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Climate Change Regulation for US Insurers: September 2021 Update and Overview

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There are less than two months before world leaders meet in Glasgow for the UN-sponsored Climate Change summit known as the Conference of the Parties (COP 26). This summer, we have been inundated with dire reports about myriad climate consequences of human activity (*e.g.*, the UN Intergovernmental Panel on Climate Change report from early August 2021 that detailed faster warming, in all regions, intensifying rainfall and droughts, increased coastal flooding, etc.) and flooded with news items about proliferating severe weather-related events worldwide, new green investment opportunities, new or updated corporate sustainability pledges, and impending regulatory crackdowns on greenwashing.

At the same time, apart from climate change regulatory activity in a few states (see summary below) there has not been much high-profile insurance regulatory progress to report. Nevertheless, there is continuing regulatory activity that should, reasonably soon, enable the US insurance industry to spot at least the outlines of an emerging climate change regulatory framework. What are the key points to keep in mind, as of September 2021?

FEDERAL INSURANCE OFFICE ENTERS CLIMATE CHANGE DEBATE

On August 31, 2021, the Federal Insurance Office (FIO) gave notice, via publication of a Request for Information (RFI) (with responses due in 75 days), that it will take a seat at or near the head of the table around which financial services regulators are assembling to begin the development of a US climate change regulatory framework. FIO's introductory language from the RFI is illuminating:

> "FIO's role and statutory authorities enable it to take a leadership position in analyzing how the insurance sector may be impacted by, and help mitigate, climate-related risks. FIO is engaging with the NAIC [National Association of Insurance Commissioners] and state insurance regulators through their work on climate-related topics. FIO also represents the United States at the IAIS [International Association of Insurance Supervisors], is a member of the UN's Sustainable Insurance Forum, and is a member of the Organization of Economic Cooperation and Development's Insurance and Private Pensions Committee—all of which are increasingly focused on climate-related issues. In addition, FIO is discussing climate-related issues with insurance authorities in both the United States and the European Union through the EU-U.S. Insurance Project. FIO also represents Treasury in the federal Mitigation

> Framework Leadership Group, which is a national structure to coordinate disaster mitigation efforts across the federal government and with state, local, tribal, and territorial representatives. FIO is engaging with the Securities and Exchange Commission [SEC] and other members of the FSOC [Financial Stability Oversight Council] on climate-related financial risks. More generally, FIO provides insurance expertise and technical assistance within Treasury and to other federal agencies, including to the Federal Emergency Management Agency in connection with the National Flood Insurance Program (NFIP). FIO's engagement on climate-related issues also includes the issuance of public reports addressing natural disasters, climate change, and insurance, including through its annual report to Congress and the President."

Those who have been following news around the early consideration of this topic will know that, earlier in 2021, US President Joe Biden directed every federal financial services regulatory body—from the Federal Reserve to the SEC to the Treasury Department (of which the FIO is a part)—to embed climate change/sustainability considerations into the regulation of financial services entities, including (controversially) in periodic financial disclosure filings by regulated entities. Developing a common language for such disclosures—including agreement on metrics and measurements—will take time, of course, but like other federal agencies, the FIO has this herculean task front and center:

> "In addition, FIO plans to consider ways to address the lack of common methodology and standardization in measuring financed emissions, particularly those of nonpublic companies in which the insurance sector underwrites and invests."

Echoing statements from Treasury Secretary Janet Yellen (in her role as FSOC chair) and SEC Chair Gary Gensler, the introduction to the RFI continued:

> "The lack of available data complicates the ability to conduct such assessments. Government and private sector stakeholders have noted the significant issues caused by the lack of available data to assess climate-related financial risk within the insurance sector. These stakeholders could all potentially benefit from high-quality, consistent, comparable, and reliable data for their risk management, disclosures, and forward plans to assess and address climate-related financial risks. State regulatory tools, such as the Own Risk and Solvency Assessment (ORSA), may capture data on some climate-related financial risks if they are recognized by a reporting insurer as having a material impact on its solvency over the next one to two years, but these tools may be inadequate to assess climate-related risks, particularly over a longer time horizon. Additionally, only six states have regularly collected from insurers certain limited, high-level qualitative data directly focused on climate-related financial risks. No federal authority is collecting climate-related financial data specific to the insurance sector."

