ESG considerations in the insurance industry

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Introduction

Environmental, social and governance (ESG) criteria provide a framework for investors to use in evaluating companies in which they may wish to invest. As investors progressively demand ESG fund options and information relating to the environmental and social responsibility of their investments, providers of insurance-based investment products face pressure to ensure that their products and product disclosures meet this demand. More widely, insurers are looking to ensure that their own practices are ethically sound from an ESG perspective, in order to maintain continued support from investors and customers.

This paper intends to cover the increasing popularity of ESG investments, how ESG investments are selected, risk and strategy considerations for insurers, the influence of ESG factors on product design, for both long-term insurance products and health and care products, and ESG disclosure requirements.

Defining ESG

Focusing on three pillars—environmental, social and governance issues—ESG criteria typically refers to the consideration of these three factors by investors when choosing which investments to make. ESG investing is often referred to interchangeably as "sustainable investing" or "responsible investing". There is, however, a distinction between ESG investing and socially responsible investing (SRI); for ESG investing, ESG factors are incorporated into decision making, whereas SRI goes a step further, actively prioritising the selection of investments based on social impact over expected financial performance.

ESG issues are becoming more widely scrutinised in today's working environment. Companies are being requested to provide their ESG policies for consideration for investment opportunities, as part of due diligence checks for partnerships, employment considerations by potential employees and in attracting customers for all types of products, including insurance policies.

MSCI, a provider of ESG indexes, uses a specific ESG ratings methodology[1] that outlines key issues by pillar[2]. These are described further below. It should be noted however that the MSCI methodology is just one approach to describing ESG concepts and other bodies will define the concepts differently.

ENVIRONMENTAL ISSUES

The MSCI lists the following environmental themes:

- Climate change, for example carbon emissions, product carbon footprint and vulnerability to climate change
- Natural resources, for example raw material sourcing and water stress
- Pollution and waste, for example toxic emissions and waste, packaging material and waste and electronic waste
- Environmental opportunities, such as opportunities in renewable energy or clean technology

In addition to the major themes identified by MSCI, other areas of environmental considerations for investors include animal welfare and testing and protected sites and species, e.g., impacts on World Heritage Sites.

SOCIAL ISSUES

The MSCI lists the following social themes:

- Human capital, for example company labour management, health and safety and human capital development
- Product liability, such as privacy and data security, financial product safety, health and demographic risk and product safety and quality
- Stakeholder opposition, for example controversial sourcing
- Social opportunities, for example the provision of access to finance, healthcare and communications

Social considerations also include a company's community relations, such as charitable donations and encouragement of voluntary work within the community.

GOVERNANCE ISSUES

The MSCI suggests the following governance considerations:

- Corporate governance, for example board structure and diversity, executive pay and use of accurate and transparent accounting methods
- Corporate behaviour, for example business ethics, tax transparency and use of anti-competitive practices

The rise of ESG popularity

In 2004, the then United Nations (UN) Secretary-General, Kofi Annan, invited the CEOs of a number of major financial institutions to participate in a joint initiative. The goal of this initiative was to find ways to integrate ESG issues in capital

[1] MSCI (April 2020). MSCI ESG Fund Ratings Summary: Methodology. Retrieved 14 July 2020 from https://www.msci.com/documents/1296102/15388113/MSCI+ESG+Fund+Ratings+Exec+Summary+Methodology.pdf/ec622acc-42a7-158f-6a47-ed7aa4503d4f?t=1562690846881

[2] MSCI ESG Ratings Methodology, retrieved from: https://www.msci.com/documents/10199/123a2b2b-1395-4aa2-a121-ea14de6d708aww.unepfi.org/psi/wp-content/uploads/2019/02/PSI-Guidance-for-non-life-insurance-underwriting.pdf

markets. The output of this initiative, the paper "Who Cares Wins"[3], explored methods to embed ESG factors in capital markets. The paper argues companies that perform better with respect to ESG issues can expect to increase their shareholder value through the proper management of risks, through accessing new markets and by improving their reputations and brands, all whilst contributing to the sustainable development of societies. Recommendations within the paper highlighted that a broad range of stakeholders (including analysts, investors, pension scheme trustees, companies and regulators) can contribute to this initiative by incorporating ESG factors into their decision making.

