American Academy of Actuaries

Issue Brief

ESG and the Actuary

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Key Points

- Certain actuaries, regardless of whether they function as financial reporting actuaries, might play a role in and carry responsibilities associated with the environmental, social, and governance (ESG) disclosures featured in a company's financial statement.
- The involvement of principals in ESG investing is expanding the role of actuarial responsibilities, making the awareness and analysis of ESG positions more prominent.
- This issue brief considers some of the basics of ESG as actuaries consider how ESG may impact their work, including the general definition of ESG and ESG scoring of companies, ESG and various investment themes, ESG and climate change-related investing, pension plans, and ESG financial disclosures.

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This issue brief is intended to present some of the basics of environmental, social, and governance (ESG) as actuaries consider how ESG may impact their work.

Actuaries may work with ESG directly or indirectly in a number of areas, regardless of their line of business or role within an organization. For example, some actuaries may have input into and responsibilities related to the ESG disclosures that are included in a company's financial statement disclosures, whether or not they are financial reporting actuaries. These disclosures are not just numerical measures, but also speak to the activities and risks that combine to present a picture of a company's approach to ESG.

Other actuaries may work in investment areas analyzing alternative investments opportunities. To the extent their principals are actively engaged in ESG investing, the awareness and analysis of ESG positions are becoming an increasingly larger part of actuarial responsibilities. Further, any actuary considering asset liability matching and the risks of changes in rate-of-return assumptions for the assets backing a set of liabilities may need to consider the ramifications of ESG. If the actuary is working with a portfolio of assets that is in the process of being reinvested in securities based on ESG considerations, the change may influence the assessment of risk margins within the valuation assumptions. An enterprise risk management actuary would also need to build alternative considerations into risk models based upon their view of an investment portfolio and its ESG profile, and its associated alternative outcomes.

Many actuaries need to understand what ESG is, as well as how and why it impacts their current and future work. This issue brief offers some insight and things to consider as we consider the growing influence of ESG in actuarial efforts.

Definition of ESG

The term “ESG” is commonly misunderstood, as most people think it only applies to environmental initiatives. However, it also encompasses both social and governance activities.

“E” stands for “environmental,” and pertains to initiatives that may have an impact on things such as waste, pollution, natural resources, or climate change. These activities can be direct (e.g., emissions produced) or indirect (e.g., compliance with environmental regulations).

“S” refers to “social,” and includes activities that benefit the community, people, and corporations. The common belief is that social projects concentrate on things such as building bridges, dams, or hospitals. However, the term also refers to projects and financing programs addressing the needs of underserved groups and aiding local communities.[1]

“G” stands for “governance,” referring to initiatives undertaken by a company’s board of directors, its senior management, and its employees to drive positive change addressing issues such as LGBTQ+ equality, racial diversity, hiring practices, and addressing the needs of other stakeholders, including shareholders.

ESG Scoring of Companies

Research firms such as Bloomberg, S&P Dow Jones Indices, JUST Capital, MSCI, and Refinitiv provide ESG scores on individual companies. The first step in obtaining an ESG rating requires a company to complete a lengthy questionnaire providing information to the research firms about its ESG activities. Next, scores prepared on these proprietary

1 “Sustainable,” a sometimes-alternative definition to the S term, refers to the transition toward an environmentally sustainable economy. Access to capital is required to invest in clean energy initiatives in order to make the transition to this state. Agricultural and catastrophe components of property insurance act as a risk mitigation tool to protect an economy against losses arising from a catastrophic event, and thus promote sustainability.

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The remainder of the committee reviewed various drafts of the paper: Dorothy Andrews, MAAA, ASA; Amy Angell, MAAA, FCAS; Shidan Chen, MAAA, FSA; Seong-min Eom, MAAA, FSA; Shiraz Jetha, MAAA, FSA; Margot Kaplan, MAAA, ASA, FCA; Kenneth Kent, MAAA, EA, FCA, FSA; Stephen Kolk, MAAA, ACAS; Stuart Mathewson, MAAA, FCAS; Charles Merz, MAAA, FSA; Robert Montgomery, MAAA, ASA; F. Ronald Ogborne, MAAA, FSA; Peter Ott, MAAA, FCAS; Rebecca Owen, MAAA, FCA, FSA; Jason Pessel, MAAA, FCAS; Linn Richardson, MAAA, FSA; Sandra Schrader, MAAA, FCAS; Andrea Sellars, MAAA, FSA; Mark Shemtob, MAAA, EA, FSA, MSPA; Lisa Slotznick, MAAA, FCAS; Charles Wisehart, MAAA, FSA; Michael Woods, MAAA, FCAS; Michelle Young, MAAA, FSA; and Navid Zarinejad, MAAA, FCAS.

scoring systems often use a 100-point scale, where a high score indicates the company is better at meeting different ESG criteria. Each firm has its own metrics, weightings, and scoring systems.[2]

ESG and Equity Investing

ESG equity investing means investing in companies that score well in environmental, social, or governance considerations. ESG equity investors invest in companies they believe strive to make the world a better place, or are positioned to do well in the future against risks such as climate change, reputation, etc.

