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In a first of-its-kind report, a US financial regulator assesses the impacts of climate risk on financial markets, recognizing it as posing serious risk to the US financial system and anticipating meaningful change on the horizon.

On September 9, 2020, the Climate-Related Market Risk Subcommittee of the Commodity Futures Trading Commission (CFTC) published its highly anticipated report on the impacts of climate risk to US financial markets[1]; the first of-its-kind from a US financial regulator.

The report represents a consensus view of the 34 advisory members of the Climate-Related Market Risk Subcommittee, many of whom are from banks, investment firms, insurance companies, agribusinesses, and energy markets.[2] It provides 53 recommendations to the CFTC, other US financial regulators, Congress, financial firms, and the wider public for mitigating climate risk.

Until recently, climate risk has received significantly more interest from financial institutions and regulators outside the US, most notably at the Bank of England,[3] Bank of France,[4] Bank of Canada,[5] the European Central Bank,[6] and through the Network of Central Banks and Supervisors for Greening the Financial System (NGFS).[7] The CFTC report seeks to shape the US financial regulatory communities' understanding of the need for more significant international engagement on climate risk.

To best advance climate risk management efforts across financial services, the report calls for strengthening regulators' capabilities, expertise, and data analytics to better monitor, analyze, and quantify risks.[8] Simultaneously, the report urges regulators to foster greater collaboration with the financial industry, as financial services firms can contribute with innovative and targeted solutions.

Recognizing that a changing climate could pose systemic risks to the US financial system, the report seeks to mobilize financial regulators to move more swiftly and decisively address and manage these risks in a uniform fashion. The report finds that existing legislation already provides US financial regulators with "wide-ranging and flexible authorities that could be used to start addressing financial climate-related risk now."[9]

The CFTC report may ultimately be a seminal document for the US financial industry. As such, corporate boards and senior

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management should continue efforts to improve and integrate their climate risk management capabilities as well as encourage innovation and raise awareness at their organizations in response to increasing regulatory interest (see chart below).

Evolution of US Financial Regulators on Climate-Related Financial Risk[10]

What does the report mean for financial institutions?

The report recommends several areas that have the potential to affect financial institutions in the short-term and ultimately how they may be regulated and supervised in the US.

Considerations for near-term impact:

- **Climate data and analytical tools must be improved to better inform decision-making across the financial system:** The report acknowledges the existing limits of climate data and scenario analysis and identifies growing opportunities for more sophisticated data analysis to measure and manage climate-related financial risks. Regulatory approaches are evolving, especially as a better understanding of climate risk continues to advance and new data and tools become available.[11] Financial firms may view this as an opportunity to support the availability of consistent, comparable, and reliable climate risk data, which may in turn elevate the role of data and analytics providers.
- **Climate stress test pilot programs for financial firms:** In aligning with other global jurisdictions, as well as the NGFS, climate stress tests may become a focus for US financial regulators, and banks will need to begin preparing to conduct them. There is an expectation that US regulators will likely develop a strategy for integrating climate risks into their existing monitoring, supervisory, and oversight functions, as has been the case globally.
- **Disclosure of climate risk as a material, financial risk:** The Securities Exchange Commission (SEC) continues to drive the point that the existing materiality regime guides when a public filer should disclose Environmental, Social, and Corporate Governance/climate performance information. This does not take the shape of mandatory material, financial risk disclosure. The CFTC calls for financial regulators to clarify the definition of materiality for disclosing medium- and long-term climate risks, including through quantitative and qualitative factors. Investors will need to be better educated on these risks, if disclosure regime shifts from being voluntary to mandatory. Climate risk disclosure could cover material risks for various time horizons, including certain emission disclosures if deemed to be material.

Considerations for longer-term impact:

- Placing a price on carbon can empower financial markets to create change: Through Congressional action, the US may align incentives to encourage the financial industry to make the transition to a low-

carbon economy as quickly and smoothly as possible. The CFTC views this to be "the single most important step to manage climate risk and drive the appropriate allocation of capital."[12] It will be important for financial firms to have greater clarity from regulators and uniform standards, both domestically and globally.

- Financial regulators can encourage the use of climate risks tools and other innovative products to improve risk management capabilities. Suggested innovative approaches include establishing climate finance labs or regulatory sandboxes to encourage the creation and adoption of innovative financial products to better address and manage climate risk. Firms may see this as an opportunity to participate in public-private partnerships that encourage innovation in a favorable environment, much like what has been done with regulatory Offices of Innovation on consumer financial data and digital assets, among other areas.[13]

How can Deloitte help?

