Draft CPG 229 Climate Change Financial Risks – July 2021

HESTA welcomes the opportunity to make a submission regarding the draft guidance on climate change financial risks.

Background

HESTA holds $62 billion of assets on behalf of more than 880,000 members in the health and community services sector, 80% of whom are women. We advocate for a fair, healthy community and a sustainable economy so that our members can face the future with confidence. The performance of our assets and our members' financial wellbeing can be materially impacted by changes to the retirement system, changes in the investment landscape and systemic risks such as climate change.

Responsible Investment

HESTA is committed to creating better futures for our members. One of the ways we do this is through being a responsible investor and thinking long-term. This approach allows us to positively impact the broader economy, society and environment.

Considering the impacts - both positive and negative – of our investments on the planet and people, is important. This is because these impacts can affect the value of an individual investment, whether it's a company, property, infrastructure asset or another type of investment. And that can affect long-term returns to members.

Responsible investing is particularly important for super funds for two key reasons.

1. We invest over a very long timeframe. This makes issues such as climate change and the government regulation around it important because they can affect investment value.
2. As a universal owner we have a highly-diversified portfolio that is representative of global capital markets. As a consequence, we have a financial interest in the wellbeing of economy as a whole.

Climate Change

Climate change is an important issue for investors and HESTA is proud to be the first major superannuation fund to commit our portfolio to align with the goals of the Paris Agreement and reach net zero carbon emission by 2050.

Climate change can impact investment portfolios in the following ways:

- **Transition risk**: For example, exposure to carbon pricing, regulation to reduce carbon emissions or market demand shifts which might also lead to stranded asset risk;
- **Physical risk**: For example, exposure to the physical impacts of climate change, such as potential sea-level rises, and increased frequency and intensity of severe weather events;
- **Liability risk**: These risks result from companies not adequately managing the impacts of climate change and their approach potentially resulting in a breach of directors' duties.

As a large global investor, with investments across a range of geographic regions, economies and asset classes, HESTA cannot diversify away from climate change impacts.

Because climate change has the potential to impact investment risks and returns, we consider it alongside traditional financial and business risk factors in making investment decisions.

General

HESTA congratulates APRA on the draft guidance in this important area which should become a useful benchmark and resource for financial institutions.

We believe the draft articulates the systemic and significant nature of climate risk and provides sensible guidance for how it should be approached by superannuation funds and other financial institutions.

HESTA welcomes the draft CPG and offers the following comments for consideration.

Alignment between the draft guidance and TCFD

Full-bodied and genuine disclosure is vital for certainty and well-functioning markets. If institutions can better understand risk, then they can make informed decisions. Disclosure of climate risk and how it is managed must be clear, useful, and appropriate for investors and relevant stakeholders.

HESTA welcomes the inclusion of the TCFD framework as a sound basis for disclosure in the guidance; however, we believe there should be a more explicit reference and endorsement provided given the framework's increasing use and the consistency it provides as an example of best practice.

Also, the benefit of stronger TCFD endorsement is that it may have a flow on effect to companies that HESTA and other funds invest in. We note the progress being made by many companies towards TCFD-aligned disclosure; however, there remain several ASX200 companies that are materially exposed and do not seem engaged with this important dimension of their business.

HESTA Recommends:

- **A compulsory phase-in be included for adoption of the TCFD framework. A period of four years is proposed**.

Misalignment between CPG 229 and Your Future Your Super performance assessment

APRA should consider how the guidance interacts with the *Your Future Your Super* legislation. Under the legislation, superannuation funds will be subject to benchmarking that is backward-looking and based on historical performance data that is not necessarily aligned with the Paris Agreement.[1] The 8-year benchmarking tests might also encourage investors to focus on a short to medium-term return horizon.[2] This is misaligned with effective management of systemic climate risk and the need for investment in new technologies, which require a long-term approach, and will generate long-term benefits to superannuation fund members.

HESTA Recommends:

- **APRA should clarify how institutions will not be penalised under the *Your Future Your Super* benchmarking regime by following the guidance and effectively managing climate risk over the long-term.**

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[1] Data from MSCI shows that if companies globally continue with status quo strategies, this will most likely result in 3.5 degrees of warming. Therefore, in order to meet targets that are lower than 3.5 degrees and effectively manage their climate risk, companies and investors will need to adjust their strategies and reallocate capital over the long-term. See MSCI, 'The Role of Capital in the Net-Zero Revolution', p4.

[2] A report by the Queensland Investment Corporation discusses how the benchmarking system encourages short-termism in investment, at the expense of long-term sustainability objectives: QIC, 'Your Future, Your Super Comparative Benchmarks', November 2020.

Scenario analysis

A key aim of the Paris Agreement is to limit the global average temperature increase to well below 2°C above pre-industrial levels and pursuing efforts to limit the increase to 1.5°C above pre-industrial levels, we recommend that this scenario should be specifically included. In addition, the importance of transition risks as well as physical risks should be highlighted. Analysis should cover quantitative and qualitative factors such as the social impacts associated with an orderly and disorderly transition.

Scenario analysis can and should help entities understand climate risk and build better systems and process to manage this risk. It should be approached as a fundamental aspect of risk management - not a perfunctory compliance undertaking.

We accept there will be different approaches to scenario analysis that will be tailored for each institution. APRA could reinforce to institutions that they have the freedom to use the tools that are most useful to them and the draft guidance from APRA is not definitive or mandatory.

As an institutional investors HESTA engages with companies to encourage better scenario analysis and overall disclosure from them as well as our asset managers. This type of engagement could be reflected and encouraged in the draft guidance.

HESTA Recommends:

- **The guidance should be clarified and strengthened in relation to scenario analysis and should specifically cover:**
  - **the need to apply a Paris Agreement aligned scenario;**
  - **the importance of transition risks; and**
  - **quantitative and qualitative factors such as the social impacts associated with an orderly and disorderly transition.**

Net-zero targets and commitments

Since the Paris Agreement was signed, there has been increasing recognition that limiting global warming to 'well below 2°C' will require the global economy to transition to net zero greenhouse gas emissions prior to 2050. We believe that effective management of climate risk requires institutions to consider net zero targets in their own strategic plans and analysis of companies they invest in.

HESTA Recommends:

- **The guidance send a clear message that institutions consider the transition to net zero and alignment with the Paris agreement in target setting.**

Alignment and reference to relevant legal opinions

Regarding director duties, the guidance should consider alignment to legal opinions such as those by Noel Hutley SC and Sebastian Hartford on climate change and directors' duties[3] and Noel Hutley SC and James Mack on superannuation trustee duties and climate change.[4]

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[3] https://cpd.org.au/wp-content/uploads/2021/04/Further-Supplementary-Opinion-2021-3.pdf

[4] https://equitygenerationlawyers.com/wp/wp-content/uploads/2021/04/Hutley-SC-Mack-Superannuation-Trustee-Duties-and-Climate-Change-Memo-2021.pdf