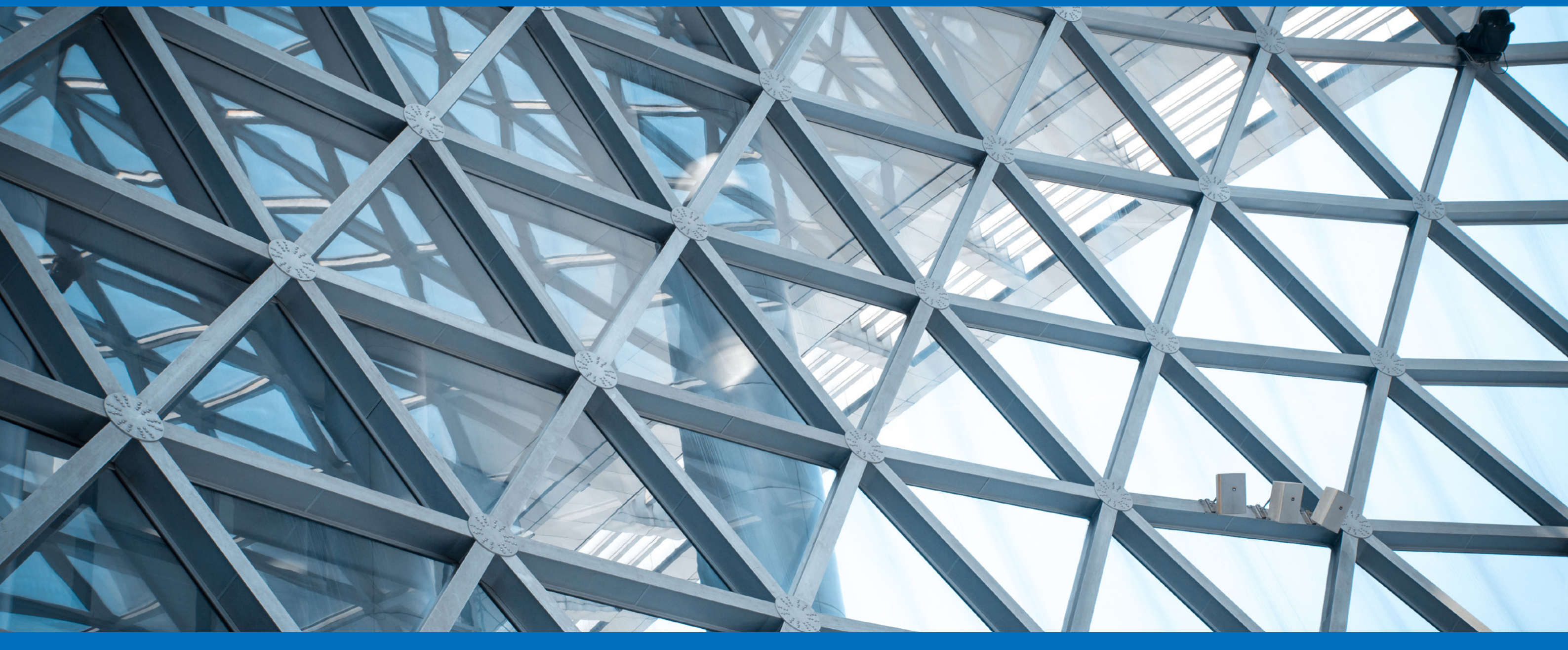
Australian Council of Superannuation Investors

Towards Stronger Investment Stewardship



May 2019

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ABOUT ACSI

ACSI provides a strong, collective voice on environmental, social and governance (ESG) issues on behalf of our members.

Our members include 39 Australian and international asset owners and institutional investors. Collectively, they manage over $2.2 trillion in assets and own on average 10 per cent of every ASX200 company.

Through ACSI, our members collaborate to achieve genuine, measurable and permanent improvements in the ESG practices and performance of the companies in which they invest.

