Don’t Let Financial Regulators Dream Up Climate Solutions

We’ll get bad policy and an even more fragile financial system if we do.

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Financial regulators are rushing to take on climate change. In its latest Financial Stability Report, the Federal Reserve states that it is investigating the full scope of implications of climate change for markets, financial exposures, and interconnections between markets and financial institutions. It will monitor and assess the financial system for vulnerabilities related to climate change through its financial stability framework. Moreover, Federal Reserve supervisors expect banks to have systems in place that appropriately identify, measure, control and monitor all of their material risks, which for many banks are likely to extend to climate risks.

The Fed formally joined the Network of Central Banks and Supervisors for Greening the Financial System (NGFS). The New York Fed has set up a top level “Supervision Committee” on climate; its president, John Williams, stated that “Climate change . . . impacts all aspects of the Fed’s mission.”
Fed governor Lael Brainard announced that the Fed will “ensure that financial institutions are resilient to climate-related financial risks.” She announced that “climate scenario analysis” would be applied to “a range of financial markets and institutions, as well as the potentially complex dynamics among them.” On March 23, Brainard announced a new board-level Financial Stability Climate Committee (FSCC) which will take a “macroprudential” approach—meaning everywhere in the financial system. And the Fed is a late addition to the alphabet soup of U.S. and global financial regulators in these efforts (these include ECB, BIS, IMF, FSB, BoE). The European Central Bank, in particular, proposes to judge bonds it will take as collateral by green standards and to buy so-called green bonds at subsidized prices.

Let us state a plain and obvious fact: climate change is an important challenge. But climate change poses no measurable risk to the financial system. This emperor has no clothes.

Climate means the overall pattern of weather—its averages and its range of ups and downs. Risk means unforeseen events. We know exactly where the climate is going over the horizon that financial regulation can contemplate. Weather is risky, but the range of weather over the next decade or so is well understood. More importantly, even the biggest floods, hurricanes, and heat waves have essentially no impact on our financial system.

Moreover, the financial system is only at risk when banks as a whole lose so much, and so suddenly, that they blow through their loss reserves and capital, leading to a run on their short-term debt. That a “climate crisis” could cause a sudden, unexpected, and enormous economic effect endangering the financial system in the next decade is a fantasy unsupported by scientific evidence.

Sure, we don’t know what will happen in 100 years, but banks did not fail...
in 2008 because they bet on radios, not TV, in the 1920s. Banks failed over mortgage investments made in 2006. Trouble in 2100 will come from investments made in 2095. Financial regulation cannot pretend to look past five years or so.

Sure, a switch to renewables might lower oil company profits. Oil stockholders may lose money. But “risk” to the “financial system” cannot be defined to mean that someone, somewhere may lose money. Tesla would not have been built if people could not take risks.

Yes, we are decarbonizing the economy, but similar transitions from horses to cars, from trains to planes, or from typewriters to computers did not cause even a blip in the financial system. Companies and industries come and go all the time.

So why is there pressure for financial firms to “disclose” absurdly fictitious “climate risks” and change investments to avoid them? Clearly, these proposals aim to defund the fossil fuel industry before alternatives are in place and to steer funds to fashionable but unprofitable investments by regulatory subterfuge, rather than politically accountable legislation or transparent rule-making by environmental agencies.

This goal is no secret. For example, the NGFS club of financial regulators states plainly that it seeks to “mobilize mainstream finance to support the transition toward a sustainable economy.”

But financial regulators are not supposed to “mobilize” the financial system—to choose projects, companies, and industries they like and defund those they disfavor. Thus, regulators must pretend that they are dispassionately finding risks to the financial system, and just happened to stumble on climate.

