Environmental, Social and Governance Review - Final Report

Pru Bennett Review Lead and

Frontier Advisors (AFS 2412661)

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Prepared with the assistance of Frontier Advisors Pty Ltd I AFS Licence No. 241266 I ABN: 21 074 287 406

Preface/Foreword

I present this report to the Treasurer in response to the Terms of Reference dated 4 April 2022

I express my appreciation to the Board and executives of TCorp as well as their clients for their active co-operation during the Review. I would also like to acknowledge the support provided by NSW Treasury and the work undertaken by the Review Consultant, Frontier Advisors Pty Limited.

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Executive Summary

1 Introduction and purpose

NSW Treasury, on behalf of the State of NSW, has engaged Pru Bennett to lead a review of the State's investment funds managed by NSW Treasury Corporation (TCorp) (the Review). The purpose of the Review is to understand how TCorp presently considers environmental, social and governance ("ESG") principles when investing and how its processes and practices could be enhanced to improve the sustainability of returns, while also promoting a better future. Asset consultant Frontier has been engaged to provide specialist support to the review.

The Review consists of the ESG Landscape Review (Appendix B), covering Part 1 of the Terms of Reference and this Report, which examines TCorp's current approaches and capabilities regarding ESG/Responsible Investing. It also provides practical recommendations that enable TCorp's alignment with leading responsible investment practices, per Parts 2 and 3 of the Terms of Reference.

2 Report Summary and Key Findings

Background

Environmental, social and governance factors, commonly referred to as “ESG”, encapsulate a range of issues which, until the early 2000s, had not typically been standard inputs for financial decision-making. Today however, the prevailing investment industry view is that ESG factors can and do impact financial outcomes, and therefore should be comprehensively incorporated into investment processes.

ESG factors are numerous, vary widely, and are continually evolving. Some, like climate change, occupational health and safety, and executive alignment (i.e., how remuneration structures incentivise corporate behaviours) are well-known and their ability to impact financial outcomes are better understood. Others, such as biodiversity, just transition and cyber security are more emergent ESG factors, and the understanding of their financial impact is still evolving.

This Report suggests that **the primary purpose of a responsible investment strategy is to better manage financial risks and opportunities arising from ESG factors** with the objective of enhancing performance outcomes on a risk-adjusted basis (especially over the longer term).

This is important, as government has established various funds through time to achieve policy aims. These aims include providing infrastructure across the State, funding social housing and promoting intergenerational equity (through the NSW Generations Fund). Helping ensure that these and other funds (e.g., those overseen by icare and State Super) manage risks and opportunities effectively – including ESG related risk factors – means they may be better placed to achieve their own aims over time.

Responsible investment differs somewhat from other approaches such as ethical investing, values-based investing or socially responsible investing. One such difference is that decisions informed by the latter approaches may be guided by specific investor values and/or beliefs, or the desire to achieve societal outcomes. This difference in approaches may be summarised as **‘value’** (responsible investment) **versus ‘values’** (ethical, etc.) and underpins much of the discussion around the role of investing, not only within the investment management industry, but across society more generally.

Despite this difference, the two approaches can be used by an investor simultaneously. Sometimes, these approaches might result in the same action. At other times however, **the investor will need to strike a balance between values and financial outcomes**. This may result in one course of action being taken over another or perhaps a blended solution incorporating elements of both drivers. What is important is that the investor will need to determine this through careful consideration, which may not be straightforward. Going through this process, however, is vital to ensure that there is clarity of purpose and an ability to measure success.

There is no single industry standard or best practice guide against which TCorp’s responsible investment approach can simply be compared. The Review draws on a combination of the experience of the Review Lead and Supporting Team, the observations of TCorp’s key clients, and learnings from peers, to derive a mainly qualitative assessment of TCorp’s current position. The Review then both identifies those areas in which TCorp is doing well and makes recommendations as to how TCorp may progress towards leading practice in others.

