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How does ESG impact the unit-linked life insurance products?

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Abstract
This article deals with the influence of ESG criteria on unit-linked life insurance. Corporate social responsibility, or the application of ESG criteria in their corporate and product design, is an essential competitive factor for providers of unit-linked life insurance today. This development is driven by the expectations of customers and other stakeholders of insurers, regulatory requirements, and especially the growing economic importance of sustainable investments for long-term competitive success. Today, sustainability has a significant influence on the economic performance and crisis resilience of companies - unit-linked life insurance must therefore also invest in line with the fulfilment of sustainability criteria by its investment partners in its investment strategies. Such an approach - including the alignment of the company's own management with ESG criteria - is gradually gaining acceptance in the industry, although various obstacles still need to be overcome. The goal of the sustainable orientation of unit-linked life insurance should be to develop holistic concepts for its ESG performance and ESG investments based on structured processes and sound quality screening.
Key words: *unit-linked life insurance, ESG, Environmental Social Governance, ESG criteria, ESG rating*

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I. Introduction

ESG (Environmental Social Governance) describes responsible corporate action that integrates social and environmental concerns into the business activities of companies and their interactions with stakeholders and entitled parties on a voluntary basis. It can thus be seen as part of an overarching corporate governance that understands sustainability in a comprehensive sense as a component of corporate management (Euramco, 2021). Due to the EU Directive 2014/95/EU, the integration of non-financial reporting or sustainability reporting is mandatory for larger and listed companies as well as for financial service providers (Amtsblatt EU, 2014; Deloitte, 2017). As a result of an amendment to this directive on corporate sustainability reporting (published on April 21, 2021), the sustainability-oriented reporting obligations will be immensely expanded once again from 2022. Among other things, the focus will be on the implementation of binding standards and quality criteria to meet the information needs of financial market participants and to minimize systemic risks regarding financial market stability (Schönauer, 2022; European Commission, 2020).

Today, the issue of sustainability also plays a role for capital investments. For example, in Germany, the market volume for sustainable investments almost doubled between 2019 and 2020, while the investment market only grew by 37% in the same period. So far, this trend has been driven primarily by private investors (Moshuber, 2022). In addition, new ESG trends and priorities are currently becoming visible as result of the Covid 19 crisis: for example, many ESG portfolios performed comparatively well under the conditions of the pandemic - among other things, because various industries that were severely affected by the crisis, such as the oil industry or airlines, were not part of the investment toolkit. At the same time, there are signs of a stronger focus on social issues compared with the earlier ecological focus of the sustainability discussion. Asset managers and fund managers are increasingly focusing on ESG when investing their clients' money and are also leveraging their market power vis-à-vis the companies in which they invest. This may involve direct demands on management, but also corresponding influence through their voting behaviour at shareholder meetings. Many sustainable companies present themselves with very good opportunity-risk profiles. On the one hand, they often operate in dynamic markets with good future prospects. On the other hand, they have lower risks - for example in the dimensions of reputation or future viability. This also has a positive impact on the returns of sustainable investments. Studies and are in some cases quite capable of outperforming classic investments without an ESG focus (Moshuber, 2022).

