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Environmental, Social and Governance (ESG) Factors in a Superannuation Context

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ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.8 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 16.1 million Australians with superannuation.

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Executive summary

Interest in Environmental, Social and Governance (ESG) factors, and the policies surrounding them, has increased quite rapidly over the past two decades.[1] ESG factors have been shown to impact on the risk and returns of investments[2] and, generally, a positive relationship has been shown to exist between integrating ESG factors in the investment process and financial effects.[3]

As such, part of a superannuation fund's practices to achieve good governance could include awareness and understanding of how ESG factors could impact their investment strategy and the broader operating environment. Especially so given APRA has advised there may be changes to the investment governance standard (SPG 530) to clarify how superannuation trustees should take into account ESG factors when developing investment strategies.

This paper provides an overview of ESG factors in a superannuation context to help superannuation trustees decide what is best for their fund. Key findings include:

- there is still a significant gap in the depth and breadth of available data on ESG factors
- there is still a question of which factors would have the greatest impact on financial performance and the type of corporate reporting that would support investors' analysis of ESG factors
- there is not a single approach to considering ESG factors that could be thought of as 'best practice'
- most entities apply their own particular approach to incorporating ESG factors into their investment decision making.

A key takeaway is that superannuation funds need to consider ESG factors from a ***value*** perspective (i.e. add to retirement savings outcomes) as opposed to a ***values*** perspective.

Environmental, social and governance (ESG) factors

The primary purpose and role of a superannuation fund trustee is to hold and invest the assets of the members to secure and maximise their retirement savings.[4] Given that many factors that fall under the ESG umbrella can influence investment returns over both short- and long-term time horizons[5], part of a superannuation fund's practices to achieve good governance can include awareness and understanding of how ESG factors could impact their investment strategy and the broader operating environment.[6]

Importantly, ESG factors are not static and evolve as markets change, requiring investors to likewise evolve. For investors - particularly superannuation funds with long-term investment horizons – there is a strong incentive to ensure that underlying investment processes can manage long-term risk and generate appropriate returns.

"Importantly, ESG factors are not static and evolve as markets change…"

Generally, a positive relationship has been shown to exist between integrating ESG factors in the investment process and financial effects.[7] The positive relationship between a company's financial performance and their consideration of ESG factors can take approximately six or seven years to be realised.[8] Part of this positive relationship is due to businesses which have above average ESG performance having higher expected growth and lower capital costs[9] and ESG factors having been shown to impact on the risk and returns of investments.[10]

Table 1: Examples of ESG factors[11]

Environmental	Social	Governance
climate change – including physical risk and transition risk	working conditions, including slavery and child labour	executive pay
resource depletion, including water	local communities, including indigenous communities	bribery and corruption
water and wastewater management	conflict	political lobbying and donations
waste and hazardous materials management	customer privacy	board diversity and structure
deforestation	data security	tax strategy
energy management	access and affordability	systemic risk management
ecological impacts	product quality and safety	competitive behaviour
	customer welfare	management of legal and regulatory environment
	selling practices and product labelling	critical incident risk management
	employee engagement, diversity and inclusion	

Developments in ESG

Credit rating agencies also consider credit risks that arise from ESG concerns. As part of their credit analysis Standard and Poor's (S&P), for example, considers ESG factors in assessing business risk, financial risk, and management and governance.[12] S&P has also started to include ESG sections in their credit rating reports about companies.[13] As part of the management and governance assessment, S&P consider how environmental and social risks are managed. Moody's, similarly, considers credit risks that may come from ESG factors and mitigating behaviour.[14] As such, it has been acknowledged that credit risks can arise from ESG factors and considering these factors in making investment decisions may not result in forgoing return.[15]

Australian Securities Exchange and ESG factors

The Australian Securities Exchange (ASX) is a partner exchange in the United Nations' Sustainable Stock Exchanges (SSE) Initiative.[16] The SSE looks to create more sustainable capital markets and advance corporate performance on ESG factors.[17] Additionally, as part of its Corporate Governance Principles and Recommendations (CGPR), the ASX recommends a listed entity disclose whether it has any material exposure to environmental or social risks and how it manages these risks.[18]

