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ESG and Insurance Credit Ratings: Frequently Asked Questions

AM Best's guide to frequently asked questions about ESG and related definitions

Environmental, social, and governance (ESG) continues to be a key topic of interest among stakeholders in the insurance industry, but there is some uncertainty as to what it actually entails, and what actions or disclosures are expected from (re)insurers. (Re)insurers generally agree that more clarity is needed from regulators about the identification, measurement, and reporting of ESG factors.

AM Best believes that communicating how it views ESG factors in the context of insurance credit ratings will provide greater transparency to the market. As a result, we have developed this frequently asked questions (FAQ) document to help provide additional background and context. In addition, we have included an **ESG Glossary** at the end of the FAQ. We recognize that there are no agreed upon definitions for many ESG-related terms and this glossary provides AM Best's perspective on how these terms are used in the domain of credit ratings.

General Information

1. What is ESG?

Environmental, social, and governance (ESG) is used to assess corporate behavior that may impact the future financial performance of companies. ESG is a broad umbrella that includes individual factors, all of which relate to an overall goal of building a resilient, inclusive, and sustainable society. The term ESG is used globally across industries and is not specific to insurance. However, understanding the relevant touchpoints of ESG on the insurance industry—particularly, on any impact on financial strength—is important.

Environmental factors pertain to the natural world and include considerations such as climate risk, resource use, energy use, pollution, and waste management. Social factors are those that affect human lives and relate to how a company interacts with the communities in which it operates, its suppliers, employees, and broader stakeholders. Governance factors relate to procedures and processes according to which a company is directed and controlled.

Consideration of ESG factors can assist companies and investors in identifying risks and opportunities that may not be captured by conventional financial metrics, to mitigate risks and enhance long-term returns.

Although accepted ESG standards are still in development, understanding how to implement and fully disclose their ESG practices can be challenging for (re)insurers. ESG factors vary by industry. Even in (re)insurance, when assessing financial strength, the relevant ESG factors will vary depending on the company's profile, level of risk transfer, and operating environment.

2. What are ESG factors?

Below are a few examples of ESG factors:

Environmental: Climate risks; carbon emissions; natural resources use, pollution, and waste

Social: Data privacy; human capital; product liability; stakeholder opposition; health and safety

Governance: Corporate governance; corporate behavior; transparency; board composition; business ethics; diversity and inclusion

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3. What areas of ESG are most important to financial strength?

The impact of ESG risks and opportunities on financial strength over the short and long terms is likely to vary depending on the nature of the company. We anticipate that factors related to climate risk and governance will have the greatest impact on financial strength over the near term, while environmental liability and certain transition risks are likely to become more relevant over time.

4. Is ESG a new concept for AM Best?

No. In many ways, we have always implicitly covered ESG risks in our credit rating analysis, when they are material and relevant. For example, governance and environmental factors have always been explicitly considered in AM Best's analysis of financial strength ratings. In 2018, our methodology was updated to explicitly include a section on ESG factors and how these may impact any of the building blocks used to determine our credit ratings. The inclusion of ESG factors in our methodology allows us to be more transparent as to how these risks impact our assessment of an insurer's financial strength.

5. Why should (re)insurers consider and monitor ESG factors?

Most (re)insurers already consider ESG factors, given the wide range of elements that fall under the umbrella of (re)insurance—e.g., management of climate risk, social inflation, cyber security, diversity and inclusion, governance, management of demographic changes, and financial transparency. Furthermore, monitoring ESG factors may help companies identify opportunities on which they may be able to capitalize, for example, by developing new insurance products that meet the changing needs of their clients, to support the renewable energy sector. However, not all components of ESG may be relevant to a particular (re)insurer. Moreover, although some ESG factors may be less important today, they may increase in importance in the future. Pressure from regulators and other stakeholders to improve transparency on ESG-related disclosures is likely to increase, so understanding and measuring ESG risks will likely become more relevant to all (re)insurers.

6. Why is AM Best focusing on ESG now?

AM Best has always considered ESG factors such as environmental risks and governance in its credit rating methodology. When material and relevant, such factors are taken into account in the analysis. More recently, there has been a drive from market participants for greater transparency on ESG. Given the growing focus on ESG by various stakeholders, AM Best believes it is serving the market in meeting its demands for greater insights on ESG and the touchpoints among ESG, insurance, and financial strength.

7. Are all (re)insurers equally exposed to ESG?

No. Property (re)insurers will have greater exposures to the increased frequency and severity of weather-related events than health insurers writing Medicare Supplemental insurance. Life insurers are more likely to be exposed to transition risks from stranded assets, given their typically widely diversified and long duration investment portfolios. All (re)insurers may be exposed to risks related to governance. However, the impact of ESG factors on financial strength may vary considerably by company, as well as over time, and is reviewed case by case.

