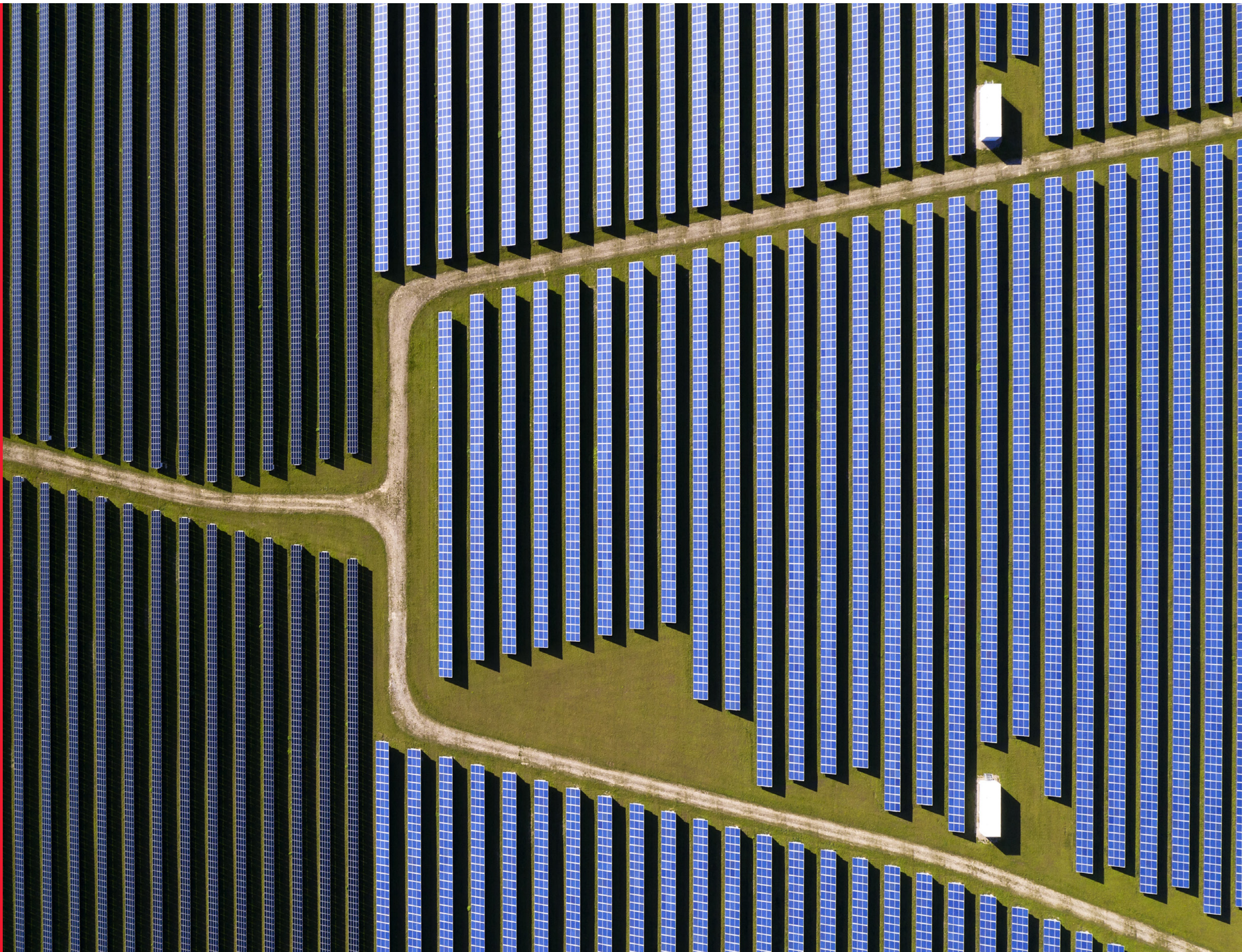
ESG and Provider Selection

Factoring ESG Into Risk Settlement Decision Making



ESG Overview

There is a global movement toward more responsible investment that addresses environmental, social and governance (ESG) risks in investment holdings, with particular publicity directed at climate change.

