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ESG risk drivers:
Do well by doing good

ENVIRONMENTAL | SOCIAL | GOVERNANCE

Allianz Global Corporate & Specialty

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Our customers are as diverse as business can be, ranging from Fortune Global 500 companies to small businesses, and private individuals. Among them are not only the world's largest consumer brands, tech companies and the global aviation and shipping industry, but also satellite operators or Hollywood film productions. They all look to AGCS for smart answers to their largest and most complex risks in a dynamic, multinational business environment and trust us to deliver an outstanding claims experience.

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Adjusting to a world of new priorities

Environmental, social and governance (ESG) metrics can be hard to measure, but the risks surrounding them are increasing, as governments and citizens exert pressure on business to change their ways for the greater good. In this report, AGCS experts highlight some of the most pressing issues which should be on the boardroom agenda and outline how companies can mitigate risk and 'do the right thing'.

Despite the shock it inflicted across the globe, the Covid crisis does not appear to have halted the march of ESG activists and agendas into the boardroom. If anything, it seems to have accelerated it, as a concern for the collective wellbeing has been thrown into sharper relief.

Social justice protests took place during the pandemic and environmental activists took to the streets, reflecting ongoing disquiet about ESG topics like climate change and diversity.

But it's not just citizens who are putting the pressure on. Investor and shareholder action is increasingly focused on ESG, and a raft of regulation and guidance in many territories is leading to tougher disclosure and reporting rules for companies and their directors and officers (D&Os). Growing concerns about social inequalities are also leading to new requirements for businesses around diversity, pay and supply chains.

Europe is leading the way in this area. The EU Taxonomy Tool is a classification system that establishes a list of environmentally sustainable economic activities (outside of Europe a similar standard will be adopted by the Institutional Shareholder Services) and the EU Non-Financial Reporting Directive obligates companies to report on a variety of ESG-related metrics. In Germany, the Supply Chain Due Diligence Act will obligate larger German companies – and foreign companies with branches in the country – to ensure suppliers abroad comply with certain ESG requirements from January 2023.

Between 2018 and the end of 2020, over 170 ESG regulatory measures at the national and EU level have been introduced – more than in the previous six years combined – with Europe accounting for around two thirds of these. Although no global benchmark exists for ESG reporting, the regulatory environment is becoming tougher. What was once a voluntary expectation of transparency is evolving into legally mandated disclosures. At the same time, litigation or investor, shareholder and activist actions increasingly focus on ESG topics such as climate change, pollution, diversity, cyber security and CEO pay.

The impact of this on the role of risk managers and directors means that elevating and identifying ESG concerns through a business' risk registers and committees, and making sure it is understood how they will play out in and out of the boardroom, is crucial.

"Legislation is evolving," says **Shanil Williams, Global Head of Financial Lines at AGCS.** "Regulators are becoming more active, as are many other stakeholders. Companies, their D&Os – and current and future D&O insurance underwriters – need to be aware of ongoing global ESG matters in order to adequately assess potential perils and how they can manifest in terms of potential liability. If an ESG issue is not handled or disclosed appropriately by the company or board, it can result in 'bad news' in their market, 'bad news' for the company share price and 'bad news' in the form of regulatory and legal action. ESG topics can pose a significant D&O risk for companies and their insurers."

5 ESG risk topics to watch

ESG & the boardroom

ESG topics can bring significant risks for companies

E

- Climate Change
- Pollution
- Resource Depletion
- Waste
- Ecological Footprint
- Green Building

S

- Working Conditions
- Local Communities
- Supply Chain
- Health & Safety
- Employee Engagement, relations
- Customer Relations
- Data

G

- Risk Management
- Executive Pay
- Corruption & Bribery
- Board Diversity
- Tax
- Cyber Security
- D&O Liability

1. Climate change and pollution actions

The coronavirus pandemic may have pushed climate change down the list of board concerns in 2020, but a series of extreme weather events has seen it rise back to prominence this year. Unprecedented wildfires, a winter storm in Texas, the 'heat dome' over parts of North America, and floods in Europe and China have changed the perception of climate change from an abstract peril to an everyday risk. There is rising activist and societal pressure on governments and businesses to address this.

The sense of urgency has been heightened by the recent landmark report from the UN-backed Intergovernmental Panel on Climate Change (IPCC)[1], which issued a "code red for humanity" and warned the world is likely to reach the key 1.5°C warming threshold within 20 years unless fast and far-reaching action is taken to cut emissions. "It is unequivocal that human influence has warmed the atmosphere, ocean and land," write the report's authors. The report comes ahead of the COP26 UN Climate Change Conference in Glasgow in November 2021, when delegates will attempt to finalize the 'Paris Rulebook' – the rules required to implement the Paris Agreement.

