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SUSTAINABLE ERM

SUSTAINABLE ERM INFLUENCES EVERYTHING FROM UNDERWRITING, PRODUCT DEVELOPMENT, CLAIM MANAGEMENT, MARKETING AND INVESTMENT TO CORPORATE STRATEGY WITH A FOCUS ON ENVIRONMENT, HUMANITY AND WELL-BEING.

BY FAN YANG

Sustainability encapsulates the concept of resilience, and the ability to maintain continuity and recover when plunged into changing circumstances. Corporate sustainability—the ability to create long-term business value—is dependent on its performance in the financial, environmental, social and governance realms. Insurers provide a unique case in sustainability since they manage not only their own risks from business activities but also the core functions concerned with customers' risks while remaining profitable. The industry bears the financial consequences of internal inefficiency, unsustainable behavior and business practices of clients and partners along the insurance value chain.

At both micro- and macro- levels, sustainability sheds light on environmental, social and governance (ESG) factors that are easily overlooked in decision-making and yet often lie at the root of an entity's rise and fall. Sustainability enables insurers to see the interdependencies of ESG risks and balance sheet risk and more accurately forecast what may occur. If insurers understand sustainability, they can be a step ahead of competitors as it challenges them to make decisions that simultaneously improve the triple bottom line: people, planet and profit.

The purpose of enterprise risk management (ERM) is to increase an

Principles for Sustainable Insurance (PSI)

1. Embed ESG issues in decision-making
2. Collaborate with clients and business partners to raise awareness of ESG issues, manage risk and develop solutions
3. Work with governments, regulators and other stakeholders to promote action on ESG issues
4. Demonstrate accountability and transparency in public disclosures on implementing the principles

Source: United Nations Environment Programme (UNEP) Finance Initiative (2012)

organization's short- and long-term value to its stakeholders. The means of accomplishing this is to assess, control, exploit, finance and monitor risks from all sources.[1] As the actual practice of ERM evolves to align with its fundamental purpose, sustainability will be recognized as a proxy of sound risk management and considered as a key indicator of a firm's health and prosperity.

The aspirational working definition of sustainable ERM (SERM) is the management of ESG issues for the purpose of stakeholders' shared value creation to realize sustainable development of the firm and the society it operates in.

This article will dig deeper into the meaning of this definition and outline characteristics and benefits of SERM. It starts with its relevance to the insurance industry.

THE GLOBAL SUSTAINABILITY TREND AND ITS IMPACT ON THE INSURANCE INDUSTRY

One major sustainability objective is to create balance among competing environmental, social and economic factors. With the growing demand from consumers, investors and regulators in a wide range of sectors such as energy, food, manufacturing and real estate, sustainability has shifted from a moral imperative to a strategic differentiator. In the banking sector, the United Nations-supported Principles for Responsible Investment (PRI) was launched in April 2006 at the New York Stock Exchange to encourage companies to take a wider view of socially and environmentally responsible investing, thus generating long-term sustainable returns.[2] For example, investors assess a company's carbon-related factors, and its relationship with customers, employees, suppliers and wider communities to evaluate its performance and future prospects. Anticipating the needs, Bloomberg started to include ESG information on its terminals in 2009. To meet with the growing interest in "green initiatives," insurers have started to offer green insurance products[3] that include green policy terms or reduced premiums for sustainable products and behaviors. During the last Earth Summit, known as Rio+20 in June 2012, leading insurers collaborating with the United Nations Environment Programme (UNEP) launched the Principles for Sustainable Insurance (PSI),[4] a global framework tailored to the insurance industry to address ESG risks and opportunities. Related practices among the signatory institutions include eco-operation, stronger corporate social responsibility (CSR) functions, and integration of ESG issues in

Premium
Coverage for ESG risks
Operating environment
Competition
Reputation

Loss
Claims
Adverse loss development
Inflation

Expense
Costs from underwriting, reinsurance and operation
Vendors, service providers
Regulatory charge

MAJOR GLOBAL PROBLEMS BY ESG CATEGORY AND CORRESPONDING INSURANCE SOLUTIONS

GLOBAL PROBLEMS		INSURANCE SOLUTIONS
ENVIRONMENTAL	Climate change, environmental degradation, water management, pollution, etc.	Property insurance, weather insurance, environmental indemnity liability, index-based products such as crop insurance, catastrophe pool, alternative risk transfer
SOCIAL	Financial inclusion, demographic change, human rights, emerging health risk such as depression, obesity, etc.	Life insurance, pension, accident and health, worker's compensation, microinsurance, general liability
GOVERNANCE	Regulations, disclosure, business ethics, information management, alignment of interest, etc.	Direct and officer liability and other commercial liability insurance

Source: United Nations Environment Programme (UNEP) Finance Initiative (2009)

product design, research and development, underwriting, investment decisions and emerging risk radar. *(See Principles for Sustainable Insurance (PSI) on page 38.)*

WHY IS SUSTAINABILITY IMPORTANT TO INSURERS?

