THE WEIGHT OF MONEY: A BUSINESS CASE FOR CLIMATE RISK RESILIENCE

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Good evening everyone.

Let me first start by thanking the Centre for Policy Development for inviting me here to share some thoughts on the theme of "building a sustainable economy".

Tonight will be the first time I've substantially addressed APRA's thinking around climate risk since a speech I delivered to the Insurance Council of Australia[1] in February this year. My main message then was that APRA believed many climate-related financial risks were no longer future concerns. They were "foreseeable, material and actionable now".

Since then, numerous developments, domestically and internationally, have shaped APRA's supervisory approach to the financial impact of global warming for our regulated entities. Tonight, I'd like to describe APRA's next steps in helping to ensure Australia's financial sector is resilient and sustainable by laying out what we're doing now, what else we're considering, and the potential implications these measures have for the institutions we regulate.

In particular, I will be outlining several new developments relating to how insurance regulators globally – and here in Australia – are working together to enhance their individual and collective understanding of this issue, and strengthen their supervision capabilities.

Finally, I want to emphasise that this is a story about opportunity as much as risk, and that businesses have much to gain from sensing the warming winds of change and moving ahead of the market and potential government or regulatory action.

APRA's interest

First, I'd like to address a fundamental question, and one that was raised in some quarters after my speech: why does APRA have an interest in this debate?

The thrust of that speech – that financial institutions should consider climate change in the context of their strategic and operational risk management – is in line with international regulatory best practice, and developments such as the Financial Stability Board's Taskforce on Climate-Related Financial Disclosures[2]. Supported by more than 100 private firms responsible for assets worth more than $24 trillion, the Taskforce in June recommended development of a voluntary global framework on disclosure to improve the spread of climate-related information among investors, lenders and underwriters.

February's speech also aligns with the views of other Australian financial organisations, including the Actuaries Institute, which last week warned many institutions were ill-prepared for the impact of rising temperatures and extreme weather on their balance sheets.

As the prudential regulator, APRA has a clear duty to warn the institutions we regulate if we identify risks that could threaten the interests of Australia's financial beneficiaries or the overall stability of the system.

Economic sustainability – the subject of tonight's address – refers to creating a level of resilience so the economy, and the financial institutions within in it, are well-placed to

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[1] http://www.apra.gov.au/Speeches/Pages/Australias-new-horizon.aspx

[2] https://www.fsb-tcfd.org/

withstand the challenges they will inevitably confront. That includes new or unexpected risks; whether that be cyber-crime, technological disruption or climate risk.

The case for resilience

I don't want to overstate APRA's view of the level of risk to the stability of Australia's financial system as a result of climate change and the transition to a low carbon economy. It's not been escalated to the top of any industry risk register, nor is that likely in the near future. Nonetheless, I'd like to paint a picture of why APRA sees a prudential threat here.

A little over a month after my February speech, Tropical Cyclone Debbie made landfall near Airlie Beach in the Whitsundays as a category four event, with wind gusts topping 225 kilometres an hour. At last count, *insured* losses from Debbie had topped $1.65 billion, making it the second-most costly cyclone of the past 50 years[3]. Economic losses, including lost productivity, foregone revenue, and damage to uninsured assets and public infrastructure, are substantially higher, perhaps several multiples of that figure.

It's not possible to attribute one cyclone to a particular factor, or suggest Debbie was stronger than might otherwise have been the case. However, mounting international scientific evidence suggests global warming will contribute to more frequent and more intense natural disasters into the future.

Moreover, population expansion and urban development trends in high-risk parts of Australia almost guarantee the cost of catastrophe events will keep rising, irrespective of other factors. For example, if Cyclone Tracey were to hit Darwin in 2017, the insurance bill – according to the Insurance Council of Australia – would top $4 billion[4], in large part because the scale of housing and business development is so much greater than in 1974. Simply put, there's more to destroy.

APRA's concern here goes beyond the impact more frequent and damaging natural disasters may have on insurers' balance sheets and their capacity to pay claims. It also flows through to insurers' ongoing ability to keep premiums affordable and available in high-risk areas. Several smaller insurers are already reluctant to underwrite policies for some customers in high-risk parts of Australia, while general insurers have come under intense political and consumer pressure to justify substantial premium rises that have made insurance in high-risk areas harder to afford.

