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ESG and actuaries: everything you need to worry about

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Overview

- What is ESG?
- Fiduciary duty
- The paradigm shift
- Regulation
- What to do
- Why should actuaries do anything?
- ESG and liabilities and other thoughts.
- Next steps



What is ESG?

Think of it as a list of issues which may affect business in future:

- **Environmental issues:** Narrow issues on the management of sources of raw materials and release of wastes; along with wider issues around the sustainability of company assets.
- **Social issues:** Narrow issues around the employment policies of the company and wider issues of the impact of the companies' products and policies on society.
- **Governance issues:** Narrow issues focussed on shareholder rights and wider issues on the companies' ability to recognise long-term threats and change the company.



What is ESG?

MSCI recognise 37 issues:

3 Pillars	10 Themes	37 ESG Key Issues	
Environment	Climate Change	Carbon Emissions Product Carbon Footprint	Financing Environmental Impact Climate Change Vulnerability
	Natural Resources	Water Stress Biodiversity & Land Use	Raw Material Sourcing
	Pollution & Waste	Toxic Emissions & Waste Packaging Material & Waste	Electronic Waste
	Environmental Opportunities	Opportunities in Clean Tech Opportunities in Green Building	Opp's in Renewable Energy
Social	Human Capital	Labor Management Health & Safety	Human Capital Development Supply Chain Labor Standards
	Product Liability	Product Safety & Quality Chemical Safety Financial Product Safety	Privacy & Data Security Responsible Investment Health & Demographic Risk
	Stakeholder Opposition	Controversial Sourcing	
	Social Opportunities	Access to Communications Access to Finance	Access to Health Care Opp's in Nutrition & Health
Governance	Corporate Governance	Board Pay	Ownership Accounting
	Corporate Behavior	Business Ethics Anti-Competitive Practices Tax Transparency	Corruption & Instability Financial System Instability



What is ESG?

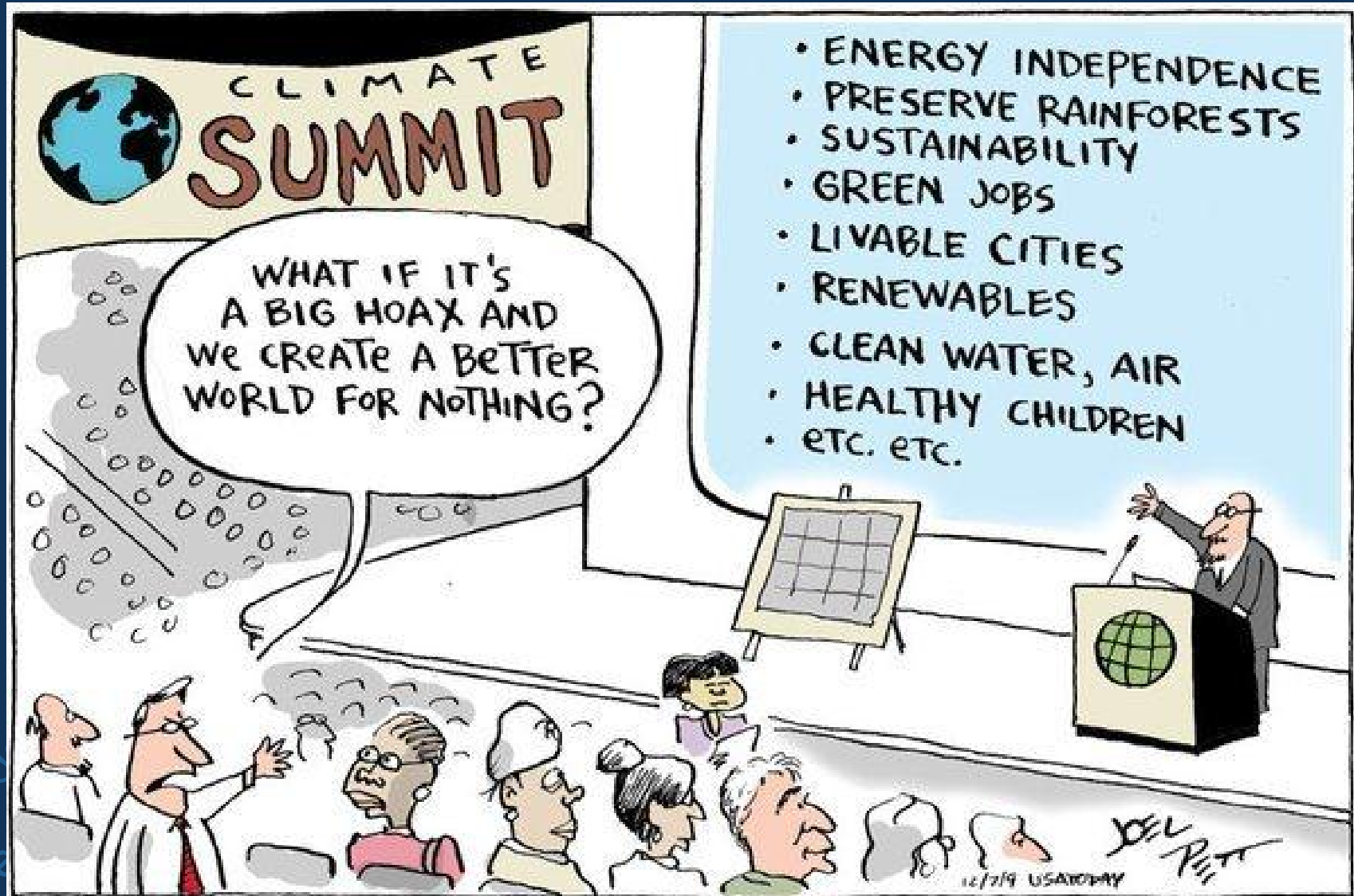
Why is ESG such an issue?

