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# Sustainable Investment – what's driving changes in insurer's investment strategy?

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## What is Sustainable Investment?

**Finance-driven**
- Fundamentally about improving outcomes – better returns and lower risks
- Analyse the risks and look for opportunities
- Approach embedded throughout the investment process

**Long-term**
- Meeting present and future needs
- Exploiting available time horizon
- Long-horizon skillset and mind-set

**Integrated ESG**
- Environmental, Social and Governance (ESG) factors
- Integrated throughout the investment process as these drive financial outcomes

**Effective stewardship**
- Exercising ownership rights to protect and enhance the value of investments
- Engagement, voting, and advocacy

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## What's driving changes? UK and global regulatory developments

### FRC (Financial Reporting Council)

Updates to the UK Stewardship Code including:
- ESG factors
- climate change

### Institute and Faculty of Actuaries (IFoA)

May 2017 - risk alert: factor climate risk into calculations and advice.

IFoA working parties on sustainability and climate change.

### Regulation abroad

EU member states will be required to: according to the Prudent Person Principle, integrate ESG, improve transparency and reporting.

European Commission's technical expert group on sustainable finance (TEG) developing sustainable finance practices in a number of different areas, e.g. taxonomy of sustainable economic activities.

EC's 10 key actions for financing sustainable growth (shown overleaf).

The Framework for U.S. Stewardship and Governance was launched in January 2018 by the Investor Stewardship Group (ISG).

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## What's driving changes? EU legislation for action on financing sustainable growth

1. Classification System for Sustainable Activities
4. Incorporate Sustainability in Financial Advice
5. Sustainable Benchmarks
7. Clarify Institutional Investors' and Asset Managers Duties
6. Better Integrate Sustainability in Credit Ratings
9. Strengthen Sustainability Disclosure & Accounting Rules
8. Incorporate Sustainability in Prudential Requirements
10. Foster Sustainable Corporate Governance
2. Standards and Labels for Green Products
3. Foster Investment in Sustainable Projects

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## Why is Sustainable Investment important?

Risk and Return

Regulation

Reputation and influence

01 Manage risk
Exploit opportunities

02 PRA and EIOPA expectations

03 Leader vs laggard
Insurers have a huge role!

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## Evidence for Sustainable Investment

- Evidence points towards a moderate long-term risk adjusted return advantage for approaches which integrate ESG and effective stewardship
- There is strong evidence for a sizeable net long-term premium, depending on investor size and governance

**ESG integration**

- Higher ESG scoring companies tend to provide moderately better risk-adjusted returns over the long term and there is some evidence for lower credit spreads in fixed income
- Governance ('G') is often found to be the most influential factor

**Effective stewardship**

- While difficult to measure, there is increasing empirical evidence to support the value of stewardship – company engagement appears to have a positive impact

**Long-horizon investing**

- There is strong evidence of a sizeable net long-term premium of between 0.5% p.a. and 1.5% p.a. depending on investor size and governance arrangements
- Eight building blocks of value creation have been identified, split between those that provide long-horizon return opportunities, and those which lead to lower costs and/or mitigate losses

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## What are the first steps for insurers to take?

**Understanding Sustainable Investment**

- Beliefs and positioning
- Current and upcoming regulation
- Benefits and costs of integrating Sustainable Investment
- Practical approaches to implementation

**Insurer to develop views**

- Discuss importance of Sustainable Investment, agree beliefs and objectives
- Draft a statement which encapsulates these views and can be included in the Investment Policy Statement

**Set up framework and integrate into investment process**

- Implement decisions into the insurer's portfolio if necessary
- Ongoing monitoring

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## Framework for integrating sustainability into the investment process


1. **Select fund positioning –** articulate mission and beliefs, and document in a policy
2. **Develop a risk management process –** integrate into risk management framework, include analysis on portfolio from both top-down and bottom-up, and consider specific topics e.g. climate change
3. **Portfolio construction –** account for material sustainable risks and opportunities. Identify strategies across asset classes and alpha-beta spectrum to manage these risks and exploit opportunities
4. **Implementation –** through active engagement with fund managers, monitoring their practices versus policies, and working with managers to evolve their activities in this area
5. **Monitoring –** to ensure activities are mission-consistent and meeting expectations. Regular reviews of progress versus plan, periodic updates of risk management and scenario analysis, and regular reviews of manager ESG and stewardship activities

