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Regulation: Australian Banks Expect to Reduce Exposure to Industries Affected by Climate-Risk

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Regulation

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According to the **results** of a climate vulnerability assessment (CVA) conducted by the Australian Prudential Regulation Authority (APRA), Australia's largest banks have outlined how they would amend both their risk appetites and lending practices in response to increasing climate-related losses. Proposed responses include reducing high loan-to-value mortgage lending and minimizing exposure to sectors such as mining, manufacturing and transport. The APRA carried out its CVA with the country's five largest banks, which prepared estimates and carried out modeling to assess the potential financial impact of climate change on their business. The banks were further required to provide potential responses to both physical and transition-related climate risk.

The participating institutions based their analyses on two scenarios developed by the Network for Greening the Financial System: (i) a transition scenario with delayed action on climate change, followed by a substantial reduction in global emissions after 2030; and (ii) a "current policies" scenario, which represented a future with continued increases in global emissions beyond 2050. The study findings show that under the given scenarios, the banking system was unlikely to be severely impacted but that banks would likely experience increased losses from their lending portfolios in the medium to long term. The climate-related risks were found to be concentrated in specific regions geographically and in particular industries, including mining, manufacturing, transport, and wholesale trade.

APRA's Deputy Chair Helen Rowell stated that "The results suggest that banks' losses from their lending portfolios could rise in the medium to long term as climate change and the global response to it unfolds. Although those impacts are not expected to cause severe stress to the banking system, climate change could lead to the banking sector being more vulnerable to future economic downturns."

The CVA also found significant variability in the bank's results, which in part was caused by different modeling approaches but primarily was due to the availability and quality of data. The report concludes that "[t]hese assessments indicated that climate-related data quality and accessibility remain a challenge. From a transition risk perspective, inputs and estimates essential to modelling a transition to a lower emissions economy scenario remain a significant challenge ... These data challenges are being experienced more broadly across industries, and [the Australian regulators] recognise that understanding the gaps in the availability and quality of data is important for the development of high-quality climate risk assessments." APRA advises that "data limitations do not provide a justification for delaying initiatives to better understand climate risk" and that the findings show that "climate scenario analysis approaches can deliver valuable climate risk insights now, and that these insights can inform climate-related planning and decision-making. Financial institutions can adopt a staged approach to climate risk assessment, leveraging available data while building their internal capacity, and incorporating modelling and data developments over time."

Taking The Temperature: Financial prudential regulators around the globe have adopted a more active approach toward attempting to assess potential climate-related impacts on financial stability. The European Central Bank (ECB) recently published the results of its thematic review into climate-related and environmental risks. As part of its review, the ECB looked at 186 banks with total combined assets of €25 trillion (approximately $25 trillion). In September 2022, the Federal Reserve Board announced that six of the nation's largest banks would participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks. The Board "anticipates publishing insights gained from the pilot at an aggregate level" toward the end of 2023, "reflecting what has been learned about climate risk management practices and how insights from scenario analysis will help identify potential risks and promote risk management practices." And just this month the Fed published a climate-related regulatory framework, which we separately discuss today. In the UK, the Financial Conduct Authority, the Prudential Regulation Authority, and The Pensions Regulator, each published Climate Change Adaptation Reports in October 2021 providing for their respective regulated institutions regarding climate-related risk assessment. As with many climate-focused regulatory initiatives, the challenge will be to form something approaching a global consensus so that institutions operating across jurisdictions do not have to navigate conflicting schemes.