Beyond the specific recommendations in the Review, there are more holistic considerations around how the broader investment management set-up for NSW state entities may more effectively address increasing requirements on responsible investment. Such considerations are likely to require a significant commitment to collective and aligned effort across all stakeholders, but the benefits are expected to be meaningful for all parties individually and the State more generally. One key example of this is a consistent approach to decarbonising investment portfolios, including a net zero target which aligns to NSW Government's broader net zero strategy. Doing so will support a clear and consistent message around decarbonisation to the wider industry and the community at large.

This Review has been done in the context of the broader ESG/Responsible Investment landscape. This context is covered in the *ESG Landscape Review* (Appendix B), and covers those topics referred to in Part 1 of this Review's Terms of Reference. This includes discussing what ESG is (and importantly also, is not), why it matters, different approaches used throughout the investment management industry as well as some of the key international developments and learnings. While Section 4 touches on some of these issues, the *ESG Landscape Review* provides more detail. Understanding this broader operating context is important for also understanding TCorp's operations and performance from an ESG/investment stewardship perspective.

High level findings

The Review found that there were no critical deficiencies[1] observed across TCorp's investment stewardship function, given its current stage of development. Therefore, the recommendations provided in this Review may be categorised as being more evolutionary rather than revolutionary.

ESG and its integration into the investment management process are not static considerations. Due to the continually changing and rapidly evolving nature of ESG factors and financial markets, a successful investment stewardship approach is one which can effectively adapt to manage emerging risks and opportunities. In this context, the overarching thesis of this Review is that the most important defining characteristic of a leading investment stewardship practice is **an intentional culture of continual improvement**.

The Review found that TCorp has demonstrated this intentionality in most areas. TCorp's progress to date in building out its investment stewardship infrastructure has established a sound foundation on which, in principle, the organisation can be expected to facilitate continual enhancement of its responsible investment approach into the future.

TCorp and its key clients should remain vigilant in identifying and managing potential impediments to the objective of continual improvement. As key clients entrust TCorp with implementing leading ESG practice, TCorp should seek to clearly understand the implications of this reliance, account for each client's aspiration and requirements, while also incorporating those of other stakeholders. Balancing these requirements is an ongoing, and multi-faceted operational challenge which, if done successfully, can help inform and clarify key client and community perceptions around the consistency and clarity of TCorp's ESG practice.

[1] A critical deficiency would be represented by a demonstrable gap in some foundational element of TCorp's responsible investment service that leaves its clients vulnerable to material ESG-related financial risks while their peers are not.

Key observations

1. TCorp has developed its responsible investment capabilities incrementally over time, and importantly, has done so while considering any prevailing objectives, preferences, and constraints for its broader business. TCorp is viewed as having taken a thoughtful and measured approach to date in building out its investment stewardship capabilities.
2. TCorp's governance arrangements involving the Board, Board Investment Committee and Management Investment Committee are considered aligned with industry practice.
3. The depth and experience of TCorp's specialist Investment Stewardship team (IS team) is broadly in line with industry peers. TCorp's incorporation of specialist ESG data and analytics directly into its centralised portfolio management system is also viewed as being leading practice.
4. Technical knowledge on ESG outside the IS team is mixed and may result in less efficient and consistent ESG integration relative to peers. A nascent investment stewardship "champions" initiative across investment teams is in line with leading peers and expected to enhance knowledge on investment stewardship throughout TCorp's Investment Management business going forward.
5. TCorp's recently developed ESG Investment Risk Framework details a systematic application of the firm's stewardship philosophy within the context of its Total Portfolio Approach (TPA) investment model. TCorp's ability to understand the aggregate portfolio's ESG complexion is viewed as demonstrating industry leadership.
6. TCorp has not yet initiated formal identification or measurement of the environmental and/or societal impacts of its capital allocation decisions. This is an area of increasing interest among asset owners and other stakeholders. While it is acknowledged this area is still very much in a developing stage, TCorp should monitor developments and consider other forms of measurement to assess the effectiveness of investment stewardship activities.
7. TCorp's active ownership activities which primarily involve proxy voting and company engagement appear well-established, continue to develop and are aligned with industry peers.
8. TCorp has made progress in establishing its service offering to clients on decarbonisation, including net zero. A desire to align with the NSW Government's net zero ambitions, and growing client and community expectations provide the impetus for TCorp to further advance its capabilities and TCorp has flagged its intention to do so.