Since then, awareness of the term ESG and the popularity of ESG investing has grown significantly, presumably as the arguments in the UN paper have become more widely known and accepted. The Global Sustainable Investment Alliance (GSIA) estimated in its most recent review report that in Europe the total amount of assets committed to sustainable and responsible investment grew by 11% between 2016 and 2018 to EUR 12.3 trillion. Globally, assets in five major markets (Europe, the United States, Canada, Japan and Australia and New Zealand) amounted to USD 30.7 trillion. An increasing societal consciousness with respect to sustainability continues to grow ESG investment and attention.

Sustainable investing is particularly likely to be popular with younger generations; a 2019 Morgan Stanley survey[4] found that 95% of millennials in the US expressed an interest in sustainable investing. To the extent that younger generations are likely to be investing for the long term (for pensions for example), ESG investments could be an appropriate choice. Sustainability-themed investing may require a longer investment period in order to realise gains, for example given that green technologies will take some time to become mainstream. Investing in green startups may also require a more risk-seeking attitude, which younger savers can afford to take.

The term ESG is largely used in an investment capacity, but ESG policies and practices by a firm may be of interest to more than just investors. McKinsey explores the ways in which ESG compliance links to cash flow, focusing on five specific ways[5]: top-line growth, cost reductions, regulatory and legal interventions, productivity uplifts and investment and asset optimisation. These links illustrate that it is more than just traditional investors who should consider ESG compliance and, given that younger investors exhibit greater ESG awareness, that intuitively there is a long-term link between ESG compliance and value creation for firms. Some examples of how ESG compliance is valued by more than just the traditional investors:

- **Customers**: With increased disclosures, information on practices of a firm can more easily reach customers, whether that business is in a supply chain or retail. ESG-related issues which may attract customers include sustainable products, better governance within a firm, less exploitation and better use of resources compared to poor sustainability practices, such as violation of human rights and the production of unsafe products or unfair labour conditions.
- **Employee retention and recruitment**: Negative publicity around ESG considerations may restrict a firm's ability to attract and retain talent if there is a "social stigma" associated with the firm, whereas ESG compliance may boost employee motivation and attract talent through social credibility.

ESG approaches and strategies

There are a number of approaches to deciding what types of investments qualify as being sufficiently ethically robust to be included within an ESG portfolio and ensuring that progress is made on key ESG issues. Strategies vary, but typically include the approaches shown in Figure 1.

FIGURE 1: ESG SELECTION APPROACHES

Approach	Details
Exclusion, or negative screening	Avoidance of companies involved in activities classified as controversial, for example those involved in production of nuclear power, tobacco, gambling, weapons or those with human rights violations.
Positive screening	Selection of companies with the best performance and policies in ESG areas. For example this might include investing in companies that produce renewable energy to encourage progress on climate change or in companies showing a commitment to promoting healthy working conditions.
Corporate engagement/ shareholder action	Working to influence companies, for example by exercising shareholder voting rights on particular issues or directly engaging with boards of companies.
Norms-based screening	Investments are screened against international norms such as those published by the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises, UN Global Compact Principles or International Labour Organization (ILO) standards.
Sustainability-themed investing	Investment in assets in sustainability sectors, such as green technology or sustainable agriculture.
ESG integration	The specific inclusion of ESG factors within investment analysis and decisions.

[3] Global Compact (2005). Who Cares Wins. Financial Sector Initiative. Retrieved 14 July 2020 from https://www.unglobalcompact.org/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf.

[4] Morgan Stanley (12 September 2019). Morgan Stanley survey finds investor enthusiasm for sustainable investing at an all-time high. Press release. Retrieved 14 July 2020 from https://www.morganstanley.com/press-releases/morgan-stanley-survey-finds-investor-enthusiasm-for-sustainable-.

[5] Henisz, W., Koller, T., & Nuttall, R. (14 November 2019). Five ways that ESG creates value. McKinsey. Retrieved 14 July 2020 from https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value.