The sustainability imperative can be illustrated in all the elements of insurer's net profit (premium – loss – expense) *(See chart to the left.)*

Premium income comes from the core business: managing risks for clients through insurance solutions and associated risk management services. The table above contains a list of selected insurance products for managing some pressing global problems. Since insurance creates sustainability value by effectively addressing ESG issues and minimizing uncertainty arising from social economic activities, sustainability lies at the heart of insurance. *(See Major Global Problems by ESG Category and Corresponding Insurance Solutions above.)*

Income outflow could result from any unsustainable activities that impede economic efficiency, fail to protect ecological systems, weaken human well-being or ignore the ethical grounding of sustainability.

Losses due to natural catastrophes possess the biggest challenges to property and casualty insurers. Climate change induced by excessive greenhouse gas emission to power the economy is associated with increasing climate perils, causing deepening economic damages around the world. Product liability and environmental liability loss are usually generated by covering products and operations that breach one or more ESG criteria. On the individual level, unhealthy lifestyle can lead to accident and health claims. Fatigue may trigger medical malpractice and worker's compensation claims. Expenses may arise from operational inefficiency, employee absenteeism, flawed processes and a weak governance structure. Insurers who do not embrace eco-efficiency are likely to forgo the opportunity cost of recycling and "go green" initiatives. Unsustainable practices such as a misaligned reward system, misrepresentation and selling inappropriate policies hold greater operational risk and reputational damage. Likewise, unrealistic return on equity (ROE) promises to the market can result in shady practice and false economies.

Equally important as net profit is the net investment. Perhaps the insurance industry is the only industry where the cost of goods sold is unknown upfront and future payouts need to be estimated. Hence, premium income and part of the shareholder's capital need to be invested in a sustainable manner to fund future obligations and insurance operation. For life insurers, sustainable investment is critical to ensure living benefits and guarantees for policyholders to thrive in the future economic environment.

In conclusion, sustainability focuses on the core business of insurers. It affects the insurers' financial statements, which directly ties to ESG performance of the company and its clients, thus making ESG assessment vital to the success of the firm.

SUSTAINABLE ERM

The purpose of SERM is to create a system where increases in the stakeholders' shared value contributes to sustainable development of the firm and society.

The definition of SERM is grounded in the belief that effective attention to ESG issues in the insurance value chain is the key to corporate sustainability. By embedding sustainability into all aspects of risk management and working in collaboration with all stakeholders, insurers can advance sustainability standards within and without. SERM revolutionizes the concepts of stakeholder, value and capital for a firm's strategic sustainable development.

Stakeholder

The company stakeholder that people think of first is the shareholder. Shareholder value, however, is determined by customer satisfaction, employee happiness, and mutual trust from regulators, rating agencies and the general public. It is the byproduct of taking care of other stakeholders. SERM goes beyond traditional stakeholders by including silent stakeholders such as the natural environment and future generations. From the standpoint of morality and long-term thinking, what this fundamentally means is to negate shortsighted, self-serving practices to gain profits upon the destruction or disregard of other life, including the environment, for ultimately the consequences would return as reputational damage or externality cost. Leadership ethics in SERM ensure no stakeholder is disadvantaged by the actions of others. Traditional shareholder value maximization theory may produce good short-term profits at the expense of reducing long-term growth by overlooking or diminishing other stakeholders' value. Many corporate failures arise from short-term fixation on increasing shareholder value by heavily relying on stock performance. The firm's commitment to foster strong stakeholder relationships is motivated by increasing stakeholder's shared value creation.

Value

SERM expands to consider intangible assets such as happiness, equity, justice and sustainability to improve long-term economic value. The biggest characteristic of SERM is enlightened value creation, which means generating shared value. Shared value focuses companies on "profits that create social benefits rather than diminish them" (Porter and Kramer, 2011). Social benefits include happiness and well-being of SERM stakeholders over the long run.

THE DEFINITION OF SERM IS GROUNDED IN THE BELIEF THAT EFFECTIVE ATTENTION TO ESG ISSUES IN THE INSURANCE VALUE CHAIN IS THE KEY TO CORPORATE SUSTAINABILITY.

