Testimony of John H. Cochrane to US Senate Committee on Banking, Housing, and Urban Affairs

Chairman Brown, Ranking Member Toomey and Members of the Committee: Thank you for the opportunity to testify today.

I am John Cochrane. I am an economist, specializing in finance and monetary policy. My comments do not reflect the views of my employer or any institution with which I am affiliated.

Climate change is an important challenge. But climate change poses no measurable risk to the financial system. This emperor has no clothes. “Risk” means unforeseen events. We know exactly where the climate is going over the horizon that financial regulation can contemplate. Weather is risky, but 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 reserves and capital, and a run on their short-term debt erupts. That climate may cause a sudden, unexpected and enormous economic effect, in the next decade, which could endanger the financial system, is an even more fantastic fantasy.

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 does not and cannot pretend to look past 5 years or so, and there is just no climate risk to the financial system at this horizon.

Sure, a switch to renewables might lower oil company profits. Oil stockholders may lose money. But “risk” to the “financial system” cannot mean that nobody ever loses any money! Tesla could not have been built if people could not take “risks.” Yes, we are in a transition to a decarbonized economy, but the transitions from horses to cars, and from trains to planes, from typewriters to computers did not cause even blips in the financial system. Companies and industries come and go all the time.

So why is there a push for regulators to force financial firms to “disclose” absurdly fictitious “climate risks,” and change investments to avoid them? These proposals aim simply to de-fund the fossil fuel industry before alternatives are in place, and to steer funds to fashionable but unprofitable investments and away from unfashionable ones, by regulatory subterfuge rather than above-board legislation or transparent environmental agency rule-making. This goal isn’t a secret. For example, The Network of Central Banks and Supervisors for Greening the Financial System (NGFS), which the Federal Reserve recently joined, [1] states plainly its goal is to “mobilize mainstream finance to support the transition toward a sustainable economy.” [2]

But financial regulators are not allowed to “mobilize” the financial system, to choose projects they like and de-fund those they disfavor. Thus regulators must pretend that they are dispassionately finding “risks” to the financial system, and oh, just happen to stumble on climate.

The climate focus proves the dishonesty. There are plenty of genuine risks to the financial system that our regulators largely ignore. Imagine a new pandemic, one that kills 10% not less than 1%, and that lasts years with no vaccine. Suppose China invades Taiwan, or a nuclear weapon goes off in the Middle

[1] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201215a.htm
[2] https://www.ngfs.net/en

East. Another financial collapse can come. Imagine a global sovereign debt crisis. Suppose that the US Treasury runs out of room to borrow, is downgraded or defaults, and financial institutions no longer accept Treasury collateral. Imagine a massive cyberattack - all the accounts at Citibank are wiped out by North Korean hackers, and people rush for cash everywhere. These would indeed be financial system catastrophes. Yet of all of these large, obvious and quite plausible risks, our financial regulators want to focus on just one, a fictitious climate "risk." Why? Obviously, the end justifies the means.

Some advocates are a bit more honest: They recognize 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. 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 it in a way that causes colossal bank failures like 2008. And if we go down this path, here too, why just climate-related risk? There is lots of political and regulatory risk. 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. Uber could be outlawed by labor legislation tomorrow. An honest list of all the ways Congress or the agencies might plausibly destroy industries would make good reading. But we're not doing that, are we? The reason is obvious.

Climate is really important. Climate is too important to let financial regulators play with it, inspired by what's fashionable at Davos cocktail parties. Climate 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 corn ethanol, switchgrass, an absurdly expensive rail line from Merced to Bakersfield that comes online just as all cars and trucks are electric, and other counterproductive feel-good policies. The US 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.

Financial regulation is really important. Financial regulation is too important to be eviscerated on the altar of de-funding fossil fuel and subsidies to pet projects. Once regulators cook up fantasy "climate risks," the books remain cooked, and financial regulation loses whatever any ability to perceive and to offset genuine risks. Once financial regulators demand funding of today's fashionable green projects, the political allocation of credit will expand.

Financial regulation and the financial system are in peril, and not because of climate. Contemplate the abject failure sitting in front of us. Despite 12 years of Dodd-Frank regulation, stress tests, and armies of embedded regulators, despite centuries of experience, ARS, H1N1, Ebola, Aids, 1918, and many federal pandemic plans, financial regulators failed to consider that a pandemic might come along. We made it through the last year by one more massive bail-out, not by regulatory prescience. The financial system remains far too leveraged and far too reliant on an even larger bailout that may not come in the next crisis. And now they want to soothsay climate?

We need to get financial regulation back to its job: making sure that run-prone financial institutions have adequate capital to withstand all sorts of shocks, which none of us, not least the regulators, can pretend to foresee. It's boring. You don't get invited to Davos to talk about it. Industry hates being told to get more capital. But that's its job and there is plenty to do.

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