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General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

30 July 2021

Feedback on Draft CPG 229 Climate Change Financial Risks

Dear Sir/Madam,

EY welcomes the opportunity to provide a response to the Australian Prudential Regulation Authority's (APRA) draft *Prudential Practice Guide CPG 229 Climate Change Financial Risks* (CPG 229).

EY is a market-leading specialist consultant with expertise in advising banks, insurers and superannuation trustees on managing the financial risks and opportunities of climate change. EY works with clients across the financial services sector to develop methodologies for measuring financed emissions, conduct climate scenario analysis and stress-testing, and provide advice on decarbonisation strategies and action plans.

Based on our market experience, EY's submission presents our views on how draft CPG 229 can be strengthened to promote greater uptake of the guidance by APRA-regulated entities and result in better management of climate change financial risks and opportunities. Section 2 of our submission provides EY's insight on the current state of market practice and where we see that organisations such as EY can support and accelerate wider decarbonisation of the economy and promote uptake and harmonisation of approaches.

We would be pleased to engage further with you on our feedback. Should you have any questions, please contact [redacted] on [redacted] and [redacted] on [redacted]

Yours sincerely,

[redacted]

[redacted]
Partner, Climate Change and Sustainability Services

[redacted]

[redacted]
Partner, Climate Change and Sustainability Services

Enclosed:

- Section 1: Response to consultation on the draft guidance paper CPG 229
- Section 2: The EY perspective

Section 1: Response to consultation on the draft guidance paper CPG 229

1.1 General feedback

EY supports steps that APRA is taking to formalise the expectation that financial institutions should manage the financial risks of climate change and address climate risk in the same manner that they manage other business risks.

EY's view is that financial institutions are more likely to follow the guidance in CPG 229 if they understand where the prudential practice guide sits in the wider context of managing climate change risks. EY recommends APRA provides additional information in the Introduction section to contextualise the regulatory landscape in relation to climate change, and clearly articulates the objectives of the guidance.

EY suggests that APRA:

- Articulates how APRA's climate-related guidance (CPG 229 and Climate Vulnerability Assessment) relates to other climate change regulatory activities by the Reserve Bank of Australia (RBA), Australian Securities and Investments Commission (ASIC) and Treasury.
- Provides greater context on the role of financial institutions in the transition to a low-carbon economy. This includes more explicitly stating the role financial institutions play in promoting wider economic stability through prudent risk management practices, by providing access to capital and by offering reliable insurance protection across the economy. Financial institutions have the opportunity to support a just transition that appropriately considers material social risks while directing the flow of capital towards activities with positive impacts.

EY observes that the draft practice guide is broad and principles-based. We recommend that more detailed guidance is provided on industry-specific nuances and implementation.

EY notes the accelerating convergence in global sustainability reporting standards, with the formation of an International Financial Reporting Standards (IFRS) working group in March 2021. The working group comprises sustainability and climate reporting standards bodies, including the Task Force on Climate-related Financial Disclosures (TCFD), the Carbon Disclosure Project (CDP) and the Value Reporting Foundation. This demonstrates growing appetite and demand for the harmonisation of approaches to measuring and reporting sustainability and climate change.

On this basis, EY recommends that APRA develops specific standards for each industry in line with the emergence and development of global standards in this area, similar to the prudential standard for operational risk requirements for Authorised Deposit-taking Institutions (ADIs) (APS 114 and APS 115), registrable superannuation entities (SPS 114), and general insurers (GPS 118). EY suggests that a minimum compliance approach should be set out to encourage consistency and enable comparability of approaches across mid-tier financial institutions in one industry, while simultaneously providing top-tier financial institutions several options to adopt more advanced approaches for competitive differentiation.

EY acknowledges that the maturity of measurement standards for climate change is less advanced than financial reporting and other ESG areas such as safety, and that extensive work needs to be done over time to develop robust standards in alignment with global developments. EY recommends that APRA actively contributes to the global discussion in the harmonisation of measurement and reporting approaches for climate change. EY notes that APRA has recently joined the Network for Greening the Financial Systems (NGFS). EY supports steps to align guidance with emerging international practice to ensure consistency across markets and jurisdictions. EY suggests that in the practice guide, APRA should note recent developments in the convergence of measurement and reporting and indicate that future APRA requirements on oversight and measurement standards to consistently quantify climate impacts across financial institutions will be forthcoming.

EY further notes that regulatory guidance from the EU, UK and Singapore goes beyond climate risk to cover environmental risk. EY recommends that the structure of CPG 229 be designed to allow for future application in other systemic environmental areas such as biodiversity loss, which is an emerging topic with a reporting framework, the Task Force on Nature-related Financial Disclosures (TNFD) currently in development.

Finally, EY recommends APRA provides clearer regulatory expectations and timeframes for the adoption of CPG 229. This includes specific information on how APRA will monitor financial institutions' implementation of the practice guide.

