March 2024

Focus on insurance

Bridging the climate-nature nexus in income strategies

Fidelity INTERNATIONAL

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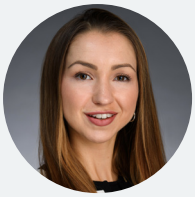

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Highlights

- Nature loss is spurring governments worldwide to introduce policies and frameworks impacting insurers' and reinsurers' investment portfolios, particularly where nature interrelates with climate change.
- Biodiversity risks and opportunities are not yet fully understood. A lack of reliable, consistent, and comparable data presents a challenging task for (re)insurers when integrating nature-related factors into their decision-making process.
- Due to (re)insurers' heavy reliance on bonds in their investment portfolios, assessing nature-related exposures is more complex. However, we believe thematic strategies can help mitigate nature-related portfolio risks.

Climate change threatens ecosystems

Biodiversity considerations are a natural extension for (re)insurers who have already started integrating climate change into their enterprise risk management processes, including investment asset allocation decisions. Mitigating climate risks also means reducing biodiversity loss and vice versa. For example, deforestation - which reduces biodiversity - also lowers the amount of carbon emissions absorbed by trees.

When deforestation occurs in tropical rainforests, the effect worsens due to their rich capacity to regulate climate, store carbon, recycle rainwater, and provide habitat for animals and plants. The Amazon Rainforest, for example, is home to about 10% of the world's known species, including some that are critical to human well-being as raw materials for pharmaceutical medicines.

Complexities at the climate-nature nexus call for investors looking to decarbonise their investment portfolios to take a more optimised approach that considers the portfolio's biodiversity as well as carbon footprint.

In this paper, we discuss the regulatory imperative for integrating biodiversity in insurance portfolio management, the challenges investors face when integrating nature in investment decisions, and why thematic approaches may be particularly suited to address biodiversity loss. From an asset allocation perspective, (re)insurers traditionally hold substantially more debt than equity instruments in their investment portfolios (see Figure 1). Therefore, we will focus on biodiversity risks and opportunities in the bond market. We will also address some differences between life and non-life (re)insurers, referring to both insurers and reinsurers collectively.

Figure 1: Average asset allocation for (re)insurers in the European Economic Area

Source: EIOPA, data as of March 31, 2023.
Note: Investment funds include pooled funds that focus on debt, equity, asset allocation, cash, private equity, real estate, infrastructure, and other asset classes.

Nature rules

Regulatory trends to mitigate environmental damage will likely extend to nature loss, and (re)insurers should be prepared. One of the most relevant developments is the Taskforce on Nature-related Financial Disclosures (TNFD) recommendations published in 2023, a risk management and disclosure framework that aligns with its climate counterpart, the Task Force on Climate-related Financial Disclosure (TCFD). The TNFD is not yet mandatory. However, governments in some jurisdictions, including the EU and UK, may lean on the recommendations to guide policy in the future.[1]

Governments, companies, and consumers increasingly recognise that climate change cannot be mitigated without addressing nature loss. Over the past several years, the number of nature-related initiatives affecting (re)insurers has risen, some of which are highlighted in Figure 2. While they differ in scope, they generally aim to improve the understanding of how corporate decisions both impact and depend on ecosystems, enhance transparency with respect to these issues and, in turn, catalyse actions to help reduce and reverse ecological degradation. For (re)insurers, the long-term effects of such policies and frameworks will impact investment selection, financial advice, and products and services, providing baseline expectations concerning risk management and associated disclosures.

Regulations form a clear incentive for (re)insurers to integrate nature-related factors into their investment decision-making. But there are others. In aggregate,

