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Public Submission to Australia's Sustainable Finance Strategy Consultation Paper

This submission is made in response to the paper released on 2 November 2023 on Australia's Sustainable Finance Strategy and the specific questions raised in the paper. This submission is made by our private equity business, Adamantem Capital, and our public equities business, Melior Investment Management.

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Treasury consultation paper on Australia's Sustainable Finance Strategy

Adamantem Capital and Melior Investment Management (the "Adamantem Group") submission

Introduction

The Adamantem Group welcomes the opportunity to provide feedback on Australia's Sustainable Finance Strategy and the specific questions raised in the November 2023 consultation paper ("Consultation Paper"). This submission is made by our two key operating businesses, our private equity business Adamantem Capital[1], and our public equities business Melior Investment Management[2] and responds to a subset of the questions raised in the Consultation Paper.

Who we are

Adamantem Capital

Adamantem Capital is a private equity investment manager, established in 2016, specialising in the Australian and New Zealand mid-market. It invests with conviction behind clear, well-articulated and well-researched value creation opportunities. Adamantem Capital currently manages three private equity investment funds. Adamantem fully integrates responsible investing into its investment approach, focussing on delivering financial returns, including through a strong focus on creating positive environmental and social outcomes.

Melior Investment Management

Melior is a specialist equities manager founded in Australia in 2018 and is manager of the Melior Australian Impact Fund. Melior's seeks to deliver long term competitive returns and contribute positively to the United Nations Sustainable Development Goals (SDGs). Melior's investment philosophy is that investing in companies that contribute to the SDGs, and have strong financial and ESG credentials, has the potential for benchmark outperformance over time. Melior seeks to contribute to the SDGs through allocating its investment capital to positive impact companies, engaging management and boards to improve their sustainability and impact practices and publicly advocating for better social and environmental outcomes and measuring progress.

[1] Adamantem Capital Management Pty Ltd (ABN 31 616 283 124)
[2] Melior Investment Management Pty Ltd (ABN 16 629 013 896)

Our Response to the Consultation Paper Questions

Overarching Messages

- A Sustainable Finance Strategy ('the Strategy') for Australia is critical to help bring Australia into alignment with global developments and support access to international capital.
- We support the 'key principles' identified in the Consultation Paper, in particular maximising alignment with global sustainable finance frameworks, Australia taking a high-ambition approach, phasing of reforms, and sensibility and usability and shared responsibility.
- We welcome the recognition in the Consultation Paper that sustainable finance goes beyond climate to include broader environmental and social considerations. We endorse the suggested focus on climate-related reforms in the near term, while providing a platform to address other sustainability-related issues over time. Other sustainability-related issues of note are nature and biodiversity, and First Nations perspectives and outcomes.
- Capacity building is a critical obstacle to achieving a number of the priorities in the Consultation Paper. This includes a shortage of sustainable finance professionals, along with a need to build a stronger understanding of climate and sustainability risks and opportunities within both the private sector and the government.
- We believe there is a need to prioritise development of publicly available Australian climate and nature scenarios in order for financial institutions, investors and industry to evaluate material climate and nature risks consistently and robustly. Development of publicly available Australian climate scenarios will support the ability to deliver on a number of priorities in the Consultation Paper.
- We agree with the approach of incorporating First Nations' perspectives and expressly considering the social and economic outcomes for First Nations Peoples.
- Integrating social concerns into sustainable finance frameworks is important for enabling financial institutions, investors, and industry to accurately recognise and consider social risks and opportunities alongside environmental ones. This will require development of key policies to include consistent social disclosures and consideration of the requirements for a 'Just Transition'.
- The Consultation Paper encompasses a wide range of topics and many of the questions posed are complex. We have found the 30-day consultation period to be a very short timeframe within which to provide full responses which take into account the perspectives of all our key stakeholders. We strongly encourage the government to continue to engage and consult with the private sector and other key stakeholder as the Strategy is developed and implemented.

