Investor Decision-making on Climate Change in Australia: an empirical study

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Context…

Recognition of climate-related financial risks for investors

& potential to mobilize capital & resources to support clean energy transition / meet goals of Paris Agreement

Renewed attention to responsible investment – sustainable finance agendas, including Australia

Explore treatment of climate change in investment decision-making by a sample of large Australian institutional investors: -

- What climate risk management practices are emerging?
- How are these developments influenced by dominant finance theories & practices? by regulatory frameworks?
- Will these help to align capital & resources to the Paris transition?
- Is there a need for law & policy reform?

Finance Theory

three decision-making phases

Phase 1: Decision to invest

- MPT (optimal portfolio) & CAPM (expected return on an asset)
- Factor and thematic investing ('style')
- Use of screens (+ve or –ve)
- Integration of 'E' risks & opportunities into valuations
- Portfolio asset allocation: asset classes & weightings
- Scenario analysis
- Lifecycle investment

Phase 2: Ownership actions

- Asset class determines ownership rights available
- Agency theory for equities (finance view)
- Stewardship -
  - Information strategies
  - Engagement strategies: private and collective
  - Voting strategies
  - Threat of divestment

Phase 3: Divestment

- Economic motivations for climate change risk: stranded assets, risk of regulation & carbon pricing, competition from renewable energy sources, unstable fossil fuel prices
- A governance mechanism

Finance Theory

climate change as a risk within the portfolio

In all 3 phases key issue is how climate change risk is considered and factored into the decision-making process

- **Is climate change risk a systemic risk?**
  - If so, does it affect my valuation of the firm?
  - Depends upon my investment style and beliefs about climate change's influence at a systemic level on the levers that drive firm value
- **Is climate change risk thought of at an industry level/ location/ firm level?**
  - If so, does it affect my valuation of the firm?
  - Depends upon my investment style and beliefs about the influence of this risk at a firm level on the levers that drive firm value

Regulatory Context

Relevance of climate change to core duties & functions?

What should be disclosed?

- **Fiduciary Duties** - best (financial) interests of beneficiaries; due care & diligence (prudent superannuation trustee)
- **APRA Regulatory Standards** (investment governance & risk management) – minimal reference to ESG / not highlighted as financial risk
- Hutley & Mack (2017) – *'climate change risks can & should be considered by trustee directors to the extent that those risks intersect with the financial interests of a beneficiary.'*
- APRA (2019) – *'while the implications of a changing climate will have a long-term impact and the time horizon for the risks can be uncertain, this does not justify inaction… APRA continues to encourage regulated entities to consider climate risks within their risk management frameworks.'*
- **Disclosure** – rules (financial information, members) + voluntary standards, best practices (ESG, Climate)
  - TCFD – Paris-compliant scenario testing, targets

Empirical Study

Sample: top 10 superfunds by assets under management in MySuper option (June 2019)

- **Regulatory & Theoretical frameworks suggest that investors will:**
  - Include climate risk in investment & stewardship decisions where financially material
  - Employ responsible investment practices to address these risks (e.g. ESG integration, positive & negative screening)
  - Disclose sufficient information on these processes to assure key stakeholders
- **Desktop research:** product disclosure statements, annual reports, website, PRI reports, public statements, member communications…
- Focus on pre-mixed investment options & two particular asset classes (Australian & international equities)
  - balanced MySuper option
  - green / socially responsible option
- **Inquiry questions - how is climate change addressed in three phases of investment decision-making?**

Findings - Disclosure

- Level of disclosure is mixed - from detailed to opaque and even absent on basic factual details
- When disclosures are made, the quality is variable
- Both findings reflect the absence of an agreed framework (legislative supplemented by best practice)
- We rely on public information and this is inconsistent across the funds and products surveyed.

Findings Phase 1

portfolio composition, asset allocation

- 7 out of 10 funds offer green pre-mix option
- Very low uptake
  - Unisuper 3.5% total investments, Hesta 1.67%, Aussie Super 1.18%, Sunsuper 0.16%, 3 funds do not disclose
- Diversification – MySuper & Green pre-mix options have similar asset classes
  - Australian and international equities generally dominate (e.g. Aussie Super 56%)

Findings Phase 1

Addressing climate risks?

- Resources allocated to understand and assess exposure but different approaches taken and tend to focus on equities not all asset classes
- Little useful reporting of results or responses.
- Investment practices include aspects of Responsible Investment but also reflect finance theory approach
  - **ESG integration across whole portfolio** – ESG research & benchmarking considered along with other investment risks in asset valuation etc – impact is hard to gauge, may result in lower weightings or shorter holdings of higher risk companies
    - Hesta: *'[we] may still choose to invest in a company where there are ESG risks if [we] believe the risks are reflected in the price.'*
    - Aussie – *'Rather than excluding particular investments on the basis of [climate] factors, we weigh the risks and returns for each investment and determine the appropriate exposure'*
  - **Assessment / benchmarking of managers on ESG** – sig. variation
  - **Negative Screening / Exclusions** – generally only for Green option. 6 funds use climate screening, sig. variation. Generally target worst fossil fuels (thermal coal, oil sands) & set threshold on % of revenue (20% - 5%). Generally allow investment in associated assets (lenders, service providers, downstream companies)
  - **Positive Screening** – less visible, some examples – e.g. Hesta international passive low carbon shares strategy

Findings Phase 2

Stewardship

- **Engagement & active ownership** – framed as central strategy to address ESG risks
- Disclosure of engagement activities variable. Some disclosure of key themes (including climate), number of meetings, expectations of asset owners
- 6 of 10 funds are active in climate engagement coalitions – Climate Action 100+. Little reporting of outcomes.
- **Voting ESG Resolutions** – poor & variable disclosure, esp. for individual resolutions.
- Evidence of highly variable (inconsistent?) practice – e.g. Unisuper, Aussie Super, Cbus, REST voted against all / majority of climate change resolutions to Australian companies since 2016.

Findings Phase 3

Divestment

- Strong message *<u>against</u>* divestment as a climate risk management strategy (preference for engagement & active ownership)
  - Hostplus: "*avoid[s] divestment as it can cause company valuations to fall and shift these from public markets to private ownership with lower reporting obligations. This shift limits the ability to engage with these companies on meaningful climate change discussions*.'
- Australian equities – market dominated by banking and insurance, energy, materials – difficult to divest?
- International equities presents many more equity investment options

Conclusions & next steps

- Approaches to climate risk still developing, as understanding improves.
- Responsible investment / risk management practices in use are unlikely to align strategy with Paris goals. Stronger practices (e.g. screening) used sparingly in green options only.
- No targets for emissions reductions / low carbon investment
- Reliance on engagement – highly variable practice, poor transparency, hard to measure outcomes, question capacity to engage/monitor magnitude of equity assets.
- Current approaches supported by legal framework (neutral, principles-based, narrow focus on financial performance/material risk)
- Growing private regulatory signals for stronger response – TCFD, PRI, Climate Action 100+ - aligning with Paris (scenario testing, targets)
- Substantive law & policy reform?
  - EU models – disclosure, clarification on duties, taxonomy of green investment.
  - French Ecology & Transition Law (2015) – targets & reporting
- Rethinking finance models: 'theory of change' (impact investment)