If implemented, the recommendations are expected to augment and accelerate TCorp's progress on investment stewardship. It is notable that in many cases, these have already been considered to some degree by TCorp's management. While practicality has been a desirable characteristic for each recommendation, they are not necessarily prescriptive in that TCorp should always ensure that each development is demonstrably fit-for-purpose and aligned with its clients' needs. Prioritisation will require TCorp to consult with both its clients and the Government, as ultimately it will be the organisation needing to balance the various considerations involved in implementation such as costs, resourcing requirements, materiality of impact, and so on.

3 Recommendations

3.1 Introduction

This section brings together the various findings throughout the Report to summarise the practical recommendations that are expected to facilitate TCorp's future progress towards leading investment stewardship practices.

ESG and its integration into the investment management process are not static considerations. Due to the continually changing and rapidly evolving nature of ESG factors and financial markets, a successful investment stewardship approach is one which can effectively adapt to manage emerging risks and opportunities. In each of the areas assessed as part of this point-in-time review, any benchmarks for leading practice are expected to evolve over time, driven by ongoing ESG research, the changing needs of stakeholders, and new data sources.

So that TCorp keeps pace with this progression, the overarching thesis of this Review is that the most important characteristic of a leading investment stewardship practice is **an intentional culture of continual improvement**. This, together with a more focussed and consistently applied approach to integrating ESG factors into investment decisions can result in several immediate and more general benefits:

- Improving the robustness and resilience of the individual portfolios themselves – considering ESG factors systematically across all investments TCorp manages can help better mitigate risks to future returns, promoting more sustainable performance over the long-term. This better-positions Government to achieve the main aims for which the various funds have been established (e.g., to fund infrastructure, social housing, retire debt or to self-insure).

- Creating the fiscal space for Government to allocate resources to other priorities – more robust portfolios can help improve their self-sufficiency, reducing the potential for further calls on the Government's budget, and may even possibly contribute additional resources which Government could use to fund other services to the NSW community.

A high-level, positive finding of this Review is that TCorp has demonstrated this intentionality to continually improve in most areas. One example is senior management's stated ambition and efforts to encourage integration of investment stewardship across all levels of Investment Management and senior levels of the organisation as appropriate. TCorp's progress to date in building out its investment stewardship infrastructure has established a sound foundation on which the organisation can be expected to progress the continual enhancement of its investment stewardship activities into the future.

The recommendations are intended to align with a culture of continual improvement and so can be characterised as evolutionary rather than revolutionary. This reflects emerging and evolving investment stewardship leading practices across the market at present. Of highest priority are several thematic recommendations which relate to TCorp as a whole and how material uplift in certain core investment stewardship services may be expedited. Additional recommendations are then provided which relate to the enhancement of specific investment stewardship functions.

The remainder of this section looks at related considerations when implementing the recommendations. These considerations include strengthening the nexus between ESG and investment performance, moving from current to leading practice, and aligning stewardship governance across NSW government entities.

3.2 Priority recommendations

There are several high-level thematic areas of investment stewardship for which progress is viewed as a priority for TCorp. These relate to certain core responsible investment services which TCorp's clients are increasingly expected to need/seek.

TCorp has already made progress in each of these areas and in the cases of decarbonisation/net zero and has flagged that work is underway to further develop these capabilities. These priority recommendations emphasise the importance of allocating suitable resourcing and time to ensure that TCorp aligns with leading peers.

1. **Decarbonisation/net zero**
   Given the NSW State Government's stated 2050 net zero ambition (including a 50% reduction in greenhouse gas emissions versus 2005 levels by 2030), it is appropriate for TCorp to develop a comprehensive approach to support its clients on their respective decarbonisation/net zero journeys. TCorp has already made progress in this area, having worked closely with STC on its recently established net zero strategy. It is recommended that TCorp leverage progress made to date to integrate decarbonisation support services across the range of its investment management portfolios.

