

CFTC Identifies Climate-Related Financial Risks and Urges Action from Financial Regulators and Legislators

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On September 9, 2020, the Climate-Related Market Risk Subcommittee of the U.S. Commodity Futures Trading Commission published a report, [Managing Climate Risk in the U.S. Financial System](#), describing the links between climate change and the U.S. financial system. The Report was largely the product of efforts from its sponsor, CFTC Commissioner Rostin Benham, but was prepared with input from the Subcommittee, comprised of over 30 stakeholders, including banks; investment firms and advisors; oil and gas companies; and public interest and non-profit organizations.

The Report makes two key arguments. First, climate change poses major risks to the stability of the U.S. financial system and its institutions. Second, U.S. financial regulators must move swiftly to understand, measure and address those risks. To that end, the Report makes 53 recommendations for federal and state regulators, legislators, and financial and business leaders to manage climate change and mitigate its impacts.

Climate-Related Risks to the U.S. Financial System

The Report argues that climate change poses two types of systemic risks—physical and transition—to the U.S. financial system. According to the Report, a failure by U.S. financial systems and market participants to address and adapt to climate risks will greatly disrupt the U.S. economy. Such failure will not only affect the health of financial institutions, but will destabilize infrastructure, agriculture, residential and commercial property, human health and labor productivity.

Physical Risks. The Report defines physical risks as material impacts resulting from climate change, such as sea-level rises, more frequent and severe weather events and increases in concentrations of greenhouse gas, or GHG emissions in the atmosphere. While the estimates of physical risks vary considerably by sector, the Report suggests that by the end of the century, the negative impacts on the U.S. economy will “amount to about 1.2 percent of annual gross domestic product, or GDP for every 1 degree Celsius increase”, which is essentially equal to eliminating half of the average annual GDP growth rate in recent years.

Transition Risks. The Report defines transition risks as “market, credit, policy, legal, technological, and reputational” impacts that occur to institutions that fail to implement measures to mitigate climate change (namely, by failing to transition to a net-zero economy). Transition risks will negatively impact certain industries more than others. Oil and gas companies, for instance, which rely heavily on fossil fuel or emissions-producing assets and technologies will be at greater risk if they do not invest in renewable energy or sustainable products and services. Similarly, the Report cites an academic study suggesting that investment firms whose portfolios focus on “greener” investments will outperform those whose portfolios do not.

Recommendations for Change

According to the Report, the U.S. financial system will be “better positioned to absorb and recover from climate-related shocks” if it measures and manages these risks through more active efforts of financial regulators and legislators, who already have administrative authority to advance these initiatives. Of the 53 recommendations to enable market players to adapt to climate change, the following recommendations are those the Report considers the most important.

- Pricing Carbon. The U.S. should set a price on carbon that applies to the entire economy and that would reduce GHG emissions in line with the Paris Agreement.
- Climate Change Disclosure. Financial regulators should mandate disclosure of material climate-related risks in financial filings and clarify the definition of materiality for medium- and long-term risks (both qualitative and quantitative). Mandated disclosure would, according to the Report, better educate investors on the most salient physical and transition risks of a sector, resolve ambiguity surrounding the materiality of climate-related risks and make data which regulators can use to adequately measure those risks more readily available.
- Greater Financial Regulatory Oversight. Federal and state regulators should work closely with financial institutions to undertake “pilot climate risk stress testing” for sectors (particularly for agriculture, community and regional banks) to identify the particular risks posed to each sector and enable regulators to tailor their regulations accordingly.
- Updates to Internal Risk Management Frameworks. Financial supervisors should require bank and non-bank financial firms to update their existing risk management frameworks to address climate-related risks. Firms should incorporate climate risk management into the broader corporate governance framework, for example by adding climate change monitoring to the “clearly defined oversight responsibilities in the board of directors”.
- CFTC-Specific Climate Program. The CFTC should create a research program to understand how climate-related risks impact markets and participants now and in the future. Under the program, the CFTC should develop plans to better supervise the financial markets to assist their adoption of climate-risk mitigation measures.

Members of the Climate-Related Market Risk Subcommittee have since issued written public statements about the Report and its recommendations. In a [joint statement](#), Citi, JPMorgan Chase and Morgan Stanley expressed their support of the “overarching goal of advancing efforts” to address climate-related financial risks, “including at regulatory agencies”. Four other Subcommittee members issued separate statements generally supporting the Report and noting a willingness to better understand the financial and other systemic risks that the Report identifies.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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