Sustainable investing for insurers – 50 shades of green?

Barely a day goes past without some reference on television or in the press to climate risks and the actions that various global governments and other bodies are looking to take to address this. This is normally framed in terms of the environmental outcomes; however, beyond an ecological risk, climate change has become a systemic economic risk as stated by the Bank of England, the Financial Stability Board, the International Monetary Fund (IMF) and several inter-governmental bodies.

As a key industry within the world economy, insurers are an important component of both the problem and the overall solution – through their business models (eg carbon intensity of their activities and offices); the liabilities they are writing; and the assets they are investing in. Given this, insurers remain subject to various insurance focused regulatory developments as well as other initiatives impacting on the wider investor universe. These are summarised in figure 1. Even though none of these regulations or initiatives have, to date, directly required or incentivised insurers to adopt a greener approach, the implicit messages are clear – investment approaches do need to change to help mitigate climate risks.

However, although most insurers have now (rapidly) turned attention towards considering a more environmentally aware asset strategy, there is no one accepted version of what having a 'green' investment allocation actually means. Variations around climate-risk aware strategies do not perhaps involve the '50 shades' referred to in the title to this piece, but there are a range of possible approaches nonetheless.

Figure 1: Insurance focussed regulatory developments and wider initiatives

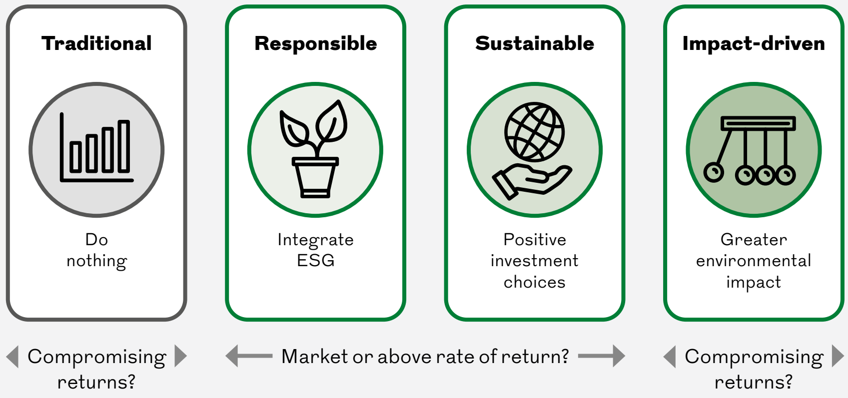
Insurance focused	Wider initiatives
Bank of England Prudential Regulation Authority **PRA expectations** Supervisory Statement (3/19) around climate risk management Letter from PRA to insurance company CEOs requiring management of climate change risks by end of 2021	**COP 26** **Global collaboration** Rearranged 2021 UN Climate Change Conference in November 2021
HM Treasury **Post-Brexit regulatory regime** Call for evidence – includes questions around whether SCR calculation should encourage long-term growth and climate change objectives	**HM Treasury** **Disclosures** Mandatory climate change disclosures (TCDD) for large proportion of UK asset owners
European Insurance and Occupational Pensions Authority **Solvency II review** Likely requirement to recognise sustainability risks when setting investment strategy (and risk and capital management)	**Bank of England** **Scenarios** Climate Biennial Exploratory Scenario (CBES) launched in June 2021
	United Kingdom Debt Management Office, Bank of England **Green bonds** Green gilts framework published in June 2021 Consultation around 'greening' the BoE's bond purchase scheme

Source: RLAM

Introducing the sustainability spectrum

Figure 2 summarises at a high level what these different green strategies could be, with the level of focus around the environmental impact increasing to the right.

Figure 2: The sustainability spectrum



Source: RLAM. For illustrative purposes only.

- '**Responsible**' investing would consider ESG criteria as part of the holistic security selection process but would not explicitly exclude any investment based on only environmental criteria.
- A '**Sustainable**' investment approach goes one step further, with ESG integration, but then with further positive screening-in of those companies who are viewed as providing goods and services that are expected to provide a longer term environmental or societal benefit, or are ESG leaders in their field.
- Lastly, an '**Impact driven**' approach would have a more specific focus on only investing in those companies who have an explicit focus on supporting environmental objectives (eg wind farms, solar power companies)

In addition to considering the environmental outcomes associated with these strategies, we believe it is important to understand the potential impact on returns, particularly given the ongoing ultra-low yield environment. Our view is that incorporating ESG criteria and having a more sustainable investment approach is expected to improve risk-adjusted returns relative to doing nothing, through utilising a more robust framework. However, there could be a potential compromise in returns from an impact-driven strategy where there is less diversification and where increased capital is now being allocated, potentially depressing returns, particularly for all but the largest insurers who are able to access these assets on preferential terms.

