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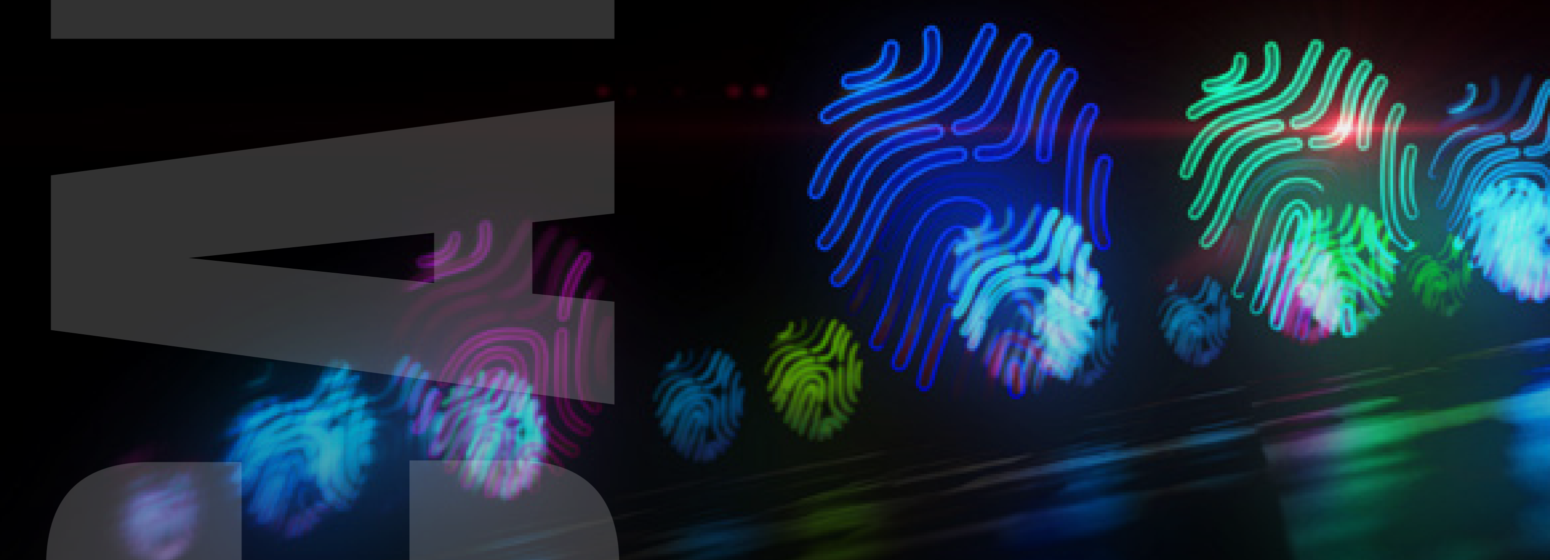
REGULATION

ESG and the insurance landscape

CHARLES SINCOCK | HUGO GOUVRAS



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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**

ESG AND THE INSURANCE LANDSCAPE

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ABSTRACT

The "environmental, social, and governance" (ESG) agenda has in recent years become increasingly more important for financial services firms, including insurers. The Paris Agreement in 2016 was a landmark event for climate action, and subsequently there has been an increase in social justice considerations. This article explores what insurers need to consider when approaching their ESG agenda, including integrating ESG within the core business and operations, as part of underwriting, investing, and risk management decisions, and developing tailored ESG products and services.

1. INTRODUCTION

The environmental, social and governance (ESG) agenda has become an increasing priority for the financial services sector, including insurers. The world has seen an increased focus from the public and political institutions on the ESG agenda. The Paris Agreement in 2016 was a landmark event for climate action with the adoption of a legally binding international treaty on climate change. Subsequently, there has been an increase in social justice considerations such as gender equality, social inclusion, and diversity.

With the advent of the COVID-19 pandemic, organizations have started to prioritize their ESG strategy and corporate stewardship. Notably, financial services are accelerating their activities in this space. With the stark realities of COVID-19 have come a wider appreciation of macro level risks in general – climate change included – and how these factors can dramatically impact the business. For insurers, this includes integrating ESG within the core business and operations, as part of underwriting, investing and risk management decisions, and developing tailored ESG products and services.

