CONSULTATION RESPONSE

APRA'S PRUDENTIAL STANDARD SPS 530 INVESTMENT GOVERNANCE

February 2022

This consultation response represents the view of the PRI Association and not necessarily the views of its individual members.

ABOUT THE PRI

The Principles for Responsible Investment (**PRI**) is the world's leading initiative on responsible investment. The PRI has over 4,500 global signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles (the **Principles**) with approximately US $120 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (**ESG**) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

ABOUT THIS CONSULTATION

On 21 September 2021, the Australian Prudential Regulation Authority (**APRA**) released draft amendments to its Prudential Standard SPS 530 – Investment Governance (**SPS 530**) for consultation. SPS 530 supports RSE licensees to fulfil their fiduciary duties and prudently manage investments in their beneficiaries' best financial interests. The amendments respond to findings from APRA's Unlisted Asset Valuation Thematic review and its 2019 post-implementation review of its superannuation prudential framework. The proposed amendments focus on stress testing, valuation and liquidity management practices. We note that subsequent to this consultation, APRA is also intending to propose amendments to its related guidance, SPG 530 – Investment Governance (**SPG 530**).

For more information, contact

Daniel Wiseman

Head of APAC Policy

[redacted]

Mayleah House

Senior Policy Analyst, Australia

[redacted]

or visit: www.unpri.org

KEY RECOMMENDATIONS

The PRI welcomes the opportunity to respond to APRA's consultation on SPS 530. We support SPS 530's objective to ensure RSE licensees comply with their legal obligations to act in the best financial interests of beneficiaries and prudently select, manage, and monitor investments. In particular, the PRI welcomes the proposal to update requirements relating to stress testing. Integrated and comprehensive stress testing practices are critical to ensure that RSE licensees are appropriately considering, mitigating market-wide risks, including market-wide ESG risks, such as climate change.

As identified by the consultation documents, prudent risk management requires that stress testing programs are integrated into the investment governance framework and that stress testing results directly inform investment decision-making. While we understand that this is the intent of the proposed amendments, they will not successfully achieve this objective in their current form. In particular, the current amendments do not provide sufficient clarity to RSE licensees about if or how market-wide investment risks and opportunities should be considered when setting investment objectives, when formulating, giving effect to and reviewing the investment strategy, and when selecting scenarios and carrying out stress testing.

In our response below, we set out our understanding of the relevance of market-wide risks to RSE licensees' duties and activities. We recommend that SPS 530 should better reflect RSE licensees' obligations to consider and manage material market-wide risks, including by explicitly requiring RSE licensees to:

1. **consider market-wide risks when setting investment objectives** (SPS 530, [17]);
2. **have regard to market-wide risks when formulating an investment strategy** (SPS 530, [18-19]);
3. **understand how their investment selection impacts and contributes to market-wide risks** (SPS 530, [23]); and
4. c**onsider market-wide risks in stress testing and selecting scenarios** (SPS 530, [30]).

RELEVANCE OF MARKET-WIDE RISKS FOR RSE LICENSEES' INVESTMENT GOVERNANCE

Market-wide risks, including both 'systematic risks' associated with overall market performance and 'systemic risks' associated with the effective operation of financial markets, can be a key source of material investment risk for RSE licensees. As has been widely recognised by APRA and others, ESG-related risks, such as climate change and the implications of the COVID pandemic, can be a significant source of such market-wide investment risk.[1]

In addition to well-known risks associated with climate change,[2] there is also growing awareness of the relevance of broader ESG-related issues as sources of market-wide risk, including in relation to biodiversity loss,[3] resource scarcity, deforestation, and social issues such as poverty and income inequality.[4] These sources of risk directly impact the performance of the broader economy, underpinning financial returns.