The risk of climate change, in particular, has been identified by market participants as having a real impact on portfolio performance.[19] Climate change risk has been identified by APRA's Geoff Summerhayes as a risk that is 'foreseeable, material and actionable now'.[20] Additionally, APRA has advised it is expecting climate change risks to be assessed as part of compliance with prudential risk management standards CPS 220 and SPS 220[21], and will be supervising how APRA-regulated entities assess climate change risks.[22] The Reserve Bank of Australia's (RBA) Deputy Governor Guy Debelle identified climate change as an economic trend change, the impact of which is ongoing.[23] He also further said that 'climate is a challenging risk to assess but an increasingly necessary one'.[24]

Climate risk is as an area that is likely to be subject to increased litigation moving forward.[25] There are also a number of contemporary court cases that indicate this may be a live concern.[26] However, climate change risk is just one example of an ESG factor. More broadly, APRA has advised there may be changes to the investment governance standard (SPG 530) to clarify how superannuation trustees should take into account ESG factors when developing investment strategies.[27]

The *Modern Slavery Act 2018* (Cth) (MSA) also came into force in late 2018. The purpose of the MSA is to establish a modern slavery reporting requirement, with reports being publicly available in an online register.[28] This legislation, which follows similar legislation overseas, is an indicator of the transition towards increased awareness of ESG factors in Australia.

Other relevant developments relating to ESG factors include the recent establishment of the Australian Sustainable Finance Initiative (ASFI). ASFI was established by leaders spanning Australia's major banks, superannuation funds, insurance companies, financial sector peak bodies and academia. In consultation with diverse sectors and stakeholders, ASFI aims to deliver a Sustainable Finance Roadmap (SFR) for Australia in 2020. The SFR will 'recommend pathways, policies and frameworks to enable the financial services sector to contribute more systematically to the transition to a more resilient and sustainable economy'.[29] The SFR recommendations are intended to influence Australian policy, legislation and regulation.

The introduction of the UN Sustainable Development Goals (SDGs) in 2015[30] has also influenced the consideration of ESG factors. The SDGs are one of the first sustainability frameworks that has broad agreement, across a range of stakeholders, reflecting the 'broader objectives of society'.[31] The seventeen SDGs aim to guide the prioritisation of global sustainable development and potentially provide a way, amongst other measures, in which to assess the ESG risk of businesses.[32]

Processes to consider ESG factors

There is no single approach to considering ESG factors that could be thought of as the 'best' approach. Most entities apply their own particular approach to incorporating ESG factors into their investment decision-making.

The focus of ESG investment principles is to consider ESG issues that have the potential to impact financial returns. This approach can be viewed from a risk management and/or a return-seeking perspective.[33] Positive ESG performance is likely to indicate that the business has better relations with stakeholders, is operating financially efficiently, and has lower risk of bad behaviour. ESG analysis differs from traditional financial analysis as it requires asking different questions.[34]

Central to the consideration of ESG factors by superannuation funds is the need to execute from a value perspective (that is, add to retirement savings outcomes), not a values perspective. This is quite different to 'socially responsible investing' or 'ethical investing', which recognises a cause that an investor might want to support through their investments.[35] Superannuation trustees, in identifying the preferred approach to consider ESG factors, need to consider their choice in the context of their duties and functions. At a high-level, it involves the trustee considering ESG factor information in making decisions to more completely assess risk and/or return.[36]

Materiality and ESG factors – impact on financial returns

Consideration of every ESG factor for every investment can be resource intensive, particularly for large and highly diversified portfolios.[37] Focusing on materiality is vital in identifying ESG factors that may impact a sector and/or country and helps to identify a list of ESG factors that should be considered for each investment.[38] The Sustainability Accounting Standards Board (SASB), for example, has identified material ESG issues for the 77 industries it covers.[39] There are other organisations, such as the International Integrated Reporting Council (IIRC) and the Global Reporting Initiative (GRI), that also identify material ESG issues.

