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Creating a climate of change digest

Creating a climate of change digest: Climate risk regulatory developments in the financial services industry

Leading off

As in the past few years, the National Association of Insurance Commissioners (NAIC) has identified climate risk in concert with natural catastrophes and resiliency as a top regulatory priority for 2023.[1] Specifically, the state standard-setter said in its February 13, 2023, press release that it would "work to close climate risk-related protection gaps" in the insurance sector.[2]

The NAIC plans to close existing protection gaps through continuing consumer education campaigns that bring attention to coverage needs and how state insurance departments can reinforce these efforts. As a likely backdrop to this ongoing work, there is a federal effort underway to explore these gaps, given that they have not been identified in an official publication. For example, in conjunction with the Financial Stability Oversight Council's (FSOC) analysis of financial stability, Treasury's Federal Insurance Office (FIO) has been asked by the Treasury Secretary to "assess climate-related issues or gaps in the supervision and regulation of insurers" and to "further assess, in consultation with States, the potential for major disruptions of private insurance coverage in regions of the country particularly vulnerable to climate change impacts."[3]

In September 2021, the NAIC proposed its Catastrophe Modeling Center of Excellence (COE), which is expected to provide states the opportunity to engage in risk analysis and harm mitigation efforts.[4] The purpose of the COE is to "provide model documentation, education, and training as well as to conduct applied research using catastrophe models that address regulatory climate risk and resilience."[5] To date, the process of operationalizing the COE is ongoing. The NAIC will also be on Capitol Hill backing a "stable and long-term" National Flood Insurance Program (NFIP), which has been subject to legislative action and reauthorization in the five-and-a-half decades since it was created.[6] Both the COE and the NFIP are mentioned in the NAIC's 2023 climate-related priorities.

A recent Federal Reserve Board (FRB) staff working paper from the agency's Finance and Economics Discussion Series (FEDS) explores bank, insurer, and household exposure to various Miami hurricane scenarios as a risk analysis exercise in response to accelerating climate change.

In the paper dated February 7, 2023, FRB staff analyzes possible future financial losses from hurricane damage to Miami residential real estate under different scenarios of destructiveness and size of the hurricane and evolving business approaches to accelerating climate change.[7] The paper suggests that the fast pace of climate change "has added urgency to efforts to understand how severe weather events might affect the safety and soundness of the financial system," further substantiating the timeliness and importance of the research.[8] The research approach uses the "flow-of-risk" across entities to look at the impact of sea level rise on the vulnerability of bank losses on residential real estate portfolios in Miami. For the purposes of the paper, and under the flow-of-risk framework, "a climate-linked natural disaster leads to insurable claims for covered homeowners, generating losses for insurers."[9] The paper quantifies insurance losses, which in some cases are far less than bank losses.

The paper explores the following three scenarios: (1) a business-as-usual scenario with no adjustments made in the market or among homeowners with their insurance coverage or with the ongoing risk in the housing/construction/mortgage market; (2) a Hurricane Ian-spillovers scenario, where the effects of the fall 2022 catastrophic storm cause some protective reactions in construction, building, and coverage risk; and (3) a cautious-markets scenario where markets become more risk averse while insurance coverage rates rise significantly.[10] Each of these scenarios are subjected to a hypothetical stress consisting of category 1 through 5 hurricanes. Tables are provided for each scenario to track losses.

The working paper concludes, for example, that "for a Cat 5 hurricane that strikes in 2050, the losses for insurers could rise to as much as $89 billion, with losses to banks on mortgages held on their balance sheets of $6.3 billion (or 54.8% of their Miami portfolio)."[11] The paper concludes that these losses, if they occurred in just one instance, would not likely threaten overall bank solvency; however, smaller banks that are more heavily concentrated in the area may experience significant distress. It is possible that the quantitative methodology used in the paper could complement modeling of market losses or other financial developments that may also affect banks.

