

ESG RELATED RISKS TO THE INSURANCE INDUSTRY

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First Environment

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ENVIRONMENT**



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- 30+ years of experience in
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Agenda

- Defining Terms
- Why Even Bother with ESG?
- Insurance Industry Addresses ESG
- Potential ESG-Related Risks
 - Environmental (Climate)
 - Financial (Credit)
 - Social (Reputational)
 - Governance (D&O)
- Current Political “Push Back” on ESG
- Closing Thoughts

Defining Terms

- **Sustainable Development:** “Meeting the needs of the present without compromising the ability of future generations to meet their own needs.” (*UN Brundtland Commission, 1987*):
 - Economic prosperity
 - Environmental protection, and
 - Social well-being such as equity.

Defining Terms

- **ESG:**
 - Environmental: “how companies manage their impact on the environment and how they mitigate environmental risks, such as **climate change** and resource shortages”;
 - Social: “the impact of company operations on labor, human rights, and other aspects of society”
 - Governance: “structures and processes that companies use to direct and manage their operations” including “relationships between management, directors, shareholders and other stakeholders.” (*ESG, Overview—Bloomberg Law. 2020*).

Sustainability and ESG – Different Perspectives?

- Sustainability: Outward focus on the Impact of organizations and projects on the natural environment (protection), society (equity), and the economy (prosperity).
 - Fairness and equitable actions considering the future (long-term).
 - Example – Sustainable Finance
 - “The right thing to do”

Sustainability and ESG – Different Perspectives?

- ESG (Investing): Inward focus on organizational impacts (risks/opportunities) by the natural environment, society and its leadership.
 - ESG-related risk management resulting in financial benefits such as lower cost of capital, lower frictional cost, lower insurance costs (D&O), and higher return on equity
 - Example – Responsible Investing
 - “The smart thing to do”

ESG Related Principles and Technical Standards

International Organization for Standardization (ISO)

- Over 400 internationally ESG-Related technical standards (principles, guidance and requirements)
- **Environmental**
 - ISO 14000 Series: Management Systems, GHG, Green Bonds, Labeling, LCAs, etc.; ISO 50001: Energy management systems;
- **Social:**
 - ISO 26000: Guidance On Social Responsibility; ISO 45001: Health and safety management systems; etc.
- **Governance:**
 - ISO 37000 Governance Standards: Compliance, anti-bribery, whistleblowing, indicators, etc.

