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The U.S. Financial System and Climate Risk: Putting the Report of the CFTC's Climate-Related Market Risk Subcommittee in Context

By Amy L. Edwards, Dianne R. Phillips, and Kara M. Ward*

Climate risk presents significant challenges, including to financial institutions. How those risks are best managed will remain a topic of discussion for the foreseeable future, so now is the time for financial institutions and regulators to focus on this important task. The authors of this article discuss recent climate initiatives and the financial industry.

The past year has taught us a lot about the interplay between global risks and the economy. With lessons from the COVID-19 pandemic continuing to evolve, climate change has earned a new spotlight as an analogous global risk to domestic financial institutions.

President Joe Biden has confirmed that two of his top priorities will be tackling both the COVID-19 crisis and climate change while rebuilding a strong economy. In preparing for the new administration, a group of more than 150 experts with high-level government expertise prepared the Climate 21 Project report, "Transition Recommendations for Climate Governance and Action,"[1] which contains recommendations for 11 White House offices, departments, and agencies.

THE CLIMATE 21 PROJECT REPORT

In addition to recommendations for the typical environmental agencies, such as the U.S. Environmental Protection Agency ("EPA"), Department of the Interior, and the Council on Environmental Quality ("CEQ"), the report contained recommendations for the Department of the Treasury, National Oceanic and Atmospheric Administration ("NOAA") and the Department of Justice ("DOJ"). For example, two recommendations for the Treasury Department were to appoint a Counselor to the Secretary for Economic Growth and Climate to coordinate climate efforts within the department, and to raise and

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[1] https://climate21.org/summary/.

emphasize climate and financial stability risks and opportunities on the agenda of the Financial Stability Oversight Council ("FSOC") within the first six months of the new administration.

Early indicators suggest that the Treasury Department will be an early adopter of the action items from the report. In fact, in her nomination hearing before the Senate Finance Committee on January 19, 2021, Dr. Janet Yellen, Biden's nominee for Treasury Secretary, said that she intends to create a "hub" of climate change-related work streams to examine the impacts and risks to the financial system. Dr. Yellen shared that the hub would be anchored by a "very senior-level" official, which echoes the same recommendation from the Commodity Futures Trading Commission ("CFTC") report. Furthermore, Dr. Yellen stated, "Climate change is an existential threat . . . both the impact of climate change itself and policies to address it could have major impacts, creating stranded assets, generating large changes in asset prices, credit risks and so forth that could affect the financial system. These are very real risks."

THE CFTC REPORT

The Climate 21 Project report is consistent with other reports that have been published in recent months, including one from the Climate-Related Market Risk Subcommittee of the Commodity Futures Trading Commission on "Managing Climate Risk in the U.S. Financial System."[2] The CFTC report, released in September 2020, contained the following key findings:

- Climate change could pose systemic risks to the U.S. financial system.
- U.S. regulators already have wide-ranging and flexible authorities to start addressing climate-related risks.
- Insufficient data and analytical tools to measure and manage climate-related financial risks remain a critical constraint.
- The lack of common definitions and standards for climate-related data and financial products is hindering the ability of market participants and regulators to monitor and manage climate risk.
- International engagement by the U.S. could be significantly more robust.
- Financial markets will be able to channel resources efficiently to activities that reduce greenhouse gas emissions only if an economy-wide price on carbon is in place that reflects the true social cost of such emissions.

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[2] https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf.

DISCUSSION AND OVERVIEW OF RISKS

The primary risks from climate change are physical risks and transition risks. These risks can occur on parallel tracks, and both can threaten financial institutions.

Physical risks are those that impact the asset's ability to perform. The assets could be infrastructure (roads, bridges, pipelines, utilities), real estate, agriculture or human health, and the climate change impact could be flooding, sea level rise, drought, wildfires, extreme temperatures, etc. The physical risks could be either acute (e.g., hurricane) or chronic (e.g., drought). Recent research mentioned in the CFTC report suggests that about 1.2 percent of the annual U.S. gross domestic product ("GDP") will be eliminated by the end of this century with each one degree Celsius increase in temperature, with much of the impact being experienced in the Southern, central and mid-Atlantic regions.

Efforts to map flooding risk[3] have become more common. Utilities will be expected to invest in upgrading their infrastructure to mitigate against physical risks (e.g., wildfires in California). The number and intensity of extreme weather events has also been increasing. According to the CFTC report, a decline in real estate values because of climate-related risks could affect underlying mortgages, including the banks that hold these mortgages on their balance sheets, mortgage-backed securities, and government-sponsored enterprises. Extreme heat is expected to have a significant impact on human health, including causing significant increases in premature deaths and significant declines in labor productivity.

