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Creating a climate of change digest

Climate risk regulatory developments in the financial services industry

Leading off

On August 25, 2023, the Commodity Futures Trading Commission (CFTC) Commissioner Christy Goldsmith Romero provided closing remarks at the Global Research Alliance for Sustainable Finance and Investment Annual Conference in New Haven, Connecticut. Romero talked about her priority to promote market resilience to climate-related financial risk and CFTC's role in building a climate-resilient economy.[1]

Romero remarked and elaborated on the impact of climate events on CFTC-regulated markets, regulators' responsibility to manage evolving risk, and a road map for CFTC to take action on climate-related financial risks:

1. **Impact of climate events on CFTC-regulated markets:** Romero remarked on how climate-driven events result in severe economic losses to farmers, ranchers, and producers and have an impact on the commodities and derivatives markets. She provided examples of damage caused by climate-driven events, such as Hurricane Ian and the persistent drought in the Midwest. She indicated that markets and market participants are aware of the economical effects of climate change and that responsible innovation in climate-related products can help in managing climate-related financial risk.

2. **Regulators' responsibility to manage evolving risk:** Romero encouraged regulators' usage and application of lessons from the past to address climate-related risks. Romero mentioned that regulators need to appreciate the size and scope of the risk that climate change poses to financial systems and markets. She advocated this by bringing up the 2008 financial crisis and how she found that the regulators had underappreciated the significance of the risks related to undercapitalization, complex mortgage derivatives, and the failure of risk management by financial institutions at that time.

3. **A road map for action:** Romero provided a reminder that CFTC has started to act on the recommendations in the report *Managing climate risk in the US financial system*,[2] which was released by the CFTC in 2020. The creation of the Environmental Fraud Task Force in June 2023[3] to tackle fraud and other misconduct in regulated derivatives markets and in relevant spot markets was also highlighted.

Further, Romero brought forth three new proposals for the management of climate-related financial risks by the CFTC. These proposals are consistent with recommendations 4.6 and 4.3 in the Financial Stability Oversight Council's Report on climate-related financial risk,[4] which was published in 2021.

Proposal[5]	Summary
Proposal #1: The CFTC should conduct a horizontal supervisory review of climate risk management at exchanges, clearinghouses, and, in conjunction with the National Futures Association, at market intermediaries.	Romero proposed that CFTC should consult with the National Futures Association in expanding its review of how some of its large members, including market intermediaries, are managing climate risks. Romero also proposed that CFTC should conduct an initial supervisory review of climate-risk management by exchanges and clearinghouses, which is flexible and is not accompanied with supervisory consequences for deficiencies.
Proposal #2: The CFTC should work with its largest regulated entities, particularly those deemed systemically significant, on scenario analyses to increase our understanding of climate impacts in derivatives markets.	Romero proposed that CFTC should work with those exchanges and clearinghouses that are already conducting internal stress tests using climate-related scenarios. This is to understand the work that is already underway and to conduct analyses using a common set of derivatives-market scenarios.
Proposal #3: The CFTC should issue principles describing how the largest regulated entities should address climate-related financial risks through existing risk management frameworks.	Romero proposed that CFTC should issue principles that would help the largest banks, brokers, exchanges, and clearinghouses understand the CFTC's expectations on management of climate risks under the existing rules. Romero proposed that such principles should seek to harmonize with banking regulators' Draft Principles for Climate-Related Financial Risk Management.

A consultation on the International Sustainability Standards Board's (ISSB) agenda priorities closed on September 1 and received more than 300 responses from accounting professionals, financial regulators, standard-setters, and asset owners. Feedback from some of the regulators across the globe encourage ISSB standards to address the full spectrum of environmental, social, and governance (ESG) topics.

The consultation focused on four potential projects:[6]

- Three on sustainability-related risks and opportunities in biodiversity, ecosystems, human capital, and human rights; and
- One on integration in reporting to explore how to integrate information in financial reporting beyond the requirements of IFRS® S1 General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 Climate-related Disclosures.

