Investor Group on Climate Change

Investor Group on Climate Change (IGCC)

Submission on:

Prudential Practice Guide: Draft CPG 229 Climate Change Financial Risks

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ABOUT IGCC

The Investor Group on Climate Change (IGCC) is a collaboration of Australian and New Zealand institutional investors, and related organisations, working on climate change issues. Our members are responsible for over $2 trillion in assets under management in Australia and New Zealand and deliver returns to 7.5 million Australians. IGCC aims to encourage government policies and investment practices that address the risks and opportunities of climate change.

Overview

The Investor Group on Climate Change (IGCC) welcomes the opportunity to make a submission on the *Prudential Practice Guide Draft CPG 229 Climate Change Financial Risks* (Draft PPG).

Climate change is now widely recognised as a systemic threat to the financial system. The economic impacts of climate change present material risks to the investment returns of long-term asset owners and their beneficiaries. Ultimately, institutional investors invest across the economy for the long-term and are exposed to the growing impact of climate change on the companies, industries, property and infrastructure assets they own.

Australia's financial regulators have taken significant steps to understand and raise awareness about the financial nature of climate change risks and existing disclosure requirements under Australian law. The positions expressed in the regulatory guidance and other materials show that there is strong alignment between financial regulators regarding expectations for industry responses to climate risk. It is encouraging that these coordinated regulatory actions have increased industry awareness and understanding and management of climate risks.

Investors support further measures to phase in mandatory economy-wide disclosures aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) by Australian financial institutions and companies. This will help investors effectively respond to and manage material climate risks and opportunities, governments and financial regulators to address systemic risks to financial stability, and avoid potential market fragmentation caused by rapid international developments on mandatory disclosure.

As outlined in our recent paper, *Confusion to clarity: A plan for mandatory TCFD-aligned disclosure in Australia*, regulatory frameworks for financial institution and company climate-related disclosures are emerging rapidly around the world. Australia must keep pace.

The report notes IGCC support for APRA to implement the Draft PPG, which is a useful benchmark and resource for financial institutions. Structuring the PPG in line with the TCFD framework is practical to maintain consistency and alignment of climate risk management practices. Of note however is that the PPG includes limited commentary on target setting and strategy, which are both important elements of the TCFD framework.

Clear supervisory guidance and expectations such as via APRA's PPG, while not enforceable, are an important part of the evolution towards an efficient and coordinated mandatory TCFD-aligned disclosure framework. APRA can play an important role in the development of mandatory TCFD-aligned requirements, in coordination with the Australian Council of Financial Regulators, industry, government and standard setting bodies.

Specific comments and suggestions on the Draft PPG are addressed in this submission and summarised in Table 1 below.

Table 1. Summary of recommendations on the Draft PPG

Overall comment	Recommendations
Governance	
Draft governance guidance is practical, emphasising board oversight and senior management responsibilities. It could further cover performance-based remuneration in *Prudential Standard CPS 510 Governance*, relevant to climate risk management.	Address in the Draft PPG the remuneration requirements under CPS 510 in the context of financial climate risk management.
Risk management	
The Draft PPG risk management guidance is well set out and valuable. It should be expanded to further address key elements of climate risk management including target setting, management of Scope 3 emissions and social (just transition) considerations.	Further address: • Target setting including reference to Paris-aligned targets and portfolios • Management of institutions' Scope 3 emissions • Social (just transition) considerations of climate change, e.g.in paragraph 33
Scenario analysis	
Draft scenario analysis section includes useful and practical guidance addressing the need for plausible and relevant scenarios and multiple scenarios, including high temperature scenario and orderly and disorderly, as well as references to coverage of physical risk and forward-looking metrics. This section should be clarified and strengthened in places. Importantly, it should cover the need to apply a Paris-aligned scenario. Based on Paris Agreement objectives and best science, this should refer to 1.5°C, not 2°C or less, as currently stated.	• Paragraph 36: Clarify link between the need to undertake scenario analysis and systemic financial risk that poses material financial risk to institutions • Paragraph 38: Clarify need for transparency of an institution's decisions about what is 'appropriate to their circumstances' • Paragraph 39: Make guidance on the use of qualitive scenarios clearer and more actionable • Paragraph 40: Explicitly reference the need for a Paris-aligned scenario (1.5°C with no or limited overshoot) • Include clear and actionable expectations around existing references to 'leading practice', e.g. by using 'should/would' at paragraphs 40 (b)(i) and (ii)
Disclosure	
Parts of the draft disclosure guidance, particularly paragraph 47, are insufficient to communicate better practice for prudent risk management and governance by institutions in relation to disclosures going forward. This should be revised to reflect industry and regulatory expectations and better practice in relation to disclosure expectations. We support draft disclosure expectations outlined at paragraph 45, which recognises a lack of absolute certainty in relation to climate risks' future impacts should not be considered a reason to avoid disclosure of exposure to these risks and paragraph 49, which remarks 'a prudent institution would continually look to evolve its own disclosure practices, and to regularly review disclosures for comprehensiveness, relevance and clarity, to ensure it is well-prepared to respond to evolving expectations in relation to climate related disclosures.'	• Paragraphs 47 and 48: Revise to more clearly articulate an expectation (albeit not a 'requirement') that institutions disclose material climate risks in line with the TCFD recommendations • Paragraph 48: Clarify that an institution applying better practice would use the TCFD framework and supporting guidance to disclose information

