03 HEALTH INSURER CARBON PEER STUDY

The Last Mile:

Implementing ESG, decarbonization, and social impact strategies

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Whether your objective is to avoid risk in a changing world, decarbonize, or create a program to achieve mission-driven goals, implementation capability is where the rubber meets the road. In this last installment of our three-part series, we'll discuss the key considerations of these strategies into action.

Our articles have focused on the bond portfolios of Blue Cross Blue Shield (BCBS) plans and other large health insurers. These investors have risk and return objectives similar to most other bond investors, and many want to decarbonize or explore ways to improve the social impact of their portfolios.

Investors are understandably confused about the meaning of ESG (environmental, social, and governance) because it is often used to describe a wide variety of ethical or sustainable investment strategies. At Allspring, we frame our sustainable strategies into four pillars: ESG Risk, Climate, Impact, and Stewardship. Insurance investors may be interested in all four elements, but there are distinct solutions to each.

ESG RISK

Develop and deploy methodologies to understand the material ESG risks of companies and other securities issuers

CLIMATE

Understand the systemic risks related to climate change, analyze the investment implications sector by sector, and design portfolio decarbonization methodologies

IMPACT

Develop frameworks to allocate capital to positive sustainability outcomes and report on the same

STEWARDSHIP

Strategically prioritize our engagement with issuers and responsibly vote proxies in a manner that we believe will maximize long-term value

ESG risk: Adapting to a changing world

While the insurance industry has been adapting to technological, legal, and environmental changes for decades, creating systems to measure all of the related risks remains a challenge. Our ESG risk process highlights risks from environmental, social, and governance sources and consolidates them into an integrated assessment of a creditor's fundamental creditworthiness.

Gathering reliable data is critical to this process. We've found that accepting ESG evaluations from vendor firms at face value is often problematic. There are three areas where reliance on third-party data providers has significant limitations:

- Different vendors measure different things. There are subjective assessments related to what the risks are and how companies line up relative to those risks. As a result, ratings from different vendors end up having only moderately positive correlation.
- The quality of data provided by assessed companies is inconsistent. Not all companies report ESG data, which leaves room for interpretation.
- ESG data, and the scores of ratings providers that use the data, can be stale and backward looking.

Allspring's proprietary ESGiQ system addresses these challenges by enhancing our ability to identify opportunities and risks as they emerge. Allspring's solution is twofold. First, we use advanced statistical learning techniques to distill insights from quantitative data providers, resulting in enhanced quantitative metrics. Second, our fundamental analysts, who have deep familiarity with their sectors, make qualitative assessments of forward-looking sector- and company-specific ESG risks, emphasizing company management and oversight.

Our ESGiQ scores combine our quantitative and qualitative assessments based on our fundamental analysts' level of conviction. This optimizes the value of data from all sources and allows us to have a single score that we believe is indicative of forward-looking ESG risks.

Implementation capability is critical for managing risk of all kinds, and ESG is no exception. While every asset manager will have their own solution, we believe our proprietary process allows a more holistic assessment of risk that ultimately benefits our clients.

Decarbonizing: Look down the road, not in the rearview mirror

We believe reduction in carbon needs to be a thoughtful process that considers both relative value in the bond market and the investor's carbon and climate goals. In a prior article, we described how the carbon intensity of a broad credit portfolio is most influenced by the utilities sector. Merely eliminating exposure to the most carbon-intensive utilities is too simplistic. We think it's better to assess where companies are headed rather than focus on last year's carbon production. This way, investors can be on the "right side of change" as companies make efforts to reduce their carbon footprints.

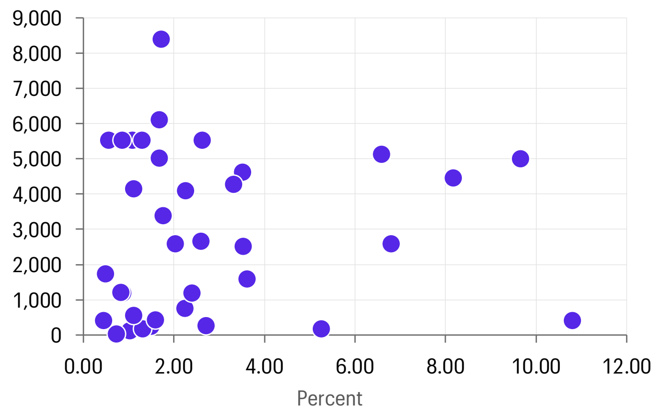
When a company seeks to decarbonize, they need both a strategy to do so and the financial strength to execute it. Our climate transition credit process has four key elements that aid implementation: strategy and governance, assets and operations, financial profile, and macro profile. A stylized example of our output is shown in the table below, with the score of each element measured on a 1–4 scale.

