The Daily Dish

Yellen Slows the Climate Change Train

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In an interview with Bloomberg News, Treasury Secretary Yellen argued, "It's just premature at this point to talk about raising capital requirements," adding that, before raising these requirements, "it's really important that regulators do the groundwork that's necessary for them to evaluate risks to individual firms." The important element of this is the phrase "raising capital requirements," which is where the rubber hits the road in bank regulation.

Recall that basic banking is not very complicated. Household deposits are aggregated by the bank and lent out to borrowers. Banks have to pay interest to the depositors and charge interest on the loans, and have an incentive to loan out as much as they can to pocket the margin on each loan. Unfortunately, if bad times hit, a great many of the loans will go bad, depositors may want their money, and there is the real possibility that there will not be enough money on hand for all those making withdrawals, also known as a bank run. Bank safety and soundness regulation includes requirements that a fraction of the bank equity be held as capital to cover loan losses, the bank has the ability to redeem deposits, and the bank can continue to operate in bad times.

But the greater the capital requirements, the less available to make loans and earn profits. At the other end of the lending equation, it also means that some potential borrowers (usually the riskiest, or those least likely to repay) will not be able to get loans; the capital requirements affect the distribution of investment in the economy.

Climate change risk can enter this business model in at least three ways. In the first, there could be clear disclosure of how climate change affects borrowers' ability to repay. A concentration of loans to coastal strip malls that could be flooded by sea-level rise might appear an unattractive loan portfolio. Investors would steer capital away from banks that make such loans. Naturally, to be competitive banks would shift their lending away from

loans that have such a climate change exposure — and already do so, minimizing their own risks through sensible underwriting. The upshot is that capital is allocated away from coastal strip malls and the like.

Alternatively, one might choose to not rely on market pressures and instead regulate banks to hold more capital if they make loans to coastal strip malls. These are riskier loans, and greater provisions must be put in place for the event of their failure. But this means those loans make less money and, again, banks will shift to other loans that have lower capital requirements. Again, the policy shifts capital way from businesses with big climate risks.

A more extreme version is that the regulator (e.g., the Federal Reserve) might simply say "we don't want you investing in coastal strip malls" or otherwise directly constrain their lending portfolio. Once again, the upshot is the same, although serious questions would need to be asked about federal agencies picking regulatory winners and losers.

Secretary Yellen argues that "Regulators need to evaluate the impact of climate change on the firms that they supervise and work through that," suggesting that there is not enough knowledge to implement any of these approaches. That's the right bottom line, but a disappointing position for those advocating for government intervention.