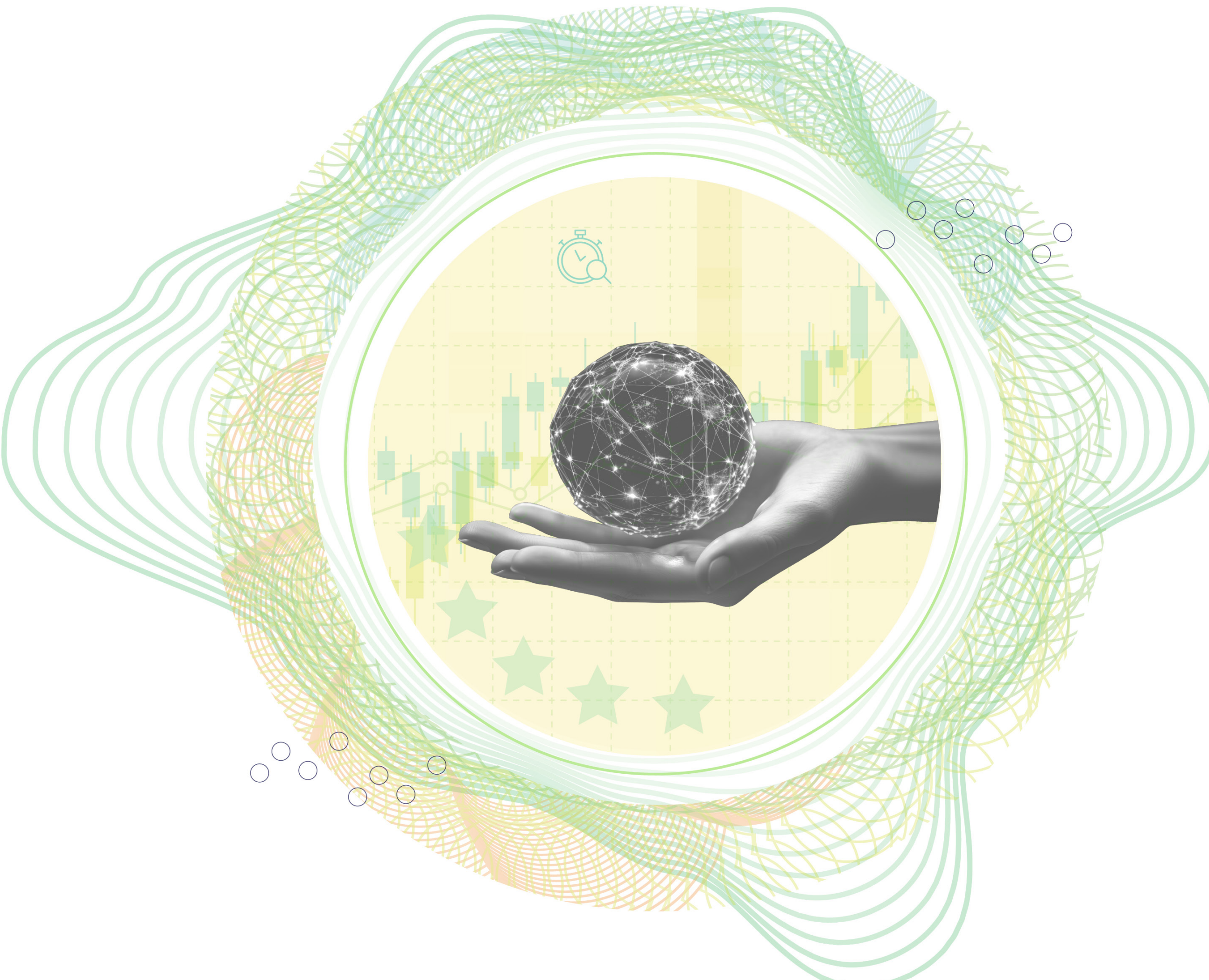

Is your enterprise risk management function climate-ready?

