

# Investing for Australia:

Clarifying climate risk expectations of the Future Fund



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## Key points

- » The report extends recent CPD work on how Commonwealth and state public authorities are addressing climate change risk by specifically considering the response of the Future Fund. It further considers whether the Future Fund's guidance should be updated to strengthen its climate risk response.
- » The Future Fund is Australia's sovereign wealth fund and one of the largest institutional investors in the country. It is governed by a suite of legislation, a government-issued Investment Mandate and a ministerial Statement of Expectations.
- » Under its legislation the Future Fund Board must seek to "maximise the return earned on the Fund over the long term, consistent with international best practice for institutional investment."
- » Integrating and addressing portfolio climate risks and opportunities is now well established investment practice and the Fund's response on these issues can be considered against other institutional investors and a growing set of industry standards and guidance.
- » Institutional investors are increasingly responding to the systemic risk of climate change and the portfolio opportunities created by the transition to a net zero emissions economy. Sovereign wealth funds have been slower to respond, but recent surveys indicate activity is now picking up amongst this cohort and there are many instances of publicly-owned investors demonstrating leadership on climate-related practice.
- » The Future Fund has stated it is responding to climate change risks and opportunities by applying climate risk-weighting to investment decisions, company engagement and via its external manager mandates and interactions.
- » However, an assessment of industry practice among sovereign wealth funds, institutional investors and industry frameworks suggests the Future Fund is likely not meeting "international best practice" in aspects of its climate response across disclosure, strategy and collaboration.
  - » A full assessment of the Future Fund's response is difficult because it has not published a climate strategy or climate risk disclosure, both concerns of themselves.
  - » A review of the Fund's publicly known activities against the established global industry assessment framework for Investor Climate Action Plans suggests it is partially reflecting what could be considered early stage practice.
- » The Federal Government can set stronger direction on climate change for the Future Fund Board through the Investment Mandate and Statement of Expectations. This could include requiring the Fund to develop a strategy to reach net zero emissions across its portfolio by 2050.
- » The Federal Government can also direct the Future Fund Board to produce and publish climate risk disclosure under existing provisions of its legislation without updating the mandate or expectations.
- » This report recommends the Federal Government:
  - » Immediately request the Future Fund produce and publish climate risk disclosure consistent with global frameworks and emerging reporting standards.
  - » Ensure the Future Fund is captured by legislation and regulation change as part of the Federal Government's commitment to strengthening climate risk disclosure across the Australian market.
  - » Convene an independent review by a panel of experienced investment professionals of the Future Fund's climate response and Investment Mandate.

## Introduction

This report considers whether the Future Fund's (the Fund) Investment Mandate and ministerial Statement of Expectations can be updated with explicit reference to climate risks and opportunities to better reflect accelerating practice in the investment industry, changes in sovereign wealth fund mandates in other jurisdictions and Australia's international commitments. It refers to and forms part of the Centre for Policy Development's (CPD) work on the climate change response of public authorities and economic institutions.

Over the past decade institutional investors have increasingly recognised and responded to the systemic economic and financial risks associated with climate change, and the opportunities created by the transition to a net zero emissions economy.<sup>1</sup>

This response has emerged within traditional investment frames, and has been largely seen as a part of investors' duties to their beneficiaries to manage financial risks and maximise return opportunities across their portfolio.<sup>2</sup> Investors recognise systemic climate risks are now materialising and threaten investment returns.<sup>3</sup> Actions investors take managing risk and performing their duties include disclosure, application of carbon pricing or risk weighting to investment decisions, divestment, decarbonisation and other portfolio targets, company engagement and industry collaboration. Industry collaboration has produced comprehensive standards, frameworks and strategies for addressing climate risk and decarbonising portfolios, for example the Paris Aligned Investment Initiative's Net Zero Investment Framework.<sup>4</sup>

This acceleration in climate risk response has extended to state-owned investors like sovereign wealth funds (SWFs) and public pension funds (PPFs). Sovereign wealth funds were responsible for over \$USD10 trillion in assets under management (AUM) in 2021 across more than 90 entities worldwide.<sup>5</sup>



Research from the International Forum of Sovereign Wealth Funds finds SWFs are typically less advanced in their approach to climate risk than many other public and private actors.<sup>6</sup> Recent surveys indicate accelerating progress in some areas of climate practice by SWFs, but the development of metrics and targets to manage risk and reduce emissions were still identified as areas of slower progress.<sup>78</sup>

Publicly-owned pension funds held a further \$USD21.4 trillion in AUM in 2021,<sup>9</sup> and collectively these two types of sovereign investors are responsible for about a fifth of all global AUM.<sup>10</sup> Given this size of their collective AUM, sovereign investors are critical actors whose capital deployment can have a major effect on the achievement of climate goals.

SWFs and PPFs have different characteristics, beneficiaries, fund sources and purposes, but are often grouped together because of the shared public oversight and governing instruments – like government-issued investment mandates – that guide their activities.<sup>11</sup>

As this report focuses on the Fund, it primarily draws on examples of SWFs, but occasionally also draws from examples of PPFs to illustrate the breadth of climate risk response across publicly-owned investors. It also refers to broader activity among private institutional investors given the Future Fund is benchmarked against industry best practice

in its Investment Mandate and governing legislation.

The Fund has made statements about its approach to climate-related risks and opportunities through its ESG policy,<sup>12</sup> investment outlook<sup>13</sup> and in appearances before Senate Estimates. However, unlike some international SWFs, and a greater swathe of the broader institutional investor industry, the Fund is not a frequent participant in global collaborations on climate risk issues. It does not issue climate risk disclosure, is not explicit about the basis of its climate engagement with companies and has not publicly stated any portfolio goals on climate risk or set policies to meet them. The absence of formal published information on the Fund's climate change responses, and the high-level nature of its statements on the topic, creates some uncertainty and opacity about the Fund's response to climate change, its associated risks and opportunities, and the relationship of this response to international best practice for institutional investment.

This report considers the publicly available information about the Fund's climate risk response with reference to international best practice. It also considers the Fund's climate risk response in the context of CPD's recent work examining public authorities' responses to climate risk,<sup>14</sup> which recommended governments issue clear and transparent expectations to directors of these entities. A 2019 precursor report from CPD identified the

Fund as a public entity that is likely particularly exposed to climate risk.<sup>15</sup>

In this light, this brief examines how the Commonwealth could ensure clear and transparent expectations for the Fund on climate risk, while also recognising limitations on direction in governing legislation.<sup>16</sup>



## Governance arrangements for the Fund's investment decisions

The Future Fund is Australia's national SWF. It was established in 2006, and is now one of the largest institutional investors in the country with almost \$AUD250 billion in AUM.<sup>17</sup> Over time it has been directed to manage a range of sub-funds to generate revenue for specific policy areas such as emergency management and drought-proofing - both issues affected by rising greenhouse gas emissions.

*The Future Fund Act 2006* (the Act) outlines the key governance arrangements of the Fund.<sup>18</sup> Part Four of the Act establishes the Future Fund Board of Guardians (the Board), which is accountable to the Federal Government for the safekeeping and performance of the investment funds. Part Five of the Act establishes the Future Fund Management Agency (the Agency), which supports the Board in performing operational activities associated with the Funds' investments.

The Act also requires the "responsible ministers" – the Minister for Finance and the Treasurer – to issue at least one written direction about the performance of the Fund's investment functions (the Investment Mandate). The Act and subsequent regulations<sup>19</sup> appoint the Minister for Finance as the "nominated minister". This allows the Minister for Finance to act alone in relation to several functions under the Act, which is discussed further below.

The Fund's investment capital comes from transfers from the Commonwealth and the returns from investments per Section 16(1) and 17(1) of the Act. Historically, these credited funds came from budget surpluses and the sale of Telstra.<sup>20</sup> The Act and associated regulatory arrangements also set out how the Board can make investment decisions. Under Section 15 of the Act, the Board's main objective in acquiring a financial asset is to enhance the ability of the Commonwealth to cover future superannuation liabilities.

Section 18(10) of the Act states: "In the performance of its Future Fund investment functions, the Board must seek to maximise the return earned on the Fund over the long term, *consistent with international best practice for institutional investment*" [emphasis added].

This objective is subject to the other provisions of the Act, and to the Investment Mandate.

The Fund's current Investment Mandate was issued in 2017,<sup>21</sup> and establishes:

- » A long-term benchmark annual return goal of the Consumer Price Index (CPI) plus four to five percent;
- » A requirement for the Board to invest in a way that minimises the potential for any abnormal change in the volatility or efficient operation of Australian financial markets

and is unlikely to cause any diminution of the Australian Government's reputation in Australian and international financial markets; and

- » Reinforces the expectation that the Board has regard to "international best practice for institutional investment" in determining its approach to corporate governance principles, including in its shareholder voting activity.

Section 19 of the Act requires the Federal Government to consult with the Board on the Investment Mandate by providing a draft for review and inviting a submission. If the Board chooses to provide a submission within a nominated timeframe, the responsible minister must table it in Federal Parliament.

The decision-making of the Board is also guided by the Statement of Expectations (the Statement), periodically issued by the Federal Government.

The current Statement was issued in 2019<sup>22</sup> and sets out, among other things, that:

- » The Board will maintain appropriate standards of corporate governance;
- » The performance of investments will be reported quarterly; and
- » The Minister will be notified of major events like the Fund being sued or suffering a large financial loss.

The Agency and Board have responded to the Statement of Expectations in the past with a Statement of Intent, which confirms it will pursue these expectations.<sup>23</sup>

The legal arrangements governing the Fund require it to maximise financial returns over the long term, consistent with international best practice for institutional investment. The reference to international best practice in today's environment would reasonably include the management of climate-related risks and opportunities. Addressing these climate-related issues is now established mainstream practice among both public and private institutional investors. The test for the Fund is whether its actions on climate-related risks and opportunities reflect international standards for institutional investors that can be drawn from both observed practice and explicit guidelines and frameworks.





