

Insurance Insights

Net-zero credit: A holistic risk management solution for insurers?



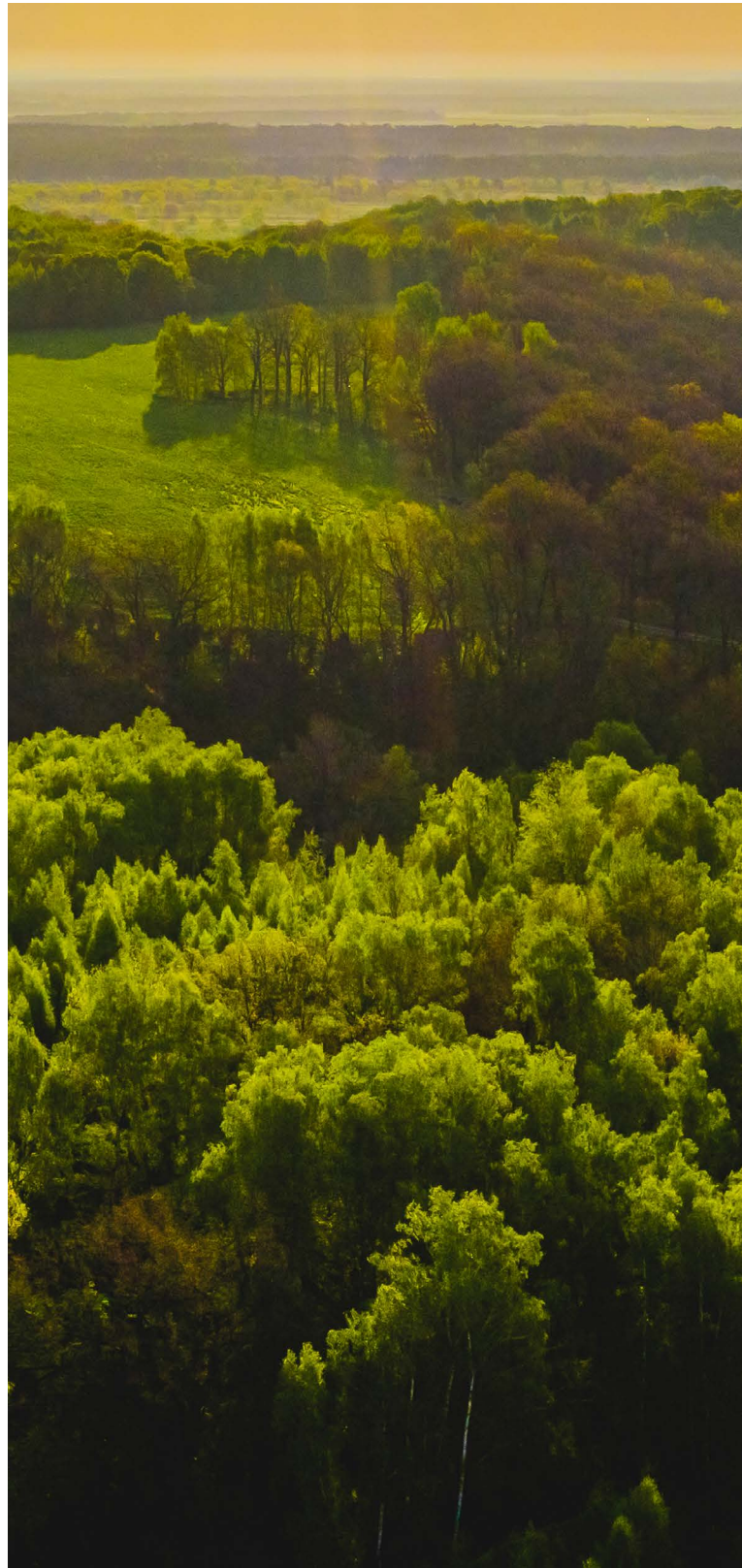
James Hayes
Head of Insurance Client Team

Investment-grade credit has long been a mainstay for insurance companies' matching portfolios. We believe, credit exposure can be used to seek attractive capital-adjusted returns and can help provide inherent sensitivity to interest rates to help match insurance liabilities. But can insurers also use credit to meet climate objectives without compromising on financial objectives?

