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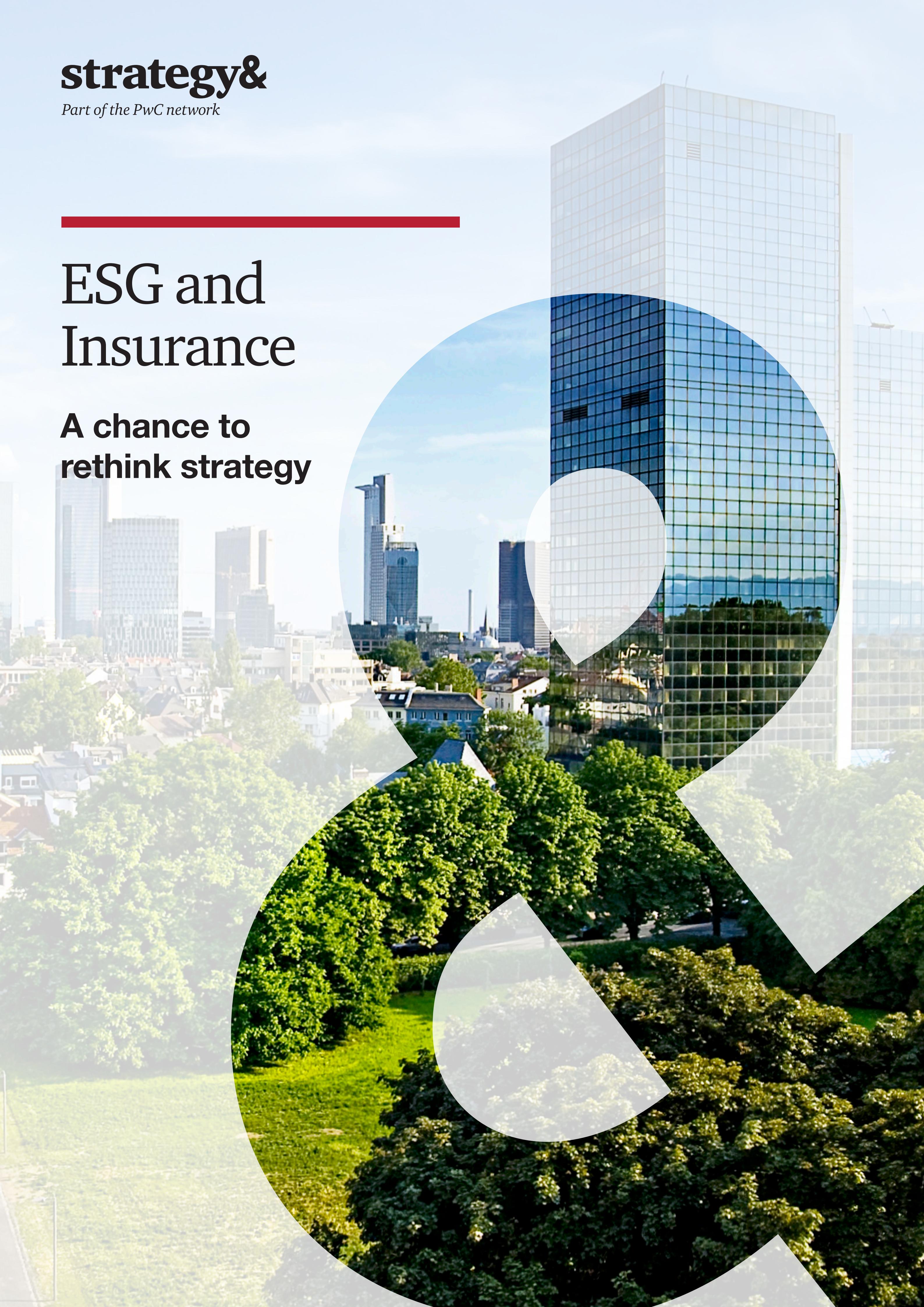
ESG and Insurance

A chance to rethink strategy



ESG and Insurance: A chance to rethink strategy

Despite a growing and significant body of thought leadership on Environmental, Social and Governance (ESG), it remains an area many executives are grappling with.

