



Australian Government
Department of Finance and Deregulation

SUBMISSION TO THE
FINANCE AND PUBLIC ADMINISTRATION LEGISLATION
COMMITTEE
INQUIRY INTO THE
GOVERNMENT INVESTMENT FUNDS AMENDMENT
(ETHICAL INVESTMENTS) BILL 2011

July 2012

INTRODUCTION

1. In response to the invitation of the Senate Finance and Public Administration Legislation Committee, the Department of Finance and Deregulation provides this submission on the Government Investment Funds Amendment (Ethical Investments) Bill 2011 (the Bill).
2. The Bill seeks to amend current legislative arrangements to provide for directions from the Government to the Future Fund Board of Guardians on 'socially responsible ethical investment practices'. This submission outlines the current legislative framework for the Future Fund, discusses the environmental, social and governance (ESG) practices of mainstream investors, outlines the Future Fund's ESG policy and makes observations on the amendments proposed by the Bill.

THE FUTURE FUND LEGISLATION AND INVESTMENT MANDATE

3. The *Future Fund Act 2006* (Future Fund Act) established the Future Fund to strengthen the Commonwealth's long-term financial position by making provision for unfunded Commonwealth superannuation liabilities.¹ The Act also establishes arrangements for how the Future Fund will be managed.
4. The Future Fund Board of Guardians is a body corporate with a separate legal identity from the Government.² The Board is responsible for deciding how to invest the Future Fund and the Nation-building Funds. It is supported by the Future Fund Management Agency, which undertakes operational activities on behalf of the Board.
5. The legislative arrangements for the Future Fund and the Nation-building Funds ensure that the Board makes investment decisions independent of the Government.³ The arrangements provide for the Government to give strategic guidance to the Board, while preserving the Board's role in managing the investments of the Future Fund at arm's length from the Government. Under the Future Fund Act, the Board is required to do this by seeking 'to maximise the return earned on the Fund over the long term, consistent with international best practice for institutional investment'.⁴

¹ See s. 3 of the *Future Fund Act 2006*.

² Investments are held in the Board's name 'for and on behalf of the Commonwealth' (s. 36).

³ S. 36.

⁴ S. 18.

6. The Government gives strategic direction on its expectations for the investment of the Future Fund to the Board through the Future Fund Investment Mandate.⁵ The investment mandate includes directions from the responsible Ministers (the Minister for Finance and Deregulation and the Treasurer) on rates of return over the long term, risk management, corporate governance and some operational matters.
7. The investment mandate requires the Board to have regard to international best practice for institutional investment in determining its approach to corporate governance principles, including in relation to its voting policy. The investment mandate also requires the Board to consider the impacts of its investment strategy, which includes acting in a way that is unlikely to cause any diminution of the Government's reputation in Australian and international financial markets.
8. The independence of the Board in its investment decision making is further reinforced by section 18A of the Future Fund Act, which prevents the responsible Ministers from giving directions that require the Board to invest in particular assets, businesses or activities.
9. The legislation and the investment mandate are designed to provide clear and transparent governance and investment decision-making structures independent of Government that promote efficiency, effectiveness and accountability, and support the Future Fund's goal of maximising returns for an acceptable level of risk.

THE INCLUSION OF ESG CONSIDERATIONS IN INVESTMENT PRACTICES

10. The inclusion of ESG considerations in the investment decision-making process is increasingly accepted by mainstream investors to be better practice. It is considered to support the fiduciary role of investors to act in the best interests of beneficiaries by maximising risk-adjusted returns over the long term. As well, the combined influence of investors exercising their ownership rights, according to generally accepted codes of best practice, can improve governance arrangements and behaviours in companies, and the management of environmental and social risks and opportunities.
11. It should be noted that the term ESG, as defined by many mainstream investors, differs from 'ethical investment'. Ethical investment decisions are often motivated by the

⁵ S. 18.

