



**APRA Prudential Practice Guide**  
**Draft CPG 229 Climate Change Financial Risks**

**Submission Paper**

**from Melbourne Climate Futures**

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## **About MCF**

Climate change is reshaping communities, the environment, health, business and beyond. The next few years are critical. Leaders from around the world have recognised this pivotal moment and are calling for immediate action. More than 110 countries have pledged to be carbon neutral by 2050. China has committed to be carbon neutral by 2060 while the USA has pledged to achieve a 50-52% reduction from 2005 levels in greenhouse gas emissions by 2030. Businesses are going green. And universities are strengthening research into protecting the planet from climate change.

To contribute to this global push, the University of Melbourne has launched Melbourne Climate Futures. This initiative builds on decades of University research in a diverse range of areas. From climate change impacts in the Pacific to environmental politics on the global stage, energy futures and bushfire resilience to better global health outcomes, Melbourne Climate Futures brings researchers from different academic backgrounds together to develop practical outcomes for the challenges ahead.

We will empower the next generation of researchers and students to strive for a sustainable climate future, and work alongside the University itself to ensure the institution is a world leader in decarbonisation.

The authors of this submission work for the [Melbourne Climate Futures Initiative](#) within the University of Melbourne. Any mistakes are our own.

## **The Authors**

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## A. Introduction

We welcome the draft Prudential Practice Guide on Climate Change Financial Risks (referred to as CPG 229 by APRA and in the remainder of this submission), released by APRA in April 2021 and the opportunity to comment as APRA determines its approach to regulated institutions' reporting on climate risk.

We concur with APRA that the risks of a changing climate will extend to all sectors of the economy. In addition to the economic, environmental and human impact of the changing climate, the impact of policies and strategies developed and implemented by governments, commercial and not-for-profit organisations, communities and individuals to reduce emissions and increase sequestration will create wide ranging opportunities and risks.

The climate risk tools used by the prudential regulators globally are evolving rapidly. The prudential guidance implemented by APRA will be important part of the framework established in Australia and can guide the evolution of coherent and useful climate risk reporting and management tools by APRA-regulated institutions (ARIs). Yet, we suggest that considerable additional detail is required to establish a reporting approach that supports an effective response to climate change, accelerating the flow of funds to investments essential to the transition to a zero-emissions future and to adapting to unavoidable physical impacts. Well-designed prudential reporting framework and supporting tools can complement global initiatives, deliver useful information to decision-makers within financial institutions, investors, and regulatory agencies, and address the risk of greenwashing.

Our comments on the draft CPG 229 relate to the approaches outlined in the draft Practice Guide for:

- Defining and assessing risks relevant to climate change, and in particular, the need for APRA to consider:
  - Systemic risks in its analysis; and
  - A broader view of liability risks.
- Specifying the scenarios against which ARIs report their climate risks.

## B. Defining relevant risks

### B.1 Systemic risk

**The current APRA guidance defines climate risk as consisting of physical, transition and liability risks. In addition to these important components of climate risk, we suggest that individual financial organisations need also to consider and integrate systemic risk.**

Systemic climate risk for investors can be thought of as the reduction in value of a diversified investment portfolio due to economy-wide effects of the warming climate<sup>1</sup>. While systemic risk may be typically seen as the purview of regulators such as APRA, we suggest that systemic risk is also an important risk for individual financial businesses to be aware of and consider. System-wide climate impacts will have implications for every financial business, irrespective of specific physical, transition and liability risks, as demonstrated by the COVID-19 pandemic. We suggest that systemic risk should be presented as a ‘component area’ risk in addition to physical, transition and liability risks.

As recognised by APRA, aggregation of the impacts of climate change upon the natural environment will have compounding effects on the economic system that individual financial businesses rely upon to create value and survive<sup>2</sup>. Research by Kalkuhl & Wenz (2020), which is used in the Network for Greening the Financial System (NGFS) and Bank of England Climate Biennial Exploratory Scenario (CBES), shows that “UK and global GDP growth is permanently lower and macroeconomic uncertainty increases”<sup>3</sup>. Similarly, research by Kompas et al. (2018) of national level economic effects shows that GDP growth rates will be reduced in Australia and other economies<sup>4</sup>.

