

# NAMIC ISSUE ANALYSIS



## UPDATED ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS FOR PROPERTY/CASUALTY INSURANCE

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*NAMIC membership includes more than 1,400 member companies. The association supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies write \$273 billion in annual premiums. Our members account for 58 percent of homeowners, 44 percent of automobile, and 30 percent of the business insurance markets.*

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## PREFACE

The officers and directors of mutual insurance companies are legally responsible to act in the interest of the company and the policyholders and to discharge these fiduciary duties with the care, skill, and diligence that a prudent person would use under similar circumstances.

This duty of care requires concern, attention, diligence, and assurance of thoughtful and good faith decision-making in discharging the tasks of a director or an officer. Their duty of loyalty requires them to place the interests of the company above their self-interest.

As nuanced and complicated as these fiduciary duties and responsibilities have been in the past for mutual insurance company officers and directors, the dramatic social changes of 2020 may impose even greater pressure to apply non-financial standards to company underwriting and investment, specifically, environmental, social, and governance standards, or ESG. These considerations can impact a company's ability to execute its business strategy and create value.

NAMIC published a white paper<sup>1</sup> in 2019 to assist NAMIC member companies in developing specific understanding of the impact of these standards on their business. The paper's intent was to define ESG and regulatory approaches to these issues, standards, and their development in the insurance industry and outlined reasons why and why not to apply ESG to insurance.

The recent and continuing social unrest has resulted in a multitude of businesses examining what role, if any, they have in addressing the perceived causes of the unrest. Senior executives and board members at many companies – including mutual insurance companies – are examining what they can and should do to address social disparities and threats. Many companies have joined in a chorus of voices to focus outside their primary business function to take action to make their community a better place. For mutual insurance companies, there is an overriding question of whether and how such actions align with their responsibility to provide the proper and complete protection to policyholders.

The purpose of this paper is to define the movement for greater social responsibility for companies and suggest how mutual insurance company management and boards can consider such actions while maintaining the duty of care and loyalty to their companies to which they are legally and morally bound.



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<sup>1</sup> Environmental, Social, and Governance Considerations for Property/Casualty Insurance, [https://www.namic.org/pdf/19memberadvisory/190617\\_ESGTK\\_v2FINAL.pdf](https://www.namic.org/pdf/19memberadvisory/190617_ESGTK_v2FINAL.pdf)

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## IT IS THE RARE MUTUAL INSURANCE COMPANY THAT HAS NOT AT LEAST CONSIDERED SOCIAL FACTORS THAT CAN IMPACT THEIR BUSINESS OPERATIONS.

Climate change activists and sympathetic regulators have maintained for years that insurance companies should divest from, and not insure, certain industries such as coal and fracking.

New York City comptroller Scott Stringer has called<sup>2</sup> on three multinational insurance companies to end business ties with the coal industry, a move he says will protect from the effects of climate change and ensure long-term value for shareholders. Massachusetts lawmakers sent a mutual insurance company a letter<sup>3</sup> signed by 38 members of the state Senate and House that requested the insurer cease insuring new coal projects or companies actively expanding their coal-related business, refuse to cover tar sands projects, and make its underwriting and investments completely emissions-free by 2050. In city council meetings in 2020, Cambridge and Somerville became the first cities in Massachusetts to pass resolutions calling on insurance companies to stop insuring and investing in fossil fuels.

Deloitte's Insurance Regulator State of Climate Risks Survey<sup>4</sup> reports that a majority of U.S. state insurance regulators expect all types of insurers' climate change risks to increase over the medium to long term. These include physical risks, liability risks, and transition risks. The Survey further states that more than half the regulators surveyed also indicated that climate change was likely to have a high or extremely high impact on coverage availability and underwriting assumptions.

