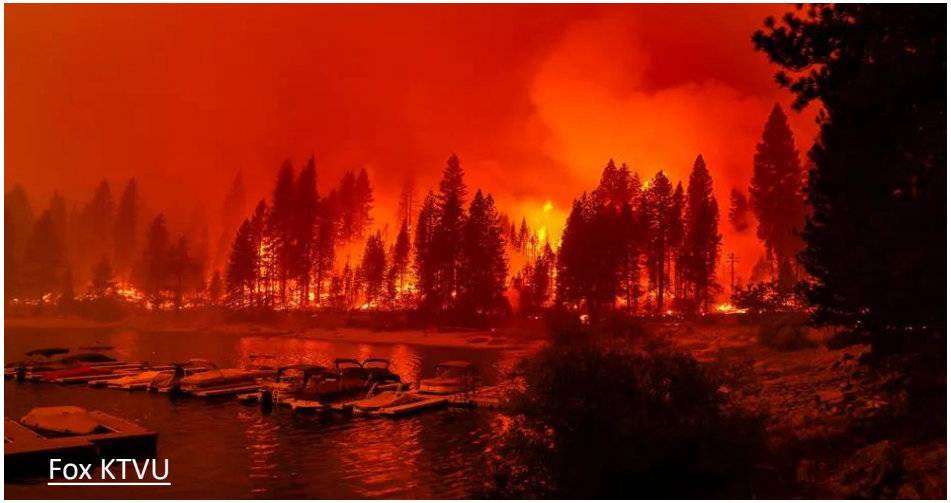
NEW YORK STATE OF OPPORTUNITY. | Department of Financial Services

Final Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change

November 22, 2021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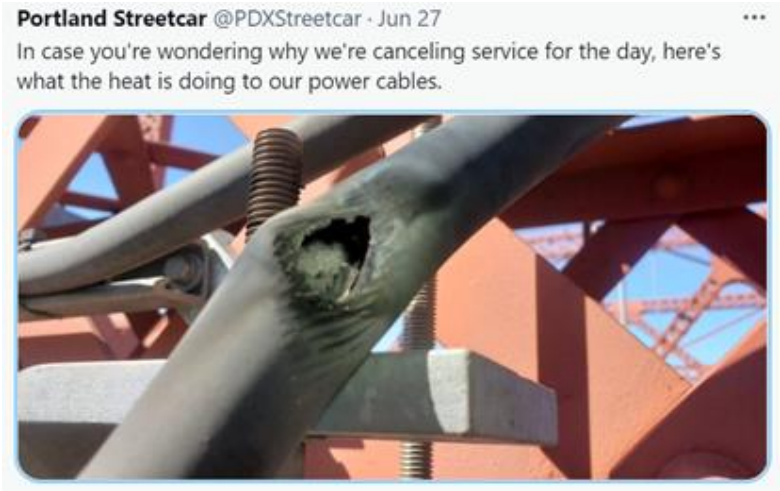
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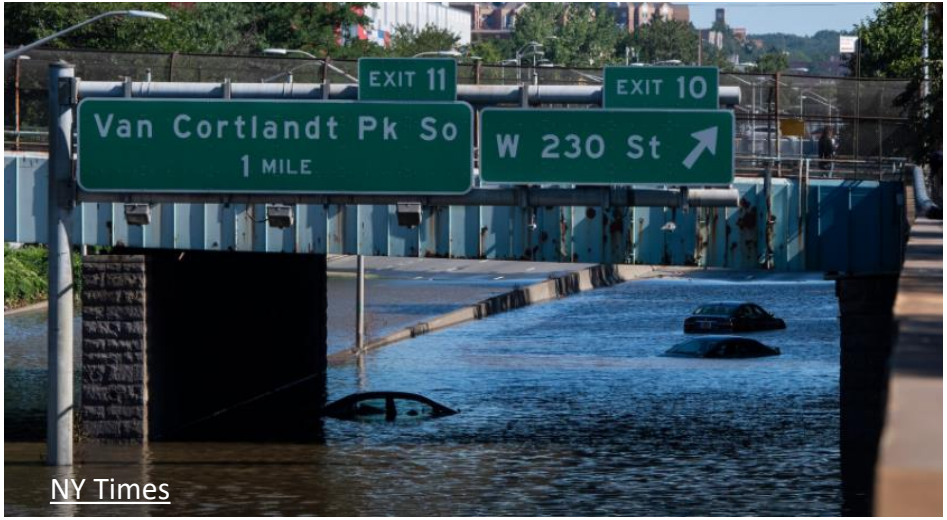
In case you're wondering why we're canceling service for the day, here's what the heat is doing to our power cables.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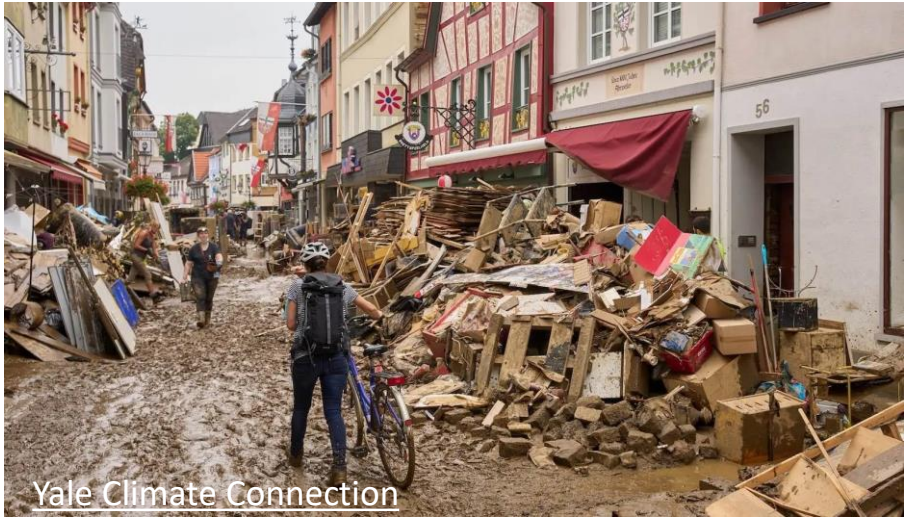
Yale Climate Connection

