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Creating a climate of change digest

Climate risk regulatory developments in the financial services industry

Leading off

On July 18, 2023, a US House of Representatives subcommittee, the Subcommittee on Financial Institutions and Monetary Policy, held a hearing called "Climate-risk: Are financial regulators politically independent?"[1]

In the hearing, several regulators were questioned on the potential for political interference in the regulation of climate-related financial risks. The witnesses in the hearing are listed below:[2]

1. Dr. Michael Gibson, director, Division of Supervision and Regulation, Board of Governors of the Federal Reserve System (FRB)
2. Mr. Greg Coleman, senior deputy comptroller for Large Bank Supervision, Office of the Comptroller of the Currency (OCC)
3. Ms. Doreen Eberley, director, Division of Risk Management and Supervision, Federal Deposit Insurance Corporation (FDIC)
4. Mr. Rendell Jones, deputy executive director, National Credit Union Administration
5. The Honorable Sarah Benatar, treasurer, Coconino County, Arizona

Among other topics, the role of financial regulators in addressing climate-related financial risks, the influence of Network for Greening the Financial System (NGFS) in the decision-making of regulators, and the definition of physical and transition risks were discussed in the hearing.

In a media release on July 25, 2023, the International Organization of Securities Commissions (IOSCO) officially endorsed the sustainability-related financial disclosures standards IFRS® S1 and IFRS® S2 recently issued by the International Sustainability Standards Board (ISSB).[3]

IOSCO is widely recognized as a global standard setter for securities regulation, and its endorsement of ISSB's standards IFRS 1 and IFRS 2 sends a signal to securities regulators worldwide that the ISSB standards are appropriate to be included within regulatory frameworks for climate and sustainability disclosures.

In its media release, IOSCO calls on its 130 member jurisdictions to consider ways in which they might adopt, apply, or otherwise be informed by the ISSB standards within the context of their jurisdictional arrangements. IOSCO also informs that its endorsement of the ISSB standards is in line with its objective to achieve a comprehensive toolkit for both sustainability-related disclosure and related assurance standards.[4]

On July 25, 2023, the Ceres Accelerator for Sustainable Capital Markets and the California Department of Insurance released a report titled "Climate risk management in the US insurance sector: An analysis of climate risk disclosure," which analyzes and reviews the climate risk strategies pursued by US insurance companies.[5]

The report reviews more than 400 responses from insurance companies to the National Association of Insurance Commissioners (NAIC) 2021 Climate Risk Disclosure Survey, which is aligned with the Task Force on Climate-related Financial Disclosures (TCFD) framework. This study by Ceres and the California Department of Insurance uses two independent methods to review the survey responses and derive insights that can assist risk managers and regulators in maintaining a sustainable insurance sector.

Key findings from the report:[6]

- The 2022 Climate Risk Disclosure Survey received a high rate of responses from insurance companies, including responses from insurers of various business types and sizes that provided detailed disclosures following TCFD recommendations.
- Most responses (78%) aligned with six or more of the 11 TCFD recommendations, while 95% aligned with the Risk Management and Strategy Pillars of TCFD. Less than 40% aligned with the Metrics & Targets Pillar. About 20% of reports mentioned scenario analysis, but not all specified for which risks. Around 12% of the reports stated Scope 3 emissions, providing specific values for multiple consecutive years.
- Insurers are introducing new products supporting risk reduction for their customers or supporting clean technology.
- Many insurers described managing any material climate risk through their enterprise risk management process.

On July 27, 2023, the Integrity Council for the Voluntary Carbon Market released a global benchmark for high-integrity carbon credits, aiming to maximize the voluntary carbon market's ability to support climate targets.[7]

The framework, developed after consultation with organizations and experts, assesses whether carbon credits meet its high-integrity Core Carbon Principles (CCPs). Carbon-crediting programs can request evaluation through the Council's application portal by providing evidence that they follow the CCPs. Once approved, programs can use the CCP label on specific categories of credits. The Council is also providing expert Multi-Stakeholder Working Groups to assess various categories of carbon credits and crediting methodologies against the CCP criteria.

The CCPs set out 10 fundamental principles for high-quality carbon credits, requiring them to have a verifiable impact on emissions and a favorable impact on sustainable development. The criteria for assessing credit categories focus on emissions impact, setting a robust threshold that will raise standards to a consistent and comparable level of quality. For carbon credits to qualify for the CCP label, they must finance measures that are compatible with net-zero transition and are permanent, additional, and robustly quantified.[8]

1. **Compatible with a net-zero transition**: The framework prohibits projects involving fossil fuel emissions or technologies, such as oil recovery, road transport, and electricity generation from coal or unabated fossil fuels. This aligns with a national low-carbon transition plan.
2. **Permanent**: Projects must check emissions reductions and removals for at least 40 years. They must maintain a buffer pool of carbon credits to compensate for reversals. A Continuous Improvement Work Program will study strengthening criteria in the next version of the carbon credit programs.
3. **Additional**: Programs must guarantee that emissions reductions or removals were not due to carbon credit incentives and not enforced by law. They must demonstrate credits were a consideration in project development and viable without them. Carbon-crediting programs have introduced restrictions on certain renewable energy and energy efficiency projects, and the Integrity Council will consider these factors.
4. **Robustly quantified**: Programs should measure emissions conservatively to avoid overestimation. They must set boundaries, consider carbon sources and sinks, and regularly review projects' effects on emissions outside their boundaries.

