Market Insights

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APRA's CPG 229 Climate Change Financial Risks

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Introducing CPG 229

An important milestone

Introducing CPG 229 Climate Change Financial Risks

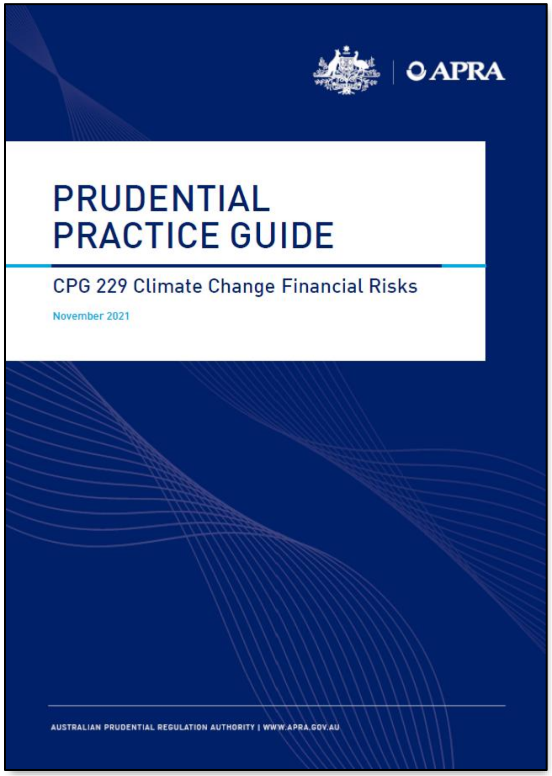
A new prudential practice guide for investors managing the financial risks of climate change

- Consistent with other regulatory authorities in Australia and abroad, APRA's focus on the financial risks arising from climate change has been intensifying in recent years. This reflects its evolving view of how climate change may impact its mandate to support a stable, efficient and competitive financial system.
- Having flagged its intention to provide formalised guidance for regulated entities, *APRA issued CPG 229 Climate Change Financial Risks* in late 2021 (following a draft version in April 2021 and an industry consultation process). Frontier sees CPG 229 as an important milestone for regulated asset owners as *it effectively confirms that managing climate change financial risks is a fiduciary duty.*
- Frontier recommends clients become familiar with CPG 229. It is available at:

  https://www.apra.gov.au/consultation-on-draft-prudential-practice-guide-on-climate-change-financial-risks

  Prudential practice guides (PPG) provide guidance on APRA's view of sound practice in particular areas, but do not create enforceable requirements. Nonetheless, Frontier recommends that APRA-regulated asset owners *take proactive steps now to progressively align with CPG 229* in anticipation that expectations of the regulator (and other stakeholders) will ultimately crystallise as requirements.
- Importantly, CPG 229 aims to support APRA-regulated asset owners in *complying with existing and enforceable standards* as follows:
  - CPS 220/SPS 220 - Risk Management; and
  - CPS 510/SPS 510 - Governance

  and more generally, to outline prudent practices in relation to climate change financial risk management.



- CPG 229 also closely reflects the recommendations of the *Taskforce on Climate-related Financial Disclosures (TCFD).* This disclosure framework has been widely adopted by asset owners globally. Refer to the link following:

  https://www.fsb-tcfd.org/
- While APRA has developed CPG 229 to specifically support regulated entities such as superannuation funds and insurers, it is Frontier's view that *the principles in the guide can readily serve as a useful framework for non-regulated asset owners* as well.

Introducing CPG 229 Climate Change Financial Risks

CPG 229's objectives

APRA's Objectives for regulated entities on CPG 229

Source: APRA

- APRA makes it clear that its mandate is not to determine an entity's individual investment, lending or underwriting decisions. However, it does aim to ensure that such decisions are *well-informed*, including with respect to the management of climate change financial risks.
- Climate change is a highly complex consideration for investors, particularly as the prevailing science, government climate policies, law, market impacts and community expectations are constantly evolving and growing.