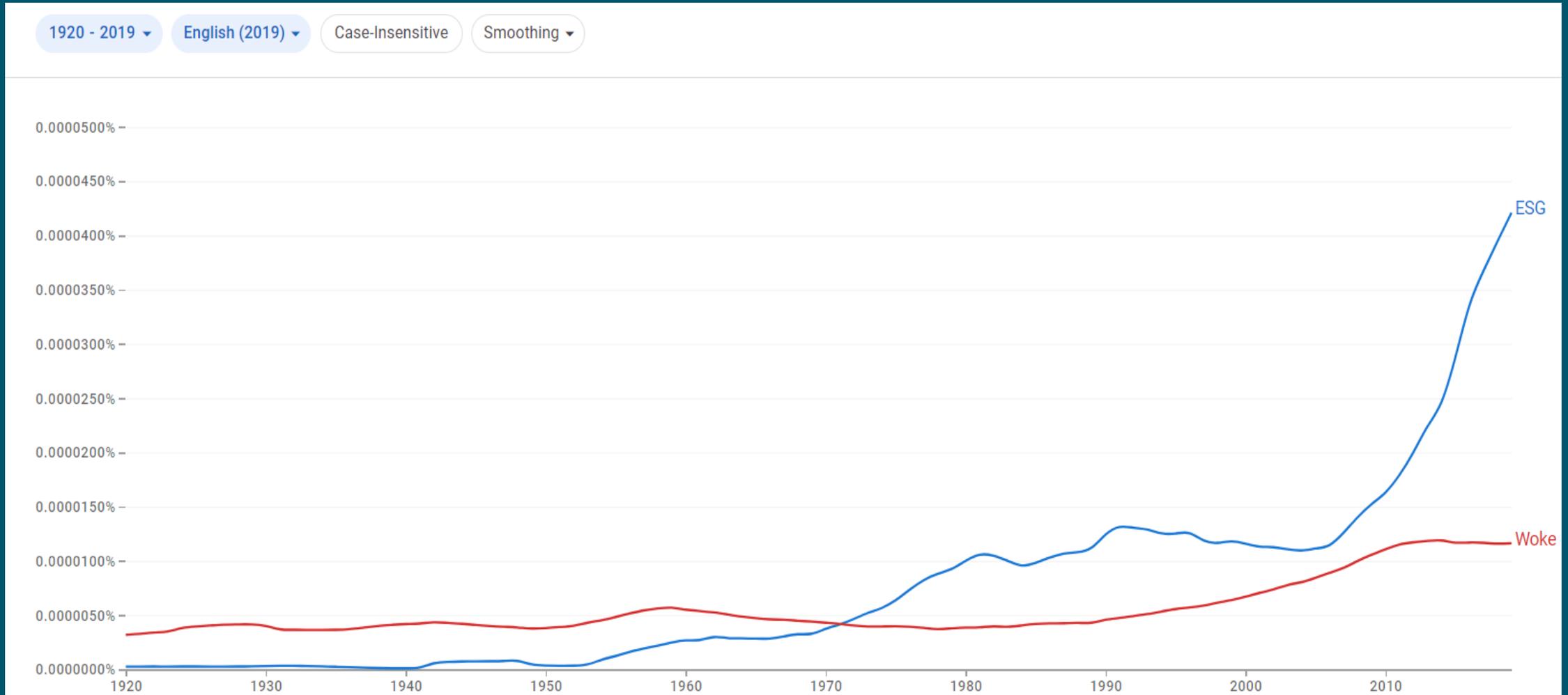
ESG Related Financial and Legal ISO Standards

- **Sustainable Finance**
 - ISO 32210: 2022 – Sustainable finance - Guidance on the application of sustainability principles for organizations in the financial sector
- **TC68 - Banking, Securities and other Financial Services:**
 - ESG Subsets – Privacy, Cyber Security
- **Legal Risk Management:**
 - ISO 31022: 2020 - Risk management — Guidelines for the management of legal risk

Defining Terms (“Anti-ESG”)

- “Woke”
 - Webster Dictionary: "woke" being aware of and actively attentive to important facts and issues.
 - Oxford English Dictionary: Adjective: Originally: well-informed, up-to-date. Now chiefly: alert to racial or social discrimination and injustice
- “Woke Capitalism”
 - “I know it when I see it”
- Technical standards related to “Woke” or “Anti-ESG”?

Evolving Use of the Terms ESG & “Woke”



Why Bother With ESG - Asset Management

- 3,800 Signatories of the Principles for Responsible Investing (PRI) represent \$103 trillion of assets under management (AuM) ¹
- Net flows into ESG funds available to U.S. investors have skyrocketed, totaling \$20.6 billion in 2019, nearly four times the previous annual record set in 2018. Nearly 60% of ESG funds outperformed the wider market over the past decade.²

¹ UNPRI.Org Website, 2022]

² Introduction to ESG,” Mark S. Bergman, Ariel J. Deckelbaum, and Brad S. Karp, Harvard Law School Forum on Corporate Governance, August 1, 2020.