Pilar 1 – Improve transparency on climate and sustainability

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

- Adamantem and Melior support the introduction of mandatory climate-related disclosures for large Australian businesses. We have engaged directly in this process by providing submissions to both Treasury consultations to date. Our submission to the Treasury's second consultation earlier this year is available here.

What are the opportunities for Government, regulators and industry to support companies to develop the required skills, resources and capabilities to make climate disclosures under the proposed new obligations?

- There are multiple issues that need to be addressed properly and promptly to support implementation of the proposed mandatory climate disclosures, most pressingly:
  - Availability and accuracy of data, and expectations for how companies should address data gaps, for example in relation to Scope 3 emissions.
  - Skill capability building, in particular for climate modelling, carbon accounting, scenario analysis and assurance and verification work, where skill sets don't exist or are limited in comparison to the level of demand that will develop in the market.
  - System capabilities, for example the development of publicly available Australian-level climate scenarios.
- The proposed new reporting obligations require entities to disclose qualitative and quantitative information about the effects of climate-related risks and opportunities on their financial position (both current effects and anticipated effects). Undertaking this analysis will not be possible for most reporting entities without all three aforementioned issues being addressed to at least some extent prior to implementation.
- Appropriate phasing in of requirements will assist in managing demand for limited skill sets and enable smaller companies to learn from larger companies reporting earlier. As part of the phasing requirements, consideration should be given to the relative cost burden of reporting on smaller entities, who in many cases will not be able to support the same level of detailed analysis (either through external consultants or internal resources) as larger entities.
- Government and regulators should take the approach of setting very clear and specific guidelines and expectations on reporting entities. Providing this clarity will not only support implementation by reporting entities, but will also contribute to the ability for investors to compare reporting entity disclosures against going forward.

How should the Government, regulators and industry prepare for global developments in sustainability-related financial disclosure frameworks and standards, including the TNFD?

- Adamantem and Melior support the Strategy's proposal to adopt evolving global sustainability reporting standards. This will reduce the reporting burden on companies by streamlining reporting standards, and also ensure Australia keeps pace with global developments, facilitating a strong environment for ongoing capital allocation to Australia by international investors.

- Australia needs to stay connected to international working groups and set up domestic structures to translate and integrate international advancements into domestic frameworks. Consistency and alignment with global practices are essential, benefiting both investors and alleviating the compliance burden on companies.
  - The Australian Government – through appropriate agencies – should engage actively in international processes that are developing sustainability standards. This would be consistent with the Strategy's commitment in Pillar 3 and would help ensure that evolving international frameworks accurately mirror and uphold Australia's interests.
- Three critical areas of focus for Government, regulators and industry in this process are:
  - Development of benchmarks: Establishing clear benchmarks is essential for interpreting financial disclosures effectively. Without a point of comparison, providing information or analysing disclosures becomes less useful. These benchmarks can be both market-wide and industry-specific, ensuring a more meaningful evaluation. These need to take into account any international benchmarks being developed, as well as adaptation to the local Australian context.
  - Governance: Rigorous governance standards play a crucial role in the successful implementation of a financial disclosure framework. Related to the comment on skills capacity building above, the Government and regulators should consider what support is required by Boards and Directors to adequately consider and sign off on sustainability-related disclosures, as this will be critical to the ability of corporate Australia to continue to attract high calibre Board candidates.
  - Data and Databases: Integrated databases and tools to provide access to data and methods for conducting the necessary analysis in a cost-effective and consistent manner will significantly enhance reporting. This is especially critical for nature-related reporting, which presents a greater complexity than climate-related reporting due to variations based on location.

Priority 2: Develop a Sustainable Finance Taxonomy

<u>What are the most important policy priorities and use cases for an Australian sustainable finance taxonomy? What are the key insights from international experience to date?</u>

- We believe that the following features are critical to the development of a sustainable finance taxonomy that supports the Strategy:
  - The goal and intended use cases of the taxonomy must be clearly identified and communicated, including with industry input.
  - The taxonomy must take into account the sustainable finance regulatory environment that is being developed alongside it to maximise consistency and usability.
  - The taxonomy must take into account international taxonomies, and seek to be as aligned as possible, although adapted as required to the local context.
  - Include detailed guidance on measurement approaches that can be practically adopted, not just definitions.