Examples of ESG factors are shown below.

Environmental (E) factors encompass how well nature is maintained and protected. This includes managing climate change risks, biodiversity, resource scarcity and waste management. This analysis can be used to evaluate the materiality of environmental risks a business might face and how it is managing those risks.

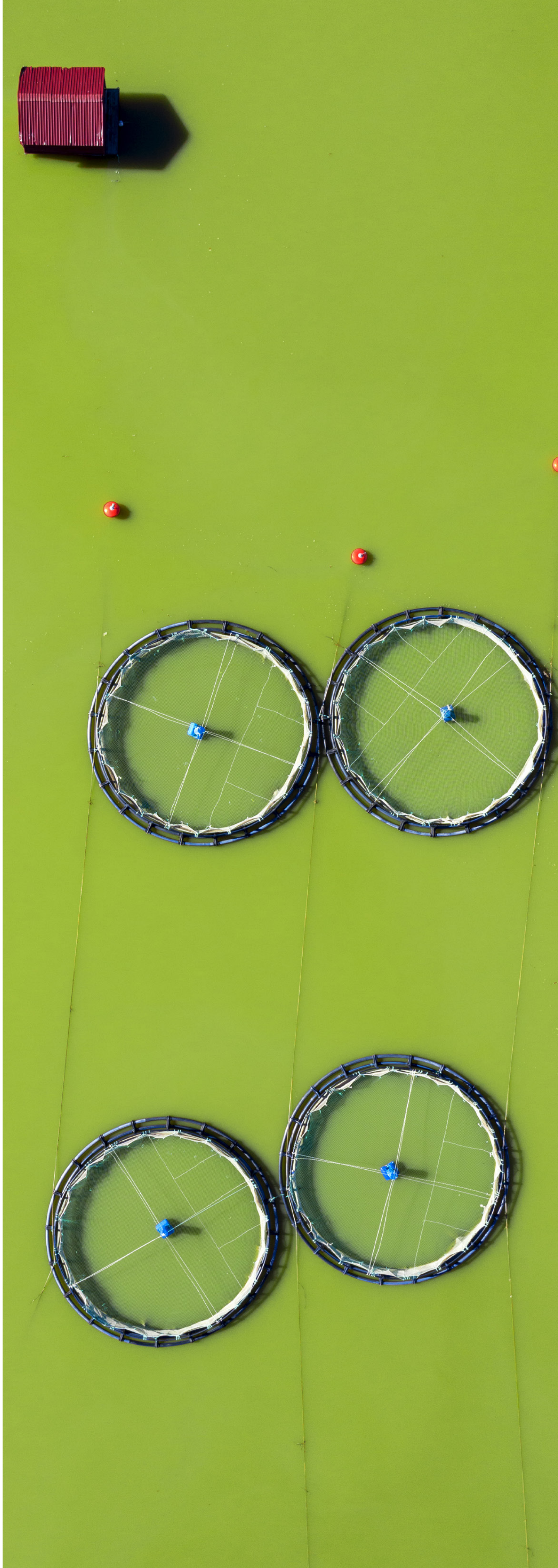
- Innovation, clean tech and renewable energy
- Pollution and waste
- Raw material and water scarcity
- Climate change

Social (S) factors examine business relationships with employees, suppliers, customers and the communities where they operate.

- Controversial sourcing
- Labour policies and relations, diversity
- Product liability, consumer protection and cyber security
- Social impact reporting and human rights

Governance (G) factors examine the internal business practices, governance and procedures that companies adopt to govern themselves. This includes how decisions are made and their effectiveness, how companies comply with the law and how the needs of external stakeholders are met.

