Moving ESG into the mainstream

The case of Allianz and its community

OVERVIEW

As part of the Airmic Leadership Group series, Airmic held a roundtable on 27 January 2021 in partnership with Allianz, and supported by Herbert Smith Freehills, to evaluate what businesses need to address and be aware of with regard to environmental, social, governance (ESG) issues.

Michael Bruch (Global Head of ESG, Allianz Global Corporate & Specialty (AGCS)) gave an overview of the Allianz Group's approach to ESG and how that is applied across the group pillars of underwriting and investment. Shanil Williams (Head of Financial Lines, AGCS) spoke about how Allianz integrates ESG principles in its underwriting, with director and officer (D&O) liability as a focus for discussion, while Nina Hodzic (ESG Integration Manager, Allianz Global Investors (AllianzGI)) spoke about AllianzGI's sustainable investment journey. Finally, Silke Goldberg (Partner, Herbert Smith Freehills) gave an overview of the regulatory and legal landscape on ESG issues. The session was moderated by Stefania Davi-Greer (Regional Head of Financial Lines, Regional Unit London & Nordics, AGCS).

INTRODUCTION – ESG ISSUES IN THE CONTEXT OF COVID-19

Against the backdrop of the global pandemic, 2020 was a big year for ESG issues for businesses, accelerating the trend towards more sustainable business models. Given the increasingly interconnected nature of risks, issues relating to climate change, diversity and inclusion, and investor activism have risen to the fore. All of this carries implications for the insurance sector, while risk professionals and their boards of management need to be well primed to navigate the rapidly evolving world of ESG.

ESG issues are extra-financial factors that can influence business activities, or be influenced by them. If not addressed appropriately and in a timely manner, they can escalate into substantial risks such as human rights violations, illegal logging activities or severe corruption allegations. If managed well, however, ESG factors can present opportunities to induce positive change. For instance, the increased requirements for renewable energy investments and the solutions targeted specifically at emerging markets have been very hopeful developments for the global transition to a low-carbon economy.

Environmental criteria consider how an organisation performs as a 'steward of nature'. Climate change and pollution are at the forefront, but resource depletion and waste management are also important.

Social criteria examine how an organisation manages its relationships with its employees, suppliers, customers, communities and other stakeholders in terms of its internal and external ecosystem. This can relate to issues of working conditions, health and safety, data privacy or the organisation's relationship with local communities.

Governance criteria deals with an organisation's leadership competence and ethical behaviour, transparency, assurance and respect for shareholder rights – especially important at a time when reports such as the 2021 Edelman Trust Barometer have shown that stakeholder trust in information is at an all-time low. These governance issues could relate to director and officer (D&O) liability, executive pay, board diversity and cyber security.

The directors and officers (D&O) governance and liability context

The pandemic has challenged the ability of directors and officers of organisations to focus on the long term. While it is understandable to focus short term on the crisis, there must be a balance between the two perspectives if organisations are to emerge from the crisis stronger. Achieving this balance has further been challenged by the velocity and scope of director responsibilities. Attention has now turned towards recommendations to be issued by the UK's Department for Business, Innovation and Skills (BEIS), which will likely include the introduction of rules in the UK similar to the US's Sarbanes-Oxley Act, itself introduced in response to the fall of Enron in 2001. These will make directors rather than boards personally responsible for the accuracy of company financial statements, through the sign-off of internal controls and risk management. Directors will face fines or temporary bans if they are found to have breached their duties to uphold corporate reporting and audit standards. There will also be new powers for the regulator to set and enforce standards for the audit committees of FTSE 350 companies, together with new rules to report environmental and social obligations such as climate risk, which are expected to be introduced through legislation.

This is the D&O insurance market context for underwriters, who have seen and are anticipating increasing challenges with regard to claims frequency and severity, as well as for many directors, who feel they are being expected to aspire to 'governance perfection'. There has been a shift in claims from financial statement-related litigation, such as bankruptcies and fraud, to event-driven litigation relating to 'bad news' in general, that is, reputational risks for the organisation that impact its share price and its standing with regulators. This shift has been a major emerging D&O risk for the underwriting community. While these risks are not new, they are permeating through businesses, and the question is how will they manifest themselves in terms of D&O liability.