1. Because passive management based on market cap investing has become dominant
2. Because no company is “clean” on all ESG issues
3. Because it is hard to prioritise between the issues
4. Because society has realised institutional investment is not doing enough on climate change

ESG is largely an investment issue, but ultimately ESG can affect funding if handled badly.



Fiduciary duty





Fiduciary duty

Generally a strange institution, but particularly in the UK:

- Applies to the governance body (eg Trustees)
- Invest prudently
- Solely in the interests of beneficiaries

Because most trusts/vehicles used in the UK focus on financial objectives (eg pensions, mutuals, life insurers) fiduciary duty is often construed to put the beneficiaries' financial interests first.

Anything that reduces expected returns (or increases risk) is dangerous to the fiduciary.



Fiduciary duty

Recent findings from the Law Commission have been responded to by the DWP in new regulations.

Essentially there is a fiduciary duty:

- To consider and react to all financially material factors (ESG)
- Factors which are not financially material can be reacted to if they do not damage performance or are predominantly the will of the members (Ethical)
- Act as stewards of assets for members (Engagement)

Time horizon is vital.



Fiduciary duty

Confirming that ESG are investment issues is material:

- Efficient markets hypothesis (passive investment) says the only important data point is the share price.
- Under this laissez-faire approach we need only wait for the market to react to ESG issues.

If ESG is material, markets are not efficient and we must be more active in allocating capital in the economy.

You were not taught this in your exams.



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The paradigm shift

We do not have data on the cost of climate change. It will happen in the future:

- Nothing to extrapolate / no testing of hypotheses
- Not a specific risk – nowhere to hide
- You must have views

This is how you make decisions in your life. You have intuitions about scenarios and probabilities, but can't and won't assess them definitively:

“Shall I cross the road?”



The paradigm shift

There are two kinds of factors that might not be included in market pricing:

- Cyclical factors where there is a natural discount/premium emerging over time (value, sentiment, economics)
- Sigmoidal factors where the world can only change once (technology, policy, clean energy, slavery etc)

Chicago school is bad at both. Cyclical factors are acknowledged deficiencies whereas Fama/Markovitz/Scholes/Black/Merton were too clever to notice sigmoidal change.



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The paradigm shift

“It’s politics, not economics”

Only people supporting the current paradigm say this eg this is in itself a political statement.

All investment is politics – it allocates capital to economic activity.

Indeed pension schemes are quasi-states: they hold state capital (tax relief) in order to transfer capital between generations. On this basis ESG has to come into decisions.



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Increasing ESG regulation

By October 2019 DC pension schemes must produce a SIP setting out:

- how they take account of financially material considerations, including (but not limited to) those arising from Environmental, Social and Governance considerations, including climate change;
- their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with the investment;

The SIP must be published on a website.

Schemes must provide an annual update on how they have implemented their policy.



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Increasing CC regulation

Government is waking up to the inaction of the financial sector in greening the economy.

2018 Environmental Audit Committee: asks 25 largest pension schemes how they are approaching Climate Change and whether they discussed it with their actuary.

2017 PRA outlines its the approach to supervising the financial risks from climate change and enhancing the resilience of the UK financial system by supporting an orderly market transition to a low-carbon economy.



What to do?

