ESG Developments and Their Impact on Insurer Ratings

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CAS Conference

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Agenda

- ESG Concepts
- UN FI Principles for Sustainable Insurance (PSI)
- ESG Impact on Credit Quality
- BCRM – Building Block Approach
- ESG within AM Best's Methodology

Understanding ESG Concepts

The consideration of environmental, social and governance factors alongside financial factors in the investment and underwriting decision-making processes

Environmental factors relate to resource use, pollution, climate risk, energy use, waste management, and other physical environmental challenges and opportunities

Social factors relate to how a company interacts with the communities it operates in, its suppliers, employees, and broader stakeholders

Governance factors relate to procedures and processes according to which a company is directed and controlled

What are ESG Factors?

Examples of ESG factors

- Climate risks
- Carbon emissions
- Natural resources
- Pollution and waste
- Environmental opportunities

Environmental

- Human capital
- Product liability
- Stakeholder opposition
- Health and safety
- Social opportunities

Social

- Corporate governance
- Corporate behaviour
- Transparency
- Board composition
- Business ethics

Governance

UNEP FI Principles for Sustainable Insurance (PSI)

- The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership established between the United Nations Environment Program (UNEP) and the financial sector. It was created in 1992, following the Earth Summit in Rio de Janeiro.

- Endorsed by the U.N. Secretary-General, the Principles for Sustainable Insurance have led to the largest collaborative initiative between the U.N. and the insurance industry. Over 140 organizations worldwide have adopted the four Principles for Sustainable Insurance, including insurers representing more than 25% of world insurance premium volume and USD 14 trillion in assets under management. The Principles are part of the insurance industry criteria of the Dow Jones Sustainability Indices and FTSE4Good.

- The Principles serve as a global framework for the insurance industry to address ESG risks and opportunities.

AM Best is a UNEP FI[1] PSI Signatory

- In March 2021, AM Best became the first credit rating agency to become a signatory of the Principles for Sustainable Insurance (PSI)

Principle 1	Principle 2	Principle 3	Principle 4
We will embed in our decision-making environmental, social and governance issues relevant to our insurance business.	We will work together with our clients and business partners to raise awareness of environmental, social and governance issues, manage risk and develop solutions.	We will work together with governments, regulators and other key stakeholders to promote widespread action across society on environmental, social and governance issues.	We will demonstrate accountability and transparency in regularly disclosing publicly our progress in implementing the Principles.

[1]United Nations Environment Programme Finance Initiative

What Becoming a UNEP FI PSI Signatory Means for AM Best

- AM Best has publicly committed to supporting the PSI Principles and the sustainability of the insurance industry

- Being a PSI Signatory fits AM Best's focus on insurance and our perspective that ESG elements play an important role in the financial strength of insurance companies

- AM Best will prepare its PSI-required annual Public Disclosure, in which we will showcase all of AMB's efforts/activities in support of the Principles and a financially strong insurance industry

ESG Impact on Credit Quality

ESG is relevant when it has a visible impact on financial strength. Positive ESG attributes may have no impact on a rating

ESG while important is not a new concept

Environmental and Governance factors have long been part of the credit analysis and captured in our rating opinions

Translating into Criteria – Importance of ESG Factors are on the Rise

- ESG factors have always been considered in our rating process and have impacted ratings when they are material. AM Best also considers the long term impact of ESG factors.

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
• Climate risk* • ESG integration in investing activities • Stranded assets	• Social inflation • ESG-related litigation • Impact of ESG integration on profitability	• Underwriting exclusions • Changing demographics • Data privacy • Reputational risk	• Corporate governance* • Stress testing* • Management of insurance and non-financial risks

*ESG factors that are most relevant over the near-term

- ESG factors, where material and relevant, may impact any one, or several building blocks
- Impact of ESG is viewed purely from an analytical perspective: focusing on the impact on the credit rating
- No judgement is made on the ethical value of ESG activities, or ESG credentials of the company

