Australian Banking Association

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General Manager, Policy Development
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Australian Prudential Regulation Authority
Via email: PolicyDevelopment@apra.gov.au

Dear APRA colleague,

Consultation on CPG 229 – Climate Change Financial Risks

The Australian Banking Association (**ABA**) welcomes the opportunity to make this submission to the Australian Prudential Regulation Authority's (**APRA**) consultation on *Draft CPG 229 – Climate Change Financial Risks* (**draft CPG 229**). The ABA understands climate-related risk to be foreseeable, material, and actionable now. Therefore, the ABA supports the work of APRA in the development of prudential guidance for climate-related risk.

The ABA supports APRA's approach in draft CPG 229. The understanding of climate-related risks is nascent and disparate. As the management of climate-related risk matures it is important that early guidance remains flexible to enable the development of those processes. Therefore, the ABA supports principles-based guidance which incorporates the following in its design:

- *International alignment* – A globally consistent view will be important to reduce work effort and complexity for banks that are subject to the requirements of different jurisdictions.
- *Collaborative exploration between the regulator and industry* –The ABA has valued the collaborative approach that APRA has taken with the Climate Vulnerability Assessment (**CVA**). Continued collaboration will be important to build capability in the banking industry.
- *Flexibility of guidance* – Flexible guidance allows each APRA regulated entity to configure its approach dependent on business objectives.

The annexure provides specific feedback on draft CPG 229 however we highlight two matters.

First, the ABA's view is that the incorporation of climate-related risk into existing governance, risk and capital management practices is an iterative process requiring:

- New knowledge and processes, for which APRA regulated entities will need to upskill.
- All banks to have access to the detailed design of the CVA to enable them to further develop their approaches to climate-related risk assessments.
- Inputs such as appropriately detailed data sets; and an economy-wide classification system for economic activity (a taxonomy).

Second, we note the importance of providing guidance to APRA regulated entities in respect to incorporating climate-related risk into the risk management framework in the first instance. The incorporation of the ICAAP as the appropriate framework to consider and record the capital impact of climate-related risks, will be an outcome of a multi-stage process and not an initial starting point.

The ABA recommends that APRA develops a roadmap which will see each of these issues considered. We look forward to working collaboratively with APRA in this evolving process.

Kind regards,

[redacted]
Policy Director

Australian Banking Association

Annexure

1. Arrangement of CPG 229

It would be useful for CPG 229 to be organised in a similar manner to CPS 220 Risk Management (**CPS 220**) and for CPG 229 to provide guidance across all aspects of the RMF. CPG 229 would then cover systematically as appropriate each element of the RMF:

- Risk governance
- Role of the Board
- Risk management framework
- Material risks
- Risk appetite statement
- Risk management strategy
- Business plan / Strategic and business planning
- Policies and procedures
- Risk management function
- ICAAP

Much of the material is already included in CPG 229, however a reorganisation of the structure will make the alignment easy to ascertain (for example paragraph 25 on the ICAAP is included in the section on Risk Identification).

The ABA suggests draft CPG 229 be reorganised to reflect the structure of CPS 220.

2. Financial risks of climate change

2.1 Lexicon for climate-related risk

CPG 229 is titled and refers to 'climate change financial risks', however the scope of CPG 229 extends beyond financial risks. For example, draft CPG 229 provides non-financial examples such as reputational risk (paragraph 10). Additionally, as CPG 229 is intended to inform the application of CPS 220, the actual scope of CPG 229 is presumably intended to be broader than just financial risks, as it seeks to provide guidance to the management of an institution's material risks. Material risks are defined in CPS 220 (paragraph 20) as 'those that could have a material impact, both financial and non-financial, on the institution or on the interests of depositors' and operational risk is included as one of the material risks that an institution's risk management framework must address (paragraph 26).

Further, globally, it is approaching common practice to refer to 'climate-related' rather than 'climate change financial risk', the former better captures the breadth of the topic[1].

ABA suggests that APRA refer to 'climate-related risk' in CPG 229 and consider changing the title accordingly to achieve consistency with CPS 220 and international alignment.

2.2 Alignment with global definitions for physical and transition risk

Given that understanding of climate-related risk is at a nascent stage, the ABA supports APRA's principles-based definitions for physical risk and transition risk in draft CPG 229.

Definitions and categorisations of physical and transition risk have already been articulated by key standards setting and regulatory agencies globally and whilst the intent of the definitions are the same, differences can lead to different interpretations and therefore applications. We also note the Australian Securities Commission (ASIC) and the Australian Stock Exchange have recommended Australian

[1] See for example recent guidance from the TCFD, ECB, EBA, BIS, NGFS.

entities refer to the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD)[2].

The ABA suggests it would be helpful for APRA's definitions of physical and transition risk to reference the TCFD definitions.