Clearly with such a range of approaches employed by fund managers there are issues surrounding consistency and comparability between funds. Fund managers may well have different attitudes towards what is an acceptable level of performance with respect to ESG issues; for example some managers may select companies which meet an independently defined threshold, whereas others may simply require the sector average performance with respect to ESG issues. The latter may particularly be true if there is an incentive for fund managers to achieve a minimum level of compliance in order to ensure that the investment universe is not overly restricted. This type of approach may result in "greenwashing," defined by the Financial Conduct Authority (FCA) as "marketing that portrays an organisation's products, activities or policies as producing positive environmental outcomes when this is not the case"[6].

From the investor or policyholder perspective there is therefore a higher level of research required to ensure that the approach taken by managers meets their expectations of an ESG fund and is aligned with their personal ethics and standards. Where negative screening is employed, for example, investors will need to ensure that they agree with the selection of activities defined as controversial. The ambiguity and lack of defined standards with respect to classifying investments as ESG-compliant therefore poses conduct risks and reputational risks to the fund manager or insurer if investors do not feel they are getting the product which has been marketed to them, i.e., if there is a mismatch between the ESG principles of those investing their money and the company.

ESG in the insurance industry

PRINCIPLES FOR ESG CONSIDERATIONS BY INSURERS

As ESG issues become more widely scrutinised by investors and consumers alike, it is key that insurers address them within their own businesses in order to contribute to sustainable economic and social development, as well as to maintain their own brands and reputations. A useful framework to examine in this context is the UN Environment Programme Finance Initiative (UNEP FI) Principles for Sustainable Insurance (PSI)[7]. It argues that the new risks and opportunities posed by ESG factors mean that it is prudent for insurers to change the risk factors they consider when managing their businesses. The PSI is motivated by the fact that, as risk managers, risk carriers and investors, insurers can play a vital role in encouraging sustainable economic development.

It defines sustainable insurance as "*a strategic approach where all activities in the insurance value chain, including interactions with stakeholders, are done in a responsible and forward-looking way by identifying, assessing, managing and monitoring risks and opportunities associated with environmental, social and governance issues. Sustainable insurance aims to reduce risk, develop innovative solutions, improve business performance, and contribute to environmental, social and economic sustainability*."

Four main principles are outlined in this PSI framework, and some of the main actions within these principles are highlighted in Figure 2.

FIGURE 2: KEY PRINCIPLES FOR SUSTAINABLE INSURANCE AND CONSIDERATION OF ACHIEVABLE ACTIONS

Principle Description	Possible Actions
Embed in decision-making ESG issues relevant to insurance business.	Ensure the company strategy identifies, assesses, manages and monitors ESG issues in business operations Develop products and services which reduce risk, have a positive impact on ESG issues and encourage better risk management Integrate ESG issues into risk management, underwriting and capital adequacy decision-making processes Educate sales and marketing staff on ESG issues relevant to products and services Integrate ESG issues into investment decision-making and ownership practices, e.g., by implementing Principles for Responsible Investment
Work together with clients and business partners to raise awareness of ESG issues, manage risk and develop solutions.	Communicate with clients and suppliers on the company's expectations and requirements on ESG issues Encourage clients and suppliers to disclose ESG issues and to use relevant disclosure or reporting framework
Work together with governments, regulators and other key stakeholders to promote widespread action across society on ESG issues.	Support prudential policy, regulatory and legal frameworks that enable risk reduction, innovation and better management of ESG issues Communicate with business and industry associations to better understand and manage ESG issues across industries and geographies
Demonstrate accountability and transparency in regularly disclosing publicly the progress in implementing the Principles.	Proactively and regularly disclose information on the company's progress in managing ESG issues publicly Participate in disclosure or reporting frameworks

ESG RISK CONSIDERATIONS FOR INSURERS

The growth of interest in ESG naturally necessitates insurers to consider the impacts on risk management and strategy. Clearly there is a reputational risk that an insurer is not seen as environmentally and socially conscious and some kind of reputational event highlighting its practices results in significant increases in lapse rates and reductions in new business. Firms could also attract litigation if they do not conduct themselves appropriately, in line with expectations. This could be particularly problematic if a firm's behavior is not in line with its external disclosures to policyholders and shareholders. To this end, integration of ESG issues within the business could require wide-ranging changes with respect to culture across the

[6] FCA (October 2019). FS19/6: Climate Change and Green Finance: Summary of Responses and Next Steps. Feedback Statement. Retrieved 14 July 2020 from https://www.fca.org.uk/publication/feedback/fs19-6.pdf.

