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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

An insurance climate risk data collection fracas has emerged between federal agency and state regulators.

The leadership of the National Association of Insurance Commissioners (NAIC), in a strongly worded letter dated November 22, 2022, told the US Treasury Department's key financial institutions official that it was deeply concerned over the department's proposal to collect market data from property casualty (p/c) insurers.[1] Citing their expertise as state regulators over Treasury's own Federal Insurance Office (FIO), the top state regulators and the CEO of the NAIC warned that the FIO was allegedly likely to misinterpret the data due to inaccurate analysis, arriving at "fallacious" results. The NAIC's leadership also accused Treasury and the FIO of not working collaboratively with the state regulators as they had on prior occasions and cited examples.

Treasury's proposed data collection centers on climate risk related to exposure in the homeowners insurance market and was proposed by Treasury Secretary Janet Yellen after the recent devastation of Hurricane Ian in Florida exposed vulnerabilities in coverage and protection gaps.[2] The NAIC, in its letter to Assistant Secretary for Financial Institutions Graham Steele, warned that the data Treasury collects will not solely reflect climate risk specifically, but also capture demographic and social-economic data unrelated to climate, giving Treasury an inaccurate picture into affordability and availability in the property insurance market. The letter was signed by the NAIC's president, president elect, vice president, secretary, and CEO. In the letter, the NAIC also cautioned Treasury and the FIO of asking unnecessarily "complex hypothetical questions" to states on whether they could produce data in 30 days in a format neither the industry nor state regulators have familiarity with, knowing the answer would be no, as it had conceded it would take 350 hours for the industry to produce the data.

Treasury said in October 2022 that its data collection would be aggregated at the ZIP code level for a specific subset of insurers and "represents a critical step toward supplying FIO with consistent, granular, and comparable insurance data needed to help assess the "potential for major disruptions of private insurance coverage in regions of the country that are particularly vulnerable to the impacts of climate change."[3] The FIO was created by the 2010 Dodd-Frank Act and, while not a regulator, has certain authority to act on behalf of the United States on international supervisory issues. A nonvoting representative sits on the Financial Stability Oversight Council and has authority to monitor access to affordable insurance products, other than health, in underserved communities, minorities, and low-to-moderate income consumers. Over the years, it has demonstrated a keen interest in the availability and affordability of consumer insurance products.[4]

On November 9, 2022, the Board of the International Organization of Securities Commissions (IOSCO) announced the launch of a 90-day consultation period where public feedback is requested for two reports covering compliance carbon markets (CCMs) and voluntary carbon markets (VCMs).[5] The announcement highlights comments from IOSCO Chairman Jean-Paul Servais on the increasing significance of carbon markets over time and their role in the path to net-zero emissions. However, the chairman's remarks also focused on identified weaknesses and opportunities to improve "integrity, transparency, and liquidity" in carbon markets.[6] The announcement also includes a statement from Rostin Behnam, chairman of the Commodity Futures Trading Commission and IOSCO Board vice-chairman, supporting the consultation and reiterating its request for feedback.

Regulations governing "cap-and-trade" determine CCMs. The mandate for the maximum amount of carbon emission allowances for domestic firms and sectors in these markets is issued by governmental organizations. These firms and sectors may then trade in a secondary market, with corporations seeking to buy and sell allowances based on their own organizational needs. Another type of CCM is the "baseline-and-credit system," in which there is no set limit on emissions, but polluters who reduce their emissions more than they would otherwise be compelled to can earn credits to sell to others who need them. The CCMs report[7] makes several recommendations for jurisdictions looking to create compliance markets to reach their commitment under Article 6 of the Paris Agreement.[8]

Voluntary carbon markets (VCMs) are markets in which entities purchase carbon credits issued in connection with climate change mitigation projects, such as emissions reductions and carbon removals, to offset some or all of their carbon emissions. The VCMs report[9] explores a variety of features that can nurture sound carbon credit markets, as well as susceptibilities that avert these carbon credit markets from scaling up. Considering the advanced framework associated with Article 6.4 of the Paris Agreement,[10] the report proposes a few key considerations for the success of resilient carbon credit markets, and it invites respondents to take up the financial market regulator's role for overseeing these markets.

