SUBMISSION

Submission to Treasury — Consultation Paper: Sustainable Finance Strategy

5 December 2023

The Association of Superannuation Funds of Australia Limited
Level 11, 77 Castlereagh Street
Sydney NSW 2000

PO Box 1485
Sydney NSW 2001

T +61 2 9264 9300
1800 812 798 (outside Sydney)
F 1300 926 484
W www.superannuation.asn.au

ABN 29 002 786 290 CAN 002 786 290

File: 2023/38

Sustainable Finance Unit

Climate and Energy Division

The Treasury

Langton Crescent

PARKES ACT 2600

Via email: SustainableFinanceConsultation@treasury.gov.au

5 December 2023

Dear Sir/Madam

Submission to Treasury - Sustainable Finance Strategy

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission in response to the Treasury Consultation Paper on the Government's Sustainable Finance Strategy.

About ASFA

ASFA is a non-profit, non-partisan 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 $3.5 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 almost 90 per cent of the 17 million Australians with superannuation.

****

If you have any queries or comments in relation to the content of our submission, please contact Andrew Craston on 0401 016 587, or by email (acraston@superannuation.asn.au).

Yours sincerely

Andrew Craston
Director, Economics

Sustainable Finance Strategy

ASFA supports – in broad terms – the Government's work agenda to develop and operationalise its Sustainable Finance Strategy. ASFA also supports the Government's prioritisation of climate within the work program, where reforms that relate to Australia's net zero transition are prioritised over broader sustainability-related reforms. ASFA agrees that prioritising climate-related reforms is consistent with the systemic nature of climate-related risks for the Australian economy, and the need for urgent economy-wide action.

That said, the policy architecture should be designed in such a way that it can be extended beyond climate to broader sustainability (for example, natural capital and biodiversity). The interdependence between climate change and the degradation of natural systems highlights the need for complementary reforms with the objective of preserving natural capital and biodiversity. Indeed, arguably, the overarching framework for a Sustainable Finance Strategy should be the notion of the circular economy – that is, to seek to reduced markedly human-produced waste (and the impact on the natural world) and to circulate materials within production processes for as long as possible – and thus facilitate the regeneration of human-induced impacts on the natural world.

While such an approach is likely to present some challenges in policy design, ultimately it would generate efficiencies for industry, government and regulators, and lead to better outcomes for superannuation fund members and for the wellbeing of Australians. Particular sources of efficiencies would be likely to include: for industry, lower costs of compliance; for government, efficiencies in consultation and policy development; and for regulators, efficiencies in the provision of guidance.

In this regard, the Sustainable Finance Strategy provides an opportunity for the Government to avoid the mistakes of other jurisdictions, where a climate-first approach has not taken adequate account of broader sustainability in architecture design.

'Climate-priority' context

Climate change represents a global systemic risk to the Earth's natural systems and to human society. In the absence of deep, rapid cuts to global emissions, the likelihood of increasingly severe and irreversible impacts on natural systems will only rise. To keep global warming to no more than 1.5°C, reductions in global emissions need to be front-loaded – in particular, the current consensus is that global net human-caused emissions need to be cut by around 45 per cent from 2010 levels by 2030, and reach net zero by 2050.

Avoiding the worst impacts of climate change will require fundamental changes to the shape of economies across the globe. In essence, economies will need to become minimally reliant on fossil fuels, less energy intensive and more energy efficient.

The required transition of the Australian economy is unprecedented (for Australia) in terms of scale and complexity. Reducing emissions to net zero will require fundamental changes to the types of goods and services we consume, how those goods and services are produced, and how goods and people are transported, and all within a timeframe of little more than a single generation.

Fixed capital investment that is consistent with the required pathway for decarbonisation will entail spending on new low-emission assets, but also upgrades to, and repurposing of, existing high-emission assets to reduce their emissions footprint (in effect, to transition from high-to-low emission assets). Fixed capital investment will be required for the maintenance of certain high-emissions assets, including as part of their orderly phase-out.

APRA-regulated superannuation funds – collectively institutional superannuation – will play an important role in the shared challenge of the orderly transition of the Australian economy to net zero emissions. Institutional superannuation is part of the broader financial sector that intermediates the savings of households with the funding needs of the real economy. Total financial investments of institutional superannuation – which stands at $2.5 trillion – is projected to reach around $10 trillion by 2050 (future dollars). The more orderly the transition to net zero (by Australia and globally), the better able superannuation funds will be to protect and preserve the value of investments on behalf of their members.

Government will play a critical role.