[7] UNEP FI. The UNEP FI Principles for Sustainable Insurance. Retrieved 14 July 2020 from https://www.unepfi.org/psi/the-principles/.

business, to ensure that its behavior matches its externally stated ethics.

With respect to long-term business with investment features, insurers risk a lack of demand for products if they do not keep up with policyholder demand for ESG fund options or policyholder expectations of due diligence on investments made. Whilst this risk is most likely to impact products where policyholders make investment choices (such as unit-linked and pension savings products) in the short term, we may see this spread to policyholders becoming more conscious of the assets held by insurers to back other product types over time.

From the insurer's perspective, there could be an opportunity cost if those managing investments do not consider new investment opportunities in green initiatives which could have huge potential for growth. On the other hand, there is perhaps a limited extent to which such investments are likely to be a good match for insurance liabilities. If such investments are taken, they should be taken only under circumstances in which they are properly understood and there are appropriate risk management measures in place.

A core ESG concern is climate change, and a key issue faced by firms in a climate-aware economy is the impact of changing perceptions of a firm based on its disclosure, which can lead to a tangible impact on the firm's value. Insurers invested in firms with poor ESG or climate-related publicity could see a similar impact on their portfolio values.

Finally, positive screening of companies and investments is likely to involve higher costs for those choosing investments. There could therefore be implications in terms of value for money for customers, or insurers might struggle to adhere to any charge caps which are in place.

ESG STRATEGY

Whilst looking to manage ESG-associated risks, firms should also have clear ideas regarding risk appetite and ESG strategy, in order to inform appropriate risk management. The extent to which firms want to pursue provision of ESG funds and products and implement due diligence on both their own actions and the actions of suppliers, from an ESG perspective, is a strategic consideration.

Pursuing the development of broad ESG compliance and product provision will naturally require some cultural changes within a firm, as well as expenditure to ensure that the strategy is implemented to a good standard. Insurers must consider the degree of public disclosure required, for example involvement of board members, and assigning responsibility to overlook and maintain ESG compliance, as well as considering conflicts of interest for the firm and its board between ESG compliance and other company targets such as profit levels and investment returns. A company may wish to extend its compliance to checking that it uses ESG-compliant suppliers and products, and further that its third-party relations also use ESG-compliant sources. This is likely to require quite a considerable input of time and expense to do thoroughly.

ESG INVESTMENTS FOR LONG-TERM INSURANCE PRODUCTS

In terms of insurance products, ESG is of most relevance to long-term products with an investment component, primarily unit-linked and pension savings products and to a lesser extent with-profits products. Given the increasing popularity of ESG funds, and the fact that unit-linked investors bear the market risk associated with their investments, it seems more likely that unit-linked providers will be required to offer ESG fund options within product offerings.

We are only aware of a limited number of providers currently offering funds which are specifically marketed and named as ESG funds. However, some insurers are setting standards for their investment managers with respect to how they take ESG factors into account. Standard Life for example has published online its policy on how it incorporates ESG into its unit-linked investments.[8] The policy expects investment managers to:

- Have policies on aspects such as how they engage, report and vote on ESG, and on any sectors or activities they specifically exclude from funds.
- Be aware of how legislation changes will impact exposure to investments.
- Be able to demonstrate how they incorporate ESG considerations into their investment processes.
- Proactively engage with companies, e.g., using voting rights to encourage positive practices and reporting on their voting and engagements.

Similarly, other unit-linked providers publish disclosures on the extent to which ESG factors are taken into account by fund managers when making investment decisions. Examples include AXA's Group Responsible Investment Policy,[9] which covers its unit-linked business, and Utmost's online statement[10] that ESG factors are incorporated into investment management. Such disclosures and policies are likely to become more widespread and detailed in response to increasing customer interest. It will certainly be interesting to see whether interest in ESG extends to assets backing other types of insurance contracts over time.

