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New York Department of Financial Services Issues Proposed Guidance on Financial Risks of Climate Change for Insurers

Detailed Guidance Would Establish Expectation That Insurers Integrate Consideration of Climate Risks Into Governance, Operations, Risk Management, Scenario Analysis and Disclosure

INTRODUCTION

On March 25, 2021, the New York State Department of Financial Services (DFS) issued detailed proposed guidance (the "Proposed Guidance") addressing how New York insurers should analyze and manage the financial risks of climate change.[1] The DFS is seeking comment by June 23, 2021 on the Proposed Guidance, which it expects 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.

The Proposed Guidance comes as U.S. financial regulators and policy makers, including the U.S. Congress, the U.S. Securities and Exchange Commission and the Federal Reserve Bank, increasingly focus on the potential systemic risk that climate change may pose to the financial sector.[2] For example, on March 24, 2021, a group of U.S. senators sent a letter to eight leading insurers asking them to provide information about climate change and their underwriting and investment policies, which is discussed below.

Insurance and other prudential regulators outside the United States have also taken recent steps to address climate-related risks, and the DFS notes that the Proposed Guidance is modeled on publications and guidance from international regulators and networks, including the Bank of England Prudential Regulation Authority (PRA), the International Association of Insurance Supervisors (IAIS), the European Insurance and

Occupational Pensions Authority (EIOPA), the European Central Bank (ECB) and the Network for Greening the Financial System (NGFS).[3]

DFS GUIDANCE ON CLIMATE RISKS

The Proposed Guidance is among the first detailed statements from a U.S. financial regulator on how financial institutions are expected to analyze and manage the risks posed by climate change, which the DFS described as "one of the most critical risk-management issues of our generation."

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. Climate change risks are most often categorized as either physical or transition risks: physical risks arise from the increasing frequency, severity, and volatility of acute weather events and chronic shifts in weather patterns, while transition risks refer to risks arising from the transition to a low-carbon economy, such as new regulations on carbon emissions. The DFS notes that insurers are likely to be affected by both types of risks:

- Physical effects of climate change directly affect property/casualty insurers' policyholder liabilities and may also indirectly lead to lower property values, corporate profitability and household wealth, which could affect insurers' assets.[4]
- Transition risks could affect the value of insurers' assets by reducing corporate profitability and property values, while increased litigation could affect insurers' liabilities and the viability of certain business lines.[5]

The DFS also notes that climate-related litigation could trigger losses under liability policies, such as directors' and officers' insurance policies, and that insurers could face direct actions for failure to manage climate-related risks.

In the Proposed Guidance, the DFS specifies the following five supervisory expectations for insurers and notes that it intends to monitor compliance with these as part of its supervisory activities:

1. Integrate the consideration of climate risks into the insurer's governance structure.
2. Consider the current and forward-looking impact of climate-related factors on the insurer's business environment.
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.

While the Proposed Guidance affects only those insurers under the DFS' supervision, the DFS notes that it is largely consistent with, and modeled on, international regulators' expectations, which also focus on long-term analysis, an expectation of an increasing level of sophistication over time, and an understanding that insurers' approach to managing climate risks should match proportionally their exposure to such risks and the complexity of their business. These principles are repeated throughout the Proposed Guidance.

Analysis of the Proposed Guidance

The Proposed Guidance focuses in particular on how the impacts of climate change will need to be reflected in insurers' risk culture and governance, business strategy, risk management and public disclosures. The Proposed Guidance frequently mentions, and builds upon, existing analytical tools developed by the DFS and the National Association of Insurance Commissioners (NAIC) to supervise insurers' risk management processes, including the corporate governance components of the NAIC's Financial Condition Examiners Handbook and insurers' enterprise risk reports and Own Risk and Solvency Assessment (ORSA) summary reports.

