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The rising importance of ESG

The COVID-19 pandemic has led to an unprecedented disruption to lives and businesses.

It has also presented an equally unparalleled opportunity to change and accelerate action in areas that were not the forefront of attention before, one of these being Environmental, Social and Governance (ESG) matters. The concept of ESG is not new by any means, however developments in this space have accelerated in the past two years. What was once only part of the "sustainability arm" of operations or dealt with in various sub-committees, has now risen to the top of boardroom agendas in an all-encompassing manner.

ESG has applicability across the globe to every organisation, industry, and sector, whether public or private. These matters should not be seen in isolation as they penetrate every aspect of business including strategy, policies, risk, and day-to-day operational considerations.

Insights

Businesses are finding that stakeholder ESG awareness has become heightened and more answers are demanded in terms of demonstrating the role they play in addressing the environmental, social, and economic challenges presented. Performance is no longer measured just by the financial bottom line, but rather through understanding the organisation's economic, social, and environmental impacts and how the related risks and opportunities are managed. There is a need for enhanced ESG disclosure that goes beyond reporting on lagging indicators and talks to impact measurement and reporting.

The KPMG 2020 CEO Outlook survey identified a change in priorities of corporate leaders, as noted below. In this evolving environment there is a clear need for businesses to understand their purpose and impact on society. It is critical to be able to adapt to maintain success and enhance resilience.

Key changes in CEO's thinking found in the survey[1]

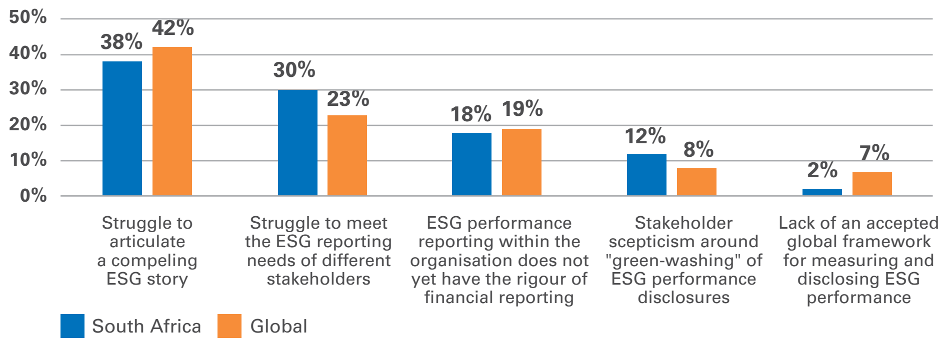
A year later, the KPMG 2021 CEO Outlook Survey[2] (which included the views of a number of CEOs of insurance companies) identified the following: 10% of South African companies rate environment and climate risk change as one of the top three risks that pose the greatest threat to an organisation's growth, with the global average not far off at 12%.

- Integrating ESG reporting into measurement and reporting processes was identified by 6% (global: 15%) of South African companies as a top operational priority in order to achieve growth objectives over the next three years. However, 58% (global: 52%) of South African companies are seeing an increasing level of demand from stakeholders (investors, regulators and customers) for increased reporting and transparency on ESG matters. 51% (global: 52%) of the demand and pressure is coming from institutional investors, 34% (global: 29%) from regulators, 11% (global: 5%) from employees and new hires and 3% (global: 14%) from customers.

1 'KPMG 2020 CEO Outlook: COVID-19 Special Edition', KPMG, 2020, https:/home.kpmg/content/dam/kpmg/xx/pdf/2020/09/kpmg-2020-ceo-outlook.pdf'

