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What's Next for Climate Risk Management?

Top Tips for Insurers to Address NY DFS's Climate Guidance

Insurers, state and federal financial regulators are coping with the impact of climate change and the increasing risk it presents to the safety and soundness of financial institutions and to the stability of financial systems. The ever-increasing regularity and gravity of extreme weather-related events such as rapid swings in temperatures, tornadoes in the Midwest, wildfires in California, hurricanes in the Gulf Coast, and others have resulted in greater regulatory focus on climate-related risks for many sectors, including the insurance industry.[1]

Reacting to these issues, regulators such as the New York Department of Financial Services (NY DFS) are releasing guidance for insurers on managing the financial risks from climate. Others such as the Securities and Exchange Commission (SEC) recently proposed rule changes requiring registrants to include certain climate-related disclosures in their registration statements and periodic reports such as data about climate-related risks that are reasonably likely to have a material impact on their business or financial condition.[2] Also required is disclosure of a registrant's greenhouse gas emissions, which are a commonly used metric to assess a registrant's exposure to such risks. Many insurance firms will also be impacted by this rule change once it becomes law.[3]

The final guidance now in effect from NY DFS provides advice for insurers to take a proportionate approach to managing climate risks.[4] Required are both current and forward-looking risks as well as actions needed to manage those risks in consideration of its exposure to climate risks and the nature, scale, and complexity of its business.[5] The guidance also calls for insurers to have specific plans in place by August 15, 2022. Even though New York is one of the first states to put forth climate guidance, the international community has led the way on climate's effect on insurance as many other countries already have similar requirements in place.[6] Because of this, we anticipate this type of guidance to grow in more states and at the federal level. We are encouraging insurers to act now so they are prepared for these future changes.

1 https://www.fdic.gov/news/press-releases/2022/pr22027.html?source=govdelivery&utm_medium=email&utm_source=govdelivery

2 https://www.sec.gov/news/statement/gensler-climate-disclosure-20220321

3 https://www.reuters.com/legal/litigation/us-sec-set-unveil-tighter-rules-blank-check-companies-2022-03-30/

4 NY DFS "Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change," November 15, 2021

5 Ibid. *See* Section 3.1

6 https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202111151

To help insurers address this guidance, below is background on the effects of climate change for insurers, best practices for insurers to consider, and tips for developing an overall approach.

The Effects of Climate Change on Insurers

At first glance, the effects of climate change may not seem unfavorable to property and casualty insurers. Firms can adjust the annual policy cycle and their highly developed understanding of evolving risks to reprice and rearrange underwriting portfolios to avoid long-term exposure to climate events. And in principle, the growth in the value at risk should increase the demand for new and diverse insurance solutions and coverages, which in turn could expand the industry's opportunities… potentially adding premiums and profitability.

However, insurers must be careful not to underestimate the true threat of climate change. The insurance industry is in a unique position when it comes to climate risk and its potential financial implications. Insurers are exposed on both sides of the Balance Sheet: underwriting risk, as noted on the liability side, and their investment portfolios on the asset side. Some regulators have begun to express concern about the amount of insurers' investments that are exposed to fossil fuels or other carbon intensive industries as they have potential to become stranded assets, *i.e.*, assets that experience unexpected or premature write-downs or devaluation caused by innovation (*e.g.*, solar, wind, EVs) changes in the market or other factors.[7]

Best Practices for Insurers to Consider

Although climate change and its effects on insurers is extremely complex, there are several best practices insurers can begin to implement now so they are better equipped to address climate-change guidance:

— **Formulate climate-risk governance:** It is critical for top management to set the "tone on top" for climate risk governance. The board should understand relevant climate risks and designate a member or committee(s) of the board to be responsible for overseeing climate risks. In addition, insurers are expected to designate one or more members of its senior management as responsible for the insurer's management of climate risks. As climate change could impact multiple business units and require expertise from multiple functions, the designated member(s) of senior management may delegate responsibility to those business units and functions, provided that such members of senior management continue to oversee any such delegation. Another option is to have a cross-functional committee of senior management charged with understanding the changing risk landscape and identifying potential ways to address climate risks.