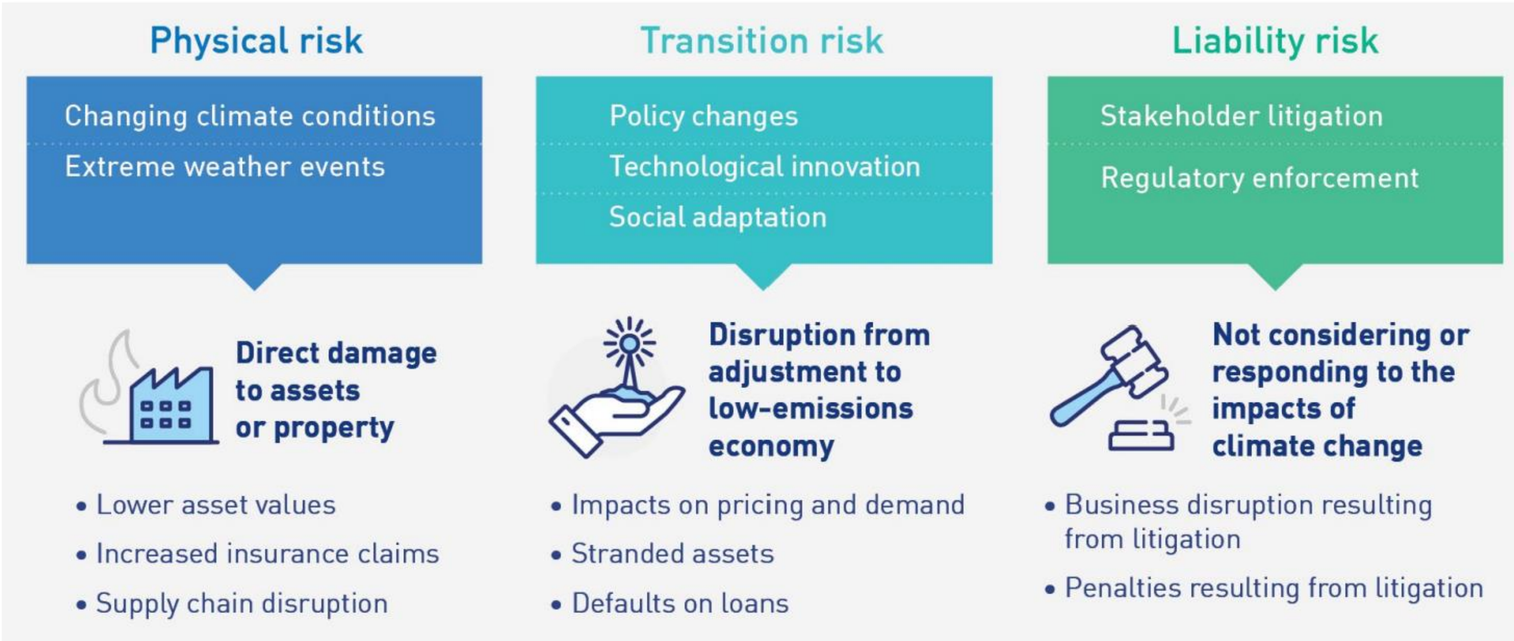
Frontier considers that *educating themselves on material climate change-related investment considerations* (while possibly requiring some upfront cost) is the most constructive early step in empowering asset owners *to implement suitable practices in line with regulatory guidance.*

There are many options for asset owners here, including engaging specialist ESG service providers and consultants, collective organisations/NGOs (such as the Principles for Responsible Investment and the Investor Group on Climate Change), and suitably-credentialled fund managers.

What are climate change *financial* risks (and opportunities)?

APRA believes the risks of a changing climate extend to all sectors of the economy

Climate change financial risks addressed in CPG 229



- Throughout CPG 229, APRA states that it is important for institutions to *understand the interaction between the above climate risks and their business activities,* including how climate risks may exacerbate other risks e.g. credit risk, market risk, operational risk, insurance risk, liquidity risk and reputational risk.
- APRA further highlights that the financial risks associated with climate change have elements which distinguish them from other financial risks and *necessitate a strategic approach* to their management. Asset owners should therefore not assume there is a simple, ‘off-the-shelf’ solution to meeting APRA’s expectations.
- APRA notes that while it is difficult to forecast how and when specific climate risks will materialise, an institution can *mitigate the magnitude of the financial risks* by aligning its climate practices to CPG 229 in a manner that is tailored to its specific business strategy and risk appetite.
- APRA also states that institutions implementing *better risk management practices will allow them to identify and benefit from financial opportunities* arising from the transition to a lower-emissions economy such as in resource efficiency, clean energy sources, new/emergent markets, and resilience.

