Integration of environmental, social and governance principles in pension funds and insurance companies activities

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Abstract
Sustainable finance has been one of the modern topics in recent years. The main reason is the growing need for active steps and measures to preserve nature and avoid the risks of climate change and its consequences. A basic concept in sustainable finance is the adoption and follow-up of ESG principles. The latter refers to environmental “E”, social “S” principles and good corporate governance “G” policies. Financial institutions are considered as the conductor of policies in the field of ESG principles. The European Union is following an action plan to implement these principles and policies in the financial sphere. This report examines the integration of ESG principles into the activities of insurance companies and capital pension funds. Potential problems are identified and possible solutions are presented.

Keywords: ESG factors, environmental, social and governance policy, sustainable finance, private pension funds, insurance companies.

Introduction
The present study is motivated by the desire to analyze a relatively new problem in the field of insurance and pensions, namely the integration and the impact of environmental, social and governance /ESG/ factors on the activities of capital pension funds and insurance companies. The paper focuses on the analysis of the Member States of the European Union /EU/ and Bulgaria. Theory and practice for other countries have been examined with a view to achieving greater depth and completeness of the study, but without going into detail.

The problem of ESG principles and sustainable finance is not completely new – it has been under consideration for more than 20 years. What is distinctive today is that the discussion has reached a stage where a fundamental regulatory framework will be developed on the basis of which the climate change targets of the United Nations Sustainable Development Program and the Paris Agreement on Climate Change will be pursued in the coming years to 2030. Specific steps have been taken in the EU over the last four years (2015 – 2019) to develop regulations that will be the basis for integrating the ESG principles into the activity of the financial institutions.

The thesis of the study is that the adoption of the ESG principles and sustainable finance in the activities of pension funds and insurers is necessary, but should be done gradually and after wide discussion among the stakeholders. Otherwise, hasty and chaotic implementation in the form of requirements and regulations will not achieve the desired effects. The integration of ESG policies into the activities of insurers and pension funds should be carried out gradually, in stages, by an impact analysis.

The objectives of the study are achieved by consistently examining the nature of the ESG principles, examining EU actions taken, analyzing draft Regulations of the European Parliament and of the Council, looking for the effects of integrating these policies in the

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activity of pension funds and in the activities of insurance companies. Possible problems have been identified and guidelines have been given to address these issues.

Public policies, initiatives and resources are not sufficient to achieve climate goals. Private investment also needs to be attracted. Financial institutions are seen as a conductor for ESG private investment policies. Sustainable finance raises two big questions for financial institutions: how to integrate ESG principles into their operations and how to manage climate risks. Sustainable finance and ESG factors are part of the concepts of a low carbon economy and a shift from a linear to a circular economy. The essence of a circular economy is to conserve nature and maximize the long and efficient use of resources.

In the context of moving from a linear to a circular economy, financial institutions need to address a number of new problems. Some of them are about new risks related to climate change and sustainable investments, about new regulations and requirements, about customers' preferences for ESG policies, about products, investment decision-making processes, structure of investment portfolios, investment risk management, information disclosure, uncertainty about the return on sustainable investment, product distribution and periodic information to customers.

At the same time, in the process of this transition, new risks are emerging that regulators, politicians and public opinion makers need to be aware of. For example, it is considered that the EU is first among the rest of the world’s major powers in its quest to enforce the ESG principles, but this could put EU financial institutions in a non-competitive position. That is why the EU should also analyze the process in the context of the actions of the rest of the world – especially the USA, China, Japan, Canada and others.

In the context of the imposition of the ESG principles the regulators can influence financial institutions through regulatory requirements, through capital requirements, through differentiated taxation and other mechanisms. For policies to succeed, it is necessary to have an equal understanding of sustainable finance, sustainable investments, green products, environmental factors, social factors and good governance practices. The balance in regulation and the imposition of standards on the market is necessary because of the risk of demotivation for market participants to adopt ESG principles in their policies and actions. Regulators should keep in mind that banks, investment firms, insurers and pension funds are different in terms of business model and regulations and a good assessment of the new requirements should be made. There is a danger of favoring/deliberately or not/ one sector over another regarding products and / or suppliers – financial institutions. Some experts have already warned about the risk of green bubbles. In my opinion, one could go further and talk about the danger of green arbitrage. This arbitrage may result from unbalanced regulations or requirements for "green" policies that benefit a financial sector or a financial product provider.