In the first instance, this entails framing the required shift in the structure of the Australian economy (consistent with net zero), and the associated scale, distribution and timing of fixed capital investment to give effect to that shift. In this regard, the over-arching policy context is the United Nations Framework Convention on Climate Change (UNFCCC), and the corresponding commitments made by the Australian Government under its Nationally Determined Contribution – net zero emissions by 2050, and a 2030 target of 43 per cent below 2005 levels.

Within this framework, government will need to ensure that prevailing policy settings will help guide private-sector financial capital to the real economy in a way that is consistent with an orderly net zero transition.

In broad terms (and beyond the scope of the specific priorities in the Consultation Paper), government policy will need to entail a combination of reforms and initiatives that will:

- Develop frameworks to improve the scope and quality of data disclosed by entities – that relate to climate-related risks and opportunities, and to projections for emissions – across the economy, in order to better inform decision-making and the allocation of financial capital.
- Reduce barriers (particularly related to regulation and planning) to the required allocation of financial capital, including for new renewable energy infrastructure.
- Provide targeted incentives for certain investments that, while necessary for an orderly transition, may not be attractive for private financial capital on a risk-return basis (for example, incentives for early-stage investment in nascent technologies, such as ‘green’ hydrogen).
- Enable critical infrastructure investment that, for the private sector, may not be attractive on a risk-return basis (for example, electricity transmission networks, which can be subject to elevated timing risk). This could include risk-sharing arrangements between government and the private sector.

Across various sectors of the Australian economy the anticipated scale, complexity and timing of required fixed capital investment will differ, as will the relative reliance on mature and emerging technologies. This implies a complex task of coordinating reforms and initiatives to enable the required scale, distribution and timing of private sector financial capital to the real economy.

Comments on the priorities as set out in the Consultation Paper

Priority 1: Establish a framework for sustainability-related financial disclosures

ASFA has lodged two submissions to the Government’s consultation process on climate-related financial disclosure. The following section re-iterates some of the key points made in those submissions.

An overarching challenge for investors globally is the lack of coherent, complete information on which to base decisions around the allocation of financial capital to facilitate the transition to net zero.

This reflects road blocks throughout the data value chain. At the entity level, estimates of and projections for Scope 1, Scope 2 and particularly Scope 3 emissions (where quantified), and the impact of physical and transition risks on business activities, are subject to significant uncertainty (given path dependency). There is substantial variability in the availability of quantitative data across the population of entities – including the variable use of proxies – and different approaches across jurisdictions. In addition, there are constraints within the broader business ecosystem for meaningful assurance, due to prevailing data quality/availability and capacity.

Superannuation funds rely (and will increasingly rely) on information produced by entities from across the economy on emissions trajectories, and their exposure to climate-related risks (and opportunities). In the absence of robust, consistent approaches around the development and disclosure of that information, the efficient allocation of financial capital from institutional superannuation will be impeded.

In this regard, ASFA supports the work of the Government regarding the adoption, by Australia, of internationally-aligned standards for climate-related disclosure. ASFA also supports the Australian Accounting Standards Board (AASB) formally establishing detailed disclosure standards, aligned as far as practicable with the final standards issued by the International Sustainability Standards Board (ISSB).

We note that the AASB's consultation on the development of Australian standards is expected to conclude in the first quarter of next year (1 March 2024), with the final standards expected to be released shortly thereafter. This is just prior to the proposed commencement of the disclosure regime for large entities (starting on 1 July 2024).

Treatment of superannuation funds within the disclosure regime

ASFA's previous submissions have highlighted that, in terms of disclosing entities, the proposed regime is more applicable to typical non-financial corporate entities than asset owners such as superannuation funds. In particular, while superannuation funds are considered large entities under the regime, and subject to similar requirements and obligations as typical large non-financial corporations, the audience for, and uses of disclosed information will be different.

Across the business ecosystem, corporate entities, in qualifying/quantifying their exposure to climate-related risks and opportunities, will rely on corresponding data produced by other entities within their supply chains. Economy-wide, the data produced by this iterative, interdependent process is expected to improve over time – and become increasingly robust and consistent.

As large institutional asset owners, superannuation funds sit at the end of the data chain. Superannuation funds will utilise corporate-level data to inform the allocation of financial capital to the real economy (and ultimately to disclosing entities). For funds, it is expected that improvements to the coverage and quality of data will enhance capital allocation – and facilitate Australia's transition to net zero.

