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Considering Environmental, Social and Governance factors

Spotlight: ESG in Risk Transfer transactions

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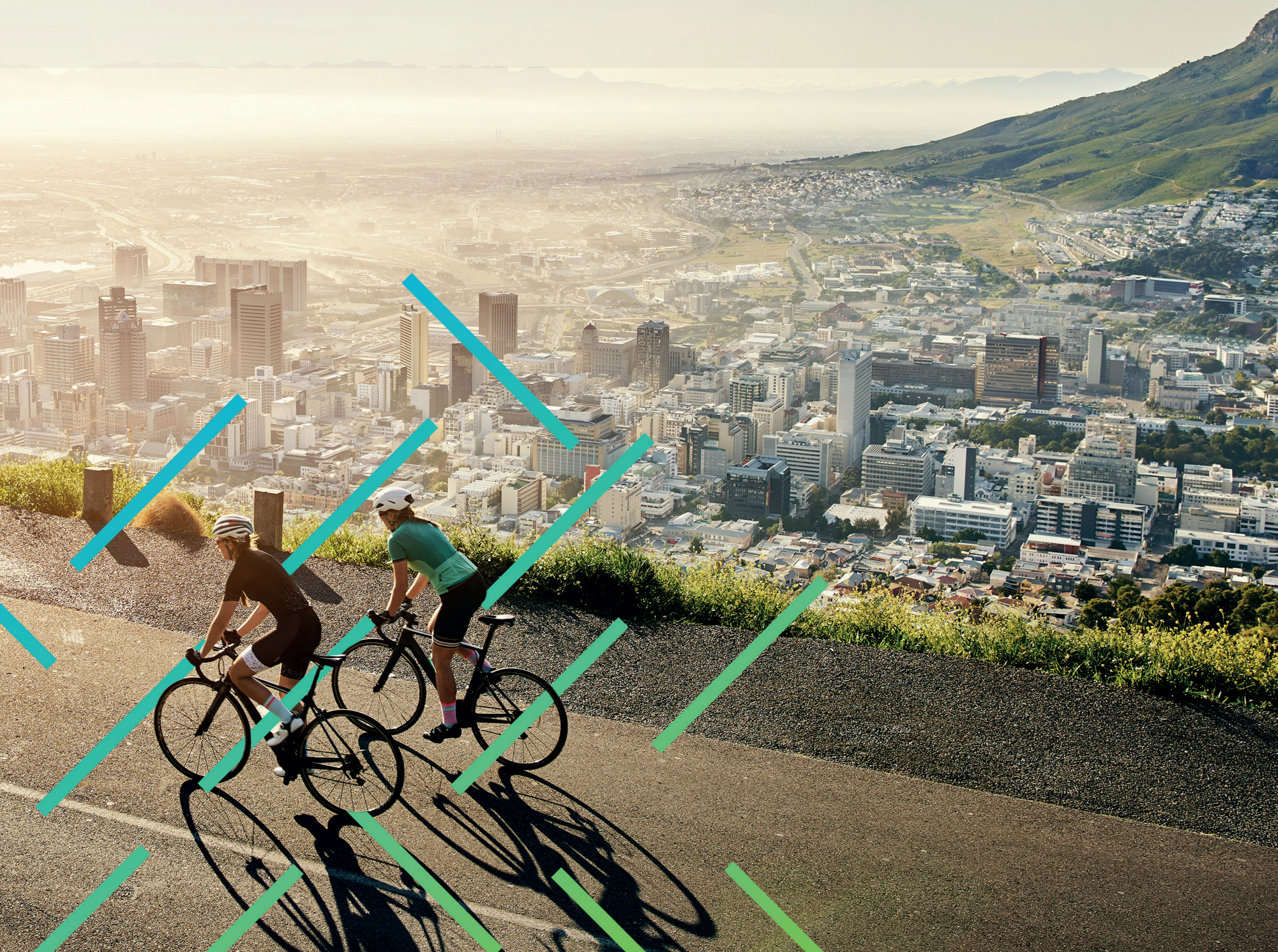

Welcome to our unique insight into the risk transfer market

Spotlight on ESG in Risk Transfer transactions

When considering the sustainability of a pension scheme's investments, guidance to Trustees had traditionally focused on managing investment risks over an 'appropriate time horizon' over which benefits are funded. This could mean that, for a pension scheme targeting buy-ins, and ultimately buy-out, the onus was only on Trustees to consider financially material short-term risks, and not explicitly consider the longer-term impacts of Environmental, Social and Governance ('ESG') factors and climate change.