— **Tailor business and credit strategy:** Climate considerations should be deeply embedded in risk frameworks and capital allocation processes. Many institutions have decided not to serve certain companies or sectors or have imposed emissions thresholds for underwriting in some sectors.[8] Some have reduced or stopped insurance access to clients that are heavy users or producers of fossil fuels (coal, oil sands, etc.). Boards should regularly track impacts, as well as identify potential threats to strategic plans and business models.

[7] "This guidance is informed by DFS's ongoing dialogue with the insurance industry over the past year, analysis of the potential climate risk exposure of insurers' assets, and collaboration with international and other U.S. regulatory bodies." NY DFS "Guidance for New York Domestic Insurers on Managing the Financial Risks from Climate Change," November 15, 2021

[8] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202111151

- **Align risk processes:** To align climate risk exposure with risk appetite, and business strategy, managers should introduce climate risk considerations into all management processes (capital allocations, underwriting approvals, portfolio monitoring, reporting, etc.). Some may have begun to develop methodologies for assessing climate risk at the level of counterparties and value chain.[9]
- **Ensure you are fully informed on stress testing:** Scenario analyses and stress tests are high on business and regulatory agendas and are critical in aiding firms assess materiality impacts and resilience. Identify important climate hazards and primary risk drivers by industry, an analysis that can then be used to generate physical and transition-risk scenarios. These in turn can help firms estimate the extent of the damage caused by events, *e.g.*, droughts, heat waves, etc. Lastly, firms should quantify the impact by counterparty, *e.g.*, reinsurers and in aggregate on a portfolio basis. Risk management should also prepare a range of potential mitigants and put in place systems to translate test results into an overview of the business's position. As regulators are prioritizing stress testing for coming periods, acquiring the necessary climate-modeling expertise and climate hazard and asset-level data is vital.[10]

Climate Risk Management: Developing an Overall Approach

The deadline from NY DFS of August 15, 2022 is fast approaching. There are concrete steps insurers can take to get started in developing a plan so they can meet the recommendations put forth in the guidance:

- **Define and communicate strategic ambition:** Effective climate risk management is based on a dedicated strategy. Firms must determine the role they want to play and identify client segments and industry sectors where they can add the most value. Next, one should establish and implement governance frameworks for climate risk. To accomplish this, firms should involve specialized senior personnel as well as a minimum standard for reporting throughout the organization.
- **Build a foundation:** Identify the processes, methodologies, and tools needed to manage climate risk effectively. This can be done by embedding climate factors into underwriting, risk, and credit frameworks. Scenario analyses and stress tests are also essential capabilities and should be included as part of supervisory frameworks. Next, hardwire outcomes into reporting and disclosure frameworks. To do this, insurers will need to accumulate skills and build relevant IT, data, analytics, etc. In some instances, these capabilities may require external personnel or software.

[9] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202111151

[10] Ibid.

- **Construct a climate risk-management framework:** To be successful, insurers must embed climate risk factors into decision-making across front and back-office activities, both financial and nonfinancial risks (operational, legal, compliance, and reputational risks). Data may be a significant obstacle, but it is required to understand the fundamentals of climate change as well as the impact it will have on activities such as pricing, credit risk, and client relationship management. Insurers should measure climate exposures at several levels, including portfolio, sub portfolio, and even transaction; then create heat maps and detailed reports of specific situations, such as a climate-adjusted credit scorecard (cash flows, capital, liquidity diversification, and management experience) for individual companies and assignment of specific risk limits.

Conclusion

The effect of climate change on insurers is a complex subject. Although NY DFS makes New York the first state in the U.S. to issue climate guidance for insurers, they have the benefit of learning from what has been done at the international level and what other US regulators are contemplating. Because of this, the NYDFS guidance is comprehensive and includes feedback from many different groups of stakeholders. Insurers should view this guidance as a bellwether for future guidance from other states and federal authorities and should use the time leading up to August 15 to prepare and implement an appropriate climate risk related foundation.

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04072022 | VN01888-v03

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