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Unlocking the Power of Truly Responsible Investment

Today, green investments represent a smaller proportion of insurers' assets than most people would like. In anticipation of COP26, we discuss why, and suggest remedial steps.

The insurance industry recognises the importance of ESG-aware investment, and it looks like a natural opportunity, since many insurance companies are major asset managers and owners with long-term investment horizons.

In many ways, the outlook for realising the opportunity seems promising: today, there are historically high levels of capital waiting to be placed, a need for investment, and pressure from stakeholders.

Already, companies have taken positive first steps and demonstrated ambitious intentions. However, within individual companies, change isn't happening as quickly or extensively as everyone would like. To move forward, companies need:

- A clear understanding of their new risk appetite and a strategic rationale that goes beyond the numbers
- Clear, objective and timely data (so that decisions cannot be undermined by naysayers with conflicting views on sustainability)
- Alignment with capital and liquidity rules

A major opportunity for insurance

Green investments have been heralded as a major opportunity for any insurance company that can invest for the ultra-long term. The choice of green investment opportunities is already wide and will continue to expand rapidly in coming years.

At the same time, there is mounting political, societal and stakeholder pressure to move in this direction. It's recognised that private as well as public investment will be needed to solve current environmental challenges – investment on a huge scale and for the long term. And the insurance industry could play a significant role: together with long-term savings, the ABI estimates that insurance companies could contribute a third of the investment needed to meet the UK's net zero target for 2050.[1]

To date, however, green investments account for a very small proportion of insurance companies' long-term assets. For example, a 2020 survey found that only 24% of insurers consider sustainability factors when identifying investment opportunities.[2]

1 https://www.abi.org.uk/news/news-articles/2021/07/abi-climate-change-roadmap/
2 https://www.aberdeenstandard.com/en/uk/institutional/insights-thinking-aloud/article-page/what-drives-esg-in-insurance

Current challenges in green investment

So what's causing the delay? We have identified three main challenges for insurance firms:

1) **Aligning with regulatory and other criteria**. Green investment opportunities need to satisfy several specific investment criteria before they will appeal to insurance companies. These criteria include capital requirements and liquidity management constraints – many of which are dictated by regulations that were not designed to incentivise green investments. For example, investing in a 30-year bond currently attracts the same capital consequences whether it's issued by a wind farm or an oil company. Another issue is that green investments often involve unlisted assets, which attract higher capital charges. Regulations aside, a lack of clarity about how well these investments fit in with the company's risk appetite can be a significant barrier to investment.

2) **Conquering unfamiliar territory**. Historic forces and trade routes push companies towards known investment processes and asset classes. Green investment means getting involved with unfamiliar sectors or sub-sectors, where the investment process itself may be different from that in traditional sectors and asset classes; for example, there is not yet a suitable exchange for tradable green assets. For green investments, it's necessary to take additional steps to identify assets or investment projects that meet the insurer's risk appetite and other criteria (credit, liquidity, valuation certainty…), and are sufficiently long dated to match the liabilities. In addition, without specialist knowledge it can be difficult to distinguish genuinely green claims from mere greenwashing, given that all those seeking funds will be striving to present themselves in the most positive light and that there is a lack of reliable data sources.

3) **Resolving doubts about yield**. The price/yield issue for fixed interest assets is clearly a consideration in responsible investment. For example, green bonds are normally issued at a "greenium" and offer a lower return than other bonds. Insurers are operating in an extremely competitive environment where a 0.1% difference in portfolio yield could determine success or failure. This is a potential drawback of green investments, especially in a prolonged low-interest environment.

We should note here that some of the challenges only apply to part of the portfolio. There are important differences, for instance, between investing one's own balance sheet (i.e. as asset owner) and investing customer money (as asset manager). Individual customers may be happy to invest in ESG funds, even accepting a slightly lower expected return. However, boards or with-profits committees may find it harder to make that decision on behalf of their entire customer base, especially as they often face a technical duty to maximise returns.

It's also worth noting that the overall picture is changing rapidly, often to the advantage of green investments. For example, regarding challenge 3 above, "brown"' assets could come to be considered untradeable by many investors in the future, leading to valuation uncertainty and making the price/yield profile of green investments look more attractive.

Tackling the challenges

We recommend that companies initiate the following actions to overcome the challenges identified above:

Challenge 1: Aligning with regulatory and other criteria

— Engage and collaborate with regulatory bodies and government to support the establishment of the regulatory and legislative changes needed to reconcile green investment with other objectives, aligning capital, governance rules, tax regime and so forth. Life will get easier if accounting bodies establish an audit standard for these assets – a step that could be announced at COP26.

— Define the ESG ambition and strategy and see how well they fit in with the company's risk appetite. This fit is fundamental to the way a company serves its customers, and will shape decisions such as whether to divest from an oil company that has committed to becoming net zero. Companies must clearly identify any ESG-related risks implicit in the existing investment model, as part of a broader assessment of their investment process through an ESG lens. It's also important to ensure that the benefits of green investing are appropriately reflected within the risk-return efficient frontier for investing.

Challenge 2: Conquering unfamiliar territory

— Invest in the specialist expertise needed to navigate the new trade routes and generally to adapt to this change. This expertise may be available from third parties, but outsourcing should only be regarded as a stopgap.

Unfortunately, the required talent is scarce and in high demand, so training as well as recruitment will be needed.

- Even more importantly, prepare the Board for the change, for example through training programmes.
- Build the capability to access consistent, reliable data sources to drive timely decisions. For example, identifying the right ESG metrics to track out of the plethora of available data points can be a challenging but critical exercise.

Challenge 3: Resolving doubts about yield

- Engage with asset managers to fully understand the potential costs, benefits and practicalities of pursuing an investment strategy that is aligned with emerging global sustainability goals and targets (such as becoming a net-zero business by a particular deadline).

Responsible asset owners and managers don't exist in isolation, of course. Industry initiatives must go hand in hand with government and regulatory action. This action is starting to happen – for example, the Solvency II review has some references to the issue – but so far there is little detail, for example, regarding the need for rules to be consistent with the government's climate change objectives. Much more action will be needed in the future, and collaboration will be essential: we expect to see greater emphasis on public-private initiatives.

Deciding your stance on sustainability

Ultimately, each company needs to decide whether it wants to take a leadership role in sustainability, rather than simply do the minimum required for compliance. Making this major strategic decision requires careful analysis of the rewards available from each option, as well as the risks. The decision cannot be based on maths alone – deciding to aim for leadership also requires a brave leap of faith.

Whether they decide to be leaders or followers in the ESG area, insurance companies will get better results by acting decisively, before they are taken to task by stakeholders such as investors and customers. This probably means putting the measures described above in place within the next two to three years.

For now, though, we're eagerly waiting to see what comes out of COP26 and hoping it will make life easier for insurance companies looking to create a greener investment portfolio.

Please get in touch if you'd like to find out more about this topic and how FTI Consulting can help.

We discuss the opportunities and threats associated with ESG in part one of our article series here.

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