EY suggests that APRA:

- Communicates the timeline for financial institutions to develop and implement action plans.
- Continues to work with the Council of Financial Regulators (CoFR) on mandating climate-related disclosures as the UK and New Zealand regulators have done, where appropriate.
- Mandates an operationally independent review on the implementation of CPG 229, as is required for CPS 220 Risk Management.
- Indicates that APRA will conduct a review of financial institutions in each sector and publish a benchmark report of climate risk management across the peer group.

1.2 Governance

EY supports APRA's view that climate risks can, and should be, managed as part of an institution's overall business strategy and risk appetite, and that a board should have ongoing oversight of these risks when they are deemed to be material.

EY views climate change as a foreseeable financial risk that triggers directors' duties in the same way that any other issue that presents financial risks. This perspective is reflected in emerging shareholder resolutions and litigation in the financial services sector that drive more sophisticated climate-related investment and disclosures. EY recommends that APRA work with industry and other regulators to provide specific guidance on how directors can continue to discharge their duties with due care, skill and diligence in the context of emerging regulatory requirements for mandatory disclosure of climate risk.

EY supports the integration of climate change within an institution's overall business strategy and risk appetite but emphasises the need to be able to evidence and demonstrate robust management, oversight and assurance across management policies, systems and frameworks. This could be achieved through greater reporting and transparency, particularly at board level for material risks. APRA should also emphasise the need to integrate climate governance into business strategy to elevate climate change opportunities relating to sustainable finance, including impact investment, portfolio diversification and innovative products that mitigate risk and incentivise the transition to a low-carbon economy (e.g. reduced premiums for the use of fire resistant building materials).

EY acknowledges that financial institutions are making efforts to build capacity across their governance and traditional risk management divisions to ensure adequate resources, skills and expertise to manage climate risks. EY recommends that APRA continues to support the development on tools for building capacity and on demonstrating that institutions have the skills, resourcing, capabilities and internal capacity building systems in place to effectively manage and mitigate material climate risks.

1.3 Risk management

EY supports APRA's guidance in CPG 229 as a first step in regulating climate risk management in a manner that is consistent with the TCFD framework. However, across all elements of risk management, EY has identified a number of barriers that financial institutions are likely to have in implementing this guidance.

EY recommends that APRA provides greater detail and tangible examples, and more clearly articulates the requirements in the guidance to overcome the barriers listed below. Addressing these barriers could help reduce the likelihood of inconsistent adoption of CPG 229 and inadequate climate risk management.

- **Data:** The majority of financial institutions lack consistent, complete and usable climate data to the same level of quality as other financial risk assessments – this is both from counterparties and more broadly. APRA should include greater discussion of publicly available data sources such as the NGFS scenarios. Working together with the CoFR to mandate TCFD disclosures for all listed entities on the ASX in a move similar to UK and NZ will improve the availability of information.

- **Knowledge:** Climate risk management is a nascent area of risk for many financial institutions, particularly in the asset management space, and as such there is a significant lack of required expertise. APRA could provide greater detail by highlighting specific examples of leading practice for how climate risk could be managed and implemented in practice at industry level.

EY supports APRA's acknowledgement that providing finance to assist customers adapt to climate change may not adequately address climate risks. EY supports APRA's suggestions for mitigation. However, EY observes that the absence of specific minimum requirements for different timeframes associated with different climate risks could mean that financial institutions do not engage with climate risks in a timely manner, especially acute physical risks.

EY supports APRA's emphasis on quantitative metrics when carrying out climate risk analysis. This could include, for example reporting on Category 15 scope 3 emissions under the GHG Protocol or 'financed emissions'. EY believes that the guidance could be improved by referring to the TCFD's 'metrics and targets' pillar and supplementary guidance, as well as more specific criteria for risk monitoring, to assist financial institutions that are less familiar with climate risk analysis. EY also recommends referencing the NGFS scenarios as a publicly available data source, both to inform APRA-regulated entities and to harmonise risk monitoring methods.

EY supports APRA's recommendation to consider the guidance in CPG 229 alongside existing climate risk identification categories outlined in CPS 220 and SPS 220, and to begin with a sectoral approach. EY recommends that APRA flags that counterparty risk assessments are the next step in obtaining sufficient climate risk visibility, as observed in EU and UK prudential regulation. EY supports the four criteria for risk identification provided as an example in the guidance and recommends that more examples are given to address knowledge gaps many financial institutions have in this space.

EY supports APRA's policies and procedures guidance regarding the inclusion of roles, responsibilities and risk functions in managing climate risks.

