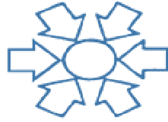

FedFin Client Report

Wednesday, September 9, 2020

CFTC Report: Regulators Need a New, Tougher and Greener Regulatory Mandate

Client Report: **GREEN4**

Executive Summary

In this report, we analyze an influential and possibly even game-changing paper released today by the CFTC's Climate-Related Market Risk Subcommittee. Approved by a 34-0 vote, the report expresses only the subcommittee's views but nonetheless reflects broad and bipartisan thinking among the experts convened by the CFTC on the controversial and consequential question of climate change's impact on U.S. banks, securities firms, insurers, financial markets, and financial stability. Commenting on the report, Chairman Tarbert observed that the transition risks highlighted in the report could be as dangerous if regulators do too much as well as if they continue to do only the too-little observed in this report.

Laying out 53 recommendations analyzed below, the report concludes that climate change is not only an acute financial risk on its own, but may also exacerbate other risks – e.g., corporate leverage, a pandemic – and thus have still more significant systemic risk than climate-alone analytics may recognize. As a result, regulators are told to ramp up measurement and risk-mitigation efforts, with the report concluding also that key agencies have ample authority under current law to do so. Climate risks should, it recommends, be quickly and officially incorporated in risk-management and governance requirements. However, the report does not adopt a remedy contemplated in a recent BIS report (see *Client Report* **GREEN**) – i.e., penalty risk-based charges for "brown" exposures. The climate-change supervisory framework outlined by the New York Fed (see *Client Report* **GREEN2**) fits well within its construct, although the paper urges the Fed like other agencies to do still more. The report also lays out innovations essential to effective risk mitigation and to increase the role financial markets play in broader climate-change reduction efforts.

Analysis

A fundamental finding is that financial markets will only be able to channel resources efficiently to greenhouse gas reduction if an economy-wide price on carbon reflects the true social cost of these emissions that take into account distributional implications so that

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carbon taxes or other remedies do not fall disproportionately on low-and-moderate income households and historically-marginalized communities. Moving on to issues for financial regulators, the paper details why climate change poses systemic risk and lays out "sub-systemic shocks" that should also be addressed (e.g., regional impact, financial-sector impact such as that limited to agriculture banking). Although the paper finds that federal financial agencies have the statutory authority needed for meaningful action, it recommends legislation to advance actions such as enhanced disclosures, ESG incentives, and new guarantees.

Key report recommendations include:

- There is a need for consistent U.S. and, preferably, international standards on what is or is not "green" and how climate risk is defined and measured.
- Scenario analysis is helpful, but limited due to uncertain model assumptions and widespread use of tools that do not capture financial risk.
- Disclosure improvements are essential, with current voluntary and SEC efforts insufficient to ensure that information enhances effective capital allocation. Regulators should clarify materiality thresholds in both qualitative and quantitative ways for medium- and long-term risks, as well as revise 2010 SEC guidance and mandate various emissions-related disclosures.
- Derivative markets can be part of the climate-change solution (e.g., via adding sustainability provisions in key contracts, developing new derivative contracts including for ESG instruments).
- All federal financial agencies should incorporate climate-related risks into their mandates, monitoring, oversight, and research functions. The FSOC should do the same. U.S. agencies are told also to join relevant international groups such as the central-bank task force on climate risk. Work should also begin on risk data, standards, disclosure templates, and related matters, including a U.S. classification and taxonomy systems for physical and transition risks, exposures, sensitivities, vulnerabilities, and resilience across asset classes and sectors. A new public-private organization may be required to do so.
- Banks and nonbanks should be required to address climate risk through existing risk-management frameworks and governance. Pilot stress testing based on standardized scenarios and assumptions set by regulators should begin and cover institutions including community, regional, and agricultural banks.
- Agencies – here presumably meaning the Fed – should incorporate climate risk into asset-purchase programs.
- The CFTC should begin a climate-risk study looking at markets, CCPs, and other entities under its supervision and identifying regulatory gaps warranting action.
- State insurance regulators should require insurers to assess and disclose the impact of underwriting activities and investment portfolios. The body of the report also suggests that state regulators mandate climate-risk stress testing.

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