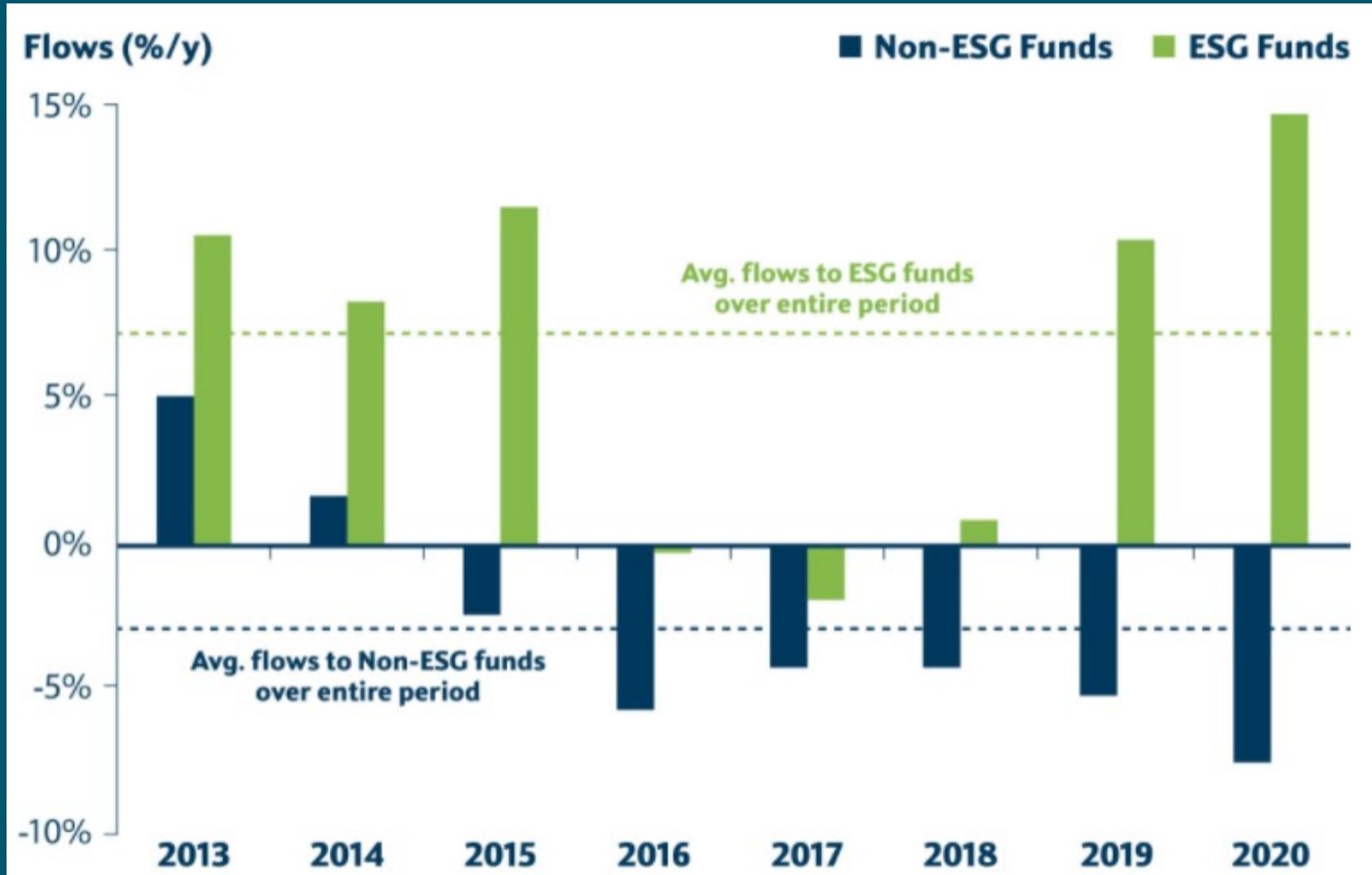
Why Bother With ESG - Asset Management

- Larry Fink (CEO, BlackRock) when asked about ESG backlash: *“We lost about \$4 billion of flows from various states, but in long-term flows last year we were awarded \$400 billion. Just last year in the United States our clients entrusted us with an additional \$230 billion. So you tell me.”*
- “AM Best has always considered ESG risks in our credit rating analysis, when they were material and relevant to financial strength.” (Matthew C. Mosher, president and CEO of AM Best Rating Services, November 21st, 2021, Press Release)

¹ “Introduction to ESG,” Mark S. Bergman, Ariel J. Deckelbaum, and Brad S. Karp, Harvard Law School Forum on Corporate Governance, August 1, 2020.

