

SUBMISSION TO APRA IN RESPONSE TO THE POST-IMPLEMENTATION REVIEW OF THE PRUDENTIAL FRAMEWORK OF SUPERANNUATION FUNDS

26 September 2018

General Manager, Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

INTRODUCTION

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2,000 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US \$82 trillion in assets under management. Over 130 signatories, managing AUD \$2.6 trillion are based in Australia.¹

As the world's leading initiative on responsible investment, the PRI works with many superannuation fund trustees as signatories to the PRI. Registrable Superannuation Entity (RSE) licensee signatories have committed to the following six Principles:

1. to incorporate Environmental, Social, and Governance (ESG) issues into investment analysis and decision-making processes
2. to be active owners and incorporate ESG issues into their voting and engagement policies and practices
3. to seek appropriate disclosure on ESG issues by the entities in which they invest
4. to promote acceptance and implementation of the Principles within the investment industry
5. to work together to enhance their effectiveness in implementing the Principles
6. to publicly report on their activities and progress towards implementing the Principles

Responsible investment explicitly acknowledges the relevance to investors of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of the financial system.

The PRI welcomes the opportunity to contribute to APRA's review of the prudential framework of superannuation funds. We have focused this submission towards the aspects of the prudential framework which are relevant to the Principles.

¹See <https://www.unpri.org/signatory-directory/>

ABOUT THE REVIEW

The Australian Prudential Regulation Authority (APRA) commenced a post implementation review of the prudential framework for Registrable Superannuation Entity (RSE) Licensees in May 2018. The prudential framework regulates authorised deposit taking institutions (ADIs), superannuation funds, and insurers, and was implemented in and around 2013.

The framework consists of principles-based prudential standards which are binding law on APRA regulated entities, and prudential guidance which intends to assist regulated entities in adopting business practices consistent with the prudential standards.

The scope of the review is focused on the effectiveness of the current framework in meeting its objectives and remaining fit for purpose and is not seeking to revisit the original policy objectives, or to weaken or strengthen the prudential framework.

APRA has released short topic papers seeking views on risk management, governance, investments, financial requirements, operational risk, and outsourcing. The consultation includes the following relevant questions:

- Whether the outcomes are in line with the objectives;
- Whether the standards and guides provide adequate clarity, certainty and flexibility; and
- How the standards and guides could be improved to achieve better risk management outcomes and facilitate better supervision

APRA have invited consultation with stakeholders to provide feedback on the prudential framework. Seeking views on:

- The effectiveness of the current prudential and reporting standards and supporting guidance material;
- The practical impact on the framework for stakeholders;
- Areas of the framework that can be reviewed to enhance outcomes or reduce costs; and
- The merits of potential changes to the framework to achieve this.

APRA indicated that the objectives of the prudential standards were to apply standards to all trustees that are aligned appropriately with existing good standards of governance in the superannuation industry regulated by APRA, and to improve the alignment of requirements across the industries APRA regulates (noting the careful consideration which was given to the structure of the superannuation industry, which resulted in some exceptions to this objective).

The APRA objectives of the prudential and reporting standards were to provide increased clarity and certainty for trustees, increased alignment with the prudential framework that applied to other parts of the prudentially regulated financial sector where appropriate, and enhanced data collection and publication to promote increased transparency on the industry.

SUMMARY OF THE PRI'S POSITION

The investment of fund assets is a fundamental responsibility by RSE Licensees. The PRI believes that asset owners should have regard to the following factors when developing an investment strategy:

- Identifying ESG factors as material (risks and/or opportunities);
- Incorporating ESG factors into investment analysis;
- Actively engaging with companies invested in; and
- Understanding and incorporating the sustainability preferences of beneficiaries into investment analysis.

The PRI holds the view that the prudential framework could be improved by better alignment with the Principles for Responsible Investment, to be more effective in achieving its policy objective of achieving better risk management outcomes and managing material risks in the best interests of beneficiaries.

We recommend that this is achieved through making amendments to the **investment governance** and **risk management** prudential standards and guidance to clearly reflect:

1. the broadly accepted materiality of ESG risk factors for RSE licensees as long-term asset owners and investors; and
2. the material role that ESG factors play in investment analysis and decision making for superannuation fund trustees as asset owners and any investment managers, and in particular, that climate risks should be incorporated alongside other material risk and return factors in investment decision making.

