CONSULTATION RESPONSE

APRA DRAFT PRUDENTIAL PRACTICE GUIDE ON CLIMATE CHANGE FINANCIAL RISKS

31 JULY 2021
THE PRINCIPLES FOR RESPONSIBLE INVESTMENT

The United Nations-supported Principles for Responsible Investment (PRI) is the world’s leading initiative on responsible investment. The PRI has over 3,800 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US $100 trillion in assets under management. Over 190 signatories, managing AUD $1.1 trillion are based in Australia.¹

As the world’s leading initiative into responsible investment, PRI works with many investment managers, insurance, and superannuation institutions as signatories to PRI.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

The PRI welcomes the opportunity to respond to the Australian Prudential Regulation Authority (APRA) consultation on its draft guidance to banks, insurers and superannuation trustees on managing the financial risks of climate change.

ABOUT THIS CONSULTATION

On 22 April 2021, APRA released a draft Prudential Practice Guide (PPG) on Climate Change Financial Risk for consultation. According to APRA "[t]he draft PPG aims to assist entities by providing guidance on prudent practice in the management of financial risks arising from climate change, including with respect to governance, risk management, scenario analysis and disclosure."

APRA has invited feedback on the draft PPG and "[t]he practices it sets out in the areas of governance, risk management, scenario analysis and disclosure." "In reviewing the draft PPG, APRA encourages entities to consider how the guidance may be applied within the context of their institution’s specific structure, business requirements and objectives. APRA also seeks feedback on the draft PPG’s overall applicability and flexibility, given the diverse institutions it is designed to assist. APRA will review the feedback received and seek to release a final version of the PPG before the end of 2021."

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¹See https://www.unpri.org/signatories/signatory-resources/signatory-directory
SUMMARY OF PRI POSITION

PRI signatories acknowledge that they have a duty to act in the best long-term interests of their beneficiaries, and in this fiduciary role, believe that ESG issues, including climate change risk, can affect the performance of investment portfolios. The Principles include the commitment to incorporate ESG issues into investment analysis and decision-making processes (Principle 1), seeking appropriate disclosure on ESG issues by the entities in which signatories invest (Principle 3), and reporting on their activities and progress towards implementing the Principles (Principle 6).

The PRI generally supports APRA’s guidance, and encourages the recognition of climate change risk as a material financial risk that has a number of elements that distinguish it from other financial risks and therefore necessitates a strategic approach to its management. The PRI also supports APRA’s position that "a prudent institution will consider both the opportunities and the financial risks of climate change as it sets its strategy."

The PRI also recognises that there are significant opportunities for the guidance to be improved, in relation to governance, scenario analysis and disclosure in particular.

The PRI’s key recommendations are:

- Include more specific guidance on how climate change risks should be considered by RSE licensees in investment governance frameworks and management of investments.

- Clarify and strengthen the guidance on the parameters that should be used for scenario analysis and the transparency entities should provide through public disclosure, including an explicit expectation that prudent entities conduct scenario analysis that is aligned to the Paris Agreement 1.5°C scenario.

- Provide a clearer and firmer statement of APRA’s expectations in relation to identifying climate related risks as material risks within the institution’s risk management framework.

- Include specific guidance and set clear expectations that entities should make public material climate risks disclosure in line with the TCFD recommendations.

- Propose a mechanism for transition to mandatory disclosure requirements.

- Confirm that APRA will monitor implementation of climate change risk management practices, scenario testing and disclosures.

- Clarify APRA’s expectations of regulated entities.

- Balance the need for flexibility, given the diverse institutions it is designed to assist, with principles-based supervision practices designed to promote practices and behaviours which maximise the probability of APRA-regulated entities seriously considering climate change risks and taking significant actions to manage those risks.
DETAILED RESPONSE

GOVERNANCE

Key points & recommendations

- Include more specific guidance on how climate change risks should be considered by RSE licensees in investment governance frameworks and management of investments.
- The PRI proposes that APRA consider including guidance on typical controls to climate related risks such as those adopted in the settlement of the McVeigh v Retail Employees Superannuation Trust case.

The PPG refers to "Prudential standards CPS 510 and SPS 510" as setting "out the minimum governance requirements of an APRA-regulated institution." No reference is made to SPS 530 – Investment Governance, which sets out APRA’s requirements in relation to investment governance for RSE licensees.