² Bloomberg TV interview at the WEF in Davos, January 2023

US ESG vs. Non-ESG Equity Funds



Source: EPFR, Barclays Research

The Concept of ESG is Not New for Insurers

Four Principles for Sustainable Insurance (2012)*:

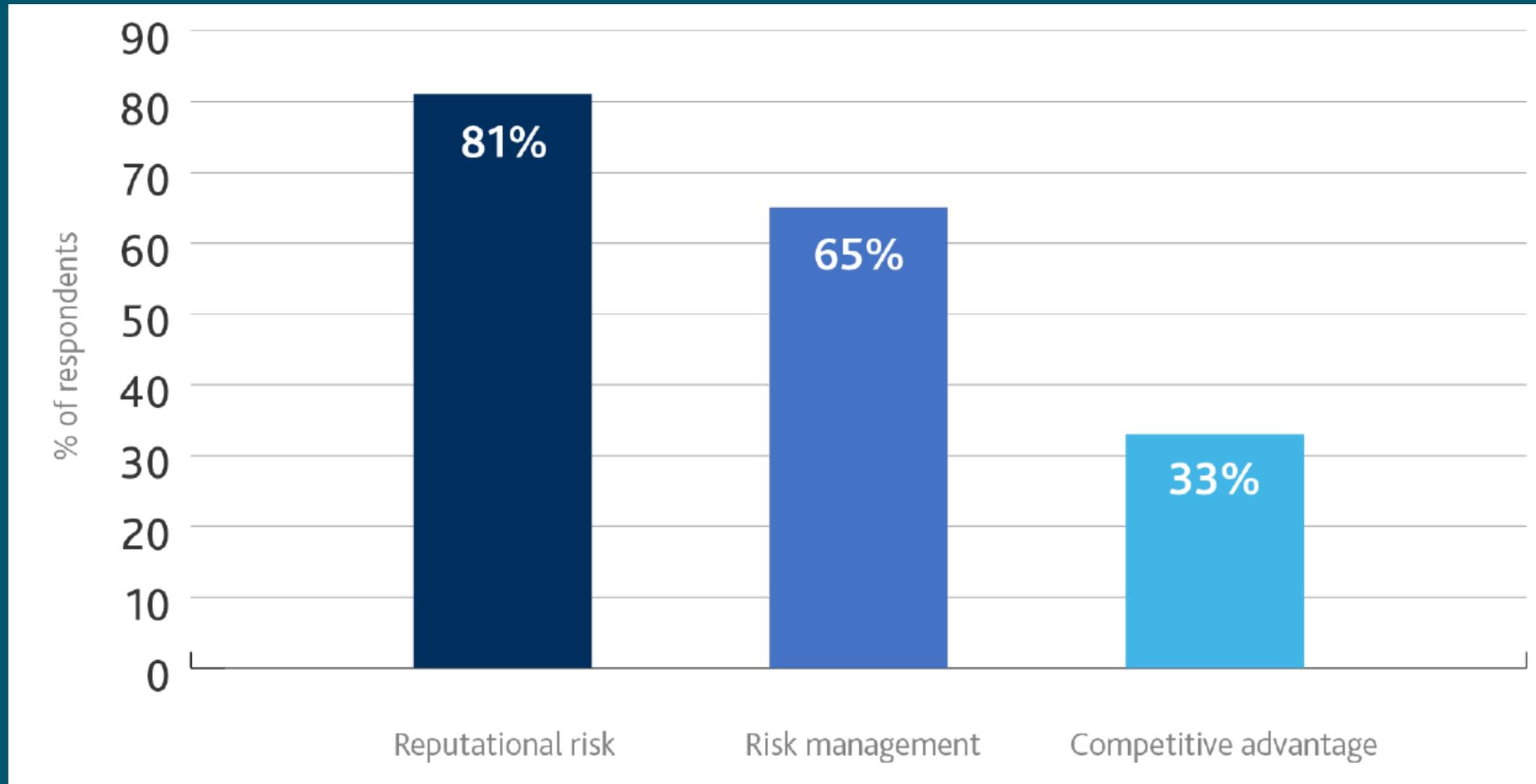
1. We will embed ESG issues that are relevant to our insurance business into our decision-making process.
2. We will work with our clients and business partners to raise awareness of ESG issues, manage risk and develop solutions.
3. We will work with governments, regulators and other key stakeholders to promote widespread action across our society on ESG issues.
4. We will demonstrate accountability and transparency in regularly disclosing publicly our progress in implementing the principles.

