SUBMITTED STATEMENT OF
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HEARING ON
How Mandates Like ESG Distort Markets and Drive Up Costs for Insurance and Housing

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How Mandates Like ESG Distort Markets and Drive Up Costs for Insurance and Housing

Chairman Davidson, Ranking Member Cleaver and members of the Subcommittee:

Thank you for holding today's hearing on "How Mandates Like ESG Distort Markets and Drive Up Costs for Insurance and Housing," and for the invitation to testify. My name is Jerry Theodorou. I am the director of the R Street Institute's (R Street) Finance, Insurance and Trade program. I have worked as an analyst of the insurance industry for 15 years, both in my present position at R Street, and earlier at Conning, an asset management and insurance research firm. My main area of expertise within the broader insurance industry is property and casualty insurance. My research, publications, public presentations and congressional testimony focus on the drivers of insurer performance, and the impact of market forces and external drivers on insurers, policyholders and the economy.

Today's hearing is timely because environmental, social and corporate governance (ESG) factors have the capacity to influence insurers' performance, and by extension the availability and cost of insurance for consumers and businesses. Government mandates impacting the insurance industry destabilize insurance markets, leading to limited choice for consumers and businesses, and create higher costs. The imposition of ESG-related mandates, albeit well-intentioned, limit choice, reduce competition and drive up prices.

In some ways, discussion about how ESG factors impact the industry may be considered moot or unnecessary. Taking ESG considerations into account in insurance coverage and investment decisions is not new. It was evident well before ESG became an established concept in the 2000s. It is an element of sound risk management, and the insurance industry is fundamentally about managing risk. Such industry-led approaches to ESG are generally not a concern. The problem is when government imposes its perspective on ESG through mandates on the private sector.

Each of the three elements of ESG is familiar to insurers. On the "E" of ESG, insurance companies have been, and continue to pay, for losses caused by weather and climate catastrophes. This is a large part of what they are in business to do. In 2022, insurers paid out $98 billion to policyholders who experienced U.S. catastrophe losses.[1] Insurers are the financial first responders on the front lines making loss payments to policyholders. These loss payments enable policyholders' financial recovery in the wake of damage from catastrophes. Regarding the "S" of ESG, insurers, like all companies, are exposed to fines and penalties for transgressing state and federal laws barring discrimination, harassment and hostile work environments. On the "G" of ESG, insurers are subjected to rigorous governance oversight because they are not regulated by any one regulatory body—insurance is regulated at the state level by insurance commissioners. Insurance regulation departments conduct regular audits of insurers operating in their state. Insurers' governance is thus examined by multiple sets of eyes.

Adverse Impact of Government Mandates on Insurance

Among the ways government or regulatory mandates create adverse consequences, with higher costs ultimately borne by consumers, are government monopolies on certain insurance products and intervention in how insurers are allowed to calculate rates and premiums. For example, workers' compensation insurance, which is required, is a monopoly in four states—Ohio, North Dakota, Washington and Wyoming.[2] The prohibition against private insurers operating in these states means that insurance buyers are unable to choose policies based on coverage and price, as they are in other states.

In North Carolina, there is a rate bureau which controls the promulgation of insurance rates for several lines of business. North Carolina is the last state to continue to have a rate bureau responsible for calculating rates insurers can use. The North Carolina Rate Bureau has been

[1] "Facts and Statistics: U.S. catastrophes," Insurance Information Institute, last accessed July 11, 2023. https://www.iii.org/fact-statistic/facts-statistics-us-catastrophes.
[2] "Monopolistic state funds," International Risk Management Institute, Inc., last accessed July 11, 2023. https://www.irmi.com/term/insurance-definitions/monopolistic-state-funds.

compared to a cartel because insurance companies in the state set and use the bureau rates, depriving insurance buyers of the opportunity of broad choice.[3]

