



# RESPONSE PAPER

## Prudential Practice Guide CPG 229 Climate Change Financial Risks

26 November 2021

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# Executive summary

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APRA's *Prudential Practice Guide CPG 229 Climate Change Financial Risks* (CPG 229) provides banks, insurers and superannuation trustees with guidance on the prudent management of financial risks and opportunities arising from climate change. The guidance covers APRA's view of sound practice in areas such as governance, risk management, scenario analysis and disclosure. The Prudential Practice Guide (PPG) does not create new requirements or obligations, but rather it aims to support institutions in complying with existing risk management and governance prudential requirements.

This response paper summarises the feedback received from industry and other stakeholders during the consultation on draft CPG 229, sets out APRA's responses, and supports the finalised guidance.

## Policy development and consultation

In April 2021, APRA released for consultation its draft guidance to institutions on managing the financial risks of climate change, with the consultation period open until 31 July 2021. Overall the submissions received via the consultation process were supportive: most submissions welcomed the PPG, with none objecting to it.

Scenario analysis, disclosure and risk management were the most common areas of feedback received on the draft guidance, while governance attracted less commentary.

Requests for more prescription and guidance were common. In many instances, increased prescription was requested to improve comparability between institutions, and also to assist institutions that are concerned that they may lack adequate capabilities or resources to address climate change financial risks. While additional clarity has been provided in some areas, APRA has endeavoured to maintain a principles-based approach to the guidance to ensure it remains flexible, adaptable to the evolving external environment, and complimentary to APRA's existing risk management and governance requirements.

In response to consultation feedback, APRA has revised guidance on considering the impacts of climate change financial risks on capital adequacy, the use of climate-related targets, and disclosing key design features of scenario analysis.

## Next steps

With CPG 229 now finalised, all APRA regulated institutions are encouraged to use this guidance to enhance their management of climate change financial risks. Institutions should consider this guidance in the context of their particular risk profile and business model. APRA recognises that not all aspects of the guidance will be relevant to all institutions.

# Glossary

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<b>APRA</b>	Australian Prudential Regulation Authority
<b>CFR</b>	Council of Financial Regulators (comprising APRA, the Reserve Bank of Australia, the Australian Securities & Investments Commission and The Treasury)
<b>CVA</b>	Climate Vulnerability Assessment
<b>ICAAP</b>	Internal Capital Adequacy Assessment Process
<b>Paris Agreement</b>	Legally binding international agreement within the United Nations Framework Convention on Climate Change, adopted by approximately 195 other countries and representing a global political consensus to limit global warming to well below 2°C above pre-industrial temperatures
<b>PPG</b>	Prudential Practice Guide
<b>RMF</b>	Risk Management Framework
<b>RSE licensee</b>	Registrable Superannuation Entity licensee
<b>TCFD</b>	Financial Stability Board's Task Force on Climate-related Financial Disclosures
<b>Tier 1 entity</b>	Entities deemed to be Tier 1 under APRA's Supervision Risk and Intensity (SRI) Model. These are entities that could have a large systemic impact.
<b>Tier 2 entity</b>	Entities deemed to be Tier 2 under APRA's SRI Model. These are entities that could have a systemic impact.
<b>YFYS</b>	Your Future, Your Super

# Chapter 1 - Introduction

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## 1.1 Background

CPG 229 is designed to assist APRA-regulated institutions in managing climate change financial risks and opportunities as part of their existing risk management and governance frameworks, in order to support better-informed decision-making.

CPG 229 does not create new requirements or obligations, and is designed to be flexible by allowing each institution to adopt an approach that is appropriate for its size, customer base and business strategy. APRA's guidance does not determine investment, lending or underwriting decisions, but rather seeks to ensure that these decisions are better informed.

The guidance is aligned with the recommendations from the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), and was developed in consultation with domestic and international peer regulators.

APRA's decision to develop CPG 229 was driven by requests from regulated institutions for information about APRA's expectations in relation to climate change financial risks, and insights into better industry practice in managing these risks. The draft CPG 229 was released for consultation in April 2021, with the consultation period running until 31 July 2021.

