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02 HEALTH INSURER CARBON PEER STUDY

A Deeper Look at ESG and Carbon Metrics for Insurance Portfolios

Our last article compared the high-level environmental, social, and governance (ESG) scores and carbon intensity scores for two Blue Cross Blue Shield (BCBS) health plans against peer groups made up of the largest health insurers and the universe of BCBS plans. Their summary scores were on opposite ends of the spectrum when compared with peers.

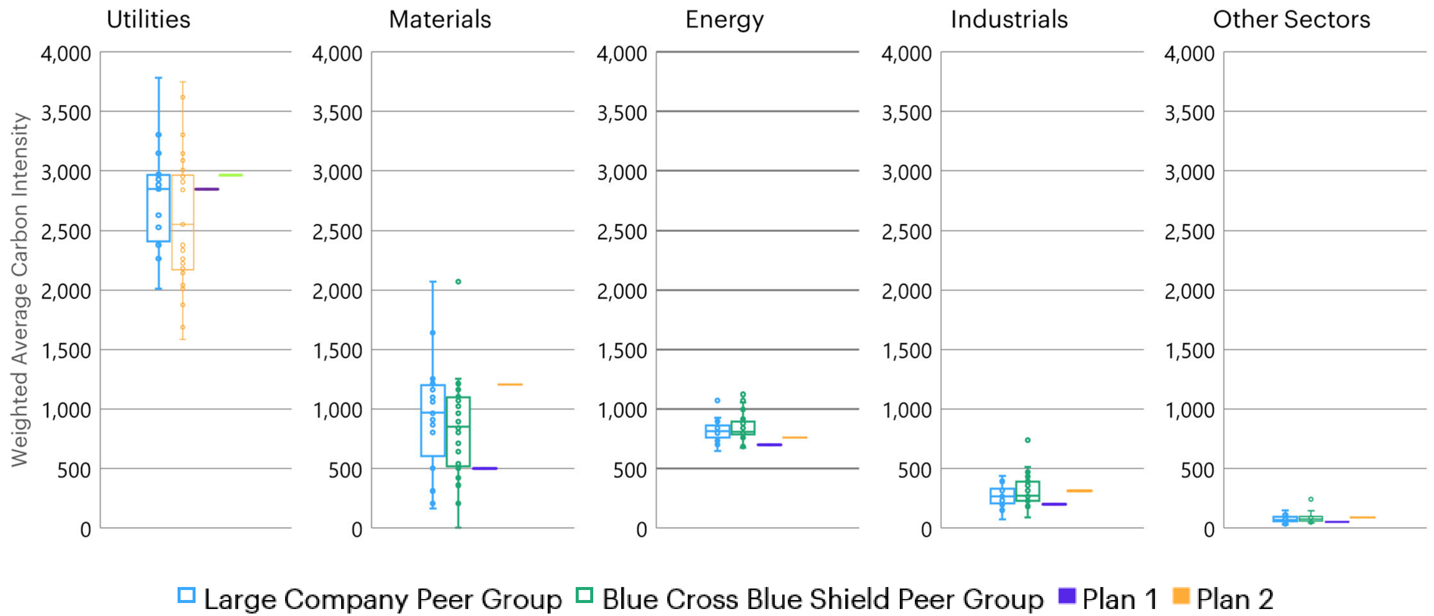
We go further in this article, breaking down the drivers of these scores and showing how they are influenced by portfolio construction.

Allocation by industry plays an important role in carbon emissions

The overall carbon intensity score can be decomposed into the impact of the individual names in the portfolio and the amount invested in different industry sectors. With carbon, certain sectors tend to have far higher emissions than others. This is shown graphically in the chart below, and as you might expect, utilities have the highest emissions, followed by basic materials, energy, and industrials.[1] Conversely, asset-light sectors, like financials and communication services (not shown), have lower emissions. In the case of our two health plans, the weighted-average carbon intensity of the portfolio holdings is similar within utilities, energy, and industrials. However, basic materials is divergent with Plan 2’s carbon intensity and is more than two times that of Plan 1.

[1] Carbon emissions include operational and first-tier supply chain greenhouse gas emissions. At the company level, carbon intensity reflects the sum of these emissions divided by revenue. A weighted-average carbon intensity is calculated using simple weighted average, excluding holdings without emissions coverage. The market value weights of the covered issuers are rescaled to sum to 100%. Data is presented in CO_2e/$1M revenue.

