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CFTC REPORT: CLIMATE CHANGE POSES MAJOR RISKS TO U.S. FINANCIAL SYSTEM

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Includes recommendations for action by SEC and other financial regulators

Last week, a subcommittee of the Commodity Futures Trading Commission issued a sweeping report addressing climate change risks, concluding that they pose both major systemic and sector/regional-level risks to the stability of the U.S. financial system and its ability to sustain the American economy. Further, it concludes that such risks are increasing rapidly, economic incentives are misdirected and immediate action across the global financial system is required.

The report is wide-ranging with a number of specific, detailed recommendations. Its length and complexity make it impractical to summarize for this blog, but fortunately, the report does include a well-organized executive summary (beginning on page i).

Some of the report's key points include:

- The United States should establish a price on carbon. A fair, economy-wide carbon pricing regime is necessary to fix a fundamental market flaw in the economic system to ensure that appropriate incentives are in place for the efficient allocation of capital
- U.S. regulators should use their broad, flexible authority to start addressing the risks now
- Research arms of federal financial regulators should study the financial implications of climate-related risks, including the potential for and implications of climate-related "sub-systemic" shocks to financial markets and institutions in particular sectors and regions of the United States (e.g., agricultural and community banks and financial institutions serving low-to-moderate income or marginalized communities)
- Financial regulators, in coordination with the private sector, should work together to rapidly improve the quality of data, analytics and understanding of climate risk
- Financial regulators should establish climate finance labs or regulatory sandboxes to enhance the development of innovative climate risk tools as well as financial products and services that directly integrate climate risk into new or existing instruments. Financial innovation is required

not only to efficiently manage climate risk but also to facilitate the flow of capital to help accelerate the net-zero transition and increase economic opportunity

For public companies, the report concludes that financial regulators should:

- clarify the definition of materiality for disclosing medium- and long- term climate risks, including through quantitative and qualitative factors, as appropriate.
- review and update the SEC's 2010 Guidance on climate risk disclosure to achieve greater consistency in disclosure to help inform the market.
- consider rulemaking, where relevant, and ensure implementation of the Guidance.
- consider additional, appropriate avenues for companies to disclose other substantive climate risks that do not pass the materiality threshold over various time horizons outside of their filings.
- require listed companies to disclose Scope 1 emissions (from owned or controlled sources) and Scope 2 emissions (indirect emissions from purchased energy (electricity, steam, heat and cooling)) and, as reliable transition risk metrics and consistent methodologies for Scope 3 emissions (all other indirect emissions across the value chain, including both upstream and downstream) are developed, require their disclosure, to the extent material. The report notes that Scope 1 and 2 data is much more available than Scope 3 data.

These selected recommendations reflect the subcommittee's view that such information is essential to ensure that climate risks are measured and managed effectively. The subcommittee noted in several instances that existing rules, including the 2010 SEC guidance, have not resulted in adequate disclosures that are sufficiently useful to market participants and regulators.

While the report is only advisory, it was unanimously approved by its 34 members, which included, among others, representatives of financial markets, the banking and insurance sectors, as well as the agricultural and energy markets, data and intelligence service providers. It also follows increasing calls from investors for "decision useful" climate risk disclosures. As a result, public companies should broadly consider climate-related financial and business risks through their existing risk management frameworks, in anticipation of possible voluntary disclosures at the request of investors or mandatory disclosures stemming from potential new and more comprehensive regulatory requirements. Climate risk monitoring and management should also be considered through governance frameworks, including by means of clearly defined oversight responsibilities in the board of directors.

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