The Frontier Line

Climate change risk management in liability-driven portfolios

Key takeaways from our roadshow

Issue 232 | March 2025

Frontier Advisors | Forefront Thinking

frontieradvisors.com.au

About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on around $800 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through through knowledge sharing; customisation; technology; and an alignment and focus that is unconstrained by any product conflicts.

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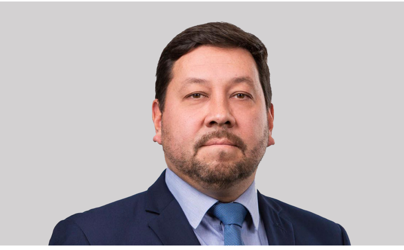

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Introduction

For many years Frontier has worked with government and insurance investors, collectively referred to as liability-driven investors (LDI). Over this time we have developed a deep knowledge of their unique investment objectives and the constraints they operate within.

Recently, there has been a growing focus on how LDI investors manage climate change risk and set decarbonisation strategies. In response, Frontier has sought to better understand these challenges and opportunities to provide meaningful support to our LDI clients. As a part of this effort, our LDI and responsible investment teams recently visited Sydney to meet one-on-one with insurers and host a roundtable to discuss these important topics.

While our discussions mainly focussed on insurers, the insights gained strengthens our ability to support the broader LDI investor base in refining climate risk management and decarbonisation strategies. The roundtable also highlighted the benefits of gathering like-minded peers to share their specific experiences when dealing with complex issues like climate change. We hope the insights shared will prove equally valuable as participants apply them in their own workplaces.

A heterogeneous group

While LDI investors have many common characteristics, each entity's unique responsible investment-related objectives and operational constraints are important to acknowledge and manage.

An area of commonality was the industry's aggregate ambition to lift efforts on responsible investment, especially in relation to climate change. This has been building over time, however, seems to have accelerated more recently. Drivers for this dynamic include:

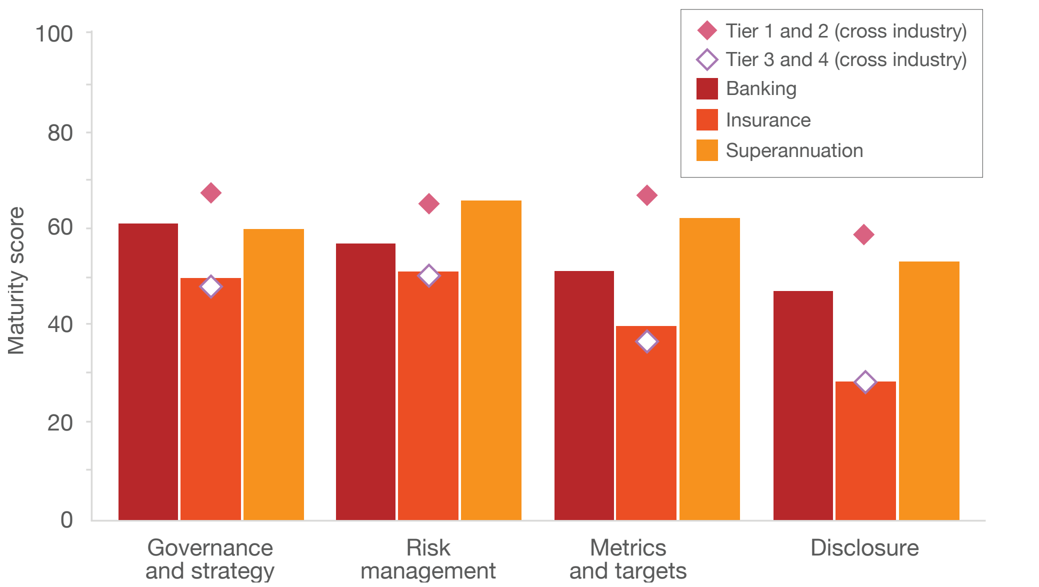
- The impending mandatory climate disclosures in Australia.
- A top-down strategic push from their individual organisations.
- A trend among some to further diversify portfolios into asset classes where ESG integration is more sophisticated, e.g. public equities, versus traditionally held LDI assets, such as sovereign bonds.

