Reserve Bank of New Zealand
Te Pūtea Matua

Managing climate-related risks

Consultation Paper on guidance for regulated entities

29 March 2023

CONSULTATION PAPER

Non-Technical Summary

What are climate-related risks?

Climate-related risks are defined as the potential negative impacts of climate change on an entity. These can be physical risks, related to the physical impacts of climate change like more frequent and extreme weather events or rising sea levels, or transition risks, related to the shift to a low-emissions, climate-resilient economy; an example being insurance retreat.

It is clear that climate-related risks are already impacting the financial system in New Zealand and have the potential to significantly affect the system in the future. It is therefore very important that those risks are managed appropriately, in order to protect and promote the stability of New Zealand's financial system which is one of our primary objectives at the Reserve Bank of New Zealand. We believe this guidance will help achieve that outcome.

Who is the guidance relevant for?

The guidance, once finalised, will be relevant for all entities that we prudentially regulate (referred to here as 'entities'). However, it is important to note that climate-related risks will not affect all entities equally and so we emphasise the principle of proportionality.

What does the guidance suggest?

Our guidance has the following chapters:

- **Climate-related risks:** introduces the concept of climate-related risks, describes how those risks could impact upon the entities we regulate, and identifies the distinct features that make it essential to give climate-related risks specific analytical consideration.
- **Governance:** emphasises that climate-related risks are like any other risk in that the ultimate responsibility for its effective management rests with an entity's governance body.
- **Risk management:** discusses how climate change manifests through conventional risks and should be managed within an entity's general risk management framework.
- **Scenario analysis:** outlines our latest thinking about leading practice as entities develop their scenario analysis capability, and emphasises that, although this is an evolving area, entities should be starting work now.
- **Disclosure:** refers to the new mandatory climate-related disclosure regime in New Zealand, and recommends that even those entities not captured by the regime should treat the mandatory disclosure as the basis of good practice to the extent it is appropriate for them.

What would be the impact of this guidance?

Our goal is to have policy that helps ensure entities are identifying and managing climate-related risks as effectively as possible, with the intention of maintaining stability across our financial system. At the same time, we also want to make sure that the policy is suitable for the broad spectrum of entities that we regulate.

Who is this consultation paper aimed at?

This consultation will be of particular interest to the entities to which it is relevant for. This is a public consultation and we welcome views from any party with an interest in the subject.

What do you think?

We are seeking views on the issues and questions set out in this consultation paper. The specific questions are contained throughout the document. You can send us your views by email to Jeremy.richardson@rbnz.govt.nz and Chris.leaney@rbnz.govt.nz (with the subject line 'Managing Climate-related Risks Guidance Consultation Paper'), or via 'hard copy' to:

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The deadline for submissions is 5pm on 7 June 2023.

Publication of Submissions

All information will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and a public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version will be published as received).

Respondents who request that all or part of their submission be treated as confidential should provide reasons for why this information should be withheld if a request is made under the Official Information Act 1982 (OIA). These reasons should refer to section 105 of the Banking (Prudential Supervision) Act 1989, section 54 of the Non-Bank Deposit Takers Act 2013, section 135 of the Insurance (Prudential) Supervision Act 2010 (as applicable), or the grounds for withholding information under the OIA. If an OIA request for redacted information is made, we will make our own assessment of what must be released taking into account the respondent's views.

We may also publish an anonymised summary of the responses received in respect of this Consultation Paper.

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1 Background

We published our first climate strategy in 2018. A key part of the strategy is understanding and incorporating the impact of climate change on our core functions. One of those core functions is to act as a prudential regulator and supervisor under prudential legislation, in pursuit of our financial stability objective of protecting and promoting the stability of New Zealand's financial system.

We have made progress on understanding how climate change affects financial stability since 2018, and it is clear that climate-related risks are already impacting the financial system and continue to evolve, with the potential to significantly affect the system in the future. We have therefore been taking steps to factor climate change into our approach to prudential supervision: we have started discussing with entities the responsibilities, oversight and implementation of their climate strategies and climate-related risk management, and conducted exercises with the systemic banks on climate-related sensitivity analysis and stress testing.

Internationally, many other financial supervisory authorities are taking similar steps to address the threats the changing climate poses to the financial system, with increasingly co-ordinated action. For example, we are a member of the Network for Greening the Financial System (NGFS), a group of central banks and supervisors established in December 2018, whose purposes include sharing best practices and contributing to the development of environment and climate-related risk management in the financial sector. The NGFS currently has 121 members.