Introduction

IGCC welcomes the Draft PPG, which aims to clarify and strengthen risk management and governance practices in relation to climate change financial risks for ARPA-regulated entities in line with existing standards.

Long-term institutional investors understand that climate change is one of the most significant investment risks and opportunities facing the industry today. Many investors are already committed to continually reviewing, building and improving their processes and disclosure on climate change in accordance with industry developments and best-practice.

APRA's Draft PPG highlights that the financial risks associated with climate change have a number of elements that distinguish them from other financial risks and which require special attention, including:

- The potential for irreversible changes in climate, leading to impacts that may not be easily mitigated or reversed
- The far-reaching impact that climate risks pose to all parts of the financial system, including different business types, geographical locations and economic sectors, as well as the potential for risks to manifest across multiple lines of business at the same time
- The uncertain and extended time horizon over which climate risks may materialise, which is likely to extend beyond typical business planning cycles
- The unprecedented nature of climate change, meaning that historical data and traditional backward-looking risk assessment methods are unlikely to adequately anticipate future impacts (paragraph 11)

Investors in Australia and internationally support further measures to phase in mandatory economy-wide TCFD-aligned disclosures. This will help investors effectively respond to and manage material climate risks and opportunities, governments and financial regulators to address systemic risks to financial stability, and avoid potential market fragmentation caused by rapid international developments on mandatory disclosure. This support for mandatory regimes recognises the ongoing absence of adequate information on climate risk and opportunities is already contributing to systemic financial stability risks and barriers to investment in low emissions and climate resilient economic activity. The implementation of mandatory approaches, under existing Australia laws and regulations, is the natural evolution in the Australian regulatory environment on climate-related disclosures and will support local business and investors compete in global markets.

Clear supervisory guidance and expectations such as via APRA's PPG, while not enforceable, are an important part of the pathway to an efficient and coordinated mandatory TCFD-aligned disclosure framework. APRA can play an important role in the development of mandatory TCFD-aligned requirements.

Need to phase in economy wide TCFD-aligned disclosure

As outlined in our recent paper, *Confusion to clarity: A plan for mandatory TCFD-aligned disclosure in Australia*, regulatory frameworks for financial institution and company climate-related disclosures are emerging rapidly around the world. Australia must keep pace.

Given the urgency of the climate threat and need for transparency, consistency and comparability of disclosures for informed and efficient asset allocation, and an orderly transition to net zero emissions, a voluntary approach to climate-related financial disclosure has proven to be insufficient.

Ensuring clear, mandatory requirements will help to align regulation with industry expectations and global standards, and reduce existing burdens by reducing and streamlining decision-making by detailing what needs to be done. This can be achieved by building existing legal frameworks and recent work of Australian regulators including APRA's PPG.

The important role of the Australian Securities and Investments Commission (ASIC) and other regulators in relation to disclosure means the current coordination under the Australian Council of Financial Regulators (CFR) provides a solid foundation to establish a joint taskforce to coordinate phasing-in mandatory reporting of climate-related risks and mainstream climate-related disclosures in companies' audited financial statements. We encourage APRA to take a proactive approach in this process.

Specific comments on the Draft PPG

IGCC welcomes the Draft PPG, which aims to clarify and strengthen risk management and governance practices in relation to climate change financial risks for ARPA-regulated entities in line with existing standards. Structuring the Draft PPG in line with the TCFD framework is practical to maintain consistency and alignment of climate risk management practices. Of note however is that the Draft PPG includes limited commentary on target setting and strategy, which are both important elements of the TCFD framework.