It is worth noting that an insurer may utilise different approaches across different parts of their portfolio – for example having a responsible approach for all assets apart from a smaller allocation to impact driven investments.

As well as considering the high-level objectives for integrating climate risk in portfolios, the exact implementation approach will also have a major say on how the environmental and financial objectives are realised in practice – and in particular avoiding some of the pitfalls that exist.

Is there the risk of brown tinges to the green shoots?

Whilst we are very supportive of insurers adopting a more climate-risk focused investment approach, to manage physical and transition risks and reflect their role as material long-term holders of capital, we believe there are several factors to be wary of that could invalidate at least some of the environmental and financial objectives. These include:

A. Greenium

Given the very large and ever-increasing amount of capital looking for environmentally focused themes and activities, there is a real risk of investors being impacted by 'Greenwashing' and the so called 'Greenium' (Green premium). There have been a number of listings and new issues heralding the 'green' accolade, but with limited detail and focus on the green opportunities this money will actually be put to. Such potential greenwashing, whilst attracting the attention purely due to the green label, often attract higher prices (lower yield) than other, non-green or brown, listings or issuances – even from the same issuer and supporting the same business activities. This has resulted in a so called 'green premium' or 'greenium' that can often be observed in the market pricing for certain investments.

Given the market interest often encountered by these new listings, investors are often more than willing to pay for the additional green credentials implied by the label. This is often seen as a simpler option for accessing green activities – particularly for less sophisticated investors – and hence the 'greenium' could sometimes be more accurately described as a 'convenience premium'. Whilst green labelling will no doubt be overall helpful for facilitating the move of investment portfolios into more environmentally focused areas, we often have concerns at an individual security level around potential compromises on financial returns and, indeed, whether this will always support better environmental outcomes.

B. Data coverage/quality

Despite the rapid growth in ESG investing, one of the biggest challenges still facing investors is data coverage, quality and consistency around climate change metrics. When comparing this data to more traditional company fundamentals, it is fair to say the former is still at a very nascent stage. This has led to a lack of consensus and consistency around how to define and quantify ESG data – also leading to low correlations between ESG ratings across providers. Initiatives have been and continue to be developed to help with classifications – for example the EU-driven Sustainable Finance Disclosure Regulation (SFDR) and EU taxonomy for sustainable activities. However, these initiatives are still work in progress and lack wider global applicability outside of the EU.

It is not just coverage that matters, but the quality of the underlying data. When reviewing this data we often find inaccuracies that can have significant impacts. One such example is Wessex Water, a regulated UK water company. When using off the shelf tools, we had previously obtained a carbon footprint of 11.2m tonnes of CO_2. However, this was the same footprint as the whole of Jamaica, so something appeared wrong. When we investigated this further, the screening tool had taken its parent company, YTL, which owns power plants, giving us a meaningless figure for the water company itself, which had almost 100 times lower carbon intensity. This highlighted the importance of bottom-up primary research rather than relying solely on third party systems and data.

C. Fungibility of capital

We are very supportive of the principle of green bonds – they have raised real awareness of sustainable investing for both issuers and investors. However, whilst they sound like an easy and convenient way to invest in environmental projects, we often see material shortcomings between theory and practice.

As an example, the German utility company e.on has issued labelled green bonds as recently as last year. As with most green bonds, these are issued out of the group's holding company, with the business highlighting its environmental credentials. As is also typical with most bonds of this kind, the bond does not have a legal claim over those environmental projects. Instead, proceeds are merely earmarked against green work they had already undertaken. Because this cash is fungible with the company's other cash, by lending at that level, bondholders may have actually freed up funds for the company's potentially less environmentally focused activities. On top of this, it is not just green assets funding the bonds coupons, but e.on's entire business. This includes several nuclear power plants, an area that our sustainable funds won't invest in. Lending in this way also means that green assets could potentially be sold in future. With no claim over those environmental assets, the investment would now be in the remaining, now less environmentally friendly business, and effectively then turning the green bond brown.