Figure 2: Key biodiversity-related initiatives affecting (re)insurers

Policies & frameworks	Highlights
European Sustainable Finance Disclosure Regulation (SFDR)	SFDR's Principal Adverse Impact (PAI) disclosures require (re)insurers within scope to publish information relating to material adverse effects of their investment decisions or advice on sustainability factors, including biodiversity, or explain why they do not. Disclosures should be at the entity and product levels.
European Sustainability Reporting Standards (ESRS)	(Re)insurers subject to the Corporate Sustainability Reporting Directive (CSRD) must disclose material information on factors related to biodiversity and ecosystems, and water and marine resources.
EU Taxonomy*	Two of the six EU Taxonomy's environmental objectives directly relate to natural capital: protection and restoration of biodiversity and ecosystems, and sustainable use and protection of water and marine resources. They are supported by the following activities: ■ Nature and biodiversity conservation. ■ Sustainable land use and management. ■ Sustainable agricultural practices. ■ Sustainable forest management.
EU Biodiversity Strategy for 2030	In February 2024, the European Parliament passed the EU Nature Restoration Law, which aims to restore 20% of the EU's land and sea area by 2030 and all ecosystems by 2050.
International Sustainability Standards Board (ISSB)	The ISSB sets sustainability standards and disclosures. The organisation has agreed to consider TNFD recommendations as and when it develops nature-related disclosure standards. Therefore, companies should look to the TNFD recommendations to anticipate future baseline expectations with respect to sustainability reporting on nature.
Kunming-Montreal Global Biodiversity Framework	The agreement aims to halt and reverse nature loss by protecting 30% of global terrestrial and marine areas and restoring 30% of degraded ecosystems by 2030 through four overarching goals[2] via 23 targets for national biodiversity strategies and action plans, including: ■ Target 14 addresses biodiversity in policies, regulations, planning, and development to progressively align relevant financials flows with the goals of the GBF. ■ Target 15 incentivises certain companies to monitor, assess, and disclose material biodiversity risks, dependencies, and impacts in their operations, supply and value chains, and portfolios.

Source: European Insurance and Occupational Pensions Authority (EIOPA), Fidelity International, March 2024. *Note: The EU Taxonomy is a classification system to standardise taxonomy-aligned, eligible activities that can be considered environmentally sustainable.

insurance and reinsurance companies in the European Economic Area hold about €8.57 trillion in assets, according to data as of March 31, 2023, from EIOPA. Stewardship responsibilities should incentivise (re)insurers to examine, report, and monitor biodiversity-related implications of their investment decisions.

In some ways, nature-related risks can be viewed through the lens of climate change. Like climate change, the transmission of biodiversity loss can be categorised into transition and physical risks. Transition risks typically result from changes in regulation, technology, and consumer preferences, among other trends, to mitigate or reverse ecological damage. In contrast, physical risk refers to the effects of nature loss on assets and services, such as the reduction in crop yields due to land degradation.

Not all climate solutions benefit nature. Sometimes, they can adversely affect biodiversity. Take biofuels, which is a lower-carbon substitute for fossil fuels. In transportation, biofuels derived from crops like corn and sugarcane can be blended with gasoline to reduce emissions. However, clearing natural ecosystems - including forests - for crops can result in biodiversity loss through pollution, habitat destruction, and the introduction of monocultures or invasive alien species. Investment decisions require a nuanced understanding of the notable differences between climate and nature-related risks to minimise unintended consequences (see Figure 3).

Figure 3: Similarities and differences when assessing biodiversity and climate change risks