Context

- International
  - Sixth Assessment of the Intergovernmental Panel on Climate Change (IPCC)
  - The 2021 UN Climate Change Conference (COP26)
- U.S. Financial Regulators
  - FSOC's Report on Climate-Related Financial Risks
  - Upcoming climate guidance from OCC and SEC

"Banks with strong climate risk management systems and capabilities will not only be better prepared to withstand climate change events but will also have a better line of sight into the many business opportunities that will arise… The better a car's brakes, the faster you can safely drive it." - Acting Comptroller Hsu

- Insurers' commitments
  - Net Zero Insurance Alliance, Net Zero Asset Owner Alliance

Purpose of the Guidance

- Support our insurers in managing the financial risks from climate change (“climate risks”)
- **Serve as a basis for supervisory dialogue**

- Over time, DFS’s approach will shift from supporting insurers’ implementation of expectations to active supervision against those expectations.

Development of the Guidance

- Basis of the guidance
  - Discussions with NY insurers
  - Review of insurers' ERMs and ORSAs
  - Review of insurers' existing disclosure materials
  - NY Insurance Law, NAIC manuals
  - International regulators' publications and guidance

- Consultation process
  - 90-day consultation period
  - Bilateral meetings

Distinctive Nature of Climate Risks

- Far-reaching in breadth and magnitude
- Uncertain but foreseeable
- Dependent on short-term actions
- Hard to predict based on past experience

3.1. Proportionate Approach

- An insurer’s approach should be proportionate to its climate risks and business
- Small insurers ≠ less climate risks
- Insurers’ approach should **mature over time**
- Scenario analysis can be used by everyone
- Risk can be managed at **the group or entity level**

3.2. Materiality

- The guidance is to address **material** climate risks.
- Insurers should make **informed judgments** about the significance of climate risks to their businesses.
- Materiality assessment should go from qualitative to quantitative if qualitative analyses demonstrate the probability of material climate risks.
- NAIC Examiners Handbook materiality benchmarks:
  - 5% of surplus or one-half of 1% of total assets
  - Subject to professional judgment and circumstances
- Insurers should **regularly assess** their materiality **assumptions**.

3.3. Time Horizon in Business Decisions

- A strategic response requires a longer-term view than typical business planning horizon.

Business Decisions	Appropriate Time Horizon(s)
Pricing and reinsurance for P&C insurers	Short term (1-5 years)
Product development, merger or acquisition, portfolio profile	Medium term (5-10 years)
Risk management, risk appetite setting, or financial reporting	Medium to long term (10-30 years)
Public policy engagement, TCFD-aligned reporting	Long term

3.4. Uncertainty and Data Gaps

- Uncertainty and data gaps do not justify inaction.
- Climate change → more extreme events → Need to consider full range of potential future outcomes and forward-looking data.
- Risk to insurers are on the downside.

3.4. Uncertainty and Data Gaps

- Technology exists today to quantitatively assess climate risks.
- Many expectations in the guidance are not affected by uncertainty or data gaps.
- Model vendors and third-party investment managers
- Contribute to reducing uncertainty and filling data gaps

3.5. Implementation Timeline

- Board governance – **implemented** by August 15, 2022
- Organizational framework – **specific plans in place** by August 15, 2022
- Other tasks – a timeline will be developed, but insurers should **start working on them now**.

3.6. Risk Culture and Governance

3.6.1. Board Governance

- The board should **understand** relevant climate risks.
- **Designate** a member or committee(s) of the board to be **responsible for overseeing climate risks**, even if climate risks are not considered material now.
- Designated board member/committee(s) can be at the group or entity level if requirements are satisfied.
- Designate **senior management** as responsible for management of climate risks.
- Board oversight of implementation of public commitments.