On February 6, 2023, FRB closed its 60-day public comment period on proposed principles for the safe and sound management of exposures to climate-related financial risks at large banking organizations.[12] The FRB's draft guidance, issued on December 8, 2022, follows similar proposals from the Office of the Comptroller of the Currency (OCC) issued in December 2021 and the Federal Deposit Insurance Corporation (FDIC) issued in March 2022. It is expected that the agencies will finalize interagency guidance outlining a common framework for climate-related financial risk management later this year.

The proposed principles aim to ensure that banks are prepared for and can effectively respond to the impacts of both physical risk ("the harm to people and property arising from acute, climate-related disaster events") and transition risk ("stresses to certain institutions or sectors arising from the shifts in policy, consumer and business sentiment, or technologies associated with the changes necessary to limit climate change").[13]

As proposed, the FRB's principles would be applicable to supervised banking organizations such as state member banks, bank and savings and loan holding companies, the US operations of foreign banking organizations (FBOs), and FRB-supervised firms designated as systemically important financial institutions. The FRB's intent is to help banks integrate climate-related financial risks into their broader risk management processes, allowing for more informed decision-making and effective climate-related financial risk management practices. The organization of the FRB's proposed risk management framework mirrors those of the FDIC and OCC, outlining responsibilities and considerations of the board, the board and management, and management. The framework would cover the following six general principles and six financial and nonfinancial risk management areas:[14]

Elements of the FRB's proposed climate-related financial risk management framework for large banking organizations

General principles	Managment of risk areas
Governance	Credit
Policies, procedures, and limits	Liquidity
Strategic planning	Other financial risk
Risk management	Operational
Data, risk measurement, and reporting	Legal/compliance
Scenario analysis	Other nonfinancial

In addition to the FRB's request for comment on all aspects of the draft principles, the FRB also seeks specific input on the following questions:[15]

Question 1: "In what ways, if any, could the draft principles be revised to better address challenges a financial institution may face in managing climate-related financial risks?"

Question 2: "Are there areas where the draft principles should be more or less specific given the current data availability and understanding of climate-related financial risks? What other aspects of climate-related financial risk management, if any, should the Board consider?"

Question 3: "What challenges, if any, could financial institutions face in incorporating these draft principles into their risk management frameworks?"

The FRB's issuance of its proposed principles, coupled with the indication that the final principles will likely be issued on an interagency basis, signifies alignment of the federal banking regulators on the importance of and supervisory approach concerning climate-related financial risk management across federally supervised banks and banking organizations. Collectively, the proposals set forth by the FRB, FDIC, and OCC represent a critical step in addressing the impact of climate change on the financial system as well as working to further promote financial stability and resilience throughout the banking sector in the face of a rapidly changing climate.

On January 30, 2023, California state legislators introduced the Climate Accountability Package, consisting of three Senate Bills (SBs): the Fossil Fuel Divestment Act (SB 252), the Climate Corporate Data Accountability Act (SB 253), and the Climate-Related Financial Risk Act (SB 261).[16] These bills are collectively expected to promote enhanced transparency on climate-related risks, exposures, and investments for certain businesses operating in California. This package would cover the financial services industry and could have a marked impact on certain financial firms operating in the state.

If passed, this package could potentially place a significant amount of additional reporting and disclosure requirements on select financial firms, the earliest of which would be enforced in 2024. Applicability is based on total annual revenue where those financial firms with total annual revenue at or above $100 billion would generally be subject to all three acts.