2. ESG

Incorporating ESG factors and determining the opportunities and risks is essential. It both helps to determine a company's business resilience from environmental and social risks, as well as measure the sustainability and societal impact of an investment/underwriting in a company or a business.

The component parts of the ESG criteria are considered below, with examples of the financial and reputational impacts felt by companies who have been negligent in their focus on ESG responsibilities.

2.1 Environmental

This component of the three factors examines a company's impact on the planet from positive and negative perspectives. Typically, the following environmental credentials of a company will be reviewed and analyzed when ascertaining their commitment to achieving sustainability goals (Figure 1). In 2010, the Deepwater Horizon oil spill negatively affected BP's share price significantly. This was one of the worst accidental oil spills in history and had severe and devastating

Figure 1: ESG and the insurance landscape

impacts on the local wildlife and ecosystems. Compensation paid out by BP ran into the billions of dollars in the wake of this disaster, which saw close to 4.9 million barrels of oil spilled into the ocean.[1]

2.2 Social

The social component of ESG looks at the people-related elements, which include issues that impact employees, customers, consumers, supplies, company culture, and the society at large. Research shows that companies that excel in engaging their employees achieve significant per-share earnings growth when compared to their peers.[2] In August 2020, Boohoo, an online retailer saw a slump in its stock price (£4.12 to £2.47 within a three-month period) following revelations about the operational and contractual conditions under which its workers were employed.[3]

2.3 Governance

A company that has robust governance, and a strong board of directors that relate well to different stakeholders, will eventually mitigate the potential risks of the principal-agent problem – that is, the risks that exist when there is no alignment between the shareholders' and the management's vision and actions. In March 2021, Deliveroo's stock market listing was at risk of being tarnished following allegations of the company's treatment of its couriers. Additionally, a couple of the U.K.'s largest asset managers, including Aberdeen Standard (now abrdn), avoided participation in the IPO because of the company's share ownership structure, which granted 50% of voting rights to the CEO. The concerns around treatment of workers has meant that the company has allocated £112m to cover potential legal costs should the employment status of its riders change if there is a future litigation against the company.[4]

3. INSURANCE CONTEXT

As very long-term custodians of assets, insurers are more exposed to sustainability issues than most other classes of investors – for them managing ESG exposures is arguably an existential issue. They are increasingly scrutinized by policymakers, as governments and regulators explicitly focus their ESG edicts on long-term investors including major asset owners, such as the insurance sector.

Given that insurers globally control around U.S.$30 trillion of global assets,[5] and that some of these assets are held for decades, it follows that ESG regulations should impact the insurance industry more than most. This regulatory push is expanding globally, hence not only are insurers exposed to actual ESG risks via both their underwriting and investment activities, but to specific new regulatory risks as well – posing a concern on two fronts.

[1] https://bit.ly/3oVVS7d
[2] https://bit.ly/30ckpdV
[3] https://bit.ly/3oVVS7d
[4] https://cnb.cx/3BCSmSZ
[5] https://bit.ly/3ADs0yX

This paper considers how insurers assess and align to their ESG agendas from three different perspectives. Firstly, from a purely investment focus, secondly, from an underwriting capability, and finally from a business operations point of view.

3.1 ESG investment

As ESG investing continues to gain momentum, it is imperative for insurers who want to reduce portfolio risks and generate returns to pay attention to ESG criteria. Firms that fail to manage the risks emanating from E, S, and G factors will likely face consequences from their shareholders, who have an increased awareness of ESG and demand accountability from their insurance investee companies. Additionally, major institutional investors have clearly voiced their expectations regarding companies' commitments to ESG criteria, particularly the management of their exposure to environmental risks. BlackRock announced that almost all U.S.$7 trillion assets under management would be governed by ESG considerations.[6] This emphasizes the growing pressure on firms to adopt and incorporate ESG into their operating models.