ESG investing by insurance companies in America is growing slowly and the trends are not at all clear. According to the 2020 Goldman Sachs Insurance Report<sup>5</sup>, two percent of American insurers consider ESG a primary investment consideration, 60 percent consider it one of several considerations and 38 percent do not consider it. This is up from one, 15 and 85 percent respectively in 2017. Distinguishing "climate risk" from ESG, that report found that in 2020 four percent of American insurers considered climate risk a primary investment consideration, 53 percent consider it one of several considerations and 42 percent do not consider it.

Climate activists track and report<sup>6</sup> on insurance companies total fossil fuel investment and how the companies consider the impact of climate change on their investment portfolios. A number of insurance companies, including mutual insurance companies, have publicly pledged to reduce or eliminate such investments, and other insurance companies have stepped away from insuring projects such as oil pipelines<sup>7</sup>. At a 2019 National Association of Insurance Commissioners meeting, demonstrators called on the U.S. insurance industry to act on climate change by cutting ties with fossil fuels.<sup>8</sup>

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<sup>2</sup> NYC Comptroller Urges Major Insurance Companies to Cut Ties with Coal Industry, Insurance Journal, April 30, 2020, <https://www.insurancejournal.com/news/east/2020/04/30/566847.htm>

<sup>3</sup> <https://static1.squarespace.com/static/5dee8c40dfaed423632dbd07/t/5ece9c78f0b09e6839e4f371/1590598777185/MA+State+Legislators+to+Liberty+Mutual+%282%29.pdf>

<sup>4</sup> Insurance Regulator State of Climate Risks Survey, conducted by the Deloitte Center for Financial Services, <https://www2.deloitte.com/us/en/pages/financial-services/articles/insurance-companies-climate-change-risk.html>

<sup>5</sup> "Ready, Set, Reset" GSAM Insurance Report, July 2020 at <https://www.gsam.com/content/dam/gsam/pdfs/institutions/en/articles/2020/2020-gsam-insurance-survey.pdf?sa=n&rd=n>

<sup>6</sup> See, <https://www.consumerwatchdog.org/sites/default/files/2018-10/Top%20Ten%20US%20Insurance%20Companies%20Investment%20in%20Climate%20Change.pdf>

<sup>7</sup> Zurich dropped pipeline coverage <https://www.reuters.com/article/us-canada-pipeline-climate-insurance/zurich-insurance-drops-cover-for-trans-mountain-oil-pipeline-idUSKCN24N2MU> and the German insurer Talanx had stepped away from the project, after reinsurance giant Munich Re signaled its intention to withdraw earlier in the year.

<sup>8</sup> Demonstrators Push Insurance Industry on Climate Change At First NAIC Meeting <https://www.insureourfuture.us/updates/2019/8/3/demonstrators-push-insurance-industry-on-climate-change-at-first-naic-meeting-since-chubb-released-coal-policy>

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On the social front, the turmoil of the summer of 2020 has brought on new discussions of the need for greater racial and ethnic diversity, inclusion, and equity in the professional workplace by companies' management and boards. In June, property/casualty insurer CEOs publicly pledged to help their communities and employees find a meaningful way forward after ongoing national protests against racism and police brutality<sup>9</sup>.

- “We are struggling to make sense of everything and determine what we can do to be a force for good and effect change.”
- “We should pay attention to these events, care about what’s happening ... and we should be angry – all of us.”
- “We have an obligation to find our voice and raise it when we see social injustice.” “This is not the world we should accept as a society. We must push ourselves to influence change and create compassion.”

The largest corporate investors and companies are paying increased attention to racial diversity issues, including asking for information on risks, goals, and strategies to foster sexual, racial, and ethnic diversity.<sup>10</sup>

Some government agencies and legislatures are not waiting for insurers to take action. In September 2020, the California Legislature passed AB-979<sup>11</sup>, which would require companies headquartered in the state and traded on a major U.S. stock exchange by the end of 2021 to have at least one director on their board who hails from a historically “underrepresented community.” That community is defined as someone who self identifies as “Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native or ... as gay, lesbian, bisexual, or transgender.” During a special session<sup>12</sup> held as part of the NAIC’s virtual summer national meeting, consumer advocates and regulators called for recognition of systemic racism and inherent bias in the insurance industry and offered thoughts on how to tackle the issue.

