Trustees' responsibilities and climate risk

Are trustees of APRA regulated superannuation funds fulfilling their obligations regarding climate risk?

The Australian Prudential Regulation Authority (APRA) and the Financial Stability Board (FSB) expect financial institutions, including Registrable Superannuation Entities (RSE's), 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 asset values and financial returns which members, investors and regulators will want to understand.

The background

October 2016
The Paris Agreement – 197 countries enter binding agreement to limit global warming to 2°C above pre-industrial levels.

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*".

December 2016
FSB Task Force on Climate-related Financial Disclosures (TCFD) 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.

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.

Research from the University of Cambridge shows that:

> *"Short-term shifts in market sentiment induced by awareness of future climate risks could lead to economic shocks and losses of up to 45% in an equity investment portfolio value (23% for fixed income), based on a 5% probability stress test. 47% of this is "unhedgeable," meaning investors and asset owners are exposed unless some system-wide action is taken to address the risks."*

In Australia, APRA now sees the transition risks associated with climate change as a key issue; 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

What this means for RSE's

- Trustees 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 Section 52 of the Superannuation Industry (Supervision) Act which requires trustees to "perform the trustee's duties and exercise the trustee's powers in the best interests of the beneficiaries".
- Prudential Standard SPS 220 - *Risk Management* sets a framework for identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating material risks of registrable superannuation entity (RSE) licensees. The standard contains a number of requirements that, at a minimum, will need additional consideration of climate risks from RSE licensees.
- SPS 220 requires RSE licensees to focus on the mitigation and control mechanisms for material risks. Climate risk may now be perceived as a fundamental consideration in the assessment of investment risk. This will require both mitigation and adaptation strategies in response to areas where an organization has a potentially material investment exposure to climate risk.

Challenges in managing climate risk

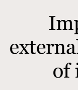
- Traditional financial risk assessments are unable to assess business wide exposure to systemic risks from climate change. RSE licensees therefore need to consider their total exposure to different sectors in different locations and jurisdictions, and how these could be impacted.
- Credit risk analysis 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'.
- Superannuation funds do not typically collect climate risk data on their investments, and credit ratings do not currently incorporate climate risk and therefore cannot be used as a proxy.
- Scenario modelling is required for superannuation funds 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 assets and liabilities (credit quality, asset values) as well as capital adequacy.

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

Provide the risk management tools to mitigate these risks and integrate them into wider risk processes.



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

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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.
- Do you have a strategy or the governance structures in place to deal with the risks to investment activities, and respond to the increasing expectations on public disclosure?

Chief Risk and/or Investment Officer

- Do you have effective risk management processes in place that integrate climate change into asset, liability and operating risk assessment?
- Does your approach to managing climate-related risk align to the requirements of SPS 220?
- Does the risk and/or investment 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 non-financial 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 and financial implications of climate change?

How we can help

While climate change is now "on the radar" for trustees, 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.

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WLT127047654