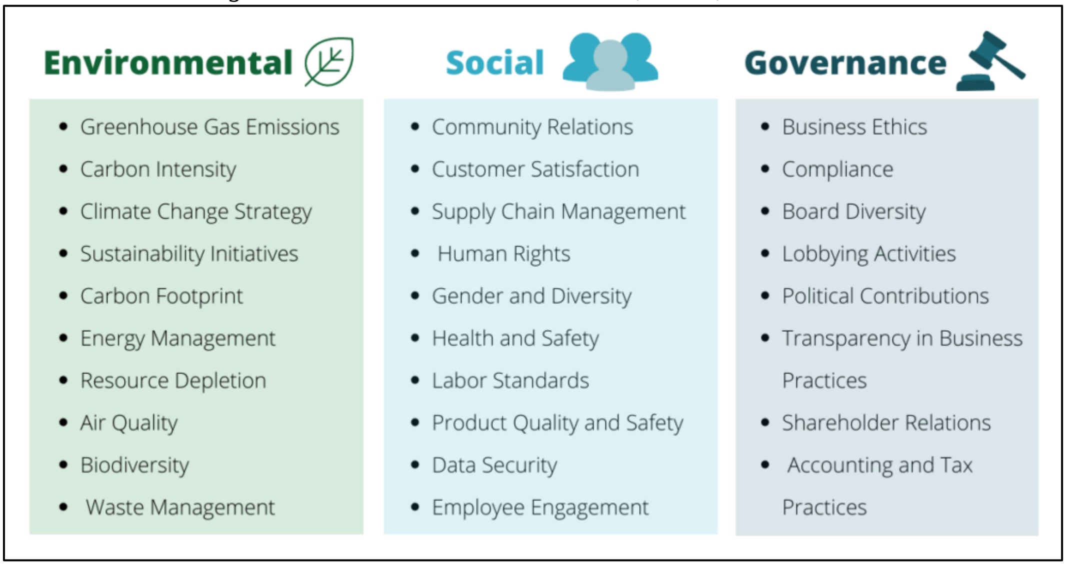
This also has consequences for unit-linked life insurance. Against the backdrop of the general trend toward corporate sustainability - on the part of consumers, but also as result of regulatory requirements - ESG bears the character of a future trend that insurers must consider from the customer perspective as well as regarding their return planning and their risk management. This article looks at these new requirements for unit-linked life insurance in terms of the current status quo, relevant future scenarios, and possible strategies for investing customer funds.

II. The ESG criteria and ESG ratings

In general, the ESG approach provides information on investments outside of the traditional financial indicators and thus enables a comprehensive assessment of investments. The United Nations, together with investors, has established six principles for incorporating ESG criteria into investment processes (KlimaVest, n. d.).

The ESG criteria comprise the dimensions of environment, social and corporate governance, for each of which verifiable criteria have been developed. Figure 1 provides an overview.

Figure 1: ESG Criteria - Environmental, Social, Governance



Source: US Gain, 2022.

The ESG criteria form the basis for ESG ratings, which are made by corresponding rating agencies using different approaches. Unlike conventional rating agencies, which only examine and evaluate the financial status of a company, ESG rating agencies assess the strengths and weaknesses of companies' social and ecological actions as well as the sustainability of their corporate governance. In some cases, they focus exclusively on the degree to which ESG standards are met, while in others they also include economic considerations, so that direct investment recommendations can be made regarding the most interesting stocks from a financial and ESG perspective (Euramco, 2022; Moshuber, 2022). ESG ratings enable greater transparency regarding the relevant investments in each case. Specific weightings are applied to the various sustainability dimensions and factors in the ratings - however, it should be noted that the various rating agencies use different assessment and weighting methodologies. In practice, most ESG rating agencies work with exclusion criteria - companies that do not meet certain criteria and values are excluded from the investment portfolio (exclusion procedure). In other ratings, positive criteria are also used - in this case, the best-in-class principle is used to assess whether a company is one of the most sustainable players within its sector. The ESG approach thus provides information on capital investments that goes beyond classic financial ratios and enables a comprehensive assessment of shares and funds (KlimaVest, n. d.; Lindmayer & Dietz, 2020, p. 201 ff.; Moshuber, 2022). Legislation has not yet mandated these ratings, but in practice their importance now goes far beyond the level of a "nice-to-have" and is now a strong focus from a stakeholder perspective. However, the absence of regulation is problematic regarding the comparability of ratings. Aspects that point in such a direction and aim at higher standardization of ESG assessments are currently the EU regulation on climate taxonomy as well as a declaration of intent by the financial sector to voluntarily define principles for responsible investments and to use them as a basis for investment decisions. Worldwide, more than 2,400 investors managing a fund volume of 86 trillion U.S. dollars have already signed the Principles for Responsible Investments, thereby committing to incorporate ESG criteria into their investment decisions (Hübner, 2021). Generally speaking, a paradigm shift in the weighting of ESG criteria is currently taking place, at least in terms of content: After ecology had long been the focus of sustainable investment decisions and thus also of rating processes due to climate change, social aspects are currently gaining in importance - partly due to the effects of the Corona pandemic - not only with regard to anti-discrimination measures and the sustainable design of supply chains, but also with regard to the realization of employee rights (Moshuber, 2022).