CASE STUDY: SINGAPORE

## GOVERNMENT OF SINGAPORE INVESTMENT CORP (GIC) AND TEMASEK CLIMATE STRATEGY

**The Singapore Government has two primary SWFs, the larger GIC (approximately \$USD800 billion in AUM) which is a traditional SWF and the smaller but still sizable Temasek (approximately \$USD400 billion in AUM), which has different corporate characteristics to traditional SWFs but is often included in the sector.<sup>122</sup>**

GIC's climate risk response has been marked by a more circumspect approach, but has still involved a significant progression in recent years. In 2021 it announced that it became a signatory to Climate Action 100+ as part of its company engagement efforts, and was joining as a signatory of CDP (formerly the Carbon Disclosure Project) and a member of the Asia Investor Group on Climate Change (AIGCC).

It has also joined AIGCC's engagement program focused on Asian electric utility companies.<sup>123</sup>

GIC has stated it does not intend to establish an overarching portfolio decarbonisation goal and instead will focus its efforts on deeper company engagement, embedding climate weighting into investment decisions,<sup>124</sup> portfolio stress testing<sup>125</sup> and investing in clean technology.<sup>126</sup>

In contrast Temasek has articulated a more aggressive approach on portfolio decarbonisation that includes clear targets. Temasek aims to halve the emissions attributable to its portfolio from 2010 levels by the end of the decade and reach net zero by 2050. It publishes a range of climate metrics as part of its disclosure.<sup>127</sup>

Other climate risk measures include incorporating and publishing an internal carbon price on investments (currently \$USD50 per tonne of CO<sub>2</sub>e and heading to \$USD100 by 2030), incorporating climate scenario analysis<sup>128</sup> and establishing a green investment arm.<sup>129</sup>

## Institutional investors are accelerating their climate change response

A growing understanding of climate change risks and opportunities has catalysed an industry-wide shift among institutional investors. Research from EY,<sup>24</sup> Macquarie Asset Management (MAM),<sup>25</sup> and others<sup>26</sup> has found institutional investors are responding to climate change by increasing exposure to green assets, divesting from emissions-intensive industries, engaging with carbon-intensive companies and pricing carbon into their asset valuations. A 2021 MAM survey found more than half of the 180 respondents considered climate change to be the highest priority Environmental, Social, Governmental (ESG) issue affecting investment decisions.<sup>27</sup> The view that climate risks already have financial implications is widely held,<sup>28</sup> and investors are responding to the value destruction that fossil fuel-related assets, infrastructure, property and other vulnerable forms of capital are projected to experience as climate change-driven extreme weather shocks worsen and as major economies transition to net zero emissions.

Global frameworks to help institutional investors decarbonise their portfolios to manage risk and contribute to real-world emissions reductions have been established by a number of industry networks. These include the Paris Aligned Investment Initiative's (PAII) Net Zero Investment Framework,<sup>29</sup> the UN-convened Net Zero

Asset Owners Alliance's Target Setting Protocol<sup>30</sup> and the Science Based Targets Initiative's sector guidance for financial institutions.<sup>31</sup> These standards and frameworks indicate a rapidly maturing field of practice. Many investors now align themselves with initiatives and commitments for reaching net zero emissions for at least part of their portfolio. These include:

- » The UN-convened Net Zero Asset Owners Alliance, a group of 73 investors with \$USD10.6 trillion in AUM<sup>32</sup>
- » The Net Zero Asset Owner Commitment, which has 58 signatories with \$USD3.3 trillion in AUM<sup>33</sup>
- » The Net Zero Asset Managers Initiative (NZAM), which has 273 signatories with \$USD61.3 trillion in AUM<sup>34</sup>

The Glasgow Financial Alliance for Net Zero (GFANZ) aims to consolidate guidance and commitments to net zero across all financial sector alliances. Its 450 members hold \$USD130 trillion in AUM<sup>35</sup> across investment, banking, insurance and professional services. In Australia, the most recent Investor Group on Climate Change (IGCC) survey found a growing number of investors are establishing net zero goals across their portfolios for 2050, and importantly, interim targets for 2025 or 2030. A large proportion of respondents are also divesting or screening out

fossil fuel investments, and many are now issuing public climate risk disclosures, among other actions.<sup>36</sup>

Relative to this evolution in strategy across the investment industry, SWFs have been slower to act and exhibit significant potential for further response in this area.<sup>37</sup> Commonwealth Secretariat economist, Daniel Wilde, argues that while many SWFs are now factoring environmental concerns into their investment decisions, disclosure of methodology and exposure among firms is still problematically uncommon.<sup>38</sup> This increases the difficulty for SWFs to measure their carbon footprints. Former Executive Secretary of the United Nations Framework Convention on Climate Change, Christina Figueres, has argued that SWFs need to go beyond traditional risk management approaches to climate change due to the seriousness of global warming and "need to take an active role in reducing their portfolio carbon footprints".<sup>39</sup>

The University of Oxford's Sustainable Finance Program has found SWFs are well positioned to play an active investment role in transition because of their long-term investment horizons and the scale of capital they are responsible for.<sup>40</sup> Oxford's team also stresses the responsibilities SWFs have to the broader community as public entities:



“[SWFs] have obligations to their citizens many decades into the future. Given this extended horizon and their scale, SWFs are well positioned to play an important role in aligning capital markets with intergenerational sustainability, and its associated investment risks and opportunities. It is our firm view that it is also in their interests to do so, protecting their long-term revenue creation and value protection for their beneficiaries.”<sup>41</sup>

Despite concerns about a lack of progress, a late-2020 survey conducted by the International Forum of Sovereign Wealth Funds (IFSWF) indicated that a significant share of SWFs (more than 60 percent of the survey’s 34 respondents) were considering or conducting carbon intensity analysis of their portfolios.<sup>42</sup>

A more recent 2022 survey by Invesco Global Sovereign Asset Management of 81 sovereign investors showed the number with climate targets rising to 30 percent, up from 23 percent a year before.<sup>43</sup> Further, 45 percent had divested from high emitting sectors, 80 percent had reduced exposure to these industries, 75 percent were engaging with companies to reduce emissions and 70 percent were proactively investing in companies working on climate solutions.

The survey found SWFs generally prefer engaging with investee companies to drive change and reduce emissions over divestment, however the survey suggested many had divested or reduced exposure to high emitting companies and sectors.

Shared global platforms like Climate Action 100+ and the One Planet Sovereign Wealth Fund (OPSWF) Framework were seen by SWF respondents as important ways to maximise influence during climate engagement, and were viewed as more influential than unilateral engagement with portfolio companies.

There are some instances where SWFs and other public investors have taken a leading position in climate risk response or advanced climate-related practice. Often this has been the product of government direction through a change to investment mandates, legislation or other directions. But in some cases it has been driven by SWF boards and management under existing guidance.

In 2017, six members of the IFSWF established a trade association to provide guidance on climate strategy to the global community of SWFs. That group, One Planet Sovereign Wealth Funds, now includes 19 government-backed funds<sup>44</sup> and has published principles encouraging climate change analysis by SWFs and other large asset pools.<sup>45</sup> The UN-supported Net Zero Asset Owners Alliance includes sovereign wealth and public pension funds from Ireland, Denmark, Germany, the United States, the United Kingdom, Gabon, and several other

jurisdictions, as do other similar global net zero collaborations.<sup>46</sup>

Some SWFs use frameworks, like the Task Force on Climate-related Disclosures (TCFD) recommendations and guidance, to publicly disclose climate risks. The case studies throughout this document detail some instances where SWFs and PPFs have adopted more extensive climate risk responses, either through their existing government mandate or via an expanded mandate, or been closely involved in advancing global collaboration.



## CASE STUDY: NEW ZEALAND

## NEW ZEALAND SUPERANNUATION FUND (NZSF) AND PORTFOLIO DECARBONISATION

**The New Zealand Superannuation Fund (NZSF) is the largest of the country's four Crown financial entities, responsible for approximately \$USD30 billion in AUM.**

In 2021, NZSF established a commitment to decarbonise (reach net zero) its portfolio by 2050. This added to an existing shorter-term goal of reducing the emissions intensity of its portfolios by 40 percent and its exposure to fossil fuel reserves by 80 percent by 2025.<sup>130</sup> In making the net zero commitment, NZSF signed the Net Zero Asset Owners Commitment of the Paris Aligned Investment Initiative,<sup>131</sup> which requires participants to invest in line with the Paris Agreement, set interim targets, and engage in advocacy and engagement in line with their net zero goals, among other activities.

NZSF's net zero commitment followed the establishment of the Crown Responsible Investment Framework by the New Zealand Government, which was supported by a letter of expectations from the Minister of Finance and the Minister for the ACC.<sup>132</sup> This framework requires NZSF and others to:

- » Have carbon neutral portfolios by 2050
- » Set interim goals every five years consistent with limiting global warming to 1.5°C
- » Report transparently on climate metrics and risk exposure against international and domestic standards
- » Engage with local and global investee companies to ensure they establish transition plans, and

- » Identify investments that can assist additionality to the low carbon transition.

NZSF has published TCFD disclosure for multiple years.<sup>133</sup> NZSF has also been specifically named as an entity that must report in New Zealand's mandatory climate risk disclosure regime, meaning it will need to meet the country's minimum accounting standards for climate disclosure.<sup>134</sup>

It is a member or supporter of the Principles for Responsible Investment, Investor Group on Climate Change, Paris Aligned Investment Initiative, OPSWF, CDP, and Climate Action 100+.<sup>135</sup>

## The depth of the Fund’s response to climate risk is hard to determine but likely falls short of international best practice

Fund Board and Agency members have recognised the risks that climate change poses to investment returns. These statements have not always been consistent in their estimations of timeframe and severity.

Former Fund Chief Investment Officer Sue Blake told Senate Estimates in October 2021:

“We know that the world is decarbonising and it’s a significant disruption for investors, and we need to negotiate the risks and opportunities that presents. We’ve been looking at these issues for a long time now and take our stewardship of the assets very seriously.”<sup>47</sup>

Fund Chair, Peter Costello, has stated the Fund regards climate change as a “long-term” issue, saying it is “obviously something we look at. It’s a significant thing to look at, it’s not the only thing to look at.”<sup>48</sup>

A 2021 position paper from the Fund about accelerating shifts in the investment environment lists climate change as one of ten “paradigm shifts that are shaping the investment order in ways that should encourage investors to think afresh about their portfolios.”<sup>49</sup>

As recently as November 2022, CEO Dr Raphael Arndt told Senate Estimates that while “best practice is still being determined,” the Fund nonetheless supports climate risk disclosure from portfolio companies so that it can assess consistent and standardised data.<sup>50</sup> This implies that the Fund uses climate risk information in its work. But the Fund has not published a specific policy for addressing climate change-related risks or opportunities, and has stated that its broader ESG policy sufficiently covers its overarching approach to climate risk.<sup>51</sup>

The Fund’s ESG policy says that the Fund will integrate ESG considerations into investment decisions, partner with its external investment managers to execute this policy and favours engagement with investee companies over portfolio exclusions.

