Environmental
Defenders Office

Submission on the APRA Draft Prudential Guide CPG 229 Climate Change Financial Risks (April 2021)

6 August 2021

About EDO

EDO is a community legal centre specialising in public interest environmental law. We help people who want to protect the environment through law. Our reputation is built on:

Successful environmental outcomes using the law. With over 30 years' experience in environmental law, EDO has a proven track record in achieving positive environmental outcomes for the community.

Broad environmental expertise. EDO is the acknowledged expert when it comes to the law and how it applies to the environment. We help the community to solve environmental issues by providing legal and scientific advice, community legal education and proposals for better laws.

Independent and accessible services. As a non-government and not-for-profit legal centre, our services are provided without fear or favour. Anyone can contact us to get free initial legal advice about an environmental problem, with many of our services targeted at rural and regional communities.

Environmental Defenders Office is a legal centre dedicated to protecting the environment.

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Submitted to:

For further information on this submission, please contact:

Senior Solicitor, Safe Climate – Gas & Corporate

EXECUTIVE SUMMARY

1. The Environmental Defenders Office (**EDO**) recognises and generally supports APRA's recent attempts to engage with its regulated entities on climate change, including the publication of the *Prudential Practice Guide: Draft CPG 299 Climate Change Financial Risks* (**Draft CPG 229**) and the commencement of a pilot program of Climate Vulnerability Assessments starting with the largest banks.

2. However, whilst the EDO considers that the publication of Draft CPG 229 is a step in the right direction, we consider that it has a number of weaknesses, including that:

    a. the guide fails to address key issues arising from the current voluntary disclosure regime, being:

        i. no/limited data for key metrics; and

        ii. lack of comparability of available data.

    b. Draft CPG 229 is drafted as a voluntary "best practice guide" rather than a statement setting out a regulatory expectation of minimum disclosure. The EDO is concerned that the failure to set out minimum expectations will dilute the effectiveness of the guidance and will likely hamper the take-up of its recommendations.

3. The EDO joins a number of high profile business groups, including the Investor Group on Climate Change, Climate Disclosure Program and UN Principles of Sustainable Investment (forming part of Investor Agenda Group) (**Investor Agenda Group**) and the Australian Sustainable Finance Initiative, in calling for mandatory disclosure, including of all APRA-registered entities with an annual consolidated revenue of $100 million or greater, or with $1 billion or more in total assets under management on a "comply or explain" or "if not why not" basis. In the event that a Mandatory Climate Change Disclosure Regime cannot be immediately adopted without legislative amendment, we also recommend important interim steps for APRA (see paras 26 and 27 of this submission).

4. **This submission addresses the following:**

    a. The failure of the current disclosure regime to address climate change risks

        i. The current disclosure regime

        ii. Climate change disclosure under the current regime

            1. Limited data for key metrics

            2. Lack of comparability of available data

    b. The call for more adequate climate change disclosure

    c. Issues with Draft Prudential Guide CPG 229

        i. Failure to address issues under the current regime

        ii. CPG 229 as a best practice guide and why this is not enough

        iii. Additional clarification required

    d. Recommendations

A - FAILURE OF THE CURRENT DISCLOSURE REGIME TO ADDRESS CLIMATE CHANGE RISKS

The current disclosure regime

5. On a broad level, the current regime mandates disclosure of material risk and its impact on (1) the financial position and performance of the entity; and (2) the liquidity/capital adequacy of the entity.

6. More specifically:

   a. Locally-incorporated Authorised Deposit-taking Institutions (**ADIs**) are required to make *“accurate, high quality and timely public disclosures of information”* in respect of their risk profile, risk management, capital adequacy, capital instruments and remuneration practices, and (where applicable) in respect of their leverage ratio, liquidity coverage ratio, net stable funding ratio and global systemically important bank indicators.[1]

   b. As part of the Internal Capital Adequacy Assessment Process (**ICAAP**), ADIs, General Insurers, Life insurers and friendly societies are required to,[2]among other things:

      i. consider all risks to which the regulated institution is exposed;

      ii. have in place adequate policies, procedures, systems, controls and personnel to measure, monitor and manage the risks arising from the entity’s activities, and the capital held against such risks. A material change in an entity’s risk profile requires reconsideration of capital needs and/or a review of the entity’s ICAAP;

      iii. have in place a strategy for ensuring adequate capital is maintained over time;

      iv. undertake stress testing and scenario analysis relating to potential risk exposures and viable capital resources; and

      v. have in place policies to address the capital impact of material risks not covered by explicit regulatory capital requirements.

