NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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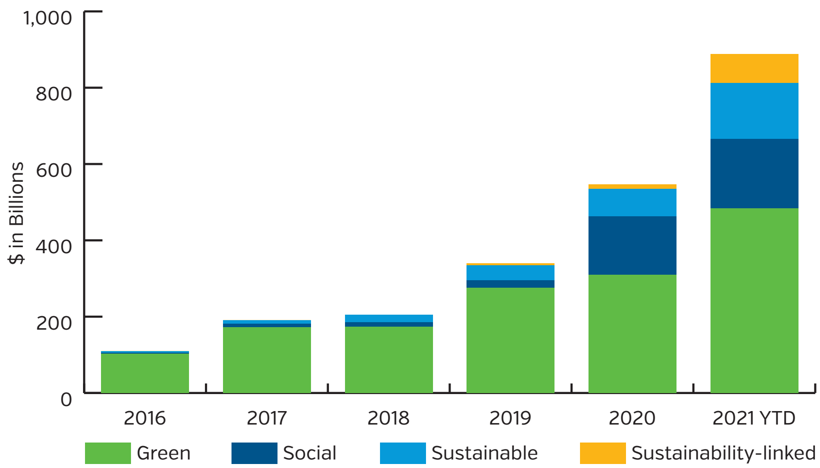
ESG Labeled Bonds: A Very Fashionable "Label"

Environmental, Social and Governance (ESG) investing is gaining relevance for insurance organizations of all sizes. What are the basics of ESG labeled bonds that insurers need to know and what is the current exposure for U.S. P&C (re)insurers?

RAPID GROWTH

ESG has taken the investment world by storm. One of the elements of this new emphasis on "sustainable" investing has been the rapid development and expansion of ESG labeled bonds. Though bonds associated with environmental themes have been around for almost two decades, issuance in ESG labeled bonds has skyrocketed in the last few years, especially for the newer label types.

Exhibit 1. Growth of ESG Labeled Bond Issuance



Source: Bloomberg's Sustainable Debt Product (as of 9/30/2021)

WHAT ARE ESG LABELED BONDS?

ESG labeled bonds, more commonly known by their largest sub-type, Green bonds, are bonds that target proceeds for uses based on a set of ESG criteria. Green bonds focus on environmentally oriented projects like renewable energy infrastructure, energy efficient buildings and waste management. The next biggest category are Social bonds which are dedicated to projects with positive social impacts like affordable housing and basic essential services like education and healthcare. The target population for these social projects are

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people living below the poverty line, people living with disabilities or those in some other way excluded or marginalized. Sustainable bonds are ones in which the project has both environmental and social benefits. For example, a municipality may wish to raise funds for a housing project that is both energy efficient *and* affordable. Finally, Sustainability-linked bonds (SLB) are structurally linked to the issuer's achievement of a self-determined sustainability goal. Unlike the other ESG labeled bond types, funds raised by SLB are *not* directed towards any specific project but can be used however the entity sees fit. The coupon of these bonds ratchets higher on failure to meet the goal. For example, a utility company may target to increase its renewable energy capacity from 40% to 50% in the next 2 years after issuance. If the company fails to meet this goal, it will increase the coupon by 25 bp for the next 5 years until maturity.

HOW TO GET "LABELED"?

The International Capital Market Association (ICMA), a European based self-regulatory trade organization, has established a set of principles for issuers to follow when issuing ESG labeled bonds. These *voluntary* best practice guidelines merely provide a framework and are not detailed which makes them subject to interpretation by each issuer. To give investors assurance that a bond is properly aligned to the ICMA principles, many issuers seek a second party opinion from one of the many providers.