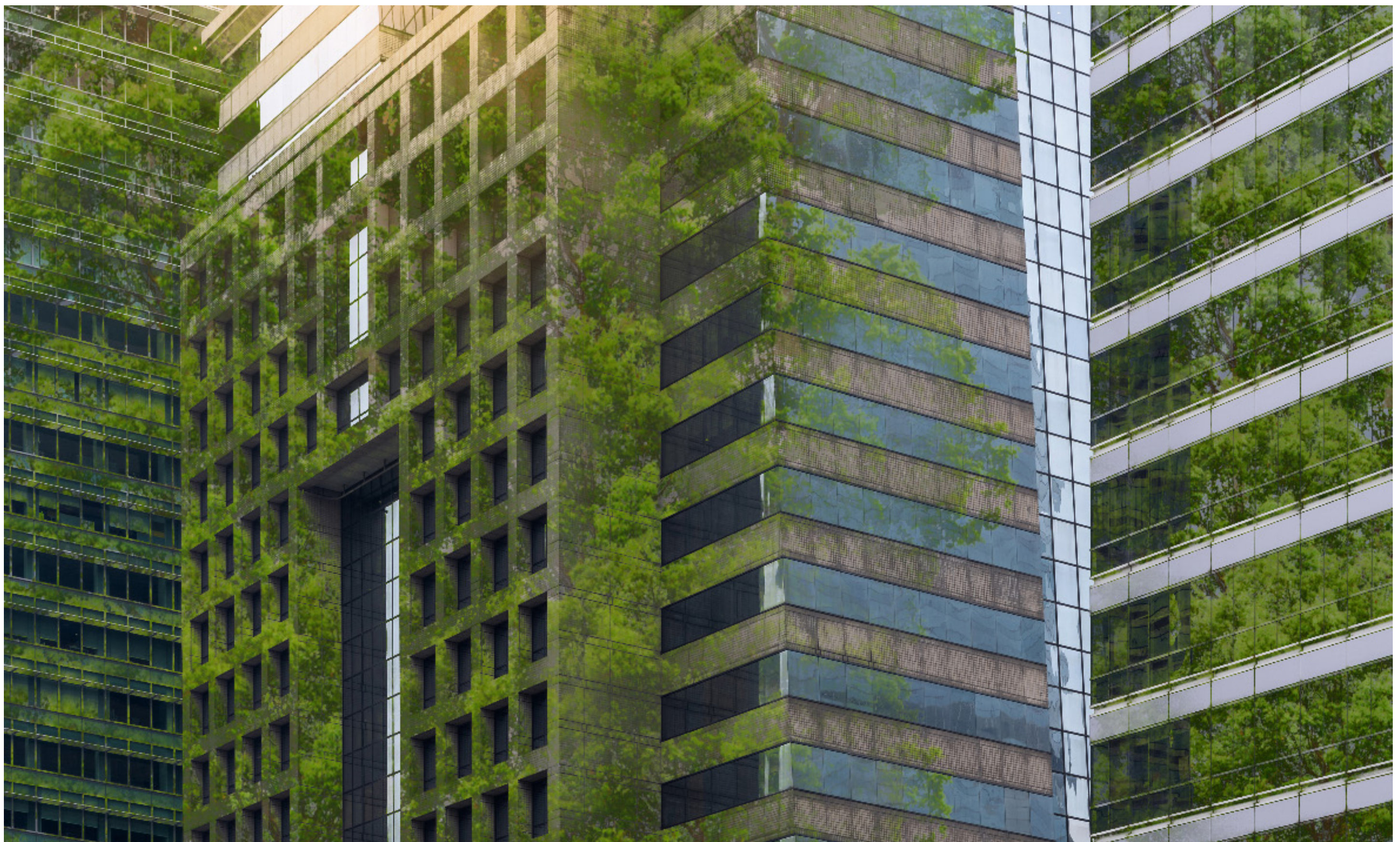
Deloitte has been at the forefront of engaging with regulators and financial services firms on these important matters, including helping leaders think through innovative ways to strengthen analysis of data and effectively manage climate risks.

With a wealth of knowledge on sustainability issues, Deloitte can advise on evolving and leading practices and ideas to turn climate risk management into a competitive advantage.
In addition to continuing to monitor the US and global regulatory agendas, financial firms should consider immediate and tangible steps toward managing climate risk, including:

- Establishing clear governance and risk ownership, including board oversight, senior management responsibilities, and staff-level engagement.
- Incorporating climate risk into the enterprise risk management framework (e.g., risk taxonomies, training, and quantitative approaches); and,
- Conducting gap analyses of current climate risk mitigation and adaption strategies, activities, and reporting, including priority areas and remediation action steps.

Closing

This is part of a new series on how climate risks are shaping US financial regulatory initiatives and the impact these developments may have on the financial services industry and broader economy.



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Endnotes

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13. Deloitte analysis of US financial regulatory agencies' Offices of Innovation.

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