   c. All APRA-regulated institutions are expected to have in place a risk appetite and risk management framework that will address all material sources of risk.[3]

   d. All APRA-regulated entities are required to report their financial position and performance to APRA. These reports are all required to be made in accordance with the Australian Accounting Standards. The Australian Accounting Standards Board (**AASB**) Conceptual Framework for Financial Reporting (Conceptual Framework) provides that information in financial reports should be (1) relevant, in the sense of being material; and (2) a faithful representation, in the sense of being complete, neutral and free from error.

   e. Registered Superannuation Entity licensees are required to formulate, review regularly and give effect to an investment strategy which has regard to the risk involved in

[1] Prudential Standard APS 330 Public Disclosure.

[2] Prudential Practice Guide CPG 110 – Internal Capital Adequacy Assessment Process and Supervisory Review

[3] CPS 220 Risk Management.

making, holding and realising investments, as well as the likely return from the investments covered by the strategy.[4]

f. Any APRA-regulated entities who are also public companies or mid and large-sized proprietary companies are also required under the *Corporations Act 2001 (Cth)* (**Corporations Act**) to prepare financial reports, disclosures and notes, a director's declaration and a director's report. The financial statements and notes must give a true and fair view of the financial position and performance of the company.[5] There are also requirements for disclosure in respect of Prospectuses.[6]

g. APRA regulated companies which are also listed companies are required to:

   i. disclose the extent to which the entity has followed the recommendations set by the ASX Corporate Governance Council, which includes Recommendation 7.4, *"A listed entity should disclose whether it has any material exposure to environmental or social risks, and if does, how it manages or intends to manage those risks"*; and

   ii. include an operational and financial review (**OFR**)[7] in their annual report. ASIC's Regulatory Guide 247 notes that climate change is a systematic risk that could have a material impact on a company's future financial position, performance or prospects, and therefore should be included in the OFR of listed entities.

7. Information is defined by the AASB to be material if *"omitting, misstating or obscuring"*[8] the information *"could reasonably be expected to influence decision that the primary users of general purpose financial reports make on the basis of those reports."*[9]

8. In April 2019 the AASB and the Auditing and Assurance Standards Board (**AUASB**) released Practice Statement 2 entitled *Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2* which stated that climate-related risks are material and should be disclosed if investors (or users of financial statements) *"reasonably expect that climate-related risks or other emerging risks have a significant impact on the entity"* and/or if the climate-related risk could qualitatively influence investors' (or users') decisions. The Practice Statement noted that disclosure of financial risk of climate change could take the form of:

   a. disclosures in the notes to the financial statements, including disclosures as to assumptions applied. The Practice Statement noted that entities in sectors particularly

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[4] s 52(6) *Superannuation Industry (Supervision) Act 1993 (Cth);* Prudential Standard SPS 530 Investment Governance.

[5] S 297 *Corporations Act.*

[6] ASIC issued an update to Regulatory Guide 228 stating that climate change risk may be required to be disclosed in a Prospectus.

[7] Section 299A(1) of the *Corporations Act.*

[8] Information is taken to be "obscured" if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or mistaking that information, such as where (1) information regarding a material item, transaction or material information is disclosed but the language used is vague or unclear; (2) information regarding a material item, transaction or other event is scattered throughout the financial statements; (3) dissimilar items, transactions or other events are inappropriately aggregated; (4) similar items, transactions or other events are inappropriately disaggregated; and (5) the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

[9] Accounting Standard AASB 101 at page 7.

impacted by climate-related risks should disclose their assumptions regarding climate-related risks, regardless of their quantitative impact;

b. recognising an asset impairment. This was the subject of an updated ASIC Information Sheet (INFO 203) in which ASIC updated its guidance on asset impairment to state that directors should consider the impact of climate change risk when devising assumptions for the making of impairment calculations;

c. recognising a reduction in the useful life of an asset;

d. factoring climate-change risk into assumptions used in the calculation of an asset's fair value;

e. recognising an increase in credit risk caused by climate change;

f. recognising an onerous contract provision as a result of potential loss of revenues or increased costs arising from climate change; or

g. recognising a provision or contingent liability as a result of responding to the risks of climate change, e.g. recognising a contingent liability for potential litigation or fines/penalties due to more onerous climate change regulations.