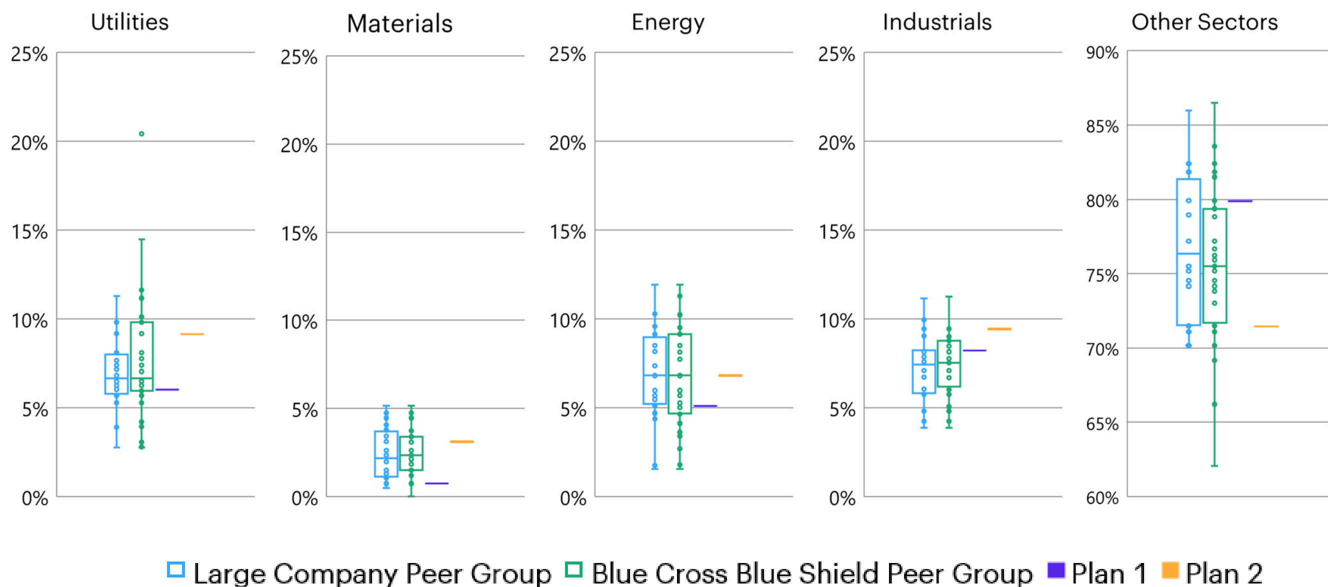
CARBON INTENSITY BY SECTOR



Source: MSCI, S&P Trucost, Allspring.

Based on how much carbon emissions vary by sector, it follows that the portfolio allocation by sector can be an important driver of overall results. In our last article, we showed how Plan 1 has lower overall carbon intensity than Plan 2. It turns out in this case that allocation to the higher-emitting sectors is a more potent factor than security selection, although both align in the same direction. The chart below shows the industry allocation for the health plans against peers.

CREDIT SECTOR ALLOCATION



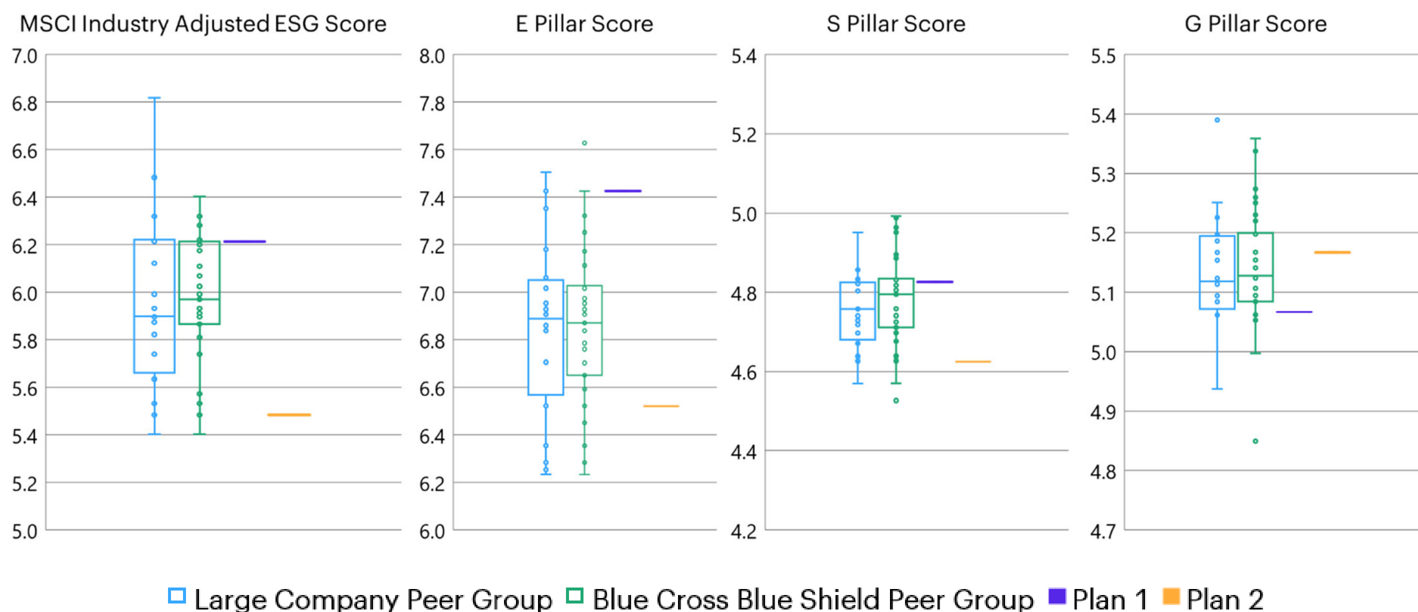
Source: MSCI, S&P Trucost, Allspring.