   A decarbonisation/net zero strategy is a complex endeavour and typically involves the establishment of a roadmap to guide an investor's activity over an extended period (noting that peers' net zero targets are most commonly aligned with a 2050 date). Key milestones/actions forming the roadmap may vary by client, but would be expected to include elements such as:

   - Foundational support to clients to facilitate client understanding of, and commitment to a decarbonisation/net zero strategy, including education
   - Alignment with industry-recognised net zero frameworks and Government policy and approaches to net zero where possible
   - Incorporating climate change into portfolio construction and scenario analysis
   - Historical and forward-looking analytics on portfolio alignment with net zero
   - Identifying partners and investments which enable progress to net zero
   - Suitably informative reporting on progress versus decarbonisation/net zero targets

2. **Comprehensive public reporting**
   Comprehensive public reporting on responsible investment is standard practice amongst leading peers, with stakeholders increasingly seeking transparency. TCorp's current public disclosures on ESG management are limited.

As such, a key recommendation for strengthening effective communication and demonstrating a culture of continual improvement is to develop (in consultation with NSW Treasury) and make public a comprehensive separate report on investment stewardship annually. Such year-on-year disclosure would highlight evolving processes relating to ESG integration, policy changes, data on investment stewardship activities, and include case studies as evidence of the effectiveness of practices.

3. TCorp should benefit from clearer guidance from Government regarding beliefs and expectations with respect to its own position on ESG issues. There is potential for Government beliefs and expectations to conflict with TCorp's integrated approach to ESG which is to achieve long term risk adjusted returns across portfolios. Should NSW Government take a stance on a particular ESG issue, it is recommended for the Treasurer to seek dialogue with TCorp to assess and address any conflicts as well as practical issues regarding implementation. Such an approach will help to ensure TCorp is acting consistently with Government policy across client portfolios and will have an understand of the impact of such Government positions on the investment process and long-term risk adjusted returns.

3.3 Other Recommendations

3.3.1 Supporting Recommendations

This section outlines those recommendations which, if implemented, can help better support the continuing improvement of TCorp's investment stewardship practices.

To better understand the context in which these recommendations are made, references to the relevant Report sections are also included.

Recommendation		Report Section
Aligning governance arrangements across NSW Government entities		**3.5**
1.	Consider establishing an appropriate forum for TCorp and its key clients to improve interactions and information sharing at the strategic level to develop common approaches (where appropriate) to responsible investing across relevant portfolios.	
2.	TCorp's ESG Working Group to update the Treasury-led Sustainable Finance Steering Committee twice a year on emerging ESG trends.	
Governance		**7.2.5**
3.	TCorp's annual report to include such a skills matrix which would also identify ESG skills of directors to demonstrate the Board has the capabilities to discharge its oversight duties with respect to investment stewardship.	
4.	Establish a continuing professional development plan available to all directors covering relevant ESG issues to keep directors informed of the changing ESG landscape, including how TCorp compares with leading peers.	

5.	For large transactions referred to the BIC, develop a template suitable for assessing investment opportunities and risks for investments in significant real assets, which includes a dedicated section for investment stewardship. Such a process will ensure a consistent consideration of relevant matters, including ESG risks and opportunities and bring the BIC assessment process into line with other investment functions.	
Resourcing capability		**7.3.6**
6.	To build out investment stewardship knowledge across investment teams, develop a program to offer teams structured and ongoing professional development on investment stewardship topics.	
7.	Resourcing should be monitored on a regular basis in terms of human resources as well as technology requirements. Particularly in relation to the latter, sources of data are increasing, with both the quality and currency of data continuing to improve, providing opportunities for TCorp stewardship activities.	
TCorp's ESG Investment Risk Framework		**7.4.6**
8.	The Investment Stewardship Beliefs and Principles and ESG Investment Risk Framework could be better aligned in terms of the five investment stewardship activities identified in the ESG Investment Risk Framework.	
9.	TCorp should monitor the development of processes and methods to measure environmental and societal impacts in portfolios and consider other forms of measurement to assess the effectiveness of investment stewardship on behalf of clients going forward.	
Application to TCorp Managed Investment Funds		**7.5.6**
10.	Incorporate investment stewardship more explicitly in discovery questionnaires and dialogue when developing client investment objectives and risk appetite statements.	
11.	Prioritise work to formally integrate ESG, particularly climate change risk and scenario analysis insights) into the portfolio construction process including development of capital market assumptions.	
12.	In consultation with stakeholders, develop a transparent framework which guides consideration of material portfolio exclusions (e.g., considerations around potential trade-off of client preferences and risk-adjusted returns over the shorter term) to facilitate collective understanding of both financial and reputational impacts which may result.	
Application to investment managers		**7.6.6**
13.	Develop asset class specific ESG questionnaires, which are systematically utilised as a part of the pre-investment due diligence process and are aligned with TCorp's Investment Risk Framework.	