The consultation received comments from regulators such as the Financial Services Agency (FSA) of Japan, the Financial Conduct Authority (FCA) in the United Kingdom, the European Securities and Markets Authority (ESMA), and the European Financial Reporting Advisory Group (EFRAG). These regulators urged the ISSB to expand its sustainability-related disclosure requirements beyond climate:

- The FSA of Japan recommended that ISSB prioritize the progress toward human capital disclosure as part of its work plan.[7]
- The FCA suggested that ISSB consider a comprehensive work plan that progressively advances work to develop new thematic standards beyond climate change. FCA highlighted the importance of paying attention to the interdependencies between sustainability topics and encouraged ISSB to consider a project that jointly develops a thematic standard for reporting on human capital and human rights. FCA also asked ISSB to develop a thematic standard on nature in the short term.[8]
- ESMA acknowledged the current international momentum on the topics of biodiversity, ecosystems, and ecosystem services. It encouraged the ISSB to adopt approaches like the Task Force on Nature-related Financial Disclosure and European Sustainability

Reporting Standards (ESRS) frameworks to better understand and address environmental issues. ESMA also asked ISSB to advance the development of social and human rights-related reporting standards.[9]

- EFRAG strongly recommended that the ISSB provide the definition of the universe of sustainability-related information to be covered in its standards. EFRAG recommended that ISSB consider all the topics that are included in ESRS.[10]

On September 7, 2023, the Network for Greening the Financial System (NGFS) published *Conceptual framework for nature-related financial risks* to guide policies and action by central banks and financial supervisors during its launch event in Paris.[11]

The framework aims to create a shared, science-based understanding and common language for nature-related financial risks, helping central banks and financial supervisors navigate the complexities and challenges associated with assessing and addressing these risks. The framework, which builds on prior work by the joint NGFS-INSPIRE Study Group on Biodiversity and Financial Stability, advances NGFS's efforts to help mainstream the consideration of nature-related risks and moves toward adoption of an integrated assessment of climate and broader nature-related risks.[12] The publication aims to do the following:[13]

- Define nature-related financial risks as well as associated concepts required for a high-level understanding of these risks.
- Provide a framework to help central banks and supervisors identify and assess nature-related financial risks.
- Outline the NGFS task force's next steps, which includes bridging the modeling and data gaps (notably on the development of nature-related scenarios) and using emerging datasets to support the alignment of policies on environmental sustainability and inform the assessment of nature-related financial risks.

The framework comprises three phases for the identification and assessment of nature-related financial risks. These are summarized below.[14]

1. **Identify sources of physical and transition risk:** The first phase is the identification of sources of risk that are potentially material from a microprudential, macroprudential, or macroeconomic risk perspective. The phase provides a high-level approach to the identification and prioritization of sources of physical and transition risk based on exposures. Forward-looking, location-specific, and systemic dimensions are considered in this approach. Under this phase, NGFS recognizes climate and environmental risks as two distinct but interrelated issues. The framework emphasizes the importance of managing the risks from climate and the other dimensions of nature in an integrated manner.
2. **Assess economic risks:** The second phase involves the assessment of the potential economic effects and risks that arise from physical and transition risk exposures. The phase lists and expands on three elements that need to be considered in the assessment of economic risks: (i) direct and indirect effects; (ii) micro, sectoral/regional, and macro effects; and (iii) substitutability.
3. **Assess risk to, from, and within the financial system:** The third phase involves the consideration of the traditional financial risks that stem from the exposures to sources of physical and transition risks. Under this phase, NGFS elaborates on how effects of nature degradation and related policies on the economy can transmit to financial institutions. This phase also discusses the negative impacts the financial sector has on nature and the feedback loops involving financial institutions and the real economy.

Two landmark bills requiring corporate climate disclosures have been approved by the California State Senate and await the governor's signature. The legislation mandates major corporations, spanning oil, gas, and retail, to divulge both direct and indirect greenhouse gas (GHG) emissions.

