Viewpoint

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ASSET MANAGEMENT | WHITE PAPER

Conning & PRI's Commitment to ESG Investing for Insurers

By Matthew Daly, CFA, Managing Director and Head of Corporate and Municipal Teams

In recent years, U.S. insurance industry investment executives have become increasingly interested in environmental, social and governance (ESG) investment strategies. As an asset manager, Conning has heard several reasons behind the rising appeal, including specific concerns related to climate-change risk, as well as increasing shareholder demands, regulatory concerns, and, not least of all, to enhance long-term business viability.

The Principles for Responsible Investment (PRI) is now ramping up efforts to better engage U.S. insurers regarding ESG practices (see "U.S. Insurers a Key Part of PRI Effort," page 2). During the past decade, Conning has also been integrating ESG principles and capabilities into our investment management process to help insurers address their long-term investment needs.

Conning expects continued growth in interest in ESG investing among U.S. insurers for multiple reasons, including more regulatory requirements addressing business and investment issues related to climate-change risks. As a result, asset managers and investment consultants must prepare for the evolving needs in managing insurance investment portfolios.

Interest in ESG – and a Disciplined Process

Recent industry surveys and news articles illustrate the growing interest among U.S. insurance company executives of ESG investment solutions as they begin to catch up to their European and Asia Pacific counterparts. Most of Conning's clients in Europe now receive both ESG and climate-related reporting, and most European insurers soon will be required to demonstrate they have the systems and processes to understand and quantify the financial impact of climate change on the business, including investments. While U.S. consumers and regulators are asking more about ESG-related issues, insurance executives also appear to appreciate how ESG can add another criterium to assess long-term business and portfolio risks.

> ***Conning views ESG integration as a firm-wide effort, core to our global capabilities and one in which we leverage skills across the enterprise. We also believe it's the right thing to do, both for our clients and for us as a firm.***

However, there is still a significant learning curve related to ESG issues across the U.S. insurance industry. Conning also notes that some insurers want a disciplined process to guide how ESG-related criteria are evaluated in their business and investment processes. Given that ESG can encompass such a significant portion of the insurance business, it's not surprising that management teams want to understand both the opportunity and process better before instituting major changes in strategy and policy.

ESG Regulatory Focus Likely to Grow

The growing regulatory concern regarding ESG has been more targeted to disclosure and risk management and less specifically to asset management. However, a growing focus on the asset side is an expected next step. U.S. insurance companies are taking notice of ESG regulatory actions already underway elsewhere. For example, in 2020 the European Commission issued regulations for asset managers, investment funds and other financial services firms. Under these regulations, asset managers must satisfy both regulatory and investor demands to change the way they invest and report, and the products they offer. While current U.S. ESG regulations lag the EU, that is not to say that federal and state regulators aren't already active in the area.

The National Association of Insurance Commissioners (NAIC), along with the states of California and New York – both viewed as first-movers in state regulatory requirements - now require that insurers provide company-level climate-risk impact assessments.

California focused early on insurance investments with its January 2016 Climate Risk Carbon Initiative, which asked insurers to voluntarily divest from thermal coal and for insurers with more than $100 million in annual premium to publicly disclose their fossil fuel investments.[1] However, pressure continues from other local voices: in September, PRI and the U.C. Berkeley School of Law's Center for Law, Energy & the Environment jointly recommended that all California institutional investors integrate material ESG factors into their investment processes.[2]

Also in September, the New York State Department of Financial Services announced that it expects all New York insurers to start integrating financial risks from climate change into their governance frameworks, risk management processes, and business strategies, and encouraged them to analyze and describe how climate change affects their investments, liquidity, operations, reputation, and business strategy.[3]

At a federal level, the SEC has established ESG reporting standards for all public companies. In August, the SEC updated its financial disclosure requirements to include ESG areas of human capital management practices and supply chain arrangements when those areas are a significant part of the company's working capital practices.[4] During the process of developing these new requirements, the SEC received comments asking it to include climate change in the expanded list. While the agency declined to do so, it remains open to adding more ESG disclosures.[5]

U.S. Insurers a Key Part of PRI Effort

PRI's U.S. Relationship Management Team

PRI

While insurance companies in other regions, most notably in Europe, have been publicly embracing and reporting on the incorporation of ESG in their investment portfolios, their U.S. counterparts have been far less forthcoming. Presently there are more than 110 insurance company signatories to the PRI but just a few of those organizations are based in the U.S.

