Senate Finance and Public Administration Committees
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

27 July 2012

**RE: Inquiry into the Government Investment Funds Amendment (Ethical Investments) Bill 2011**

Dear Committee Secretary,

The Responsible Investment Association Australasia (RIAA) is the peak industry body for professionals working in responsible investment in Australia and New Zealand. Our members include superannuation funds, asset consultants, fund managers, financial advisers, dealer groups, insurance companies and many other participants in the investment chain.

WHAT RIAA DOES:

RIAA's main activities are centred around:

- Providing training and professional development for corporate and financial services professionals through the RI Academy. The RI Academy[1] is the world's first structured learning pathway for financial services, corporate and other professionals needing to understand how environmental, social and governance (ESG) issues are impacting investment decision making, company and shareholder value and ongoing access to investment & capital markets.
- Managing the world's first Certification Program for providers of specialist responsible investment products and services. Once certified, the organisation or individual is licensed to use the RIAA Certification Symbol, which indicates to investors that an organisation or individual has met the strict disclosure practices required in their licence category.
- Producing unique research on the size and growth of the responsible investment industry in Australasia.
- Engaging with government to assist in the delivery of market reforms that recognise the links between ESG factors and financial outcomes.
- Holding networking events for its members and those interested in learning from globally recognised leaders from all parts of the investment chain.

WHY DOES RIAA DO IT:
Australia is now the fourth largest investment market in the world and in many ways is a global leader in responsible investment. Commitment here has deepened among super funds and investment houses as concerns about market stability have grown. Responsible investment is now commonly considered to be 'best practice', as consideration of ESG factors is seen to assist in the management of investment risk.

DIFFERENT METHODOLOGIES AND APPROACHES TO RESPONSIBLE INVESTMENT:
Responsible investment is a practice that has evolved and matured within the last four decades and now encompasses a broad range methodologies and approaches. ESG-themed products seek to offer clients a product that aligns their investments with their values. Common words used in this space include ethical investment, sustainable investment and socially responsible investment.

[1] http://www.riacademy.org

The RI Annual Benchmark Report of 2011[2], produced annually by RIAA, demonstrates how specialist responsible investment funds have outperformed their benchmarks in every one of the twelve categories covered in the report over one, three, five and seven years across Australian shares, international shares and balanced funds.

More recently the emergence of the UN-backed Principles for Responsible Investment (PRI) has lead to a growing recognition among mainstream investors that environmental, social and governance (ESG) factors play a role in long-term portfolio returns. PRI signatories now comprise over half of the funds under management in Australia. While they are generally not motivated by values, the integration of ESG factors into investment decisions is judged to be a positive development in global financial markets.

GENERAL DISCLAIMER:
RIAA's members include organisations that have adopted a range of methodologies and distribute a variety of different products geared towards responsible investment. Our role is not to promote a specific approach or methodology used in responsible investment – rather we seek to encourage the growth of responsible investment generally, and act to ensure that practitioners are as transparent as possible about the ESG factors and outcomes associated with the financial products and services they provide.

As the peak body for responsible investment in Australia, however, RIAA is happy to provide some general suggestions and guidance re the Government Investment Funds Amendment (Ethical Investments) Bill 2011.

COMMENT 1 – METHODOLOGY:
The Bill in its current form will require government investment funds to exclude investment in companies on values-based grounds – the use of the term 'ethical investment' is appropriate in this context.

Many ethical investors in Australia and globally incorporate a negative screening methodology when managing ethical investment products – it has the advantage of ease of definition and clarity of communication to stakeholders.

A key challenge that arises when using a values-based approach to responsible investment is 'whose values' are you using? This situation can be readily resolved when the product is being offered by a commercial enterprise that is seeking to differentiate itself on these grounds, or by a superannuation fund that represents a specific group of employees (health industry employees and the tobacco industry). It is more problematic for funds that represent a broad range of stakeholders, however.

There are examples around the world of other sovereign funds that use a negative screening methodology – in particular the New Zealand Superannuation Fund and the Norwegian Pension Fund. There is no one definition of 'best practice', however. In the case of the NZ Superannuation Fund their commitment is enshrined in their Statement of Investment Principles, and is based on the underlying expectation that the Fund's investments will not harm the reputation of the country as a whole.[3] In the case of the Norwegian Pension Fund, a dedicated 'Council on Ethics' works to interpret the approach taken by the Fund to different issues.[4]

Indeed the Future Fund itself already avoids investment where a company's activities are judged to be inconsistent with Australia's position on global treaties.[5]

The Bill as proposed leaves the decision as to what is 'ethical' in the hands of the Minister of the day. Given the potential political sensitivities that may arise, ***Government may wish to consider including a more detailed consideration of the process for developing and interpreting the ethical investment guidelines used.***