- Diversity
- Transparency
- Shareholder rights
- Business ethics



Why ESG Matters

- ESG factors are important to institutional investors.
- The prominence of ESG factors will continue to increase, driven by the potential for long-term value creation and risk management as well as increasing regulatory pressure.
- Expectations from regulators will add to the demands on your pension scheme operations. ESG considerations will have an increasingly important role in protecting and securing your members' retirement income.
- Risk settlement and the selection of an insurance provider is a key long-term decision for trustees. It is important for trustees to demonstrate they have factored ESG into that decision.

Why Aon Offers This Guide

ESG factors are an increasingly important consideration for trustees and companies in risk settlement transactions.

Trustees' investment policies must cover all financially material considerations in choosing and managing their investments, which includes ESG factors.

Aon has developed an ESG rating system for insurance providers, designed to assess whether and how well they integrate ESG considerations into their investment decision-making process.

Factoring ESG Into Risk Settlement

Risk settlement products such as annuity policies and longevity swaps are purchased for long-term risk protection and there is generally no expectation of a future policy surrender. However, we believe that evidence of a strong ESG policy is a positive factor to consider when choosing between providers before purchasing such a product.

Aon's ESG ratings are designed to provide an added dimension of analysis and due diligence to your decision-making process.

We believe the best-in-class approach requires ESG integration, engagement and collaboration to completely address sustainability issues. A suitable culture is also needed within an organisation and its portfolio management teams for high levels of ESG integration to be credible.

How UK Insurance Providers Look at ESG

UK bulk annuity providers are now noticeably placing more focus on demonstrating their ESG credentials. The majority of providers are signatories to the UN Principles of Responsible Investment (UNPRI), and several now carry out specific annual reporting of their ESG policies and progress.

However, there is still a broad range of approaches from UK bulk annuity providers when it comes to their credentials and how well-integrated ESG is in their operations.

Environmental issues, especially climate change, are currently receiving particular attention. The Prudential Regulation Authority (PRA) has demanded that all UK insurers integrate climate change considerations into their businesses across all assets, liabilities and disclosures. In addition, the Association of British Insurers (ABI) is a trade association across the insurance and long-term savings industry, of which seven of the eight UK bulk annuity providers are members. Last year, the ABI published their Climate Change Roadmap to facilitate collaboration and collective action across the insurance and long-term savings sector to achieve net-zero targets. The ABI's initiative arose through a wave of actions from insurers, so has been timely with some insurers already leading the way and others quickly responding in line with the ABI suggestions.

Certain providers have set clear carbon-reduction policies for their asset portfolios, with some aiming for net-zero emissions as early as 2040. Others have yet to commit to such targets.

Beyond environmental issues and initiatives, providers' policies generally cover social and governance aspects as well. Across the industry, in the area of diversity, equity and inclusion, we see a wide-ranging set of targets with numerous inclusive initiatives. With public reporting on gender pay gaps now mandatory, there are some clear leaders in this area.

Aon's ESG Ratings

How to integrate ESG into your decisions.

Aon has developed an ESG rating system for UK risk settlement providers designed to assess whether and how well they integrate ESG considerations into their investment decision-making process.

The ratings sit alongside our existing administration due diligence ratings and financial strength commentary. They are designed to provide an added dimension of analysis for clients considering a transaction or monitoring an existing policy.

The ESG ratings are based on a variety of qualitative factors, starting with a proprietary due-diligence questionnaire completed annually by the provider.

We also conduct a review of the provider's ESG policy and other responsible investment policies and procedures (where they apply) and examples of real-time application of these policies.

The ESG assessment process is consistent with the investment manager reporting framework of the UNPRI. The UNPRI is a leading authority and their framework is helpful to an investment industry that contains a wide range of views and interpretations as to what constitutes responsible investment.

The ratings are assessed according to a three-tier scale and a description of each ESG rating can be seen on the following page.

Advanced

The provider demonstrates an advanced awareness of potential ESG risks in the investment strategy and operations, can demonstrate advanced processes to identify, evaluate and potentially mitigate these risks across their entire portfolio and operations.

Integrated

The provider has taken essential steps to identify, evaluate and mitigate potential financially material ESG risks within their portfolio and operations.