Up to now, corporate value has been based on financial indicators using analytics and tools made available to them. Willard (2012) estimates that as much as 80 percent of enterprise value is now dependent on intangible factors that traditional risk management programs fail to address. There are promising developments in green accounting where social and ecological costs and benefits are integrated in traditional economic accounting systems. The participation in the Global Reporting Initiative (GRI), which combines the analyses of financial and nonfinancial performance, is increasing in different industries, including with insurers such as Aegon and Sompo Japan. Many emerging standards led by the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) are driving the needs and facilitating preparation for such sustainability reporting.[5] These new accounting and reporting principles not only support ERM to broaden the scope of value under consideration, but also help produce credible data for holistic decision-making. As sustainability issues pervade every aspect of social ethos, they will be integrated into existing financial reporting[6] and sustainability criteria are

Triple-Capital Regime

Economic capital: Financial capital to cover the economic effects of risk-taking activities

Natural capital: Natural resources and processes needed by organizations to maintain operations, produce products and deliver services

Human capital: Health, knowledge, skills, intellectual outputs and culture of the individual; it also includes human relationships, partnerships and co-operation (social capital)

Source: Porritt (2007)

likely to be adopted for regulatory solvency measurement and credit rating.

Capital
Sustainable insurance recognizes fundamental economic value of natural capital, social capital and good governance. Most analytics and resources are employed in the economic capital calculations of insurers to better estimate financial risk and formulate business strategies. To form decisions that capture the interdependencies of the firm's activities, capital management needs to expand and integrate two other important forms of capital: natural capital and human capital. *(See Triple-Capital Regime, on page 40.)*

The inclusion of nonmonetary measures of well-being in enterprise value calculation necessitates renovation of quantification tools to capture sustainability benefits. The ecological footprint developed by Global Footprint Network[7] utilizes available science to quantify natural capital under human influence. The development of far-sighted risk measures and happiness science in economics, psychology and sociology can be tailored to develop sustainability key performance indicators (KPIs) and proxy data for modeling human capital. The Big Four, which all are GRI-participating firms, now offer consulting services on developing clients' KPIs (e.g., carbon dioxide emission, gender ratio in leadership, employee turnover) and assessing sustainability goals.

Today, corporate and societal value creation is becoming more closely connected. A corporation may win over the competition by employing a sustainability strategy where environmental and social goals are incorporated in a corporate strategy as drivers

Sample Definition of Triple Capital

of financial performance. The triple-capital regime better shapes staffing and funding decisions, which optimizes resource allocation and methodology development. Ecological integrity, social benefits and solid financial performance stem from good management, fueling a virtuous cycle: Actions to increase environmental and social performance create financial capital, which allows for additional investments in natural and human capital, which again improves financial performance.

Simple SERM Program
Here is a snapshot of an insurer's SERM program. The goal is to improve business practices and offer excellent ESG coverage for the benefit of stakeholders. This fit-for-future ERM program will be built upon each company's unique ESG profile. *(See chart above)*.

Some leading insurers have started to turn their knowledge of ESG risks into operational practice and product features as well as promote a caring/inclusive work culture.[8]

For the environmental aspect, there are growing providers of green insurance to mitigate the impact of climate change. Operational excellence initiatives enable bottom-line cost savings through reducing unnecessary consumption of energy, water and paper from daily operations. Ecological literacy programs can be developed to raise environmental awareness to foster holistic thinking for sustainability stakeholder engagement.

As risk carriers, insurers provide social services through risk solutions. Leading insurers are expanding frontiers of insurability to include low-income families and cancer or HIV patients through external partnerships. Insurance is a human-capital-intensive industry and SERM recognizes employees as the true wealth of the company. Superior customer service and innovation come from great employee care. Under the SERM framework, there would be more focus on building a workplace that cultivates good qualities, inspires growth and realizes each employee's unique potential. Notably, human rights are usually regarded as basic rights to freedom and life; however, fundamentally they also include full human development, including

AXA's Corporate Sustainability

AXA, a French insurance and asset management group, identifies corporate responsibility (C.R.)* that incorporates financial, environmental and social considerations as a key driver of business value. Efforts are put to align all the activities and corporate functions with the corporate mission of "protecting people over the long term." ESG factors are actively managed in insurance business through commitment to Principles for Sustainable Insurance and embedded in investment through Principles for Responsible Investment. Each local entity has a local chief C.R. officer and is accountable for a robust and measurable C.R. approach integrated into local strategic plans. The central C.R. team led by a group chief C.R. officer regularly reports to the group's senior executive management and the board of directors. The company has innovative approaches for all stakeholders, including the environment. A C.R. score and a C.R. index are developed for stakeholder engagement and value creation.