    - Consideration needs to be given to how the taxonomy will evolve as the international context evolves, the transition unfolds, and changes are made to the Australian regulatory environment. There must be a balance between certainty and flexibility.
- The substance of the taxonomy must appropriately address hard to abate sectors. The decarbonisation of many hard to abate sectors is critical to achieving Australia's decarbonisation targets, and the taxonomy should appropriately consider this to ensure these sectors are not stigmatised or excluded from capital allocation pools.
- It cannot be emphasised enough that it is critical that all the components of Australia's sustainable finance architecture are developed consistently and with engagement across all key working groups. For example, the taxonomy must be compatible with any Australian-level climate scenarios, sector decarbonisation pathways, and transition planning guidelines.
- Insights from our experience with international taxonomies include:
    - Keep the taxonomy as simple as possible.
    - Having a list of 'bad industries' is counter-productive and stops investors allocating capital to improve actions/behaviours and creates ambiguity about supply-chain related investments.
    - Developing a robust approach to 'do no significant harm', which clearly articulates what is meant by "significant harm" and provides sufficiently detailed guidelines for investors to follow (including in relation to the timing of the application of the test), will significantly enhance investor's ability to allocate capital into taxonomy-aligned investments.

<u>What are priorities for expanding taxonomy coverage after the initial focus on climate mitigation objectives in key sectors?</u>

- The climate first approach, covering both mitigation, adaptation and resilience, is consistent with the approach being taken in most taxonomies internationally and therefore seems appropriate for Australia's taxonomy progression.
- The Australian taxonomy should ultimately cover other key sustainability objectives if it is considered the best tool to mobilising capital towards sustainability goals. Following climate, topics coverage should eventually expand to nature and biodiversity, human rights and social inclusion and equity. Expansion to other topic areas should take into account international developments, but also key areas which are most important to the Australian economy and investment environment.
- The roadmap for the taxonomy coverage should prioritise outcomes necessary by 2030 and give precedence to activities and industries that are crucial for advancing decarbonisation in this decade.

What are appropriate long-term governance arrangements to ensure that the taxonomy is effectively embedded in Australia's financial and regulatory architecture?

- We believe that it would be more effective, and reduce complexity, if responsibility for the taxonomy was integrated into the mandate of an existing body.
- However, it is crucial in the development phase to incorporate substantial input from the finance sector, industry and independent technical experts. This is essential to establish credibility, align with the expectations of global capital markets, ensure usability, and garner broad support through stakeholder input. Once established, it is important that consultation with these stakeholders continues and is embedded into the taxonomy governance structure.
- Initially we believe the taxonomy should be voluntary to allow for capacity building. Consideration should be given at intervals as to whether taxonomy-aligned reporting should be made mandatory or continue to be voluntary, and broad private sector consultation should be part of the consideration process. If it were to be mandatory further consideration would need to be given to whether the initial governance arrangements are still appropriate.
- As noted above, it will be important to embed a recurring review process to continuously update elements aligned with the taxonomy as the transition to Net Zero unfolds.

Priority 3: Support credible net zero transition planning

What are key gaps in Australian capability and practice, including relative to 'gold standard' approaches to transition planning developed through the TPT and other frameworks?

We believe the following is required in the Australian context in order to support best practice transition planning:

- A clear definition of 'Net Zero,' including specific guidelines on the timeframe for achieving 'Net Zero,'.
- Clear and robust standards governing the utilisation of offsets, encompassing considerations of when, how many, and what types, for how long and the associated disclosures required. This is crucial for establishing credible transition planning and should be addressed as a priority. The Transition Plan Taskforce (TPT) Disclosure Framework contains relevant guidance on this.
- Clear models for evaluating physical and transition risk. Standardisation and public availability of these models are necessary to ensure high-quality transition planning, extending beyond large corporates.
- Detailed guidelines for incorporating 'just transition' elements. Climate action in Australia will disproportionately impact various groups, including First Nations Peoples, those in declining sectors (like coal mining) and rural and regional Australia. Australia's transition planning framework should establish a high standard for 'just transition' requirements, encompassing social dialogue, re-education, re-skilling and engagement with traditional landowners and rural communities.