The development of CPG 229 is one component of APRA's broader portfolio of work on climate change financial risks. APRA, in conjunction with the Council of Financial Regulators (CFR), is continuing its Climate Vulnerability Assessment (CVA). This assessment will allow APRA and other CFR agencies to better understand the key drivers of climate change financial risks that could impact assets, liabilities and business strategies of particular institutions and the resilience of the economy. In September 2021, APRA released an Information Paper that provides further details on the CVA design and approach.<sup>1</sup>

## 1.2 Consultation process

In April 2021, APRA released draft CPG 229 for consultation. The consultation was open for over three months, with stakeholders invited to make written submissions. APRA also encouraged regulated institutions to consider how the guidance may be applied within the context of their specific structure, business mix and objectives. Feedback was also sought on draft CPG 229's overall applicability and flexibility, given the diverse impact climate change financial risks can have.

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<sup>1</sup> APRA, [Climate Vulnerability Assessment](#) (Information Paper, 3 September 2021)

APRA received 48 written submissions from a diverse range of stakeholders. In addition to receiving feedback from insurers, authorised deposit-taking institutions and Registrable Superannuation Entity licensees (RSE licensees), submissions were also received from financial services industry and professional bodies, the resources sector, investment management firms, academics and a range of consultants: non-confidential submissions are available on APRA's website. Submissions were generally supportive of the guidance, with none objecting to it. APRA's responses to the issues raised in submissions are detailed in this paper.



### 1.3 Next steps

APRA encourages institutions to adopt CPG 229 in a manner that reflects their size, business mix and complexity. Institutions are encouraged to determine and follow their own implementation approach and timeframes.

APRA intends launching a survey on climate change financial risk, which would assist APRA in understanding the alignment between institutions' management of climate change financial risks, the guidance set out in CPG 229, and the TCFD recommendations. APRA completed a pilot of this survey with 10 institutions in October 2021, and will now expand this to a wider group of participants.

# Chapter 2 - Response to submissions

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This chapter details the feedback received on the draft CPG 229, as well as APRA's response to the feedback. It is structured around the four sections of CPG 229: governance; risk management; scenario analysis; and disclosure, with the final section of the chapter covering general themes emerging from submissions and matters relating specifically to superannuation trustees.

## 2.1 Governance

CPG 229 provides guidance on governance, including prudent practice for the board and senior management in understanding, assessing and managing climate change financial risks.

### Comments received

Many submissions expressed support for the guidance in CPG 229 on governance, including how the respective roles of the board and senior management are described. Respondents suggested some changes in specific areas.

Incorporating expectations for remuneration practices into CPG 229 was a theme in multiple submissions. Some submissions suggested there should be a connection between climate change financial risks performance objectives and remuneration to provide clear incentives on those accountable.

Respondents also expressed a desire for the governance section of CPG 229 to explicitly reference legal opinions on climate change and directors' duties.

### APRA's response

APRA's prudential requirements for remuneration are set out in *Prudential Standard CPS 511 Remuneration* (CPS 511). Under this prudential standard, APRA-regulated institutions must design and maintain a remuneration framework that promotes effective management of both financial and non-financial risks. For larger institutions, this includes giving material weight to non-financial measures in the determination of variable remuneration.

APRA's remuneration requirements are principles-based. It is up to institutions to determine the non-financial measures that best suit their particular strategy and risk objectives, and reflect their specific risk profile. APRA's *Prudential Practice Guide CPG 511 Remuneration* (CPG 511) provides some illustrative examples of non-financial measures that institutions may include in the design of variable remuneration, based on better practices observed domestically and internationally. This could include, for example, measures designed to promote the prudent management of climate risks.

APRA has observed that some international regulators are increasingly making a direct connection between climate risk and remuneration. APRA continues to monitor international developments in this respect, but retains the view that boards should maintain the discretion to design a remuneration framework that is appropriate for their institution.



CPG 229 is already well aligned with other relevant governance requirements and guidance, including the specific examples raised within submissions. APRA has not referenced specific legal opinions on climate change and directors' duties within CPG 229 to maintain the broad applicability of the guidance. Institutions are encouraged to consider all current information considered relevant.

## 2.2 Risk management and ICAAP

CPG 229 provides guidance on managing climate change financial risks under existing risk management frameworks. The guidance encourages an institution to ensure that its arrangements to identify, measure, monitor, manage, and report on its exposure to climate change financial risks are conducted in a manner appropriate to the institution's size, business mix and complexity of its business operations.

### 2.2.1 Risk management

Guidance is provided on understanding climate change financial risks, and how they may affect an institution's business model.

#### Comments received

Many submissions welcomed APRA's guidance to consider climate change financial risks within existing frameworks, including the board-approved risk appetite statement, risk management strategy and business plan. Submissions included comments on areas for additions and clarification.

