SUSTAINABLE FINANCE STRATEGY CONSULTATION PAPER

HESTA Submission – November 2023

HESTA welcomes the opportunity to make a submission to the Sustainable Finance Strategy Consultation paper, which seeks views on a range of proposed policies to underpin the development of Australia's Sustainable Finance markets.

HESTA's Super with Impact purpose

HESTA invests more than $76 billion of assets on behalf of more than one million members working primarily in the health and community services sectors. We recognise the importance of pursuing a growing, sustainable, and inclusive economy. By managing systemic risks, integrating responsible investment factors and pursuing impact, we believe we can deliver strong, long-term returns for our members while accelerating our contribution to a more sustainable world. Our work program therefore seeks to address systemic risks and opportunities that have the potential to either undermine or support strong and stable markets which underpin the long-term returns we can deliver to HESTA members. Our Responsible Investment Policy identifies several priority Sustainable Development Goals (SDG) and we aspire to contribute to outcomes aligned with the aims of these priority SDGs through our allocation of capital and active ownership activities. This approach to investment underpins our response to the Consultation paper.

Overarching Comments on the Paper

HESTA supports the Government's approach to identify the policy priorities required to develop a foundation for sustainable finance in Australia that will be aligned with international standards. HESTA endorses the key principles articulated in strategy paper.

The development of internationally-aligned sustainable finance markets and standards in Australia is important to help deliver long-term financial returns to members and to support communication of sustainability credentials to members. HESTA is committed to contributing to national efforts to establish sustainable finance standards in Australia.

There are several complex questions in the Consultation paper and HESTA endorses the detailed submissions of the Australian Sustainable Finance Institute (ASFI) and the Australian Council of Superannuation Investors (ACSI). HESTA has chosen to also make a standalone submission to emphasize the importance of several areas. Specifically, we make the following recommendations. Further background on these is provided throughout our submission.

Summary of Key Recommendations

1. *The future investment product labelling system should incorporate elements of both organization and product labelling.*

2. *Consider adopting an Australian stewardship code that draws upon existing industry knowledge, applies to both asset owners and investment managers and is reported on an 'if not, why not' basis.*

3. *Consider supporting the development of new Your Future, Your Super benchmarks that change through time and reflect the economy Australia wants, rather than the one it has.*

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

Consistent with our previous submissions on climate-related disclosures, HESTA supports the introduction of a mandatory, internationally-aligned framework for disclosure of climate-related financial information. HESTA was an early advocate for and adopter of climate disclosure frameworks. Climate disclosures are an important tool for investors, supporting delivery of strong, long-term financial outcomes for members by providing transparent and consistent information to enable assessment and management of climate-related risks and opportunities across the investment portfolio. Furthermore, climate-related disclosure by companies allows investors to better communicate climate risk within the portfolio to members and other stakeholders.

HESTA supports the extension of the climate disclosure framework to other areas of sustainability risk over time, where these areas are material to companies' financial performance and/or broader economic outcomes that impact our members' financial wellbeing. This could be achieved through the adoption of the International Sustainability

Standards Board’s (ISSB) IFRS S1: General Requirements for Disclosure of Sustainability-related Financial Information. In particular, we support the extension of sustainability-related financial disclosures beyond climate-related financial disclosure, to include aspects of biodiversity (in line with the Taskforce on Nature-related Disclosures (TNFD)), and social issues (possibly drawing on the Taskforce on Inequality and Social-related Disclosures (TISFD) which is under development and/or future ISSB standards on human capital and human rights).

While we welcome the introduction of these mandatory disclosures, we note that their adoption will require significant resources and education.

Recommendation: Accordingly, we suggest that the strategy consider supporting the establishment of an Australian Sustainability Standards Board, consistent with the international approach, which could consult on and facilitate the implementation of relevant local standards.