Examples of ESG-related Challenges Affecting Reinsurers

Financial Flexibility	Environmental Changes	Sustainability Policies	Transparency and Disclosure	Reputational Risks
Pressure to remain an attractive investment proposition in a context in which institutional investment are turning greener	Reinsurers on the first line to monitor and better understand changing environmental exposure due to position in the underwriting chain and impact of severe natural catastrophe events	Increased attention on sustainability policies linked with investments, underwriting or corporate behavior	Increased pressure on ESG transparency and disclosure stemming from various stakeholders	Increased reputational risks stemming from environmental, social or governance factors

ESG Impact on Credit Quality

ESG Credit Factors are the intersection between standard credit factors and ESG factors that are applicable to the insurance industry – ESG are not new factors but a subset of credit factors

Credit Factors | ESG Credit Factors | ESG Factors

AM Best analyses credit issues and how these risks / opportunities can affect the Financial Strength of insurers. If risks / opportunities fall outside of expectation (relative to market, peer group), then there could be an impact on financial strength. This could be a positive or a negative impact

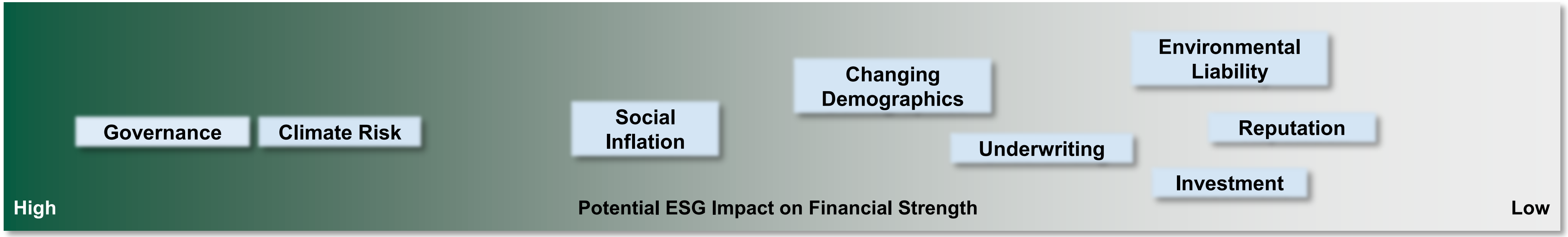
Are ESG risks and opportunities* relevant? — **How is the company managing them?**

* ESG risks and opportunities will vary by company subject to their profile, exposures, protection and market(s) they operate in

Some ESG issues may seem less important today, but may have greater importance over the medium-to-long term, and thereby have the possibility to impact financial strength, particularly if no action is taken. The concept is forward looking to understand how companies will shape (if required) their business in light of forthcoming challenges.

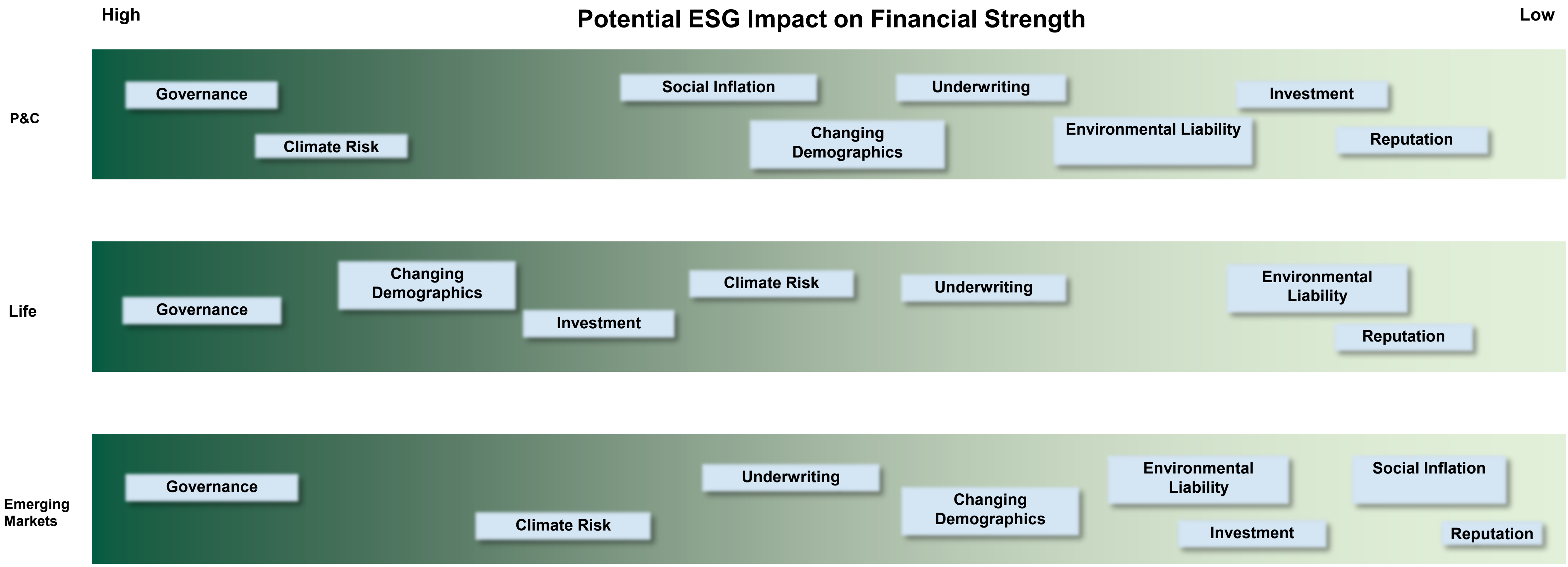
Potential ESG Impact on Credit Quality is not Uniform