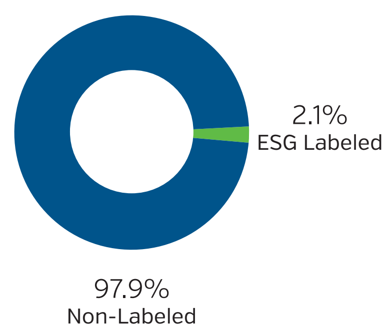
GLOBAL MARKET OVERVIEW

Despite the tremendous issuance growth, ESG labeled bonds account for a small fraction of global bonds outstanding. The current ESG labeled market is approximately $2.5 trillion or just 2.1% of the $123.5 trillion global bond market. Even if one assumes an ambitious ESG labeled issuance amount of $1.5 trillion for 2021, that would still equate to only 6% of the year's global issuance.[1]

We use the ICE Global Broad Market Index (GBMI) as a proxy for the global bond market and find stark differences between the overall market and the ESG labeled bond market:

Exhibit 2. ICE Global Broad Market Index

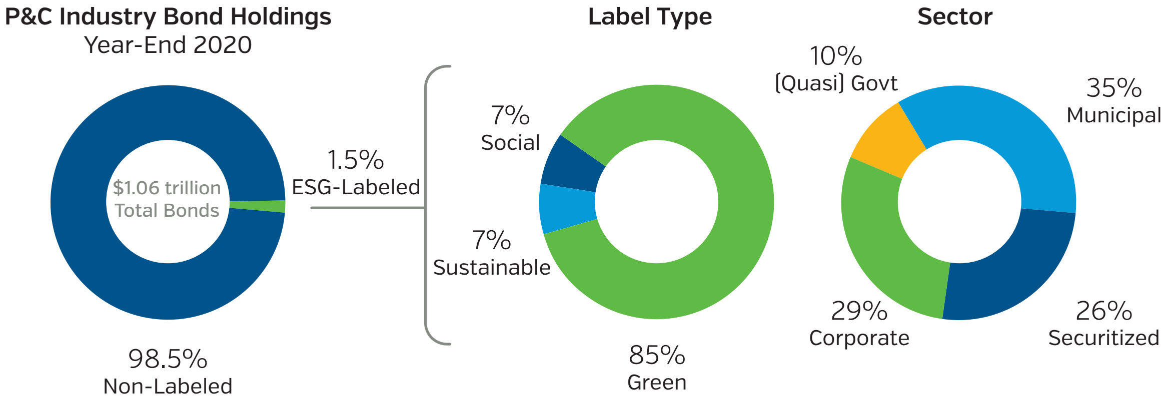
Country	Overall GBMI	ESG Labeled Portion of GBMI
U.S.	46%	10%
Non-U.S.	54%	90%
Total	**100%**	**100%**
Sector	**Overall GBMI**	**ESG Labeled Portion of GBMI**
Sovereign	54%	10%
Quasi Government	10%	46%
Corporate	21%	41%
Securitized	15%	3%
Total	**100%**	**100%**



Source: ICE Indices

- The majority of the labeled issuance has been outside of the U.S. in non-USD currencies, predominately in Europe
- There is relatively little Sovereign ESG Labeled debt outstanding
- Quasi-Government bonds make up a much larger segment
- Within the Corporate sector there is far less sub-sector and name diversity:
    - The 3 largest sub-sectors of the overall Corporate Sector make-up only 37% of the total, whereas the 3 largest sub-sectors of ESG labeled Corporate bonds comprise 70%
    - Less than 20% GMBI Corporate issuers have ESG labeled bonds
- Only a small fraction of the Securitized market is ESG labeled with most of it being Agency CMBS

