INTERNATIONAL INSURANCE SOCIETY

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The ESG Agenda and Insurance

Regulatory Developments, Goals and Limitations

Environmental, social, and governance (ESG) issues are among the hottest topics in our industry today. The ESG agenda is important for all enterprises, but it has unique relevance for the insurance industry.

ESG issues go to the core of the industry's value proposition. Insurers also have a unique multifaceted engagement with ESG issues given their role as risk financing/risk assessment experts, institutional investors, and operating companies, often with a significant global workforce and network of professional partners and customers.

The ESG agenda can drive business opportunities, enhance (or diminish) the reputation of insurers, affect balance sheet performance, and impact insurers' relationships with policyholders, shareholders, employees (including talent recruitment), and the communities in which they operate.

In two recent International Insurance Society (IIS) Insights articles—"Embracing Today's Opportunity" and "Unlocking Tomorrows Opportunities"—Joan Lamm-Tennant discussed the value of incorporating ESG principles into the operations and governance of insurers. She provided cogent examples of how focusing on ESG goals can enhance a company's economic performance and business prospects.

I agree with the author and know that many major insurers are now engaged in developing, establishing, enhancing, and deploying their ESG principles and goals. This is not an easy task and I think it is fair to say that wherever one is on the ESG development curve it is a fluid situation, and everyone is exploring what is best for their company.

As the author notes in "Unlocking Tomorrow's Opportunities" motivation to incorporate ESG principles into a company is driven by many factors, including investor demands, rating agency actions, pressure from policyholders, employees, public relations, and reputational concerns.

One must add to the list of ESG drivers the growing number of regulatory and quasi-regulatory initiatives that have evolved over the past four to five years. These initiatives have accelerated markedly over the past year alone, with a proliferation of reporting requirements, stress testing, and other regulatory requirements around ESG issues. Developments in early 2021 demonstrate that this pace of change will not abate.

As a result, in addition to developing their own ESG goals, it is imperative that insurers engage with regulators on this topic. There is much that can be done to promote coordination and harmonization of regulatory requirements in this area. Careful consideration of goals and methods for achieving them will enhance the efficiency and effectiveness of ESG regulatory initiatives.

Furthermore, all must consider the lessons learned about the ability to fashion global rules for an industry that operates under a range of very different regulatory regimes and serves markets with different policyholder needs and economic prospects.

This paper notes a few of the many recent regulatory and policy developments surrounding ESG and the insurance industry and discusses some of the key opportunities they present for both regulators and the industry.

ESG and Insurance

The insurance industry is a relatively latecomer to the ESG agenda. While some major insurers (primarily European) were early supporters, it is only in the past few years that the topic has gained real traction within the insurance sector. Indeed, just in in the past 12 months, insurance industry engagement on ESG issues has skyrocketed, particularly within the United States.

ESG principles and goals, however, have been around for decades, though, with leading voices coming from the asset management industry. In many countries, business enterprises have long had a legal duty of care to employees, customers, communities, and society at large. In contrast, generally well-established U.S. corporate law provides that a company's duty is to maximize value for its shareholders. (The important debate over short-term versus long-term shareholder value and the role that ESG factors have in increasing shareholder value are beyond the scope of this article.)

Regulatory Developments

Insurance regulatory efforts around ESG issues have evolved dramatically over the past few years.

A few selected events provide a snapshot history of the ESG agenda for the insurance sector:

- 2006—The National Association of Insurance Commissioners (NAIC) forms the Climate Change and Global Warming Task Force.
- 2010—The NAIC Climate Risk Disclosure Survey is adopted. (It is currently mandated in a few states, including California and New York.)
- 2012—The United Nations Environment Programme (UNEP) Principles for Sustainable Insurance (PSI) is adopted and launched at the IIS Global Insurance Forum.
- 2015—The Task Force on Climate-Related Financial Disclosures (TCFD) is formed by the Financial Stability Board, which has insurance company representation.
- 2015—The Insurance Development Forum—an industry-led partnership between the World Bank, UN, and other international organizations—is formed.
- 2015—The United Kingdom Prudential Regulatory Authority (PRA) publishes the paper, "The Impact of Climate Change on the UK Insurance Sector."
- 2015—The UN adopts the Sustainable Development Goals (SDGs).
- 2016—The UN Environmental Program sponsors the establishment of the Sustainable Insurance Forum, an organization made up of 30 global insurance supervisors who are focused on climate change issues and support other ESG goals.
- 2016—The California Insurance Commissioner calls on all insurers doing business in California to voluntarily divest from their investments in thermal coal.
- 2017—The New York Department of Financial Services (DFS) issues Insurance Circular Letter No. 9: Climate Change and Sustainability.
- 2018—The European Insurance and Occupational Pensions Authority (EIOPA) releases its first recommendations on incorporating ESG and climate risks into Solvency II.
- 2019—The EU Sustainable Finance Disclosure Regulation is entered into force.
- 2019—The UK PRA launches an insurance stress test that includes climate scenarios.
- 2020—The New York DFS issues Insurance Circular Letter No. 15: Climate Change and Financial Risk as well as a letter to financial institution CEOs on the steps it expects institutions to take regarding climate risk.
- 2020—The NAIC forms the Climate and Resiliency (EX) Task Force.
- 2020—The California Department of Insurance conducts a survey and publishes a database on 400 sustainable insurance products.
- 2020—Sam Woods, CEO of the PRA, publishes a letter to all PRA-regulated firms on managing climate-related financial risk.
- 2020--EIOPA publishes a consultation paper on the use of climate change scenarios in Own Risk and Solvency Assessment (ORSA). A final opinion is to be released by EIOPA in spring 2021.
- 2021—The Bank of England will run a biennial exploratory scenario (BES) to test the resilience of the UK's largest banks and insurers, and its financial system overall, to climate change risks.