3.2 Underwriting

The insurance industry has a pivotal and influential position in promoting ESG sustainability. Incorporating climate related risks in underwriting and investment policies, for example the reduction of greenhouse gas (GHG) emissions from thermal coal, will facilitate the transition towards a cleaner future. Many insurers intend to stop providing insurance or risk management services for new thermal coal mines or major pollutants, and for potential new clients that derive a significant amount of revenue from mining thermal coal. There is also a growing shift towards renewable energies. This highlights the changing priorities for insurance firms that are now actively pursuing environment and social benefits in addition to investment returns. In December 2020, Apollo Lloyd's announced that they will no longer underwrite Adani's Carmichael coal mine following their latest ESG report that sets targets for responsible underwriting and investment practices. Included in this are their plans to phase out existing coverage on certain coal and oil activities by 2030.[7]

3.3 Business operations/resilience

Insurers can promote the ESG agenda and drive towards sustainability through their own operations and business activities. Promoting diversity and inclusion, reducing their greenhouse gases (GHGs), readdressing gender equality, and supporting communities via charitable work will all enhance the firm's brand and ESG credentials. Even though there are risks and burdens associated with the implementation of ESG, such as increased costs, insurers should look past these and understand the importance of prioritizing this topic to ensure success of their businesses going forward.

4. THE EMERGING INSURANCE INDUSTRY TRENDS

A Blackrock survey has found that 78% of insurers believe that the COVID-19 pandemic has accelerated their focus on ESG, with a greater emphasis being placed on social and governance considerations. Over 50% of respondents have invested in specific ESG strategies in the previous year. A further 52% have made ESG a key component of their investment risk assessment for new investments, and nearly one in three (32%) have turned down an investment opportunity in the last 12 months due to ESG concerns.[8] In addition, Refinitiv found 63% of companies within their ESG database have a policy linked to reducing emissions.[9]

4.1 Regulatory trends

4.1.1 CLIMATE RELATED DISCLOSURES

Until the Paris Agreement was signed and ratified in 2016, there had been various other treaties to address climate change issues, such as the Kyoto Protocol. The Paris Agreement was pivotal in that it was a legally binding international treaty on climate change with a clear goal to limit the global average temperature rise to below 2 degrees Celsius to avoid impacts of human-induced climate change. It also provided a framework for financial, technical, and capacity building, and required companies to communicate the actions they will take to reduce their GHGs.

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6 https://bit.ly/3mVvoQW
7 https://bit.ly/3aDoyte
8 https://bit.ly/3lJ9MrD
9 https://bit.ly/3ABU9q6

In 2015, The Financial Stability Board (FSB) created the Task Force in Climate-related Financial Disclosures (TCFD) to improve and increase reporting of climate (change) related financial information. Its objective was to look beyond the existing methodology of collecting historic metrics and targets. The task force wants the incorporation of broader aspects of understanding across governance, strategy, and risk management on a forward-looking basis using scenario planning to price risk on investments accurately.

In 2017, TCFD came up with a set of recommendations for climate risk disclosure. This has become the main go to framework for firms to disclose their risks in a climate related context, and regulators are increasingly putting pressure on companies to disclose climate related risks and ESG. Notably, the Financial Reporting Council (FRC) stated in November 2020 that corporate reporting needs to improve to meet the expectations of investors and other users on the urgent issue of climate change.