institution's beliefs or values, with a focus on excluding certain types of investments, rather than seeking to improve investment decision making.⁶

12. According to the 2011 Responsible Investment Annual, approximately half of the funds under the management of Australian asset managers integrate ESG principles in investment practices. Typically, such an approach would involve integrating ESG issues into the selection of assets and exercising ownership rights (including voting and engagement). These strategies are used to improve risk-adjusted returns over the long term, recognising that ESG issues can affect the performance of investment portfolios.⁷
13. The practice of exclusion often receives publicity, but is usually a narrow part of a broader ESG approach. Some investors may choose to exclude investments based either on the involvement of companies in certain economic activities or on their operating behaviour. Although such exclusions can be motivated by financial risk management, the reason for exclusions is generally reputation risk management.
14. Examination of a group of large public funds, many of which are proponents of ESG principles in investing, or members of the International Forum of Sovereign Wealth Funds, or both, provides some insight into the variety of approaches adopted on exclusions of certain types of investment.

Canada: The Canadian Pension Plan Investment Board excludes companies that are not in compliance with the *Convention on the Use, Stockpiling, Production and Transfer of Anti-Personnel Mines and on their Destruction* (MBT), and is considering exclusions based on the *Convention on Cluster Munitions* (CCM). It does not make exclusions based on tobacco products or any other economic activities.

Denmark: The Danish national pension fund, ATP, excludes certain companies on the basis of the CCM and the MBT. It does not exclude on the basis of tobacco products or nuclear weapons.

France: The French pension reserve fund, Fonds de Reserve pour les Retraites, excludes certain companies on the basis of the CCM and the MBT. It does not exclude on the basis of tobacco products or nuclear weapons.

⁶ For example, an institution investing on behalf of a client with certain religious beliefs may have exclusions based on those beliefs.

⁷ Responsible Investment Association Australasia (2011) 'Responsible Investment Annual 2011', available at <http://www.responsibleinvestment.org/wp-content/uploads/2011/12/RI-Annual-2011-Report.pdf>.

The Netherlands: The pension fund ABP (for public sector employees and the largest Dutch fund) excludes certain companies on the basis of the CCM and the MBT, but has no blanket exclusion on nuclear weapons, nor does it exclude tobacco products. The pension fund PFZW (for the healthcare and welfare sector, and the second largest Dutch fund) excludes on the basis of the CCM and MBT and producers of nuclear weapons. It does not exclude tobacco products.

New Zealand: The New Zealand Superannuation Fund excludes on the basis of the CCM and MBT, the manufacture and testing of nuclear explosive devices, tobacco and whaling.

Singapore: The Government Investment Corporation, Singapore's sovereign wealth fund, is not known to make any exclusions on the basis of economic activities.

Sweden: The National Pension Funds 1 to 4 exclude certain companies on the basis of the CCM and the MBT and on the recommendation of its Ethical Council. The National Pension Fund 7 excludes on the basis of the CCM and MBT and producers of nuclear weapons. None of the funds excludes tobacco products.

United States: The Alaska Permanent Fund, a state savings fund for oil revenue, is not known to make any exclusions on the basis of economic activities. The Californian retirement fund for public employees, CalPERS, excludes tobacco products, but does not make any weapons-related exclusions.

15. The Explanatory Memorandum to the Bill compares its proposed arrangements to those of the Norwegian Government Pension Fund. The Norwegian Fund is part of the Ministry of Finance, is managed by the Norwegian central bank, and has a Council on Ethics. The Council's role is to make recommendations to the Norwegian Ministry of Finance on whether to exclude entities based on the Ethical Guidelines for the Government Pension Fund.⁸ The Ministry of Finance is responsible for making the decision to divest or not. If not convinced that the conditions for exclusion are met, the Ministry can place a company under observation.

