Insight

# CFTC Acknowledges Climate Change As A Systemic Risk To The Economy

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## Executive Summary


- A Commodity Futures Trading Commission (CFTC) subcommittee has approved the release of a first-ever federal report on the risks to the stability of financial markets posed by climate change; while the CFTC subcommittee has not officially endorsed the contents of the report or its recommendations, the fact that the subcommittee (and by extension the CFTC) voted to release it is a strong indication of support .
- The report notes that the potential risks to financial markets are systemic in scope and that, while regulators are already empowered to embark on a program centralizing the environmental risk of climate change in financial regulation, significant barriers exist, including the availability of data.
- Of the more than 50 concrete recommendations made by the report's authors, most striking is the determination with which the report calls for carbon pricing as central to any future efforts.


## Introduction

In June 2019 the Commodity Futures Trading Commission (CFTC), the U.S. federal agency that regulates the derivatives markets, commissioned a Climate-Related Market Risk subcommittee with the goal of evaluating and managing the dangers that climate change and global warming present to financial–sector markets. The intention of the subcommittee was not to litigate the science of climate change but instead to focus on its likely impact on the financial system and broader economy. The report, released today and approved by the CFTC subcommittee, represents the first federal study commissioned by the Trump Administration that assumes that climate change poses a material risk to financial markets that is worth review.

The report's first line powerfully confirms the centrality of this assumption, noting "Climate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy." The report also notes that while potential risks seem certain, significant uncertainties and insufficient data remain and that the priority of regulators must be able to identify and assess these risks. The report's authors observed that federal regulators already possess the tools required to undertake these initiatives but noted that a significant improvement in company disclosures relating to environmental risks will be required. The report makes a number (53) of concrete recommendations for next steps, from pricing carbon tax emissions to requiring that federal regulators include climate risk into their mandates and new environment risk–specific stress scenarios for businesses.

## Key Findings

At its core, the key finding is that "climate change could pose systemic risks to the U.S. financial system." Even a conclusion that climate change could pose *any* risk to the financial system would be dramatic enough, particularly from this administration.

That the report elevates this potential risk to "systemic," or having the capacity to collapse an entire industry or the economy, is a startling indication of the seriousness of the perceived threat. The CFTC report notes in particular the dangers of mis-priced assets undergoing sudden revision and having cascading impacts on portfolios. A key element in most considerations of systemic risk is the notion of contagion, and the report's authors posit a scenario in which the U.S. financial markets are so severely undermined as to leave significant portions of the U.S. market without access to basic financial services. These problems could be exacerbated by a scenario where house prices rapidly fall and defaults rise in regions with continuous natural disasters. Contagion is not the only potential risk factor, as physical damage is also a concern (considering, for example, the impact on the housing market of widespread property destruction).

Notably, the report does not envisage that significant action is immediately required by Congress, noting that existing legislation already empowers U.S. financial regulators to take the steps required to at least begin confronting the problems that could be caused by climate change. The report also suggests that international cooperation among regulators could be significantly more robust, and that the United States' current regulatory approach is under-developed. These issues are further exacerbated by changes in administration which can fundamentally undermine the United States' willingness to cooperate, as demonstrated by the Trump A dministration, and impact foreign governments' willingness to adhere to emissions reduction targets.?

Other than inertia and a late start by regulators, the report identifies two key obstacles to identifying and mitigating the risks posed by climate change. First, the report identifies as its "fundamental finding" the need for an economy-wide price on carbon that reflects the true social cost of carbon emissions (SCC). This, too, has proven difficult with changes in administration. While the Obama Administration calculated the global social cost of carbon to be around $45 per ton of CO2, the Trump Administration has since revisited the calculation and considered only the domestic costs and decreased the value to somewhere between $1 and $6 per ton of CO2. The report adds an additional wrinkle by suggesting that the financial system would be best served by "immediately implementing carbon pricing globally," which suggests that a singular methodology for calculating SCC would need to adopted by all cooperating countries.?