Climate change disclosure under the Current Regime

9. There been some progress in respect of companies disclosing climate change risk. According to the Investor Agenda Group, in 2019 sixty of the ASX 200 disclosed under the Task Force for Climate Related Financial Disclosures (**TCFD**) framework and a further 14 companies committed to future disclosure under the TCFD.[10] Further, over 56% of companies from higher risk sectors are now reporting as against the TCFD. [11]

10. However, there are two major issues in respect of disclosure under the current regime:

    a. there is no/limited data for key metrics; and

    b. of the data that is available, there is a lack of comparability of data.

Limited data for key metrics

11. Companies are failing to disclose and/or are failing to adequately disclose the following key information:

    a. **Scope 3 emissions** - The National Greenhouse and Energy Reporting Scheme (**NGER**) does not require disclosure of Scope 3 emissions and there is concern that there is an across-the-board under estimation of Scope 3 emissions. According to the Investor Agenda Group, the Carbon Disclosure Project's recent analysis suggests that real Scope 3 emissions, being indirect greenhouse gas emissions within an entity's value chain, are more than double previous estimates.[12] The Greenhouse Gas Protocol has noted that Scope 3 emissions can account for over 90% of total lifecycle emissions in a value chain, meaning a failing to disclosure this information can significantly under-estimate both

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[10] Investor Group on Climate Change, Climate Disclosure Project, PRI Principles of Responsible Investment (Investor Agenda Group), June 201, *Confusion to Clarity: A Plan for mandatory TCFD-aligned disclosure in Australia.* Available at: https://igcc.org.au/wp-content/uploads/2021/06/ConfusiontoClarity_APlanforMandatoryTCFDalignedDisclosureinAus.pdf

[11] Ibid.

[12] Ibid.

the environmental impacts of activities and the trade exposure of companies. [13] For example, Kraft Foods found that Scope 3 emissions comprised more than 90% of their total emissions.[14] A failure to capture Scope 3 emissions data therefore fails to give a holistic picture of an entity's contribution to global warming.

b. **Emissions reduction targets** – According to the Investor Agenda Group, only 37% of ASX 200 companies have set emissions reduction targets, and that of those that have set targets, most are short term and/or do not include Scope 3 emissions reductions targets.[15]

c. **The exposure of companies to significant carbon holdings in their lending and investing activities** - As far as we are aware, there is currently no mandatory requirement in Australia for APRA-regulated entities to publicly disclose the portfolio holdings and/or the carbon intensity of their lending and investing portfolios. Such information is critical to assessing the exposure of companies to transition risk, particularly the risk of stranded assets.

d. **How companies are incorporating climate change into their business strategy** – Companies are failing to provide information on how they are incorporating climate change into their business strategy, including climate change's impact on the company's risk appetite and risk profile, supply chain, demand for products/services, credit and liability risk.

e. **How companies are assessing their vulnerability to climate change in response to scenario analysis and stress testing** - Despite the increasing uptake in scenario analysis and stress testing, very few companies are coming to the conclusion that their companies are negatively impacted by climate change, even in those industries (such as coal, oil and gas) that are most heavily impacted. This is most likely caused by the application of questionable assumptions and inputs resulting in overly optimistic views on the future financial position and performance of the disclosing entity.[16]

f. **How climate change is practically affecting the financial position and performance of their company** - Few companies are reporting on climate change risk in their financial reports (as set out in paragraph 8.a to 8.g above).

Lack of comparability of available data

12. In circumstances where there is no single mandated set of scenarios and associated assumptions against which to report, companies engage in ad hoc and incomparable disclosure practices. This has led to up to 35 different scenarios, each with different assumptions, being used,[17] which makes comparing results across companies extremely difficult.

13. There is also no requirement to disclose the assumptions and data behind scenarios, and no requirement to disclose when and why assumptions in standardised scenarios applied by an entity are reduced or excluded.

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[13] World Resources Institute, World Business Council for Sustainable Development and the Greenhouse Gas Protocol, *GHP Protocol Corporate Value Chain (Scope 3) and Product Life Cycle Standards.* Available at: http://pdf.wri.org/ghgp_launch_factsheet_2011.pdf

[14] See also: ghgp_launch_factsheet_2011.pdf (wri.org)

[15] Ibid at 9.

[16] Ibid at 9.

[17] Ibid at 9.

