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A Convenient Myth: Climate Risk and the Financial System

By JOHN H. COCHRANE | November 17, 2021 6:30 AM

Treasury Secretary Janet Yellen attends the House Financial Services Committee hearing in Washington, D.C., September 30, 2021. (Al Drago/Pool via Reuters)

Politicians are using financial regulations to circumvent the legislative process.

NRPLUS MEMBER ARTICLE

In an October 21 press release, Janet Yellen — Treasury secretary and head of the Financial Stability Oversight Council (FSOC), the umbrella group that unites all U.S. financial regulators — eloquently summarized a vast program to implement climate policy via financial regulation:

> FSOC is recognizing that climate change is an emerging and increasing threat to U.S. financial stability. This report puts climate change squarely

step forward in addressing the threat of climate change.

You do not have to disagree with one iota of climate science — and I will not do so in this essay — to find this program outrageous, an affront to effective financial regulation, to effective climate policy, and to our system of government.

Of all the threats posed by a slowly warming climate, why is Ms. Yellen talking about financial stability? The answer is simple: Financial regulators are not supposed to implement each administration's policies on non-financial matters. Financial regulators may only act if they think financial stability is at risk.

Why? Imagine that Trump returns. He declares, "Illegal immigration is an existential crisis. I can't get Congress to do anything about it. Financial regulators: Tell banks to freeze the bank accounts of any customers who can't prove legal status. Scour people's accounts for payments to illegal employees. Freeze out any business that hires an illegal." You would be shocked. The nation would be shocked. Ms. Yellen would be shocked. There is no financial risk here, we would all say. This is a vast abuse of power.

Financial regulation can only touch climate policy if there is a risk to the financial system that only coincidentally involves climate. But how could climate possibly pose a risk to the financial system?

A "risk to the financial system" does not mean that someone, somewhere, someday, might lose money on an unwise investment. A risk to the financial system means an event like 2008: a shock so big, so pervasive, and so fueled by short-term debt that it sparks a widespread run, a wave of defaults, and threatens the ability of the whole system to function. "Financial regulation" means looking at the assets and liabilities of financial institutions to mitigate such a risk. It can at best look a few years in the future.

“financial regulators” can contain must mean the climate might change so drastically, so abruptly, and so unexpectedly, in the next five years, that the economy tanks so terribly that financial institutions blow through the cushions of equity and long-term debt, to spark a widespread systemic crisis like 2008 or worse.

The trouble is, there is absolutely nothing in even the most extreme scientific speculations to support that possibility. Climate is the probability distribution of weather: the chance of heat and cold waves, floods, fires, and so forth. We know with great precision what the climate will be for the next five years. Nobody writing insurance in Florida is unaware of the chance of hurricanes. The chances of extreme weather are not going to change unexpectedly in even ten years. The sea level is rising. It will continue to rise, about 4 millimeters per year – 2 cm in the next five years – slowly and predictably. Risk is the unknown. This is known.

Moreover, even weather extremes just don’t move the economy that much. We have had many financial crises in history. Not one was sparked by an extreme weather event. Our modern, national economy is remarkably immune to weather.

It is simply not true that the economic damage of extreme weather events is either large or substantially increasing. Weather-related damages were 0.18 percent of global GDP in 2020. That’s tiny, and it’s decreasing, down from 0.26 percent in 1990. The part of it that could be described as unexpected, threatening financial reserves, is tinier still. GDP fell 10 percent during the COVID recession. Unexpected climate risks would have to be 50 times larger in the next few years to approach that level of damage. Even the most extreme weather events are local, a blip on the national economy and the assets of diversified banks.

In 1900, half a million people died in storms, floods, droughts, wildfires and extreme temperatures. By 2020, the number had declined to 14,000. So far,

about 35,000 car crash deaths each year in the U.S. alone, and COVID has killed 750,000 Americans.

Still, one could defend the effort. Our financial regulators completely missed the possibility that mortgage-backed securities might bring down the financial system in 2008. Despite the army of Dodd-Frank regulators and stress-testers, regulators missed the possibility that a pandemic threatened to do the same in 2020. Only another massive round of bailouts saved us from another 2008. The Fed went on to completely miss the chance that inflation might break out, while it orchestrated the printing of $3 trillion sent out to people as checks. A dispassionate, honest effort to look at out-of-the-box risks to the financial system, together with a humble attitude towards regulators' ability to foresee them, is a good idea.