- Farmers Insurance 1st US Insurer to Sign, Nov. 2022

Global Insurers Address ESG (2022)*

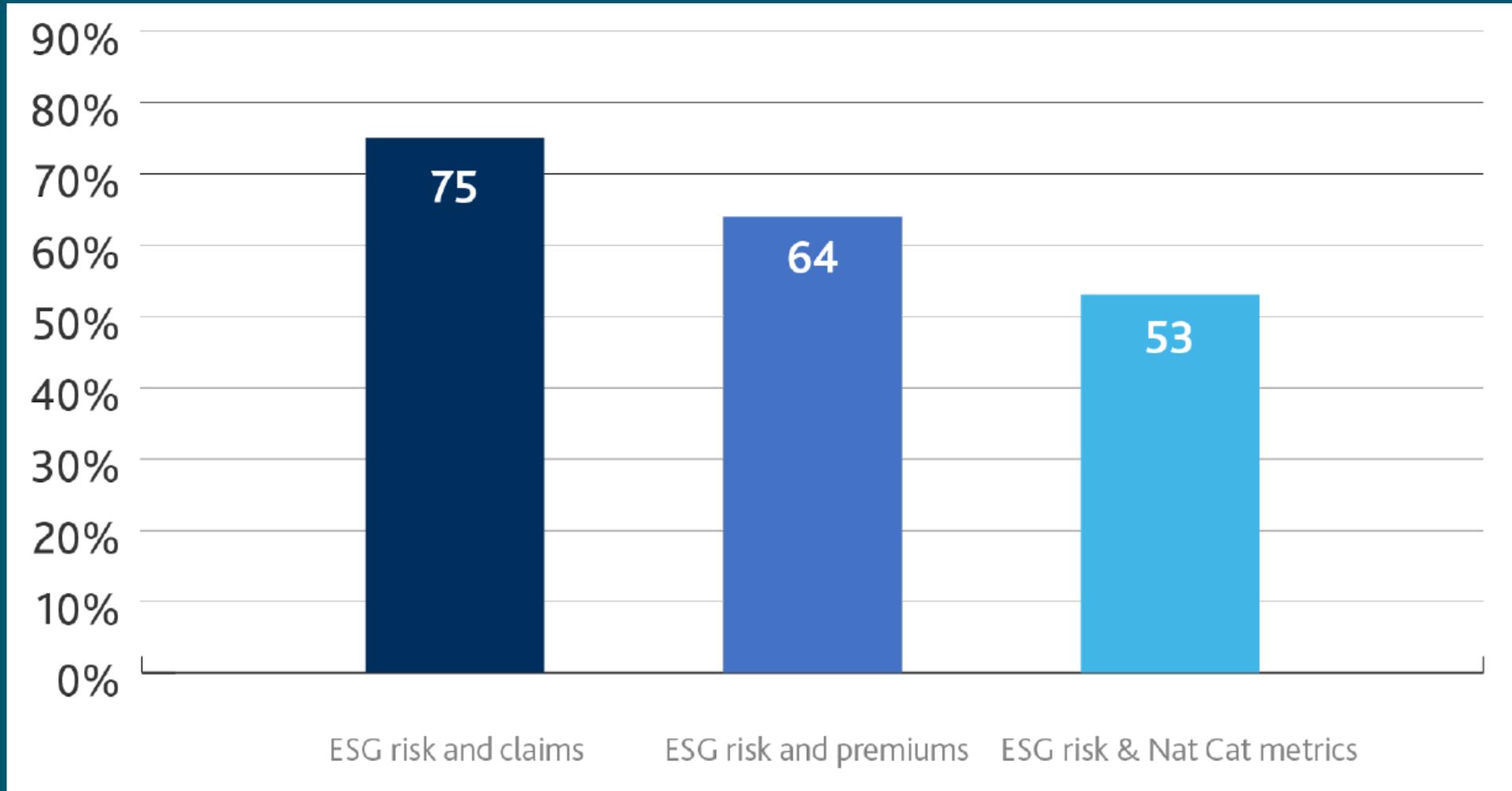
- 85% of global insurers believe ESG will impact all functions of their business. They identified investments as the single largest area of impact (91% of respondents), followed by risk and internal audit (90%) and underwriting (88%).
- The main driver of their ESG pursuit is “to minimize the impact from climate change” (26%), “to gain a better reputation as a firm” (11%) and “to minimize risk” (11%).
- 68% of global insurers tell us they’ve taken action or are planning to take action in the next 12 months in order to align with the UN Principles for Sustainable Insurance

