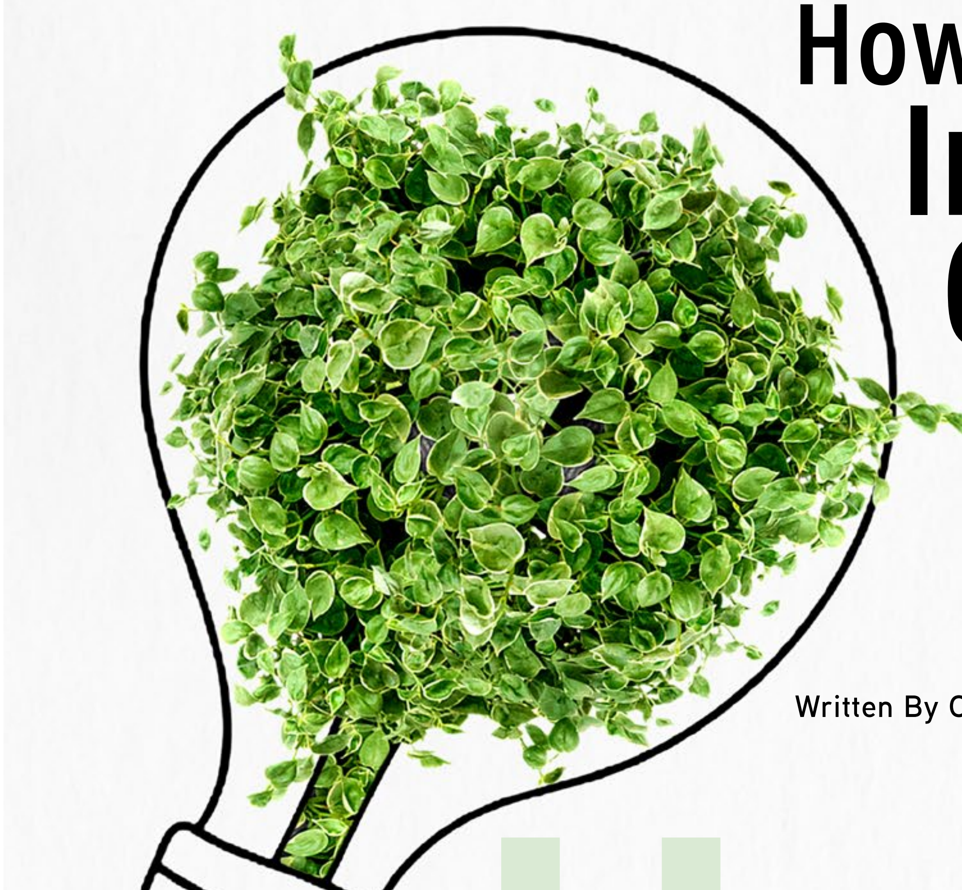
How ESG is Impacting Captives



Written By Caroline McDonald

Up until now, quality, style and value were the main drivers of the consumer economy. But consumer-driven attention is propelling another component to the forefront: Environmental, Social and Governance (ESG).

Once on the fringe, ESG has acquired more significance for consumers, which makes it more important to businesses for a number of reasons. It also adds new considerations and opportunities for captives.

EFFECTS OF ESG ON BUSINESSES

Dawn Hiestand, head of group captives for Zurich North America noted that before doing business with a company, vendors, suppliers and consumers are increasingly examining that company's ESG commitments and actions. Regulators and shareholders, too, are looking beyond financial considerations to a company's ESG record.

“They are asking companies to demonstrate stronger environmental stewardship, social responsibility and integrity in their leadership,” she said. “And if those consumers make buying decisions based on what they see in that regard, that will impact the bottom line.”

Another impact is on employees. “Many job seekers want to work for companies that are proactive role models on ESG considerations such as carbon reduction,” Hiestand said.

These are some of the reasons for a recently created group captive by Zurich, Hiestand said. The captive, Envision Re., Ltd., “brings together companies from diverse industries that share a common interest in not only optimizing their risk management programs but also in advancing environmentally sustainable business practices.”

Nancy Gray, regional managing director, captive & insurance management, commercial risk solutions at Aon, notes, “There are four ways we've identified how captives can help with ESG initiatives:

--Deducting captives' assets in an ESG aligned portfolio. A lot of captives tend to have more fixed income, shorter duration portfolios. If they take a portion of their assets and invest in an ESG-aligned portfolio, it helps to support the ESG goals at a corporate level.

--Funding initiatives that improve ESG risk management in an organization by using some of the surplus it has built over time, to help improve ESG risk management initiatives.

--Aligning underwriting by adding ESG objectives. Certain risks, such as wildfire and climate change, are difficult to insure, and aligning underwriting for those objectives and using the captive to help support that can be beneficial.

--And providing employee-based initiatives. For example, if you are a food producer, it would involve taking some of the company profit of the captive and providing weather insurance to farmers in developing countries. This is about helping in terms of an ESG initiative perspective," she said.