The Fund’s ESG strategy does not specify the metrics it uses to assess risks or the thresholds that would influence an investment decision.

The Fund has a legislated requirement to work through external managers, and the current ESG strategy emphasises collaboration with these actors on ESG concerns. The methods, metrics and thresholds employed in this collaboration are not published or described publicly.





Statements by Agency representatives at Senate Estimates, in annual reports and in proxy voting summaries give further insight into the Fund's approach to climate risk, albeit in a fragmented and incomplete way in the absence of a published climate-specific strategy or TCFD disclosure.

- » The 2020-21 and 2021-22 annual reports state that the Fund considers climate change from a “total portfolio risk management and disruption perspective”<sup>52</sup> and relevant risks and opportunities are integrated into its investment processes. These reports do not detail the metrics used, but lists risks considered which include the future implementation of carbon pricing, transition risks and physical risks.
- » Practices described in these annual reports include:
  - » Reviewing climate risk during due diligence for specific investments and periodic industry assessments
  - » Monitoring investment managers' performance on climate risk
  - » Engaging with investee assets and companies
  - » Considering climate-related risks in proxy voting and Board engagement activities
- » The Fund's publicly available voting summaries from recent years shows that it has not generally supported climate-related shareholder resolutions at Australian company annual general meetings (AGM) where they were not also backed by the company board.
  - » One exception appears to be a resolution lodged by the Australasian Centre for Corporate Responsibility at the 2021 Incitec Pivot AGM. This resolution requested the company disclose Paris-aligned emissions reduction targets, and how its executive remuneration and capital expenditure are connected to these goals, which was opposed by the company board. The resolution, ultimately advisory, received support of 43.71<sup>53</sup> percent of voting shareholders including the Future Fund.<sup>54</sup>
  - » The Fund states overall it participated in 234 Australian-listed company AGMs in 2021-22 and voted against board recommendations on 8.8 percent of all resolutions.<sup>55</sup>
- » The Fund does not produce climate risk disclosure, claiming it is not necessary on cost and market efficiency grounds. At Senate Estimates in 2019, former Fund Chief Executive Officer, David Neal, said “nobody buys and sells the Future Fund, so those sorts of disclosures—from our perspective, that's not contributing to market efficiency and is a considerable overhead.”<sup>56</sup>
- » Dr Arndt told Senate Estimates in 2021<sup>57</sup> and 2022<sup>58</sup> that:
  - » The Future Fund board believes exclusion of companies based on their involvement with or exposure to fossil fuels would not be “consistent with the long-term requirement to meet the investment mandate”, which is to maximise risk-adjusted returns over the long run
  - » The Fund was engaging with companies that constituted significant holdings in their portfolios on their climate risk approach
  - » The Fund had run scenario analysis on its portfolios to determine the scope of climate risk on its books and that “while there are some exposures, they're not particularly concentrated or larger than other sorts of scenarios we might run through the portfolio around other types of long-term risks.”
- » The Fund lists itself as a member of broader responsible investment initiatives Thinking Ahead Institute, Focusing Capital on the Long Term, and Institutional Investor Roundtable.<sup>59</sup> It is also a member of the Coalition for Climate Resilient Investment.<sup>60</sup>

These statements by Board and Agency members cover three broad areas of practice that will guide the following discussion of the Fund's climate response in the context of “international best practice”: disclosure; strategy (including investment decision integration, targets, divestment and engagement) and collaboration.

Elements of these subsections are also addressed in the case studies of SWFs and PPFs practice, and discussion on the broader investment industry practice, which indicate many domestic and global counterparts of the Fund have significantly advanced climate risk responses, at least in some areas.



## Climate risk disclosure

The Fund does not produce regular public disclosure on climate risk in line with the TCFD recommendations or other relevant international frameworks and emerging reporting standards. Nor is it among the 3400 financial, corporate and not-for-profit organisations listed as supporters of the TCFD framework.<sup>61</sup> The absence of disclosure makes it difficult to assess in detail the depth, appropriateness and reach of the Fund's climate risk exposure and response.

This position creates several concerns:

- » As a public entity, the Fund should be predisposed to transparency and accountability to Australian citizens. Taxpayers bear the risk of the Fund's investments
- » The Federal Government has committed to strengthening disclosure for a range of market participants. If the Fund avoided obligations that apply to private institutional investors it would create a double standard in the market and undermine the Federal Government's commitment to strengthening climate risk disclosure standards
- » Current disclosure practice does not reflect international best practice among other SWFs, PPFs and private institutional investors. Publicly-owned investors in other nations including Japan, Singapore and New Zealand, have produced several years of disclosure using the TCFD recommendations
- » It does not meet the expectations Australian financial regulators have begun to signal to financial organisations. The Australian Prudential Regulation Authority (APRA) has stated: "Beyond any statutory or regulatory requirements, a prudent institution would consider whether additional, voluntary disclosures could be beneficial in enhancing transparency and giving confidence to the wider market in the institution's approach to measuring and managing climate risks"<sup>62</sup>
- » As one of the largest Australian investors, the Fund's disclosure is important information for regulators charged with managing Australian financial stability to fulfil their mandates, such as the Reserve Bank of Australia<sup>63</sup>
- » It makes it unreasonably difficult to assess the performance of the Board and Agency in meeting

the Act's requirement to match its investment activity against international best practice.<sup>64</sup> For example, it is unclear whether the Fund's portfolio testing is being conducted against sufficiently robust scenarios such as the International Energy Agency's Net Zero Emissions by 2050 scenario (IEA NZE2050) or other 1.5°C scenarios, as is now required of Norway's main SWF (see case study on page 24).

The Agency has stated it is carrying out future-facing climate scenario testing and monitoring the carbon intensity of its listed markets portfolio,<sup>65</sup> which could be used as a partial basis for public disclosure.

## Portfolio decarbonisation goals and climate risk strategy

Unlike many private institutional investors and a growing number of SWFs and PPFs, the Fund does not have a published climate change strategy. The Board and Agency have said – through periodic statements and publications – that it addresses climate risk with risk-adjusted weighting in investment decisions, integration and review of external manager mandates, and engagement with investee companies.<sup>66</sup>

The limited public information available obscures sight of the depth of this practice, the metrics and thresholds being used, whether it meets international best practice, and whether it is proportional to the systemic risk created by climate change. This could be avoided if the Fund had a clearly stated climate change plan, alongside regular disclosure. Guidance for developing and issuing comprehensive climate action plans has been developed by The Investor Agenda, a global collaboration of climate and responsible investment membership organisations.<sup>67</sup> This reflects maturing international practice on climate risk among institutional investors that suggests a specific climate strategy is now regarded as industry best practice.

Based on the publicly available information, there are other missing strategic components of Fund's climate risk response compared to other SWFs and the broader institutional investment industry. The Fund has not set goals for portfolio decarbonisation, short-term portfolio emissions intensity or green investment.

CASE STUDY: USA

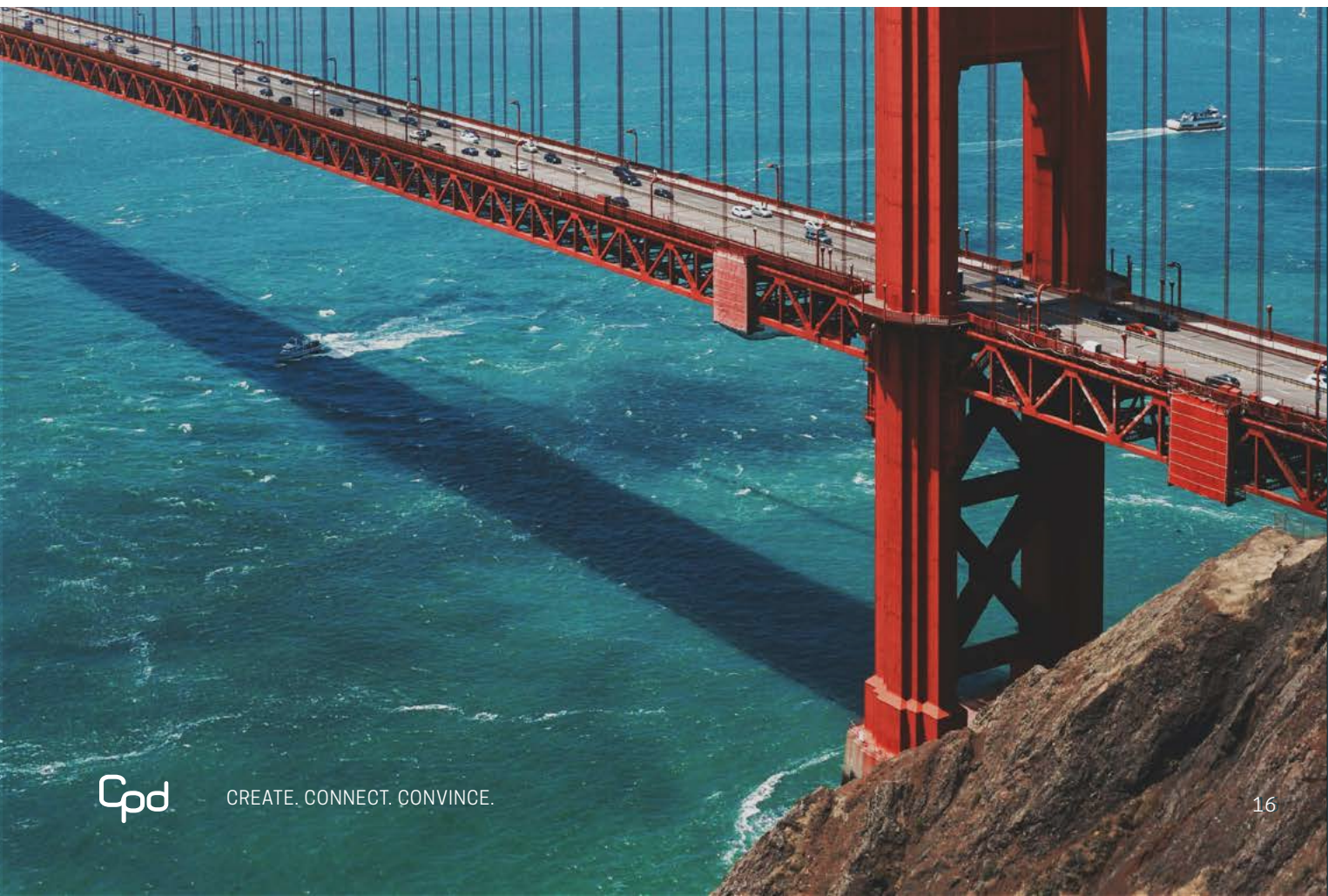
## CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CALPERS) AND GLOBAL COLLABORATION