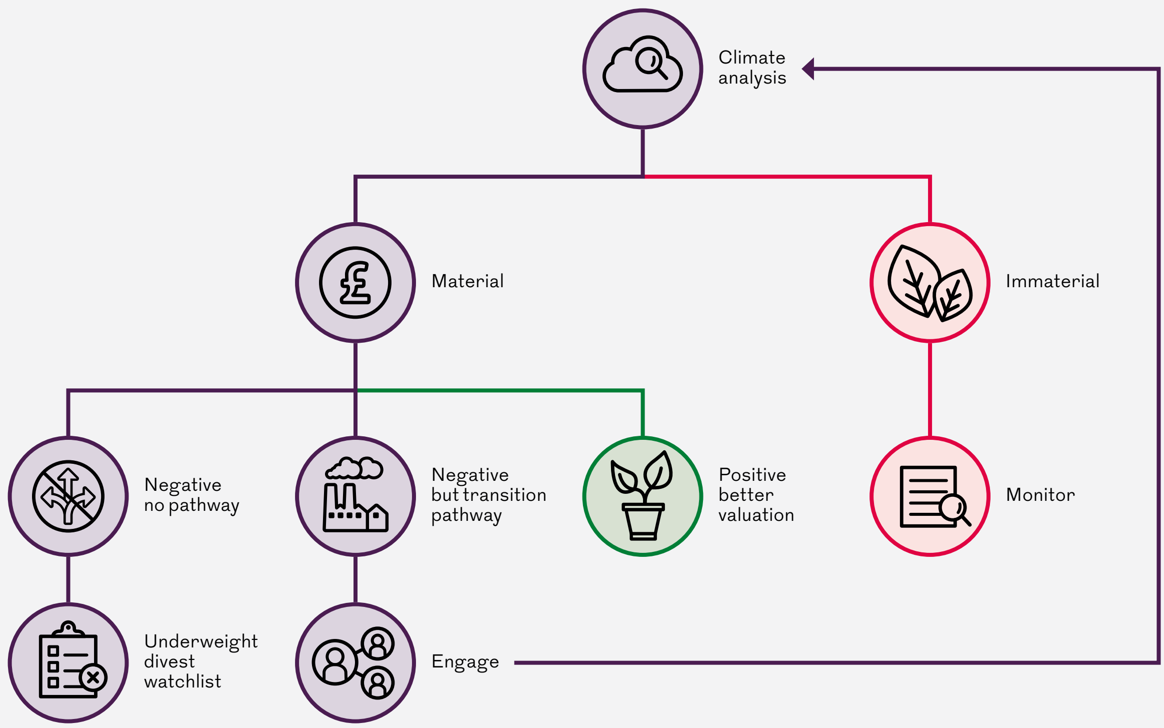
Furthermore, because of the green label, some investors are willing to accept a lower credit spread on this green bond compared with an unlabelled bond of the same maturity, despite them both being structurally identically, raising concerns around both environmental and investment credibility. This is another potential example of the 'Greenium' referred to earlier.

Preserving the integrity of the environmental and financial objectives

There are two primary ways in which a more climate risk focused strategy can be implemented:

1. Positive screening – this approach looks to include companies that are either expected to deliver goods and services that specifically support better green outcomes, and / or companies that have a superior environmental profile relative to their peers (whilst not necessarily having an environmentally focused business)
2. Negative screening – for example specific exclusions around the exploration or extraction of fossil fuels or refining of oil, gas or coal.

Figure 3: Climate risk integration conceptual framework



Source: RLAM. For illustrative purposes only.

It is the details of the implementation of this screening that are key in being able to deliver the environmental and financial outcomes that insurers are seeking. Employing a negative screen blindly, for example, whilst ensuring that short-term green credentials are apparently met, can potentially just transfer the problem elsewhere, where the underlying climate risk issues are still not being appropriately managed and transitioned. This may also cost investors through lower returns if being sold at depressed valuations with the wider market also selling out of these assets.

In addition, whilst such a screening process may provide exposure to more obviously green companies, it may avoid allocating capital and support to those companies that are in the process of adopting significant green changes or at the tipping point of deep and significant new green technological advances.

To recognise the above, within RLAM we have developed a climate risk integration conceptual framework (summarised in figure 3 on the previous page) that includes analysis of climate risks and opportunities with four potential outcomes:

1. **Immaterial**: climate is not used in financial analysis;
2. **Material and positive**: climate can be used to support a better valuation or an investment opportunity;
3. **Material and negative**, but the assessment of the company or issuer **can be enhanced through engagement**: e.g. through mitigation measures, requests for change;
4. **Material and negative**, and the company or issuer is **not an engagement target**, due to business model/exposure, time horizon or other reasons: we will consider whether to underweight the security, divest, or avoid investment.

We appreciate that not all insurers would wish to continue holding assets within 'category 3' above, due to the shorter term need to decarbonise portfolios for example. However, where there is the flexibility to incorporate a longer-term perspective (ie improvement through engagement rather than divestment) then we believe this can potentially result in better green outcomes and higher returns.