Performing well on addressing material ESG issues has been shown to positively impact the financial returns of businesses, whereas performance (negative or positive) on immaterial ESG issues has been shown to have a negligible effect on financial returns.[40] As such while not every ESG factor needs to be considered and analysed, consideration of material ESG factors may be relevant as they are likely to have an impact on the financial returns of a business. There may be a range of material ESG factors which the market agrees will impact on a business's performance. The materiality of other ESG factors, and the consideration of these, will depend on the trustee's time investment horizon, internal processes, risk appetite and performance targets.[41]

Analysis of governance factors, in the broader analysis of ESG, can often suggest whether a business has environmental and social issues.[42] That is, if there are indications that a business has weak governance, it may signify that it is likely there are environmental and social issues as well. Some investors, therefore, increase the weighting of governance factors in analysing the ESG performance of their investment.[43]

Costs of implementing ESG factors criteria into investment decision-making

Although incorporating ESG criteria in portfolio decision-making has been shown to not have a negative effect on returns and in some circumstances can enhance returns, including by helping to reduce portfolio volatility, it can be expensive to implement ESG criteria into an investment strategy.[44]

The extent of the expense also depends on the way in which trustees approach ESG factors (for example, screening can be easier/cheaper to implement than integration). However, given the potential value that considering ESG factors may provide to members and the feedback that regulators have provided in relation to ESG factors, superannuation trustees might feel the need to pre-emptively include ESG factors in their investment decision-making.

There is still a significant gap in the depth and breadth of available data on ESG factors.[45] While there has been a substantial increase in the amount of data available on ESG factors, there is still a question of which factors would have the greatest impact on financial performance and the type of corporate reporting that would best support investors' analysis of ESG factors.[46]

Third-party providers of ESG reports and ratings also have different methodologies they apply in creating their reports and ratings.[47] Understanding the methodology used can help in understanding how each factor is integrated, and to what extent, in their assessment. Determining the type of ESG information third-party providers request from businesses can be difficult, as well as how this information is analysed. Therefore, different ESG rating providers can come to different conclusions for the same business.[48]

Third-party ESG ratings

Third-party ESG ratings should not be considered in isolation. Superannuation trustees could also consider, for example, whether the business is changing or adapting to improve their approach to ESG factors. Given the long-term nature of superannuation, there may still be future value from a poorly ESG rated business if the business is actively and effectively working on their sustainable value proposition.

A concern raised by investors in considering ESG factors in their analysis is that sustainability reporting undertaken by businesses tends to focus not on the needs of the investor, but rather other stakeholders such as non-government organisations (NGOs).[49] There are attempts to change this through, for example, the Taskforce on Climate-related Financial Disclosures (TCFD).[50] However, there are broader ESG factors that also need to be considered where 'clean' data may be difficult to find. This may place limitations on the quality of the ESG factor analysis.

Appointing investment managers

Prior to finalising a decision to appoint an investment manager, superannuation trustees need to conduct appropriate due diligence. If a superannuation fund has decided to consider ESG factors in the investment process, it's important that the consultant (if any) and the fund incorporate a review of the externally appointed manager's approach to ESG factors and the appropriateness of the approach given the investment style.[51]

ESG Factor consideration: Engagement

Engagement with businesses on ESG factors can take a number of forms, such as dialogue or letters. Engagement by investors is considered to benefit both businesses and investors. Investors, in their continuous and broad consideration of ESG factors, often identify emerging ESG developments and can share this knowledge with businesses with the aim of improving the business's approach to ESG factors. Engagement is also not just about identifying shortcomings – it is also an opportunity to foster best practice.[52] It provides businesses with opportunities to learn from investors (and vice versa).[53]

A market economy works well when investors can observe that their investment in a business is the best allocation of those funds. To ensure an investor can observe effectively, it is in their interests to collect as much information about the business's future outlook. The information collected can be used to engage with the business on key issues with the purpose of maximising returns on investment.[54]

As such, effective engagement requires investors to prepare and understand the business model in order to influence. Knowing more about the business also helps facilitate constructive conversations rather than superficial ones.[55] Understanding the business model helps link ESG progression to a business's operations, facilitating a nuanced interaction that is more likely to result in successful and constructive engagement. Engagement with businesses can be an effective way to improve, for example, governance processes in a business.[56]

Engaging through discussion and consultation, major shareholders can make known their views and concerns about the actions or direction of businesses they are invested in. Ordinarily, larger funds with significant shareholdings and research capabilities may do this directly. Particularly controversial issues might be resolved quickly without there having to be adverse publicity that may affect the company's share price or public image.