- The impact of ESG Factors on financial strength is not uniform and can vary due to:
  - Type of company
  - Exposure
  - Level of risk transfer
  - The markets a company operates in
- Issues like Governance and Climate Risk in particular can have a material impact on an insurers financial strength



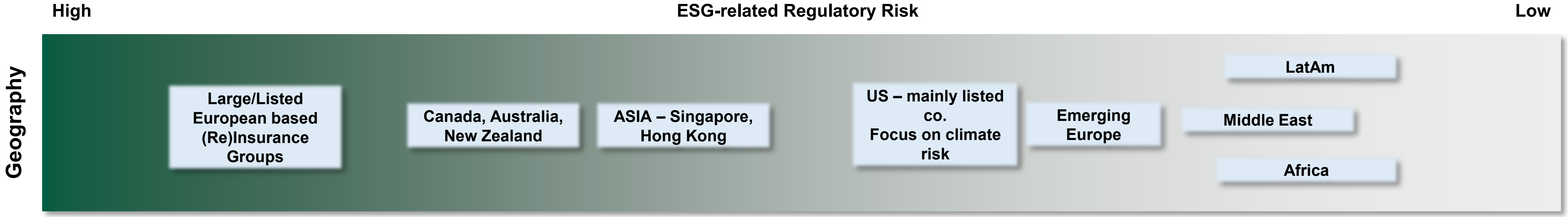
The impact of some ESG credit factors may be increasing over time

ESG Impact on Credit Quality is not Uniform – Examples



ESG and Regulation

- In general we see regulation as a driving force of more ESG-related activities by companies:
  - Opportunity for insurance companies to strengthen their risk awareness by coming into line with regulatory requirements
  - Risk of non-compliance with regulatory requirements
  - Risk of additional costs and consumption of management time associated with compliance
  - Risk of market losses associated with forced divestment of assets
- Level of risk varies considerably by geography:



Assessing Physical Climate Risk through the Rating Process

Climate Risk	Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
+	• Capital position withstands shocks • Protection against peak exposures and aggregation of losses • Low volatility / sensitivity to climate risk • Diversification in investment portfolio	• Stability of earnings • Limited impact of stranded assets • Adequate modelling and pricing • New climate products earnings accretive	• Underwriting profile diversified and insulated against climate risks • Development of new products • Clearly defined policy wording and contracts	• Climate risks factored into ERM approach • Ability to absorb climate stress tests • Ability to model weather-related risks • High visibility of climate reporting, (financial disclosures, regulatory reporting) • Board oversight
–	• Rapid decline in capital position – over-exposure, unexpected losses • Inadequate protection against peak exposures • High volatility / sensitivity to climate risks • Material write-downs of stranded assets	• Volatile earnings • Financial losses due to stranded assets • Climate risks not considered in underwriting model • Unexpected losses • Adverse mortality and morbidity rates from resistant disease	• Underwriting or investment profile concentrated and exposed to climate risk • Uncertain or indirect exposures to climate risks	• Breaches of appetite and tolerance • Stress test failures • Inadequate risk modelling – poor data quality • Non-disclosure in financial reporting • Inadequate protection against peak exposure, or aggregation of risks