IOSCO, the international standard-setter for securities regulation, is the key international policy forum for securities regulators. The organization's membership, which currently stands at around 130 jurisdictions, regulates 95% of the world's securities markets. The IOSCO Board, which is composed of 35 securities regulators, is the organization's governing and standard-setting body.

On November 8, 2022, the UK Transition Plan Taskforce (TPT) published the Transition Plan Taskforce Disclosure Framework (Framework)[11] and accompanying Implementation Guidance (Guidance) for private-sector climate transition plans in the United Kingdom. The Framework and Guidance provide a road map for the development of net-zero transition plans and the determination of approaches to disclose those plans.

The TPT was launched in April 2022 and was tasked to develop stringent actions that would stem greenwashing and assist select UK firms with the development of transition plans.[12] The Framework is built on the five themes of GFANZ's (Glasgow Financial Alliance for Net Zero) financial institution net-zero transition plan framework.[13] The TPT provides the framework structure (figure 1) where it recommends disclosures across 19 sub-elements under the five themes.[14]

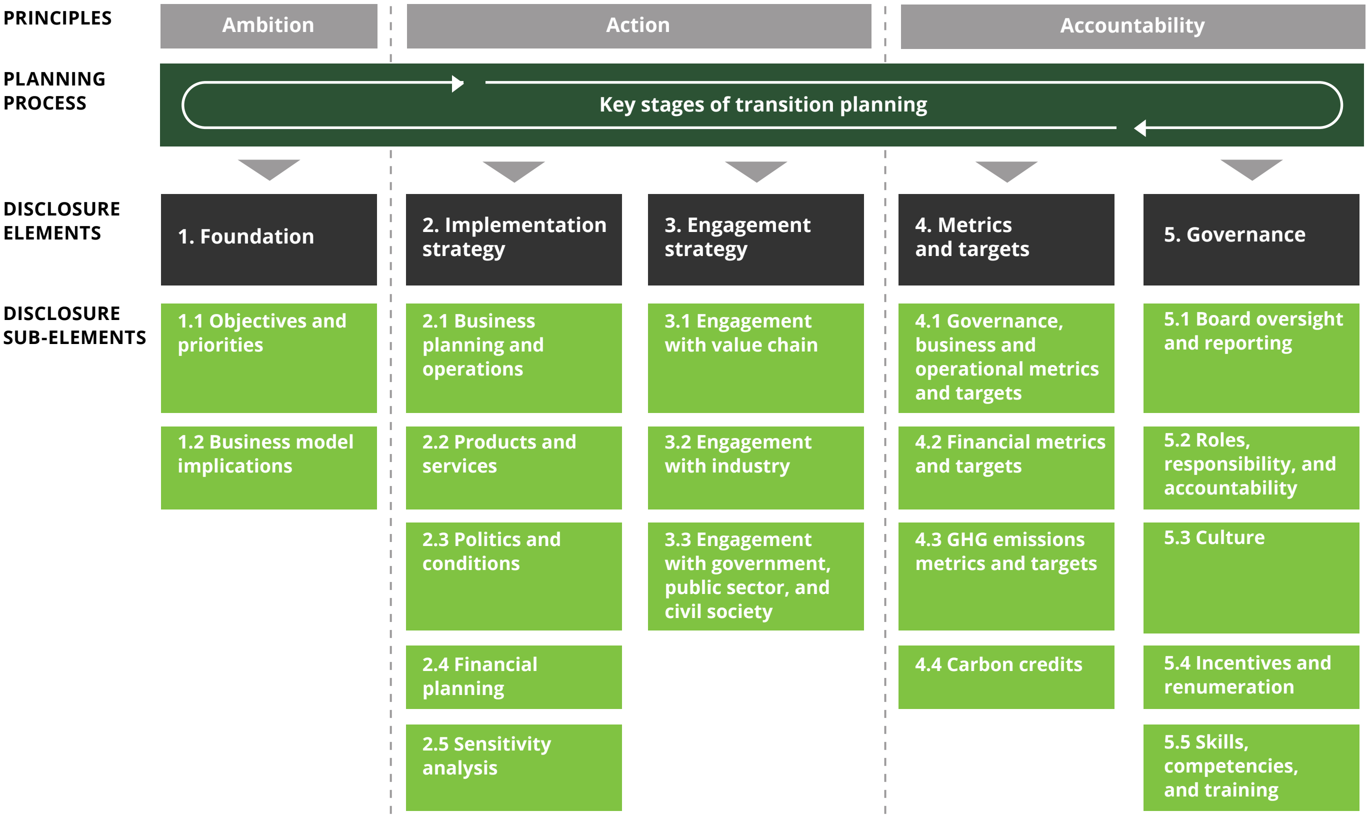
The TPT also recommends that a good practice transition plan should include:[15]