Exhibit 3. U.S. P&C Industry Analysis

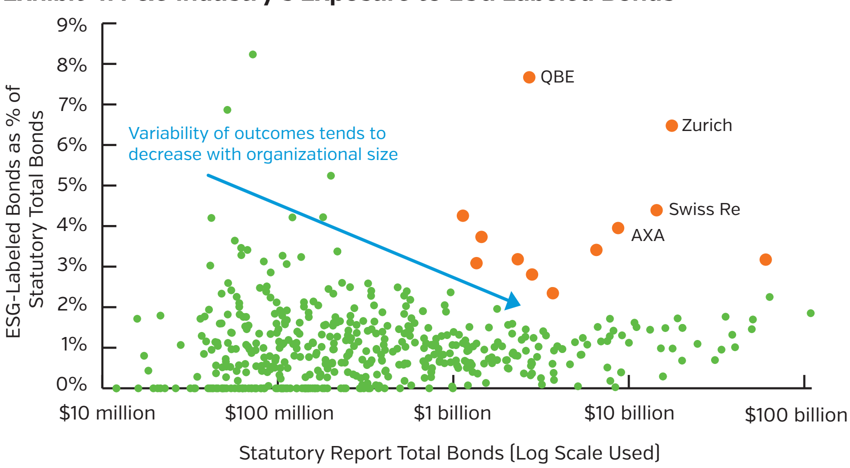


Source: NEAM, Bloomberg's Sustainable Debt Product, S&P Global

The U.S. P&C Industry's exposure to ESG labeled bonds is 1.5%[2] as of year-end 2020, which is broadly in line with the U.S. debt market when we reflect the industry's specific bond sector allocation. Exhibit 3 summarizes holdings by ESG label type and sector.

Individual (re)insurers' exposures to ESG labeled bonds vary between 0% and 8.2% with an average exposure of 1.1% and a median of 0.9%. Exhibit 4 plots company size measured by statutory total bonds on the horizontal and the percentage of ESG labeled bonds on the vertical axis.

Exhibit 4. P&C Industry's Exposure to ESG Labeled Bonds



Source: NEAM, Bloomberg's Sustainable Debt Product, S&P Global

For the P&C industry, 20% of organizations have an exposure below 0.2%, 30% below 0.5% and 90% below 2.2%. Companies of similar size can have varying degrees of allocations to ESG labeled bonds. Smaller organizations appear to have a wider variety of outcomes, potentially related to the relatively fewer number of bonds they own. If any owned bond *happens* to be ESG labeled, it can significantly impact the company's overall ESG exposure and vice versa. Larger companies tend to own more bonds, and their overall exposure appears more in line with that of the overall U.S. debt market. A few (very) large organizations (highlighted orange in Exhibit 4) are an exception as they exhibit meaningfully larger exposures than the industry average and median. Four of them are non-U.S. domiciled.

Finally, we believe the industry's aggregate exposure to ESG labeled bonds is largely coincidental. This finding is based on our analysis of a representative bond portfolio that was chosen independently of any ESG preferences but with otherwise similar investment characteristics to the P&C industry.[3] It delivered a coincidental allocation to ESG labeled bonds only marginally lower than that of the industry.

As usual, the devil is in the details and maintaining a large exposure to ESG bonds does not necessarily guaranty advancement of green, social or sustainable causes. A subsequent *Quick Takes* will shed further light on this aspect.

KEY TAKEAWAYS

- ESG labeled bonds make up a small but rapidly growing percentage of the overall bond market
- Currently, it is not feasible to construct a typical U.S. insurance company bond portfolio using only ESG labeled bonds because the U.S. ESG labeled bond market has a very different make-up than the overall U.S. bond market
- The U.S. P&C industry's ESG labeled bond exposure is broadly in line with the broad market and *appears* coincidental except for a small number of mid-to-large sized (re)insurers with larger ESG bond allocations. Of these, some are non-U.S. domiciled
- NEAM's peer and ESG reports can provide detailed insights into your organization's ESG bond exposure relative to your peers

ENDNOTES

[1] Assuming global total bond issuance for 2021 is an average of 2019 and 2020's global total bond issuance of $22.8 trillion and $27.3 trillion, respectively. SIFMA.org

[2] NEAM defines the U.S. P&C Industry as top tier statutory filing entities with at least $50 million in total invested assets and $10 million in Net Written Premium, excluding Financial Guarantors. For year-end 2020, 479 (re)insurers and their respective bond holdings are reflected. Exposure is measured as ESG labeled bond statutory carry value expressed as a percentage of statutory net admitted total bonds.

[3] For this analysis we express the P&C Industry's year-end 2020 bond portfolio in terms of a refined set of carry value weighted ICE fixed income indices that in the aggregate reflect the industry's (sub)sector, credit and duration profile. ESG considerations do not impact bond index constituent eligibility and the resulting proxy portfolio's ESG allocation can therefore be deemed coincidental.

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