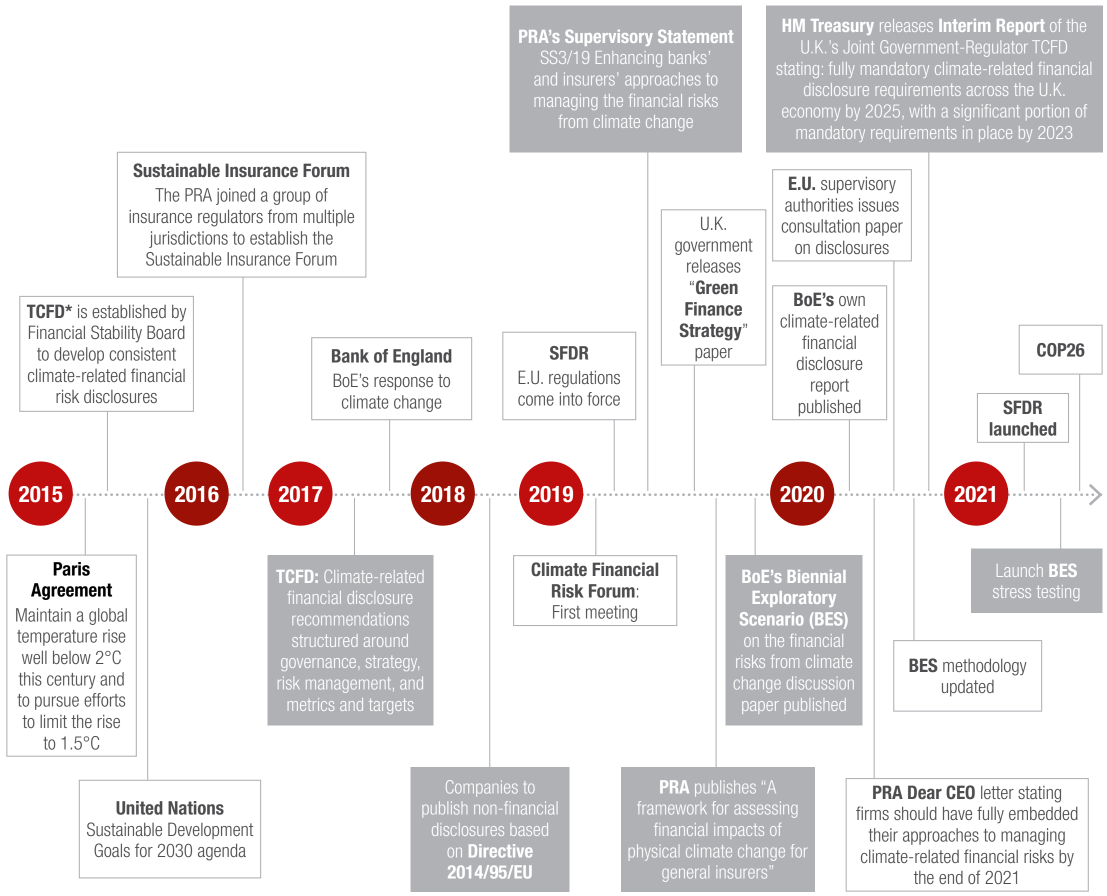
Mark Carney, who is currently the UN Special Envoy for Climate Action and the Prime Minister's Finance Adviser for COP26 (UN Climate Change Conference), highlighted how pressing an issue climate change is for the sector in October 2019, stating that, " …changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset. Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist. The longer that meaningful adjustment is delayed, the greater the disruption will be."[10]

On November 9th, 2020, the U.K. set out its objectives to extend its global leadership in green finance including the following main action points:[11]

- Announcements of the issuance of the first Sovereign Green Bond[12]
- TCFD aligned disclosures to be fully mandatory across the economy by 2025[13]
- Implementation of a green taxonomy, taking the E.U. taxonomy as its basis[14]
- The U.K. also intends to join the International Platform on Sustainable Finance.[15]

[10] https://bit.ly/3AHER2N
[11] https://bit.ly/3oYv0Un
[12] Supra
[13] https://bit.ly/3FMdusu
[14] https://bit.ly/3BH84fU
[15] https://bit.ly/3mlE8JW

Figure 2: Financial services regulatory timeline



*Task Force on Climate-related Financial Disclosures (TCFD) to improve and increase reporting of climate-related financial information.

4.1.2 NON-FINANCIAL DISCLOSURES

The E.U. Sustainable Finance Disclosure Regulation (SFDR) introduced a set of ESG data metrics and rules. The E.U. identified 64 adverse impact indicators that should be calculated, of which 18 will be mandatory to report. The focus is across the whole of ESG and not just the environment, but includes social aspects involving human rights, equality, and employee diversity. These specific identifiable key performance indicators (KPIs) will need to be disclosed and published on a timely basis.

Figure 2 shows a timeline of the growing regulatory and public demand to embed and report on ESG across the financial service sector including the insurance industry.