In contrast, the key audience for disclosures from superannuation funds will be the individual members of funds. By far the largest component of a fund's disclosed emissions (around 90 per cent) will be financed emissions – that is, the emissions related to investee entities. Unlike typical corporate entities, a fund's financed emissions will represent an endpoint in the chain of disclosures within the economy – and so not feed into the disclosures of other entities.

In addition, disclosed financed emissions will be subject to a far greater degree of uncertainty – particularly in the early stages of the regime – compared with aggregate disclosures of typical corporate entities. The reasons are complex, and are described in detail in ASFA's previous submissions.

Overall, as noted in previous submissions, ASFA considers that this warrants a delayed timetable for funds' disclosure of financed emissions and/or greater scope within the regime to account for the inherent uncertainty in quantifying certain estimates.

That said, it should be acknowledged that the latest version of the IASB standards (which are likely to be reflected in the final Australian standards) appear to better reflect the challenges that entities will face in developing meaningful quantitative information about the current or anticipated financial effects of climate-related risk, particularly during the early stages of a disclosure/reporting regime, and the expectations on entities around disclosure obligations (in particular Paragraphs 18-20 of final standards).

> *For example, Paragraph 19(b) states that: An entity need not provide quantitative information about the current or anticipated financial effects of a climate-related risk or opportunity if the entity determines that the level of measurement uncertainty involved in estimating those effects is so high that the resulting quantitative information would not be useful.*

Disclosure: skills and resources gaps

ASFA considers that the realisation of high-quality climate disclosures across the economy would benefit from a collaborative approach between government, regulators and industry to develop the required skills, capabilities and resources.

- For regulators, this would include working with industry to develop and roll-out specific education and training resources – particularly around the reporting of Scope 3 financed emissions.
- For government, this would include working with industry to centralise trusted, authoritative data to support high-quality climate disclosures, including on critical matters such as identifying and measuring physical climate risk across Australia (Section 7)

In previous submissions, ASFA drew attention to the current skills gap in the market, both domestically and globally, in terms of both reporting (as per disclosure requirements) and assurance.

There is a critical role for independent external assurance, aligned with international standards, to lend credibility to climate-related disclosures. Of course, decisions on reporting obligations including consistency and standardisation of reporting (yet to be finalised for the Australian context), will affect an entity's ability to provide accurate information and, ultimately, the ease with which the auditing process can be conducted. Accordingly, entities and assurance providers will need to await the final requirements before a judgement can be made on how feasible it will be to facilitate the audit process.

Given the alignment of the proposed framework to corporate financial reporting requirements, ASFA understands the logic behind the proposal that financial auditors would lead climate risk assurance engagements, with support from technical climate and sustainability experts as required. We believe the participation of climate reporting experts in this market will be important to address skill and supply gaps. However, we would caution that this approach may lead to unnecessary concentration of experts within a subset of professional firms. This may have an impact on the overall level of supply of services and the diversity of approaches to overall climate reporting assurance, and this may be something policymakers need to monitor over time.

Regulatory guidance for disclosure

Government and regulators have a critical role in providing industry with practical guidance on making disclosures. In this regard, guidance should focus on communicating information relevant to implementation (and so not divert scarce resources).

The tight timeframe between the finalisation of standards and the commencement of the disclosure regime means that it is crucial that government provides (concurrently) the appropriate guidance and education resources in timely manner.

As noted in ASFA's previous submission, the ISSB, in developing its disclosure standards, has also developed industry-based guidance for some 11 aggregated sectors and 68 sub-sectors (built on the Sustainability Accounting Standards Board Standards). Within the financial sector, specific industry guidance has been developed for asset management, commercial banks, insurance (and other financial services). This means, for example, in the financial services context, the standards give clear direction on the required disclosures expected for sub-sectors within the broader sector, rather than having to translate all requirements from a general, cross-industry perspective.

ASFA considers that Australia should draw on this approach in the development of its standards and accompanying materials. Industry-specific requirements for Australian superannuation funds and investment management firms will be important in defining and measuring the particular inputs of these entities given they operate as pooled, wholesale investors. Expectations with respect to disclosure will also be required where entities invest in unlisted and direct assets, where availability of data and comparability may be more challenging than in other investment markets.

Implementation of the disclosure regime

It is likely that industry may have further feedback on implementation matters following the release of the final standards, including on the required legislative changes. Industry would be grateful for an opportunity to comment on such matters as soon as practicable.

With respect to enforcement of the finalised regime, ASFA considers that regulators should take a facilitative approach with industry during the initial years of the disclosure regime. This approach would recognise that it will take time for many businesses to build the knowledge and capacity needed to make high-quality disclosures.