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“ *A new Marshall Plan for the planet….governments to allocate 5% of pension funds and sovereign wealth funds to the UN Sustainable Development Goals and shape fiscal incentives for insurers….* ”

Maurice Tulloch, CEO, Aviva
UN General Assembly / Climate Week
September 2019

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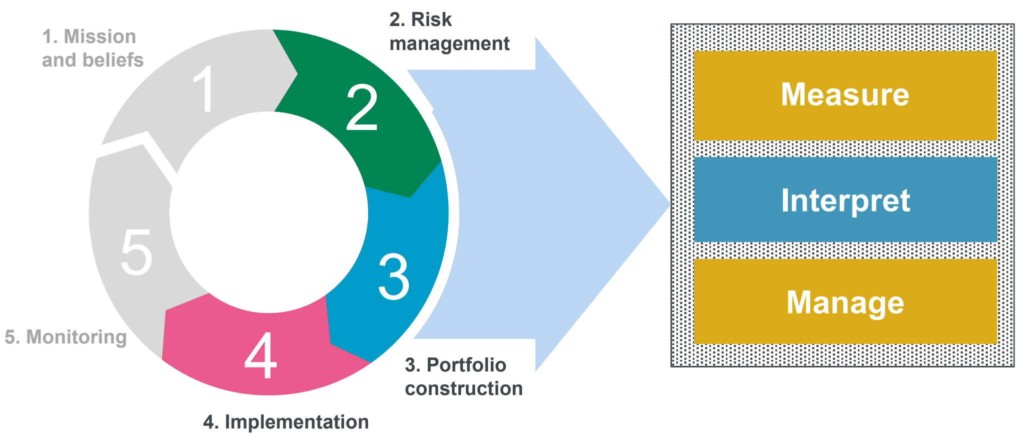
## Measurement is the First Step to Management…




**But you need to understand what you are looking at**

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## Challenges with Measuring and Interpreting

**The measurement and interpretation of "ESG exposures" presents a number of challenges**

| | | | |
|---|---|---|---|
| Information on public companies widely available | ✓ | Illiquid / private deals present a number of additional challenges | X |
| Assessment / scoring not standardised across external providers | X | Standardisation across asset classes is still a problem | |
| Sector level information is not sufficient individual name analysis required | | All scoring contains various levels of subjectivity | |
| Forward looking / momentum assessment of companies required | | There are a lot of grey areas where a wide range of scores ratings are possible | X |

**Individual scores not sufficient and require qualitative overlay**

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## What about Exclusions…

**More challenges…..**

| | |
|---|---|
| **Every investment is "special"** | ▪ A blunt instrument when expressed as sector / project type level |
| **Grey areas** | ▪ Doesn't cope with grey areas….and there are many |
| **Prevents engagement** | ▪ Not able to use active ownership / stewardship to influence corporate behaviour |
| **Portfolio construction issues** | ▪ Excluding whole areas impedes robust and diversified portfolio construction and potentially impedes investment potential |

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## A Practical Framework

| | | |
|---|---|---|
| **Portfolio Scorecard** | • Focus on overall portfolio score / rating rather than individual<br>• Target improvements over time to overall fund score / rating<br>• Minimum standard limits at the margins to prevent obviously red line investments | Main focus areas |
| **Engagement** | • Active stewardship around ESG – actively engaging with companies<br>• Use shareholder power to influence decisions<br>• Use investor voice to influence policymakers and regulators | |
| **Exclusion** | • Exclusion at the margin of red line industries typically on moral grounds or to mitigate significant franchise risk<br>• For example cluster bombs, munitions etc.<br>• Where engagement has failed as necessary divest and exclude | |
| **Support** | • Support strong policy action around ESG and climate change | |

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## Its easy isn't it ? There can't be that many grey areas….

