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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

Leading off

On January 17, 2023, the Board of Governors of the Federal Reserve System (FRB) released instructions for its first piloted climate scenario analysis (CSA) exercise applicable to six of the largest banks.[1] Quantitative and qualitative information collected during the pilot CSA exercise is expected to improve knowledge about climate-related financial risk and risk management activities.[2]

The pilot CSA exercise consists of two modules: (1) physical risk, "the harm to people and property that may result from climate-related events," and (2) transition risk, "stresses that may result from the transition to a lower-carbon economy."[3] The physical risk module would forecast the impact of the scenarios "on residential real estate and commercial real estate (CRE) loan portfolios over a one-year horizon in 2023," and the transition risk module would forecast the impact of the scenarios "on corporate loan and CRE loan portfolios over a 10-year horizon from 2023–32."[4] The exercise will involve the firms providing the anticipated impact of scenarios, provided by the FRB, on specific loan portfolios assuming a static balance sheet. For each scenario and each loan, firms will need to report resultant credit metrics, such as the probability of default

(PD) and loss given default (LGD). The key requirements under each of these modules are summarized below.[5]

A. Physical risk module:

i. Participants are required to choose a common shock event and idiosyncratic shock event and estimate the impact of the hazard on their residential real estate and CRE credit exposures.

ii. Participants are required to provide loan-level or facility-level projections for select risk parameters.

iii. There is a focus on the direct impact of physical risk on credit risk. Participants are encouraged, but not required, to incorporate indirect impacts of the physical risks. Six sets of estimates are required (three iterations for common shock and three iterations for idiosyncratic shock) for each of the credit risk parameters.

B. Transition risk module:

i. The Federal Reserve has chosen two scenarios: Current Policies (all countries do not adopt any new policies to abate emissions) and Net Zero 2050 (limits global warning to around 1.5°C by 2050). Based on these scenarios, participants are required to estimate the transition risk drivers on select credit risk portfolios over a 10-year projection horizon.

ii. Network for Greening the Financial System (NGFS) variable paths that capture only transition risks are required to be used.

iii. Participants are required to estimate the impacts of the scenarios on their wholesale credit exposures comprising corporate and CRE lending exposures. Participants are required to provide loan-level or facility-level projections for select obligor-specific or facility-specific risk parameters.

iv. Participants are required to estimate the expected credit losses as a percentage of exposure at default. All the qualitative adjustments or judgmental overlays are required to be applied at the risk parameter level, and their impact must be documented and quantified.[6]

The participants of the CSA exercise are required to submit completed data templates, supporting documentation, and responses to qualitative questions to the FRB by July 31, 2023.

The FRB intends to engage with participants during the pilot CSA exercise to get a sense of how they are managing climate-related financial risk and what challenges they have faced in the process. Key observations and aggregated information from the pilot CSA exercise will likely be issued at year-end 2023. Despite a limited number of banks participating in the piloted CSA exercise, the proposed large bank climate principles issued by the FRB, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC), as mentioned in the previous edition, all point to company-run scenario analysis as an integral part of climate-related financial risk management. It is unclear if the FRB's CSA exercise will be applicable to a broader group of large banks in the future.

During his remarks before the California '40 Acts Group, Securities and Exchange Commission (SEC) Commissioner Mark T. Uyeda discussed the growth of environmental, social, and governance (ESG) investing over the past few years and the potential for further growth going forward.[7]

Commissioner Uyeda's speech mentioned generally higher fees charged for ESG products compared to "plain vanilla" products and the concern that this fee differential has enticed some asset managers to misrepresent products as "ESG" for better revenues.[8] This practice, along with an unclear definition of ESG, makes it difficult to determine the actual assets under management in ESG.[9]

Three factors that complicate ESG investing, as outlined in Commissioner Uyeda's speech, are:[10]

A. Definition of ESG: The ESG rule for investment advisers proposed by the SEC has various perspectives about what ESG means, issues or objectives it encompasses, and the methods to implement an ESG strategy. Since it is impractical to have a universal ESG definition, this creates the potential for abuses that can drive assets to particular companies based on political and social agendas. To avoid this, when an adviser uses a third-party ESG rating as an input to its ESG strategy, the identity of the firm and its methodology should be disclosed to the investors.

