S&P Dow Jones Indices

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InsuranceTalks

Incorporation of Sustainability

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Brishni Mukhopadhyay is Western Asset's ESG Product Specialist and works with a range of clients across geographies to help integrate ESG (environmental, social and governance) considerations and design mandates to meet their sustainable and investment objectives.

María Sánchez is part of the Sustainability Indices Product Management team at S&P DJI, which enables market participants, including insurance companies, to align their products, investments, and decision-making processes with their value to achieve sustainable results and promote positive change.

S&P DJI: Are sustainability considerations important for insurers to consider?

Brishni: As long-term investors with business models centered around the assessment and pricing of risk, ESG considerations are paramount for insurers to integrate holistically into their strategy, underwriting, investments, and relationships with stakeholders. Rapid acceleration in the frequency of natural disasters has rightfully increased the focus of the insurance sector on climate risks, but there are additional areas of ESG risk that insurers need to assess and manage. These include product safety and cybersecurity, health and injury risks, shifts in consumer sentiment, human rights and supply chain management, as well as corporate governance and transparency.

Additionally, as ESG regulations on companies in the financial sector expand across the globe, insurance companies will need to navigate a complex set of requirements across the states and regions in which they operate. These requirements, particularly for publicly traded insurance companies, are likely to include broader and more detailed disclosures, augmentation of climate modeling capabilities and more formalized oversight by boards and senior management.

It is therefore imperative that insurers analyze and understand how ESG risks can impact the policies they are underwriting and the issuers in their portfolios, and to strategically position themselves to benefit from ESG-related megatrends across their markets.

S&P DJI: When looking at sustainable investing, there is a wide array of choices: PACT, Net Zero, Fossil Fuel Free, Carbon Efficient, etc. What are the different types of sustainability indices and their uses?

María: S&P Dow Jones Indices' philosophy is to offer choices to the market. Our sustainability indices can be broadly categorized under four groupings.

- Core: These are broad market indices with a sustainability lens that serve to add ESG to the core investments of an insurance company. For example, the S&P 500 ESG Index, which is designed to measure S&P 500 constituents that meet sustainability criteria, while maintaining similar industry group weights. Other examples are the S&P/BMV IPC ESG Tilted Index that we offer in Mexico, the S&P/TSX Composite ESG Index in Canada or the S&P/ASX 200 ESG Index in Australia.
- Climate: These are indices designed to reflect climate change considerations and the effects of the transition to a low carbon economy.
- Thematic: These indices focus on specific sustainability-related issues and have a narrower objective. For example, we have indices that track the clean energy and water sectors.
- Fixed Income: These indices provide exposure to the green bond market and fixed-income variants of our equity benchmarks. For example, we have the S&P Green Bond Index and S&P Green Bond Select Index.

We offer a wide range of sustainability indices and index-based solutions to meet the unique needs of our clients. These range from divestment approaches to 1.5°C aligned approaches. One example of the divestment approach is the S&P Fossil Fuel Free Index Series, which removes exposure to proven and probable fossil fuel reserves. An example of the decarbonization approach is the S&P Carbon Efficient Index Series, which is designed to measure the performance of companies in a specific universe while overweighting or underweighting companies depending on their levels of carbon emissions per unit of revenue and whether or not they disclose their emissions. In respect of the 1.5° aligned approach, we offer the S&P PACT™ Indices (S&P Paris Aligned and Climate Transition Indices), which are based on EU regulatory framework.

Brishni: There is a wide array of sustainability indices, ranging from those that are climate aware and aligned with net zero decarbonization goals and targets, to others that include socially responsible investment (SRI) exclusions and tilts based on ESG scores, and yet others that focus on various sustainability themes. Prior to the use of any sustainability index, it is imperative to understand the type of index, the implications to the investment universe and the type of portfolio that is being sought to be managed.

Depending on the choice of index, the implications on the investment universe, objectives and management style are likely to vary not just across asset classes but also within an asset class. For instance, a net zero-aligned strategy for a core/core plus fixed income index that includes sovereigns as the largest component is likely to look different from one for an equity index with elevated exposure to technology and financial sectors.

Even within a sub-asset class such as credit, the choice of an objective may have notable implications. While energy issuers comprise a significant portion of the iBoxx USD Investment Grade Corporate Bond Index, at 7.9%, they form an even larger component of the iBoxx USD High Yield Corporate Bond Index, at 11.7%.So SRI exclusions on fossil fuels will have a more material impact on a high yield universe than investment grade.

Furthermore, there are wide variations between indices, depending on their investment universe, in terms of issuers that align with net zero and decarbonization goals. The Task Force on Climate-related Financial Disclosures (TCFD), for instance, suggests insurers monitor the number of issuers that align with a below 2°C goal, which varies across equity, investment grade and high yield credit and core/core plus investment universes.