**Fifty shades of grey…..**

**What about the big oil producers ?**

**What about tobacco companies ?**

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# Case studies from recent private debt opportunities

Fifty shades darker …..

**Liquified Natural Gas ….that's clean energy isn't it?**

**What about oil pipelines?**

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## ESG Investment Beliefs

Recognise and embrace our duty to act as responsible long-term stewards of our clients' assets.

Maintain a deep conviction that environmental, social and governance (ESG) factors can have a material impact on investment returns and client outcomes.

Believe that being a responsible financial actor means our investment approach must support, and not undermine, the long-term sustainability of capital markets, economies and society.

**Governed by a firm-wide ESG Governance Committee**

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## ESG-embedded investment process

**Origination**

- Investment selection decisions which identify and value ESG
- Driving sustainable and resilient performance

**Due Diligence**

- Rigorous due diligence process
- ESG factors considered through the asset lifecycle

**Approval**

- Potential investments reviewed by the Investment Committee
- ESG and Commercial factors considered when decided whether to approve transaction

**Asset Management / Development**

- Active asset management programs targeting ESG improvements
- Regular and consistent monitoring and review of progress of the programs

**Reporting**

- Integrated performance measurement frameworks
- Advocate for resilient and sustainable capital markets

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## ESG Risk Assessment

Additional due diligence for potential investments in Higher Risk Activities or Practices. The proposal will need sign off from the CIO and Chief Responsible Investment Officer.

| | |
|---|---|
| **Exclusions** | Certain activities and products are excluded. |
| **Higher Risk Activities** | Activities we believe represent a higher risk in terms of Responsible Investment considerations, which could in turn negatively impact clients' interests because of the reduced liquidity of the asset class. |
| **Higher Risk Practices** | Practices which may trigger reputational franchise risks caused by irresponsible business practices. |

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## ESG Impact Assessment

Assess whether investments have a positive contribution to society, aiming to validate the sustainable value through the selection process.

| Environmental | Social | Governance |
|---|---|---|
| • Reducing waste production or recycling waste<br>• Improvement to air quality<br>• Improving efficiency in water consumption | • Meaningful community engagement<br>• Improvement of wellbeing<br>• Contribution to heritage<br>• Improving health and safety conditions | • Robust governance structures and controls<br>• Effective stakeholder engagement<br>• Clear, unbiased reporting<br>• Market advocacy |

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## Carbon-neutral office development

- One of the UK's first carbon neutral office development and greenest educational environments
- Powered by 100% renewable energy from an associated windfarm
- Environmentally friendly features - photovoltaic panels and rainwater harvesting systems
- Number of people working at the Park increase to over 10,000 making it one of the most successful Business Parks in the UK


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## Oil & Gas Storage Facilities

**Balancing infrastructure needs versus environmental risks in two similar projects.**

**Net ESG balance: One positive, one negative**

*UK's current decarbonisation efforts. Increasing popularity of renewable alternatives, oil and gas is a high-impact sector in terms of ESG implications.*

**Nuanced approach.** One storage facility was purely meant to stock traditional fossil fuel, with no potential for other uses. In contrast, the other primarily held jet fuel (no commercially viable alternative).

**Stranded asset risk** becoming stranded within our investment timeframe was low. In addition, this second facility had potential capacity to store biofuels, further mitigating the transition risk.

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# Refinancing an oil refinery

**Balancing economic and social development potential versus corruption and CO2 emissions risks.**

**Net ESG balance: positive**

*Provide loan to a major state-owned company to refinance high-interest debt, using the gains to fund improvements to an existing oil refinery.*

**Environmental efficiency.** Refinancing used to improve operational efficiency

**Social impact.** Create jobs and part of the country's National Development Plan to improve domestic economy and reduce reliance on energy imports.

**Governance momentum.** Corruption Perceptions Index has improved significantly over recent years and robust oversight mechanisms.

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## Key takeaways

- Establish beliefs and framework
- Measure your exposure
- Engage
- Assess risk and impacts
- Acknowledge the uncertainty

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**Questions**

**Comments**



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Thank you
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