One insurer is taking a prudently staged approach to incorporating responsible investment, having first integrated ESG into its investment charter. The next step will involve setting metrics and targets, including a possible net zero target. Another insurer's investment team is being driven by an organisation-wide strategic push to increase ambition on sustainability across its underwriting activities, internal operations, and investment portfolio. *This was in response to the incoming Australian Sustainability Reporting Standards.*

Also apparent, however, were the differences among the cohort, across several dimensions.

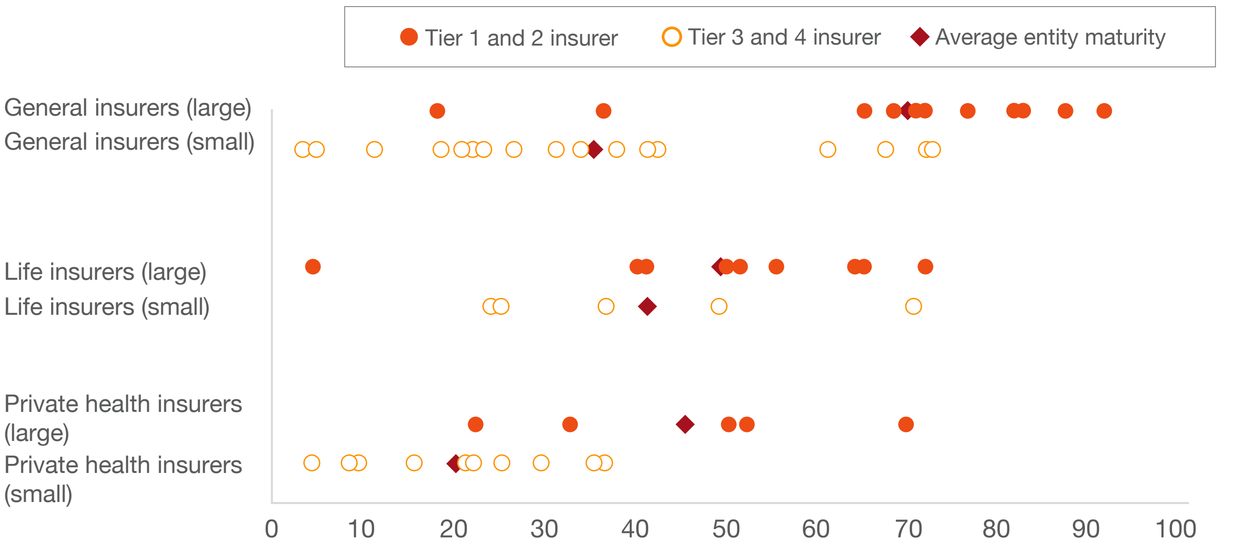
Some of the differences between insurers' climate change risk management approaches were recently highlighted in APRA's Climate Risk Self-Assessment Survey 2024[1]. This survey of regulated financial institutions showed insurers in aggregate are less mature in their climate risk assessment than other financial institutions, such as banks and superannuation funds. Across underwriting types, general insurers were found to be the most mature, and private health insurers the least. This disparity is partly because a general insurer's underwriting business, particularly in home and contents insurance, is more directly exposed to the impacts of climate change. As APRA acknowledges, for insurers, climate risk can and will impact their underwriting businesses as well as their investment portfolios.

Chart 1: Maturity scores for CPG 229 sections by industry (by count of industry respondents)



Source: APRA

Chart 2: Insurance entity climate risk maturity scores, by insurance industry and size (tier)



As categorised under APRA's Supervision Risk and Intensity (SRI) model: Tier 1 are individual entities that could have a large systemic impact; Tier 2 are individual entities that could have a systemic impact; Tier 3 are individual entities unlikely to have a systemic impact; and Tier 4 are individual entities that would not have a systemic impact.

