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Climate Change Financial Risks

APRA CLIMATE CHANGE

The Australian Prudential Regulation Authority (APRA) has released its final prudential practice guide on climate change financial risks. The guide is designed to assist banks, insurers and superannuation trustees to manage the financial risks of climate change. The guide imposes no new regulatory requirements or obligations, but will instead assist APRA-regulated entities to manage climate-related risks and opportunities within their existing risk management and governance practices.

APRA Climate Risk Management

APRA has come up with the Prudential Practice Guide (PPG) CPG 229 Climate Change Financial Risks in November 2021. This PPG reflects the established framework for considering and managing climate risks developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), as well as good practice observed through APRA's own analysis. In this post we are analysing the risk management guidelines and action items to be followed by APRA-regulated institutions.

Risk Management

As a prudent practice, institutions should consider climate risks to be within the institution's existing framework, including the board-approved risk appetite statement, risk management strategy and business plan.

Institutions need to ensure that its arrangements to identify, measure, monitor, manage, and report on its exposure to climate risks are conducted in a manner appropriate to the institution's size, business mix and complexity of its business operations.

Policies and procedures

Policies and procedures under the institution's risk management framework should have clear articulation of the respective roles and responsibilities of business lines and risk functions (i.e. Line 1 and Line 2 activities) in relation to managing climate risks.

Risk identification

Institutions should seek to understand climate risks and how they may affect its business model, including being able to identify material climate risks and assess their potential impact on the institution. Institutions should use scenario analysis, with both a shorter- and longer-term time horizon, as a useful tool for risk identification.

Institutions need to identify economic sectors with higher or lower exposures to physical and/or transition climate risks. The risk criteria for this identification may include a range of factors, such as:

a) vulnerability to extreme weather events;

b) the level of greenhouse gas emissions;

c) potential exposure to changes in climate-related policy or technology;

d) vulnerability to climate-related supply chain changes or disruption;

e) vulnerability to climate-related disruption of business activities; and/or

f) linkages to unsustainable practices.

Good practice would see an integrated approach to climate risks taken across different business lines for an institution to consider and record any material impact on capital adequacy as a result of climate risks. An institution may choose to use the Internal Capital Adequacy Assessment Process (ICAAP) for this purpose.

Risk monitoring

Institutions can include both a qualitative and quantitative approach, including developing metrics to measure and monitor climate risks appropriate to the institution's size, business mix and complexity of business operations. Such metrics might typically be used, for example, to assess portfolio exposures to geographical areas and economic sectors with higher or lower climate risk.

Quantitative metrics can be direct and indirect emissions (usually classified into scope 1, scope 2 and relevant scope 3 emissions), exposure to physical risks, monitoring potential impacts to core business metrics such as credit risk, losses or investment returns, modelling the impact of climate scenarios on project returns and/or quantifying the impact of adaptation measures.

Quantitative metrics would assist an institution in understanding the potential current and future impacts of climate change on its customers, counterparties, and organisations to which the institution has an exposure.

Institutions can also use data from both publicly available and proprietary sources, and potentially seek assistance from external experts where necessary (including academics, specialist consultants, and scientific bodies). This data may be used to better understand the possible impacts of climate change on its own operations as well as those of its customers, counterparties, and organisations to which the institution is exposed.

Institutions may also set climate-related targets for their activities. A climate-related target is a specific level, threshold, quantity, or qualitative outcome that an institution wants to achieve, over a defined time horizon, to assist in managing its climate-related risks and opportunities. Climate-related targets should be linked to an institution's climate-related metrics, and aligned to an institution's overall business strategy and risk management framework. The climate-related targets established by an institution may also reference external benchmarks, such as sector, national and/or international targets.

As a part of prudent risk management, Institutions need to ensure that climate risk data, metrics and targets are updated regularly to support decision-making by the institution's board and senior management. It would also consider the circumstances which might trigger a review of its strategy or engagement with customers and counterparties.

Institutions should extend their risk monitoring best practices to monitor the impacts that climate risks may have on outsourcing arrangements, service providers, supply chains and business continuity planning.

Risk controls

For material climate risks, Institutions should establish and implement plans to mitigate these risks. An institution may need to consider standard risk mitigation options such as:

a) reflecting the cost of the additional risk through risk-based pricing measures;

b) applying limits on its exposure to such an entity or sector; or

c) where the risks cannot be adequately addressed through other measures, considering the institution's ability to continue the relationship.

Risk reporting

To facilitate well-informed decision-making, APRA expects that a prudent institution would establish procedures to routinely provide relevant information on its material climate risk exposures, including monitoring and mitigation actions, to the board and senior management. This information would allow the board and senior management to understand and review the activities, and to make decisions consistent with the institution's overall risk appetite and risk management approach.

The extent and frequency of reporting should be tailored to the nature and magnitude of the risks to which the institution is exposed.

Detailed analysis of APRA guidelines shall be published in subsequent posts.