# EXECUTIVE SUMMARY

This discussion paper is about the use of scenario analysis by companies and other financial actors to manage, disclose, and regulate climate-related risks and opportunities in Australia. It suggests how Australian practice can be consistent with our international climate commitments under the Paris Agreement and with the leading international framework for robust climate disclosures, the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). Its intent is to accelerate discussion between policymakers, business, investors, and regulators so that practices and capabilities for scenario analysis are fit for purpose.

**It is abundantly clear that Australian companies and investors must now disclose the financial and economic risks that climate change poses to their business.** This is not just a market expectation, but a legal requirement. To discharge it, businesses need to develop tools and expertise required to assess, report and respond to climate risks in a robust way. This is especially important in Australia, where climate risks are profound.

**Scenario-based analysis of climate-related risks and opportunities is a key tool at a crucial time.** Scenario planning considers how risks and opportunities might evolve under different climate and policy trajectories, and the implications for financial performance and strategy. The TCFD – a business-led group chaired by Michael Bloomberg and charged with providing a global roadmap for better information on climate risks – said systematic use of scenario analysis in climate risk planning and disclosure should be a key priority for firms and investors. But such analysis is complex. Achieving consistent, robust scenario analysis will be particularly challenging while standards and capabilities are still developing and different stakeholder expectations are emerging.

**There is a danger that inconsistent or flawed approaches to scenario analysis will obscure more than they reveal.** The TCFD raised awareness and expectations but did not set out a standard approach. The most readily available and global scenarios have key shortcomings. Many tools for judging local and sectoral impacts on climate risks are promising but incomplete. Building the full suite of standards and capabilities for robust scenario analysis will take time. But we cannot make perfection the enemy of the good. A disjointed approach, where stakeholders cannot agree on the right standards and scenarios, or where corporate spin masks low-quality analysis, will make a pressing challenge much harder.

**To work towards greater consistency, stakeholders should focus on fundamental principles that are hallmarks of robust scenario analysis.** These principles can guide those designing and assessing scenario analysis and ensure that early efforts set a high bar for broader take-up. This will be especially important in Australia because our climate-specific corporate disclosure requirements are relatively weak and the physical and transition risks we face are profound.

**This paper puts forward five core propositions as a basis for further discussion as Australian responses to the TCFD recommendations gather pace**. Scenario analysis efforts should:

- Include a scenario that is genuinely consistent with Paris targets. This means a scenario that incorporates a high probability of limiting warming to below 2°C, and towards 1.5°C.
- Include the physical impacts of climate change, not just transition risks. In Australia, physical risks (such as from droughts, floods and other exceptional weather events) will be significant even if warming is kept below 2°C, and will be extreme under business-as-usual settings.
- Engage with the most robust and relevant sectoral or regional scenarios and resources, and consider incorporating challenging sector-specific scenarios for technological, policy and other changes.

- Be transparent about assumptions and parameters used to develop the scenarios, in line with the TCFD disclosure framework.
- Show evidence of responses to scenario analysis results through changes to strategy, governance, and risk management processes.

**Businesses and investors need to take the lead on scenario analysis – but there is a key role for regulators and policymakers too.** The Australian Prudential Regulation Authority (APRA) and others have highlighted the relevance of climate-related risks at a company and systemic level. Australian regulators can take further steps to promote a consistent, robust approach by:

- Providing unambiguous support for the widespread adoption of the TCFD recommendations in Australia, including on scenario analysis.
- Updating their guidance, supervision, and internal capabilities in order to better understand the systemic implications of climate risk. This should include scope for system-wide stress testing around tail risks, as well as proactive oversight of how companies and investors are mapping and managing their own climate-related risks.
- Considering more stringent climate-related financial disclosure requirements, including in light of how effectively Australian institutions respond to the TCFD.
- Improving co-ordination and information sharing on climate-related risks between key regulators. Several key organisations are likely to face common goals in identifying and understanding the financial implications of climate change. Better co-ordination could be overseen by Australia's Council of Financial Regulators, which is an established forum for considering matters that overlap the respective mandates and roles of APRA, the Australian Securities and Investments Commission, the Reserve Bank, and Treasury. Involvement of the financial reporting authorities (the Financial Reporting Council, Australian Accounting Standards Board, and the Auditing and Assurance Standards Board) may also be warranted.

This paper draws on early examples of climate-related scenario analysis that are already available (see Appendix). It is informed by conversations with a variety of stakeholders and experts in Australia and overseas, plus several forums held under the Chatham House Rule during the past 12 months.[1]

Our primary aim is to identify and tease out key areas of interest and debate. The TCFD notes that the use of scenario analysis for financial climate risk is at an early stage, and that various actors (including industry groups, NGOs, and official bodies) have a role to help develop better scenarios and drive better practice.[2] Our intent here is to provoke a bigger conversation around scenario analysis and to provide a jumping-off point for further consultation and research into both stakeholder needs and empirical information.

CPD will hold a series of high-level consultations on these issues in the first quarter of 2018, which will inform an updated major report that responds to many of the issues and questions highlighted in this discussion paper.

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[1] Including the Commonwealth Climate Law Initiative forum with reporting and other financial authorities in July 2017; roundtable discussions with Dr Paul Fisher of the Bank of England and Cambridge University in October 2016 and October 2017, and engagement with other stakeholders, experts and authorities during this period.

[2] TCFD, 2017, *Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-related Risks and Opportunities*, June 2017, p.11.