III. ESG and sustainability in unit-linked life insurance

In the unit-linked life insurance segment, it is becoming apparent that investments based on ESG criteria are playing an increasing role. In the European Union, the trend toward sustainable insurance products is also being driven by the EU's new Financial Markets Directive (MIFID II), which will come into force in 2022 and stipulates, among other things, that insurance intermediaries must explicitly offer sustainable insurance products to their clients. A survey conducted in the summer of 2022 among 26 insurance companies active in the EU shows that insurers were already stepping up their commitment to sustainable investments at that time. The focus was on actively managed ESG funds, while ETFs have so far played a secondary role (Fonds Professionell, 2021).

At the same time, insurance companies are in the process - in view of corresponding expectations of their customers as well as the public at large - of profiling themselves as sustainable organizations. According to a survey conducted by the consulting firm Bain & Company with 43 leading insurers, the Corona pandemic and the high demands on corporate resilience resulting from it, on the one hand, and growing pressure from institutional investors, rating agencies, regulatory authorities, and other corporate stakeholders, on the other, are acting as ESG drivers in the industry. In particular, the study participants cited the following factors as relevant reasons for a stronger sustainability focus: relevance to investors (49%), risk mitigation and customer expectations/retention (47%), profit optimization (40%), corporate public reputation (35%). Employee engagement and retention (33%), and cost savings (23%). In contrast, a corresponding "passion" among senior management (16%) and ESG as an innovation driver (7%) were of secondary importance. However, to realize their sustainability ambitions, companies need to overcome various internal obstacles - foremost among these is a lack of organizational alignment with ESG requirements. Overall, unit-linked life insurance providers, like the whole industry, face the task of aligning sustainability and their corporate strategies, translating their ESG ambitions into products and services, redesigning their business models accordingly, and assessing sustainability-driven progress using a combination of financial and non-financial indicators (Goosens, D'Acunto & Pallotta, 2021, based on Bain Sustainability Transformation Survey, 2021).

At insurance companies such as Foyer Group/Wealins, Octium, or Zurich, the development and implementation of sustainability strategies are now an integral part of their corporate governance. Internal sustainability - for example regarding excellent working conditions, employee involvement and employee rights - and sustainable investments form a single entity (Foyer, n.d.; Octium, 2021; Zurich, n.d.). Zurich highlights four basic requirements for integrating sustainability into its own corporate activities and - implicitly - throughout the industry: training, information, and active ownership by employees and decision-makers. ESG is incorporated into all investment decisions at this company, and sustainability skills and commitment are also important in the selection of portfolio managers and other executives, as well as a key component of performance measurement. The four defined sustainability requirements are evidenced by specific KPIs. In this context, ownership includes, for example, discussing ESG issues with potential investment partners (companies or fund management companies) as part of a clear, structured, and documented process (Zurich, n.d.).

IV. Conclusion

Generally speaking, sustainability and thus the practical implementation of ESG criteria are of growing importance in the financial industry and thus also in unit-linked life insurance. This trend is based on the following factors, which include, for example, corresponding expectations of customers and other stakeholders as well as the significance of ESG for the expected returns and risk management of insurance companies. Overall, ESG must now be viewed not only as an ethical obligation of the insurance industry, but also as a key profit driver and economic resilience factor.

Independent research on the implementation of ESG in unit-linked life insurance has been very limited. From the available sources and from the publications of various insurers, the industry is currently engaged in intensive efforts to align its business models not only with economic efficiency but also with the fulfilment of sustainability criteria. Central to this is the development of holistic approaches - focusing on investments in organizations, companies, and countries with an excellent ESG record that create long-term value from a financial and investment perspective. According to Svoboda (2021, p. 77, 80 ff.), ESG portfolios should be constructed on a topic-specific basis, considering regulatory requirements, and based on a comprehensive quality screening process using existing ratings. All ESG criteria - i.e. not exclusively or primarily ecological aspects, but also social criteria and the governance practices of the respective organization - must be included in the company rating.

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