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Graham S. Steele
Staff Director, Corporations and Society Initiative
Stanford Graduate School of Business

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Mr. Robert B. Litterman
Chairman
Climate-Related Market Risk Subcommittee
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Mr. Litterman:

The recent stress in financial markets caused by the COVID-19 pandemic is an important reminder that shocks do not just come from shocks that are both endogenous and exogenous to the financial system. Indeed, Federal Reserve Bank of New York President John Williams likened the economic impact of COVID-19 to that of a "natural disaster of global proportions."[1] In this sense, COVID-19 provides valuable lessons about the prospective risks of climate change, to say nothing of the impact that climate-linked industries like oil and gas are experiencing in the present moment.[2] Below I will outline the types of climate risks, the systemic nature of these risks, and some policy responses within the CFTC's jurisdiction as a regulator, as well as its capacity as a member of the Financial Stability Oversight Council.[3]

Climate change poses risks by causing physical damage as well as losses to certain asset classes from the transition away from a carbon-based economy. These risks can then manifest in financial transactions by increasing the risk of a credit default or by impairing the operation of financial markets. Those risks can then spread throughout the financial system through either troubled counterparties or assets. Climate-related risks have the potential to compound: the more that financial institutions invest in fossil fuels, the more climate change they cause, leading to more potential and actual damage to their investment assets. Financial institutions' continued investment in carbon-intensive assets increases the costs of the transition to a clean energy economy.

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[1] John C. Williams, President, Fed. Reserve Bank of N.Y., "A Time for Bold Action," Remarks at Economic Club of New York, Apr. 16, 2020.
[2] *See* Graham Steele, *A Climate Bailout Is a Big Finance Bailout*, THE AMERICAN PROSPECT, Apr. 22, 2020, https://prospect.org/economy/climate-bailout-is-big-finance-bailout/.
[3] These points are essentially a summary of my article *Confronting the 'Climate Lehman Moment': The Case for Macroprudential Climate Regulation*, forthcoming in the CORNELL JOURNAL OF LAW & PUBLIC POLICY, and available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3542840.

The potential for a climate-driven financial event has been given such names as the "climate Minsky moment" or "green swan" event. Such events are driven by financial institutions' investments in the drivers of climate change, primarily fossil fuels, deforestation-related commodities, and the "carbon majors," that produce two sets of negative externalities. First, there is the carbon pollution that is pumped into the air that falls on governments to abate in some fashion. Second, there are the financial risks that threaten to grow into distress that spreads from the financial system to the broader economy, resulting in bailouts. The financial sector's ability to support the economy depends on whether the financial system is vulnerable to, or resilient in the face of, a climate crisis. Ex ante regulation will keep markets functioning and avoid making public authorities into "climate rescuers of last resort."

Threats to financial stability require a macroprudential framework that attempts to anticipate emerging risks, account for interlinkages across various financial sectors, and regulate system-wide risks in a comprehensive manner regardless of entity or market-type. The major proposed innovation in climate-related macroprudential regulation is 'stress testing'—the measurement of potential risks in hypothetical market scenarios. This is an important avenue for measuring and understanding a range of quantitative issues related to climate risk, from institutions' carbon footprints to second-order effects of climate-related stresses on companies' balance sheets.

Effective macroprudential climate regulation requires prudential rules for climate change-driving investments, including heightened capital and margin requirements for lending, securities, derivatives, and commodities transactions that contribute to climate change, and therefore increase climate-related financial risks. These regulations could be applied at the individual transaction level, or at the aggregate portfolio level. Ideally, such rules would be designed with the aim of requiring financial institutions to internalize the costs of the dual externalities created by those activities. Depending upon the impact of these mechanisms, regulators might also consider more robust interventions, such as impose portfolio limits on financial institutions based upon aggregate financing or carbon emissions. These regulations could be instituted for the largest bank holding companies, asset managers, and insurance companies by the Federal Reserve on a consolidated basis following FSOC designation, or, failing that, by functional regulators such as the CFTC.[4]

Regulators have a range of tools at their disposal to move beyond mere quantification and disclosure and meet the urgency of the climate crisis. Macroprudential measures, while necessary, are not sufficient to fully mitigate climate risk. In addition to addressing

[4] The Commodity Exchange Act, the CFTC can establish capital and margin requirements for swap dealers, *see* 7 U.S.C. § 6(e), and require company-run stress tests by any regulated company with $250 billion or more in total assets, *see* 12 U.S.C. § 5365(i)(2).

the role of financial institutions in *creating* climate risk, policy makers must also make the financial more resilient to the *effects* of climate change. Recalibrating the potential risks of asset classes, communities, and entire geographic regions that are most vulnerable to climate change raises issues of socioeconomic and racial equity and inclusion, and needs to be part of a comprehensive investment plan that ensures these communities are being made more climate resilient.

In closing, I would like to make one final point about the subcommittee's composition. A number of the members of the subcommittee represent either companies that are directly responsible for the drivers of climate change or financial institutions that finance the drivers of climate change, and therefore would be affected by significant climate financial regulations. In my view, the subcommittee would be wise to explain the measures it has taken to address any conflicts, both real and perceived, as well as provide greater transparency into its deliberative process so that the public has full confidence in the integrity of its work product.

Thank you for considering my views on this important matter.

Sincerely,

Graham Steele

Graham S. Steele (steele63@stanford.edu)
Staff Director
Corporations and Society Initiative
Stanford Graduate School of Business