SULLIVAN & CROMWELL LLP

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# New York Department of Financial Services Issues Final Guidance on Managing the Financial Risks of Climate Change for Insurers

## Final Guidance Requires Insurers to Integrate Consideration of Climate Risks into Governance, Operations, Risk Management, Scenario Analysis and Disclosure

### SUMMARY

On November 15, 2021, the New York State Department of Financial Services ("DFS") issued detailed final guidance (the "Final Guidance") addressing how New York domestic insurers should analyze and manage the financial risks of climate change.[1] The Final Guidance builds on the DFS's proposed climate guidance released in March 2021.[2]

The Final Guidance reflects relatively limited changes from the proposed guidance. The changes include additional guidance on the time horizon insurers should consider when integrating climate risks into business decisions; how insurers should manage uncertainty related to climate change; and how the guidance applies to insurers that are part of groups. The DFS notes that it expects insurers to implement its guidance relating to board governance and to have specific plans in place to implement the guidance relating to organizational structure by August 15, 2022. The DFS plans to issue further guidance on the timing for implementation of more complex areas that will take insurers longer to implement, such as those relating to risk appetite, analysis of the impact of climate risks on existing risk factors, reflection of climate risks in the Own Risk and Solvency Assessment ("ORSA"), scenario analysis and public disclosure, but the DFS notes that it encourages insurers to begin working on these now.

The Final Guidance comes as U.S. financial regulators and policy makers, including the U.S. Department of Treasury, the U.S. Securities and Exchange Commission ("SEC") and the Federal Reserve Bank, are focused on the potential systemic risk that climate change poses to the financial sector.[3]

Insurance and other prudential regulators outside of the U.S. are also addressing climate-related risks, and the DFS notes that the Final Guidance is modeled on publications and guidance from international regulators and networks, including the Bank of England Prudential Regulation Authority, the International Association of Insurance Supervisors ("IAIS"), the European Insurance and Occupational Pensions Authority ("EIOPA"), the European Central Bank and the Network for Greening the Financial System.[4]

An overview of recent actions by regulators and lawmakers in the U.S., EU and UK related to climate change and other environmental, social and governance topics is provided in the Firm's ESG update newsletter, available here.

## DFS'S FINAL GUIDANCE ON CLIMATE RISKS

The DFS notes that insurers are likely to be particularly affected by climate change, as it will affect both sides of insurers' balance sheets—assets and liabilities—as well as their business models. In the Final Guidance, the DFS emphasizes that insurers will need to both manage the financial risks and also take advantage of the opportunities arising from climate change, including opportunities to help communities be more resilient through providing inclusive and affordable insurance and enhancing the insurability of climate-related risks.

The Final Guidance largely confirms the five supervisory expectations for insurers that the DFS outlined in its March proposal:

1. Integrate the consideration of climate risks into the insurer's governance structure at the group or insurer entity level.
2. Consider the current and forward-looking impact of climate-related factors on the insurer's business environment, using appropriate time horizons.
3. Incorporate climate risks into the insurer's existing financial risk management.
4. Use scenario analysis to inform business strategies and risk assessment and identification.
5. Disclose the insurer's climate risks, including via engagement with the Task Force on Climate-Related Financial Disclosures ("TCFD").

The Final Guidance by its terms applies only to domestic New York insurers (i.e., insurance companies domiciled in New York, including New York subsidiaries of non-U.S. insurance groups). The DFS notes that the Final Guidance is largely consistent with international regulators' expectations and that the DFS intends to continue to work closely with international and other U.S. regulators to reduce the compliance burden on insurers.

The DFS states that the Final Guidance is intended to serve as a basis for supervisory dialogue and to help insurers familiarize themselves with climate risks and develop their capacity and processes for managing them in accordance with the timelines specified in the Final Guidance. The DFS will monitor insurers' progress in implementing the expectations set forth in the guidance and, over time, it expects its approach to shift from supporting insurers' progress in implementing the DFS's supervisory expectations in accordance with the timelines specified in the Final Guidance to active supervision against those expectations.

### Analysis of the Final Guidance

The Final Guidance focuses in particular on how insurers' risk culture and governance, business strategy, risk management and public disclosures will need to reflect the impacts of climate change.