Balance Sheet Strength → Operating Performance → Business Profile → Enterprise Risk Management → Issuer Credit Rating

Assessing Governance through the Rating Process

Governance

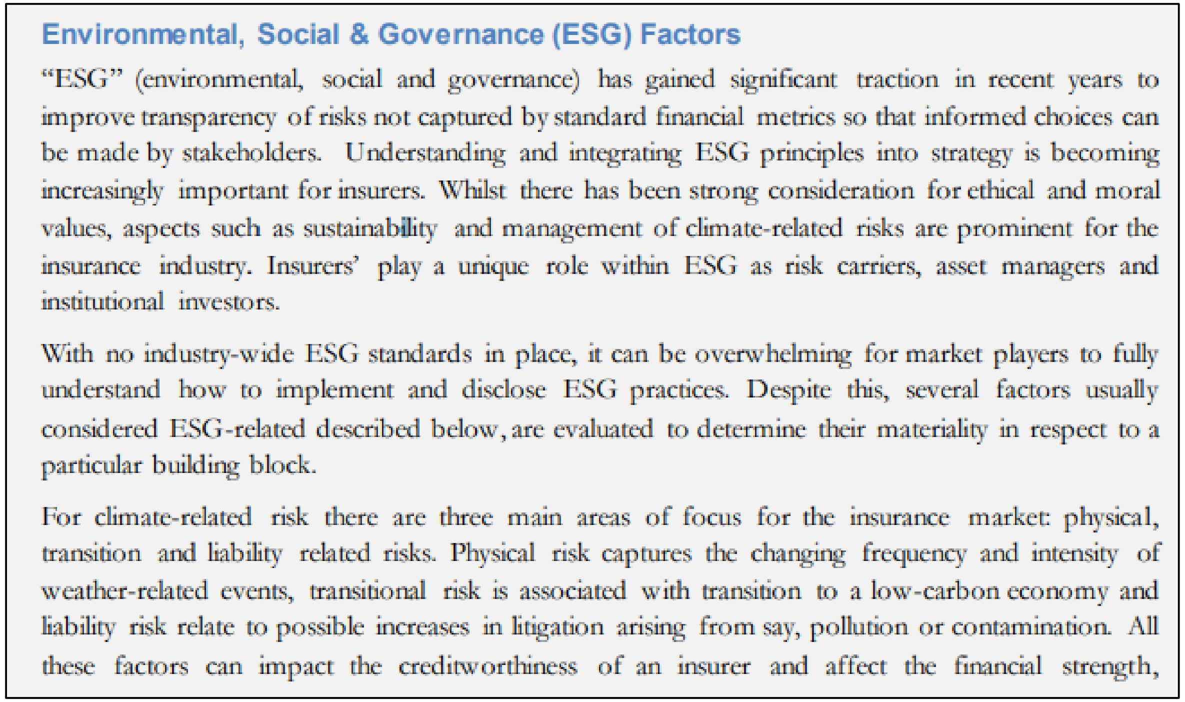
	Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
+	• Capital planning and monitoring • Measurement and control of asset risk • Risk-based assessment of capital position	• Consistent ability to achieve budgeted performance. • Effective KPI-linked executive incentives • Losses within board-approved appetite	• Effective decision making and strategy setting • Management and board members with strong market and product knowledge	• Board oversight of risk function • Risk management considered in decision making • Effective internal controls • Detailed and timely management information and KPI tracking
–	• Poor ability to manage capital and solvency • Inadequate protection against peak exposures • Problems with audit and valuations	• Mismanagement leading to poor strategy and loss-making operations • Poor decision making around risk/reward • Losses associated with fraud, fines	• Weak or inexperienced management and/or board members • Excess product risk due to poor decision making • Reputational risk associated with mismanagement	• Lack of board involvement in risk-management • Breaches of appetite and tolerance • Inadequate financial reporting • Ineffective third party experts e.g. actuary