Emerging regulatory expectations for insurers

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Introduction

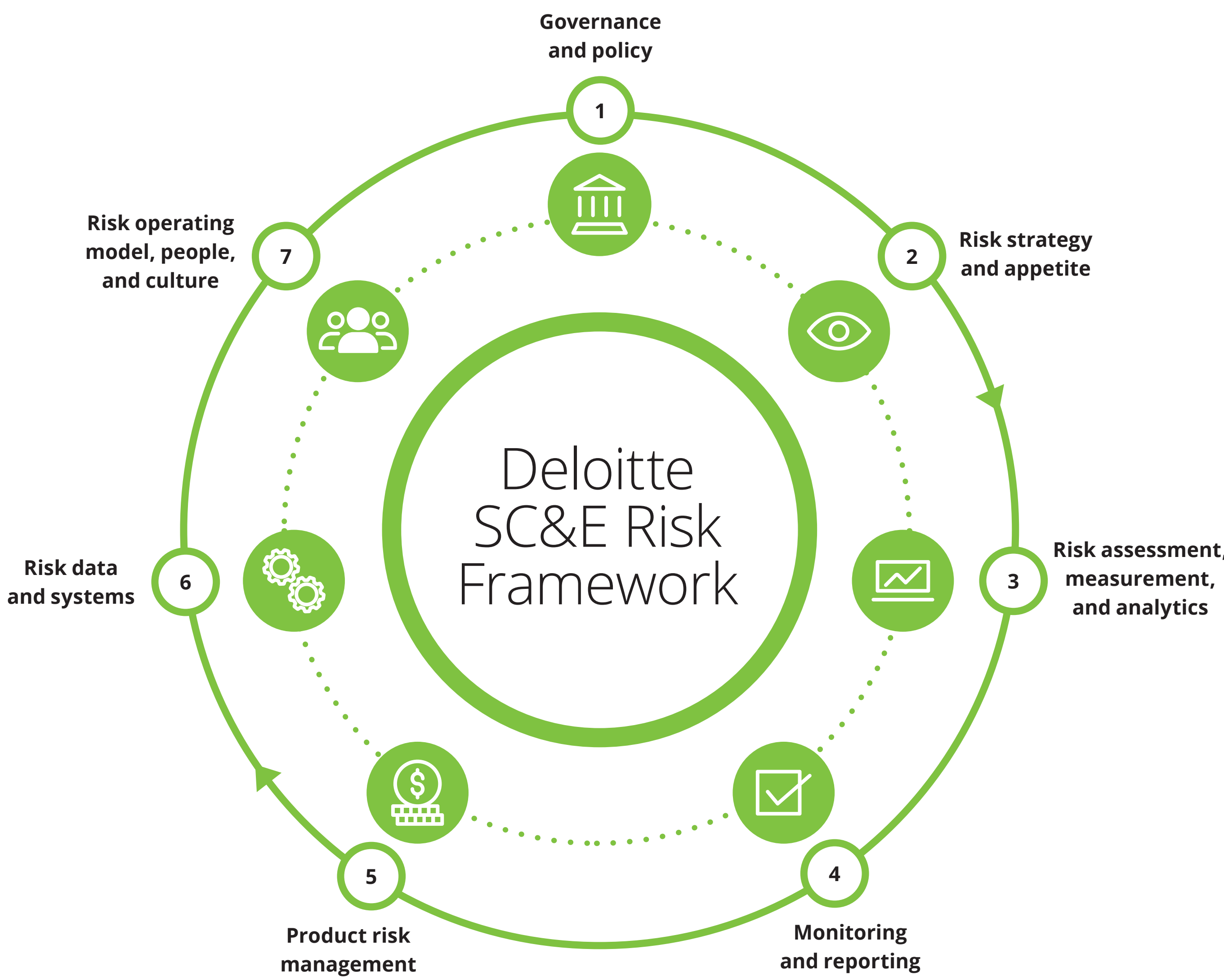
It's not easy to keep track of the evolving regulatory landscape for climate issues. Multiple international bodies have recently issued guidance and requirements, which can affect US financial companies as well.[1] In the United States, it is well known that the forthcoming Securities and Exchange Commission (SEC) rule could greatly change how public companies approach climate risk analysis and reporting.