Application to real assets		**7.7.6**
14.	Further use the Global Real Estate Sustainability Benchmark (GRESB) process to monitor and drive continuous improvement in the Real Assets and Private Markets (RAPM) portfolio. This could be further enhanced by taking note of the way more advanced peers have effectively used GRESB.	
Application to active ownership		**7.8.6**
15.	Public disclosure of proxy voting statistics for both domestic and international equities on an annual basis.	
16.	Enhance the current process for providing voting intentions of controversial meetings to clients before the shareholder meeting noting TCorp and clients would need to agree to a practical process.	
Decarbonisation/Net Zero		**7.9.5**
17.	TCorp to consult with key clients and determine the appropriate pathway to achieve net zero across all portfolios by 2050 to align with NSW Government Policy.	
Reporting and transparency		**7.10.6**
18.	As seen from the review of peers, leading practice involves the publication of an annual stewardship report which demonstrates effective stewardship of assets under management. Such a report would include TCFD-aligned reporting on climate change risks and opportunities.	

3.4 Moving from current practice to leading practice

3.4.1 Strengthening the nexus between ESG and long-term sustainable risk-adjusted return objectives

The ESG Landscape Review (Appendix B) describes the link between ESG, and long-term sustainable risk adjusted returns. Below is an excerpt:

Investors are required to make decisions, and they base those decisions on information and data. Generally, the better the information and data, the higher the likelihood the investor is to make decisions that achieve their desired outcomes. ESG factors are therefore important because they are sources of information and data that may impact the long-term value of an investment. By identifying relevant ESG-related inputs and integrating these in an appropriate fashion together with more traditional sources of information and data, an investor can make a more informed decision to help achieve their objectives.

This notion is consistent with the Principles for Responsible Investment's (PRI) definition of responsible investment:

"…**a strategy and practice to** incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership."

That TCorp already exhibits a clear and consistent focus on this is comforting. As it further develops and improves its investment stewardship function, long-term investment performance outcomes for its clients should also be strengthened.

There is likely no single or specific action that will materially enhance TCorp's stewardship function. Nevertheless, doing what TCorp can to maintain an intentional culture of improvement on investment stewardship will be the most impactful driver to help ensure more sustainable risk-adjusted returns.

3.4.2 Measuring and monitoring progress and performance

Measuring performance of the investment stewardship function is challenging because activity does not necessarily correlate with effectiveness, and the long-term nature of company engagements means that outcomes may not be evident within short term performance review time frames. It is unlikely, for example, that investment stewardship will result in quarterly changes in corporate behaviour, and it would be a mistake to judge the impact along these lines. Simply measuring the number of engagements or number of votes against management are not measures of effective stewardship.

The Review has identified current leading practice of peers and recommendations for TCorp to achieve leading practice. TCorp will need to consult with the Treasurer to determine the extent to which these recommendations should be adopted to ensure alignment with current and emerging policies and government expectations.

Nevertheless, comprehensive public reporting, as per one of this Review's priority recommendations, will provide stakeholders external to TCorp with the necessary information to assess TCorp's investment stewardship performance and progress over time. This may include periodic benchmarking of peers' investment stewardship functions to ensure TCorp's own function evolves to reflect leading practice and high standards are maintained.