Another expression of the lack of a good balance is the granting of a competitive advantage to large financial institutions over small, local players. Next, the risk to the success of green policies is to take these initiatives as steps to build a single market in the EU in sectors still dominated by local financial institutions or where national legislation is prevailing. This will not be taken unequivocally by the Member States and would lead to resistance from some of them to Union legislative initiatives.

**Results and discussion**

**The essence of the ESG principles**

The ESG (ESG principles refer to Environmental, Social and Corporate Governance principles) principles require that investment decisions take into account aspects in three areas – the environment, social impact and governance. The aim is to achieve sustainable economic growth while preserving the environment, reducing pollution, reducing waste disposal and using natural resources more effectively while
simultaneously taking into account social effects and following good corporate governance practices. The environmental aspects are linked to reducing the impact on and adaptation to climate change, as well as the resulting risks. The social aspects are related to inequality, social exclusion, employment and investment in human capital. The governance aspects are considered in the context of good governance practices for public and private organizations, linking up with management structures, employee relationships, remuneration of management personnel, and involvement of environmental and social aspects in decision-making processes. The three components are considered as part of the concepts of sustainable economic development and sustainable finance.

A number of organizations and institutions have an attitude towards adopting these principles in their activities. For financial institutions, in particular pension funds and insurers, adopting these principles is central to investment decision-making, risk management and management processes. The EU has declared itself a strong supporter (European Commission, 31.01.2018) of policies to move towards a low carbon industry, resource efficiency and a sustainable economy. The financial system is seen as one of the tools to achieve these goals.

The European Commission (EC) pursues three fundamental objectives by incorporating the concept of sustainable finance into the business processes of financial institutions: to direct cash flows to sustainable investments; to improve the assessment and management of financial risks arising from the ESG factors and to promote transparency and a long-term approach to financial and economic activities.

The EU supports the UN’s 2030 Sustainable Development Program and the Paris Climate Agreement. Specifically, in order to achieve the 2030 Agenda, the EU has set itself a target of reducing greenhouse gas emissions by 40% and further investing in these activities by € 180 billion per year. In order to achieve the key objective of the ESG concept for financing the sustainable development in Europe two urgent tasks for the European financial system have been identified (European Commission, Final report) – to increase the financial sector’s contribution to sustainable and inclusive growth and to strengthen financial stability, such as in the process of making investment decisions environmental, social and governance factors are included.

In order to achieve these goals, the EU is also trying to engage private sector resources in addition to public resources. The creation of the European Strategic Investment Fund is seen as a step towards achieving these goals. The next steps of the EC in this direction are the document “Capital Markets Union – Accelerating the Reform” (European Commission, “Capital Markets Union” /September 2016/ and the establishment of a High-Level Expert Group on Sustainable Finance /December 2016/. In January 2018, the Group of Experts presented a report (European Commission, Final report) on sustainable finance ‘Financing a sustainable economy in Europe’. The report is about directing the flow of public and private capital towards sustainable investments, identifying the steps that financial institutions and supervisors need to take to protect the stability of the financial system from environmental risks and the implementation of EU-wide policies across Europe. In March 2018, the EC adopted an Action Plan for Financing Sustainable Growth (European Commission, “Action Plan: Financing Sustainable Growth”). Some of the measures included in the Action Plan are the preparation of a taxonomy for sustainable activities, the creation of labels for green financial products, the formulation of the responsibilities of asset managers and institutional investors on sustainability and the introduction of a green support factor in prudential rules of the EU for banks and insurance companies. The latter means integrating climate risks into the policies of financial institutions and support for those of them that contribute to the financing of
sustainable projects.

In May 2018, the Commission adopted a **package of documents on sustainable finance**. The package includes three draft regulations. The first document is a proposal for a *Regulation on the establishment of a framework to facilitate sustainable investment*. This Regulation aims to define the framework for the creation of a single classification system (‘taxonomy’) for what can be considered an environmentally sustainable economic activity. Article 3 of the Proposal for a Regulation sets out the criteria for defining an economic activity from an environmental point of view for the purpose of establishing the environmental sustainability of an investment. According to these criteria, economic activity must contribute significantly to one or more environmental objectives and not cause significant harm to any of the others. While respecting the principles enshrined in the European pillar of social rights, the criteria also require that economic activity be carried out in accordance with minimum social and labor international standards. These criteria will be applied after the EC has determined, by means of delegated acts, the technical verification criteria that determine what constitutes a significant contribution to environmental objectives and what constitutes significant harm to other objectives. Article 4 of the draft Regulation obliges Member States and financial market participants to apply, in specific cases, the criteria set out in Article 3. It states that Member States and the EU use uniform criteria for environmentally sustainable economic activities when defining requirements for offering financial products or corporate bonds as environmentally friendly, in particular under labeling schemes (for example, so-called ‘green’ bonds). It imposes an institutional investor obligation to disclose information when offering financial products as “environmentally sustainable” or as investments with similar characteristics. The scope of this obligation will be further specified by EC delegated acts.