B. Attempts by regulators to follow ESG investing: Because of the lack of a consistent framework for issuing ESG ratings, the ESG ratings could reflect a particular social or political agenda. As a result, the companies would be forced to further the agenda of the ESG rating firm to obtain the capital. In the United States, regulatory efforts are able to target the asset managers and other fiduciaries but found it difficult to tackle the ESG rating firms.

C. Activism by asset managers: Sometimes, asset managers try to further their social and political goals, which are unrelated to the interest of the clients. Sometimes, even after the adviser's proxy-voting policies and procedures are disclosed, it might still not be clear if the adviser to a fund is acting in accordance with its fiduciary duty when it uses fund assets to pursue non-financial goals. The asset managers that have a control purpose to remove board members or impose operational changes should report on Schedule 13D, which requires detailed disclosures in a prompt and frequent basis, instead of reporting on Schedule 13G.

The SEC has proposed several rules that should provide additional clarity concerning ESG investing should the rules be approved. The proposed rules include the Enhancement and Standardization of Climate-Related Disclosures for Investors; Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices; and Investment Company Names.[11] These rules were covered in previous editions of this publication and are expected to see some movement during the first half of this year.

On February 16, 2023, the International Sustainability Standards Board (ISSB), informed by the feedback received during extensive consultation last year, made final decisions on all technical content of its initial Standards.[12] These decisions build up to the issuance of the International Financial Reporting Standards (IFRS®) S1 General Sustainability-related Disclosures[13] and IFRS S2 Climate-related Disclosures standards at the end of Q2 2023.[14]

The ISSB has finalized the technical content of its initial standards and will introduce programs to support those applying IFRS Sustainability Disclosure Standards, S1 and S2, that will go into effect in January 2024 as market infrastructure and capacity are built. The ISSB is focusing its efforts on developing additional guidance and training material, as well as collaborating with partners to deliver a core capacity-building program across various economic settings so that all market participants can access its benefits. To address the unique circumstances of emerging and developing economies as well as smaller businesses, the ISSB is introducing structured partnerships that will leverage specialist expertise to build local understanding for standard implementation.

ISSB has also voted to include European Sustainability Reporting Standards as an appendix to S1—the ISSB's general requirements standard guidance—for companies to consider in the absence of a particular ISSB standard in identifying metrics and disclosures that meet the information needs of investors. The ISSB is also working with several other jurisdictions and organizations involved in sustainability standard-setting to ensure the interoperability of its global baseline of cost-effective, decision-useful standards and to prepare for their effective rollout.

In February 2023, the NGFS opened its initial user feedback survey[15] requesting comment on the third edition of NGFS climate scenarios issued in September 2022.[16] The survey was open for three weeks, and information collected during that time was expected to contribute to the development of climate scenarios used by a broad range of international stakeholders for analytical purposes.

In its survey, the NGFS primarily sought feedback from users to improve future scenarios and ensure their ongoing relevance. The NGFS scenarios are already being used in US analysis both formally and informally, with one of the most recent examples being in the FRB's pilot CSA exercise (mentioned earlier in this publication). Key findings from the survey are expected to be published in Spring 2023, with the results informing future NGFS scenario development efforts.[17]

The Connecticut General Assembly is weighing a 5% surcharge on fossil fuel premiums. Connecticut state legislators received testimony in February and in early March on a bill requiring that the state Insurance Department collect a surcharge of 5% of an insurance company's total premium amount received from fossil fuel companies. [18] The bill calls for 70% of the total surcharge proceeds to go to the State General Fund for use by the Commissioner of Energy and Environmental Protection and 30% toward the State Insurance Fund.