Priority 2: Develop a Sustainable Finance Taxonomy

In the context of transitioning investment portfolios to net zero emissions, superannuation funds (and institutional investors more generally) will require a comprehensive and consistent criteria by which to determine whether funding decisions (to the real economy) align with Australia's (and the global) net zero transition. This also applies to the broader set of sustainably objectives beyond the transition to net zero – that is, clear and consistent definitions of what is classified as a sustainable activity, or consistent with sustainability objectives.

Globally, myriad frameworks are evolving to evaluate whether economic activities are aligned with, or contribute to the net zero transition, and sustainability objectives more broadly. For investors, a taxonomy landscape comprising inconsistent or even conflicting information will create distortions and increase costs – and so impede the allocation of financial capital. For superannuation funds, in the context of global net zero transition, this suggests the risk of a lower quantum of funding from superannuation than otherwise would be the case, as well as a less efficient allocation of that funding (in respect of net zero outcomes).

In this regard, the most important priority in the development and use of an Australian sustainable finance taxonomy is to facilitate the Australian economy's transition to net zero.

However, the taxonomy framework should be developed in a way that its coverage can be extended (over time) to encompass the universe of sustainability-related issues – from climate mitigation across all sectors of the economy, climate adaptation, activities that contribute to the preservation of natural capital and biodiversity, and sustainability more broadly.

The Consultation Paper notes that the initial development phase of a sustainable finance taxonomy will be led by the Australian Sustainable Finance Institute (ASFI) with oversight provided by the Council of Financial Regulators (CFR) Climate Working Group. Development will entail ongoing consultation with industry. Separately, ASFI states that this initial development phase will run to at least mid-2024 (or more realistically the end of 2024).

Prioritisation of climate in taxonomy development

ASFI notes that the initial development phase will focus on three key sectors: electricity generation and supply; minerals, mining and metals; and construction and the built environment (with the possibility of extending this to two more of; manufacturing, transport and agriculture). The chosen sectors align with the sectors identified by the Government for specific sectoral emissions reduction pathways (as per Priority 3).

ASFA supports this approach. As per Priority 3, six sectors have been identified by the Government as being critical to Australia's net zero transition. The associated sectoral emissions reduction pathways will help guide the allocation of financial capital across the economy in a manner that is consistent with Australia's net zero transition. In this context, a climate-related taxonomy would help investors to determine whether particular entities/activities (as a destination for financial capital) are consistent with net zero transition. In this regard, it is important that there is alignment between sectoral pathways and taxonomy.

With respect to expanding the coverage of the taxonomy (beyond net zero for six key sectors), it would be preferable in the first instance for the net zero taxonomy to be extended to remaining sectors of the economy. This approach would be consistent with the Government's proposed approach to prioritise climate (reflecting the systemic nature of climate-related risks for the Australian economy, and the need for urgent economy-wide action), and would be able to leverage work undertaken for the key sectors.

This approach is also likely to most closely align with priorities and progress in other jurisdictions.

More broadly, it is crucial that the Australian taxonomy is developed in concert with equivalent taxonomies in other jurisdictions, such that it is internationally credible and operable. Inter-jurisdictional consistency will help to limit costs for Australian investors who allocate capital offshore. This is particularly relevant for superannuation funds – whose total allocation to offshore assets is around 47 per cent (and rising). It will also mean that Australia, as a destination for foreign financial capital, will not be at disadvantage.

Incorporating transitional activities for net zero

ASFA agrees that, of particular importance, is a taxonomy framework that acknowledges the role of transitional activities and finance in the broader net zero transition – and that the framework does not, in and of itself, impede transitional finance. That is, a credible taxonomy regime needs to recognise that certain economic activities will be necessary to support Australia's transition to net zero in the short-to-medium term, even if they are not consistent with net zero or other goals in the long term.

It worth noting that ASFI's work in this regard revealed broad in-principle support for the inclusion of a transitional category in the taxonomy. However, ASFI has noted that there is limited consensus on the appropriate methodology for how a transitional category could be integrated into the taxonomy. The lack of consensus on this point highlights the core challenge: the balance between the need to direct financial capital toward transiting sectors/entities, while also maintaining the credibility of the taxonomy. Accordingly, an important priority for the taxonomy is to define what activities are 'transitional'.

Design for achieving sustainability outcomes

The core purpose of the taxonomy is to facilitate investment decisions, and flow of financial capital, which is consistent with sustainability objectives.