It should also be noted that while the Bill envisages three key ethical areas for screening (tobacco manufacture, cluster munitions components and nuclear weapons), it also makes reference to a much broader

[2] http://www.responsibleinvestment.org/riaa-research
[3] http://www.nzsuperfund.co.nz/index.asp?pageID=2145876519
[4] http://www.regjeringen.no/en/sub/styrer-rad-utvalg/ethics_council.html?id=434879
[5] http://www.ethicalinvestor.com.au/index.php?option=com_content&task=view&id=4253&Itemid=402

set of ethical practices that are to be considered (without limit to these criteria): "environmental concerns, human rights concerns, responsible labour practices, profit from conflict or the manufacture of weapons of war". It is conceivable that broad application of a negative screening approach using all of these criteria could result in an outcome which has implications for the fund's investible universe.

<u>COMMENT 2 – CLARITY OF CRITERIA DESCRIPTIONS:</u>
As noted previously, the responsible investment industry has a large number of participants that use negative screening methodologies, and there are a range of service providers who can assist government investment funds to apply the broad criteria as set out in the Bill.

It is important to note that the RIAA Certification Program is built around clarity of communication to stakeholders and transparency regarding underlying investments in a portfolio. While initially seeming relatively straightforward, there are a number of different ways in which the three core negative screening criteria (tobacco, cluster munitions and nuclear weapons) could be interpreted in practice.

For instance, when looking at the issue of tobacco manufacture, at what point is a company judged to be 'involved' – 0-1% revenue, 1-5% revenue? Is a company involved in tobacco packaging judged to be involved in tobacco manufacture?

When looking at cluster munitions or nuclear weapons, the use of revenue thresholds that might be relevant to other criteria areas are less practical, because almost no listed companies make a measurable percentage of total revenue from such activities – and in many cases involvement is difficult to prove.

Specialist responsible investment products have a lot of experience in communicating with these issues with their clients. When considering the Bill, ***Government should seek wherever possible to ensure that communication about criteria and materiality thresholds is as clear and as transparent as possible.***

<u>COMMENT 3 – ESG INTEGRATION:</u>
While noting above that negative screening is a useful tool used by a range of responsible investors around the world, RIAA would like to suggest that when considering the Bill, Government might like to review the range of other tools in the responsible investment toolkit.

On March 6, 2012 the Financial Services Council announced a new benchmark for transparency and governance through their "Raising the Bar" Superannuation Corporate Governance Policy, which includes the following statement: *"Trustees must develop an Environmental & Social Governance (ESG) risk management policy that is made available to members."*[6]

The logic behind this mandate is that the environmental and social governance of a company can be a major factor impacting on its financial performance, and therefore monitoring the ESG activities of investee companies is an important aspect of trustees' duties.

Superannuation funds collectively own a diversified portfolio of assets covering practically the entire economy. They are what is termed "Universal Owners" and as such their returns are substantially driven by market returns and systematic risk. Improving standards in respect to environmental, social and governance (ESG) policies and practices generate better market returns and reduce systemic risk by reducing risk, inefficiencies and costs associated with the poor management of ESG issues.

The consideration of ESG issues by large institutional investors such as government investment funds is therefore not just an issue of enlightened self interest, but plays a key role in improving overall market standards, generating better market returns and reducing systemic risk.

The important role that ESG analysis plays in improving investment strategy and processes have been publicly recognised by Australian institutional investors through signatory support of the United Nations Principles for

[6] http://www.fsc.org.au/downloads/file/submissionsfile/fscsupercorporategovernancefinal.pdf

Responsible Investment (UN PRI). In fact Australia boasts the largest proportionate signatory base in the world, resulting in over 60% of all funds under management in Australia now being part of that global program.

However, even among these committed investors there is little evidence that they actively reward external investment managers for the integration of ESG issues into their investment process.

As a matter of public policy we believe that superannuation funds should be strongly encouraged to consider ESG issues in their investment strategy and selection of external investment managers.

***By focussing solely on the avoidance of activities judged to be not ethical, the Bill as it is framed misses an opportunity to promote industry best practice in the form of ESG integration - we would encourage Government in consideration of the Bill to also consider other areas where government investment funds could play a leading role (noting that some funds may already do some of the below), including:***

- ***disclosing their broad approach to ESG integration in the investment strategies;***
- ***incorporating specialist ESG-themed investment funds in their outsourced fund manager line-up;***
- ***disclosing the degree to which ESG capacities are addressed in their external manager selection strategies (mandates);***
- ***providing stakeholders with clear transparency around their investments; and***
- ***active ownership – reporting on how they vote their shares.***

For more information on the role of education in responsible investment or for questions about the certification of responsible investments please contact the RI Academy and the Responsible Investment Association Australasia.

Best regards,

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