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DFS Issues Climate Change Guidance: Framework for Future Regulations, Nationwide Standards and Management Accountability?

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The New York Department of Financial Services (the "DFS") announced proposed guidance (the "Guidance")[1] on March 25, 2021 that will incorporate environmental considerations into the insurance regulatory sphere, following up on a circular letter (the "Circular Letter")[2] issued by the DFS last year.

Following the Guidance's comment period, we would expect the DFS to issue regulations implementing the Guidance and conduct examinations monitoring compliance. Given the focus on governance and accountability in the Guidelines, as well as statements in the Circular Letter, the DFS may look to hold individual members of senior management responsible for failures to comply.

Climate Change Guidance. As set forth in the newly issued Guidance, the DFS expects New York domestic insurers to manage financial risk from climate change. The Guidance sets forth the following five expectations of New York domestic insurers ("insurers") with which the DFS intends to monitor compliance.

- *Governance*: The DFS expects insurers' boards to assess and oversee the management of relevant climate risks, including a board-approved risk policy that addresses climate risks. The DFS also expects insurers to modify management control functions to manage for climate risks.

- *Integration into Decision-Making Processes*: The DFS expects each insurer to document how its analysis and stress testing with respect to climate change is integrated into its business strategy, risk appetite framework and risk management and compliance processes, including ERM functions.

- *Integration into Financial Risk Management*: The DFS acknowledges that climate risks will impact insurers' existing risks (e.g., credit risk, market risk, legal risk,

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1 New York Department of Financial Services, Proposed Guidance for New York Domestic Insurers on Management the Financial Risks from Climate Change, dated March 25, 2021, available here.

2 For further information on Circular Letter Number 15, issued September 22, 2020, please see our previous client alert here.

underwriting risk, reputational risk, operational risk, etc.). The DFS expects each insurer to address climate risks through its existing ERM function and to integrate climate risk identification and mitigation enterprise-wide, including as part of compliance, actuarial, audit and risk management roles. Insurers should have a process to identify and prioritize climate risks; consider climate risks in setting risk appetite, tolerance and limits; and develop plans and policies for mitigating climate risk.

- *Scenario Analysis*: Each insurer will be expected to use forward-looking scenario analysis and stress testing to inform their identification and management of climate-related risks. This scenario analysis should cover the impact of climate-related physical and transition risks in the short, medium and long term.

- *Disclosure*: Each insurer should enhance the transparency of its integration of climate risks into its governance and risk management using the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD) and Carbon Disclosure Program (CDP) and the Sustainable Accounting Standard Board's (SASB) Insurance and other developed frameworks. If an insurer deems climate risks to be immaterial to its business, the insurer should disclose that assessment and its methodologies for making that determination.

Proportionate, Progressive, Quantitative Approach. The DFS acknowledged in the Guidance that its supervisory approach to climate risks, and its requirements for insurers, will be further developed over time and will be subject to a progressive timeframe as industry and regulatory sophistication around climate change risks evolves and insurers develop more quantitative approaches. The DFS indicated in the Guidance that it understands that insurers are currently in different stages of this process and that some insurers may take longer than others in order to incorporate the necessary long-term risk assessments. The Guidance also calls for a proportionate approach based on an individual insurer's exposure to climate risk and the nature, scale and complexity of its business.

Industry Perspective. With the Guidance, the DFS is again putting itself forward as a leader in regulation and supervision of newly evolving risks facing the insurance industry, as it did in the area of cybersecurity. The Guidance is the first climate-related guidance issued by a U.S. state insurance regulator. It is reasonably likely that other states will follow the example of New York in short order and begin requiring insurers to incorporate climate change risks into their governance and risk management processes. The DFS acknowledged the need to cooperate and collaborate with U.S. and foreign regulators and international stakeholders to reduce compliance burdens.

We note, however, that in contrast to regimes being implemented outside of the United States, the Guidance does not include any prescriptive regulations prohibiting or limiting investments in assets with negative climate effects, requiring investments in assets with positive climate effects or creating any special capital treatment for such investments. The Guidance is also limited to climate change-related risks and addresses the social aspects of the broader ESG movement only through a comment that climate change disproportionately affects disadvantaged communities. Finally, the Guidance is only applicable to New York domestic insurers, though last year's Circular Letter indicated that the forthcoming guidance would cover all New York insurers, including foreign insurers licensed in New York.

The DFS has scheduled a webinar on April 8, 2021 to provide an overview of the Guidance and has requested public comments on the Guidance by June 23, 2021.

We expect that comment on the Guidance will require a significant amount of industry attention over the next few months, and we would be happy to consult on any of these issues.

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Please do not hesitate to contact us with any questions.

NEW YORK

Alexander R. Cochran
arcochran@debevoise.com

Eric R. Dinallo
edinallo@debevoise.com

Franklin L. Mitchell
flmitchell@debevoise.com

AJ Salomon
asalomon@debevoise.com

Brita Siepker
bsiepker@debevoise.com