3.5 Aligning governance arrangements across NSW Government entities

Based on interviews across TCorp and its key clients, there appears to be a reasonable case relating to responsible investment to foster an overarching alignment and consistency (wherever practicable) of effort and outputs from TCorp with respect to its engagement with clients.

Given the Review found that <u>no critical deficiencies</u> were observed across TCorp's investment stewardship function, this creates an opportunity for other agencies and government owned businesses to learn from the experience TCorp has gained through its investment stewardship journey over the last six years.

3.5.1 Recommendations

- Consider establishing an appropriate forum for TCorp, and its key clients to improve interactions and information sharing at the strategic level to develop (where appropriate) common approaches to responsible investing across relevant portfolios.

Background to the Review

4 Setting Responsible Investment in Context

Environmental, social and governance factors, commonly referred to as ESG, encapsulate a range of issues which, until the early 2000s, had not typically been standard inputs for financial decision-making. Today however, the prevailing investment industry view is that ESG factors can and do impact financial outcomes, and therefore should be comprehensively incorporated into investment processes.

Examples of ESG factors are shown in the table following.

Environmental	Social	Governance
Climate change	Human rights	Corporate culture
Resource depletion	Labour standards	Board composition
Biodiversity	Modern Slavery	Cyber Security
Waste management	Supply chain	Executive alignment
Pollution	Equality	Regulatory environment
Water resilience	Just transition	Corruption
Deforestation	Local communities	Disclosure and transparency

For the purposes of this review, the term “ESG investing” is interchangeable with “responsible investment”. Responsible investment is defined as “**a strategy and practice to incorporate ESG factors in investment decisions and active ownership**.”[2]

The primary purpose of a responsible investment strategy is to better manage financial risks and opportunities arising from ESG factors with the objective of enhancing performance outcomes on a risk-adjusted basis (especially over the longer term). Assessing whether a given institutional investor’s responsible investment practices are leading is a complex and multi-faceted exercise, and not an exact science. Such an assessment must consider the many processes by which ESG factors are ultimately integrated into the investment portfolios to manage financial risks and opportunities.

Arguably, it is more important to assess the suitability of the arrangements in place to support those integration processes. This includes reviewing how effectively the investor governs, resources and reports on its responsible investment function. This Review looks at TCorp’s approach by examining each of these elements closely, to provide a detailed assessment of the responsible investment function. It is acknowledged that TCorp also has a financial markets business. However, the scope of the Review is limited to how responsible investment considerations are applied only within TCorp’s investment management business.

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[2] Principles for Responsible Investment (PRI), https://www.unpri.org/investment-tools/an-introduction-to-responsible-investment

The NSW Government relies on TCorp for investment management advice and services. The expectation is that TCorp's responsible investment practice should be industry leading given the nature of the assets which TCorp manages on its behalf. It is therefore important that the NSW Government can be confident that TCorp is suitably capable on responsible investment to ensure that material ESG-related financial risks and opportunities are being appropriately managed.

There is no single industry standard or best practice guide against which TCorp's responsible investment approach can be compared. As such, this Review draws on a combination of the experience of the Review Lead and Supporting Team, the observations of TCorp's clients, and peer practices to derive a predominantly qualitative assessment of how TCorp's current position. The objective is then to both identify those areas in which TCorp is already leading and make recommendations as to how it may progress towards leading practices in other areas.

The **ESG Landscape Review** (Appendix B) provides a detailed review of these issues, which are important to understand and place the content of this Review within the broader ESG context.

5 Review Methodology

The following outlines key activities undertaken in conducting the Review.

Reviews of documentation

Reviews were undertaken of publicly available and confidential documents provided by TCorp and TCorp's key clients (NSW Treasury, SAS Trustee Corporation (STC or State Super) and Insurance and Care NSW (icare)). In addition, there was a review of disclosures made by a selection of institutional investors regarded as relevant peers of TCorp. Documents reviewed included Responsible Investment/ESG policies, annual reports, climate change and/or Responsible Investment/ESG reports, governance and organisational charts, and others pertaining to the responsible investment practices of the peers.