Pension regulation is increasingly encouraging the consideration of climate change-related and ESG issues by trustees. Since

[8] Standard Life. Integrating a Responsible Approach to Your Pension Investments. Retrieved 14 July 2020 from https://www.standardlifeworkplace.co.uk/employer/assets/invcp53.pdf.

[9] AXA (March 2020). AXA Group Responsible Investment Policy. Retrieved 14 July 2020 from https://www-axa-com.cdn.axa-contento-118412.eu/www-axa-com%2Fdaadd8ce-58bf-4c1f-bd28-96890bdb51aa_axa_ri_+policy_march2020.pdf.

[10] Utmost Life and Pensions. How We Manage Our Unit-Linked Funds. Retrieved 14 July 2020 from https://www.utmost.co.uk/investment-funds/how-we-manage-our-unit-linked-funds/.

October 2019 trustees have been required[11] to explain how they take into account ESG considerations (including climate change) in the selection of investments within a Statement of Investment Principles (SIP). Unit-linked pension providers may therefore see pressure from trustees to adjust their product offerings and disclosures to ensure that ESG principles are taken into account within investment management.

ESG ISSUES FOR HEALTH AND CARE PRODUCTS

It is reasonable to anticipate a growing consumer demand for ESG-compliant products, as well as increased disclosures on how a product is ESG-compliant, not just in investment-focused products but in all forms of insurance.

Whilst investment considerations may form the initial forefront of ESG strategy, they do not necessarily tackle key ESG issues faced by health and care products, such as critical illness, income protection, private medical insurance or long-term care. Primary ESG considerations within the health and care industry are the type and appropriateness of healthcare services utilised as well as the economic and social impact of these services.

Given the breadth of healthcare providers within any healthcare system, and the number of service providers that often make up the chain of services accessed in a health product, the challenge of determining the ESG compliance of a health product can seem like a never-ending rabbit hole.

In terms of introducing ESG strategy into the product design of a health and care product, a potential starting point is extending the concept of ESG ratings to various players within the healthcare industry, such as pharmaceuticals, hospitals and equipment providers, with emphasis on encouraging the use of services from providers with higher ESG ratings than those with lower ratings. More widely, this principle could be extended to any suppliers providing insurers with products and services.

In measuring any provider within the healthcare industry, the ESG rating methodology will need to consider potentially varying ESG issues in comparison to other industries. We discuss some healthcare-specific ESG considerations below:

- Environmental considerations such as disposal of waste and use of renewable energy and clean technology are relevant. More specific considerations in assessing pharmaceutical providers centre on concerns regarding disposal of waste and contamination of food, air and water as well as potential links to topical issues such as antibiotic resistance.
- Social considerations are at the core of ESG issues within the healthcare industry, and would be at the forefront of health-related ESG ratings. The impact of the services of a particular provider on the health and well-being of individuals will be a key consideration, looking at the quality and safety of the practices of a provider as well as the affordability and access to services among other things.

  A case study[12] published by the Principles for Responsible Investment (PRI) illustrates how customised key performance indicators have been created to measure healthcare performance by AllianceBernstein in the US. These indicators include consideration for readmission rates, healthcare-acquired infections and patient satisfaction as part of its proxies for the quality of healthcare services within hospitals.

  Whilst the ultimate use of the above performance indicators is investment-focused, the same indicators and ratings can be used to align the providers of services within a product to an insurer's ESG stance, allowing the integration of ESG strategy into product design.
- Governance issues highlighted above on the considerations around executive pay, transparency of accounting and tax methods as well as business ethics would be relevant in a similar fashion to other industries.

If health insurers are able to develop specific ESG criteria to measure service providers against, they should be able to increase the amount of services acquired from providers meeting this criteria and will be better able to align their business models with the key principles of sustainable insurance discussed in Figure 2 above.

