



Submission by Westpac Banking Corporation

Garnaut Climate Change Review

Issues paper 2

Financial Services for Managing Risk - Climate Change and Carbon Trading

February 2008

Background

Westpac's submission to the Garnaut Review draws upon the bank's considerable experience in factoring environmental considerations into business policies, systems, and procedures as well as our practical participation in environmental markets to date.

Westpac has been examining and addressing the impact of climate change on our business for well over a decade. Our response to date has been fourfold:

- reducing direct environmental impacts,
- anticipating and responding to changes in trade and regulatory frameworks;
- identifying and responding to emerging business risks and opportunities; and
- broader advocacy in the community.

In that time, Westpac has reduced its own emissions by over 40%, begun trading in environmental markets, launched a number of environmental products and services, promoted the application of ESG issues in risk assessment and investment considerations and publicly advocated for greater certainty in climate change policy and regulation in the wider community.

In 2007, Westpac was one of just four companies and the only bank globally to achieve a Climate Disclosure Leadership Index score of 100 and a AAA rating under the Carbon Disclosure Project.

Westpac, through the Energy desk in Westpac Institutional Bank, has traded Renewable Energy Certificates (RECs) in Australia since 2002. In late 2006 Westpac also commenced trading in the EU ETS. Westpac's participation in the EU ETS is an extension of our Energy trading activities. Significantly, the experience gained in participation in this market positions Westpac favourably to offer risk management solutions for our customers who are increasingly considering carbon risk as Australia transitions to a national emissions trading scheme by 2010.

Westpac's submission provides feedback on the specific aspects of an Australian Emissions Trading Scheme referenced in the discussion paper *Financial Services for Managing Risk: Climate Change and Carbon Trading*, and provides some high level comments on issues facing the insurance sector.

Westpac would be happy to discuss any aspect of this submission in further detail, or to provide additional detail on any of the initiatives referred to.

Insurance issues

Both the physical risks associated with climate change, and emerging regulatory and market responses, have the potential to impact the insurance sector and financial institutions more broadly.

Increased volatility and further incidents of extreme weather events will significantly impact the provision of insurance, and potentially finance, in industry sectors vulnerable to the impacts of changing weather conditions. Government assistance packages, in the form of 'Exceptional Circumstances' packages or emergency relief packages, are likely to continue to increase.

Government has an important role to play in limiting exposure to weather damage and the ensuing costs, by explicitly incorporating climate change considerations into buildings standards and codes, by working with local governments to identify and address areas of particular vulnerability to changing weather conditions and to examine the provision of funding for mitigating measures, such as coastal protection infrastructure, in zones subject to rising sea levels or increasing storm surge.

This will also serve to address concerns in the wider financial services sector, around ensuring long life fixed assets are protected from changing weather conditions and potential earning impairments for lending and investment in impacted sectors.

Westpac is aware that financial institutions are beginning to innovate in the provision of climate change risk management products and services, both in terms of the physical risks posed by climate change, and in responding to carbon market mechanisms.

New insurance products and services are also developing to support international carbon market mechanisms, around both the market mechanisms of the Kyoto Protocol and emerging voluntary markets.

Currently, a number of companies are developing combined risk cover for carbon credit delivery to build confidence for financiers to support the Kyoto Flexible Mechanisms, Clean Development Mechanism (CDM) and Joint Implementation (JI).

More broadly, there are a number of global collaborative research initiatives, currently focused on assessing the impact of climate change on the insurance sector and the role that financial institutions can play in the adaptation and mitigation of climate change related risk.

In particular, UNEP FI is a global partnership between UNEP and the financial sector. Over 160 institutions, including banks, insurers and fund managers, work with UNEP to understand the impacts of environmental and social considerations on financial performance. UNEP FI was launched in 1991 when a small group of commercial banks, including Deutsche Bank, HSBC Holdings, Natwest, Royal Bank of Canada, and Westpac, joined forces with UNEP to catalyse the banking industry's awareness of the environmental agenda.

In 2007, the UNEP FI insurance working group published a discussion paper [*Insuring for Sustainability: how and why the leaders are doing it*](#). The publication includes case studies of how insurance companies from around the world are innovating to respond to new risks including climate change, and serves as a useful examination of the current state of play.