Heightened social awareness by insurance companies in 2020 has taken a number of forms. Mutual of Omaha chose to retire its 70-year-old Native American corporate logo, provide \$1 million in additional funding for community-based initiatives and nonprofit organizations committed to racial equity, inclusivity, economic equality, and social justice. The company also committed to provide its management team additional training on diversity and inclusion, including unconscious bias training.

A number of insurance companies signed on to the 2019 Business Roundtable ‘Statement on the Purpose of a Corporation,’ which replaced the idea that a company’s primary duty was to its owners, or in the case of a mutual insurance company, the policyholders, with a commitment to “stakeholder capitalism.” The statement provides that while each individual company serves its own corporate purpose “we share a fundamental commitment to all of our stakeholders,” who are defined as “customers, suppliers, employees, and the communities in which we work,” to which the signers pledged “sustainable practices across our businesses.”<sup>13</sup> Current presidential nominee and former Vice President Joe Biden has reportedly called for “an end to the era of shareholder capitalism,” and he has said that it is “untrue and a farce” that a company’s primary responsibility is to generate returns for shareholders.<sup>14</sup>

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<sup>9</sup> P/C CEOs and Their Companies Pledge a Renewed Fight for Social Equality, Carrier Management, June 4, 2020, <https://www.carriermanagement.com/news/2020/06/04/207445.htm>

<sup>10</sup> State Street Global Advisors pushes portfolio companies for race disclosures, S&P Global Market Intelligence, August 27, 2020, <https://platform.marketintelligence.spglobal.com/web/client?auth=inherit#news/article?KeyProductLinkType=2&id=60113423>

<sup>11</sup> [https://leginfo.ca.gov/faces/billTextClient.xhtml?bill\\_id=201920200AB979](https://leginfo.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979)

<sup>12</sup> NAIC re-examining issues of race in insurance after decades of inaction, SNL Risk and Regulation, August 17, 2020, <https://platform.mi.spglobal.com/InteractiveX/article.aspx?CDID=A-59935817-11045&KPLT=4>

<sup>13</sup> study has indicated that the companies committing to the BRT Statement may not have had board approval to do so. The Illusory Promise of Stakeholder Governance, Forthcoming, Cornell Law Review, December 2020, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3544978](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3544978)

<sup>14</sup> Biden’s Assault on ‘Shareholder Capitalism’ Wall Street Journal, August 18, 2020, [https://www.wsj.com/articles/bidens-assault-on-shareholder-capitalism-11597705153?mod=hp\\_opin\\_pos\\_2](https://www.wsj.com/articles/bidens-assault-on-shareholder-capitalism-11597705153?mod=hp_opin_pos_2)



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## DO ESG INVESTMENTS AND INSURANCE DECISIONS PROVIDE ECONOMIC BENEFITS?

The combination of environmental, social, and governance issues into topic for mutual insurance companies was described in detail in NAMIC's 2019 white paper<sup>15</sup>, which examined instances where insurance regulators have taken positions on ESG investing, why some insurance companies consider ESG factors and why some don't, and recommendation of ESG considerations for insurance companies. More recently, there has been a growing chorus of advocates who maintain that ESG investment and insurance decisions may be as economically beneficial as other investments.



One of the primary problems is that ESG investing and insurance resist precise definition, but it is generally thought of as investment and insurance strategies that focus on a company's corporate governance and the social and environmental impacts of the firm's products or practices in making a decision to insure or invest in that company. There are no universal standards for what is and is not "good" for the environment, society, and/or corporate governance. Objective, external verification or measurement of such factors is subjective. General practices do exist – some insurers' ESG investment strategies can and do include avoiding anti-union or fossil fuel companies, based on a determination that the company is not socially or environmentally responsible – but the weight and application of such standards are particular to each company.