Focus on climate-aware matching portfolios

2023 was the hottest year on record¹, with extreme weather events becoming far more frequent. We believe investors, including insurers, have a crucial role to play in driving the transition to a low-carbon economy and seeking to mitigating climate-related risks. We believe, two ways insurance companies can seek to exercise this power while still remaining mindful of the need for matching assets is i) to consider a net-zero credit approach and ii) include a private credit sleeve.

1. Source: Climate.gov



Key risk: The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.



Using company emissions data in credit selection

A key metric that net-zero credit portfolios use as an input into their investment decision-making process is data from companies showing their Weighted Average Carbon Intensity, known as WACI. WACI gives a current snapshot of how much carbon a company is emitting today.

It is worth noting that certain industries will usually have higher or lower carbon profiles depending on their business area. For instance, an energy provider is typically likely to emit far more carbon than a technology or media company. If an investor is solely focused on reducing WACI therefore, that's likely to drive significant sector skews, which in turn can materially affect the portfolio's profile.

We believe a sole focus on WACI can also potentially lead to some overly short-term behaviour, however. For instance, just reducing the carbon score of a portfolio based on today's considerations does not necessarily enable the largest potential impact on the climate transition. This is because we believe companies in low-emitting sectors using additional capital to reduce emissions further is likely to have a much less material impact than if companies in higher-emitting sectors decide to reduce emissions.

So, while WACI is important, we believe it is not the only data point investors should be considering.

Beyond WACI: harnessing Destination@risk

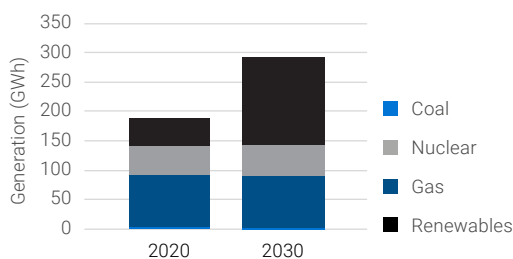
In our view, it is very important that investors aim to align with the climate transition by taking a forward-looking view, using focused credit analysis to seek to invest in the most appropriate names in each sector. This means giving capital to the companies that need it the most to reduce their carbon intensity and also have good strategies around environmental, social and governance (ESG) factors.

In our view, one way investors can seek to exercise this power is by applying LGIM's Destination@Risk framework. This framework can potentially enable investors to assess the climate-related risk and temperature alignment of individual companies and, by extension, make investment decisions that can both seek to reduce risk and improve the environmental impact of their portfolios.

Furthermore, we believe taking a forward-looking view of temperature alignment gives investors more chance of uncovering a potential 'transition winner' that the markets have not yet priced in. By contrast, we believe many of the 'lower-WACI' companies are already likely to trade with an 'ESG premium' given their popularity in many existing climate-related investment strategies.

Figure 1: Companies in same industry with similar WACI, but differing temperature alignments

Electric Utility A



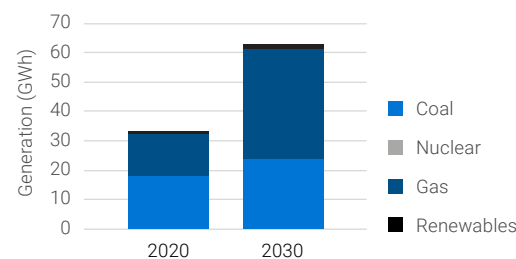
Region: NAM

Alignment: 1.67 C

Current Carbon Intensity: 2535 tCO2 / \$m revenue

Rapid coal phase out nearly complete, expansion of renewables, ambitious forward-looking carbon intensity targets

Electric Utility B



Region: NAM

Alignment: 2.75 C

Current Carbon Intensity: 2795 tCO2 / \$m revenue

Coal phase out slow, gas ramp up and renewables deployment too slow starting from a low base. Targets set but low probability assigned

Figure 1 uses an anonymous case study to give a clear example of how taking a forward-looking approach in addition to reviewing WACI data can highlight where companies in the same sector can have a similar current carbon intensity, but very different long-term temperature alignment paths.

Source: Destination@Risk, LGIM Analysis, December 2023. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Key risk: The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

Adding a private credit sleeve

We believe, extending a core public credit portfolio to include an investment-grade private credit sleeve can be another way to potentially make a significant contribution to achieving net-zero objectives.