For American insurers, there is the additional variable of state-level laws, the interpretation and requirement of which by state insurance regulators matter even more than federal actions. This paper will give a high-level view of the current environment of state-level climate regulations for insurers, using the guidelines from the New York Department of Financial Services (NYDFS) as the main example. New York and California lead the way, and their direction points toward insurers needing to meet increasingly thorough and quantitative climate risk standards. These expectations align with the determination of the International Association of Insurance Supervisors (IAIS) that climate change is a material risk for the insurance industry.[2]

Among regulators like the ones already mentioned, as with numerous other external stakeholder groups interested in advancing climate policy, hopes are high for managing climate risk in the long term. The NYDFS guidance builds on an earlier circular letter from September 2020 and advises all licensed New York insurers to begin building capabilities for considering and responding to climate risk to the company's financial health and, to some extent, impact on insurance products and actuarial considerations. As for the future, "[NYDFS] will continue to develop its supervisory approach to managing and disclosing climate risks, considering US federal and state regulatory developments as well as evolving practices in the industry and in the national and international supervisory community. Over time, [NYDFS] expects its approach to shift from supporting insurers' progress in implementing [NYDFS's] supervisory expectations in accordance with the timelines specified in this guidance, to active supervision against those expectations."[3]

A sustainability, climate, and equity (SC&E) risk framework

To clarify the different ways climate risk regulations can impact an insurer, we will organize the NYDFS's insurance industry expectations according to Deloitte's sustainability, climate, and equity (SC&E) risk framework. The framework reflects the seven main areas where climate risk and climate regulations have the most impact on an organization: governance and policy; risk strategy and appetite; risk assessment, measurement, and analytics; monitoring and reporting; product risk management; risk data and systems; and risk operating model, people, and culture.



1. Governance and policy

An insurer's board is the beginning and end of the climate risk oversight operation and is an essential piece of developing a climate risk framework, climate expertise, and continuous oversight. To start with, boards should establish a robust plan that highlights key timelines, internal and external stakeholders, and interdependencies. Details on the company's implementation plans and pathway to meeting the expectations relating to organizational structure were to be in place as of August 15, 2022. Board governance includes the following points:

- The guidance envisions a board deeply involved with climate risk considerations, one that is actively engaged and ready to tap into and communicate risks at any time, more so if climate risk is considered a material risk to the insurer's position or is expected to be so in the future. The board should understand climate risks and maintain oversight over climate risk management personnel and functions. In general, climate risk should be integrated into the governance structure at the group or entity level.
- The board must designate a member or committee to be responsible for overseeing climate risks. A board member with climate risk expertise is recommended to ensure that the board can understand and actively manage the ongoing threat and impact of climate risk for the long term, not just for a three- to five-year time horizon.
- Insurers should not limit climate expertise to one individual at the executive and board level. NYDFS recognizes that climate change could affect operations and businesses across the company, and this reality demands multiple senior management individuals who develop or have expertise in responding to climate risk.
- NYDFS also expects each insurer to designate one or more members of its senior management to manage climate risks. For example, the insurer's chief underwriting officer might take responsibility for embedding climate risks in the company's underwriting processes. The designated member(s) of senior management may delegate responsibility to the business units and functions they oversee but must continue oversight of the functions and activities. As an alternative, NYDFS suggests a cross-functional committee of senior management. This group must take charge of comprehending climate risk, identifying it, and addressing it.
- The board should adopt a written risk policy detailing its system to evaluate and manage its unique material climate risks. This policy should state the insurer's risk tolerance levels and limits for financial risks. The policy should also consider change as a constant variable. A static assessment and evaluation will not suffice as ongoing regulatory and legislative policy changes, technological advancements, and investment/underwriting evolution affect future financial risk.