Senate Bill (SB) 1115, entitled "An Act Establishing a Surcharge on Insurance Companies in This State That Underwrite Fossil Fuel Companies," would mandate that the state regulator identify the total premium amount that each insurer received from a fossil fuel company in the immediately preceding year no later than January 1, 2024.[19] This would be an annual assessment. The bill defines a "fossil fuel company" as an entity that is involved in the exploration and production of fuel that is formed from plant or animal remains.[20] This includes coal, oil, natural gas, propane, or any other petroleum product. Fossil fuel, however, does not include renewable biomass or waste vegetable oil biodiesel, according to the legislation.

Insurance representatives expressed strong opposition to the measure in their testimony, citing unintended consequences and potential violation of the Due Process Clause of the US Constitution.[21] In a March 2, 2023, letter to the legislature's Insurance and Real Estate Committee, the American Property Casualty Insurance Association argued against the measure using the following example: "Assume an Oklahoma-based insurer is licensed in Connecticut—if that Oklahoma-based insurer provides coverage for a fossil fuel company in Texas, those premiums would be subject to the proposed 5% surcharge even though the premium/risk have no connection whatsoever to Connecticut."[22]

The Sierra Club testified that it supports the bill.[23] It championed the intent for the revenue from surcharges to support the microgrid and resilience grant and loan pilot program. This would enable distributed energy generation for critical facilities at the state Department of Energy and Environmental Protection and the Insurance Fund at the Connecticut Department of Insurance.

US Secretary of the Treasury Janet L. Yellen points to climate change insurance coverage issues as a potential threat to the US financial system. Secretary Yellen kicked off the inaugural meeting of the Climate-related Financial Risk Advisory Committee (CFRAC), an external advisory committee of the Financial Stability Oversight Council (FSOC), by underscoring the urgency of climate change risk to US financial stability.[24]

In remarks prepared for delivery March 7, 2023, Secretary Yellen noted there has been at least a fivefold increase in the annual number of billion-dollar disasters over the past five years compared to the 1980s, even after adjusting for inflation.[25] She pointed to recent incidents of severe storms, tornadoes, and wildfires and specifically natural disasters mentioned in California and Florida as evidence that climate change is accelerating.

Secretary Yellen also zeroed in on the nexus between insurance coverage and the US financial system's health after acknowledging the significant adverse impact on lives caused by natural disasters. Her remarks reflect that "in response to rising insured losses, some insurers are raising rates or even pulling back from high-risk areas," noting the possible negative effects of such actions on homeowners and their property values.[26] Secretary Yellen acknowledged how "developments like these can spill over to other parts of our interconnected financial system," further substantiating FSOC's 2021 report and its recommendations for US financial regulatory agencies.[27]

While mentioning work underway by FSOC's member agencies, such as the FRB, FDIC, and Treasury's own Federal Insurance Office, in everything from climate scenario analysis to a proposal to collect data from insurers to assess climate-related financial risk, Secretary Yellen expressed enthusiasm for the CFRAC to begin meeting and bringing expertise to addressing climate-related financial risk and corresponding data.

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 for banks

Contacts

Kristen Sullivan
Audit & Assurance partner | Sustainability and ESG Services leader
Deloitte & Touche LLP
ksullivan@deloitte.com

Ricardo Martinez
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
rimartinez@deloitte.com

David Sherwood
Managing director | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
dsherwood@deloitte.com

Deloitte Center for Regulatory Strategy

Irena Gecas-McCarthy
FSI director, Deloitte Center for Regulatory Strategy, Americas
Principal | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
igecasmccarthy@deloitte.com

Michele Jones
Senior manager | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
michelejones@deloitte.com

Meghan Burns
Manager | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
megburns@deloitte.com

Kyle Cooke
Senior regulatory analyst | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
kycooke@deloitte.com

Liz Festa
Senior Research Specialist | Deloitte Services LP
lfesta@deloitte.com

Additional contributors

Trupthi Gorur
Senior solution advisor | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
tgorur@deloitte.com

Nikhilesh Parashar
Lead solution advisor | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
niparashar@deloitte.com

Shruthi Kundar
Advisory lead solution advisor | Deloitte Risk & Financial Advisory
Deloitte & Touche LLP
skundar@deloitte.com

Endnotes

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