There were diverse views on determining the materiality of climate change financial risk within the risk management framework (RMF), particularly the relationship between risk materiality assessments within an institution's RMF and CPG 229. Submissions contended that APRA should expect institutions to identify climate change financial risks as a material risk, others requested flexibility for how to incorporate it into the RMF.

Submissions also raised the following:

- in relation to risk identification, a number of submissions highlighted challenges associated with appropriately identifying climate change financial risks, including the sometimes complex nature of processes and the need for specialist expertise;
- on risk monitoring, many submissions noted that better data is needed to effectively monitor climate change financial risks, as well as highlighting difficulties in developing metrics. More guidance was requested on the assessment of scope 3 emissions, as they typically account for the majority of greenhouse gas emissions for finance sector businesses. Submissions also highlighted that significant direct and indirect emissions data gaps exist across the industry; and
- a number of submissions suggested CPG 229 include commentary on climate-related target setting, with some submissions suggesting that the inclusion of target-setting within CPG 229 would further align the guidance with the TCFD recommendations. Submissions also recommended the guidance contain more explicit emphasis and coverage on the role of net zero commitments and Paris Agreement-aligned targets within the prudent management of climate change financial risks.





design features as this limits practices and constrains innovation in an area that is still developing. Instead, APRA has amended the PPG to make it clear that where institutions voluntarily disclose the outputs of their scenario analysis, they should also disclose the key design features influencing the results. Additionally, when institutions present climate scenario analyses to their boards, they should be able to explain why the scenarios used were appropriate for assessing the climate change financial risks faced by the institution.

### 2.3.2 Scenario prescription

#### Comments received

A common request across responses was for APRA to provide additional prescription around the capabilities that institutions conducting leading analysis should seek to develop. A number of responses also asked that APRA promote examples of best practice analysis and conduct CVAs with a wider range of institutions.

Some of the more specific requests asked that APRA highlight the strengths of different forms of scenario analysis and stress testing, and further explain how institutions should conduct shorter-term and longer-term analysis. Many responses requested that the wording of the less than 2°C scenario pathway be altered to more closely align with the Paris Agreement. Other responses questioned the relevance of global average versus location-specific or event-specific climate change, and the appropriateness of a 4°C scenario, given the severity of the associated physical risks.

#### APRA's response

An overly prescriptive approach would make the guidance less flexible and potentially less relevant to institutions with different business models. APRA recognises the value provided by best practice case studies for a range of institution sizes, business mixes and scenario purposes. However, climate risk scenario analysis and stress testing is an emerging field and best practice is quickly evolving. For this reason, it would not be appropriate to include case studies in the guidance at this stage.

APRA is also not adding further prescription to the guidance around shorter- and longer-term scenario horizons. The current descriptions allow institutions the flexibility to design scenarios aligned with their shorter-term business cycles and longer-term strategic directions.

APRA has amended its guidance for the second scenario to better align to the Paris Agreement objective of limiting the increase in global average temperatures to well below 2°C by 2100<sup>2</sup>. Additionally, APRA has updated the scenario specifying average global warming

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<sup>2</sup> It is standard practice for temperature pathways to refer to a level of average global warming by 2100, relative to a 1850-1900 baseline. APRA does not expect entities to conduct assessments to 2100.

in excess of 4°C by 2100 to a scenario of 3°C or more by 2100. This change has been made to better align the guidance to current understanding of potential future climate trajectories<sup>3</sup>.

APRA is not suggesting institutions conduct financial modelling to 2100, but rather to 2050. In assessing the associated physical risks, APRA would expect institutions to consider the impacts of increased frequency and severity of idiosyncratic tail-end weather events. Additionally, APRA maintains that better practice analysis would take various levels of geographic specificity into consideration when assessing the physical risks of climate change.

## 2.4 Disclosure

In CPG 229, APRA notes that there is increasing demand from investors and other stakeholders for institutions to disclose climate change financial risks. In light of these pressures, a prudent institution would likely consider whether additional voluntary disclosures could be beneficial. Voluntary disclosures may enhance transparency, and provide confidence to the wider market of the institution's approach to measuring and managing climate change financial risks. Where an institution does choose to provide additional voluntary disclosures, APRA considers that the framework established by the TCFD to be a sound basis for producing this information.