One leading critique of ESG investing and insurance is that the application of ESG standards limits economic opportunity and companies applying these factors will incur negative economic results from these limitations. But there is a growing amount of data being offered that indicates that good-ESG initiatives can actually drive up financial performance.

- 64 percent of actively managed ESG funds beat their benchmarks versus 49 percent of traditional funds through the first week in August 2020, according to research from RBC Capital Markets.<sup>16</sup>
- A Fidelity report found that between February 19, 2020, and March 26, 2020, the S&P 500 index fell by 26.9 percent. During the same period the companies rated most highly on ESG characteristics fell by 23.1 percent. Those rated worst fell much more than the market as a whole, down 34.3 percent, while the companies in between traced a straight-line correlation. The middle three rankings fell by 25.7 percent, 27.7 percent, and 30.7 percent respectively.<sup>17</sup>

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<sup>15</sup> Supra at note 1, [https://www.namic.org/pdf/19memberadvisory/190617\\_ESGTK\\_v2FINAL.pdf](https://www.namic.org/pdf/19memberadvisory/190617_ESGTK_v2FINAL.pdf)

<sup>16</sup> Investing in Social Good Is Finally Becoming Profitable, New York Times, August 28 2020, <https://www.nytimes.com/2020/08/28/your-money/impact-investing-coronavirus.html>

<sup>17</sup> Businesses doing the right thing make better investments, Fidelity International, April 21, 2020, <https://www.fidelity.co.uk/markets-insights/viewpoints/businesses-doing-right-thing-make-better-investments/>

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- High net worth investors reportedly see investment performance as the main driver for ESG participation, according to Nuveen's Fifth Annual Responsible Investing Survey. Nearly nine out of 10 of these ESG investors, 85 percent, claim that they would only have invested in ESG issues if the returns are the same or better.<sup>18</sup>
- The Institute of International Finance, a global association of financial institutions, concluded that 85 percent of ESG equity indices and 80 percent of ESG fixed-income indices outperformed their non-ESG peers in 2020.<sup>19</sup>
- Research from the Center for Sustainable Business at New York University Stern School of Business indicates that embedding ESG concerns into business strategies is not only good for making money, but also essential to customer allegiance.<sup>20</sup>
- Research by the Harvard Business Review reports that an ESG focus can help management reduce capital costs and improve the firm's valuation as more investors look to put money into companies with stronger ESG performance, as well as larger pools of capital will be available to those companies. The research found this happening not only in equity markets but also in loan markets, where some banks are linking interest rates on loans to ESG performance.<sup>21</sup>

These points can be compelling. Indeed, the Consultation Paper on the Development of the CFA Institute ESG Disclosure Standards For Investment Products in August 2020<sup>22</sup> reiterated its 2019 position that the consideration of relevant and material ESG information and risks is consistent with fiduciary duty and is required for investment professionals who adhere to the CFA Institute Standards of Professional Conduct.

The important issue here is to define what are and what are not "relevant and material ESG information and risks." While there is a general consensus on some broad ESG factors, such as toxic waste, discrimination, and excessive compensation as bad, precise standards on what is environmentally, socially, and governance positive do not exist. As eloquently stated by Professors Schanzenbach and Sitkoff in their comments to the SEC, "When moving from abstract principles to specific implementation, the inherent subjectivity of the ESG rubric itself becomes even more apparent. There is no exhaustive or universal list of ESG considerations, and there is no consistency in the labels used to describe investment strategies that consider ESG factors. There are hundreds of ESG ratings services and ESG-themed mutual funds, and they often disagree."<sup>23</sup>

But companies that would like to promote their ESG credentials have no standards for either compliance or leadership. The SEC has not adopted ESG-specific guidelines, but the SEC has been pressed in recent years to adopt regulations or interpretations to harmonize ESG disclosure. The SEC's Investor Advisory Committee, established under the Dodd-Frank Wall Street Reform and Consumer Protection Act to advise the commission, recommended<sup>24</sup> in May 2020 that the SEC promulgate specific disclosure policies regarding ESG topics and incorporate them into the integrated disclosure regime for SEC-registered issuers.