ESG equity investing relies on independent scoring and grading systems done by outside advisory firms that help investors assess a company's practices and policies with respect to environmental performance, social impact, and corporate governance performance. Currently, there is very little standardization or definition in the measurement of a company's activities in each of these three areas. These third-party impact consultants play a key role in the ESG investment selection process by reviewing ESG scores of companies and advising clients on which securities to invest in. Morningstar Investment Rating Services has constructed several index funds comprised of common stock investments of large cap companies with high Morningstar-derived ESG scores, allowing for the comparison of investment return results against other comparable large-cap funds within its proprietary rating system.[3]

ESG and Fixed Income Investing

ESG scores for fixed income investments are determined by specialists using separate ESG factors that identify ESG-related credit risks. Investment management companies, such as Pimco, Black Rock, and Morningstar, integrate ESG factors as part of their underwriting processes. [4,5] An ESG risk assessment is performed, which supports the traditional credit rating analysis. The portfolio investment manager, the ESG specialist, and the investment underwriter will often hold in-depth discussions with the lender and borrower regarding the results of the ESG risk assessment tests. In addition, specialized consulting firms focused on evaluating ESG activities can often provide recommendations to improve the ESG scores.

2 "Environmental, Social and Governance: What is ESG Investing"; Benjamin Curry and E. Napoletano; Feb. 24, 2022.
3 "ESG"; Morningstar; 2023.
4 "ESG-Investing"; Pimco; *2023.*
5 "ESG-Fixed-Income"; BlackRock; 2023.

ESG frameworks for corporate bond issuers are often based on sector and business profiles. Issuers in the energy and natural resources industries are often included in categories where environmental factors have the largest weight. Social categories generally have the largest weight for pharmaceutical debt issuers. Governance activities will frequently have the largest weight for financial services companies.

The overall score is based on an assessment for each of the ESG factors. The assessment reviews the strategic fit between the lender's environmental, social, and governance strategies, which is then compared against the use of the bond's proceeds. The goal for fixed-income investment managers is to identify leading ESG issuers versus issuers that are less advanced with respect to ESG scores.

Climate Change Investing

Certain investors may believe that climate change presents tremendous investment opportunities for those willing to invest in companies offering "next-generation" climate change technologies that reduce carbon emissions. These investors are aware of the risks arising from climate change and the long-term impact carbon emissions have on the sustainability of the current environment to future generations. Their focus is to invest in companies that provide solutions to address climate risk.

Net-Zero Emissions Investing

Another closely related investment theme is net-zero emissions investing. There is a difference, however, between net-zero emissions investment strategies and ESG investment strategies. Net-zero emissions investing pertains to a company's commitment to the complete elimination of hydrocarbons from its business model, which is a more narrow focus on addressing the risk of climate change when compared to the broader ESG focus.

Other ESG-Related Investment Themes

Other related investment themes include "impact investing," "alternative investing," and "socially responsible investing." "Impact investing" is an investment strategy that aims to generate specific beneficial social or environmental effects in addition to financial gains. The goal of "alternative investing" is to maximize potential returns and assume additional risk by focusing on investments in early-stage companies. "Socially responsible investments" allow investors to take positions in companies that agree with the investor's specific social values. If, for example, health and well-being are key values, then investments in alcoholic beverages or tobacco companies are likely avoided.

Private Pension Plans and ESG

A November 2022 press release from the U.S. Department of Labor announced a final rule that allows private pension plan fiduciaries to consider climate change and other ESG factors when they select retirement investments and exercise shareholder rights, such as proxy voting. This is a major change from the late 2020 policy, instructing fiduciaries to strictly adhere to financial concerns when making investment decisions. Questions will continue to arise about how to apply the new standards to ESG investments. Additional future changes to fiduciary standards affecting both corporate pension plans and individual 401(k) investment accounts will likely impact demand and supply for ESG investment portfolios.

Public Pension Plans and ESG

States are becoming more interested in the construction and composition of ESG funds in state-sponsored retirement plans. Some states are considering legislation encouraging consideration of environmental factors or restricting investments in gun companies in state-sponsored pension plans. Other state legislatures have passed or proposed bills that ban ESG investing altogether in state-sponsored retirement plans.