Source: APRA

[1] APRA, Climate Risk Self-Assessment Survey 2024, accessed https://www.apra.gov.au/climate-risk-self-assessment-survey-2024

In our engagements, the differences between and within insurer types were evident. For example, one insurer shared that while they were still early on in their integration of responsible investment, a recent push from shareholders has accelerated progress on several ESG issues, including climate change. Another client in the private health insurance sector mentioned that while climate change is perceived to be a lower risk for its organisation relative to a general insurer, it is still material enough to commit to integrating climate change considerations into their investment decision making.

The limited progress by insurers on climate relative to other investor types was also evident in our discussions. For example, Frontier has long supported our superannuation clients in integrating responsible investment into their approaches, with ESG evolving to be a sophisticated, business-as-usual consideration today. The clear opportunity for our insurance clients is to leverage this experience to enhance their own responsible investment approaches, while adapting solutions to fit their unique organisational objectives and constraints.

As part of a broader approach to managing investment portfolios, understanding the varied approaches to responsible investment and climate change risk management across the industry is vital. This foundation will shape how Frontier works with our clients and continues to customise solutions in future.

Mandatory climate reporting

The mandatory Australian Sustainability Reporting Standard on climate-related risks and opportunties, AASB S2, is now in effect, while the broader sustainability-related financial information standard, AASB S1, remains voluntary.

AASB S2 was a key talking point among investors during the roundtable, as many insurers fall under Group 1 for reporting obligations. This means climate-related reporting within portfolios, considered part of an organisation's Scope 3 emissions ('financed emissions'), will be required in the 2026 financial year annual report if deemed material at the organisational level.

Many investors are still seeking clarity on the reporting requirements for their investment portfolios and continue to engage with regulators to understand expectations. Attitudes toward the standards were mixed; some embraced them as a positive step in the broader push for systemic action on climate change, while others viewed them as a distraction from day-to-day portfolio management. Given the materiality allowances in the AASB S2 standard, some insurance organisations have determined, or are in the process of determining, that their investment portfolios are not material sources of climate change risk at the organisational level, and therefore, are not currently including them in reporting.

Resource constraints, along with issues of data availability and reliability, were among the top challenges cited by LDI investors in meeting reporting requirements. These concerns are compounded by ASIC's recent crackdown on greenwashing. LDI investors are cautious about publishing incomplete or imperfect data, particularly as many are doing so for the first time. There were also concerns about how such data might be interpreted by stakeholders, such as policyholders. These challenges have led to inertia for some investors, who are struggling to reconcile assumptions-heavy data with investment implications, particularly given the perceived gap between investment objectives and the materialisation of climate change risks.

Insurers typically immunise portfolios by matching assets and liabilities. For most general insurers who have short-tail liabilities, the bonds and credit held in the portfolio will have a low duration. One insurer with predominantly short-term assets highlighted the challenge in reconciling this with the often longer-term risks posed to portfolios by climate change.

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In our view, these concerns are valid but not insurmountable. Some institutional investors have disclosed information on their responsible investment activities despite imperfect data, long before the legal requirement to do so. Being transparent with stakeholders has not come without challenges, including increased scrutiny from stakeholders, however, it has undoubtedly 'lifted all boats' by illustrating what leading practice is and motivating others to progress further.

LDI investors disclosing such information for the first time should embrace the benefits of doing so, while closely following guidance by ASIC to avoid misleading report users.

Frontier recommends investors disclosing in line with the AASB S2 for the first time consider:

- Familiarising themselves with the standards.
- Establishing or refining an overarching objective to develop a strategic approach to managing material climate change financial risks.
- Reviewing current resources (staff, data, systems) and filling in gaps where required.
- Committing to ongoing training with respect to climate change financial risks.
- Incorporating the four key implementation areas identified in the standards.
- Assessing climate change risk from a materiality lens, ensuring the climate change strategy is fit-for-purpose depending on the portfolio's size, business mix and complexity.
- Tracking progress in developing a climate change strategy.
- Working towards making climate change risk management a standard, business-as-usual consideration in investment decision-making.

