Insurers Take the Lead on ESG/Sustainability Initiatives

September 30, 2021
Insights for Insurers

Environmental, social, and governance (ESG) criteria or standards – often referred to simply as sustainability – are having an impact on all sectors of society, including corporate, entity, and professional policyholders and insurance companies. Many of the same societal factors driving social inflation are also involved in driving ESG. It is hardly surprising then that insurance companies, with increasing frequency and at greater depth, are playing a leading role with respect to ESG.

As ESG Pressures from External Stakeholders Intensify, Executives and Boards of Directors Are Paying Attention

ESG considerations have been in play for many years. Most companies value social responsibility and regard their role as responsible corporate citizens seriously. The legacy of corporate generosity, philanthropy, and volunteerism has been impactful. In the past, attention to environmental, social, and governance considerations above and beyond legal and regulatory compliance was largely voluntary. It usually was done for altruistic reasons or simply because it was considered "good business." Companies have always faced pressure from various stakeholders, but such pressures have ramped up considerably in recent years.

In the contemporary corporate world, as insurers and other companies tackle ESG, they are discovering that ESG is not only "good business," but increasingly, that ESG components are becoming mandatory or "essential business." European companies and regulators have, in large measure, been ahead of U.S. companies and regulators with respect to ESG. The focus, intensity, and pace of ESG have increased substantially over the past couple of years around the globe.

Fueled in part by events in 2020, activist groups, investors, regulators, customers, suppliers, rating entities, and others are calling upon companies to act in what these external "stakeholders" deem to be a "socially responsible" or "fair and just" manner with greater frequency, more intensity, and at a higher volume. They seek to have corporate policies and practices align with their standards or criteria (which sometimes differ or conflict among stakeholders) and to impose consequences for conformance or non-conformance with their ESG standards. It is fair to say that ESG is near the top of the list of issues

Attorneys

Scott M. Seaman

Service Areas

Sustainability & ESG

receiving attention from many executives and boards of directors of insurance companies and corporate policyholders.

ESG Presents Opportunities and Challenges

Although often viewed as an obstacle, ESG considerations can also present numerous opportunities for insurers and other companies. Indeed, the ability to respond and lead effectively in these areas will likely be a major determinant of the success of corporations and insurance companies. This includes taking action where companies believe action is appropriate. Equally important, companies must be able to effectively resist action where they believe it to be unwarranted and, at the same time, minimize collateral damage associated with their decisions. Companies performing well in ESG tend to lower their probability of sustaining workforce-related accidents, reputation-damaging controversies, and fines and other adverse actions by regulators. Companies that are embracing and playing offense on ESG are usually successful and well-positioned. Those companies playing defense and responding reactively to these issues may lose their competitive edge. Companies who seize the moment and view ESG as an opportunity are more likely to thrive in the current environment. Indeed, successfully addressing these issues could be necessary for corporate survival.

ESG remains central to legal, corporate, and financial risk assessment. In the past couple of years, ESG has moved away from being siloed within some aspects of corporate behavior and has become embedded in the DNA, strategy, and operations of the entire company. Stakeholders are using the full panoply of measures to achieve their goals, including traditional media, social media, investment decisions, purchase decisions, boycotts, threats, pressure, intimidation, lobbying, legislation, regulation, and cancel culture. Some of the goals and tactics are laudable, while others are not.

In some instances, ESG considerations are driven by political and generational considerations. We are not expressing any normative views on the political or social aspects or on the propriety of any specific ESG measure. Rather, we attempt here simply to outline the realities confronting insurers and corporate policyholders and the corresponding challenges and opportunities presented.

Internal Stakeholders Are Driving ESG

It is important to understand that the ESG pressures are not only being applied by external forces, but increasingly internal forces also are seeking to exact change. The reality is that Millennials, Generation X, and Generation Z are now, by the numbers, dominant members of the workforce and management, and are rapidly replacing Baby Boomers. The educational, experiential, methodological, value, and demographic differences between generations are undoubtedly having a large influence on internal decision-making. Not only have corporations adjusted to create a workplace that attracts and retains Millennial, Generation X, and Generation Z talent, these workers are increasingly becoming the corporate decision-makers. Thus, corporations are now becoming entities that increasingly are seeking and effectuating change, rather than entities that are resisting change.