### Comments received

A large number of respondents focused on how active APRA should be in setting disclosure guidance, and ensuring any expectations are internationally aligned. Some respondents supported APRA's stance on disclosure, commenting that they see mandating disclosures as outside APRA's remit. Many others sought for APRA to mandate, or at least expect, disclosures in line with actions taken by international peer jurisdictions. All respondents that commented on the most appropriate disclosure framework supported the use of the TCFD. Many requested APRA to highlight that, where an institution chooses to disclose, it would be best practice to do so in line with the TCFD.

### APRA's response

APRA is not making any amendments to the current disclosure guidance. Requiring disclosure falls beyond the scope of CPG 229, which is intended to provide guidance rather than set new requirements. Any proposal by APRA to require disclosure would be subject to usual consultation processes before introduction.

Where institutions do choose to disclose, APRA has strengthened the guidance to highlight that it would be better practice to do so in line with the TCFD framework.

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<sup>3</sup> For example, the highest emissions scenario assessed by the Network for Greening the Financial System is for approximately 3°C of warming (Current Policies scenario) by 2100, while the best estimate temperature outcome for the two highest emissions scenarios assessed by the Intergovernmental Panel on Climate Change in its Sixth Assessment Report are 3.6°C (SSP3-7.0 scenario) and 4.4°C (SSP5-8.5 scenario) by 2080-2100.

## 2.5 Other issues

Stakeholders provided several suggestions on language and structure, and requested clarification on a range of issues, both procedural and technical in nature. Respondents also raised issues specific to superannuation trustees.

### 2.5.1 Supervision, implementation and proportionality

#### Comments received

Requests for clarification on APRA's approach to supervision and implementation were raised in a number of submissions. Respondents sought further information on APRA's supervisory approach to climate change financial risks. Regarding implementation, some submissions requested guidance around timelines for institutions to become 'compliant', while others emphasised the importance of not creating binding compliance dates. Respondents also requested that APRA allow international institutions to demonstrate compliance with an established and comparable framework in its home jurisdiction. Additionally, the importance of proportional and flexible guidance was emphasised in submissions.

#### APRA's response

Like all PPGs, CPG 229 reflects APRA's views on sound practice and should be considered by all regulated institutions. APRA has previously conveyed that institutions should retain the flexibility to configure their approaches to climate change financial risk management in a manner best suited to their particular risk profile and business model.<sup>4</sup> Not all of the guidance will be relevant to all institutions, and there will not be a 'compliance' deadline. This flexibility extends to implementation.

Similarly, foreign owned institutions are not constrained from aligning with comparable frameworks in a home jurisdiction.

APRA's approach to the supervision of institutions' management of climate change financial risks is expected to progress along two related pathways. The first, as indicated with the current CVA work with Australia's largest five banks, will follow a quantitative approach to understanding climate risk, and the management actions that may be taken in response. Over time, APRA expects the scope to extend from banking to institutions in other regulated sectors, and for methods to develop for a wider range of institutions to implement.

The second pathway is closely associated with CPG 229, and the TCFD guidance. In recent months, APRA has piloted a climate risk self-assessment survey, which tests the maturity of institutions' approaches to climate risk in the domains of governance, risk, strategy, and metrics and targets. With the benefit of lessons learnt from the pilot, APRA intends to

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<sup>4</sup> APRA, [Consultation on Draft Prudential Practice Guide on Climate Change Financial Risks](#) (Letter, 22 April 2021)

undertake a wider survey across all Tier 1 and 2 entities in the near future: APRA will use the results of the survey to benchmark entity performance against CPG 229, as well as the TCFD.

The self-assessment survey will also allow APRA to compare entity results to those of peers, industry and national averages, identify common areas where institutions face challenges, leverage the results of the survey to better target supervisory engagement on climate risk with individual institutions in Australia, and to potentially compare Australian entity performance with peer institutions internationally. APRA will publish further details when the climate self-assessment survey commences for Tier 1 and 2 entities.

## 2.5.2 Structure and language

### Comments received

While there was broad recognition that CPG 229 is intended to be read alongside CPS 220, *Prudential Standard SPS 220 Risk Management (SPS 220)*, *Prudential Standard CPS 510 Governance (CPS 510)* and *Prudential Standard SPS 510 Governance (SPS 510)*, a number of submissions requested that the guidance more explicitly highlight the linkages within APRA's prudential framework. Some submissions made requests for direct links to risk management and governance requirements, as they wanted more clarity on how they interact with CPG 229. One submission suggested that, to more clearly understand this alignment, APRA restructure the guidance to replicate the sections of CPS 220.

