THE

Frontier Line

Thought leadership and insights from Frontier Advisors

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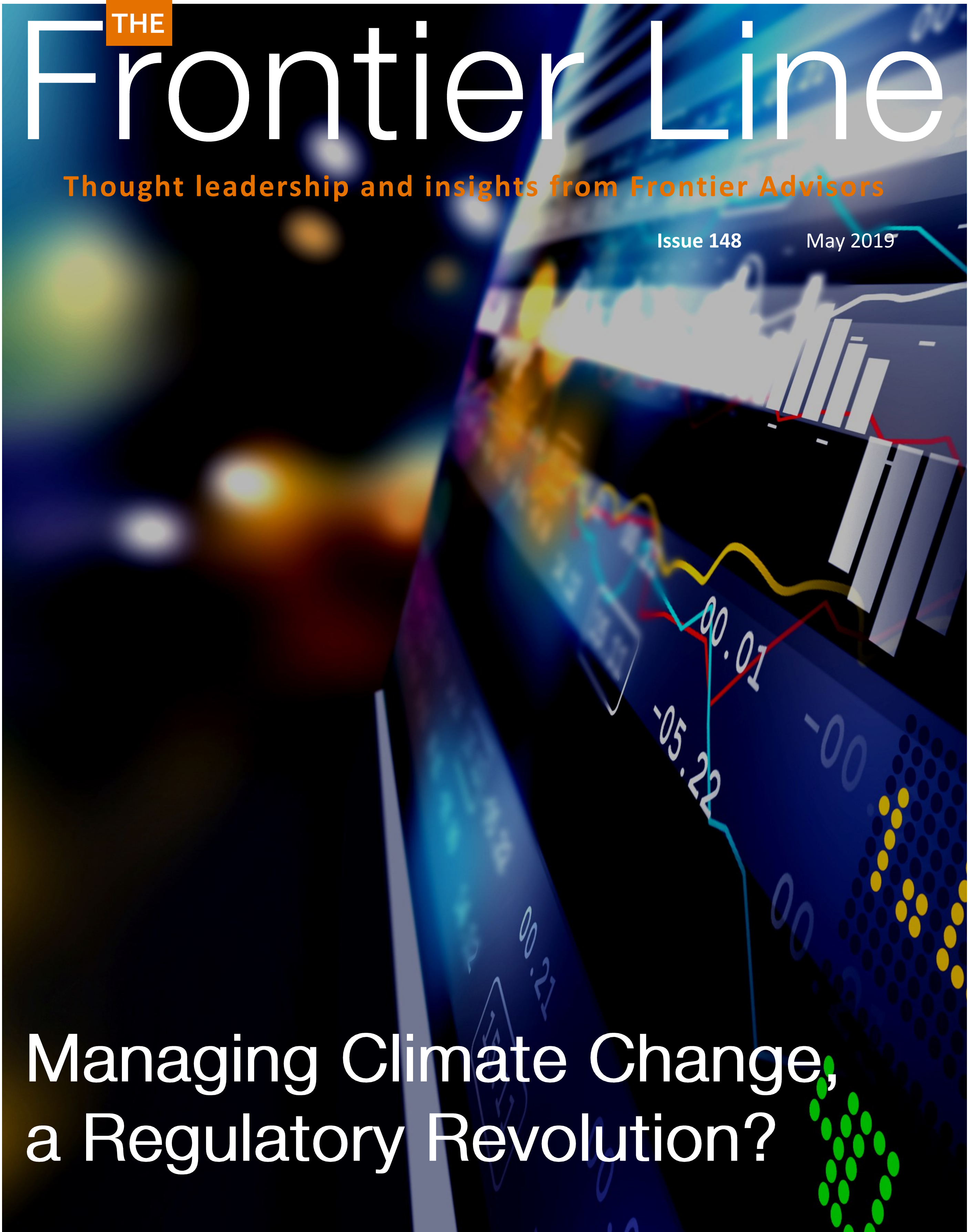

Managing Climate Change, a Regulatory Revolution?