In California, two significant bills have been passed with far-reaching implications for businesses. The first, CA SB253, known as the "Climate Corporate Data Accountability Act," focuses on the urgency of climate change. It mandates annual reporting of GHG emissions data for US companies with more than $1 billion in annual revenues operating in the state. This data, covering scope 1, 2, and 3 emissions, must be made publicly accessible. Noncompliance penalties aim to ensure adherence to regulations, emphasizing the importance of emissions transparency.[15]

The second bill, CA SB261, addresses "Greenhouse gases: Climate-related financial risk." It highlights the potential harm of climate change to California, its residents, and investors. Large businesses (with annual revenues exceeding $500 million) must prepare biennial reports on their climate-related financial risks and mitigation measures, akin to the Task Force on Climate-related Financial Disclosures (TCFD) framework. Violations may incur penalties, urging businesses to proactively address climate risks.[16]

For businesses, these bills carry implications beyond regulatory compliance. They signal a growing expectation for corporations to not only disclose their environmental impact but also integrate climate risk into their financial planning and decision-making processes. Failing to do so could lead to legal repercussions, reputational damage, and financial losses. Institutions doing business in California will need to proactively address these disclosure requirements and align their operations and strategies with California's commitment to climate accountability. It is not just a legal necessity but a strategic imperative in a world increasingly focused on sustainability and responsible business practices.

Governor of California Gavin Newsom's support for CA SB253 displays California's dedication to environmental transparency. This bill redefines climate risk reporting for US companies, potentially influencing national standards. His intent to sign CA SB261 emphasizes California's commitment to confronting climate issues by mandating large corporations to disclose climate-related financial risks. Together, these actions highlight the state's leadership in environmental accountability and climate change mitigation.[17]

The Science Based Targets initiative (SBTi) is responding to the urgency of climate action by enhancing its credibility and integrity for businesses and financial institutions setting science-based climate targets. The SBTi is separating its target validation services division, aligning with best practices to ensure impartiality and boost trustworthiness.[18]

To meet the increasing global demand for science-based targets, the SBTi plans to expand its validation capacity, following an 87% year-over-year increase in companies setting such targets. This aims to maintain the highest level of trust in corporate climate goals through best practices, increased capacity, and service excellence.

The SBTi has made changes to its governance structure, appointing Francesco Starace as chair of the board of trustees. The demand for credible corporate climate action is rising due to more frequent and intense extreme weather events, and by 2025, the SBTi expects more than 10,000 companies to adopt science-based targets.

In the past year, the SBTi has doubled its workforce, reduced target validation waiting times, and established an independent Technical Council to enhance technical integrity. It is now operating as an independent entity in the United Kingdom (UK), with an application submitted to the Charity Commission while maintaining ties with its founding partners.

The transformation program includes:

1. Incorporation: The SBTi is developing as an independent legal entity and aims to become a regulated charity in the UK.
2. New leadership: Francesco Starace is the new chair, joined by independent trustees Iván Duque and Ester Baiget.
3. Separate entities: The SBTi is creating separate entities for standard-setting and target validation, aligning with best practices.
4. Strengthened standard-setting: The SBTi is enhancing its standard-setting procedures, with a focus on technical governance.
5. Validation service provider: The validation service provider is being structured to meet growing demand for target validations.

The Initiative Climat International (iCI) has taken a significant step in promoting climate transparency by releasing a concise guide for carbon footprint measurement. This guide is specifically designed to empower companies to disclose their GHG emissions effectively to stakeholders, including fiscal sponsors, lenders, and debtholders. In an era when climate disclosure is critical, iCI's guide simplifies the complex process of GHG emissions measurement, offering practical steps and drawing from globally recognized standards to enhance transparency and sustainability.[19]

The existing guidance on GHG emissions measurement is often found to be complex by senior company executives, thus making its implementation challenging. iCI seeks to address this issue by offering companies practical and straightforward guidance on the fundamental steps required for measuring and reporting GHG emissions. The guide released by iCI incorporates insights, resources, and tools from globally recognized organizations and standards, such as the GHG Protocol, the TCFD, and the SBTi, to inform and assist decision-making processes, with a focus on promoting measurement and information sharing.