To reduce carbon intensity, a plan could choose to place less weight on these higher-intensity sectors, choose credits with a lower emissions profile, or do a combination of the two. In our third article, we'll discuss how our credit team looks at individual securities and how our proprietary analysis can help investors. We'll also discuss how relative-value considerations between credits can be brought into the equation.

Shedding light on the E, S, and G

Recalling the first article in this series, we showed a single-composite ESG score for two health plans and peer groups, but we can also calculate the individual ESG components. These scores are designed to measure risks and opportunities for issuers based on ESG factors, and the industry-adjusted score weight the ESG pillars differently by industry to make the numbers more comparable across industries. The charts below show the industry-adjusted score in the left panel, followed by the E, S, and G pillar scores. Higher is better for these metrics, with a possible score of 0–10.

MSCI ESG SCORES



Source: MSCI, S&P Trucost, Allspring

Similar to carbon intensity, a portfolio's allocation among industry sectors can have a large influence on its ESG numbers, particularly for environmental scores. As a whole, sectors like financials and communication services have relatively good environmental scores but average social scores. Industrials companies are valued by bond investors because of the hard assets and tangible products they possess, but they often have high carbon emissions and below-average social scores.

In this case, the environmental score jumps off the page as being most divergent. Plan 1 has a markedly higher score than Plan 2 in this area. Further analysis of these results shows that individual security selection is the biggest driver of the environmental scores above, and allocation by industry has a smaller but directionally similar impact. This is in contrast with the carbon intensity scores, where industry plays a bigger role. There are two reasons for this: MSCI's focus is on environmental risks and opportunities to a company, and it places energy companies at greater risk from environmental change and is less punitive to utilities.

Second, the ESG grading scale has a smaller numerical range than the carbon intensity numbers, which dampens the impact of sector allocation.

When compared with peers, Plan 1 also does better on the social score compared with Plan 2. While Plan 1 emphasizes the environment in its annual statement, the two plans have similar social goals. Plan 2 might want to look at the drivers of its lower social score of its portfolio. Plan 2 has a stronger governance score than industry competitors—including Plan 1.

The translation between social score and the community impact that health insurers value is not exact. Some social issues assessed by MSCI directly align with common health plan values, such as access to health care, but some, like product liability, are indicative of risk management and overall corporate citizenship. Others are contextually relevant to a given industry yet might not be important to health insurers' own social goals. To improve social impact, companies will have to identify areas that align with their values and can be tracked as part of a customized program.

Plan 1 would probably feel good about its results, with an allocation by sector that is close to the industry average while posting good results mostly due to security selection. Plan 2 may want to look at ways to complement its social mission by improving its social pillar score. For example, what holdings are acting as a drag on the social score, and is the plan comfortable with why? If the shortcomings overlap with the plan's priorities, can they expect the company to improve?

A health insurer may be willing to invest in companies that are headed in the right direction despite less-than-ideal scores in today's world. Similarly, it may want to consider social dimensions that are not captured in the ESG scoring. Our third article will discuss the evaluation of individual companies and shed some light on these nuances.

We believe all investors, even those who don't have ESG objectives on the front burner, can benefit from understanding the drivers of their ESG and carbon intensity scores. Those keenly interested in the path of decarbonization and enhancing their focus on ESG will find this a helpful way to plan their journey.

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