Introducing CPG 229 Climate Change Financial Risks

Addressing APRA's minimum requirements and expectations

- At its core, CPG 229 comprises four key sections, which are outlined below and discussed in further detail in the next section of the paper.
- Most sections are informed by relevant APRA prudential standards.
- APRA's prudential standards set out minimum capital, governance and risk management requirements, while prudential guides provide direction on how institutions may adhere to the standards, as well as to other related expectations.
- In CPG 229, APRA interprets the prudential standards and provides guidance as to how they relate to climate change financial risks.

Governance	Risk management	Scenario testing	Disclosure
• This section sets out APRA's minimum requirements and expectations for governance as they relate to climate change financial risks. • APRA states climate risks can and should be managed within an institution's overall business strategy and risk appetite, and boards should be able to demonstrate oversight of these risks.	• This section sets out APRA's minimum requirements and expectations for risk management as they relate to climate change financial risks. • APRA states a prudent institution could identify, measure, monitor, manage, and report on its exposure to climate risks in a manner that is appropriate for its size, business mix and complexity of business operations.	• This section sets out APRA's minimum requirements and expectations for scenario testing as they relate to climate change financial risks. • APRA states a prudent institution could develop climate risk scenario analysis and stress testing capabilities, or access these externally. APRA also expects approaches to evolve and mature over time.	• This section sets out APRA's expectations for disclosure as they relate to climate change financial risks. • APRA considers it best practice for any disclosures to be produced in line with the framework established by the TCFD.
CPS 510, SPS 510	CPS 220, SPS 220	CPS 220	n/a*

* Not identified as part of CPG 229.

CPG 229's four key implementation areas

Governance, risk management, scenario analysis and disclosure

Governance

Getting practical - defining a climate change policy/statement is paramount

Enabling consistency of decision-making on climate change.

- We view an important early step in developing a strategy for managing climate change financial risks is *establishing a clear and considered climate change policy* (or statement) that has been approved by, and is the responsibility of the board. This may be part of an overall responsible investment/ESG policy or standalone but either way should be intrinsically linked to your overall investment policy.
- *Investor inaction*, as it relates to managing climate change financial risks, is *a primary risk in this space*. Climate change is considered a significant risk to economic stability, and has the potential to impact investment returns across all asset classes, so should not be ignored/deferred.
- An asset owner's climate change policy must align with its overall business strategy and risk appetite in order to:
  - Accurately reflect its key investment beliefs relating to climate change.
  - Provide a robust decision-making framework that is consistent with the objectives of the business.
  - Enable clients to navigate their path to managing these risks in a manner that is appropriate for their size, business mix and complexity of operations.
- In preparation for developing a climate change policy, ensure all key decision-makers are 'on the same page' with respect to their investment beliefs and objectives relating to climate change. In Frontier's experience, it is not unusual for decision-makers to initially presume a strong commonality of beliefs on the financial impacts of climate change, but after some discussion, find that there are material differences of opinion.

Frontier recommends asset owners undertake an *initial survey and a moderated workshop discussion* to iron out any major differences of opinion up front and limit the risk of decision-making being impeded down the track. The outcomes of this process should then be integrated into a climate change policy.

Most importantly, Frontier recommends asset owners *adopt a genuine approach to managing climate change financial risks*. The regulator is clearly focussed on ensuring APRA-regulated institutions do not engage in 'greenwashing', i.e. when a company or organisation spends more time or money on marketing themselves as being sustainable than on actually managing their climate change financial risks. An effective policy acts to help keep an asset owner on course to 'walk the talk'.

Risk management

Getting practical – using climate change data and metrics

'What is measured gets managed' – bring the understanding of climate risks to life.