ESG and Credit Ratings

8. Why is ESG important to a (re)insurer's financial strength?

AM Best's view is that ESG factors, when material and relevant, play an important role in the financial strength of a (re)insurance company. As our perspective is forward looking, AM Best seeks to understand all the risks and opportunities that could impact the (re)insurer's financial strength and creditworthiness. AM Best's analysis includes identifying the impact of credit factors that are related to ESG on a (re)insurer's credit ratings. Certain ESG factors may not impact (re) insurer's financial strength today but may do so in the future or may become more relevant. ESG factors have the potential to affect positively or negatively any of the building blocks considered in AM Best's analysis: Balance Sheet Strength, Operating Performance, Business Profile, or Enterprise Risk Management.

Property and Casualty (Re)Insurers

For most P/C (re)insurers, environmental factors such as climate risk (the changing frequency and severity of weather-related events) may pose a severe threat to the balance sheet, as they may result in material, rapid, and unexpected consequences on capitalization, as well as elevated operating performance volatility. AM Best has always considered environmental risks a key part of its analysis and conducts stress testing to see how a (re)insurer's capital position can withstand shock events. Moreover, the ability to model weather-related events can vary greatly by company, peril, and market, so an understanding of gross and net exposures, as well as the management of these risks, is important to ensure that climate-related risks are captured appropriately. For some P/C (re)insurers, other ESG factors may be more important, such as environmental litigation (pollution and contamination) or social inflation for casualty insurers.

Life and Health (Re)Insurers

Environmental factors may also be relevant to L/H (re)insurers, particularly those that may have exposures to stranded assets owing to longer-duration investment portfolios and are thus more susceptible to transition risk. Furthermore, L/H (re)insurers that take into account changing demographics, which could affect longevity, mortality, and morbidity assumptions, would be viewed as prudent.

Governance

Governance is relevant for all (re)insurers and is captured under AM Best's Enterprise Risk Management building block. Governance, which can impact financial strength, has always been an important consideration in AM Best's ERM framework evaluation. Solid corporate governance is essential for establishing a company's risk culture as well as implementing the structures, processes, and policies by which a (re)insurer abides by. The governance aspect of ESG takes into account financial and non-financial risks, including insurance activities, financial irregularities, management or board disputes, regulatory intervention or solvency breaches, and fraud monitoring. The severity of incidents is important to credit quality.

9. Will ESG impact my rating?

AM Best considers numerous credit factors, including those that fall under the E, S and G, when they are material and relevant to the financial strength of a (re)insurer. In our rating analysis, we consider a rating factor (including ESG factors) relevant only if we believe it will have an impact on financial strength within our time horizon (typically 36 months). The impact of ESG factors on financial strength can vary based on the type of company, the company's balance sheet exposure on both the asset and liability sides, the level of risk transfer, and the markets in which the (re)insurer operates. ESG factors may become more important to financial strength over the longer term.

10. If a (re)insurer is a good environmental steward will that improve its rating?

Not necessarily. Credit rating factors and ESG factors may not always intersect, and positive (or negative) ESG factors may have no impact on credit quality. Although good internal practices such as recycling programs and internal sustainability targets may improve a company's image, they may not impact financial strength.

11. Will ESG-related questions be added to the Supplemental Ratings Questionnaire (SRQ)?

AM Best already requests information pertaining to exposure management and stress testing in its SRQ but does not anticipate adding new ESG-specific items to it at this time. However, we reserve the right to obtain additional information on ESG or any topic we feel is relevant to the evaluation of the credit rating.

12. How has climate risk been factored into the assessment of financial strength?

AM Best's approach to assessing climate risks and opportunities includes assessment of a company's climate exposures, its strategic business plans, and how these exposures can affect creditworthiness over the rating time horizon. For climate risks, AM Best considers the impact of physical, transition, and climate-related liability risks.

Weather-related events are considered a severe threat to insurers' balance sheet strength because of the often significant, rapid, and unexpected impact of such losses. AM Best expects (re)insurers accepting climate-related risks to be able to demonstrate that they can effectively manage these risks, including consideration of the increased severity and frequency of weather-related events, and that they have the financial wherewithal to withstand potential losses.

When calculating overall risk exposure, (re)insurers may want to consider both their investing and underwriting operations, and include investments that may be affected by climate risk, such as coastal properties at risk of flooding due to rising sea levels.

The financial impact of climate risks will vary depending on a company's mix of business and geographic exposures. Its business profile and the level of reinsurance protection will dictate underlying volatility in financial metrics and the ability to generate profitable returns.