Second, too much about the scale of the problem remains unknown and unquantified – insufficient data and analytical tools "remain a critical constraint." The CFTC report notes that the ability of regulators to provide the appropriate degree of analysis and form a basis for recommendations fundamentally depends on the quality of the information they have access to, and suggests that while industry–standard common definitions will be absolutely necessary, the onus will be on firms to significantly improve the quality and quantity of the environmental risk disclosures that are made. Any disclosures do not need to be the only source of information available to financial regulators, however, with the report's authors noting the potential utility of climate-related stress and scenario analysis.

Of course, the key limitation of the CFTC's report is that it is not binding in any way, shape, or form – not even on the CFTC itself. The recommendations of the report's authors, 35 appointed experts to a CFTC subcommittee , do not even necessarily represent the views of the CFTC itself, although that the CFTC subcommittee approved the report and in doing so released it under a CFTC imprimatur is a strong indication of support.

**Report Recommendations and Analysis**

*The United States should establish a price on carbon.*

While the report suggests that major legislation is unnecessary, it is difficult to imagine a scenario where a dependable price of carbon could be established without it. The calculation of the SCC has been conducted to date by methodologies that have varied from one administration to the next. In order to provide the financial

system with the consistency and transparency necessary to assess risk, a more permanent framework that thoroughly considers the implications of the SCC in application would need to be enacted.??

In order to accomplish this, factors that contribute to the calculation of SCC, such as emissions reduction targets and timelines, would need to be established, which presumably would be the case were the United States to cooperate internationally.??

*All relevant federal financial regulatory agencies should incorporate climate-related risks into their mandates* ; and

*Research arms of federal financial regulators should undertake research on the financial implications of climate-related risks*; and

*Financial regulators, in coordination with the private sector, should support the development of U.S.-appropriate standardized and consistent classification systems.*

With these three recommendations, the report proposes expanding the mandate for responding to the potential threats they have identified to all federal financial regulatory agencies. The CFTC, while powerful, is not the most influential financial regulator, and the report indicates that addressing the problems of climate change will require concerted effort across the government, including the Federal Reserve (the Fed) and Treasury. The report 's recommendations have no legal force, however, and at best remain only suggestions for the other regulators to adopt. A glossary of standardized terms and products would however represent a significant step – if not the required preliminary response – in the development of a federal response.

*U.S. regulators should join, as full members, international groups convened to address climate risks.*

An explicit recommendation to participate in international cooperation is a perhaps surprising proposal from a federal agency under an administration noted for withdrawing from international treaties and agreements. It is worth noting, however, that this retrenchment is felt more in humanitarian and trade sectors, and that with the exception perhaps of some reluctance to join the International Association of Insurance Supervisors (IAIS) in its more drastic proposals for international standardization, the relationship between U.S. and international financial services regulators is cordial.

*The Financial Stability Oversight Council (FSOC) as part of its mandate to monitor and identify emerging threats to financial stability, should incorporate climate-related financial risks into its existing oversight function.*

FSOC, the embattled regulator created by the Dodd-Frank Act, in late 2019 shifted approach from its ultimately unsuccessful attempts to designate nonbanks as systemically important to instead hew closer to the original mandate by shifting to lateral "activities-based" supervision. A focus on the risks posed by climate change in theory should already be covered by FSOC's mandate to assess growing systemic risks, although recently FSOC has received criticism not simply for failing to anticipate the impact of the coronavirus pandemic (a clearly systemic risk) but for failing to provide a plan to address the ongoing crisis.