Importantly, the PRI also supports APRA's position that it is important for the prudential framework to maintain flexibility to enable RSE Licensees to approach their responsibilities in a manner consistent with their mandate and needs of beneficiaries.

This however should be balanced with principles-based supervision designed to promote practices and behaviours which maximise the probability of satisfying the best long-term financial outcomes for beneficiaries. Accordingly, the PRI recommends that improvements are made to the prudential standards and related guidance. These recommendations follow the PRI's fiduciary duty Australia roadmap² and the PRI's TCFD Australian country review³, which calls on the Government to endorse the TCFD's recommendations.

Prudential standards

The PRI recommends the improvement of **SPS 220 (Risk Management)** to include ESG risk in the minimum risk coverage of the risk management framework (either as a stand-alone or as a specific inclusion for investment governance risk) as a way of improving the effectiveness in achieving the policy objectives of managing material risks in the best interests of beneficiaries.

Prudential guidance

The PRI also recommends the following improvements to the prudential guidance, to improve the effectiveness in achieving the policy objectives:

² <https://www.unpri.org/download?ac=1385>.

³ <https://www.unpri.org/policy-and-regulation/tcf-recommendations-country-reviews--australia/2886.article>.

- improve attachment A to SPG 220 (Risk Management) to include ESG risk as a material risk
- improve wording in SPG 530 (Investment Governance), specifically sections 34-36, to:
 - remove ambiguity in the wording around ESG and better align with global equivalents;
 - provide clarify that trustees are obliged to take material environmental, social and governance factors into account in their investment decision; and
 - provide clarity that trustees are permitted to take other environmental, social and governance and ethical factors into account provided all other obligations under the *Superannuation Industry (Supervision) (SIS) Act* are complied with.

DETAILED RESPONSE TO QUESTIONS RAISED BY THE REVIEW

The PRI has focused its response on the aspects of the prudential framework which relate to the Principles for Responsible Investment and have not answered all questions asked by APRA.

- What outcomes have resulted from the implementation of the prudential standards and are these outcomes in line with their objectives?
- Are there any aspects of the prudential standards or prudential practice guides that could be improved to achieve better risk management outcomes?

Risk management

The objective of SPS 220 is to ensure that RSE licensees have in place effective risk management frameworks that include systems for identifying, assessing, managing, mitigating and monitoring material risks, and accompanying structures, policies, processes and people to support their effective implementation.

Paragraph 10 of SPS 220 requires all RSE licensees ensure that its risk management framework covers **all material risks**, both financial and non-financial, to the RSE licensee's business operations. Paragraph 12 prescribes certain risks as being the minimum coverage of material risks, however does not specifically nominate ESG risk.

The current wording of SPS 220 accommodates the consideration of ESG factors under the catch all clauses requiring RSE licenses to identify "other risks that may have a material impact on the RSE licensee's business operations."⁴ Furthermore, investment governance risk is nominated as a material risk which must be covered at a minimum by RSE licensees.⁵

The importance of ESG risk factors to RSE licensees as asset owners with long term investment horizons heightens the importance of elevating the requirement to consider ESG factors as a material risk, rather than relying on a catch all or investment governance material risk.

The PRI does not believe that the identification of ESG risk factors as material risks to all RSE licensees will constrain or restrict the investment activities or objectives of RSE

⁴ SPS 220 (Risk Management) p.12(g).

⁵ SPS 220 (Risk Management) p.12(b).

licensees, rather it will ensure that a robust process is followed in managing ESG risks within the RSE’s appetite.

The PRI considers that ESG risk factors should be identified as a material risk by all RSE Licensees, if the prudential standards are to be effective in achieving the policy objective of achieving better risk management outcomes and managing material risks in the best interests of beneficiaries.

The PRI does not consider the prudential framework to have been effective in this regard, as ESG risk factors are often not identified as material risks by RSE Licensees.

