Australia’s financial institutions face rising pressure to adopt global climate risk standards

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Australia's regulators and investors may force financial institutions to adopt international risk measures to accurately assess, report and manage the impacts of climate change.

In a Dialogue Paper*, *Climate Risk Disclosure – financial institutions feel the heat*, co-authors Sharanjit Paddam and Stephanie Wong said many Australian institutions are ill-prepared for the impact of rising temperatures and extreme weather events and the effect these will have on their balance sheets.

Banks and general insurers have acute and long-term exposures and "many Australian financial institutions have yet to understand the scope of the risk and their opportunity," states the report, which has been issued by the Actuaries Institute and prepared independently by the authors.

The Australian Prudential Regulation Authority has already warned that the risks of climate change are "foreseeable, material and actionable now", and have potential system-wide implications. APRA expects banks and insurers to incorporate climate risk within the risk management framework of regulated entities.

The international Financial Stability Board's Taskforce on Climate-related Financial Disclosures wrote recommendations for a single international cross-industry standard for disclosing climate risk in mainstream financial reporting of companies in 2017. The FSB, chaired by Mark Carney, the governor of the Bank of England, reports to the G20.

While the Taskforce's recommendations are currently voluntary, "it seems likely that financial institutions will respond to pressure from investors and regulators to adopt them", Mr Paddam and Ms Wong state in the report.

Mr Paddam and Ms Wong set out the impact across industries of rising temperatures and an increase in floods, bushfires and cyclones, which are likely to result in acute physical risk to property.

“Australian banks have amongst the highest concentrations of residential lending assets in the developed world,” the report states. “Home loan contracts are long term, typically up to 30 years, which means that banks are already potentially exposed to climate risk."

The Commonwealth Bank recently faced legal action from shareholders who alleged the bank's Board did not adequately disclose climate change risks in its 2016 annual report. CBA committed to further disclosures and the claim was withdrawn.

But the report warns: "If there is a finding in favour of such a shareholder action providing a legal precedent, we anticipate a deluge of similar claims being triggered, giving rise to a systemic legal risk for financial institutions.”

General insurers are better able to manage risk exposure than banks because they reprice contracts every 12 months. However, physical risks to property may rise in the absence of mitigation efforts, and insurers face reputation damage if policyholders make claims that sit outside the current policy coverage. Homeowners may not comprehend that most insurers do not cover acts of the sea.

"Over the longer term, we expect that climate change will increase the risk of losses from natural hazards, which may result in increased premiums for home and property insurance," the report states. The increase may be significant for customers in high-risk areas.

"If premiums become unaffordable for even a small group of customers, even if they accurately reflect the underlying risk, insurers may face significant reputational damage, and potential government intervention, resulting in a shrinking insurance market."

Rising temperatures, rising sea levels, heat waves, droughts, bushfires, coastal erosion and inundation will affect the wider economy. Damage to the Great Barrier Reef means jobs could be lost in tourism. Carbon-intensive industries and farm and fishery yields may fall.

The transition to low carbon energy presents both risks and opportunities for financial institutions, investors and workers. But it will also lead to market risk with shifts in supply and demand for certain commodities, products and services, including lower demand for carbon-intensive industries and increased demand for renewable energy.

The paper makes eight recommendations. Australia's financial institutions should:

- identify risk and opportunities across all operations including lending, underwriting, investments and business strategy;
- review how those risks are managed;
- develop or acquire the capability to measure the financial impact of climate risk;
- document appropriate governance and controls including oversight from the board;
- develop a strategy to manage climate risk and opportunities;
- undertake scenario testing;
- develop metrics and targets to measure the institution's performance; and
- disclose the measures to stakeholders in line with the Taskforce recommendations.

***The Dialogue** is series of thought- leadership papers, written by actuaries, that aim to stimulate discussion on important issues. Opinions expressed are those of the authors and not necessarily those of their employers or the Actuaries Institute. A copy of *Climate Risk Disclosure – financial institutions feel the heat* can be downloaded **here**.

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