a) High-level ambitions on climate change mitigation, climate change management, and climate response and on leveraging opportunities in the transition to a net-zero economy.
b) Short-, medium-, and long-term actions toward the achievement of the organization's strategic ambition and the details on financing such activities.
c) Governance and accountability processes and procedures for the implementation and reporting of the transition plan.
d) Measures to manage material risks and leverage opportunities for the natural environment and the organization's stakeholders (e.g., workforce, supply chains).

The TPT also provides guidelines for the reporting and disclosure of transition plans. It recommends that transition plans are published annually in conjunction with financial reports and reported separately as a supplement to the annual financial report.

The comment period for the Framework and the Guidance is open until February 28, 2023. Organizations may also provide feedback on their experiences in applying the Guidance via the **TPT's Online Sandbox**.

Figure 1. TPT Disclosure Framework



Source: https://transitiontaskforce.net/wp-content/uploads/2022/11/TPT-Summary-Recommendationst.pdf

The California Department of Insurance (CDI) has partnered with the United Nations (UN) Principles for Sustainable Insurance Initiative (PSI) to create a first-of-its-kind roadmap of strategies for the insurance sector and its stakeholders in the face of accelerating climate-intensified risk. This partnership features wide-ranging actions, both planned and in progress, to strengthen and fortify communities through risk reduction. The roadmap urges speedier progress: It calls for a faster transition to net zero and a faster alignment of both the industry and regulatory environment with the Paris Climate Change Agreement.[16]

The roadmap is divided into four strategies with specific actions that align with eight of the 17 interlinked UN Sustainable Development Goals adopted in 2015 and are mapped to the four strategies. Methods to accomplish these actions include regulations, legislation, and market-based actions to benefit consumers. The four strategies are as follows:[17]

- **Strengthen transparency and financial oversight of insurance companies.**
  How: This can be accomplished with the tools of climate-related financial disclosures, data collection and analysis, insurer stress testing, and scenario analysis. The TCFD-aligned NAIC climate disclosure survey adopted under a taskforce co-chaired by California Insurance Commissioner Ricardo Lara is an example of this measure.[18]
- **Accelerate transition to more sustainable investment strategies.**
  How: California wants greater sustainable insurance markets through "investment strategies that identify and prioritize resilience and green investments that support climate solutions," aiming to move the economy closer to net-zero emissions, while reducing climate change. One CDI action considered under this strategy is the development of scorecards that assess individual company efforts and achievement of sustainability benchmarks in their investments, operations, and products.
- **Catalyze insurance product innovation to achieve climate goals to enable more holistic climate mitigation and adaptation.**
  How: Expanding insurance products that incentivize reductions in greenhouse gas emissions and increase community resilience; providing policyholder incentives for climate mitigation and adaptation, such as property-owner incentives for fortifying properties or communities; and developing new insurance products for zero-emission technologies. Partnerships

and collaborative pilot projects that ultimately result in the development of climate-risk tethered products are another vehicle featured in the roadmap. Lara's Climate Smart Insurance Products Database, a consumer-oriented list for green insurance policies, falls under this strategy as does the recent regulation on policy pricing tied to wildfire mitigation.[19] A proposed CDI concept paper on an extreme-heat neighborhood protection insurance strategy is also an example.