Accordingly, the PRI proposes two possible approaches to improving paragraph 12 of SPS 220:

SPS 220 Improved Wording Proposal A	SPS 220 Improved Wording Proposal B
<p>12. An RSE licensee’s risk management framework must, at a minimum, cover:</p> <ul style="list-style-type: none"> (a) governance risk; (b) investment governance risk; (c) liquidity risk, including the liquidity characteristics of investment options offered or proposed to be offered; (d) operational risk; (e) insurance risk; (f) strategic and tactical risks that arise out of the RSE licensee’s strategic and business plans; (g) environmental, social, and governance risks; and (h) other risks that may have a material impact on the RSE licensee’s business operations. 	<p>12. An RSE licensee’s risk management framework must, at a minimum, cover:</p> <ul style="list-style-type: none"> (a) governance risk; (b) investment governance risk, including the role of environmental, social, and governance risk factors; (c) liquidity risk, including the liquidity characteristics of investment options offered or proposed to be offered; (d) operational risk; (e) insurance risk; (f) strategic and tactical risks that arise out of the RSE licensee’s strategic and business plans; and (g) other risks that may have a material impact on the RSE licensee’s business operations.

Attachment A to *Prudential Practice Guide SPG 220 Risk Management* (SPG 220) provides a description of APRA’s expectation of the categories of material risk.

To correspond with the inclusion of ESG as either a stand-alone material risk or nominated as an aspect of investment governance risk, the PRI recommends that SPS 220 is improved to describe ESG risk.

SPG 220 Additional Wording	SPG 220 Improved Wording
<p><i>Attachment A</i></p> <p>Environmental, social, and governance risks are the risks to sustainability and impact of the RSE investments resulting from:</p>	<p>6. Investment governance risk is the risk that threatens the ability of an RSE licensee to manage its investments to adequately protect the interests, and meet the reasonable expectations, of beneficiaries.</p>

SPG 220 Additional Wording	SPG 220 Improved Wording
<p>(a) environmental factors relating to the natural environment which may include, but is not limited to:</p> <ul style="list-style-type: none"> - climate change, including physical climate risk and climate transition risk. - resource depletion, including water - waste and pollution - deforestation <p>(b) social factors which may include, but is not limited to:</p> <ul style="list-style-type: none"> - working conditions, including slavery and child labour - local communities, including indigenous communities - conflict - health and safety - employee relations and diversity <p>(c) governance issues which may include, but is not limited to:</p> <ul style="list-style-type: none"> - executive pay - bribery and corruption - political lobbying and donations - board diversity and structure - tax strategy 	<p>Investment governance risks may include, but are not limited to, weaknesses in:</p> <p>(a) the investment governance framework;</p> <p>(b) delegations and decision-making processes;</p> <p>(c) the integration of environmental, social, and governance factors in investment strategy and decision-making;</p> <p>(d) the selection, retention, monitoring and reporting of investments; and</p> <p>(e) management of the services provided by investment managers, advisors and other third-party service providers.</p>

Investment Governance

The objective of **SPS 530 (Investment Governance)** is to ensure that RSE licensees have a sound investment governance framework and manage investments in a manner consistent with the best interests of beneficiaries.⁶

Paragraph 18 of SPS 530 requires RSE licensees to identify the risk factors, and sources of return with which the risk factors are associated when determining an appropriate level of diversification for each investment strategy.⁷ RSE licensees are also required to set target exposures for identified risk factors.

The PRI considers that ESG risk factors, and appropriate target exposure should be included in the investment analysis activity undertaken by or on behalf of RSE Licensees, including when determining the appropriate level of diversification for each investment strategy.

While considered best practice by the PRI, the integration of ESG risk factors in the investment decision-making process is only being adopted by some RSE licensees. The Responsible Investment Association of Australia recently found that 22 out of 53 RSE

⁶ Prudential Standard SPS 530, Investment Governance.

⁷ Prudential Standard SPS 530, Investment Governance p.18.

licensees (42%) surveyed noted the systematic analysis of ESG factors by internal investment functions.⁸

The PRI does not consider the prudential framework has been effective in this regard, as ESG risk factors are often not adequately integrated in the investment governance framework of RSE licensees.

If the prudential framework is to be effective in achieving the policy objective of ensuring that RSE licensees implement a sound investment governance framework and to manage investments in a manner consistent with the interests of beneficiaries, the PRI recommends that improvements are made to the investment governance prudential guidance.