What might that effort find? What if (when?) China invades Taiwan, and the U.S. and allies blockade China? A huge global recession. What if the U.S. chooses to fight and loses? Greater catastrophe. What if the Middle East blows up, or a nuclear weapon goes off? What if we have a real pandemic, one that kills 10 percent of the people it infects as plague, cholera, typhus, and tuberculosis did? What if that pandemic comes out of a lab, this time deliberately? What about a massive financial cyberattack? What if bond investors give up on U.S. Treasury debt and force a sovereign-debt crisis? These are all unlikely. But the chance of any of these is thousands of times greater than the danger of climate change to the financial system.

And what should one do about such risks? Does it make sense for bank regulators and stress testers to demand that each bank rank the sensitivity of each loan it makes for its exposure to Chinese-invasion risk, and calibrate its portfolio accordingly? Or, as is increasingly popular, to interact these risks and model general-equilibrium effects? No. The response to out-of-the box unquantifiable risks is simply to demand that banks finance themselves with much more equity capital, which can absorb unforeseen losses without imperiling the bank and financial system.

Pandora's box, or consider why, of all the risks to the financial system, climate change is the only one worth talking about. Regulators want to tell banks to stop lending to fossil-fuel companies while, coincidentally, the political parts of the administration decided on the same climate policy. And given their method, to regulate bank investments against "climate risks" that they cannot even define, rather than protect the system with equity (financial adaptation!), they are clearly not interested in actually protecting the financial system against unknowable catastrophes.

Pressed, advocates will quickly admit that's not what they mean. Instead, they say, they worry about the risk of "stranded assets," "transition risks," losses in fossil fuel and other legacy industries.

Will environmental regulators, legislators, presidents, prime ministers, really fly back from Glasgow and pass laws and regulations so onerous that they tank the economy and financial system? Well, they just might. But then at least one might be honest and call it "climate-policy risk!"

But even this story does not pass muster. Climate-policy advocates are turning to financial regulation precisely because presidents and legislatures, accountable to voters, are refusing to impose draconian carbon-killing policies. It has some chutzpah, too: Carbon regulations might kill the fossil-fuel industry. So we have to. . . kill the fossil-fuel industry first.

This view has resonated through financial-policy circles for the last few years, though a tiny dose of econ-101 common sense told us that if you restrict fossil-fuel supply, prices and profits go up, not down. Today's spike in coal, natural-gas and oil prices illustrates just how competent this effort is.

We are in an energy transition. But old, dying technologies never cause crises. New ones do. The 1929 stock-market crash did not come from the horse and buggy industries; radio, movies, and cars crashed. The 1999 stock market

landline-telephone industries. Tech, slightly ahead of its time, failed. Tesla, valued at $1 trillion, upwards of ten times more than GM — now there is a teetering domino! Since the tulips themselves, so-called bubbles have always come from exciting new technologies, often fueled by subsidies and cheered on by central banks and regulators, not from slowly decaying legacy industries.

And stock-price declines, whether in Tesla or Exxon, are not a financial crisis. Heaven help us if regulators expand their view that their job is to keep prices from going down. Crises come from debt. Legacy industries have very little debt. Exxon has a $200 billion total capitalization. Of that, $157 billion is common stock, $51 billion is long-term debt, and a paltry $19 billion is short-term debt. Financial regulators should give Exxon and its investors a financial-stability gold star, not hound it for a net-zero plan on stability grounds. If the Biden administration nominee for Comptroller of the Currency, Saule Omarova, gets her wish to starve and "bankrupt" fossil-fuel companies via financial regulation, stockholders might indeed lose money. But with no appreciable debt there is no threat whatsoever to "financial stability."

An honest, unbiased appraisal of political risk might also be interesting. Bring it on. The FTC might break you up. Labor, Justice, EEOC, EPA, might descend and close down your business and make your loans worthless. A wave of questionable product-liability-litigation losses might bankrupt you. Financial regulators might decide to starve you — now that would make a fun disclosure. Again, this is obviously not the question.

Climate risk to the financial system is a Big Lie. I don't know how to put this politely. A little lie is a knowing untruth spouted by a devious individual. A Big Lie is a whopper, self-evidently false when parsed in standard English, passed around and around the bubbles of Davos, Glasgow, alphabet-soup financial agencies, philanthropies, and the narrative-endorsing media, until earnest do-gooders come to believe in its nonsense. Spouting it gains one the

justifies extraordinary grasps of political power.