Both sets of researchers note that their modelling is limited, not including recognised effects such as migration and conflict, and so under-represent the expected damage to economic systems. Their research also does not incorporate the recognised ‘tipping points’ that would raise the level of economic damage, something that the next IPCC report is expected to highlight<sup>5</sup>. Irrespective

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<sup>1</sup> Covington, H., Thornton, J., & Hepburn, C. (2016). Global warming: Shareholders must vote for climate-change mitigation. *Nature News*, 530(7589), 156.

<sup>2</sup> Climate Council (2021). Hitting Home: The Compounding Costs of Climate Inaction. 27/1/21. <<https://www.climatecouncil.org.au/resources/hitting-home-compounding-costs-climate-inaction/>>

<sup>3</sup> Bank of England (2021). Key elements of the 2021 Biennial Exploratory Scenario: Financial risks from climate change. 8/6/21. <<https://www.bankofengland.co.uk/stress-testing/2021/key-elements-2021-biennial-exploratory-scenario-financial-risks-climate-change>>

<sup>4</sup> Kompas, T., Pham, V. H., & Che, T. N. (2018). The effects of climate change on GDP by country and the global economic gains from complying with the Paris climate accord. *Earth's Future*, 6(8), 1153-1173.

<sup>5</sup> Harvey, F. (2021). IPCC steps up warning on climate tipping points in leaked draft report. *The Guardian*, 24/6/21. <<https://www.theguardian.com/environment/2021/jun/23/climate-change-dangerous-thresholds-un-report>>

of physical, transition and liability risks, economy-wide (marginal) negative growth rates will impact the ability of individual financial businesses to create value and possibly survive<sup>6</sup>. Prudent ARIs would consider the possibility for system-wide climate impacts in organisational decision making.

Systemic risk is recognised by numerous economic and regulatory bodies. The World Economic Forum's survey of global risks<sup>7</sup> finds that climate action failure is the second-placed global risk by impact, with 4 of the top 6 associated with our impact upon the environment. The Bank of International Settlements (2020) described this risk as a "green swan" event: that is, "potentially extremely financially disruptive events that could be behind the next systemic financial crisis"<sup>8</sup>. The impact on the financial system has been known for some time. A Carbon Tracker and Grantham Institute study in 2013 found that energy companies' sharemarket value would be reduced by 40-60% due to the stranding of assets necessary to meet a 2°C target<sup>9</sup>. Covington et al. (2016) reported global economy-wide losses of \$7 trillion, based on a 10% damage scenario<sup>10</sup>. All scenarios, however, exist, including total destruction of the economy, civilisation and species<sup>11</sup>.

We are especially motivated to make the case that systemic risk be included in the APRA guidance as we observe some financial corporations taking an 'adaptation' response to the current suite of component risks. For example, recognising the threats of increasing bushfires to the physical assets in a loan portfolio could simply be met with an adjusted rate or exclusion of physical assets in particular geographies. This obfuscates the actual risks. The required response to maintain the stability and prosperity of the Australian financial sector and economy requires urgent, proactive mitigation efforts<sup>12</sup>. Temperature increases beyond 1.5°C are recognised to have increasingly unacceptable effects, including the risks of tipping points<sup>13</sup>.

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<sup>6</sup> Covington et al. (2016), *op cit*.

<sup>7</sup> World Economic Forum (2021). The Global Risks Report 2021. 19/1/21. <<https://www.weforum.org/reports/the-global-risks-report-2021>>

<sup>8</sup> Bolton, P. et al. (2020). The green swan: Central banking and financial stability in the age of climate change. Bank of International Settlements, January 2020. <<https://www.bis.org/publ/othp31.pdf>>

<sup>9</sup> Carbon Tracker Initiative and Grantham Research Institute, London School of Economics (2013). Unburnable Carbon 2013: Wasted capital and stranded assets. <<https://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2014/02/PB-unburnable-carbon-2013-wasted-capital-stranded-assets.pdf>>

<sup>10</sup> Covington et al. (2016), *op cit*.