Climate change manifests in two main risk types: transition and physical.

- **Transition risk:** These risks arise from society's transition toward a lower-carbon environment driven by changes in government regulation and technological abilities. The reduction in the use of carbon can, and will, affect market investments, real estate, infrastructure, and business offerings. The reduction can cause a great change in value in any—perhaps all—assets. Profitability can be affected by an increase in litigation and the cost of changing business plans. Insurers are intertwined with sectors and businesses with high transition risk through insurance coverage and investing.
- **Physical risk:** These risks arise from the impact of climate change on weather patterns, affecting communities, health and well-being, infrastructure, agriculture, and natural resources. New York echoes climate science by noting that climate change has increased heat and precipitation extremes across the globe and warns that physical risks "will likely become more complex and harder to model, further challenging insurers' attempts to manage those risks." Moreover, "if significant action is taken but too late to achieve the Paris Agreement goal of limiting global warming to well below 2 degrees Celsius above pre-industrial levels, the resulting financial disruption could be severe."

2. Risk strategy and appetite

NYDFS advises companies to proactively manage climate risk through existing enterprise risk management (ERM) functions. So that climate risk doesn't become a superficial exercise, the goal should be to embed climate risk metrics in the overall risk appetite framework and to be used to inform decision-making.

NYDFS also expects insurers to undertake robust examination of a "full range of potential future outcomes and consider forward-looking data" in their risk analysis. Risk functions will need to become fluent in the climate risk activities for adjusting to analysis results and material risk changes over time. Such an expansive approach can stave off or reduce the potential for higher losses stemming from underestimation of future extreme weather events, or from failing to understand the connections between transition and physical climate risks. "Prudent risk management requires that insurers look at the full range of potential future outcomes and consider forward-looking data," NYDFS states.

NYDFS understands that in the early stages of incorporating climate risk, the approach and risk appetite statements are going to be qualitative and exploratory. The expectation is clear, though, that embedding climate risk into a quantitative risk appetite framework is the end goal.

3. Risk assessment, measurement, and analytics

The NYDFS guidance, like similar documents from other bodies, sees a quantitative scenario analysis function as an ideal way for insurers to understand and plan for climate risk. Insurers' risk functions should start to think about what this would look like, even if in a highly preliminary state, as eventual maturation into a quantitative and repeatable scenario analysis process is the goal. Early iterations of climate risk scenario analysis are expected to be qualitative in nature.

Whether qualitative or quantitative, the NYDFS says an insurer should be able to understand and address material climate risks. Materiality assessments, such as scenarios, are expected to be qualitative at first, with greater incorporation of quantitative metrics that will enable companies to demonstrate the probability of these risks. Finally, an additional but important layer to developing these new capabilities is the ability to analyze and measure vulnerabilities of important counterparties as well.

4. Monitoring and reporting

The transformations mentioned previously will, of course, need to be reflected in reporting documents, including own risk and solvency assessment (ORSA) filings with state regulators. Insurance companies should work toward being able to describe how climate risks are identified, categorized, managed, and monitored in disclosures, including details on assessment tools and methods used. To meet the emerging expectations, insurers should establish a dynamic and well-rooted reporting plan that highlights key timelines, internal and external stakeholders, and interdependencies. The plan should also detail any data and analysis gaps and how they impact near- and long-term reporting requirements—NYDFS expresses in its guidance that uncertainty and data gaps do not justify inaction.

Keeping with the trend, an insurer's analysis of climate risks and assessment of their materiality for its business should shift from a qualitative approach to an approach that is both qualitative and quantitative over time, which will become necessary for risks that are quantifiable and as more data becomes available through modeling, research, and statistical resources. The planning for this approach should begin or be underway if an internal risk assessment demonstrates the increased probability of material climate risks.