Insurers must assess their strategies in the context of ESG, to transform themselves and reaffirm their purpose in society

This report intends to resolve that challenge, bridging the gap between high-level ESG thinking and more technical literature. It offers a framework to think through and put in place business initiatives to address ESG and identify growth opportunities.

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Why is ESG important?

Considerations on the sustainability of businesses have a long history. The current interest in ESG can be traced to the political and social upheavals of the 1960s which promoted the formation of ethical banks. This was followed by the emergence of Corporate Social Responsibility (CSR) in the 1980s and the launch of the first sustainability-linked mutual funds and financial products in the 1990s. But the dramatic acceleration of interest in ESG over the past 18 months has increased awareness of the impact of companies on the environment and society. Insurers can no longer ignore it, especially given the impact of the pandemic on insurers' reputations.

The importance of defining ESG

At its simplest, ESG provides an umbrella framework to consider a company's impact and dependencies on the environment and society, as well as the quality of its corporate governance.

> "Business leaders should consider their level of ESG ambition against the expectations of those stakeholders who matter to the long-term viability of their businesses."

Figure 1 – Environmental, Social and Governance (ESG) definition

ESG provides an umbrella framework to consider a **company's impact and dependencies on the environment and society**, as well as the **quality of its corporate governance**

Environmental Minimising the impact of a company on nature	• Includes controls of: **carbon emissions**, impact on **deforestation and nature loss**, over-consumption of **non-renewable resources**, and production of **waste products** • Also incorporates positive contributions such as the **financing of environmental improvements** (e.g. green finance initiatives)
Social Contributions of a company to fairness in society	• Considers **contributions to equality, trust and welfare in society** (including **improving labour rights** and **diversity and inclusion**) within a company's workforce, and across its supply chain and distribution • Also includes **product safety**, respect for **privacy and data security**
Governance Processes for decision making, reporting and ethical behaviours	• Focuses on the quality and scope of **reporting**, the nature and type of **accountability**, level of **independent oversight**, and **ethical behaviours** in a firm – on both ESG and non-ESG matters • Considers elements such as **board structure**, director and audit **independence** and **executive compensation**

Source: Strategy& analysis

But there are no official, comprehensive definitions beyond those being developed by the European Commission. What if a significant percentage of what we are calling ESG today was not ESG tomorrow under country and regional taxonomies? We detail below the next level down of each element of E, S and G, and have laid out an innovative approach for developing a broad corporate ESG strategy.

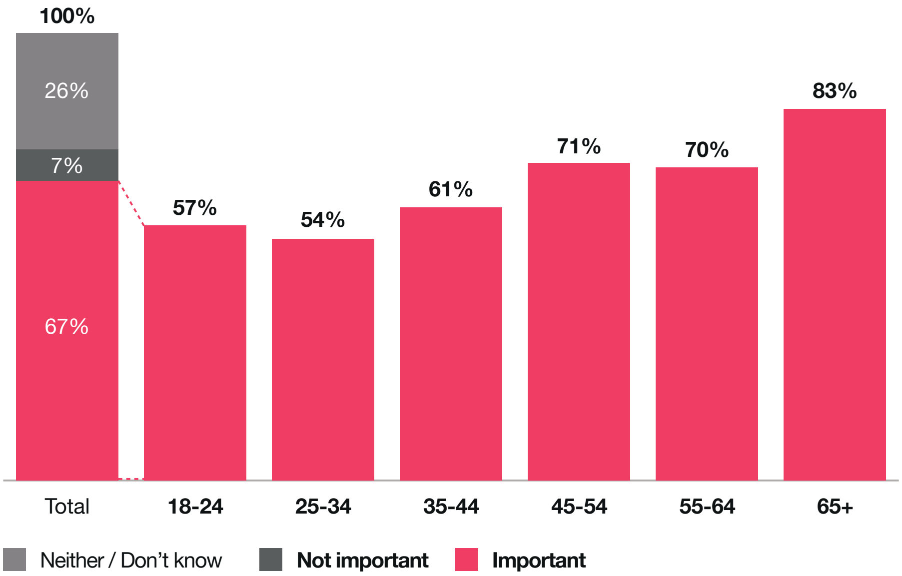
> “What if a significant percentage of what we are calling ESG today was not ESG tomorrow under country and regional taxonomies?”

