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Climate Change Risks and US Insurance Industry Regulation

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In late November 2020, we published a high-level review of insurance regulatory developments relating to climate change, available here. In the six weeks since, regulators and industry participants on both sides of the Atlantic Ocean have been keeping up the pace—and there will be more to report in early 2021.

This brief update piece will focus first on a December 16, 2020, Sustainable Finance Roundtable from the European Insurance and Occupational Pensions Authority (EIOPA), then on upcoming comments (due on January 12, 2021) on the International Association of Insurance Supervisors' (IAIS) "application paper" about managing climate change risks. Next, the New York Department of Financial Services (DFS) held the second in a series of climate change briefings in early December and has another session scheduled for January 15, 2021. The DFS has also published some guidance for industry in the form of FAQs and right before Christmas posted a "pre-proposed outreach" proposal for a second amendment to New York's Enterprise Risk Management (ERM)/Own Risk and Solvency Assessment (ORSA) Regulation 203 (comments due January 8, 2021). Finally, also pre-Christmas, the industry itself, notably the Lloyd's Market, weighed in with climate change-related goals to reduce and then phase out underwriting and investments in coal-related businesses.

In Depth

EIOPA Sustainable Finance Roundtable

In the words of its director, Gabriel Bernardino, EIOPA is beginning to move from "policy to practice" with respect to climate change risks. During the all-day Roundtable, several of the segments included discussion of metrics that regulators might employ to assess re/insurer progress in integrating environmental sustainability concerns into underwriting and investing…and into capital requirements. EIOPA is proposing two new key performance indicators: i) on the asset side, the proportion of assets that fund or are associated with environmentally sustainable economic activities; and ii) on the underwriting side, the proportion of gross written premium from insuring activities/exposures that are environmentally sustainable. EIOPA appears determined to advance the climate change ball with respect to natural catastrophe modelling ("nat cat modelling") as well, serving notice that future models will need to include new countries within the European Union, new perils (*e.g.*, wildfire and drought as well as flood, quake, etc.) and new lines of business…and should include loading factors to

account for increasing climate change risk. All this initial work will need to be reassessed and recalibrated regularly to incorporate new science and changes in exposure as well as new insurance products. Comments on EIOPA's framework proposals are due at varying times over the first two months of 2021.

It is also worth noting that EIOPA is working with the European Banking Authority and the European Securities and Markets Authority with respect to climate change disclosures per the European Union's Sustainable Finance Disclosure Regulation. Expect to see similar increasing communication and coordination in the United States, although the sheer number of our federal and state banking, securities/commodities trading and insurance regulators may slow such efforts. To some degree, however, regulator competition, both nationally and internationally, may produce some whipsaw effects for regulated entities. Something to watch for in any event.

IAIS Application Paper

As noted in our November 23, 2020, report, the IAIS' Application Paper on managing climate risk is in a public consultation period. From a US perspective, we know that the National Association of Insurance Commissioners (NAIC) itself and various industry trade associations are in the process of putting together their comments—all due January 12. The scope of the application paper includes several regulatory compliance aspects—ranging from supervisory review and reporting, corporate governance, risk management, investments and financial disclosures—but does not address topics such as asset valuation and capital requirements, conduct of business or macroprudential supervision. We will report further as this paper is finalized.

DFS DEVELOPMENTS

New York financial regulators (it is worth remembering that the DFS regulates both insurers and state-chartered banks and has in recent months made it clear that the DFS' focus on climate change regulatory issues applies to both sectors) will continue to host a series of short climate change "knowledge exchange" sessions with a mix of speakers, not just regulators. As noted above and as announced in the DFS September 22, 2020, Circular Letter No. 15 on Climate Change and Insurance Industry, there was a knowledge exchange session in early December, and another is scheduled for January 15. In connection with announcing the January 15 session, the DFS' Director of Sustainability and Climate Initiatives, Dr. Nina Chen, posted a short series of climate change FAQs on the DFS website.

FAQs

Following is a brief review of FAQs of most interest:

- Circular Letter No. 15 applies to both domestic (New York-domiciled) and foreign-authorized (domiciled in some other US state) insurers, but the DFS acknowledges that its "oversight over domestic and authorized insurers, however, is not identical" (somewhat understated!)

