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Creating a climate of change digest

Climate risk regulatory developments in the financial services industry

Leading off

October 2023, Acting Comptroller of the Currency Michael J. Hsu issued statements at the Federal Deposit Insurance Corporation board meeting in support of rulemakings on the Community Reinvestment Act (CRA) and the finalization of interagency principles for climate-related financial risk management for large banks.[1]

Hsu strongly supported the finalization of the interagency rule implementing CRA and the finalization of the interagency principles on climate-related financial risk management for large banks.

In his remarks on the final CRA rule,[2] Hsu noted that the rule has been responsive to the commenters, reduced undue burden on banks, and recognized the differences in bank size and business models. He discussed how the final rule modernizes and strengthens the CRA and brings the nation a step closer to fulfilling its promise to prevent redlining and to encourage banks and savings associations to help meet the credit needs of the communities in which they operate.

In his remarks on the principles for climate-related financial risk management,[3] Hsu took pride in the Office of the Comptroller of the Currency (OCC) for taking the initiative and being the first US federal banking agency to propose for public comment principles for large banks. He highlighted the exclusive focus of the principle on risk management and noted that the principles clarify how large banks can maintain effective risk management and keep sound balance sheets.

US Department of the Treasury's (Treasury) Federal Insurance Office (FIO) is moving forward with its first-ever data collection from insurers to evaluate climate-related financial risk to consumers.[4]

FIO provided public notice on its intent to proceed with the climate-related financial risk data collection for US homeowners multi-peril underwriting data. Under this initiative, FIO aims to gather insurance data at a ZIP code level on a consistent, granular, and comparable basis from the largest homeowners insurance providers that collectively underwrite around 70% of homeowners insurance premiums nationwide. FIO will use the collected data to analyze nationwide trends, including comparisons of trends in availability and costs for homeowners insurance.

FIO's data collection will cover the following key elements:[5]

- Focus on insurer underwriting
- Insurance lines of business
- Insurers
- Data fields
- Reporting framework
- Reporting period (six years of underwriting data)
- Geographic granularity
- Geographic scope

FIO has submitted the data collection request to the Office of Management and Budget (OMB) for approval and public comment. This action advances the proposal for data collection that FIO published in October 2022.[6] FIO stated it had refined its proposal based on feedback after engaging with numerous stakeholders, including the National Association of Insurance Commissioners (NAIC) and state insurance regulators, to establish a national baseline for analysis while reducing the burden on small insurers. FIO says the initiative aligns with President Biden's executive order on climate-related financial risk[7] (May 20, 2021) and FIO's statutory mandates to monitor insurance accessibility for underserved communities and all aspects of the insurance industry.

FIO's Federal Register notice and copies of the data collection form and instructions are available through *FIO Reports & Notices* on Treasury's website.

The International Association of Insurance Supervisors (IAIS) has published a report to outline actions for insurance supervisors in addressing natural catastrophe protection gaps.[8]

The report titled *A call to action: The role of insurance supervisors in addressing natural catastrophe protection gaps*, outlines the importance of addressing natural catastrophe (NatCat) protection gaps,[9] which refer to the uninsured portion of economic losses caused by natural disasters. The report presents a range of supervisory actions to address challenges related to affordability, availability, and uptake of insurance coverage against NatCat events. For the nonsupervisory community, the report explains the actions that supervisors are currently taking or could potentially take to address protection gaps in the context of a broader architecture of response—spanning both public- and private-sector actors.

The report identifies the following five major areas of supervisory activity that can contribute to addressing NatCat protection gaps, as supported by case studies from jurisdictions spanning all IAIS regions:[10]

1. Contributing to the assessment of protection gaps
2. Enhancing consumer financial literacy and risk awareness
3. Incentivizing risk prevention
4. Fostering and enabling a regulatory and supervisory environment to support insurance availability and coverage uptake
5. Advising government and industry on financial inclusion and societal resilience

The report aims to facilitate further engagement among stakeholders and spur concrete action on this issue, recognizing the need for collaborative efforts between the public and private sectors. The IAIS will collaborate with partners including the Access to Insurance Initiative (A2ii), the Global Shield against Climate Risks, the International Development Fund (IDF), and the Organisation for Economic Co-operation and Development (OECD) on key issues identified in the report.

In November 2023, the Network for Greening the Financial System (NGFS) published the fourth edition of its long-term climate macro-financial scenarios (Phase IV) for assessing forward-looking climate risks. The scenarios have been updated to account for the latest economic and climate data, policy commitments, and model versions.[11]

The NGFS Climate Scenarios are a range of plausible futures that have been developed for the assessment of financial risks from climate change.