Key Drivers for Integrating ESG - Insurance



Moody's Analytics Survey of P&C Insurance Senior Management – Global Insurers, Sept. 2022

Integrating ESG into Underwriting Workflows



Moody's Analytics Survey of P&C Insurance Senior Management – Global Insurers, Sept. 2022

ESG-Related Financial Risks - Credit

Moody's Investors Service – 4 Trends ESG Trends in 2023 impacting Credit:

1. Increased scrutiny of corporate decarbonization plans amid heightened execution risks for green investments which will heighten policy and market risks for companies highly exposed to carbon transition risks.
2. Elevated social risks for a range of public and private sector entities due to high cost of living concerns.
3. Heightened refinancing risks for lower-rated issuers for which governance attributes tend to weaken resilience to external shocks.
4. An increasingly complex ESG regulatory landscape that is raising reputational and financial risks for financial companies in particular.

ESG-Based Credit Scores

Credit Scores that Consider ESG-Related Financial Risks:

- AM Best
- Moody's
- S&P
- Fitch
- Fair, Isaac & Company (FICO)

Impact of a Ban on ESG Considerations on Credit-Score Underwriting?

ESG-Related Environmental Risks - Climate

- Physical/Property Damage (Severe Weather)
- Business Interruption (Aftermath of Severe Weather)
- Climate Disclosures (SEC Enforcement of Errors, Omissions, and Misrepresentations)
- Climate Change Lawsuits (Duty to Defend, D&O Claims)
- Carbon Transition Risks (Stranded Assets, Cap & Trade/Invest)

Climate-Related Insurance Impacts - Florida

- Since 2020, 15 Property Insurers have gone Insolvent.¹
- State has Established \$1 Billion fund to Backstop Regional Insurers.
- Total Housing Market Overvaluation, Based on Updated Flood risk for Florida (2020 to 2050): \$50.2 Billion²
 - Greater than the next 4 States combined!