14. There is also a lack of consistently defined terminology. For instance, there is no single definition of short, medium and long term time horizons.
15. To this end, in its May 2020 report entitled 'Guide for Supervisors – Integrating climate-related and environmental risks into prudential supervision,' the Network for Greening the Financial System stated that *"if a supervisor wants to be able to compare results between financial institutions then it needs to specify not only the scenario, but also provide details of how financial institutions should perform the exercise of what assumptions they should make (e.g. in respect of management actions.[18]"*

B - THE CALL FOR MORE ADEQUATE CLIMATE CHANGE DISCLOSURE

16. There has been increasing pressure from industry and investors to improve climate-risk disclosure by corporations in Australia. More recently, this has included calls for mandatory TCFD disclosure.
17. In November 2020, the Australian Sustainable Finance Initiative published a report entitled *'Australian Sustainable Finance Roadmap: A plan for aligning Australia's financial system with a sustainable, resilient and prosperous future for all Australians'*[19] which included a recommendation that all financial institutions with annual consolidated revenue of more than $100 million report according to the TCFD recommendations by 2023 on an 'if not, why not' basis.
18. Likewise, in June 2021, the Investor Agenda Group published a report entitled *'Confusion to Clarity – a Plan for mandatory TCFD-aligned disclosure in Australia'*[20] which recommended making TCFD reporting mandatory for ASX listed companies, beginning initially with the ASX 300, large unlisted non-financial companies and large financial institutions, including banking, superannuation, asset management and insurance companies.

C - ISSUES WITH THE DRAFT PRUDENTIAL GUIDE CPG 229

19. Whilst a step in the right direction, the draft Prudential Guide CPG 229 fails to do enough to strengthen the usefulness of climate-related disclosures to end users. This is because Draft CPG 229:
    a. fails to address the issues in disclosure under the current regime, namely the lack of data for key metrics and the lack of comparability of available data;
    b. is drafted as a "best practice guide" rather than as a statement of regulator minimum expectation; and
    c. there are several parts of Draft CPG 229 which require clarification and/or follow up guidance.

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[18] Network for Greening the Financial System, May 2020. Technical Document – 'Guide for Supervisors – Integrating climate-related and environmental risks into prudential supervision.' Available at: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf

[19] https://static1.squarespace.com/static/5c982bfaa5682794a1f08aa3/t/5fcdb70bfe657040d5b08594/1607317288512/Australian+Sustainable+Finance+Roadmap.pdf

[20] https://igcc.org.au/wp-content/uploads/2021/06/ConfusiontoClarity_APlanforMandatoryTCFDalignedDisclosureinAus.pdf

Failure to address issues in climate change disclosure under current regime

20. Draft CPG 229 does not address any of the information gaps identified in paragraph 11 above. More specifically:

    a. there is no statement of expectation that companies should be disclosing their scope 3 emisions;

    b. there is no statement of expectation that companies should be setting emissions reduction targets;

    c. there is no statement of expectation that companies should be identifying and disclosing those investments within their lending and investing portfolio which have high carbon intensity and therefore the largest exposure to climate change risk;

    d. there is no statement of expectation that companies should be referring to climate change risk in their financial reports and/or notes to their financial reports. In fact, there is no reference to disclosure in financial reports in the entire 5 paragraph Disclosure section of Draft CPG 229; and,

    e. there is no mention of linking executive remuneration with climate change outcomes, which is something that is promoted by the UN Principles of Responsible Investment,[21] and which has already been adopted by large international financial institutions such as Deutsche Bank as well as by eight ASX 100 companies in 2020.[22]

21. Draft CPG 229 also fails to address the existing issues in respect of comparability of information, as identified in paragraphs to 12 to 14 above. Specifically:

    a. Whilst APRA identifies 6 long-term scenarios in paragraph 40(b), which is commendable, this guidance will not assist the issue of comparability in circumstances where the scenarios are not mandatory and there is no detail on underlying assumptions. For example, in the 'future temperature rise in excess of 4 degrees Celsius by 2100' scenario, there is a reference to "greater physical climate risks" but no clarification as to what these risk swill entail. Similarity, in respect of the 'orderly transition' scenario, there is no detail as to what the policies leading to a lower-emissions economy would look like.

    b. Whilst APRA refers to "short-term" (in paragraph 40(a)) and long-term (in paragraph 40(b) and 41(a)), there is no definition of these timeframes.

    c. There is also no statement of expectation that entities disclose their assumptions and data behind scenarios employed in scenario analysis, and no requirements to disclose why assumptions in standardised scenarios were reduced or excluded.

CPG 229 as a best practice guide and why this is not enough

22. Unlike the majority of APRA's Prudential Practice Guides which are drafted using the language of supervisory expectations (adopting language such as *"APRA expects…."*), Draft CPG 229 is drafted in the language of best practice, adopting the language of *"APRA considers it prudent."* In our view, this will significantly hamper the implementation of the Practice Guide.