Companies can no longer ignore ESG

Driven by factors such as climate change, social inequality and the impact of COVID-19, and amplified through social media platforms, ESG has become front of mind for all. PwC UK's 24th Annual CEO Survey shows organisations are increasingly focusing on sustainability. This year, 70% of UK CEOs told us they are concerned about climate change, compared to just 44% in 2019. And there are already positive signs of change, with 60% of UK CEOs planning to increase their investment in sustainability and other ESG initiatives over the next three years. Around a third also noted they should be doing more to report on their organisation's impact on its wider communities.

These concerns are further reflected in a PwC survey of UK consumers which found 67% of respondents want businesses to operate sustainably, by minimising their environmental and social impact. Contrary to popular belief, older consumers are more concerned than millennials, demonstrating that ESG worries are not limited to younger generations.

Figure 2 – Views on the importance of businesses operating in a sustainable way, by age group
Question: When considering the role of business in society, how important is it that business operates in a sustainable way (e.g. minimises its environmental impact, supports diversity, behaves ethically)?



Source: Nationally representative survey of UK consumers, PwC UK, February 2021

67%

of respondents want businesses to operate sustainably

Source: Nationally representative survey of UK consumers, PwC UK, February 2021

More stakeholders to manage

Companies are no longer answerable just to shareholders but also to a new set of stakeholders: customers, employees, suppliers, communities, the press and regulators. These broader and more vocal groups are increasingly interested in how ESG drives corporate performance. Other topics on the corporate agenda, such as Brexit, while complex and important, are focused on narrower stakeholder sets.

Below, we summarise the breadth of stakeholders that companies need to consider when addressing ESG.

Figure 3 – ESG stakeholder environment – Insurance example

Customers

- Personal lines customers **increasingly consider ESG impact** when purchasing products and services
- Companies with environmentally-friendly and renewable assets **increasingly demand coverage at preferential rates**

Shareholders / investors

- Fund Managers are **putting pressure on companies to act on climate change** (e.g. Blackrock)
- Investor demand for **ESG-linked assets has increased significantly** over past decade, linking insurer's ESG actions to access to capital

Value chain partners

- Brokers and reinsurers **increasingly assess insurers' ESG exposure**, and vice versa, as part of partnership due diligence checks
- Awareness of offshore **labour standards pressures insurers** to consider their own outsourced arrangements (e.g. call centres)

Management

- Executive remuneration is **increasingly linked to ESG outcomes**
- Boards are **requesting executives to incorporate ESG** into firm strategy and decision making

Communities / press

- Insurers are **held to higher standards** in community engagement (e.g. advertising protections for vulnerable customers)
- Press reporting on weather events requires **insurers to respond** to describe how they addressing environmental concerns

Employees / unions

- Employees are increasingly considering a company's record on **environmental and social issues** when making employment decisions
- Unions and employee organisations are increasingly pressuring insurers to **improve workplace equality and diversity**

Regulators

- Regulators now require insurers to **embed climate-related risks** in their risk management frameworks (e.g. Bank of England climate stress tests)
- Regulators are increasingly compelling insurers to disclose **climate risks, gender pay gaps** and to improve **accounting standards** (e.g. IFRS17)

Internal stakeholders | External stakeholders

Source: Strategy&

How should companies think about ESG? Break it down and choose where to participate

ESG addresses a broad spectrum of topics and can affect all components of a company's strategy, operating model and execution. To make it easier to tackle, executives should first think through the three elements of ESG separately, and do so at the next level down, with the five or six sub-elements of E, S, and G (for instance, 'E' would include the impact from an insurer's buildings and footprint, its products and services, as well as its value-chain operations and partners). Figure 4 provides a framework for breaking down ESG into more structured and manageable sub-elements.