Engagement with TCorp

In reviewing TCorp's current ESG capabilities, several interviews were conducted with key personnel across various levels of the organisation, including key directors and employees. Insights gained through these interviews, from both top-down and bottom-up perspectives, provided detail and clarity on TCorp's decision making and implementation processes with respect to investment stewardship.

Key insights gained through the interviews related to:

- TCorp's responsible investment philosophy and objectives
- TCorp's governance arrangements
- The involvement of the Board and executives
- The general scope of investment services provided by TCorp including its Total Portfolio Approach (TPA)
- Integration of ESG throughout the investment process and across asset classes
- Industry leadership and collaboration with TCorp's stakeholders

The findings arising from the interview process are documented throughout the Report.

Engagement with TCorp Clients

An important input to the review process was the perspectives of TCorp's key clients, which cover about 93% of TCorp's total funds under management (FUM). TCorp's clients and their requirements are key influences on the direction and evolution of its ESG practices given the role TCorp has as investment management service provider. In turn, TCorp's clients and their beneficiaries stand to benefit from any uplift in those same practices. Therefore, it was important to understand how effectively TCorp's current ESG efforts meet clients' requirements and expectations.

Representatives from TCorp's three key clients, NSW Treasury, State Super, and icare participated in interviews to augment the documentation reviews. Throughout this paper, these three clients are collectively referred to as TCorp's 'key clients' to distinguish them from the other clients it services.

Client attendees for the interviews were those closest to each client's responsible investment activities, and/or with greatest exposure to TCorp's ESG capabilities.

We acknowledge TCorp's openness and co-operation and TCorp's clients are thanked here for their efforts and contributions throughout this Review.

Peer Analysis to identify leading practice

To identify and understand contemporary leading responsible investment practice, valuable insights were sourced from both publicly available information and direct contacts for several of TCorp's institutional investor peers. The intent was to compare TCorp's own responsible investment practices and approaches across several dimensions against peer examples deemed to be leading. Peer practices were not as comprehensively assessed as TCorp's. Given the varying nature of the selected peers (including their purpose, objectives, stakeholders), direct comparisons are not always possible across all areas assessed. The Review notes areas where TCorp's practices were consistent with leading practices and identifies leading ESG investment management principles to inform the Report's recommendations.

The peer group had suitable diversity (by geography, investor type, size) to enable exposure to a wide variety of examples of leading practice both domestically and internationally. Several of TCorp's direct state-based peers were included, plus other entities recognised as forward-thinking responsible investors by various industry associations (such as the Principles for Responsible Investment).

Ultimately, the resultant peer group comprised six institutional investors including:

- An Australian industry superannuation fund
- Two state government investment managers
- Two sovereign wealth funds
- An international public pension fund

Where permission was given, interviews were also held with key responsible investment decision-makers (such as Head of Responsible Investment) at several of the peers to gain a more nuanced and deeper understanding in areas such as examples of leading practice, constraints on achieving responsible investment objectives, and main responsible investment priorities and challenges. New Zealand Super, Queensland Investment Corporation ("QIC") and the Future Fund are acknowledged and thanked here for their direct contributions to this report.

Appendix A summarises responsible investment characteristics for each peer.

6 TCorp's background and purpose

TCorp was constituted as a corporation by the Treasury Corporation Act 1983 (the "Act") with the principal objective "*to provide financial services for or for the benefit of the Government, public authorities and other public bodies*"[3]. Within its remit, are activities including the investment of funds for which it is the mandated provider (the focus of this Review), and providing the Government, a public authority, or any other public body, with borrowings. The Act states that TCorp's policies are to be determined by the Board and managed by the Chief Executive, subject to the control and direction of the NSW Treasurer. Notably, in circumstances where TCorp disagrees with a Treasurer's direction, it may request the Treasurer to review it. If after the review both the direction and TCorp's opinion are unchanged, TCorp must include details of the direction and TCorp's opinion in its annual reporting. In 2012[4] TCorp was instructed to divest from tobacco-linked assets and in March 2022 the Treasurer directed TCorp to divest from Russian assets[5]. These exclusion policies are currently reflected in TCorp's investment activities.