Why repeat this Big Lie? Well, it's obvious. Many people in our government and surrounding policy elites want to expand a particular kind of climate policy. That policy centers on stopping fossil-fuel development and use, before alternatives are available at scale, and subsidizing a particular kind of "green" projects. Windmills, solar panels, electric cars, rail, yes. Nuclear, carbon capture and storage — which would permit fossil-fuel burning — natural gas, hydrogen, geothermal, hydropower, innovation, zoning and land-use reform, adaptation, no. It focuses on domestic policies, hoping our "leadership" will inspire the elephants in the room (China, India, Africa) to fall in line and deny their populations the benefits of fossil-fuel led growth, and Russia, Iran, and Saudi Arabia deny theirs the profits of supplying that demand.

The trouble: This policy is falling apart quickly. Well-informed critics such as Steve Koonin and Bjorn Lomborg have completely undermined its distortion of the science, even that found in official IPCC and U.S. government reports. Democratically elected legislatures and accountable administrations refuse to quickly implement this policy. Even the Biden administration, which on day one canceled the Keystone pipeline, quickly turned around to ask OPEC and the Russians to turn on the spigots when voters noticed gas prices rising. The climate parts of the grand infrastructure and reconciliation bills are falling apart, leaving only a few hundred billion ineffective dollars to be thrown down corporate-welfare ratholes. The November elections made it pretty clear that 2022 will be the end of legislating this policy. Glasgow is ending with a whimper, with many countries refusing even to end fossil-fuel subsidies. Corporations will make bland "net-zero" (whatever "net" means) promises which they can quickly reverse in 2024. Europeans are facing spiking energy prices, restive gilets jaunes, and a skeptical eastern bloc.

What to do? Well, turn to financial regulation. What they can't accomplish by accountable, democratic methods, they can accomplish by unleashing the

funding to fossil-fuel companies and their customers, and freezing them out of the financial or payments system as we do to pot farmers, by demanding "disclosures." The European Central Bank (ECB) is already printing money to buy "green" bonds, declaring them to be "undervalued."

It is a particularly effective idea, because once thousands of pages of regulations are written, once the right people are appointed with all the protections of office, once the Twitter mob has silenced dissenters in the financial-regulatory community, once private businesses have gotten the message how to please regulators and hired hundreds of thousands of climate-disclosure compliance officers, the effort will be immune to the whims of pesky voters.

What's wrong with this? The climate is in crisis, you say, the voters are morons, legislatures and politicians won't move: Use whatever tools we have.

The minor issue: Financial regulators have a competence deficit. Environmental regulators are not doing a great job of scientific, technocratic, cost-benefit-metered climate policy. Climate policy is not a great certainty, waiting only for more activism. That central bankers will figure out what to deny, what to subsidize, and how to rate banks on their climate investments is a fantasy. The same crew that missed mortgages, pandemic, and inflation is going to figure out what businesses to subsidize, what to freeze, all to change global temperatures 100 years from now?

Most of all, it is blatantly illegal. In a democracy, independent agencies have broad but limited powers. Financial regulators are limited to financial risks. Securities regulators are supposed to enforce the "fiduciary rule" that asset managers must invest only on financial basis, not to please either the managers' or politicians' preferences. And there are great reasons for this limitation. If the Fed starts buying "green bonds," the next Trump can force it to start buying "build the wall" bonds.

sounding words like the rest of finance, to give it the aura of technocratic competence.

What they mean is not climate risk to the financial system, but the financial system's risk to the climate, by financing the "wrong" investments. But they're not allowed to regulate that. Hence the Big Lie: We looked for risks, and guess what, climate came out on top!

They are so brazen, so unafraid of legal or political pushback, that they no longer even hide it. Read the second half of Ms. Yellen's eloquent summary quote: "This report puts climate change squarely at the forefront of the agenda of its member agencies and is a critical first step forward in addressing the threat of climate change."

Guilty as charged! Climate change is not supposed to be at the forefront of all U.S. financial regulators' agenda. It's not supposed to be on their agenda everywhere!

When the Biden administration says that climate would be a "whole of government" approach, I answer equally: Guilty as charged! "Whole of government" is blatantly illegal and unconstitutional. Will the judiciary be next? Our government is limited, with checks and balances.

Mark Carney, a former governor of both the Bank of England and the Bank of Canada likewise pronounced, "These seemingly arcane but essential changes to the plumbing of finance can move and are moving climate changes from the fringes to the forefront and transforming the financial system in the process."

Guilty as charged.