3.6.2. Risk Appetite

- An insurer should have a written risk policy adopted by the board on how it manages **material** climate risks.
- Factors to consider:
  - Long term financial interest
  - Results of scenario analysis
  - Uncertainty and sensitivity of climate risks
- Climate's impact on risk tolerance levels can be reflected in existing risk factors.
- Start the process and evolve over time.

3.6.3. Organizational Structure

- Manage climate risks through **existing** ERM functions
- Clear roles and functions, processes and procedures
- Conduct objective, independent, and regular **internal** reviews
- Develop climate risk expertise at the board and employee levels
- Consider remuneration to align incentives

3.7. Business Models and Strategies

- Be aware of changes in business environment and address them strategically.
- Business strategy is implemented at the entity, business unit, and product line level.
- Use scenario analysis and stress tests to help set business models and strategy for potentially **material** climate risks.
- Document the analysis.
- Are encouraged to support the low-carbon transition.

3.8. Risk Management

3.8.1. Risk management framework

- Address climate risks through **existing ERM functions**,
- Identify, assess, monitor, manage, and report on their exposure to these risks,
- Document in their written ERM and board risk reports **material** climate risks considered,
- Manage and monitor risks with **appropriate** time horizons,
- Review risk analysis on a regular basis.

3.8.1. Risk management framework

- Risk identification and prioritization
- Risk appetite, tolerances, and limits
- Risk management and control
- Risk reporting and communication

3.8.2. Climate's Impact on Existing Risk Factors

- **Credit risk** – Effect of physical and transition risks on counterparties' profitability and viability.
- **Legal risk** – Climate-related regulatory requirements, risk of litigation for failing to adapt to climate change or to avoid or minimize adverse impacts on the environment.
- **Liquidity risk** – A lack of reliable information on climate-sensitive exposures could cause procyclical market dynamics.

3.8.2. Climate's Impact on Existing Risk Factors

Market risk

- Consider how physical and transition risks affect current and future investments,
- Consider correlation between investments and underwriting,
- Monitor on an ongoing basis,
- Consider timeframe of climate risks relative to maturity of fixed income assets, and sudden credit rating changes.

3.8.2. Climate's Impact on Existing Risk Factors

- **Operational risk** – Consider how climate-related events adversely impact assets and business continuity.

- **Pricing and underwriting risk** – Consider:
  - Increased natural catastrophes → increased claims
  - Whether pricing models properly reflect climate risks
  - Demand elasticity
  - Transition risks' impacts on underwriting

3.8.2. Climate's Impact on Existing Risk Factors

- **Reputational risk** – Consider negative publicity from:
  - Underwriting or investing in high-carbon sectors
  - Reduction in insurance affordability or availability

- **Strategic risk** – Consider:

- How climate risks affect competitive position and financial condition,
- Constraints on business caused by risk-based pricing rising beyond demand elasticity and customer willingness to pay,
- Correlation between liabilities and assets.

3.8.3. ORSA

- Describe how climate risks are identified, categorized, managed, and monitored, including assessment tools and methods used.
- If climate risks are **not material**, **document the justification**.
- If climate risks are **material**, **document assessment process**.
- Address how insurers' **current strategies and risk appetites** are affected by **long-term** climate concerns.
- **Quantitative** assessment for **material** risks with metrics over time.
- **Implement** climate-related policies and procedures **at the entity level** when ORSA is done at the group level.

3.9. Scenario Analysis

- Embed climate scenario analysis in governance and risk management for **material** climate risks.
- Consider opportunities in scenario analysis.
- Consider factors where **material:**
  - Climate risks on both assets and liabilities
  - Include both physical and transition risks
  - With various carbon emission and transition scenarios
  - Not fully reflected in historical data
  - How they materialize in short, medium, and long term.

3.9. Scenario Analysis

- Scenario analysis should include:
  - A short- to medium-term assessment
  - A long-term assessment based on business model and for decisions that require a long-term horizon, can be less precise and less frequent.

- Scenario analysis is to inform strategic planning and mitigation efforts, exploratory in nature.

- Should avoid creating a false sense of security and precision in results.

3.9. Scenario Analysis

- Use scenarios to for decisions such as:
  - Whether reactive actions are realistic or not
  - Merits of precautionary actions
  - Climate risks not fully reflected in asset pricing
  - Abrupt shifts in market
- Scenario selection: relevant to their businesses
- Insurer are encouraged to identify data, methodology, and talent gaps.
- Can be qualitative to start.

3.10. Public Disclosure

- Acceptable through NAIC Climate Risk Disclosure Survey
- Can be done at the group level if covers practices at insurer level
- Publicly disclose approach to managing climate risks and opportunities
- Go beyond operational metrics and cover physical and transition risks' impacts on underwriting, investments, and strategies
- Encourage disclosure by the wider economy
- Disclosure approach to mature over time
- Engage with Taskforce for Climate-related Financial Disclosure and other initiatives

Questions?
Feedback?

Contact: climate@dfs.ny.gov