Key takeaways from the TPT for consideration in an Australian framework include:

- A recommendation that entities update the standalone transition plan periodically, either when there are significant changes to the plan, or at least every three years. It is not necessary for businesses to update the plan each year if there have been no material changes. In the interim years, progress against the plan and all other content in the plan that is deemed material to investors should be reported on an annual basis as part of TCFD- or ISSB- aligned disclosures (if required).
- The inclusion of an engagement strategy as a key component of transition planning. Scope 3 emissions for most businesses are significantly higher than Scope 1 & 2 and should be addressed in transition planning to the extent influence is possible.
- Linking transition planning to management incentives and remuneration. This link can be to transition plan considerations or transition-plan performance indicators, however it is expected that this form of governance will garner action.

<u>To what extent will ISSB-aligned corporate disclosure requirements improve the transparency and credibility of corporate transition planning? What additional transition disclosure requirements or guidance would be most useful in the medium-term?</u>

- There is currently no standardisation in sustainability-related corporate disclosure. ISSB will be the first step to progressing in this direction and as such is expected to improve the transparency and credibility of corporate transition planning. The recommendations above are, however, critical to this.
- We support the proposed approach in the Consultation Paper for ASIC to release its expectations and priorities regarding disclosure of transition-related targets, plans and claims and for the government to conduct consultation in 2024 with industry and other stakeholders to consider options for strengthening transition planning. We would expect transition-related targets, plans and claims, should align with Australia's national decarbonisation targets, the decarbonisation pathways being developed, and international commitments to the transition.

<u>Are there related priorities and opportunities for supporting enhanced target setting and transition planning for nature and other sustainability issues?</u>

- Similar to our responses on the taxonomy, transition planning should begin integrating nature risk, given the substantial reliance on nature across the Australian economy.
- However, substantial additional work is required before this will be practically possible:
    - A key driver for Australian businesses to develop transition plans for nature (including setting entity level targets) is the presence of nationally endorsed targets in legislation (taking into account the global target set out under the Kunming-Montreal Global Biodiversity Framework (GBF)), supported by policies to achieve them, and the availability of data enabling businesses to understand their dependencies, impacts, risks, and opportunities. Before committing to any targets, it

    is crucial to benchmark Australia's current nature outcomes as a basis for target setting.
  - the Government should define what ‘sensitive locations’ and ‘areas deemed to be ecologically sensitive’ are for Australia. This involves creating and maintaining robust, credible tools, and datasets that make these locations, and associated information, accessible for consultation and use by financial institutions, industry, and the broader public.
- To catalyse private sector investment in Australia for nature restoration and protection, it is also critical to ensure that other reforms to Australia’s environmental protection laws (e.g. EPBC reform) and the development of the proposed Nature Repair Market (and any future environmental-related funding mechanisms) are aligned with Australia’s nature-related targets and commitments.

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

<u>What should be the key considerations for the design of a sustainable investment product labelling regime?</u>

Careful consideration of the purpose and goals of the regime:

- Similar to our comments on the taxonomy, the goal of the regime must be clearly identified and communicated, including with industry input. Consideration needs to be given to carefully balancing the impacts of such a regime – for example, there needs to be a balance between seeking to reduce greenwashing risks while also designing the regime to continue to attract capital into sustainable investments that promote the achievements of the Strategy’s goals.

Consistency with other Australian sustainable finance developments:

- Any regime must align with the Australian sustainable finance taxonomy and the sustainable finance regulatory environment that is being developed alongside it to maximise consistency, usability and effectiveness. For example, the lack of alignment between the SFDR and the EU taxonomy has created an array of implementation issues and impacted the allocation of capital to sustainable investments.
- Consideration needs to be given to how the regime will evolve as the international context evolves, the transition unfolds and changes are made to the Australian regulatory environment. There must be a balance between certainty and flexibility to ensure investment managers and investors are not negatively impacted by a change in law risk as a result.