Roles and responsibilities in carbon risk management

Westpac strongly believes that the design and construction of technical market architecture for a national emissions trading scheme must occur in close collaboration with key financial industry players to ensure maximum market liquidity, viability and efficiency.

Westpac would also recommend that policy makers learn from the experience of existing comparable markets. Environmental markets which function most effectively are often designed in close collaboration with existing market and financial intermediaries.

Emission trading schemes are essentially policy driven markets. Government has a crucial role to play in creating clear and certain policy to build market confidence and ensure market liquidity. Financial markets are capable of designing and implementing a range of tradeable instruments and incorporating appropriate levels of carbon risk assessment into credit analysis, once suitable policy frameworks and parameters have been set.

An Australian emissions trading scheme should also incorporate the establishment of an independent agency with a clear mandate to appropriately monitor the market and further develop and enhance trading and liquidity. Within a defined framework, such an agency could also formally review the overall effectiveness of the market on an ongoing basis in achieving policy and environmental objectives.

Once it has been established, oversight of the carbon market and supporting financial instruments, documentation and accreditation requirements could reasonably be undertaken by existing financial regulatory authorities such as ASIC.

Building effective carbon trading markets

Westpac supports flexible, market-based policy instruments which facilitate reductions in greenhouse gas emissions while maintaining economic competitiveness.

We believe that Australian financial institutions are well placed to develop and deliver the necessary infrastructure, products and services to support a national emissions trading scheme.

However, we believe there are a number of institutional inhibitors which need to be addressed. These include:

- Lack of awareness and capacity across industry sectors;
- Transitional arrangements for existing voluntary markets into the Australian ETS;
- Regulatory certainty around institutional frameworks and market signals;
- The need for complementary measures to support cost-effective emission reductions.

Government, and financial institutions, have a role to play in raising awareness and educating participants in impacted sectors around the commercial risks and opportunities posed by the emergence of carbon trading markets.

Westpac believes that the availability of high quality, validated and transparently disclosed data will be crucial to the effective functioning of the market and the ongoing management of price volatility.

Recent surveys of business sentiment in Australia by organisation such as PriceWaterhouseCoopers support the view that while Australian companies are generally aware of the emerging risks to business posed by the establishment of a national carbon emissions scheme, there remains considerable confusion over the specific impacts and the actions required by business to respond and comply.

By way of example, in June 2007 the Westpac & CSU Agribusiness Index, a quarterly survey providing a detailed national and state-based overview of business performance in the agribusiness sector, found that while 78% of agribusiness operators are aware of federal government plans to introduce a carbon trading scheme, only 41% had an understanding of how a proposed scheme would operate.

Westpac has been participating in existing environmental markets and other voluntary market schemes for a number of years. At this stage it appears that there is certain to be some form of overlap between credits traded in the voluntary market and Australia's ETS. Credits for early action and from offset mechanisms will represent important components of Australia's ETS and should be supported as they are more likely to encourage early action in reducing greenhouse gas emissions.

However, the market for credits prior to and in the lead up to the commencement of Australia's ETS will be small and the price signal relatively weak. A robust forward market will not be able to determine the marginal cost of emitting greenhouse gases or investment in projects to generate credits from early action or approved offset mechanisms until firm interim emission reduction targets are set. In addition, the mainstream financial community are unlikely to become substantially involved until regulatory certainty and emission reduction targets are in place.

The timely development of market trading infrastructure will also play an important role in transitioning to an Australian ETS. This includes trading infrastructure, legal and financial documentation, systems and processes and benchmarkable price data.

Lastly, it needs to be acknowledged from the outset that as a stand alone policy response emission trading will not deliver substantial greenhouse gas reductions.

To achieve the environmental outcomes required without unduly compromising Australia's economic competitiveness, a suite of complementary policy responses, including emissions trading, within a clearly articulated framework is required.

This essentially requires five core elements:

1. The establishment of a long-term aspirational goal for Australia to reduce greenhouse gas emissions, supported by a short term binding target.
2. A national emissions trading scheme, incorporating appropriate international linkages.
3. A practical strategy supporting the development and deployment of low emission technology.
4. Demand management and behavioural change, facilitated through appropriate education and awareness raising across the community.
5. A strategic response to adaptation requirements across impacted communities, natural habitats and industry sectors.