Indeed, to fully understand the scope and pace of efforts surrounding ESG, Baby Boomers need to better appreciate the values, methods, and preferences of Millennial, Generation X, and Generation Z employees.

ESG Considerations Are Far-Reaching

ESG considerations are not static. ESG encompasses a broad range of topics and implicates most corporate departments and business operations. Below is a general overview of these components.

The first component – environmental considerations – concerns how a company performs as a steward of nature and the environment. These considerations may include a company's energy use; waste and pollution streams and volumes, as well as disposal practices; natural resource conservation; carbon and greenhouse gas blueprint; use of renewable energy; use of raw materials; ownership of contaminated land; environmentally compatible production; compliance with environmental regulators and laws; and treatment of animals.

The second component – social criteria – concerns how a company manages its relationships with employees, suppliers, customers, and the communities in which it operates. Social factors include occupational safety practices and loss history; inclusion and diversity; equity in hiring, pay, opportunity, and advancement; compliance with labor laws; community engagement; employee engagement; training and development; respect for employee rights; working environment and conditions; unionization and labor practices; and freedom of association. This may include an examination of whether, to whom, and how much the company is donating to non-profit organizations; whether the company encourages and supports employee volunteer work; whether the company's working conditions show high regard for its employees' health and safety; whether there are allegations of trafficking, human rights violations, or child labor; and whether the interests of various other stakeholders are taken into account. Social criteria may extend beyond a company to the company's business relationships with suppliers, customers, regulators, unions, and others, and involve an examination of the business practices of those entities. It will be interesting to see the extent to which stakeholders focus on the human rights and other practices of countries in which a company does business.

The third component – governance – includes practices and policies regarding anti-bribery; corruption; money laundering; executive pay; transparency in financial and public reporting; gender pay gaps; composition of management and the board; risk management and oversight; board actions and obligations; cyber and data security; regulatory compliance; allowing shareholders to vote on significant issues; and avoiding conflicts of interests.

It is true that many elements of ESG have been subject to longstanding state and federal law and regulation. For example, compliance with environmental laws and regulators has been a regulatory focus for decades. Increasingly, however, these laws and regulations are taking deeper dives into company business practices, actions, and relationships.

The Focus on an Insurer's Own Business Practices and Operations

First and foremost, insurers (and insurance brokers) – like all companies – are focusing on their own practices and operations. Many insurers have made commitments regarding their own operations. Zurich, for example, plans to be a net-zero emissions company by 2050 and has developed science-based targets for underwriting. Source: Press Release, Zurich Insurance Group, *Zurich publishes its Sustainability Report 2020* (Mar. 12, 2021). Aon has committed to becoming a net-zero carbon emissions producer by the end of the decade. Source: Report, Aon plc, *2020 Aon Impact Report* (2021). It committed to setting science-based targets and adopting achievable objectives by setting out plans focused on sustainable sourcing, energy efficiency, business travel, and renewable energy. Aon established an internal ESG committee to play a central role in reaching the 2030 target. Aon stated it was also committed to the "social" element of ESG by building diverse and thriving teams with the brightest talent.

Insurer panel counsel calls traditionally focused on billing practices, compliance with litigation management guidelines, and legal trends implicating liability and coverage claims and lawsuits. Over the past few years, however, ESG has increasingly dominated the agenda of these calls, with insurers spelling out their ESG targets and letting their counsel and vendors know what will be expected of them. It will be interesting to see the extent to which insurers, companies, and courts will have less of an appetite for travel, and whether remote hearings, discovery, and meetings will continue after COVID-related travel restrictions are abated. Reducing carbon emissions as well as cost savings may motivate reduced travel in the future and impact use and demands for commercial real estate space.