Insurance provides a measure of financial resilience for policyholders, allowing them to avoid or minimise an economic loss beyond what they could bear alone. That resilience provides households and businesses confidence to make investments, and to take chances, which would otherwise be too risky. A lack of insurance availability for some towns or cities would be deeply financially damaging, reducing investment, supressing economic growth, harming employment and raising credit risk for adversely affected households and businesses.

After the remnants of Cyclone Debbie struck Lismore in northern NSW, submerging the main street under three and a half metres of water, it turned out many small business were

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[3] http://www.insurancecouncil.com.au/media_release/plain/436

[4] Ibid3

uninsured for flooding[5]. It wasn't for lack of awareness of the threat. They just couldn't afford the cover because the flood risk to their properties was so high, and several business owners spoke in the aftermath of shutting down for good.

This type of scenario has consequences. Banks, credit unions and other lenders may take a hit, as they juggle a rise in poorly performing loans with a reduction in property values, negative customer equity or properties becoming unsellable. With loan terms of 30 years, the banking sector is already exposed to this risk. In June last year, about 10 beachfront homes on Sydney's Northern Beaches suffered substantial damage from storm surge during an east coast low that caused insured losses of $421 million across four states. I'm not in a position to know what impact that had on the real estate values of these multi-million dollar homes, but it would not have been positive.

Should extreme weather events become more frequent and intense, as scientists predict, the types of adverse economic impacts I've just described will become magnified and more common. Consequently, raising awareness about climate risk, and the need for resilience, is entirely within APRA's regulatory mandate of promoting financial system stability and the interests of depositors, policyholders and superannuation fund members.

APRA's response

Since laying down a marker in February, APRA has been improving our own understanding of how the transition to a low carbon economy may impact on individual entities, financial sectors and the broader economy. APRA has established an internal Climate Change Financial Risk Working Group to develop our supervisory response. The group is responsible for updating APRA staff on relevant developments, and providing training and high-level guidance for supervisors. To aid APRA's understanding of the risks, the group is also developing a cross-industry heat map through the lens of prudential standard CPS220, identifying the key climate-related risks across each of the industries we regulate.

APRA supervisors have begun to ask questions of regulated entities. Initially, these have related primarily to awareness: is the entity aware of APRA's comments about climate-related risks? Has it investigated or planned to investigate the issues raised? And if it has investigated them, is action required?

Increasingly, APRA will expect more sophisticated answers, especially from well-resourced and complex entities. As APRA identifies entities with better practices, we will further engage those institutions to gain a deeper understanding of how they approach, measure and manage these risks, and share this as industry guidance.

Externally, APRA has commenced discussions with Treasury, as well as fellow regulators ASIC and the RBA, on the sustainability and financial risk dimensions of the economy related to climate change. Through the creation of an interagency initiative, we intend to focus on information-sharing and improving our understanding in this area.

Through such initiatives as I've just described, APRA intends to gain insights in areas such as how exposed regulated entities are to physical, transitional and liability risks, and whether they're taking steps to protect themselves and their customers. Information on these metrics

[5] https://www.dailytelegraph.com.au/news/nsw/cyclone-debbie-aftermath-lismore-floods-tear-heart-out-of-city-business-zone/news-story/90b578312ce2ab830ae8fc6b3a1bd2ef

remains limited, and while that is slowly changing, recent global developments may be about to accelerate the process.

International engagement

Since setting out our expectations in February, APRA has continued to liaise with international peers to ensure Australia's supervisory response to climate risk is aligned with global best practice. In late October, I attended a meeting of the Sustainable Insurance Forum[6] in Kuala Lumpur. The SIF is a network of leading insurance regulators and supervisors working together to exchange ideas and share learnings to better understand and respond to sustainability issues. Several developments at the Kuala Lumpur meeting have implications for insurers, and also send a signal to the market more widely.

Since its establishment last December, the SIF has been developing capacity-building tools for supervisors on sustainable insurance issues, including a review of supervisory toolkits, creating training materials, and conducting outreach. Now the International Association of Insurance Supervisors[7] (or IAIS) has signalled its intention to share the SIF's guidance with all insurance supervisors globally. As an IAIS member, APRA will be mindful of this guidance as we develop our supervisory response. In this context, it makes sense for insurers, and other regulated entities, to start getting a sense now of what may soon be required of them, and thinking about how to respond.