In 2020, there was an uptick in litigation on board diversity issues in the US, where it has been alleged that boards that did not have diversity had failed in their fiduciary duty. This has stemmed from data that diversity on the board brings different perspectives, enabling the board as a whole to manage risks effectively. Increasingly, the lack of diversity on a company's board is negatively perceived by investors, activists and shareholders, and can be relevant to D&O litigation. By committing to diversity within boards, organisations can align themselves more closely with a wider customer base, thus enabling them to create tighter bonds with customers of different backgrounds.

Climate change is another major issue. Recently, most D&O litigation has revolved around whether the disclosure of climate-related material risks by an organisation has been adequate. For instance, lawsuits have been brought against companies relating to the wild fires in the US, alleging that there had not been full disclosure of the risks to the environment arising from their activities. Given how climate change has increased the frequency and severity of natural catastrophes, it has become more important for insurers to model these risks and disclose them to the market.

There has also been litigation on 'greenwashing', where organisations have been accused of misleading consumers and investors by dressing up their efforts in tackling climate and sustainability. As part of its efforts in building trust in sustainable investments, the UK's FCA announced in 2020 that it was working on guiding principles on ESG disclosures to guard against greenwashing. Organisations will be called on to provide assurance on the quality of ESG data, to understand their source and derivation, and to articulate clearly and accessibly how they are being used.

The legal and regulatory landscape

While there are no standardised reporting requirements at the global level, there are many voluntary ESG frameworks for the insurance sector and the wider market. ESG frameworks such as the Global Reporting Initiative (GRI) Standards for sustainability reporting are not legally binding – they represent best practice. But such frameworks are gradually finding greater national and international acceptance, leading increasingly to legal or regulatory requirements. One example is the European Union's (EU) Non-Financial Reporting Directive (NFRD). Since it came into effect in EU member states in 2018, the NFRD has required large companies to disclose certain information on the way they operate and manage social and environmental challenges.

There has been a push internationally towards greater transparency in matters relating to ESG issues. Since 2016, France's Article 173-VI has obligated investors to disclose precisely how ESG factors in their investment decisions, through their annual reports and on their websites. Meanwhile, the revised UK Stewardship Code drafted by the Financial Reporting Council (FRC), which came into effect in 2020, requires signatory companies to publish annual stewardship reports on the activities they undertake to fulfil their stewardship responsibilities and the outcomes of those activities. These measures are ultimately aimed at increasing the level of transparency surrounding the activities of institutional investors as shareholders, for the benefit of the institutional investors' underlying clients.

The EU has one of the most advanced sets of mandatory ESG frameworks in the world, especially where it relates to transparency, reporting and disclosure. Indeed, disclosure and transparency through these frameworks have become an important risk management tool for organisations. Frameworks such as the EU Shareholder Rights Directive, which links directors' remuneration to ESG targets, are likely to have an impact on the UK even following Brexit. This is because frameworks and directives that find widespread adoption in the larger EU market are likely to catch on in the UK, for reasons of market harmonisation. There are now more than 170 ESG-related regulatory measures in the EU and the UK, which are often quite specific in scope, resulting in a patchwork of ESG frameworks that companies have to navigate.

One notable key development in the EU relates to the European Commission's Technical Expert Group's final report on EU Taxonomy. Published in March 2020, it includes legally binding definitions of some climate change mitigation and adaptation economic activities that can be considered 'sustainable'.

Organisations should also pay attention to their communications on ESG issues. Litigation risks increase when there is a discrepancy between what an organisation does internally and says publicly. As part of due diligence, organisations should look out for risks internally and then monitor their external communication on those risks. This relates to another important point – tackling ESG risks should go beyond tick-box exercises. ESG expertise should be integrated into boards, and where gaps in such expertise are found, directors should be provided with the necessary training. Boards can then demonstrate that they have the appropriate skills to deal with ESG risks.

Case study – ESG at Allianz Group and Allianz Global Corporate & Specialty (AGCS)

Allianz's journey in ESG began around 2010, with the realisation that ESG issues relating to systemic risks cannot be solved by individual companies within the Allianz group. Rather, the participation of every Allianz stakeholder is needed. Since then, Allianz has integrated environmental and social factors into its underwriting processes. Policy positions have been adopted, for example, Allianz no longer provides insurance to single coal-fired power plants and coal mines, and will phase out insurance relating to coal exposure completely by 2040. This constitutes part of its commitment to keeping global temperature increases to below 1.5 degrees Celsius, by supporting the transition to a low-carbon economy.