Priority 2: Develop a Sustainable Finance Taxonomy

HESTA is a member of ASFI and is represented on the ASFI Board as well as on the Taxonomy Technical Expert Group (TTEG). We are very supportive of the development of an Australian Sustainable Finance Taxonomy as a core building block for the broader sustainable finance strategy. We note in particular that the development of a taxonomy is not an end, but rather a means through which to drive positive sustainability outcomes aligned to nationally agreed objectives.

We support the immediate taxonomy priorities being to develop criteria that covers all six priority economic sectors for both climate mitigation and adaptation. In terms of future expansion, we support the extension of the taxonomy beyond climate mitigation and adaptation to also include as aspects of natural capital and biodiversity, and social issues. Objectives for these potential areas of focus could be aligned to the Government’s Measuring What Matters Framework.

As a core foundation of the sustainable finance strategy we believe that once established as credible and practicable, the taxonomy has a range of potential use cases, including support of investment product labelling, investment industry benchmarks and green bond criteria.

Recommendation: Given our view that the taxonomy has a range of potential use cases, for the taxonomy to be effectively used for these purposes, there must be alignment between the rules of the taxonomy and its use cases.

Priority 3: Support credible net zero transition planning

HESTA welcomes the introduction of transparent, credible, ambitious transition planning that is consistent with relevant sector emissions reduction pathways. We note that the focus of this planning must be on reduction in emissions in the real economy.

Recommendation: Consideration should be given as part of transition planning to the interaction between emissions reduction and the effect of transition plans on other sustainability considerations such as natural capital and biodiversity; and social issues. We would also encourage alignment between transition plan disclosure requirements and transition methodologies that will be developed as part of the Sustainable Finance Taxonomy.

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

HESTA supports disclosure of sustainability characteristics for all products to enable members to make an informed choice. Further, we support the introduction of a labelling system for products marketed as sustainable but note that such a system must be designed to be practicably implementable based upon the investment universe and the fiduciary requirements of superannuation funds. Further it is important that any labelling system has sufficient flexibility to support product innovation.

Consideration should be given to align any labelling scheme for investment products with the taxonomy categories and criteria (as noted in our response to priority 2) and both should be aligned with investment industry benchmarks (with further detail available in our response to priority 8). This may require that just as standards for categorization under the taxonomy would change over time based on sector pathways, so too could thresholds for product labelling and investment benchmarks. This approach would support an orderly increase in allocation to green assets without making certification impracticable due to an overly narrow investment universe that could impinge on investors' ability to meet their fiduciary obligations.

HESTA is a member of the Responsible Investment Association Australasia (RIAA). Our Sustainable Growth investment option is certified under the RIAA Responsible Investment Certification Program according to the strict operational and disclosure practices required under the program. We observe that there are two key elements of labelling systems being developed globally and that different global approaches adopt these elements to different degrees. These key elements are:

- Product labelling – which is typically based on the capital allocation of a particular product. It might require a specific proportion of assets to be designated 'sustainable' under a relevant taxonomy. UK SDR is an example of a scheme that incorporates elements of product labelling.

- Organisation labelling – which is typically based on an investor's intent, which might vary from integrating environmental, social and governance factors as part of risk management; to seeking to address systemic sustainability challenges; or to drive positive impact. Importantly, this type of labelling takes account of use of investor tools beyond capital allocation, such as active ownership. PRI Progression Pathways (currently under development) is an example of how this type of labelling might operate.

Ultimately, we recommend that Australia's labelling scheme incorporate elements of both approaches outlined above. This would be similar to elements of the Sustainable Finance Taxonomy which it is proposed consider both organisation level intent and use of proceeds. It is particularly important that to ensure consistency with other elements of the Sustainable Finance Strategy, any labelling scheme places a focus on addressing material systemic risks and that the role of stewardship is acknowledged in driving change, particularly in terms of transition.

Key recommendation 1: The future investment product labelling system should incorporate elements of both organization and product labelling.

Priority 5: Enhancing market supervision and enforcement

HESTA supports the current approach to market supervision and enforcement. In terms of data and input into investment decision making, we note that a range of sustainability-related data is used and that currently the providers of that data don't have specific obligations with respect to accuracy.