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[21] https://www.unpri.org/executive-pay/esg-linked-pay-recommendations-for-investors/7864.article

[22] https://www.afr.com/work-and-careers/leaders/how-to-get-the-link-between-executive-pay-and-climate-right-20210713-p589cf

23. Such language is also out of step with regulators in comparable jurisdictions. In the UK Prudential Regulation Authority (**PRA**)'s April 2019 Supervisory Statement (on which it appears the Draft CPG 229 was largely modelled), the PRA adopts the language of expectation. For example, in the section on scenario analysis, the PRA states that "*the PRA <u>expects</u> firms to conduct scenario analysis to inform their strategic planning and determine the impact of the financial risks from climate change on their overall risk profile and business strategy.*" In contrast, APRA's section on scenario analysis reads "*APRA <u>considers it prudent</u> for institutions to develop capabilities in climate risk scenario analysis and stress testing.*"

24. In circumstances where some comparable jurisdictions (such as New Zealand) are moving towards mandatory financial disclosures of climate change risk, it appears counter-intuitive for APRA to be unwilling to couch its Prudential Guide even in the language of expectation of minimum compliance (let alone moving towards mandatory disclosure, as we recommend).

Additional clarification needed

25. Further clarification is needed as to how Draft CDP 229 interacts with other Prudential and Reporting Standards issued by APRA including, but not limited to:

    a. Liquidity and Capital Adequacy (CPG 110, GPS 110, APS 110);

    b. Reporting on financial position and performance (GRS 300, ARS 322, ARS 323, LRS 1, LRS 300, SRS 320, SRS 320.1, SRS 330, SRS 330.1, SRS 330.2);

    c. Governance (CPS 510, SPG 510, SRS 600, SRS 601);

    d. Investment Governance (SPS 530, SPG 530, SRS530);

    e. Remuneration (CPG 511);

    f. Risk Management (CPS 220, CPG 220);

    g. Public Disclosure (APS 330); and

    h. Disclosure of Investments (SRS 110.1).

D - RECOMMENDATIONS

26. We echo the Investor Agenda Group and the Australian Sustainable Finance Initiative in calling for **mandatory disclosure of climate-change risk under the TCFD regime** by all APRA-registered entities with an annual consolidated revenue of $100 million or greater, or with $1 billion or more in total assets under management on a "comply or explain" or "if not why" basis (**Mandatory CC Disclosure Regime**).

27. As recommended by the NZ government in respect of its mandatory Climate Change disclosure regime, we recommend that the form of the disclosure is within a separate mandatory section within the Annual Report and/or principal APRA report (**Mandatory Climate Change Section**).

28. In the event that a Mandatory CC Disclosure Regime cannot be adopted without legislative amendment, we **recommend** that as an interim step:

    a. APRA set out, in comprehensive detail, the precise scenarios which all entities are required to conduct scenario analysis against, and their underlying assumptions. If entities do not apply these scenarios, they must set out why, and provide an alternative substituted scenario and detail the assumptions used. Deviation from the standard

scenarios should be discouraged and should only be allowed in exceptional circumstances.

b. APRA set the expectation that, given the broad cross-sectoral impact of the physical, transition and liability effects of climate change, that the majority, if not all, entities would be impacted by climate change, and that APRA will be closely interrogating any disclosures which conclude that (1) climate change is not a material risk; and/or (2) in relation to in sectors particularly vulnerable to climate change, that those entities are experiencing/will experience no impact as a result of climate change.

c. APRA require that APRA-regulated entities specifically disclose the following:

    i. the entity's own Scope 1, 2 **and** 3 emissions[23];

    ii. the composition of their portfolio holdings and/or companies within their lending and investment practice, broken down by business line and industry sector and:

        1. each company's Scope 1, 2 and 3 emissions; and

        2. each firm's carbon intensity, being the ratio of the company's emissions relative to its total sales;[24]

    iii. if the company holds any holdings in real estate, the location of that real estate holding; and

    iv. in the case of general insurers, the location of the risk that is being insured against.

[23] If imposing a requirement to disclose scope 3 emissions is considered too onerous, then a middle ground could be adopting the Science-based Targets Initiative (**SBTi**)'s approach and requiring disclosure of Scope 3 where those emissions account for over 40% of total emissions.

[24] Greenhouse Gas Protocol, '*Technical Guidance for calculating Scope 3 Emissions version 1.0 – Supplement to the Corporate Value Chain (Scope 3) Accounting and Reporting Standard.*' Available at: https://ghgprotocol.org/sites/default/files/standards/Scope3_Calculation_Guidance_0.pdf