

## **WORKING TOWARDS A CLIMATE RESILIENCE INVESTMENT FRAMEWORK**

**A discussion paper by IIGCC. Response by Leadenhall Capital Partners LLP**

**14 October 2022**

### **Q1. What are the main risk transmission channels through which physical climate hazards impact investment portfolios?**

When physical climate hazards occur they often negatively impact both the corporate and consumer sectors of economies. One of the main consequences of catastrophe events such as hurricanes, floods, earthquakes and wildfire is that this usually results in the damage or destruction of residential and commercial properties. In addition to the impact on properties natural disasters such these also create financial costs associated with business interruption and the housing of residents before properties are rebuilt and repaired. There are also related economic impacts limiting consumer spending and corporate expenditure. When considering corporates many sectors are impacted, for example:

- In the primary sector harvests are decimated when the natural environment and farming equipment is damaged
- In the secondary sector manufacturing can be halted when industrial properties equipment are damaged
- In the tertiary sector services companies are hit when retail and office properties are become unusable. Damage to transportation and distribution infrastructure disrupts supply chains

When natural catastrophe events occur one of the primary impacts is on commercial and residential property. Much of the discussion paper focusses on related impacts on corporate earnings, equity and credit investments. In addition to these effects longer term climate effects can potentially affect human mortality and ill-health rates.

### **Q2. Do you agree that it is relevant and important for investors to aim to address asset risks, portfolio risks, and systemic risks?**

We agree that it is important for investors to address the effects that climate hazards can have on asset, portfolio and systemic risks. The most significant risks are the systemic ones and Leadenhall's view is that financial resilience can be best built to protect against this through the provision of insurance, which has not been considered in the discussion paper. Insurance protection can be provided though asset owners investing in Insurance Linked Strategies (ILS). Insurance rebuilds societies and communities in their times of need after catastrophes including after climate events. Residents are re-homed and corporates are provided with business interruption cover. Finance is provided for the repair and rebuilding of commercial and residential properties to complete the provision of resilience. With regards to longer term effects of climate, that people can face due to potentially higher rates of mortality and ill-health, life insurance products can also provide them with financial resilience.

Insurance (or reinsurance premiums) is made investable for end investors through the structuring of Insurance Linked Strategies (ILS). Investors provide resilience to the consumer and corporate sectors by supplying of (re)insurance cover for residential and commercial properties (in non-life ILS) and for life insurance products (life ILS). Investors in turn benefit by harvesting regular reinsurance premiums

(which can have an attractive levels of potential returns relative to other asset classes and also provide diversification from cyclical markets).

Leadenhall therefore believe that investors that allocate to Insurance Linked Strategies help significantly address systemic climate resilience risks. The financial cover provided (limit) can be much more significant than considering smaller bottom up contributions to asset and portfolio risks as to whether particular equity or corporate bond holdings with subjective climate policies are overweight in traditional fund holdings. Leadenhall's view is therefore that more onus should be put on systemic climate resilience issues that can have a more significant impacts on societies. Insurance Linked Securities that provide systemic resilience should be considered as a priority in the discussion paper.

**Q3. Do you agree that the six levers in section 5 are the main avenues through which investors can build climate resilience at the asset and portfolio levels?**

Leadenhall do not agree that the six levers outlined are the main avenues through which investors can build a Climate Resilience Investment Framework. One of the main financial instruments whose primary purpose is to build financial resilience for societies to meteorological and climate effects is Insurance Linked Strategies (ILS). Investors in this asset class earn a (re)insurance risk premium over the long term for providing financial resilience to society and covering systemic climate risks often at national and state levels.

The discussion paper poses how investors can provide systemic resilience at a macro level to climate effects but focusses more on micro issues at asset levels as to how corporate equity and bond issuers have climate policies in place. Capital markets provide systemic resilience to the physical effects of climate through ILS and so there should be a priority to include the ILS asset class in its own standalone lever. ILS instruments have been transforming (re)insurance risks to the capital markets for over the last 25 years. The reinsurance market stands at c.\$675bn with c.\$100bn of this being passed on to the capital markets as ILS (as at April 2022 as reported by Aon Benfield in their latest Annual Reinsurance Market Outlook). This transformation makes insurance risks investable allowing asset owners to build and grow climate resilience for across both consumer and corporate sectors.

**Q4. Which levers are most important for investors to contribute towards building systemic climate resilience?**

Leadenhall agrees that engaging with individual corporates as issuers of securities can help build climate resilience bottom-up at asset level.