The Draft PPG includes useful and relevant information including articulating the nature of financial risks of climate change, and providing guidance on governance, risk management, scenario analysis, and disclosure. Introductory material on the financial risk of climate change outlines the nature of climate risk well and provides useful guidance and expectations for institutions, including emphasising the need for a strategic approach to managing climate risk.

That being noted, parts of the Draft PPG could be clarified, strengthened or expanded as appropriate to better reflect industry and regulatory expectations and better practice, particularly in relation to disclosure and scenario analysis. These are addressed in further detail below.

Comments and recommendations in this section are structured in line with the Draft PPG, addressing in turn governance, risk management, scenario analysis, and disclosure, with an emphasis on the need to tighten disclosure guidance and ensure scenario analysis guidance is actionable and addresses a Paris-aligned scenario of 1.5°C.

We also briefly outline further considerations regarding alignment of the Draft PPG with *Your Future Your Super* benchmarking requirements and the need to update *Prudence Practice Guide* *SPG 530 Investment Governance* (SPG 530).

IGCC acknowledges the challenges in producing one PPG for all APRA regulated entities, which have different organisational structures and requirements. While this submission does not cover this issue, we recognise further steps may be required to ensure appropriateness of guidance for different institutions.

Governance

Overall, the draft guidance on governance is practical with a strong emphasis on board oversight and senior management responsibilities. Currently the Draft PPG does not mention performance-based components of remuneration, which is covered by *Prudential Standard CPS 510 Governance* (CPS 510) and is relevant to management of climate risk. For example, paragraphs 56-58 of CPS 510 require that the performance-based components of remuneration be designed to encourage behaviours that support the institution's long-term financial soundness, and the risk management framework of the institution.

The Draft PPG governance section could be revised to make clear that climate risk is one of the risks referred to in paragraphs 56-58 of CPS 510. This could refer to appropriate actions such as linking climate risk management responsibilities and performance-based remuneration metrics for relevant executives (where applicable) and could be added after the current paragraph 16 of the Draft PPG.

Specific recommendations
Paragraph 16: Address in the PPG the remuneration requirements under *Prudential Standard CPS 510 Governance* in the context of financial climate risk management.

Risk management

The combination of climate risk management and emerging investment opportunities means global capital markets are rapidly mainstreaming net zero emissions investment. The Draft PPG risk management guidance is well set out and valuable, with coverage of policies and procedures, risk identification and monitoring and an important recognition that evolving understanding of climate change means institutions need to regularly review and update approaches. This should be expanded to further address key elements of climate risk management relevant to financial institutions, including target setting, management of Scope 3 emissions and social (just transition) considerations. Recent draft guidance published by the TCFD on *Climate-related Metrics, Targets, and Transition Plans* and the associated *Measuring Portfolio Alignment: Technical Supplement* provides a useful reference in relation to targets along with coverage of Scope 3 emissions.

Specific recommendations
Expand coverage of target setting including reference to Paris-aligned targets and portfolios, recognising references to target setting in the PPG are currently very limited
Expand commentary on management of financial institutions' Scope 3 emissions
Include explicit reference to social (just transition) considerations of climate change for example in paragraph 33 which relates to stakeholder engagement and risk mitigation options

Scenario analysis

The draft scenario analysis section includes detailed and relevant guidance. However, this can be clarified and strengthened in places and should refer to the need to apply a Paris-aligned 1.5°C scenario.

Improving clarity and actionability

In our view *Prudential Standard* [*CPS 220 Risk Management*]() (CPS 220) supports stronger language to be used in the PPG in some areas. Paragraph 24 of CPS 220 provides: "The risk management framework must include forward-looking scenario analysis and stress testing programs, commensurate with the institution's size, business mix and complexity, and which are based on severe but plausible assumptions."

The specific recommendations below include suggestions for bolstering language, supported by CPS 220, as well as ensuring that the guidance is clear and actionable for institutions. For example, in the context of providing examples of 'leading practice' under Draft PPG paragraph 40, it may be more appropriate to use clearer and more actionable language such as would or should, rather than 'could'.

Paris-aligned 1.5°C scenario

Paragraph 49 of the Draft PPG includes useful information, addressing the need for reference to plausible and relevant scenarios and to a variety of scenarios, including high temperature scenario and orderly and disorderly. The additional coverage of physical risk and forward-looking metrics are particularly important and align with investor expectations for better practice.

Importantly however, the current wording of the Draft PPG "global average temperatures rising by 2°C or less" is not consistent with the objectives of the Paris Agreement, which has been ratified by the Australian and most other world governments. Revision is required to ensure this section explicitly references the need for Paris-aligned scenario of a 1.5°C target with no or limited overshoot. This would recognise that the long-term temperature goal of the Paris Agreement establishes 1.5°C as the preferred warming limit on global average temperatures.

