The growing influence of ESG factors on insurers' investment decisions

By Ryan **Allison**

Why is there increased ESG activity from insurance investors, and how can the listed infrastructure market can adapt to seize the opportunity?

Executive Summary

The signing of the Paris Agreement[1] in December 2015 resulted in a global commitment to align financial flows with a pathway towards low-carbon and climate-resilient development. The European financial sector in particular has since faced disruption, as the EU has looked at ways of achieving the 2030 targets outlined in the Paris Agreement, including filling an estimated investment gap of €180bn[2] per year. As a result, there is an increased focus on ESG (Environmental, Social and Governance) factors, and how investors monitor, measure and integrate such factors into their investment strategy.

ESG factors are increasingly being used by insurance investors as a way to appropriately identify and invest in sustainable assets. We introduce the three components of ESG below:

Environmental: The environmental component of ESG captures any >

1 https://ec.europa.eu/clima/policies/international/negotiations/paris_en
2 The estimate is a yearly average investment gap for the period 2021 to 2030, based on PRIMES model projections used by the European Commission in the Impact Assessment of the Proposal of the Energy Efficiency Directive (2016).

impact on the environment as a result of an investment, such as increased carbon emissions or toxic waste products. An infrastructure investment in solar or windfarms, for example, would likely score well on the environmental component of ESG, while an infrastructure investment in a coal thermal power station is likely to not.

Social: The social component of ESG may be thought of as the impact of investments on the local community. An infrastructure investment in a school, for example, would be expected to have a positive impact on society. Conversely, an infrastructure investment in a new airport runway may not necessarily positively contribute to the experience of the local community.

Governance: The governance component of ESG focuses on how projects or companies are governed on a day-to-day basis. For example, infrastructure investments in projects or companies that strive to comply with certain diversity initiatives, such as 'The 30% Club',[3] may expect to score well in this component.

Although the "E" of ESG is perhaps the component which immediately springs to mind when considering sustainable investing, all three components outlined above should be appropriately balanced and taken into consideration. Based on our observations of the market, insurance investors have demonstrated varying sophistication with respect to applying ESG factors. Some insurers apply basic exclusions (e.g. "we will not invest in deepwater drilling infrastructure projects"), while others attribute scores to all of their investments and optimize on this basis.

Why Are Sustainable Investing and ESG Factors of Increased Focus Now?

Insurance investors have engaged in selective investment and divestment along ethical lines for more than half a century. Examples of this include the campaign to divest from companies doing business with apartheid South Africa in the 1970s, and the Boycott Gulf campaign (also in the 1970s) which led to the divestment

of oil companies supporting Portuguese colonial rule in Africa.[4]

More recently, politicians and governments have taken a stronger stance on the impact of investments on climate change and the social responsibility of insurance investors. The following items of legislation, which have emerged prior to or as a result of the Paris Agreement in December 2015, may be responsible in particular for the increased interest in sustainable investing and ESG factors:

- In August 2015, Article 173 was introduced in France[5] which requires investors to disclose how they address climate change-related risks, and report on their contribution to international efforts to capping global warming and France's "energy transition". Article 173 applies to French companies only and addresses publicly traded companies, banks and credit providers, asset managers and institutional investors.
- In June 2017, the FSB Task Force on Climate-related Financial Disclosures (TCFD)[6] released its final recommendations[7] report. This outlines voluntary,

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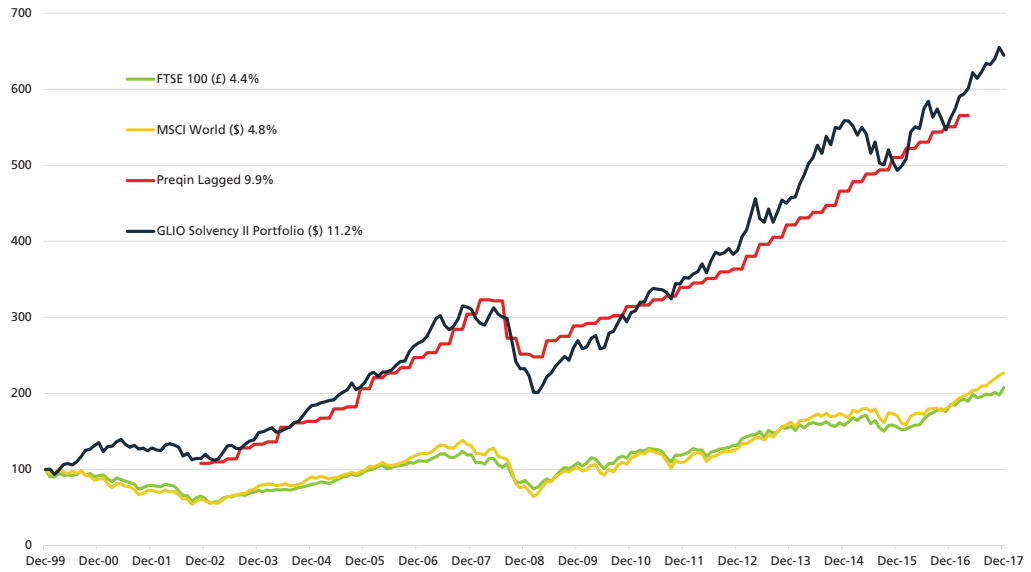
3 The 30% Club was launched as a campaign in the UK in 2010 with a goal of achieving a minimum of 30% women on FTSE-100 boards. https://30percentclub.org
4 www.nytimes.com, Is divestment an effective means of protest, https://goo.gl/pLbmEB
5 http://427mt.com/2017/01/16/impact-french-law-article-173/
6 www.fsb-tcfd.org
7 www.fsb-tcfd.org/publications/final-recommendations-report