The objective of SPS 530 is to ensure that RSE licensees have a sound investment governance framework and manage investments in a manner consistent with the best interests of beneficiaries. The Superannuation Industry (Supervision) Act 1993 requires that superannuation trustees, in formulating, reviewing and giving effect to an investment strategy for the whole entity and for each investment option offered by the trustee, they have regard to the risk involved in making, holding and realising the strategy. SPS 530 requires that RSE licensees consider and articulate a measurable risk objective when setting an investment strategy for an investment option.

In the first instance, the PRI suggests that the PPG also makes reference to SPS 530. The PRI also considers that the proposed PPG 229 should specify specific governance measures that RSE licensees should take in light of APRA’s recognition that climate risks should be managed by an institution’s risk management framework and the financial risks associated with climate change have a number of elements that distinguish them from other financial risk, necessitating a strategic approach to their management.

The PRI considers that climate change risks (and other ESG factors more broadly) and appropriate target exposure should be included in the investment analysis activity and considered by RSE licensees as part of their investment governance.

The PRI does not consider the prudential framework has been effective in this regard, as climate change risks are often not adequately integrated in the investment governance framework of RSE licensees.

If the prudential guidance is to be effective in achieving the objective of assisting APRA-regulated entities in complying with Prudential Standards, and more generally outlining prudent practices in relation to climate change financial risk management, the PRI recommends that improvements be made to the guidance.

The PRI proposes that APRA consider whether the commitments undertaken by REST, resulting from the settlement of the McVeigh v. Retail Employees Superannuation Trust case should be incorporated into the guidance, including but not limited to:

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2 Section 52(6) Superannuation Industry (Supervision) Act 1993.
RSE licensees should enhance their consideration of climate change risks when setting their investment strategy and asset allocation positions, including by undertaking scenario analysis in respect of at least two climate change scenarios;

RSE licensees should actively consider all climate change related shareholder resolutions of investee companies and otherwise continue to engage with investee companies and industry associations to promote business plans and government policies to be effective and reflect the climate goals of the Paris Agreement;

RSE licensees should conduct due diligence and monitoring of investment managers and their approach to climate risk; and

RSE licensees should seek to require that investment managers and advisers comply with climate change risk management governance akin to that adopted by the trustee.

The proposed improvements would provide greater clarity to RSE licensees that climate change risks (and other ESG factors more broadly) should be integrated in the investment strategy.

RISK MANAGEMENT

Key points & recommendations

- Provide a clearer and firmer statement of APRA’s expectations in relation to identifying climate related risks as material risks within the institution’s risk management framework.
- Provide directive guidance on how entities can set portfolio targets that are aligned to Paris Agreement objectives.
- Include less conditional language such as “would,” “could” and “may” but rather, set clear expectations as to what APRA expects to see from prudent institutions.

The PRI supports APRA’s guidance that prudent institutions would seek to ensure that their arrangements to identify, measure, monitor, manage, and report on their exposure to climate risk are conducted in a manner that is appropriate to the institution’s size, business mix and complexity.

The PRI believes that the guidance could be improved by providing a clearer position on APRA’s expectations that climate risk (or climate related risks) is identified as a material risk within the institution’s risk management framework (in accordance with the relevant obligation to identify any other material risks under the relevant risk management prudential standard).

APRA-regulated entities would also benefit from more directive guidance on how to set portfolio targets that are aligned to the Paris Agreement objectives. The PPG recognises that prudent APRA-regulated entities would use metrics and data to monitor risks and establish and implement plans to mitigate these risks and manage exposures, however, it does not provide any guidance to regulated entities on "how" this should be done. No specific reference to the setting of portfolio targets in the context of risk management and governance is made in the PPG.

The PRI also recommends that the guidance is revised to include less conditional language such as "would," “could” and "may” but rather, set clear expectations as to what APRA expects to see from prudent institutions.
SCENARIO ANALYSIS

Key points & recommendations

- Include further guidance and specific parameters around how scenario analysis should be conducted and disclosed.
- Include guidance on the use of alternative scenario testing models such as the Forecast Policy Scenarios.
- Make a clearer connection between scenario analysis expectations and existing investment strategy stress testing obligations for RSE Licensees under SPS530.

