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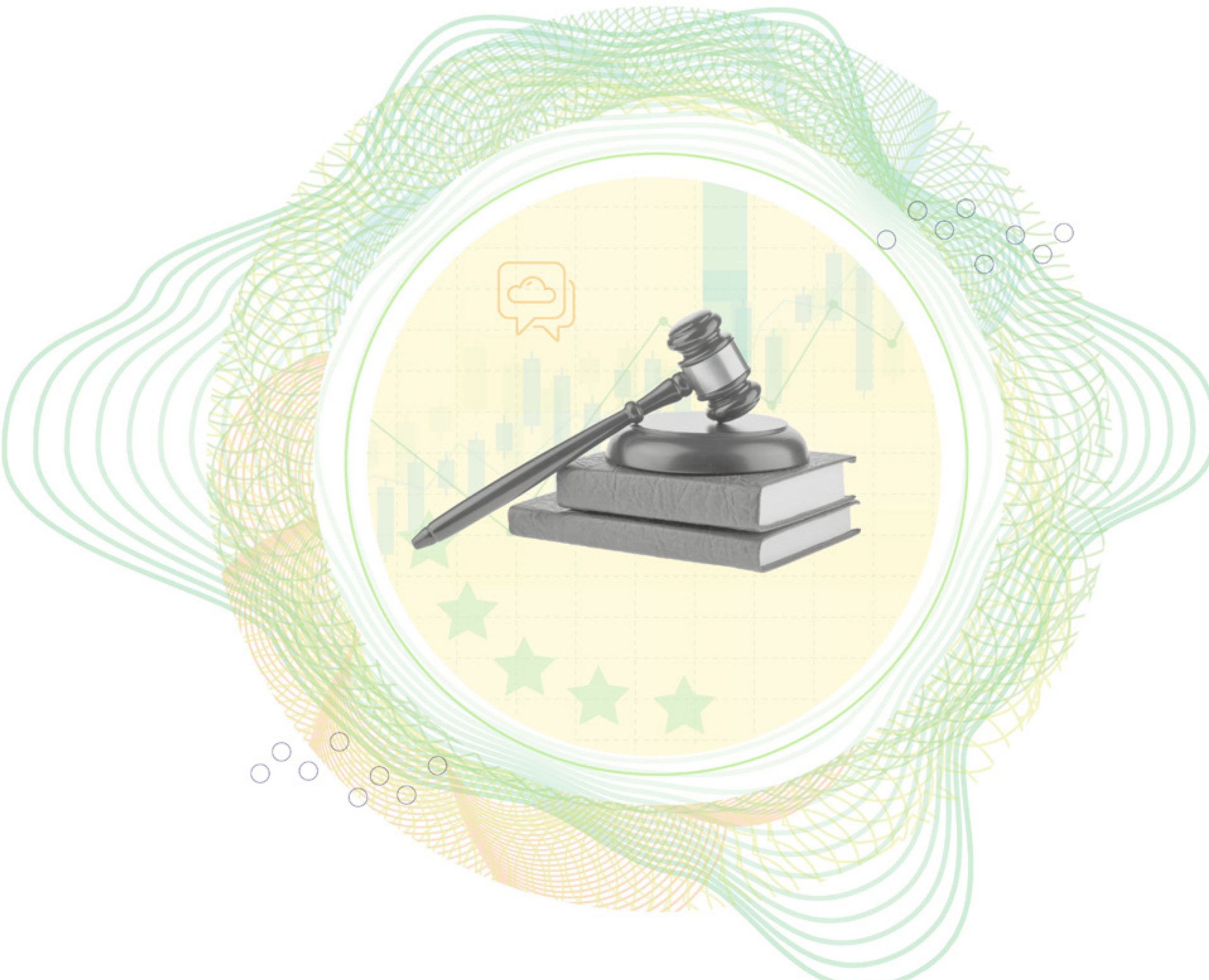

Environmental, social, and governance (ESG) transformation

ESG transformation refers to a total mindset within an organization that includes an active awareness of the risk of climate change and a greater sense of social responsibility and their incorporation at every decision level from top to bottom. This article discusses ESG at the governance and controls level for insurers. With governance being the body setting the tone at the top, it is important for insurers to embrace the concept of ESG transformation at the governance level to enforce sustainability of ESG in governance and internal controls.