We consider two case studies below to highlight the value that can be obtained from having a more nuanced, in depth, and longer-term view on climate-related risks.

Each of these companies has apparent negative exposures associated with climate change. To exclude these stocks from the investment universe may improve green credentials under some measures, but this may come at a subsequent cost in the future if insurers can look deeper into company structures and assess and understand the potential value they can provide in mitigating climate risk.

Case study 1

Steel Dynamics — looking deeper under the bonnet

Steel Dynamics specialise in manufacturing steel using electric arc furnaces, an alternative technology to blast furnaces which rely on electricity (rather than coking coal) to produce steel. Traditionally, this had been relatively poorly judged by third party rating agencies, although in the last couple of years Steel Dynamics' rating has improved.

However, in our view the role electric arc steel producers like Steel Dynamics can play in the US economy is underappreciated for two reasons. First, while they already offer a lower carbon production process than a blast furnace, this will be a greater advance further in the future as more and more renewables are connected to US grids, something which is being encouraged under the new administration. Without a significant investment into very large-scale carbon capture and storage technology, it would be very hard to decarbonise blast furnaces to the same extent.

The second is the tilt towards the circular economy built into Steel Dynamics' business model: the company relies on recycling and reusing scrap steel in order to produce new sheets, and should benefit further as industrial customers move to increase the levels of recycled content in the goods they produce.

However, in recognising that the steel industry as a whole has a number of challenges to face, the Steel Dynamics business model is in an arguably much better position versus its peers when it comes to transitioning to a 'greener' company. The company has revolutionised its process and primarily uses recycled steel in efficient electric arc furnaces, a process where the carbon intensity is 80% lower than some global peers. As regulations and scrutiny around carbon emissions increase, Steel Dynamics' transition to lower carbon intensive methods means it is likely to be more resilient versus competitor peers if stricter carbon taxes are imposed. Between 1 January 2020 and 31 March 2021 the stock delivered returns of more than 50% (38% annualised and higher for the 12 months to 31 March 2021 given the impact of Covid in previous year).

Case study 2

First Hydro/Engie — searching beyond simple green classifications

When looking at First Hydro using third party systems, the limited data which is available tends to focus on parent company Engie, one of France's most significant utility companies.

However, First Hydro's assets are very different from the wider group and offer a very different ESG profile. The two hydroelectric dams at Dinorwig and Ffestiniog offer a measurable social benefit, providing a clean source of peaking power to help meet spikes in electricity demand when most other flexible generation remains powered by fossil fuels. Outside of its core operations, First Hydro's broader ESG profile remains strong compared to some other hydropower assets. Water quality and wildlife protection are monitored, including providing open access for fish breeding and other biodiversity initiatives throughout the year. The assets are also relatively well protected from a risk of water scarcity going forwards.

For bondholders there are additional protections from potential governance risks at parent company Engie thanks to the strength of the guarantees and security over the assets underpinning the bond. And more broadly, the ESG profiles of the assets are very different, where around half of Engie's energy production continues to come from fossil fuels, although the company has very recently set a formal net zero objective. First Hydro bonds provide bond investors with unique exposure to renewable assets in a way which would be far harder to access as equity investors.

In general, we recommend a more considered approach to climate risk integration than a blind screening process, a process where we embed environmental considerations into the overall decision-making process. Whilst the screening of securities can be useful, we believe this cannot be used in isolation, given not only the lack of robustness of some of these screens but also the real value that can often be achieved through more in-depth analysis of a company and a company's direction and motivations, and the potential to positively influence future behaviours.

Delivering strong and sustainable long-term returns

Insurers have been subjected over recent years to increasing expectations and pressures around managing climate-related risks throughout their businesses, and these pressures show no signs of abating. This is likely to result in most insurers adopting, on average, a greener and more climate-risk focused investment strategy. However, there are many different 'shades of green' possible within an investment approach, and it will be important for insurers to firstly clarify what the overall objectives are – namely how explicit should the focus be on prioritising specific green investments (relative to more broadly integrating climate risk within investment portfolio decisions) and how this balances against return expectations.

At a more detailed implementation level, we view the increasing focus on issuers demonstrating green credentials as a big step forwards in the industry but believe that it is critical that investors and their asset managers do their homework and do not blindly rely on the green label. A thorough evaluation of a company's activities, future plans and intention to improve business practices around environmental policies is needed.

We remain positive on the ability of the insurance industry to play its role in supporting the necessary transition to a low carbon economy but believe that the implementation of this via the greening of investment portfolios does need very careful consideration.

Risk warning

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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