INTRODUCTION

The Final Report of the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* outlined the need for change in the finance sector.[1] It is imperative that we keep building on the momentum generated by the Royal Commission. This is an opportunity for businesses, boards and governments to rebuild trust with Australians and adopt long-term sustainable practices, underpinned by the responsible management of assets. Strengthening the framework for investment stewardship is an essential component.

While there are some variations in definitions, stewardship generally involves active oversight by asset owners and asset managers of the assets in which they invest. Stewardship activities include monitoring assets and service providers, engaging with issuers and holding them to account on material issues, voting and publicly reporting on the outcomes of these activities.[2]

Our members consider that long-term, sustainable investment is underpinned by ESG principles. We regard good stewardship and effective fulfillment of ESG principles as complementary.

This policy outlines proposals to strengthen investment stewardship by making it more consistent, which we will advocate for on behalf of our members and investors. Stronger investment stewardship will support the quality and integrity of our financial markets and contribute to sustainable long-term value creation for beneficiaries.[3]

POLICY PROPOSALS	
1	Revise APRA standards and guidance to explicitly recognise the importance of ESG issues in the formulation of investment strategies and require superannuation trustee boards to have access to capacity and competence on ESG issues.
2	Review the regulatory framework for stewardship. The review should consider appropriate minimum standards and reporting, the appropriate regulatory framework, and a stewardship code that applies to all institutional investors.

ACHIEVING STRONGER STEWARDSHIP

ESG considerations have a material financial impact on investment value over the long term. Effective stewardship aims to protect and enhance the long-term value of investments. The Royal Commission has given organisations the drive for change. It is now imperative to deliver on that momentum and achieve stronger stewardship and ESG outcomes.

Stronger stewardship can be achieved through:

Revised APRA guidance → Framework for stewardship → Broad Stewardship Code

[1] *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, website, https://financialservices.royalcommission.gov.au/Pages/default.aspx, accessed 28 February 2019.

[2] UK Financial Conduct Authority/Financial Reporting Council Discussion Paper DP19/1 January 2019 Building a regulatory framework for effective stewardship p.11. The UK FCA and FRC are currently consulting on the definition of stewardship.

[3] Ibid p.4

APRA STANDARDS AND GUIDANCE

The Australian Prudential Regulation Authority (APRA) is the Australian financial services regulator with responsibility for the banking, insurance and superannuation sectors. APRA's prudential standards and guidance are limited in their coverage of ESG principles and need to be clarified.

APRA recently released Information Paper *Review of APRA's 2013 superannuation prudential framework*. While the primary purpose of this review was to look at the effectiveness of the 2013 framework, the Information Paper also identifies potential areas for future enhancement. One of the areas identified for enhancement is to review and update the guidance on consideration of ESG factors in formulating an investment strategy. We support ESG integration being incorporated into APRA standards and guidance.

In particular, APRA Practice Guide SPG 530 – *Investment Governance*[4] highlights that the *Superannuation Industry (Supervision) Act 1993* (SIS Act)[5] requires a Registrable Superannuation Entity (RSE) to consider the risk and likely return from investments, diversification, liquidity, valuation and other relevant factors. It identifies that where it does not conflict with the requirements of the Act, RSEs are permitted to consider additional factors to act in the best interest of beneficiaries.[6]

SPG 530 currently provides that ethical investing could be one of the additional factors that an RSE licensee may consider. According to this guidance, 'ethical investment' is "typically characterised by an added focus on environmental, sustainability, social and governance considerations, or integrates such considerations into the formulation of the investment strategy and supporting analysis."

SPG 530 confuses two different concepts. Ethical investing attempts to balance the desire for returns with an investor's values by excluding investments that are inconsistent with those values (for example, excluding investments in tobacco, firearms or gambling). ESG integration on the other hand takes a different approach, based on the premise that investments will perform better over the long term when ESG risks and opportunities are appropriately managed. Therefore, the management of ESG risks and opportunities is material to long-term returns.