4.2 Social changes and demographics

The pool of ESG-minded customers is growing, with an increasing focus on sustainability and ethical practices evident among Generation Z and Millennials as they enter the working environment. This population is typically more environmentally and socially aware. These customers take more accountability for their finances, investments, and pensions than previous generations. As such, these insurers will need to address the demands and needs of these customers and demonstrate the same values to their ESG agenda.

One company that emphasises this potential is Tickr, a platform where customers can invest in positively impactful companies whilst offsetting their own carbon footprint. 99% of Tickr's customers are Millennials.[16] These generations

[16] https://bit.ly/3BCQklJ

are also driving digitalization by expecting more product personalization and customer engagement from their insurers through the likes of IoT to bring them fairer and more accurate pricing. This indicates the growing need of insurers to adapt to this social change and ensure they can create a successful environment for both employee and customer engagement alike.

5. UNDERWRITING

Traditionally, underwriters have utilized decades of static, historical information to assess potential risk to clients. With advances in technology and innovation this method is now regarded as inadequate in predicting accurately future trends and exposures. Artificial intelligence and machine learning can interpret large pools of data and predict with a greater degree of accuracy future events and the changing ESG risk patterns. Integrating these technologies and transforming the underwriting process will provide insurers with a competitive advantage. Parametric, synthetic, and dynamic modeling are all methods used within insurers that are providing competitive advantage to satisfy investors' growing demands. Below are examples of how underwriting is advancing with new technology and innovation.

5.1 Parametric modeling

Parametric modeling offers financial protection against losses that are hard to predict. Parametric insurance pays out when a pre-defined event occurs, such as floods and earthquakes, and breaches a pre-agreed figure or index. As climate related weather risks become more complex and unpredictable the requests for this structure of insurance will increase.[17]

5.2 Synthetic modeling

Natural catastrophe modeling originally took historical losses and built factors such as wind speed and landscape profiles into predictive models. The layers of analytic data have grown considerably. Satellite images in combination with weather, traffic, building, and other ground sensors can be combined and overlaid to provide a more nuanced and accurate picture of risk.

5.3 Dynamic modeling

The ability to collect data about your customers continuously and use artificial intelligence to analyze that data is allowing insurance companies to provide more accurate, up-to-date risk analysis, and to update price polices accordingly. This is linked to ESG core values – treating all customers fairly. There are several examples where technology is driving better outcomes for customers, the following are just a few.

For many years, health insurers have been capturing fitness data among their insured populations and using it as reward points or premium discounts. Fitness to health trackers provide underwriters with a dynamic view into past health status and the ability to monitor current health, which provides a more accurate risk profile and value for money.

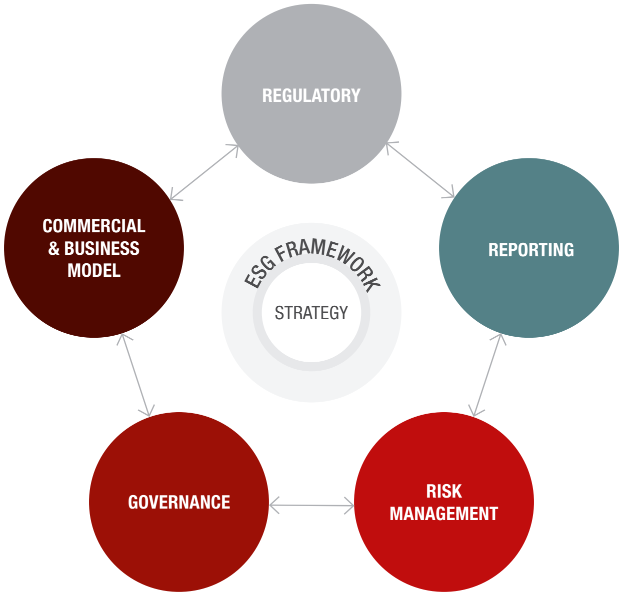
The car industry is another example where telematics supply a live feed on data and updates the overview of the insured party's driving style and risk profile.[18] Tesla is growing its own insurance business that offers Tesla car owners specific products. This is a significant threat to traditional car insurers. The size and level of the data that Tesla has about its customers compared to other manufactures is vast. Tesla CEO Elon Musk told investors at a recent earnings call: "Ultimately, where we want to get to with Tesla Insurance is to be able to use the data that is captured in the car, in the driving profile of the person in the car, to be able to assess correlations and probabilities of crash and be able then to assess a premium on a monthly basis for that customer."[19]

