Principles for Responsible Investment

ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

GORDON AND BETTY MOORE FOUNDATION

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NOTES FROM THE WORKSHOP

The PRI's [ESG in credit risk and ratings initiative] is bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with insurance companies, bringing together their representatives, investors, and credit rating agencies (CRAs). This workshop is the fifteenth of the series Bringing credit analysts and issuers together, as part of the ESG in credit risk and ratings' initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 4 May 2022 workshop attracted 25 market participants, including four representatives from two insurance companies (see Figure 1 below), representatives from three credit rating agencies (CRAs), and 12 investors from 11 firms (see Appendix for the full list of participating organisations). The discussions were held under the Chatham House Rule and were structured around a set of guidelines that were circulated to participants prior to the event and tailored by sector.[2]

Figure 1: Participating insurers

Companies	
Legal & General	M&G

Identifying and evaluating risks, as well as offering protection against them, is at the heart of the insurance business. Therefore, the insurance industry has been at the forefront in adopting a holistic approach to incorporating environmental, social and governance factors in risk assessment.

Insurance companies have always included such factors as extreme weather events and people's health in risk analysis. However, the need for a more rigorous framework and greater scrutiny has increased along with greater regulatory pressure, changing investor expectations and more evident effects of secular trends related to demographics, climate change and changing consumer habits.

Insurers wear many hats: risk assessors, underwriters and institutional investors (with some also operating as asset managers). As a result, they are well positioned to incorporate responsible investment practices both from a risk mitigation perspective (evaluating the right price at which to insure risks) and from an outcome-driven angle (selecting which entities to ensure and by investing thematically or targeting specific environmental and/or social objectives).

This article contains highlights from discussions during the workshop, which was convened with the objectives of:

[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.

- promoting consensus around credit-relevant ESG issues in the insurance sector;
- aligning expectations around sustainability considerations (e.g. relevance of ESG questionnaires and disclosures);
- improving communication between credit analysts and issuers.

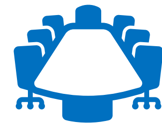
Several observations were common to those expressed in previous workshops, therefore this report focuses mostly on new and/or insurance sector specific, credit-relevant themes. This article also highlights some emerging solutions that participants have begun to consider.

Key discussion findings are grouped as follows:

1. Governance: incorporating E and S risks
2. Climate risk: choosing credit-relevant time horizons
3. Social: assessing the societal cost of the energy transition

It is worth noting that issuers were represented by only life insurance companies. While discussions were intended to reflect a broader view of the insurance industry, issues regarded as material for non-life insurance and reinsurance companies were not discussed.

1. GOVERNANCE: INCORPORATING E AND S RISKS



Governance is considered by investors and CRAs as the most important ESG pillar in the insurance sector, with the key credit relevant areas covering organisational structure, board independence, management credibility, financial strategy, risk management and track record. The better the company's governance performance, the lower the risk of controversies, regulatory fines, and reputational damage.

Furthermore, strong governance credentials are especially important in managing the risks that are central to an insurer's business: protecting people and businesses from environmental and social risks. CRAs and investors mentioned several factors to consider when analysing insurance companies:

- Integration of environmental and social issues in executive committees and throughout the governance structure
- Top management commitment and accountability
- Regulatory compliance
- Appropriate implementation and supervision of an ESG strategy
- Top management remuneration linked to ESG Key Performance Indicators (KPIs)
- Performance against ESG targets and track record
- Quality and transparency of ESG reporting

"We seek evidence of how governance structures are working and limiting the company's exposure to environmental and social risks." – CRA

A representative from one insurer stated that the remuneration of both senior and executive level employees is linked to ESG performance in relation to the company's sustainability goals. The company has created a steering committee for sustainability to integrate and monitor the implementation of ESG issues in the company's governance structure and strategy.

> "From a financial perspective, before looking into sustainability-related solutions, we spent a fair amount of time focusing on how our decision-making process affected environmental and social issues, and ensuring these issues were well governed." – Corporate borrower

As in other industries, cyber-attacks are a growing concern. As a result, insurance companies are devoting more time to running scenarios on these sources of risk across all lines of business to identify risk mitigation solutions. As one issuer pointed out, cybersecurity is also a business opportunity for insurers that should be further explored.

Investors and CRAs also mentioned the size of insurance companies as a factor affecting the quality of governance and ESG performance and reporting, due to limited resources for smaller organisations. In addition, the latter can have less diversified portfolios and business models, which could imply a larger exposure to certain ESG risks.

EMERGING SOLUTIONS
One insurer has introduced KPIs and incentives linked to ESG issues for not only top management but also all employees as a way for the workforce to understand how ESG priorities relate to their daily work.