¹ Bloomberg Law, Dec. 29th, 2022. ² Axios, Feb. 17th, 2023

ESG-Related Social Risks - Equity

- Environmental Justice
 - Redlining
- Reputational
- Diversity, Equity, and Inclusion
- Supplier/vendor Practices
- Data Privacy/Cyber Security

ESG-Related Governance Risks

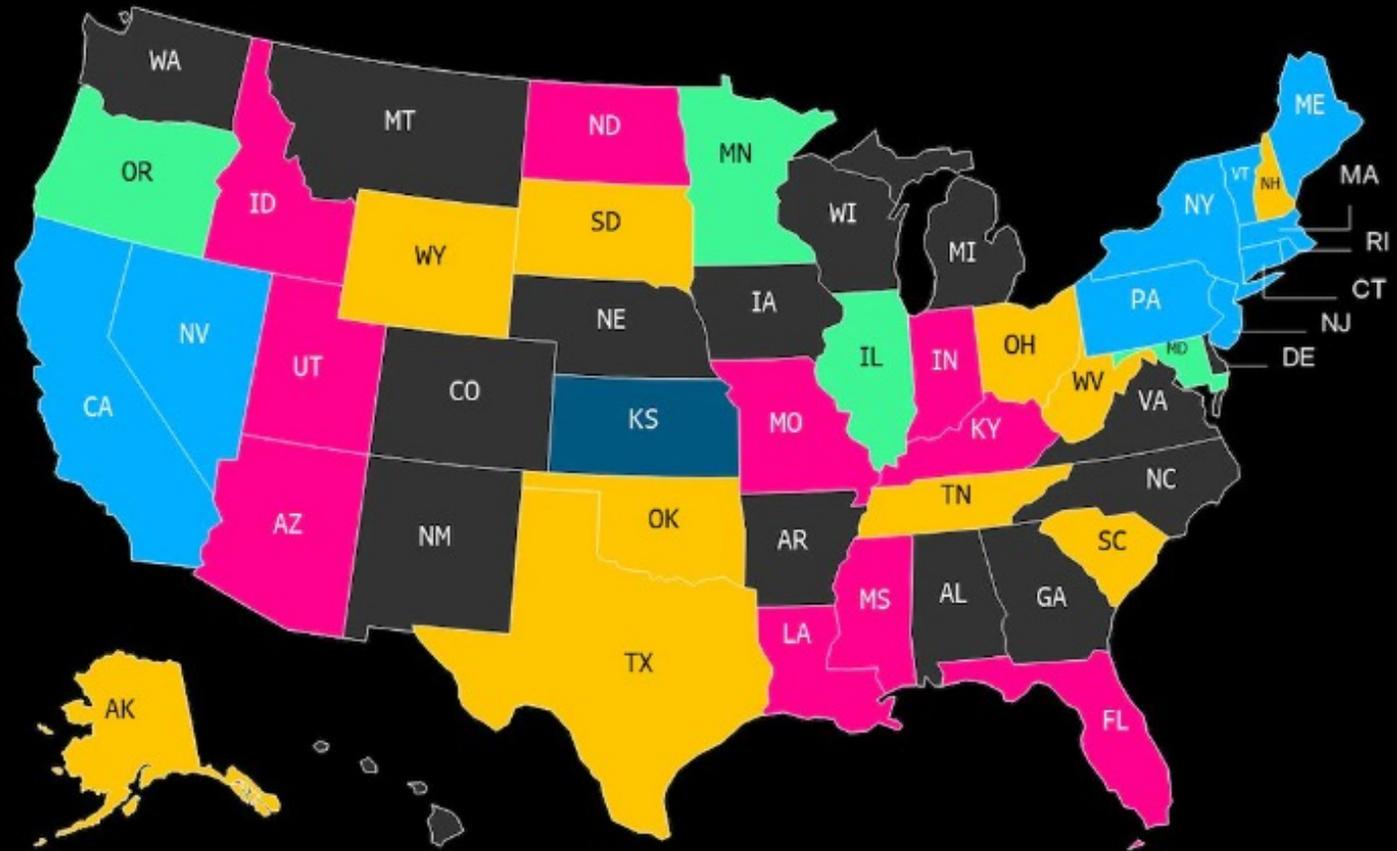
- ESG-Related Law Suites (Duty to Defend)
- Directors & Officer Claims
 - ESG disclosures
 - Board structure and diversity
 - Corruption and fraud prevention
 - Organization integrity and ethics
 - Executive compensation

State-Level Pushback & Endorsement of ESG

State Decisions on ESG

Republican-led states push back on ESG while Democratic-led states seek to incorporate it.