Climate change risk management versus net zero objectives

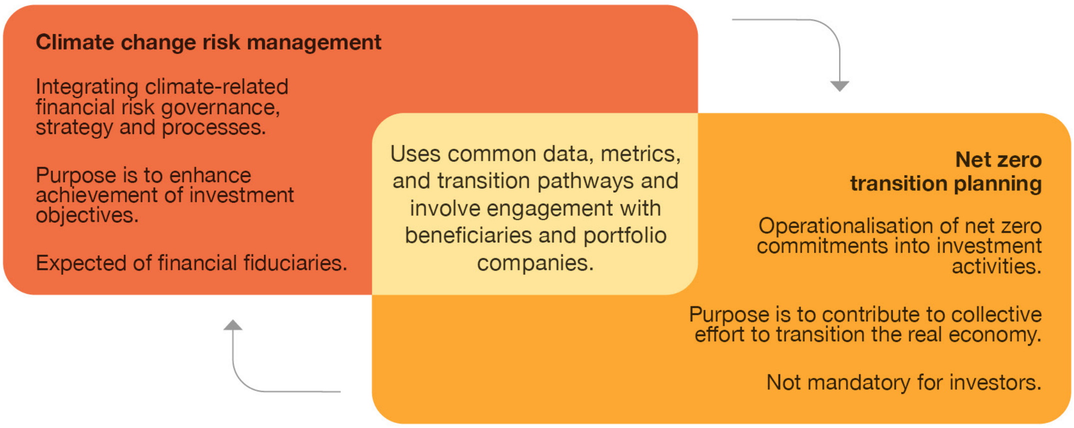
Pertinent to the disclosure standards, during the roundtable discussion, we collectively agreed on the importance of making clear the distinction between climate-related financial risk management and net zero transition planning; two related but different concepts that are often conflated.

While the mandatory disclosure standards require disclosure regarding any net zero (or other decarbonisation) targets, adopting such targets are not a requirement of asset owners. Rather, a net zero objective is a signal of ambition to stakeholders to contribute to a collective effort in the real-world energy transition.

Globally however, regulators, including APRA in Australia[2], have confirmed that climate change risk management is squarely the concern of investment fiduciaries.

There is meaningful overlap between these areas, such as the metrics and portfolio analysis required. However, we recommend keeping the distinct goals of these activities clear when setting expectations and directing often resource-constrained teams.

Climate change risk management practices clarify the need for transition plans and help achieve net zero objectives.



Net zero transition planning can contribute to the mitigation of both physical and transition climate change risks.

Source: Frontier Advisors, adapted from the Institutional Investors Group on Climate Change

As an example of an investor clearly distinguishing these two concepts, one insurer we met with had an internal portfolio net zero target established by leadership. However, this target was not yet operational. The investment team's view was that, while climate risk needed to be managed as it impacted investment outcomes, net zero was not seen as an investment matter. This gap in expectations and understanding is a common challenge within organisations and can be a source of frustration. Frontier has supported several clients in aligning internal understanding, ensuring all stakeholders are on the same page regarding climate ambition.

[2] APRA Prudential Practice Guide: CPG Climate Change Financial Risks, November 2021

Broader strategic considerations

Within the LDI space, managing an investment portfolio is typically not the primary focus within an organisation's overall function.

This can present challenges when investment teams are directed to undertake actions based on goals set at the organisation level. These goals, while well-meaning, may not always readily align with meeting investment objectives, understandably causing friction among stakeholders and distracting investment teams from their main mandates.

Net zero is an area where this dynamic can play out. Investment teams are often given the mandate to deliver on a net zero portfolio objective to align with an organisation level objective, but the investment and implementation implications of this goal are not always comprehensively understood at the organisation level. For example, LDI portfolios often have relatively high allocations to fixed income. It is typically more challenging to accurately measure the emissions profile of fixed income securities, relative to listed equities for instance, due to data limitations. This makes measuring and managing portfolios in line with a net zero target over time challenging. Further, because of their typically smaller portfolio sizes relative to some institutional investors, often LDI investors are invested via pooled vehicles, and therefore do not have the same level of influence over companies and governments, limiting the effectiveness of stewardship activities.