FRONTIER ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $320B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Executive summary

To date, Australian institutional investors have chosen whether to (or not to) formally integrate climate-related factors into their investment and disclosure processes. Frontier's view is that the wide disparity across asset owners in the degree to which they consider climate-related investment factors has been, at least in part, due to it being discretionary. Now however, we observe clear signs that going forward, such integration will no longer be a choice.

Globally, there has been a step change increase in focus by regulators on the assessment and management of climate-related risks and opportunities, as well as environmental, social and governance (ESG) related factors more generally. Locally, the Australian Prudential Regulation Authority (APRA), while perhaps slower off-the-mark relative to its counterparts (particularly in Europe and the UK), has become increasingly vocal and prescriptive on the need for effective management by regulated entities of financial risks associated with human-induced climate change.

It would seem inevitable that integration of climate factors (and potentially broader ESG considerations) will become a standing requirement of superannuation trustees in the short to medium term. For trustees who have not already taken proactive steps to formally consider climate/ESG factors, serious consideration should be given to doing so ahead of the rising tide of regulatory pressure. Furthermore, while formal enforcement may well end up coming from the regulators, we note that it may also arise informally through competition, pressure from stakeholders and the wider community.

APRA's survey and information paper

As the most recent expression of APRA's increasing focus on climate factors, it recently published an information paper with the findings of its 2018 climate change survey[1] that focused on areas closely aligned with the framework developed by the Task Force on Climate-related Financial Disclosures (TCFD). 38 large regulated entities (registrable superannuation entities (RSEs), insurers (life, general and private health) and banks) were surveyed.

Broader themes arising from the survey suggest that RSEs are at varying stages along the path toward formalised integration of climate and ESG more generally. Even so, it was notable that all responding RSEs stated they recognised the potential financial risks and opportunities that come with climate change and are taking steps to improve their understanding. The dispersion between RSEs with regards to ESG integration today is significant, but APRA was encouraged to see the general trend of investor ESG integration is positive.

Key findings from the survey are:

- All responding RSEs and general insurers are taking steps to improve their understanding of climate risks;
- No responding RSEs view climate risks to be immaterial from a financial perspective;
- RSEs generally indicated their investment teams (including an increasing number of ESG specialists) have day-to-day responsibility for assessing and managing climate-related financial risks;
- Only around 40% of RSEs surveyed are currently undertaking specific climate change scenario/stress-testing analysis, although 30% suggested they may do so in future; and
- 70% of RSEs advised they are disclosing climate-related financial risks.

While APRA's lack of movement with respect to a greater prescriptiveness in its standards on climate integration is a topic of much discussion, it nonetheless has made clear that it expects to see "a continuous improvement in the sophistication of entities' management of climate change risks and preparations for the transition to a low-carbon economy". APRA also expects to see an increase in regular stress-testing and the adoption of the TCFD voluntary disclosure framework. While only 40% of superannuation funds currently do so, Frontier has observed a sharp uptick in the degree of interest in its Climate Module (as part of the PRISM platform) from clients and prospects alike.

[1]APRA March 2019 Information Paper "Climate Change: Awareness to Action"

Recent action from the regulators

APRA has repeatedly signalled that climate change risks are "material, foreseeable and actionable now"[2]. APRA Executive board member and Head of Insurance, Geoff Summerhayes, recently reiterated at the May 2019 Australian Council of Superannuation Investors (ACSI) conference that the regulator does not view climate change as a moral or ethical issue, but as one that is distinctly financial in nature.