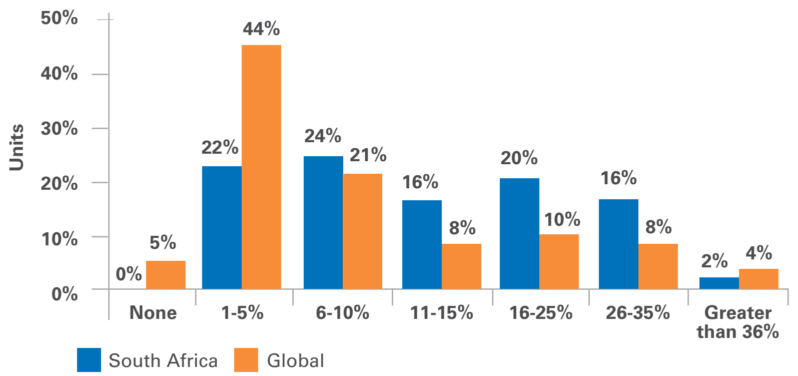
2 https://home.kpmg/xx/en/home/insights/2021/08/kpmg-2021-ceo-outlook.html

- Key challenges identified by South African respondents in communicating ESG performance to stakeholders include:



- Respondents were also asked to rate the impact of the company's ESG programme on financial performance. 46% (global: 23%) of respondents indicated a reduction in financial performance, 20% (global: 25%) an improvement in financial performance, 18% (global: 40%) a neutral or negligible impact on financial performance with 16% (global: 11%) indicating a significant improvement on financial performance.

- Lastly, respondents were asked to indicate what percentage of revenue will be invested in programs that will enable the organisation to become more sustainable:



KPMG's Survey of Sustainable Reporting[3] 2020 sampled 5 200 of the largest companies by revenue in 52 countries and noted the following trends in ESG reporting:

- 80% of companies worldwide now report on ESG or Sustainability – with 96% of the top 100 companies in South Africa reporting on ESG or Sustainability publicly.
- One in five companies globally report climate risk in line with recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).
- Globally, more than 70% of companies are now disclosing carbon reduction targets in their reporting and a growing number are linking them to external targets. Of these external linkages, the most popular climate goal was to link targets to the Paris Agreement goal to limit global warming to 2°C above pre-industrial levels.
- The United Nations (UN) Sustainable Development Goals (SDG) have also begun to resonate strongly with businesses. Close to 70% of companies globally connect their business activity to the SDGs in their corporate reporting in some way, although, there is significant room for improvement in the quality of reporting.
- The transition of companies to net-zero carbon emissions is somewhat slower.

Why should ESG matters be considered in the insurance industry?

Through their roles as risk managers, risk carriers, and investors, insurers are well positioned to lead and assist in addressing wider ESG challenges. Whilst in the past, ESG issues may not have been widely integrated into investment analysis and decision-making by investors, this is changing. There is an increased appetite to understand how ESG factors and an organisation's improved performance are intertwined.

It is known that the insurance industry is highly affected by environmental changes. It is critical that material climate risks and exposures are identified and measured and responded to through governance, strategy, risk management, product offerings and related reporting. The role that this industry plays is vital in the transition to a low carbon economy.

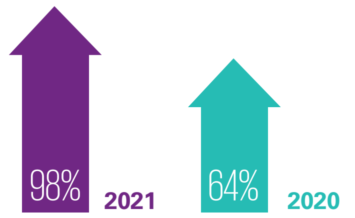
3 The KPMG Survey of Sustainability Reporting 2020 - KPMG Global (home.kpmg)

Social risks also have a significant impact on the industry, and these should be equally considered and addressed. KPMG's 2021 CEO Outlook Pulse Survey[4], noted such heightened focus on the social component of the ESG agenda by the insurance industry.

Continued focus on environment and climate risk

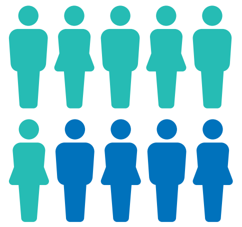
90% of insurance CEOs are looking to lock in the **sustainability** and **climate** change gains made during the crisis.

Heightened focus on "S" component of ESG

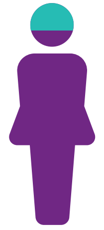


Insurance leaders are shifting their focus to the **social** component of their ESG program up from August 2020.

Diversity, equity and inclusion top agenda issues for insurance CEOs



60% of insurance leaders believe progress has moved **too slowly** on **diversity** and **inclusion**.



90% agree there is still much to do to build **gender diversity** on boards.