**CalPERS is the pension fund for Californian public sector workers and has approximately \$USD470 billion in AUM.**

In 2017, CalPERS co-convened the Climate Action 100+ initiative, a global collaborative effort among institutional investors to engage with the 166 highest emitting companies globally and others that are relevant to the net zero emissions transition.<sup>136</sup> CalPERS Managing Investment Director of Global Equity, Simiso Nzima, sits on the Climate Action 100+ Steering Committee<sup>137</sup> and CalPERS is engaging directly with 22 companies alongside other investors through the initiative, using its common platform.<sup>138</sup>

CalPERS is also a founding signatory of the UN-convened Net Zero Asset Owners Alliance and has previously been a member of the initiative Steering Committee.<sup>139</sup> The Alliance requires members to transition investment portfolios to net zero emissions by 2050 consistent with keeping global warming to 1.5°C, with an emphasis on reducing greenhouse gas emissions in the real economy.<sup>140</sup>

CalPERS has commitments to reach net zero emissions by 2050 across its investment portfolios and has established an undisclosed 2025 emissions intensity goal.<sup>141</sup> It has published climate risk disclosure using the TCFD framework.<sup>142</sup>





Other SWFs such as NZSF, Fonds zur Finanzierung der kerntechnischen Entsorgung (KENFO) in (Germany), Fonds Gabonais d'Investissements Stratégiques in (Gabon) and Temasek have adopted these types of goals.

This goal-setting is more mainstream in private institutional investment, as evidenced by the large memberships of global net zero coalitions and the high number of Australian institutional investors with net zero commitments.<sup>68</sup> These include asset owners with comparable AUMs to the Fund such as AustralianSuper,<sup>69</sup> the Australian Retirement Trust<sup>70</sup> and Aware Super.<sup>71</sup>

The Fund says that while it monitors the carbon intensity of its listed markets portfolio, it does not target a certain rate but rather seeks to “maximise ‘climate-aware’ risk-adjusted returns”. The Fund says it aims to allocate capital to assets with growth potential linked to decarbonisation, such as renewable energy and carbon credits, to drive risk-adjusted returns as economies decarbonise, and it now holds \$AUD1 billion in investments in wind and solar energy assets.<sup>72</sup>

Explicit green investment goals or strategies form part of some SWFs’ climate risk response, including Temasek. In Norway, the Government Pension Fund Global (GPF) has moved away from this approach, with government-backing, because climate risk response has been more deeply mainstreamed across the entirety of its investment management. These types of specific green asset allocation and investment targets are a feature of global climate investment frameworks, especially for institutions that are at an earlier stage of climate risk strategy development.

The Fund is broadly consistent with industry practice in focusing on climate-related engagement with investee companies and assets. Many institutional investors view company engagement as central to reducing their exposure to climate risk and to achieving institutional strategic objectives like reducing the emissions intensity of their portfolios. Engagement is a significant feature of global decarbonisation frameworks because it is regarded as being more connected to real-world emissions reductions than divestment alone.<sup>73</sup>

In the Fund’s case it is unclear which companies and assets its engagement captures, what the Fund seeks through engagement and the place of engagement in its overall climate risk strategy.

The Fund has made a statement in its 2020-21 annual report supporting corporate TCFD reporting “where appropriate”.<sup>74</sup> A fledgling number of Australian-listed companies have held AGM advisory votes on climate action plans and statements over the last 18 months, partially in response to the global Say on Climate initiative<sup>75</sup>. At a minimum this means the Agency is likely discussing to some degree the details of climate targets and other elements of these statements and plans with these companies. The Fund appears to have supported company directors on the details of these climate action plans and statements in its resolution voting across 2021-22.<sup>76</sup>

Other SWFs are being more publicly explicit about their engagement as a result of mandate directions, their membership in global engagement collaborations or commitments under global decarbonisation frameworks. The recent review and mandate reforms of GPF will lead to the Norwegian SWF engaging more directly with companies about how they plan to achieve net zero emissions by 2050. The New Zealand Crown Responsible Investment Framework requires NZSF and other Crown investors to “utilise your position as significant investors to engage with New Zealand and global companies on developing transition strategies”.<sup>77</sup> Industry guidance, such as the Institutional Investors Group on Climate Change (IIGCC) Net Zero Stewardship Toolkit, recommends investors publish specific stewardship and voting policies.<sup>78</sup>

The Fund does not articulate escalation or divestment triggers for investments with particularly high climate risk exposure, such as thermal coal, or those that are unresponsive to engagement. The Fund has stated it will exclude investments where “serious breaches of ESG standards have been identified” but with a preference for engagement to improve practice first.<sup>79</sup> A threshold for a serious breach of ESG standards is not publicly available. Similarly, the Fund states its ESG strategy informs its proxy voting decisions, but records published by the Fund show that it has mostly voted against climate-related resolutions at company AGMs. For example, in recent years the Fund voted against resolutions that attracted large proportions of shareholder support at companies like Woodside<sup>80</sup> and Santos.<sup>81</sup> This cuts against shifting industry practice among institutional investors, whose support for climate-focused resolutions at company



AGMs has grown in recent years.<sup>82</sup> An exception to this was a 2021 resolution requesting Incitec Pivot disclose Paris-aligned climate targets, which may suggest some emerging evolution in Fund practice. The Fund supported climate-related resolutions that were also supported by company boards at BHP,<sup>83</sup> Rio Tinto,<sup>84,85</sup> and South32,<sup>86</sup> alongside previously mentioned Say on Climate votes.

The University of Oxford's Sustainable Finance Program has recommended SWFs' "engagement with companies lagging behind should make clear the improvements expected and the consequences of non-compliance, including (if appropriate) the option of divestment."<sup>87</sup> Unlike some other SWFs, the Fund does not have a stated policy on fossil fuel investments and threshold conditions to consider divestment, nor formalised governance architecture like the GPF's Council of Ethics. The Fund recently disclosed through an answer to Questions on Notice for Senate Estimates that it holds an approximate \$AUD3.4 billion exposure to the 50 highest emitting companies in the world.<sup>88</sup> This includes a mix of diversified miners and energy companies such as BHP and Rio Tinto, alongside fossil fuel-dominated entities such as Chevron, Whitehaven Coal and Petroleo Brasileiro.<sup>89</sup>

## Collaboration

The Fund is a notable absence from a number of prominent investor collaborations and industry groups for asset owners and SWFs that seek to address common areas of concern on climate risk. Given the systemic nature of climate risk across economies and the financial system, industry-wide collaboration is necessary to produce a systemic response. International collaboration with a peer network exposes institutions to the investment industry best practice referred to by the Act and the Investment Mandate.

The Fund's 2021-22 annual report details membership of the Thinking Ahead Institute, Focusing Capital on the Long Term, and Institutional Investor Roundtable initiatives that focus on responsible investment more broadly.<sup>90</sup> The Fund recently joined the Coalition for Climate Resilient Investment (CCRI),<sup>91</sup> which is developing tools to better integrate adaptation issues into investment decisions. Little public information is available on how the Fund's involvement in these collaborations is informing or changing its climate strategy,

for example whether the Fund plans to pilot the resilience-focused tools developed through CCRI.

The Fund is not yet a member of broadly-supported industry bodies on responsible investment and climate change such as the UN-supported Principles for Responsible Investment (PRI), the Investor Group on Climate Change Australia/New Zealand (IGCC) and the Responsible Investment Association of Australasia (RIAA), or the primary SWF collaboration on climate risk, the OPSWF. Each of these initiatives has SWF and PPF members, supporters or observers.

The Fund appears to be similarly absent from collaborative company engagement. Collaborative investor engagement initiatives between institutional shareholders send strong market signals to high-emitting companies. The largest global engagement initiative is Climate Action 100+, comprising 700 investors representing \$USD68 trillion in AUM. Publicly-owned members include NZSF, CalPERS and GIC, while Japan's Government Pension Investment Fund (GPIF) has been listed as an observer.<sup>92</sup> GIC is also a member of the Asia Investor Group on Climate Change's Asian Utilities Engagement Program that seeks emissions reduction goals consistent with the Paris Agreement, and a phase out of coal power in line with the IEA NZE2050 scenario, from the region's energy generation companies.<sup>93</sup> These platforms require signatories to engage with common aims such as establishing targets, producing climate risk disclosure and putting in place clear climate risk governance processes. Climate Action 100+ now publishes a detailed benchmark of company performance across ten indicators and two dozen sub-indicators, demonstrating industry best practice on engagement is further accelerating.<sup>94</sup>

The Fund's Head of Corporate Affairs, Will Hetherington, said in 2021: "ESG and sustainability are important issues to us, and we recognise they can have an impact on performance. We aim at collaborating regardless of membership and we are always cautious on what we can fully commit into and add value to."<sup>95</sup> The Fund has not publicly detailed this collaboration activity or elaborated on the caution around membership, which presents an additional barrier to benchmarking against best practice. It should be noted that some industry collaborations on climate change and responsible investment come with membership fees for joining and therefore could create modest additional overheads.