A key risk in taxonomy design is that the criteria by which to determine whether funding decisions align with sustainability objectives ultimately discourage investment that otherwise would be consistent with objectives (and so would be at odds with the purpose of the taxonomy).

- In this regard, design principles should ensure that the criteria are clear and principles-based, and that the process for development of the taxonomy includes ongoing, wide-ranging consultation with industry – see next section.

There is an inter-temporal element to this risk: the more restrictive the criteria, the greater the risk that (over time) activities and investments that might have been considered sustainable (in accordance with the taxonomy) at a particular point in time, might not be considered sustainable at a later point in time.

While this risk can be reduced through taxonomy design, it cannot be eliminated. In this regard, it would be appropriate to incorporate a grandfathering mechanism, coupled with an obligation to disclose that an investment is no longer consistent with a sustainability criterion. Not only would this avoid penalising funds for making decisions that were, at one time, consistent with sustainability criteria, it also would avoid disorderly disinvestment from such assets (which would be at odds with the broader ambition for an orderly economy-wide transition to net zero).

Governance for taxonomy development

The Consultation Paper notes that the initial development phase of a sustainable finance taxonomy will be led by ASFI with oversight provided by the CFR Climate Working Group.

It is crucial that the governance arrangements for development of taxonomy provide for a transparent, consultative process, and instil confidence across the broader business and financial sector (these shorter-term governance issues are arguably more critical than longer-term governance arrangements for a finalised taxonomy – as per the Consultation Paper).

- Part of this would involve demonstrated adherence to the scientific understanding of what is needed to limit global warming and mitigate the risks of climate change.

Ultimately, governance arrangements will have a significant bearing on whether the final taxonomy will be widely considered credible and legitimate, and whether it is widely adopted.

ASFI should ensure good governance practices. In particular, ASFI’s consultations and deliberations should be transparent. This includes soliciting feedback from stakeholders, publication of submissions to consultations, publication of responses to consultation drafts, and publication of meeting agendas and minutes.

Integrating the taxonomy into the regulatory architecture

At this time, ASFA considers that is too early to specify the particular form of integration into regulatory architecture (by legislation or otherwise). Ultimately, this will depend on the final shape of the taxonomy – and in particular whether it is widely regarded as credible and legitimate, is widely adopted, and is considered by market participants as materially supporting Australia’s transition to net zero.

Priority 3: Support credible net zero transition planning

The Consultation Paper notes that disclosure requirements regarding corporate transitions plans will be consistent with those within the proposed regime for the disclosure of climate-related risks and opportunities (Priority 1), and that the Government does not intend to introduce transition plan disclosure requirements that go beyond those standards in the near term.

ASFA considers that credible transition plans are essential for Australia to meet its net zero targets. As such, it is appropriate for government to require corporate entities to develop and disclose transition plans.

Government will have a critical role in supporting corporate entities – including by providing guidance on what credible transition plans look like, and by providing 'baseline' transition pathways for specific sectors and economy-wide (see below).

- Other jurisdictions have established frameworks that could inform development of Australian transition plan requirements, such as the UK's Transition Plan Taskforce Disclosure Framework.

Transition plans will need to be referenced against sectoral, economy-wide transition

Ultimately, the transition plans developed by individual corporate entities will need to be 'benchmarked' to the macro-level transition plans for the Australian economy.

As noted in the Consultation Paper, the Government is developing 'national sectoral emissions reduction pathways', which will provide emissions reductions trajectories and priorities in key sectors: electricity and energy; transport; industry and waste; agriculture and land; resources; and the built environment. Directly, these sectors account for roughly one-third of Australia's GDP and one-third of the total fixed capital investment undertaken within the Australian economy each year.

The overarching context for the sectoral pathways is the Government's commitment to reduce aggregate national emissions to net zero by 2050. Within this context, the core role for government in Australia's sectoral transition planning reflects, in part, that a range of planning and regulatory constraints would otherwise impede the required allocation of financial capital, and that incentives to encourage private sector investment in certain assets is likely to be required (for example, nascent technologies).

For corporate entities, their transition plans will be informed by, and contingent on, the Government's sectoral pathways. This includes corporate entities within the six key sectors, but also corporate entities that sit outside those key sectors (that will be impacted by developments in the key sectors).

The Climate Change Authority (CCA), which has been tasked with undertaking this work, will deliver its outcomes on 1 August 2024. Given this, it would be unrealistic for corporate entities to be able to develop credible, robust transition plans that are consistent with the Government's proposed timing for large corporate entities (in effect, from 1 July 2024).