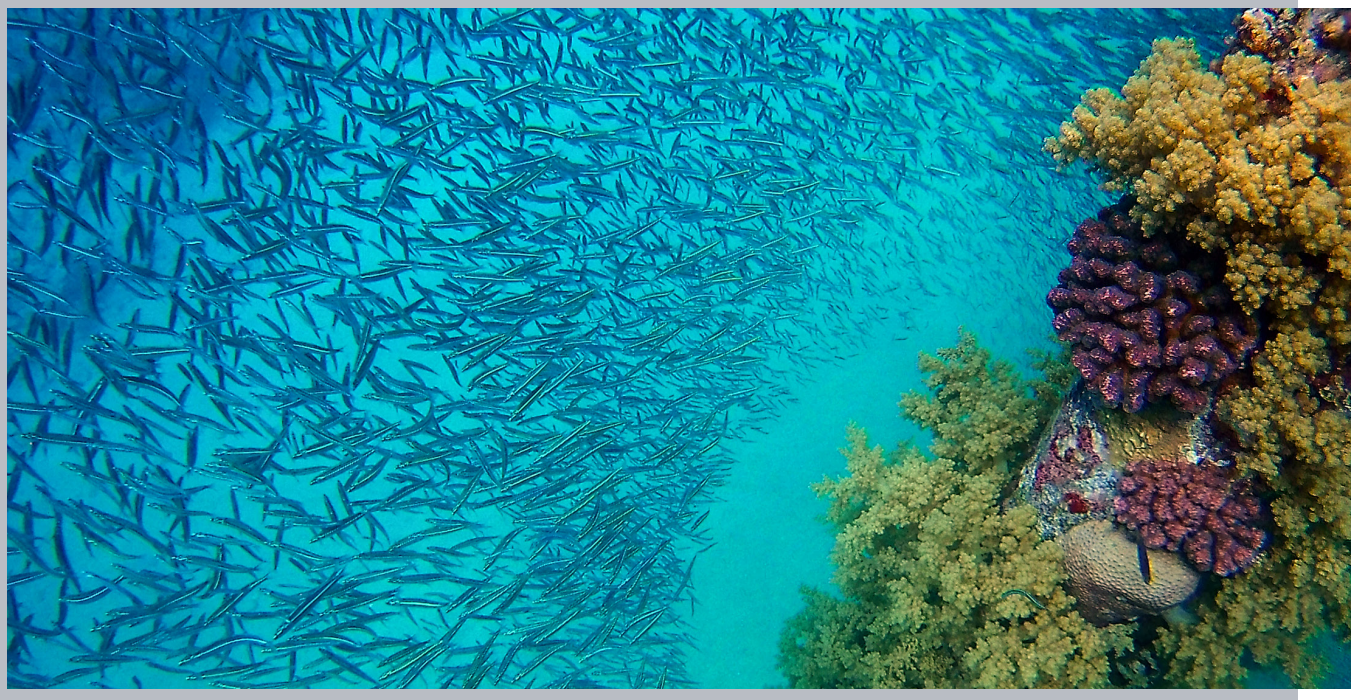
Similarities

- Environmental risks can be transmitted to (re)insurance through physical and transition risks.
- Uncertainty exists around timing and severity.
- The non-linearity of natural processes and the potential for irreversible tipping points make these risks highly complex and far-reaching.
- The interrelation of risks adds complexity.

Differences

- Measuring nature-related risks is more difficult, without common metrics such as carbon emissions in climate.
- Nature-related risks are more multi-dimensional. For example, restoration and conservation involve intricate interactions that must be better understood.
- Climate change is global while mitigating biodiversity risks is often at the local and regional levels.
- The economic impacts of nature damage may be more tangible relative to climate change due to the higher dependency of economic activities on localised ecosystems.

Source: EIOPA, Fidelity International, March 2024.