Limited

The provider team has taken limited steps to address ESG considerations in their portfolio and operations.

Assessing the Responsible Investment Behaviours of Providers

The ESG ratings assess the key responsible investment behaviours:

ESG Integration

The degree to which ESG risk factors are incorporated in the provider's investment decision-making processes.

To date, providers have built valuation models based primarily on traditional financial analysis. ESG integration looks for evidence that providers are also reviewing investments in the light of sustainability issues over longer investment horizons.

Engagement

The willingness of a provider to engage with companies in relation to ESG risk factors and the ability of a provider to make progress on these issues.

The providers should be willing to engage with companies that exhibit weaker ESG risk management to effect positive change and ultimately increase stock value. For example, fixed income holders, who do not have the ability to vote, can employ many other ways to engage and pursue important issues with companies to bring about change. Levels of engagement should be tracked and monitored.

Collaboration

The extent of external collaboration a provider undertakes with the wider responsible investment community, furthering best practice and understanding.

While arguably of less direct relevance to an ESG rating, levels of collaboration are indicative of an annuity provider's resolve and commitment to furthering understanding and best practice. Ultimately, we believe higher levels of collaboration will lead to better integration of ESG risks into portfolio management decisions.

A best-in-class approach to responsible investment needs all of the above behaviours within an organisation to fully address sustainability issues. A strong, responsible investment culture is also needed within an organisation and its portfolio management teams for high levels of ESG integration to be credible. While the level of an annuity provider's ESG integration is at the core of our ESG ratings, other behaviours are then taken into account to form an overall view.

The Shift of Responsible Investment

In the past, responsible investment was driven by corporate social responsibility and, for investments, value-based decisions around an investor's ethics.

In recent years, however, with growing awareness of the financial significance of ESG risks, especially the growing risks of climate change, the focus of responsible investment has shifted. The larger conversation today is around mitigating risk with the following two steps:

ESG Integration

"The systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions."

Impact Investing

"Impact investing aims to positively impact society beyond ESG-related compliance and investing."

Source: Principles for Responsible Investment (PRI)

Increasingly, the notion of fiduciary duty is being broadened by regulators to include explicitly the consideration of ESG risks in the selection of all investments.

How UK Trustees Should Respond

New regulations from the Department for Work and Pensions (DWP) require a more active approach from trustees when taking into account ESG risks. They reflect the expectation that trustees will more actively take steps to understand the issues, engage and then report on an ongoing basis. These actions are meant to have a real impact and not to be a tick-box action.

Timeframe to Meet New Requirements by Asset Size

Scheme asset size*	Meet new governance requirements by	Meet new disclosure requirements by
£5 billion or more	1 October 2021	Within seven months of the end of the scheme year in which 1 October 2021 falls
£1 billion or more	1 October 2022	Within seven months of the end of the scheme year in which 1 October 2022 falls
Less than £1 billion	Not currently in scope, but schemes are encouraged to take action now.	

*Excluding existing annuity policies

Trustees of defined benefit schemes must set out their ESG policies in the Statement of Investment Principles (SIP), particularly around climate change, and stewardship, including voting and engagement. They must also prepare an Engagement Policy Implementation Statement (EPIS) to document how and to what extent they have followed their engagement policy over the scheme year.

Furthermore, there are additional (voluntary) codes and guidelines. For example, the UK Stewardship Code requires ESG reporting across asset classes, covering both activities and outcomes, and with a renewed focus on purpose and governance.

Given the statements made for regulatory and scheme-specific beliefs on ESG it means that, as a minimum, the approach to insurer selection and due diligence should align with the ESG statements in the scheme's SIP. In addition, following a risk settlement transaction and pre-buyout, the trustee needs to refer to the transaction in their SIP. It is good practice for schemes to include details of the insurance arrangement and the selection process within the EPIS.

When choosing and managing their investments, trustees' investment policies must cover all financially material considerations, including ESG factors.