- No new regulations regarding "climate-related supervisory activities" are contemplated (but with the regulatory action "Timeline" quoted below AND the "pre-proposed outreach" proposal below)

- As to stress testing, the DFS continues to "develop its approach"

- No “formal expectation” to include climate considerations in ORSAs (but with the “pre-proposed outreach” proposal below)

- As to financial disclosures, the DFS will continue to evaluate Task Force on Climate-Related Financial Disclosures (TCFD) (or equivalent) disclosures as to “governance, strategy, risks and metrics” but bearing in mind “proportionality and materiality” considerations as insurers obviously are not all exposed to climate change risks to the same degree

- Timeline for future DFS action?”Although the timeline is still being finalized, DFS plans to:

    - Launch the global knowledge exchange seminar series on climate change at the end of 2020, with sessions scheduled to take place through the first quarter of 2021;

    - Issue proposed detailed guidance on insurers’ approaches to managing the financial risks from climate change in the first quarter of 2021 and provide 90 days for public comment;

    - Organize an industry roundtable to gather feedback on the proposed guidance and, after incorporating the feedback, issue the detailed guidance in the third quarter of 2021; and

    - Analyze the financial risk exposure to New York domestic insurers’ assets from climate change.

As stated in the Circular Letter [No. 15, issued September 22, 2020], questions pertaining to an insurer’s approach and activities related to the financial risks from climate change will be integrated into DFS’ examination process starting in 2021. To prepare for these exams, insurers will start receiving information requests related to climate in their First Day Letters in December 2020.”

Pre-Proposed Outreach

It appears that the FAQs’ “no formal expectation” rhetoric noted immediately above was modified during December (possibly influenced by the EIOPA Sustainable Finance Forum on December 16?) as the DFS published a “pre-proposed outreach” proposal to amend the state’s enterprise risk management/own risk solvency assessment Regulation 203 to specifically include “climate change” (along with cybersecurity, epidemics and pandemics!) among the “reasonably foreseeable and relevant material risks” (heretofore confined to “underwriting, asset-liability matching, credit, market, operational, reputational, and liquidity”) that domestic New York insurers (again, just those domiciled in the state—including branches of non-US insurers) are expected to include in their annual ERM/ORSA filings. Comments on this “pre-proposed outreach” proposal are due January 8.

“Policy into practice” with respect to climate change appears to have been fast-tracked in New York…or at least it is in the process of being fast-tracked. Will the NAIC and other states follow suit? While management at any insurance group that includes a New York domestic insurer should be paying close attention to the evolving DFS climate change regulatory framework and plans for further development in 2021, it is encouraging to consider the DFS’ recognition that one size does not fit all:

> **“…each insurer should take a proportionate approach that reflects its exposure to the financial risks from climate change and the nature, scale, and complexity of its**

business. DFS understands that climate change affects each insurer in different ways and to different degrees depending on the insurer's size, complexity, geographic distribution, business lines, investment strategies, and other factors. DFS appreciates that insurers do not have the same level of resources to manage these risks and are at different points in the process of incorporating these risks into their governance, strategy, and risk management."

Lloyd's Climate Change Goals

Also before Christmas, Lloyd's CEO John Neal announced a slew of climate change/ESG (environmental, social and corporate governance) targets in the Market's first ESG Report, focusing on reducing involvement with companies engaged in thermal coal extraction and use, oil sands mining/extraction and Arctic energy extraction activities, including:

- No longer underwriting new risks in these sectors, starting January 1, 2022, and phasing out underwriting any company that derives 30% or more of its revenues from activities in these sectors completely by 2030
- No new investments in companies in these sectors by 2022 and phasing out investments in any company that derives 30% or more of its revenues from activities in these sectors, with termination dates starting as early as January 1, 2026
- Committing 5% of Central Fund investments to ESG "impact" investments
- Committing 2% of the Market's annual premium to insuring "innovative and sustainable" activities/products
- Committing the Corporation of Lloyd's to be carbon neutral by 2025

While Lloyd's is not the first insurance enterprise to announce climate change goals and commitments and while many policymakers and regulators will welcome reports like the Lloyd's ESG Report, US insurers should expect that some domestic regulators, notably New York, seem very determined to drive climate risk management improvements in "governance, strategy and risk management" for those insurers with higher levels of climate risk. Policymakers and regulators in other jurisdictions, *e.g.*, in Alberta or in Louisiana and Texas, may have other views on underwriting and investment cutbacks targeting non-renewable energy industries.

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