Balance Sheet Strength → Operating Performance → Business Profile → Enterprise Risk Management → **Issuer Credit Rating**

AM Best and ESG – Resources

- ESG webpage: http://www.ambest.com/about/esg.html

ESG Webinar



Environmental, Social & Governance (ESG) Factors

"ESG" (environmental, social and governance) has gained significant traction in recent years to improve transparency of risks not captured by standard financial metrics so that informed choices can be made by stakeholders. Understanding and integrating ESG principles into strategy is becoming increasingly important for insurers. Whilst there has been strong consideration for ethical and moral values, aspects such as sustainability and management of climate-related risks are prominent for the insurance industry. Insurers' play a unique role within ESG as risk carriers, asset managers and institutional investors.

With no industry-wide ESG standards in place, it can be overwhelming for market players to fully understand how to implement and disclose ESG practices. Despite this, several factors usually considered ESG-related described below, are evaluated to determine their materiality in respect to a particular building block.

For climate-related risk there are three main areas of focus for the insurance market: physical, transition and liability related risks. Physical risk captures the changing frequency and intensity of weather-related events, transitional risk is associated with transition to a low-carbon economy and liability risk relate to possible increases in litigation arising from say, pollution or contamination. All these factors can impact the creditworthiness of an insurer and affect the financial strength,

ESG within Best's Credit Rating Methodology

Swiss Re

ESG Considerations in Liabilities

Andy Tran

Defining: How do we use sustainability, ESG and the SDGs?

Sustainability

We aim to meet the **needs of the present without compromising the ability of future generations to meet theirs**.

We do so by taking a **strategic and forward-looking view,** and by considering our **economic, environmental and social impacts.**

Environmental, social & governance criteria (ESG)

We consider ESG criteria in our business processes (e.g. investing, underwriting, sourcing) to make them more sustainable and responsible, and as part of our risk considerations.

Sustainable Development Goals (SDGs)

We use the 17 UN Sustainable Development Goals to **understand our positive and negative business impacts**, and to identify **areas** for **business opportunities**.

Consider ESG criteria — For better decision making

Unlock the SDGs — To create positive business impact

Sustainability:
Creating long-term value

COP26 Fact Pledges not adding up to meet the Paris Agreement

~50%

Reduction in emissions required by 2030 to limit warming by 1.8°C by 2100

- to limit average global temperature increase to "well below 2 °C" and
- to "pursue efforts for 1.5° C" above pre-industrial levels

FAIL

Warming well underway		Significant risk to human life		High economic cost
1.2°C	**2.7°C**	**800M**	**1.7Bn**	**-25%**
Current increase in global average temperatures above pre-industrial levels	**Warming** projected by 2100 with pre-COP26 policies	**People at risk from rising sea levels** on pre-COP 26 trajectory	**People experiencing severe heatwaves** on pre-COP26 2.7°C trajectory	**Loss in GDP** by 2100 on current climate trajectory

Why does this matter to the industry? 25 states signed on to Paris Agreement standards via US Climate Alliance. Pressure is coming...

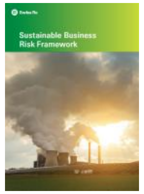
Swiss Re has a long tradition of sustainability

1979 – First sustainability-related publication

2003 – 100% GHG neutral

2007/08 – Signing of UN Global Compact (WE SUPPORT) and PRI (Principles for Responsible Investment)

2009 – Formal Sustainable Business Risk Framework developed



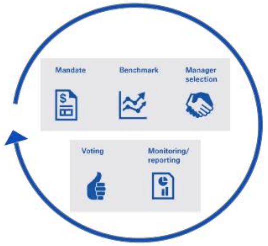
2012 – Signing of PSI (Principles for Sustainable Insurance)

2015 – Commitment to PARIS2015 (UN Climate Change Conference COP21·CMP11)

