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Australia Issues Draft Guidance on Climate-Related Financial Risk

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TO: ICI Global Members

ESG Task Force

ICI Global Regulated Funds Committee

ICI Global Regulated Funds Committee - Asia SUBJECTS: ESG

International/Global RE: Australia Issues Draft Guidance on Climate-Related Financial Risk

On 22 April 2021, the Australian Prudential Regulation Authority (APRA)[\[1\]](#) has released for consultation[\[2\]](#) its draft *Prudential Practice Guide CPG 229 Climate Change Financial Risks* ("draft CPG 229"), outlining voluntary prudential practices for APRA-regulated institutions, including banks, insurers, and superannuation trustees, in relation to climate change financial risk management. The consultation is open for public comment until 31 July 2021. The final guide is expected to be released before the end of 2021.

The plan to develop this guide was first outlined in APRA's 2020 letter[\[3\]](#) to industry on climate change financial risks. In response to requests from the industry for greater clarity of regulatory expectations and examples of better industry practice, the draft CPG 229 is developed based on the recommendations from the Task Force on Climate-related Financial Disclosure (TCFD). It is designed to be flexible in allowing each institution to implement governance, risk management, scenario analysis, and disclosure practices in a manner that is proportionate to its size, business mix, and complexity. The guide CPG 229 will apply only to APRA-regulated institutions, but other stakeholders, including asset managers, may experience its impact as trustees implement the new practices. This memorandum provides a brief summary of the proposed practices in the draft CPG 229.

1. Roles of the Board of Directors and Senior Management

APRA is of the view that climate risks should be managed within an institution's overall business strategy and risk appetite, and a board should be able to evidence its ongoing oversight of these risks. A prudent board is expected to have or obtain an appropriate level of understanding of climate risks, and take into account the risks and opportunities arising from climate change when approving the institution's strategies and business plans. APRA suggests senior management should be responsible for developing appropriate framework and policies in managing climate risk exposures, regularly reviewing their effectiveness,

and allocating adequate resources to manage climate risks.

2. Climate Risk Management Process

APRA encourages institutions to identify and measure the materiality of climate risks to understand the potential impacts on their business models. They may also assess climate risk exposures of different economic sectors, thus develop corresponding sector-specific policies and procedures for undertaking business engagements, e.g., investing, insuring or lending, with those sectors. Institutions should monitor climate risks through both qualitative and quantitative metrics. These metrics should be updated regularly given the evolving understanding of climate change.

Where climate risks are material, a prudent institution should establish and implement plans to mitigate these risks and manage its exposures. APRA envisages that an institution would engage with customers and counterparties with higher climate risk exposure and provide support to assist these customers and counterparties in reducing climate risk. In cases where such engagement will not reduce the climate risk to an acceptable level, other mitigation options may be considered, for instance, limiting exposure to such an entity or sector, or in extreme cases, considering the institution's ability to continue the relationship. Relevant information on material climate risk exposures, including monitoring and mitigation actions, should be reported to the board and senior management on a routine basis.

3. Climate Risk Scenario Analysis

Climate risk scenario analysis is a developing area where APRA sees a wide range of capabilities and practices. APRA expects the use of scenario analysis and stress testing to be proportionate to an institution's size, business mix and complexity. Institutions may either develop their own capabilities, or access to external capabilities, in climate risk scenario analysis and stress testing. APRA proposes that a prudent climate risk scenario analysis should include both a short-term assessment of current exposures to climate risks and a long-term assessment of future exposures based on a range of climate-related scenarios. An institution may seek input for its scenario analysis from external experts, including academics, scientific bodies and specialist consultants. APRA further highlights that TCFD recommendations are one of the useful guidance on scenario selection and analysis.

Where an institution lacks the data, resources or expertise to conduct climate risk stress testing with appropriate quantitative assessments, it may instead conduct narrative-driven scenario analysis,^[4] which can also provide insights into the operations and channels of risk transmission.

4. Disclosure

An institution may consider making additional voluntary disclosures, beyond statutory or regulatory requirements, to enhance transparency of the institution's approach to measuring and managing climate risks. APRA considers the framework established by the TCFD to be a sound basis for producing information that is useful for an institution's stakeholders. The disclosure practices should be regularly reviewed for comprehensiveness, relevance and clarity.

endnotes

[1] APRA is the Australian prudential regulator that supervises banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, private health insurance, friendly societies and superannuation funds (other than self-managed superannuation funds).

[2] The consultation on the proposed revisions to the Governance Code and Guidelines is *available at*
<https://www.apra.gov.au/consultation-on-draft-prudential-practice-guide-on-climate-change-financial-risks>

[3] See Understanding and managing the financial risks of climate change, published on 24 February 2020, *available at*
<https://www.apra.gov.au/understanding-and-managing-financial-risks-of-climate-change>

[4] Climate risk narratives provide an overview of climate scenarios, and typically include a description of the economic, policy, technology, social and other features of the scenario. Narrative-driven scenario analysis can use these features of climate scenarios as a basis for a qualitative evaluation of potential climate risks.