Risk management plays an important role in a company's ability to effectively model weather-related events and factor climate risk into the pricing and modeling of risks. A key area for consideration is the availability of appropriate data and analytical tools to accurately model weather-related events. Overexposure, inadequate modeling, or insufficient protection arising from an event are concerns if losses fall outside of AM Best's or the company's expectations. For life insurers, climate risk can change the pattern and resistance to infectious disease, which could affect future mortality and morbidity rates.

Market Communication

13. Is AM Best publishing any information on ESG?

Our plan to include a dedicated ESG section in the credit report for each rated company will enhance market transparency and is in line with AM Best's aim to provide accurate, timely, and comprehensive information to all parties interested in the creditworthiness of insurance companies and insurance-linked securities.

14. Is AM Best providing ESG ratings?

Not at this time. AM Best's primary ratings focus is on assessing a (re)insurer's creditworthiness; credit ratings are not intended to measure a (re)insurer's ESG credentials. As an insurance industry thought leader, AM Best will continue to look for ways to provide transparency and effective communication on ESG to the market.

15. Should I expect my analyst to talk to me about ESG at our rating meeting? How should I prepare for this discussion?

Although the term "ESG" may or may not be used in the meeting, we will continue to discuss ESG factors during rating meetings through our review of strategy, underwriting, investments, enterprise risk management, or regulation. In some cases, ESG may be broken out as a separate agenda item. Regardless of the format and terminology, we expect (re)insurers to be able to discuss ESG risks and opportunities that are relevant to the company.

16. How does AM Best communicate ESG-related issues that affect ratings?

AM Best discloses ESG factors that lead to a rating action in the Rating Disclosure Form (RDF), which accompanies any rating action determined by a rating committee. Rating actions include upgrades, downgrades, changes in outlooks, and ratings placed under review. Rating affirmations do not have ESG factors disclosed in the RDF.

To improve transparency on ESG, AM Best will be including additional commentary about ESG, under the Enterprise Risk Management section in its Best's Credit Reports, on a rolling basis beginning in the fourth quarter of 2021. AM Best's website also contains a section devoted to ESG, including thought leadership pieces and information detailing AM Best's corporate involvement in ESG. AM Best frequently participates in industry conferences and webinars that discuss ESG-related topics.

17. Where in AM Best's methodology can I find ESG?

AM Best incorporates its perspective on ESG and the potential impact on financial strength in Best's Credit Rating Methodology (BCRM). The ESG factors are reviewed in the context of the core building blocks used to determine financial strength ratings: Balance Sheet Strength, Operating Performance, Business Profile, and Enterprise Risk Management.

18. What will be captured in the ESG portion of the credit report?

The credit report focuses on areas that have the potential to impact a (re)insurer's financial strength. The new section in the credit report focuses primarily on the impact of ESG-related factors (e.g., exposure to and management of climate risk, demographic changes, potential regulation, and ESG opportunities) on the credit rating. It will not be a summary of sustainable activities in which the insurer is engaged or an ESG "score." The new section will discuss issues such as the insurer's ESG framework, governance, and management of ESG risks and opportunities. Although ESG factors can impact any of the building blocks and will be addressed in those areas, a summary discussion of key ESG factors is included under Enterprise Risk Management.

ESG Glossary

Below is a list of terms used in the discussion of ESG. This list is not intended to be all-inclusive but should prove useful in understanding how AM Best uses these terms.

Common Terminology

Carbon Footprint: The annual amount of greenhouse gas emissions, mainly carbon dioxide, that result from the activities of individuals or organizations, especially their use of energy and transport and consumption of goods and services.

Carbon Tax: Directly sets a price on carbon by defining a tax rate on greenhouse gas emissions or—more commonly—on the carbon content of fossil fuels.

Cleantech: An umbrella term encompassing investment asset class, technology, and business sectors, which include clean energy, environmental, and sustainable or green products and services.

Climate Risk: The financial risks stemming from changes in weather patterns that have the potential to affect companies, industries, and whole economies.

Corporate Social Responsibility (CSR): A broad business concept that describes a company's commitment to conducting its business in an ethical way. Many companies implement CSR by contributing to society through philanthropy.

Digital Disruption: The change that occurs when new digital technologies and business models affect the value proposition of existing goods and services.

Environmental Factors: Relate to resource use, pollution, climate risk, energy use, waste management, and other physical environmental challenges and opportunities.

Environmental, Social, Governance (ESG): The consideration of ESG factors alongside financial factors to assess corporate behavior that may impact the future financial performance of companies.

Externalities: Refers to situations in which the production or consumption of goods and services creates costs or benefits for others that are not reflected in the prices charged for them—in other words, externalities include the consumption, production, and investment decisions of firms that affect people not directly involved in the transactions.