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<sup>18</sup> Performance tops investors' motives for responsible investing, Nuveen, <https://documents.nuveen.com/Documents/Nuveen/Default.aspx?uniqueid=6F1A2627-C8C7-4915-BBDB-C4070968B6A1&subid=4%7C7>

<sup>19</sup> IIF Green Weekly Insight, ESG funds deliver! June 18, 2020, [https://www.iif.com/Portals/0/Files/content/200618WeeklyInsight\\_vf.pdf?\\_cldee=cmhYXRoQHbVbGloaWN-vLmNvbQ%3d%3d&recipientid=contact-1cf2d2e8e8f0e81180d102bfc0a80172-e447d7c9d448cc09ef4cca8fd2be4&utm\\_source=ClickDimensions&utm\\_medium=email&utm\\_campaign=Press%20Emails&esid=c6de00f3-37b2-ea11-80e6-000d3a0dce1c](https://www.iif.com/Portals/0/Files/content/200618WeeklyInsight_vf.pdf?_cldee=cmhYXRoQHbVbGloaWN-vLmNvbQ%3d%3d&recipientid=contact-1cf2d2e8e8f0e81180d102bfc0a80172-e447d7c9d448cc09ef4cca8fd2be4&utm_source=ClickDimensions&utm_medium=email&utm_campaign=Press%20Emails&esid=c6de00f3-37b2-ea11-80e6-000d3a0dce1c)

<sup>20</sup> Return on Sustainability Investment (ROSI™) Methodology, <https://www.stern.nyu.edu/experience-stern/about/departments-centers-initiatives/centers-of-research/center-sustainable-business/research/return-sustainability-investment-rosi>

<sup>21</sup> Social-Impact Efforts That Create Real Value, Harvard Business Review, <https://hbr.org/2020/09/making-sustainability-count#social-impact-efforts-that-create-real-value>

<sup>22</sup> <https://www.cfainstitute.org/-/media/documents/code/esg-standards/consultation-paper-on-esg-disclosure-standards.ashx>

<sup>23</sup> May 5, 2020, SEC Comment Letter, <https://www.sec.gov/comments/s7-04-20/s70420-7153846-216455.pdf>

<sup>24</sup> Investor Advisory Committee Recommendation of the SEC Investor Advisory Committee Relating to ESG Disclosure, May 21, 2020, <https://www.sec.gov/spotlight/investor-advisory-committee-2012/esg-disclosure.pdf>



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The Government Accountability Office has concluded<sup>25</sup> that the lack of consistent and comparable metric standards has hindered companies' ability to effectively report on ESG topics because they are unsure what information investors want. In addition, some investors have said that companies may change which metrics they use to disclose on an ESG topic from year to year, making disclosures hard to compare within the same company over time.

It is also important to note that mutual insurance companies' investment policies are generally driven by statutory accounting and state-specific laws and regulations. Prior to any considerations of ESG factors, a mutual insurance company must conform to very specific parameters for investing concerning liquidity and other considerations. Regardless of any positive ESG attributes, investments and policies that entail unacceptable levels of risk may be contrary to the insurance laws and regulations of a state.

Clouding the issue further is that some data indicates that ESG financial decisions may not always be beneficial. Eliminating investment or insurance categories inherently restricts financial opportunities and applying additional ESG screens or conditions will increase investment expenses. A recent study<sup>26</sup> specifically challenged the "widespread claims by fund managers, ESG data purveyors, and the financial press," that companies with high ESG scores were better situated in the pandemic. In another study<sup>27</sup>, using 14 years of panel data on U.S. public firms, researchers found that firms with more gender-diverse boards suffered a market penalty as a result. They argue that a gender-diverse board is interpreted as revealing a preference for diversity and a weaker commitment to shareholder value. Consequently, they concluded that firms with more female directors will be penalized.