ESG disclosures within the insurance industry

The EU sustainable finance strategy aims to channel private investment to the transition to a climate-neutral economy. One of the key elements of the sustainable finance strategy is to introduce regulation on disclosure requirements for institutional investors and asset managers relating to how ESG factors are integrated into risk management processes and investment decisions.

As a precursor to the introduction of regulation on ESG disclosure requirements, part of the EU sustainable finance strategy was to develop a unified classification system for environmentally sustainable economic activity, known as the "EU taxonomy." Creating a common language and understanding of sustainable investments was considered a vital first step in the

[11] 2005 Occupational Pension Schemes Regulation (Section 2.3), retrieved from http://www.legislation.gov.uk/uksi/2005/3378/regulation/2/made

[12] PRI (8 January 2019). Case Study: Delivering Social and Environmental Impact in the Healthcare Sector. Retrieved 14 July 2020 from https://www.unpri.org/fixed-income/delivering-social-and-environmental-impact-in-the-healthcare-sector/3912.article.

efforts to channel investments towards sustainable activities. The final report on the EU taxonomy was published in March 2020.[13]

The EU Regulation 2019/2088[14] on sustainability-related disclosures in the financial services sector (SFDR) is set to come into force from 10 March 2021. The SFDR provides a harmonised set of ESG disclosure standards for financial market participants, and therefore helps to achieve one of the key aspects of the EU sustainable finance strategy. It is important to note that the SFDR applies to all financial market participants (as defined within the SFDR) to at least some extent, regardless of their current ESG status.

The aim of the SFDR is to provide investors with "accurate, fair, clear, not misleading" product-specific ESG information across a broad range of providers, such as insurers selling insurance-based investment products, investments firms, pension providers and investment fund managers. This will enable greater transparency and comparability of the ESG characteristics of entities and their products.

The SFDR is therefore applicable to insurers selling insurance-based investment products, in particular as the increasing popularity of ESG funds may influence the types of unit-linked products offered by insurers. Given the UK's departure from the EU, it is unclear whether the SFDR will apply to UK-based insurers when it comes into force in 2021. However, given that the origin of the SFDR can be traced back to the 2015 Paris Agreement,[15] it is likely that the UK would seek to adopt regulations that are at least similar to the SFDR as it works towards meeting the goals of the 2015 Paris Agreement.

In light of the upcoming SFDR, the European Supervisory Authorities (ESAs) have developed draft Regulatory Technical Standards[16] (RTS) which specify the content, methodology and presentation of ESG disclosures as required under the SFDR at both an entity level and a product level. The ESAs are seeking input on the draft RTS during the consultation period, which is currently ongoing, with feedback from financial market participants due by 1 September 2020.

Under the SFDR there are three broad types of disclosure requirements.

1. Entity-level principal adverse impact assessments.
2. Pre-contractual and website product disclosure.
3. Periodic product disclosure.

Each of these is discussed further below.

1. ENTITY–LEVEL PRINCIPAL ADVERSE IMPACT ASSESSMENTS

Firms will be required to publish an annual "adverse sustainability impacts statement" on their websites in a prescribed format. This requires firms to assess the adverse impacts of investment decisions on a number of sustainability factors. Key items that must be contained within the statement include:

- Measures against a core set of mandatory environment-related indicators such as: carbon emissions, total energy consumption from non-renewable sources, water emissions and non-recycled waste ratio
- Measures against a core set of mandatory social indicators such as: gender pay gap, board gender diversity, human rights policy and anticorruption and antibribery policies
- Measures against at least one additional environment-related indicator and one additional social indicator
- A description of the policies used to identify and prioritise the principal adverse sustainability impacts
- A comparison of the measure against each indicator compared to the previous year

Where a firm does not consider the adverse impacts of its investment decisions on sustainability factors, a clear reason for why it does not must be published on its website.