An explicit reference to 1.5°C would also be more consistent with emerging best practice and industry expectations.

Specific recommendations
Paragraph 36*:* Bolster language in paragraph 36 to make clear the connection between the need to undertake scenario analysis and the recognition that climate change is a systemic financial risk posing material financial risk to institutions.
Paragraph 38: Add further detail in paragraph 38 regarding transparency of an institution's decisions about what is appropriate to their circumstances. • This paragraph is useful and could be further clarified and strengthened regarding transparency of an institutions' decisions about what is appropriate to its circumstances. • Example proposed wording is shown in red • *38. An institution in the early stages of climate risk analysis is likely to begin by developing an understanding of the material risks to which it is exposed, including identifying industries and regions with particular risks within the institution's portfolio. A range of analytical approaches, from simple to complex, are available to support an institution's understanding of their material climate risks; institutions should choose approaches appropriate to their circumstances and*

maintain records and disclose why that approach was considered reasonable in the institution's circumstances. Institutions should also disclose the assumptions and key parameters/signposts that were relied upon.

Paragraph 39: Make minor revisions to paragraph 39 to make it clearer and more actionable.

- This paragraph is important in recognising institutions can start where they are and build capacity over time. There is no need to delay or let perfect be the enemy of good.
- Example wording that could make this paragraph more actionable for institutions is suggested below, shown in red.
- *39. Where an institution lacks the data, resources or expertise to conduct climate risk stress testing with appropriate quantitative assessments, it may still benefit from and should consider narrative-driven scenario analysis[6]. Qualitative scenarios can still provide insights into the operations and channels of risk transmission, and findings from such an assessment can be reflected in business plans, strategies and risk management practices.*

Paragraph 40(a)-(g): Revise to set clearer and more actionable expectations by replacing **'could'** with **'should'** and include explicit reference to the need for a Paris-aligned scenario (1.5°C with no or limited overshoot).

- Paragraph 40(b)(i) should explicitly reference a Paris-aligned scenario. The long-term temperature goal of the Paris Agreement establishes 1.5°C as the preferred warming limit. Current wording "global average temperatures rising by 2°C or less consistent with the Paris Agreement" is not consistent with the objectives of the Paris Agreement, which has been ratified by the Australian and most other countries. An explicit reference to a 1.5°C target would also be consistent with emerging best practice and industry expectations.
  See detailed recommendations on scenario analysis in the *Confusion to Clarity* report at section 5.2, with further commentary at section 4.4.2.
- Recognising this paragraph refers to 'leading practice', stronger language is warranted to set clearer and more actionable expectations, for example by replacing 'could' with 'should' at paragraph 40 (b)(i) and (ii).
- Further reference to targets, including net zero or Paris-aligned targets would be beneficial.

Disclosure

Disclosure is a critical element of prudent risk management and governance practice. Disclosure enhances risk management and governance by providing greater transparency, accountability and discipline. Recognition of this, that institutions 'implement proportionate... disclosure practices', is one of the Draft PPG's key objectives outlined in Figure 1 of the Draft PPG.

Currently, parts of the draft disclosure guidance, particularly paragraph 47, are insufficient to communicate better practice for prudent risk management and governance by APRA-regulated financial institutions in relation to disclosures going forward. This should be revised to reflect industry and regulatory expectations and better practice in relation to disclosure expectations.

We support draft disclosure expectations at paragraph 45, which recognises that a lack of absolute certainty in relation to climate risks' future impacts should not be considered a reason to avoid disclosure of exposure to these risks. Similarly, we support the expectations in paragraph 49 that 'a prudent institution would continually look to evolve its own disclosure practices, and to regularly review disclosures for comprehensiveness, relevance and clarity, to ensure it is well-prepared to respond to evolving expectations in relation to climate-related disclosures.'