Between 2010 and 2019, the Standard & Poor's 500 index returned 13.56 percent annualized during the period, while all ESG funds returned 10.84 percent. "ESG funds not only trail benchmarks, but also exhibit nearly identical volatility as the index itself. That means that ESG funds did not protect them from market drawdowns, even though managers of ESG funds often claim that environmental and social screens can help them avoid stocks that pose the biggest financial risks."<sup>28</sup>

There is also the complex problem of including and/or balancing each of E, S, and G. Does an investment or insured need to meet environmental, social, and governance requirements, or is just one of the factors enough? What about when an investment has positive ratings in one factor and less than positive or negative ratings in another? Is a fracking company that supports Black Lives Matter and has a diverse board an ESG positive? What about a solar power company with discrimination complaints? There are studies<sup>29</sup> that conclude that in ESG, there is a dominance of corporate governance in driving financial performance and a generally negative effect of environmental and social indicators, indicating that G may > E + S.

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<sup>25</sup> Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them, United States Government Accountability Office, July 2020, <https://www.gao.gov/assets/710/707949.pdf>

<sup>26</sup> ESG Didn't Immunize Stocks Against the COVID-19 Market Crash, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3675920](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3675920)

<sup>27</sup> Isabelle Solal, Kaisa Snellman (2019) Women Don't Mean Business? Gender Penalty in Board Composition. *Organization Science*, 30(6):1270-1288, <https://doi.org/10.1287/orsc.2019.1301>

<sup>28</sup> ESG Has Failed to Outperform for Years. Is this a Fix?, *Institutional Investor*, May 13, 2020, <https://www.institutionalinvestor.com/article/b1lm2j93w09cv9/ESG-Has-Failed-to-Outperform-for-Years-Is-this-a-Fix>

<sup>29</sup> See, for example, Milton Was Right, *Corporate Governance Matters*, IFC, April 16, 2020, [https://www.ifcreview.com/articles/2020/april/milton-was-right-corporate-governance-matters/#\\_ednref5](https://www.ifcreview.com/articles/2020/april/milton-was-right-corporate-governance-matters/#_ednref5)

## GUIDANCE FOR MUTUAL INSURANCE COMPANIES TO CONSIDER FOR ESG INVESTING OR INSURING

Mutual insurance company management and boards may be facing increased pressure to do more to address environmental, social, and governance issues, and some insurance company leaders have publicly expressed<sup>30</sup> their intention to do so. At the same time, these management and boards remain subject to their fiduciary duties in making and implementing investment and insurance decisions that may consider these same environmental, social, and governance issues. The use of ESG factors, if motivated only by one's own sense of ethics or to obtain collateral benefits for third parties, may well violate the duty of loyalty. As detailed above, there are no clear standards and practices to gauge and apply these potentially competing interests.

Professors Schanzenbach and Sitkoff, mentioned earlier, have also recommended looking at ESG considerations in investment and insurance by organizing them into two categories<sup>31</sup>. They conclude that ESG investing/insuring is legally permissible by a fiduciary only if: (1) the fiduciary believes in good faith that the ESG decision will benefit the beneficiary directly by improving risk-adjusted return, and (2) the fiduciary's exclusive motive for adopting the ESG decision is to obtain this direct benefit. "In other words, risk-return ESG can be consistent with fiduciary duty but is not required by it, and collateral benefits ESG is generally not consistent with fiduciary duty." They further conclude that there is theory and evidence in support of risk-return ESG, but this support is far from uniform, is often contextual, and, in all events, is subject to change, especially as markets adjust to the growing use of ESG factors.