Why biodiversity matters

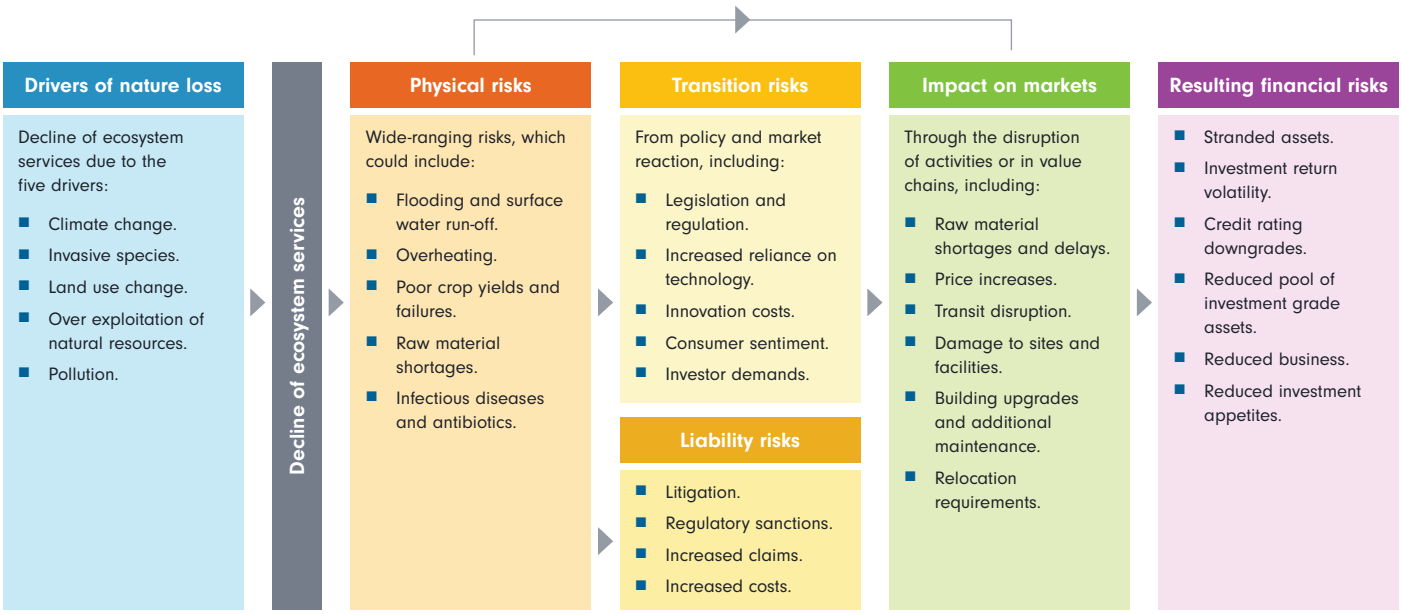
Around the world, about half of the global gross domestic product (GDP) - or about $44 trillion in economic value generation - is moderately or highly dependent on nature. Therefore, failure to mitigate and reverse ecological degradation affects economic growth. As demonstrated in Figure 4, environmental factors can result in transition and physical risks that flow through the economy. However, the effects on issuers are not equal. Key industries such as construction, food & beverage, agriculture, and pharmaceuticals are among sectors that are relatively more dependent on nature.

One of the clearest examples is in agriculture. Globally, more than three-quarters of the different food crops rely on pollinators to some extent. Yet as much as 40% of the world's insect species are under threat of extinction, according to the World Economic Forum.[3] A dwindling population of pollinators, for example, will likely result in poor crop yields, leading to higher demand for pesticides and increased deforestation risks because more land is needed for farming. Over time, these disruptions may increase raw material costs, and cause supply shortages or delays, leading to balance-sheet volatility and increasing investment risks.

> "Failure to mitigate and reverse ecological degradation affects economic growth."

In addition to its vital role in economic stability, nature also acts as a defence against climate change. An imbalance in climate dynamics can disrupt ecosystems. For example, climate change is increasingly exacerbating nature loss. Other drivers of nature loss include an increase in invasive species, pollution, over-exploitation of natural resources, and change in land use. The negative feedback loop accelerates nature's continued decline. It undermines society's ability to achieve the goals of the Paris Agreement, which is to keep global average temperature increases at 1.5°C and well below 2.0°C relative to pre-industrial levels.

Figure 4: How drivers of nature loss can lead to financial instability



Source: Association of British Insurers (ABI), based on information from the Cambridge Institute for Sustainability Leadership Handbook for Nature-related Financial Risks, July 2023.