Some respondents also suggested changes to the language used in CPG 229, suggesting that stronger language was required to compel institutions to address climate change financial risks. Another submission suggested that the title be changed from 'climate change financial risks' to 'climate risks', arguing the guidance goes beyond financial risks, such as reputational risk.

### APRA's response

The draft CPG 229 was drafted to support compliance with APRA's existing risk management and governance requirements, providing guidance to assist an institution to understand and manage climate change financial risks and how these risks can be considered within existing frameworks. In some sections APRA has sought to more directly link sections of CPG 229 with existing risk management and governance frameworks while still allowing the relevance of the guidance to extend beyond these specific requirements.

APRA has not amended the structure of CPG 229 to align with CPS 220 (noting that some aspects of the guidance also link to other APRA standards). This is because APRA believes that it is more useful to align the structure with the international TCFD framework.

The language in CPG 229 reflects its status as guidance: APRA recognises that climate change financial risks are an emerging risk category, and it is appropriate to provide flexibility in how institutions understand and respond to these risks.

APRA has not changed the title of the guidance to 'climate risks'. The risks highlighted in the guidance, while not always purely financial in the first instance, ultimately pose financial risks to institutions and the system more broadly.

### 2.5.3 Matters specific to superannuation

#### Comments received

Submissions sought alignment between CPG 229 and existing provisions in *Prudential Standard SPS 530 Investment Governance* (SPS 530) and *Prudential Practice Guide SPG 530 Investment Governance* (SPG 530). Respondents requested specific guidance on how climate change financial risk should be considered by RSE licensees in investment decision making. Respondents also noted that CPG 229 does not include common terms used in the superannuation sector, such as asset allocation and investment strategy.

The interactions between the Government's *Your Future, Your Super* (YFYS) reforms that came into effect on 1 July 2021 and CPG 229 were raised in multiple submissions. Respondents focused on the intersection between CPG 229 and the new best financial interests duty, and how RSE licensees should be contemplating managing climate change financial risk in the context of the performance test.

#### APRA's response

APRA has noted the feedback received on alignment between CPG 229, SPS 530 and SPG 530: this feedback will be considered as part of APRA's proposed enhancements to SPS 530 and SPG 530.<sup>5</sup> CPG 229 has not been updated to cover concepts such as asset allocation and investment strategy, as these fall within the scope of SPS 530 and SPG 530.

On the issues raised in relation to the YFYS reforms:

- RSE licensees must comply with both the best financial interests duty and the sole purpose test (refer to sections 52(2)(c) and 62 of the *Superannuation Industry (Supervision) Act 1993* respectively) when making investment decisions. This means that RSE licensees are required to generate returns and manage risks in the best financial interests of members, regardless of the type of investment, and to act where these outcomes require improvement. Given climate risks are material, especially when investing over long time horizons, APRA expects prudent RSE licensees will take climate change financial risk into account in the same way as other risks they consider, with the ultimate objectives unchanged: considering whether the proposed investment is ultimately in the best financial interests of members, is consistent with the RSE licensee's investment governance framework and aligns with a properly formulated investment strategy or strategies, including the relevant risk and return objectives.
- On the performance test, the benchmarks used to assess investment performance are set by the *Treasury Laws Amendment (Your Future, Your Super—Addressing Underperformance in Superannuation) Regulations 2021*. RSE licensees should consider the investment performance delivered by their approach to managing climate change financial risk in the context of these benchmarks. Over time different indices may be

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<sup>5</sup> APRA, [Strengthening investment governance](#) (Letter, 29 September 2021)



considered more appropriate, and APRA will provide advice to the Government on possible revisions to benchmarks.

#### 2.5.4 Additional issues raised

Two additional topics were raised in submissions regarding liability risk and social considerations: these are summarised in Table 1, together with APRA's response.

**Table 1. Additional issues and APRA's response**

Topic	Comments received	APRA's response
Liability risk – categorisation	Some respondents questioned the categorisation of liability risks, suggesting the current approach means the guidance is broader than, and inconsistent with, the TCFD (which includes liability risk within transition risk).	Liability risk is identified separately from transition risk within CPG 229 to highlight its unique properties when compared to other transition risks. Entities have discretion to categorise and report on this risk in a manner that suits their business.
Social consideration	A number of respondents suggested APRA include reference to social considerations and a just transition.	Including this in CPG 229 would be beyond the scope of the guidance and outside of APRA's mandate.



APRA