2016 – Adopted FSB TCFD recommendations

Reduced investing in thermal coal companies

2017 – Shift of investment portfolio to follow ESG investment benchmarks



2018 – Reduced providing re/insurance to thermal coal

2019 – Commitments to UN Climate Action Summit

2020 – Obtain 100% of power from renewable sources

2021 – Founding member of Net-Zero Insurance Alliance (Convened by UNEP FI's Principles for Sustainable Insurance)

2030 – Net-zero GHG emissions in operations

2050 – Net-zero GHG emissions across entire business

Swiss Re Group sustainability strategy

Comprised into three 2030 ambitions

Through our enhanced Group Sustainability Strategy, we aim to reinforce our efforts **to make the world more resilient and sustainable**

Swiss Re is committed to reach net-zero emissions by 2050 across our whole business

Present focus		Future: saying **yes** to <2°C	
Re/insurance	e.g. thermal coal phase-out	UN Business Ambition for 1.5°C pledge Net-zero Insurance Alliance	We become a credible partner to access new risk pools, …
Asset Management	e.g. carbon reduction targets	Net-zero Asset Owner Alliance	… asset classes…
Operations	e.g. internal Carbon Steering Levy (CSL)	Net-zero operations	… and buy removal credits
	Today	**2030** **2050**	

Swiss Re supports the worldwide reduction of greenhouse gas emissions and contributes to the goal of limiting global warming to 1.5°C above pre-industrial levels

Integrating sustainability into underwriting at a deal and portfolio level

ESG Risk process applied to underwriting

- ESG Risk Assessment
- UW referral Tool
- Policies applied to UW: human rights; environmental protection + sector-specific guidelines

Exclusions | Inclusions

Underwriting to enable

- UW portfolio steering using the UN Sustainable Development Goals
- ESG and Carbon steering
- Products and solutions that address sustainability challenges

The bottom line is:

Sustainable business is good business in the long run

“

We must always ask ourselves the question: how does the business we write **impact, support or detract from sustainability?**

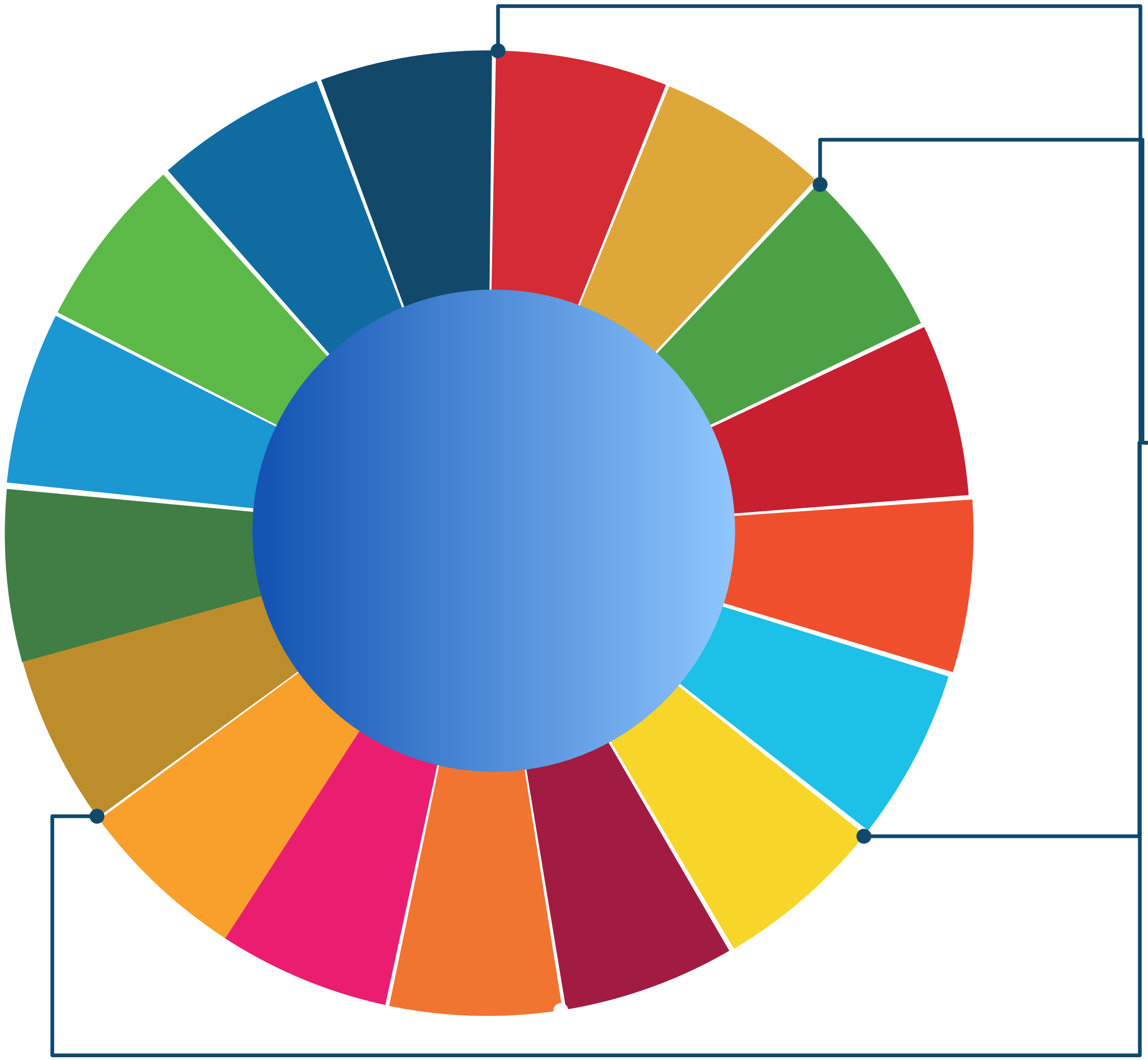
”