5. Product risk management

Climate risk is present in many business activities, product development not the least among them. Deloitte's SC&E risk framework emphasizes product risk because 1) products are the economic motor of an organization, and 2) the climate risk inherent in insurance products is a new and important frontier for much of the industry. Farthest along in this space is the incorporation of physical risk from increasingly severe weather events for property, but many other types of insurance products do not have climate built in as an underwriting factor. It will be important for organizations such as life insurers, health insurers, and reinsurers to understand, as quantitatively as possible, how climate risk can impact the profitability and effectiveness of products.

Climate's impact on products may present an opportunity for insurers to capitalize on new markets, customers, and technologies that need risk transfer products. Specializing early will facilitate a competitive edge in an environment of economic transition to a low-carbon economy.

6. Risk data and systems

For many insurance companies, the technological aspect of measuring and tracking various climate metrics—and socializing them in a way that impacts decision-making—is perhaps the area in need of the most improvement. If you find the climate software and data space to be daunting, you're not alone. The field is relatively new and rapidly evolving, with few leading practices or universal standards to use as guideposts.

Yet as stated before, uncertainty does not justify inaction. Insurers should be building internal expertise on relevant climate data sources and systems, as well as identifying process owners. From there, the organization's climate subject-matter experts should work to identify information technology (IT) system assumptions and limitations that affect measurement, tracking, and reporting of key metrics. As an end state, the goal should be a battery of flexible climate systems that can adapt to changing standards of technology and data, as well as defined internal process and general IT controls that help mitigate climate-related risks.

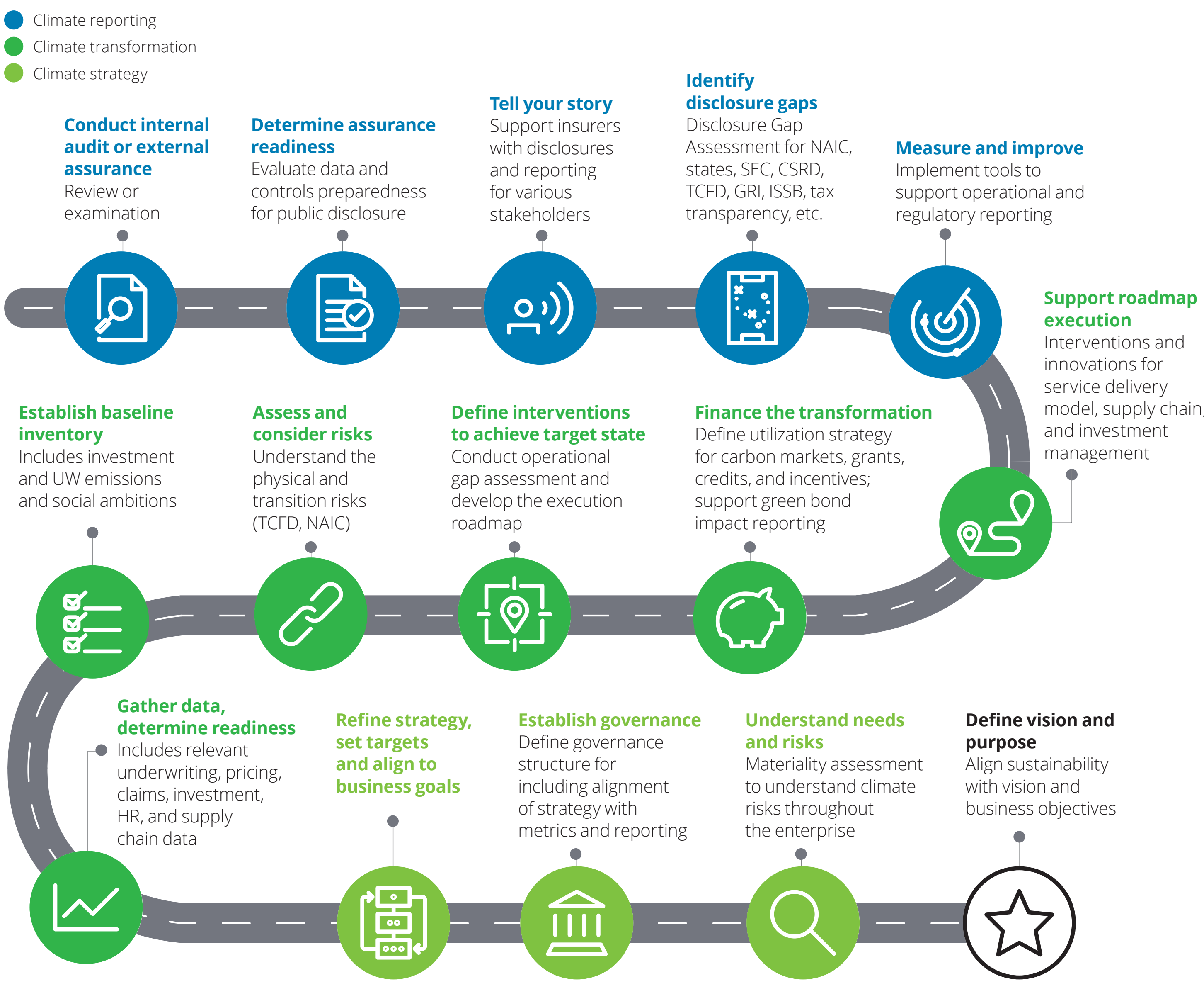
In Deloitte's experience, insurers usually need to undergo a substantial amount of internal transformation to satisfy these steps. This journey should not be delayed until hard regulatory requirements set in.