## Testing the Fund's climate risk approach against international industry frameworks for climate plans

Industry frameworks for developing climate plans are well established. Guidance for Investor Climate Action Plans (or ICAPs) was issued in 2021 by The Investor Agenda, a collaboration of seven global investor organisations working on climate risk - including IGCC, AIGCC, IIGCC, Ceres, the United Nations Environment Programme Finance Initiative (UNEP FI) and PRI.<sup>96</sup>

ICAPs set out the components that investors should be adopting in establishing, expanding and maintaining a dedicated climate change strategy. The initiative published an Expectations Ladder for investors to assess progress, from an organisation starting their climate journey (Tier 4) through to intermediate (Tier 3) and more advanced responses (Tier 2 and Tier 1).<sup>97</sup> *Table 1* assesses publicly available information about the Fund's climate risk response against these measures and tiers, and summarises the results. The full assessment can be found in *Appendix 2*.

There are two qualifiers to this assessment.

First, the Fund does not make regular public disclosures, nor has it published a climate strategy. This itself is a departure from best practice. It additionally impairs external measurement of the Fund's full performance, especially of internal processes like Board responsibilities and skills training. Where there has been some signal of practice, or there is a reasonable assumption that some practice is occurring because of other statements, but no disclosure about the depth or reach, this report considers that the Fund has made a partial response, which is indicated with an orange shade.

The second qualification is that the Expectations Ladder includes a focus area of measures on policy advocacy. All SWFs will be constrained by convention in this area by their public nature, beyond potential further limitations in their legislation and mandate. It would be unfair to test the Fund's response against this criteria. The other focus areas - investment, corporate engagement, investor disclosure and governance - are areas that SWFs like the Fund can reasonably engage with, and Board and Agency members have made public statements that allow some assessment of their response against these Expectations Ladder categories and measures.

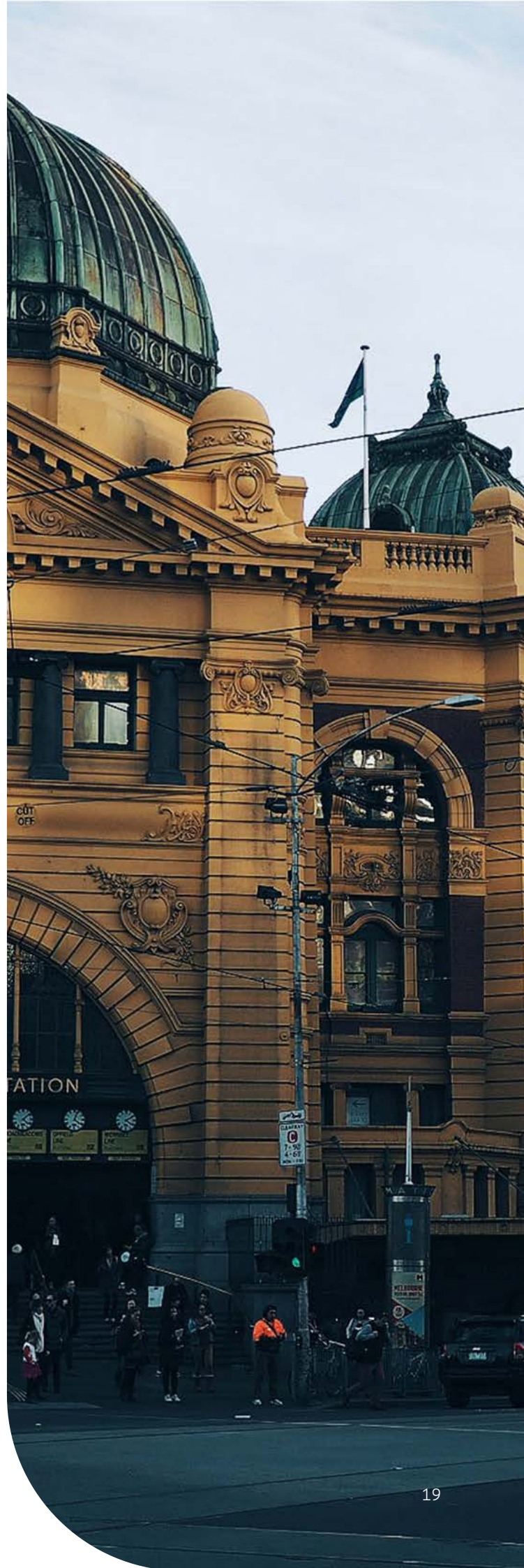




Table 1: Average results of the Fund’s climate change response against the ICAPs Expectations Ladder<sup>98</sup>

Focus Area	Tier 4 (Beginner)	Tier 3 (Intermediate)	Tier 2 (Advanced)	Tier 1 (Standard Setter)
Investment	Orange circle	Red circle	Red circle	Red circle
Corporate Engagement	Red circle	Red circle	Red circle	Red circle
Investor Disclosure	Orange circle	Red circle	Red circle	Red circle
Governance	Orange circle	Red circle	Red circle	Red circle

Red - No evidence of action; Orange - Partially enacting; Green - Enacting; Scores are averaged across all components of the focus area at the appropriate tier to reach a single measurement.

On the ICAP Expectations Ladder, the Fund’s climate risk activity constitutes a partial Tier 4 response reflecting an investor that is “starting to think about its climate journey”.<sup>99</sup>

Public statements of the Board and Agency indicate awareness of climate risk and practice in response. Overall, this assessment finds the Fund’s strategic response is less advanced than the best practice of SWFs, other sovereign investors and private sector investors across the industry. On the basis of available information, it is not possible to argue that the Fund is approaching international investment industry best practice on climate risk and opportunities.



CASE STUDY: JAPAN

# GOVERNMENT PENSION INVESTMENT FUND (GPIF) AND CLIMATE RISK DISCLOSURE

**Japan’s GPIF is the largest pension fund in the world, and has approximately \$USD1.3 trillion in AUM.**

Since 2018, GPIF has been releasing public disclosure on its exposure to climate risk following its public support for the TCFD framework.<sup>143</sup> In 2021, GPIF produced its most detailed climate disclosure to date, expanding its analysis to all emissions across the supply chain (including Scope 3 emissions), inter-industry risks and opportunities and alternative asset classes.

Notably, GPIF has been credited with adopting and publishing data assessing the “implied temperature rise” of its portfolio make-up, namely what level of global warming the assets across its portfolios would translate to if applied across the global economy.<sup>144</sup> In FY20 the GPIF reported the global warming potential across asset classes was 3.26°C - 4.34°C.<sup>145</sup>

GPIF has also published a statement detailing “excellent” TCFD disclosure by companies as identified by their external asset managers. This acts as a positive market signal to companies on good reporting practice.<sup>146</sup>





## Changing the Fund’s investment mandate to deepen climate risk response

On the basis of the gap between industry best practice and the Fund’s performance in some areas assessed on available information, there is a *prima facie* case for the Australian Government to set a clearer direction for the Board on climate change via a refreshed Investment Mandate and Statement of Expectations.

Clearer direction could better enable the Fund to meet its obligation under the Act to observe best practice, by managing climate risks and opportunities using tools, frameworks and practices employed by leading institutional investors globally. The OECD has found that often the structure and mandate of SWFs may restrict them from committing additional resources to climate-related action from a cost-to-return perspective without policy direction:

“Sovereign funds receive their mandates from their governments. They are unlikely to take climate-related action on their own, and unless governments provide them with the resources necessary to meet associated costs. These costs may include the upgrading of mandates, governance structures, investment strategy, partnerships and risk-management frameworks, as well as recurrent costs associated with operating as active climate-aligned owners.”<sup>100</sup>

The following considers what limitations might exist in the Act on issuing climate change directions in the Investment Mandate and Statement of Expectations, and explores possible responses. It also considers existing enabling provisions in the Act that could allow the Federal Government to improve the Fund’s climate risk reporting practices.

Finally, it places the discussion in the context of growing efforts to bolster the climate risk response of public authorities.

### As a first step, the responsible minister can request reports on climate risk exposure

The Federal Government can request the disclosure of climate risk information by the Fund under existing provisions of the Act. Section 54 allows the responsible minister to request and publish a report, documents or information about “one or more specific matters relating to the performance of the Board’s functions”. Climate risk matters would be captured by these provisions. The minister could request the TCFD framework and other international reporting standards, such as those being developed by the International Sustainability Standards Board, be used as a reference to provide this information.

The Fund’s stated position that it does not need to issue climate risk disclosure is not in line with the practice of other SWFs and PPFs, which have reported in line with TCFD recommendations and other global frameworks. New Zealand has explicitly included Crown investors, including NZSF, in its mandatory disclosure regime, even when other public entities were excluded.<sup>101</sup>

In light of this international practice on climate risk disclosure, a request of the Fund through Section 54 of the Act should only be seen as a short-term measure. As the Federal Government develops a strengthened climate risk disclosure regime for Australian entities, it should include the Fund alongside other relevant public entities in any enabling legislation and regulation. In the interim, a ministerial request for reporting would allow the Fund to prepare for this disclosure regime, demonstrating good faith to the broader market that the Federal Government will apply consistent expectations to sovereign and corporate market participants.

## The Federal Government can direct the Fund to decarbonise its portfolio and meet other broad climate objectives via the Investment Mandate

The Act gives the Federal Government broad scope to set terms for the Fund’s investment strategy and goals through the Investment Mandate and Statement of Expectations. Section 18(4) requires the mandate to provide guidance that aligns “risk and return” and the “allocation of financial assets”. Section 18(4)(b) allows ministerial direction on asset allocation and Section 18(10) makes clear that the Investment Mandate takes precedence over the requirement that the Fund maximise returns over the long-term where these conflict.

There are some questions about whether including climate risk considerations in an Investment Mandate could contravene provisions in Section 18A of the Act, which restricts what the mandate can address. This section of the Act states that the government cannot direct the Fund to invest in, acquire or allocate financial resources to a particular asset, derivative, business, or activity. The Fund and Finance Department have in the past interpreted this section of the Act as constraining portfolio exclusions:

“[ALP] Senator [Katy] GALLAGHER: But if the government wanted to exclude something, they could issue a direction to the fund. Is that correct?”

[Former Fund CEO] Mr [David] Neal: I’m not sure they could, actually, no—

Senator GALLAGHER: What do you think?