Mike Mitchell
Head P&S Underwriting Reinsurance
Swiss Re

What are the links between insurance and the SDGs?

- Companies play a key role in delivering solutions to the world's problems. They increasingly need to quantify their contribution to the UN's Sustainability Development Goals (SDGs), driven by growing regulations, stakeholder expectations, and performance drivers.
- Many re/insurance products and services already support the SDGs but industry lacks a comprehensive, standardised
  - systematic mapping of those;
  - clear narratives;
  - methods to measure impact
- Swiss Re is leading the "iSDG" initiative with UNEP PSI, an industry R&D effort to develop insurance-relevant SDG indicators and a quantification methodology for our industry to track our progress towards the global UN goals.
- Swiss Re is working with companies and industry associations across the globe to ensure we can all collectively build a common framework.

Portfolio Assessment



- Identify Risks & Opportunities
- Align to product/ solutions inventory
- KPIs for success

Taking the SDGs a step further with mapping

SCORES:

		1 NO POVERTY	2 ZERO HUNGER	3 GOOD HEALTH AND WELL-BEING	4 QUALITY EDUCATION	5 GENDER EQUALITY	6 CLEAN WATER AND SANITATION	7 AFFORDABLE AND CLEAN ENERGY
Property Facultative	+	2					3	3
	-	1					1	2
Engineering	+	2		4	2		3	4
	-	1		2	1		2	3
Marine	+	3	3	2				1
	-	1	2	1			1	3
Motor	+	4	1	2				2
	-			3				1

Example Only

\+ Contribution
\- Harm

Is it sustainable? The Double-edged sword

E-BIKE INSURANCE

CONTRIBUTION:

No Poverty – keeping people "on their bike" via the damage/theft product i.e.: not losing wages for inability to get to work/cost to replace

Good Health and Well Being – medical coverage post-accident & improved air quality

Climate Action – supporting less $CO2$ production

HARM:

Responsible Consumption – anything with electricity, where are the components coming from, are they being ethically sourced and how are they being handled in the case of the bike being "totaled"?

No Poverty – Liability requirements, is this a barrier to entry for those living in poverty or on the brink?

How can you contribute?

1. Data

- Challenge ourselves. Where can we find nontraditional sources

2. Skill set evolution

- Can't do this alone. Need to work with a cross functional mindset.

3. Model development

- Faster feedback loop and responsive stakeholder engagement

Actuaries' skill and objectivity will help the insurance industry better manage the risks of climate change and biodiversity degradation, as well as find new solutions and approaches.

Questions???

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