In states where the insurance commissioner is elected, rather than appointed by the governor, commissioners may be more likely to pursue populist agendas. An example is Washington State, where the insurance commissioner has served for 23 years. In recent years, Washington State was a driving force in a failed broader effort to prevent insurance companies from examining a broad panoply of factors relating to loss propensity in their ratemaking process.[4]

California is an example of a state where the heavy hand of government regulation has disrupted the insurance market in numerous ways due to regulators intervening heavily in insurance pricing decisions. The California Department of Insurance ties insurers' hands in three ways.[5] It prohibits insurers from pricing prospectively by taking into account the output of climate models.[6] It prohibits insurers from incorporating the cost of reinsurance into their ratemaking.[7] And finally, it permits public "intervenors" to challenge requests for rate increases greater than 7 percent.[8] As a result of these restrictive regulations, many national insurers have curtailed their California business writing.[9] Even Farmers Insurance, founded and headquartered in California, announced in July 2023 that it would no longer write new homeowners business in California.[10]

R Street has published a regular series of studies on the efficiency of insurance regulation in all states.[11] The study presents a detailed evaluation of the effectiveness of each state's regulation of

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[3] R. J. Lehmann, "Breaking up North Carolina's auto insurance cartel," *Real Solutions*, March 12, 2013. https://www.rstreet.org/commentary/breaking-up-north-carolinas-auto-insurance-cartel.
[4] Rachel La Corte, "Washington judge overturns insurance rate credit scoring ban," *The Seattle Times*, July 29, 2022. https://www.seattletimes.com/seattle-news/washington-judge-overturns-new-insurance-rate-rule.
[5] Steven Greenhut, "California's Insurance Market Is Burning Down," *The American Spectator*, May 31, 2023. https://spectator.org/californias-insurance-market-is-burning-down.
[6] Ibid.
[7] Ibid.
[8] Ibid.
[9] Breanne Deppisch, "Home insurers pull out of California thanks to wildfires and state regulations," *Washington Examiner*, June 1, 2023. https://www.washingtonexaminer.com/policy/energy-environment/insurers-pull-out-california-wildfires-regulations.
[10] Matthew Kupfer, "After State Farm's and Allstate's Exits, Farmers Insurance Sets Limits in California," *The San Francisco Standard*, July 7, 2023. https://sfstandard.com/2023/07/07/farmers-insurance-state-farm-allstate-california.
[11] Jerry Theodorou, "2022 Insurance Regulation Report Card," *R Street Policy Study* No. 272, December 2022. https://www.rstreet.org/wp-content/uploads/2023/01/r-street-policy-study-no-272-REVD.pdf.

insurance in seven key categories. It synthesizes those category evaluations by offering a "report card" grade for each state for analysis and comparison purposes. In the 10 editions of this study published since 2012, we have found that in states with less intrusive intervention in the functioning of the insurance market, the market is more competitive, and insurers have more choice. States graded "A" or "A+" in our latest report included Arizona, Kentucky, Indiana, Nevada, South Dakota and Virginia.

If government-mandated ESG considerations require insurers to insure certain risks or require them to invest in certain firms, the market is disrupted. When such government intervention prevents insurers from insuring certain risks or investing in certain firms, insurers have less power, and the market is disrupted in ways that ultimately lead to higher costs for insurance buyers.

Negative Consequences of Government Mandates

There are three main ways the insurance industry may be affected by ESG considerations:

1. Availability of insurance coverage may be reduced
2. Cost of available insurance protection may rise
3. Insurers' investment portfolios may underperform

Examples of potential ESG-related impacts on insurance cost includes insurers announcing they will not underwrite risks related to construction and operation of new coal-fired plants.[12] If other insurers adopt this policy, coal-fired plants would have to obtain coverage from the excess and surplus lines insurance marketplace, where insurance premiums are higher.