Transition risks are those that result from the uncertain economic impacts created by a transition to a net-zero emissions economy. Transition risks occur because of changes in technology, changes in policy or changes in consumer preferences. They also can occur when organizations fail to prepare for broader market transformations. For example, as U.S. electricity generation shifts away from coal or other fossil fuels, the potential for stranded costs increases.

There also will be technological risks as the country switches to new technologies to achieve net-zero emissions, such as all-electric vehicles or hydrogen-based fuels. The public and private sectors face climate-related legal risks from litigation and contract liability, and these costs are part of the transition risk. The United Nations-supported Principles for Responsible Investment ("PRI")[4] is an initiative designed to help markets understand the investment implications of environmental, social and governance ("ESG")

[3] https://floodfactor.com/.

[4] https://www.unpri.org/.

factors, including short and mid-term climate policies. The PRI has launched a flagship project titled "Preparing investors for the Inevitable Policy Response to climate change."[5]

WHAT DOES THIS MEAN FOR FINANCIAL INSTITUTIONS?

So, what does this mean for financial institutions? Current research suggests that systemic shock could occur because climate risk is underpriced and climate-exposed financial assets may be overvalued. These risks could also present sub-systemic shocks in a particular sector, asset class or region. For example, farmers experiencing repeated flooding in the Midwest could experience difficulty accessing insurance or credit. Liquidity could deteriorate quickly during shocks, as happened in the commercial paper market in the early days of the COVID-19 crisis.

The CFTC is primarily concerned with designated clearing organizations ("DCOs"), some of which have been designated as systemically important. Failure of these organizations could threaten the stability of the U.S. financial system, but financial institutions can use scenario planning and climate stress testing to manage these financial risks. Studies have shown that six percent of the properties held in the commercial mortgage-backed securities ("CMBS") market are in Federal Emergency Management Agency ("FEMA") flood zones, and that 2,000 CMBS loans are at risk of flooding along the East and West coasts.[6]

On the single-family residential side, this concern is clearly on the radar of the Federal Housing Finance Agency ("FHFA"). On January 19, 2021, the FHFA published a Request for Information on "Climate and Natural Disaster Risk Management at the Regulated Entities."[7] Comments are due in April.

A clear takeaway from the CFTC report is a strong desire for the prudential financial regulators and federal guarantors to seriously engage in scenario planning and climate stress testing on their regulated entities. Not far behind that effort will be pressure from regulators for entities who bear significant exposures to rebalance their risk profiles with climate change impacts in mind.

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[5] https://www.unpri.org/sustainability-issues/climate-change/inevitable-policy-response.

[6] *See, e.g.*, "Climate Risk in the Housing Market Has Echoes of Subprime Crisis, Study Finds," *The New York Times*, Sept. 27, 2019, https://www.nytimes.com/2019/09/27/climate/mortgage-climate-risk.html.

[7] https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-RFI-on-Climate-and-Natural-Disaster-Risk-Management-at-the-Regulated-Entities.aspx.

In June 2020, the Central Banks and Supervisors Network for Greening the Financial System ("NGFS")[8] published a "Guide to climate scenario analysis for central banks and supervisors"[9] to aid in this process. The Federal Reserve Board of Governors joined the NGFS in mid-December. As the U.S. continues engagement in international discussions, such as those with the Financial Stability Board ("FSB"), the application in the U.S. will be of considerable focus. For example, the FSB's November 2020 report, "The Implications of Climate Change for Financial Stability,"[10] warns that climate risks could "amplify credit, liquidity and counterparty risks and challenge financial risk management in ways that are hard to predict."

NEXT STEPS

The drafters of the CFTC report identified a number of key things that regulators can do:

- Provide oversight of physical and transition risk at a systemic level. This oversight would include ensuring that the entities they oversee have the capability and tools to manage climate risk effectively. The regulators should identify climate-related operational vulnerabilities in financial market utilities ("FMUs") and critical service providers as part of their oversight function.
- Utilize existing authorities, including the Financial Stability Oversight Council ("FSOC"), to identify risks and threats to financial stability in the U.S. Regulators have the ability to require annual stress tests so that regulators and the firms can better understand their risk profiles. This type of stress test is just beginning to be applied to climate-related risks in other parts of the world. Insurance regulators could also require stress testing.
- Under the Dodd-Frank Act, the Federal Reserve may require nonbank financial companies that it supervises and bank holding companies to periodically disclose information supporting a market evaluation of the risk profile, capital adequacy and risk management capabilities of those companies. Likewise, the U.S. Securities and Exchange Commission ("SEC") may obtain from publicly traded companies, via Regulation

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[8] https://www.ngfs.net/en.