The Consultation Paper states that ASIC will set out its expectations and supervisory priorities relating to the disclosure of transition-related targets after the finalisation of the regime for climate-related disclosures (after 1 March 2024). ASFA suggests an appropriate transition period for compliance with disclosure of corporate transition plans.

Superannuation fund transition plans

ASFA understands that, as large corporate entities, superannuation funds would be subject to the requirements for transition plans. It should be noted that in terms of transition planning, a distinction can be made between the superannuation business, and the portfolio of assets that funds hold on behalf of members.

The operational aspects of superannuation funds are analogous with operations of other typical corporate entities, and as such it would be reasonable to expect that the standard transition plan requirements should apply to a superannuation fund's business.

With respect to investment portfolios, their transition to net zero portfolio emissions is fundamentally intertwined with economy-wide transition both in Australia and globally. APRA-regulated superannuation funds are universal asset owners. While exposure to, and the impacts of, climate-related risk can vary markedly across different entities within an economy, for superannuation funds exposure is more systemic in nature.

Critically, for superannuation funds, as universal asset owners, their transition plans (to net zero portfolio emissions) will be particularly informed by, and contingent on, the Government's sectoral pathways. This relates to fund investments in corporate entities across the Australian economy (in the six key sectors and more broadly). Clarity of the Government's expectations for each sector, and how emissions are expected to evolve, will help superannuation funds determine what degree of emissions-reduction ambition to expect of companies in different sectors.

Priority 4: Develop a labelling system for investment products marketed as sustainable

The Government intends to standardise the use of sustainability terminology in investment product marketing by setting minimum standards for what qualifies for a prescribed sustainability label. ASFA notes that a labelling regime will require a comprehensive consultation process that goes beyond this Consultation Paper.

A standardised, transparent and well-understood labelling regime would have broad benefits. It would build confidence among retail investors that the investment products marketed as sustainable are true to label. This would help facilitate growth in the sustainable investment product markets, and enhance the allocation of financial capital more broadly.

ASFA agrees with the proposal in the Consultation Paper that – in the interests of regulatory consistency across all forms of investment products marketed to retail investors – a given labelling regime should apply to all sustainable investment products marketed to retail investors, including managed investment scheme products and superannuation investment options.

Main design principles for labelling

Product-level labelling should be easily understood by, and easily accessible to, consumers. Product-level labelling should help consumers to understand the key sustainability-related features of an investment product, and allow consumers to navigate the market for those products more easily. Some elements of regimes currently in development in other jurisdictions are instructive.

- Product classification should be based on 'intentionality' to achieve positive sustainability outcomes.
- Product-level labelling should use objective, descriptive language rather than subjective comparisons.
- Product level labelling should be underpinned by a set of clear, objective criteria: the product's sustainability objective, the product's investment approach, and the product's performance against its objective. These criteria should be disclosed to consumers.

- Product names/marketing should be aligned with, and proportionate to, the product's sustainability-related objectives and strategy. Product-level labelling of sustainability-related claims must be clear, fair and not misleading.
- Metrics for measurement of social and environmental contribution need to be able to be practically implemented, without narrowing investment approaches unnecessarily.

A labelling regime would need to account for the potential for confusion on the part of consumers between fund, product and investment option

The Consultation Paper states "that funds that integrate sustainability into investment processes without an explicit sustainability objective would not qualify for a label." There are potential points of confusion for consumers in distinguishing between sustainable funds and products.

For example, consider the case of a fund that has a robust net zero transition plan for emissions – that is, a net zero ambition (by 2050) at the fund level. The fund's ambition would be consistent with the Government's net zero target, and consistent with the requirements of a sustainable labelling regime (with respect to net zero). It might be the case that some individual investment products may not have an explicit net zero sustainability objective (such as the fund's MySuper product option). However, it would be likely that the fund would be considered 'sustainable for net zero' if the labelling regime were to be applied at the fund level.

Beyond this, there are challenges around the transition to a sustainable labelling regime. In particular, it is likely that some investment products that are currently labelled as 'sustainable' may not meet the minimum standards under a new regime. This would be a potential source of confusion for retail investors in such products – so a transition mechanism would be appropriate.

Consistency with the broader Sustainable Finance Strategy

From the perspective of superannuation funds, it is important that the labelling regime is consistent with other elements of the Sustainable Finance Strategy. In particular, that investment product labelling align as closely as possible with the forthcoming sustainable finance taxonomy.