- ***Risk Culture and Governance:*** The DFS expects an insurer's board or governing entity to understand and oversee relevant climate risks within the insurer's overall business strategy and risk appetite, taking into account climate risks' "unprecedented nature" and "long-term impact beyond the standard business planning horizon," and to designate a member or committee of the board and a member of senior management responsible for climate risk assessment and management. An insurer is expected to have a written risk policy adopted by its board describing how the insurer monitors and manages climate risks in line with its risk appetite statement. Insurers are also expected to integrate climate risk management into their organizational structure by, for example, clearly articulating roles and responsibilities in setting climate risk limits and overseeing their implementation.
- ***Business Strategy:*** The DFS notes that insurers are already exposed to climate risks and are expected to be aware of potential changes in their business environment. Questions insurers should be attuned to include: which business areas are exposed to a climate-related physical or transition risk; the materiality of the risk; whether affected areas should be continued, scaled back, or adapted; and whether climate risks require consideration across all business areas and processes on the basis of their materiality or only those business areas and processes that are particularly exposed.
- ***Risk Management:*** Insurers are expected to have in place processes and enterprise risk management functions to identify, monitor and manage exposure to risks in a manner appropriate for their businesses. In particular, if the potential impacts of climate risks are determined to be material, the DFS expects insurers to demonstrate how they will mitigate those risks and develop a plan or policies for managing their exposure to such risks. The DFS notes that these mitigation plans and policies should reflect the unprecedented nature of climate risks, and how they differ from or might compound other risks. Insurers should also analyze how the 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. In that respect, the DFS notes that risk identification and prioritization will likely require additional information gathering from publicly available sources or external experts. Finally, the DFS emphasizes the need for coordination between the group level, where enterprise risk may be managed and reports may be produced, and the entity level, where the DFS expects that insurers' climate-related policies and procedures should be implemented.
- ***Scenario Management:*** Insurers' risk management functions are expected to use prospective solvency assessments, including scenario analysis and stress testing, to evaluate climate risks. The DFS highlights, in particular, that, given the forward-looking nature of climate risks and their

inherent uncertainty, "Insurers are […] expected to go beyond using historical data to inform their risk assessment and consider future trends."[6] The DFS also notes that insurers should expand existing scenario analysis practices, which generally focus on investments, to also encompass liabilities, and that scenario analyses should include not only short- to medium-term assessments but also a long-term assessment, referred to in various parts of the Proposed Guidance as meaning "in the order of decades" and "e.g., 30 years."

- ***Public Disclosures:*** The DFS provides detailed guidance for how it expects insurers' disclosure of climate risk to evolve over the next few years. Insurers should publicly disclose how climate risks are integrated into their corporate governance and risk management and should address how physical and transition risks (including liability risks) might impact insurers' underwriting, investment, and strategies. Such disclosure will also be expected to take into consideration the Task Force on Climate-related Financial Disclosures (TCFD) framework. The DFS advises that while analysis and disclosure may initially be more qualitative, especially for smaller or less sophisticated insurers, its expectation is that disclosure should "become more quantitative, including key metrics and targets, over the next two to three years." The DFS also notes that because insurers would benefit from greater climate-related disclosure in the wider economy, they should encourage such disclosure through their ownership of financial assets.

The Proposed Guidance also addresses what the concepts of proportionality and materiality mean in the context of climate risk analysis. On proportionality, the DFS notes that it expects all insurers, regardless of size, to analyze their climate risks on both the underwriting and investment sides of their balance sheets, but recognizes that each insurer's approach should be tailored to "its exposure to climate risks and the nature, scale, and complexity of its business" and that some insurers may take longer than others to develop and implement appropriate practices. 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, and should also gradually extend from a short- and medium-term horizon to a long-term view. On materiality, the DFS notes that when assessing the materiality of climate risks, insurers may use the standard NAIC materiality benchmarks (e.g., 5% of surplus or one-half of 1% of total assets), but should recognize that certain quantitatively smaller risks may still be material, due to investor expectations or an insurer's exposure to specific geographies and sectors.

Comments on the Proposed Guidance have been requested by June 23, 2021. All written comments submitted will be made public.

DFS' Previous Actions on Climate Change

The Proposed Guidance is the latest in a series of actions by the DFS to prompt insurers under its supervision to address climate change-related financial risks. In 2017, the DFS had issued Circular Letter No. 9 (2017), which urged insurers to manage resources prudently in their operations and to provide incentives to their policyholders to adopt environmentally friendly practices.[7] In May 2020, the DFS had also announced the hiring of its first Director of Sustainability and Climate Initiatives to engage with the industry and develop expert guidance in this area. In addition, since 2011, the DFS has been administering the NAIC Climate Risk Disclosure Survey to large life, property/casualty, health, and title insurers; the survey provides regulators with information on how insurers assess and manage climate risk.[8]

More recently, on September 22, 2020, the DFS issued Circular Letter No. 15 (2020), which outlined the DFS' expectations with respect to insurers' exposure to financial risks from climate change, and indicated that, starting in 2021, the DFS' examination process would integrate questions on an insurer's approach and activities related to the financial risks from climate change.[9] In that same circular, the DFS also announced that it would publish detailed guidance "consistent with international best practices on climate-related financial supervision" and that it welcomed input from industry in that process. The Proposed Guidance is generally consistent with the DFS' expectations set forth in Circular Letter No. 15 (2020).

U.S. SENATORS' LETTER TO MAJOR INSURERS

On March 24, U.S. Senators Sheldon Whitehouse (D-RI), Jeffrey A. Merkley (D-OR), Elizabeth Warren (D-MA) and Chris Van Hollen (D-MD) sent letters to eight major U.S. insurers requesting information on their underwriting and investment policies as they pertain to coal and other carbon-intensive projects.

