Australian Banking Association

11 February 2020

Mr Graham Sinden
Head of Climate Risk – Operational Resilience
Australian Prudential Regulation Authority
By email: Graham.Sinden@apra.gov.au

Dear Graham

APRA Climate Vulnerability Assessment

Thank you for sharing APRA's proposed draft strategy on the ADI Climate Vulnerability Assessment at the workshop on 2 February.

The Australian Banking Association (ABA) reconfirms the ABA's offer for the industry to work collaboratively with APRA and the CFR agencies. The ABA supports the need for a Climate Vulnerability Assessment (CVA). Whilst we have undertaken varying levels of analysis already, the CVA will support comparability and a sector-wide perspective of climate vulnerability risk. Additionally, bank boards and management, and external stakeholders are increasingly seeking to understand progress made by Australian banks in climate risk management. Investors require increasingly detailed and comparable disclosure to inform their assessments.

In the slide deck, APRA suggested three different 'ownership' models[1], it is the ABA's view that a hybrid, '*Option 2.5: Collaboration-plus solution*' is preferred. Where proposed Option 2 will enable the ABA and members to provide expert input to complement that of APRA and the Council of Financial Regulator (CFR) agencies, the ABA sees a role for APRA to provide assumptions for key economic variables such as unemployment.

High level feedback

The ABA welcomes the direction and ambition of the CVA. The ABA notes that to achieve the proposed full-balance sheet scope combined with a target end-2021 date is very challenging.

First, there are CVA project related matters require resolution to enable a better understanding of the human resource impact and stress testing model impacts (or capability). These include, finalising the design, shoring up Australian data, gaining understanding and agreement of the governance model of the project.

Second, there are practical matters which need to be considered. Preparation for banks' reporting season spans the entire calendar year. As climate and governance subject matter experts drive the reporting, they will have limited capacity during their bank's reporting season. The regular prudential stress testing which will be undertaken later in 2021 requires stress testing subject matter experts who are the same resources who will be undertaking the CVA. Therefore, it is not practical to run them concurrently. Finally, whilst the ABA has indicated that it will not be practical to change the stress testing models for this exercise in the timeframes available, we also note that we have not yet modelled out to 30 years. Therefore, there may be some complications arising from the extended time of the assessment which may need to be managed.

The ABA also notes that it is important to consider the 'downstream' consequences of a broad-based but shallow CVA. At the conclusion of the exercise, it is likely that stakeholders (Government, Shareholders, Climate groups, Industry sectors) will want an understanding of not only the macro level output but also the meso and micro level. The ABA is currently meeting with members from the farming

[1] APRA, 2021, Climate Vulnerability Assessment ADI Workshop DRAFT Presentation and Discussion, 2 February, p17

community who wish to know banks approach to funding farmers given the climate risk considerations. The farmers are seeking a policy response at the sector-level (the meso level) and at the regional level and even crop-type level (the micro level). Therefore, it is the ABA's view that a broad balance-sheet-wide approach will not provide sufficient detail to explain the results.

Options to move forward

Principles

The ABA considers that the following principles ought to guide the CVA:

- Strive for a consistent approach with overseas jurisdictions; while sequencing activities in Australia that are fit for purpose; Notably the Bank of England's Prudential Regulation Authority (PRA) and the Network for Greening the Financial System (NGFS)
- Adopt a sequential 'building blocks' approach which allows macro, meso, and micro level analysis per 'building block'.
- Learn as we go and iterate for subsequent 'building blocks.'
- Work in an exploratory, collaborative mode, under Chatham house rules.
- Distinguish the CVA as non-supervisory activity.

Project stages

The ABA agrees that the CVA be undertaken using project management methodology to guide the work effort. The ABA suggests an additional stage 'implementation', this will enable all participants to prepare for the scenarios. Therefore, the stages of work could be:

- Stage 1: Design – the key deliverable from this stage will be the set CVA design and participants will be able to provide an assessment of effort required to execute the scenarios.
    - Note: ABA recommends participation of its multinational members with experience in undertaking stress tests overseas at this stage could be helpful. The ABA would seek to connect with the international staff from those banks with direct expertise.
- Stage 2: Implementation – the key deliverable from this stage will be participants readied to run the scenarios.
- Stage 3: Execution – the key deliverable from this stage be ADI submitted outcomes of the scenarios.
- Stage 4: Analysis – the key deliverable from this stage will be CFR synthesis of the scenario outcomes.
- Stage 5: Response – the key deliverable from this stage will be APRA and CFR agency debriefing of findings to the industry. Additionally, this stage will provide the data to enable planning and iteration for the next stage of testing.