Commissioner Hayne highlighted aspects of this approach in the Final Report of the Royal Commission:

The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long-term financial advantage. And long-term financial advantage will more likely follow if the entity conducts its business according to proper standards, treats its employees well and seeks to provide financial results to shareholders that, in the long run, are better than other investments of broadly similar risk.[7]

Updating the APRA standards and guidance to reflect ESG integration would align with global investment practice. For example, the regulator of auditors, accountants and actuaries in the United Kingdom (UK), the Financial Reporting Council (FRC), is proposing changes to the UK's Stewardship Code to require signatories to integrate stewardship into their investment approach and demonstrate how they take material ESG issues into account when fulfilling their stewardship responsibilities.

[4] Australian Prudential Regulatory Authority, *SPG 530 – Investment Governance*, November 2013, p.5.
[5] Commonwealth Government, *Superannuation Industry (Supervision) Act 1993*, Section 52, website, https://www.legislation.gov.au/Details/C2019C00114, accessed 9 April 2019.
[6] Australian Prudential Regulatory Authority, *SPG 530 – Investment Governance*, November 2013, paragraph 34, p.8.
[7] *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, https://financialservices.royalcommission.gov.au/Pages/default.aspx, p.403.

The FRC consultation paper[8] highlights significant developments that support an ESG integration approach. These include:

- Clarification by the UK Law Commission that it is within trustees' duties to take account of material ESG factors[9]
- The growth of over 300 policy instruments in the largest 50 economies to support investors to consider long-term value drivers, including ESG factors[10]
- Explicit reference to ESG issues in international stewardship codes issued since the last revision of the UK Stewardship Code.[11]

In addition, the International Organization of Securities Commissions recently made a statement highlighting the importance for issuers of considering the inclusion of ESG information when making disclosures.[12]

These examples demonstrate there is significant opportunity to bring Australia up to date with other developed markets. We also recommend that trustee boards be required to have access to capacity and competence on ESG issues.

We welcome the potential revision of APRA standards and guidance and recommend that the materiality of ESG considerations to investment risk and return be explicitly recognised. We recommend that further consultation takes place as soon as possible.

PROPOSAL 1

Revise APRA guidance to explicitly recognise the importance of ESG issues in the formulation of investment strategies and require superannuation trustee boards to have access to capacity and competence on ESG issues.

[8] UK Financial Reporting Council Proposed Revision to the UK Stewardship Code January 2019 Annex A Revised UK Stewardship Cod page 2 https://www.frc.org.uk/getattachment/bf27581f-c443-4365-ae0a-1487f1388a1b/Annex-A-Stewardship-Code-Jan-2019.pdf, accessed 9 April 2019.

[9] The Law Commission, Fiduciary Duties of Investment Intermediaries, June 2014. See also The Law Commission, Pension Funds and Social Investment, June 2017.

[10] UNPRI, *Global Guide to Responsible Investment Regulation* https://www.unpri.org/download?ac=325 accessed 9 April 2019.

[11] UK Financial Reporting Council Proposed Revision to the UK Stewardship Code January 2019 p.8. https://www.frc.org.uk/getattachment/dff25bf9-998e-44f6-a699-a697d932da60/;.aspx accessed 9 April 2019.

[12] Statement on Disclosure of ESG Matters by Issuers, Statement of the Board of IOSCO 18 Jan 2019 https://www.iosco.org/publications/?subsection=public_reports.

STEWARDSHIP FRAMEWORK

ACSI believes a discussion on the regulatory aspects of stewardship would benefit the Australian market. This could pave the way towards more consistent investment stewardship, promote higher stewardship standards and put Australia's financial services sector on par with global best practice. A key focus of the discussion would be to advance the debate about what effective stewardship entails, what the minimum expectations should be, and how to strike the right balance between regulation and voluntary codes. The terms of reference should include consideration of a stewardship code that applies to institutional investors broadly (discussed below).