Source: AXA (2014)

*By intention, C.R. is synonymous with sustainability.

human capacities for caring, empathy, consciousness and creativity (Ikeda 2010). Human rights, stakeholders' shared value and sustainability are a single entity. When one disintegrates, they all disintegrate.

On governance, good governance practice instills in the company the essential vision, process and structure to make decisions that ensure long-term sustainability. Establishing a culture of human rights is essential, which is to make human well-being and human happiness a consistent focus and to make business goals that internalize the concept of sustainability. ESG awareness is established at the board level and a business's approach to risks is formed from both strategic and ethical perspectives. Infrastructure and system are created to incorporate sustainability measures and goals into ERM. An ESG advisory group led by the chief sustainability officer can be added to the existing corporate structure. This team consists of people with comprehensive knowledge of environmental, social and economic aspects of the company's operations and impacts. The group examines risk indicators, risk sources and objectives to ensure effective handling of ESG risks and to improve overall company performance and value. *(See AXA's Corporate Sustainability above.)*

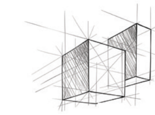
SERM AIMS TO ENHANCE THE TRIPLE BOTTOM LINE: PEOPLE, PLANET AND PROFIT. IT IS A WIN-WIN-WIN SITUATION.

SERM influences everything from underwriting, product development, claim management, marketing and investment to corporate strategy with a focus on environment, humanity and well-being, which in return contributes to long-term financial prosperity. Since a typical company's mission statement already contains commitment to ESG issues, insurers can simply start by revitalizing the original mission statement, transforming culture to reflect ESG values and aligning business models with environmental and social goals. In this way, it shapes a more coherent corporate identity. Talent and investment capital come to the firm because people want to work for and invest in good companies with good earnings prospects. By having SERM, what have traditionally been seen as "softer risks" such as trust, transparency and ethical conduct become a company's core pillars.

CONCLUSION

SERM aims to enhance the triple bottom line: people, planet and profit. It is a win-win-win situation. Companies create sustainable value by aligning business activities with the broader objectives of society: caring for the environment and the people. SERM re-orients the enterprise to function for the happiness and well-being of the people and the society by creating new value from actively considering ESG issues in decision-making.

In the increasingly complicated and interconnected world, actuaries have a valuable skill set to transform knowledge into value. Equipped with risk expertise on



ESG issues, actuaries can serve as a key asset in a company's sustainable development. Collectively as an industry, insurers have the power to improve the risk landscape through managing the ESG profile of the local communities. By being among the world's largest institutional investors, the industry also has the influence to re-channel investment from today's economy to the future's more caring and green economy.

Lastly, the transition to SERM requires culture change. In fact, the biggest challenge and opportunity for having a sustainable mindset is culture. Whether it is covering ESG risks through insurance policies or considering ESG issues in the risk management process, it requires a shift in thinking and prioritization. However, culture—a product of shared values and common behaviors—cannot be forced by strategies. The change has to come from awareness and inner resolve of individuals—with even one person developing the will for cultivating culture within while working to improve the external circumstances. Actuaries, the risk experts with an understanding of the risk state of the world, can become such a cause for effecting genuine change. A

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END NOTES

[1] Casualty Actuarial Society's definition of ERM.

[2] As of October 2014, over 1,260 signatories representing $45 trillion in assets under management have committed to the principles.

[3] For a comprehensive list of sustainable/green insurance products, see Zona, Roll and Law (2014).

[4] As of June 2014, 70 organizations had adopted the principles, including insurers representing approximately 15 percent of world premium volume and $8 trillion in assets under management. The principles are part of the insurance industry criteria of the Dow Jones Sustainability Indices and FTSE4Good Index.

[5] In 2013, 72 percent of S&P 500 companies published a sustainability report. Of the world's largest 250 companies, 90 percent issued a corporate responsibility report, of which 82 percent refer to the GRI guidelines. (Global Reporting Initiative North America 2014). According to Ernst and Young, currently 33 global stock exchanges require or highly recommend sustainability reporting.

[6] In April 2013, the European Commission announced proposals for a directive of the European parliaments and the council of the European Union that would require large companies to disclose economic, environmental and social impacts of their business as part of their annual reporting cycle. Companies are expected to start to report in 2017.

[7] For more information, visit *footprintnetwork.org/en/index.php/GFN/page/basics_introduction/*.

[8] For a select list of insurers' sustainability practices, see Strandberg (2010). Also, see PSI disclosures from signatory companies in the insurance industry on their ESG practices at *www.unepfi.org/psi/signatory-companies/*.

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