Mr Neal: I don’t think the Act allows that, and it’s never been done.

Senator GALLAGHER: No—it couldn’t be done, Dr Helgeby?

[Former Deputy Secretary of Governance and Resource Management, Department of Finance] Dr [Stein] Helgeby: My understanding is you’d need a change in the act.

Senator GALLAGHER: In order for the minister to direct the fund?

Helgeby: That’s right, yes.”<sup>102</sup>

Section 18A has not been the subject of judicial interpretation. However, on its face, Section 18A appears only to restrict the responsible ministers from issuing directions that relates to a particular company, asset, derivative, business or activity. This would prohibit directions to divest from, say an individual high-emissions company, such as an oil and gas producer, or to invest in an individual renewable energy developer. But Section 18A does not prohibit broad directions to the Board. In introducing the Act in 2005, Mr Costello, then Federal Treasurer, said the intention was to leave detailed investment decisions to the Board but establish a framework, including the Investment Mandate, for the government to set “the broad parameters within which the Fund can operate.”<sup>103</sup> Mr Costello stated that as part of the Investment Mandate the government could include restrictions on the Fund’s investments “where there are sound policy or national interest reasons to do so.”<sup>104</sup>

Establishing Investment Mandate objectives such as developing a portfolio strategy reflecting Australia’s commitment to net zero emissions by 2050 and its other emissions reduction targets would be consistent with the Act. A revised Investment Mandate could instruct the Fund to align its assessment of risks over the long term with legislated climate goals without producing conflict between the revised mandate and the statutory requirement to maximise returns.



## CASE STUDY: NORWAY

## GOVERNMENT PENSION FUND GLOBAL (GPF) AND REVIEW OF ITS CLIMATE RISK STRATEGY AND MANDATE



**The GPF is the world's largest SWF, with approximately \$USD1.2 trillion in AUM. The fund specifically invests earnings from Norway's petroleum industry. It is complemented by a smaller fund dedicated to investments in domestic and Scandinavian assets. The GPF is managed by Norges Bank.**

The Norwegian Ministry of Finance has been more prescriptive and definitive in terms of the responsible investment approach it expects of Norges Bank in managing the GPF than Commonwealth policymakers in Australia. For example, from 2009 the Ministry required the Bank to develop a mandate for investments, normally in the range of \$USD3-12 billion, that focus on eco-friendly assets or technology, including "climate-friendly energy, improving energy efficiency, carbon capture and storage, water technology and environment-related services such as management of waste and pollution, etc."<sup>147</sup>

The mandate also set guidance for portfolio exclusions that inform the decisions of an established Council of Ethics for the GPF. Decisions over several years on the mandate by the Ministry of Finance and decisions of the GPF Council of Ethics has led to divestment from 170 companies on the basis of climate-related risks.<sup>148</sup>

In 2021, the Ministry of Finance commissioned an expert review of the GPF's approach to climate

risk, which recommended significant changes to its mandate to strengthen the GPF's fund-wide approach.<sup>149</sup> In response, the Norwegian Government announced via its annual White Paper that:

- » The GPF will base responsible investment efforts on a long-term goal that investee companies align their activities with global net zero emissions in accordance with the Paris Agreement
- » Norges Bank will detail principles for the management and measurement of climate risk
- » The Bank will conduct stress testing of the portfolio, including using a 1.5°C scenario; report in accordance with recognised standards and leading frameworks
- » Responsible investment efforts will be reviewed on a regular basis.<sup>150</sup>

In addition to the enhanced climate risk response required of the GPF, the Norwegian Government plans to remove the specific environment-related management mandate (though allowing investment in unlisted renewable energy assets at a higher cap) and to allow the Norges Bank to make climate-related exclusions without having to wait for the Council of Ethics.<sup>151</sup> However, to some criticism, Norges Bank will not set a net zero 2050 goal for the GPF portfolio.



The Act likewise allows the Investment Mandate and/or Statement of Expectations to contain directions on other climate-related issues, including the Fund's engagement approach, scenario testing, disclosure, industry collaboration and disclosure.

This approach could:

- » Clarify evolving expectations for the Board to meet international best practice per the Act as it relates to climate-related risks and opportunities
- » Ensure taxpayer-funded investments are not unnecessarily exposed to climate risk, and do not worsen climate risks to investment returns or the community more broadly
- » Ensure the Fund's activities are consistent with Australia's obligations under the Paris Agreement and legislated climate goals
- » Align expectations of the disclosure practice of a major sovereign investor with future requirements for standardised disclosure for Australian corporate entities.

The Board would maintain independence to decide how to meet the climate risk guidance of its Investment Mandate in its detailed investment decisions, as it does in determining how to meet its current mandated goal of a return of CPI plus four to five percent over the long term.

Establishing a clear climate risk mandate and/or emissions reduction goals would also not necessarily entail individual company divestment, at least as a first step. Many net zero frameworks for investors emphasise direct engagement with existing investee companies alongside investment in emissions-reducing assets. However, international best practice may include divestments of assets that are significantly exposed to climate risk such as shareholdings in companies deriving the entirety or a high proportion of their revenue from thermal coal, per the activity of some SWFs and a growing number of Australian institutional investors.<sup>105</sup>

Ultimately, due to the opaque nature of the Fund's operations, the recommendation of this report is for an independent review before a new Investment Mandate is issued under Section 18 of the Act.

## Stronger direction for the Fund is consistent with growing efforts to manage climate risk across public authorities

In 2022, CPD released *Raising the Bar: Managing climate change risk in public authorities*. This work considered the progress of public authorities on climate risk and what governments could do to elicit a more fulsome response.<sup>106</sup> It also found that directors of these public authorities likely have legal duties to respond to climate risk that are at least as stringent as those of private corporation directors.

This followed a 2019 report by CPD that explicitly considered the duties of Commonwealth public authority directors on climate risk,<sup>107</sup> building on the Hutley Hartford-Davis legal opinions on climate risk and subsequent guidance from Australian financial regulators. The 2019 report identified the Fund as a Commonwealth public entity that may have significant exposure to climate risk. Neither the 2019 or 2022 work explicitly examined the specific legal duties on climate risk arising from the Board's unique governing legislation, as distinct from general governing legislation such as the *Public Governance, Performance and Accountability Act 2013*.

*Raising the Bar* found that climate risks for public authorities continue to increase. The physical impacts of climate change have worsened, and transition concerns have intensified as global capital markets and government policies accelerate emissions reductions and green technology deployment. In reviewing current practice across Commonwealth and state public authorities, the report concluded that while it was improving, significant deficits remained in their response to these growing threats and opportunities. These included a lack of tools to assess, manage and disclose risk, and the absence of a consistent, holistic approach to managing climate change risks that is relevant to the specific roles of public authorities.

This lagging response is in part due to the different market dynamics facing public authorities when compared to private entities. For example, public authority boards are not facing the direct and growing shareholder and consumer



pressure on climate change as many companies, including at AGMs.

Similarly, the climate risk duties of directors of government-owned corporations are unlikely to ever be tested and confirmed in the courts. In a private corporation, any shareholder can sue directors for a breach of due care and diligence. In a government corporation, only the responsible minister could bring such a case to the courts.

To address these gaps, CPD made six recommendations in *Raising the bar* for governments at all levels to strengthen the climate risk response of public authorities, including:

- » Give clear and transparent policy direction through ministerial statements
- » Standardise the technical frameworks for risk assessment and reporting, particularly around financial risk disclosure
- » Create a whole-of-government picture of climate risk exposure
- » Leverage audit office powers to examine climate risk among government agencies and/or public authorities
- » Invest in building capability and capacity
- » Influence private sector take up of climate risk reporting.

There are also emerging climate policy reforms that are relevant to public authorities, including the Fund. In particular, the Federal Government plans to strengthen and standardise climate risk disclosure practice

in the Australian market to align with international standards and frameworks.<sup>108</sup> The likely treatment of public authorities under this potential mandatory disclosure regime was unclear at the time of writing. The Federal Government has also committed to “demonstrate Commonwealth leadership”<sup>109</sup> by reducing the Australian Public Service’s own emissions to net zero by 2030, however it is unclear whether this commitment extends to financed emissions of Commonwealth finance entities like the Fund.

Reform of some Commonwealth public authorities has also recently occurred via the *Climate Change (Consequential Amendments) Bill 2022*, which changed the objectives and functions of several entities with specific reference to Australia’s emissions reduction targets.<sup>110</sup> While some Commonwealth financial institutions, such as the Clean Energy Finance Corporation and Export Finance Australia, were included, the Fund was not despite its exposure to climate risk and significant footprint in capital markets.

Finally, as noted above, there is already international precedent of governments establishing stronger climate direction for SWFs on climate risk response, notably in the case of NZSF and GPF in New Zealand and Norway respectively. Similarly, the NSW Government commissioned a review of the ESG practices of its state-owned asset manager, TCorp, which is expected to conclude in late 2022.<sup>111</sup>

Establishing stronger direction for the Fund on climate risk would be consistent with these local and

international trends, and with the growing effort to improve the public sector’s response and reporting.

## Recommendations

This report finds that the Fund's current climate risk practice likely falls short of international best practice, at least in some areas. This is hard to assess in full due to the lack of public information and disclosure, itself a concern. The Federal Government has several options to establish clearer direction for the Board on its climate response through the Act, Investment Mandate and Statement of Expectations. This would be consistent with steps in other jurisdictions and broader efforts to improve the climate risk response of Australian public authorities.