The development of clear guidance and metrics:

- The regime must be completely transparent on methodology, assumptions, investment approach and reporting requirements.

- Deep consideration needs to be given to the standards required for each tier of product labelling, with a particular focus on ensuring that the regime does not have the effect of deterring investment into exactly the areas the Strategy is seeking to support. The EU has experienced issues where the Article 9 standard is unattainable in some cases, leading perversely to market participants pulling away from lodging as Article 9 aligned investments based on greenwashing concerns.
- We strongly recommend that consideration should be given to contemplating a product category where, initially, an investment within a sustainable investing product may not satisfy all elements of the highest tier but includes within its investment thesis a change agenda to achieve it. This will provide more certainty to stimulate investment into genuinely impactful “pivot” or “transition” type investments, which is aligned with the goals of the Strategy.
- The regime should consider tolerance levels for potentially negative side effects – there should be limited, but not zero, tolerance within the higher product tiers, as zero tolerance is an unattainable standard for the majority of investments.

Investor input:

- It is absolutely crucial that substantial investment industry input and consultation is carried out as part of the development of any product labelling regime.
- Any product labelling regime is likely to significantly increase the compliance and reporting burden on investment managers of sustainable investment products, and consideration must be given to simplifying and streamlining this as much as possible in order to reduce this.

Interoperability:

- In the context of international capital flows, it is crucial for the Australian Government to engage with foreign jurisdictions to secure international recognition of each other’s regimes. For example, as an Australian based fund manager if we comply with the Australian product labelling regime for a certain type of sustainable investing product, it significantly enhances our ability to attract international capital if this regime is recognised as credible under offshore jurisdiction product labelling regimes without duplicating compliance and reporting requirements.
- Any product labelling regime should also consider rapidly developing global standards for “impact” measurements.

<u>How can an Australian model build off existing domestic approaches and reflect key developments in other markets?</u>

- Refer to previous response.

Pilar 2 – Financial system capabilities

Priority 5: Enhancing market supervision and enforcement

Are Australia's existing corporations and financial services laws sufficiently flexible to address greenwashing? What are the priorities for addressing greenwashing?

- In order to address greenwashing, it should be considered whether the most effective approach is calling out bad behaviour or applauding good behaviour.
- Currently, there is limited market advantage associated with making disclosures. However, if a greater number of entities were to engage in disclosure practices, it would enhance the assessment of disclosure quality. Encouraging businesses to view disclosure through a positive lens could foster increased participation.
- There also needs to be an allowance for capability building as disclosing entities develop appropriate internal capabilities.

Is there a case for regulating ESG ratings as financial services?

- If the ESG rating is being used to convey to an investor a level of ESG risk or opportunity, then we believe consideration should be given to regulating ESG ratings providers particularly given the wide variety of methodologies used by ESG rating houses. The primary goal of regulation should be to encourage transparency on ratings methodologies to enhance consistency and comparability for investors and also to require ESG rating groups to disclose how often the data is updated and the date the assessment was conducted.

Priority 6: Identifying and responding to potential systemic financial risks

Are there specific areas where the Government or regulators could further contribute to market-wide understanding of systemic sustainability related risks, including climate-related financial risks?

- As noted above, priority should be given to developing a set of Australian climate and nature scenarios for financial institutions and industry use in scenario analysis, alongside the sector decarbonisation pathways and the Australian sustainable finance taxonomy.
- The Government should continue to include increasing detail of the systemic impact of climate and nature risks in the Federal budget. This will contribute to developing a broader understanding of systematic sustainability risks.
- The Government should engage closely with:
    - The superannuation industry, as there are significant consequences for retirement incomes.
    - The insurance industry, as physical climate risk is forecast to have a systematic impact on the insurance sector (and on the entire economy). This needs to be assessed, quantified, and managed as effecitvley as possible.