2. PRE-CONTRACTUAL AND WEBSITE PRODUCT DISCLOSURE

The SFDR and supporting RTS specify the pre-contractual information that firms must disclose for products, which show they either:

- Promote environmental or social characteristics, amongst other characteristics
- Have sustainable investments or reductions in carbon emissions as their objective

Insurance-based investment products are unlikely to have a primary objective of sustainable investment or a reduction in carbon emissions, because protection is of course a key focus for insurance-based products. However, as demand for ESG-compliant products grows, insurers may opt to incorporate environmental or social characteristics into their insurance-based investment products. Therefore, the description below sets out the requirements for the former product type, i.e., those that promote environmental or social characteristics, amongst other characteristics. However, the requirements for products which have sustainable investments or reductions in carbon emissions as their objective are similar.

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[13] EU Technical Expert Group on Sustainable Finance (March 2020). Taxonomy: Final Report. Retrieved 14 July 2020 from https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/200309-sustainable-finance-teg-final-report-taxonomy_en.pdf.

[14] The full text is available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN.

[15] An agreement within the UN Framework Convention on Climate Change, dealing with greenhouse gas emissions, mitigation, adaptation and finance.

[16] Joint Consultation Paper: ESG Disclosures (23 April 2020). Retrieved 14 July 2020 from https://www.esma.europa.eu/sites/default/files/jc_2020_16_-_joint_consultation_paper_on_esg_disclosures.pdf.

The information that is to be provided at the pre-contractual stage for products promoting environmental or social characteristics includes:

- The planned proportion of total investments that are sustainable investments including, where relevant, the subdivision of the sustainable investments between environmental or social objectives
- An explanation of how the investments of the product comply with the "do not significantly harm" principle whereby, for an investment to be considered sustainable, it must not significantly harm any environmental or social objectives
- A description of the type of investment strategy that is used to attain the environmental or social characteristics and the binding elements of the strategy for selecting investments which attain those characteristics
- A list of the sustainability indicators used to measure the attainment of each of the environmental or social characteristics
- Where an index has been designated as a reference benchmark for the product, an explanation of how the reference benchmark is continuously aligned with each of the environmental or social characteristics or, where the reference benchmark is not aligned to these characteristics, a clear statement that it is not

It is planned that the RTS will provide a mandatory template for presenting this pre-contractual information. However, this template has not yet been developed.

In addition, the SFDR and supporting RTS specify the information that must be published on a firm's website in respect of such products. This largely overlaps with the pre-contractual information requirements, but some additional website disclosure requirements include: details on how environmental or social characteristics and the sustainability indicators are monitored throughout the life of the product, the methodologies used to measure the attainment of the environmental or social characteristics, the data sources used to attain each of the environmental or social characteristics and any limitations to the methodologies and data.

3. PERIODIC PRODUCT DISCLOSURE

For products promoting environmental or social characteristics, firms must produce periodic reports focusing on the success of the product in attaining these characteristics. Specific information to be contained within the report includes:

- A description of the extent to which the environmental or social characteristics were attained during the period, including performance against the sustainability indicators and a historical comparison against previous periods
- A list of the largest investments of the financial product, including the sector and location of the investments
- A breakdown of total investments during the period into the following categories: sustainable investments, other investments that contribute to the attainment of the environmental or social characteristics and remaining investments (including investments in fossil fuel sectors)
- The actions taken within the period to attain the environmental or social characteristics

It is planned that the RTS will provide a prescribed template for the periodic reports. However, this template has not yet been developed.

OBSERVATIONS ON THE UPCOMING SFDR REQUIREMENTS

Whilst the precise form that the requirements under the SFDR and supporting RTS will take is yet to be finalised, the SFDR and draft RTS make it clear that increased disclosure requirements relating to ESG matters are imminent. The SFDR indicates the general direction that regulation in this area is likely to be heading, with a growing requirement for financial market participants to understand and disclose the ESG impacts of decisions taken by entities and the products they offer.

We consider this to be a step in the right direction, with consistent ESG disclosures enabling investors to compare products and make more informed investment decisions, which may drive further innovation of ESG-compliant products. The SFDR will also help to combat "greenwashing," as firms will be required to disclose the data supporting any claims on the environmental attributes of a financial product.