Narrowly, this approach throws what remains of central-bank and financial-regulatory independence under the bus. Central banks and financial

party in power. “That’s where the money is,” said the bank robber Willie Sutton, and we have long put this particular piggy bank off limits. And this is only the beginning of politicized central banks and financial regulations. The social and governance part of ESG investing and disclosures comes next. The regional Feds seem to think their main mandates are to cure racism and inequality, worthy aspirations but also completely beyond their competence or mandate, for the same reasons. The same regulatory tools are waiting.

Most of all, it is profoundly un-democratic. Reflect: The whole point is to bend financial regulators to this climate policy precisely because elected officials will not do it, and in advance of elections that will surely put a larger brake on the movement. In this way, it is a soft version of the “eco-authoritarian” movement. These are people who, like Greta Thunberg, take apocalyptic climate rhetoric seriously and pursue it to its logical conclusion. If indeed the climate is in a “crisis,” “emergency,” “catastrophe” — I can’t keep up with the word of the day — if indeed we are at a “tipping point;” if the planet will soon be “uninhabitable,” then we surely cannot wait for slow politicians and thick-headed voters to come to their senses. Seize power, keep it, and shove it down their uncomprehending throats.

Now the financial climate movement doesn’t take its own rhetoric that seriously. It aims for a benevolent climate aristocracy, not yet authoritarian, and it knows most of the hysteria is hogwash. But the whole point is to enshrine this brand of climate policy where voters cannot get at it.

Except they will. We still do live in democracies, and when the power starts going off, the pesky voters will return. The peasants can still rise up and throw out today’s self-proclaimed elites. Brexit ought to be a warning to the ECB.

Why should we care?

effective financial regulation. If firms are asked to "disclose" nonsense, and regulators demand fictitious net-zero disclosures, firms will do as asked. But then the whole regulatory system will be full of nonsense. Politicized central banks playing climate czar will not foresee it, forestall it, and will deal with it chaotically.

Central banks and regulators have already become far too politicized and their activities have expanded past their mandates. Under Dodd-Frank regulations, there are over 100 Fed employees in each big bank signing off on all major deals. Why not add, "Hey, make those a bit greener?" The Fed bought $2.5 trillion of mortgages to funnel money to housing. How can they say no to green bonds? The ECB is already buying sovereign and "green" bonds. We looked for "underpriced" bonds and guess what, we just happened to find windmills. It will be hard to say no to more.

I care about climate. I want robust, effective, cost-benefit-tested, long-lasting climate policy, based on actual science. Today's enthusiasms will fade like corn ethanol and switchgrass. Even this policy will not last. Around 2022, the congressional inquiries into just what is happening here will start, undermining the whole project even if it was good climate policy. To address a hundred-year problem, you need policy with a solid, bipartisan electoral constituency, not one shoved down voters' throats while they aren't paying attention, based on a Big Lie.

I care about democracy, rule of law, political stability, limited-purpose, technically competent, and effective institutions. Climate is not the kind of problem that requires us to abandon our form of government, and accept the chaos that will occur as new politicians use the expanded tools to implement their unpopular agendas.

To the central banker who responded to me, "But the climate is a crisis, we must do something," I say, first of all, "who appointed you Queen?" Then I say, when they come calling, say no. That's what independent central banks

policy, say no. Follow rules, laws, norms and traditions, so you can say no when Trump's immigration policy comes along, or whatever else will surely follow.

Of course, nobody became the toast of Davos by saying no. Nobody moved on to be prime minister or other political success by getting right the mark-to-market rules of derivative contracts, or forcing banks to issue a faintly reasonable amount of equity. If you feel the need for greater meaning in your life, quit your job, join EPA, the agencies implementing the EU green deal, or the Sierra Club. Advocate on your time off. But central banks and financial regulators must not be bent to this cause — and thus not to the next cause that comes along.

To voters, commentators, politicians in the U.S.: Don't be blindsided by technical gobbledygook. Financial regulators barely know what they're doing about actually regulating finance, and have absolutely no idea when they're making up buzzwords like "climate-risk disclosure." Stand up to this infamy.

In practical terms, many of the heads of these organizations are being appointed now. There will soon be four open seats on the Federal Reserve Board. Forget about money, interest rates and inflation. One question matters about the Fed: Whether the awesome power of financial regulation will be unleashed to enforce this administration's climate policy, with social, governance, and racial agenda all rejected by voters soon to follow, and then whatever else politicians demand after that.