Governance Factors: The procedures and processes according to which an organization (in this context, mainly a company) is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization—such as the board, managers, shareholders, and other stakeholders—and lays down rules and procedures for decision making.

Greenwashing: Falsely communicating the environmental benefits of a product, service, or organization to make a company seem more environmentally friendly than it really is.

Liability Risks: Financial risks stemming from an increase in litigation (e.g. pollution, contamination, environmental lawsuits).

Physical Risks: Financial risks stemming from changing frequencies and intensities of weather-related perils.

Reputational Risk: Refers to the potentially adverse impact of negative publicity, public perception, or uncontrollable events on a company's reputation, thereby affecting its revenue.

Social Factors: Relates to how a company interacts with the communities in which it operates, its suppliers, employees, and customers. These include labor standards, health and safety, supply chain management, and nutrition and obesity.

Social Inflation: The rise in the cost of current and future claims caused by higher court awards and legislated rises in claims payments driven by changing societal behavior.

Sustainability Report: A report produced by an organization to inform stakeholders about its policies, programs, and performance regarding ESG issues. Sustainability reports, also known as corporate citizenship reports (CSRs), are usually voluntary and are sometimes independently audited or integrated into financial reports. The trend toward integration and assurance continues to grow.

Transition Risk: Financial risks that could result from significant policy, legal, technology, and market changes as we transition from a high- to a low-carbon global economy and climate resilient future.

Urbanization: The population shift from rural areas to urban areas, the gradual increase in the proportion of people living in urban areas, and the ways in which each society adapts to this change.

Weather-Related Events: Hurricanes, cyclones, wildfires, droughts, storms, and floods.

Investing Terminology

Best-in-Class/Positive Screening: Selecting issuers that perform better on ESG factors than their peers in a particular industry, sector, or region.

Engagement: The use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), guided by comprehensive ESG guidelines. Engagement is an integral part of active ownership.

ESG Integration: The systematic and explicit inclusion of ESG factors into traditional financial analysis.

Ethical Investing: An investment strategy in which you invest in line with your ethical principles and exclude companies that you deem to be unethical.

Exclusions/Negative Screening: Excluding from an investment or underwriting portfolio, based on specific ESG criteria. Excluded activities could be tobacco production, coal mining, or nuclear energy.

Green Bond: A bond whose proceeds are used to fund new and existing projects with environmental benefits, such as renewable energy and energy efficiency projects.

Impact Investing: Impact investments are investments made into companies, organizations, and funds to generate an intentional and identifiable social and environmental impact alongside a financial return. Examples of impact investments are social/green bonds, community investing, and renewable energy infrastructure.

Stranded Assets: Assets that have suffered from unanticipated or premature write-downs, devaluations, or conversion to liabilities as we transition to a low-carbon economy. Assets can be "stranded" by a range of environmental-related risks.

Sustainable & Responsible Investing (SRI): SRI funds seek to build a portfolio with above average ESG quality; SRI most often uses a combination of positive and negative screening.

Thematic Investing: Investing in companies that can be classified under a particular investment theme, such as renewable energy, waste, and water management; education; or healthcare innovation.

Value-Based Investing: Investing that prioritizes an investor's ethical objectives, rather than simply maximizing financial returns.

Relevant Organisations / Reporting Bodies

Global Reporting Initiative (GRI): Organization that publishes the GRI Standards, which provide guidance on disclosures of ESG factors for all stakeholders, including investors. Used by organizations worldwide, the GRI framework is one of the most well known.

Paris Agreement: A 2015 landmark agreement to mobilize a global response to the threat of climate change. The agreement's long-term goal is to keep the increase in global average temperatures to well below 2°C (3.6°F).

Principles of Responsible Investing (PRI): A set of six principles created by the world's leading proponents of responsible investment. The PRI acts in the long-term interests of its signatories, the financial markets and economies in which they operate, and, ultimately, the environment and society as a whole. The PRI is supported by the United Nations.

Principles of Sustainable Insurance (PSI): A global framework for the insurance industry to address ESG risks and opportunities. The purpose of the PSI Initiative is to better understand, prevent, and reduce ESG risks, and better manage opportunities to provide quality and reliable risk protection.

Sustainability Accounting Standards Board (SASB): A foundation that aims to establish and improve industry-specific disclosure standards across financially material ESG topics. SASB facilitates communication between companies and investors about decision-useful information. It is now part of the Value Reporting Foundation.

Task Force for Climate-Related Financial Disclosure (TCFD): The TCFD is a voluntary organization that promotes a consistent framework to facilitate both the production and use of climate-related financial disclosures. Forms the basis for climate-related disclosure requirements for regulatory bodies, including the European Commission.

UN Sustainable Development Goals (SDGs): A set of 17 goals reflecting the biggest challenges that societies, environments, and economies around the world face today.

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