- ***Risk Culture and Governance:*** The DFS expects an insurer's board or governing entity to understand and oversee relevant climate risks, and notes that an insurer may determine that having a board member with climate expertise is necessary to ensure that the board can properly oversee the company's management of climate risks. The DFS expects insurers to designate a member or committee of the board and a member or committee of senior management responsible for climate risk assessment and management. The insurer's board will be expected to oversee management's progress toward meeting any announced climate commitments and ensure that related strategies are being employed and evaluated for effectiveness. The DFS also outlines detailed expectations with respect to insurers' organizational structures: these include an expectation that the insurer's organizational structure is reinforced by a risk culture supporting accountability in setting and implementing climate risk limits; an expectation that the board and management support allocation of resources to developing the skills needed to assess and manage climate risk; and an expectation that insurers consider remuneration policies that align incentives with climate risk management and performance against climate metrics. In addition, the DFS notes it expects an insurer's ORSA to describe climate risk management, as well as relevant assessment tools and methods of incorporating climate risk information into monitoring and responding to changes in the insurer's risk profile.
- ***Business Strategy and Time Horizon:*** The DFS notes that the unprecedented and long-term nature of climate change risks means that insurers considering how climate risks affect business strategy should go beyond the standard three to five years to take a medium-term (five to ten years) and ultimately long-term (more than ten years) view. Questions insurers should be attuned to include: which business areas are exposed to physical or transition risks; the materiality of the risks; and whether affected areas should be continued, scaled back or adapted. The DFS also specifies in the Final Guidance that insurers are encouraged to develop strategies to engage with their customers and the companies in which they invest on climate and sustainability issues and to urge those customers to develop transition plans, adapt to climate risk, and move towards more climate-resilient business models.
- ***Risk Management:*** In the Final Guidance, the DFS emphasizes that the unprecedented nature of climate risk means that insurers often do not contemplate climate risk in the context of their investments and pricing, and that underwriting models may not properly reflect climate risks as those risks are not fully captured in historical data. The DFS notes that if the potential impacts of climate risks are determined to be material, it expects insurers to demonstrate how they will mitigate those risks and to develop a credible plan or policies for managing those risks, including reducing their concentration. Insurers should also analyze how physical and transition risks from climate change could affect other categories of risk that insurers monitor, including credit risk, legal risk, liquidity risk, market risk, operational risk, pricing and underwriting risk, reputational risk and

strategic risk. The DFS added in the Final Guidance discussion of how insurers can consider developing plans to mitigate their climate risks both by adapting their business strategies, such as by setting limits on certain sectors or geographies, and by contributing to a low-carbon transition. The DFS notes that reducing financed and underwritten greenhouse gas emissions in line with science-based targets is also a way to mitigate the financial and consumer risks that climate change poses to insurance markets.

- ***Scenario Analysis:*** Insurers' risk management functions are expected to use prospective solvency assessments, including scenario analysis and stress testing, to evaluate the impact of climate risks on their assets and liabilities and to understand the impact of climate risks on their probable maximum loss, solvency, liquidity and claims-paying ability. The DFS highlights, in particular, that given the forward-looking nature of climate risks and the inherent uncertainty of both the physical impact of climate change and resulting societal responses, past experience will not necessarily be a good indicator of future conditions. Given the early stage of climate scenario analysis, the analysis should be: focused on understanding potentially material climate risks; exploratory in nature; and balanced between quantitative and qualitative data and observations in order to produce reasonably reliable outputs useful for decision making and to avoid creating a false sense of security and precision in the results.
- ***Public Disclosure:*** The DFS provides detailed guidance for how it expects insurers' disclosure of climate risk to evolve over the next few years. All insurers should publicly disclose how climate risks are integrated into their corporate governance, risk management and business strategies, and should address how physical and transition risks (including liability risks) might affect their underwriting, investment and strategies. The Final Guidance also encourages insurers to highlight opportunities that arise from the transition to a low-carbon economy. Insurers will also be expected to take into consideration the TCFD framework in developing their approach to disclosures. While analysis and disclosure may initially be qualitative, if climate risks are determined to be material, the DFS notes that disclosure should become more quantitative, including key metrics and targets for quantifiable risks, over the next two to three years. The Financial Guidance provides that public disclosure through the National Association of Insurance Commissioners ("NAIC") Climate Risk Disclosure Survey are acceptable if the responses satisfy the expectations in the Final Guidance. Disclosure at the group level would be acceptable if such disclosure specifically addresses practices at the insurer level.

