CLIMATE CHANGE RISK

FAILING TO TAKE ACCOUNT OF CLIMATE CHANGE RISK MAY EXPOSE SUPERANNUATION TRUSTEE DIRECTORS TO POTENTIAL LIABILITY, SAYS MERCER LEGAL CONSULTING.

Climate change is an environmental, social and economic risk that is expected to have its greatest impact in the long term.

Mercer's 2015 study, Investing in a Time of Climate Change, (Mercer 2015 Study) estimates the potential impact of climate change on industry sectors, asset classes and total portfolio returns between 2015 and 2050. Four scenarios are modelled according to the degree of global warming and the extent to which climate change mitigation action is taken. The study shows that, under the four modelled scenarios, climate change will inevitably have an impact on investment returns. The most meaningful impacts are demonstrated at the industry sector level,[1] but asset class return impacts could also be material.[2] Total portfolio returns are also impacted in three of the modelled scenarios.

Superannuation trustees can be long-term investors. If long term investment returns are impacted by failure to properly consider the impact of climate change risk in formulating and implementing a fund's investment strategies, might the trustee directors be personally liable to fund members for the loss?

This article considers the new duties imposed on superannuation trustees and their directors following the "Stronger Super" reforms and concludes that failure to take climate change risk into account may expose the trustee and its directors to liability.

LEGAL BACKGROUND

EQUITABLE PRINCIPLES

It is a settled position that in equity:

- trustees must invest the trust fund in the best financial interests of the beneficiaries;[3] and
- trustees are subject to a standard of prudence in investing the assets of the fund on behalf of the beneficiaries. The standard of prudence is that of a prudent person of business, although for a paid trustee, the standard is that of a professional.[4]

Equity also recognises a "modern portfolio theory" approach to investment, with the focus being on the prudence of the investment portfolio as a whole.

As noted by Hoffman J in Nestle v National Westminster Bank plc (Nestle):[5]

> Modern trustees acting within their investment powers are entitled to be judged by standards of current portfolio theory, which emphasizes the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation ... an investment which in isolation is too risky and therefore in breach of trust may be justified when held in conjunction with other investments....

The Trustee legislation in most states now incorporates a "prudent investor" approach and validates the modern portfolio approach.[6]

It is also worth noting that the courts do not judge compliance with the standard of prudence by reference to the financial success of investments (ie with the benefit of hindsight), but rather by the prudence of a trustee's decision-making process.[7]

SUPERANNUATION LAW

The Superannuation Industry (Supervision) Act 1993 (Cth) (SIS Act) originally mirrored equity in that it also included a covenant for trustees of regulated superannuation funds to:

- perform the trustee's duties and exercise the trustee's powers in the best interests of beneficiaries;[8] and
- exercise the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide.[9]

The SIS Act mandated that trustees formulate an investment strategy for the fund having regard to a range of factors.[10] One of the mandated factors is "the risk involved in making, holding and realising ... the [fund]'s investments, having regard to its objectives...".[11] Another factor is "the composition of the [fund]'s investments as a whole including the extent to which the investments are diverse or involve the entity in being exposed to risk from inadequate diversification".[12] It is generally considered that the factors to be considered in formulating an investment strategy for a superannuation fund also reflect a "modern portfolio theory" approach to investing.

With the "Stronger Super" reforms,[13] the standard of prudence for superannuation trustees has been elevated to that of a professional investor (being the care, skill and diligence that a prudent superannuation trustee would exercise … on behalf of beneficiaries of which it makes investments).[14] In addition, the range of factors that must inform an investment strategy (for the whole of the fund and for each investment option offered in the fund) has been increased.[15] New covenants to "exercise due diligence in developing, offering and reviewing regularly each investment option" and "to ensure that the investment options … allow adequate diversification" were also introduced.[16]

However, from the perspective of trustee director liability, the most significant change introduced by the Stronger Super reforms was to introduce personal "covenants" deemed to be made by each trustee director as if they were a party to the governing rules, accompanied by a statutory right for fund members to sue a director for losses arising from a breach of a covenant.[17]

SOCIALLY RESPONSIBLE INVESTMENT

One of the questions often debated is whether it is permissible for trustees to take account of environmental, social and governance (ESG) issues in making investment decisions. The established legal position appears to be that trustees may take account of ESG issues to the extent that it is consistent with the financial interests of beneficiaries to do so.[18]

Some argue that investment in companies that behave ethically and responsibly will always be in the best financial interests of beneficiaries of superannuation funds because those companies will be more sustainable and produce better returns over the longer term.[19] In this regard, the preamble to the United Nations (UN) Principles of Responsible Investment states:

> As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social and corporate governance (ESG) issues can affect the performance of investment portfolios.

The findings of the Mercer 2015 Study shifts the focus from permission to compliance. Instead of asking whether superannuation trustees may take account of an environmental issue like climate change, the question becomes: should superannuation trustees ignore the economic risks of climate change when it has been demonstrated to impact investment returns? It is no longer a question of socially responsible investment; it has become a question of prudent investment.

THE TRUSTEE DIRECTOR COVENANTS

Under s 52A of the SIS Act, each director is deemed to have made the following covenants under the governing rules of the fund:

- to exercise … the same degree of care, skill and diligence as a prudent superannuation entity director would exercise in relation to an entity where he or she is a director of the trustee of the entity and that trustee makes investments on behalf of the entity's beneficiaries (s 52A(2)(b));
- to perform the director's duties and exercise the director's powers as director of the corporate trustee in the best interests of the beneficiaries (s 52A(2)(c)); and
- to exercise a reasonable degree of care and diligence for the purposes of ensuring that the corporate trustee carries out the covenants referred to in s 52 (s 52A(2)(f)), which include the investment covenants under s 52(6).

