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Incorporating ESG-C into P&C underwriting: Owning the risk appetite

Long considered an 'emerging risk' for insurers, Environment, Social, Governance, and Climate (ESG-C) risks are now one of the most talked about topics in the insurance industry. As such, the importance attached by senior management to this topic has increased. According to a survey conducted by PwC[1] on the global insurance market, ESG-C was the number eight on the list of senior Management priorities in 2018; in 2021, it is now the second priority behind COVID-19.

However, there is often a lag between recognition of ESG-C as a priority risk area, and action being taken to manage those risks. As such, insurers who acknowledged the risks earlier have been able to get ahead of the problem, develop frameworks, and assign responsibilities faster than others. Life insurers have progressed further and faster than their P&C counterparts incorporating ESG-C into their decision-making process, particularly for their investment portfolios.

[1] Global Insurance Market Insights 2021, PwC, September 2021

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Work on ESG-C for underwriting is accelerating

P&C insurers, who take less investment risk and tend to hold liquid, highly rated assets, have lagged behind life insurers in terms of integrating ESG-C factors into their operations. However, in recent months, Moody's Analytics has noted a significant shift in activity from P&C insurers towards incorporating ESG-C into their decision-making processes. While P&C companies can benefit from the work done by life insurers in developing ESG-C metrics and frameworks for their investment operations (through adoption of best practices), a lot of work still needs to be done to understand how to incorporate ESG-C into underwriting activities.

Thus far, strategies to incorporate ESG-C into underwriting have varied considerably between insurers. Some focused purely on certain business lines and sectors (For example, excluding new coal power plant developments), others have looked to create balanced scorecards to measure ESG-C risks. The scores are then used to guide risk selection and pricing as well as providing mechanisms for referral to underwriting committees for risks that fall outside of ESG-C tolerances.

Due to these variations in strategy, insurers, particularly large European insurers, have sought to find common ground and collaborate to send consistent messages to the marketplace. It has resulted in a number of partnerships and alliances, of which the most visible is the UN-convened Net Zero Insurance Alliance (NZIA). The NZIA brings together 24 of the world's leading insurers and reinsurers to play their part in accelerating the transition to net-zero emissions economies. They are committing to individually transition their underwriting portfolios to net-zero greenhouse gas (GHG) emissions by 2050, consistent with a maximum temperature rise of 1.5°C above pre-industrial levels by 2100.

As strategies evolve and converge, best practice will too. Given the varying benchmarks and taxonomies for ESG-C, insurers have sought to align with international standards. Particularly when it comes to communicating with external stakeholders. The most frequently referenced standards are the UN Sustainable Development Goals (SDGs). Many insurers, both life and P&C, have found the SDGs useful in defining their targets and ambitions. Consequently, insurers have sought to acquire ESG-C data and metrics that use the SDGs as reference points, allowing them to align with these standards.

Thinking beyond downside risks

Historically, insurers have focused their attention on the downside risks associated with ESG-C, in particular risks related to reputational, and regulatory concerns. In addition, there has been a focus on transition risk[2] in recent months, driven by increased environmental regulation, including carbon taxes, incentives for sustainable activities, technological, and consumer demand changes. Such measures to support the transition to a low carbon economy, could potentially create loss of premium revenue for those insurers who continue to focus on these sectors and don't adapt their products for a carbon-efficient economy. In particular, those carriers who maintain large underwriting exposures to hydrocarbon industries will find fewer opportunities as the economy pivots to greener energy sources.

The focus has shifted from looking at ESG-C purely from a downside/defensive point of view to a forward looking, revenue generating point of view. Many P&C insurers, particularly those involved in corporate specialty P&C insurance are becoming more vocal of the revenue opportunities that ESG-C brings to the marketplace. Green infrastructure and renewable energy projects which support the transition from a high carbon to low-carbon economy should present new risks and premium opportunities for P&C insurers. As such, those insurers who are better able to adapt their business models for these new risks are most likely to capture these growth opportunities. This requires obtaining data on transition risks for sectors and insurers, and then deploying capacity and expertise into sectors that are likely to benefit from the transition to a low-carbon economy.