The main updates made to Phase IV of the climate scenarios are as follows.[12]

1. Scenarios have been updated to account for the latest GDP and population data and the most recent country-level commitments until March 2023.
2. Acute physical risk modeling has been enhanced with the addition of two new acute physical risk hazards (droughts and heatwaves) and with the use of more granular hazard indicators.

3. Scenarios have been updated to reflect a more pronounced disorderly future considering the delayed implementation of climate policies, persistently high emissions, and the consequences of the war in Ukraine on energy system trajectories.
4. Two new scenarios, the "Too-little-too-late" Fragmented World scenario and the "Orderly" Low Demand scenario, have been developed.
   - "Too-little-too-late" Fragmented World scenario illustrates the adverse consequences of delayed and divergent climate policy ambitions globally.
   - "Orderly" Low Demand scenario explores a Paris-aligned transition driven by substantial behavioral changes in which global warming is limited to 1.5°C.
5. The Divergent Net Zero scenario (1.5 °C) has been discontinued given the reduced likelihood of a successful uncoordinated transition.

The NGFS has also published three accompanying documents—a revamped technical documentation, a data user guide, and a technical note on compound risks—to provide guidance on the use of the scenarios by central banks and supervisors.

An update to the Phase IV scenarios has been planned for 2024. The scenarios will be updated to improve sectoral disaggregation and to enhance the chronic physical risk damage function.

Commodity Futures Trading Commission (CFTC) Commissioner Kristin N. Johnson addressed pressing issues in the carbon credit market, advocating for reforms at the Federal Reserve Bank of Dallas. She emphasized climate-related risks and the CFTC's intervention to ensure market integrity and support energy transition investments.[13]

On November 29, 2023, Commissioner Johnson delivered a keynote address at the Federal Reserve Bank of Dallas, focusing on the evolving carbon credit market and advocating for reforms to address important issues related to climate-related risks in financial markets. She underscored the imperative of safeguarding the integrity of carbon offset markets and highlighted the transformative energy landscape in the United States and the global economy's resilience amid challenges like the COVID-19 pandemic and geopolitical events impacting energy and grain markets. She drew attention to the growing impacts of climate change, referencing reports on severe weather events and escalating costs associated with climate disasters.

Acknowledging the ongoing COP 28 conference in Dubai, she discussed proposals for market reforms to be implemented by financial regulators, asserting that these reforms fall within the existing authority of the CFTC. Additionally, the commissioner raised concerns about the susceptibility of the carbon offset market to malfeasance and fraudulent practices, referencing a Board of the International Organization of Securities Commissions (IOSCO) paper identifying vulnerabilities, including the lack of a uniform definition for "high quality" credits, risks of reversal, double counting, leakage, and insufficient transparency and verification. She cited a few academic studies suggesting some carbon offset projects may fall short of achieving their climate change mitigation goals.

Her discussion revolved around the market for carbon credits, encompassing futures, swaps, and forwards, emphasizing the existing regulatory framework for environmental futures. She highlighted a regulatory gap in transactions involving environmental commodities excluded from the CFTC's swaps regulations, particularly forwards intended for physical settlement.

In her conclusion, Commissioner Johnson made a call for sustained intervention by the CFTC to bring order to the carbon offset market. Emphasizing the need for robust, fair, and well-functioning markets, she underscored the role of supporting the escalating investment in energy transition technologies.

On December 2, 2023, the Biden-Harris administration announced the United States' multiyear pledge of $3 billion for the Green Climate Fund (GCF) for its second replenishment (GCF-2), 2024–2027.[14]

At COP 28, the Biden-Harris administration demonstrated how it is delivering on its US commitment to combat the climate crisis. The latest pledge of $3 billion for the GCF would be additional to another $2 billion previously delivered by the United States.[15] The pledge signals that the US government is willing to do its part in supporting delivery of climate finance to developing countries.

In the context of this pledge and building on its year as co-chair of the GCF Board with Pakistan, the US government will champion an ambitious GCF evolution agenda to explore ways to better leverage the GCF's balance sheet, including through an improved private-sector financing platform; increasing innovation to unlock private capital; and improving access for small island developing states (SIDS), least developed countries (LDCs), and African States.[16]

The pledge would be subject to the availability of funds. The US government also reserves the ability to direct a portion of the pledge to other climate programs to the extent necessary based on the pace of progress in tackling the impacts of climate change and in protecting vulnerable communities.

On December 4, 2023, IOSCO published a final report presenting supervisory practices across its members to address greenwashing.[17]

The *Supervisory practices to address greenwashing* report[18] provides an overview of initiatives undertaken in various jurisdictions to address greenwashing, in line with 2021 IOSCO recommendations[19] and the call for action.[20]

This report provides a mapping of the regulatory and supervisory approaches and practices (current or planned) by regulators to address greenwashing in the areas of asset managers and ESG ratings and data product providers, including challenges and data gaps hindering the implementation of the 2021 IOSCO recommendations.