- Actions targeting entities boycotting certain industries
- Actions restricting use of ESG factors
- Actions promoting divestment from certain industries
- Actions neutral on use of ESG factors
- Actions promoting integration of ESG
- No significant action



Source: Ropes & Gray LLP
Note: As of Dec. 12

Finding Common Ground

- Senate Blocks Federal (DOL) Rules Allowing Non-Financial ESG Considerations in Pension Plans
 - Must consider financial factors that could impact returns (ESG-risk adjusted Returns?) – Pretty low hurdle
- Michel Leonard, chief economist and data scientist at the Insurance Information Institute:
“ESG is in the DNA of any insurance company,”*

* ,Politico, March 7th, 2022. “Anti-ESG comes for the insurance industry”

Red States are Beginning to Reject Their own ESG Regulations

- Wyoming – Appropriation Committee recommended not passing two anti-ESG Bills:
 - The measures would impair the state’s ability to invest; restricting investment in an extremely wide range of companies, including many energy companies!
- North Dakota – Voted 90-3 against rule mandating Public Pension System Divest from Funds Considering ESG Factors
 - The measure would cost the system nearly \$7 billion in returns over 10 years.

Anti-ESG Limits Diversification – Lower Returns

- Texas – Cities in Texas will pay between \$303 million and \$532 million in additional interest on 432 billion in bonds due to the state's ESG ban (Wharton School of Business, July 2022)*
 - The demand for Green/Sustainable Bonds continues to out stripe supply. Fastest growing fixed asset classes.
 - Simple Law of Supply and Demand

ESG Ratings for Insurance Companies

- Fitch Ratings (Feb 2023) said insurers' underwriting and investment strategies in the coming years will be increasingly influenced by ESG considerations: “Evolving strategies could gradually reshape some insurers' credit profiles, potentially with implications for ratings.”¹
- Disagreement on ESG Performance
 - Correlation between ESG ratings was about 0.3 (2016)² and now about .4 to .8 (2022)³ – getting better
 - Correlation between S&P and Moody's credit ratings is 0.99

¹ Insider Engage, February 1st, 2023. ² Chatterji, et. al., 2016; ³ Burg, et. al., April 2022.

Are Insurance Companies Next to Fall under Anti-ESG Legislation?

- Texas State Senator (R), Bryan Hughes:
 - “Insurance companies are being targeted by activist investors and by firms who buy stock, take positions in insurance companies and try to push them in a certain political position,” ... “Just like cutting off financing shuts down a business, cutting off insurance does as well.”*
- SB No. 1060 (3/3/2023 Referred to State Affairs):
 - Prohibit insurers from acting on shareholder proposals that seek to put limits on insuring risks related to fossil fuels, require an insurer to reduce or track greenhouse gas emissions or **prohibit insuring** an entity involved in otherwise legal activity “for the purpose of achieving environmental, social or political goals,” or including such proposals in proxy statements.

Closing Thoughts

- Sustainability, Climate Awareness, and ESG Have a Significant History
- Many if not most Insurance-related ESG Risks and Rewards are Financially “Material”
 - Impact on ESG-related risk underwriting? (e.g., Business lines that use credit score underwriting, EIL, D&O, etc.)
 - Impact on ESG-related opportunities? (e.g., reputation, brands, alignment with global Re-insurers, etc.)
- To be Successful, ESG-related Legislation Must be Based on Precise Language and Standards
- We Will See More ESG Consensus (Middle ground including financial factors) Based on Standardization and Litigation

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