The Final Guidance also updates how the DFS views the concepts of proportionality and materiality in the context of climate risk analysis, and provides additional background on determining the time horizon for evaluating risks and on managing data gaps in current knowledge of the impact of climate change.

- ***Proportionality:*** The DFS notes that all insurers should analyze their climate risks but recognizes that each insurer's approach should be tailored to its particular exposure and business complexity. Over time, however, the DFS expects that insurers' analysis of climate risks and assessment of their materiality for their business should shift from a qualitative approach to a quantitative approach. The Final Guidance specifies that insurers that are part of a group can use policies, procedures and processes developed at the group level to comply with the Final Guidance subject to certain requirements, including that the risks considered at the group level include those facing the insurer; that the policies, procedures, and processes developed at the group level are implemented at the level of the insurer and address the insurer's material climate risks; and that the insurer has access to group resources and expertise.
- ***Materiality:*** The DFS notes that when assessing the materiality of climate risks, insurers may use the standard benchmarks in the NAIC Financial Condition Examiners Handbook (e.g., 5% of surplus or one-half of 1% of total assets), subject to adjustment based on professional judgment and circumstances. A risk may also be considered material where knowledge of the risk could influence the decisions or judgment of an insurer's board, management, regulators or other relevant

stakeholders. The Final Guidance states that insurers should conduct an assessment of their materiality assumptions at least annually and in the event of a significant change, such as a material regulatory development or material change to their internal climate modeling.

- ***Time Horizon:*** The Final Guidance notes that the time horizon for analyzing risks and opportunities related to climate change should gradually go beyond the standard three to five years to a medium-term (e.g., five to ten years) and ultimately long-term (e.g., ten to 30 years) view, although the appropriate time horizon will vary according to the nature of a particular business decision. For example, merger activity may require a medium-term horizon, while decisions on risk management or the impact on life insurers' liabilities may require a longer-term view. In particular, the DFS notes specifically that a 30-year time horizon, with interim science-based targets and milestones, may be appropriate for net zero investment or underwriting commitments made by some insurers. However, the DFS notes that all insurers should think now about how climate risks and opportunities might affect their investment strategies because transition risks can materialize suddenly. The DFS also expects sophisticated insurers, including those with the most material climate risks, to start experimenting with the long-term horizon now, and other insurers in the next two to three years.
- ***Uncertainty and Data Gaps:*** The DFS cautions that although many aspects of climate change, as well as governments' and society's evolving response to climate change, remain uncertain or unknown, such uncertainty and data gaps do not justify insurers' inaction, and insurers will need to adapt their traditionals tools for identifying, monitoring and managing risks to address such challenges. Insurers will need to look at a full range of potential future outcomes and consider forward-looking data. In particular, insurers should review whether and how their model vendors and third-party investment managers manage uncertainty and data gaps, as insurers remain the ultimate owners of the risks even if they rely on vendor models for underwriting or third-party investment managers. The DFS also notes that insurers can help fill data gaps by collecting data from their customers and requesting or requiring climate disclosure from the companies in which they invest, among other steps.

## FURTHER CONSIDERATIONS FOR INSURERS

Insurers with U.S. reporting obligations should also be aware of forthcoming new rules from the SEC regarding disclosure of impacts and risks related to climate change, which are expected in early 2022.[5]

In the United Kingdom, the Bank of England's Prudential Regulatory Authority, which oversees UK insurers, last month published a report highlighting how it will embed climate change into its supervisory approach from the end of 2021, requiring that regulated entities demonstrate their ability to understand and manage climate-related financial risks on an ongoing basis.[6] In Europe, EIOPA proposed mandatory public disclosure of an insurer's and reinsurer's "sustainable investments ratio" and "sustainable underwriting activities ratio" pursuant to the EU Taxonomy Regulation and its related delegated acts.[7] NAIC's Climate and Resiliency Task Force is also coordinating discussion and engagement on climate-related risk and resiliency issues, including dialogue among state insurance regulators, industry and other stakeholders on workstreams including pre-disaster mitigation, solvency, disclosure, innovation and technology.[8]

Insurers should consider the adequacy of their existing governance, business models, risk management practices, scenario analysis and disclosure related to climate change in light of the Final Guidance (if applicable) and under existing applicable law and track further developments in this space closely in the next year.