The Integrity Council plans to increase ambition in future versions of the CCP Assessment Framework, announcing Continuous Improvement Work Programs to review and strengthen key requirements and explore complex topics, such as satellite monitoring of projects and price transparency.

On July 28, 2023, the Financial Stability Oversight Council's (FSOC) Climate-related Financial Risk Committee (CFRC) issued a staff progress report on a range of actions underway to support capacity building and disclosure, address data gaps, and assess climate-related financial risks.[9]

The report details the progress made in the last year by the FSOC and its member agencies toward advancing the recommendations included in the FSOC Climate Report[10] and is a follow-up to the fact sheet on FSOC's progress[11] that was published last year. The progress made by FSOC and its member agencies in the last year, across the major thematic areas of the FSOC Climate Report, includes the following:[12]

1. The CFRC continues to serve as a forum for interagency information sharing, coordination, and capacity building on climate-related financial risk.
2. The CFRC is developing a robust framework to identify and assess climate-related financial risk and identify a preliminary set of risk indicators for banking, insurance, and financial markets.
3. The Office of Financial Research launched a new platform—the Joint Analysis Data Environment—to integrate and analyze a broad spectrum of financial and other relevant data.[13]
4. The Department of the Treasury's Federal Insurance Office (FIO) issued a request for comments on a proposed collection of data from property and casualty insurers regarding current and historical underwriting data on homeowners' insurance to 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.[14]
5. The OCC, FDIC, and FRB each released for public comment a set of proposed principles for climate-related financial risk management for certain large financial institutions.[15]
6. The FIO released a report, "Insurance supervision and regulation of climate-related risks," that assesses climate-related issues and gaps in the supervision and regulation of insurers and provides a set of policy recommendations.[16]
7. The FRB launched a pilot climate scenario analysis exercise for six large bank holding companies.[17]

As part of its next steps, FSOC and its member agencies will advance the recommendations from the Climate Report, with focus on cross-cutting issues such as the development of key risk indicators for risk assessment. The report also highlights that the intersection of physical risk, real estate, banking, insurance, and household finances would be prioritized for future analysis for the CFRC.

In a news release on July 28, 2023, Acting Comptroller of the Currency Michael J. Hsu applauded the FSOC for its strong leadership and efforts in addressing climate-related financial risk.[18]

Hsu supported the publication of a 2023 staff progress report on CFRC activities, which should help financial institutions manage climate-related financial risks and promote safety and stability. Hsu highlighted the efforts of CFRC in developing a framework to identify and assess climate-related financial risk. Hsu also informed that the OCC would continue to monitor progress and encourage safe and sound practices at large banks, pending next steps with the proposed climate risk management principles.[19]

On August 1, 2023, the International Swaps and Derivatives Association (ISDA) released commentary from its Chief Executive Officer Scott O'Malia on the challenges faced by banks in the development of climate scenario analysis in the trading book.[20]

In a survey conducted by ISDA last year, ISDA found that most banks have prioritized the development of trading book scenario analysis capabilities in 2022 and 2023.[21] The commentary opines that the design and implementation of climate scenarios for trading book analysis could be challenging because they require an approach that is different from that of the existing climate scenarios. The scope and severity of climate risks on trading book assets would require assessment with shorter time horizons (e.g., days and weeks), whereas existing climate scenarios have typically taken a long-term view. Also, additional focus is needed in capturing the macroeconomic shocks due to climate risks in market risk parameters because of the low availability of historical data to determine market risk impacts.

The ISDA worked with Deloitte UK to conduct research with more than 30 banks to develop a conceptual framework for climate scenario analysis in the trading book. This conceptual framework was published in July this year.[22] The commentary mentioned that the framework provides a valuable starting point for the development of a more robust and consistent approach to trading book scenarios and that ISDA will further build out the framework and develop scenarios in the months ahead.[23]

On August 2, 2023, the International Auditing and Assurance Standards Board (IAASB) released its proposed International Standard on Sustainability Assurance (ISSA) 5000, General Requirements for Sustainability Assurance Engagements.[24]

The proposed ISSA 5000 is a principles-based standard suitable for limited and reasonable assurance engagements on sustainability information. The standard is profession agnostic and has been drafted to work with sustainability information reported across any sustainability topic and prepared under multiple frameworks, including those issued by the European Union, the ISSB, the Global Reporting Initiative, the International Organization for Standardization, and others.