Now among the leading sustainable companies recognised by the Dow Jones Sustainability Index, Allianz's corporate responsibility strategy rests on three pillars:

- **Social inclusion:** Allianz uses its roles as an insurer, investor, employer and corporate citizen to contribute to more inclusive societies. Encouraging Future Generations is Allianz's Corporate Citizenship programme that promotes the social inclusion of young people worldwide.

- **A low-carbon economy:** Allianz uses its roles as an insurer, investor and asset manager to help manage the risks arising from climate change and to promote the low-carbon economy. Allianz's Climate Change Strategy lies at the heart of its business model that aims to protect people and businesses from risk.

- **ESG business integration:** This involves managing material ESG risks and seizing opportunities, while embedding compliance, responsible sales, transparency as well as data protection and privacy across all areas of its business. The Allianz ESG approach ensures that ESG principles are integrated throughout all insurance business and investments of proprietary assets.

For Allianz, a sustainability strategy and commitment is long term, and pays off by reducing overall risks for its customers and other stakeholders. Increasingly, ESG matters to various stakeholders such as clients, NGOs, regulators, politicians, employees and the public. Many companies need to adapt their business for a low-carbon world and risk managers need to be at the forefront of this transition. Close partnerships between insurers, clients, policymakers and society will accelerate a climate-friendly and 'socially just' future.

ESG and investment at Allianz Global Investors (AllianzGI)

Given AllianzGI's diverse client base, with its diverse sustainability objectives, AllianzGI tailors its sustainable investment offerings according to four categories:

- 'Integrated ESG' funds, which focus on financially material ESG risks;
- 'Sustainable' funds, which focus on values, and excludes companies that are involved in controversial activities such as human rights violations;
- 'SDG (Sustainable Development Goals)-aligned funds', which contribute to social and environmental activities in alignment with one or more of the United Nation's SDGs; and
- 'Impact' funds, which generate measurable environmental and societal outcomes against specific key performance indicators.

Active stewardship is also an important element of AllianzGI's investment approach, which sees active engagement with company management and board directors, especially on issues of corporate governance and climate change. AllianzGI has a transparent approach to proxy voting, where a dashboard on its website shows how AllianzGI has voted at various Annual General Meetings – in particular, how it has voted on management proposals that do not meet their expectations.

AllianzGI's ESG specialists are very active in various ESG related (industry) initiatives. One of these initiatives is the Investor-Director ESG Working Group, which was created by LeaderXXchange in 2017, with the objective of bringing investors and directors together to exchange ideas and best practices on ESG, and to develop a roadmap that includes concrete recommendations relating to purpose, accountability, training, stewardship and transparency.

To see how the findings of the working group matched global trends, a survey of 130 of investors and directors in Europe and North America on climate risk management was conducted by LeaderXXchange and Columbia University. The survey found that silos still need to be broken down for the investment and business communities to work together to address urgent environmental challenges and create long-term value for shareholders and other stakeholders.

CONCLUSION – COMMITMENT OF THE BOARD IS CRITICAL

ESG issues relate to some of the most important challenges for mankind, and addressing these require various stakeholders to join forces and work together. ESG issues are vital not only for carbon-intensive industries, which are the focus of urgent efforts in tackling climate change, but also for all businesses.

It is crucial that ESG issues are incorporated into company processes and that boards monitor progress in this respect. Board members themselves are also increasingly subject to an evaluation of their skills and knowledge on ESG issues. One place to start is by undertaking a thorough view internally of the skills matrix of board members, for example, through an exercise where board directors score each other through a peer review process. Board directors can also use the ESG frameworks available to guide them in examining the ESG issues for their own organisations in order to become ESG champions.

ESG issues will be a hot topic in governance, and they sit at the top of Airmic's agenda as far as governance matters are concerned. Airmic will produce more thought leadership initiatives on ESG issues, through its annual members survey report and its Roads to Repurposing project this year, and by keeping members up to date with news and developments in the ESG space.