Insurers As Agents of ESG Change

Insurance companies are being viewed – with increasing frequency and severity – as agents for imposing affirmative ESG change on other entities such as their policyholders and vendors, as well as implementing change in their own operations. In essence, the insurance industry is being targeted because many stakeholders believe it can affect change by not insuring companies that harm the environment, engage in anti-competitive practices, or lack sufficient diversity in the management ranks (or company-wide), or by increasing costs of insurance on these companies. "Globally, the insurance industry is in a unique position when it comes to climate risk as insurers are exposed on both sides of the balance sheet: Their investments face climate risk on the asset side of the balance sheet, and they face underwriting risk, particularly in the property and casualty line, on the liability side." Source: Ross, H., *Climate risks for insurers: Why the industry needs to act now to address climate risk on both sides of the balance sheet*, S&P Global (Aug. 27, 2021).

Insurers' Investment Portfolios

Property and casualty insurers also are large institutional investors. Accordingly, their investment practices are also subject to scrutiny. Insurers and reinsurers now face damage to their reputations by reason of insuring or investing in companies whose ESG considerations are questionable or perceived to be subpar. Indeed, many trace the origins of ESG to investment strategy – not investing in industries or companies with a poor environmental performance. Zurich, for instance, has committed to fully de-carbonizing its $200 billion asset portfolio. Source: *Climate Change Report 2021*, Zurich Insurance Group (2021). It has committed to using its influence as an investor and insurer to pressure companies to take action on climate change. It plans on engaging with companies directly and through various organizations in furtherance of these goals. These ESG efforts have trended towards generally accepted practices. According to the Forum for Sustainable and Responsible Investment (US SIF), as of 2020, one-third (approximately $17 trillion) of all U.S. assets under management were invested following sustainability principles, with money managers paying closest attention to climate change/carbon emissions, natural resources/agriculture sustainability, and board governance issues. This figure represents a 42% increase over 2018. Source: *Report on US Sustainable and Impact Investing Trends 2020* (2020).

AM Best, in a November 2020 report, emphasized that insurers and reinsurers that ignore ESG in their underwriting and investment decisions confront serious reputational risk. These risks may cause buyers and investors to flee to competitors, affecting the companies' creditworthiness and ratings. By contrast, insurers that invest in and underwrite companies and technologies that will help tackle climate change stand to gain reputationally and with respect to earnings. Source: Report, AM Best Information Services, *Insurers and Reinsurers – Ignoring ESG Factors Poses Reputational Risk* (2020).

Insurer Underwriting Activities

Attention is also focused on insurer underwriting activities. Some insurers are already actively moving away from underwriting risks that deal with fossil fuels. Zurich, for instance, has committed to terminating its relationship with companies that generate more than 30 percent of revenue from mining or generate more than 30 percent of their electricity from thermal coal, oil sands and oil shale, extract more than 20 million tons of thermal coal or continue to invest in coal mining and infrastructure. Source: Dalton, R., *Zurich cuts ties with over 90 companies over green issues*, Insurance Insider (Mar. 12, 2021); Zurich Insurance Group, *Exclusion policies*, (2021). For those that exceed the thresholds, Zurich stated it would engage in a dialogue on transition plans, but if companies fail to demonstrate meaningful improvement, it will cease to underwrite or invest in them. Aviva stated it will stop insuring companies generating more than 5 percent of revenues from thermal coal or unconventional fossil fuels by the end of 2021. Source: Report, Aviva, *Taking Climate Action: Sustainability* (2021). Aviva added it would make exceptions for companies serious about their transition out of high-carbon fuels that have already "committed to clear science-based targets aligned to the Paris Agreement target of limiting temperature rises to 1.5 degrees." Even oil companies appear to be jumping on the ESG bandwagon. BP's Chief Executive, Bernard Looney, stated in February 2020 that it was BPs "new ambition to become a net zero company by 2050 or sooner, and to help the world to get to net zero." Source: Press Release, bp p.l.c., *BP sets ambition for net zero by 2050, fundamentally changing organisation to deliver* (Feb. 12, 2020).

Changes in underwriting have been taking place. The analysis of risks are expanding from traditional elements such as the types of operation or geographical characteristics to qualitative analyses in relation to ESG criteria. This may include examination of employee rights and audits of supplier companies, as set out in the proposed Supply Chain Acts in Germany and the EU. Policyholders that actively address sustainability issues could also benefit from this change in the underwriting process. For example, opportunities could arise in pricing, policy terms, and program structuring, including lower deductibles. Companies could be given incentives to change their processes and also contribute to compliance with sustainability and climate targets.