2. CLIMATE RISK: CHOOSING CREDIT-RELEVANT TIME HORIZONS

On the asset management side, the participating insurance companies are engaging with investees to support them in their energy transition, with divestment as a last resort if progress is not made. Although there is a significant lack of data available on corporates' environmental indicators and transition plans, participants see increasing mandatory requirements for climate-related reporting as a useful tool for improving the quality and availability of corporate data. In the UK, for example, a range of entities face compulsory disclosure under the Task Force on Climate-related Financial Disclosures (TCFD).

For CRAs and investors, investment policies, carbon neutrality strategies (including scope 3 emissions) and scenario analysis are crucial components in credit risk assessments. This is

particularly the case in the European market, where litigation risk could arise from binding EU emission reduction targets. However, different perspectives were expressed on when these climate related issues might become relevant in terms of default risk for insurance companies. While some investors are sceptical about the impact of these risks on credit defaults near term, others expressed concern that regulators could increase capital requirements for companies that are more exposed to climate change, as this increase could affect bond valuations.

“If an insurer suddenly needs to hold much more capital because it is overly exposed to climate change transition or physical risks, this could have an impact on bonds.” – Investor

Moving on to underwriting, investors and CRAs see climate risk as relevant for credit analysis, particularly for non-life insurance and reinsurance companies. They expect insurers to assess the likelihood and the magnitude of accepted insurable climate related risks. However, there are too many uncertainties regarding the time horizon of these risks, making some investors and CRAs wary of the implications for credit risk assessments.

“There are three things you want to know about risk: likelihood, timing, and scale. We know the likelihood of several climate risks is high, but we don’t know the timing and scale. That is why we are doing scenario analysis. The question is, when will we be comfortable incorporating horizon uncertainty into credit risk assessments?” – Investor

There is even more uncertainty on the underwriting side for life insurers because of the added complexity stemming from health risks associated with different climate scenarios. However, insurance companies shared that these aspects are being gradually incorporated into their underwriting risk analysis.

All participants agreed that increasing regulatory-driven climate disclosure, specifically to the EU Taxonomy and TCFD, will become increasingly important as part of risk assessment in the future, with limitations related to consistency, comparability and transparency expected to decrease.

“Having formalised frameworks (under TCFD) helps us be more forward-looking and have discussions about where the risks lie.” – CRA

EMERGING SOLUTIONS

The International Sustainability Standards Board, created by the IFRS Foundation Trustees, presented a proposal to establish a comprehensive global baseline of sustainability-related disclosures.[3] This was mentioned by all participants as a much needed solution to dealing with reporting and regulatory differences between jurisdictions.

3. SOCIAL: ASSESSING THE SOCIETAL COST OF THE ENERGY TRANSITION

Both investors and CRAs expressed concerns about the social and economic costs of divesting from high greenhouse gas emitting industries and ceasing to finance specific economic activities (e.g. new oil sites) or geographical areas (e.g. wildfire-prone regions).

Even though insurance companies are divesting as a last resort to reduce their exposure to increasing physical risks, some investors fear that the overall strategy and risk pricing process are not always clear.

"If we believe divesting will result in better investment performance then it's the most logical thing to do." – Corporate borrower

While CRAs agree that lowering exposure to climate risks is critical, they argue that corporates' size and portfolio diversity are important factors to consider. For example, abandoning wildfire insurance may have a greater impact on smaller insurance businesses, since their business models are typically less diverse.

It remains unclear how these exclusionary practices affect credit risk. However, some participants mentioned that failing to protect people and businesses can result in reputational damage, a risk that could become financially material.

"Some insurance companies are starting to exclude oil companies in underwriting, but this may create bigger economic problems." – CRA

[3] See https://www.ifrs.org/groups/international-sustainability-standards-board/

According to CRA participants, companies that demonstrate the ability to capitalise on the opportunities presented by this challenge, such as developing new products or deploying innovative risk management strategies, will stand out to credit analysts for their risk management agility.

> “Innovating products are needed to address the challenges of this transition.” – CRA

EMERGING SOLUTIONS

Risk-reduction solutions, such as insurance-linked securities and risk-sharing mechanisms, which are common among reinsurance companies, may become more relevant for the broader insurance sector, as a means of reducing its vulnerability to social challenges related to the energy transition.

APPENDIX

Figure 2: Other participating organisations

Investment institutions	
AllianceBernstein	Morgan Stanley Investment Management
Atlanticomnium SA	Neuberger Berman
General Insurance Asset Management	PGIM Fixed Income
HSBC Asset Management	QIC
Janus Henderson	Saturna Capital
MEAG Munich Ergo Asset Management	
CRAs	
KBRA	National Rating Agency
Moody's Investors Service	

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