Priority 7: Addressing data and analytical challenges

What are the priorities for ensuring that data-related initiatives already underway are tailored to meet the needs of firms and investors?

- Ensuring the credibility, accessibility, and comparability of information within mandatory sustainability-related disclosure frameworks is crucial to its utility in the market. The government plays a crucial role in safeguarding the integrity, accessibility, and proper management and utilisation of sustainability-related data.
- The most important priority is ongoing consultation with investors and industry to ensure data-related initiatives are fit for purpose, and consideration should be given to formalising this consultation. The consultations should include adequate representation from the private capital market. Part of this should include conducting a suitable amount of pilot programs and case studies for data initiatives, and publicly sharing the key insights gained from these experiences.

What key sustainability data gaps or uncertainties faced by financial institutions in Australia should be prioritised by the CFR?

- As previously stated, the Government should produce a set of Australian climate and nature scenarios, including sensitivities, in order for financial institutions and industry to assess the climate risk of their operations in a consistent and robust manner. There is currently no 'source of truth' and there is a crucial role for the government to facilitate consistent data sets and modelling.
    - For example, there is limited publicly available data on the physical risk impacts of climate change at a granular level across Australia. This makes it challenging to conduct a robust assessment of physical climate risk for a business or investment.
- The development and utilisation of the Australian sustainable finance taxonomy involves key data-related aspects. Specifically:
    - The capacity for taxonomy users to evaluate taxonomy alignment relies on the availability of supporting data.
    - Reporting by entities against the taxonomy generates a data stream that requires careful management to ensure integrity, accessibility, and comparability.
    - Similar data-related considerations are relevant to the implementation of mandatory climate-related disclosures.
- Establishing baselines and scenarios related to nature is essential for reporting and setting targets. See our response on this above.

Priority 8: Ensuring fit for purpose regulatory frameworks

Do you agree that existing regulatory and governance frameworks and practices have adapted well to support better integration of sustainability-related issues in financial decision making? Are there barriers or challenges that require further consideration?

This may include:

- Corporate governance obligations, including directors' duties
- Prudential frameworks and oversight, including in relation to banks and insurers
- Regulation of the superannuation system and managed investment schemes

Directors' duties

- The introduction of mandatory sustainability reporting represents one of the biggest changes in Directors' responsibilities in recent times. As noted above, the Government and regulators should consider what support and flexibility is required by Boards and Directors to adequately consider and sign off on sustainability-related disclosures, as this will be critical to the ability of corporate Australia to continue to attract high calibre Board candidates.

Your Future, Your Super

- The Your Future, Your Super performance test framework should be reviewed as it appears to be constraining the ability of superannuation funds to implement some responsible investing strategies which support investment in sustainable assets aligned with the goals of the Strategy (and in some cases their members' long-term interests and preferences).
- We recommend conducting a thorough review with full industry consultation with a view to considering amendments to the performance test to address this limitation, aligning the superannuation regulatory framework with Australia's broader climate transition and sustainability objectives.

What steps could the Government or regulators take to support effective investor stewardship?

- The Government should clarify expectations for effective stewardship and provide guidance on best practice.
- The UK Stewardship Code is the most well-known and internationally recognised standard, therefore should be referenced in this process.
- When developing stewardship recommendations for the Australian market the Government or regulators should consider:
    - Annual election of Board members (to align with other international jurisdictions).
    - Widening the Director pool base (with a focus on diversity, including diversity beyond gender).
    - Mandatory voting for shareholders.
    - New Directors presenting their case for election to shareholders prior to voting day.

Pilar 3 – Australia’s Government leadership and engagement

Priority 11: Promoting international alignment

What are the key priorities for Australia when considering international alignment in sustainable finance?

- As a relatively small market with significant global integration, aligning sustainable finance policy and regulation with international standards is crucial for facilitating capital inflow into Australia as well as reducing the reporting burden on local reporting entities required to report across a range of jurisdictions.
- We would encourage the Government to prioritise involvement in the development of international frameworks, both to represent key Australian perspectives for inclusion as well as developing the knowledge and skillset required to translate these frameworks into an Australian context.