But perhaps more authoritative guidance can be found in the June 23, 2020, U.S. Department of Labor proposed regulation<sup>32</sup> outlining the duties of an Employee Retirement Income Security Act (ERISA) fiduciary when considering an investment that incorporates ESG factors. Prior to this proposed regulation, the DOL had taken the earlier position<sup>33</sup> that ESG factors could be considered as a tiebreaker when considering two investments similar in performance and cost. In the new proposed rule, the DOL asserts that there is no agreement as to what constitutes a genuine ESG investment, that existing ESG rating systems are vague and inconsistent, and that ESG funds often come with higher fees. Overall, the DOL expressed concern that the growing emphasis on ESG investing may prompt fiduciaries – in this case, ERISA fiduciaries – to make decisions for purposes distinct from their duties. The DOL noted that the U.S. Supreme Court as recently as 2014 unanimously held<sup>34</sup> in the context of ERISA retirement plans that such interests must be understood to refer to "financial" rather than "nonpecuniary" benefits.

While ERISA fiduciary duties are far greater in many ways than the fiduciary duties of mutual insurance company officers and directors, the analysis and proposals by the DOL are instructive and provide a level of compliance obligations to which mutual insurance company officers and directors can refer. Specifically, the proposed regulation is designed in part to make clear that fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of nonpecuniary objectives. The fundamental principle is that a fiduciary's evaluation of

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<sup>30</sup> See footnote 8 above.

<sup>31</sup> The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary, Max M. Schanzenbach, Northwestern University, and Robert H. Sitkoff, Harvard Law School, <https://corpgov.law.harvard.edu/2018/09/20/the-law-and-economics-of-environmental-social-and-governance-investing-by-a-fiduciary/>

<sup>32</sup> Financial Factors in Selecting Plan Investments, A Proposed Rule by the Employee Benefits Security Administration, June 30, 2020, <https://www.federalregister.gov/documents/2020/06/30/2020-13705/financial-factors-in-selecting-plan-investments>

<sup>33</sup> Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments 29 CFR Part 2509 A Rule by the Employee Benefits Security Administration on October 26, 2015, at <https://www.federalregister.gov/documents/2015/10/26/2015-27146/interpretive-bulletin-relating-to-the-fiduciary-standard-under-erisa-in-considering-economically> RIN 1210-AB73

<sup>34</sup> Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421, 2014.

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plan investments must be focused solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan's funding policy and investment policy objectives. The corollary principle, like that proposed by Professors Schanzenbach and Sitkoff is that fiduciaries must never sacrifice investment returns, take on additional investment risk, or pay higher fees to promote nonpecuniary benefits or goals.

The proposed regulation requires fiduciaries to consider how the contemplated investment compares to other available investments with regard to diversification of the overall portfolio, liquidity relative to the cash flow requirements of the plan, and projected return of the portfolio relative to the funding objectives of the plan. Acknowledging that ESG factors can be pecuniary factors, these factors must present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories.

The proposal makes clear that if, after such an evaluation, alternative investments appear economically indistinguishable, a fiduciary may then, in effect, "break the tie" by relying on a nonpecuniary factor. The DOL believes that such true ties will be rare and proposes that the fiduciary "must document the basis for concluding that a distinguishing factor could not be found and why the selected investment was chosen based on the purposes of the plan, diversification of investments, and the financial interests" of the beneficiaries.

Basically, the DOL has merely restated what it has consistently demanded of fiduciaries: always place the best interest of the participants ahead of all else. The head of the global ESG practice at Aon has pointed<sup>35</sup> out that the proposed DOL guidelines do not seem to argue the point that material environmental, social, and governance issues may positively or negatively impact financial performance. Rather, the guidance seems focused on ensuring investors focus on materiality and financial performance and do not use ESG packaging to invest in ways that may not be fiduciarily sound.