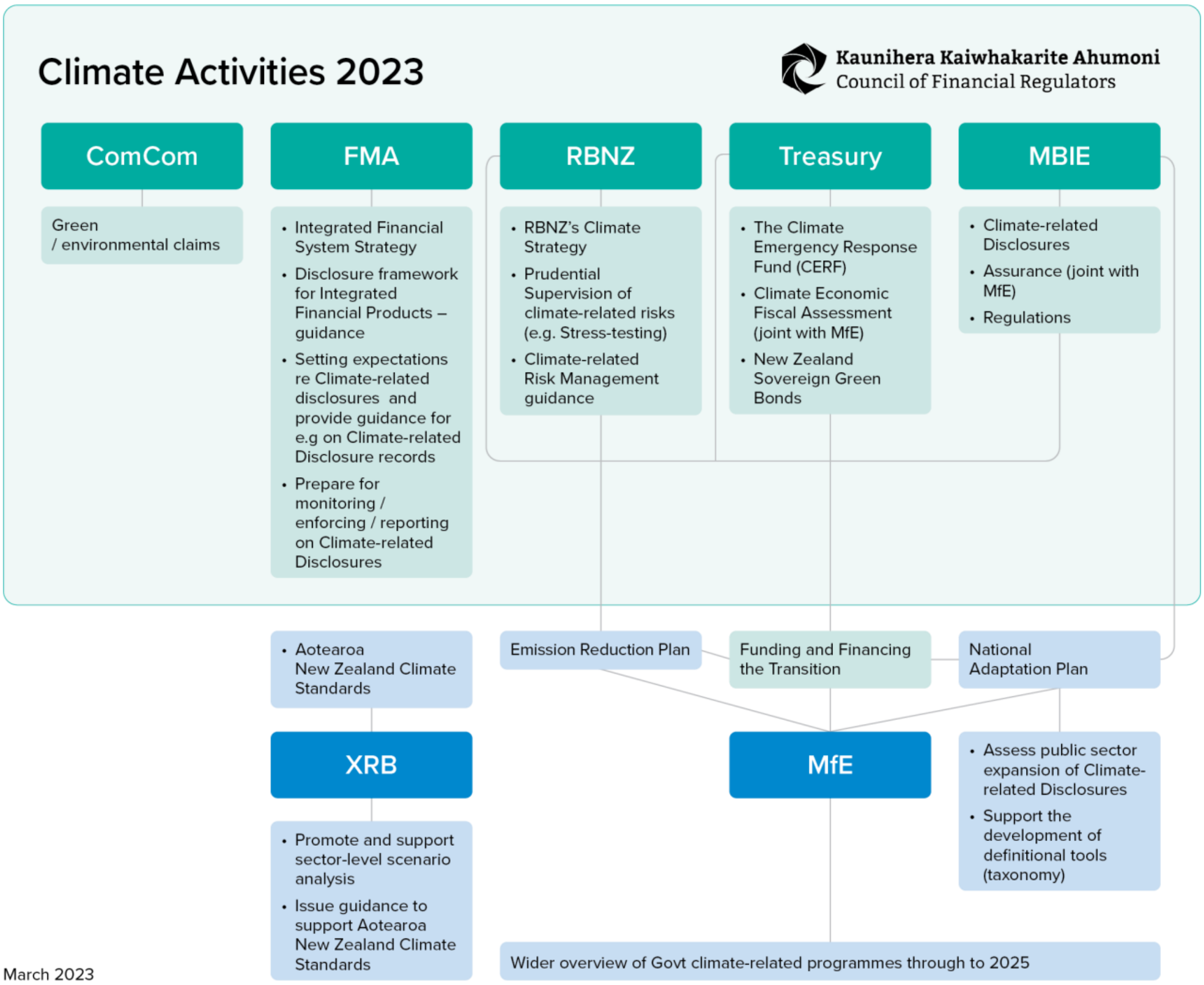
The NGFS published a key framing document in May 2020, *Guide for Supervisors: integrating climate-related and environmental risks into prudential supervision*. This recommends, among other things, that a supervisor should set expectations to provide transparency for entities regarding its understanding of a prudent approach to climate-related risks. Overseas supervisory bodies including the Australian Prudential Regulation Authority (APRA), the UK Prudential Regulation Authority, and the European Central Bank have published guidance on managing climate-related risks.