Therefore, the Federal Government should consider:

- » Exercising its power under Section 54 to request the Fund report on climate risks and opportunities with reference to the TCFD recommendations and international reporting standards. As a starting point the Federal Government could request the Fund report on the following:
  - » Which climate scenarios it uses to test its portfolio and the results
  - » What metrics are being used to assess the carbon intensity or other relevant climate measures of its portfolio
  - » The current emissions intensity of its portfolio
  - » Its corporate governance approach to the management of climate risks and opportunities, including which directors, managers, and Board committees are responsible
  - » What, if any, explicit or implied carbon price is applied to investment decisions
  - » What action the Fund is seeking of investee companies on climate change via its corporate engagement
  - » What, if any, portfolio or other climate-related goals it has established
- » The scale of its exposure to carbon-intensive activities such as fossil fuel industries
- » The scale of its exposure to intensifying physical risk
- » The scope of its industry collaboration on climate risk
- » In more broadly strengthening Australia's climate risk disclosure regime, ensuring the Fund is explicitly captured in any relevant legislation and regulation change as an ongoing reporting entity to avoid ambiguity and the need to request reporting via periodic ministerial direction under Section 54 of the Act.
- » Convening an independent expert panel to review and make recommendations on:
  - » What reflects best investment industry practice on climate change
  - » Potential changes to the Investment Mandate and Statement of Expectations to ensure the Fund reflects international best practice on climate risks and opportunities
  - » The role of the Fund in advancing industry practice on climate risk
  - » The role of the Fund in helping Australia meet its legislated net zero goal for 2050 and other climate targets, including through company engagement
  - » The establishment of an overarching portfolio decarbonisation objective and interim targets for the Fund
  - » The governance of climate risk and opportunities by the Board and management
  - » Any other relevant matter



## APPENDIX 1: FURTHER CONSIDERATIONS BEYOND CLIMATE AND THE FUND

This report addresses climate change issues given CPD’s previous work on the response of public authorities to these issues. There has been significant public debate about other aspects of the Fund’s activities across broader ESG concerns. Civil society organisations and political representatives have raised questions about the Fund’s investments in arms manufacturers<sup>112</sup> and companies associated with the Myanmar junta.<sup>113</sup> Given this, the Federal Government may want to consider a wider review beyond climate risk response to:

- » Address other ethical and investment concerns
- » Provide broader direction on its interpretation of the Investment Mandate guidance that the Fund not cause “any diminution of the Australian Government’s reputation in Australian and international financial markets”<sup>114</sup>
- » Consider whether the Fund needs further enabling mandate changes or institutional architecture similar to the GPF’s Council of Ethics.

Similar climate risk considerations covered in this report may also reasonably be applied to the Commonwealth Superannuation Corporation (CSC). The CSC is the main Federal Government-owned pension fund, with 730,000 members and nearing \$AUD190 billion in AUM.<sup>115</sup> It is governed by the establishing *Governance of Australian Government Superannuation Schemes Act 2011*<sup>116</sup> and is responsible for a plethora of individual schemes for specific workers, such as those in the defence industry, which have their own enabling legislation and regulations. While the CSC has different beneficiaries and legal make-up to the Fund the public nature of the entity means the Federal Government remains responsible for its activity, including risk management. The CSC has stated it aims to reach net zero emissions across its portfolios “as soon as possible”.<sup>117</sup>

Finally, CPD’s *Raising the Bar*<sup>118</sup> report recommends that governments take action beyond expectation setting to strengthen public authority directors’ response to climate change.

These include:

- » Standardising risk and reporting frameworks
- » Producing whole-of-government disclosure
- » Leveraging the authority of audit offices
- » Building skills and capacity.

Implementing these recommendations would further assist the Fund in enhancing its climate risk response beyond changes to its Investment Mandate and any immediate request for climate risk disclosure.

# APPENDIX 2: ASSESSMENT OF THE FUND'S CLIMATE RISK RESPONSE AGAINST THE ICAPS EXPECTATIONS LADDER

## Focus area: Investment

Tier 4	Tier 3	Tier 2	Tier 1
<p><b>Measure portfolio carbon emissions</b></p> <p>The Fund has stated that it is tracking the carbon intensity of its listed assets. It is unclear if other assets or the entire portfolio is being measured.</p>	<p><b>Align portfolio emissions reduction target with domestic policy goals or NDCs</b></p> <p>The Fund has no climate targets and has stated no intention to align with Australian emissions goals.</p>	<p><b>Align portfolio emissions reduction target with 1.5°C and global net zero emissions by 2050</b></p> <p>The Fund has no climate targets and has stated no intention to align with Paris Agreement goals.</p>	<p><b>Align portfolio emissions reduction target with 1.5°C and global net zero emissions by 2050 or sooner</b></p> <p><b>Set intermediate targets covering all assets every five years using recognised methodologies and frameworks for setting, assessing, reporting, and verifying performance</b></p> <p>The Fund has no climate targets and has stated no intention to align with Paris Agreement goals.</p>

### STRATEGY

<p><b>Establish a formal policy on integrating climate change into:</b></p> <ul style="list-style-type: none"> <li>» <b>Investment analysis</b></li> <li>» <b>Decision-making</b></li> <li>» <b>Investment manager selection and appointment</b></li> </ul> <p>The Fund has indicated that climate risk is integrated into analysis, external manager mandates and investment decisions. However, it does not have a published policy specifically on climate risk, with a broader ESG policy established instead.</p>	<p><b>Commit to increasing investments in appropriate clean energy and low- carbon opportunities</b></p> <p>The Fund has no specific public commitments to increasing these investments.</p>	<p><b>Establish a formal investment policy on fossil fuels and other high impact activities, such as deforestation and biodiversity loss, that:</b></p> <ul style="list-style-type: none"> <li>» <b>Aligns with a net zero target</b></li> <li>» <b>Includes an explicit commitment to phase out exposure to fossil fuels (either through engagement or divestment) in line with science-based net zero pathways</b></li> <li>» <b>Aligns with just transition principles</b></li> <li>» <b>Develop and start implementing a decarbonisation strategy for at least one portfolio or asset class</b></li> </ul> <p>The Fund has no specific investment strategy in this regard and has stated that withdrawing from fossil fuels assets would be contrary to its Investment Mandate.</p>	<p><b>Eliminate all investments in thermal coal, tar sands, and Arctic drilling</b></p> <p><b>Define a strategy for all high emitting sectors</b></p> <p>The Fund has not made this commitment and has stated its intention not to pursue this approach.</p>
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<b>RISK MANAGEMENT</b>			
<p><b>Undertake portfolio climate risk assessment</b></p> <p><b>Regularly monitor portfolio climate risks including physical risks</b></p> <p>The Fund has carried out scenario testing and has become a member of the Coalition for Climate Resilient Investment.</p>	<p><b>Conduct a 1.5°C and 2°C scenario analysis including transition and physical risks, using a recognised methodology</b></p> <p><b>Revise and update this analysis annually</b></p> <p>The Fund has said it has carried out scenario testing, but has not stated against what scenarios this has been conducted or how frequently this analysis is being carried out.</p>	<p><b>Use scenario analysis and stress testing to:</b></p> <ul style="list-style-type: none"> <li>» <b>Assess the impacts of physical and transition risks on the portfolio</b></li> <li>» <b>Inform current and future investment decisions</b></li> </ul> <p>The Fund has made general statements about its climate risk exposure based on its scenario analysis. It is unclear whether this analysis uses information about both current and future investment decisions.</p>	<p><b>Explicitly incorporate net zero scenario analysis</b></p> <p>The Fund has carried out scenario analysis but has not stated what scenarios it is testing its portfolio against or how testing is incorporated into investment decisions.</p>
<b>ASSET ALLOCATION</b>			
<p><b>Invest part of the portfolio in 2°C-aligned products</b></p> <p>The Fund has stated that as part of having a diversified portfolio it will increase its exposure to assets that have better risk weighting in decarbonisation strategies. It is unclear if these investments are tested against temperature goals or what part they form of a broader strategy.</p>	<p><b>Invest part of the portfolio in 1.5°C-aligned companies, products, and projects</b></p> <p>The Fund has stated that as part of having a diversified portfolio it will increase its exposure to assets that have better risk weighting in decarbonisation strategies. It is unclear if these investments are tested against temperature goals or what part they form of a broader strategy.</p>	<p><b>Incorporate climate change into strategic asset allocation and invest in 1.5°C-aligned companies, products, and projects in multiple asset classes</b></p> <p>The Fund has stated it is applying risk-adjusted weighting on investment decisions and is pursuing investments consistent with decarbonising economies, however it is unclear if this is tied to a formal strategy or assets are being tested against temperature goals.</p>	<p><b>Invest (and grow the proportion annually) in 1.5°C-aligned companies, products, and projects in all asset classes</b></p> <p>The Fund has not stated how its current approach applies across all asset classes, whether it is growing these investments annually or whether decisions are tied to a temperature goal.</p>
<b>ADDITIONAL TARGET SETTING</b>			
<p>N/A</p>	<p><b>Set Scope 1 and 2 decarbonization targets for your own operational emissions</b></p> <p>The Fund has no stated goals for operational emissions.</p>	<p><b>Implement explicit net-zero aligned targets for clean energy and low carbon investments in each asset class</b></p> <p><b>Set Scope 3 decarbonization targets if they are material i.e. &gt;40% of emissions of underlying assets</b></p> <p>The Fund has no stated targets for clean energy investment across asset classes or Scope 3 emissions.</p>	<p><b>Set 1.5°C targets in all assets classes where recognised methodologies exist</b></p> <p><b>Establish net zero-aligned targets for high impact sectors</b></p> <p><b>Set intermediate targets that enable progression and assessment of portfolio emissions reduction in line with achieving net-zero emissions</b></p> <p>The Fund has no stated climate targets and has explicitly stated it is not targeting a carbon intensity rate in its portfolio.</p>