We have begun to increase our efforts in engaging U.S.-based insurers. Our goals are to encourage those with substantial ESG practices to demonstrate leadership in the field by publicly disclosing their efforts and to provide specific resources and guidance to insurers without a current responsible investment strategy. Insurance companies may have particular interest in these PRI flagship projects:

- The majority of insurance portfolio assets are invested in bonds. The PRI's work on ESG in credit ratings, which sheds light on how ESG factors are gaining prominence in credit rating agencies' commentaries, are especially relevant to the investment management of insurance portfolios.
- Climate risk is becoming more of a focus for insurers because of business risks posed by the increasing frequency and intensity of extreme weather events. However, another dimension of climate to consider is transition risk. Within an investment portfolio – particularly in liability-driven investing – understanding the extent to which markets have priced in the transition to a low carbon economy is an essential part of evaluating portfolio risk. PRI's flagship project, the Inevitable Policy Response (IPR), begins with the assumption that financial markets are underprepared for climate-related policy risks and uses a policy-based forecast scenario to describe how capital markets may respond to the future policies implemented to meet global climate target commitments.
- It is widely considered a best practice to incorporate responsible investment criteria to mitigate portfolio investment risk and maximize portfolio resiliency. Many smaller insurers outsource the investment management of their insurance portfolios. Our newly released asset owner guides on selection, appointment and monitoring offer specific guidance to these asset owners on how to address these issues with investment managers.

Principles for Responsible Investment (PRI) is a global membership organization for investors. Our mission is to develop and promote frameworks for the incorporation of ESG information into investment processes and practices with the ultimate goal of supporting sustainable global investment markets. For additional information, please contact usgno@unpri.org.

ESG at Conning: A Firm Commitment and Clear Process

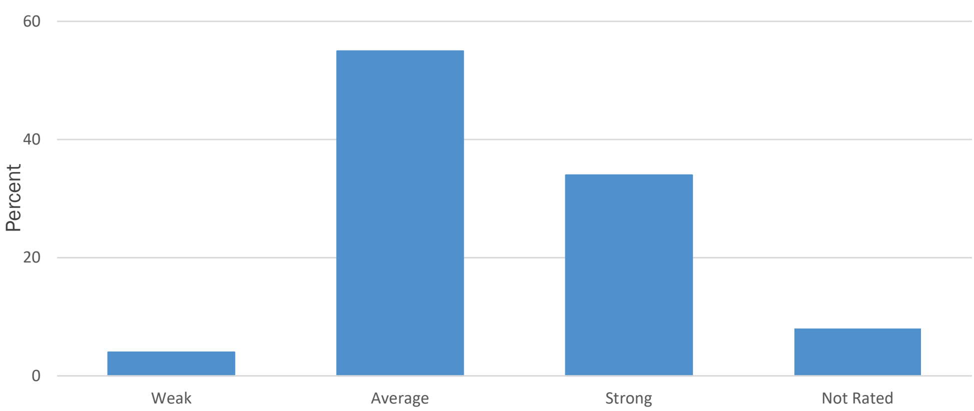
Conning's view is that integrating ESG risk factors into insurance portfolios enhances the research process and better allows us to adhere to the fiduciary duty we owe each client.

We view ESG integration as a firm-wide effort, core to our global capabilities and one in which we leverage skills across the enterprise. We also believe it's the right thing to do, both for our clients and for us as a firm.