The property and casualty insurance industry holds $1.2 trillion in long-term bonds, amounting to close to half its $2.7 trillion in total assets.[13] The life insurance industry holds an additional $3.4 trillion in bonds, and $7.8 trillion in total assets.[14] Property and casualty and life insurers

[12] "Chubb Coal Policy," Chubb Group of Insurance Companies, last accessed July 11, 2023. https://about.chubb.com/citizenship/environment/coal-policy.html.
[13] S&P Market Intelligence/Capital IQ as of July 11, 2023.
[14] Ibid.

thus hold $4.6 trillion in bonds, almost 10 percent of the entire $51 trillion U.S. bond market.[15] The insurance industry is the second-largest holder of bonds; the pension fund industry is the first.[16] If ESG considerations compel investment in some issues or restrict insurers from investing in others, insurers' investment income—the largest generator of returns for insurers—could be compromised, leading insurers to raise rates and prices in order to meet shareholders' return expectations. The private sector may use ESG considerations in this regard as a risk management tool, which government should not inhibit. But if government prescribes specific forms of ESG management, it can undermine efficient risk management.[17]

Market Disruption

The operations of insurance companies are remarkably complex, but their core activity is to allocate their capital to the risk they assume. They charge premiums commensurate with risk magnitude. Past losses and claims payments are signals that help inform insurers about the magnitude of risk. If government bodies mandate rates or rating factors that insurance companies may or may not incorporate into their pricing, rate is decoupled from risk, weakening the signal and attenuating the ability of the market to function efficiently. If government intervention is extreme and insurers are coerced to price their policies with little regard for risk magnitude, they may abandon markets where this happens.

If ESG considerations or ESG investing drive insurers to make coverage, pricing or investment management decisions in ways contrary to sound risk management, insurers are less able to fulfill the three basic ways insurance plays a critical role in the economy. These are:

1. To pay claims to individual and business policyholders experiencing unexpected losses
2. To enable businesses to take risks they would not take on in the absence of insurance

[15] Ibid.
[16] David Farris, "What is the Size of the US Bond Market?," CCB Financial, last accessed July 11, 2023. https://www.ccbfinancial.com/assets/publications/81014be3-d8fa-446f-a4c1-42bf19cb0cee.pdf.
[17] Philip Rossetti, "Public Input from the R Street Institute on Proposed Rule for 'The Enhancement and Standardization of Climate-Related Disclosures for Investors'," R Street Institute, June 2022. https://www.rstreet.org/wp-content/uploads/2022/06/2Final_SEC-Climate-Disclosure-Rule-Final-Philip-Rossetti-.pdf.

3. To purchase for their investment portfolios municipal, government and corporate bonds that support construction and maintenance of the country's and states' critical infrastructure, and respond to corporate America's need for capital

Because the insurance industry plays such a critical role in the economy, external forces that may disrupt the industry deserve serious consideration. Exploration of the potential impact of ESG on insurers is therefore a timely and important undertaking.

Defining ESG and ESG Investing

One reason that ESG-related discussions have become polarized and heated is because there is a lack of agreement on the actual definition of ESG. It is an umbrella term that has different meanings for different people. To many on the left, it is a vehicle to achieve environmental and social objectives.[18] To many on the right, it is a way for "woke" radical elements to drive a liberal agenda into the investment sphere.[19] Among pro-ESG proponents, there are further distinctions, such as whether ESG considerations enhance pecuniary returns. However, proponents also want to amplify values or impact-driven ESG approaches, where some pecuniary gain is given up to attain non-pecuniary objectives.[20]

The term "ESG investing" is sometimes used as an alternative to ESG.[21] "ESG investing" is, however, also a fraught term that needs to be defined. It suggests that ESG is an investment methodology. Investment managers typically follow one of two main methodologies in selecting stocks. Fundamental analysis focuses on value by looking at financial metrics, such as price-to-earnings ratio, price-to-book ratios and debt ratios. Technical analysis, by contrast, focuses on