“First, think through the three elements of ESG separately…”

Figure 4 – ESG framework for companies – insurer example

Dimensions		Examples
Environmental Minimising the impact of a company on nature	**Operations**	• **Carbon emissions** from offices and data centres • **Waste to landfill and incineration** e.g. non-recycled computers, servers, photocopiers and general office waste • **Business travel** including emissions from flight and train travel and vehicle fleets
	Products & services	• **Underwriting** to support development of renewable energy assets (e.g. solar and wind farms) and companies reducing emissions (e.g. providing specialised D&O cover for renewable energy companies) • **Financing** such as issuing green bonds
	Supply chain & distribution	• **Non-renewable resource** use for electronics and office materials (e.g. minerals used in computer and server production, paper and office consumables)
Social Contributions of a company to fairness in society	**Workforce**	• **Diversity & inclusion** across employee categories (e.g. gender, BAME), social mobility, and pay equality • **Health & safety** and **wellbeing** – programmes to support health & wellbeing, including employee mental health programs • **Human capital development**, including upskilling of employees and training provided, such as digital analytics training for experienced employees
	Products & services	• Customer **privacy & data security** e.g. investing in personal data protection for customer data • **Underwriting** to support social services, such as by providing preferential rates to not-for-profit enterprises
	Supply chain & distribution	• **Diversity & inclusion** in supplier base, such as through office supply and professional services contracts (e.g., catering and events)
Governance Quality of processes for decision making, reporting and ethical behaviours	**Transparency**	• **Providing accurate and timely reporting to stakeholders** vs. recognised standards – on corporate purpose, strategy, financial performance, and ESG tax benefits – e.g. implications from investments in ESG initiatives
	Accountability	• Ensuring leaders are **accountable for performance and risk management**, across both ESG and other decisions, and pay is aligned to ESG-outcomes within company
	Independence	• **Ensuring appropriate independent oversight**, incl. board composition, diversity, remuneration, and limiting controlling shareholders and concentrated voting rights
	Ethical behaviour	• **Corporate governance:** undertaking business in an ethical manner (e.g. avoiding bribery and corruption)

Source: Strategy&

Business leaders should then consider their level of ESG ambition, overall and for each chosen sub-element, against the expectations of those stakeholders who matter most to the long-term viability of their businesses and the ESG dependencies for corporate strategy and financial performance. Will just keeping up with evolving regulations be enough (for instance, for insurers in the middle of a significant turnaround programme which might prevent them launching bold ESG initiatives immediately)? Or should they view ESG as an opportunity to realign their market-participation strategy with major long-term customer trends (for example, a broker seeking to enter new markets would have a 'greenfield' opportunity to do so while being ESG aligned from the start)?

An insurer's ambition will determine whether they develop an ESG strategy that sits on the side of their existing corporate strategy; or whether they develop a new, ESG-aligned corporate strategy.

Taking action on ESG

To avoid ending up with a long list of disjointed initiatives, executives should assess how impactful potential ESG actions are, versus their ambitions, stakeholder expectations, importance to business and risk management, and how easy they are to implement, including how 'doable' ESG innovations are. While businesses will want to estimate the return on investment of potential initiatives, there is still a lot to do to narrow the gap between the historical way of measuring performance (such as return on equity, or revenue growth) and the new, longer-term concepts coming with ESG.

The illustration on the next page shows a prioritisation exercise for an insurer. In this example, the company faces pressure from its customers and distributors to incorporate ESG into some of its investment offerings. By incorporating ESG into its product strategies, it plans to grow new customer segments and increase its reputation with existing customers.