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## ENDNOTES

1 New York Department of Financial Services, "Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change" (November 15, 2021), *available at*: https://www.dfs.ny.gov/system/files/documents/2021/11/dfs-insurance-climate-guidance-2021_1.pdf.

2 New York Department of Financial Services, "For Public Comment: Proposed Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change" (March 25, 2021), *available at*: https://www.dfs.ny.gov/system/files/documents/2021/03/proposed_ins_climate_guidance_2021_public_comment_1.pdf.

For an analysis of the initially proposed guidance, *see* our Client Memorandum, dated March 31, 2021, "New York Department of Financial Services Issues Proposed Guidance on Financial Risks of Climate Change for Insurers," *available at*: https://www.sullcrom.com/files/upload/sc-publication-ny-regulator-focuses-on-insurers-climate-risk.pdf.

3 On October 21, 2021, the Financial Stability Oversight Council ("FSOC") issued a report on climate-related risk that identified climate change as an "emerging threat to the financial stability of the United States" and reviewed existing actions by FSOC members to incorporate climate-related financial risks into their regulatory and supervisory activities. *See* our Client Memorandum, dated November 2, 2021, "Financial Stability Oversight Council Report on Climate-Related Financial Risk," *available at*: https://www.sullcrom.com/files/upload/sc-publication-financial-stability-oversight-council-report-on-climate-related-financial-risk.pdf.

The SEC is also expected to propose new rules requiring reporting companies to provide disclosure on climate-related risks in 2022, which are expected to apply to insurers subject to SEC reporting and disclosure requirements. *See* our Client Memorandum, dated July 29, 2021, "SEC Chair Addresses Details of Potential New U.S. Climate-Related Disclosure Rules," *available at*: https://www.sullcrom.com/files/upload/sc-publication-SEC-Chair-Discusses-Potential-New-US-Climate-Disclosure-Rules.pdf.

4 The Final Guidance cites to, among other international precedents, the following sources:

EIOPA, "Opinion on the supervision of the use of climate change risk scenarios in ORSA" (April 19, 2021), *available at*: https://www.eiopa.europa.eu/content/eiopa-issues-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa_en.

IAIS and Sustainable Insurance Forum, "Application Paper on the Supervision of Climate-related Risks in the Insurance Sector" (May 2021), *available at*: https://www.iaisweb.org/page/supervisory-material/application-papers/file/97146/application-paper-on-the-supervision-of-climate-related-risks-in-the-insurance-sector.

PRA, "Supervisory Statement, SS3/19, Enhancing banks' and insurers' approaches to managing the financial risks from climate change" (April 15, 2019), *available at*: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.

NGFS, "Guide for supervisors: integrating climate-related and environmental risks into prudential supervision" (May 2020), *available at*: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf.

5 For a discussion of the potential content of forthcoming rules, *see* our Client Memorandum, dated July 29, 2021, "SEC Chair Addresses Details of Potential New U.S. Climate-Related Disclosure Rules," *available at*: https://www.sullcrom.com/files/upload/sc-publication-SEC-Chair-Discusses-Potential-New-US-Climate-Disclosure-Rules.pdf.

## ENDNOTES (CONTINUED)

6 Bank of England, Prudential Regulation Authority, "Climate-related financial risk management and the role of capital requirements, Climate Change Adaptation Report 2021" (October 28, 2021), *available at*: https://www.bankofengland.co.uk/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021.

7 *See* our Client Memorandum, dated March 19, 2021, "EU Authorities Propose Mandatory Sustainability-Related Key Performance Indicator (KPI) Reporting for EU Companies," *available at*: https://www.sullcrom.com/files/upload/sc-publication-eu-mandatory-reporting-on-sustainability-kpis-under-eu-taxonomy-update.pdf.

8 NAIC, "Climate Risk and Resiliency Resource Center," *available at*: https://content.naic.org/climate-resiliency-resource.htm.

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