- CPG 229 states 'better practice in monitoring climate risks includes both a qualitative and quantitative approach, including *developing metrics to measure and monitor climate risks*'. Asset owners will be expected to become accustomed to acquiring (i.e. paying for), reviewing and using climate change-related metrics and data as part of their standing consideration of climate change financial risks.
- There is a *spectrum of climate change metrics and data* available from a wide range of providers which varies by complexity, level of intellectual property (IP) and cost. The below graphic provides a general sense of this spectrum from simple (LHS) to complex (RHS).

	Basic climate data	Climate analytics	Multi-dimensional climate assessments
Level of data processing	Low	Medium	High
IP from data provider	Low	Medium	High
Cost	Low	Medium	High
Examples	• GHG emissions • Carbon intensity ratios • Fossil fuel reserves	• Transition risk metrics • Physical climate risk metrics • Climate solutions alignment metrics • Temperature scenario analysis	• Proprietary climate value-at-risk metrics • Proprietary climate risk ratings

- APRA again emphasises that a client's use of climate metrics and data should be consistent with its size, business mix and complexity. *Climate metrics and data should be but one input* into the client's efforts in identifying, assessing and measuring the financial risks arising from climate change in the portfolio.
- Going forward, periodically acquiring basic climate data such as GHG emissions data and carbon intensity ratios (e.g. emissions per $revenue) should be a minimum for step for asset owners. For some, such data may be sufficient for some time to come, although considering more complex metrics over time is worthwhile. In general however, seek to pay only for the data you need (noting that what you need may evolve in the future).
- Over time, asset owners will become more experienced at interpreting climate metrics and data but it is important to recognise:
  - Climate data is not an end in and of itself. It is a lens through which asset owners may make more informed decisions/actions e.g. engaging with their fund managers to understand how they are addressing a fossil fuel exposure etc.
  - Climate data is highly contextual e.g. relatively high GHG emissions metric for a given part of your portfolio doesn't necessarily mean higher investment risk.

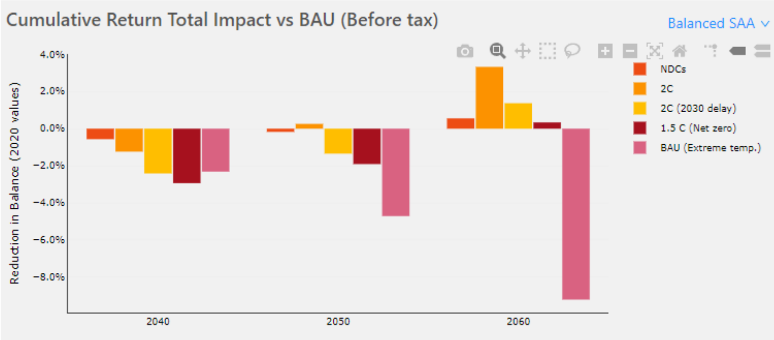
Frontier recommends asset owners identify and acquire suitable climate change-related data and metrics to bring quantitative rigour to their risk management.

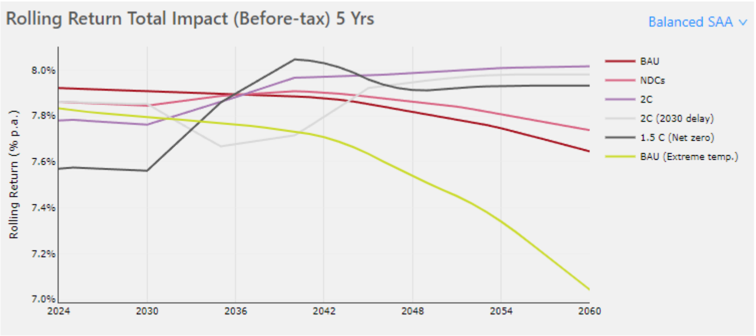
Scenario analysis

Getting practical – using climate change scenario analysis

Helping to inform the identification of climate change financial risks.