Domestically, we are a member of the Council of Financial Regulators (CoFR), which was established in 2011 to contribute to maximising New Zealand's sustainable economic wellbeing through effective and responsive regulation of the financial system in New Zealand. The members are us, the Financial Markets Authority (FMA), Ministry of Business, Innovation and Employment (MBIE), the Commerce Commission, and the Treasury. CoFR's mandate was strengthened in 2019 and, as part of this, five priority themes were agreed on to cover developing issues for financial sector regulation, one of which was climate-related risks.

CoFR's 'climate-related risks' priority theme is managed by a community of practice with membership from the CoFR agencies. The working group also includes two non-CoFR agencies that are leading key pieces of work CoFR wishes to contribute to and support, namely the Ministry for the Environment (MfE) and the External Reporting Board (XRB). The group's current priority is to increase coordination, capacity building and knowledge sharing across the CoFR agencies. This will help inform the regulation needed as the financial sector moves towards a more sustainable footing.

The diagram below summarises the activities of the agencies in the climate change community of practice. Issuing this guidance document on climate-related risk management ("the Guidance") supports our prudential supervision activities. The Guidance also has linkages with climate-related disclosure (CRD), which falls within the activities of XRB, FMA, MBIE and MfE, as shown in the diagram. The CRD regime is discussed in more detail in section 2.5 below.

CoFR Climate Change Activities



Source: *https://www.cofr.govt.nz/priority-themes/climate-risks.html* (Council of Financial Regulators, March 2023)

Aspects of our expanding climate work stream have been formalised recently in the Government's first National Adaptation Plan, published in August 2022. The plan contains Government-led strategies, policies and proposals that will help New Zealanders adapt to the changing climate. Chapter 10 covers the economy and financial system, and identifies as a 'significant risk' risks to the financial system from instability due to extreme weather events and ongoing, gradual change and its effects. In response, in consultation with the Reserve Bank, one of the four 'critical actions', Action 10.4, is the following –

Action 10.4: Reserve Bank of New Zealand supports the stability of the financial system

Timeframe:	Years 1-2 and ongoing (2022-24
Lead agency:	RBNZ
Relevant portfolio:	Finance
Primarily supports:	Objective EF2
Status:	Current

The Reserve Bank of New Zealand (RBNZ) is taking action to help regulated financial entities identify and manage climate risks better. This includes:

- Introducing climate-related stress tests that model the effect of severe but plausible scenarios on the balance sheets of regulated financial institutions
- Incorporating climate change in scheduled supervisor engagements with the management and boards of regulated entities
- Developing guidance on managing risk for the entities the RBNZ regulates.

By March 2024, the RBNZ will have climate change considerations increasingly integrated into its supervisory, stress-testing and policy work.

We have already made good progress on the first two bullet points.[1] This consultation works towards completing the action under the third bullet point.

2 Consultation

2.1 Problem definition

Entities are in the business of managing risks. Historically, our approach to prudential regulation has placed significant reliance on market discipline, and we have not for the most part issued detailed guidance on how we suggest entities manage the respective business risks they face. Licensed insurers and non-bank deposit-takers (NBDTs) are subject to high-level requirements to have a risk management programme in place, and operators of designated financial market infrastructures (FMIs) soon will be subject to similar requirements. Directors of registered banks have to sign regular public attestations that the bank has systems in place to manage all material risks, and that those systems have been properly applied. It is only in the case of NBDTs and (soon) operators of designated FMIs that we have issued (or will issue) guidance on the approach to managing risks in general.

[1] See https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2022/nov-2022/fsr-nov-2022-box-c, published in the November 2022 *Financial Stability Report*, for a summary of the Reserve Bank's current work on climate-related stress tests.

We have relied on entities to fill in the details of what is needed for an adequate risk management framework, in line with their own commercial interests. We encourage an entity to manage its climate-related risks within its broader risk management framework, and the Guidance recommends this approach. But the nature of the risks that climate change poses to entities has several distinct features, as noted in paragraph 22 of the Guidance. Understanding of the linkages between climate change and other risks is at a fairly early stage and developing rapidly, and many areas of data needed to illuminate the impact of climate-related risks are still lacking sufficient detail and consistency.

The problem is that climate-related risks are growing and will continue to grow[2], and there is a pressing need for entities to incorporate them into their existing risk management frameworks. Some entities have already made good progress, and some are being incentivised to do more by the forthcoming disclosure requirements. We believe that the Guidance will play a role in accelerating progress. It can do so directly by promoting common understanding of good practice across all of our entities. It can also provide a helpful starting point for supervisory discussions with entities on climate-related risks, which will increasingly become part of our prudential approach.