Specific recommendations
Paragraph 47: Revise the disclosure guidance at paragraphs 47 to more clearly articulate an expectation (albeit not a 'requirement') that institutions should disclose material climate risks in line with the TCFD recommendations, as part of their prudent risk management and governance practices. • Example of how paragraph 47 could be revised: '*A prudent institution would disclose its approach to measuring and managing climate risks in a manner that is clear and meaningful to its stakeholders. APRA encourages institutions to disclose the potential impact of material climate risk on the institution, including quantitative metrics such as exposure to sectors with higher climate risk.*' • While we recognise APRA is constrained how far it can go on statements on disclosure, in our view it is appropriate for APRA to reflect leading, prudent and proportionate disclosure practice in relation to risk management and this would not establish a new obligation. • The proposed revision aligns with industry practice and recent non-binding guidance by the Monetary Authority of Singapore (MAS), for example. Like APRA's Draft PPG, MAS acknowledges that its guidelines are not enforceable, but communicate MAS' expectations and support entities to comply with risk management standards.
Paragraph 48: Clarify that a prudent institution would use the TCFD framework and supporting guidance to disclose information. • APRA's endorsement of the TCFD is useful and consistent with broad industry, government and regulator support for the TCFD framework. • This existing statement could be enhanced by clarifying that institutions should use the TCFD framework and supporting guidance to disclose information. • For example, APRA could insert an additional statement in front of the current paragraph 48, example proposed text shown in red: ○ *48. Better practice disclosures would be in accordance with well-regarded international reporting frameworks such as the TCFD recommendations and take account of generally accepted measurement practices, methodologies, and guidance. APRA considers the framework established by the TCFD to be a sound basis for producing information that is useful for an institution's stakeholders.*

Further considerations

Alignment with *Your Future Your Super* legislation

APRA should consider whether and how the Final PPG will interact with the *Your Future Your Super* legislation and ensure that the benchmarking and performance requirements under *Your Future Your Super* do not limit institutions' ability to effectively manage their climate risk. Under *Your Future Your Super*, superannuation funds will be benchmarked against current investment performance. However, data from MSCI shows that under a scenario where companies globally continue with status quo strategies it *"would keep the world on a calamitous path toward becoming approximately 3.5°C warmer by the end of this century."* Therefore, in order to meet targets that are lower than 3.5°C and effectively manage their climate risk, investors will likely need to reallocate capital over the long-term.

On the other hand, the *Your Future Your Super* benchmarking is backward-looking and based on historical performance data that is not aligned with the Paris Agreement. The *Your Future Your Super* legislation arguably encourages a short-term approach to investment risk because of the eight-year benchmarking tests, encouraging investors to focus on a short-term return horizon. This is misaligned with effective management of systemic climate risk and investment in technologies, which requires a long-term investment horizon and will generate long-term benefits to superannuation fund members.

APRA should address this concern by clarifying how institutions implementing leading practice climate risk management in accordance with the Draft PPG would not be penalised by requirements to track a benchmark based on historic data and which is not Paris-aligned.

Alignment with SPG 530 Investment Governance

We understand APRA has existing plans to update SPG 530 and reviewing its consistency with the Draft (or final) PPG would likely be part of that process. We suggest that APRA considers updating SPG 530 to ensure that it is consistent with the Draft PPG and reflects the financial materiality of climate risk. SPG 530 suggests that institutions may consider 'ethical investment' as relevant to their duty to act in the best interests of beneficiaries, which can lead to 'an added focus on environmental, sustainability, social and governance [ESG] considerations'. As APRA makes clear in this Draft PPG, climate change gives rise to physical, transitional and legal risks that are financially material, so it is incongruent for SPG 530 to refer to environmental considerations as merely 'ethical'. ESG integration is based on the premise that investments will perform better over the long term when ESG risks and opportunities are appropriately managed. Therefore, the management of ESG risks and opportunities - including related to climate change - is material to long-term returns.

Conclusion

Long-term institutional investors understand that climate change is one of the most significant investment risks and opportunities facing the industry today. Many investors are already committed to continually reviewing, building and improving their processes and disclosure on climate change in line with industry developments and best practice.

Overall, the Draft PPG is a useful guide and benchmark for APRA regulated entities. There is a need to clarify and strengthen some elements, particularly regarding disclosure and scenario analysis. Further consideration should also be given to the Draft PPG's interaction with the *Your Future Your Super* benchmarking requirements and the need to update SPG 530.

Beyond the PPG, investors support further measures to phase-in mandatory economy-wide TCFD-aligned disclosures by Australian financial institutions and companies. This will help investors effectively respond to and manage material climate risks and opportunities, governments and financial regulators to address systemic risks to financial stability, and avoid potential market fragmentation caused by rapid international developments on mandatory disclosure.

Clear supervisory guidance and expectations such as via APRA's PPG are an important part of the pathway to an efficient and coordinated mandatory TCFD-aligned disclosure framework. We support APRA playing an important role in the development of mandatory TCFD-aligned requirement, in coordination with the Australian Council of Financial Regulators, government, industry and standard setting bodies.