5.4 Responsible and sustainable underwriting

Insurers are considering alternative measures of performance outside of traditional financial metrics, looking to wider social imperatives beyond wealth enhancement. For example, Allianz refers to this as "Impact underwriting" and highlights the difference between "responsible" and "sustainable" investment/underwriting.[20] The drive is not only to focus more on the shareholders benefits, but also to achieve environmental and social benefits. The competitive advantage in this contested space is to not only adopt current and future regulations, but to also satisfy investors' growing demands for sustainability. The potential in expanding revenues in growing sustainability markets and benefiting society at the same time offers what Allianz term a "double dividend".

[17] https://bit.ly/2YP48eI
[18] https://bit.ly/3oYZyFe
[19] https://bit.ly/3v82ssl
[20] https://bit.ly/3lAk78Y

Figure 3: The ESG model



6. CORPORATE CENTER – DRIVING PROFITABILITY WHILE ADHERING TO MORAL, ETHICAL AND LEGAL OBLIGATIONS

Society is facing both an environmental and health crisis that is forcing companies' hierarchies to act both through an ethical and moral obligation, and also to comply with ever increasing regulations. This is making companies and boards focus on the link between values and value. Good stakeholder governance is now an operational and strategic condition that is vital to a firm's resilience and long-term success.

Insurance companies are in a commanding position and can establish themselves as leaders in the integration and promotion of ESG within the financial services sector. The significant and large amounts of capital flows can be the catalyst to ensuring sustainability goals.[21] The moral obligation implies that companies need to take responsibility and action to focus on long-term societal impact, and contribute to positive developments through choices and behaviors. Companies with a strong sustainability approach will influence others and equally as important, increase public perspectives regarding ESG.

In addition to climate risks, many insurers are reporting on non-financial disclosures. However, the risk to the company is how can the benefits be realized from reporting this information. The European Commission has stated that there is a lack of comparability, reliability, and relevance of non-financial information provided. There needs to be stricter audit requirements and a common reporting standard.[22,23]

7. THE CAPCO FRAMEWORK – EMBEDDING ESG IN INSURANCE

There are many risks and opportunities where ESG can impact the insurance ecosystem. It is imperative that insurers capture, integrate, and monitor ESG risks and opportunities. We have designed a framework to help insurers on ESG. At the highest level, the following model creates an overall approach for ESG consideration:

[21] Supra
[22] https://bit.ly/3Dz0lkv
[23] Supra

- An ESG strategy should be established at the corporate level to integrate ESG into business operations, along with a framework to help embed ESG into the organization.
- Regulatory requirements must be met via processes and policies; reporting mechanisms must be developed to enable ESG reporting to stakeholders and customers.
- Climate-related and general ESG risks must be identified, assessed, and managed. Underpinning this should be the governance structure to help integrate ESG into the organisation's culture, businesses, and operations.

8. CONCLUSION

Insurers are moving forward with their ESG programs. These are due to regulatory and customer pressures as well as the overall current climate of "building back better". The COVID-19 pandemic has only emphasized the need for insurers to move swiftly on ESG topics. Insurers that have yet to embed and embrace ESG will face greater uncertainty in the future that will potentially impact their growth, add a degree of uncertainty to their resilience, and overall undermine their competitive positioning.

ESG is a topic that is here to stay and is growing more and more relevant in the short term, and clearly has over the horizon fundamental implications for the insurance industry. Insurers therefore need to embrace ESG and seize the opportunities that are presented, or risk being left behind. This paradigm shift towards ESG-focused strategies and business dynamics appears to be inevitable for the insurance industry. This highlights that in order to embrace the opportunity that this approach affords, insurance market participants will need to consider a new and dynamic approach to risk modeling, investments, and business operations. This imperative will seek to manage the insurers' overall risks, but ultimately provide a right to play and occupy a space in this emerging and developing business ecosystem.

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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