It is worth noting that there are some parallels with the *Guidance on Cyber Resilience* that we published in April 2021. The nature of the problem and the way the guidance addresses it are somewhat analogous. Cyber risk shares with climate-related risks that it is novel and rapidly evolving. The guidance outlines our expectations around cyber resilience, and is intended to illustrate current best practice and encourage continual improvement.

2.2 How have we developed the Guidance?

The Guidance aims to meet the needs noted in the problem definition.

We took as our starting point for the Guidance the *Prudential Practice Guide CPG 229, Climate Change Financial Risks*, issued by APRA in November 2021. Our Guidance has broadly the same main section headings as CPG 229. We have also reflected some material from the 'Principles for the effective management of climate-related risks' published by the Basel Committee on Banking Supervision in June 2022, where it goes further than the APRA guidance, and where it is relevant for entities generally, not just banks.

We have adapted those sources to suit the New Zealand context. In particular, this means taking account of the new CRD regime, and ensuring that the terminology used is consistent with the standards issued by the XRB to implement that regime. For example, we use the term 'climate-related risks' rather than 'climate risks' or 'the financial risks of climate change'.

Another difference with APRA's guidance is that CPG 229 provides guidance to assist entities in complying with specific prudential standards including CPS 220 'Risk Management'. We do not currently have any equivalent of CPS 220 and the Guidance does not impose any enforceable requirements, nor does it provide guidance to assist entities in complying with any enforceable requirements under our prudential legislation. However, as is discussed in more detail in section 2.4, we do not rule out issuing enforceable requirements in the future should we deem it appropriate to do so.

[2] See for example the first national climate change risk assessment for New Zealand published by the Ministry for the Environment in August 2022.

Q1	Do you think that the Guidance sufficiently promotes common understanding of good practice in managing climate-related risks?
Q2	Is there anything in the Guidance that you would remove, add, or amend? Please provide specific reasons and details as far as possible.

2.3 Who is in scope of the Guidance?

We intend the Guidance to be relevant for all entities regulated under any of our prudential regulation legislation. This means registered banks, licensed insurers, licensed NBDTs, and operators of designated FMIs.

Climate-related risks will not affect all entities equally and the Guidance stresses the principle of proportionality. Nevertheless, entities should identify and manage risks that are material to them. In that context, we encourage entities to understand how material climate-related risks are to their business, and to act on the Guidance to the extent that climate change does turn out to pose material risks to them.

The Guidance does not refer to specific powers under the respective legislation for the different types of entities. Rather, we intend it to supplement current Reserve Bank expectations of what is required to prudently manage all material risks. It is those expectations that derive more broadly from the various legislative backgrounds and supervisory approaches to the different sectors, as noted above.

2.4 Other options considered

Option 1: Status quo

Doing nothing is a feasible alternative at this point: this is the status quo option. This would avoid any chance of regulatory burden being imposed.

But on the downside we are concerned that this would lead to slower progress by entities that are already not prioritising climate-related risks enough, and that fall some way short of current best practice in the financial sector. We think that the absence of the Guidance would lead to more difficult supervisory discussions, starting from a lower level of common understanding. It would leave the drive for good practice relying more heavily on market discipline (in the form of the new disclosure requirements), and would leave smaller entities that are not subject to that disclosure without clear pointers on where to start. It may also result in lower levels of discussion and activities related to climate-related risks, and therefore potentially increase risks from the status quo over time as the physical impacts of climate change ramp up.

This option would also result in the Reserve Bank failing to meet NGFS recommendations for central banks and its obligations under the National Adaptation Plan.

Option 2: Impose requirements under respective legislation

The other option that seems most natural to consider would involve setting more specific requirements for the different sectors under existing legislative powers. The advantage of this approach would be to promote faster action in specified areas, and to give us greater powers to take action against specific entities to require them to remedy failings in their approach to managing climate-related risks. Our recently strengthened enforcement framework (announced in May 2022) would enable this approach.

But we see a number of drawbacks of this option:

- it would likely take considerably longer to put in place than issuing guidance, given the additional work needed to develop the more legalistic approach to requirements, and the need to do this in varying ways across the four different empowering acts;
- given the rapid pace of development in understanding climate-related risks for entities, we see risks in locking in an approach that would likely be less flexible in application, and would take longer to revise when needed. This increases the risk of unintended consequences;
- for these same reasons, consensus among prudential regulators globally currently favours a guidance-based approach. We do not think it makes good sense to move faster than that consensus; and
- issuing guidance now does not rule out a stronger response at a later stage if needed. The Guidance flags this point in paragraph 15, 'Maintenance of the Guidance': that response would benefit from experience with the Guidance and also seeing how good practice has evolved in response to climate-related disclosure requirements.