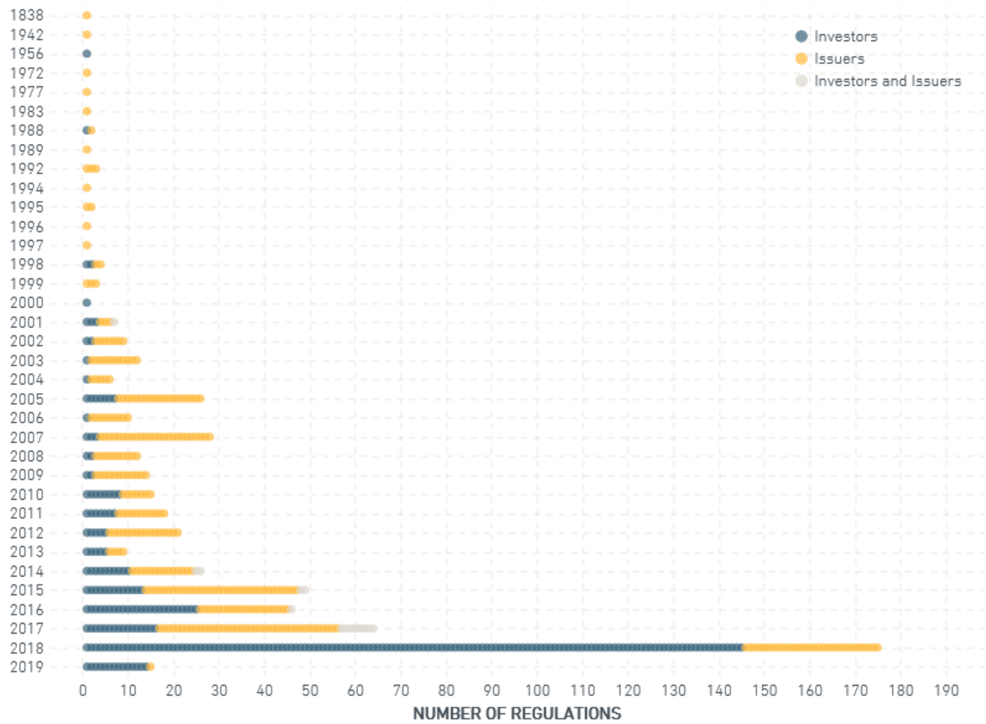
APRA has previously indicated it does not have any short-term plans to issue additional prudential standards prescribing minimum expectations specific to the management of climate change risks. Nonetheless, it will embed the assessment of climate change risk into its ongoing supervisory activities (within the existing prudential framework of CPS 220 and SPS 220 (Risk Management) in an increasingly "intense" manner.

Although the current language in APRA's Prudential Standard SPS 530 (Investment Governance) lags the current positioning statements and still conflates ESG and ethical investing, it is Frontier's view that APRA has concluded that the SIS Act, which requires RSEs to "perform the trustee's duties in the best interests of the beneficiaries" is not in conflict with ESG integration. It is the definition of acting "in the best interest of the beneficiaries"[3] that has evidently changed in the eyes of the regulator in response to the increasing evidence that ESG can bare real, material financial risk.

Other Australian regulatory bodies are riding the wave, as evidenced by their involvement in Australian Sustainable Finance Initiative – and other working groups looking at ESG and climate-related risks[4]. John Price, Commissioner at the Australian Securities and Investments Commission (ASIC), stated that ASIC's two key priorities regarding climate change risks were 1) To encourage strong and effective corporate governance, integrity, transparency and accountability and 2) Disclosure. Like APRA, ASIC suggests the voluntary framework developed by the TCFD may help companies and advisors when considering how to disclose climate related risks and opportunities.

Globally, we observe a clear upward trend in the level of regulatory action with respect to asset owners and their responsibilities around climate management and responsible investment more generally. The following chart from MSCI shows the rapid increase in ESG-related regulation activity in recent years, with 2018 representing somewhat of a watershed period. While European and UK regulators have been the leaders in these efforts, APRA has clearly been monitoring these developments, referencing the dynamic in its climate information paper as being indicative of how investment markets are evolving.

Chart 1: History of ESG Regulation



Source: MSCI

[2]APRA February 2017 (Australia's new horizon: Climate change challenges and prudential risk)

[3]Superannuation Industry (Supervision) Act 1993, No. 78 (Registered 24 April 2019)

[4]Regulation Asia March 2019 (Australian Financial Sector Teams Up on Climate Initiative)

Other pressures for ESG integration are rising

Pressure on asset owners to formally integrate and disclose their climate/ESG activities is not only rising from a regulatory perspective. Members and their representative bodies, as well as broader competitive dynamics are contributing to this greater momentum.

