Regulatory Alert

Regulatory Insights

September 2020

Managing climate risk in the financial system – CFTC subcommittee report

The Climate-Related Market Risk Subcommittee (Climate Subcommittee) under the CFTC's Market Risk Advisory Committee has released a report and recommendations on Managing Climate Risk in the U.S. Financial System. The report is not binding on the CFTC or market participants but may signal evolving public policy and regulatory expectations within financial services.

Key points

The report of the Climate Subcommittee calls on financial regulators to move "urgently and decisively" to measure, understand, and address climate risks, noting:

— Climate change poses serious emerging risks to U.S. financial stability and may exacerbate vulnerabilities in the financial system that are unrelated to climate change.

— Financial regulators have existing authority to begin to incorporate climate-related risk management into their regulatory and supervisory frameworks in areas of oversight of systemic financial risk, risk management of particular markets and financial institutions, disclosure and investor protection, and safeguarding of financial sector utilities.

— Initial efforts may be constrained by barriers, including available data, analytical tools, and the quality of disclosure.

— Policy and regulatory choices should be flexible, open-ended, and adaptable to new information based on experience, research, and iterative dialogue with the private sector.

— Establishing an economy-wide price on carbon emissions is fundamental to decisively addressing climate change though beyond the remit of financial regulators.

— A coordinated national response is necessary and U.S. participation in international initiatives should be more robust.

CFTC anticipates the Climate Subcommittee's report will serve as the basis for policymakers, regulators, and stakeholders to take "thoughtful and intentional steps" toward building a climate-resilient financial system. The report calls for financial services regulators to work closely with the private sector to ensure that financial institutions and market participants together address the risks, adopt current systems, and innovate new approaches to effectively move forward. It further suggests that extreme weather events, such as the West Coast wildfires and the Gulf Coast hurricanes, which may result in financial vulnerabilities associated with prolonged fiscal deterioration, stressed business balance sheets, and depleted household wealth, increase the importance and urgency of managing climate-related risk.

The Climate Subcommittee's key findings include these observations:

— Climate change could pose systemic risks to the financial system as well as "sub-systemic" shocks (defined as those that affect a particular sector, asset class, or region)
— Current legislation provides financial services regulators with authorities that could be used to begin addressing climate risks
— Efforts to understand, monitor, and manage climate risk are in the early stages for regulators and market participants alike
— Measuring and managing climate-related financial risks is constrained by insufficient data and analytical tools as well as a lack of common definitions and standards for climate-related financial products
— Demand for disclosure of material, climate-relevant financial risks is growing but existing disclosure regimes have not resulted in disclosures of scope, breadth, or quality to be sufficiently useful to market participants and regulators
— 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
— Additional barriers holding back capital for sustainable, low-carbon activities, include misperceptions regarding financial returns on sustainable investments and the size of "green" markets, concerns regarding "greenwashing," and policy uncertainties
— The U.S. is not fully engaged with, or supportive of, international climate initiatives—it is a "reluctant participant."

The Climate Subcommittee's key recommendations include the following:

— Federal financial regulatory agencies should:
  – Incorporate climate-related risks into their mandates and integrate these risks into their regulatory and supervisory frameworks
  – Require bank and nonbank financial firms to address climate-related financial risks through existing risk management and governance frameworks
  – Undertake research on the financial implications of climate-related risks
  – Clarify the definition of materiality for disclosing medium- and long-term climate risks, including quantitative and qualitative factors, and update existing guidance on climate risk disclosure
  – Integrate climate risk into balance sheet management and asset purchases
  – Establish labs or regulatory sandboxes to enhance the development of innovative climate risk tools and financial products and services
  – Join, as full members, international groups convened to address climate risks
  – Work with the private sector to:
    – Undertake pilot climate risk stress testing for financial institutions, including mandating assessment against a consistent and common set of broad climate risk scenarios, guidelines, and assumptions
    – Support the availability of consistent, comparable, and reliable climate risk data and analysis
    – Support development of U.S. appropriate standardized and consistent classification systems or taxonomies for physical and transition risks, exposure, sensitivity, vulnerability, adaptation, and resilience.
— State insurance regulators should require insurers to assess the impact of climate-related risks on their underwriting activity and investment portfolios.
— Policymakers should:
  – Establish a price on carbon to reduce net greenhouse gas emissions
  – Integrate climate risk into fiscal policy, particularly for economic stimulus activities covering infrastructure, disaster relief, or other federal rebuilding
  – Consolidate and expand government efforts such as loan authorities and co-investment programs addressing market failures
  – Review relevant laws, regulations, and codes and provide any necessary clarity to confirm the "appropriateness" of making investment decisions using climate-related factors in ERISA retirement and pension plans and non-ERISA managed situations where there is a fiduciary duty (i.e., clarify that ESG factors may be considered to the same extent as "traditional" financial factors.)

The Climate Subcommittee states that the views, analyses, and conclusions expressed in the report reflect the work of the Climate Subcommittee and do not necessarily reflect the views of the Market Risk Advisory Committee, the CFTC, or the U.S. government.

The Climate Subcommittee was established in July 2019 to "identify and examine the risks that climate change poses to the stability of [the] financial system, and determine what future actions policymakers and market participants must consider to mitigate these risks." It is comprised of 34 members representing the financial markets, banking and insurance sectors, agricultural and energy markets, the environmental and sustainability public interest sector, data and intelligence service providers, and academia.

For additional information on climate-related financial risks or ESG issues more generally, please contact Amy Matsuo, Larry Godin, Todd Semanco, or Michael Scarpa.

Amy Matsuo
Principal and National Lead
Regulatory Insights
T: 919-664-7302
E: amatsuo@kpmg.com

Contributing authors:
Amy Matsuo, Principal and National Lead, Regulatory Insights

Karen Staines, Director, Regulatory Insights

kpmg.com/socialmedia