

# Directors' responsibilities and climate risk

## Are directors of APRA regulated institutions fulfilling their obligations regarding climate risk?

The Australian Prudential Regulation Authority (APRA) and the Financial Stability Board (FSB) expect financial institutions to respond to the risk of climate change sooner rather than later. Climate change is no longer just a reputational issue. It can have real impacts on the credit quality of borrowers which investors, auditors and regulators will want to understand.

## Why now?

The financial risk of climate change is firmly on the global agenda. The Bank of England has identified climate change as the most material threat to financial stability that isn't being managed.

In Australia, APRA now sees the transition risks associated with climate change as a key issue for the financial services sector; changes in regulation, technology and the physical environment as well as investor behaviour linked to climate-related risks will determine how carbon-intensive resources are repriced, and how capital is allocated.

APRA's view is that some of these risks have the potential to have systemic implications for the Australian economy, and will be monitoring entities to make sure they are managing the risks appropriately. While this does not mean climate change risk has moved to the top of APRA's agenda, it is a signal to the sector that it's firmly on their radar.

Meanwhile, the FSB Task Force has issued recommendations on how companies should publically disclose climate-related financial risks within financial filings, which will be presented to the G20 in July 2017. The recommendations are applicable to all companies with listed debt/equity as well as asset managers and owners, and are widely expected to be translated into regulation over time.

## The background



### October 2016

Senior barrister Noel Hutley SC legal opinion - Australian directors "who fail to consider 'climate change risks' now could be found liable for breaching their duty of care and diligence in the future".



### October 2016

The Paris Agreement – 197 countries enter binding agreement to limit global warming to 2°C above pre-industrial levels.



### December 2016

FSB Task Force on Climate-related Financial Disclosures releases recommendations on the reporting of climate-related risks to be presented to the G20 in July 2017.



### February 2017

APRA publically warns about the risks of climate change, and their expectation for financial institutions to "rise to the challenge". This position has been publically reiterated by ASIC.

## What this means for directors

Directors need to be asking questions and putting measures in place to show that action is being taken to understand and respond to climate-related risks. As well as the focus from APRA, this is fundamental to their fiduciary duty under the Corporations Act which requires directors to apply care and diligence in considering all the "foreseeable" risks that might apply to their company.

Prudential Standard CPS 220 – *Risk Management* sets a framework for identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating material risks of APRA-regulated institutions. The standard contains a number of requirements that, at a minimum, will need additional consideration of climate risks from regulated institutions.

CPS 220 requires APRA-regulated institutions to focus on the mitigation and control mechanisms for material risks. In the context of climate risk, this may mean deploying both mitigation and adaptation strategies in response to areas where an organization has a potentially material exposure to climate risk, including loan books and investments.

## Challenges in managing climate risk

- Traditional financial risk assessments are unable to assess business wide exposure to systemic risks from climate change. Businesses therefore need to consider their total exposure to different sectors in different locations and jurisdictions, and how these could be impacted.
- Credit risk analysis typically will perform forward modelling of up to five years for specific activities, and is not geared to account for longer term climate policy or climate impact scenarios.
- Environmental risks are managed through an Environmental Risk Management framework, which looks at environmental risks at the transactional level, rather than across the entire sector or portfolio.
- Companies do not currently disclose the information needed to understand credit implications of climate risk, resulting in significant data gaps.
- There is currently no standard for managing climate risk, leading to a lack of consistent approaches that can be applied 'off the shelf'.
- Banks do not typically collect climate risk data on their clients, and credit ratings do not currently incorporate climate risk and therefore cannot be used as a proxy.
- Scenario modelling is required for banks to understand how climate change may impact them financially – climate risk is not currently integrated into stress testing models.

## The business benefits



Identify how climate-related risks can impact on asset values, non-performing loans, investment returns and earnings.

Understand how climate-related risks can impact client credit quality and subsequently, risk weighted assets and capital adequacy.



Improve data on climate-related risks to enable greater analytics and insight at an asset, client, portfolio and institutional level.

Provide the risk management tools to mitigate these risks and integrate them into wider credit, operational, market and reputational risk processes.



Improve internal management reporting and external disclosure of these risks, to meet the growing expectations of investors, ratings agencies and regulators.

## Getting the conversation started

### Chairman / CEO / Board

- Does your business have a clear picture of its exposure to climate risk? This doesn't just relate to the threat of flooding, drought and damage to assets. In fact, the biggest immediate risk for many businesses is the reduction in value of high-carbon assets and changes to the cost of their supply chain.
- Do you have a strategy or the governance structures in place to deal with your potential value at risk and respond to the increasing expectations on public disclosure?

### Chief Risk Officer

- Do you have effective risk management processes in place that integrate climate change into credit, market and operating risk assessment, at the asset, client, portfolio and institutional level?
- Does your approach to managing climate-related risks align to the requirements of CPS 220?
- Does the risk committee have sufficient oversight of climate risks?

### Chief Financial Officer

- Do your data and reporting systems provide adequate management information on climate risk that you are able to understand, manage and report on them?
- Do they integrate to your other financial and nonfinancial reporting systems?
- Are you able to explain these risks to investors and regulators?
- Are you comfortable with signing off on external financial reports containing climate-related financial disclosures?

### Audit & Risk Committee Chair

- Are you satisfied with management's reports on the effectiveness of the internal controls and risk management systems for climate risk?
- Are you satisfied that the financial statements prepared reflect any material climate risk exposures, and are complete and accurate?
- Is the audit & risk committee sufficiently well-informed on the strategic, business and financial implications of climate change?



## ***How we can help***

While climate change is now "on the radar" for directors, there is limited guidance on how they should deal with the issue. PwC has an established Risk & Regulation team with dedicated climate change specialists to help financial institutions navigate their climate risk responsibilities:

- Understand and assess risks at a transaction, client and portfolio level.
- Help identify and manage climate risk data and feed this into current credit risk modelling.
- Interpret what the low-carbon transition means for their institution to inform decision making at all levels and capitalise on the opportunities.
- Establish policies, strategy and tools to embed climate risk management across the business.
- Prepare robust and comprehensive climate-related financial disclosures.
- Establish strategies to ensure business continuity and resilience, to minimise disruption in the face of transition risks and policy uncertainty.
- Financial stress testing and risk management framework reviews in response to climate-related risk.

## ***Contacts***



### ***John Tomac***

Partner, Risk & Regulation Consulting  
Sydney  
(02) 8266 1498  
[john.tomac@pwc.com](mailto:john.tomac@pwc.com)



### ***Symon Dawson***

Principal, Risk & Regulation Consulting  
Melbourne  
(03) 8603 0067  
[symon.b.dawson@pwc.com](mailto:symon.b.dawson@pwc.com)



### ***Adam Cunningham***

Director, Risk & Regulation Consulting  
Melbourne  
(03) 8603 2759  
[adam.cunningham@pwc.com](mailto:adam.cunningham@pwc.com)



### ***Marna Slabbert***

Director, Risk & Regulation Consulting  
Melbourne  
(03) 8603 5607  
[marna.slabbert@pwc.com](mailto:marna.slabbert@pwc.com)

© 2017 PricewaterhouseCoopers. All rights reserved.

PwC refers to the Australian member firm, and may sometimes refer to the PwC network.

Each member firm is a separate legal entity. Please see [www.pwc.com/structure](http://www.pwc.com/structure) for further details.

At PwC Australia our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 223,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at [www.pwc.com.au](http://www.pwc.com.au)

Liability limited by a scheme approved under Professional Standards Legislation.

WLT127047654