Policies and programs in these areas need to be addressed in parallel to the development of the Australian ETS.

Facilitating forward trading markets

The creation of deep and liquid forward markets with the maximum number of market participants should be a key design objective of any emissions trading scheme. This would provide greater certainty and reduce carbon risk for long-term investments.

To the extent that the Australian ETS is expected to act as a market driver for increased investment in new technology, policy infrastructure should encourage maximum forward market efficiency.

Ultimately, auctioning is the most effective means of driving price discovery, particularly in the early stages of market development. However, to ensure ongoing economic competitiveness, Westpac recognises that the national emissions trading scheme will need to ensure that trade-exposed sectors (import and export) are not severely impacted as Australia transitions to a low-carbon economy.

This could potentially be achieved through the design of the permit allocation system as it seeks to compensate or shelter trade exposed sectors until a comparable carbon price signal applies to competitors.

Therefore, any mix of free allocation and auctioned permits will need to be appropriately balanced to ensure optimal price discovery and market efficacy. Over-allocation of permits to impacted sectors could lead to many of the same issues experienced in Phase 1 of the EU ETS, and undermine the efficiency of the market and its ability to deliver genuine environmental outcomes.

In response to an examination of the potential for 'banking' and 'borrowing' within the scheme, Westpac notes that no other major scheme currently in operation allows unrestricted borrowing.

Both the State-based National Emissions Trading Task force and the Prime Minister's Task Group supported banking and recommended against borrowing. The EU ETS allows for limited borrowing within phases of its scheme and under NSW GGAS a 10% shortfall is allowed without penalty as long as shortfall is made up the following year.

Banking provides compliance flexibility, encourages early emission reductions and reduces compliance costs. It also allows firms to manage emissions profiles more smoothly from year to year to reflect production variations and the business cycle.

The ability to bank carbon permits for use in future years would also serve to smooth out price volatility, helping to avoid situations where an excess of permits at any given time might depress the carbon price.

The concern with 'borrowing' lies in the risk that it may incentivize borrowing from the future to cover current emissions in the hope that any serious shortfall between available permits and underlying emissions will be offset by intervention. This would increase the pressure on a future government to weaken the credibility of the scheme through an opportunistic additional issuance of permits in order to avoid sharp increases in the cost of permits.

Such behaviour could also potentially undermine the integrity of the market by removing scarcity and weakening the price signal.

While it is important to consider the wider economic impacts of reducing greenhouse gas emission at the national level, it is also important to recognise that financial market players will develop and deliver tradeable instruments, products and services which will achieve the same ends without neutralising the price signal which the market provides or creating price distortions in the forward markets.

Positioning Australia as a regional hub

Westpac supports the development of Australia as a regional carbon trading hub and global financial centre. However, it is clear that other regional financial trading hubs are also currently positioning to become the primary carbon trading hub in the Asia-Pacific region.

Australia has a number of inherent advantages in positioning to be an international carbon trading centre. These include a strong, stable political and economic regime, sophisticated domestic financial systems and services to support carbon trading and the development of secondary markets.

To support this goal, the establishment of Australia as a regional hub should be incorporated as an explicit objective in policy formulation around the design and implementation of the Australian ETS.

Particularly in regard to issues around supporting documentation and carbon registry infrastructure, tax treatment, fungibility with international markets and in ensuring that market frameworks and key policy-based price signals are determined and communicated in a timely manner.

Australia should also look to put in place an effective approach to build alliances, identify market sharing opportunities or complementary roles to play in the likelihood that another regional locality become the Asia-Pacific regional hub for carbon trading.

Concluding comments

Australia has the expertise, skills, resources and technical expertise within the financial services sector to support the development and implementation of a national ETS.

Many of the specific aspects of the technical design of the Australian ETS will need to be developed in consultation with financial markets, to ensure that critical decisions on supporting infrastructure, documentation and key design considerations are made with a view to implementing a highly liquid market with fully functioning forward and secondary markets.

Westpac welcomes the next phase of the consultation process, aimed at focusing on specific aspects of the proposed ETS framework and will continue to actively engage in ongoing policy development on climate change frameworks.