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Alerts

Part One: Reviewing Key U.S. Insurance Decisions, Trends, & Developments

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Insights for Insurers

These are challenging times for insurers, policyholders, and reinsurers. In the coming days, we will review—in a series of articles—some of the key trends and developments currently impacting the U.S. insurance industry.

Part One reviews the significant impact of environmental, social, and governance (ESG) criteria—often referred to simply as sustainability—and the impact on the insurance industry.

ESG/Sustainability

ESG encompasses a broad range of topics and implicates most corporate departments and business operations. 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; disposal practices; natural resource conservation; carbon and greenhouse gas blueprint; use of renewable energy and 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 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; unionization and labor practices; freedom of association; and charitable donations and support. Social criteria may extend beyond a company to the company's business relationships with suppliers, customers, regulators, unions, and others. Often, it involves an examination of the business practices of those entities.

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.

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Sustainability & ESG

As businesses, insurers naturally are focused on their own ESG practices and operations, reviewing, establishing, revising, and implementing their goals regarding their own emissions, carbon blueprints, diversity, and governance.

Insurance companies are being viewed with increasing frequency as agents for imposing affirmative ESG change on other entities, such as their policyholders and vendors. The underwriting, pricing, investment, claims, and business practices of insurance companies are under heightened scrutiny, both internally and externally. For example, insurers are altering their investment portfolio with ESG considerations in mind. Insurers are reviewing their business and underwriting practices. Some insurers already are moving away from underwriting policyholders with unsatisfactory carbon blueprints and/or risks that deal with fossil fuels.

The Federal Government's Focus On ESG

ESG has become a central component of many policies under the Biden Administration. Indeed, virtually all agencies and arms of the federal government are involved in reviewing ESG factors with a view toward increased regulation.

Earlier this year, the U.S. Security and Exchange Commission (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. 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.

The SEC has already increased its focus on climate change and ESG disclosures. In September 2021, the SEC published a sample comment letter forecasting comments that the SEC may issue to companies because of the absence of sufficient climate-related disclosures. Many U.S. companies anticipate that the SEC will promulgate and implement mandatory ESG-related disclosures in the near future.

On August 6, 2021, the SEC approved the diversity disclosure rule proposed by the Nasdaq Stock Market (Rule 5605(f)). Nasdaq is the second-largest exchange in the U.S., with over 3,700 public companies listed and market capital in excess of $19 trillion. SEC disclosure requirements may not be far behind. We appear to be heading toward a regulatory environment in which climate change-related disclosures—and disclosures of the demographic composition of company boards and executives—will be required, with potential penalties and other consequences to follow. Such developments fuel claims and litigation against companies, their directors and officers, and others.

The Federal Insurance Office of the U.S. Department of the Treasury (FIO) issued a Request for Information (RFI), following the May 20, 2021, Executive Order on Climate-Related Financial Risk, that solicited "public input on FIO's future work relating to the insurance sector and climate-related financial risks." FIO expressed the intent for its climate-related work to respond to the Executive Orders and the Treasury Department's broader climate work, including working with Treasury's Climate Hub. Public comments were due on November 15, 2021. The RFI and other developments strongly suggest that the FIO will be regulating the business of insurance in a significant manner.

Sustainability is also being used in connection with governmental review and analysis of mergers and acquisitions. Indeed, in 2021, the Federal Trade Commission has started inquiring about unionization, environmental issues, and corporate governance practices.

State Regulators' Are Focused On ESG

Many state regulators also are laser-focused on ESG. In November 2021, the New York State Department of Financial Services (DFS) announced that it formed a climate division. Later that month, DFS issued final guidance to insurers subject to the department's regulation regarding their management of the financial risks from climate change. DFS claims to be the first U.S. financial regulator to issue a holistic set of expectations on managing the financial risks from climate change. As described in the guidance, DFS expects insurers to take a strategic approach to managing climate risks that consider both current and forward-looking risks and identifies actions required to manage those risks in a manner proportionate to the nature, scale, and complexity of insurers' businesses. DFS also has taken action to promote diversity, equity, and inclusion in the insurance industry.

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% 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 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.

The United Nations' Principles For Sustainable Insurance

AM Best, like many insurers, is a signatory to the United Nations' Principles for Sustainable Insurance (PSI). The United Nations' PSI is a framework designed to embed ESG issues in decision-making that has been gaining traction over the past couple of years. PSI was launched by the United Nations Environment Programme Finance Initiative in 2012 as a voluntary sustainability framework. It requires insurers to demonstrate their adoption of sustainable insurance practices and make transparent disclosures to the public around ESG issues. 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.

Traditional Practices Are Subject To Scrutiny and New Practices Are Emerging

Many of the traditional tools and practices of insurers are under assault. Insurance scoring, which is a type of credit-based analysis used by insurers for a long time, is now prohibited in several states including, California, Hawaii, Maryland, Massachusetts, Michigan, Oregon, Washington (by emergency order), and Utah. Several other states have introduced bills that would ban the use of credit-based scoring. Additionally, gender has been an element of automobile insurance pricing for a long time. Some states do not allow gender to be a factor or require pricing to be gender-neutral. As non-binary gender identification becomes more prevalent, insurers and regulators are revisiting the issue more broadly. The use of zip codes and educational levels in underwriting and pricing is also under attack. Insurers' use of zip code and level of education in underwriting as pricing factors are considered by some to be discriminatory, as this practice can result in poor and minority communities experiencing higher insurance rates.

