A Call to Internalize Greenhouse Gas Cost Externalities: CFTC Subcommittee Publishes First-of-Its-Kind Report Regarding Climate Change's Impact on Financial Markets

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Amid the recent, almost daily news of raging wildfires in the western United States and elsewhere, increasingly destructive and deadly hurricanes in the southeast, and record high temperatures in many locations around the world, the Climate-Related Market Risk Subcommittee (Subcommittee) of the Market Risk Advisory Committee (MRAC) of the Commodity Futures Trading Commission (CFTC) unanimously voted on September 9, to publish a wide-ranging report (Report) warning of climate change's potential adverse effects on the stability of the US financial system.[1]

The publication of this unprecedented Report marks the first time a US financial regulator has ever released a report or statement that highlights the risks of climate change from a financial stability perspective.

The Report contains an extensive set of findings and recommendations which are highlighted in this Katten advisory. The key finding of the Report is that climate change is likely to have significant adverse effects on the US financial system on both a systemic and sub-systemic level. The key recommendation is that the United States should establish a fair, economy-wide price on carbon that reflects the true social cost of pollution and that will enable financial markets to channel resources efficiently to activities that reduce greenhouse gas (GHG) emissions.

Background

More than a year ago, CFTC Commissioner Rostin Behnam, who is the MRAC's sponsor, publicly stated that he intended to form a panel of experts and produce a report on the effects of climate change on US financial markets.[2] As a former staffer for US Senator Debbie Stabenow, a Michigan Democrat serving on the Senate Agriculture Committee, Commissioner Behnam has been outspoken in his views on actively combatting climate change.[3]

Shortly after Commissioner Behnam's public statements, the Subcommittee was formed for the purpose of preparing a report on climate-related financial and market risks. The Subcommittee presently consists of 34 members who represent the financial services, agriculture and energy industries, academia, environmental and financial market policy groups, and is chaired by Robert Litterman who is a respected economist, former risk-management executive within the financial services industry and currently an authority on climate change research.

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[1] *Managing Climate Risk in the U.S. Financial System: Report of the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission* (2020), 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.

[2] Coral Davenport, "Climate Change Poses Major Risks to Financial Markets, Regulator Warns," *New York Times* (June 11, 2019), https://www.nytimes.com/2019/06/11/climate/climate-financial-market-risk.html.

[3] *Id.*

Managing Climate Risk

In his foreword to the Report, Mr. Litterman highlighted the importance of managing climate risk and noted that, in order "[f]or the financial risk management of climate change to succeed, we need to be able to understand how physical climate impacts and the transition to a sustainable economy will affect the valuations of financial instruments."[4] According to Mr. Litterman, the Report represents a consensus among the Subcommittee members — who traditionally may not have generally agreed on ways to address climate change — on proposed ways to properly identify and address climate risks to the US financial system.

In making various key findings and setting forth 53 recommendations intended to mitigate climate change risks to financial markets, the Report draws heavily from the prior work of various international groups and individuals, including the World Bank, the Bank for International Settlements and multiple central banks such as the Bank of England.

CFTC's Stance

It is important to note that the Report only reflects the views of the Subcommittee and has not been formally endorsed by the MRAC, the CFTC or the US government more broadly. In his recent remarks, CFTC Chairman Heath P. Tarbert tried to strike a balance on the issue by acknowledging the existence of climate risks cited in the Report, but also highlighting that the risks associated with government efforts to mitigate climate change may be "just as disruptive" to US financial markets.[5]

Central Findings of the Report

The Report embraces two fundamental conclusions:

- US financial regulators must accept that climate change is introducing material emerging risks to the US financial system and that they "should move urgently and decisively to measure, understand and address these risks";[6] and
- the financial industry should provide solutions and not solely be reactive.

In one of its first specific findings, the Report affirmatively concludes that climate change poses significant risks to "nearly every facet of the US economy."[7] The Report also defends its position as consistent with "the US government's official position on the scientific consensus on the causes, occurrence, and impacts of climate change,"[8] citing the recent Fourth National Climate Assessment presented to Congress, which finds that it is "extremely likely that human activities, especially emissions of greenhouse gases, are the dominant cause of the observed warming since the mid-20th century."[9]

The Report further concludes that "financial markets will only be able to channel resources efficiently to activities that reduce greenhouse gas emissions if an economy-wide price on carbon is in place at a level that reflects the true social cost of those emissions."[10] Relying on the classical underpinnings of macroeconomics, the Report argues that GHG emissions are "a powerful example of a negative externality," and that establishing a price for carbon emissions would enable financial markets to more efficiently and effectively manage climate risks.[11] As Mr. Litterman pointed out in his foreword, "[a] fundamental flaw in the economic system lies at the heart of the climate change problem — the lack of appropriate incentives to reduce GHG emissions."[12]

4 Report at xx.

5 Andrew Ackerman, "Climate Change Poses Major Risk to Financial Stability, Report Finds," *Wall Street Journal*, (Sept. 9, 2020), https://www.wsj.com/articles/climate-change-poses-major-risk-to-financial-stability-report-finds-11599668612.

