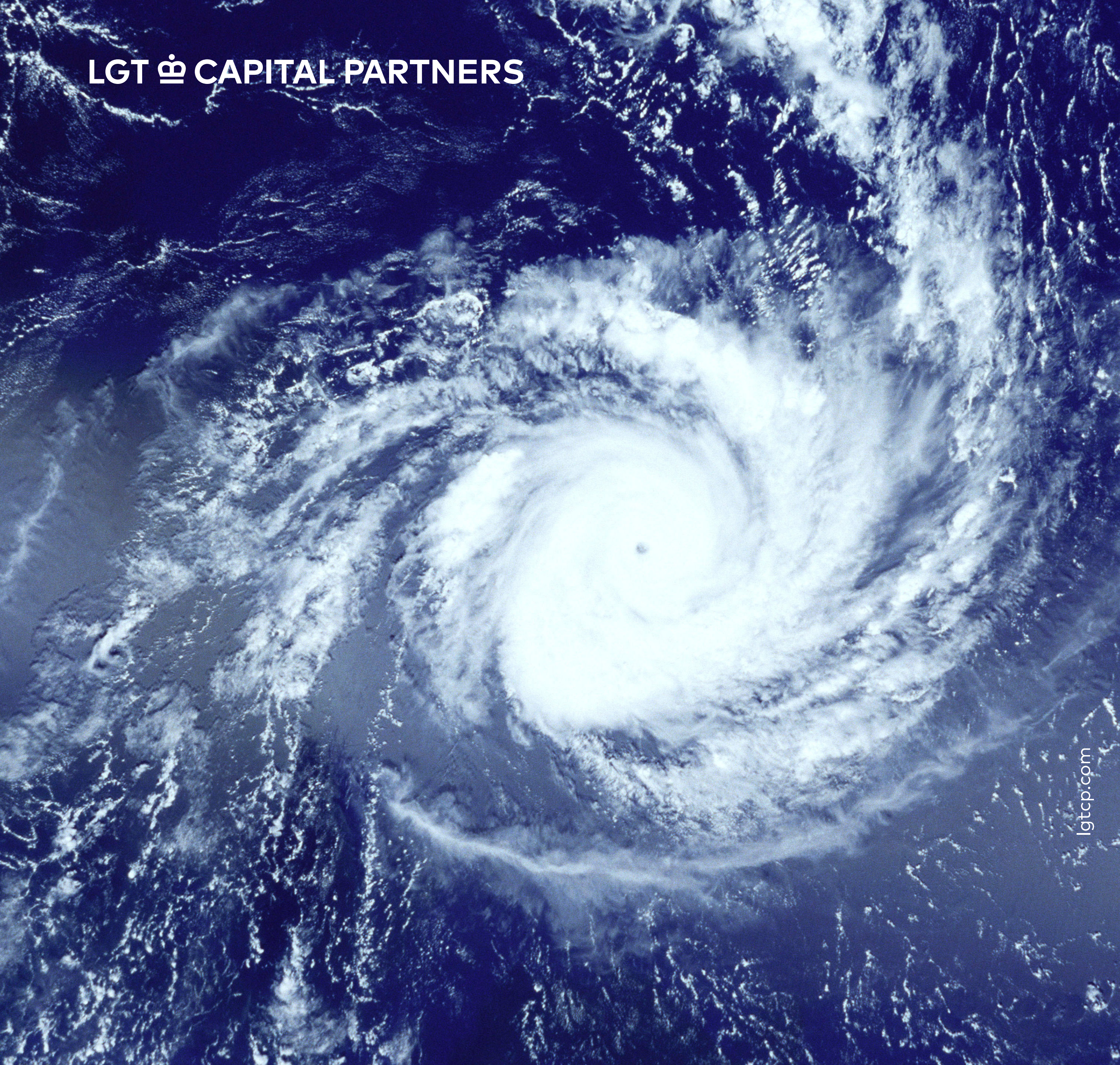


ESG in insurance-linked strategies

Marketing material

Introduction

Insurance-linked strategies (ILS) are a mainstay of sustainability focused investing, as ILS may offer a combination of positive ESG outcomes and attractive investor returns. ILS work by pricing climate risks through insurance policies, whose premia provide an incentive for proactive climate mitigation and adaptation activities. The investment class has been growing as the increase in climate induced catastrophic events is forcing insurers to buy more protection to meet their regulatory capital requirements, while under the EU Taxonomy Regulation such catastrophe protection is recognized as a sustainable investment. For investors, these strategies can be attractive for their premium returns, because performance is not correlated to capital markets or business cycles and on account of their sustainability characteristics.

