How is climate risk being addressed by bulk annuity insurers?

No matter where you look, what newspaper you read or what industry you work in, it's difficult to avoid the topic of climate risk. The pensions industry is no different, with trustees of large pension schemes needing to produce reports in line with the Taskforce on Climate-related Financial Disclosures (TCFD) requirements either from 2021 (for the very large schemes with relevant assets* above £5bn) or 2022 (for schemes with relevant assets above £1bn).

To help trustees and sponsors understand the impacts of climate risk on their portfolios, every two years we run Responsible Investment surveys of both asset managers and bulk annuity insurers. This year we asked Aviva, Canada Life, Just, Legal & General, Standard Life, Pension Insurance Corporation, Rothesay and Scottish Widows to participate in the insurer survey.

We view this survey as one of our key tools for engaging with insurers on ESG (environmental, social and governance) topics. Trustees and sponsors can engage too by considering the **results of our survey** when selecting or monitoring bulk annuity insurers.

Four key questions we address in this report

- How are insurers managing climate risk in their portfolios?
- Have insurers set net zero targets that apply across their business?
- Are insurers producing reports in line with TCFD requirements and are they well prepared to help trustees meet their own requirements for producing TCFD reports?
- Have insurers applied to become signatories of the UK Stewardship Code 2020?

Tom Farrell
Partner

We are encouraged that insurers are taking positive steps on managing climate risk. With climate related metrics and approaches to climate risk management soon becoming publicly available, trustees will be able to factor action on climate change into their insurer selection decisions.

*relevant assets exclude those held in buy-in policies
Note: Data collected at 30 September 2021

How are insurers managing climate risk in their portfolios?

Why is this important? Insurers are required to reserve enough assets to cover their liabilities in the event of a wide range of risk scenarios. However, risks such as those arising from climate risk are difficult to model so they are somewhat untested in the insurance regime (and indeed anywhere else) and have the potential to negatively impact an insurer's solvency position if left unmanaged (and, as a consequence, put members' pensions in retirement at risk).

We asked the insurers for examples of how they are managing climate risk across their businesses. We were provided with a range of responses, but on the whole were encouraged that climate risk is taken seriously and processes are in place to manage this risk.

The main examples given by the insurers on managing climate risk were:

- **Scenario analysis** – four insurers (Aviva, L&G, Phoenix Life and Scottish Widows) are part of the Bank of England's Climate Biennial Exploratory Scenario (CBES), a stress testing exercise directed at insurers and banks. Encouragingly, two insurers that aren't in scope said they would be voluntarily shadowing this exercise to understand the impact on their solvency position.
- **Bottom-up analysis** - Assessing the impact of climate change on underlying asset portfolio holdings, from a bottom-up security perspective (eg reviewing individual company plans for cutting emissions to help decide whether to lend to the company).
- **Sector limits** - Introducing asset limits for high-emitting companies or sectors.
- **Green investments** - Investing in renewable energy.
- **Net zero targets** – More on insurers setting net zero targets on page 3.
- **Monitoring metrics** - Monitoring climate metrics and producing reports in line with TCFD requirements - more on this on page 4.

That said, not all the examples above apply to all insurers. In fact, we found a range of responses to this question and it's clear that some insurers are further along their journey than others when it comes to managing climate risk.

Note: Data collected at 30 September 2021

Have insurers set net zero targets?

We asked the insurers if they have set net zero targets and if these were publicly available. By net zero targets we are referring to the carbon emissions emitted by their underlying asset portfolios used to back insured pension liabilities (not the emissions of the insurer's business operations).

Have insurers set net zero targets?

Yes: 7

No: 1

Overall, we are encouraged that the vast majority of insurers have now publicly committed to a net zero target. We see a large degree of commonality, with most adopting 2050 as their target year (Aviva has set an ambition to reach net zero by 2040).

Even more important than setting the long-term objective of net zero, is setting interim targets and working towards those. The following information is available publicly in relation to the five insurers who have set interim targets.

Where insurers have not disclosed interim targets yet, we understand that they are likely to do so, so watch this space.

Insurer publicly disclosed emissions reduction interim targets

	Aviva	Just	L&G	Rothesay	Scottish Widows
First interim target	25% by 2025	50% by 2030	18.5% by 2025	20% by 2025	50% by 2030
Second interim target	60% by 2030	n/a	50% by 2030	n/a	n/a
Baseline year	2019	Not yet publicly disclosed	2019	2020	Not yet publicly disclosed

Here we see some differentiation between insurers. Perhaps of note is that Aviva's headline reductions to 2025 and 2030 appear slightly more ambitious than its counterparts. The devil will be in the detail though, as a more ambitious percentage reduction may not necessarily lead to lower absolute emissions (for example if the starting point was higher). We will look to make these sorts of comparisons as data becomes available across insurers, reported in a consistent manner.

