

ESG: Banks and Insurance

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Banks are heavily regulated institutions, and governance issues – from whether board members and senior managers are ‘fit and proper’, to enforcement of anti-money laundering laws and sanctions against ‘rogue’ nations – loom large with regulators as well as with the public. Furthermore, civil and criminal penalties can be heavy, and operating licenses can be revoked for ineffective governance controls. Several Nordic banks, for example, have been wrestling with the after-effects of years of weak anti-money laundering compliance, with persistent negative effects on their profits, credit ratings and stock prices. Environmental change is affecting banks’ borrowers, such as in the coal, energy and utility industries which have varying degrees of carbon footprints. Social issues facing banks include ensuring that hiring, firing and promotions are done so all people are treated in an even-handed manner, and that a diversity of experiences and backgrounds is represented at all levels. COVID-19 is placing significant stress on banks’ borrowers, with resulting effects on banks’ loan losses, earnings and capital. COVID-19 is also creating governance challenges of operating remotely, and placing stress on technical systems. A positive outcome is an acceleration of the trend to digital banking and related cost saving, and more rapid shrinkage of expensive branch networks. In addition, COVID-19 creates possible workplace and customer health risks that need to be managed, as well as compels a rethinking of central office space needs if work from home becomes more commonplace, and if social distancing becomes a more permanent fixture.

Insurers are also highly regulated firms and governance factors remain key. Low interest rates make reserving for certain policyholder liabilities challenging given dependence on generating suitable risk adjusted investment returns. A lack of appropriate risk-management systems can lead to regulatory intervention and large charges, *e.g.*, long-term care insurance providers. From a social perspective, legal battles over payouts to cover lost profits under business interruption (BI) insurance can be reputationally harmful. However, BI contracts generally shield insurers from paying large sums for COVID-19 related shutdowns. If insurers were forced to pay claims that were never contemplated, their fundamentals could be weakened and pricing for new insurance could become prohibitive. Despite BI lawsuit defenses, insurers recognize their important social role and are partnering with governments to design future public-private pandemic coverage. Meanwhile due to COVID-19 shutdowns, some global insurers have offered smaller BI settlements, while others have voluntarily returned a portion of personal auto premiums. Environmentally, numerous insurers have adopted policies limiting their underwriting for and investment in high carbon-emitting companies. As such, utility and energy companies have set aggressive targets to reduce their carbon and climate impacts. This pivot by capital providers and companies alike may help to slow the effects of rising global temperatures and mitigate natural disasters linked to extreme weather such as hurricanes and wildfires.

Spectrum’s ESG approach complements that of our parent, Principal Global Investors, which has received the 2019 UN Principles for Responsible Investment highest score of A+ in Strategy and Governance.

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