7. Risk operating model, people, and culture

Many insurers will need to transform at least some of their internal operations to meet the expectations touched on previously, which will transition over time from suggested actions to required ones. The seven-part SC&E risk framework provides a helpful first view, by organizing guidance from a regulator such as the NYDFS into operational components familiar to most corporate environments.

From there, an insurer will likely need to plan on internal transformation and realignment to content with climate challenges. Deloitte's sustainability and climate journey for insurers map is a more detailed view of the steps needed to become an insurance company of the future.

Sustainability and climate for insurers: The transformation journey



Conclusion

In addition to NYDFS's guidelines, other states are converging on climate risk standards for insurers. Fifteen states, representing 80% of insurance companies in the United States, are in alignment with the Task Force on Climate-related Financial Disclosures (TCFD) to enhance transparency about how insurance companies manage climate-related risks and opportunities. While the governing bodies, acronyms, and standards can be difficult to keep straight, it all points in the same direction, which is a future where insurance companies need to be knowledgeable about their climate risk exposures. Insurers will be expected by regulators, as well as other important stakeholder groups including customers, to have a coherent narrative about their environmental impact, exposure to and measurement of physical and transition risks, and strategies to mitigate risks and capitalize on opportunities.

With past and forthcoming guidance from the National Association of Insurance Commissioners' (NAIC) Climate Risk Disclosure Survey, the proposed SEC climate disclosure rules, and the other sources of guidance discussed previously, a picture of the next generation of risk management disclosure for climate is coming into focus. It is important for firms to consider their ERM framework, the impacts of climate on their business models, and how to enable accurate disclosure. The ideal time to begin working toward that future state is now, before regulatory requirements harden.

Endnotes

1. Examples include the International Association of Insurance Supervisors' (IAIS) *Public consultation on climate risk supervisory guidance—part one*, EU's Corporate Sustainability Reporting Directive (CSRD), and Japan's Financial Services Agency requirement of disclosures in accordance with the Task Force on Climate-related Financial Disclosures (TCFD).
2. IAIS, *Public consultation on climate risk supervisory guidance—part one*, March 2023, p. 4.
3. New York Department of Financial Services (NYDFS), "Guidance for New York domestic insurers on managing the financial risks from climate change," November 15, 2021, p. 3.
4. Ibid, sec. 3.6, pp. 9–11.
5. Ibid, sec. 2.1, pp. 4–5.
6. Ibid, sec. 3.4, pp. 8–9.
7. See the National Association of Insurance Commissioners' Climate Risk and Resiliency Resource Center, accessed June 11, 2023.

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