The following ESG issues are material to the insurance industry and developing mechanisms to manage and report on these could lead to improved performance.

Environmental issues:

- Climate change
- Carbon emissions
- Air and water pollution
- Deforestation
- Water management
- Water scarcity

Social issues:

- Human rights
- Labour standards
- Social inclusion
- Data protection and privacy
- Gender and diversity

Governance related issues:

- Executive remuneration
- Risk management
- Boards and committee composition
- Whistle-blower policy lobbying

Environmental risks and events are not new to insurers. Their quantification has always been on the radar of actuaries working particularly in non-life insurance fields through, for example, pricing and reserving for extreme weather-related events such as hurricane, earthquake, wildfire and flood damages, or even crop and weather or rainfall index type products. The observed increase in both the frequency and severity of global insured weather-related property losses has however refocused attention and initiatives on modelling and managing these risks.

The global COVID-19 pandemic has also highlighted second and third order impacts that may well have not been adequately considered by insurers when performing their historic extreme event scenario testing. Although some, mainly life insurers, may have considered and potentially modelled pandemic type scenarios within their Own Risk and Solvency Assessment (ORSA) scenarios, few, if any, had adequately considered the linkages and connectedness between risks sufficiently to fully foresee the impacts on equity markets, interest rates, operational risks (including physical operational and sales, fraud and cyber risks) and persistency risks.

4 KPMG 2021 CEO Outlook Pulse Survey Insurance sector (home.kpmg)

Environmental risks similarly may lead to a wide spectrum of potential knock-on impacts that insurers should be considering when modelling such scenarios and considering in their management actions. Rising temperatures, for example, can lead to rising sea levels and subsequent property damage. Furthermore, rising temperatures could also change weather patterns and thus alter rainfall levels with knock-on impacts on agricultural activities and crop yields leading to direct insured losses. Such events, however, may then have further impacts on food and water supply potentially leading to inflationary pressures and health risk events. These types of events may have further impacts to life and health claims as well as impact insurers' operations due to physical and people risks. Under such scenarios, global markets via interest rate changes and company financial performance, may then also be adversely impacted leading to further risks manifesting and insured events being triggered.

The modelling of such scenarios and events is complex with the need to consider second and third order impacts, the inter-connectedness of risks, as well as their velocity of onset to obtain a comprehensive understanding of potential implications.

In recognition of this risk, insurance (and banking) regulators and industry bodies are taking ever more proactive actions towards testing and ensuring industry resilience and robustness. Some examples include the Bank of England which has introduced targeted climate change stress testing for various banks and insurers via their Climate Biennial Exploratory Scenario (CBES) testing requirements[5]. In their discussion paper on methodological principles of insurance stress testing, the European Insurance and Occupational Pensions Authority (EIOPA) also sets out methodological principles to incorporate climate change risks[6], both physical and transition risks, into European Union insurers' stress testing frameworks. In addition to these regulatory activities, the International Actuarial Association (IAA) established the Climate Risk Task Force to deliver on several IAA activities relating to climate-related risks. The objective of these activities is to contribute to global efforts to further identify, measure and manage climate risks. The IAA has, to date, released three papers in a series aimed at creating awareness and promoting actuarial approaches in climate-related risk management and reporting including the use of, and formulation and implementation of climate related scenario testing[7].

The emergence of a greater ESG related regulatory burden on insurers will, in the short-term, lead to an increase in regulatory driven costs borne by insurers. The level of this is however currently divergent between jurisdictions.

The "Environmental" component of ESG may receive the most attention from the actuarial and quant teams within insurers. However, the corporate governance, market conduct (including miss-selling and policyholder disclosure issues) and data privacy and cyber security breaches are all relevant ESG issues insurers are increasingly concerned about. The recent changes in the work environment and practices, brought on by government enforced lock-down measures in response to the spread of COVID-19, have also raised the profile of additional "Social" risks to insurers and their clients' and employees' wellbeing.