Developing an 'own view' of ESG-C risk

Incorporating ESG-C into underwriting requires insurers to redefine their underwriting risk appetites. Insurers are accustomed to changing their risk appetites based on pricing dynamics, capital requirements, and growth targets. Incorporating ESG-C into underwriting decisions will provide another lens to view risk selection and appetite. At the same time, insurers should ensure that there are, at least initially, no 'red lines'. Instead a balanced approach should be developed, that considers ESG-C holistically. For example, it may seem convenient to cease coverage for coal-powered energy producers, who would score poorly on the "E" part of ESG-C. However, these insureds may provide electricity to communities in developing countries. Leaving such assets unprotected would be damaging to communities who rely on these assets.

[2] Transition risks are business-related risks that follow societal and economic shifts toward a low-carbon and more climate-friendly future.

In addition, whilst ESG-C scores and metrics can provide a view of an insured's position at a point of time, this would often ignore forward looking measures. Many companies might not have strong ESG-C scores today, but senior management would have plans to transition their companies to more sustainable business models. Drawing 'red lines' based purely on today's ESG-C metrics of an insured may inhibit the insureds ability to execute its own transition plan. Insurers would be abdicating their responsibilities as risk partners and advisors should they take a simple go/no go approach that doesn't engage meaningfully in transition. It is essential that insurers collect and incorporate appropriate forward-looking data into their ESG-C score cards, and engage with their insureds to understand their future plans.

However, in order to appropriately re-define risk appetites, it is also critical that insurers develop their own view of ESG-C, that is consistent with other business functions at the company such as, investments, risk, operations, and also consistent with the ethos of the company and its objectives. Some insurers have sought to buy vendor-developed ESG scores, others have sought to purchase vendor-gathered raw ESG-C metrics to incorporate into their own balanced scorecards, that better reflect their own view of ESG-C risk. It also allows companies to take ownership and accountability of the decisions they take based on the balanced scorecards. Furthermore, it aligns with one of the key principles of the NZIA, namely independently setting their underwriting criteria with regards to emissions and ESG.

Challenges

Insurers have been more successful at measuring ESG-C risk for their investment portfolios than underwriting operations. One reason is, the better quality of data to identify the correct counterparty in investment portfolios relative to underwriting portfolios. P&C insurers, particularly those with significant corporate specialty operations, have poor data on the actual names of their insureds. Additionally, ESG-C scores and metrics are provided at a group level, rather than subsidiary level. Consequently, insurers struggle to match ESG-C scores to insureds. Obtaining good quality and consistent corporate entity information is key in ensuring not appropriate ESG-C scores are obtained, and accurate heatmaps are generated.

Furthermore, the investment portfolios of insurers tend to be focused around well rated, public corporates and sovereigns, for which ESG-C scores are readily available. Conversely, insurance portfolios of P&C insurers are mostly focused on non-public entities and, in the case of retail insurers, on private individuals. ESG-C scores for private entities are not as readily available as they are for public companies. To ensure a level of completeness for understanding the ESG-C exposure of an underwriting portfolio, insurers must obtain ESG-C data on private companies as well as public.

There is likely to be considerable resistance to change, particularly from those underwriters who's lines of business benefit from hydrocarbon extraction and refining. Underwriters for these lines of business may see ESG-C risk assessment as a threat to their divisions as well as their own careers within the insurance market. Additionally, other underwriters may feel concerned that they may have to stop providing coverage to long-standing clients. To counter this, it is again essential to underscore the importance of engagement with insureds, rather than 'walking away'.

Conclusion

Incorporating ESG-C into underwriting is part of the larger challenge of incorporating ESG-C across an insurance company's investments, risk management and supplier management operations. It is critical to develop consistency in the metrics and tolerances used across the business to assess and understand ESG-C risk. Failure to do this could result in siloed decisions being made in different functions that are inconsistent with each other.

As P&C insurers continue their ESG-C initiatives, the door is open to build competitive advantages by imposing their own view of ESG-C risks, redefining risk appetites, incorporating it into the decision-making process, and critically engaging with insureds. It will, however, require insurers to fully appreciate that ESG-C does not only represent a threat, but a growth opportunity. The right data, particularly on private companies, is required to make consistent decisions across different underwriting lines of business.

This is part of a series of papers on climate risk topics for insurers. Read the others here:

» Climate change – The biggest risk multiplier for the insurance industry

» Constructing Climate Pathway Scenarios to Assess the Financial Impact of Climate Risk

» Climate aware Own Risk Solvency Assessment

» [Incorporating Climate Risk into Strategic Asset Allocation]

» [Exploring the impact of IFRS Sustainability Disclosure Standards on Insurers]

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