A superannuation entity director is defined as:[20]

> a person whose profession, business or employment is or includes acting as director of a corporate trustee of a superannuation entity and investing money on behalf of beneficiaries of the superannuation entity.

The standard of prudence for a trustee director of a regulated superannuation fund is therefore an objective "professional fiduciary investor" standard.

In the face of evidence that climate change risk can negatively impact investment performance, would a prudent professional investor, making investment decisions in the best financial interests of beneficiaries, fail to take account of that risk in formulating and implementing its investment strategies? In my view, there is a very strong argument that a prudent professional investor would at least consider climate change risk in making long-term investment decisions, particularly in those sectors or asset classes where impacts on returns have been demonstrated. My view is reinforced by the express requirement that a superannuation trustee consider the risk in making and holding investments, having regard to its investment objectives. If climate change risk could adversely impact the prospect of achieving those objectives, how could a prudent professional investor fail to address it?

More saliently, if a trustee director fails to factor climate change risk into the board's investment decisions and as a result the fund's investment performance suffers, could members of the fund claim any loss from the trustee director personally on the basis that the trustee director had breached his or her personal covenant to exercise a prudent superannuation entity director standard of care, skill and diligence? Before answering this question, it is worth considering whether any defences in the SIS Act might apply.

Under s 55(5) of the SIS Act, it is a defence to an action for loss suffered as a result of the trustee making of an investment on behalf of the fund, if the defendant can show compliance with all of the covenants in ss 52–53 of the Act. The difficulty for a trustee director attempting to rely on s 55(5) is that a failure to consider risks that a professional investor would have considered is, in and of itself, a breach of a covenant. So the defence is not available in these circumstances. Subject to obtaining leave of the court,[21] a member who could demonstrate loss as a result of a trustee's failure to properly consider climate change risk would be able to sue both the trustee and its directors.[22]

CONCLUSION

This analysis is not to suggest that superannuation trustees should immediately divest their funds of shares in fossil fuels, timber or agriculture.[23] Rather it is to suggest that, as part of their investment decision-making process, it would be prudent for superannuation trustees and their directors to demonstrate an informed consideration of climate change risk and, if appropriate, a process for managing it. After due consideration,[24] a trustee might conclude that there is no need for any active management measures if, for example, the investments of the fund are sufficiently diverse to minimise adverse impacts or the fund's investments are held over shorter-term horizons. Conversely, a superannuation trustee and its directors may expose themselves to potential legal liability if they simply close their minds to the issue and dismiss climate change risk as relevant to "ESG investors" only.

ABOUT THE AUTHOR

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FOOTNOTES

1. For example, the study shows that, depending on the climate scenario that plays out over the next 35 years, the average annual returns from the coal sub-sector could fall anywhere between 18%–74%, with the effects more pronounced over the coming decade. Conversely, the renewables sub-sector should see average annual returns increase by between 6%–35% over a 35 year time horizon (or between 4% and 97% over the next 10 years): Mercer 2015 Study, p 7.
2. Growth assets are more sensitive to climate risks than defensive assets. For example, a 4°C scenario could negatively impact emerging market equities, real estate, timber and agriculture: Mercer 2015 Study, p 7.
3. Cowan v Scargill [1985] Ch 270; [1984] 2 All ER 750.
4. Australian Securities Commission v AS Nominees Ltd (1995) 133 ALR 1 at 12.
5. Nestle v National Westminster Bank plc (Ch D, Hoffmann J, 29 June 1988, unreported).
6. See, eg Trustee Act 1958 (Vic), s 8(1).
7. Above n 5.
8. SIS Act, s 52(2)(c) — this covenant has been held to reflect its equitable counterpart: see Manglicmot v Commonwealth Bank Officers Superannuation Corp Pty Ltd (2011) 282ALR 167; [2011] NSWCA 204; BC201105601.
9. SIS Act, former s 52(2)(b) — arguably this standard was slightly lower than the equitable standard.
10. SIS Act, former s 52(2)(f).
11. SIS Act, former s 52(2)(f)(i).
12. SIS Act, former s 52(2)(f)(ii).
13. Introduced through a "package" of legislation with effect from 1 July 2013.
14. SIS Act, s 52(2)(b).
15. SIS Act, s 52(6)(a).
16. SIS Act, ss 52(6)(b) and (c).
17. SIS Act, ss 52A and 55; before an action can be brought against a director personally, leave of the court must be obtained.
18. Harries v Church Commissioners for England [1992] 1 WLR 1241; [1993] 2 All ER 300.
19. See, eg G Morgenson, "Shares of Corporate Nice Guys Can Finish First" New York Times 27 April 2003, s 3 at 1.
20. SIS Act, s 29VO(3).
21. See SIS Act, s 55(4A).
22. The government's proposal for a fund's portfolio holdings to be transparently disclosed on its website may make it easier for members to model the fund's holdings with or without assets alleged to be impacted by climate change.
23. Being some sectors where the Mercer 2015 Study shows that climate change risk may impact over the longer term.
24. Involving perhaps a sensitivity analysis, stress testing and scenario planning to assess the relevant risks and weigh them against potential opportunities.

IMPORTANT NOTICES

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