CLIENT ALERT

CFTC Subcommittee Publishes Report Warning of Risk to Financial Markets Posed by Climate Change

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AUTHORS

Athena Eastwood | Michael Hartz

On September 9, 2020, the CFTC's Climate-Related Market Risk Subcommittee (the "Climate Subcommittee") of the Market Risk Advisory Committee (the "MRAC") released the first-ever U.S. government report detailing the risks of climate change to the stability of the U.S. financial system. The report, titled "Managing Climate Risk in the U.S. Financial System," presents 53 recommendations to mitigate the risks to financial markets posed by climate change.

In a press release issued today, Commissioner Rostin Behnam, MRAC sponsor, stressed that "[b]eyond their physical devastation and tragic loss of human life and livelihood, escalating weather events also pose significant challenges to our financial system and our ability to sustain long-term economic growth. Now, with this report in hand, policymakers, regulators, and stakeholders can 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."[1]

In preparing the report, the Climate Subcommittee drew on the expertise of a diverse group of industry professionals, including energy and agricultural producers, financial institutions, commercial end-users, academic institutions and

1 Commodity Futures Trading Commission, *CFTC's Climate-Related Market Risk Subcommittee Releases Report* (Sep. 9, 2020), here.

nonprofit organizations.[2] The Climate Subcommittee was formed in 2019 under CFTC Chairman J. Christopher Giancarlo. The Climate Subcommittee voted unanimously 34-0 to adopt the report, which can be accessed here.

Climate Change Poses Risks to the U.S. Financial System

According to the report, climate change is anticipated to impact nearly every facet of the U.S. economy, from agriculture and energy to real estate and infrastructure across varying geographies and assets, possibly simultaneously. However, rather than extensively detailing the physical risks of climate change (*e.g.,* rising temperatures and volatile weather patterns), the report primarily focuses on the risks that extreme weather events and changing weather patterns pose to financial markets. The report explains that the impact to the financial system could be systemic, meaning that conditions could allow a given shock to propagate widely thus magnifying its effect with the potential to spill over into the real economy. This could result in limited access to credit, insurance and hedging instruments when needed the most.[3]

The report also describes so-called transition risks, namely those risks presented by the nation's transition to a net-zero emissions economy, which likely will be accompanied by rapid changes not only in policy, but also in technology and consumer preferences. The transition itself poses risks to the extent that market participants are unable to quickly adapt to such changes. Moreover, systemic shocks are more likely when financial markets and prices do not fully internalize these physical and transition risks. Indeed, a "sudden revision of market perceptions about climate risk could lead to a disorderly repricing of assets, which could in turn have cascading effects on portfolios and balance sheets and therefore systemic implications for financial stability."[4]

Regulators and Congress Urged to Protect Against Risks

Although the report is largely focused on how regulators can leverage existing frameworks to address these risks today, a fundamental finding of the report is that Congress must act to establish a price on carbon. The report 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. Addressing climate change will require policy frameworks that incentivize the fair and effective reduction of greenhouse gas emissions. In the absence of such a price, financial markets will operate suboptimally, and capital will continue to flow in the wrong direction, rather than toward accelerating the transition to a net-zero emissions economy."[5]

2 Commodity Futures Trading Commission, *CFTC Commissioner Behnam Announces Members of the Market Risk Advisory Committee's New Climate-Related Market Risk Subcommittee* (Nov. 14, 2019), here.

3 Commodity Futures Trading Commission, *Managing Climate Risk in the U.S. Financial System* at i (2020).

4 *Id.* at ii.

5 *Id.*

While the lack of a carbon price, as well as insufficient data and analytical tools to adequately measure risk remain obstacles, the report finds that, in general, existing legislation provides U.S. financial regulators with many of the tools needed to start addressing climate risk today. This is particularly true in the areas of financial stability oversight, risk management requirements for particular dealers and markets, disclosure requirements and investor protection. The report recommends that regulators act swiftly to incorporate climate-related risks into their mandates and develop a strategy for integrating these risks into their existing monitoring and oversight functions.

Serving as both a warning and a blueprint, the report outlines a number of areas for immediate attention, including:

- Access to data: Regulators and market participants need reliable and consistent data for risk management.
- Development of common definitions and standards: While progress has been made, standardized definitions for climate risk data are required for effective disclosure and risk management. These also are needed for comparing markets for financial products labeled as "green" or "sustainable."
- Use of climate-related scenario analysis: This can be a useful tool enabling regulators and market participants to understand and manage climate-related risks.
- Mandatory disclosures: Corporate disclosures of material, climate-related financial risks are essential to ensure that these risks are managed effectively.
- Financial innovation: Commodity derivatives exchanges could address climate and sustainability issues by incorporating sustainability elements into existing contracts and by developing new derivatives contracts to hedge climate-related risks.

These and other recommendations are addressed in greater detail in the report available here. For further information, the Bipartisan Policy Center will be hosting a webinar, with Q&A, on Thursday, September 10, at 9:30 a.m. Details for this webinar are available here.

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If you have any questions regarding this client alert, please contact one of the authors, any member of our CFTC team listed below, or the Willkie attorney with whom you regularly work.

Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

Athena Eastwood 202 303 1212 aeastwood@willkie.com	**J. Christopher Giancarlo** 212 728 3816 jcgiancarlo@willkie.com	**Rita M. Molesworth** 212 728 8727 rmolesworth@willkie.com	**Paul J. Pantano Jr.** 202 303 1211 ppantano@willkie.com
Deborah A. Tuchman 212 728 8491 dtuchman@willkie.com	**Conrad G. Bahlke** 212 728 8233 cbahlke@willkie.com	**Lisa Eskenazi** 212 728 3349 leskenazi@willkie.com	**Neal E. Kumar** 202 303 1143 nkumar@willkie.com
James E. Lippert 212 728 8945 jlippert@willkie.com	**Steven C. Matos** 212 728 8757 smatos@willkie.com	**Michael Hartz** 202 303 1161 mhartz@willkie.com	