- APRA views *scenario analysis as an important tool* for regulated entities to assist in identifying climate change-related financial risks. APRA-regulated asset owners will be expected to become accustomed to acquiring (i.e. paying for), reviewing and using climate change scenario analysis as part of their standing consideration of climate change financial risks.
- While climate change scenario analysis comes in a range of forms, typically we see these models underpinned by forecasted economic metrics (e.g. GDP growth). These forecasts are frequently based on climate change research (transition and physical impacts) produced by *well-regarded, relevant entities such as the Intergovernmental Panel on Climate Change (IPCC).* Clients just beginning to explore climate scenario analysis should ensure that the underpinning economic forecasts are obtained from reliable sources such as the IPCC.
- Providers of climate change scenario analysis seek to translate these economic forecasts into impacts on investment outcomes (most typically on returns but also on risk). As with more traditional macroeconomic scenario analysis (e.g. scenarios based on comparative levels of economic growth, inflation), forecasting an investment impact for a given scenario is not a precise science (or art) and therefore subject to variation by provider. In CPG 229, APRA *flags the need for asset owners to be able to interpret and understand the workings of their chosen climate scenario analysis.*
- Frontier launched its Climate Change Module in 2015 and this is an example of climate change scenario analysis. The module provides clients an indicative impact on investment returns at an overall portfolio level under a range of different temperature and policy 'pathways' (the scenarios). Clients have had outputs from the Climate Change Module included annually as a standard part of their investment strategy reviews (see following).





- Acquiring climate scenario analysis is not an end unto itself. APRA emphasises that *such analysis is to inform the process of identifying material investment risks arising under a range of different futures.* Given the complexity of how transition and physical impacts of climate change will play out going forward, research on assigning probabilities to different scenarios occurring remains nascent. Frontier expects that this is a key area which will continue to evolve and improve over time but for now, the *primary focus is on enhancing understanding of what could happen under different scenarios.*

Frontier recommends asset owners source suitable climate change scenario analysis (if not developed internally) as a standing part of risk management approach.

Disclosure

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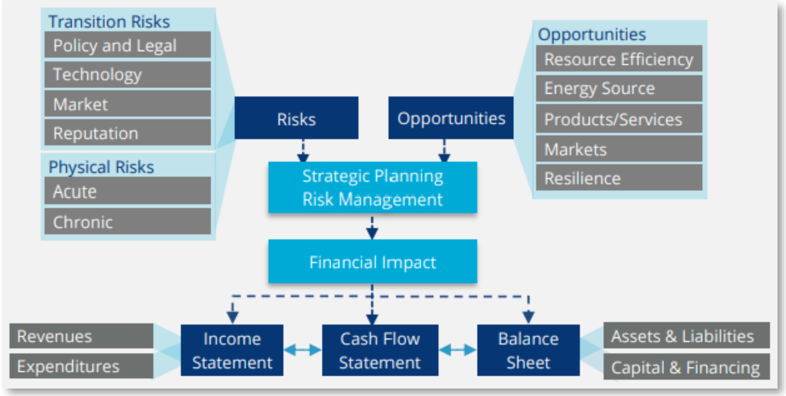
Getting practical – disclosure and reporting on climate change actions

Build towards climate change disclosure in line with TCFD

- APRA expects that 'decision-useful' information on an asset owner's approach to managing climate change risks will be of increasing importance to that asset owner's stakeholders going forward. Frontier notes APRA's explicit reference to stakeholder litigation risk in CPG 229 as being illustrative of this expectation.
- Stakeholders in this context include *beneficiaries* and also a wide range of other interested parties such as *customers, potential new members, existing or potential employees, APRA and other regulators, media channels, NGOs and the wider public.*
- Frontier observes that how effectively an asset owner discloses its climate change risk management strategy is increasingly a factor in a stakeholder's decision-making such as:
  - deciding whether to become a member of your fund/company
  - deciding whether to work for your fund/company
  - deciding whether to target your fund/company in a media campaign on climate change
  - deciding whether to investigate your fund/company to determine whether climate change risk is being suitably addressed.

TCFD's Climate-related risks and opportunities



Source: TCFD

Frontier recommends establishing a goal of publicly reporting on your climate change strategy and progress which aligns with the recommendations of the TCFD.