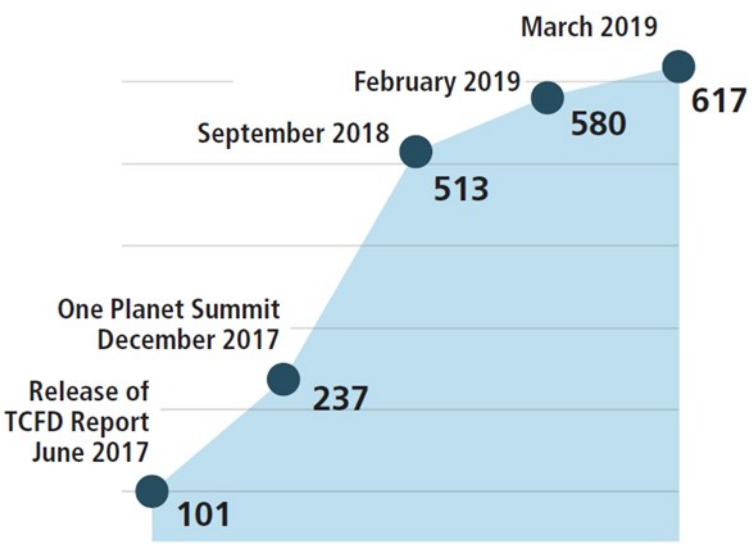
ACSI's Chief Executive, Louise Davidson, recently noted that "Australia's regulatory framework lags behind other developed economies in recognising the importance of ESG factors" but that "momentum for change is strong following the royal commission". ACSI has recently reinforced its recommendation that APRA revise its guidance to recognise the importance of ESG issues in investment strategies. ACSI has also proposed to extend its own regulatory framework – that investors can voluntarily adopt – for stewardship (Australian Asset Owner Stewardship Code 2018) to apply to all institutional investors.

The working group on TCFD has stated that "companies that invest in activities susceptible to climate-related risks may be less resilient to the transition to a low-carbon economy and their investors may experience lower returns[5].

This statement supports the ever-increasing pool of evidence of the relationship between climate change risks and financial risk. A company's failure to properly manage ESG risks can have a material negative impact on reputation and social licence – as well as open the doors to regulatory risk, litigation – ultimately lending itself to financial risk. It is therefore unequivocally in the best interest of investors to assess and manage risks related to climate change and ESG more broadly. The rise in interest and support for TCFD continues to grow as shown in the following chart.

We are seeing members increasingly push RSEs to take a broader scope when considering member interest, demonstrating that those interests extend beyond financial interests alone – to include other impacts, such as environmental and social. The case of a member of REST taking legal action against the fund on the grounds of insufficient consideration of climate-related risks is a high-profile example.

Chart 2: Number of TCFD Supporters



Source: TCFD

[5]TCFD September 2018 (Status Report)

The final word...

It is now widely recognised that climate change (and ESG more broadly) can, and does, have a material impact on financial markets. Investors need to be able to assess and manage the risks and opportunities that are shaping the current and future economic environment.

Australia is lagging behind other developed countries regarding the regulation of ESG integration, but this gap is beginning to close. Pressure is also coming from competition, stakeholders and the wider community, and quickly shaping the players in the financial services industry, including regulators.

APRA continues to promote the assessment and management of climate change-related risks as being a fiduciary duty of regulated entities. We note that even if formal standards are not being introduced in the short term, this may still occur over time and perhaps apply to broader ESG considerations, not just climate change. APRA anticipates regulated entities will continue to improve in their awareness and action regarding climate change and prepare for the transition to a sustainable low-carbon economy. In line with APRA's support of industry-led initiatives, the assessment of climate change risks will be increasingly integrated into APRA's ongoing supervisory activities in future.