Recommendation: This lack of specific obligations could be addressed through either the regulation of data providers, or potential government management and availability of key sustainability data, such as that gathered as part of taxonomy adherence.

Priority 6: Identifying and responding to potential systemic financial risks

HESTA welcomes deepening analysis of sustainability-related systemic risks and in particular recent developments in capability and practice by the RBA and Treasury. We believe that the government and regulators could further contribute to market understanding of systemic sustainability-related risks through further development of:

- The understanding of the inflationary or deflationary effect of a range of climate transition policy measures;
- Information on the cost of transition via a range of pathways and policy measures and comparison of these costs to an appropriate physical climate risk base case; and
- The analysis of the macro-economic impact and drivers of a range of additional sustainability-related systemic risks including social risks such as inequality as well as environmental risks such as natural capital and biodiversity loss.

Priority 7: Addressing data and analytical challenges

Large and diversified asset owners such as HESTA need to draw on a range of data sources to both support investment decision making and disclosure. Often this data is expensive, inconsistent between providers and no assurance is given by providers as to its accuracy. To enable an effective taxonomy, supporting mandatory disclosure by companies will be required. We believe this data must be readily accessible. As noted above, we believe there is an opportunity for the government to gather and make a range of data gathered from companies centrally available. Such data should be digitized.

Recommendation: We recommend two additional areas where government and regulators could contribute to market-wide understanding. These are:

- *Development of common Australian climate scenarios. While use of these scenarios in transition planning should not be mandatory and alternative scenarios could be used with appropriate justification, we believe that common scenarios would enhance the consistency and comparability of company transition plans.*

- *Development of localised data relating to the state of the environment. While relevant indicators exist at a national level, natural capital and biodiversity loss varies significantly at a localised geographic scale and granular data at a localised level would significantly support decision making.*

Priority 8: Ensure fit for purpose regulatory frameworks

Overall, HESTA believes that regulatory frameworks have adapted well to incorporate financially material sustainability considerations, particularly climate change. While significant progress has been made, we consider there to be two areas that warrant further focus – stewardship and alignment of financial regulation with sustainability objectives.

Regarding stewardship, HESTA is a signatory to the Australian Asset Owner Stewardship Code. We disclose our approach to stewardship and examples of our stewardship practices through our website, Annual Report and Climate Change Report. Stewardship is an important part of how HESTA manages risks. By actively engaging with our investment managers, portfolio companies, assets, regulators, and policy makers we can influence the management of responsible investment factors that can impact long-term returns at both the company and market level. We do this as part of our responsibility to protect and enhance long-term investment value for HESTA members.

Our stewardship program focuses on addressing systemic issues, selecting the appropriate combination of active ownership levers, and pursuing implementation. We prioritise engaging with companies and stakeholders on systemic issues, however, will engage on specific concerns at the company level should another material risk arise. HESTA pursues stewardship through the tools of engagement (directly; through collaborative initiatives; and through specialist service providers and investment managers), voting and advocacy. It is worth noting that stewardship is resource intensive and that applying stewardship tools for a range of issues across the thousands of assets that we invest in is clearly not practicable given limited resourcing. Accordingly, we must prioritize which companies and issues to focus on. However, by combining direct and indirect approaches to engagement, we're able to achieve both breadth in terms of the number of companies covered by our engagement program as well as depth by focusing our direct engagement on those issues or holdings that are most material.

HESTA notes that while we view stewardship as equally important to capital allocation in terms of contributing to the achievement of sustainability objectives, stewardship is less well understood by both government and the public. We would support broad adoption of a stewardship code to the extent that such a code draws upon existing industry knowledge, for example, that developed through the Australian Asset Owner Stewardship Code or the UK Stewardship Code. We believe that disclosure against a stewardship code on an 'if not, why not' basis would raise the standing of stewardship as an effective tool for driving change; establish a consistent understanding of what stewardship is and isn't (e.g. engagement should seek to influence achievement of an objective); and increase the take up of stewardship practices across the industry. We believe it should apply to both asset owners and investment managers. We would also encourage the government to consider how stewardship could be better recognised through other elements of the Sustainable Finance Strategy (for example, through the planned labelling system).