*Working closely with financial institutions, regulators should undertake—as well as assist financial institutions to undertake on their own—pilot climate risk stress testing.*

The Comprehensive Capital Analysis and Review (CCAR) is an annual exercise performed by the Fed that seeks to determine whether banks (or, slightly more specifically, bank holding companies with greater than $50

billion in assets, operating in the United States) hold sufficient capital to appropriately manage the unique risks each bank faces and be able to absorb losses in the event of unforeseen crises. The U.S. stress testing regime is already in a period of flux as for the first time the Fed will use the results of stress testing to determine bank capital requirements. Adding environment-specific stress and scenario testing would complicate an already lengthy and expensive process but would likely not be a significant additional demand on either the Fed or participating banks. Environment-specific stress testing is under development but not yet implemented in European regulatory systems.

*Financial supervisors should require bank and nonbank financial firms to address climate-related financial risks through their existing risk management frameworks in a way that is appropriately governed by corporate management;* and

*State insurance regulators should require insurers to assess how their underwriting activity and investment portfolios may be impacted by climate-related risks and, based on that assessment, require them to address and disclose these risks.*

These two recommendations represent perhaps the largest concern for financial services firms. While adding to what is, in many cases, already a significant regulatory burden under the stress testing regime is probably undesirable, it remains an external exercise that the Fed will argue falls within sensible reserving practices for firms anyway. By contrast, with these two recommendations the CFTC subcommittee report proposes restricting the ability of financial services firms to manage their own businesses. The report does not go into further detail as to what would be involved – probably intentionally, and so as to leave it up to federal regulators – but these recommendations could be used by regulators to inspire sweeping new powers to investigate and control company investment and operating practices.

Of course, to some critics even these broad suggestions will not go far enough, with more calling for a fundamental revisiting of all aspects of financial services regulation (including, for example, the setting of bank capital) with a view to environmental risk factors.

*Material climate risks must be disclosed under existing law, and climate risk disclosure should cover material risks for various time horizons.*

In an altogether less opaque recommendation, the report recommends a codification of climate risk disclosures. While the Securities and Exchange Commission (SEC) currently requires the disclosure of all "material" risks under federal securities laws, this is neither particularly well understood, governed, or required by any federal regulator other than the SEC. While many firms have taken the initiative to make climate disclosures of their own volition, without a standardized approach (or even much in the way of a definition of "material" beyond that which an investor would need to make an informed decision) climate risk disclosures become extremely difficult to comparably assess, particularly where significant data are missing.

*The United States should consider integration of climate risk into fiscal policy, particularly for economic stimulus activities covering infrastructure, disaster relief, or other federal rebuilding.*

The report contemplates fiscal policy – the exercise of the nation's sovereign power to borrow, tax, and spend – to advance a transition to a net-zero emissions economy. According to the report, this effort will require "trillions of dollars," and incorporation of climate risk in fiscal policy design could serve to integrate the goal of a net-zero emissions economy into the direction of the nation's fiscal policy, both in the immediate future as the United States responds to the pandemic-induced recession and going forward.

*The United States and financial regulators should review relevant laws, regulations and codes and provide any necessary clarity to confirm the appropriateness of making investment decisions using climate-related factors in retirement and pension plans covered by the Employee Retirement Income Security Act (ERISA).*

The CFTC report also takes the opportunity to disapprove of recent moves by the Department of Labor to make it more difficult for asset managers to incorporate environmental considerations in their investment decisions and for financial advisors to make recommendations on any basis relating to environmental factors.

**Conclusions**

The CFTC's subcommittee report has three key implications. First, it is the first federal study of the impacts of climate change on financial markets, and it implicitly recognizes the dangers of climate change (a fact made more startling for other attempts by this administration to restrict global warming science). That this report was made at all is welcome. Second, in the authors' view the risks posed by climate change, even with insufficient data available, represent not just a real but potentially *systemic* risk to financial markets and the economy. Third, the report makes thoughtful and, most important, concrete recommendations that federal agencies would be advised to begin adopting immediately, most notably on carbon pricing. While none of these recommendations have any legal force, and there is no obvious path toward progress prior to the election, the CFTC has all but endorsed a principled blueprint that should be of enormous value to future administrations as a starting point for the incorporation of climate change risk into financial markets regulation.