We are proud to report that the firm, along with our subsidiary Global Evolution, received an A+ score for our overarching approach to ESG Strategy and Governance in the 2020 Assessment Report from PRI. Conning has been a signatory to the UN Principles since 2012 and underscored our commitment to incorporating ESG factors into credit ratings and analysis in a systematic and transparent way by signing the PRI's ESG in credit risk and ratings statement in 2019.*

Figure 1 Conning Client Portfolio ESG Dashboard

Portfolio Distribution by ESG Rating



Summary of Weak Holdings

Issue Description	ESG Commentary
ABC Comp.	While there is yet no evidence of material damage to the ABC's market-leading financial services brand from the recent report of operational concerns, its reputation for strong corporate governance as a leading global company (with historically very strong risk controls) is vulnerable until the situation is resolved. At this time, we believe that a "Weak" ESG assessment is appropriate.
DEF Inc.	We assign a "Weak" ESG risk factor to DEF due to quality control issues at its acquired XYZ business and recent aggressive attempts at raising prices which were outside industry norms.
GHI Group	We assign a "Weak" ESG score to GHI. The company scores low on our Corporate Governance assessment given areas of concern including an entrenched and low-diversity board and combined role of CEO/Chairman. There are multiple related-party transactions which could point to abuse. The firm also lags in our Environmental and Social assessments with a very low percentage of buildings being "green certified" and very high employee turnover.

Prepared by Conning, Inc. Hypothetical example provided for illustrative purposes only.

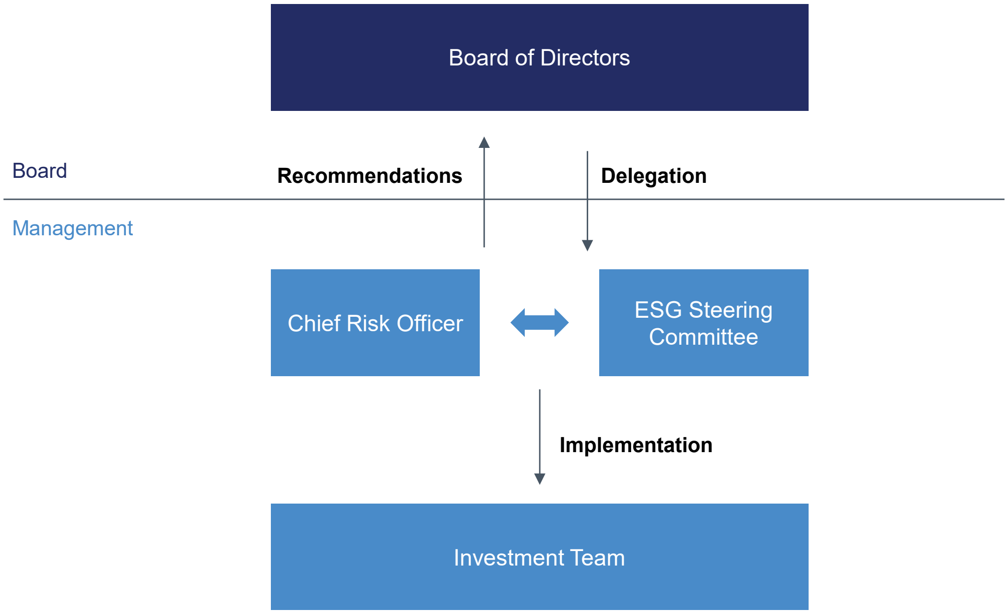
When it comes to integrating ESG criteria into our investment process, Conning's analysts assign a proprietary ESG risk factor score of "Strong," "Average" or "Weak" to issuers in our coverage universe and provide a brief synopsis of their rationale. We incorporate this information into our database of fundamental analysis, which is accessible to all Conning investment professionals and used in the underwriting assessment we require for each security we consider for client portfolios.