S&P DJI: What is the role of climate change in insurance portfolios?

Brishni: Regulatory bodies are aligning on the view that climate change poses a systemic risk to the U.S. financial system. The Commodity Futures Trading Commission (CFTC) has recognized that unless accounted for and managed, transition and physical risks stemming from climate change may interact with and amplify each other, resulting in significant loss. Along these lines, the Federal Reserve is a member of a group of central banks called the Network for the Greening of Financial Services (NGFS), which shares best practices on environmental and climate risk management.

Insurers need to account for the physical and transition risks stemming from climate change, given the costs that these may entail. For instance, the physical risks of climate change (hurricanes, wildfires, droughts, floods and wind) can cause damage that insurers with property and casualty lines have long been aware of.

Similarly, transition risks such as the move to lower carbon solutions, investment into renewables, supply chain implications, changes in consumer demand and regulatory and policy decisions are also important to factor into investments for insurance portfolios. Companies that are best able to align with changes in consumer preferences, adhere to policy and regulatory changes and incorporate transition risks are those that are most likely to be sustainable and meet their future obligations to investors.

Moreover, for portfolios that are managed to specific carbon reduction targets, it is imperative to understand the implications of these aspects. For instance, it is important to understand whether metrics are based on Scope 1 and 2 emissions or include Scope 3 emissions, which stem from the value chain. Sectors such as Financials, which tend to have low Scope 1 and 2 emissions due to the very nature of their businesses, can have high Scope 3 emissions based on issuers that capital has been lent to. Additionally, metrics such as carbon footprint and total carbon emissions, which are based on enterprise value, are less relevant for fixed income portfolios such as for core/core plus mandates that include sovereigns and securitized fixed income.

S&P DJI: How does one seek to avoid claims of greenwashing?

Brishni: Transparency is a key element to avoid claims of greenwashing. When investing in issuers or labeled green, sustainable, social or sustainability-linked bonds (SLBs), it is important to assess the credibility of the issuer, the use of proceeds and any green or sustainable KPIs to understand alignment.

Given the fungibility of capital for green, social and sustainable bonds, it is important to assess whether the use of proceeds is indeed deployed by issuers as they claim. Credible third-party verification may help improve transparency. It is also important to assess the underlying issuer and its credibility in terms of meeting its environmental objectives. Issuers with poor records that issue labeled bonds are more likely to elicit claims of greenwashing.

For sustainability-linked bonds, which offer coupon step-ups in the event of a failure to meet green goals, it is important to understand the precise nature of the KPI, current levels and when these step-ups come into being. Investing in SLBs that have a low threshold to meet their sustainable KPI from current levels or a late step-up in coupon that is triggered toward maturity may elicit claims of greenwashing the issue to raise capital from investors.

When assessing issuers, it is necessary to understand capital expenditure allocation and pathways to decarbonization to gauge credibility. Concerns around credibility should be explored and highlighted to the issuer through engagement. Failure to elicit a clear response from the issuer may lead to disinvestment.

S&P DJI: How can index selection help mitigate and avoid greenwashing?

María: As Brishni says, transparency is the key. At S&P Dow Jones Indices, index methodologies are public. Moreover, our main data source, Sustainable1, another division of S&P Global, is committed to providing the highest level of transparency in order to make sustainable decisions with conviction.

While market participants often value a diversity of opinions to support their decision-making, there must be transparency to mitigate confusion and enhance understanding. At S&P Dow Jones Indices, our index methodologies are all public, and they have a clear stated objective. Although there are different variations on sustainability indices, having a transparent methodology allows the investor to understand the criteria for decisions regarding inclusion/exclusion of securities.

S&P DJI: What are some challenges to implementing ESG in a portfolio?

Brishni: ESG as an acronym has implied different things to different people. For some, ESG implicitly relates to “values,” along the lines of SRI exclusions or norms, while for others it relates to “valuations” stemming from the incorporation of material risks and opportunities. Yet for others, ESG is split between “outcomes” and “inputs.” Therefore, the essential first step is to understand specifically how one is delineating ESG and what the use of ESG tools is meant to address and achieve.

Another challenge when implementing ESG considerations is the lack of available data. While certain sectors by their very nature may have good data available for a range of ESG-related metrics, this is less accessible for other sectors. For instance, data metrics for sectors such as municipal bonds, mortgage-backed securities and asset-backed securities are often limited. Similarly, disclosures for private issuers and smaller developing market sovereigns tend to lack the detail and depth that public companies and developed market sovereigns provide.

Finally, ESG disclosures and data are backward-looking and generally refreshed on an annual basis at best. To address timeliness issues, it is important to incorporate forward-looking perspectives when assessing ESG risks and opportunities.

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