As with other market wide risks, in most cases it will not be possible for RSE licensees to entirely mitigate such risks through diversification and asset allocation at the portfolio level alone. With widely diversified portfolios, many RSE licensees are effectively 'universal owners', with their investment returns being highly dependent on the continuing good health of the overall economy and the environmental and social systems on which it depends.[5]

Consequently, investors in Australia and globally are increasingly integrating explicit consideration of market-wide risks into their overall investment governance and strategic risk management processes. Actions that investors are taking to address these risks include the setting of additional investment objectives and associated performance targets, adjustments to asset allocation and manager selection decisions, and increased attention to the role of engagement and stewardship practices as a means of reducing social and environmental externalities from individual companies that can negatively affect broader portfolio performance.[6]

Given the direct implications of market-wide risks for overall investment performance and emerging market practices being developed to address them, SPS 530 currently provides insufficient clarity about if and how such risks should be integrated into investment governance frameworks and

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[1] See, eg., Summerhayes, G. (2017, February 17). *Australia's new horizon: Climate change challenges and prudential risk*. https://www.apra.gov.au/news-and-publications/australias-new-horizon-climate-change-challenges-and-prudential-risk; Summerhayes, G. (2019, June 21). *APRA executive board member, Geoff Summerhayes – Speech to the International Insurance Society Global Insurance Forum.* https://www.apra.gov.au/news-and-publications/apra-executive-board-member-geoff-summerhayes-speech-to-international; See further, Freshfield Bruckhaus Deringer, PRI, UNEP FI, The Generation Foundation. (2021). *A legal framework for impact*, https://www.unpri.org/download?ac=13902, pg 27.

[2] Council of Financial Regulators (2021, September) *Climate Change Activity Stocktake 2021*. https://www.cfr.gov.au/publications/policy-statements-and-other-reports/2021/council-of-financial-regulators-climate-change-activity-stocktake-2021/. Debelle, G. (2021, October 14). *Climate risks and the Australian financial system*. https://www.rba.gov.au/speeches/2021/sp-dg-2021-10-14.html; APRA. (2021, November). *Prudential practice guide: CPG 229 climate change financial risks.* https://www.apra.gov.au/sites/default/files/2021-11/Final%20Prudential%20Practice%20Guide%20CPG%20229%20Climate%20Change%20Financial%20Risks.pdf.

[3] DeNederlandscheBank. (2020). *Indebted to nature: Exploring biodiversity risks for the Dutch financial sector*. https://www.dnb.nl/media/4c3fqawd/indebted-to-nature.pdf.

[4] PRI. (2017). *The SDG Investment Case*. https://www.unpri.org/download?ac=5909.

[5] PRI. (2017). *The SDG Investment Case*. https://www.unpri.org/download?ac=5909. [16]; Hawley, J., & Likomnik, J. (2018). The third, systems stage of corporate governance: Why institutional investors need to move beyond modern portfolio theory. *SSRN*. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3127767.

[6] See, eg, Condon, M. (2020). Externalities and the common owner. *Washington Law Review*, 95(1). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3378783; Gordon, J. N. (2021, February 14). Systematic Stewardship. *Columbia Law and Economics Working Paper No. 640; European Corporate Governance Institute - Law Working Paper No. 566/2021.* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782814.

incorporated into the selection of scenarios and performance of stress testing. This lack of clarity can be a source of confusion for RSE licensees, undermining effective investment governance and risk management practices, and ultimately, the best interests of beneficiaries.

In this respect, we note that the proposed amendments to paragraph 10 of SPS 530 do state that "[a]n RSE licensee's responsibilities include generating returns to meet investment objectives while managing and monitoring *all identified sources of investment risk*." However, the sources of material risks included in SPS 220, that are referred to in the associated footnote [6], do not explicitly refer to market-wide investment risk. While market-wide risks are referred to in SPG 530,[7] this alone does not provide sufficient indication to RSE licensees that such risks require specific attention, what types of actions may be taken to manage or mitigate them, and if or how they should be integrated with the increased stress testing requirements included in the proposed amendments.