⁸ Exclusions or observations of companies are allowed under the Guidelines for certain weapons, tobacco production and the provision of weapons to proscribed states. The Council on Ethics can also investigate companies that are involved in a range of other behaviours such as human rights, environmental damage and gross corruption. See http://www.regjeringen.no/en/sub/styrer-rad-utvalg/ethics_council/ethical-guidelines.html?id=425277.

16. The Norwegian approach has resulted in a growing list of exclusions, currently at 55. It includes companies such as Boeing, Wal-Mart and Rio Tinto.⁹
17. The Norwegian model requires additional resources dedicated to screening and implementing the exclusion policy. This model requires a high level of involvement by the Norwegian Government in the Fund's investment decisions. It is very different from the Australian approach with the Future Fund, where the Board of Guardians is a separate legal entity to the Commonwealth and makes investment decisions independent of the Government.

THE FUTURE FUND'S ESG POLICY

18. The Board has developed and published a Statement of Investment Policies, which includes its policy on ESG issues. The ESG policy focuses on managing ESG risks and opportunities and using ownership rights to support its objective of maximising the financial returns earned on investments. The policy addresses standards of good governance and the ESG practices expected from entities in which it invests.
19. There is consideration of the management of ESG issues in the selection of the Future Fund's external investment managers, who are required to comply with the Board's investment policies, including the ESG policy. For Australian listed equities, the Agency exercises voting rights directly according to the Board's policy on ESG Risk Management and Ownership Rights. With the Future Fund's holdings of international equities, the Board delegates voting rights to its external investment managers. The Board monitors whether its investment managers are investing according to the Board's instructions and are applying the Board's policies.
20. Investments that the Board assesses as unlawful under Australian law are excluded or removed from the portfolio. If an investment may contravene an international convention ratified by Australia, the Board will consider the exclusion or removal of the investment from the portfolio.
21. The Agency has advised that the Board's governance subcommittee will regularly review the ESG policy as part of its remit.

⁹See the Norwegian Ministry of Finance website:
<http://www.regjeringen.no/templates/RedaksjonellArtikkel.aspx?id=447122&epslanguage=EN-GB>.

OBSERVATIONS ON THE BILL

22. The Bill seeks to amend the Future Fund Act and the *Nation-building Funds Act 2008* (NBF Act) to require directions from the Government to the Future Fund Board of Guardians on ‘socially responsible ethical investment practices’. Under the Bill, the responsible Ministers must make Ethical Investment Guidelines for the Future Fund and the Nation-building Funds to prohibit investments. These prohibitions must include, but are not limited to, holding an interest in a body corporate that:
- manufactures tobacco products;
 - produces components for cluster munitions;
 - or produces, maintains or simulates nuclear weapons.
23. In addition, the Guidelines may make provision for ‘socially responsible ethical investment practices’. These can include, but are not limited to, environmental concerns, human rights concerns, labour practices and the manufacture of weapons of war.
24. Finance considers that there are several matters that would arise from the application of the Bill, both practically and in terms of efficacy of policy outcomes.

Interaction with the investment mandate

25. The Bill would amend the existing legislation to establish a second set of Ministerial directions to proscribe investments in particular financial assets and to provide for ethical investment practices.¹⁰ The Board has had a single clear objective with a clear hierarchy of priorities.¹¹ The responsibility to maximise returns is subordinate to the parameters of the Future Fund Act and the investment mandate. The Bill does not address where the Ethical Guidelines would sit in the hierarchy of priorities for the Board.
26. Therefore, the Board is likely to be faced with conflicting demands when making investments. These conflicts would require careful consideration by the Board or the Government, to enable the Board to continue to invest with a clear mandate. Should this consideration be done by the Board, it would effectively be determining the

¹⁰ The Bill would require the responsible Ministers to consider the views of the Board on the proposed Guidelines and to table any submission by the Board in Parliament. This is consistent with the legislative requirements for changes to the investment mandate.

¹¹ Refer to the Explanatory Memorandum for the Future Fund Act.

constraints of the guidelines and exclusions intended by the Bill. This could be a difficult task for the Board.