1.4 Scenario analysis

EY supports APRA's guidance for financial institutions to conduct scenario-based climate risk analysis and stress-testing, and that the scenario analysis should cover both physical and transition risks across different time horizons. EY supports APRA's position that scenario development should be tailored to an institution's particular circumstances (e.g. size, business mix, complexity) and that independent and external specialist support should be sought where appropriate, in line with current market practice.

EY recommends that APRA includes medium-term time horizons for scenario analysis. This will enable further alignment with the TCFD framework, particularly on the assessment of climate-related risks and opportunities (as per the 2017 TCFD Recommendations) and the setting of appropriate quantitative metrics and targets to monitor progress (as per the June 2021 TCFD Supplementary Guidance on Climate-related Metrics, Targets and Transition Plans).

EY recommends that APRA could provide greater detail by highlighting specific examples of what they believe are leading practice examples of the granularity and methodology of climate scenario analysis. This should enhance the sector's understanding of how scenario analysis should be conducted and ensure that their investment, lending or underwriting decisions are well-informed. Providing industry-specific guidance would assist smaller financial institutions to adopt a compliance-based or least-cost approach to scenario analysis, and thereby better manage their risks, while allowing larger institutions wanting to carve out a competitive advantage to undertake more tailored scenario analysis to inform their strategy and risk appetite parameters. EY recommends that APRA provides the following stakeholders with further support:

- **Banking/Authorised Deposit-taking Institutions (ADIs):** Provide clear guidance on the preference and methodology for top-down versus bottom-up approaches for portfolio-wide versus counterparty scenario analysis.
- **Superannuation:** Recommend key metrics that superannuation funds should stress-test though scenarios analysis, e.g. ROI, attrition rate.
- **Insurance:** Provide suggestions for how the insurance industry can improve its scenario analysis to most effectively map the systemic risks that climate change presents, given the short-term nature of many general insurance products and the use of historical rather than projected data in current modelling.

EY recommends that APRA includes high-level guidance on the need for increased data capture and integration to overcome the data access barrier that inhibits adequate scenario analysis in many cases. This could also include providing guidance on data quality (similar to the data quality scorecards by the Partnership for Carbon Accounting Financials (PCAF) and industry practices such as the Climate Measurement Standards Initiative (CMSI)) and examples of external data sources where standard data proxies could be obtained if customer-specific data is unavailable.

1.5 Disclosure

EY supports APRA's endorsement of the TCFD as a consistent and effective disclosure framework for climate risk. However, EY recommends that CPG 229 uses more specific language and provide greater guidance on APRA's expectations of financial institutions. This would address the risk of inconsistent adoption of the guidance and of poor-quality disclosure that fails to aid investors in their decision-making. Specifically, EY recommends that APRA references the emerging support from individual institutions for mandatory TCFD disclosure and Recommendation 11 from the Australian Sustainable Finance (ASFI) Roadmap to shift TCFD reporting to a 'if not, why not?' approach. The ASFI Roadmap is supported by the majority of large financial institutions in Australia. EY recommends that APRA highlights the increase in mandatory disclosure in key markets such as New Zealand and the UK and the need for alignment in a phased-in approach.

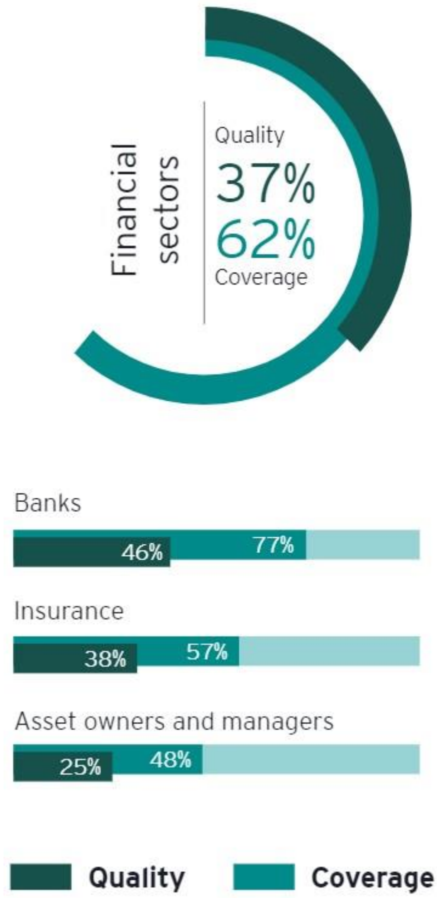

Figure 1 Financial services climate risk disclosure (EY Global Climate Risk Barometer, June 2021)

EY's annual Global Climate Risk Barometer noted that while financial institutions are reporting on climate risk, financial institutions need to improve the quality of their disclosures. This is particularly the case for asset owners and managers where, of the sample assessed, only 25% had quality disclosures, with the insurance and banking industries faring slightly better at a quality score of 38% and 46% respectively. In addition, relatively few had made climate-related disclosures within their financial statements, which were qualitative in nature. EY recommends that APRA includes specific examples taken from the TCFD metrics and relevant TCFD supplementary guidance to assist financial institutions to provide comparable and decision-useful disclosure. EY recommends adopting the concept of materiality as per the AASB Practice Statement 2 for Climate-related and other emerging risks disclosures, as well as the following accounting and reporting principles for disclosure:

- Relevance
- Completeness
- Consistency
- Transparency
- Accuracy

Building a better working world

Section 2: The EY perspective

EY is a long-standing advocate for the effective identification and management of climate change risks and impacts.