Similarly, given the fundamental role that 'transitional' activities and finance will play in the Australian economy's net zero journey, the ability of the product labelling regime to identify companies/investments where transition plans are credible/best practice is also critical. This in turn emphasises the pressing need for government guidance and requirements for companies disclosing transition plans (as per Section 3 above).

Leveraging existing work

As a basis for a labelling regime, there is an argument for leveraging existing frameworks already developed for the Australian context – such as the certification regime developed by the Responsible Investment Association Australasia (RIAA).

The RIAA certification program indicates whether a product or provider is delivering on its responsible investment objective. Certified responsible products/providers must meet a range of requirements around investment approach, disclosure and governance. With respect to the former, this includes whether a product/provider has implemented an investment style and process that systematically takes into account environmental, social, governance or ethical considerations.

That said, the RIAA certification is not, in and of itself a labelling regime – that is, the certification regime is not a consumer facing tool. ASFA considers that the fundamental purpose of labelling would be to help consumers to distinguish between investment products with respect to:

- different sustainability themes
- (within each theme) particular objectives and characteristics.

This could, for example, include investment approaches that; integrate ESG factors in investment decisions, use an exclusions-based approach, or distinguish between investment approaches that focus on social or environmental factors.

Priority 5: Enhancing market supervision and enforcement

Broadly speaking, ASFA considers that regulators should take a facilitative approach (rather than enforcement-focused approach) with industry during the initial years of the various elements of the Sustainable Finance Strategy. This includes the disclosure regime for climate-related risks and opportunities; the sustainable finance taxonomy; and transition plans.

In each case, a facilitative regulatory approach would recognise that it will take time for superannuation funds, and the entities in which funds invest (and from which funds derive data) to build the required expertise and capacity to develop high-quality, broad-based disclosures.

Similarly, regulators will have a crucial role – particularly during the initial years of the various elements of the Sustainable Finance Strategy – to provide industry with practical guidance on making disclosures, and to work with industry to develop and roll-out specific education and training.

Priority 6: Identifying and responding to potential systemic financial risks

At a system level, the transition of institutional superannuation to net zero is fundamentally intertwined with economy-wide transition both in Australia and globally. APRA-regulated superannuation funds are universal asset owners. While exposure to, and the impacts of, climate-related risk can vary markedly across different entities within an economy, for superannuation funds exposure is more systemic in nature – and to an even greater degree at the system level.

Superannuation funds are exposed to climate risk in terms of operations and investments.

- Operational risks: these relate to the impacts of climate change on both members and the industries in which they work. For example, member impacts include changes in membership in-flows as industries are impacted by climate change in different ways, and the likelihood of increased insurance requirements and payouts as health and safety is impacted.
- Investment risks: the physical and transition risks associated with climate change impact the value of investments and increase the likelihood of stranded assets.

Conversely, with respect to the Australian economy at least, the superannuation system will play a key role in the required economy-wide transition. In particular, the superannuation system (as a major source of funding for the Australian economy), can support a transition that avoids the worst impacts of climate change, while limiting disorderly economic or financial adjustments – and thus support the wellbeing of Australians.

Ultimately, the more orderly the transition to net zero (by Australia and globally), the better able superannuation funds will be to manage the systemic and operational risks highlighted above, enabling them to protect and preserve the value of investments on behalf of their members.

ASFA considers that government and regulators can contribute to market-wide understanding of systemic sustainability-related risks by providing access to sophisticated modelling of climate-related risk facing the

Australian economy (both physical and transition), that looks at specific key sectors, as well as projections for emissions for key sectors of the economy (as per Section 3).

ASFA acknowledges the work of APRA in the first stage of the CFR's Climate Vulnerability Assessment, which measured the potential physical and transition climate risks of climate change faced by the major banks and highlighted the value of collaboration between financial institutions and regulators to identify and manage these risks. ASFA considers there would be benefit in extending this assessment to the superannuation sector.

Priority 7: Addressing data and analytical challenges

As ASFA noted in its submission to the Government's consultation on climate-related financial disclosure, from the perspective of superannuation funds, there are myriad gaps in the quantum and quality of climate-related data from the entities in which funds invest.

At the entity level, estimates of and projections for Scope 1, Scope 2 and particularly Scope 3 emissions (where quantified), and the impact of physical and transition risks on business activities, are subject to significant uncertainty (given path dependency). There is substantial variability in the availability of quantitative data across the population of entities – including the variable use of proxies – and different approaches across jurisdictions. In addition, there are constraints within the broader business ecosystem for meaningful assurance, due to prevailing data quality/availability and capacity.