The PRI supports APRA’s position that “it is prudent for institutions to develop capabilities in climate risk scenario analysis and stress testing, or to have access to external scenario analysis and stress testing capabilities to inform their risk identification in both the short and long term.” The PRI also supports APRA’s current undertaking of climate vulnerability assessments involving Australia’s largest banks and sharing its findings to the wider industry.

The PRI understands that it is appropriate to ensure that some degree of flexibility is permitted to cater for the diverse institutions the PPG is designed to assist. However, as recognised by ASIC’s recent surveillance exercise to examine climate-change-related disclosure and governance practices of a cohort of large, listed companies, “there is limited consistency in the adoption, application and disclosure of specific scenarios and underlying assumptions.”

Climate Action 100+ found the same in evaluating corporate ambition and action of the world’s largest greenhouse gas emitters and other companies with significant opportunity to drive the net zero transition: "Almost three quarters (72% of the total) of companies assessed commit to align their disclosures with the Task Force for Climate-related Financial Disclosures (TCFD) recommendations and/or support the recommendations. However, only 10% use climate-scenario planning that includes the 1.5-degrees Celsius scenario and encompasses the entire company.”

The FSB recently submitted a roadmap for addressing climate-related financial risk to the G20, which provides a basis for coordinating international efforts in the coming years. Its key areas of focus include data and vulnerability analysis. The roadmap recognises that "[c]hallenges currently exist concerning the availability of granular and comparable data and the development of metrics that adequately translate climate outcomes into financial impacts," reflecting to some extent a general lack of underlying data. Data and scenario analysis are closely intertwined. The FSB Roadmap suggests that the "development of a framework for monitoring vulnerabilities would bring together work on metrics and indicators of climate risk," and "[g]iven the importance of a long-term, forward-looking perspective, further deepening scenario analysis, making use of [Network for Greening the Financial System] NGFS scenarios, will be important.

A more detailed description of the expectations for scenario analysis will assist entities to engage in more robust scenario analysis and in turn achieve greater confidence in the results that will enable

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comparison with peers and progress over time. It will equally assist regulators to carry out and monitor climate vulnerability assessments over time.

The PRI considers that APRA-regulated entities will benefit from further guidance and specific parameters around how scenario analysis should be conducted and disclosed.

At a minimum, the PRI suggests that:

- Rather than state that key considerations when building scenarios include future rise scenarios, including a global average temperature rising by 2°C or less, the guidance must make clear that APRA expects that prudent entities must at minimum conduct scenario analysis that is aligned to the Paris Agreement 1.5°C scenario. Australia is a party to the Paris Agreement which aims to strengthen the response to climate change risks by pursuing efforts to limit temperature increase to 1.5°C (not 2°C of less).

- Rather than proposing key-considerations scenarios "could" include, the guidance may be more useful if it proposes the key scenarios that "should" be included by APRA regulated entities.

- Rather than proposing that a "prudent institution would maintain appropriate documentation of the process and results of its climate risk scenario analysis and stress testing," propose that APRA-regulated entities "should" document not only the process and results, but also the input assumptions utilised and any variance to standard sets of assumptions.

- Rather than suggest that the results of scenario analysis would be communicated to the board and senior management only where material, propose that APRA-regulated entities "should" communicate "any" results of any scenario analysis to the board and senior management. The most recent Memorandum of Opinion authored by Noel C Hutley and JE Mack titled "Superannuation Trustee Duties and Climate Change" noted that "it is the board of a superannuation trustee that is required to take the steps to understand and manage the risk" and "[i]n order to act prudently and in the best interests of members, it is the board who must have in place processes that enable it to understand and manage the financial risk posed by climate change."7 Disclosing results only where they are material does not provide adequate transparency to boards to allow them to understand and manage the risks posed by climate change.

- Rather than suggest that the scenario analysis be "used to inform business planning and strategy setting" suggest that the impact on current business planning and strategy as a result of the scenario analysis should be reported and actions taken as a result of material impacts documented and agreed by the board.

The PRI’s Inevitable Policy Response (IPR), a pioneering programme which aims to prepare financial markets for climate-related policy risks includes the Forecast Policy Scenario (FPS), models the impact of the forecasted policies on the real economy up to 2050, tracing detailed effects on all emitting sectors, including changes to energy demand (oil, gas, coal), transport, food prices, crop yields, and rates of deforestation.8 Later in the year, the programme will publish detailed modelling of the implications of the IPR FPS for key asset classes.