There are plenty of genuine risks to the financial system that regulators
largely ignore. Imagine a new pandemic—one that kills 10 percent, not less than 1 percent, and that lasts years with no vaccine. Suppose China invades Taiwan, or a nuclear weapon goes off in the Middle East. Another financial collapse can come, or a global sovereign debt crisis, with the U.S. running out of borrowing capacity the next time we turn to bailouts and stimulus. Suppose the U.S. Treasury is downgraded or defaults, and financial institutions no longer accept Treasury collateral. Imagine a massive cyberattack: North Korean hackers wipe out all Citibank accounts, and people rush for cash everywhere. These would indeed be catastrophes for the financial system. Yet out of all of these large, obvious, and plausible risks, our financial regulators want to focus on just one—a fictitious climate “risk.” Why? Obviously, the end justifies the means.

Some climate advocates are a bit more honest: they recognize that there is no financial risk due to climate itself, but climate regulation could come along and “strand” assets or hurt companies. The Godfather would be proud: nice business you’ve got there, it would be a shame if something should happen to it. You should buy some “insurance.”

But think about it. This view posits that our environmental regulators are so bone-headed, so ignorant of basic cost-benefit analysis, that they might suddenly and dramatically not just wipe out industries and millions of jobs, but do so in a way that causes colossal bank failures on the scale of the 2008 crisis. And here, too, why just climate-related risk? Plenty of political and regulatory risks exist, too. Regulate and disclose tech exposure, in case the FTC breaks up big companies. Regulate steel exposure, always on the edge of tariffs, one way or another. Labor legislation could outlaw Uber tomorrow. An honest list of all the ways that Congress or the agencies might plausibly destroy industries would make good reading. But we’re not doing that, are we? The end justifies the means.

Climate is too important to let financial regulators play with. It needs clear-
headed, science-based, steady, and transparently enacted policy, with explicit cost-benefit analysis. Underhandedly funding and defunding financial regulators’ momentary enthusiasms will repeat counterproductive feel-good fiascos like corn ethanol, switchgrass, and an absurdly expensive rail line from Merced to Bakersfield. The U.S. leads the world in carbon reduction today because of natural gas produced by fracking, which no regulator “mobilized.” Climate answers may include nuclear power, geoengineering, carbon capture and storage, hydrogen fuel cells, genetically engineered foods, zoning reform, a carbon tax, and other approaches, which financial regulators will never even envision, let alone implement.

Indeed, honest risk analysis goes both ways. Tesla’s stock price could plummet. If better technologies come along, if regulators start doing cost-benefit analysis, if a new administration or bond market realities undo the sea of subsidies keeping many projects afloat, many of today’s green darlings could fail. It is not inconceivable that we are in a bubble of green appearances, abetted by central banks, just as they abetted the previous housing bubble for similar political reasons.

Financial regulation is too important to be eviscerated on the altar of defunding fossil fuel and subsidies for pet projects. If financial regulators cook up fantasy “climate risks,” and force regulated firms to do so, financial regulation will lose any capacity to detect and to offset genuine risks, and politics will determine the allocation of credit.

Financial regulation and the financial system are in peril, but not because of climate. Contemplate regulation’s abject failure in the face of the pandemic. Despite 12 years of Dodd-Frank regulation, stress tests, and armies of embedded regulators, despite many federal pandemic plans and centuries of experience with outbreaks like SARS, H1N1, Ebola, AIDS, and the Spanish flu, financial regulators failed to consider that a pandemic might come along. We made it through the last year not because of
regulatory prescience, but because of another massive bailout. The financial system remains far too leveraged and far too reliant on an even larger bailout that may not come next time. And now they want to soothsay climate?

We need to get financial regulation back to its job: making sure that financial institutions have adequate capital to withstand shocks that none of us, not least the regulators, can pretend to foresee. Yes, it’s boring. You don’t get toasted at Davos for tough capital requirements. Industry hates being told to get more capital. But that’s the regulators’ job.

Don’t let the EPA regulate banks, and don’t let our financial regulators dream up climate policy. We will get bad climate policy and an even more fragile and sclerotic financial system if we do.

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