ENVIRONMENTAL THREATS

A looming risk worldwide is environmental degradation which means that every organization needs to plan for an escalation of risks from natural disasters.

A new study by Aon, The 2023 Weather, Climate and Catastrophe Insight report, looks at the cost of natural disasters in 2022 and how these losses were insured globally. Findings include:

- Natural disasters caused a $313 billion global economic loss in 2022, with only 42 percent covered by insurance.
- Much of this was driven by the impact of Hurricane Ian, which was the second costliest natural disaster for insurers on record globally.
- 75 percent of all insured losses were recorded in the U.S. alone.

Captive insurers are taking heed and becoming more important in bridging the widening insurance gap caused by these losses.

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"Captives can help parent organizations fund coverage gaps and enhance resilience to climate-related risks," said Adriana Scherzinger, head of captives sales & execution for Zurich North America.

"For example, as climate risks grow, companies in certain industries or regions may find it difficult to secure the desired amount of property coverage in the traditional market."

CAPTIVES AND CARBON CREDITS

John R. Capasso, president & chief executive officer of Captive Planning Associates LLC, said that what they are seeing is increased attention for one specific sector of clients.

"From an insurance perspective, as captive managers we have a large book in the agribusiness world," he said "So, we are very involved from an environmental, social and governance perspective."

From an environmental perspective, "What we're seeing in the farming sector are carbon credits," he said. "We've created a venture-like structure using captives to backstop the value of carbon credits coming from farming bio charge – which eliminates the source for forest fires and hog waste."

What is a carbon credit?

According to the Department of Agriculture and Consumer Economics:

> "A carbon credit is a tradeable certificate representing the right to emit one metric ton of carbon dioxide or the equivalent amount of another greenhouse gas, such as methane or nitrous oxide, called a carbon dioxide equivalent. There are two types of carbon markets: compliance and voluntary."

Capasso noted that, "Carbon can be thought of like a crop produced on a farm. A carbon credit – also known as a carbon offset – represents either greenhouse gases removed from the atmosphere or greenhouse gas emissions that are reduced."

Agricultural carbon markets, he explained, exist through privately and publicly owned companies with the aim of reducing carbon emissions through trade of carbon units gained at the farm level. "The sale of carbon credits presents an opportunity for farmers to receive financial benefits from changing to more environmentally beneficial agricultural practices," he said.

This is being seen globally, Capasso added, "Even among coffee growers in foreign countries. We have many growers using captives for carbon credits in farming, bio charge and hog waste."

The goal, he said, is "assurance that the value of these credits doesn't depreciate in the future. The people selling the credits are providing a backstop."

For example, he explained, if an airline's fleet "can't reduce their carbon footprint, they have to buy credits to offset that." Because these credits depreciate, "the companies that are providing them are ensuring they will maintain their value. If not, the captive insurer will pay a claim for any depreciation, based on a certain benchmark."

He added, however, that liquidity in a captive is a director's first concern. "So, if you become too ESG sensitive, are you derelict in your responsibility of managing? Trying to segregate and invest could be a detriment to the liquidity of the insurance company." In addition, he said, "All of these captives must have an investment policy statement and be approved by regulators."

ESG growing worldwide

In European locations and increasingly in the U.S., "Regulatory bodies are requiring disclosures and so, are pushing companies to embrace ESG," Gray said.

Regulators want disclosures of what organizations are doing, "and that will continue to increase: how they are embracing ESG objectives and how they are benchmarking in terms of their ESG initiatives, and how they are reducing their carbon footprints."

She added, "We can learn from European captive use, and this will become more prevalent in the U.S."

Overall, companies that are proactive in assessing their ESG risks will be in a better position to take action to mitigate those risks, Scherzinger noted. While this kind of assessment is not currently required for many companies, "It may be in the not-too-distant future, based on regulations and other actions by various stakeholders. So, companies would be wise to start acting now," she said.

What is ESG?

ESG in general refers to a broad range of environmental, social and governance concerns that are gaining attention from executives, investors, regulators, employees and consumers.

ESG issues were first mentioned in the 2006 United Nation's Principles for Responsible Investment (PRI) report. For the first time, ESG criteria were required to be incorporated in companies' financial evaluations for the purpose of developing sustainable investments.

According to Forbes, "The emphasis on ESG is increasingly growing as major institutional investors are making it clear they expect the companies they hold to commit strongly to ESG criteria."

This has meant increased risks for corporate directors and officers, said Adriana Scherzinger, head of captives sales & execution for Zurich North America. One example, she said, is that "ESG-related litigation is sometimes triggered by headlines reporting negative facts or allegations about a company's business practices."

To monitor the risks related to environmental sustainability, the Securities and Exchange Commission formed an ESG task force in 2021, she said. Within a year the task force had issued its first enforcement action, "challenging statements in a company's sustainability reports after a dam operated by the company collapsed, releasing toxic waste into surrounding areas."■

Caroline McDonald is an award-winning journalist who has reported on a wide variety of insurance topics. Her beat has included in-depth coverage of risk management and captives.