On March 21, 2022, the Securities and Exchange Commission (SEC) released a proposed rule to regulate the disclosure of climate-related risks across public companies.[1] The rule requires public insurers to include climate-related disclosures in their registration statements and reporting, including climate-related risks that are likely to have a material impact on the business, results of operations, or financial condition. This would include disclosure of greenhouse gas (GHG) emissions.[2] The SEC proposed rules are built into the disclosure framework of the Task Force on Climate-related Financial Disclosures (TCFD) and the GHG Protocol.

In April 2022, the Executive (EX) Committee of the National Association of Insurance Commissioners (NAIC) approved revisions to the annual Climate Risk Disclosure Survey to better align with the TCFD disclosure framework and the GHG Protocol.[3]

While the comment period has closed, the SEC received almost 15,000 comments related to the proposed rules. With this high response rate, the discussion of the rules is prevalent throughout the industry. If passed, it should lead to greater consistency and comparability of emissions and climate-related data across companies, industries, and locations.

As a result of this new regulation requirement, finance teams will play a crucial role in ensuring that the existing financial reporting systems and processes are updated to include the correct information to meet the disclosure requirements. Many insurers are wondering what the best approach is to comply with this SEC rule and NAIC revision and produce financial disclosures that capture sufficient and reliable data. Beginning with the end in mind, insurers should review and assess how the existing financial reporting architecture should be enhanced to manage these changes and what would be the ideal governance structure that can enable an effective climate-related disclosure.

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ESG governance

As a part of this journey, governance bodies will play a pivotal role in establishing top-down accountability mechanisms to support the SEC proposed rules on climate change. To achieve the expected results, organizations should treat this as a large-scale change by establishing a robust plan that highlights key timelines, internal and external stakeholders, and interdependencies to allow them to manage the various projects. Having a strong governance structure can facilitate effective decision-making and balance competing priorities.

Insurers should consider building an ESG governance body that comprises a diverse team with skill sets to understand each aspect of ESG reporting requirements and their effective execution. ESG initiatives have typically been managed separately from the rest of the business, either by a sustainability group or through the corporate or marketing departments. Given that the sustainability information is prepared outside of the financial reporting team, the ESG group within a company should, at a minimum, include the following background: underwriting, investments, data/risk management, corporate social responsibility (CSR) reporting, marketing, internal audit, and financial reporting. The combination of those backgrounds can support an effective ESG reporting process for the long run. The ESG governance body should work on integrating ESG into the overall organizational strategy by fostering a corporate culture aimed to reduce environmental risks and increase climate resilience, and by supporting corporate initiatives related to energy and environmental sustainability strategies and programs in the workplace (e.g., green leaders, green training).

This can enable ESG to be an integral part of the overall corporate vision and future planning at the organization and facilitate the mitigation of risking the omission of ESG materials from regulatory filings.

Although the insurance industry (specifically property and casualty insurers) has been proactively monitoring climate risk for years, ESG transformation provides an opportunity to broaden the governance framework to include meaningful controls and processes. Many insurers have already started to align their underwriting and investment strategies with ESG principles, which in turn can help them achieve robust governance and transparency within the organization.

Furthermore, a sustainable ESG strategy should include motivation from leaders to take on leadership roles in sustainability programs or local communities' green opportunities as well as training that fosters awareness of climate-related risks.

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Risk assessment

Climate-related risks are defined as the actual or potential negative impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations, or value chain. Under the SEC proposed rule, a registrant must disclose the following information:

Governance of climate-related risks: How identified climate-related risks have or are likely to have a material impact on a company's strategy; business model; outlook over the short, medium, and long term; and risk management processes.

Climate-related financial statement metrics (e.g., disaggregated climate impacts on financial statement line items) and impact of climate-related physical events and transition activities on estimates and assumptions.

GHG emissions including Scopes 1 and 2 (and Scope 3 phased in if material or if registrant has Scope 3 target).

Reasonable assurance phased in for accelerated and large accelerated filers over certain GHG emissions disclosures; limited assurance precedes.

Information about climate-related targets and transition plans.

Public insurers should consider revisiting their current overall risk assessment strategy and framework to account for the above-mentioned risks associated with climate. The enterprise risk assessment should be updated to reflect the impact of climate change-related risks.