2.3 Emergent risk considerations

It is likely that the stress testing activities of other jurisdictions will illuminate emergent risks or new ways of considering existing risks of which APRA, through its membership of the Network for Greening the Financial System (**NGFS**), will have visibility. For example, risk management for asset repricing or valuation risk may become more complex under different climate change scenarios:

- For a 'disorderly transition' scenario, the rapid repricing of assets will result in initial liquidity pressure.
- For an 'orderly transition' scenario, the risk of long-term value destruction by having stranded assets which will result in a loss of capital.

The ABA suggests that APRA could consider incorporating some of these new types of risks into CPG 229 as examples for ARPA regulated entities to consider when assessing their climate-related risks.

3. Governance

The ABA recognises climate-related risk is foreseeable, material, and actionable now. We note that bank boards have commenced incorporating climate-related risk oversight into their practices. These practices are evolving as understanding of climate-related risks deepen and as methodologies for the assessment of climate-related risk mature.

The ABA supports APRA's position regarding the role of boards in the oversight of climate-related risk management. Further, we support alignment of CPG 229 to the governance requirements of the ASX as well as the 2021 Hutley advice[3].

4. Risk management

4.1 Approach to climate risk management

Draft CPG 229 states

> '*CPS 220 and SPS 220 identify categories of risk that the risk management framework must cover at a minimum. Climate risks can be considered within these established risk categories. A prudent institution should be able to demonstrate how it determines the materiality of climate risk within each of these categories.*' (Paragraph 23)

An alternative view is the emergent and evolving understanding and management of climate-related risk may require an interim approach to allow for flexibility in working towards the end goal of integration into existing risk types.

Therefore, the ABA recommends that CPG 229 not prescribe a specific methodology for incorporating climate-related risk into the banks' Risk Management Framework (**RMF**), enabling flexibility for banks to determine how to best incorporate this risk.

[2] ASIC 2019 19-208MR ASIC updates guidance on climate change related disclosure (link) and ASC 2020 'Climate Change risk disclosure (link)

[3] Refer to CPD, 2021, https://cpd.org.au/2021/04/directors-duties-2021/

4.2 Disclosure

The ABA endorses APRA's support for the TCFD. However, we note that the mandating of climate related disclosure should be done by government for all Australian companies (all corporates as well as public and private entities). Widespread disclosure will be required across the economy to enable APRA regulated entities to assess counterparty risk.

4.3 Prescribed Actions

The ABA notes the suggested mitigating actions listed in paragraph 33. The nature of banking is such that the options listed occur in the ordinary course of banks' risk management activities, irrespective of the risk type. Therefore, these suggested actions are not seen as being specific to the management of climate-related risk alone.

In addition, there may be segments of the economy that are unable to fully mitigate their exposure to climate change, e.g., certain parts of the farming sector. These customers play an important role in supporting regional economies and communities. The actions prescribed in 33 (a) to (c) may not align to the strategic considerations of the APRA regulated entity.

The ABA suggests that the mitigating actions listed in paragraph 33 (a) to (c) be removed.

4.4 Scenario Analysis

The ABA notes that a quantitative methodology, which is augmented with qualitative methods, is the approach adopted by the NGFS. The NGFS also suggests scenario analysis as a useful methodological framework. APRA's principles-based approach in the 'Scenario Analysis' section of draft CPG 229 aligns with that of the NGFS.

The ABA supports a 'globally consistent-locally relevant' approach to climate change scenario analysis as is reflected in paragraph 40.

However, it would be helpful to reference the CVA as the mechanism by which quantitative (and qualitative) climate risk assessment can be undertaken. Given the CVA is charting the course for how climate risk assessment will be undertaken by APRA regulated entities it will be unhelpful for those entities to develop their own methodologies which over time may not align to the CVA approach. This will cause rework for those regulated entities and any published results, even under a common disclosure framework such as the TCFD, will not be comparable.

The ABA encourages APRA to provide the CVA design to all banks.

4.5 Internal Capital Adequacy Assessment Process

Draft CPG 229 nominates the ICAAP as the 'appropriate framework to consider and record the capital impact of capital adequacy of climate risks' (Paragraph 25).

The ABA agrees with APRA that incorporation of climate-related risk in the ICAAP will be the end-state for all APRA regulated entities. However, it is worth noting that draft CPG 229 rightly identifies the starting point for climate-related risk assessment as the embedding of that risk into the entity's RMF and additional steps subsequent to this (described below) will need to be accomplished before climate-related risk can be successfully incorporated into the ICAAP.

The ABA's view is that the incorporation of climate-related risk into the ICAAP at this stage is premature.