The second part of the package is a proposal for a *Regulation on Sustainable Investment Disclosures and Sustainability Risks* and amending Directive (EU) 2016/2341. The document aims to further develop the information disclosure requirements of institutional investors in how they have integrated the ESG factors into their investment and advisory processes.

The third element of the package of measures is a proposal for a *Regulation amending Regulation (EU) 2016/1011 with regard to low carbon benchmarks and positive carbon benchmarks*. The regulation aims to create benchmarks against which investors can measure their carbon footprint.

In the period after May 2018, the draft regulations have been subject to political debate in the EU. As of September 2019, it is assumed (EIOPA, “Financial Stability Report”) that political agreement was reached between Member States on two of the projects /the Disclosure Regulation and the Benchmark Regulation/. Policy consultations are still underway on the third draft Regulation establishing a framework to promote investment in sustainable development /the Taxonomy Regulation/.

Completion of the taxonomy for green activities by the EC is currently a top priority (ESAs, Joint Committee of the European). This will most help institutional investors identify investment opportunities. One element of the ESG principles has already been incorporated into national law, reflecting the requirement to disclose non-financial information. The disclosure of non-financial information is made under the 2014 Directive (DIRECTIVE 2014/95/EU).

Continuing its efforts to leverage green investment and sustainable finance in March 2019, the EC organized its second high-level conference on sustainable finance. The idea of the event was to promote a global approach to sustainable financing and to discuss ways to channel private equity to sustainable projects.

**Integration of ESG in insurers and pension funds**

Sustainable finance and ESG factors directly influence the activities of insurers and pension
funds. The extent of the impact of the ESG factors on insurance companies can be found in one of the analytical documents (EIOPA, Technical Advice) of the European Insurance and Occupational Pensions Authority /EIOPA/. EIOPA examines the impact of the ESG factors on all insurance companies, including reinsurers, not just life insurers (as in the EC’s initial request for advice to the supervisory body). The document states that “… sustainability risks should be understood as risks that could affect the insurance and reinsurance undertakings’ risk profile, on the investments and liabilities side, due to ESG factors”. With a view to integrating sustainable finance and ESG factors into the activities of insurers and pension funds, EIOPA’s technical advice include proposals for changes to regulations and requirements in the areas of risk management, investment strategy, stewardship and product management.

The impact of ESG factors on the activities of insurers and pension funds is through various channels. One channel of influence is on the valuation of insurers’ assets. According to the EIOPA (EIOPA, Opinion on Sustainability), institutional investors need to take into account the degree of adoption of sustainable finance by the issuers. The ratings of rating agencies will play a significant role here. Another channel of influence is on the amount of insurers’ liabilities. The debt calculation will take into account the ESG risks by developing different scenarios and simulations. The third channel of reflection is on the investment decision-making process. The fourth channel of influence is the underwriting process. The fifth area are the organizational requirements. Risk management is the other channel of influence in the activities of insurers and pension funds. The distribution of insurance products is another area in which sustainable finances and ESG factors are reflected. Customer preferences, expressed in preference for ESG products, are another area /product design and management/ that reflects the principles of sustainable finance.

The integration of sustainability factors will affect the investment decision-making process. This integration will affect key functions, and in particular the risk management function. Other areas are the prudent person rule, the written risk management policies and the own risk and solvency assessment (ORSA). In particular for non-life insurers and reinsurers, sustainability risks will first affect their obligations. EIOPA finds that it would be unbalanced to introduce changes to Solvency II Regulation that only affect assets without affecting the liabilities of insurers. It is envisaged that insurers will be required to account more closely for assets exposed to climate risks against existing Solvency 2 requirements. Another impact will be the refinement of the Solvency 2 risk assessment system, taking into account climatic risks.

EIOPA plans to change the organizational requirements and operating conditions, most notably changes in the delegated acts under the Solvency 2 Directive and the Insurance Distribution Directive. In addition, EIOPA is deeply concerned (ESAs, Joint Committee of the European Supervisory Authorities, p.14) about the widening protection gap from catastrophic risks. This gap is considered to represent uninsured potential losses (for business and households) from natural disasters. The supervisory body notes that this risk can become systemic.