Prudential Practice Guide SPG 530 Investment Governance (SPG 530) includes three paragraphs addressing the role of environmental, social, and governance issues within an RSE licensee’s investment strategy.⁹

The PRI proposes changes to the wording of these paragraphs in order to:

- Remove ambiguity in the wording around ESG and better align with global equivalents;
- Provide clarify that RSE licensees are obliged to take material environmental, social and governance factors into account in their investment strategy and activities; and
- Provide clarify that RSE licensees are permitted to take other environmental, social and governance and ethical factors into account provided all other obligations under the SIS Act are complied with.

SPG 530 Existing Wording	SPG 530 Improved Wording
<p>34. The SIS Act requires an RSE licensee, when formulating an investment strategy, to give regard to the risk and the likely return from the investments, diversification, liquidity, valuation and other relevant factors. An RSE licensee may take additional factors into account where there is no conflict with the requirements in the SIS Act, including the requirement to act in the best interests of the beneficiaries. This may result in an RSE licensee offering an ‘ethical’ investment option to beneficiaries to reflect this approach. An ‘ethical’ investment option is typically characterised by an added focus on environmental, sustainability, social and governance (ESG) considerations, or integrates such considerations into the formulation of the investment strategy and supporting analysis.</p>	<p>34. The SIS Act requires an RSE licensee, when formulating an investment strategy, to give regard to the risk and the likely return from the investments, diversification, liquidity, valuation and other relevant factors. APRA expects that this would include the systematic and explicit integration of material ESG factors into investment strategy, analysis and decision-making even where there are no “ethical”, “themed”, or “impact” investment objectives for the strategy.</p> <p>An RSE licensee may also incorporate additional factors into investment strategies (including ‘ethical’, ‘themed’ and/or ‘impact’ investments), provided that it is consistent with the investment objectives and satisfies the requirements of the SIS Act, including the requirement to act in the best interests of the beneficiaries.</p>
<p>35. APRA expects that an RSE licensee would have a reasoned basis for</p>	<p>35. APRA expects that an RSE licensee would have a reasoned basis for</p>

⁸ Super Fund Responsible Investment Benchmark Report 2018, Responsible Investment Association Australasia

⁹ Prudential Standard SPS 530, Investment Governance p,34-36.

SPG 530 Existing Wording	SPG 530 Improved Wording
<p>determining that the investment strategy formulated for such an investment option is in the best interests of beneficiaries, and that it satisfies the requirements of s. 52 of the SIS Act for liquidity and diversification.</p> <p>While ESG considerations may not be readily quantifiable in financial terms, APRA expects an RSE licensee would be able to demonstrate appropriate analysis to support the formulation of an investment strategy that has an ESG focus.</p>	<p>determining that the investment strategy is in the best interests of beneficiaries, and that it satisfies the requirements of s. 52 of the SIS Act for liquidity and diversification.</p> <p><i>APRA expects an RSE licensee would be able to demonstrate appropriate analysis to support the formulation of all the licensee's investment strategies.</i></p>
<p>36. In offering such investment options, a prudent RSE licensee would be mindful of exposing the interests of beneficiaries to undue risk stemming from matters such as a lack of diversification, where investment in some industries are excluded or a positive weighting is placed on certain nonfinancial factors as a result of ESG considerations.</p>	<p>Remove</p>

The proposed improvements to **paragraph 34** would provide greater clarity to RSE licensees that ESG factors are able to be integrated in the investment strategy in all circumstances.

We recommend that **paragraph 35** is improved by removing the statement “while ESG considerations may not be readily quantifiable in financial terms” from the guidance, as this can be seen as suggesting that the integration of ESG factors may be inconsistent with fiduciary and statutory (s. 52 SIS Act) duties.

The PRI also recommends that **paragraph 36** is removed, as the paragraph seems to confuse ESG risk factors with ethical, themed, or impact investment objectives and suggests that the integration of ESG factors in decision-making limits of constrains the RSE licensee's ability to adequately diversify investments.

For further details, please contact:

Will Martindale, Head of Policy, PRI

M: +44 (0) 78 0583 6778

Email: Will.Martindale@unpri.org

Matthew McAdam

Head of Australasia, PRI

M: +61 (0) 427 535 380

Email: Matthew.McAdam@unpri.org