These are just some of the ESG-related regulatory developments in Europe and the U.S. There are many more, including an increasing number of initiatives in Asia-Pacific insurance markets. (e.g., Hong Kong and New Zealand have been leaders in the adoption of disclosure requirements) and elsewhere. These events, however, demonstrate that the insurance sector has been connected to the ESG agenda for decades and that the number of initiatives has increased significantly over the past few years.

The nature of regulatory engagement on ESG issues has also evolved. Earliest efforts focused on probing the impact of ESG factors, particularly climate change, on the insurance industry. This led to consultations and surveys regarding insurers' assessment of risks and the steps they were taking to address them. These engagements were largely voluntary and exploratory.

More recently, with the increased urgency over climate change and other ESG and sustainability issues, such as pandemic responses and socio-economic inequality, ESG concerns are even more prominent on the regulatory agenda. Regulatory activity is also moving away from discussions and fact finding to requirements, particularly around disclosures and stress testing.

Regulatory Goals

There has also been an evolution of the regulatory nexus for these initiatives. To date, the nexus has largely been solvency regulation. Regulatory concerns included the dangers of stranded assets on the investment side or failure to accurately assess increasing liabilities caused by climate change. This has led to an increasingly common regulatory approach to hard wire ESG concerns into elements of enterprise risk management (ERM) and the preparation of ORSAs.

There is logic but also limits to this approach. The limits will be tested by the fact that while insurance regulators have legitimate solvency concerns regarding climate change issues, the ESG agenda is broader than climate change. Even with regard to climate change, I believe that regulators are motivated by more comprehensive concerns and goals, such as ensuring that the insurance industry does its part to help combat climate change—and address other ESG concerns in order to save the planet and make societies more equitable, resilient, and sustainable.

It is important to understand the ultimate regulatory goals, because if couched in terms of just solvency regulation (that is, prudent management of liabilities and assets), there are certain regulatory requirements that are justified. If there is a broader agenda, a different course may ensue. But of course, this may also raise the question of whether some of the goals, albeit laudable, are beyond the remit of insurance regulators.

In addition to the question of how broad the insurance regulatory ESG agenda should be, there is also a critical question of how to address these issues on a national and/or global level. And here, even if we just focus on climate change issues for a moment, we see conflicting goals and needs. On many matters, insurers and regulators will benefit from consistent obligations that are reasonable, not duplicative or conflicting. Climate change reporting requirements are a case in point. There has been a proliferation of disclosure requirements from TCFD and beyond. As a result, there is a growing chorus of insurers, regulators, and others calling for a single set of metrics and reporting requirements. This seems essential, but is easier said than done.

But if we go beyond reporting and disclosure measures and begin to consider operational mandates, specific solvency requirements, or other measures such as prescriptive rules on investments or businesses that can or cannot be insured., we run into very challenging issues as a result of significant differences in the structure, needs, and dynamics of national insurance markets.

We have seen in many different contexts, in the insurance industry and other industries, that while establishing global regulatory standards for businesses that operate in many different markets may sound attractive, even laudable, but they can be highly problematic. For example, efforts to establish uniform international capital standards for insurers have not succeeded despite over 10 -15 years of effort. Despite decades of effort, it has been impossible to establish uniform accounting standards for the insurance industry. The reasons for this lack of harmonization are many and powerful. They include strong sentiment around national sovereignty, profoundly different national markets, and significant

differences among companies within a particular market. The argument that "one size does not fit all" rings loudly.

When looking at issues at the core of the ESG agenda, including climate change, one can easily see that new rules will affect companies very differently and there will be winners and losers. This will lead regulators—and the political forces to which they are subject—to insist on rules that are fit for their country.

Accordingly, I urge the industry and global regulators to advance the ESG regulatory agenda with an eye towards doing all that is possible to educate, encourage and facilitate implementation and adoption of ESG measures. There is potentially great benefit in agreeing on a common language and set of definitions surrounding ESG principles, but there is also a danger that regulatory overreach will bog down the ESG movement in protracted debates about which country's approach is best or in efforts to impose one country's idea of the best approach to mandatory requirements on another.

Moving Forward

The ESG agenda is profoundly important to the insurance sector and its regulators. The ESG movement has been propelled by growing evidence of climate change risk, but also by the broader resilience agenda, and calls for socio-economic justice in society. The Covid-19 pandemic has only increased the pressure to address ESG issues.

This has also led to a myriad of standard setters, including regulators, rating agencies, accounting standards organizations, multinational organizations, and others. And the justified sense of urgency has created a challenging, fast-changing environment with a rush of new rules, expectations, and demands on insurers and other global businesses.

It is therefore imperative that insurers engage actively and imaginatively to incorporate ESG factors into their business operations and engage with regulators to determine how insurance regulation can best serve the ESG agenda.

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