Measuring biodiversity-related impact

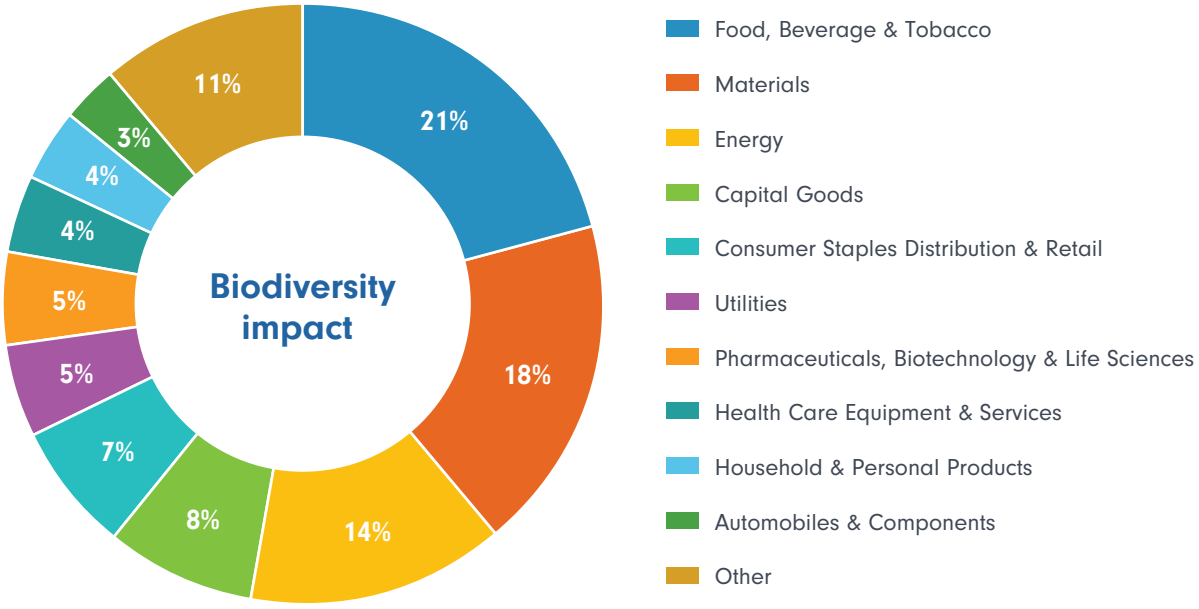
To effectively address nature loss, (re)insurers must understand the synergies and potential trade-offs associated with the climate-nature nexus. Crucially, nature and net zero strategies should complement and reinforce one another. Misalignment of investment decisions with nature-related regulatory, technological, legal and consumer trends can negatively affect the return expectations from their portfolios due to mispriced risks.[4]

Compared to climate change, assessing exposure to biodiversity impacts and dependencies is far more challenging. When decarbonising a fixed-income portfolio, carbon emissions can serve as a relevant, comparable, and reliable global metric. There is no equivalent metric when gauging a portfolio's biodiversity footprint.

Most (re)insurers are at an early stage of integrating biodiversity factors into their portfolio management decisions, though this may change as metrics become more available. Despite the data gaps, we believe investors can still make progress. For example, Fidelity relies on proprietary research, engagement, and a third-party online tool, Exploring Natural Capital, Opportunities, Risks and Exposure (ENCORE), to help map the potential nature-related dependencies and impacts on investments such as corporate debt.

The information can help investors better understand nature-related implications for investment portfolios and engagement activities. Such data also help determine priorities. For example, we consider water resources a material factor across many sectors. Additionally, some sectors have more influence on biodiversity than others (see Figure 5). Discerning how a portfolio's biodiversity-related exposures intersect with climate and social risks can help investors understand return drivers at a deeper level.

Figure 5: Potential biodiversity impact, by sector



Source: Finance for Biodiversity Foundation, April 2023. Note: The data are calculated based on 250 listed companies of the MSCI World Index.

Bonded matters

In addition to a lack of clarity in nature-related data, there are other hurdles when reducing biodiversity risk in a portfolio. For example, biodiversity risk is location-specific, with more interconnectivity between ecosystems, making it more difficult to quantify and predict. Additionally, biodiversity encompasses a broad range of species, ecosystems, and genetic diversity, each with its unique characteristics, distribution, and functions.

Another challenge is (re)insurers' reliance on bonds (see Figure 1). When assessing biodiversity risks and opportunities, the lack of homogeneity of the asset class adds another layer of complexity, particularly when engaging with issuers to influence change. The bond market is broader with about $130 trillion in securities outstanding in 2022, compared with about $101 trillion in the equity market.[5] Bonds are issued in a range of different maturities, durations, subordination characteristics, callability and coupon ratchet mechanisms. And there are more types of issuers, including sovereigns, agencies, and public and private issuers.

However, the complex nature of the asset class also provides some advantages, such as more opportunities to influence outcomes. For example, the bond market potentially offers a broader universe relative to equities when directing capital towards specific investment themes. This approach can help investors manage their biodiversity exposure due to the following investment potential:

- Focus on specific themes to identify issuers that are better positioned to manage biodiversity risks or take advantage of the opportunities, potentially leading to more resilient portfolios.
- Gain insights with more targeted engagement activities, considering the effects of climate-nature themes on the issuers' business models and operations.
- Channel investment decisions to support issuers with priorities aligned to organisational goals, such as climate action, biodiversity conservation, or social progress - all of which are interconnected.

