
- Product innovation – does ESG integration present business growth opportunities through new investment solutions or target markets, particularly for the life and pensions sector?

4. CONCLUSION

In conclusion, there are challenges to be overcome for insurers to progress ESG investment themes, particularly for climate-related investments. But the opportunity for the insurance investment industry to shape and influence how ESG goals are achieved in domestic and global economies is significant. This is because of the size and scale of insurers' investment portfolios. These challenges are not insurmountable, but they will require insurers, asset managers, policymakers, and regulators to work together to find practical and scalable solutions.

All insurance participants in this sector – life and pensions, property and casualty, and reinsurers – have a role to play. They have the ability, through the design and implementation of ESG-focused investment strategies, to make a meaningful contribution to achieving net-zero targets. But they also have the ability to influence the future of impact investing.

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving digital transformation in the financial services industry. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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