> *"Communications should be managed to ensure no investor or potential investor obtains material or price sensitive information that has not been disclosed to the market"*

Communication should aim to achieve a constructive dialogue with the appropriate business's representative. Funds with a relatively small holding should consider working with other funds or through a suitable service provider to ensure that views are heard. There must not, however, be conduct that is inconsistent with the requirements of the relevant *Corporations Act 2001* (Cth) or ASX Listing Rule provisions. Communications should be managed to ensure no investor or potential investor obtains material or price sensitive information that has not been disclosed to the market in accordance to the *Corporations Act 2001* (Cth) or ASX Listing Rules.[57]

However, engagement such as this can be difficult if the portfolio held is comprehensive and covers a large range of businesses. Having quality engagement that is informed by the operations of the business can be costly if an investor has quite a diversified asset portfolio. This often leads to diversified portfolio investors outsourcing monitoring functions and engaging based on a formulaic approach.[58]

ESG Factor consideration: Divestment and Screening

The divesting of asset holdings in a particular sector or industry can place limitations on potential investments that can be considered by a trustee.[59] Generally, this method is used when a business is not open to engagement.[60]

Screening involves excluding particular sectors or businesses based on an ESG factor criteria.[61] This tends to be the most common method used internationally.[62] It is important to consider the proportion that the screened activity contributes to the revenue of the business, and whether it is material enough to warrant exclusion.[63] The data underlying the decision to screen particular investments should also be accurate and valid.

Some examples of screening include: [64]

- consideration of World Bank's Worldwide Governance Indicators in choosing government bonds
- excluding companies that invest or own companies that trade in sectors included on the World Bank's IFC Exclusion List.

These two methods of considering ESG factors should be contemplated with APRA's SPG 530 in mind. APRA notes that RSE licensees should ensure members are not exposed to risks because of a lack of diversification due to consideration of ESG factors.[65]

ESG Factor consideration: General ESG integration

Considering ESG factors in analysing investments, managing risk and building a portfolio is general ESG integration.[66] This includes thorough analysis and ongoing management of all relevant investment factors during an investment process, including those of an ESG nature.[67] Most investors use different methods to integrate ESG into their decision-making.[68]

Integrating ESG factors into the investment process can take time, especially when determining the best fit for the organisation.[69] There can be several challenges in effectively integrating ESG factor analysis within the investment process, including[70]:

- ensuring various teams with different abilities work together successfully
- training staff on how to consider ESG factors
- finding consistent and comparable ESG factor data that appropriately reflects the financial prospects of a business.

Table 2: Examples of ESG Integration techniques for equities[71]

ESG Integration technique	Explanation of technique	Example of technique in use
Fundamental strategies[72]	Adjusting forecasted financials or business valuation models for expected ESG factor impact.	• Linking health and safety to operating margins: Manufacturing company's operating margin may be reduced to incorporate less production caused by high injury from poor health and safety standards.
Quantitative strategies	Construction of models that integrate ESG factors with other factors like value, size, growth and volatility.	• Linking ESG ratings to returns and volatility: Grocery store chain, at first glance, looks attractive because it has a comparative Price-to-Earnings (PE) ratio with its peers and a higher return on equity. However, it has a number of ESG related concerns such as health and safety issues and supply chain labour standards. Weighting of the stock can be reduced.
Smart Beta strategies/Factor investing	ESG factors used as weight in constructing portfolios in order to generate risk-adjusted returns. [73]	• Constructing a smart water index: Develop an index through: picking members of the water supply sectors and identifying companies that operate in water-intensive industries and innovative water solutions providers.
Passive/Indexing	Overall ESG risk profile, or exposure to a particular ESG factor, is reduced by adjusting index constituent weights or tracking an index that does this.	• Reweighting high-carbon stocks (low carbon index): Considers the carbon emissions and carbon reserves exposures of securities. Index will overweight the security with lower carbon exposure and underweight the security with higher carbon exposure.

