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6.4 Proactively managing climate risk

The mutual sector is facing a new requirement – to incorporate climate-related risks into traditional risk management practices. This comes on top of the challenges already posed by increasing economic uncertainty, geopolitical dynamics and a fast-evolving regulatory landscape. Here we look at how KPMG's Climetric tool can help mutuals face this head-on.

Climate risk – a complex concept

Despite the Australian Prudential Regulation Authority (APRA) declaring climate risk as "distinctly financial in nature" in 2017¹, it remains a complex concept. Indeed, the results of APRA's climate risk self-assessment survey released in August 2022 show that it is still considered an emerging discipline when compared with other more traditional risk types and has yet to be fully embedded into risk management frameworks.

This is because of its multidisciplinary nature and a lack of relevant, readily available data to perform analysis. Traditional backward-looking risk assessments and existing risk models cannot anticipate the long-term and multifaceted form that climate-related risks may take.

Nonetheless, the mutual sector has a two-fold responsibility. On the one hand, it needs to prepare itself for the negative effects of climate change on its business and customers — only recently, we witnessed the catastrophic

damage and impacts to communities and livelihoods due to flooding emergencies in the Eastern states. On the other hand, the sector can help mitigate economic risks and transition effectively into the low-carbon economy by proactively considering climate risk.

With increased momentum in mergers and acquisitions across the mutual sector, climate risk due diligence forms an important consideration in consolidation activities because it directly impacts strategic direction and long-term viability. As the global economy paves a decarbonisation agenda, not understanding and managing climate risk means losing competitive advantage and potentially failing.

Getting started

A logical starting point in this journey is for mutual banks to understand their climate-related vulnerabilities and how climate risk may manifest within their portfolios. The larger banks have already commenced this work via the APRA-led Climate Vulnerability Assessment exercise², and the mutual sector should follow suit.

¹ <https://www.apra.gov.au/news-and-publications/australias-new-horizon-climate-change-challenges-and-prudential-risk>

² https://www.apra.gov.au/sites/default/files/2021-09/Climate%20Vulnerability%20Assessment_1.pdf

KPMG's Climetric tool aims to address this challenge. It performs portfolio-wide climate risk stress testing to quantify the impact of various physical and transitional risk scenarios on a portfolio's credit quality and key financial metrics. Climetric uses internationally accepted climate scenarios, Australian climate and industry performance data and an adaptable methodology, which aligns with Prudential Practice Guide CPG 229³.

Climetric covers two key dimensions that constitute climate risk:

1. Calculating the impact of multiple transition pathways on a customer's financial performance and credit risk. The results are calibrated to account- and sector-specific outcomes, which can be aggregated into portfolio-level results.
2. Quantifying the impact of multiple acute and chronic hazards under various temperature scenarios, based on granular geospatial coordinates of loan collateral. These hazards include cyclones,

floods, bushfires, heat and drought stress among others. Given the heavy skew towards residential mortgage lending within the mutual sector, understanding the impacts of physical risks, compared to transition risks, is particularly pertinent. In addition, the geographical concentration in mutual banks' lending books coupled with localised climate risks, point to an even greater need for sufficiently granular analysis, which Climetric can provide.

Climetric's outputs can speed up a financial institution's integration of climate risk analysis into its risk management universe. This can reveal hidden vulnerabilities in portfolios and enable lenders to leverage opportunities associated with financing a green agenda.

Climetric use cases

Climetric's outcomes can be applied in a broad variety of ways, such as:

- enhancing credit risk policies and frameworks to capture the

treatment of climate-sensitive sectors and debtors, collateral management, and limit setting

- incorporating climate risk factors into the credit approval and monitoring process, including early warning indicators
- updating risk appetite statements for climate-related risks based on reliable, trackable and decision-making metrics with associated limits
- highlighting data collection gaps and uplifting the overarching data strategy to support climate risk management, modelling and reporting
- regulatory compliance for enterprise-wide stress testing, as well as reporting and disclosures.

Managing climate risks

Climate-related risks are pervasive and can impact aspects of the risk management universe.

Integration of climate risk into the risk management universe



³ <https://www.apra.gov.au/sites/default/files/2021-11/Final%20Prudential%20Practice%20Guide%20CPG%20229%20Climate%20Change%20Financial%20Risks.pdf>

The process of fully embedding climate risk into the risk management universe is protracted, complex and iterative. However, the mutual sector cannot afford to simply respond to regulatory impetus. There are tangible consequences for customers and many are already affected. Establishing a strong focus on managing climate risk will be key in maintaining the relationship-based, corporate citizenship-oriented business model many mutual banks already employ.

Where there's a disproportionate balance between social responsibility and in-house capability, mutuals should look externally to consider how to implement their climate risk roadmaps. Tools such as KPMG Climetric can facilitate this by identifying the risks and impacts of changing strategies.

Over time, climate-risk analysis can enable the mutual sector to build financial products and strategies to support their communities and members, while mitigating the effects of climate change.