70%

of UK CEOs are concerned about climate change

Source: PwC UK's 24th Annual CEO Survey

Figure 5 – Strategic ESG opportunities assessment framework

Example ESG opportunity set for a potential insurer (Illustrative)

Environmental Minimising the impact of a company on nature

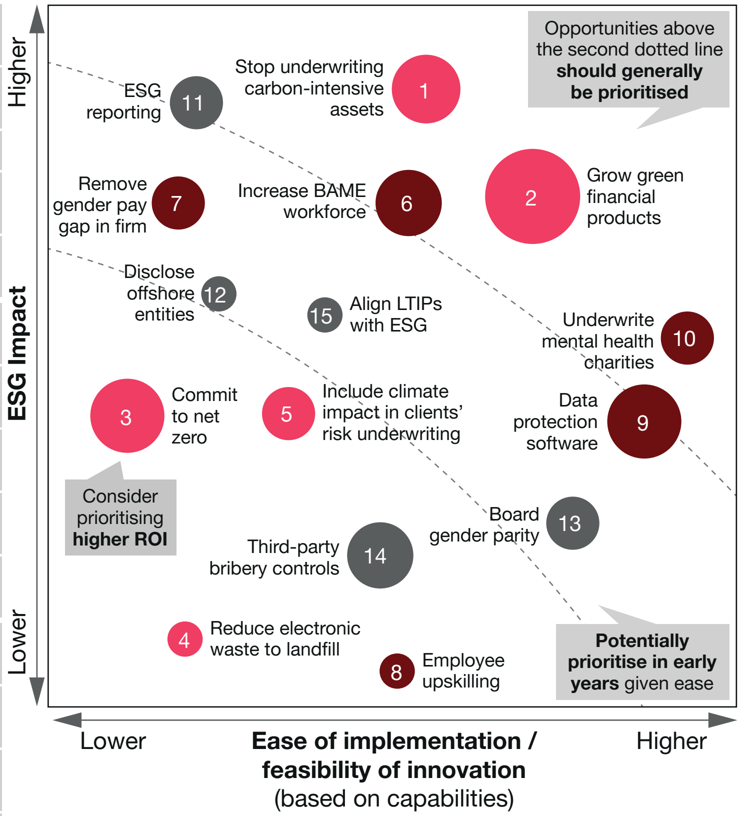
1. Stop underwriting carbon-intensive assets (e.g. coal mines)
2. Grow investment in green financial products (e.g. green bonds and ILSs)
3. Commit to net zero across the business
4. Reduce electronic waste to landfill (e.g. computers)
5. Include climate impact in corporate risk models and pricing

Social Contributions of a company to fairness in society

6. Increase BAME workforce representation by 10% in graduate intake in 2 years
7. Remove gender pay gap across company in 5 years
8. Provide digital analytics upskilling training for employees
9. Invest in leading personal data protection software
10. Underwrite property, liability and D&O cover for mental health charities

Governance Processes for decision making, reporting and ethical behaviours

11. Voluntarily commit to higher-standard ESG reporting, such as SASB Standards
12. Disclose offshore entities to increase tax transparency
13. Realise gender parity in Board membership
14. Implement third party controls, databases and monitoring to reduce potential bribery
15. Align executive LTIPs with corporate ESG outcomes



Environmental Social Governance **Bubble size indicates ROI**[1]

Note: 1) Return on Investment
Source: Strategy&

A call to action

Having considered the multiple ESG dimensions, companies should decide how to integrate ESG into their strategies and operating model. To do so effectively, there are a number of steps to take.

First, they should confirm their ESG ambition, assess strategic options and align with their corporate strategy or create a new, ESG-coherent strategy. Where required (for example, if new resources, assets and capabilities are needed) they may have to redesign their business or operating model.