Q3	Do you agree that issuing guidance is better than either of the alternative Options 1 and 2?

2.5 Relationship to CRD regime

Under the new CRD framework set out in Part 7A of the Financial Markets Conduct Act 2013, every Climate Reporting Entity (CRE) will have to publish an annual Climate Statement for each financial year beginning on or after 1 January 2023. The tests for qualifying as a CRE are set out in the legislation, and CREs include most registered banks, and a number of licensed insurers. There is also one licensed NBDT that is currently large enough to qualify.

The required disclosure will bring market discipline to bear on the entities that are also CREs. To the extent that the market reallocates capital in response, it will incentivise these entities to make progress on developing robust long-term plans for responding to climate change and managing the emerging risks. Our intention is that our Guidance and related supervisory discussions will complement the disclosure requirements, applying regulatory discipline pushing entities towards the same broad goals. We aim to ensure consistency, and minimise overlap, between our Guidance on climate-related risk management, and the standards and guidance that make up the disclosure regime. We have co-ordinated with the XRB and FMA to achieve that, and will continue to do so.

The Guidance will also be relevant for entities that are not CREs, and for them the Guidance stresses the benefits of disclosure and recommends drawing on the CRD framework as a good starting point.

Q4	Do you foresee any conflicts between complying with the CRD regime and using our proposed Guidance on managing climate-related risks? Please provide specific details as far as possible.

2.6 Financial Policy Remit

The Financial Policy Remit emphasises the desirability of a strong, efficient and inclusive financial system, with a low incidence of failure of entities. It also signals that we should encourage a competitive financial system and have regard to Government priorities on sustainable house prices, building resilience and facilitating adaption to climate change, improving financial inclusion, and improving cyber resilience. The full text of the Remit is available on the Reserve Bank's website.[3]

The Guidance is consistent with the Financial Policy Remit. In drafting the Guidance we have had regard to the desirability of an inclusive financial system, within the constraints of commercial viability, by encouraging entities as far as possible to support customers in adapting to climate change. The Guidance is directly supportive of the 'building resilience and facilitating adaptation to climate change' component of the Financial Policy Remit.

The Guidance would have negligible effects on the sustainability of house prices, cyber resilience, and the competitiveness of the financial system.

2.7 Regulatory burden of proposals

We expect the regulatory and supervisory costs of issuing the Guidance to be less than if we impose formal obligations on entities. The costs to an entity of taking appropriate steps to improve its management of climate-related risks and its resilience to climate change over the longer term should be outweighed by the benefits of doing so. Some entities are less exposed to climate-related risks because of the nature of their business, and they may not need to do much more in light of the Guidance than they are already doing. The principle of proportionality applies (see Guidance paragraph 7). We view the Guidance as there to provide support to entities in doing what they need to do in any case. However, we welcome feedback on this assessment.

The Guidance encourages entities to manage climate-related risks within their existing risk management framework. We are not suggesting that a whole separate approach is necessary, which could impose unjustified additional burden. Any entity for which climate-related risks are material should manage those risks along with all the other material risks it faces, and the Guidance is not imposing a new obligation to do so.

[3] The text of the Financial Policy Remit is available on the Reserve Bank's website: https://www.rbnz.govt.nz/about-us/responsibility-and-accountability/our-financial-policy-remit

For CREs, our assessment is that many of the outcomes that an entity will achieve by following the Guidance will be strongly incentivised in any case by the information it will be required to disclose in its annual climate statement. Some of the more substantial matters covered, such as climate scenario analysis, are effectively mandated by the disclosure requirements: under NZ CS1, an entity must describe the scenario analysis it has undertaken, including a 1.5 degree scenario, a 3 degree or greater scenario, and one other scenario.

We will continue to assess costs and benefits, including considering stakeholder views, before making final decisions. We will publish a regulatory impact statement with the finalised Guidance, drawing on any estimated cost data provided by entities.

Q5	What new compliance costs (if any) do you expect your organisation to face as a result of the Reserve Bank issuing the Guidance? Please provide estimated dollar amounts as far as possible.
Q6	What areas of the Guidance (if any) do you view as imposing regulatory burdens on your entity that are not justified by expected benefits?

3 Next steps

We welcome feedback on the specific questions asked above, and on any aspect of the content of the Guidance, by the consultation deadline. Subject to the feedback we receive, we plan to publish the finalised version of the Guidance in H2 2023.