



24 February 2020

TO: ALL APRA-REGULATED ENTITIES

UNDERSTANDING AND MANAGING THE FINANCIAL RISKS OF CLIMATE CHANGE

The effects of a changing climate extend to all sectors of the economy. Those effects are being transmitted directly as well as indirectly, through changing policies, technological developments, investment and consumer preferences. They pose financial risks, as well as provide new business opportunities, to all APRA-regulated entities.

Over the past couple of years APRA has, supported by other agencies of the Council of Financial Regulators, sought to ensure regulated entities are actively seeking to understand and manage the financial risks of a changing climate just as they would other economic and operational risks. Given the diversity of business models and activities within the regulated sector, APRA has not been prescriptive as to how this should be done, nor imposed any particular constraints on specific sorts of business activity. Rather, APRA has simply sought to make sure that the effects on businesses from a changing climate – both direct and indirect – have been actively considered within entities' decision making.

APRA's 2018 climate change survey highlighted that many large entities understand the financial risks and opportunities from a changing climate, and described the efforts taken by some entities to embed climate change considerations into risk management frameworks.¹ However, this work also highlighted the need to address the climate data deficit, to quantify the likely impact of the physical, transitional and liability risks of climate change and accurately assess and appropriately price these risks. This needs to ultimately be tackled through scenario analysis, stress testing and disclosure of market-useful information. Effective action now on these fronts will promote strong understanding and management of the potential financial impacts of a changing climate on current and future business prospects, allowing well-managed entities to minimise costs and optimise benefits.

APRA therefore continues to encourage the adoption of voluntary frameworks to assist entities with assessing, managing and disclosing their financial risks associated with climate change, such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) recommendations.

Looking ahead, the financial risks of climate change will continue to be a focus of APRA's efforts to increase industry resilience, and more supervisory attention is being given to understanding these risks. This includes deeper supervisory assessments of each entity that participated in APRA's 2018 climate change survey, which are due to be completed in mid-2020.

¹ APRA, *Climate change: Awareness to action* (Information Paper, March 2019)

<https://www.apra.gov.au/sites/default/files/climate_change_awareness_to_action_march_2019.pdf>.

Development of climate change financial risk guidance

Many industry participants have indicated they would like APRA to provide more information on better industry practice in relation to climate-related financial risks, as well as greater clarity on regulatory expectations. In response, APRA intends to develop and consult on a climate change financial risk prudential practice guide (PPG). This industry guidance is not intended to establish new obligations, but rather will be designed to assist entities in complying with their existing prudential requirements, including those found in *Prudential Standard CPS 220 Risk Management*. The cross-industry PPG, relevant to all entities, will set out APRA's views on better practice and outline prudent practices in this area. The PPG will cover areas relevant to the prudent management of climate change financial risks, aligned with the recommendations of the TCFD, including aspects of governance, strategy, risk management, metrics and disclosure.

The guidance will be informed by APRA's engagement with other regulators domestically and internationally, as well as its ongoing engagement with industry participants. APRA will consult on the draft PPG in mid-2020 and, subject to feedback, will seek to publish final guidance before the end of the year.

Climate change financial risk vulnerability assessment

Regulators and supervisors around the world are developing responses to the climate data deficit. In particular, the insights gained through climate-related scenario analysis are being considered, including through the Central Banks and Supervisors Network for Greening the Financial System (NGFS). Domestically, industry-led initiatives are considering taxonomy and scenario design questions to improve understanding of the financial risks of climate change and support strategic decision-making for all businesses.

In collaboration with these international and local stakeholders, APRA will be seeking to undertake a climate change financial risk vulnerability assessment. The assessment will begin with Australia's largest authorised deposit-taking institutions (ADIs). Beginning with the ADI industry will provide helpful insights on the impact of a changing climate on the broader economy, which will be analysed in conjunction with the Reserve Bank of Australia (RBA). The ADI vulnerability assessment will be designed in 2020 and executed in 2021, with other industries to follow. This timing also aligns with the expected release of international peer regulator guidance on scenario analysis for the banking sector.

The vulnerability assessment will involve entities estimating the potential physical impacts of a changing climate, including extreme weather events, on their balance sheet, as well as the risks that may arise from the global transition to a low-carbon economy.

APRA will coordinate this work with the Australian Securities and Investment Commission (ASIC) and the RBA via the Council of Financial Regulators to ensure consistency in the application of scenario analysis, disclosure recommendations and to analyse the macro-economic impacts of climate change. APRA will also seek input from the Commonwealth Scientific and Industrial Research Organisation and the Bureau of Meteorology. The scenarios that will form the basis of the vulnerability assessment will be consistent with practices being developed and utilised by peer regulatory authorities internationally.

Update of environmental, social and governance investment prudential guidance

In response to industry views outlined in the post-implementation review of the superannuation prudential framework (post-implementation review),² APRA also intends to update *Prudential Practice Guide SPG 530 Investment Governance* (SPG 530). SPG 530 aims to assist a registrable superannuation entity licensee in complying with requirements in relation to the formulation and implementation of an investment strategy, including in relation to environmental, social and governance (ESG) considerations.

APRA will consult on specific changes to *Prudential Standard SPS 530 Investment Governance* and SPG 530 around the middle of the year, in conjunction with other changes to the superannuation prudential framework as part of APRA's response to the post-implementation review.

Though this guidance will provide insights into better practice, a coordinated focus from both industry and regulators is required to ensure that the financial risks of a changing climate are managed effectively. APRA will continue to engage with entities and support industry-led initiatives to encourage this coordination. However, entities should be proactive in taking steps to assess and mitigate climate change financial risks now, and not delay action until further guidance or scenario analysis from APRA is released.

If you have any questions on the matters discussed in this letter, please contact William Harding (william.harding@apra.gov.au or 02 9210 3519) or your responsible supervisor.

Yours sincerely,

Geoff Summerhayes
Executive Board Member

² APRA, *Review of APRA's 2013 superannuation prudential framework* (Information Paper, 30 April 2019) <https://www.apra.gov.au/sites/default/files/information_paper_review_of_apras_2013_superannuation_prudential_framework.pdf>.