As the world transits to a low-carbon future, we are seeing a surge in climate-related legislative activity and a change in the regulatory landscape. In the US, President Joe Biden has pledged to cut carbon emissions by 50% by 2030 (from 2005 levels) and set the country on a path to carbon neutrality by the middle of the century. The European Green Deal sets out similar carbon-reduction goals.

Climate-change litigation is increasing, with 'strategic' cases – or those that aim to create a societal shift – dramatically on the rise. According to a report published by the London School of Economics[2], the cumulative number of climate change-related cases has more than doubled since 2015. Just over 800 cases were filed between 1986 and 2014, while over 1,000 cases have been brought in the last six years. Much of the litigation has been around disclosure, when companies and boards have failed to adequately disclose the material risks of climate change. For example, there have been lawsuits in the US where it was alleged companies did not disclose changes in the environment that were leading to wildfires and how this could negatively impact the business.

Companies' boards of directors have a vital duty to ensure solid corporate climate responsibility with appropriate reporting and due diligence. The prospect of climate change litigation risk increases the more there is a discrepancy between what a company does and says internally and what it does and says externally (even further to the extent to which any public statements or actions of a company might contravene a legally-binding framework).

Pollution and environmental disasters are also an area of concern. Following incidents such as the explosion of hazardous cargo or the collapse of a dam affecting an ecologically sensitive area, the boards and directors of companies involved are being increasingly questioned about their risk-management strategies to prevent such events and the extent to which they were aware of potential risks.

1 IPCC, Climate Change 2021, The Physical Science Basis, Working Group contribution to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change
2 LSE, Global trends in climate litigation: 2021 snapshot, July 2, 2021

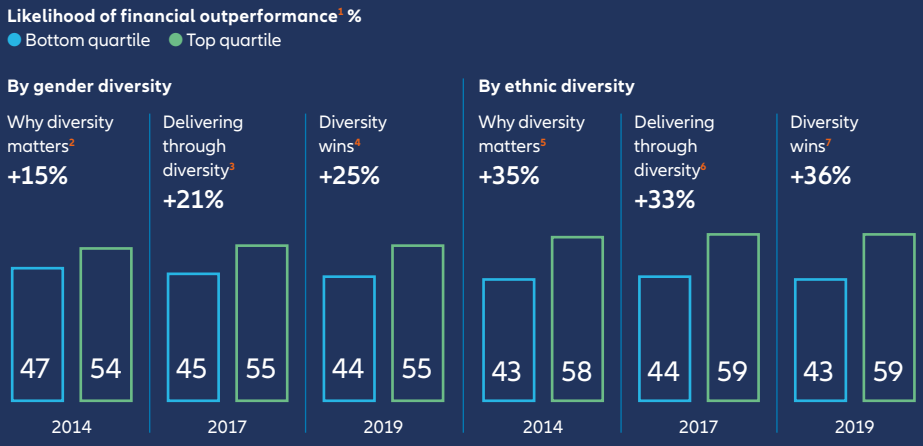
2. Board diversity

Diversity issues are growing in prominence and businesses are coming under increasing scrutiny. This was seen in the wake of the Black Lives Matter protests of 2020, which were followed by an uptick in diversity-related litigation, particularly in the US. Cases typically allege a failure in the fiduciary duties of directors given the inadequate level of diversity on the board or in management positions. With changes in regulation and legislation on diversity increasingly likely, D&O litigation risk will increase further still. As will the risk to a company's reputation if it is deemed negligent in this area. For example, the US Securities and Exchange Commission (SEC)[3] recently approved a proposal from stock exchange operator Nasdaq that requires its listed companies to have diverse boards or explain why they do not. The UK's Financial Conduct Authority is exploring diversity requirements as part of its listing rules.

Diversity has been shown by a number of studies to bring better risk management and financial performance to a board. A study in 2019 by McKinsey & Co showed companies in the top quartile for gender, ethnic and cultural diversity on their executive team were 25% more likely to have above-average profitability of outperformance on the earnings before interest and taxes (EBIT) margin than companies in the fourth quartile[4]. Diversity also brings advantage to recruitment and can help address skills gaps and shortage of talent.