APRA-regulated entities should be encouraged to also consider such alternative scenario analysis models, especially when testing the resilience of investment strategies under different economic

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8 https://www.unpri.org/inevitable-policy-response/forecast-policy-scenario-macroeconomic-results/4879.article
and climate assumptions because financial markets have not adequately priced-in the likely near-term policy response to climate change.

DISCLOSURE

Key points & recommendations

- The PRI considers that setting 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 making it apparent what needs to be done.
- Include specific guidance and set clear expectations related to disclosure, rather than at a high level stating that a prudent institution would look to continually evolve its own disclosure practices.
- Provide a suggested mechanism for transition to mandatory disclosure requirements.
- Consider providing guidance in relation to expectations of phasing in standard mandatory disclosure in relation to climate related risk exposures and management.

The PRI supports standardised, mandatory disclosure of material climate and ESG information, which helps its signatories to fulfil their fiduciary obligation to fully consider material information and make informed investment decisions for long-term value creation.

The draft PPG takes a significant step towards assisting APRA-regulated entities in understanding and raising awareness about the financial nature of climate-related risks. As recognised in the PPG it is strongly aligned with global trends (i.e., the consideration that the TCFD framework is a sound basis for producing information and recognition that the demand for reliable and timely climate risk disclosure will increase over time and institutions with international activities need to be prepared to comply with mandatory climate risk disclosures in other jurisdictions).

APRA recognises that the "disclosure of decision-useful, forward-looking climate risk information allows interested stakeholders to assess an institution’s resilience to climate risks." Rather than recognising the risks associated with non-disclosure, however, the PPG simply states:

Beyond any statutory or regulatory requirements, a prudent institution would likely consider whether additional, voluntary disclosures could be beneficial to the institution by enhancing transparency and giving confidence to the wider market in the institution’s approach to measuring and managing climate risks.

... APRA considers 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.

The risk of litigation and damages for failing to meet the necessary standard of care in failing to adequately disclose exposure to climate-related risks and how an entity manages those risks was recently demonstrated where a member of the Retail Employees Superannuation Trust (Rest) filed suit against the trustee. The case highlighted the need to manage ESG risks and the necessity for transparent disclosure. In 2018, member McVeigh filed suit against Rest, first alleging breaches of the Corporations Act 2001 for failure to provide information related to climate change business risks and later amended his suit to
allege the fund’s trustee failed to act with the requisite care, skill and diligence and failed to act in his best interests by not properly considering climate change risk.

The parties agreed to settle the litigation with Rest agreeing that its "policy requires that the management of climate change risks also involves the disclosure to members of those risks, as well as the systems, policies and procedures maintained by the trustee to address those risks."  

In 2016, Noel Hutley SC and Sebastian Hartford-Davis published a Memorandum of Opinion titled "Climate Change and Directors' Duties" opining, among other things, that "whether or not [directors] decide to act, directors who perceive that climate change does present risks to their business should also consider the adequacy of the disclosure of those risks within the company's reporting framework."  

In addition to referring to the requirements of the ASX Listing Rules, the memorandum also points out that it is "worth bearing in mind that annual reports constitute and contain representations, which will often become the focus of allegations of misleading and deceptive conduct in company litigation," and it "is well established that non-disclosure of material information can, depending on the circumstances, constitute misleading and deceptive conduct." The memorandum notes that "significant variation" has been observed in the approach of Australian companies to the disclosure of climate change and other sustainability risks within annual reports.

In 2019, the authors published a supplementary opinion that noted "developments in the state of scientific knowledge" since the earlier memorandum and opined that these developments elevated the standard of care expected of a reasonable director - "Company directors who consider climate change risks actively, disclose them properly and respond appropriately will reduce exposure to liability. But as time passes the benchmark is rising."

ASIC recently undertook a surveillance exercise on the TCFD recommendations and observed that while the quantity of climate-related disclosure has increased materially, the quality still varies significantly; there is limited consistency in the adoption, application and disclosure of specific scenarios and underlying assumptions; and "greenwashing" was prevalent in some disclosures reviewed.