When analyzing the potential effects, it should be borne in mind that the EC package of measures will result in direct changes to and / or the drafting of delegated acts linked to multiple directives. Examples of such directives are Directive 2009/65/EC (UCITS), Directive 2009/138/EC (Solvency II), Directive 2011/61/EU (AIFM), Directive 2014/65/EU (MiFID II) and Directive 2016/97/EU (Insurance Distribution Directive, IDD). We can summarize these effects as new regulatory requirements.

There is a consensus among European financial supervisory authorities (ESAs, Joint Committee of the European Supervisory Authorities, p.12) that climate change and the transition to a low carbon economy pose significant risks to financial stability. Typically, climate change risks are divided into two groups – physical risks and transition risks. Physical risks are related to actual climate change and the impact on the
value of assets. An example of the significance of these risks is the data on the annual costs of insurers related to natural disasters. These costs are estimated at USD 80 billion for 2018, which ranks the year as the 4th highest cost of damage for insurers (EIOPA, “Financial Stability Report”).

Transition risks are seen as a consequence of the abrupt transition to a sustainable, low-carbon economy. An example of these risks (EIOPA, FSR December 2018 Risk assessment) is the significant and unplanned impairment of assets in the climate-sensitive sectors. This transition may be due to political, technological or consumer reasons. Therefore, to address these risks, there is an understanding of a timely and steady transition. Sustainable finance is one of the main priorities under which the ESAs work (European Supervisory Authorities). As tools for identifying risks in the financial sector, ESAs develop scenario analysis and stress testing.

EIOPA analyzes the exposure of climate risk insurers to assets. The purpose of the analysis is to identify risky investments in the transition to a zero-carbon economy. The scenario shows that 12.9% of assets are sensitive to this transition. The data is shown in Figure 1.

![Climate related asset exposures of the European insurance sector (% of total investment assets)](image)

Fig. 1 – Climate related asset exposures of the European insurance sector (% of total investment assets)

Source: EIOPA, FSR December 2018 Risk assessment, p. 8

These 12.90% represent assets worth around EUR 1 trillion. EIOPA’s report draws attention to the fact that the data presented is unlikely to fully reflect the dependence on climate risks because financial sector investments (approximately 57% of total investments) are also sensitive to these risks, but this sensitivity was not measured in the study. In this regard, the risks are considered at two levels, the first and the second level, depending on the criterion of direct and indirect influence. The first level of risk reflects the direct impact. The second level of risk reflects the possible losses that insurers would indirectly suffer through the impairment of investments in financial institutions that have suffered from climate risks. In the study, the types of investments exposed to climate risks are grouped into 6 groups: energy intensive sectors – 1.5%, real estate and mortgages (housing) – 7%, fossil fuels – 0.8%, utilities – 0.8%, transport – 0.4% and potential /for which detailed information cannot be provided/ – 2.5%.

From a risk management perspective, it is of interest in what financial instruments are invested assets exposed to climate risk. This information is presented in Figure 2.

![Climate related asset exposures split by financial instruments](image)

Fig. 2 – Climate related asset exposures split by financial instruments

Source: EIOPA, FSR December 2018 Risk assessment, p. 10

The highest share of investments exposed to climate risks is in the form of real estate and mortgages – 35%. Corporate bonds and equities are next, 25% and 24% respectively. Assets invested in equities are considered to be the most threatened, as they would absorb the first losses in the event of climate shock. During 2019 EIOPA is analyzing interesting analytical information – the occupational pensions schemes (IORPs) is undergoing stress tests part
of which is information on 'brown' investments and the carbon footprint of pension scheme portfolios.

Institutional investors are charged with high expectations of being active in the process of transition to a sustainable economy, given the fact that they can channel significant funds to specific sectors and projects. In different EU Member States, financial institutions have different influence and power in the economy. For example, in Western European countries (most notably Luxembourg, Belgium, the Netherlands, France and Germany), insurers, pension funds and investment funds manage significant assets. In Bulgaria, non-banking financial institutions manage assets about four times smaller than those of the banking system. That is why there is a huge need of balance in the development of new 'green' regulations across sectors, so that there is no competitive advantage for one type of financial institution or product.

