Commentary

P&C Insurance: Regulatory Oversight Essential for Broad Adoption of ESG Reporting Principles

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Key Highlights:

- Apart from large companies operating in the European Union, reporting on ESG is currently voluntary. Making it mandatory in other jurisdictions will have a positive impact on broadening the adoption of ESG reporting.
- Standardized reporting will facilitate comparability across companies; however, there is no clearly defined format for reporting, so it is not easy to compare across companies or geographic regions.
- We include ESG factors in the rating criteria for assessing an issuer's financial strength rating.

Effective management of environmental, social, and governance (ESG) risk factors and their inclusion as part of an organization's risk exposure helps a company to develop a better understanding and assessment of its overall risk profile. ESG disclosures in published annual reports are being used to assess an organization's corporate purpose, strategy, and management quality. Socially conscious investors decide how to allocate resources based on ESG principles with the perception that rewarding these values will support a company's long-term performance. Incorporating ESG risk factors into investment decision making is a growing trend for insurance companies globally, especially in Europe where it is mandatory for large companies. Many corporations around the globe are increasingly aligning themselves with this trend. However, regulatory backing and standardization are essential to drive broad acceptance of the practice.

Importance of ESG Factors in Assessing the Financial Strength of a P&C Insurance Company

The assessment of environmental risks is a major component of the rating analysis for property and casualty (P&C) insurance companies. These include the impact of insured catastrophes on an insurance company’s financial strength, as well as considerations regarding claims predictability, frequency, and severity. P&C insurance and reinsurance companies have made progress incorporating environmental factors into their strategic planning and risk management processes. For the investment portfolios of insurance companies, environmental risk exposures could be likened to fixed-income or equity investments in securities issued by fossil-fuel-producing companies, which are in the spotlight for their generation of high levels of greenhouse gas emissions. Social risk factor issues could include investments in companies that produce products that are deemed detrimental to society, such as vaping, tobacco, and munitions manufacturers, or bonds issued by sovereigns with a poor human rights record. Governance risk factors relate to issues around board composition and corporate governance, including corruption and political risk and transparency, among others.

DBRS Morningstar has highlighted seven significant ESG factors for financial institutions (including insurance companies).[1] These factors (see Exhibit 1) are already incorporated into the ratings process and are discussed during the ratings process.

1 "A Look at ESG in Credit and the DBRS Morningstar Approach: Presentation Slides," April 24, 2020.

Exhibit 1 DBRS Morningstar: Prominent ESG Factors for Financial Institutions

Environmental	Social	Governance
• Climate & Weather Risks	• Product Governance	• Corporate/Transaction Governance
• Carbon & Greenhouse Gases	• Data Privacy & Security	• Business Ethics
	• Social Impact of Products & Services	

Increasing Focus on ESG Factors Due to Climate Change, Which is Considered a Leading Cause of Natural Catastrophe Losses

There is increasing awareness of the damaging effects of the rising levels of greenhouse gases on the environment, with declining support for industries that are heavy polluters. Due to concerns about the negative impact of climate change on the environment, an increasing number of P&C insurers are deciding not to provide insurance cover for some high-polluting sectors, such as coal mining and oil extraction. These industries or their products are high generators of greenhouse gas emissions, which are seen as one of the leading causes of global warming. For example, in December 2019, it was reported that The Hartford will stop providing insurance cover for coal mining and oil extraction operations.[2] Prior to this, in July 2019, Chubb, the largest commercial lines insurance company in the U.S., had disclosed that it will stop insuring new coal-fired power plants and phase out coverage of coal mining companies.[3] Several other P&C insurance companies have made similar announcements since then.

ESG Reporting Mandatory for Large Companies in the European Union but Not in Other Regions

EU law requires large companies, including P&C insurance companies, to disclose certain nonfinancial information on how they operate and manage social and environmental challenges. This encourages these companies to develop a sustainable approach to doing business; it also helps investors, clients, and stakeholders evaluate the nonfinancial performance of large companies. These reporting rules apply to large public-interest companies with over 500 employees, equating to approximately 6,000 companies and groups across the European Union, including banks, insurance companies, listed companies, and other companies designated by national authorities as public-interest entities. These rules are codified in the European Union's Directive 2014/95/EU—also referred to as the *nonfinancial reporting directive*—which identifies the rules on disclosure of nonfinancial and diversity information to be provided by large companies. Under this directive, large companies have to report on environmental protection, social responsibility and treatment of employees, respect for human rights, anticorruption/bribery, and diversity of boards.

Increasing scrutiny from investors, stakeholders, and activists located outside of the European Union has resulted in many non-EU companies implementing sustainability and corporate social responsibility programs. Many companies in North America, especially the large ones, now participate in voluntary initiatives and report on ESG standards. However, this is not mandatory, and there is no required

2 Carrier Management, "The Hartford to Stop Insuring Coal Mining, Oil Extraction Operations," December 26, 2019.

3 Rainforest Action Network, "First Major U.S. Insurance Company to Stop Insuring and Investing in Coal," July 1, 2019.

standardized form of reporting. Making it mandatory in other jurisdictions outside of the European Union will have a positive impact on broadening the adoption of ESG reporting in a more comparable manner.