Other ESG Investment Classes

There are a wide variety of ESG investment classes that are available to individual, institutional, pension plan, and corporate investors, each reflecting different risk and return profiles. ESG asset classes include the aforementioned equity and debt classes, but also can include joint venture, and partnership investments offered by both public and privately held companies.

ESG Investment Returns

Investing has the potential for higher-than-expected as well as lower-than-expected returns. A current topic in the investment world that is highly debated is whether investment returns on ESG portfolios are less than comparable investment returns earned on non-ESG portfolios. Although there is some evidence of higher ESG fund returns, there is also some evidence of lower returns, depending on the study and the time period.

A particular risk for ESG-based investing relates to potentially higher expense ratios associated with the research needed to determine the ESG scoring and the investment selection process, thus reducing the net returns on the investment.

Outside of ESG mutual funds, there are many other forms of privately held ESG investments. These include partnerships and joint ventures commonly referred to as Schedule BA assets, mezzanine lending made to early-stage companies, real estate, and private equity and private placement investments. The risk, return, and capital profile on these classes differs from investments held in publicly traded ESG funds. There is often a lack of transparency with privately held ESG investments, however, and it can be difficult to obtain investment return information in order to truly understand investment performance.

Very recently, there have been some questions as to whether financial firms should concentrate on financial performance rather than other considerations, such as ESG.[6]

6 "BlackRock and Vanguard were once ESG's biggest proponents—now they seem to be reversing course"; *Yahoo Finance*; Sept. 13, 2023.

Climate Change Investment Risks

Investors and portfolio managers wishing to reduce exposure to investments subject to climate risk may rebalance investment portfolios. Investment risks associated with climate change in investment portfolios include Physical, Transition, Portfolio Rebalancing, and Stranded Asset Risks. These terms are defined in the *Glossary of Climate Change Terms and Definitions*, published in May 2023 by the American Academy of Actuaries.

ESG Scoring Risks

ESG investing relies primarily on ESG scores, but there is an additional risk that investment asset classes cannot be thoroughly evaluated by ESG research firms or fund managers due to a lack of publicly available information. Currently, ESG scoring—and thus the makeup of a particular ESG portfolio—is based upon a particular fund manager's proprietary ESG scoring model. In addition, publicly available information that is used within the scoring system to determine an individual company's ESG score may not necessarily be on the same basis, or even indicative of actual ESG accomplishments, which the score implies. There is also the additional investment risk that arises from the lack of comparability and credibility.

The evaluation of risks within an ESG portfolio will also require a thorough review of each investment holding in the ESG portfolio to understand the nature of the risk and potential tail volatility arising from governmental, legislative, and regulatory developments. The presence of a high ESG score does not eliminate the need for a thorough review.

ESG Financial Disclosures

For publicly traded companies, disclosures related to ESG and associated risks are often included in the information provided to shareholders. Currently, there is very little guidance to companies on how to compose these disclosures. Consequently, there is very little consistency among the disclosures, which impedes the ability for comparability. The Securities and Exchange Commission is in the process of standardizing guidelines for both climate and ESG disclosures in required financial filings; however, it is not clear when such guidance will be completed. Similarly, in the international community, the IFRS Foundation has created the International Sustainability Standards Board (ISSB), which is working to standardize disclosures.

Domestically, California is moving ahead with state legislation that would require major companies to publicly disclose greenhouse gas emissions directly emitted by their operations, as well as the amount of indirect emissions, such as employee travel, waste disposal, and supply chains.[7] Should California's proposal pass, it is likely that other states would be prompted to follow suit and adopt of similar disclosure requirements. Whether or not such state mandates would comport with federal regulations or create state-federal conflict is still to be determined.

Summary

Although not free of challenges and issues, ESG investing is rapidly growing in popularity. There is mixed opinion on the returns of ESG funds compared to non-ESG funds, and there are concerns around ESG score transparency. Greater transparency and company responsibilities will also continue to lead the public policy and governance discussions. The answers to these questions will provide actuaries greater opportunities to better understand how to evaluate risks within ESG portfolios and in the preparation of ESG disclosures.

Role of the American Academy of Actuaries Climate Change Joint Committee
The American Academy of Actuaries has established a Climate Change Joint Committee that oversees the ongoing work the Academy is undertaking on Financial Statement Disclosures and the Actuaries Climate Index. But in addition to those ongoing activities, the Academy provides input to various public policy stakeholders who are seeking ways of increasing climate change awareness. Academy volunteers provide presentations as well as comment letters that make use of Academy research as well as additional knowledge and thoughts based on questions these stakeholders ask. The Academy prepares work products, such as this issue brief, that emphasize the range of actuarial issues that climate relates to.

7 "California Governor Set to Sign Landmark Disclosure Bill"; *New York Times*; Sept. 18, 2023.

The American Academy of Actuaries is a 20,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.