Secondly, the IAIS is reviewing the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) as it considers whether to adopt them. It's another signal to the market of the direction financial regulation is starting to take. Some companies have already recognised this and acted accordingly, such as ANZ, which became the first Australian bank to report using the Taskforce's recommendations for its 2017 Annual Review. And just this morning, the Australian Council of Superannuation Investors, whose members manage $1.6 trillion in assets, formally endorsed the TCFD recommendations in updated guidance for Australian listed companies.

The weight of money

These developments bring me to the most important message I want to impart tonight.

The Sustainable Insurance Forum's view, which APRA shares, is that climate change and – here's the crucial bit – *society's responses to it* – are starting to affect the global economy.

APRA is not a scientific body, and I can't say with 100 per cent conviction to what extent scientists' predictions of increasing temperatures, rising sea levels, more frequent droughts and more intense storms will impact the Australian economy. But what I can tell you with absolute certainty is that the transition to a low carbon economy is underway and moving quickly. The weight of money, pushed by commercial imperatives such as investment, innovation and reputational factors, is increasingly driving that shift, rather than scientists or policymakers.

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[6] http://unepinquiry.org/sif/

[7] https://www.iaisweb.org/home

In Kuala Lumpur, the SIF heard that keeping the planet on track to meet the Paris Agreement's two degree target could reduce fossil fuel revenues globally by a cumulative $33 trillion by 2040. In the US, shareholders of oil giants ExxonMobil and Occidental Petroleum have passed resolutions calling on the companies to publish regular reports of the possible impact on their businesses of climate change. Voting in favour were Blackrock and Vanguard, the world's two biggest investment management firms. As money seeps from carbon-intensive assets, the flow into green investments, though still more a stream than a torrent, is gaining in volume and velocity. The market for green bonds, to take one example, has grown from issuance of only $11 billion in 2013 to more than $65 billion so far this year.

In Australia, as globally, investors, businesses and consumers are driving the low carbon transition. As examples, there is an electric car showroom in Martin Place, and Australia has more rooftop solar panels per capita[8] than any other country. Shifts in market sentiment have increased the risk of asset value volatility, and the potential for stranded assets. Institutions that fail to adequately plan for this transition put their own futures in jeopardy, with subsequent consequences for their account holders, members or policyholders.

So while the debate continues about the physical risks, the transition to a low carbon economy is underway, and that means the so-called transition risks are unavoidable: changes to market sentiment, new financial or environmental regulations, or the emergence of new technologies with the potential to prompt a reassessment of the value of a large range of assets, and consequently the value of capital and investments.

But that doesn't mean these risks are unmanageable, or that the impacts on businesses and the wider economy need be negative.

Opportunity knocks

This brings me to the story of opportunity.

In its draft recommendations released a few months back, the EU's High Level Expert Group on Sustainable Finance[9] predicted that over the next two decades, Europe would need about 180 billion euros in additional yearly investment, notably in clean energy, to keep the average global temperature increase below two degrees. Over 20 years, that equates to $3.6 trillion euros worth of investment – just in Europe. A recent report released at the COP23 talks[10] in Bonn by the UN and the World Bank forecast investment opportunities of more than $US22 trillion in the years to 2030 to keep countries on track to meet their Paris commitments. The 2017 Lancet Countdown report[11] found global employment in renewable energy increased to 9.8 million in 2016, with employment in fossil fuel extraction decreasing, to 8.6 million. In other words, opportunities abound in the shift to the low carbon economy, and the financial sector is key to enabling this transition.

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[8] https://theconversation.com/factcheck-qanda-is-australia-the-world-leader-in-household-solar-power-56670

[9] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

[10]http://unepinquiry.org/news/amid-growing-momentum-un-and-world-bank-lay-out-roadmap-for-sustainable-financial-system/

[11] http://www.lancetcountdown.org/the-report/

The case for greater physical resilience is also a powerful one: avoiding loss, unlocking economic potential, and generating development co-benefits. And yet the Productivity Commission in 2014 found that funding for reconstruction and recovery in Australia consumed 97 per cent of disaster funding[12], compared with only 3 per cent for mitigation and community resilience measures. Amid predictions the annual cost of natural disasters to Australia will rise from the current $18 billion a year to $39 billion by 2050[13], any measures that combat this would have a positive impact on economic resilience, as well as insurance affordability and availability.