The main findings of the report indicate the following:[21]

1. There is no global definition of greenwashing.
2. Most jurisdictions have in place supervisory tools and mechanisms to address greenwashing in the area of asset managers and their products.
3. Educational awareness measures and capacity-building activities are used as proactive tools to prevent greenwashing.
4. The market for ESG ratings and data products is in a phase of rapid growth.
5. Steps are being taken by Affiliate Members Consultative Committee (AMCC) members to improve the consistency of terminology, which could lead to better classification of funds and labeling.
6. Enforcement measures have been applied to greenwashing cases, from infringement notices to monetary fines, to license revocations, to suspension of business, to other public reprimands, or even to potential civil or criminal liability, depending on the severity of the greenwashing case at hand.
7. The cross-border nature of sustainable finance investments requires adequate cross-border cooperation.

The report recognizes greenwashing as a high risk to the reputation of global sustainable finance markets and informs that IOSCO is looking to assist jurisdictions in building the capacity to address greenwashing and, more concretely, to assist in implementing new corporate sustainability requirements and new or enhanced supervisory practices.

Governor Kathy Hochul announced comprehensive guidance from the New York State Department of Financial Services (NYDFS) for regulated banking and mortgage institutions to manage climate-related financial and operational risks effectively, emphasizing a balanced, forward-looking approach for safety, soundness, and operational resilience.[22]

NYDFS has issued comprehensive guidance for state-regulated banking and mortgage institutions to effectively manage the material financial and operational risks associated with climate change. The guidance emphasizes the necessity for regulated institutions to anticipate, measure, monitor, and control climate-related risks, aligning with established risk management principles.

The guidance covers key components of prudent risk management, including corporate governance, internal control frameworks, risk management processes, data aggregation and reporting, and scenario analysis. It aims to facilitate institutions in integrating assessments of material climate-related financial and operational risks into their existing risk frameworks.[23] The approach advocates a strategic and forward-looking perspective to ensure preparedness for emerging challenges associated with climate change.

NYDFS has finalized this guidance after careful consideration of feedback from regulated entities and other stakeholders. In response to this guidance, NYDFS has also made available additional resources to aid smaller organizations in adopting measures to address their climate-related risks effectively. NYDFS' interest lies in enhancing the safety, soundness, and operational resilience of regulated organizations, advising them on incorporating novel and evolving risks into existing risk management frameworks.

While the guidance does not set specific timelines for implementation, it encourages regulated organizations to make proportional progress. NYDFS stresses ongoing coordination with state, federal, and international counterparts on climate-related supervision. The overarching goal is to ensure that regulated institutions continue to thrive and remain resilient in the face of changing climate conditions, upholding safety, soundness, and operational effectiveness.

The US Securities and Exchange Commission (SEC) deferred its final ruling on climate change disclosure rules to April 2024, facing ongoing debates, notably regarding the inclusion of scope 3 emissions. Despite delays, global momentum for climate disclosure is intensifying with initiatives from various regulatory bodies and jurisdictions.[24]

The SEC has postponed the final ruling on its proposed climate change disclosure rules, now setting a tentative date for April 2024. This decision comes after multiple delays, and the actual timing remains uncertain, subject to potential adjustments. A key point of contention in the proposed rules revolves around whether to include scope 3 emissions, which encompass emissions within a company's value chains that are beyond their direct control, such as those generated by the use of their products (automobiles, for example).

The debate over scope 3 inclusion has sparked opposition from certain industry groups, while an analysis of the extensive public comments received by the SEC reveals that more than 95% of commenters support the inclusion of scope 1, 2, and 3 emissions.[25] Investors view these rules as crucial, as they provide essential information about the risks and opportunities associated with climate change. Gary Gensler, chair of the SEC, has defended the proposed rules, asserting that they would benefit capital markets, and he emphasizes the need for rulings that can withstand potential legal challenges.

Despite the delays at the SEC, several other agencies and countries have moved forward with similar climate disclosure rules. Notably, California recently enacted a law requiring companies to disclose all three emissions scopes, and the European Union's corporate sustainability reporting directive could compel disclosures from numerous US firms operating in Europe. If implemented, the SEC's rules would bring about a significant transformation for public companies, ensuring that investors receive standardized, comparable, and reliable information regarding climate-related risks. While the SEC navigates these complexities, the broader landscape is witnessing an increasing momentum toward climate disclosure, with various regulatory initiatives globally aiming to address environmental concerns and provide transparency for investors.[26]

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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:

- 2024 financial services industry outlooks
- 2024 financial services regulatory outlooks
- 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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