As highlighted there are three broad routes:

- Investment/disinvestment based on ESG factors – to increase returns or reduce risk
- Investment/disinvestment based on Ethical factors – to make investors feel better.
- Engage with investee companies – for some reason

Engagement is talked up by a conflicted, passive industry as being the most prominent solution, but achieves virtually nothing (eg Unilever).



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Portfolio tilts

Ethical tilts: reduce exposure to an ESG issue without believing it will change the returns.

Financial tilts: reduce exposure believing it will improve returns or reduce risk.

Index houses (FTSE, S&P, MSCI etc) investing in their data for this purpose. A tilt is a low tracking error change in portfolio weights.



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Why should we do anything?

Actuaries worry about the range of things the future *might* throw up to advise our clients how to take risk.

We strive for appropriate allocations of costs, risks and returns among a stakeholder network.

We ensure the time-horizon of risk-taking is commensurate with liabilities



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ESG is a great opportunity!

Environmental, Social and Governance issues:

- A list of risks that might occur to businesses in the future
- A way of thinking that recognises externalities in cost benefit calculations
- A way of thinking that focusses on the long-term impact of short-term decisions

This is all about financial outcomes, but understanding they are affected by non-financial issues.



ESG is a great threat!

Increasing political and regulatory focus on a financial system that:

- Takes risks it doesn't understand on ESG issues, particularly climate change
- Has no model of shareholder value beyond short-term quarterly numbers
- Offers inappropriate governance of the economy

Actuaries have been asleep; and many will argue we have been at the wheel.



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ESG liabilities

Insurance has some ESG-linked liabilities, but most impact on liability is on risk of failure of funding plan.

Environment Agency PF received a discount rate adjustment on the basis that its high ESG portfolio would have better security of returns. IE they made their funding cheaper because they had incorporated ESG.

Climate change in particular presents a major headwind on returns. BAU may be depressed vs estimates with ESG portfolios meeting estimates.



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ESG crystal ball

Climate change – we'll be talking about this until we retire.

Plastic – we'll deal with this in the next 5-10 years, but the consequences will be longer.

Water security – particularly for developing economies

Diversity – gender, faith, LGBTQ

Inequality – pay gaps, pay multiples

Impact – we're hardly scratched the surface. I believe this is the next big theme.



Further updates

- IFoA issued a risk alert on Climate Risk in May 2017:
*“Actuaries should include considerations of climate-related **risks** in any relevant decisions, calculations or advice.”*
- IFoA has published a number of “practical guides”: Pensions, Covenants, Mortality and DC. More to come.
- Taskforce for Climate-related Financial Disclosures (TCFD) published in July 2017.
- Provides a process for articulating climate risks and strategy. Applicable to companies, asset managers and asset owners.

IFoA Resource and Environment links

- Sign up for the Resource and Environment newsletter:
<http://www.actuaries.org.uk/news-and-insights/newsletters#Resource%20and%20environment>
- Climate change policy briefing (2015):
<http://www.actuaries.org.uk/news-and-insights/media-centre/media-releases-and-statements/risk-management-approach-essential>
- Commissioned research on Limits to Growth (2013):
<http://www.actuaries.org.uk/documents/resource-constraints-sharing-finite-world-evidence-and-scenarios-future>
- Literature reviews:
 - Sustainability and the financial system (2015)
<http://www.actuaries.org.uk/documents/sustainability-and-financial-system-review-literature-2015>
 - Climate change and resource depletion (2011)
<http://www.actuaries.org.uk/documents/climate-change-and-resource-depletion-challenges-actuaries-review-literature-2011>
 - Climate change and resource depletion (2010)
<http://www.actuaries.org.uk/documents/climate-change-and-resource-depletion-review-literature>



Further reading

- World Economic Forum – Global Risks Report
<http://reports.weforum.org/global-risks-2016/>
- IPCC AR5 Synthesis Report - Key points and questions
<https://www.gov.uk/government/publications/ipcc-5th-assessment-report-synthesis-report/key-points-and-questions-ipcc-ar5-synthesis-report>
- PRA - The impact of climate change on the UK insurance sector
<http://www.bankofengland.co.uk/pradocuments/supervision/activities/pradefra0915.pdf>
- Mercer – Investing in a time of climate change 2015
<http://www.mercer.com/services/investments/investment-opportunities/responsible-investment/investing-in-a-time-of-climate-change-report-2015.html>
- Kay Review – UK equity markets and long-term decision-making
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
- Law Commission - Fiduciary Duties of Investment Intermediaries
<http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/>



Questions

Comments

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