We have observed TCFD increasingly being used as a basis on which to structure asset owner climate change disclosure/reporting.

- We have previously flagged the benefits of developing a climate change policy or statement, as well as acquiring climate change data and analytics (including scenario analysis). These elements are typically seen in the climate change reporting of entities that are more advanced on their climate change strategy, along with explanatory information which enhances the understanding of their stakeholders.
- Start simple but expect your climate change reporting approach to *evolve in sophistication over time* (which is also APRA's expectation), considering your specific stakeholders' needs and industry trends. Aim to make this area of implementation a part of your business-as-usual over time.

Conclusions

(And what about net zero?)

What about net zero?

Decarbonisation targets are not yet a formal expectation of APRA under CPG 229

- 'Net zero' has undoubtedly been *the* climate change-related topic of focus for asset owners over the last two years, with many entities adopting decarbonisation targets, including the Australian Government.
- The term 'Net zero' is intrinsically linked to the 2015 Paris Agreement's ambition of limiting global temperature increase to a maximum of 1.5ºC above pre-industrial levels by the end of the 21st century. A 2018 special report by the Intergovernmental Panel on Climate Change (IPCC) concluded the global economy would need to reach 'Net zero' by 2050 for the 1.5ºC ambition to be achievable.
- A Net zero-aligned investment strategy should include both:
  - decarbonisation of the portfolio in a way that is consistent with achieving real economy emissions reductions
  - increased investment in 'climate solutions' needed to meet the IPCC's 2050 net zero milestone.
- As part of the consultation process around the April 2021 draft of CPG 229, APRA noted that it was widely encouraged to include greater specificity on 1.5ºC/net zero-aligned temperature scenarios and other related considerations.[1]
- For the final version of CPG 229 APRA subsequently included the following guidance around setting targets (paragraph 30).

"A prudent institution may also wish to set climate-related targets for its 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"

This broad guidance on setting targets is consistent with the regulator's approach of permitting flexibility of approach to developing a climate change strategy and *stops short of classifying net zero as better practice in the context of CPG 229's headline objectives.*

- So for the time being at least, having a net zero strategy/target (or other formal decarbonisation strategy) has not been identified by APRA as an expectation of prudent entities with respect to managing climate change financial risks. This may well change over time, but highlights how net zero also typically involves a different level and type of ambition. In Frontier's view, some level of thoughtful decarbonisation of a portfolio is a reasonable expectation for an asset owner seeking to manage climate change risk although this doesn't assume this is undertaken as part of a top-down, portfolio-level emissions reduction target.

Frontier recommends that asset owners be informed on the key areas of commonality and difference between a holistic strategy to manage climate change financial risks (such as APRA is seeking to guide asset owners toward via CPG 229) and a standalone net zero strategy.

1. Further information on APRA's response to consultation is available at https://www.apra.gov.au/sites/default/files/2021-11/Response%20paper%20-%20CPG%20229%20Climate%20Change%20Financial%20Risks.pdf