In an ever-more interconnected world, diversity of race, age and gender should be a governance priority for all boards of directors. While it might be too early to talk about a D&O claim trend, the frequency of diversity lawsuits brought since the beginning of July 2020 should raise the concern that any company lacking racial, gender and age diversity in its board of directors might be impacted by similar lawsuits. One other expected impact on the D&O insurance market is the type of information underwriters will be looking for and questions that can be expected at customer/carrier meetings. D&O underwriters will increasingly be interested to understand how important diversity, equality and inclusion are to the management team and how this is reflected in related key performance indicators.

The business case for diversity in executive teams remains strong



Source: McKinsey, Diversity wins: How inclusion matters

1 Likelihood of financial outperformance vs the national industry media; p-value <0.05, except 2014 data, where p-value <0.1.
2 n = 383; Latin America, UK and US; earnings before interest and taxes (EBIT) margin 2010-13.
3 n = 991; Australia, Brazil, France, Germany, India, Japan, Mexico, Nigeria, Singapore, South Africa, UK, and US; EBIT margin 2011-15.
4 n = 1,039; 2017 companies for which gender data available in 2019, plus Denmark, Norway, and Sweden; EBIT margin 2014-18.
5 n = 364; Latin America, UK, and US; EBIT margin 2010-13.
6 n = 589; Brazil, Mexico, Singapore, South Africa, UK, and US; EBIT margin 2011-15.
7 n = 533; Brazil, Mexico, Nigeria, Singapore, South Africa, UK, and US, where ethnicity data available in 2019; EBIT margin 2014-2018.

3 Reuters, US markets regulator approves Nasdaq proposal to require corporate board diversity, August 7, 2021
4 McKinsey, Diversity wins: How inclusion matters, May 19, 2020

3. Greenwashing

As the pressure on businesses to improve their carbon credentials mounts, concerns have been raised about 'greenwashing' – when businesses produce misleading information to exaggerate their ESG credentials and present a more responsible public image. With legal action by stakeholders and investors in this area on the rise, directors should be wary of setting unrealistic ESG targets they might fall short of or they could become the subject of litigation. For example, pressure groups often use institutions' own ESG reports when it comes to assessing progress on carbon-neutral targets.

Such is the concern about greenwashing in the UK financial services sector that the Financial Conduct Authority (FCA) recently published a letter to the chairs of fund managers setting out guiding principles and raising the prospect of future reform. It is also consulting on new rules that will align with recommendations from the Task Force on Climate-Related Financial Disclosures. In the US, investors have pressed the SEC for more disclosures on ESG issues, and it may introduce new rules in October. The EU's Sustainable Finance Disclosure Regulation, which came into effect in March, also mandates more transparency from financial services companies in this area.

"Companies that commit to addressing climate change, diversity and inclusion, and other ESG concerns will need to be true to their word," says **Chris Bonnet, Head of Environmental, Social and Governance (ESG) Business Services at AGCS.** "If they don't follow through, it could come back to haunt them."

> "Legal action by stakeholders and investors is on the rise

4. CEO pay

> Nearly half of FTSE 100 companies have linked executive pay to ESG targets

Executive remuneration is another potential hot potato, particularly for investors. Norway's $1trn sovereign fund – one of the largest in the world – is just one that has developed active stewardship of management compensation proposals in the companies it invests in, amid concerns about pay transparency. Several large global companies have announced they are linking executive pay to ESG and climate-related targets and outcomes, such as greenhouse gas reductions. Nearly half (45%) of FTSE 100 companies have linked executive pay to ESG targets, according to research published by Pwc[5], with just over a third including an ESG measure in their bonus plans.

Although metrics such as health and safety, risk, and employee engagement have been a component of bonuses for some time, the newer ESG targets in executive pay reflect emerging stakeholder concerns around climate change, sustainability and diversity.

Investors are increasingly expecting boards to reflect a broader view of corporate responsibilities to their stakeholders but their targets need to be realistic and attainable or they may not stand up to scrutiny.

5 Pwc, Paying well by paying for good.

5. Cyber security

Whether it's the rise of home working, the acceleration of digitization, or the far-reaching effects of the ransomware attack on the Colonial Pipeline in the US, the potential and actual vulnerabilities exposed by cyber-crime and other cyber incidents have become shockingly apparent over the last year. The consequences of a data breach in terms of financial and reputational costs to a company can be grave – even if it is the result of an accident – and high-profile cases have raised ESG concerns, particularly surrounding the sustainability of businesses.

Investors are increasingly concerned to establish the cyber resilience of companies. Potential cyber exposures are becoming an essential part of any M&A process, especially as an acquiring business can be liable for incidents predating a merger. This was the case in 2018, when the hotel group Marriott was fined $20mn+[6] for a data breach that affected millions and was traced to a cyberattack in 2014 on Starwood, a group it had acquired in 2016.