Insurers also are taking into account the consequences of disclosure requirements imposed on companies. Increased use of artificial intelligence and scoring systems are being formulated and deployed as part of an integrated underwriting process. Underwriting applications and questionnaires are being updated, and early dialog regarding ESG risks is being incorporated into the underwriting process.

Unquestionably, insurers have to be cognizant of the ESG practices and risks of policyholders as ESG issues impact claims and loss activities. ESG issues are rife for litigation and claims.

ESG Is a Central Component of the Biden Administration Agenda

ESG has become a central component of most policies and departments under the Biden Administration. On May 20, 2021, President Biden signed an executive order on climate-related financial risk. The order directs federal agencies to analyze and mitigate the risks that climate change presents to homeowners, consumers, businesses and workers, and the U.S. financial system. A fact sheet distributed during a White House briefing indicated that the executive order will:

- Develop a whole-of-government approach to mitigating climate-related financial risk. The order directs the White House national climate advisor and the director of the National Economic Council to develop and identify, within 120 days, public and private financing needed to realize economywide net-zero emissions by 2050, while also advancing economic opportunity, worker empowerment and environmental mitigation, particularly in disadvantaged communities and communities of color.

- Encourage financial regulators to assess climate-related financial risk. The order urges the secretary of the Department of the Treasury to work with Financial Stability Oversight Council (FSOC) members to assess climate-related financial risk as it pertains to the stability of the federal government and of the U.S. financial system within a 180-day period. The order also requests a report on plans of member agencies to improve climate-related disclosures and other sources of data and to incorporate climate-related financial risk into regulatory and supervisory practices.

- Bolster the resilience of life savings and pensions. The order directs the secretary of the Department of Labor to consider suspending, revising or rescinding any rules from the prior administration that would have barred investment firms from considering environmental, social or governance (ESG) factors, including climate-related risks, in investment decisions involving workers' pensions. The order also requests a report on other potential measures to protect the life savings and pensions of U.S. workers and families from climate risk and an assessment of how the Federal Retirement Thrift Investment Board will incorporate ESG risk factors.

- Modernize federal lending, underwriting and procurement. The order requests recommendations for how federal financial management and reporting can incorporate climate-related financial risk, in particular in federal lending programs. The order also directs consideration of new required disclosures of greenhouse gas emissions and climate-related financial risks for federal suppliers and seeks to minimize such risks in federal procurements.

- Reduce the impact of climate change to the federal budget. The order mandates fiscally responsible action to respond to the risk of increased costs and lost revenue resulting from climate change. It also directs the federal government to develop and publish annual assessments of climate-related fiscal risk exposure.

Source: Press Release, White House, *FACT SHEET: President Biden Directs Agencies to Analyze and Mitigate the Risk Climate Change Poses to Homeowners and Consumers, Businesses and Workers, and the Financial System and Federal Government Itself* (May 20, 2021).

A United States Securities and Exchange Commission (SEC) Risk Alert stated that companies should engage in clear and simple disclosures that are precise and tailored to firms' specific approaches to climate and ESG investing, that accurately convey the material aspects of the firms' approaches to ESG investing, and that align with the firms' actual practices. Source: Risk Alert, SEC, *The Division of Examinations' Review of ESG Investing* (Apr. 9, 2021). In 2021, the SEC announced the formation of the Climate and ESG Task Force, with an initial focus on identifying any material gaps or misstatements in disclosures of climate risks under existing rules and proactively identifying related misconduct. Source: Press Release, SEC, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues* (Mar. 4, 2021). Treasury Secretary Janet Yellen charged the Financial Stability Oversight Council with assessing the financial risks associated with climate and shared that information with regulators and private investors. Source: Press Release, U.S. Department of the Treasury, *Remarks by Secretary of the Treasury Janet L. Yellen on the Executive Order on Climate-Related Financial Risks* (May 20, 2021). This increased regulatory focus comes as investors have turned their attention and funds to climate issues.