Key recommendation 2: Consider adopting an Australian stewardship code that draws upon existing industry knowledge, applies to both asset owners and investment managers and is reported on an 'if not, why not' basis.

Regarding alignment of financial regulation with sustainability objectives, HESTA notes that Your Future, Your Super is in tension with the Government's sustainable finance agenda because current benchmarks reflect the economy Australia has, rather than the one it wants. The current performance tests mean that investors are encouraged to hold assets in the existing benchmarks (e.g. including significant fossil fuels, gambling, tobacco, and weapons) and penalized by taking on additional relative risk if they don't invest in those assets. Further, many newer opportunities that align with sustainability objectives (e.g. investment in natural capital, affordable housing, aged care and even climate solutions), are not well represented in benchmarks. Differences relative to the benchmarks must be tightly managed as they introduce risk of performance that diverges from the benchmark over the short term.

Accordingly, it is recommended that the government should consider supporting the development of new benchmarks and making these widely available. New benchmark indices should reflect the economy that Australia wants rather than the one that it has. These benchmarks could be designed to change composition over time (aligned to the change in taxonomy criteria through time consistent with sector transition pathways). Give the volume of investments held through passive mandates, such a change would be very significant in driving capital allocation towards sustainable solutions, but ratcheting indices through time would enable this to be achieved in a measured way. It would also be significant in addressing a material barrier to investing in line with climate and sustainability objectives.

Key recommendation 3: Consider supporting the development of new Your Future, Your Super benchmarks that change through time and reflect the economy Australia wants, rather than the one it has.

Priority 9: Issuing Australian sovereign green bonds

HESTA believes that as a source of significant new capital, debt markets have a significant role to play in Australia's climate transition. In our view, the key elements of Australia's future sovereign green bonds program are strong use of proceeds requirements and liquidity. Government must implement rigorous standards to ensure that funds are ring-fenced for a specific purpose via clear use of proceeds and the programs that debt finances are helping to drive specific sustainability outcomes at the economy level. This could be facilitated by alignment of taxonomy criteria with criteria for green debt financing. Green bonds should not be issued for general purposes, and it is not sufficient that bonds be linked to issuer-level sustainability credentials.

Recommendation: Government should implement rigorous standards to ensure that funds are ring-fenced for a specific purpose via clear use of proceeds and the programs that debt finances are helping to drive specific sustainability outcomes at the economy level.

Priority 10: Catalysing sustainable finance flows and markets

We acknowledge the CEFC's significant role in scaling up sustainable investment and welcome the governments continuing commitment to catalysing sustainable finance flows and markets. We believe there are three key roles for government in this respect: de-risking early-stage investment; supporting scaling up; and relationship building between potential project proponents and investors. We support the extension of CEFC's remit to including climate adaptation and nature and biodiversity.

Priority 12: Position Australia as a global sustainability leader

We welcome the government's commitment to position Australia as a global sustainability leader by promoting sustainable finance. We believe the following represent specific opportunities for Australia:

- Seek further opportunities to support climate change adaptation, particularly with the broader Asia-Pacific region;
- Focus on the interconnectivity of a range of sustainability-related risks and opportunities and in seeking to address one issue, ensure that consideration is given to the others. For example, in seeking to build out renewable energy capacity within Australia, doing so in a way that seeks to address rather than exacerbates modern slavery risks within global renewable energy supply chain. Or ensuring a just transition is central to other climate mitigation measures.
- Seeking to capture a greater portion of relevant value chains – Australia has traditionally been known for its extractive industries. As the mining sector has sought to capitalise on new opportunities such as those in rare earth mining, it has been positive to see a shift to also consider how Australia could support processing. In some cases, capturing more of the value chain will require the government to support precinct development.