Climate Accountability Package overview

	SB 252[17]	SB 253[18]	SB 261[19]
Applicability	Board defined as the Board of Administration of the Public Employees' Retirement System or the Teachers' Retirement Board of the State Teachers' Retirement System, as applicable.	Reporting entity defined as a partnership, corporation, limited liability company, or other business entity formed under the laws of this state, the laws of any other state of the United States or the District of Columbia, or under an act of the Congress of the United States with total annual revenues exceeding one billion dollars ($1,000,000,000) and that does business in California.	Covered entity defined as a corporation, partnership, limited liability company, or other business entity formed under the laws of the state, the laws of any other state of the United States or the District of Columbia, or under an act of the Congress of the United States with total annual revenues exceeding five hundred million dollars ($500,000,000) and that does business in California. Covered entity excludes a business entity that is subject to regulation by the Department of Insurance in this state, or that is in the business of insurance in any other state.
Triggering date(s) for firm action	• Commencing February 1, 2025, and annually on February 1 thereafter (reporting). • July 1, 2030 (liquidation of investments in fossil fuel companies).	Starting in 2026 on or by a date to be determined by the state board, and annually thereafter on or by that date.	On or before December 31, 2024, and annually thereafter.
Summary of key requirements for firms	• Refrain from making additional or new investments or renewing existing investments of public employee retirement funds in a fossil fuel company. • Liquidate investments in a fossil fuel company on or before July 1, 2030. • Create a report that includes: – A list of fossil fuel companies where the board liquidated its investments. – A list of fossil fuel companies where the board has not yet liquidated its investments. – A list of fossil fuel companies of which the board has not liquidated its investments but determines that a sale or transfer of investments is inconsistent with the fiduciary responsibilities of the board.	• Publicly disclose to the emissions registry all of the reporting entity's Scope 1 emissions and Scope 2 emissions for the prior calendar year and its Scope 3 emissions for that same calendar year no later than 180 days after that date. – Disclosures should be made using the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard and the Greenhouse Gas Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard developed by the World Resources Institute and the World Business Council for Sustainable Development.[20]	• Prepare a climate-related financial risk report disclosing: – Climate-related financial risk, in accordance with the recommended framework and disclosures contained in the Final Report of Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) (June 2017) or any subsequent publication.[21] – Measures adopted to reduce and adapt to climate-related financial risk outlined in the report. • Submit the report to the state board and make it available to the public on the entity's website.

	SB 252[17]	SB 253[18]	SB 261[19]
Summary of key requirements for firms,continued	– An analysis of methods and opportunities to reduce dependence on fossil fuels and transition to alternative energy sources in a realistic time frame that avoids negatively contributing to economic conditions. • Submit the report to the legislature and the governor, and post the report on the board's internet website.	– Disclosures should reflect the acceptable use of both primary and secondary data sources, including the use of industry average data, proxy data, and other generic data in Scope 3 emissions calculations.	• Submit to the Secretary of State a statement affirming, not under penalty of perjury, that the report discloses climate-related financial risk in agreement with the TCFD framework.
Notes		SB 253 bill was first introduced as SB 260, the Climate Corporate Accountability Act, in the 2022 California legislative session but failed to pass on the Assembly floor.	

The Office of Financial Research (OFR) released its 2022 Annual Report to Congress on January 12, 2023, where the agency reports that the overall threats to US financial stability were elevated when compared to the previous year.[22] The report discusses several emerging threats posed by climate-related financial risks.

Specifically, the report discusses the impact of physical and transition risks to the safety and soundness of financial institutions and broader implications for the economy. It also mentions that liability risks associated with climate-related financial risk are becoming increasingly common and are expected to have significant impacts if firms fail to account for legal and regulatory changes; environmental, social, and governance (ESG) commitments; and other actions.

Highlights from the report include the following:[23]

- Climate-related financial risk has introduced vulnerabilities into the financial system. Both physical and transition risks will have impacts on the federal budget, financial institutions, and markets.
- Not all climate-related financial risks have been priced into financial assets. There may be potential risk mispricing in the market.
- There has been less progress made in the quantification of climate-related events in financial sectors. Models linking climate-related financial risk and financial impacts continue to be refined, but these models and data are still in the early stages of development.
- Third parties may end up paying for the cost of climate change related to damages and mitigation efforts.
- Climate-related risks could affect financial institutions and government-sponsored mortgage companies through securitization, especially in flood-prone areas.

The report emphasizes that monitoring of climate-related financial risks is vital to the maintenance of financial stability. The report also recaps the OFR's launch of the Climate Data and Analytics Hub pilot program in 2022.[24]

New York State Department of Financial Services (NYDFS) hosted its 2023 climate change webcast on banking January 11, 2023,[24] titled "Proposed Guidance for New York State Regulated Banking and Mortgage Institutions Relating to Management of Material Financial Risks from Climate Change," in regards to guidance issued December 21, 2022.[26] The NYDFS webcast and guidance came out on the heels of similar proposals from the federal banking agencies (FRB, OCC, and FDIC) and is one example of state banking supervisors setting similar expectations for climate-related financial risk management.