Key activities for carbon footprint measurement, as outlined in the guide, involve choosing appropriate reporting boundaries, identifying emissions sources, collecting source data, selecting appropriate emission factors, and calculating emissions.[20] The guide informs that, based on the level of business complexity, institutions can conduct GHG emission measurement either in-house (manually), through a software provider, or through an external advisor—or a combination of these approaches. The guide provides a framework for comparing these approaches and considerations for assessing and selecting one of these approaches for GHG emission measurement. The guide also provides references to key resources that can be used for emission measurement and next steps for institutions that have completed foundational GHG emissions measurement.

In essence, the iCI guide serves as a valuable resource for institutions seeking to enhance their GHG emissions measurement and for their fiscal sponsors, direct lenders, and other debtholders.

On September 19, 2023, the US Department of the Treasury published the *Principles for net-zero financing and investment*.[21] The principles encourage financial institutions to adopt the emerging best practices for their net-zero commitments and intend to promote consistency and credibility in institutions' approaches toward these commitments.

Key takeaways of the report:

- The principles primarily focus on scope 3 financed and facilitated GHG emissions.
- The principles can be adopted by institutions voluntarily. They do not impose legal requirements.
- The principles have been developed after review of existing literature and research and with inputs from financial market participants, tribes, research organizations, and civil society organizations and in consultation with representatives of various other US cabinet agencies and the White House.

Summary of the Principles for net-zero financing and investment[22]	
Principle 1	A financial institution's net-zero commitment (commitment) is a declaration of intent to work toward the reduction of greenhouse gas emissions. Treasury recommends that commitments be in line with limiting the increase in the global average temperature to 1.5°C. To be credible, this declaration should be accompanied or followed by the development and execution of a net-zero transition plan.
Principle 2	Financial institutions should consider transition finance, managed phaseout, and climate solutions practices when deciding how to realize their commitments.
Principle 3	Financial institutions should establish credible metrics and targets and endeavor, over time, to have associated metrics and targets for all relevant financing, investment, and advisory services.
Principle 4	Financial institutions should assess client and portfolio company alignment to their (i.e., financial institutions') targets and to limiting the increase in the global average temperature to 1.5°C.
Principle 5	Financial institutions should align engagement practices—with clients, portfolio companies, and other stakeholders—to their commitments.
Principle 6	Financial institutions should develop and execute an implementation strategy that integrates the goals of their commitments into relevant aspects of their businesses and operating procedures.
Principle 7	Financial institutions should establish robust governance processes to provide oversight of the implementation of their commitments.
Principle 8	Financial institutions should, in the context of activities associated with their net-zero transition plans, account for environmental justice and environmental impacts, where applicable.
Principle 9	Financial institutions should be transparent about their commitments and progress toward them.

On September 20, 2023, the Securities and Exchange Commission (SEC) adopted amendments to rule 35d-1 under the Investment Company Act, the "Names Rule."[23] The amendments extend the "80% investment policy requirement" to funds whose names suggest an investment focus on ESG-related factors.

The Names Rule was initially adopted by the SEC in 2001 to prevent fund names from misrepresenting the fund's investments and risks.[24] The Names Rule requires a fund to invest at least 80% of the value of its assets in the type of investments suggested by the fund's name. For example, funds with names suggesting investment in certain types of securities or certain geographical areas are required to adopt an investment policy to invest at least 80% of its assets in those securities or geographic areas.