Reports of failures by insurance markets to adequately and appropriately consider the treatment of customers in designing their processes and products have been ever increasing. Task force investigations into such behaviours include the likes of the well-publicised Financial Services Royal Commission in Australia[8]. Such failures have led to the introduction of Treating Customers Fairly (TCF) type regulations in many jurisdictions and further highlights the social and reputational risks that the outdated and less customer centric practices of insurers may be introducing. This has a direct and negative impact on insurers through fines, impaired financial performance, and external credit ratings. Thus, increased focus and scrutiny is being given to the governance structures insurers employ in order to manage and limit such risks and that of resultant reputational damage.

Reporting landscape

Whilst ESG reporting is becoming more mainstream, one of the challenges it presents is the number of ESG reporting frameworks, standards, and the amount of guidance available to companies. This has resulted in reporting fatigue and confusion in deciding on where to concentrate efforts to ensure mandatory reporting is covered and what to report in order to stay on par with industry peers when it comes to voluntary reporting.

[5] https://www.bankofengland.co.uk/stress-testing/2021/key-elements-2021-biennial-exploratory-scenario-financial-risks-climate-change

[6] https://www.eiopa.europa.eu/sites/default/files/publications/consultations/eiopa-bos-20-341_second-discussion_paper-methodological-principles-for-stress-testing.pdf

[7] https://www.actuaries.org/IAA/Documents/Publications/Papers/CRTF_Application_Climate_Scenarios.pdf

[8] https://home.kpmg/au/en/home/insights/2019/02/financial-services-royal-commission.html

In South Africa, insurance companies have begun to respond to the changing landscape. Performance in terms of environmental and corporate social investment commitments is more common amongst reporters, including disclosure around alignment to UN Principles for Responsible Investment (PRI), UN SDGs and the Code for Responsible Investing in South Africa (CRISA). Momentum is gaining in terms of alignment to the recommendations of the Task Force on Climate Related Financial Disclosures; however, many are still grappling with how this is to be implemented.

In 2020 a partnership between the World Economic Forum International Business Council, Bank of America and the Big Four professional services firms resulted in a White Paper entitled "Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation". The White Paper[9] does not create new standards or metrics, but the teams evaluated all the available global standards, frameworks and guidance and came up with a set of core metrics and expanded metrics (based on existing material) that all companies can use to provide meaningful, comparable and transparent information to stakeholders.

More framework and standard setters are starting to work together:

- In June 2021, the International Integrated Reporting Council (IIRC) and Sustainability Accounting Standards Board (SASB) announced their merger to form the Value Reporting Foundation. The Foundation aims to "support business and investor decision-making with three key resources: Integrated Thinking Principles, Integrated Reporting Framework and SASB Standards. These tools help businesses and investors develop a shared understanding of enterprise value and how it is created, preserved or eroded over time."
- A call for improving the consistency and comparability in sustainability reporting has resulted in the IFRS Foundation undertaking the creation of a Sustainability Standards Board whose aim is to develop a global set of sustainability standards.

In South Africa, the National Treasury in its draft technical paper released in May 2020 *"Financing a Sustainable Economy"*, proposed a framework for financial institutions to better disclose public information on their green practices and investments. This paper includes insurance specific recommendations for authorities to enhance the supervisory processes to deal more explicitly with sustainability risks and consider using regulatory instruments and supervisory tools to improve their understanding of climate risks and the impacts on insurers as well as on the financial system. It further suggests that the authority's own risk and solvency assessment requirements should be enhanced to deal more explicitly with the risk management of sustainability and, specifically, climate risks.

The landscape is changing at a fast pace and it will be imperative that standard setters and those that provide guidance come together to create a stable environment which results in meaningful and transparently reported information for stakeholders.

Conclusion

The rapidly changing landscape is driving businesses to evaluate their purpose and redefine their strategies, products and manner of operation. Businesses need to understand, evaluate and measure their economic, social and environmental impacts now in order to be responsive to the changing future. Whilst the focus on the environmental impact in ESG continues to remain important, the social impact requires much more attention and insightful action. Success and resilience will be measured by businesses' ability to embrace and interconnect the three areas equally.

[9] Toward Common Metrics and Consistent Reporting of Sustainable Value Creation | World Economic Forum (weforum.org)