MEMORANDUM OF OPINION

Superannuation Trustee Duties and Climate Change

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Equity Generation Lawyers

Level 40, 140 William Street
MELBOURNE VIC 3000

N C Hutley

Fifth Floor St James Hall
169 Phillip Street
SYDNEY NSW 2000
nhutley@stjames.net.au

J E Mack

Level 22 Chambers
Level 22 No 52 Martin Place
SYDNEY NSW 2000
jmack@level22.com.au

Introduction

1. In 2017 we gave advice and concluded that "it appears likely from recent comments of an APRA Member, that APRA will conduct its regulatory functions conferred by the SIS Act on the basis that climate change presents a financial risk". Since then, APRA has continued to make public statements consistent with this simple proposition. So have other persons who participate in the Australian superannuation system. Our client, Market Forces, an affiliate project of Friends of the Earth (Australia) Inc, has asked us to provide an updated opinion having regard to these developments.

2. In our view, these developments reflect the basic obligation that a superannuation trustee must act prudently and in the best financial interests of a beneficiary. It is clear that in order to comply with obligations under the superannuation law, a superannuation trustee needs to ensure its processes, structures and expertise are responsive to the financial risk posed by climate change. This is so because the nature of the financial risk posed by climate change to a superannuation trustee is ascertainable and also likely to be material.

Recent developments

3. Recently, key persons in the superannuation industry including regulators, actuaries, superannuation trustees, and investment consultants have made statements consistent with this proposition. For example:

    a. ASIC in August 2019 stated that "Climate change is a systemic risk that could have a material impact on the future financial position, performance or prospects of entities" [1];

    b. APRA on 20 March 2019 stated "There is a high degree of certainty that financial risks will materialise, and entities can mitigate the magnitude of the impacts of these risks through action in the short-term" [2];

    c. the Actuaries Institute in September 2019 stated that climate change is expected to impact on investment returns and the "The negative long-term return implications of climate change for investment returns, outlined in the previous section, have the potential to negatively impact retirement incomes. A greater number or severity of

[1] Regulatory Guide 247: Effective disclosure in an operating and financial review at RG 247.66.
[2] 20 March 2019, APRA's Climate change: awareness to action.

such shocks can compound and reduce individuals' accumulated superannuation saving"[3];

d. HESTA, a large superannuation trustee, on 26 June 2020 stated "Climate change presents a financial risk to the HESTA investment portfolio and the world in which our members will retire. An urgent response is required and the actions within the Climate Change Transition Plan have been thoughtfully and carefully designed to provide an effective and tangible response" [4];

e. CBUS, another large superannuation trustee, on 13 December 2018 stated "we have crossed the line where our obligation [to future proof investments] has become a commercial imperative" [5];

f. AustralianSuper, another large superannuation trustee, in May 2020 identified climate change as a material issue for its investment portfolio[6];

g. JANA, a large asset consultancy company that focuses on the Australian superannuation sector, has recently stated that climate change presents an emerging systemic financial risk that is likely to impact the returns of risk assets and that climate change scenario analysis should be included in investment decisions[7];

h. Rest, another large superannuation trustee, in November 2020, in the context of a settlement of a Federal Court proceeding which challenged its compliance with obligations of prudence and disclosure, stated that climate change is a material, direct and current financial risk to the superannuation fund. Further, Rest committed to achieving a portfolio wide net zero by 2050 target, advocating for companies and governments to align with the climate goals of the Paris Agreement, incorporating climate risks into its risk management framework, aligning the fund's disclosure practices to the TCFD, and to disclosing *all* portfolio holdings.[8]

New quantitative analysis

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[3] Institute of Actuaries Australia: *The Impact of Climate Change on Mortality and Retirement Incomes in Australia*, p 14.

[4] HESTA media release 26 June 2018, available at https://www.hesta.com.au/about-us/media-centre/HESTA-announces-net-zero-by-2050-aim-climate-change-plan.html

[5] CBUS media release 13 December 2018, available at https://www.cbussuper.com.au/about-us/news/media-release/cbus-commits-to-zero-emissions-for-property-portfolio

[6] AustralianSuper "Climate Change Report: Managing The Transition To a Low Carbon Economy" May 2020 p7.

[7] https://jana.com.au/capabilities/environmental-social-and-governance .