Naturally, climate change is highly relevant to this asset class. The Sustainable Finance Disclosure Regulation (SFDR) and the supporting EU Taxonomy Regulation classify ILS as a sustainable investment activity, as the EU finance regulator recognizes that such investments ultimately act to support economic activities for mitigating or adapting to climate change.

In this paper, we aim to provide a comprehensive overview of the regulatory framework governing ESG considerations within insurance-linked securities, focusing specifically on the SFDR and the EU Taxonomy. We delve into the practical implications of implementing the SFDR directive in the context of insurance-linked strategies, offering an examination of how these strategies align with the requirements of an Article 8 fund, as classified by the SFDR. Furthermore, we present insights from our own portfolio by highlighting the strategies that adhere to these regulatory standards. At LGT Capital Partners, we believe that continuous, incremental improvement is key to achieving long-term, sustainable investment outcomes and invite you to explore the paper.

SFDR and EU Taxonomy at a glance

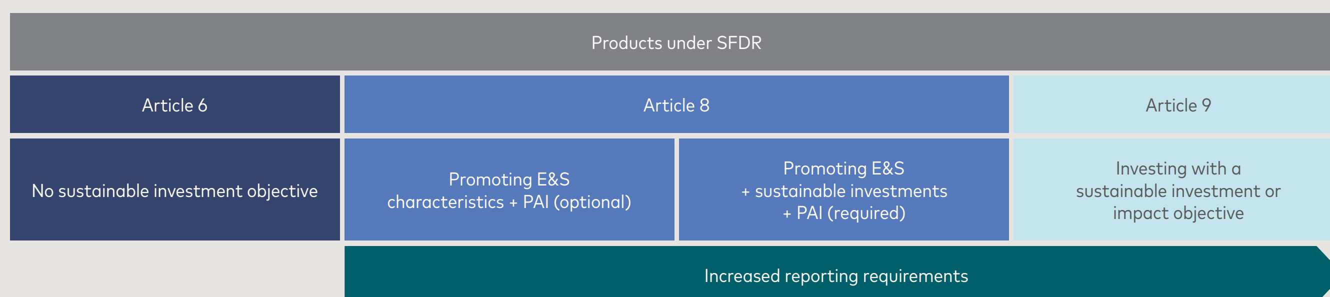
The SFDR is part of the EU Action Plan on Sustainable Finance, and ultimately the European Green Deal, with the specific aim to support the move toward a more sustainable financial system. The SFDR's aim is to provide transparency to investors about the environmental and social characteristics of financial products.
The regulation introduces a core set of requirements for asset managers:

- Transparency – asset managers must disclose ESG features of investment programs (including risks) in pre-contractual documentation, on their websites and in periodic reporting
- Standardization – Principle Adverse Impacts (PAI), a set of standard indicators to measure negative effects
- Comparability – a common, clear and comparable set of rules for defining sustainability, which utilizes templates, making it easier for investors to compare the ESG features of products

Aside from reorienting further capital flows towards sustainable outcomes, the goal of the EU is to prevent asset managers from "greenwashing." Under SFDR, investment managers need to clearly spell out for each investment program how they consider sustainability factors, with specific disclosures required, depending on the type of fund:

- "Article 9" includes offerings that have an outright sustainable investment objective and a (high) binding sustainable investment commitment. These strategies also consider PAIs
- "Article 8" includes offerings that promote social and/ or environmental characteristics. Such strategies give binding ESG-related commitments, for example, to sustainable investments or other ESG features, and they may consider PAIs
- "Article 6" includes offerings that do not meet the criteria of Article 8 or 9, but still have a reporting and consider sustainability-related risks

Figure 1: Overview of SFDR product types



Source: LGT Capital Partners

Implementation of SFDR for insurance-linked strategies

Insurance-linked strategies (ILS) focus on pure event-driven risk, with investors assuming the role of quasi-reinsurers. Investors receive premiums (investment income) in exchange for acting as a backstop to insurance and reinsurance companies in the event of a very severe catastrophe, such as a strong earthquake or a hurricane. The asset class has long attracted investors for its low correlation to financial markets, while the recent introduction of SFDR has further highlighted the sustainability dimensions of ILS.

The EU Taxonomy specifically lists non-life catastrophe insurance, LGT CP's area of ILS specialization, as a sustainable "enabling" economic activity. The EU has recognized that ILS investments act to improve the performance of wide-ranging economic activities for mitigating or adapting to climate change. For example, homeowners and business entrepreneurs choose to buy protection against climate-related perils, such as hurricanes or floods, which effectively assigns a cost to such climate-related insurance events (by charging a premium for the insurance cover). Increasing insurance premiums brought on by climate change is thought to incentivize society to invest in preventive measures, which should ultimately increase communities' resilience to natural disasters.