This is not to say that the DOL proposal has been widely accepted. The investment community, which has been awash in new fund flows to ESG investments, has been uniformly opposed<sup>36</sup> to the DOL proposal, which could stem that tide. One analysis<sup>37</sup> of the comment letters on the proposal received by the DOL reports that 95 percent of the comments opposed the rule. Similarly, 13 U.S. senators sent a letter<sup>38</sup> to the DOL secretary July 15, 2020, expressing deep concern with the proposal and urging its immediate withdrawal.



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<sup>35</sup> Opponents Of New ERISA ESG Guidance May Inadvertently Prove DOL's Point, Forbes, July 29, 2020, <https://www.forbes.com/sites/chrisarosa/2020/07/29/opponents-of-new-erisa-esg-guidance-may-inadvertently-prove-dols-point/#d20abb510d1e>

<sup>36</sup> See, e.g. Commenters Hammer DOL on Proposed ESG Rule, <https://401kspecialistmag.com/commenters-hammer-dol-on-proposed-esg-rule/>, DOL's ESG Proposal Blasted by Commenters, <https://www.napa-net.org/news-info/daily-news/dols-esg-proposal-blasted-commenters>

<sup>37</sup> Public Comments Overwhelmingly Oppose Proposed Rule Limiting the Use of ESG in ERISA Retirement Plans, The Forum for Sustainable and Responsible Investment, [https://www.ussif.org/Files/Public\\_Policy/DOL\\_Comments\\_Reporting\\_FINAL.pdf](https://www.ussif.org/Files/Public_Policy/DOL_Comments_Reporting_FINAL.pdf)

<sup>38</sup> <https://www.help.senate.gov/imo/media/doc/LTO.%202020.7.15.%20DOL%20ESG%20Comment%20Letter.pdf>

## RECOMMENDED ESG CONSIDERATIONS FOR MUTUAL INSURANCE COMPANIES

Before beginning any integration of ESG factors in investing or underwriting, the board of directors and senior management of an insurance company would be well served to understand the process and ramifications of that integration in the business and the ongoing acceptance of responsibilities that apply. In the absence of universal standards for what investments or insurance policies are negatively or positively impacted by ESG, management and the board should adopt and document their specific definitions of ESG and the positive and negative impacts.

Defining and documenting the procedures and the appropriate implementation of those ESG procedures would provide clarity, as well as a method to validate any subsequent questioning of these decisions. It may not be prudent to systematically accept or reject environmental, social, and governance issues as positively or negatively impacting financial performance. The focus should instead be on identifying and verifying those specific ESG factors that may be material to your business and how the application of those factors will be fiduciarily sound.

## CONCLUSIONS

For a mutual insurance company, ESG factors in investing and underwriting are complex and far reaching. Societal pressures, business practices, and regulatory schemes are always evolving, but more dramatically in 2020. While there is no one-size-fits-all ESG approach for insurance companies to consider and implement, there is danger in ignoring the environmental, social, and governance concerns of policyholders, regulators, and other stakeholders.

The best position for prudent officers and board members of mutual insurance companies would be to have a clear and documented definition and understanding of specific ESG investment and insurance issues and to document how any application of ESG standards to a specific business decision has been made in full consideration of the best interests of the policyholders.

The officers and board should document how an ESG investment/insurance decision compares to other available investments/insurance coverage regarding diversification of the overall portfolio, liquidity relative to the cash flow requirements of the plan, and projected return of the portfolio relative to the company objectives. Company decisions to consider and apply ESG investment/insurance factors should include documentation of material economic risks or opportunities under generally accepted investment theories. The focus must remain on value to policyholders and the ongoing financial condition of the company. The management of each firm is in the best position to make decisions about what sustainability and/or ESG information is financially material.

Overall, ESG standards and regulations for insurance companies should be strictly limited to providing an objective principles-based framework to assist insurance company management in defining how such factors impact financial materiality. Conversely, standards and regulations for insurance companies promoting ESG goals that do not directly and objectively benefit policyholders and the ongoing financial condition of the company to serve policyholders should not be enacted.

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