Design considerations

In respect to the CVA design, the ABA makes the following comments.

Design Element	ABA Comment
Scenarios	The ABA supports two proposed scenarios: • Disorderly transition (delayed 2ºC with limited CDR technologies) • Hot house world (current policies) ***For further consideration***:

Australian Banking Association

Design Element	ABA Comment
	The ABA agrees with APRA that there is a lack of granularity in the scenarios for the Australian context. One option is to engage the developers of the NGFS Climate Scenarios[2] for an extension to their data by incorporating more granular data from Australia (and potentially New Zealand).
Modelling period	The ABA supports the suggested 30-year period to 2050 at 5-year intervals.
Static or dynamic balance sheet	The ABA supports assessment based on a static balance sheet. ***For further consideration:*** As this process matures, it will be helpful to plan future discussions for graduating the testing from a static to dynamic balance sheet.
Credit risk modelling	The ABA agrees that a whole of balance sheet perspective should be the end-goal of this process however given the scale, data gaps, and timeframes to turnaround the analysis, the ABA suggests an alternative pathway. ***For further consideration***: A future workshop to map out a building block pathway for sectors of the economy. Stage 1 scope could cover: • Residential Mortgage for physical risk • Up to three sectors of the economy could be selected to model transition risk. • Encourage CFR to keep close contact with RBNZ to support alignment with future RNBZ assessments. The ABA offers to present options for 'building blocks' which can be workshopped with APRA and the CFR.
Counterparty analysis	ABA supports further discussion in respect to the scope and timing of Counterparty analysis. ***For further consideration:*** • As an exercise in exploratory risk, consider restricting it to a small number of counterparties to focus of which is to calibrate the risk modelling.
Qualitative assessments	ABA recommends an initial focus on credit risk. The qualitative assessments for Market Risk, Liquidity Risk, and Operational Risk to be scheduled for a later building block.
Data quality assessment	ABA supports the approach suggested.
Output	***For further consideration:*** Should the output of the CVA focus on credit impairments and credit RWA as opposed to the complete regulatory capital ratios entirely?

[2] Potsdam Institute for Climate Impact Research (PIK), International Institute for Applied Systems Analysis (IIASA), University of Maryland (UMD), Climate Analytics (CA) and the Swiss Federal Institute of Technology in Zurich (ETHZ).

Project timeline

Importantly, once the Stage 1 scope is agreed and set, participants will be able to estimate the preparation effort required. This estimate will inform the complexity and duration of stage 2.

The ABA notes that reporting periods for the five banks span the entirety of the calendar year. Additionally, it will be very challenging to run the CVA concurrent to the regular APRA stress test and could put at risk the quality of both exercises.

Therefore, the ABA suggests that it should be possible to undertake stage 1 design and stage 2 implementation of design by July 2021. Stage 3 execution could aim to be undertaken in 2021 in place of the regular stress test or it can be planned to be run in 2022.

Use and confidentiality of data

In respect to the operational elements and data governance processes, the ABA requests confirmation from APRA and CFR agencies regarding the protection of the data.

As the nature of this exercise is largely experimental and will involve trial and error with potential 'false readings', the ABA seeks confirmation from APRA and other CFR agencies that the data and information gathered from the CVA process will be kept separate to supervisory activities currently and into the future. The ABA suggests that there be a permanent information barrier for this information between the CVA testing team and the supervisory teams of CFR agencies.

APRA has asked whether APRA can share information it gathers from member banks with other CFR agencies without gaining consent for each information packet and for each CFR agency recipient. The ABA suggests that (subject to the outcome of the request for information barriers), this request be considered at the end of stage 1 when the information requirements will become clear. Additionally, some principles would need to be put in place whereby APRA informs banks where the banks' data has been shared. Data should not be shared beyond the project teams of CFR agencies without banks' consent.

Further, the ABA seeks confirmation from APRA and the other CFR agencies that information relating to the banking sector accessed from the CVA will not be made publicly available without the prior consent of the ABA and the participating ADIs. The ABA recommends a joint participant information release be made to explain the exercise and the knowledge gleaned.

In due course, as the CVA process takes shape and becomes routinised in the CFR agenda, the ABA suggests that the ABA and participant banks be notified in advance that supervisory activity will commence.

The ABA will co-ordinate where an industry response is required. We believe that stage 3, the execution stage, will be undertaken bilaterally between APRA and each bank.

The ABA is looking forward to discussing the options presented in this letter with you.

Kind regards

Emma Penzo
Policy Director
Emma.Penzo@ausbanking.org,au