Annuity policies and longevity swaps are products purchased for long-term risk protection. ESG risks are widely seen as critically important long-term risks. Therefore, we believe evidence of a strong ESG risk identification and management policy is an important factor to consider in choosing between providers.

The Backing Investments

The life insurance company funds backing annuities and longevity swaps are generally restricted to a limited number of asset types. These are chosen specifically to provide predictable and relatively secure levels of income.

Income on these assets is preferably fixed or linked to UK inflation, and the investments should be long-term in nature so the overall asset income very closely matches the expected outgoing benefit commitments.

This creates challenges for asset sourcing:

- Government debt provides the main publicly accessible form of both long-dated and index-linked debt, but does not offer an attractive yield, so currently does not materially back new annuity sales.
- Investment-grade corporate bonds offer better yields, but spreads have been relatively constrained in recent years. Also, in isolation, the UK corporate bond market is not large enough to offer sufficient opportunities for institutional investors.
- Even when taking into account the much larger U.S. corporate bond market, there are still constraints that the bonds available are mostly shorter duration (under 10 years) and not index-linked.
- Spreads in investment-grade bonds have also been insufficient in recent years to produce competitive annuity prices and funds of this type are largely invested in BBB+ rated stocks.

A Move Toward Direct Assets

New annuities and longevity swaps are increasingly backed by more directly sourced investments, such as:

- Infrastructure debt
- Commercial mortgages
- Ground rents
- Equity release mortgages
- Social housing

In considering these investments, the appropriate credit rating, security, duration and inflation linkage will all be considered.

Reserving Impact

In addition, providers consider the investment's treatment under their reserving requirements. UK and EU reserving requires prudent yield deductions in valuing assets of different types and ratings.

Synthesising Debt

For some of the assets, a variable level of income is paid, making the assets unsuitable for a life fund.

To resolve this, the asset is held within a different corporate entity in the group that then pays more stable 'synthesised' debt income on to the life fund.

Other Constraints

Insurers also need to give careful consideration to the levels of exposure to particular countries, currencies, sectors and companies.

In this context, the desire to show ESG credentials forms an extra constraint on top of a complicated set of existing constraints when searching for appropriate yield opportunities with an acceptable level of risk.

Constraints

The assets held by providers to back annuity funds are already restricted to those that are predictable, secure, accessible and which receive favourable treatment under regulatory reserving requirements.

Adding ESG credentials to these considerations creates even further constraints.

Providers will increasingly need to direct the creation of ESG-driven assets to meet their needs.

Demonstrating ESG Thinking

Some existing asset choices have ESG credentials, e.g. the environmental benefits of investing in solar energy or new sewer systems, and the social benefits of supporting parts of the residential markets.

However, ESG thinking may only have partly driven the investment choice, given the other factors to consider. There is a limited supply of good quality direct assets and investment-grade corporate bond issuance to support the growing global risk settlement market. However, there is a growing move toward investment in infrastructure that is expected to give rise to an increasing flow of new ESG investments, with insurance companies often the key investors in these programmes.

There is also recognition in the market of environmentally supported bonds being in greater demand, hence attracting slightly lower interest costs than other bonds, encouraging more issuance. Conversely, this does mean the highest yielding opportunities may currently relate to investments with lower ESG credentials. This can provide a driver for investee companies to improve in these areas, ahead of seeking capital from the markets.

Defining Other Asset Holdings

Some of the providers we review are part of wider groups that offer a large range of passive and active investment products beyond those described, such as:

- Active or passive equity funds where the provider only benefits from performance indirectly through the impact on the level of investment management charges.
- Participating products where the group benefits directly from investment performance, such as with profits arrangements.

Therefore, we seek evidence of the overall investment policies of the group entity as well.

About

Aon plc (NYSE: AON) exists to shape decisions for the better—to protect and enrich the lives of people around the world. Our colleagues provide our clients in over 120 countries with advice and solutions that give them the clarity and confidence to make better decisions to protect and grow their business.

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