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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

California became the first state in the nation to craft and deliver regulation that would require insurance companies to take pricing action that recognizes mitigation measures taken by homeowners and building owners against wildfire risk.

Specifically, insurers will have to provide discounts to policyholders if they implement such measures as upgraded roofs and windows, creating defensible space in front of the structures and otherwise hardening homes, and participation in community fire risk reduction programs.

The regulation is still going through the state's Office of Administrative Law (OAL) review; but if it is approved and not challenged in court by the industry, it will become state law. Thus far, consumer advocates are encouraged by evidence of reaction from the property/casualty stakeholders. This could spark action in other states. The regulation was proposed in February 2022 after a series of town hall meetings on safety from wildfires and submitted September 7, 2022, to the California OAL, which has 30 working days to make sure it passes muster with the state's Administrative Procedure Act.

"My [California Insurance] Department is laser-focused on doing everything we can to protect consumers and hold insurance companies accountable," said California Insurance Commissioner Ricardo Lara in a press release accompanying the submission to OAL.[1]

The regulation to provide discounts was derived from the Safer from Wildfires framework created by the state's Department of Insurance in partnership with state emergency preparedness agencies, it stated.

Other states with a great interest in wildfire mitigation might be next, as ways to incentivize building owners to harden their structures is a priority across emergency preparation, education management groups, insurers, state regulators, and policymakers. Commissioner Lara is also co-chair of the National Association of Insurance Commissioners (NAIC) Climate Risk and Resiliency Task Force.

The Connecticut Insurance Department (the Department) issued a bulletin on September 15, 2022, informing insurers who do business in the state that it has a series of expectations with respect to climate change risk and disclosures, including reminding carriers that a company's board is ultimately responsible for overseeing the management of climate risk.[2]

The guidance is aligned with a biannual report the Department files with state lawmakers on progress toward addressing climate-related risk.

Commissioner Andrew Mais laid out actions and expectations in the bulletin and addressed risk culture and governance, risk appetite, risk management and controls, reporting and communications, and public disclosures. He said the Department expects insurers to take a "proportionate approach to managing climate risks that reflects its exposure to climate risks and the nature, scale, and complexity of its business," acknowledging that the force of climate change can affect each insurer in different ways based on a wide variety of business factors and characteristics, such as its investment strategies and geographic range and liens of coverage.

Connecticut is also one of the 15 US states that expects insurers to align their NAIC Climate Disclosure Survey with the Task Force on Climate-related Financial Disclosures (TCFD) guidance.[3] In fact, the NAIC, along with nonprofit Ceres, has been conducting webinars to provide help with the TCFD framework for insurers. The threshold for required participation is having at least $1 billion in annual countrywide premiums. The Department also made it clear it expects the disclosures to be public, as well.

The Department said it expects domestic insurers to implement its expectations relating to board governance and to have specific plans in place to implement the expectations relating to aligning their organizational structure by January 1, 2023.

Briefly, as summarized in the bulletin's overview, insurers should:

- Integrate the consideration of climate risks into its governance structure at the group or insurer entity level. The insurer's board should understand climate risks and maintain oversight over the management team responsible for managing climate risks. The roles of the board and management should be reflected in the company's risk appetite and organizational structure.
- Incorporate climate risks into the insurer's existing financial risk management. This should include embedding climate risks in its risk management framework and analyzing the impact of climate risks on existing risk factors.
- Appropriately disclose its climate risks and engage with the TCFD, the NAIC Climate Risk Disclosure Survey, and other initiatives when developing its disclosure approaches.
- Ensure compliance with the NAIC's Own Risk and Solvency Assessment (ORSA) Guidance Manual, if applicable, and be prepared to discuss the content in relation to climate risks with the Department at the insurer's annual meeting, or as requested by the Department. Annual meeting topics will include, but not be limited to, strategy around investment and underwriting activity.
- Use scenario analysis to inform business strategies and risk assessment and identification. Scenarios should consider physical and transition risks, multiple carbon emissions and temperature pathways, and short-, medium-, and long-term horizons.

The House Financial Services Committee's Subcommittee on Housing, Community Development and Insurance (the Subcommittee) examined the insurance market in the face of wildfire risk with a special focus on California during a hearing on September 22, 2022.[4] Lawmakers revealed directions they might be considering for future programs or legislative action as well as trying to calibrate insurance risk versus cost to the public.