## Focus area: Corporate engagement

TIER 4	TIER 3	TIER 2	TIER 1
<b>COLLECTIVE/COLLABORATIVE ENGAGEMENT</b>			
<p><b>Support collective/ collaborative engagement initiatives that encourage better governance, management and disclosure of greenhouse gas emissions and physical climate risks</b></p> <p>The Fund is not a member of collaborative engagement programs.</p>	<p><b>Actively participate in collective/ collaborative engagement initiatives that encourage companies to establish 1.5°C-aligned business strategies</b></p> <p>The Fund is not a member of collaborative engagement programs.</p>	<p><b>Lead collective/collaborative engagement initiatives that encourage companies to establish 1.5°C-aligned business strategies and publish target companies</b></p> <p><b>Support climate resolutions that call on companies to address material and systemic climate risks and opportunities (in situations where the company has shown little commitment to aligning its business strategies with 1.5°C pathways)</b></p> <p>The Fund is not a member of collaborative engagement programs. The Fund's recent proxy voting records suggest it has not supported the large majority of climate-themed resolutions.</p>	
<b>BILATERAL ENGAGEMENT</b>			
<p><b>Engage directly with companies, asset managers, industry forums and other entities to encourage better governance, management and disclosure of greenhouse gas emissions and physical climate risks</b></p> <p>The Fund has stated it is engaging with companies and assets on climate risk, with a focus on promoting disclosure. It is unclear if it is engaging with companies on the governance and management of emissions and physical risk.</p>	<p><b>Engage with companies to:</b></p> <ul style="list-style-type: none"> <li>» <b>Reduce greenhouse gas emissions across their value chains in line with just transition principles, and</b></li> <li>» <b>Align their public policy activities with the goals of the Paris Agreement (directly or via industry associations and trade bodies)</b></li> </ul> <p>The Fund has not stated what its climate engagement focuses on except for TCFD promotion.</p>	<p><b>Ensure that most of the companies in the portfolio have 1.5°C-aligned business strategies or have committed to establishing such strategies</b></p> <p><b>Support and/or file climate resolutions at companies whose public policy engagement is not aligned with the goals of the Paris Agreement</b></p> <p>The Fund has not stated what its climate engagement focuses on except for TCFD promotion. It has not supported resolutions to this effect at company AGMs.</p>	<p><b>Ensure that most of the companies in the portfolio meet 1.5°C-aligned (external) sector-specific benchmarks, taxonomies, or thresholds</b></p> <p><b>Publish detailed voting policy on ESG (focusing on director votes, shareholder resolutions). Publish criteria that need to be met for the investor to vote for a company's climate plan and/ or resolution</b></p> <p>The Fund has not stated what its climate engagement focuses on except for TCFD promotion. It has not published a detailed ESG voting policy or criteria.</p>
<b>CORPORATE ESCALATION AND SHAREHOLDER ENGAGEMENT</b>			
<p><b>Explicitly integrate climate change into proxy voting guidelines</b></p> <p>The Fund has not stated whether climate change is included in its proxy voting guidelines or published any guidelines.</p>	<p><b>Establish a clear escalation strategy for companies or other entities that have not responded appropriately to engagement</b></p> <p>The Fund has not stated a clear escalation strategy, nor to date used its voting as an escalation tactic on climate issues.</p>	<p><b>Support, file or co-file climate resolutions at companies who have not responded appropriately to engagement, and vote against directors on climate grounds</b></p> <p>The Fund has not supported climate-related resolutions except in exceptional examples.</p>	<p><b>Pre-declare voting intentions on ESG defining resolutions and at company laggards</b></p> <p>The Fund has not done this in regard to climate-related resolutions (however the Fund did make a public intervention on the destruction of Indigenous heritage at Juukan Gorge by Rio Tinto).<sup>119</sup></p>

## Focus area: Investor disclosure

TIER 4	TIER 3	TIER 2	TIER 1
<b>COMMITMENTS, OBJECTIVES AND TARGETS</b>			
<p><b>Publish a formal statement recognising that climate change:</b></p> <ul style="list-style-type: none"> <li>» <b>Presents new and material challenges</b></li> <li>» <b>Requires an organisation-wide commitment to integrating related risks and opportunities into investment practice</b></li> </ul> <p>The Fund's Position Paper, <i>A New Investment Order</i><sup>120</sup>, stated in general terms that climate change creates risks and opportunities and indicated it is one of ten shifts shaping the Fund's investment approach.</p>	<p><b>Publish organisational and portfolio objectives/targets on climate change and report on progress against these</b></p> <p>The Fund has no published targets or progress tracking on climate risk.</p>	<p><b>Disclose quantitative details of interim net zero targets and report progress against them</b></p> <p>The Fund has no targets and no stated plans for disclosure.</p>	
<b>CARBON EMISSIONS</b>			
N/A	<p><b>Publish a carbon emissions profile for at least one portfolio or asset class</b></p> <p>The Fund has not published information about the emissions profiles of its assets.</p>	<p><b>Publish a detailed account of the analytical methodology and underlying data for calculating the portfolio's emissions profile</b></p> <p>The Fund has not published information about how it is tracking the emissions intensity of its portfolio.</p>	
<b>PORTFOLIO ASSESSMENT</b>			
N/A	<p><b>Publish an assessment of the risks and opportunities presented by climate change to the investment portfolio</b></p> <p>The Fund has not published any detailed assessment or disclosure about portfolio exposure.</p>	<p><b>Publish details of the scenario analysis conducted by the investor, including information on the underlying assumptions and scenarios used</b></p> <p>The Fund has not published information about its scenario analysis.</p>	<p><b>Report on the investor's approach to scenario analysis, including details of the assumptions, the data used and the actions taken as a result</b></p> <p>The Fund has not published information about its scenario analysis.</p>
<b>TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD) ALIGNMENT</b>			
<p><b>Issue a public statement supporting TCFD</b></p> <p>Fund management has stated in Senate Estimates it supports TCFD reporting for companies, but does not plan to publish its own report. It is not listed as a formal supporter on the TCFD website.</p>	<p><b>Publish information on TCFD recommendations in financial report</b></p> <p>The Fund has indicated it does not intend to issue TCFD reporting.</p>		
<b>ASSESSMENT OF DISCLOSURES</b>			
<p><b>Assess current disclosures against guidance from TCFD and other relevant reporting frameworks</b></p> <p>The Fund has not issued disclosure.</p>	<p><b>Publish an assessment of the outcomes and impacts achieved from corporate engagement</b></p> <p>The Fund has not issued disclosure on engagement</p>	<p><b>Publish an assessment of the outcomes and impacts achieved from policy advocacy</b></p> <p>This is not applicable to the Fund.</p>	<p><b>Publish an independent third-party assessment of the investor's climate change reporting</b></p> <p>The Fund has not issued disclosure.</p>



## Focus area: Governance

TIER 4	TIER 3	TIER 2	TIER 1
<b>POLICY</b>			
<p><b>Develop investment beliefs or statements of investment policy that define the organisation’s approach to managing climate risks and opportunities</b></p> <p><b>Explain how this is integral to long-term value creation and to the fiduciary/ other duties owed to beneficiaries or clients</b></p> <p>The Fund has included climate change in its Position Paper and has an overarching ESG policy, both of which detail how the Fund believes these broader issues interact with its responsibilities. The Fund does not have a specific published climate position beyond this.</p>	<p><b>Ensure that climate change is central to the organisation’s strategic plan and that the climate strategy is fully endorsed by the Board</b></p> <p>The Fund has no specific published climate strategy or policies.</p>	<p><b>Ensure that the organisation’s climate change policies and plans are actively supported by the Board and senior management</b></p> <p>The Fund has no specific published climate strategy or policies.</p>	
<b>ACCOUNTABILITY</b>			
<p><b>Define roles and responsibilities for:</b></p> <ul style="list-style-type: none"> <li>» <b>overseeing and implementing the organisation’s commitments on climate change</b></li> <li>» <b>reporting on the organisation’s climate change performance</b></li> </ul> <p>The Fund has provided no information on this area, but has stated that climate risk is a feature of its ESG team’s activities and policy.</p>	<p><b>Define formal climate change responsibilities in Board and/ or Board Committee Terms of Reference and role descriptions</b></p> <p>The Fund has no stated policy or disclosure on climate risk governance as it relates to the Board.</p>	<p><b>Provide adequate resources to ensure the effective implementation of the organisation’s climate change policies and plans</b></p> <p>The Fund has no stated climate policy, and therefore it cannot be assessed if the areas have been properly resourced. As noted above, past management statements have suggested resourcing may be a reason why the Fund has not joined collaborative efforts on climate risk.</p>	<p><b>Align achievement of climate-related metrics with executive remuneration incentives</b></p> <p>The Fund has no stated metrics or published statement on remuneration.</p>
<b>PLANNING AND EVALUATION</b>			
<p><b>Develop a plan for delivering on the organisation’s climate-related objectives and for managing the risks and opportunities to the portfolio</b></p> <p>The Fund has no published climate plan.</p>	<p><b>Implement processes to review and revise investment strategy as:</b></p> <ul style="list-style-type: none"> <li>» <b>Targets are met</b></li> <li>» <b>Climate risks exposures and best practices emerge/evolve</b></li> </ul> <p>The Fund has no published policy or targets.</p>		

<b>BOARD REPORTING</b>			
N/A	<p><b>Ensure that the Board/Board Committees:</b></p> <ul style="list-style-type: none"> <li>» <b>Regularly review portfolio-related climate risks and opportunities</b></li> <li>» <b>Assess progress against climate-related objectives</b></li> </ul> <p>Given climate risk issues are a feature of the Fund’s ESG policy and Position Paper, and are being tracked in parts of the portfolio, it is assumed these issues are reviewed by the Board periodically. However, the frequency and governance process has not been disclosed and the Fund has no stated climate-related objectives.</p>	<p><b>Report regularly to the Board and senior management on climate performance and portfolio climate risk exposures</b></p> <p>Given climate risk issues are a feature of the Fund’s ESG policy and Position Paper, and are being tracked in parts of the portfolio, it is assumed these issues are reviewed by the Board periodically. However the frequency and governance process has not been disclosed.</p>	
<b>SKILLS ASSESSMENT</b>			
N/A	<p><b>Provide training to staff on climate risks and opportunities and the implications for investment portfolios</b></p> <p>The Fund has not disclosed if this has occurred. This report assumes staff uplift has occurred to some degree based on the Fund carrying out risk weighting and scenario assessments.</p>	<p><b>Formally assess organisational knowledge and expertise on climate change for:</b></p> <ul style="list-style-type: none"> <li>» <b>The Board</b></li> <li>» <b>Senior management</b></li> <li>» <b>Investment teams</b></li> </ul> <p>The Fund has not disclosed if this has occurred. This report assumes some level of skills identification has occurred based on the Fund carrying out risk weighting and scenario assessments.</p>	<p><b>Ensure that the Board has sufficient capabilities and competencies to oversee, assess and manage climate change-related risks and opportunities</b></p> <p>There is no stated Board skills matrix including climate change or assessment against it. Given the experience of the Board,<sup>121</sup> it is assumed there are relevant skills among the current directors.</p>

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