Rationale

(i) *The incorporation of climate-related risk in the RMF is in its early stages and is complex.*

An APRA regulated entity's RMF is multi-faceted. CPS 220 identifies the following elements:

(a) 'A risk appetite statement

(b) *An RMS [risk management strategy]*

(c) *A business plan*

(d) *Policies and procedures supporting clearly defined and documented roles, responsibilities, and formal reporting structures for the management of material risks throughout the institution*

(e) *A designated risk management function that meets the requirements of paragraph 37*

(f) *An Internal Capital Adequacy Assessment Process (ICAAP)*

(g) *A management information system …. For measuring, assessing, and reporting on all material risks across the institution and*

(h) *A review process to ensure that the management framework is effective in identifying, measuring, evaluating, monitoring, reporting, and controlling or mitigating material risks'* (paragraph 23)

The ICAAP models a detailed understanding of risks. Its effectiveness is premised on risks being assessed and mitigation strategies being embedded within business practices. The ICAAP is defined as:

> *'an integrated approach to risk management and capital management, based on assessing the level of, and appetite for, risk in the [entity] and ensuring that the level and quality of capital is appropriate to that risk profile*'[4]
>
> A '*key component of an ICAAP is the setting of target levels of capital. The capital standards require a regulated institution, as part of the ICAAP, to set capital targets based on its own assessments of its capital needs*'[5]

To incorporate climate-related risk management into the ICAAP, climate-related risk management must first be considered, assessed, and integrated into the APRA regulated entity's Risk Appetite Statement, RMS, business plan, policies etc. This requires a mature understanding of the climate-related risk management. Whilst the processes to understand, assess and respond to climate-related risk are underway in banks these processes are nascent and therefore may not be able to be integrated into ICAAP presently.

Additionally, assessing climate-related risk impacts from a stress testing perspective requires the traditional stress tests approach to be substantially re-imagined. For example, ARPA regulated entities will need time to adapt stress modelling techniques to incorporate risks associated with climate change that will manifest over a longer time horizon and support an exercise that, at a minimum, needs to be composed of four parts:

1. Modelling the climate variables,
2. Measuring the impact of climate on macroeconomic variables,
3. Breaking down the overall macroeconomic impact across sectors, and
4. Quantifying the combined impact on financial firms.

As noted above, developing these will take time, requires upskilling of people, process and systems and will have dependencies on successfully accomplishing other aspects of CPS229.

(ii) *The incorporation of ICAAP processes into climate-related risk management will be dependent on other elements, such as a climate change data and a taxonomy which are not yet in place.*

We note the European Banking Authority's (**EBA**) publication[6] of the results of the EU-wide pilot exercise on climate-related risk which focussed on developing a common understanding of the process for assessing climate-related risk, stress testing protocols, data gaps, and common taxonomy. The pilot

[4] CPG 110 ICAAP and Supervisory Review paragraph 7
[5] CPG 110 ICAAP and Supervisory Review paragraph 19
[6] EBA, 2021, Mapping Climate Risk: Main findings from the EU-wide pilot exercise

sought to construct a 'Green Asset Ratio' (GAR) for each bank in the pilot; the GAR reflects a limited set of exposures for the pilot banks. Many of the elements which the EBA is currently seeking to resolve for Europe will also need to be resolved in the Australian context. This includes, data gaps, and common taxonomy, regulatory reporting obligations.

(iii) European exercises confirm that it is premature to incorporate capital impacts of climate-related risk

Finally, we note the recent publication of the Bank of International Settlement which concludes that for climate-related risk scenario analyses, the setting of an additional level of capital is 'considered premature given the preliminary nature of the exercises and the high-level of uncertainty attached to their results.'[7] This is the case in the EU where the capital implications from the pilot have not yet been ascertained. In Australia, the CVA is in its early stages and covers only a small number of APRA regulated entities.

The ABA considers that it is premature to introduce additional capital for climate-related risks.

4.6 Recommendation

The ABA's view is that the incorporation of climate-related risk into existing risk and capital processes is an iterative process. It requires new knowledge, data, and processes. Further, smaller APRA regulated entities will need to upskill for climate-related risk assessments.

The ABA recommends APRA work with its regulated entities to develop a roadmap to fully incorporate climate-related risks and capital impacts in the ICAAP. We further suggest:

- The roadmap should incorporate appropriately phased key milestones and appropriate deadlines to achieve these, as well as a supervisory process/framework (e.g., yearly review by APRA) that will assist regulated entities and APRA in meeting the agreed timetable.
- Potential roadmap elements for further discussion could include[8]:
    - CVA:
        - Publishing the design of the CVA
        - Development of the CVA process
    - Bridging data gaps.
    - Developing a common understanding of green, brown, and grey asset types per the EU's Taxonomy.
    - Development of additional climate and stress testing related data to supplement traditional risk related information in APRA regulated entities' ICAPP:
        - The supplementary climate-related risk data would not inform ICAAP outcomes.
        - A key area for consideration could be the alignment of the ICAAP time horizon compared to the longer-term scenario analysis time horizon.

The ABA would be pleased to work with APRA as it undertakes development of a roadmap.

[7] Bank for International Settlements, FSI Insights on Policy Implementation No 34. P2. https://www.bis.org/fsi/publ/insights34.pdf
[8] The following are indicative only.