These dynamics mean that a large share of ILS investment activity can be considered sustainable. However, the EU Taxonomy currently focuses only on climate-related perils, such as windstorms or floods, which are considered within the framework as "enabling" activities. Non-climate related insurance risks, such as earthquakes, are not covered by the EU Taxonomy, but transactions with such risks can still be considered sustainable if the counterparty adheres to sound ESG practices and the transaction's exposure to heavy industry is no more than 5%.

From this promising starting point, LGT CP's ILS funds align with Article 8 requirements under SFDR, since these investments "promote E&S characteristics." As part of the investment process, we work to ensure that both the counterparty and the underlying transaction meet the various SFDR requirements for Article 8 alignment. To this end, we have developed a two-step ESG analysis, which is described in detail further below. We first analyze whether the deal counterparty (typically an insurance or reinsurance company based in North America, Europe, Japan or Australasia) meets certain minimum standards of ESG practices as a firm. As a second step, we assess the actual risks covered by the individual transaction to ensure that such risks are climate driven and pass the Do No Significant Harm (DNSH) test as outlined in the SFDR and the EU Taxonomy, as applicable.

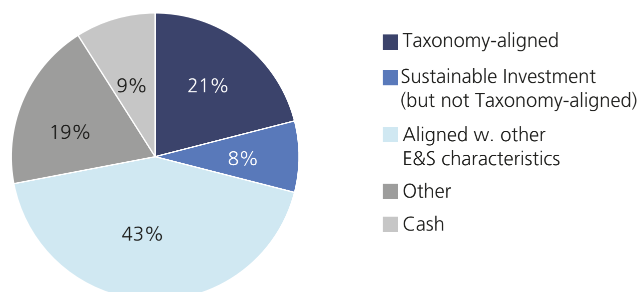
This DNSH-test aims to verify that the risk-transfer does not provide coverage to businesses focused primarily on fossil fuel production or consumption (such as coal mines or coal-fired power plants, for example). Investments are considered to be fully Taxonomy aligned only if:

- the counterparty is in line with ESG expectations
- the transaction avoids exposure to fossil fuels
- the transaction covers climate-related perils

However, if the investment meets the first two requirements but includes an allocation to non-climate related perils (which are not yet covered by the EU Taxonomy), the deal can still be deemed sustainable under LGT CP's SFDR sustainable investment framework.

For LGT CP's ILS strategies – which are all aligned with Article 8 requirements under SFDR – we have committed to allocating at least 50% of the portfolio to investments that are Taxonomy aligned, sustainable or "aligned with other E&S characteristics." Furthermore, the portfolio will allocate at least 20% of capital to Taxonomy-aligned and sustainable investments. Figure 2 shows the breakdown of a sample LGT ILS portfolio according to the EU Taxonomy, which indicates that the portfolio is well above these thresholds.

Figure 2: Investment breakdown of a representative LGT ILS fund portfolio



Source: LGT Capital Partners, data as of Q4 2023

Step 1: Assessing ILS counterparties with the ESG Cockpit

As a first step in ESG due diligence of ILS counterparties, we assess the ESG practices of the counterparty (primary insurance or reinsurance companies), using our proprietary ESG analysis tool for companies, the ESG Cockpit. The tool draws on company-specific ESG information from well-established providers to create a set of ESG-related KPIs. Taken together, they culminate in an overall ESG score based on objective, relevant and systematic ESG information. The ESG Cockpit enables the team to check a counterparty's "alignment with E&S characteristics" and its compatibility with minimum safeguards and standards of good governance.

Step 2: Transaction-level analysis and the DNSH test

The second step is a thorough review of the risk-transfer element of the underlying ILS position. ILS investments ultimately serve to finance reconstruction after extreme natural catastrophe events.
In doing so, these investments make a positive contribution to sustainable investments, according to SFDR. In particular, ILS investments support two SDGs: 11 (Sustainable Cities and Communities) and 13 (Climate Action).

Furthermore, ILS can also qualify for EU Taxonomy-aligned investments by applying the EU Taxonomy technical screening criteria (TSC) for non-life insurance and the underwriting of climate-related perils. To do so, 75% of the transaction's risk must derive from climate-related perils. Transactions that fall below this threshold may still be considered investible – as they could still qualify as "promoting E&S characteristics" – if they pass the DNSH test described earlier.

Transactions that provide reinsurance coverage to businesses involved in the extraction, storage, transport or manufacture of fossil fuels or other assets dedicated to such purposes are deemed ineligible for consideration as sustainable investments. If a transaction provides such cover, it must be excluded from the investment universe. In order to meet the requirements of this DNSH test, we carry out a thorough review of the underlying portfolio covered within the ILS investment. For example, a portfolio that only covers residential property typically meets the DNSH test because it does not have exposure to unsustainable economic activities conducted by industrial companies. By contrast, an investment that provides insurance coverage for large industrial companies – some of which could be active in the area of fossil fuel production – is unlikely to pass the test.