As insurers have turned to artificial intelligence and modeling with greater frequency to address the complex challenges confronting them, the use of algorithms and predictive modeling is itself being subject to increased scrutiny. For example, the Colorado Insurance Commissioner is required to adopt rules to require insurers to test their algorithms, predictive models, and information sources to measure their performance and ensure that they do not unfairly discriminate against protected classes beginning in 2023.

In an example of emerging practices, Marsh launched a D&O insurance initiative in October 2021. Under this initiative, enhanced policy terms and conditions are offered to companies that meet certain ESG criteria. Companies wanting to participate must agree to be evaluated by a law firm to determine whether their ESG framework meets the initiative's requirements. AIG, Berkshire Hathaway, Sompo International, and Zurich North America are reportedly participating.

Successful Companies View ESG As Presenting Important Opportunities

Although often viewed as presenting challenges, ESG considerations 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 usually are winning and well-positioned. Indeed, successfully addressing ESG issues may be necessary for corporate survival.

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.

Internal Pressures Are Causing Companies To Be Agents For Change

External stakeholders are using the full panoply of vehicles 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. With increasing frequency, companies face reputational as well as financial consequences for alienating groups or not responding in a manner they deem to be acceptable. Cancel culture impacts companies as well as individuals.

It is important to understand, however, that ESG pressures are not only being applied by external forces but increasingly by internal forces 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, as they replace 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, but these workers are also increasingly becoming the corporate decision-makers. Thus, corporations are now becoming entities that will drive change, rather than resist change.

ESG Factors Are Driving Losses

ESG factors, of course, are driving losses and litigation with increasing frequency. Insurance claims professionals, risks managers, and company executives must understand these impacts and trends. 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. 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.

We have also seen the emergence of new types of claims, such as greenwashing cases. These cases, brought by activist organizations and consumers, allege companies overstate the recyclability of their single-use plastic products or make untrue or exaggerated representations regarding environmental stewardship.

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, people from poorer socio-economic backgrounds, and employees with disabilities in order to ensure equal pay are expected.

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For example, press releases reflect that Zurich plans to be a net-zero emissions company by 2050 and Aon by 2030.

As of 2020, one-third (approximately $17 trillion) of all U.S. assets under management were invested following sustainability principles, a 42% increase from 2018. US SIF, "Report on US Sustainable and Impact Investing Trends" (2020).

Zurich, for instance, has committed to terminating its relationship with companies that generate more than 30% of revenue from mining or generate more than 30% 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. R. Dalton, "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% of revenues from thermal coal or unconventional fossil fuels by the end of 2021. 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." Press Release, BP P.L.C., "BP sets ambition for net zero by 2050, fundamentally changing organization to deliver" (Feb. 12, 2020).

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, workers, and the U.S. financial system; develop a whole-of-government approach to mitigating climate-related financial risk; encourage financial regulators to assess climate-related financial risk, modernize federal lending, underwriting and procurement; incorporate climate-related financial risk in federal lending programs; consider new required disclosures of greenhouse gas emissions and climate-related financial risks for federal suppliers and seek to minimize such risks in federal procurements; and reduce the impact of climate change to the federal budget. 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).

Press Release, SEC, "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues" (Mar. 4, 2021).

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).

S.M., Seaman, "Comments Due to the Federal Insurance Office on its Wide-Ranging Work Relating to the Insurance Sector and Climate-Related Financial Risks," *JD Supra* (Oct. 13, 2021).

Bryan Koenig, "Nontraditional Questions Appearing In FTC Merger Probes," *Law360* (Sept. 24, 2021).

See "New York Issues Final Guidance to Insurers on Managing Risks of Climate Change," *Insurance Journal* (Nov. 15, 2021). DFS states that insurers should: integrate the consideration of climate risks into its governance structure at the group or insurer entity level; when making business decisions, consider the current and forward-looking impact of climate-related factors on its business using time horizons that are appropriately tailored to the insurer, its activities and the decisions being made; incorporate climate risks into the insurer's existing financial risk management, including by embedding climate risks in its risk management framework and analyzing the impact of climate risks on existing risk factors; use scenario analysis to inform business strategies and risk assessment and identification; and disclose its climate risks and engage with the Task Force on Climate-related Financial Disclosures and other initiatives when developing its disclosure approaches. Acting Superintendent of Financial Services, Adrienne A. Harris, stated, "[c]limate change is an urgent issue that poses wide-ranging and material risks to the financial system. Insurers, which are uniquely impacted as climate change affects both sides of their balance sheets, also play a critical role in managing climate risks."

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." B. Moorcraft, "Insurers facing greater pressure to manage ESG risk factors," *Insurance Business America* (Mar. 1, 2021).

UNEPFI, "The UNEP FI Principles for Sustainable Insurance" (June 2012).

See S.B.169, 73rd Gen. Assemb., 2021 Reg. Sess. (Colo. 2021).

See Angela Childers, "Boards Enhancing ESG To Prove They're Worth The Risk," *Law360* (Jan. 7, 2022).

R. Nadeem, "Munich Re estimates overall 2020 nat cat losses at $210B," *S&P Global* (Jan. 7, 2021).