EU insurers and pension funds are one of the most active players in investing in green financial instruments. For example, they are the largest investors in green bonds – 64% of total investments in 2017. Green bonds are a relatively new instrument in the financial markets. The first green bond was issued in 2007 by the European Investment Bank. As of May 2019, the volume of traded green bonds is EUR 210 billion. Green bonds are still a very small percentage of total bond volume, but there has been a significant increase in recent years. Green bonds account for 2% of total new issues for 2017 and 2018, reaching a relative share of 4.4% for the last quarter of 2018. Another example of the role of institutional investors is the fact that 19 insurers /based on officially announced information, but those cases for which no public information is available should be added to this number/ have already divested from investments in the securities of coal companies. The divestment from brown assets is estimated at USD 6 trillion (EIOPA, “Financial Stability Report”, June 2019) for 2018.

Another positive trend is the decline in mistrust among institutional investors regarding sustainable investments. Schroders survey (Schroders, Institutional investor study 2019) shows that only 11% are investors in 2019 who do not believe in sustainable investments, compared to nearly twice as much – 20% in 2017.

Several main aspects are identified as challenges to the spread of sustainable investment. First, investors cited a reliable database and evidence of potentially good returns – 49%. Second are the fears of a lower return – 48%. Improved transparency on financial and non-financial information in the accounts is third with 36%. Clearer and more reliable benchmarks are cited by 34% of investors as a challenge to invest in sustainable activities. The data shows that still large percentage of institutional investors considers sustainable finance as a challenge.

Some risks related to the adoption of sustainable finance concepts and ESG preferences must be considered. One of these risks is related to the emergence and development of fake /hypocritical/ green products, green policies and greenwashing. In their quest to attract new customers, some financial institutions may be tempted to offer pseudo-green products. Another risk is related to transparency in green investments. In this regard, there are already examples of exiting green investments. Next, the comparability of the different green alternatives may be a problem for the customers. One of the biggest concerns for institutional investors is the risk of diminishing returns on investment. It is no coincidence that many surveys of customer attitudes include the question of whether customers are willing to receive a lower return when meeting their green investment preferences. Consumers tend to change their investment decision according to the sustainability criterion (Eurosif, European SRI Study 2018). A study (University of Cambridge, 2019) of potential clients shows their willingness to “sacrifice” 2-3% of the return on sustainable investments. On the other hand, it means 20-40% lower pensions. It is reasonable to expect
that if the question were put differently – are you prepared to risk 20-40% of your pension at the expense of sustainable investments – then the percentage of those who agree is likely to be much lower. Another concern for experts is whether ESG do not increase inequality by favoring large companies. Large institutional investors can relatively easily and quickly allocate resources for information disclosure, coping with new regulations, marketing and distribution. Another aspect to consider is the risk that sustainable finance and ESG factors can shift the focus of regulators and supervisors from other priority topics. For example, the most important risks to the financial system at present, according to ESAs (ESAs, Joint Committee), are low interest rates and Brexit.

Conclusions

Sustainable finance and ESG factors have been a major focus of the EU and the Union’s financial regulators over the last four years. These policies already affect the activities of the financial institutions in the EU. The fact is that customer preferences include ESG policies. Sustainable finance will increasingly enter the business processes of banks, insurers, pension funds and investment firms. The financial institutions are forced to participate in this process not only for regulatory reasons. We can add ethical, reputational and financial reasons to them. The integration of ESG factors and sustainable finance is considered as a new source of revenue for the financial institutions.

We can summarize that ESG factors and sustainable finance will have impact on all business processes of insurers and pension funds, with the most significant effect being on investment activity, risk management, product management and assets and liabilities valuation. One of the findings of the study is that the adoption of ESG principles in the business processes of insurers and pension funds is necessary. Their hasty and chaotic implementation in the form of requirements and regulations will not achieve the desired effects. The integration of the ESG policies should be carried out gradually, in stages, with an impact analysis.

Standardizing sustainable finance is a necessity. Clear goals are needed – long-term and intermediate. Supervisors should develop sound mechanisms for periodic review and analysis. Stakeholders need to be very active in discussing and in developing the underlying regulatory documents.

Regulators and supervisors should strike a balance between standards and market. Balance in regulation and the imposition of standards on markets is necessary because of the risk of demotivation for market participants to adopt ESG principles in their policies and actions. Sectoral balance is also needed. Regulators should keep in mind that banks, investment firms, insurers and pension funds are different in terms of business model and regulation and good judgment should be exercised when designing and implementing new “green” requirements.

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