Standardized Reporting Needed to Facilitate Comparability Across Geographic Regions and Between Companies Operating in Similar Sectors

Companies that have taken the step to incorporate ESG factors usually demonstrate this by issuing an annual sustainability report or, in some cases, a corporate social responsibility report. However, the reporting is not mandatory for all companies or regions, and it is difficult to compare across geographic regions because not all companies report on their sustainability. Companies that choose to do so have adapted reporting formats developed by different standard-setting organizations, such as the Global Reporting Initiative, an international independent standards organization that assists businesses and governments in understanding and communicating the impacts of issues such as climate change, corruption, and human rights. Other organizations that provide sustainability reporting guidance include (but are not limited to) the United Nations–supported Principles for Responsible Investment (PRI), the Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-Related Financial Disclosures (TCFD).

A brief description of the business models of these bodies is given below:

- **Global Reporting Initiative:** This is an international not-for-profit organization headquartered in Amsterdam that operates with a network-based structure. Its goal is to enable companies and organizations to report their economic, environmental, social, and governance performance based on the organization's Sustainability Reporting Guidelines.

- **Principles for Responsible Investment:** This is an international network of investors that works collectively to practice the body's six principles of responsible investing. The intention of this organization to provide an understanding of the implications of sustainability and support signatories to incorporate ESG issues into their investment decision-making and governance practices. These principles include (1) incorporation of ESG issues into investment analysis and decision-making processes; (2) incorporation of ESG issues into signatories ownership policies and practices; (3) seeking disclosure on ESG issues by the entities in which signatories invest; (4) promotion of the acceptance, and implementation of the principles within the investment industry; (5) signatories will work together to enhance effectiveness in implementing the principles; and (6) signatories commitment to report on activities and progress toward implementing the principles.

- **Sustainability Accounting Standards Board:** The SASB is a nonprofit organization that sets financial reporting standards. The standards set by the SASB differ by industry, which enables investors and companies to compare the performance of companies that operate within the same industry.

- **Task Force on Climate-Related Financial Disclosures.** The TCFD was initiated in 2015 by the Financial Stability Board to develop consistent climate-related financial risk disclosures to be implemented by

Insurance companies, banks, and companies operating in other industries. These disclosures are voluntary, and are used to provide information to investors, and stakeholders.

DBRS Morningstar Has Developed and Included ESG Factors in Its Financial Strength Ratings of Issuers

ESG risk factors have been incorporated into our credit ratings historically; however, there is now a stronger emphasis on highlighting the relevant ESG risks for issuers. On March 10, 2020, we provided the market with greater clarity and detail with respect to our analysis of ESG risk factors, their definitions, and their significance to credit ratings across governments, financial institutions, corporate finance, and structured finance. ESG risk factors are incorporated into our rating analysis.[4]

Our ESG assessment framework encompasses up to 17 ESG risk factors that are currently considered in our rating analysis (Exhibit 2). These factors are grouped into three categories: Environmental, Social, and Governance. They represent the key considerations commonly analyzed with respect to a company's ESG assessment framework. ESG risk factors are part of the rating process, and where appropriate are detailed in press releases and rating reports.

Exhibit 2 DBRS Morningstar ESG Assessment Framework

Environmental	Social	Governance
• Emissions, Effluents, & Waste	• Social Impact of Products & Services	• Bribery, Corruption, & Political Risks
• Carbon & Greenhouse Gases	• Human Capital & Human Rights	• Business Ethics
• Resource & Energy Management	• Product Governance	• Corporate/Transaction Governance
• Land Impact & Biodiversity	• Data Privacy & Security	• Institutional Strength, Governance, & Transparency
• Climate & Weather Risks	• Occupational Health & Safety	• Peace & Security
	• Community Relations	
	• Access to Basic Services	

4 "DBRS Morningstar's Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings," March 10, 2020.

About DBRS Morningstar

DBRS Morningstar is a global credit ratings business with approximately 700 employees in eight offices globally.

On July 2, 2019, Morningstar, Inc. completed its acquisition of DBRS. Combining DBRS' strong market presence in Canada, Europe, and the U.S. with Morningstar Credit Ratings' U.S. footprint has expanded global asset class coverage and provided investors with an enhanced platform featuring thought leadership, analysis, and research. DBRS and Morningstar Credit Ratings are committed to empowering investor success, serving the market through leading-edge technology and raising the bar for the industry.

Together as DBRS Morningstar, we are the world's fourth largest credit ratings agency and a market leader in Canada, the U.S., and Europe in multiple asset classes. We rate more than 2,600 issuers and 54,000 securities worldwide and are driven to bring more clarity, diversity, and responsiveness to the ratings process. Our approach and size provide the agility to respond to customers' needs, while being large enough to provide the necessary expertise and resources.