With the introduction of the climate regulations, Trustees are now required to consider the risks and opportunities that climate change will bring, over appropriate short, medium and long-term time periods for their scheme. These could be related to expected future changes to scheme investments, improvements in climate change data quality, or the longer term period over which members benefits will be paid. For those schemes targeting buy-ins and buy-out, an important part of this will also be how bulk annuity insurers are considering ESG factors.

In this short report we look at ESG risks in the context of buy-in and buy-out transactions from both sides of the fence – that of the insurer and that of the Trustee – and provide more details on the way in which these risks can be evaluated when looking to secure benefits with an insurer.

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The Insurer's perspective

ESG is becoming an increasingly important area of focus for most insurers. Insurers are long-term buy and hold investors and it is hugely important for insurers to consider ESG when undertaking risk management activities, to ensure their business performs as expected in the long term. Their size and the long-dated nature of insurers' portfolios gives them a strong position when it comes to influencing positive change in the financial services sector.

There are opportunities for insurers to gain a competitive advantage by having strong ESG credentials. Trustees are increasingly assessing insurers on their ESG capabilities. In our view, it is important to assess insurers' approach to ESG in the following areas:

Culture

Organisations with a strong ESG culture tend to have a strong organisational commitment to ESG, which may include contributions to industry best practice. They also have clear governance structures which include clear, senior level accountability for ESG.

Integration

ESG considerations are incorporated on both the asset and liability side of the balance sheet and have good, well thought through policies which ensure that ESG is embedded in what the organisation does.

Stewardship

Insurers with strong stewardship capabilities may be signed up to the UK Stewardship Code and would have thought through their own logic for the impact they would like their stewardship to achieve, rather than relying on asset managers to do that thinking for them.

Transparency

Insurers with strong ESG capabilities will aim to be as transparent as possible, not just filling a regulatory requirement to publish a TCFD report when required, but also making as many of their policies as possible available in the public domain.

Insurers that make a meaningful impact embed ESG into their product design, distribution process, marketing, customer relationships, claims processes, and third-party relationships (such as reinsurers, procurement processes, and supply chain).

Environmental aspect of ESG

The environmental aspect of ESG is of particular interest to insurers due to the high level of uncertainty and long-term nature of climate change. When considering climate change, insurers will need to look through two lenses:

Lens 1

Risk management:
Ensuring that the implications of climate or other risks don't materially adversely affect the value of the portfolio and therefore their ability to meet the pension payments to members.

Lens 2

Impact:
Ensuring the decisions made today have a meaningful impact on the global goal of aligning to the Paris Agreement i.e. impact beyond the portfolio in question.

These viewpoints are not necessarily distinct; however, it is important for insurers to consider how much weight to put to each of these perspectives and also be clear when communicating with customers and clients which viewpoint is driving decision making. Where insurers are not clear with communication, there is a risk of being perceived, rightly or wrongly, of "green washing".

The Trustee's perspective

The Trustee's key duty is to act in the best interests of members of the pension scheme. When approaching decisions around buy-in or buy-out, a Trustee needs to be mindful that their chosen insurer can ultimately take on responsibility for the payment of members' benefits many decades into the future.

In selecting an insurer, the main focus with will often be price. However, there will also be a number of other factors that would typically be considered as a matter of good governance to ensure the right decision is made for the pension scheme and the members:

Financial strength and security of the insurer, including their credit rating(s) and level of reserves they hold above statutory requirements, to provide additional support in case of adverse future events;

Experience and commitment to market, especially where subsequent buy-ins may be considered by the Trustee;

Brand strength and name awareness, for members who are likely to become individual policyholders of the insurer in the long-term; and

Administration capabilities and member options, to ensure members get the best service and consistency of options that would otherwise be offered by the pension scheme.

In addition to these factors, emerging risks such as climate change, could also affect insurers' future financial strength. Understanding insurers' approaches for how ESG factors and climate-related risks are integrated into their standard processes and investment decision making, and comparing this with the approach being taken by the pension scheme, is critical to help trustees reassure themselves that a risk transfer transaction will be in the best interest of members in the long term.

There is a definite direction of travel amongst insurers, acknowledging the benefits of focussing on Responsible Investment factors in what they do. Many have been following the latest disclosure recommendations for some time and from this we can identify differences in the way they:

- **Invest** in socially beneficial projects and low carbon initiatives;
- **Reject** investments involved in controversial activities;
- Actively **engage** with companies they invest in to drive positive changes to their ESG performance; and
- **Expect** third party asset managers to become signatories to the UN Principles of Sustainable Insurance.