[8] Rest Media Release 2 November 2020 "Rest reaches settlement with Mark McVeigh" available at https://rest.com.au/why-rest/about-rest/news/rest-reaches-settlement-with-mark-mcveigh

4. Such statements reflect a scientific and economic reality which ultimately informs the nature of the legal obligations on superannuation trustees. Moreover, there is now a large body of quantitative analysis which may inform the nature of the legal obligations. For example:

    a. JANA in June 2020 found that, without further action by government or diversification by trustees, returns on superannuation portfolios could decline by 2% per year[9];

    b. Mercer in 2019 concluded "for nearly all asset classes, regions and timeframes, a 2°C scenario leads to enhanced projected returns versus 3°C or 4°C and therefore a better outcome for investors" [10];

    c. Frontier Economics, an Australian asset consultant, in 2019 found investors could expect lower returns across all asset classes, by 0.25% per year, primarily due to the long-term impact on the global economy of climate change[11];

    d. Australia's Actuaries Institute in 2019 calculated that climate change could result in the accumulated superannuation balance of a median-income worker being up to 18% lower[12];

    e. Schroders, a large asset manager, in 2020 calculated that, as a result of physical and transition risks, 10 year Australian government bond returns are forecast to reduce by 1.2% p.a to 2050, and Australian equity returns by 1.8% p.a. to 2050.[13]

Understanding and managing the risk

5. In our view, the likelihood of the financial risk being a material risk to investments managed by a superannuation trustee is such that a trustee is obliged to undertake a two-step exercise (if they have not already) in order to comply with obligations under superannuation law. The first step is to *understand* the risk posed by climate change to investments. The second step is to *manage* any identified risk. The degree and nature of the financial risk will be determined

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9 Sydney Morning Herald 24 June 2020, available at https://www.smh.com.au/business/banking-and-finance/super-returns-at-risk-from-climate-inaction-study-finds-20200622-p55517.html.

10 Mercer, Investing in a time of Climate Change (2015), available at: https://www.mercer.com/ourthinking/wealth/investing-in-a-time-of-climate-change.html; Mercer, Investing in a time of Climate Change: The Sequel (2019), available at: http://www.mmc.com/content/dam/mmc-web/insights/publications/2019/apr/FINAL_Investing-in-a-Time-of-ClimateChange-2019-Full-Report.pdf

11 Frontier Economics 23 September 2019, available at https://www.frontieradvisors.com.au/climate-change-erodes-investment/.

12 Actuaries Institute, *The impact of climate change on mortality and retirement incomes in Australia,* September 2019, available at https://actuaries.asn.au/Library/Opinion/2019/TheDialogue10ClimateWEBLres.pdf

13 Schroders, *The uncomfortable truth about climate change and investment returns*, July 2020, available at https://www.schroders.com/en/bm/asset-management/insights/equities/the-uncomfortable-truth-about-climate-change-and-investment-returns/

during the first step. The action required in order to respond to the degree and nature of the financial risk will be determined during the second step. Both the first and second steps have their source in the duty which arises by force of ss 52(2)(b) and (c) of the *Superannuation Industry Supervision Act 1993* (Cth) ("SIS Act"). These steps need to be entrenched in the processes of a trustee because the nature of the financial risk posed by climate change will continue to evolve and a trustee, at all times, needs to understand and manage the financial risk posed by climate change.

6. In order to *understand* the financial risk posed by climate change, in the first step, a superannuation trustee should take a thorough approach. The precise approach will vary vary depending on the nature of investments. If an investment is held directly or is proposed to be held directly there is a need to seek detailed advice in relation to whether the particular investment will be exposed to the financial risks of climate change. Further, if a trustee holds assets indirectly in the form of shares (for example), it is not enough for a trustee to rely on investment managers who, in turn, rely on an omniscient and supposedly efficient market to factor in risk. A trustee needs to commission and consider expert advice which is capable of informing the trustee of the financial risk posed by climate change. This advice needs to be renewed and revisited such that the trustee is continually apprised of the scope of any financial risk posed by climate change. A trustee should ensure that advisors such as accountants, actuaries and consultants are themselves sufficiently qualified to identify the financial risk posed by climate change.

7. In relation to the the *management* of the financial risk posed by climate change, in the second step, we see no reason why this would be different from the management of other identified financial risks. For example, if there is a risk that an investment (either direct or indirect) will be impacted by climate change (for example by the physical or transition aspects of climate change), a superannuation trustee will need to weigh that risk and consider whether the risk aligns with the investment objectives of a particular investment option. If a risk is too great for a particular investment objective, a superannuation trustee will need to consider divestment or a reallocation of funds to less risky investment options/asset classes. In order to manage the risk a superannuation trustee should also seek advice on the structural nature of any identified risk[14] and whether, having regard to an investment horizon, the risk is diversifiable.