Case study: Water and marine health

Water and marine health is critical to the global economy. For example, oceans contribute an estimated $2.5 trillion in annual "goods and services" (gross marine product), about 5% of the global GDP based on data as of 2015.[6] Examples of its economic role include facilitating global trade, with 90% of international goods transported by sea and shipping volume expected to triple by 2050. Other economic activities include marine aquaculture, marine capture fisheries, marine fish processing, and offshore wind.

Water stress poses economic disadvantages. As previously noted, insufficient water reduces crop yields, causing supply chain problems among other disruptions. From a social perspective, it also adversely affects a vital source of income and employment for emerging economies. It is estimated about $260 billion is lost annually due to unsafe water and sanitation systems globally.[7] In assessing an investment's impact, investors should closely examine evidence of whether it is contributing to water and marine health. Highlights of some of the things (re)insurers can look for are listed in Figure 6.

Figure 6: Elements of issuer commitments to nature

Corporate

- Commitments and policies.
- Sustainability reporting.
- Third-party certifications/standards.
- Collaboration in industry/initiatives.
- Sustainable innovation/solutions.
- Improved sustainability performance.
- Sustainability ratings.
- Labelled bonds, such as green/blue bonds with water use of proceeds.
- Supply chain sustainability.

Sovereign

- National policies/commitments.
- International collaboration.
- National adaptation plans.
- Labelled bonds, such as green/blue bonds with water use of proceeds.

Source: Fidelity International, March 2024.

Contrasting approaches for life vs. non-life insurers

(Re)insurers already face direct nature-related risks in their underwriting activities. For example, deforestation can increase flood risks, causing physical damages to properties. The next step is to manage the indirect nature-related physical and transition risks in their investment portfolios. The task will vary, depending on the products on offer and the risk encountered in the balance sheet.

Non-life insurers, for example, tend to focus on short- to medium-term products such as health, auto, and property and casualty. Therefore, the risk exposure may be more tangible and closely linked to underwriting activities with a more direct biodiversity impact, such as floods, droughts, and wildfires. Non-life insurers tend to focus more on liquidity and capital preservation, so investment risk analysis may require assessing vulnerabilities to physical and transition risks at the asset-liability management level and considering them across the balance sheet for consistency.

In contrast, life insurers' biodiversity risk exposure is long-term since they offer products such as life insurance, annuities, and pensions. The nature of the risk is more tied to their income requirements. Although life insurers are exposed to higher interest rate risks, they have liabilities that are generally more predictable than non-life insurers. As a result, their investment strategies reflect a longer time horizon, allowing for more potential to influence change through engagement activities.

The longer investment time horizon also reflects a higher exposure to nature-related physical and transition risks, so more rigorous management of material nature-related risks may be required. Furthermore, thematic strategies, labelled bonds, and other opportunities to invest in nature may improve the portfolio risk-return characteristics.

The ability to manage exposure to biodiversity risk and opportunities is still in its early days, and best practices are evolving. Nevertheless, by using existing tools and data, (re)insurers can better understand the effects of their investment decisions on contributing to - or mitigating - nature loss. The choice will have long-term consequences on both their investment portfolios and the environment.

[1] Taskforce on Nature-related Financial Disclosures, "Sector guidance: Additional guidance for financial institutions", September 2023.

[2] Convention on Biological Diversity, "COP15: Nations adopt four goals, 23 targets for 2030 landmark UN Biodiversity Agreement", Dec. 19, 2022.

[3] World Economic Forum, "75% of crops depend on pollinators - they must be protected", Dec. 9, 2019.

[4] EIOPA, "EIOPA Staff paper on nature-related risks and impacts for insurance", March 2023.

[5] Capital Markets Fact Book, 2023.

[6] OECD, 2022.

[7] UNICEF, "Universal access to water, sanitation and hygiene", April 28, 2021.

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