	CLIMATE PILLAR				
ISSUER	STRATEGY AND GOVERNANCE	ASSETS AND OPERATIONS	FINANCIAL PROFILE	MACRO PROFILE	COMPOSITE SCORE
Utility 1	1.4	1.6	2.0	2.0	**1.7**
Utility 2	2.6	2.0	2.0	2.0	**2.2**
Utility 3	2.4	2.0	3.0	2.0	**2.5**
Utility 4	3.0	2.8	2.7	2.0	**2.8**

Source: Allspring Global Investments. For illustrative purposes only.

To visualize the carbon contribution of different issuers at a single point in time, we've used a scattergram of each issuer's weight within the utilities sector versus its carbon intensity. The one shown below is derived from one of the BCBS plans we used as a subject in our prior article's case study, with the names of the credits removed.

Utilities sector carbon intensity



Source: S&P Trucost, S&P Capital IQ, Bloomberg, NAIC, Allspring Global Investments. For illustrative purposes only.

This chart helps us identify what drives carbon intensity higher, putting more weight on the highest emitters and vice versa. From there, we can discuss our forward-looking view of the issuers and their relative value in the market.

We believe this insight is useful to our clients who seek to understand the drivers of carbon intensity at the portfolio level. Carbon intensity is likely to come under more focus in the future, and we are positioned to help our clients understand and manage this aspect of their portfolios.

Social impact: Doing well while doing good

Many insurers, especially BCBS entities, have broader goals to improve their communities. Many focus on improving access to health care; education; reducing food insecurity; diversity, equity, and inclusion; and sustainability. These fall under the Impact pillar of our sustainability strategies.

Investors have often approached these concerns by excluding certain sectors. In the health care field, common exclusions are tobacco, alcohol, and certain arms manufacturers. Sometimes certain energy companies such as coal miners are also excluded.

We use this "addition by subtraction" approach on many accounts. However, the improved availability of data combined with deep research has the potential to track positive impact rather than just exclude unwelcome bond issuers from a portfolio.

We recommend breaking social goals into specific, customized items. A good lens for thinking about the details of health impacts include the United Nations Sustainable Development Goals (SDGs), such as SDG3: good health and well-being or SDG 6: clean water and sanitation. Allspring is building a system for assessing company contributions to SDGs that we plan to implement in the first half of 2023. While not as specific as some health plans' local goals, these represent a realistic way to track the social impact of the investment portfolio.

Stewardship

As a fiduciary, Allspring believes being an active influencer of companies can help to maximize the long-term value of our investments and protect invested capital. To do this, we monitor systematic risks such as the transition to a low-carbon economy, changing demographics, regulatory shifts, and technological change. We emphasize a collaborative approach between the Investments and Stewardship teams to uncover financially material ESG issues that help identify leaders and laggards. From there, we have several avenues of engagement with companies.

We also have a set of governance principles that emphasize strong independent leadership, shareholder rights and representation, accountability to shareholders, responsiveness to stakeholders, and clear communication. Our first course of action is always to communicate our concerns to company management. Proxy materials are also strongly correlated to corporate governance issues, and proxy votes can be an important conduit for Allspring to influence a given company.

Conclusion

Our clients are keenly interested in relative value and our portfolio managers discuss market opportunities with them regularly. We believe carbon intensity and specific ESG themes will become a larger part of the discussion as company management increases their focus on these factors. We are working with clients to customize goals aligned with their corporate priorities and measure the outcomes with relevant data. Our clients can monitor trends in these metrics today. We have the ability to report on carbon intensity, carbon footprint, Allspring's proprietary ESG ESGiQ scores, vendor ESG scores, and excluded sectors.

Allspring has made the assessment of ESG investment risks and the development of sustainability-related investment themes a priority because we believe they contribute to generating positive investment outcomes for our clients. ESG integration is crucial to risk management and highlights important issues that may be mispriced or misunderstood. Sustainability may have been a distant goal on the horizon some time ago, but as technology and data improve, the ability to act has arrived. Allspring has made assessment of sustainability-related investment risks a focus and has invested in the systems and capabilities to be a strong partner that investors can rely on in this part of their investment journey.

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