27. Accordingly, the Government will have to determine some of these matters. This would differ from the current intent of the Future Fund Act and practice to date – i.e. that the Australian Government should not be involved in the investment decisions of the Fund. Rather, it would require the increased influence of the Government in investment decision making, which, to date, Parliament has not considered in the best interest of taxpayers.
28. Further, it may be necessary to revisit elements of the investment mandate, including the benchmark return. In particular, there would likely be a negative impact on risk and return if the constraints in investment opportunities resulting from the Bill change the investment strategies to a significant degree from what they might otherwise be. This would reduce the Government's ability to provide for unfunded superannuation liabilities after 2020. That is, there is a potential fiscal cost that may not be offset by additional benefits achieved by the new arrangements.

Definitional matters

29. The Bill would prohibit an interest in financial assets in companies involved in the manufacture of tobacco products, the production of components for cluster munitions and the production, maintenance or simulation of nuclear weapons. The definitions given for the prohibited assets appear insufficient to allow effective implementation without further guidance. For example, under the Bill it may be possible for the Board to invest in elements of tobacco production or the packaging or supply of tobacco products, because these appear to be outside the scope of the definition. Investments in a company that produces the components for cluster munitions is prohibited under the Bill, yet an investment in a company that assembles whole cluster munitions systems appears to be allowed under this definition and is a weaker standard than the Board already applies.
30. The Bill also appears to have some ambiguity regarding what would constitute an 'interest'. The concept of interest is not defined in the Bill nor in the Future Fund Act or the Nation-building Funds Act. Depending on the corporate structure of a manufacturer or producer, or the particular type of financial asset acquired, an investment by the

Board might not involve the acquisition of a prohibited financial asset within the terms of the legislation. Conversely, if a broad definition of an 'interest' was adopted, this could apply not only to the Future Fund's direct investments, but to a range of other investment arrangements such as co-investments, joint ventures, fund-of-fund structures and pooled investments. This could result in a large number of exclusions. Additionally, there would be potential complexities for the Board in managing and monitoring the portfolio to assure compliance with the requirements of the Act.

31. The Bill states that the Ethical Investment Guidelines may make provisions for 'socially responsible ethical investment practices'. Finance considers that there is considerable ambiguity in the meaning of this term, and of what standard would determine the ethics to be applied.

Resourcing

32. The Bill is likely to have resourcing implications; evidence from funds with like guidelines is that they can be resource intensive. In the Explanatory Memorandum to the Bill, ethical investment guidelines are described as 'guidelines which examine the ramifications of an investment beyond the financial returns, such as the impacts on the environment, the rights of those employed by the various enterprises, impacts on human health or potential effect on peace and stability'. Establishing and maintaining guidelines to meet these criteria, and assessing their effectiveness and outcomes, would be a significant role for the responsible Ministers and require Departmental support.
33. The expenses of the Future Fund Management Agency would also need to increase, resulting in some reduction in net returns. For example, the Future Fund would need to undertake additional analysis of listed companies around the world to be satisfied that it does not invest in prohibited financial assets. This could either be done by developing further in-house capability or by contracting the expertise, but both options would carry significant costs.

SUMMARY

34. The Future Fund is designed to strengthen the Commonwealth's long-term financial position. This Bill seeks to use the Future Fund to support other Government policies. The intersection between these two aims may result in conflicting priorities, which could have an impact on risk and return. As a result, the investment mandate may need to be revisited, including the benchmark return, which would reduce the Government's ability to meet the unfunded superannuation liability by 2020.
35. A further consideration is the extent to which the Bill would reduce the independence of the Board in its investment decision making. The current 'arm's length arrangement' for the Future Fund, whereby Ministers are not involved in investment matters beyond the broad parameters established by the Future Fund Act and the investment mandate, would be altered.
36. These are significant considerations that would need to be weighed against the policy outcomes intended by the Bill, and the degree to which they may be achieved.