Conclusions

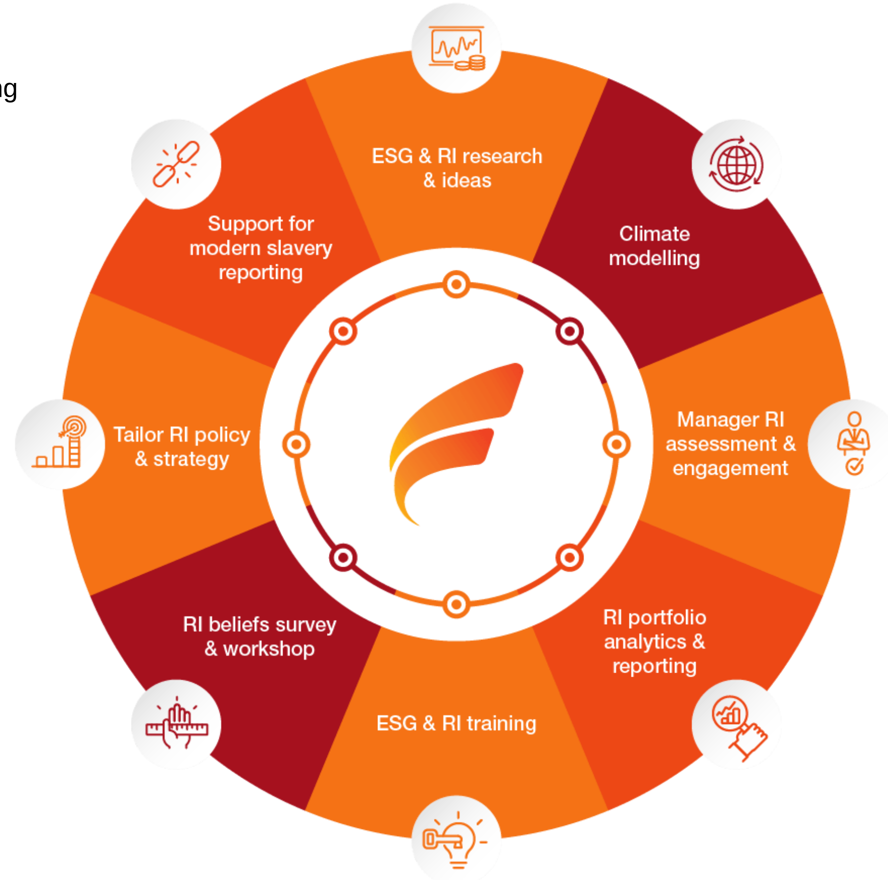
CPG 229 is a valuable guide for asset owners developing a climate change risk strategy

- Frontier sees CPG 229 as an important milestone for Australian institutional asset owners, whether regulated or unregulated, as *it effectively confirms that managing climate change financial risks is a fiduciary duty.*
- Furthermore, it should serve as a recognised 'industry standard' for Australian asset owners given it was developed by APRA and carries a level of weight perhaps not ascribed to previous guidance produced by NGOs and/or foreign regulators. Over time, we expect CPG 229 to drive greater consistency in climate change risk management across the investment industry.
- Frontier recommends asset owners consider how the guidance in CPG 229 may be appropriately incorporated into their business activities by:
  - Familiarising themselves with CPG 229.
  - Establishing an overarching objective to develop a strategic approach to managing material climate change financial risks.
  - Committing to ongoing training with respect to climate change financial risks.
  - Incorporating the four key implementation areas identified in CPG 229 into the strategy.
  - Ensuring that the climate change strategy is fit-for-purpose depending on your fund's size, business mix and complexity.
  - Tracking progress in developing a climate change strategy using the checklists provided in this paper.
  - Working towards making climate change risk management a standing, business-as-usual consideration in investment decision-making.
- By incorporating these recommendations into their business strategy, Frontier believes clients will be better-placed to align themselves with APRA's guidance, but importantly, be more effective in managing material climate change risks and opportunities to enhance their investment outcomes.

How Frontier can help

Frontier's responsible investment and governance advice is integral to our traditional consulting services

- Frontier believes that climate change is the highest priority responsible investment issue facing asset owners.
- Frontier is committed to supporting its clients in identifying, assessing and managing climate change financial risks as part of achieving their investment objectives.
- Ways that Frontier can assist you today in meeting CPG 229 guidance include:
  - Frontier-moderated surveys and workshops on climate change risks
  - reviewing and providing feedback on climate change policies/statements
  - providing educational sessions on climate change strategy/net zero
  - Frontier's Climate Change Module (scenario analysis)
  - formally integrating climate change considerations in our manager ratings
  - identification of high quality, climate-aligned investment products
  - climate change analytics e.g. decarbonisation pathway calculations
  - providing perspectives on the peer landscape to identify better practices
  - ongoing research on investment topics relating to climate change.
- We also continue to evolve our services in light of CPG 229 and broader trends:
  - enhancement of the Climate Change Module for greater usability
  - partnering with specialist climate change data providers to facilitate access to key data and metrics for clients
  - internal training of our client consultant teams to ensure climate change is integrated in your business-as-usual advice.



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