Investment in infrastructure may require the consideration of different factors comparative to equities. The UNPRI, for example, steps through the application of its six principles to infrastructure investment.[74] GRESB also, for example, benchmarks the ESG performance of real assets. Depending on the type of infrastructure asset, different considerations are likely to arise. Some factors to consider could include the health and safety record of the infrastructure's management; how well the management monitors and reports to stakeholders; environmental performance and the ability to obtain environmental certificates; and, governance policies and systems in place.[75]

In adopting general ESG integration, trustees should consider[76]:

- the current approach their investment managers are taking to factoring in the ESG issues that are relevant to their investment strategy (for example a passive manager will have a different approach to an active manager, and unlisted investment will be different again)
- what skills the fund's investment personnel and/or consultant have to assess the extent to which the fund's investment managers are considering ESG issues
- how the fund may be able to collaborate with other asset owners to address ESG issues. For example one of the biggest challenges in incorporating a consideration of ESG issues into the investment process for listed equities is accessing quality data
- how involved the trustees want to be or if they would prefer their investment staff or consultant to simply incorporate ESG into the existing investment strategy or statement of investment principles
- trustees need to agree with their consultant or custodian exactly what information they require (e.g. summaries, exception reports) and the frequency with which it is to be provided. ESG performance and activities undertaken by the managers may also be included in the reporting requirements.[77]

Disclosure of consideration of ESG factors

Given ESG factors can have a material impact on the financial performance of assets[78], it is important that superannuation funds clearly disclose if and/or how ESG factors are considered in their investment decisions and investment management. While the proposed financial risks associated with ESG factors might not eventuate, it is crucial to show that the appropriate processes in considering ESG factors were followed.

As a first step, where a superannuation fund considers ESG factors in their decision making, disclosing this consideration demonstrates to members a recognition by the superannuation fund that ESG factors may have an impact on the performance of their portfolio.[79]

In determining disclosure requirements, trustees should be mindful of the requirements introduced under the *Financial Services Reform Act 2001* (FSR Act), which amended the *Corporations Act 2001.* The FSR Act notes that a Product Disclosure Statement should include, where there is an investment component, information that indicates 'the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment'.[80] ASIC's Regulatory Guide 65 provides further guidance on the disclosure guidelines within the *Corporations Act 2001.*[81]

In disclosing consideration of ESG factors, some examples of how this can be done include:

1. G20/OECD Principles of Corporate Governance
2. Integrated reporting
3. Taskforce on Climate-related Financial Disclosures (TCFD).

1. G20/OECD Principles of Corporate Governance

The OECD recommends institutional investors disclose their policies around corporate governance and how these policies are applied in relation to shareholder engagement.[82] Some of the disclosures that the OECD recommends institutional investors make are:

OECD disclosure recommendation	Description
Corporate governance and voting policies with respect to investments, including procedures in place for deciding on the use of voting rights[83]	As holders of investments, superannuation funds have certain ownership rights. How superannuation funds exercise these ownership rights, including the right to vote, is recommended to be disclosed. The right to vote in particular can be seen as a way to nurture and protect the value of the investment. The reason for the disclosure is a way for stakeholders to understand how superannuation funds approach investments and the ownership rights associated with them. This could involve publishing voting guidelines for securities, as an example, grouped into themes that reflect common issues that appear during shareholder meetings.[84] Another example is publishing the voting records, if there is a policy to vote.[85]
Votes should be cast by custodians or nominees in line with directions of the beneficial owner of the shares[86]	Where particular investments are held by custodians or nominees, votes should not be cast by them unless the superannuation trustee has provided specific directions on voting.
Institutional investors should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments[87]	This may occur where a superannuation trustee is both a trustee and responsible entity of a managed investment scheme. This would also be applicable in situations where something might impact the exercise of ownership rights by the superannuation trustee.
Corporate governance framework should require that proxy advisors, analysts, brokers, rating agencies and others that provide analysis or advice relevant to decisions by investors, disclose and minimise conflicts of interest that might compromise the integrity of their analysis or advice[88]	Superannuation fund trustees rely on a number of different avenues for advice. There may be a conflict of interest for the provider of advice. For example, the provider of advice may have an interest in a company. These potential/actual conflicts of interest should be clearly disclosed.