[18] Laura Tomasko et al., "Strategies for Advancing Impact Investing through Public Policy: A Guide for Advocates and Field Leaders," Urban Institute, January 2021. https://www.urban.org/sites/default/files/publication/103535/strategies-for-advancing-impact-investing-through-public-policy-a-guide-for-advocates-and-field-leaders.pdf.
[19] Michael Copley, "How ESG investing got tangled up in culture wars," National Public Radio, Sept. 12, 2022. https://www.npr.org/2022/09/12/1121976216/esg-explained.
[20] Sarah E. Fortt et al., "DOL Final Rule on ESG Factors to Take Effect February 1, 2023," Latham & Watkins *Client Alert Commentary* No. 3058 (Jan. 24, 2023). https://www.lw.com/admin/upload/SiteAttachments/Alert%203058.pdf.
[21] Rossetti. https://www.rstreet.org/wp-content/uploads/2022/06/2Final_SEC-Climate-Disclosure-Rule-Final-Philip-Rossetti-.pdf.

share price movement, looking at charts of stock performance to identify signs or triggers for future price movement and opportunities to buy or sell. If one defines “ESG investing” as making investment choices based on the environmental impact of the investment at the expense of looking at other factors, ESG investing is not new, but is just a nuanced term for sustainable investing or socially responsible investing—which results in putting a premium on attaining social ends.

According to rating agency Standard & Poor’s, ESG investing does not advance attainment of social ends at the expense of returns.[22] It recognizes that there may be material risk factors related to companies’ ESG practices that may affect long-term performance. Defined thus, investment managers do not violate their fiduciary responsibilities of care, loyalty and oversight. To be sure, if investment managers were to ignore material ESG factors in their investment decisions, they would be derelict in failing to fulfill their fiduciary duties.

Unintended Consequences

Today’s heightened interest in ESG has led to the mushrooming of a cottage industry providing ESG consulting services, ESG ratings assigned to individual companies, and categorization of companies as either “brown” or “green.” Brown companies generate high levels of greenhouse gas emissions, and green companies produce low levels of greenhouse gas emissions. A recent study by scholars at Boston University and Yale University explored the impact of investing in green, rather than brown companies.[23] It found that solely investing in green firms rather than brown firms does not lead to environmental benefit. The greenest firms are mainly services firms, such as insurance companies, which do not leave a notable carbon footprint, and have virtually no greenhouse emissions. The fact that SVB Bank, which failed in March 2023, had a

[22] “What is the difference between ESG investing and socially responsible investing?,” Standard & Poor’s Global, Feb. 25, 2020. https://www.spglobal.com/en/research-insights/articles/what-is-the-difference-between-esg-investing-and-socially-responsible-investing.

[23] Samuel M. Hartzmark and Kelly Shu, “Counterproductive Sustainable Investing: The Impact Elasticity of Brown and Green Firms,” *Social Science Research Network*, July 5, 2023. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4359282.

high ESG rating, calls into question the value of such scores.[24] The Boston/Yale study found that there is much more environmental benefit in making brown firms greener than attempting to make green firms greener. Other studies have found that diverting investments from brown companies to green companies results in green companies having higher value, but lower returns.[25] And importantly, depriving brown firms of investment reduces brown firms' ability to develop new sustainable technologies.[26]

Pro-ESG versus Anti-ESG

The discussions and debates surrounding ESG issues have led to polarization of positions, with both sides adopting extreme views. In addition to extreme positions, there is a spectrum with varying degrees of support or opposition to ESG investing.[27] Ardent pro-ESG proponents are found in radical environmental circles. At this end of the spectrum, one group maintains we are in the middle of the "sixth mass extinction"—termed the Anthropocene extinction—caused by human activity, which will result in the extinction of a million species.[28] This group holds that failure to address environmental concerns immediately will lead to the extinction of humanity and other forms of life. At the other end, an extreme anti-ESG position that made its way into a company's proxy statement maintains that the World Economic Forum, an affiliate of the company, "openly advocates for transhumanism, abolishing private property, eating bugs, social credit systems, the great Reset, and a host of other blatantly Orwellian objectives."[29]