The RFI lists out the FIO's three priorities in the notice:

> "1. Insurance Supervision and Regulation: Assess climate-related issues or gaps in the supervision and regulation of insurers, including their potential impacts on U.S. financial stability
>
> "2. Insurance Markets and Mitigation/Resilience: Assess the potential for major disruptions of private insurance coverage in U.S. markets that are particularly vulnerable to climate change impacts; facilitate mitigation and resilience for disasters
>
> "3. Insurance Sector Engagement: Increase FIO's engagement on climate-related issues; leverage the insurance sector's ability to help achieve climate-related goals."

We mention all this because you may recall that the 2010 landmark Dodd-Frank legislation, which created the FIO, tasks the FIO with "monitor[ing] all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States financial system…." Even if the FIO has no direct role in solvency regulation of insurers, its involvement in what is shaping up to be a broad-based federal effort to develop a climate-change regulatory framework for financial institutions means that the industry—regulators and regulated insurers, including US-admitted/licensed insurers and IID-listed (International Insurers Department) surplus lines insurers—ought to be paying close attention.

NAIC STUDIES

In mid-August 2021, during the NAIC's Summer National Meeting, the organization's Climate and Resiliency (EX) Task Force convened to consider the work of its five workstreams:

1. **Pre-Disaster Mitigation:** This group is monitoring a variety of developments, most notably funding arrangements in federal legislation, *e.g.*, in the infrastructure bill passed by the Senate last month and awaiting House action that reportedly includes $3.4 billion in funding that could be used to enhance pre-disaster mitigation efforts.

2. **Climate Risk Disclosure:** With the first phase of its work completed (including deciding whether to add or modify the organization's own climate risk survey questions—there were no changes for 2021—and whether insurers required to respond to the annual climate risk survey should be able to submit responses using the Task Force on Climate-Related Financial Disclosures (TCFD) format—the answer to this latter question was yes, as in past years), this working group will be reconsidering climate-risk disclosures in light of a number of other projects underway at the SEC (*e.g.*, will industry-specific metrics be mandated?) and at the Financial Stability Board (*e.g.*, will TCFD reporting be updated?). The group will continue to evaluate whether the NAIC disclosure survey is asking the correct questions and, before making any recommendations, the Climate and Resiliency (EX) Task Force will be exposing any suggested changes or additions for public comment later in the year. This year, the NAIC will have the benefit of more climate change disclosures from US insurers to evaluate, as nine additional states are requiring domestic insurers to complete the surveys. As to timing, survey letters were sent on or about July 22, 2021, and responses were due by August 31, 2021.

3. **Solvency:** The chair summarized the various presentations made to this group over the course of several sessions by a variety of interested parties. On or about September 20, 2021, this group will begin to pivot from receiving input to beginning to consider incorporation of various sustainability analytic tools into existing solvency measurements. Given Moody's recently announced purchase of modelling company RMS and AM Best's announcement in July 2021 that more than one in 10 rating actions (69% negative, 31% positive) were driven by climate-related factors, rating-agency judgments could become an increasingly important driver of climate-related change for insurers.

4. **Innovation:** The chair summarized various presentations made to this group during the past several months; most such presentations focused on parametric insurance solutions.

5. **Technology:** This workstream has concentrated on understanding various climate change modelling advances and how/whether states regulate the use of models in rate making. A compendium of relevant state laws is being created. The NAIC's *Catastrophe Modelling Handbook*, originally produced in 2010, will be updated in due course. The group will hold an open meeting in the near future to further discuss these issues.

The NAIC's mid-September "insurance summit" will include a number of climate change-related presentations by representatives of the UK's Prudential Regulatory Authority (reviewing the main climate change risk analysis frameworks), by catastrophe modelers who will review the models being used in the UK's 2021 Climate Biennial Exploratory Scenario (CBES) exercise and by the New York Department of Financial Services (NYDFS) on next steps with respect to climate change regulation in New York, as well as two presentations by Praedicat, one of which will review climate change liability lawsuits as an emerging "casualty cat risk."