ADDITIONAL GUIDANCE ON MARKET-WIDE AND IDIOSYNCRATIC ESG RISKS

While our detailed recommendations are directed at the need for RSE licensees to consider all market-wide risks, explicit guidance should also be provided to RSE licensees (either within SPS 530 or subsequent revisions to SPG 530) regarding requirements to consider and manage ESG-related risks at both market-wide and idiosyncratic (i.e., asset specific) levels. It is our understanding that recent legal analysis makes it clear that RSE licensees must take into account material ESG-related risks in all relevant aspects of their decision-making.[8] In light of widespread market practice and industry and academic analysis,[9] a failure to take into account material ESG-related risks has the potential to constitute a breach of an RSE licensee legal duties.

Currently, there is no explicit mention in SPS 530 of the need for RSE licensees to consider or take into account ESG-related risks. While SPG 530 does refer to the consideration of ESG related factors, it does so only in the context of the potential for an RSE licensee to offer an 'ethical' investment option.[10] No direction or guidance is provided regarding if or how RSE licensees should take into account material ESG-related risks in their decision-making. This framing is out of step with current investment practice and broader legal and regulatory developments and is inconsistent with issue specific guidance issued by APRA.[11] Lack of explicit guidance on this issue has the potential to undermine the prudent management of material risks, harm the best financial interests of beneficiaries and expose RSE licensees to increased legal and operational risks.

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[7] APRA. (2013). *SPG 530 – Investment Governance*. https://www.apra.gov.au/sites/default/files/prudential-practice-guide-spg-530-investment-governance_0.pdf. [121].
[8] PRI, & UNEP FI. (2019). *Fiduciary duty in the 21st century*. https://www.unpri.org/download?ac=9792, pg 18; Freshfield Bruckhaus Deringer, PRI, UNEP FI, The Generation Foundation. (2021). *A legal framework for impact*. https://www.unpri.org/download?ac=13902, pgs 12 & 27 (Box 4).
[9] See, PRI's database of academic research on ESG topics, available here: https://www.unpri.org/research/academic-esg-review/5024.article.
[10] See APRA. (2013). *SPG 530 – Investment Governance*. https://www.apra.gov.au/sites/default/files/prudential-practice-guide-spg-530-investment-governance_0.pdf. [34-36].
[11] See, e.g., APRA. (2021, November). *Prudential practice guide: CPG 229 climate change financial risks.* https://www.apra.gov.au/sites/default/files/2021-11/Final%20Prudential%20Practice%20Guide%20CPG%20229%20Climate%20Change%20Financial%20Risks.pdf.

DETAILED RECOMMENDATIONS

RECOMMENDATION 1: INVESTMENT OBJECTIVES

Based on the above, we recommend that paragraph 17 of SPS 530 be amended to read:

17. An RSE licensee must, when formulating the investment strategy for each investment option, set investment objectives that ~~are~~:

    (a) are aligned with the size, business mix and complexity of the RSE from which the investment option is offered; and

    (b) are specific and measurable and, at a minimum, include:

        (i) a return objective; and

        (ii) a risk objective~~.~~; and

    (c) take into account market-wide risks.

Taking into account market-wide risks in investment objectives

In order to ensure that material market-wide risks are adequately integrated into an RSE licensees' investment governance framework, they will need to be identified and considered in the process of setting investment objectives. In this respect, many entities are now setting outcomes objectives that are designed to address material market wide risks, alongside and related to their risk and return objectives.[12]

An outcomes objective typically involves the setting of predefined goals to influence or mitigate market-wide risks that may affect portfolio and beneficiary returns over the course of a defined investment horizon. Having clear outcomes objectives can help focus and direct RSE licensees to account for and reduce non-diversifiable, market-wide risk in a manner that cannot be managed through the ordinary risk and return objectives that are designed primarily to address idiosyncratic risk and benchmark alignment.