2. Integrated reporting

Integrated reporting combines financial and ESG factors in the single report, with a view on the future prospects of a particular organisation.[89] The International Integrated Reporting Framework (IIRF), released by the IIRC, provides principles for organisations preparing integrated reports.[90]

Integrated reporting intends to highlight the 'integrated thinking' within an organisation. This includes consideration of: how and why an organisation uses its capital, whether an organisation can respond to stakeholders' interests, how an organisation adapts its business model to its surroundings, and how the organisation performed in the deployment of its resources.[91] It requires an organisation to consider how it will create value over the long-term.

The ASX CGPR mentions integrated reporting as part of its commentary on recommendation 7.4. Recommendation 7.4 recommends listed entities disclose whether they have any material exposure to environmental or social risk, and how they manage or intend to manage those risks. As part of the commentary for recommendation 7.4, the ASX CGPR mentioned integrated reporting was not required to be published. However, publishing and cross referencing an integrated report that meets the IIRF could fulfil the requirements of recommendation 7.4.[92]

ASIC has also advised company directors to consider whether additional information, that would be relevant under integrated reporting, should be disclosed.[93]

Superannuation funds, while expecting integrated reporting from the businesses in which they invest in, could also implement integrated reporting in their own reporting requirements for transparency.

3. Taskforce on Climate-related Financial Disclosures (TCFD)

The Financial Standards Board (FSB) TCFD has developed climate-related financial risk disclosures for mainstream use by investors and companies. The TCFD's purpose is to provide better access to data to improve the way climate-related risks are 'assessed, priced and managed'.[94]

APRA's Geoff Summerhayes stated, in his speech at the International Insurance Society Global Insurance Forum, that APRA is 'strongly encouraging entities to adopt the TCFD recommendations around disclosure'. While APRA has not mandated this type of disclosure and will not be, in the immediate future, introducing a prudential standard around climate-change, this may change in the future to reflect where global regulation is heading.[95]

Further, in relation to risk management, Mr Summerhayes goes on further to say that investors and regulators will want to know the answer to questions of how APRA-regulated entities have modelled and identified trends, opportunities and risks relating to climate change.[96]

The Reserve Bank of Australia's (RBA) Deputy Governor Guy Debelle also emphasised the importance of disclosure to ensure investors have appropriate information available in order to make decisions about climate risk.[97]

ASIC has also advised company directors to consider whether additional information, that would be relevant under TCFD, should be disclosed.[98] ASIC has 'strongly encouraged' listed companies that have material exposure to climate change to voluntarily report under TCFD.[99]

The TCFD developed seven principles for effective disclosure[100] are summarised below.

1. Disclosures should represent relevant information

To ensure disclosures do not obscure information, the TCFD recommends organisations do not disclose 'immaterial or redundant' information. Additionally, there should be enough detail in the disclosure to facilitate assessment of approaches to climate-related issues.[101]

2. Disclosures should be specific and complete

The TCFD recommends organisations provide a comprehensive review of the potential impact climate-related issues will have on them. This includes, for example, explaining the scope and definition of any quantitative information, and having both historical and future related information.[102]

3. Disclosures should be clear, balanced, and understandable

The TCFD recommends that disclosures strike a balance between the information needs of both experienced and non-experienced users of financial information, using both quantitative and qualitative information.

4. Disclosures should be consistent over time

Disclosures that are consistent over time allow for comparisons to be made between particular time periods and, if changes are required, they are explained appropriately.

5. Disclosures should be comparable among companies within a sector, industry or portfolio

Details provided in disclosures should allow for comparisons and benchmarking to occur between organisations, sectors and jurisdictions.[103]

6. Disclosures should be reliable, verifiable, and objective

The information included in disclosures should be of a high quality, including being based on objective data.

7. Disclosures should be provided on a timely basis

The disclosures should be included at least annually through the financial report or, in the event of a climate-related event occurring, as the organisation progresses a response to the event.

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