[9] https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_scenario_analysis_final.pdf.

[10] https://www.fsb.org/2020/11/the-implications-of-climate-change-for-financial-stability/#:~:text=Climate%2Drelated%20risks%20%E2%80%93%20physical%20and,financial%20system%20responds%20to%20shocks.&text=The%20FSB%20will%20conduct%20further,well%20as%20any%20data%20gaps.

S-K, information about trends, events or uncertainties that are reasonably likely to have a material effect upon a company's financial condition or operating performance. The SEC reminded companies via guidance issued in 2010 to consider climate change and its consequences in making their disclosures, although the issuance of this guidance does not appear to have had a significant impact on the nature or consistency of climate-related disclosures. The Biden Administration may reemphasize the importance of climate-related disclosures through updated guidance or new regulations. The CFTC can likewise require a number of disclosures to market participants, both upstream and downstream, and these disclosures could include climate-related risks. State insurance regulators can also require insurance companies to disclose climate-related risk information, such as the percentage of their investments in fossil-fuel related industries, as recommended by the Task Force on Climate-Related Financial Disclosures ("TCFD"), although most do not at the present time. The SEC and CFTC can designate FMUs and other service providers as systemically important, as well as require that they incorporate climate-risk management protocols into their payment, clearing and settlement activities.

The drafters of the CFTC report recommended the following:

- All relevant federal financial regulatory agencies should incorporate climate-related risks into their existing authorities and develop a strategy for integrating these risks into their work, including developing tools for risk measurement and management.
- The FSOC should incorporate climate-related financial risks into its existing oversight function, including its annual reports to Congress.
- The FSOC should encourage its members to share best practices, build institutional capability, integrate climate-related risks into the regulatory framework and be alert to spill-over effects across the financial system.
- U.S. regulators should join international groups such as the NGFS,[11] the Coalition of Finance Ministers for Climate Action,[12] and the Sustainable Insurance Forum ("SIF").[13] The Federal Reserve should continue to participate in the Basel Committee on Banking Supervision's climate task force, and the SEC should continue to participate in

[11] https://www.ngfs.net/en.

[12] https://www.financeministersforclimate.org/.

[13] https://www.sustainableinsuranceforum.org/.

the sustainable finance network established by the International Organization of Securities Commissions ("IOSCO").

- Regulators should undertake pilot climate-risk stress testing as recommended by the NGFS.
- Financial authorities should consider integrating climate risk into their balance sheets, and should support the development of appropriate classification systems for physical and transition risks.
- Financial regulators should clarify the definition of materiality for disclosing medium- and long-term climate risks.
- The U.S. should establish a price on carbon.

CAREFUL PLANNING REQUIRED

Although much about the future is uncertain, one thing learned from the global pandemic is that careful planning is required to manage any crisis, and all crises have an impact on financial institutions and their role in the larger economy. Climate risk is no different and presents significant challenges, including to financial institutions. How those risks are best managed will remain a topic of discussion for the foreseeable future, so now is the time for financial institutions and regulators to focus on this important task.

CONCLUSION

In summary,

- The Commodity Futures Trading Commission issued a report in September 2020 highlighting the risk that climate change poses to the stability of the U.S. financial system and the economy. The report, "Managing Climate Risk in the U.S. Financial System," was a detailed study of the topic that will provide insights to the Biden Administration's team of regulators.
- The CFTC report emphasized that regulators have sufficient existing legislative authority to begin addressing climate-related risks now, through better oversight, risk management and disclosures.
- Major findings in the report include:
  (1) More consistent, reliable, and comparable data is needed to make this task meaningful and manageable;
  (2) Regulators and companies can use scenario planning and climate stress testing to reduce climate risks; and
  (3) An economy-wide price on carbon would allow financial markets to help reduce greenhouse gas emissions more efficiently.

- The CFTC effort is a significant, but overlooked, piece of the puzzle in light of the work of the Federal Reserve Board of Governors, the Financial Stability Oversight Council, the Federal Housing Finance Agency, the Council of State Bank Supervisors, and the National Association of Insurance Commissioners in assessing the impact of climate change on the financial system.