RECOMMENDATION 2: FORMULATING THE INVESTMENT STRATEGY

We recommend paragraphs 18 and 19 be amended to read:

18. When formulating each investment strategy for the whole of the RSE, and for each investment option, an RSE licensee must document how it has regard to:

    (a) each of the factors in section 52(6) of the SIS Act;

    (b) any market-wide risks.

19. An RSE licensee must, when determining an appropriate level of diversification for each investment strategy:

    (a) identify the risk factors and sources of return with which the risks factors are associated;

[12] See, eg, HESTA, Impact and the UN sustainable development goals. https://www.hesta.com.au/about-us/hesta-impact/un-sustainable-development-goals.html; Aware Super, Our approach to ESG: Sustainable outcomes without compromising on investment returns. https://aware.com.au/member/investments-and-performance/our-approach-responsible-ownership/our-approach-to-esg.

(b) where the strategy includes multiple assets and/or asset classes, identify how sources of returns are expected to interact, the variability in these interactions and the impact of these interactions on the overall diversification of the strategy in different market conditions;

(c) determine the target exposure to the risk factors in paragraph 19(a);

(d) determine the asset classes and/or individual assets that it will invest in to achieve the desired risk exposure and whether making, holding and realising investments in those asset classes and/or individual assets can be implemented in a manner consistent with the interests of, and the RSE licensee's duties to, beneficiaries;

Considering and integrating market-wide risks in investment strategy

The current section on formulating the investment strategy directs RSE licensees to address "risk factors". However, there is no explicit mention within SPS 530 or associated standards of the need for RSE licensees to consider market-wide risks. This is despite their potential implications for a range of factors contained in s 52(6) of the *Superannuation Industry (Supervision) Act 1993* (Cth) (**SIS Act**),such as the likely return on investments, the liquidity and valuation of investments, and the need for diversification in the investment option composition.[13] Additionally, the explicit reference in paragraph 19 to diversification levels might be construed as limiting the consideration of "risk factors" to idiosyncratic risks.

Accordingly, SPS 530 seemingly encourages RSE licensees to only address idiosyncratic risks when formulating their investment strategy. In this context, RSE licensees could be discouraged from addressing market-wide risks when formulating their investment strategies, despite their relevance for long term financial performance. Given broader duties on RSE licensees to take into account and mitigate market-wide risks, the investment governance standards should codify these requirements and confirm they apply to all RSE licensees.

Accordingly, and in light of the requirements under s 52(6) of the SIS Act, APRA should explicitly require RSE licensees to document how they have regard to market-wide risks when setting their investment strategy.

We further recommend that when APRA subsequently updates SPG 530, detailed guidance is provided to RSE licensees regarding the types of actions available to them for mitigating, managing and integrating market-wide risks in investment strategy. In this respect, additional guidance should be provided regarding the management of market-wide ESG-related risks, through a combination of asset allocation, manager selection, individual and collective stewardship activity and policy engagement.[14]

APRA's authority in relation to this recommendation

In making this recommendation, we submit that APRA is authorised to make the proposed changes in paragraph 18(b), despite there currently being no specific covenant to address market-wide risks

[13] PRI, & UNEP FI. (2019). *Fiduciary duty in the 21st century.* https://www.unpri.org/download?ac=9792, pg 18; Freshfield Bruckhaus Deringer, PRI, UNEP FI, The Generation Foundation. (2021*). A legal framework for impact*. https://www.unpri.org/download?ac=13902, pgs 12 & 27 (Box 4).
[14] See further, PRI. (2018). *Asset owner strategy guide: How to craft an investment strategy*. https://www.unpri.org/download?ac=4336.

under the SIS Act s 52(6). When parliament enacted what is now s 52(6), it stated that additional covenants could and should be included in regulation if they deal with matters which the SIS Act relates to.[15] The main objective of the SIS Act is to make provision for the prudent management of superannuation funds.[16] Requirements for RSE licensees to address market-wide risks are designed to encourage prudent management of the fund for members' outcomes and their long-term financial interests. Our recommendations are therefore within APRA's purview.