Conning's ESG factor-weighting matrix provides a consistent evaluation framework across industries. The impact of ESG factors can vary by industry, e.g., environmental issues have a greater impact on utilities and energy issuers than on financials issuers. This proprietary matrix helps us better understand the impact of ESG factors for each issuer based on its industry. We incorporate data from MSCI ESG Research Inc. into our review, monitoring and screening of corporate holdings. In addition, we contract with various nationally recognized statistical rating organizations (NRSROs) as well as an independent research firm for ESG-related research.

However, our analysts determine Conning's ultimate ESG ratings. Our analysts are highly experienced, many having spent decades in the industry, and they have a great grasp of issuer fundamentals, a critical perspective helping them focus on the most relevant ESG factors.

*See Related Content herein for additional information regarding the award.

Figure 2 Conning's ESG Governance Framework



Prepared by Conning, Inc.

As Conning manages each client portfolio according to its unique guidelines and constraints, portfolio managers review and discuss the ESG risks of individual issuers with research analysts and decide whether to include or exclude issuers based upon each client's unique risk tolerance and portfolio objectives. We provide a proprietary ESG assessment of each client portfolio and report on each issuer we classify as "Weak" (see Figure 1).

Finally, our commitment to ESG exists at the highest levels of the firm. Conning's Chief Risk Officer (CRO) is responsible for oversight and compliance of client guidelines related to ESG issues, supported by a global ESG Steering Committee. Conning's Board of Directors supervises management's efforts to adhere to the firm's standards for investment operations, including ESG considerations (see Figure 2).

Our ESG Steering Committee, created in 2017, provides strategic guidance for the firm's ESG initiatives to strengthen our responsible investment practices. The ESG Steering Committee includes senior leadership from investment operations in the U.S., Europe and Asia and meets quarterly.

While adoption of ESG investment practices currently may not be as high a priority for U.S. insurers as it is for insurers in some other countries, it seems highly likely that interest will continue to grow. Investment consultants may want to get in front of this potential shift sooner rather than later and learn as much as they can about asset managers and their respective ESG capabilities.

Matthew Daly, CFA is a Managing Director and Head of Corporate and Municipal Teams and a member of Conning's Investment Policy Committee. Prior to joining Conning in 2003, he held credit analyst roles with Webster Bank, Brown Brothers Harriman & Co. and FleetBoston. Mr. Daly earned a degree in economics and business administration from Gordon College.

RELATED CONTENT

More information is available about Conning's ESG initiatives:

New Climate Risk Reporting and Scenario Service – The new capability equips institutional investors with the tools and analytics needed to assess portfolio risk under a range of climate change stresses.

"Conning Achieves Top Score for ESG Strategy & Governance From PRI"- Conning received an 'A+' score for its overarching approach to ESG Strategy and Governance in its 2020 Assessment Report from the UN Principles for Responsible Investment.

"ESG: AI Makes Us Smarter" – A video from Conning affiliate Global Evolution, a leading emerging markets debt manager, on how artificial intelligence – AI – may help asset managers integrate ESG factors into their investment process.

"Diversity, Equity and Inclusion at Conning" – A discussion of Conning's journey to address diversity, equity and inclusion with Board member Meryl Hartzband and CEO and Chair of the Board Woody Bradford.

ABOUT CONNING

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

1. "California Insurance Commissioner Dave Jones calls for insurance industry divestment from coal," press release, California Department of Insurance, January 25, 2016, http://www.insurance.ca.gov/0400-news/0100-press-releases/archives/statement010-16.cfm

2. "Fiduciary Responsibility in the 21st Century - California Roadmap," September 29, 2020, Principles for Responsible Investment, https://www.unpri.org/download?ac=11646

3. "During New York Climate Week, DFS Superintendent Linda A. Lacewell Announces Actions Bolstering DFS'S Commitment to Addressing Climate-Related Financial Risks," press release, New York State Department of Financial Services, September 22, 2020, https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202009221

4. "Final Rule: Modernization of Regulation S-K Items 101, 103, and 105," Securities and Exchange Commission, https://www.sec.gov/rules/final/2020/33-10825.pdf

5. Ibid.

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