However Leadenhall's view is that ILS is a significant main lever that should have equal prominence in building systemic, and often more significant, resilience to the physical effects of climate. For example 5.2 in the discussion paper gives the example that businesses, as well as their supply and value chains, may be impacted by flooding across a region. However what is not mentioned is that various ILS already provide cover recompensing residents and businesses in regions when these events occur. For example regions covered include the US, Europe and Japan (as well as specific states), and investing in ILS covering these areas builds systemic resilience across the regions covered and helps close insurance protection gaps.

Consequently Leadenhall's view is that ILS is an asset class should be added to the Climate Resilience Investment Framework as its own lever and in one of the circles in Figure 1 to show that ILS provides climate resilience for both human settlements and corporate activity.

**Q5. Are there other levers that have not been identified here?**

As mentioned in question 4 Insurance Linked Strategies (ILS) should be included in the Climate Resilience Investment Framework as a specific lever that builds systemic climate resilience (often more significantly than asset and portfolio risks addressed more subjectively in climate policies by equity and corporate bond issuers). ILS are specifically structured to provide human settlements and corporates mentioned in Figure 1 with resilience to the effects of climate.

Section 5.5 of the discussion paper poses whether national and regional action on climate resilience can be supported. ILS directly covers nationwide risks in the US, Europe, Japan, Mexico, Philippines, etc. as well as state level risks. ILS therefore directly addresses the systemic climate risks that are mentioned, and so should be explicitly considered as a lever and asset class in the framework.

**Q6. Does the proposed core structure of the Climate Resilience Investment Framework seem complete and encapsulate existing thought leadership on the key components? Are any further improvements needed?**

Insurance Linked Strategies help build climate resilience at systemic, portfolio and asset class levels and so the proposed framework generally fits with this. However ILS has most effect at a systemic level. Systemic climate resilience was mentioned in previous sections but has unfortunately been dropped from the table in Figure 2. Leadenhall's view is that for consistency a section on systemic risk should be introduced back into the framework at this point as, importantly, investments that build systemic climate resilience are likely to have most effect in building overall climate resilience. ILS helps close the insurance protection gaps that exist both in consumer and corporate sectors. As this asset class continues to grow this gap will further narrow and in so doing increase systemic climate resilience.

**Q7. When adding specificity to recommendations for different asset classes, are there any key initiatives, methodologies, and/or data sets that should be included within the framework?**

As previously mentioned Insurance Linked Strategies should be specifically considered within the framework rather than be excluded in its current form. ILS holdings can provide resilience to specific perils (such as hurricanes, earthquakes, typhoons, wildfires, etc.) and to specific systemic regions (eg. US, Europe, Japan, etc.). Within countries resilience can also be provided to specific areas and states. Therefore within the Climate Resilience Investment Framework table it should be ensured that there is enough latitude for ILS mandates to describe how they're aligning to deliver climate resilience, for example by saying at a systemic level how much financial resilience (insurance limit) they provide, and which perils and areas they aim to cover. The systemic approach taken by ILS funds is likely to have significant effects on climate resilience compared to traditional asset classes.

**Q8. Is the approach to target setting under the Net Zero Investment Framework considered suitable and possible in the context of climate resilience?**

The approach to target setting under the Net Zero Investment Framework is not fully consistent and aligned with the most current concepts on carbon accounting and resilience outlined in PCAF's Public Consultation on Insurance-Associated Emissions. The Net Zero Investment Framework mainly covers how corporates can account for their carbon emissions and how they can target lowering them. However as described in 5.2 of the discussion paper and PCAF's insurance consultation societies are faced with the climate risk that physical property that they own is damaged or destroyed. Therefore in the case of property catastrophe risks (commercial and residential) the concept that is proposed for insurance-associated emissions these should be based on the emissions of the physical assets at risk (ie. properties in the case of property catastrophe risk).

Given that NZIF does not yet consider the emissions associated with physical assets when considering climate and considers the historic method of attributing corporate carbon emissions by instruments in corporate capital structures we propose that the reference to NZIF is removed at this current time.

**Q9. Are the same indicators applicable across all asset classes within scope (listed equities, corporate fixed income, real estate, infrastructure, private markets, alternatives) or is there a need to define asset class specific indicators?**

Previously in the discussion paper the concept of climate resilience was discussed at systemic, portfolio and asset levels. However these levels are not mentioned in the table of proposed indicators in the Climate Resilient Investment Framework. Insurance Linked Strategies are some of the most powerful financial instruments in providing societies with systemic resilience to the effects of climate. Most of the metrics listed in the table refer to corporates who may have less significant subjective climate policies in place.

