

CFTC Climate Risk subcommittee: Climate Safe Lending and Positive Money submission

Climate Safe Lending and Positive Money welcome the opportunity to respond to the CFTC Climate Risk subcommittee's call for evidence.

Positive Money is a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

Climate Safe Lending is a network of diverse bank stakeholders from across North America and Europe who are collaborating to move align bank lending with a less than 2 degree global temperature rise.

(1) whether climate change poses systemic risks to our economy

Climate change presents two types of immediate risk to the financial sector, and therefore to the economy as a whole. These are: i) 'transition' risk, meaning the revaluation of assets due to changes and costs associated with the shift to a low-carbon economy, and ii) 'physical' risks, meaning the damage and resultant loss in value that occurs due to weather and climate-related events. An additional subsequent risk is the higher leverage across the private sector that will likely result from an attempt to compensate for output and capital losses from climate change.

'Transition' risk results from the revaluation of assets due to changes and costs associated with the shift to a low-carbon economy. The valuations of fossil fuel firms are based on the anticipation of extraction that push warming far in excess of global climate targets. The overvaluation of fossil fuels (or other high-carbon industries) is called the 'carbon bubble'.¹ Financial instability will be caused by the inevitable bursting of the bubble, so if we account for transition risk now, we can - in theory - deflate the carbon bubble in a more managed and less volatile way. Financial losses from the drop in value of fossil fuels is already underway: for example, a Carbon Tracker Initiative report showed how the EU's largest five power generators collectively lost over 37 per cent of their value from 2008 to 2013.² And projections published by Mercer show that 'annual returns from the coal sub-sector could fall by anywhere between 18 per cent and 74 per cent over the next 35 years'.

'Physical' risk is the damage and resultant loss in value that occurs due to weather and climate-related events like floods and storms. Extreme weather events can have a dramatic effect even over a relatively short time period. An example is the Pacific Gas & Electric

¹ https://www.banktrack.org/download/unburnable_carbon/unburnablecarbonfullrev2.pdf

² https://www.carbontracker.org/reports/eu_utilities/

company, which filed for bankruptcy following the wildfires in California in 2017. The big challenge is how to calculate this type of risk. Given the inherent unpredictability associated with many aspects of climate change and the damage it will cause, physical risks are not necessarily calculable and may be better framed as sources of radical uncertainty.³

The International Energy Agency (IEA) and International Renewable Energy Agency (IRENA) calculate that losses from stranded assets in the upstream energy, electricity generation, industry and buildings sectors alone would reach \$20 trillion, if policy action is delayed. However these costs could be significantly reduced if decarbonisation efforts are accelerated, with the IEA and IRENA estimating that such losses would be halved in scenarios where two-thirds of the global energy supply is provided by renewable sources by 2050.⁴

Finally, a recent study on debt and climate change by Bovari et al. identifies high levels of leverage across the private sector, resulting from likely efforts to compensate output and capital losses due to the impacts of climate change, as another source of considerable prudential risk.⁵ While this source of risk is as of yet under-acknowledged in the wider literature, it has the potential to further endanger financial stability beyond the immediate transition and physical risks discussed above.

(2) the need for mandatory disclosure of material climate risks and opportunities

Without comprehensive disclosure it is difficult for investors to assess their exposure to climate risks. A recent global report on the uptake of disclosures under the Taskforce for Climate Related Financial Disclosures (TCFD) showed that the average number of recommended disclosures per company is just a third of the 11 the TCFD recommends, while nearly a quarter of large companies have made no TCFD-aligned disclosures whatsoever.⁶ If the current rate of progress continues, the number of disclosures per company won't reach the necessary level until 2028, which is far too late.

(3) importance of robust and rapid actions by federal financial regulators to address climate risks

While most governments have committed to limit the global temperature rise to as near as possible to 1.5°C, the financial system is still financing emissions that will trigger runaway warming that exceeds 4°C.⁷ Unless financial flows are urgently reoriented, our efforts to address the climate crisis have no chance of success.

³ <https://positivemoney.org/2019/10/climate-risk-vs-uncertainty-in-financial-policy-making/>

⁴ https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2017/Mar/Perspectives_for_the_Energy_Transition_2017.pdf

⁵ <https://www.sciencedirect.com/science/article/pii/S2110701717302615>

⁶ <https://www.fsb-tcfd.org/publications/tcfd-2019-status-report/>

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<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/bank-of-england-financial-stability-reports/oral/106363.html>

Banks and insurers, and the financial system as a whole, face catastrophic consequences if they fail to adapt. If warming is left unchecked, extreme weather events will cause devastating losses. And if markets fail to anticipate regulation that makes future activity unviable, carbon-exposed firms and their supply chains could see a sudden and significant drop in value.

Federal financial regulators can guide the reallocation of capital, so that markets are aligned with global climate goals as quickly and smoothly as possible. This could include the following measures:

- Stress tests on climate risk could help to identify potential shortfalls in firms' ability to withstand shocks, and force them, where necessary, to change course.
- Mandatory disclosures of climate risks by banks and insurance companies, consistent with the recommendations by the Taskforce for Climate Related Financial Disclosures, would make it easier for investors to assess their exposure, issuers to reprioritise their long-term investment strategies and for regulators to identify weaknesses across the system.
- This should include disclosure of financed emissions, so that finance firms are able to track, report and reduce their financed emissions and become fully aligned with global agreements to combat climate change.
- By revising the macroprudential framework, regulators could ensure that the risks associated with high-carbon loans are more accurately reflected in the amount of capital banks hold against them.