8. Much of the legal architecture of the superannuation system relates to the identification and management of financial risk. Thus, there are pre-existing processes which a superannuation

[14] Our instructors have briefed us with many examples of fossil fuel investments declining over the last 5-10 years.

trustee should utilise in order to understand and manage the financial risk posed by climate change. These pre-existing processes will need to engage with emerging standards and practices that are designed to aid an understanding of the financial risk posed by climate change. In short, the pre-existing processes and structures are reflected in APRA prudential standard SPS 530 Investment Governance which "must be complied with".[15] The emerging standards and practices include scenario analysis, as foreshadowed in the Technical Supplement to the Task Force on Climate-Related Financial Disclosures (TCFD).

Role of the board and directors

9. In our view, it is the board of a superannuation trustee that is required to take the steps to understand and then manage the risk. This does not mean that a board is required to involve itself in the minutiae of investment decisions. To the contrary, it means that a board is required to ensure that the structures and processes of the trustee are capable of understanding and then managing the financial risk posed by climate change. In order to act prudently and in the best interests of members, it is the board who must have set in place processes that enable it to understand and manage the financial risk posed by climate change. The board's role is reflected in SPS 530 which states that the board is "ultimately responsible" for investment governance. Further, board directors of superannuation trustees have a cognate personal responsibility to act prudently and in the best interests of beneficiaries by force of the statutory covenants in s 52A of the SIS Act.

Specific action required

10. In our view, a superannuation trustee should ensure that its processes relating to financial risk are adapted such that they are capable of understanding the financial risk posed by climate change and are capable of managing any identified risk conformably with the degree of risk posed. Consistent with this view, a superannuation trustee should ensure:

    a. that the processes it has in place to conform with the investment covenants in s 52(6) of the SIS Act are capable of identifying and managing the financial risk posed by climate change;

    b. that its investment governance framework, which is required by SPS 530, is capable of identifying and managing the financial risk posed by climate change. In our view, superannuation trustees should read and give effect to SPS 530 with a particular eye

[15] Section 34C of the SIS Act.

for understanding and managing the financial risk posed by climate change. For example:

i. in determining an appropriate level of diversification for an investment strategy, including to diversify away from a particular risk, a superannuation trustee, in many cases, will need to identify any financial risk posed by climate change as a risk factor for the purposes of cll 18(a), 29, 30 and 31 of SPS 530. We note that the scale and breadth of some of the impacts of climate change are such that risk may not be diversifiable;

ii. target exposures, such as portfolio wide net zero emissions reduction targets, will need to be determined having regard to any financial risk posed by climate change for the purposes of cl 18(c) of SPS 530;

iii. climate change scenario analysis is consistent with and complements the requirement in cl 19(b) of SPS 530 to undertake stress testing. Such testing will aid an understanding of any financial risk posed by climate change to investments. We note that in February 2017, Geoff Summerhayes, an Executive Member of APRA, gave a speech to the Insurance Council of Australia, which included a section entitled "Scenario analysis as the new normal" in which he stated "the questions investors (and regulators) will want answered are not just about "what" but "how". How do you model and identify relevant trends, opportunities and risks? How robust are your strategies given different scenarios and contingencies";

iv. an investment selection process must result in a superannuation trustee being satisfied that it has a sufficient understanding of any climate related financial risk of an investment for the purposes of cl 23 of SPS 530;

c. that it is seeking information from its investment manager(s) that enables it to assess the capability of the investment manager(s) to manage any financial risk posed by climate change associated with investments. This obligation arises from the duty in s 102 of the SIS Act to seek information from investment managers. In our view, the SIS Act requires superannuation trustees to maintain a constant vigilance over investment managers (whether internal or external). It is not enough for superannuation trustees to unquestionably rely on investment managers to manage any financial risk posed by climate change. Rather, superannuation trustees are required to request investment managers to provide information as to the exposure of investments to the financial risk posed by climate change.

Conclusion

11. Superannuation trustees should expect that regulators will exercise their enforcement powers consistently with their statements on climate change risk. Therefore, trustees should ensure they receive advice from asset consultants and other experts which is consistent with the reality of the financial risk posed by climate change. Superannuation trustees should ensure that they have the expertise to assess any advice, and to mitigate any risks of climate change. Trustees should expect that, increasingly, every investment turn will require an engagement with the financial risk posed by climate change. The engagement is also required by the law. If that engagement identifies a risk, the law also requires that a superannuation trustee manage that risk.

Noel Hutley
5 St James Hall

James Mack
Level 22 Chambers

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