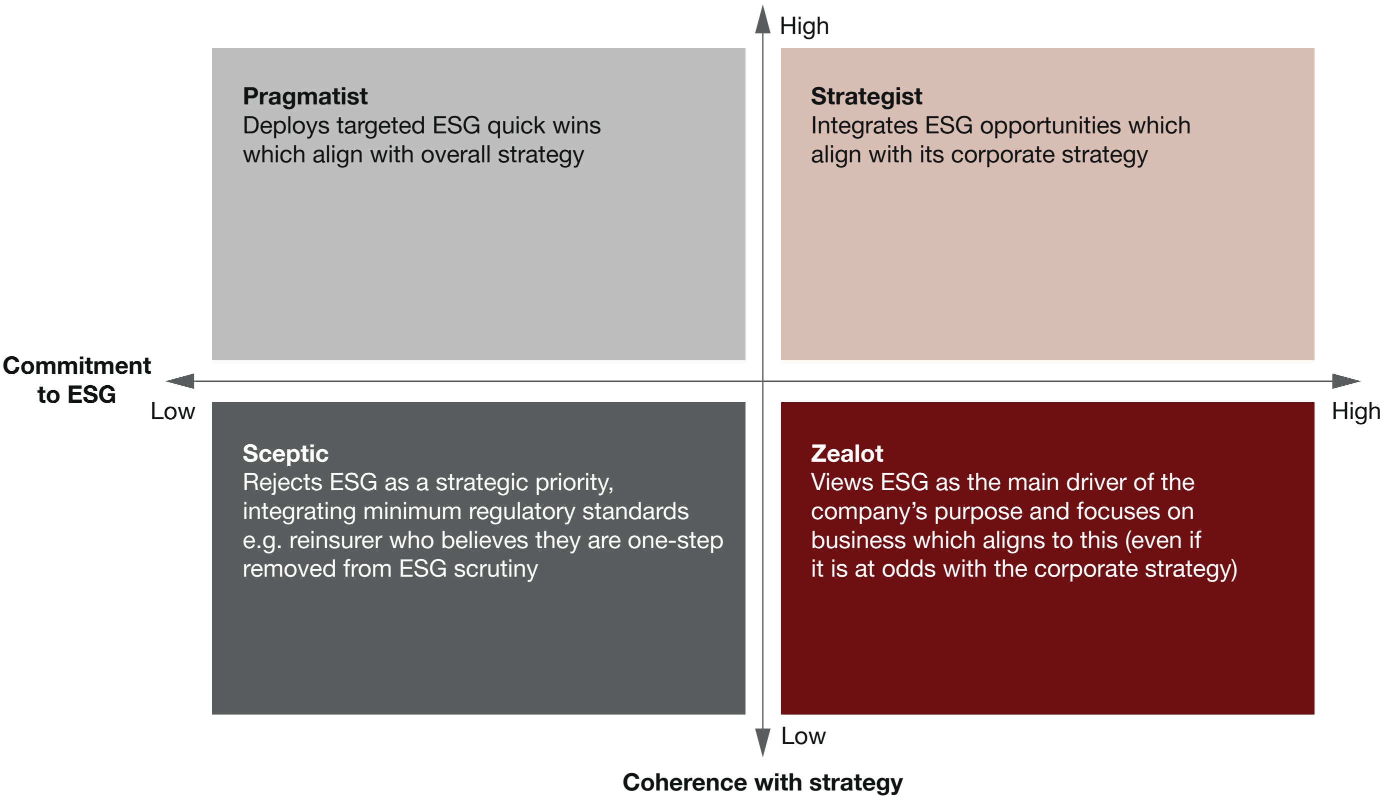
Next, they must execute these changes and transform, rolling out the chosen initiatives backed by the support of strong senior sponsorship.

Finally, to ensure success, organisations should set targets, and track and report these back to stakeholders.

These last two factors are critical. Success in execution will be influenced by the tone at the top of organisations. It is hard for an executive to divorce their own attitude to ESG from their corporate role. If feasible, they should set an ESG persona for their company that reflects their ESG beliefs and commitment.

> “Success in execution will be influenced by the tone at the top of organisations.”

Figure 6 – Spectrum of ESG adoption



Source: Strategy& analysis

Being aware of one's persona can help determine how the company responds. 'Sceptics' with a low level of commitment may choose to focus on minimum regulatory requirements. 'Strategists' may have a high level of belief in ESG principles, incorporating actions fully into strategies and changing their organisations more fundamentally. But ultimately, companies need to decide their corporate ESG persona if they are to form a collective ambition and strategy.

On reporting, more needs to be done to bridge the gap between historical ways of measuring performance and new, longer-term concepts coming with ESG. A practical way to do this is 'integrated reporting'. This combines historical metrics and ESG indicators (starting with business indicators such as revenues from ESG-compliant products) and integrates ESG factors with corporate strategy, informing stakeholders on both elements at the same time.

What does ESG mean for Insurers?