In its March 2020 report Prospering in a low-emissions world: An updated climate policy toolkit For Australia, the Climate Change Authority considered prudential regulation of climate-related risk and recommended that a joint taskforce of the Council of Financial Regulators, together with the major accounting bodies, examine the phasing-in and mandatory reporting of climate-related risks and mainstream climate-related disclosures in companies’ audited financial statements.

Considering the above, the PRI recommends that APRA more clearly describe its expectations for disclosure and over time, through phased compliance periods, a step-by-step approach to

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increasing the quality of disclosures. APRA should similarly establish a review process to consider improvements to disclosures.

The CDP, the Investor Agenda and the PRI through a joint initiative recently published Confusion to Clarity: A Plan for Mandatory TCFD-Aligned Disclosure in Australia (the Paper). The Paper recognises that "[g]iven 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. Rather investors report that the current voluntary regime has resulted in lacking quality and consistency of company disclosure, which leads to under-pricing of climate risks in the market." Effective disclosure is critical to managing the systemic financial risks associated with climate change," and "setting clear, mandatory requirements will help align regulation with industry expectations and global standards." The Paper proposes that APRA take the immediate step to "establish[] via its climate change financial risk [] PPG a clear expectation that regulated entities publicly disclose material climate risk according to the TCFD recommendations and additional regulatory guidance."

The PRI considers that setting 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 make it apparent what needs to be done.

The PRI understands that Australian regulators are closely following the progress of the International Financial Reporting Standards Foundation, which is establishing a Sustainability Standards Board that will focus first on developing a climate disclosure standard. The proposed IFRS standard, built on the TCFD recommendations and supported by IOSCO, would provide a consistent standard for inclusion of relevant material climate related financial risk in financial statements, which would be subject to assurance requirements. This global standard is expected to increase the breadth of jurisdictions mandating disclosures. The PRI supports this monitoring and recommends that APRA monitor and update its guidance in line with any international developments and international standard setting.

The PRI, however, does not recommend that APRA delay progress towards a mandatory disclosure regime aligned to the TCFD. As recognised by the FSB, taking disclosure initiatives, while work towards a global baseline corporate reporting standard progresses, is "an important step forward on the path towards a global baseline standard that is interoperable with jurisdiction-specific requirements in order to achieve comparability in disclosures." The PRI recommends that APRA consider the proposal contained in the Paper – Confusion to Clarity: A Plan for Mandatory TCFD-Aligned Disclosure in Australia and begin work on implementing a mandatory disclosure regime, including amending the PPG to include a clear expectation that prudent entities make public TCFD aligned disclosure on climate related risks.

In 2018, the PRI introduced TCFD-aligned indicators to its reporting framework, including reporting on four indicators of climate risks: governance, strategy, risk management, and metrics and targets. Reporting against the governance and strategy indicators became mandatory from 2020 for PRI investor signatories (but still voluntary to disclose in this first year). From 2021, it will be

18 https://www.ifrs.org/projects/work-plan/sustainability-reporting/#about
mandatory to report and disclose against the strategy and governance indicators; with the risk management, and metrics and targets indicators also becoming mandatory in the near term.

APRA could adopt a similar approach to phasing in mandatory disclosure.

The PRI recommends further that APRA monitor implementation of climate change risk disclosures to ensure APRA-regulated entities are appropriately disclosing climate risk exposure.

OVERALL APPLICABILITY AND FLEXIBILITY

Key points & recommendations

- Confirm that APRA will monitor implementation of climate change risk management practices, scenario testing and disclosures.
- Use firmer language in appropriate circumstances on APRA’s expectations of regulated institutions.
- Balance the need for flexibility, given the diverse institutions it is designed to assist, with principles-based supervision practices design to promote practices and behaviours which maximise the probability of APRA-regulated entities seriously considering climate change risks and taking significant actions to manage those risks.

The PRI supports APRA’s position that, subject to meeting the requirements of the prudential standards, APRA-regulated entities have the flexibility to configure their approach to climate risk management in a manner best suited to achieving their business objectives.

This however should be balanced with principles-based supervision designed to promote practices and behaviours which maximise the probability that appropriate and consistent consideration and management of climate change risks is occurring. Accordingly, the PRI recommends that improvements are made to the prudential guidance to reflect APRA’s specific expectations of prudent institutions.