During the hearing, several members of Congress appeared to be especially interested in not only incentivizing mitigation but also receiving assistance from the federal government in dealing with wildfire insurance costs.[5] However, when asked whether a mechanism similar to the National Flood Insurance Program (NFIP)—called a National Wildfire Insurance Program—should be created for wildfire risk and whether it was a good idea for the insured and taxpayers, the former deputy administrator of the NFIP promptly said, "it is a bad idea" for the insured and taxpayers.[6] However, he acknowledged that since "the changing climate has a cost," there is a need to create financial nudges to homeowners and drive them to do their own retrofits and other wildfire mitigation measures, with government grants to help them. "Actions at the federal, state, and local levels can provide these financial mechanisms to spur resilience-enhancing actions by homeowners," the former NFIP deputy testified.

There was also interest, noted during the hearing, among the Subcommittee members on whether a federal response to wildfires is warranted, with federal agencies involved in the customer experience from underwriting to borrowing as consumers purchase insurance for homes mortgaged through lenders or federal lending agencies. A federal home lender is engaged to promote and mitigate risk reduction, a California-based national insurance consumer advocate assured.[7] In addition, lawmakers heard that California leads the way on the building code with respect to fire safety; that despite some pullback by insurers from underwriting in the highest risk areas after the megafires of 2017 and 2018, the California homeowners insurance market remains robust; and that the "vast majority" of homeowners policies have been renewed. The Fair Plan, the California residual homeowner's insurance market, grew from 125,000 insured properties in 2017 to now about 270,000, a California insurance industry representative testified.[8] Rep. French Hill, R-Ark., expressed concern that rates are not allowed to increase to reflect risk in California due to Proposition 103, which requires rate approval.[9]

California Insurance Commissioner Ricardo Lara responded to chairperson of the full committee, Rep. Maxine Waters, D-Calif., that nationally, consumers are underinsured and that disclosure on policies is critical so people understand the risk they have should they lose their home or see it damaged.[10] Rep. Waters is interested in teasing out whether the appropriate consumer-oriented actions should be on a state-by-state or federal basis. Rep. Waters sponsored a bill, H.R. 8483, which has passed the House, as contained in the full Wildfire Response and Drought Resiliency Act, that would require studies by the Government Accountability Office regarding insurance coverage for damages from wildfires, and for other purposes.[11]

In his first speech since assuming the position of vice chair for supervision at the Board of Governors of the Federal Reserve System (FRB) in July 2022, Michael Barr addressed supervisory priorities including those involving climate-related risk.[12]

Of note were Vice Chair Barr's remarks outlining the FRB's plans to collaborate with the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) to develop large-bank climate-related financial risk management guidance. The FRB has not yet issued climate principles; however, Vice Chair Barr's speech confirmed that climate is indeed part of the agency's supervisory policy agenda.

Vice Chair Barr also disclosed the agency's 2023 plans to conduct a "pilot micro-prudential scenario analysis exercise" at certain large banks.[13] The distinction between the FRB's supervisory capital stress tests and the forthcoming scenario analysis is that the latter will likely not have direct capital or supervisory implications on the participating banks. The FRB expects to provide additional detail on the pilot in advance of its launch.

A September 12, 2022, OCC press release communicates the appointment of Dr. Yue (Nina) Chen as the agency's chief climate risk officer.[14]

Dr. Chen, formerly the executive deputy superintendent of the New York State Department of Financial Services (NYSDFS) Climate Division, replaced Jonathan Fink upon his recent retirement from the OCC earlier this year. Dr. Chen performed climate-related supervisory work in her previous role at NYSDFS and was welcomed by the OCC's Acting Comptroller Michael Hsu to lead the agency's supervisory climate initiatives.

The OCC has taken a proactive approach to considering matters involving climate-related financial risk, as evidenced by its 2021 issuance of risk management principles, as well as Acting Comptroller Hsu's ongoing coverage of climate-related risk management in speeches. During his recent remarks at The Clearing House and Bank Policy Institute Annual Conference, Acting Comptroller Hsu mentioned Dr. Chen's appointment and reiterated the agency's view on climate-related policy actions such as the review of public comments on the climate principles, addressing climate risk management from a community bank perspective, and working through potential challenges for large banks (e.g., alignment of cross-jurisdictional requirements, and ensuring a functional approach to scenario analysis).[15]

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***
- ***Ingraining sustainability in the next era of ESG investing***
- ***Addressing the business ramifications of climate risk on banks***
- ***Building a more sustainable insurance industry***

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Endnotes

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