The irony of the polarization of both positions, is that, if pursued, will lead to the opposite of what they seek to accomplish. The extreme pro-ESG position leads to the crippling of firms'

[24] Alastair Marsh and Saijel Kishan, "SVB Exposes 'Lazy' ESG Funds as Hundreds Bet on Doomed Bank," Bloomberg, March 14, 2023. https://www.bloomberg.com/news/articles/2023-03-14/svb-exposes-lazy-esg-funds-as-hundreds-bought-into-doomed-bank.
[25] Ľuboš Pástor et al., "Dissecting green returns," *Journal of Financial Economics* 146:2 (November 2022), pp. 403-424. https://www.sciencedirect.com/science/article/abs/pii/S0304405X22001672.
[26] Ibid.
[27] "Navigating State Regulation of ESG Investments," Ropes & Gray, last accessed July 11, 2023. https://www.ropesgray.com/en/navigating-state-regulation-of-esg.
[28] "Extinction Rebellion – Why Rebel?," Extinction Rebellion, last accessed July 11, 2023. https://rebellion.global/why-rebel.
[29] "Notice of 2023 Annual Meeting of Stockholders and Proxy Statement," Alphabet, June 2, 2023. https://abc.xyz/assets/1e/1f/796609564a91ad9ab98328ec44b0/2023-alphabet-proxy-statement.pdf.

ability to attain desired climate goals. The handicapping of investment managers' ability to consider ESG factors in their investment decisions leads to lower investment returns.

Anti-ESG in the States

Several states have adopted anti-ESG legislation, including Texas and Florida. In Texas, financial managers are prohibited from considering ESG policies when making investment decisions.[30] The Texas law requires the Texas Comptroller to develop and maintain a "blacklist" of financial entities that boycott fossil fuel companies.[31] In Florida, a bill bars state officials from investing public money to promote ESG goals, and prohibits ESG bond sales.[32]

Further, in May 2023, 23 state attorneys general wrote to members of the Net-Zero Insurance Alliance, a coalition of insurers, questioning the legality of their "commitments to collaborate with other insurers and asset owners in order to advance an activist climate agenda."[33]

Conclusion

Government mandates on insurers, whether ESG-related or not, introduce coercive or restrictive controls on insurers. Mandates erode choice and competition and inflate cost. Both extremes of the ESG debate distort insurance markets and can generate pressure to raise insurance rates. A hard position advocating attainment of non-pecuniary goals at the expense of insurer profitability dents returns, leading to higher insurance premiums. A hard anti-ESG position prevents insurers' investment managers from being cognizant of material risks to insurers' financial health. Whether insurers' investment managers follow pro-ESG or anti-ESG frameworks does not dilute their fiduciary duty to make investment decisions in the best interests of insurers. Mandates in

[30] "Texas Anti-ESG Legislation Targets Insurers and Pensions," Cobb & Counsel, April 12, 2023. https://cobbxcounsel.com/2023/04/texas-anti-esg-legislation-targets-insurers-and-pensions.
[31] Ibid.
[32] Isla Binnie and Ross Kerber, "DeSantis signs sweeping anti-ESG legislation in Florida," Reuters, May 3, 2023. https://www.reuters.com/business/sustainable-business/desantis-signs-sweeping-anti-esg-legislation-florida-2023-05-02/#:~:text=May%202%20(Reuters)%20%2D%20Florida,and%20prohibiting%20ESG%20bond%20sales.
[33] Sean D. Reyes et al., "Letter to Net-Zero Insurance Alliance," *Property Insurance Coverage Law Blog*, May 15, 2023. https://www.propertyinsurancecoveragelaw.com/files/2023/05/2023-05-15-NZIA-Letter.pdf.

insurance, including ESG-related mandates, militate against competitive markets and stable pricing environments.

Thank you for holding this hearing, and thank you for your consideration of my views. I look forward to any questions you may have.