The ESG team should conduct a materiality and risk assessment to identify the sustainability areas that are important and material to the organization. The ESG team should also implement appropriate board oversight for ESG, similar to board oversight on other matters such as audits. The ESG team should then integrate ESG topics into the enterprise risk management (ERM) process, given how prevalent ESG-related risks are. In the proposed SEC rule, there is no requirement on the ESG board; however, the rule seems to suggest that the board should have expertise in GHG or environment-type science.

It is crucial for insurers to clearly understand the impact of climate change in the following risks:

- Financial risk, including data accuracy due to internal and external data sources
- Third-party risk and the potential for negative business impacts, such as loss of customers related to third-party ESG practices
- Reputational risk, such as ability to reach ESG-related goals set publicly by the organization
- Regulatory risk, including the ability to fulfill regulatory obligations and confirm accuracy of regulatory data inputs

Furthermore, insurers should specifically understand how the ESG-related changes will impact the following risks in their overall risk assessment:

- Insurance risk: The risk that actual experience deviates adversely from insurance assumptions, including mortality, morbidity, and policyholder behavior assumptions.
- Material risk: The risk of loss from changes in interest rates, equity prices, and foreign currency exchange rates.
- Liquidity risk: The risk that the company is unable to meet near-term obligations as they come due.
- Operational risk: The risk of loss resulting from inadequate or failed processes or systems.

Data management

Insurers should first assess their system capabilities and process flows to consider the data needed to support ESG reporting requirements. Given that ESG significantly increases the volume and complexities of data that must be captured, the company's IT capabilities and processes may require enhancements to manage the increased workload. Otherwise, the company should assess leveraging a third-party service to help support ESG data management with adequate tools.

One common gap that insurers face in their existing reporting concerns how actuarial considerations may be included—for example, impacts on reserving, underwriting, pricing, or stress testing/event modeling. Many insurers do not have a tool in place that captures results at a sufficiently granular level to support ESG reporting. Implementing a strong solution can drive considerable time savings in the reporting process as the time required to manually compile and process data will be exponentially higher in the face of the increased volumes of data.

Many insurers have therefore recognized that implementing a strong solution represents the backbone of a strong financial reporting architecture and are deploying solutions to facilitate a smooth production run and reduce the operational risk of generating robust disclosures. Insurers that do not have a strong repository in place should begin by defining their strategy for managing this actuarial data and assess in-house and vendor alternatives that may fill this gap.

Furthermore, insurers should think through what technology solution might be appropriate to support compliance with ESG in the long run. The technology should be able to capture more specifically accurate and complete data (e.g., GHG emissions including Scopes 1 and 2) to support ESG reporting requirements and allow comparability within the industry.

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Internal controls and reporting

The SEC proposed rule on climate change requires insurers to disclose both qualitative and quantitative information related to GHG inside and outside the financial statements. Furthermore, the proposed rules require public insurers to include climate change disclosures in their registration statement and Exchange Act annual report in Management's Discussion and Analysis (MD&A) and in the notes of their audited financial statements.

One of the biggest challenges insurers will likely face is how to ensure the existence of adequate internal controls to support effective and accurate reporting of climate change-related information.

Insurers should revisit their control environment and determine whether they are building robust internal controls to support effective ESG reporting.

The following are some items to consider:

1. **Controls around data**
   A. Processes are in place to provide data needed to meet ESG reporting requirements
   B. Processes are in place to ensure data related to GHG is available, accurate, secure, and complete
   C. Process is in place for data reliance on third parties
2. **Reporting ESG data**
   A. Definition of ESG targets and metrics
   B. Structure of the report to be used for ESG metrics
   C. Impact of ESG targets and metrics on the overall enterprise risk assessment
3. **Tools**
   A. Assessment of the existing tools and their capacity to support the ESG reporting requirement
   B. Assessment of effectiveness of Information Technology General Controls (ITGCs) around the technology supporting ESG reporting

Next steps

Insurers should consider the impact of the proposed and adopted regulatory changes in their overall reporting. Forward-looking insurers should consider the impact of the proposed and adopted regulatory changes, with a focus on the implications on their governance and internal controls frameworks, and perform an initial assessment of their ESG reporting readiness.

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Endnotes

1. Securities and Exchange Commission (SEC), Proposed Rule Release No. 33-11042, The Enhancement and Standardization of Climate-Related Disclosures for Investors.
2. SEC, "SEC proposes rules to enhance and standardize climate-related disclosures for investors," press release, March 21, 2022.
3. NAIC, 2022 Spring National Meeting materials, Kansas City, Missouri, April 6, 2022.

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