Sustainable investing in the insurance industry: expanding risk considerations while focusing on returns

Environmental, social and governance (ESG) investing is increasingly becoming an important topic of discussion for asset managers and their clients, and insurance companies are no exception. Insurers have long been in the business of calculating risk and building durable portfolios to match those risks over long time horizons in order to meet liabilities and build surplus income. Many asset managers believe it is becoming increasingly important to consider ESG risks that could impact their investment performance.

The last two quarters have been a challenging time for insurance companies, with many confronting issues that impact both their business operations and investment portfolios. As a result of COVID-19 and related adjustments to social behaviors, there is unprecedented uncertainty around workplace safety and future economic activity. Massive wildfires in California, Oregon and Washington have caused catastrophic destruction across the region. And according to the NOAA, the extremely active hurricane season in the southeast portion of the U.S. appears poised to break records for the number of storms in a calendar year. More than perhaps any other industry, insurance companies must plan for and react to a number of unknown variables.

ESG and risk management

As 2020 has demonstrated time and time again, the cost of ignoring material ESG risks is becoming untenable for insurers. The COVID-19 crisis has highlighted the importance of risk analysis to credit underwriting. For instance, when evaluating governance impacts, companies with strong leadership were better prepared for catastrophic disruptions, and those with systems and technology that could be adapted quickly for remote work fared better. And although wildfires and weather events such as hurricanes are not an unusual occurrence in the U.S. – and insurers have planned for them for decades – the size and scale of current events is unprecedented. Climate change risk is uncertain in time horizon, scale and scope. This makes it a critically important risk to monitor, as it can affect not only insurers ability to meet their liabilities, but the credit quality of an investment in their portfolio.

Conducting enhanced stress testing on portfolios and focusing on modelling a range of asset and operational risk variables can help clients better understand potential liquidity needs. Scenario analyses can focus on accounting for potential physical damage to real estate investments under a severe climate outcome over a three to five year period and financial impacts from the transition to a low-carbon economy. Credit research and investment teams that conduct comprehensive stress testing can help to advance a clients understanding of economic risks, as well as potential responses and mitigating actions.

In addition to accounting for how ESG risks could materially impact insurers own business operations, portfolios need to maintain consistent performance in order to not only account for, but meet these increasing risks and liabilities.

ESG and portfolio construction

Whether ESG or liquidity risks, insurance companies are well versed in risk management within their own business operations. However, consideration of ESG risks on the asset side of the business is lacking. In fact, there is currently only one insurance company signatory to Principles for Responsible Investment (PRI) in the U.S.

With myriad environmental, regulatory and market uncertainty, it is the right time for insurers to consider

ESG on both sides of their balance sheet. Asset managers consider ESG risks in their investment process because they believe that it can lead to better risk-adjusted returns for clients. Each client has unique investment goals and there are industry-specific considerations for insurers. The portfolio construction process should be tailored to meet their needs and consider a number of different factors, including the objectives of the underlying mandate, the expected investment holding period and the availability of information.

Overall portfolio risk exposure is largely driven by specific industry and sector risks, and the materiality of relevant factors vary by industry. We've discussed how climate risks can impact real estate investments, but human rights abuses or lax labor standards could lead to boycotts or sanctions in the global manufacturing industry. And bribery or corruption issues in the financial sector could signal poor governance and loss of confidence in company leadership. Comprehensive analyses can help managers avoid investing in companies where investors are not being compensated for any risks associated with ESG.

Similar to varying risks by industry, the nature and timing of ESG analysis should reflect the liquidity profile of the asset class. Conducting ongoing ESG research for all investments is important, but there are different upfront considerations. Private fixed income investments are longer term and require detailed analysis prior to any initial outlay since there will be little chance to adjust positions afterwards given their less liquid nature. In contrast, public bonds are shorter term investments that can be purchased or sold at any time and therefore will have a focus on both initial and on-going analysis to be sure that there hasn't been a material change to potential ESG risks.

Portfolio managers also need to vary their approach depending on the mandate. ESG risks may be higher for a long duration bond mandate in sectors impacted by climate change or another long-dated trend, with assets that might mature in 30+ years, versus a short duration mandate with assets that mature in the next couple of years.

A focus on outcomes and solutions

At its core, ESG is strong bottom up research that can help investors identify higher quality long term investments and avoid unnecessarily risky ones. The reality for insurers is that the low rate environment continues to challenge their ability to meet their return and income objectives while balancing the risk they take within their investment portfolios. As the search for yield continues, there are ways for investors to achieve both their income objectives and sustainability goals.

Investment grade private credit is becoming more popular among insurance companies. By allocating to investment grade private market asset classes, they have the potential to enhance returns and income, while optimizing their asset allocation in a capital efficient way. From an ESG perspective, the inherent nature of many investment grade private credit deals provides a clear picture of how the funds will be used. In other words, investors know what individual projects or initiatives are being financed through their investments. This enables them to measure the impact of an investment in terms of factors such as the amount of carbon offset and the populations who benefit. Compared with public markets, investors can tailor their portfolios to more tangible and measurable outcomes that meet their ESG goals.

Insurers sit at a unique intersection of sustainable investing: their businesses inherently bear ESG risks from more frequent climate events, and their portfolios must continue to perform in order to meet liabilities and maintain adequate levels of investment income. Understanding how emerging ESG risks impact public and private asset values is critical as asset managers build and steward investment portfolios on behalf of investors. Since there is no one size fits all approach to ESG, we believe investors should evaluate how asset managers incorporate sustainable investing into their portfolio construction process. And working with an asset manager to identify investment opportunities that meet both investment portfolio and sustainability objectives will become increasingly important to the long term success of a portfolio.

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