Disclosure

I'd like now to give some guidance on what APRA sees as the major trends in global financial regulation and supervision of climate risk.

The first concerns disclosure, a trend further emphasised by the IAIS considering adopting the FSB's Task Force on Climate-Related Financial Disclosures recommendations, which I mentioned earlier. Elsewhere, America's National Association of Insurance Commissioners established a Climate Risk Disclosure Survey[14] as far back as 2009 to determine whether insurers were incorporating climate change into their risk management and investment strategies. Under France's Energy Transition Law[15], listed companies and institutional investors are required to disclose the contribution of their investment portfolios to the objectives of the Paris Agreement and French national energy transition strategy. The UK and Brazilian insurance regulators have launched a survey process with regulated entities to gather data about market practices on sustainability issues.

At APRA, we are planning a survey of regulated entities to gain a better understanding of emerging best practice, as well as an industry-wide review of climate-related disclosures. The questions, method and entities to be surveyed will be confirmed over the next few months.

So whether due to regulatory action or – more likely – pressure from investors and consumers, Australia's financial sector can expect to see more emphasis on disclosure around climate risk exposure and management.

Stress testing

Increasingly, financial regulators are also using climate risk scenarios as the basis for stress tests. Britain's Prudential Regulation Authority this year carried out general insurance stress testing to gauge the industry's resilience to liability shock event, and analysed the impact of several extreme weather-related scenarios. The Dutch De Nederlandsche Bank has also announced it will develop and implement climate stress tests. Another emerging area of practice is scenario-based analysis of climate risks and opportunities. The Task Force on

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[12] Productivity Commission report into Natural Disaster Funding Arrangements Vol. 1, p9, December 2014

[13] http://australianbusinessroundtable.com.au/2017-facts/national

[14] http://www.naic.org/cipr_topics/topic_climate_risk_disclosure.htm

[15] http://www.gouvernement.fr/en/energy-transition

Climate-Related Financial Disclosures report sets out clear expectations that companies and investors conduct scenario exercises to analyse these risks.

To date, APRA hasn't conducted any stress tests specifically related to climate risk, but in the future we will consider doing so. In the meantime, we encourage entities to perform their own stress tests that consider such scenarios. APRA's risk management standard CPS220 requires entities to test for key risks, so if factors related to climate change are key business risks, it makes sense to test for them.

Internationally, the trend is moving towards regulators taking a more interventionist approach. The UN and World Bank report recorded global growth in policy and regulatory measures targeting sustainability had grown 20 per cent year on year since 2010, and 30 per cent in the past year alone. APRA has no immediate plans to introduce new prudential standards related to climate risk, and will continue to rely on CPS-220 for setting out general risk management expectations. For now, our focus is on raising awareness rather than prescribing additional prudential standards, though consideration may be given to updating prudential guidance.

A risk like any other

I'd like to conclude now by returning to where I started: February's speech where APRA first brought our views on this issue to public attention. In the course of writing this address, I went back and re-read those remarks. In hindsight, the attention, even controversy, they garnered at the time seems somewhat curious. The steps so many Australian businesses have voluntarily taken before and since then in areas such as disclosure, emissions reduction and greener products, underscore the relative orthodoxy of recognising that climate risk – and responses to it – have financial and economic implications that must be considered.

In a recent a meeting with APRA, a member of the EU's High Level Expert Group on Sustainable Finance argued businesses should treat climate risk like any other hazard. That position is entirely consistent with the thrust of APRA's message to regulated entities both in February and today: think about this issue and weigh up how to respond. Put the appropriate risk management processes in place, calculate your exposure, assess your risk appetite, and make sound business decisions that limit your vulnerability and capitalise on opportunities.

The impact of climate change on weather patterns or sea levels isn't certain. That's why we call them risks, not certainties. But what I am sure about – and what I hope I've been able to convey today – is the transition to the low carbon economy is in motion, with consequences for all of us. APRA will be continuing to build our internal capabilities and knowledge base. Understanding in this area is still developing among regulators and supervisors, and so far APRA is only asking entities to consider climate change in their risk management frameworks. But over time, as risks become more apparent, that is likely to change. By utilising forums such as this, APRA can hopefully encourage our regulated entities to more effectively plan ahead, so they float with the transitional current rather than fighting against the rising tide.