RECOMMENDATION 3: GIVING EFFECT TO THE INVESTMENT STRATEGY

Building off the above recommendations, RSE licensees should be further directed to understand potential market-wide risks when selecting their investments in order to adequately implement their investment strategies. Paragraph 23 should therefore be updated as follows:

23. An RSE licensee's investment selection process must enable the RSE licensee to ensure:

  (a) it has sufficient understanding and knowledge of the investment selected, including an assessment of any factors that could have a material impact on achieving the investment objectives of the investment option;

  (b) it has sufficient understanding of how the investment is expected to perform under the range of stress scenarios determined under paragraph 29; ~~and~~

  (c) it has sufficient understanding of how the investment impacts and contributes to any market-wide risks; and

  (~~c~~d) the investment is appropriate for the investment option.

RECOMMENDATION 4: INVESTMENT STRESS TESTING

We recommend paragraph 30 be amended to read as follows:

30. An RSE licensee must, at a minimum, determine appropriate adverse stress scenarios for the investment strategy of each option. These adverse stress scenarios must cover a range of factors that can create extraordinary losses or make the control of risk within accepted tolerance level in the investment strategy difficult, which includes market-wide risks, like climate change.

Stress testing market-wide risks

Comprehensive stress testing practices that are closely integrated in the investment governance framework are critical to ensure that RSE licensees are appropriately considering, managing and mitigating market-wide risks, including market-wide ESG risks, such as climate change. Currently, the proposed amendments do not provide sufficient clarity to RSE licensees about if or how market-wide risks should be considered in the selection of scenarios for the purposes of stress testing or how the results the stress testing process should inform the setting of investment objectives and strategy. We therefor recommend that an explicit reference to market wide risks be included in these amendments.

[15] Explanatory Memorandum, Superannuation Industry (Supervision) Act 1993 (Cth) [81].
[16] *Superannuation Industry (Supervision) Act 1993* (Cth) s 3.

In light of the explicit refence in CPG 229 - Climate Change Financial Risks to the need for prudent institutions to develop proportionate capabilities in climate risk scenario analysis and stress testing,[17] we also believe that these amendments (and/or subsequent amendments to SPG 530) should include an explicit reference to climate change. This would help ensure consistency between the Practice guide and the Standards.

Directly referring to market-wide risks and climate change in paragraph 30 would also help to codify Noel Hutley QC and James Mack's leading legal opinion on superannuation trustee duties and climate change. The memorandum concludes that undertaking a "*climate change scenario analysis is consistent with and compliments the requirements in* [what was previously] *clause 19(b)*."[18]

With APRA's proposed changes to and restructuring of the stress testing provisions, our recommendations would clarify that Noel Hutley QC and James Mack's opinion would still apply to the new provisions. It would also help to ensure that all RSE licensees are aware of and compliant with their legal requirements and reduce potential future legal risks.

The PRI has experience of public policy on sustainable finance policies and responsible investment across multiple markets and stands ready to further support the work of the Australian Prudential Regulation Authority to improve superannuation trustee's governance with respect to systemic, sustainability risks and issues in Australia.

Any question or comments can be sent to [redacted]

[17] APRA. (2021, November). *Prudential practice guide: CPG 229 climate change financial risks.* https://www.apra.gov.au/sites/default/files/2021-11/Final%20Prudential%20Practice%20Guide%20CPG%20229%20Climate%20Change%20Financial%20Risks.pdf.

[18] Hutley, N., & Mack, J. (2021). *Superannuation trustee duties and climate change*. https://equitygenerationlawyers.com/wp/wp-content/uploads/2021/04/Hutley-SC-Mack-Superannuation-Trustee-Duties-and-Climate-Change-Memo-2021.pdf, [10(b)(iii)].