However, insurers differ considerably in the range of business they provide, the services they employ and the investment strategies they follow. Measuring the "outputs" doesn't provide a clear or comparable picture of the different insurers' approaches to Responsible Investment.

To get to the heart of the issue, trustees need insight into how insurers have integrated the consideration of ESG factors in their business processes, business oversight and resource allocation. It's the evaluation of these "inputs" that will better identify differences between how insurers are currently geared up to addressing the risk and ethical issues that Responsible Investment focusses on.

How we can help

Our comprehensive assessment of insurers' ESG capabilities and regular ongoing discussions, means we're able to support Trustee boards' assessment of the insurers through an ESG lens – whether this occurs at the point of selecting an insurer for a buy-in, or in monitoring an existing insurer's ongoing position and latest developments from an ESG perspective.

Within our review of their ESG capability, we focus on the harder task of assessing these "inputs", forming informed views in the four key dimensions of Responsible Investment:

Culture

Does each insurer have a formal ESG or Responsible Investment framework, which demonstrates institutional maturity? To what extent do they have an ongoing commitment to ESG issues from the top down, such that it is embedded in the culture of the firm? Do staff undergo regular training on ESG risks, raising wider awareness in the business?

Integration

Are ESG issues built into standard processes and business as usual decision making, at all stages of the investment process? Is there evidence of their formal ESG policy being followed in practice?

Stewardship

Does the insurer proactively engage with the companies it invests in, or via external managers, to promote ESG issues? Are case studies published?

Transparency

Are ESG risk exposures on investments measured and reported on within the firm? What information on ESG risks is provided by external managers and how often do governance discussions take place? Do TCFD disclosures include details on progress towards net zero targets?

We research these areas so that Trustee boards are equipped with the information they need to extend their approach on Responsible Investment through to their choice of insurer in a meaningful way.

Appendix

Insurer ESG headlines

Understanding and comparing each insurer's approach to ESG risks and Responsible Investment means digging beyond the headlines:

Aviva plc priority to invest £10bn in UK infrastructure and real assets – achieved £4.3bn up to the end of 2021

Invested £7.6bn in green assets as at 31 December 2021

During 2021, Just invested c.£175m in green and social projects and were the first European insurer to issue a sustainable bond

Over 2021, Phoenix Group invested £1.3bn in sustainable assets, beating their target of 60% of illiquid assets originated

Canada Life Asset Management joins 2022 Non-Disclosure Campaign, to increase environmental disclosure and corporate transparency

Scottish Widows lend more than £8bn from their annuity assets which includes supporting sustainable energy and infrastructure projects needed for the low-carbon transition

PIC on track to divest holdings in companies which rely on either the extraction or the burning of coal for more than 10% of their turnover, by the end of 2025

Legal & General Retirement Institutional to invest over £2bn of retirement funds into affordable housing over the next five years to 2027

Rothesay takes action to make its own operations net zero for the next decade – verifying its direct emissions to offset with carbon credits and using direct air capture to remove CO2 from the air

Initiatives with insurer signatories

There are a wide variety of recognised Responsible Investment and climate-related initiatives – a summary of these and which insurers are signatories are set out below. In some cases, the wider group entity or associated investment management business are signatories (as noted).

	Aviva	Canada Life	Just	L&G	PIC	Rothesay	Scottish Widows	Standard Life
PRI Principles for Responsible Investment	🟢[1]	🔴	🟢	🟢	🟢	🟢	🟢	🟢[4]
FRC UK Stewardship Code	🟢	🟢[2]	🔴	🟢[3]	🔴	🔴	🟢	🔴
Net-Zero Asset Owner Alliance	🟢	🔴	🔴	🟢	🟢	🟢	🔴	🟢[4]
IIGCC The Institutional Investors Group on Climate Change	🟢[1]	🟢[2]	🔴	🟢[3]	🔴	🔴	🟢	🟢[4]
Principles for Sustainable Insurance	🟢	🔴	🔴	🔴	🔴	🔴	🔴	🔴
UKSIF UK Sustainable Investment and Finance Association	🟢[1]	🟢[2]	🔴	🔴	🔴	🔴	🟢	🔴
Climate Action 100+	🟢[1]	🟢[2]	🔴	🟢[3]	🔴	🔴	🟢	🟢[4]

Notes

Signatories as at 7 September 2022

1. Aviva Investors; 2. Canada Life Asset Management (CLAM); 3. Legal & General Investment Management (LGIM); 4. Phoenix Group