Current issues

Insurance Investment & ALM Panel Discussion: Climate Change

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Over the summer of 2021, the Insurance Investment & ALM team at Hymans Robertson ran a climate change survey for the insurance industry, with around 20 participants including life insurers, composite firms, and reinsurers.

The survey revealed a number of interesting findings – and the team brought some of the key issues to our panel discussion at the 7th Annual Insurance & Financial Services Seminar in London on 2nd November. The panel explored the challenges faced by institutional investors as a result of climate change. In this article, we summarise the most interesting insights from the discussion.

The participating panellists were:

- **Nicola Kenyon** – Chair of the Panel
- **Maeve Sherry** – Operational Sponsor of Climate Risks & Opportunities project at Aviva
- **Neil Mitchell** – Actuary & PhD Candidate in Climate Change Finance and Governance at the University of Manchester's Global Development Institute
- **Gerard Anderson** – Climate Risk Consultant at Hymans Robertson

Given the onerousness of the regulatory requirements of climate change and with the PRA focusing on managing climate risk, is climate change purely a risk for institutional investors to manage or should all institutional investors be playing an active role in mitigating severe climate change?

To meet net-zero emissions in line with the Paris Climate Accord, all sectors of the global economy have to embark on an unparalleled transformation. This means that not only do firms have to manage short-term risks in their own portfolios, but they also have to respond to the systemic challenge of stewarding the transition to a Net Zero climate resilient economy. As managers of a significant proportion of the world's assets, insurers and other institutional investors are key players in ensuring an orderly climate transition and have a corporate responsibility to play an active role.

However, there are a range of factors that may prevent institutional investors from prioritising climate impact in their investment decisions:

The views expressed by panel members were their own and not necessarily those of their employer.

- Investors' fiduciary duty may not necessarily align with wider climate impact goals – investing for the greater good in 40-50 years' time may be difficult to justify for some firms, if the primary focus is maximising more short-term profits for shareholders.
- Although there is plenty of evidence that ESG funds do as well if not better than non-ESG funds, there is less evidence and research into impact investing. It is unclear whether returns would be sacrificed through impact investing.
- Whilst this is changing, there remains insufficient low-cost liquid market instruments or established secondary markets for investing in climate-friendly assets. Collaboration with Development Finance Institutions could reduce this challenge.
- Insufficient data and metrics are a key barrier to pricing climate risk – integral to the proper functioning of markets and efficient capital allocation.

Given the scale of the challenge, it is vital that institutional investors play an active role in influencing an appropriate regulatory landscape for the whole of the industry to work with. Collaborative initiatives, such as the UNPRI and NGFS, are crucial in addressing the challenges faced by institutional investors. Through collaboration, a series of monitoring regimes and sanctions, all investors will be encouraged to act.

The survey revealed a split across the industry on the merits of divestment and exclusions. Some favoured stewardship while others saw it as a key component of their overall climate risk strategy. Is divestment or exclusions the most effective way of managing climate risk and taking action?

Divestment and exclusions can be an effective way of managing climate risk simply through avoiding it. However, there is evidence that divesting is not as effective as engagement in influencing behaviour in mature markets. In mature markets, unless everyone divests from the fossil fuel industry, capital can and will be sourced elsewhere. In contrast, in immature markets, positive screening can improve capital availability for sustainable projects that may not otherwise be available.

In many situations, engagement can be a more effective means of driving change than divestment – especially when investors are able to collaborate. Potential engagement activities include transition roadmaps, science-based targets, interim performance checks and ultimately holding the Board of the invested companies to account. Many firms are using engagement to encourage companies to act, and then divestment to punish those do not. One example is Aviva's climate engagement escalation programme.

Aside from making a positive impact, investors who engage with their invested firms tend to experience less downside risk and volatility. Climate impact and risk management are not necessarily exclusive, it is possible to achieve both through a thoughtful combination of engagement and divestment.

Green-washing has gained a lot of prominence in recent years as investors turn to green assets to manage climate risk. Similarly, there is much discussion over whether ESG assets generate better returns than non-ESG assets. What is the evidence on returns and on green-washing and how do we guard against it?

Investors are increasingly turning towards ESG and responsible investing – however, questions are being raised about the true greenness of certain investment products, as in some cases it may be nothing more than clever marketing. To guard against greenwashing, there needs to be a robust means of identifying green assets and greater transparency around these assets. Increasing regulation around green assets is crucial to ensuring green and ESG labels are appropriately used. For example, when the Sustainable Finance Disclosure Regulation became mandatory in the EU, European investment managers stripped the ESG label off of $2trn in assets.

Considering returns on green assets on the stock market, according to research undertaken by Morningstar, ESG-friendly securities have seen better than market returns both in bull and bear markets over the last decade or so. The actual reason for this is debatable – some say that recent outsized returns are simply due to the increasing demand for ESG-friendly funds, especially from retail investors and pensioners.

ESG investing has also influenced bond markets – recently the UK government issued its first Green gilt totalling £10bn. The demand was enormous, with over £100bn worth of bids for the 12-year debt – resulting in yields on the debt of c.2.5bps less than non-green equivalents. Some criticism of the UK green gilt issuance was that the amount

earmarked for investing in climate friendly activities was already decided on, and none of the proceeds of the green gilt issuance was earmarked or ringfenced for green spending.

Whilst returns on green assets may be driven by high demand in the short-term, ESG considerations are likely to be a key factor in influencing returns over the longer term. Firms with good climate risk management practices, lower emissions and a forward-looking, future-proof, progressive mentality may be more sustainable, profitable and financially stable for longer.

At Hymans Robertson we are supporting our clients to navigate the ever-changing regulatory landscape. Climate change is just one element in a broader set of Responsible Investment considerations. Hymans Robertson has a wealth of experience assisting financial firms and pension funds with their climate-related disclosures, roadmaps to net-zero, scenario analysis and many other climate considerations. If you would like to discuss with one of our specialists, or you would like to participate in one of our seminar panel discussions next year, please get in touch.

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