STATE-LEVEL ACTIVITY: NEW YORK, CONNECTICUT AND CALIFORNIA

New York Remains in the Lead; NYDFS Publishes Report on Transition Risks

In early summer 2021, using 2019 Schedule D invested asset data, the NYDFS published a captioned report, "An Analysis of New York Domestic Insurers' Exposure to Transition Risks and Opportunities from Climate Change," prepared by a multinational, non-profit climate change consultancy. The DFS explained that "The purpose of the report is to provide an example of a tool that insurers can use to assess their transition risks, as well as investment-related strategies that insurers can implement to mitigate those risks."

"Transition risks," for those not (yet) deep into climate change issues, are energy transition-related risks that can lead to having "stranded assets" on one's books. The NYDFS asserts that there are three principal risks: "policy and regulation changes, low-carbon technology advancement, and changing public sentiment and demand patterns."

While dependent on many variables, the total global value of carbon-intensive financial assets—representing ownership in upstream oil and gas production, coal mining, coal-fired power plants and the like—that are subject to transition risks clearly amounts to many trillions of dollars. The overall conclusion of the report is that "…in the aggregate, insurers' assets were meaningfully exposed to transition risks." At the individual company level, out of the 250 insurers whose data was studied, one P+C insurer had 100% of its equity investments in the fossil fuel sector while another had over 40% of its corporate bond portfolio devoted to fossil fuel issuers. One life company's bond portfolio included more than 50% devoted to fossil fuel issuers.

Following explanatory webinars for New York domestic insurers and interested parties last month, we now await publication of additional climate change guidance. But with the August 24, 2021, resignations of ex-Governor Andrew Cuomo and ex-NYDFS Superintendent Linda Lacewell, it is possible that publication will be delayed.

Connecticut Legislature Requires Biennial Insurance Department Reporting on Climate Change Factors

Included in the summer 2021 Connecticut state budget legislation was a climate change section that resurrects part of a standalone climate change disclosure/reporting bill that died earlier in the year. The budget bill requires the state's insurance commissioner to submit a report to the legislature every two years, beginning April 1, 2022, that addresses the Insurance Department's progress in integrating climate change risks into various solvency regulatory tools and processes, including periodic financial examinations, ORSA reports and risk-based capital requirements. The insurance commissioner is directed specifically to assess the "impacts of thermal coal, tar sands and Arctic oil and gas" (presumably both on insurers' underwriting and investment activities). The budget bill does not include aspects of the standalone bill that insurers found most objectionable, *e.g.*, publicly available detailed climate change risk disclosures.

California Insurance Commissioner Releases Climate Insurance Working Group Report

In July 2021, Insurance Commissioner Ricardo Lara released the results of an effort to identify, assess and recommend risk-transfer approaches to reduce the impacts of climate change, with a focus on wildfires, floods and extreme heat. The report was less about how to ensure that insurers embed climate change risk analysis into core operational activities than it was about what the community as a whole can do to improve:

- Risk assessment.
- Risk communication.
- Risk reduction/mitigation.
- Risk transfer (*i.e.*, closing protection gaps), in part by encouraging community-based insurance purchases and by developing new insurance products, including but not limited to parametric insurance policies.

OUTLOOK

There is no shortage of political, economic, public health, weather and other variables that will impact the scope and pace of development of climate change-related risk analysis for US financial services companies generally and insurers specifically. But the push to better understand the risks that climate change poses to the economy and to financial services companies seems set to continue at the federal level as long as Democrats hold the White House. Importantly, federal regulators seem determined to develop a common language to measure sustainability and to protect investors (and insureds). States such as California and New York seem likeliest to continue to advance the integration of climate change risk analysis into the regulation of insurers. Whether other states—and whether the NAIC—will follow suit remains to be seen. At the very least, however, more states are requiring insurers to file climate disclosures and, judging by the NAIC's Insurance Summit agenda this week, the NAIC now appears to be paying close attention to climate change regulatory activity in the European Union and the United Kingdom.

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