<sup>11</sup> IPCC (2018). Global Warming of 1.5°C. An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty. <<https://www.ipcc.ch/sr15/>>

<sup>12</sup> International Energy Agency (2021). Net Zero by 2050: A Roadmap for the Global Energy Sector. May, 2021. <<https://www.iea.org/reports/net-zero-by-2050>>

<sup>13</sup> IPCC (2018), *op. cit.*

We suggest that the current guidance does not sufficiently motivate individual ARIs to act urgently and proactively to mitigate emissions within their sphere of influence for collective effect, and hence protect the long-term interests of all interested parties (e.g. shareholders, beneficiaries, stakeholders). This is not to diminish the mainstreaming of ESG investing and other proactive efforts, such as by those supporting the Australian Sustainable Finance Initiative. The climate implications of ‘universal ownership’ for larger financial organisations are beginning to be accepted. Yet, responses have not meaningfully shifted the emissions of the Australian economy to the extent and at the pace required. Incorporating systemic risk as a further component risk emphasises the collective nature of the problem and reduces the perception that minimal adaptive actions can allow ARIs to manage their climate risks.

## ***B.2 Liability risk***

**While we concur that liability risks are an important component risk for ARIs, our research finds that risks emanating from this area are increasing rapidly.<sup>14</sup> We recommend that the definition of liability risks be more detailed to better reflect the growing threat this presents. Further, we recommend that liability risks be better integrated and emphasised throughout the Guidance, as this is likely to be a key area of concern for directors and trustees.**

A broad view of liability risks includes:

- Personal liability for directors or trustees not fulfilling their duties of care and diligence and acting in the best of interests of the company or beneficiaries by not sufficiently incorporating climate considerations.<sup>15</sup>
- Liability for entities failing to comply with their disclosure and reporting requirements at law, e.g. failure to disclose material financial climate risks from climate change.<sup>16</sup>

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<sup>14</sup> Jacqueline Peel, Hari Osofsky, Brett McDonnell, Anita Foerster and Rebekkah Markey-Towler, *Corporate Energy Transition* (September 2020) <<https://law.unimelb.edu.au/centres/creel/research/current-research-projects/corporate-energy-transition>>; Jacqueline Peel, Ben Neville and Rebekkah Markey-Towler, ‘Four seismic climate wins show Big Oil, Gas and Coal are running out of places to hide’ *The Conversation*, 31 May 2021 <<https://theconversation.com/four-seismic-climate-wins-show-big-oil-gas-and-coal-are-running-out-of-places-to-hide-161741>>.

<sup>15</sup> E.g. *Corporations Act 2001* (Cth) ss 180-183, 185; *Superannuation Industry (Supervision) Act 1993* (Cth) s 52(2)(b)(c)(j), s 102; *Public Governance, Performance and Accountability Act 2013* (Cth) s 25(1).

<sup>16</sup> *Corporations Act 2001* (Cth) ss 299 and 299A(1), 295, 674; ASIC, *Regulatory Guide 228 Prospectuses: Effective disclosure for retail investors* (August 2019); ASIC, *Regulatory Guide 247: Effective disclosure in an operating and financial review* (August 2019); Australian Accounting Standards Board and Australian Auditing and Assurance Standards Board, *Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2* (April 2019).

- Conduct which may constitute misleading or deceptive conduct, or conduct that is likely to mislead or deceive, e.g. ‘greenwashing’ in communications on climate.<sup>17</sup>
- Stakeholder litigation such as shareholders or beneficiaries bringing court cases with material consequences for the organisation.
- The compliance costs of regulatory investigation and enforcement.
- Recourse to ‘soft’ law mechanisms such as shareholder resolutions.
- Reputational risks from not considering or adequately responding to climate change (which might instead be subsumed as transition risk).