IAASB Chair noted that the ISSA 5000 proposal aims to improve trust and confidence in sustainability reporting by responding to IOSCO recommendations and complementing other standard setters. Corporate reporting is more trusted when it receives external assurance based on globally accepted standards developed in the public interest.

The IAASB is using an extensive, high-level outreach plan to gather stakeholder feedback and insights on the proposed standard. This includes four roundtables starting in September and virtual, regional, and national events throughout the consultation period that ends on December 1, 2023. The IAASB also invites all stakeholders to comment on the proposed standard via the IAASB website.

On August 7, 2023, 77 members of Congress issued a letter to the chair of the Securities and Exchange Commission (SEC) highlighting the financial risk posed by climate change and calling for a strong rule to address this issue.[25]

The letter acknowledged and appreciated the SEC's issuance of the proposed climate disclosure rule in 2022, which required public companies to provide standardized and reliable climate disclosures.[26] The letter recognized climate change as a significant financial risk and noted the cost of climate and weather disasters in the United States in the last year, which totaled more than $165 billion.[27] The letter mentioned that investors have an urgent need for access to information regarding climate risks and opportunities that will potentially have a material impact on public companies' business, operations, or financial conditions.

The letter persuaded the SEC to accelerate the finalization and adoption of a credible mandatory climate disclosure rule and urged it to lead, not follow, its global counterparts in implementing a strong climate-related disclosure rule.

The NAIC plans data call to create a template to better address climate risk-induced insurance protection gaps.

The NAIC is forging ahead on a plan to develop a data call to better understand localized protection gaps in property insurance markets as challenges spread for US consumers in more regions across the country.[28] The NAIC announced its data call in mid-August, citing the increasing frequency and severity of weather events as well as rising insurance costs and inflationary pressures. According to the NAIC, these conditions impact the availability and affordability of insurance, creating localized protection gaps.

The goal of the data call will be to develop a long-term, robust data collection strategy to help its members, the state insurance regulators, respond more readily to questions pertaining to their property markets. It contrasted its strategy with that of a one-time data call, indicating this will be an ongoing exercise.

While the standard-setting organization for state insurance regulators did not offer specifics in its announcement, it did say it intends to develop a data template. It also noted that at least 30 states had already begun preliminary work to identify areas where regulators might need more granular data related to availability and affordability, as they might not have it currently. The NAIC did assure that the state insurance departments possess robust financial data to be able to understand climate and other forces on insurers' solvency and investments and could assess insurance companies' strength and resilience.

However, it acknowledged that this exercise is pointed at gathering more specific data to study consumers' ability to have available and affordable property coverage in specific localized geographic areas.

The project is under the direction of the NAIC's Property and Casualty Insurance Committee, chaired by Alan McClain, Arkansas's insurance commissioner.

In its release, the NAIC reiterated the theme that its members "believe the state insurance departments have both the expertise and necessary regulatory authority to gather, analyze, and utilize data about their unique market conditions and meet the needs of policyholders," and added that these "state regulators are best positioned to lead this work." It has previously shared its sentiments on its role pertaining to data collection.[29]

This state-led effort contrasts with an almost year-long proposal by the FIO at the US Treasury Department to collect underwriting data from property insurers to help it assess the potential for disruptions in the market in areas vulnerable to climate change.[30]

The FIO's proposed data collection, announced October 18, 2022, would be aggregated at the ZIP Code level for a specific subset of insurers, citing a critical need to gather consistent, granular, and comparable insurance data related to climate change. As of the date of this publication, the FIO had not moved to collect data yet.

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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:

- Deloitte 2023 *CxO Sustainability Report*
- Ingraining sustainability in the next era of ESG investing
- The CIO's call to action: Driving an environmentally sustainable tech agenda to accelerate organizational change
- Climate Change and Financial Risk Digest
- Center for Regulatory Strategy - Sustainability, climate & equity

Endnotes

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21. ISDA and EY, *Climate Risk Scenario Analysis for the trading book*, October 2022.
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23. Ibid.
24. IAASB, "IAASB launches public consultation on landmark proposed global sustainability assurance standard," press release, August 2, 2023.
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27. Jill E. Fisch et al., "Climate change, *West Virginia v. EPA*, and the SEC's distinctive statutory mandate," CLS Blue Sky Blog, September 6, 2022.
28. NAIC, "NAIC to issue data call to help regulators better understand property markets," news release, August 15, 2023.
29. NAIC, "Letter to Treasury FIO Assistant Secretary re: FIO climate-related financial risk data collection comments," November 22, 2022.
30. Treasury, "Treasury's Federal Insurance Office takes important step to assess climate-related financial risk—seeks comment on proposed data call," press release, October 18, 2022.