In that regard the baseline year from which emissions reductions are measured is important. Where a baseline year has been disclosed we see that as a stronger commitment as it removes ambiguity. We understand that where insurers have not publicly disclosed the baseline year yet, they will do so in the near future.

Overall, we are encouraged by the commitment that insurers have shown to setting net zero targets, and look forward to seeing the progress made towards interim targets. We hope to see all the insurers setting both interim and long-term targets in the near future.

Note: Data collected at 30 September 2021

TCFD reporting and climate metrics

An increasing number of companies across many sectors are publishing climate reports that follow the principles set out by the Task Force on Climate-Related Financial Disclosures (TCFD).

Regulations will soon require most UK insurers to produce a TCFD-style report, but insurers appear to be progressing well in this area with most either already producing one or planning to do so in the future, as shown in the graphic below.

Are insurers producing TCFD style reports?

Yes: 4

Not yet but will be within the next year: 3

Not yet but will be by 2023: 1

Part of TCFD reporting involves monitoring climate-related metrics in relation to an insurer's asset portfolio. We asked insurers what metrics they were monitoring. Aggregate portfolio **emissions intensity** (a measure of a company's total emissions relative to the level of its business output, measured by its revenue or enterprise value) was the most common metric quoted. Commonality is encouraging although once again the devil is in the detail: we would like to see standardisation across the industry in terms of how metrics are calculated to ensure investors and policyholders can make fair comparisons.

Other metrics quoted were **climate value at risk** (a forward-looking measure of climate-related risks that estimates the fall in portfolio value if a particular climate scenario unfolds) and **temperature alignment** (a forward-looking metric that attempts to assign a temperature rise to a portfolio, eg a portfolio is aligned with a 3 degree increase in global temperatures).

Once again, we would call for standardisation of metrics and methodologies across the industry to help make like-for-like comparisons across insurers.

Insurers that already disclose carbon footprint metrics will be well placed to help trustees who are required to produce their own metrics, given there is a best efforts requirement to obtain metrics for all of the scheme's assets (and bulk annuities fall under the scope of this requirement).

Note: Data collected at 30 September 2021

2020 UK Stewardship Code

The 2012 UK Stewardship Code was recently overhauled and a 2020 version was launched, which took effect on 1 January 2020. The 2012 code was directed at owners of UK listed equities whereas the scope of the 2020 code has been broadened to better capture other asset classes, including fixed income and real assets. Given its re-positioning and wider scope, we asked insurers whether they (as owners of various assets) had applied to become a signatory of the 2020 code.

Have insurers applied to become signatories of the 2020 UK stewardship code?

Yes: 2

No: 6

The list of successful applicants was published on 6 September 2021 on the Financial Reporting Council's website (following a first round of applications). Aviva and Scottish Widows are listed under the asset owner category.

Where insurers have not applied for the 2020 UK Stewardship Code, we saw a range of explanations as to why, including:

- Some reported to be considering it
- Some referred to fund managers they delegate to having applied to become signatories. However, one of the first principles of the 2020 UK Stewardship Code is that responsibility for following it cannot be delegated.
- Some reported that, as they do not invest in equities, the code is less relevant to them. We think this may be a spill-over from the 2012 code, given the scope of the 2020 UK Stewardship Code has been broadened.

We were somewhat disappointed by this result, particularly given the new code is designed to capture investment in a broader range of asset classes. To us it suggests that insurers are behind the curve in recognising their important role in stewarding the assets they own and using their influence throughout the investment chain.

We note that most insurers did mention being signatories of other industry groups or alliances such as:

- UN Principles for Responsible Investment (PRI)
- Institutional Investors Group on Climate Change (IIGCC)
- Net Zero Asset Owner Alliance.

Note: Data collected at 30 September 2021

Conclusion and next steps

We are encouraged that insurers have been developing their approaches (and devoting resources) to managing climate risk. However, it is clear that some insurers are further ahead in this journey than others.

In their ongoing monitoring or at the point of selecting an insurer, we believe that trustees and sponsors of schemes should consider an insurer's approach to managing climate risk and integrating broader ESG factors into their ongoing processes. Indeed many trustees have words to this effect in their Statement of Investment Principles.

To help with this, we have recently concluded our biennial review of bulk annuity insurers' ESG practices. Our review provides trustees and sponsors with a rating for each insurer to help them factor these aspects into their decision making. We then break this rating down into three areas:

1. **ESG Integration**
2. **Stewardship**
3. **Climate risk**

and provide an overview of how each insurer has performed in each area.

An overview of the review service LCP can provide can be **found here**

Note: Data collected at 30 September 2021

Contact us to find out more

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