Liability risks are defined as part of ‘climate risks’ in the introduction to CPG 229, but we suggest these are not well integrated with the steps outlined later in the Guidance. This means that at times, the impression conveyed is that management of climate risk is ‘optional best practice’, rather than ‘necessary to fulfil legal obligations’. This is to be contrasted with statements from leading lawyers making it clear that failure to adequately manage climate risks could expose directors or trustees or a prudentially regulated entity to liability. In this regard, we point to the guidance provided in the seminal Hutley and Hartford Davis opinions from 2016, 2019 and 2021 on ‘Climate Change and Directors Duties’<sup>18</sup> and Hutley and Mack opinions from 2017 and 2021 on ‘Superannuation Trustee Duties and Climate Change’.<sup>19</sup> We also point to the Commonwealth Climate Law Initiative’s recent ‘Primer on Climate Change: Directors’ Duties and Disclosure Obligations’.<sup>20</sup>

Legal developments in Australia also demonstrate the trajectory of increasing liability risks, and this trajectory should be emphasised. For example, we point to Mark McVeigh’s recent settlement with his superannuation fund, REST, on their management of climate change risk,<sup>21</sup> as well as the earlier case of *Abrahams v Commonwealth Bank of Australia*.<sup>22</sup> EDO Australia, on behalf of Market Forces, have requested an ASIC investigation into potentially misleading or

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<sup>17</sup> *Corporations Act 2001* s 1041H; *Australian Securities and Investment Commission Act 2001* (Cth) s 12DA; Australian Consumer Law s 18.

<sup>18</sup> Noel Hutley SC and Sebastian Hartford Davis, *Climate Change and Directors Duties: Memorandum of Opinion* (7 October 2016); Noel Hutley SC and Sebastian Hartford Davis, *Climate Change and Directors Duties: Supplementary Memorandum of Opinion* (26 March 2019); Noel Hutley SC and Sebastian Hartford Davis, *Climate Change and Directors Duties: Further Supplementary Memorandum of Opinion* (23 April 2021).

<sup>19</sup> Noel Hutley and James Mack, *Superannuation Fund Trustee Duties and Climate Change Risk: Memorandum of Opinion* (15 June 2017); N C Hutley and J E Mack, *Superannuation Trustee Duties and Climate Change: Memorandum of Opinion* (16 February 2021).

<sup>20</sup> Commonwealth Climate and Law Initiative and Climate Governance Initiative, *Primer on Climate Change: Directors’ Duties and Disclosure Obligations* (June 2021).

<sup>21</sup> *Mark McVeigh v Retail Employees Superannuation Pty Ltd*  
<<https://equitygenerationlawyers.com/cases/mcveigh-v-rest/>>.

<sup>22</sup> *Abrahams v Commonwealth Bank of Australia*  
<[https://envirojustice.org.au/sites/default/files/files/170807%20Concise%20Statement%20\(as%20filed\).pdf](https://envirojustice.org.au/sites/default/files/files/170807%20Concise%20Statement%20(as%20filed).pdf)>.

deceptive statements made by the CEO of New Hope.<sup>23</sup> Recent trends in shareholder resolutions further suggest key pressure points where investors and stakeholders are expecting to see action. For example, ‘Say on Climate’ resolutions request an annual climate report, aligned with the TCFD framework, of a company’s emissions and strategy to reduce emissions (detailing short-, medium- and long-term targets), and giving shareholders an advisory vote.<sup>24</sup>

In summary, we propose that more detailed and updated guidance is important to convey that managing climate risk is no longer optional but legally necessary and to provide ARIs with the toolkit needed to respond to such risks. This might take the form of more tailored guidance for particular ARIs who will have different liability risk profiles e.g. ADIs, superannuation entities. It might also include ongoing awareness raising of and training to respond to developments in the legal space.

### **C. Specification of scenarios against which APRA–regulated institutions report**

We consider that the prudential practice guide requires a greater level of specificity regarding the scenarios against which ARIs report. This is necessary to ensure regulated institutions are evaluating their climate related risks using a common starting point. Greater comparability will both reduce the risk of opportunistic green-washing and facilitate a more robust assessment of systemic risk than is possible if there is no comparability of the basis on which different institutions assess their climate exposure.

The current draft CPG 229 provides an indication of future temperature rise and economic transition scenarios that could be included, refers to other processes, including the TCFD?, the Climate Measurement Standards Initiative and the NGFS useful guidance on scenario selection. Beyond this, it does not state the details of which scenarios should be adopted.

