Briefing

Climate change

Investing for the ‘greater good’

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Climate change clearly presents risks for insurers, whether it be through impacts on claims or asset values. However, having an investment strategy that has a ‘greater good’ element could be a significant opportunity to increase engagement and trust with policyholders and members. It could also help to attract tomorrow’s customers.

This briefing note outlines the key issues faced when investing with climate change targets in mind. It concludes with a five point check list of what you should be doing now, including risk management requirements.

Review your aims

We have long championed the need for firms to document their investment ABCs – aims, beliefs and constraints – in their investment policy documents. Typically, aims have been something along the lines of ‘maximise return, subject to staying within risk limits.’ However, there is now a third dimension that needs to be formally considered in the aims discussion; consistency with climate change targets.

Many insurers have been aware, for a number of years, of ‘Environment, Social and Governance (ESG)’ issues when investing. Certainly asset managers have had it at the top of their agendas for a while. Typically, however, this has been limited to aiming for strategies that enhance return, mainly through investing in firms that have strong governance* or by avoiding firms that are likely to have future issues as the world moves towards being more environmentally friendly.

*I would have hoped that this is what active managers have always done so should not be anything new.

Is this approach enough?

Is this focus on return only what your policyholders want? We believe there will be movement towards a situation where society, especially younger generations, sacrifice some individual return for the greater good. We also believe that insurers, especially mutuals, will be at the forefront of that change. We think, therefore, that you should be considering a third dimension when you next review your investment policy.

How to invest to support all our futures

If you decide that you want to invest in a way that is consistent with climate change targets, how could you do that? You could aim to increase your investment in the equities and bonds of firms with environmental aims; e.g. renewable power. However, there is a limited supply of such assets. You could exclude firms that are unlikely to survive the move to a carbon neutral world; e.g. coal miners. Most firms now recognise the need to regenerate and many oil and gas firms are investing heavily in renewables. If this transition is successful, there may be less long term impact on the weightings within your portfolio.

> So you could invest in firms that are actively trying to make a difference or exclude those that aren't. It is possible to get ESG ratings and carbon footprint figures for many listed firms – you could aim to meet targets based on ratings or footprints.

However, you need to ensure that the target gives you what you want to achieve. For example, the most well-known ratings, the MSCI ESG ratings, cover 37 ESG aims and give an average across all of them for the company. So if you are looking for an environment indicator, you may find this is being distorted by governance factors, such as Board pay. Also, the way agencies provide ratings for data they don't have is not consistent. We have seen evidence that the ratings for the same portfolio of companies from different agencies can vary significantly.

The recent European Insurance and Occupational Pensions Authority (EIOPA) opinion paper on sustainability within Solvency II stated that EIOPA had seen insurers target portfolios in line with specific climate change scenarios. The example given was a portfolio in line with the 2°C Paris Agreement scenario, which requires a 25% reduction in 2010 CO_2 levels by 2030.

> Identifying climate change targets and then setting the appropriate investment goals to be consistent with them is essential.

You could also consider the stewardship and voting record of your asset manager. For example, do you want a manager who can, and is, influencing the environmental policies of the firms they invest in? At the moment this would typically involve using the larger managers. Over time, if the larger asset managers are able to influence the firms, then it will be possible for smaller managers to piggy back on the work done.

What does the regulator need you to do?

The regulator doesn't (yet) require you to invest in a sustainable way. However, it does expect you to consider the investment risks that could materialise through climate change.

The Prudential Regulation Authority (PRA) published CP22/19 in September 2019, setting out its draft Supervisory Statement (SS) in respect of practices to demonstrate adherence to the Prudent Person Principle of Solvency II. This will require many firms to make wide-ranging changes to their investment risk management. In terms of sustainability, the draft SS states that:

> “The PRA expects firms to ensure that their investments do not expose them to unmanageable longer-term risks. For example, firms should consider whether there is an excessive accumulation of financial risks from climate change in their investment portfolio, consider appropriate mitigants to that risk where it arises and note the expectations set out in SS3/19 ‘Enhancing banks' and insurers' approaches to managing the financial risks from climate change.

SS3/19 set out a number of expectations, including the below:

- The firm's Board to understand and assess the financial risks from climate change that affect the firm and to address and oversee these risks within the firm's business strategy and risk appetite
- The firm to monitor and manage the financial risks from climate change, including risk exposure limits
- A requirement to have allocated responsibility for identifying and managing financial risks from climate change to a relevant existing Senior Management Function (SMF) and include this in the SMF's Statement of Responsibilities

Therefore, it is likely that firms will need to update their risk thresholds and risk management information (MI) to cover the exposures to physical and transition risks caused by climate change

Does understanding the risks justify your approach? The above is about risk management. As long as you understand the risks, does this mean you can therefore justify holding the worst of planet polluters?

SS3/19 also sets out that the PRA expects firms to consider engaging with the Task Force on Climate related Financial Disclosures (TCFD) framework and other initiatives when developing their approach.

> The TCFD focuses on risk management but we have seen, and expect it to become more common, for firms to disclose what they are doing to contribute to the environment, through measures such as the total carbon footprint of the companies they hold equities in.

If it becomes clear you are investing in companies that are having a negative impact on climate change, will policyholders stick with you? Will you attract new business? We think not.

Whilst this level of disclosure may not become mandatory for a while, we would recommend getting ahead of the pack and have a strategy of moving towards a 'greener' portfolio.

In conclusion

Climate change is no longer an emerging risk. The investment risks are unlikely to occur in the short term but the regulator is insisting they be considered, monitored and managed. However, reputational risks could materialise quickly and we believe that, by changing your investment stance to consider climate change, these can be avoided. Indeed we believe there are also opportunities to enhance reputation and engagement.

- Consider adding a third dimension of 'consistency with climate change goals' to your investment aims
- Ensure investment policies and mandates are in line with your climate change goals
- Allocate climate change responsibility to a Senior Management Function (SMF)
- Add climate change risks to all aspects of risk management; appetite statements, risk limits, scenario testing (including walk-throughs) and risk reporting
- Consider improving your disclosures in line with your investment aims and TCFD requirements

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