In their letter, the senators noted the body of research suggesting that "climate change and the failure to plan for an orderly transition to a low-carbon economy are capable of producing staggering economic losses" related to both "the physical risk of damages caused by climate change or the transition risk of stranded fossil fuel assets." In particular, the senators' letter cites to the Federal Reserve Bank's most recent biannual financial stability report, which for the first time addressed the risk posed by climate change to financial stability.[10]

While the senators' letter does not address any plans to propose new legislation, the letter does mention that competitors of the eight companies to whom they sent the letter had already stopped underwriting and/or restricted their investments in coal and certain other fossil fuel projects, such as tar sands. The letter asks the recipients to provide information on, among other matters, (1) how claims and premiums may change in the coming decades as climate-related losses rise, (2) what any stress tests they may have conducted revealed about their company's exposure to fossil fuel assets, and (3) how their company's fossil fuel underwriting and investment policies are consistent with their broader commitments to sustainability.

The senators have asked for responses from the letter's recipients by April 16, 2021.

FURTHER CONSIDERATIONS FOR INSURERS

Insurers with U.S. reporting obligations should also be aware of potential new guidance or rules from the SEC regarding disclosure of impacts and risks related to climate change, on which the SEC issued a request for public input in mid-March.[11] There are also several bills related to climate change disclosure under consideration in the U.S. House and Senate, as well as in certain states, which may affect U.S. insurers and those with U.S. reporting obligations.

In Europe, EIOPA has recently 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.[12] The UK government has also recently formally added climate change to the scope of the UK prudential regulators' remits.[13]

Insurers are advised to consider the adequacy of their existing risk management practices and disclosure related to climate change under existing applicable law, standards and regulatory guidance and to track developments in this space closely in the coming year.

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ENDNOTES

[1] 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.

[2] See our Client Memorandum, dated March 19, 2021, "SEC Focuses on Potential Updates to U.S. Climate Change Disclosure Requirements," *available at* https://www.sullcrom.com/files/upload/SC-Publication-SEC-Updates-Climate-Change-Disclosure-Requirements.pdf.

[3] The Proposed Guidance cites to, among other international precedents, the following sources:

EIOPA, "Consultation Paper on draft Opinion on the supervision of the use of climate change risk scenarios in ORSA" (October 5, 2020), *available at* https://www.eiopa.europa.eu/content/consultation-draft-opinion-supervision-of-use-of-climate-change-risk-scenarios-orsa_en.

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.

[4] In its Circular Letter No. 15 (2020), the DFS noted that single- and multi-family residential homes in New York City alone with $334 billion of reconstruction value are at high risk of storm surges, and that 2,000 commercial mortgage-backed securities, worth more than $56 billion, were identified as exposed to flooding along the East and West Coasts, with more than half estimated to lie outside Federal Emergency Management Agency flood zones. *See infra* note 9.

[5] In its Circular Letter No. 15 (2020), the DFS noted, for example, that France's banking and insurance regulator had estimated that 10% of French insurers' portfolios (representing EUR 250 billion) would be subject to transition risks related to the fossil fuel, electricity, gas and water-producing sectors, as well as energy consumers, and that these risks could affect New York insurers' investments in a similar way. *See infra* note 9.

[6] For example, the DFS expects insurers to consider external factors in their scenario analysis, including whether the transition phasing out fossil fuel-based energy occurs, is orderly or disorderly, and whether it is accompanied by financial market disruption and/or a drastic increase in natural disasters. Elsewhere in the Proposed Guidance the DFS cites the potential imposition of a meaningful national carbon tax as a factor that could increase the vulnerability of additional companies to transition risks and should be taken into account in analyzing exposure.

[7] New York Department of Financial Services, Insurance Circular Letter No. 9 (2017), dated July 26, 2017, *available at* https://www.dfs.ny.gov/industry_guidance/circular_letters/cl2017_09.

[8] The NAIC included climate-related questions in the NAIC Financial Condition Examiners Handbook in 2013.

[9] New York Department of Financial Services, Insurance Circular Letter No. 15 (2020), dated September 22, 2020, *available at* https://www.dfs.ny.gov/industry_guidance/circular_letters/cl2020_15.

ENDNOTES (CONTINUED)

10 *See* Board of Governors of the Federal Reserve System, Financial Stability Report, dated November 2020, *available at* https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf.

See also Statement by Governor Lael Brainard, dated November 9, 2020, *available at* https://www.federalreserve.gov/publications/brainard-comment-20201109.htm.

11 *See supra* note 2.

12 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.

13 HM Treasury, dated March 24, 2021, "Climate considerations now fully embedded across UK principal financial regulators," *available at* https://www.gov.uk/government/news/climate-considerations-now-fully-embedded-across-uk-principal-financial-regulators.

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