In contrast, other prudential regulators globally are providing clear guidance on the scenarios that must be adopted and the assumptions relevant to each. The Bank of England, for example, sets out in detail three scenarios for assessing physical and transition risk, drawing on a subset of the scenarios explored by the NGFS.<sup>25</sup> The Bank of England CBES goes beyond specifying the scenarios at a high level to list also relevant variables participating institutions apply in

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<sup>23</sup> Market Forces, ‘ASIC investigation requested into New Hope statements’ (21 July 2021) <<https://www.marketforces.org.au/asic-investigation-requested-into-new-hope-statements/>>.

<sup>24</sup> ACCR, <<https://www.accr.org.au/topics/say-on-climate/>>.

<sup>25</sup> Bank of England June 2021, Key elements of the 2021 Biennial Exploratory Scenario: Financial risks from climate change. <https://www.bankofengland.co.uk/stress-testing/2021/key-elements-2021-biennial-exploratory-scenario-financial-risks-climate-change> accessed July 2021



considering the risk posed by climate impacts or policies designed to reduce emissions and facilitate the transition to a lower-emissions economy.<sup>26</sup>

We consider a detailed approach to scenario selection, such as has been adopted by the Bank of England, is a necessary component of any robust climate risk reporting and stress testing framework. This will be supported by scenarios specified at a level of detail that includes at a minimum:

- The emissions scenario and annual-average global-mean warming outcomes at different points in time.
- Benchmark data for projected physical climate impacts relevant to Australia and other regions where APRA-regulated institutions have significant exposure. This could include, for example, metrics for changes in regional temperature and temperature extremes, precipitation, sea-level rise, wind, agricultural yields, and bushfire and flood risk that correspond to the projected emissions and global-mean warming levels.
- Effective carbon prices that correspond to the global emissions and global-mean warming levels in the relevant scenario and possibly other prices for key commodities likely to be significantly affected. In the case of Australia, this could include projected fossil fuel prices (which are also incorporated in the CBES material), and potentially minerals important to the energy transition. The effective carbon price is an indication of modelled policy cost or incentive to achieve the emissions pathway, whether implemented as an explicit price, subsidy or other regulatory tool.

We concur with the suggestion in CPG 229 that up to four (and, we would suggest, a minimum of three) well-specified scenarios will be needed to support an assessment of entity specific physical and transition risks and enable a coherent assessment of systemic risk to the Australian financial system and economy. We also concur that one scenario should incorporate high physical risk consistent with no additional policy drivers to support the transition to a zero emissions global economy. The NGFS includes such a scenario and estimates it would be consistent with a projected change in annual-mean global mean temperatures of around 3°C warming. It notes that economic impacts at high degrees of warming would be unprecedented and much more severe than currently estimated given known gaps in modelling.<sup>27</sup> The APRA guidance material

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<sup>26</sup> Ibid, Ch 4 and Bank of England 2021 Guidance for participants of the 2021 Biennial Exploratory Scenario: Financial risks from climate change <https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2021/the-2021-biennial-exploratory-scenario-on-the-financial-risks-from-climate-change.pdf?la=en&hash=2E5CAECE75E701315B51B09303F99FCF8D21C8E2>, accessed July 2021

<sup>27</sup> NGFS Climate Scenarios for central banks and supervisors, June 2021, [https://www.ngfs.net/sites/default/files/medias/documents/ngfs\\_climate\\_scenarios\\_phase2\\_june2021.pdf](https://www.ngfs.net/sites/default/files/medias/documents/ngfs_climate_scenarios_phase2_june2021.pdf) last accessed July 2021

requires further detail on how the likely extreme impacts of a 3°C scenario might be captured in such an exercise, including as noted above, details on the projected physical impacts that should form the basis for this assessment.

#### **D. Concluding remarks**

The increasing focus on financial institutions' exposure and response to climate change by prudential regulators is an important vehicle for both addressing and adapting to the changing climate. The tools used by the sector and regulators globally is evolving rapidly, and the same rapid development of approaches is likely for APRA and ARIs. The elements discussed above are important issues relevant to the framework established. Considerable additional detail is required to establish a reporting approach that supports an effective response to climate change, accelerating the flow of funds to investments essential to the transition to a zero-emissions future and to adapting to unavoidable physical impacts. A well-designed prudential reporting framework, will complement global initiatives, deliver useful information to decision-makers within financial institutions, investors, and regulatory agencies, and address the risk of greenwashing.