Strong governance, effective risk management, forward-looking scenario analysis and transparent, usable disclosure are the bedrock of managing the systemic and financial risks presented by climate change. They are also crucial to ensuring that Australia's financial system is stable, efficient and competitive.

Achieving this requires all players across the financial system, including regulated financial institutions, intermediaries, regulators and professional services and advisory firms to play their part.

EY welcomes the work that APRA and other members of the CoFR have undertaken in recent years to steadily grow capability and expertise across the financial system in understanding and managing the financial risks of climate change. CPG 229 is an important next step in this journey.

There remain significant challenges that need to be addressed. Some of these include the availability of data, asymmetry of information, lack of analytical capability, the development of tools and frameworks for the harmonisation of definitional frameworks to better inform comparative risk analysis, and the complete and timely disclosure of material information to inform intelligent risk-based decision making. These apply across the sector, and indeed across many sectors, when dealing with climate risk assessments.

Regulatory frameworks for climate change risk management and disclosure are emerging across a range of jurisdictions. This includes, the mandating of climate-related disclosures in line with the TCFD framework, which is gaining momentum. Countries and regions, including New Zealand, UK, EU, Hong Kong, Switzerland and Brazil, have already made public commitments to support the framework.

In addition, the upcoming sustainability reporting standard by the IFRS, which is built on the TCFD framework and supported by the International Organization of Securities Commissions (IOSCO), will bring greater robustness to climate-related disclosures.

EY's 2021 Global Climate Risk Disclosure Barometer assessed disclosures of more than 1,100 companies across 42 countries. It showed potential for improvement as the average quality of disclosures by the financial sector is 37%, compared to coverage (62%) by the sector. This would indicate that greater, more specific guidance is required on how to disclose better and more decision-useful information. In the financial services sector, banks continue to lead, with asset owners and managers still well below the average. In many cases, asset owners are not required to report publicly, and the vast majority do not.

In June 2021, the Investor Group on Climate Change (IGCC), CDP and the UN Principles for Responsible Investment (PRI) jointly issued *Confusion to Clarity: A plan for mandatory TCFD-aligned disclosure in Australia*. The plan notes that current voluntary climate reporting in Australia is insufficient and calls for clear mandatory signals from regulators. The plan also sets out a roadmap for companies to improve their reporting practices by 2024.

EY also notes the emergence of regulatory frameworks for sustainable finance in the EU, as well as comparable discussions underway across Asia, in New Zealand and in North America. The ASFI and the Australian Sustainable Finance Roadmap released in 2020 also provide an indication of the market appetite for more granular guidance from regulators on how companies should approach and implement of managing climate risk.

Organisations such as EY have an important role to play.

For the private sector, EY supports organisations at all stages and levels of maturity in decarbonisation. This includes:

- **Awareness raising and education** amongst internal stakeholders, including boardroom engagement on the risks and opportunities of climate change and the transition to a low-carbon economy.
- **Qualitative and quantitative scenario analysis** of an organisation's exposure to climate risks and opportunities, including mapping the impacts on financial statements.
- **Decarbonisation strategy development** including emissions abatement pathways modelling, metrics and target-setting, as well as other governance, risk management or strategy support.
- **Climate-related disclosures** in line with external frameworks such as the TCFD or emerging regulatory frameworks in other jurisdictions**.**
- **Limited or reasonable assurance** over climate-related disclosures.

For the public sector, EY supports federal, state and municipal governments with:

- **Decarbonisation strategy development** including emissions abatement pathways modelling and broader policy analysis.
- **Regional climate risk and opportunity assessment** and the associated policy responses.
- **Facilitating industry stakeholder engagement** to support policy development.

Key to the successful management of climate risks, both across the economy and within regulated financial institutions, is the need for consensus building, harmonisation of approaches and greater granularity on implementation. This can be done through a practical blend of principles-based and direct guidance, and consistent coverage of regulatory requirements.

For the financial services sector, the next logical step is to deepen understanding of climate risks specific to each sector of the financial services industry and to adapt and apply risk management systems to the specific issues arising for banking, insurance and investment when managing transition and physical issues and impacts. CPG 229 coupled with the additional recommendations EY has presented above, would greatly assist Australian financial entities to better identify and manage their exposure to emerging and current climate change risks, in line with emerging global market practice.