The table in Figure 3 shows three examples of how our team has assessed different types of transactions in practice. Deal 1 passes all tests and qualifies as Taxonomy aligned, while Deal 2 passes as a transaction that "promotes E&S characteristics" but is not Taxonomy aligned, as the contribution from climate-related perils is too low. Deal 3 does not meet the requirements given the coverage granted for industrial companies active in the area of fossil fuel exploration.

Figure 3: Assessing ILS transactions under SFDR and EU Taxonomy

	Deal 1	Deal 2	Deal 3
Counterparty	US residential insurance company	Global insurance company	Global reinsurance company
Country (HQ)	USA	France	Switzerland
Counterparty ESG score (0 to 100)	83	80	89
Deal description	Catastrophe reinsurance, focus on US hurricane and severe storm events	Catastrophe reinsurance, focus on European winter storm, flood and earthquake	Property reinsurance for large industrials active in the area of fossil fuel extraction
Industrial exposure (maximum 5% for Taxonomy alignment)	0%	3%	100%
Contribution from climate related perils (minimum 75% for Taxonomy alignment)	88%	56%	0%
Type of ESG investment under SFDR	Fully EU Taxonomy aligned – clear target transaction.	Meets E&S characteristics – eligible for investing.	Not eligible for investment – deal covers only industrial risks and perils related to fossil fuel extraction.
Allocation	Yes	Yes	No

Source: LGT Capital Partners, data as of Q3 2024

About us

LGT Capital Partners is a leading global specialist in alternative investing offering a wide range of investment programs focusing on private markets, multi-alternatives and diversifying strategies, as well as sustainable and impact strategies. The core team began investing in private markets in 1997, and in November 2000, they founded LGT Capital Partners, based in Pfaeffikon, Switzerland. The founding team continues to be a key part of the firm's senior management today, ensuring stability and consistency in our culture and approach.

The firm has a long-held commitment to incorporating ESG considerations into its client programs and its business overall. Since 2003, many of our programs have had a responsible investment clause written into their governing documents, authorizing us to exclude investments that are substantially exposed to arms-related activities, violations of human rights, irresponsible treatment of the natural environment or other non-ethical conduct of business. Consideration of ESG issues is an integral part of our investment process, as our investment teams are responsible for taking into account ESG considerations when performing due diligence on investments. Any opportunity that is pursued will have been vetted for such issues.

LGT Capital Partners has been a signatory to the Principles for Responsible Investment (PRI) since 2008. In 2018, Tycho Sneyers, a managing partner and chairman of the firm's ESG Committee, joined the PRI board of directors. LGT Capital Partners also participates in various other initiatives such as the Net Zero Asset Managers initiative, the Institutional Investors Group on Climate Change (IIGCC), Climate Action 100+, the ESG Data Convergence Project, GIIN, the European Sustainable Investment Forum (Eurosif), Nature Action 100, the Net Zero Engagement Initiative as well as PRI Advance, the largest social stewardship initiative.

Membership or signatory status to the above organizations & partnerships is specific to certain non-US LGT CP group entities and does not extend to all LGT CP group entities

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ESG disclosures

The strategies mentioned in this document, are considered to be aligned with Art. 8 or 9 strategies under EU 2019/2088, but do not have carbon reductions as their objective. They do not attain their portion of sustainable investment, if applicable, in the manner prescribed in Article 9(3) of such regulation. Investors should note that, relative to the expectations of the Autorité des Marchés Financiers, these strategies present disproportionate communication on the consideration of non-financial criteria in their investment policy. Further, it is considered that the names of these strategies are disproportionate to the AMF's consideration of non-financial criteria. The "do no significant harm" principle applies only to those investments underlying the strategy that take into account the EU criteria for environmentally sustainable economic activities. The investments underlying the remaining portion of this financial product do not take into account the EU criteria for environmentally sustainable economic activities. For all other strategies mentioned in this document, investors should note the Investment Manager's assessment of ESG characteristics may change over time and the ESG conclusions of the Investment Manager might not reflect the ESG views of investors. There is no guarantee that a company meets the expectations in relation to ESG. LGT CP integrates an assessment of Sustainability Risks into its investment processes. The results of this assessment and the potential impact on returns may vary. LGT CP or the appointed manager may rely on third-party ESG data or research providers to produce any ESG-related analysis. Such data or research may be imprecise, incorrect or unavailable and the resulting analysis may be impacted. It is considered that the policies adopted to assess and mitigate Sustainability Risks may mitigate such risks to the strategy. The investments underlying the strategy do not take into account the EU criteria for environmentally sustainable economic activities. Further details on ESG integration and sustainability-related stewardship can be found on lgtcp.com.

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