6 Report at ii.

7 *Id.* at 11.

8 *Id.* at 2.

9 *Id.* (citing *Climate Science Special Report: Fourth National Climate Assessment, Volume I*, U.S. Global Change Research Program (2017)).

10 *Id.* at ii.

11 *Id.* at 4.

12 *Id.* at xix.

Other central findings of the Report include the following:

- US financial regulators currently possess many flexible authorities and tools under existing legislation to begin to address climate change risks without further legislative action;
- insufficient analytical tools and data, as well as the absence of common definitions and standards for data and financial products, constitute a critical constraint on financial regulators' ability to mitigate climate risks;
- under existing disclosure regimes, corporate disclosures on measuring and managing climate-related financial risks have not been "sufficiently useful to market participants and regulators";[13] and
- derivatives markets can play a role in mitigating various barriers that have historically reduced the capital allocated to sustainable economic activities.

Key Recommendations of the Report

As mentioned above, the Report contains broad-ranging recommendations aimed at a variety of audiences, beyond just the CFTC and even beyond other financial regulators.

For example, in line with the findings indicated above on carbon pricing, the Report asserts that the "single most important step to manage climate risk and drive the appropriate allocation of capital" is establishing an economy-wide carbon price, consistent with the Paris Agreement on climate change.[14] Such a carbon pricing policy should consider and address the following principles: fairness (with respect to how costs and benefits are allocated among income groups); scope (i.e., generally applicable or industry specific); and effectiveness in achieving reductions in emissions.[15] The Report acknowledges that implementing this recommendation would require significant Congressional action.

At an even more general level, the Report urges US policymakers to broadly integrate climate risk into government fiscal policy. Government spending programs — like those addressing economic stimulus, disaster relief and infrastructure — could be structured to decrease climate risks and promote job creation. In addition, the Report notes that the government has the capacity to "drive continued innovation" through allocating resources to scientific research and technology deployment, and that the government could establish and expand programs intended to "de-risk" and attract additional private capital to products designed to mitigate climate risks.[16] These recommendations would require the participation of a wide range of government actors, beyond the CFTC and other US financial regulators.

Many of the other recommendations in the Report focus on actions that can be taken specifically by the CFTC and other US financial regulators, some of which could be undertaken without any legislative action on the part of Congress. Other key recommendations include the following:

- federal financial regulators should integrate climate risks into their mandates, develop risk-mitigation strategies that address those risks, and undertake research on the potential financial impact of those risks;
- the Financial Stability Oversight Council should incorporate climate risks into its oversight activities, as part of its mandate to identify and monitor threats to financial stability;
- financial supervisors should conduct pilot climate-risk stress testing and require the entities they regulate to account for climate risks in their existing risk management frameworks;
- regulators should update and amend existing disclosure frameworks to ensure the availability of more consistent and useful climate-risk disclosures by market participants;

13 *Id.* at v.

14 *Id.* at 9.

15 *Id.* at 6.

16 *Id.* at 108-09.

- financial regulators should establish climate finance "sandboxes," or other regulatory relief schemes, to encourage innovative financial product development, particularly in derivatives markets, to address climate risks;
- to further support innovation in climate-related derivatives markets, the CFTC should survey market participants regarding currently-available climate-related derivatives and data; consider issuing specific exemptive relief to promote market development; study and adopt alternative execution methods that could attract additional capital to climate-related markets; and work alongside other regulators to help develop a more "robust ecosystem of climate-related risk management products";[17] and
- insurance regulators should require climate-based underwriting and investment assessments, as well as related risk disclosures.

Next Steps

Relying on the Report, Commissioner Behnam has moved quickly to urge "policymakers, regulators, and stakeholders [to] begin the process of taking thoughtful and intentional steps toward building a climate-resilient financial system that prepares our country for the decades to come."[18] He has arranged a number of speaking engagements, in part, to promote the Report's recommendations and stress one of its many warnings that time is of the essence in addressing climate change's impacts on US financial markets.[19]

Similar Report by FIA

Separately, the Futures Industry Association (FIA) recently issued a climate change report of its own, focusing specifically on the important role that derivatives markets play in assisting those needing to hedge climate change risks.[20] The FIA report also identified ways in which the derivatives industry can assist in the fight against climate change by fostering innovation and market-driven solutions and supporting shared standards and best practices with regard to sustainability. Finally, the FIA report emphasized the importance of regulatory harmonization in order to encourage consistency in policy actions across jurisdictions.

17 *Id.* at 117.

18 "CFTC's Climate-Related Market Risk Subcommittee Releases Report," CFTC Release No. 8234-20 (Sept. 9, 2020), https://www.cftc.gov/PressRoom/PressReleases/8234-20.

19 Such speaking engagements include, for example, participation in panels hosted by the Bipartisan Policy Center, CERES, Duke Law School and Bloomberg. See CFTC, Press Room: Events, https://www.cftc.gov/PressRoom/Events.

20 FIA, How Derivatives Markets Are Helping the World Fight Climate Change (Sept. 2020), https://www.fia.org/sites/default/files/2020-09/FIA_WP_Sustainable_Finance.pdf.

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