Figure 1: GLIO Coverage Solvency II Portfolio vs. Global Equities & FTSE 100 December 1999 to June 2018 Total Returns (USD & GBP)



consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders. The recommendations report aims to help companies understand what financial markets want from disclosure in order to measure and respond to climate change risks, and encourage firms to align their disclosures with investors' needs. From a UK perspective, the House of Commons Environment Audit committee has recommended mandatory disclosures by 2022 in line with TCFD.[8]

In May 2018 the European Commission (EC) proposed the implementation of new legislation[9] to support investment in sustainable finance. It is proposed that this legislation is integrated into the Solvency II Delegated Act, and hence would impact European insurers operating under Solvency II. This has been the culmination of discussions among the EC's High-Level Expert Group, which delivered its final report[10] on the subject in January 2018. The proposed legislation aims to increase the transparency of ESG policies and stimulate sustainable investment, and consists of:

- A proposal for a regulation that establishes the conditions and framework on what can be considered an environmentally sustainable economic activity;
- A proposal for a regulation on disclosures relating to sustainable investments and sustainability risks, such as the consideration of ESG factors in the investment decision making and risk management processes;
- A proposal for a regulation amending the benchmark regulation that will create a new benchmark on the carbon footprint of investments.

The upshot of the regulations and proposals outlined above is that sustainable investing and ESG risks will be of increased importance for many insurers, with some insurers having already begun integrating ESG metrics into their investment decision-making and regular reporting processes. For example, Aviva reports ESG metrics alongside its annual report and accounts,[11] while Zurich has established a responsible investment team that considers ESG scores prior to making investments.[12] >

Listed infrastructure investments which comply with the Solvency II infrastructure investment qualifying criteria attract a lower capital charge relative to those which do not comply.

8 www.parliament.uk, Greening Finance Report, 7 Sess 17-19, https://goo.gl/pRwpaV
9 https://ec.europa.eu, Sustainable Finance, https://goo.gl/q6gsS8
10 https://ec.europa.eu, Final report of the High-Level Expert Group on Sustainable Finance, https://goo.gl/L9TMDd
11 www.aviva.com, Environmental Social and Governance datasheet 2017, https://goo.gl/WqEDcP
12 www.zurich.com, Responsible investment at Zurich, November2017, https://goo.gl/itNfHK

Combining ESG factors and Solvency II criteria, global listed infrastructure is indeed an attractive proposition for insurance investors.

Furthermore, increased focus has been driven by the recent actions of rating agencies. S&P, for example, has started using Economic and Climate (E&C) and social factors[13] in their credit-rating models. Coupled with action and pressure from organizations such as Lieef[14] and Unfriend Coal,[15] the market for sustainable and responsible investing is growing.

An ESG survey[16] conducted by the CFA Institute in 2017 across more than 45,000 portfolio managers showed that 76% of respondents considered ESG a priority for listed equity investments. The messages from EY's latest market surveys conducted amongst UK life insurance CIOs and asset managers concur with these sentiments; 82% of asset managers who participated in the survey had observed an uptick in ESG requests / requirements from insurance investors, while 45% of UK life insurance CIOs see ESG risks as a major disruptor to the insurance industry over the next 12-24 months.

An Opportunity for the Listed Infrastructure Market?

Given the growing momentum outlined above, insurers are expected to increasingly analyze their investment opportunities through an ESG lens. Since insurers are key investors in infrastructure, this creates an opportunity in particular for the listed infrastructure market.

Infrastructure asset owners should consider the additional information and data demands they may receive from prospective investors, and reflect on how well their assets may score in each of the three components of ESG. The listed infrastructure market can play a key role in making a material environmental and social impact in particular, owing to the function or purpose of many underlying infrastructure assets, and should be cognisant of the growing demand for sustainable investments from insurance investors.

As outlined in the *GLIO Journal* issues 1 and 2, global listed infrastructure is indeed an attractive proposition for insurance investors. In addition to the possible attractiveness of such an investment from an ESG perspective, listed infrastructure investments which comply with the Solvency II infrastructure investment qualifying criteria attract a lower capital charge relative to those which do not comply.

In the GLIO Coverage, many of the companies comply with the Solvency II infrastructure investment qualifying criteria, and subsequently the GLIO Solvency II Portfolio tracks the GLIO Coverage very closely. Combined with the historic strong returns of such an investment (as outlined in Figure 1. which illustrates how the GLIO Solvency II Portfolio has performed relative to other equity investments, and how it has tracked the unlisted infrastructure as defined by Preqin over the long-term), this makes for a particularly compelling investment argument.

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13 S&P Global Ratings, How Social Risks and Opportunities Factor Into Global Corporate Ratings, https://goo.gl/7kXXW6
14 www.Lieef.com has started reporting ESG metrics on behalf of companies and investment funds in an effort to increase transparency in this space
15 The Unfriend Coal campaign brings together a global network of NGOs and social movements calling for insurance companies to divest from and cease underwriting coal, and to support the transition to clean energy.
16 www.cfainstitute.org, ESG Survey Report 2017, https://goo.gl/FdMJTf