Leadenhall therefore suggest introducing systemic indicators that show the significant steps they take in building systemic climate resilience such as:

- Systemic resilience (limit) provided in response to meteorological and climate events
- Systemic resilience (limit) provided to residential and small and mid-sized businesses
- The allocations to systemic risks (eg. US wind, US earthquake, Japanese typhoon, etc. contribution to risk)

**Q10. Given the more qualitative nature of climate resilience relative to mitigation, how can the framework ensure that future targets are specific, measurable, achievable, relevant, and time-bound?**

The indicators current in the discussion paper are focussed on measuring corporate holdings which may have a climate resilient strategy in place, although this is subjective as to whether a corporate's plans around climate issues may have reached arbitrary levels.

The indicators would be more meaningful if allocations are measured to strategies that definitively measure systemic climate resilience. For instance Insurance Linked Strategies specifically define the financial resilience or cover (limit) they provide in response to meteorological and climate events. Leadenhall therefore propose that Systemic Financial Resilience should be included as one of the more significant indicators. Non-life ILS strategies can share the specific, measurable, achievable and relevant financial limit that they provide. They can also provide the allocations to systemic risks as described in question 9.

**Q11. Do you believe that the six levers for action identified in section 5 can be the basis of a resilience commitment statement for investors?**

Leadenhall does not believe that the six levers in section 5 fully represent the basis of a resilience commitment statement. As stated in 5.2 properties are usually the assets most impacted when there are climate disaster events. Insurance Linked Strategies (ILS) are assets that specifically provide systemic resilience when property catastrophe events occur. They should therefore be included within the Climate Resilient Investment Framework and be included in one of the circles in Figure 1 as an asset and lever that can most directly address systemic climate resilience.

**Q12. Do you agree with an investor commitment to support public investment in activities which address physical climate risks, particularly investment in listed use of proceeds bonds by governments or public-private partnerships?**

Leadenhall supports governmental and state supported ILS issuance, providing resilience to countries such as Mexico and the Philippines. These are not recognised as ‘use of proceeds’ bonds. However Leadenhall’s view is that ILS should be recognised as providing systemic resilience to the effects of climate. The investor commitment should therefore be expanded to include the valuable and measurable resilience that ILS provides.

**Q13. What should be included in an advocacy statement calling for more opportunities to collaborate in national efforts to address physical climate risk?**

Many ILS provide nationwide (and wider) cover in regions such as the US, Europe, Japan, etc. from climate-related perils including wind and flood. They therefore provide national systemic climate resilience. ILS should therefore be included in advocacy statements to address physical climate risk.

**Q14. Which components of a Climate Resilience Investment Framework should be prioritised for development and why?**

Insurance Linked Securities should be prioritised for development as part of the Climate Resilience Investment Framework. ILS is the natural asset class that provides society with systemic financial resilience to meteorological and climate events. The (re)insurance that it provides protects, recompenses and rebuilds residential and commercial properties when meteorological and climate events occur.

Consequently ILS should be recognised in the discussion’s investor view 9 (Figure 1), the CRIF outline (Figure 2) and proposed indicators (Table 3). Focussing on indicators and metrics that primarily consider corporate securities can help make micro incremental improvements in climate resilience bottom-up at an asset level as individual companies are engaged to consider climate considerations. However investments in ILS make a more significant top-down systemic difference in improving climate resilience at national and state levels. Leadenhall’s view is therefore that indicators should be prioritised in the Climate Resilient Investment Framework that quantify the insured amounts (limits) and associated resilience in financial terms that is provided by ILS allocations mandates. These insured amounts are likely more significant when financial resilience is quantified than whether traditional equity or credit funds are incrementally overweight (or effect change at) companies with more climate resilient practices and policies.

**Q15. Should a phased approach to investor implementation of the recommendations in the framework be adopted or should the CRIF only be operationalised when significantly completed?**

Leadenhall agrees that a phased approach should be taken when implementing the Climate Resilient Investment Framework. This should follow a list of priorities that enables the initial introduction of the CRIF after implementing the most important priorities. One of the first priorities should be the inclusion of Insurance Linked Strategies due to the natural systemic climate resilience that the asset class provides to both consumer and corporate sectors. The quantifiable financial resilience provided by ILS (insured amounts or limits) are likely significant and more measurable than less tangible asset level metrics as to whether traditional equity and credit portfolios are more marginally overweight or underweight companies with subjective climate policies.

Concepts that are currently less joined up such as how CRIF may be aligned with NZIF should be given a lower priority and delivered in a later release of the CRIF. It is currently less clear how concepts align, particularly as the concepts in PCAF’s recent Public Consultation on Insurance-Associated Emissions have not been considered.