The requirements as detailed in the draft RTS do, however, appear to be quite onerous. Under the adverse sustainability impacts statement, the number of indicators that firms must measure against are significant; in total there are 32 mandatory indicators and a further 18 additional indicators, of which firms must report against at least two. Firms will need to assess how they will measure their performance against each indicator (for some indicators there is a prescribed methodology in the draft RTS), determine the data that will be required to calculate each measure and set aside resource to perform the calculations on an annual basis. In addition, a number of the indicators are related to the companies the firm invests in, which will add to the data-gathering burden. This task should however become less onerous over time as a process is established which can be replicated each year and as stakeholders become more familiar with the requirements.

The SFDR is due to come into force on 10 March 2021, with the exception of the requirements around periodic product reporting which are due to apply from 1 January 2022. Firms therefore have a relatively short timescale to prepare for the SFDR. In addition to the work required to produce the adverse sustainability impacts statement, prior to 10 March 2021 firms must produce product-level disclosures, which will require an assessment of all products in its portfolio that promote environmental or social characteristics. This assessment may highlight that changes are needed to ensure a product meets the requirements of the SFDR, such as a reallocation of investments to increase the proportion of total investments that are sustainable.

The operational aspects of ensuring SFDR readiness will lead to cost implications for firms, as processes and systems will need to be established and maintained to enable the various disclosure requirements to be produced. Interestingly, in the European Commission's public consultation into duties of institutional investors and asset managers regarding sustainability,[17] all but one respondent gave the lowest possible answer when asked what level of costs would be associated with the integration of sustainability factors into investment decision making. Specifically, all but one respondent expected that the total costs, covering areas such as investment policy, valuation, disclosure, governance and risk management, would be less than 0.5% of assets under management. However, we note that this question was raised before the SFDR and draft RTS had been published, and the prescriptive nature of the disclosure requirements under the SFDR may result in firms revising their estimated costs of integrating ESG considerations upwards.

The SFDR requirements as specified by the draft RTS aim to strike a balance between setting minimum disclosure standards and allowing for some tailoring for the specific entity. For example, for the adverse sustainability impacts statements there is a prescribed set of mandatory indicators combined with additional optional indicators, whereas the product-level disclosures are all based on mandatory templates. This approach helps to achieve the aims of the SFDR of harmonising ESG disclosure standards and enabling a more meaningful comparison across financial market participants and products, whilst allowing for some tailoring to the specifics of different entities and products.

Overall, whilst there are clear merits of the upcoming SFDR requirements, firms should be aware of the extent of these requirements and should ensure that adequate time and resources are set aside to achieve SFDR readiness.

Conclusions

ESG considerations cannot be overlooked by insurers in today's environment, given the growing prominence of such issues. As awareness of sustainability increasingly influences customer demand and as regulatory attention to this area grows, insurers must ensure their positions on ESG matters are clear and that their strategies, product designs and day-to-day business management are aligned to them. This will be increasingly important not only in order to maintain brand and reputation, but also to remain competitive as customer demand evolves.

ESG matters pose numerous risks to insurers and therefore, as per other risk types, insurers should be clear on their ESG risk appetites and their approaches to managing this risk exposure. The risk appetite of firms for the closely related emerging risk, climate change,[18] is currently being explored by the insurance industry through the introduction of specific disclosure requirements and scenario testing recommendations, among other developments. Whilst ESG has a broader spectrum, including social and governance issues as well as other environmental concerns, the avenues that insurers travel to embed climate change risk could form useful reference points as ESG-specific risk exposure is explored further within the insurance industry, expanding beyond investments alone.

The regulatory response to growing ESG consciousness is developing, and most notably the upcoming SFDR will introduce material ESG disclosure requirements for insurers.

Overall, whilst ESG matters will increase the regulatory burden for insurers and will inevitably introduce risks, if managed properly within the business and effectively embedded into product design, they can also provide insurers with considerable opportunity.

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[17] European Commission (24 May 2018). Feedback Statement: Public Consultation on Institutional Investors' and Asset Managers' Duties Regarding Sustainability. Retrieved 14 July 2020 from https://ec.europa.eu/info/sites/info/files/2017-investors-duties-sustainability-feedback-statement_en.pdf.

[18] Milliman literature specific to climate change is available at https://uk.milliman.com/en-GB/risk/climate-change.