"Cyber security is a big governance topic for companies – making sure it is understood at the board level and that cyber risk-monitoring processes are in place," says **Shanil Williams, Global Head of Financial Lines at AGCS.** "The main complaint from the investment community has been around transparency. It is hard to understand a company's cyber risks. And companies for various reasons have been slightly hesitant to provide enough transparency but the ones that do certainly see the benefit."

> "Companies that are transparent certainly see the benefit

6 BBC, Marriott Hotels fined £18.4m for data breach that hit millions, October 30, 2020

ESG best practice: What do boards need to know?

Michael Bruch, Global Head of Liability Risk Consulting/ESG at AGCS, answers the key questions.

Q: Which areas of ESG are causing the most concern, and what is the role of the risk manager and board of directors in overseeing these?

A: ESG investment is growing significantly and we are seeing several important trends emerging, in particular surrounding climate change, human-rights violations and severe corruption allegations. The major challenge for corporates is that there is no standardized approach to calculating ESG metrics. Truly understanding the relative benefits and limitations of the various metrics can help to build a more complete ESG picture and highlight opportunities for change. So, for example, risk managers need to be able to assess the ESG risks associated with any transaction and – crucially – they also need to be able to inform others of the nature of those risks.

It's important to note, however, that identifying and mitigating risks is not limited to the risk-management function in a company. ESG risk topics should be integrated into enterprise risk management and all relevant operational processes. What we are noticing in many of the industry sectors of our client community – and in particular the power and utilities sector, which is heavily challenged by the transition of its own business model into a more green energy-related power supplier – is that ESG and sustainability are having a high impact on virtually all functions within the company.

Q: What are the consequences for companies that don't meet ESG expectations or fail to live up to their own commitments?

A: The consequences can be severe – and far-reaching. Take climate-change litigation as an example. Climate change is a subject that cuts across all stakeholders as well as company employees. So we have seen increasing levels of engagement from employees, who want to know that their employer is doing the right thing by the environment. At the same time, there are institutional investors – pension fund and fund managers – pushing for more action from boards to protect the environment. And then there's the question of reputational risk. If companies don't live up to their commitments or, worse still, if they attempt to greenwash their credentials, their reputation can plummet. Disclosing misleading corporate messages about climate-change impact poses a severe risk in terms of company liability.

Q: We know that climate change is one of the key ESG factors driving litigation and investor/shareholder actions against companies. But how widespread is this kind of action?

A: According to the London School of Economics (LSE)[7], there have been more than 1,800 cases of climate-change litigation in 40 countries as of the end of May 2021. The majority were in the US (1,387), followed by Australia (115), the UK (73) and the EU (58). The numbers are steadily growing, and the implications are significant.

In a recent landmark ruling, for example, a Dutch court ordered Royal Dutch Shell to reduce its carbon emissions by 45% compared to 2019 levels by 2030[8] – much deeper cuts than it had planned. The ruling only applies to the Netherlands, but it could have wider consequences for the energy industry elsewhere. For the moment, this kind of litigation remains concentrated in high-income countries, but we've seen cases in Colombia, India, Pakistan, Peru, the Philippines and South Africa. We expect it will continue to grow in the Global South.

7 LSE, Global trends in climate litigation: 2021 snapshot, July 2, 2021
8 BBC, Shell: Netherlands court orders oil giant to cut emissions, May 26, 2021

Q: What other tips can you suggest to identify and mitigate ESG risks?

A: What we have learned from our own ESG experience is that you need a strong commitment to ESG at the management and board level, setting specific targets from the top down. Within Allianz, we have implemented our own ESG board, so that all the important group centers are really committed to sustainability and the ESG topic.

The board must acquire the appropriate skills that will enable it to fully understand what the external requirements are for a successful ESG strategy in the long term. ESG matters should be a regular fixture on boardroom agendas, and that way of thinking should be embedded throughout the organization. It should ultimately become part of the company DNA so that everyone sticks to it, everyone embraces it, and at a certain point no one even thinks about it because it's an integral part of all your processes and everything you do.

At the same time, ESG information can also help to improve the underwriting process, to the benefit of insurers and companies. We have statistically modeled a lot of ESG data points against claims and public litigation and we do see some predictive power there. From an insurer's point of view, conversations around ESG-related topics, in addition to financial topics, are becoming much more important.

Podcast

Find out more by tuning into the AGCS podcast:
ESG and the insurance industry

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