The webcast addressed several discussion topics such as the purpose of the guidance, guidance development approach, key themes, significant provisions, and ways to provide feedback to the NYDFS.[27] The webcast was geared toward raising awareness about the guidance and providing clarification about its contents.

The proposed guidance suggests that New York State–regulated banking and mortgage institutions would be subject to its requirements, which should assist these institutions in identifying, measuring, monitoring, and controlling their material climate-related financial risks in accordance with existing risk management principles.[28] Alignment with the requirements of the federal banking regulators will be most helpful for those covered institutions that receive both state and federal supervisory oversight.

The supervisory guidance covers several requisite aspects of climate-related financial risk management as listed below.[29]

A. Corporate governance:

- A *regulated organization's* governance structure will include a process for identifying, monitoring, measuring, and controlling the financial risks associated with climate change through the development and implementation of sound processes for understanding and assessing the potential impact of climate-related financial risks on businesses and the environment in the short, medium, and long term, to inform the strategy, policies, and procedures implemented by each business line.
- The *board and management*, including senior management, should have adequate understanding and knowledge to assess climate-related financial risks and their impact on the organization's overall risk appetite.

B. Internal control framework:

- The *three lines* should be incorporated into internal control frameworks.
  - The *first line* assesses climate-related financial risks during the client onboarding, credit application, and credit review processes; the *second line* investigates independent climate-related financial risk assessment and monitoring, including assessments conducted by the first line of defense; and the *third line* undertakes regular independent reviews of an organization's climate-related internal control framework and systems considering changes.

C. Risk management process:

- *Regulated organizations* should identify how physical and transition risks may affect specific asset classes and counterparties, as well as develop appropriate key risk measurement tools to monitor emerging risks and ensure that related risk data and metrics are regularly updated.
- The *board and management* should develop and implement plans to reduce and manage each organization's exposure to material climate-related financial risks, and these plans should be reviewed regularly.
- *Regulated organizations* should assess the impact of physical and transition risks as drivers of their existing risk categories, such as changes in cash flows and/or asset values affecting the probability of default and loss causing credit risk.

D. Data aggregation and reporting:

- *Regulated organizations* should establish risk data aggregation capabilities and risk reporting capable of measuring material climate-related financial risks and be able to produce prompt information to help boards and senior management make decisions.

E. Scenario analysis:

- *Regulated organizations* should consider using an array of climate scenarios based on assumptions about the effect of climate-related risks over different time horizons, including physical and transition risks, and identify and quantify vulnerability to relevant climate-related risk factors and potential impacts.

The NYDFS intends to continue its coordination with state, federal, and international counterparts on matters of climate-related financial supervision. The NYDFS is requesting feedback on the proposed guidance by March 21, 2023.[30]

On January 4, 2023, the Office of Information and Regulatory Affairs released the Fall 2022 Unified Agenda of Regulatory and Deregulatory Actions, which included the Securities and Exchange Commission's (SEC) semiannual regulatory agenda.[31] The SEC continues to maintain an active regulatory agenda, which includes proposals that address climate-related matters.

The SEC's regulatory agenda prioritizes a list of 52 rules, which includes the proposed rule to Enhance and Standardize Climate-Related Disclosures for Investors.[32] The SEC intends to release its final rule in April 2023.[33] However, it is to be noted that in the Fall 2022 Agenda Agency Preamble, the SEC informs that it may consider or act on any matter earlier or later than the estimated date provided on the agenda.[34]

Additional Deloitte US perspective on climate risks

For additional insights, please see our ongoing series on how climate risks are shaping US financial regulatory initiatives and the impact these developments may have on the financial services industry and the broader economy:

- Centering around sustainability in financial services firms: Navigating risks, finding opportunities
- Deloitte 2022 CxO Sustainability Report
- The CIO's call to action: Driving an environmentally sustainable tech agenda to accelerate organizational change

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