Diversity, Equity, and Inclusion Disclosures and Requirements

On August 6, 2021, the SEC approved the diversity rule proposed by the Nasdaq Stock Market (Rule 5605(f)). Nasdaq is the second-largest exchange in the United States with over 3,700 public companies listed and with market capital total in excess of $19 trillion. Nasdaq-listed companies will generally be required to either have (or explain why they do not have) at least one director who self-identifies as female and at least one director who self-identifies as an underrepresented minority or LGBTQ+ as those terms are defined in the rule. See Notice, SEC, *Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, to Adopt Listing Rules Related to Board Diversity and to Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service* (Aug. 6, 2021).

As insurers who write directors and officers and professional liability coverages are aware, numerous diversity-related lawsuits have been filed, including cases against businesses such as Facebook, Oracle, and Monster Beverages. One common charge in these suits is that the directors and officers of the sued companies breached their fiduciary duties and violated Section 14(a) of the Securities Exchange Act by failing to include diverse directors on their boards and in their senior executive ranks, while proclaiming their commitment to diversity, equity, and inclusion in the company's proxy statements/other publications. Suits are seeking a wide-range of relief, including disgorgement of compensation, attorney fees, forced resignations, termination of auditors, vendors, diversity training programs, and establishment of hiring committees focused on diverse hiring.

Some laws and regulations add further fuel to these claims. For instance, several states have provided additional ammunition by passing laws requiring that public and private companies promote diversity. California required public companies headquartered in the state to include a stated number of women on their boards by 2019, to increase the number again by 2021, and elect at least one director from an underrepresented community by the end of 2021. New York requires all boards to report the number of women board members, effective June 27, 2020.

The New York State Department of Financial Services (DFS) has taken action to promote diversity, equity, and inclusion in the insurance industry. In a circular letter to all New York-regulated insurers, DFS outlined its expectation that insurers make the diversity of their boards and senior management a business priority and key element of their corporate governance. Source: Letter, New York DFS, *Diversity and Corporate Governance* (Mar. 16, 2021). This includes fostering a diverse pipeline of future leaders. The letter follows informal conversations with insurers, trade groups, and diversity experts as well as input from the committee of New York State's Council on Women and Girls formed in 2019.

Scrutiny on Pricing or Premium Practices

Pressure from various external stakeholders and regulators is calling into question traditional pricing of insurance policies. Governmental entities and regulators are weighing in with various pieces of legislation and regulations to implement their policy agendas. One recent example aimed directly at insurers is the State of Washington's removal of insurers' right to use credit scores in pricing despite its close correlation with risk. More broadly, property and casualty insurance are being pressed to alter their premium pricing structures.

Rating Agencies Are Focused on ESG

Insurance rating agencies across the globe have become increasingly aware of ESG risk factors and their potential impacts on their investment portfolios and lending policies. Since March 2020, when AM Best began disclosing whether ESG factors were key rating drivers, roughly 10 percent of rating movements have been a result of ESG factors. Environmental and governance factors have been the most frequent drivers of these rating movements. DBRS Morningstar reports that large institutions are facing greater pressure from external shareholders to better manage their exposures to environmental risks. This has become more important than ever for property and casualty insurers after several years of heightened natural catastrophe losses. DBRS Morningstar announced it is taking a more formal approach to incorporating ESG factors into its rating process across all rating groups worldwide, including in rating insurance companies and financial institutions. It identified 17 significant ESG factors – five environmental, seven social, and five governance – that now will be considered when rating companies. Source: DBRS Morningstar, *ESG Risk Factors by Sector* (2021). AM Best is a signatory to the United Nations' Principles for Sustainable Insurance.