Regulators in the UK are currently conducting a similar conversation.[13] This process recognises that a lack of shareholder engagement and poor corporate governance can result in short-termism. The discussion also includes consultation on an updated stewardship code. The UK Stewardship Code is underpinned by the Financial Conduct Authority's (FCA)[14] requirement that firms disclose their commitment to the UK Stewardship Code, or where the firm does not commit, its alternative investment strategy.[15] The revised UK Stewardship Code aims to more clearly focus on outcomes and effectiveness. The consultation draft of the UK Code specifically asks signatories to demonstrate how they take material ESG issues into account.

A BROADER STEWARDSHIP CODE

In Australia, ACSI developed the Australian Asset Owner Stewardship Code (Code). The Code provides principles and guidance to assist improve the transparency of asset owners' stewardship practices in fulfilling their fiduciary obligations to their beneficiaries. It recognises the role of asset owners in setting the tone for behavior across the industry, and the influence they exert over asset managers. While the Financial Services Council (FSC) also has a number of relevant standards,[16] they apply to FSC members, and not the market more broadly.

The UK has had a Stewardship Code since 2010, recognising that as providers of capital, collective investment vehicles such as superannuation funds establish the tone for stewardship and can directly influence effective implementation across industry.

With day-to-day responsibility for managing investments, asset managers also influence long-term investment performance. As a result, the UK Stewardship Code is directed at 'institutional investors' more generally – which includes asset owners and asset managers.[17] The UK Stewardship Code also states "the Code also applies, by extension, to service providers, such as proxy advisors and investment consultants." At all times, however, institutional investors are responsible for ensuring that outsourced activities abide by their own stewardship approaches.

The benefits of a stewardship code that applies to a more comprehensive array of stakeholders are tangible. For example, where asset managers are signatories to the UK Stewardship Code, asset owners are better equipped to judge the compatibility of their manager's stewardship commitments with their own. Conversely, asset managers are better able to meet asset owners' expectations.

It is ACSI's view that a stewardship code that is applicable to all institutional investors should be introduced, within an appropriate regulatory framework. This could be undertaken in coordination with relevant stakeholders such as APRA and the FSC, and as part of the consultation outlined above.

PROPOSAL 2

Review the regulatory framework for stewardship. The review should consider appropriate minimum standards and reporting, the appropriate regulatory framework, and a stewardship code that applies to all institutional investors.

[13] Financial Conduct Authority & Financial Reporting Council, *Building a Regulatory Framework For Effective Stewardship*, January 2019.

[14] The Financial Conduct Authority is the UK's conduct regulator for financial services firms and financial markets in the UK.

[15] The UK's Financial Conduct Authority Code of Business Sourcebook provision 2.2.3 requires any firm authorised to manage funds, which is not a venture capital firm and which manages investments for professional clients that are not natural persons, to disclose clearly on its website the nature of its commitment to the FRC's UK Stewardship Code, or where it does not commit to the Code, its alternative investment strategy. https://www.handbook.fca.org.uk/handbook/COBS/2/?view=chapter.

[16] Such as FSC Standard No 20. Superannuation Governance Policy, FSC Standards 23: Principles of Internal Governance and Asset Stewardship and FSC Standard no. 13: Voting Policy, Voting Record and Disclosure https://www.fsc.org.au/resources/standards.

[17] Financial Reporting Council (UK), *The UK Stewardship Code*, September 2012, p.2.

[18] Ibid.

CALL TO ACTION

The proposals outlined in this document will help establish an appropriate regulatory and stewardship framework.

Momentum currently exists across global capital markets to strengthen investment stewardship in the finance sector. This is complemented by a similar momentum here in Australia, and a deep well of public support.

Policy makers have an opportunity to instigate changes in the Australian finance sector that are good for Australian investors, good for sustainable practices and in line with growing ESG expectations.

We are calling on policy makers and regulators to make a commitment to the proposals contained in this document:

1. **Revise the APRA standards and guidelines to explicitly recognise ESG issues in the formulation of investment strategies and require superannuation trustee boards to have access to capacity and competence on ESG issues.**

2. **Review the regulatory framework for stewardship. The review should consider appropriate minimum standards and reporting, the appropriate regulatory framework, and a stewardship code that applies to all institutional investors.**

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