Feedback from investment managers indicates that asset owners are now using an array of reporting platforms to source ESG, particularly climate change-related greenhouse gas data.

Superannuation funds are at the end of the chain of disclosures in the economy. Estimates of Scope 3 financed emissions are reliant on the disclosures of the multitude of entities that funds invest in on behalf of their members. Given their position at the end of the investment chain, the most significant challenge for superannuation funds relates to the availability and quality of the required data from third parties in order to construct meaningful and accurate Scope 3 financed emissions reporting. This adds an extra layer of complexity to the capabilities and systems required to collect, process and generate the necessary outputs required.

Data quality and availability will improve incrementally. Individual entities will gain a better understanding of climate change risks and opportunities (learning-by-doing), reinforced by positive feedback loops between entities (as part of common supply chains). Data sharing and transparency to foster industry-wide progress will improve, and assurance expertise and capacity will rise. But all this will take time.

At a system level, a standardised approach led by government is required.

In the first instance, the Government could standardise requirements on how this data is presented (that is, Scope 1, 2 and 3 emissions). For entities, such as superannuation funds, which need to aggregate and compile data from a multitude of different sources, a standardised approach would lead to significant efficiencies and in data collection/compilation, but also increase confidence around the comparability of data from different sources.

More broadly, government has an important role in centralising trusted, authoritative data to support high-quality climate disclosures, including on critical matters such as identifying and measuring physical climate risk across Australia. As noted above, this could include access to outputs of sophisticated modelling of climate-related risk facing the Australian economy (both physical and transition), that looks at specific key sectors, as well as projections for emissions for key sectors of the economy.

With respect to sustainability more broadly, the Government can play a role in supporting the data foundations regarding natural capital and biodiversity that are needed to develop risk assessments. Because of Australia's diverse ecology, data would need to be developed at a regional level – which, in turn, would help corporate entities and institutional investors to develop more precise risk assessments.

Priority 8: Ensuring fit for purpose regulatory frameworks

The Government needs to be cognisant of sustainability matters just becoming another tick-the-box exercise through integration into other regulatory frameworks. For Australia, the context is the evolving legal opinion on directors duties with respect to climate-related risks – which is that for companies, climate-related risks should be regarded as foreseeable given the large amount of information already available. As such, failure to identify, manage and disclose material nature-related risks may lead to increased shareholder pressure and even litigation.

To assist superannuation funds in their stewardship activities, ASFA supports the development of an industry-led stewardship code. This would provide funds with guidance on how to navigate sometimes contentious stewardship issues – such as potential divestment. It also would help improve industry standards on issues such as benchmarking, consistency in stewardship practices, quality of reporting and would set a minimum basis for stewardship activities. The UK Stewardship Code 2020 is a potentially useful model for the Government to consider. A code that is overseen by the appropriate regulator (likely ASIC), and that applied to the universe of institutional investors, would help drive improvements in stewardship practices across the whole sector, including asset managers and assets consultants.

Your Future, Your Super performance test

The Consultation Paper notes that the Government will continue to explore and consult on further changes that improve the sophistication of the Your Future, Your Super (YFYS) performance test.

Recent research reveals that the YFYS test does affect fund investment decisions, and so does impact the ultimate allocation of financial capital across the Australian economy.

Potential impacts include disincentives to investment in new projects. In terms of industry composition, the YFYS benchmarks necessarily comprise current assets and thus are heavily weighted to conventional energy generation rather than alternatives (and so are 'backward-looking'). Renewable energy assets comprise a very small component of the current benchmark allocation. Thus, being over-weight in renewables is a potential source of tracking-error risk vis-à-vis the benchmarks.

More broadly, however, is the risk that for some funds, increased sensitivity to benchmarks (as it relates to investment decisions) is driving overall strategic asset allocation towards asset classes that are readily benchmarked – listed equities for example. This relates to infrastructure, but also private equity investments.

ASFA has previously put forward policy options that would help reduce the risk of 'underinvestment' by superannuation funds in certain asset classes due to the YFYS regime. This includes a 'right-of-review' process for products that fail the performance test (for more details, see the ASFA submission to Treasury on the Review of the YFYS regime).[1]

The Government also should consider measures such as adopting high-quality benchmarks (asset classes or sub-asset) that include an ESG component, to help incentivise sustainable investments across asset classes.

[1] ASFA 2021, Submission to Treasury, *Review of the YFYS Regime*.

To ensure integrity, these benchmarks would need to be universally recognised, specified, chosen in advance, and unable to be gamed in retrospect once the result of the product and benchmark is known.