The United Nations' Principles for Sustainable Insurance

The United Nations' Principles for Sustainable Insurance (PSI) is a framework designed to embed ESG issues in decision-making. The PSI is a voluntary sustainability framework launched by the United Nations Environment Programme Finance Initiative in 2012. It requires insurers to demonstrate their adoption of sustainable insurance practices and make transparent disclosures to the public around ESG issues. AM Best Rating Services CEO Matthew Mosher said the move forms part of the agency's focus on insurance and its continued belief that ESG elements play an important role in the financial strength of an insurance company. Source: The ESG Insurer, *Edition 1* (April 2021)

According to PSI:

> ESG issues are increasingly influencing traditional risk factors and can have a significant impact on the industry's viability. Therefore, a resilient insurance industry depends on holistic and far-sighted risk management in which ESG issues are considered.
>
> As risk managers, risk carriers and investors, the insurance industry has a vital interest and plays an important role in fostering sustainable economic and social development. We believe that better management of ESG issues will strengthen the insurance industry's contribution to building a resilient, inclusive and sustainable society. However, many ESG issues are too big and complex and need widespread action across society, innovation and long-term solutions.
>
> Therefore, it is our aspiration to build on the foundation the insurance industry has laid in supporting a sustainable society. The future we want is a society in which people are aligned and incentivised to adopt sustainable practices. To realise this aim, we will use our intellectual, operational and capital capacities to implement the Principles for Sustainable Insurance (the 'Principles') across our spheres of influence, subject to applicable laws, rules and regulations and duties owed to shareholders and policyholders.
>
> UNEPFI, *The UNEP FI Principles for Sustainable Insurance* (Jun. 2012).

ESG Has a Major Impact on Losses

ESG has a major impact on insured and uninsured losses. Apart from claims related to climate change, the environmental component of ESG has substantially impacted what were traditionally called losses from natural disasters. Global losses from natural disasters in 2020 were $210 billion, according to Munich Re, of which only $82 billion was insured. Source: Nadeem, R., *Munich Re estimates overall 2020 nat cat losses at $210B*, S&P Global (Jan. 7, 2021). Both overall losses and insured losses were significantly higher than in 2019, which experienced a total loss of $166 billion, of which $57 billion was insured. Climate change will play an increasing role in all of these hazards, requiring property and casualty insurers to manage their environmental exposures appropriately. The assessment of environmental risks is a major component of DBRS Morningstar's analysis for the property and casualty insurance business. It explained "[t]his includes the impact of insured catastrophes on an insurance company's financial strength, as well as considerations regarding claims predictability, frequency, and severity." Source: Moorcraft, B., *Insurers facing greater pressure to manage ESG risk factors*, Insurance Business America (Mar. 1, 2021).

Social risk factors similarly may have a significant impact on an insurance organization's customer and employee base, as well as its financial strength. Weak corporate governance and unethical conduct may have a detrimental impact on financial performance and reputation, and could result in fines, damages, or loss of operating licenses. Increases in costs associated with recruitment and retention of women and workers from ethnic minorities, poorer socio-economic backgrounds, and employees with disabilities, and ensuring equal pay are expected.

Insurers Have Important Tools and Products Available for ESG Response

Not only are insurers leading thought leaders on ESG, they also have a leading role to play in ESG response. It is key for insurers to take advantage of the opportunities associated with ESG. Insurers have insurance and risk management products that are useful to corporate policyholders in managing risks and addressing ESG issues. Insurers have expertise and capabilities in risk assessment, management, and response, and loss control that could benefit corporate policyholders. Sustainable insurance products are already being marketed. For example, in a sustainable household insurance policy, policyholders can expect compensation for additional costs if appliances need to be replaced with new ones that meet the highest energy efficiency class. In the automotive sector, better differentiation can be achieved through the use of telematics, or discounts could be considered for the purchase of an electric car. Source: Genre Blog, *Why ESG Spells Big Changes Ahead For Insurers* (June 17, 2021).

Various insurers have and are developing methodologies, applications, and platforms for their use and the use of their policyholders. Insurers may provide readiness questionnaires, guidance, and best practices based upon objective criteria for environmental compliance, assessments, and readiness.

Finally, for those who believe in following the money, markets generally have been responsive to ESG. Global financial institutions have increased their commitments to sustainable and clean energy projects, and money is moving into climate-related funds and bonds. Bonds centered on and investing in the climate have seen appreciable growth. With all of the dynamics and the significant stakes, insurance companies will continue to play an important role with respect to ESG.