- **Empower communities to become more resilient and more equitable in recovery by closing the insurance protection gap.** How: Direct engagement with communities, with extensive efforts to help strengthen understanding of insurance concepts. Risk assessment, communication, risk reduction, and raising risk awareness are among the contemplated actions of this pillar. These might include recently enacted legislation creating climate resilience districts and authorization for CDI to study the insured and uninsured costs of extreme-heat events.[20] CDI is also planning to research regions where risks from wildfires, flooding, and heat waves are high but coverage is relatively low to help it with future outreach to these communities.

On October 19, 2022, the Federal Reserve Bank of New York (FRBNY) published a report claiming that "identifying paths to finance upgrades to affordable housing is a central issue in meeting New York State's and New York City's climate goals."[21] New laws in New York call for more energy efficiency and less greenhouse gas (GHG) emissions in buildings throughout the state and are expected to impact 6.8 million households of which about 1 million are deemed "low- and moderate-income" households.[22] The FRBNY's report outlines recommendations for financing a clean energy transition for New York's affordable housing.

The FRBNY, New York State Energy Research and Development Authority, and the Community Preservation Corporation engaged in several discussions on climate adaptation risks to collateral portfolios and the identification of public and private-public financing options to fund the necessary decarbonization of New York's affordable housing. The FRBNY's report,[23] a product of these discussions, covers the consensus needed to expand private funding sources.

Specifically, Local Law 97[24] sets forth parameters for energy efficiency and GHG emissions for certain buildings in New York. According to the report, the law lays out a series of deadlines, beginning with emissions limits in 2024, requiring expensive upgrades. The report recognizes the challenges of obtaining financing for affordable housing upgrades given factors including high inflation, a rising interest rate environment, and supply chain issues.[25]

The report's recommendations include the following:[26]

- Providing tax incentives and regulatory relief, particularly to first movers
- Lowering the cost of financing decarbonization by adjusting underwriting
- Developing (or evolving existing) certificate standards, including a common set of metrics, to cover decarbonized buildings
- Providing tax relief to utility companies to incentivize them to reduce electricity rates to decarbonized buildings
- Simplifying and aligning existing tax incentive programs to help owners finance retrofits to building systems
- Recognizing the increased future value of carbon-neutral buildings in appraisals
- Creating mortgage products that address decarbonization

The Safeguarding Investment Options for Retirement Act was presented by Rep. Greg Murphy, along with Reps. Carol Miller, David Schweikert, and Lloyd Smucker for the purpose of ensuring that investment returns are of more importance than matters related to environmental, social, and governance (ESG), regarding retirement plans.[27]

This comes after the Department of Labor's October 13, 2021, notification of its proposed rule, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights."[28] The proposed rule seeking to allow pension plan fiduciaries to consider climate change and other ESG factors when they select investments and exercise shareholder rights now faces criticism.[29]

Importantly, recent research for the first half of 2022 shows an inverse relationship between large-cap funds' ESG ratings and their returns, such that funds with higher Morningstar sustainability ratings experienced average losses of 13% while funds with lower ratings saw losses averaging 4%.[30] This research gives rise to the types of losses that could potentially be assumed if ESG goals and initiatives were given more weight than returns.

The proposed legislation would require plan fiduciaries to act solely in the interest of the participant and beneficiaries of the plan based only on financial factors that are expected to have a material effect on the risk and return of an investment. In addition, if the plan does not offer an option that is not based on non-financial factors, the bill uses the Internal Revenue Code to classify it as a prohibited transaction. The proposed legislation has garnered support from the American Securities Association as well as other trade and advocacy groups.

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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***
- ***Global foreword to 2022 financial markets regulatory outlook, highlighting climate risks in FSI US climate risk***

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