> The small investment team of one insurer felt management's sustainability objectives did not sufficiently consider the investment and operational implications of applying these to the portfolio, such as its investments being limited to pooled vehicles.

Given the challenges in implementing such objectives, it is crucial investment teams are sufficiently resourced and incentivised to meet them. We saw evidence of this when speaking with the local investment team of a global insurer. The team believed its mandated portfolio net zero objective was manageable because it was able to leverage global group resources and support to measure portfolio emissions and implement a decarbonisation strategy. The team's main challenges regarding the net zero objective were local in nature, such as the implications of Australia's economy potentially decarbonising at a slower rate than the economy of its parent company. On the other hand, another investment team we spoke with detailed its ambitions to lift the responsible investment capabilities and processes within the portfolio, however, given limited resources, was restricted in what could be achieved. As well as more resources, this team believed responsible investment needed to be incorporated into KPIs for it to be meaningfully integrated.

We recommend all relevant stakeholders are supported in understanding the investment implications of any organisation-wide sustainability objectives being applied to the investment portfolio. This may involve providing suitable training. It is also important investment teams are appropriately resourced and incentivised to empower them to achieve these objectives.

Impact: a new frontier for LDI investors

Positively, a theme we observed was the industry's ambition to invest for impact (being positive social and/or environmental change alongside suitable financial returns), which aligns with an increasing trend across the wider investment industry.

Unfortunately, while the desire is there, the lack of implementation options was a challenge we repeatedly heard in these same discussions.

One insurer believes investing for impact is a way to communicate its ambition on sustainability to its members in a more measurable and tangible way than traditional ESG integration. It had not yet set a goal to invest a certain percentage of its portfolio in impact investments, citing challenges in finding appropriate products as a hurdle. Conversely, another insurer had been mandated a certain percentage of the portfolio which was required to be invested in impact. However, it had similarly not funded the allocation given constraints in finding appropriate products, as well as a lack of clarity around the type of impact it was targeting. A third insurer had also not funded a climate transition impact allocation; facing challenges both in the lack of available products and in defining the 'climate solutions' it aimed to target with its impact investments. Across the board, impact was predominantly being sought within private credit, green bonds and infrastructure allocations, with little focus on private equity.

The discussions regarding impact echoed those we have had with other institutional investor types including charities, foundations and universities. Impact investing, in its purest form, is not as easy to implement as some may assume. For this reason, Frontier advocates for investors to cement a clear and robust investment governance structure to supporting their impact investing program.

Frontier's impact investing series – Part One, Part Two and Part Three – is a useful resource for investors establishing or building an impact investing allocation. Frontier can support clients in establishing an impact investing program by creating a robust governance framework and identifying suitable investment opportunities. Our dedicated teams in governance, responsible investment, and research are ready to assist.

Our discussions demonstrated the demand for impact investments within the LDI segment is well and truly present, along with the challenges we must address to support the funding of these ambitions.

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The final word

Investors in the LDI space are at various stages in their responsible investment and climate change risk management maturity, both among themselves and relative to other institutional investors.

The rapidly growing ambition of this segment was clear, while the limitations around resources and data, competing strategic priorities, and for some, the lack of implementation options, are challenges we look forward to helping these investors solve.

We hope sharing some of these learnings and experiences can provide both motivation and perspective to our clients as they seek to meet their climate change-related obligations and ambitions. Frontier would like to thank the clients that contributed to the success of our roundtable.

Learn more

If you want to discuss this paper in more detail, please reach out to your consultant or a member of our Responsible Investment Team.

Frontier Advisors is committed to promoting a supportive community for our clients and the wider asset owner universe. We invite you to join us in future roundtable discussions to share your experiences, learn from your peers, and collaborate in improving investment outcomes for your organisation.

If you have an idea for a topic you'd like to discuss with other like-minded investors in a roundtable environment, please contact your consultant at Frontier Advisors.

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