Founded on the ability to understand risks and find solutions to manage them, the insurance sector has rarely been unsettled by emerging risks and trends in the industries they underwrite. ESG is no different for insurers, presenting both challenges and opportunities.

Climate-related risk is one area that comes to mind. Physical risk, such as changes in the frequency and severity of extreme weather events, as well as chronic climate factors, may mean larger losses. Many insurers may find it more difficult in the medium-term to underwrite certain classes accurately, and prices for coverage may increase to compensate for the uncertainty. Transition risk, driven, for example, by changes in regulation, technologies and market demand, may lead to changing business dynamics in the short-term, and are much harder to identify, measure and manage.

There are also broader environmental and social challenges that go to the heart of the insurance sector's role in society. Insurance plays a key role in supporting the operations of many industries which, for instance, emit large volumes of carbon dioxide, or those that face challenges in meeting modern labour standards, such as the shipping industry. As awareness of the insurers' role in underwriting these sectors increases they are likely to face renewed pressures from stakeholders to demonstrate how they are contributing to changing industry practices.

> "On reporting, more needs to be done to bridge the gap between historical ways of measuring performance and new ESG concepts."

Figure 7 – Spectrum of ESG ambition – Commercial Insurance product example

	Minimum requirement	Emerging	Mature	Leading
Environmental The impact of a company on the environment	Review product portfolio to ensure it meets **minimum requirements for prioritised stakeholders'** environmental concerns (e.g. reporting and risk management)	**Tactically offer green products and incentives** (e.g. electric vehicle fleet coverage, preferential premiums for reducing environmental liability)	**Offer new products and services** which seek to actively minimise **environmental impact** across the entire supply chain (e.g. energy efficient insurance)	Provide **consulting services to support transition** to **greener business models** (i.e. carbon emissions assessment paired with energy efficient insurance)
Social Contribution of a company to fairness in society	Deploy tactical changes to meet **minimum requirements for stakeholders' social concerns** (e.g. amending product branding)	Subsidise **existing products to support emerging businesses** that further social welfare (e.g. to support an adult training start-up)	Pro-actively develop products to support **emerging risk** areas and **underserved markets** (e.g. property coverage for social enterprises such as adult training and employment not-for-profits)	**Provide consulting services to advance** to **social development goals for insureds** (e.g. increasing gender equality in workforce)
Governance Processes for decision making and reporting and ethical behaviours	**Provide summary reports** of ESG impact across of all product lines at a high-level	Providing reports on how **individual products** are contributing to ESG objectives (e.g., focusing on electric fleet insurance products)	Providing data to policyholders on **ESG product performance**, to assist and incentivise their own ESG objectives	Leading **industry groups to develop consistent approaches to reporting** and providing full transparency of ESG impact of all products

Source: Strategy&

Changes in industries provide product innovation opportunities for insurers as illustrated in the chart above. By thinking through ESG ambitions and commitment levels, insurers are starting to manage their transition to supporting businesses that have a positive impact.

The current focus on ESG also provides an opportunity for insurers to highlight their societal role. Climate change provides opportunities for insurers to use their risk and underwriting expertise to manage and minimise risks for society as a whole.

Additionally, the disproportionate impact of COVID-19 on minorities and smaller companies has highlighted the importance of life protection, particularly for minority groups, exposed individuals and more vulnerable companies. Improving access to certain products, especially if they offer tangible value to the insured, will allow insurers to reach broader customer segments, while also improving social inclusion by serving more vulnerable customers.

A good thing for insurers

ESG presents transition challenges and opportunities to insurers. Narrowly defined, the transition to a low-carbon economy presents risks for insurers who do not adapt their business model and products. But it also provides significant opportunities for those in the insurance sector that address these topics.

Given their role in underwriting the activities of other corporates, and in addition to considering their own firms' responses to ESG, insurers are well placed to influence how others respond. They have a unique responsibility in considering if and how they should influence behaviours and help accelerate ESG outcomes. By doing so, they can reaffirm their role as an essential link in society.

For insurers, ESG can only be a good thing.

> "Given their role in underwriting, insurers are well placed to influence how corporates behave."

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