A private credit sleeve can seek to do this in three ways:



1. Primary market

Private credit lending can offer the opportunity to provide new capital to finance climate transition investment (versus refinancing existing debt)



2. Sectors with climate impact

Greater access to sectors and names that can seek to make a significant contribution to achieving a net-zero society. For example, renewables (solar, offshore wind), the infrastructure that service these sectors (such as offshore transmission assets) and nature financings (e.g. lending to emerging market sovereigns, with insurance provided by a government agency (e.g. US government), to fund nature preservation in places like Belize and the Galapagos Islands)



3. Covenants

Use of contractual terms to incentivise a positive transition by the borrower e.g. lending to a Housing Association where the interest rate can step-up if specified targets on improvements in energy efficiency of its housing stock are not achieved.

Targeting both net-zero and financial objectives simultaneously

At LGIM, we believe that a net-zero approach to credit investing can further an insurer's climate objectives without compromising on financial objectives. The table on the right illustrates this by comparing yield and spread risk SCR (solvency capital requirements) for a traditional global investment-grade public credit portfolio, one with a net-zero aligned objective and one with both a net-zero aligned objective and a private credit sleeve.



Illustrative modelling	Gross redemption yield	Spread risk SCR
LGIM Global Corporate Bond Fund	5.1%	9.7%
L&G Net Zero Global Corporate Bond Fund	5.1%	9.1%
L&G Net Zero Global Corporate Bond Fund with 20% private credit sleeve	5.3%	9.5%

Source: LGIM. Gross redemption yield as at 31 March 2024, unhedged and gross of fees. Spread risk SCR based on Solvency II Standard Formula. Private credit sleeve based on model portfolio including private corporate debt (60%); real estate debt (20%) and infra debt (20%) with 6.5 years average duration. All private credit investment grade according to internal ratings; external rating distribution assumed: 4% AA, 24% A; 12% BBB, 60% NR.

If you would like to talk to LGIM more, please contact your usual LGIM representative. Also, see our recent blogs on [innovating in credit strategy](#) and [how private credit can drive the net zero transition](#).

Key risk: The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative



LGIM is the global asset
management business of
Legal & General



Key risks

The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance.

Important information

The information in this document is for professional investors and their advisers only. This document is for information purposes only and we are not soliciting any action based on it. The information in this document is not an offer or recommendation to buy or sell securities or pursue a particular investment strategy and it does not constitute investment, legal or tax advice. Any investment decisions taken by you should be based on your own analysis and judgment (and/or that of your professional advisers) and not in reliance on us or the Information.

This document does not explain all of the risks involved in investing in the fund. No decision to invest in the fund should be made without first reviewing the prospectus, key investor information document and latest report and accounts for the fund, which can be obtained from <https://fundcentres.lgim.com/>.

This document has been prepared by Legal & General Investment Management Limited and/or their affiliates ('Legal & General', 'we' or 'us'). The information in this document is the property and/or confidential information of Legal & General and may not be reproduced in whole or in part or distributed or disclosed by you to any other person without the prior written consent of Legal & General. Not for distribution to any person resident in any jurisdiction where such distribution would be contrary to local law or regulation.

No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the information in this document. The information and views expressed in this document are believed to be accurate and complete as at the date of publication, but they should not be relied upon and may be subject to change without notice. We are under no obligation to update or amend the information in this document. Where this document contains third party data, we cannot guarantee the accuracy, completeness or reliability of such data and we accept no responsibility or liability whatsoever in respect of such data.

This financial promotion is issued by Legal & General Investment Management Limited.

Legal and General Assurance (Pensions Management) Limited. Registered in England and Wales No. 01006112. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, No. 202202.

LGIM Real Assets (Operator) Limited. Registered in England and Wales, No. 05522016. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 447041. Please note that while LGIM Real Assets (Operator) Limited is regulated by the Financial Conduct Authority, it may conduct certain activities that are unregulated.

Legal & General (Unit Trust Managers) Limited. Registered in England and Wales No. 01009418. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119273.

© 2024 Legal & General Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 119272. Registered in England and Wales No. 02091894 with registered office at One Coleman Street, London, EC2R 5AA.

D008372