The Final Rule adopted in September 2023 follows the amendments and requirements proposed by the SEC on May 25, 2022. The Rule amendments have expanded the 80% requirement to funds suggesting an investment focus on ESG-related factors through names such as "sustainable," "green," or "socially responsible." Names suggesting a focus on characteristics like "growth" and "value" and names with reference to thematic investments are also included. The other key requirements from the amendments are as follows:[25]

- The amendments update funds' prospectus disclosure requirements to require a fund with an 80% investment policy to define the terms used in its name, including the criteria the fund uses to select the investments that the term describes.
- The amendments require funds with derivatives in their holdings to use the derivatives' notional amount, rather than their market value, for the purpose of determining the funds' compliance with their 80% investment policy, with certain adjustments.
- The amendments require a fund to review its portfolio assets' treatment under its 80% investment policy at least quarterly.
- The amendments include specific time frames—generally 90 days—for getting back into compliance if a fund departs from its 80% investment policy.
- The amendments prohibit a registered closed-end fund or business development company whose shares are not listed on a national securities exchange from changing its 80% investment policy without a shareholder vote.
- The amendments update the Names Rule's notice requirement to expressly address funds that use electronic delivery methods to provide information to their shareholders and incorporate additional specificity about the content and delivery of the notice.

The original proposal released in May 2022 sought effectively to prohibit the use of ESG-related terms in funds' names if those funds consider ESG factors along with, but not more significantly than, other factors. This aspect of the original proposal is still being considered by the SEC staff. Currently, SEC is not taking action on the proposed approach regarding the use of ESG terms in the names of such ESG "integration funds."[26]

The final rule will become effective 60 days after the date of its publication in the Federal Register.

California Insurance Commissioner Ricardo Lara announced the Sustainable Insurance Strategy[27] to improve the state's market conditions for consumers.

The commissioner announced a package of executive actions that aims to improve insurance choices and protect citizens from increasing climate threats while addressing long-term sustainability.

These executive actions include changes to the FAIR Plan,[28] new rules for the review of climate catastrophe models, and public meetings exploring incorporating California-only reinsurance costs into rate filings. The Sustainable Insurance Strategy is described as a comprehensive approach building a multi-year effort to modernize California's insurance market.

Governor Newsom issued an executive order[29] urging prompt regulatory action in support of Commissioner Lara's actions for communities affected by climate change. The actions announced are aimed at addressing problems fueled by climate change, including global inflation and increased costs for rebuilding that have led to several insurance companies pausing coverage for writing new homeowners and commercial insurance policies.

Key regulatory elements of the plan include:[30]

- Executive action by Commissioner Lara to transition homeowners and businesses from the FAIR Plan back into the normal market with commitments from insurers to cover all parts of California by writing no less than 85% of their statewide market share in high-wildfire-risk communities.
- Giving FAIR Plan policyholders who comply with the new Safer from Wildfires regulation first priority for transition to the normal market.
- Expediting the department's introduction of new rules for the review of climate catastrophe models that recognize the benefits of wildfire safety and mitigation actions.
- Directing the FAIR Plan to further expand commercial coverage to $20 million per building[31] to close insurance gaps for homeowner associations and condominium developments to help meet the state's housing goals and to provide required coverage to other large businesses in the state.
- Holding public meetings exploring incorporating California-only reinsurance costs into rate filings.
- Improving rate filing procedures and timelines by enforcing the requirement for insurance companies to submit a complete rate filing, hiring additional department staff to review rate applications and inform regulatory changes, and enacting intervenor reform to increase transparency and public participation in the process.
- Increasing data reporting by the FAIR Plan to the department, legislature, and governor to monitor progress toward reducing its policyholders.
- Ordering changes to the FAIR Plan to prevent it from going bankrupt in the case of an extraordinary catastrophic event, including building its reserves and financial safeguards.

California's Sustainable Insurance Strategy is an addition to the set of actions that Commissioner Lara has previously taken to improve insurance benefits. Some of these actions include the Enactment of the Safer from Wildfire Regulation that provides consumers with their property's "wildfire risk score," including a right for consumers to appeal that score, modernizing the FAIR Plan by expanding its coverage options and ensuring wider availability for its policyholders, promoting policyholder security through mandatory one-year moratoriums on non-renewals and cancellations, sponsoring new insurance protections, and supporting multi-year funding for wildfire safety.

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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*
- 2024 financial services industry outlooks
- 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
- Creating a climate of change digest | Deloitte US
- Center for Regulatory Strategy - Sustainability, climate & equity | Deloitte US

Endnotes

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