TCorp began as a central borrowing authority for NSW to issue bonds on behalf of NSW to both domestic and international investors. Since 2018, TCorp has also issued green and sustainability bonds under the NSW Sustainability Bond Programme. It was not until 1988 that TCorp Investment Management Funds (TCorpIM) was launched, facilitating investment on behalf of NSW entities and departments. TCorpIM's funds under management grew substantially in 2015 when the funds managements activities of STC and icare were amalgamated within TCorp.

TCorp is now the mandated provider of investment advice and implementation for three key clients: NSW Treasury, STC and icare NSW. These mandates include the recommendation of investment objectives, risk appetite, portfolio construction and asset class benchmarks and ranges.

In addition, TCorp also manages funds for another 160 clients, mainly via co-mingled funds, with the selection of both assets and external managers delegated to TCorp. The investment management services also include the annual investment strategy, risk and performance reporting of the TCorp portfolios. As of 30 June 2022, TCorp's total funds under management was $101 billion.

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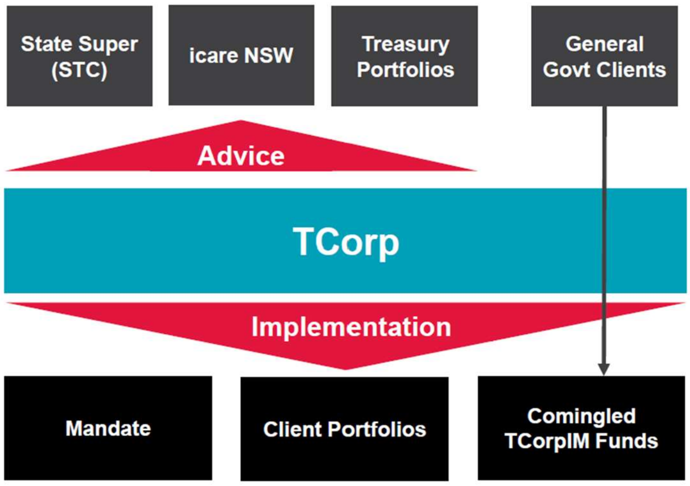
[3] s.5, *Treasury Corporation Act (1983),* https://legislation.nsw.gov.au/view/whole/html/inforce/current/act-1983-075

[4] Media Release, Mike Baird MP, Jillian Skinner, MP, NSW Government, 'NSW Government Bans all Tobacco Investments', November 2012.

[5] Media Release, Matt Kean MP, NSW Government, 'Statement from NSW Treasurer on Ukraine', February 2022.

TCorp client investment and governance structure



Source: TCorp

An important feature of TCorp's investment approach (and relevant to its investment stewardship activities) is its implementation of a Total Portfolio Approach (TPA) model to portfolio construction. TPA emphasises a portfolio-level perspective to investment decisions. For example, portfolio exposures may be defined as risk factors (such as a targeted exposure to fixed income risk) rather than traditional asset allocation approaches which typically separate the portfolio into asset classes (such as equities). TPA can vary widely across investors. Where required in this Review, TCorp's TPA is referenced within the context of how it has impacted the organisation's investment stewardship practices.

6.1 Nature of TCorp's client relationships

Below, TCorp's three key clients are briefly profiled, including their own responsible investment governance and frameworks, as well as the nature of each of their relationships with TCorp from a responsible investment perspective. Generally, each client (and in some cases each fund of each client) has its own distinct purpose and objectives, and TCorp is required to tailor its service offering on investment stewardship to align with these.

NSW Treasury

NSW Treasury's responsible investment awareness and capabilities are evolving, driven by several factors including the NSW Government's commitment to sustainably managing its wider financial activities, and growing awareness among the Government and its stakeholders of ESG risks and opportunities.

It is important to distinguish between NSW Treasury's ESG efforts from an investment perspective, and those related to other types of government financial activities, such as resource allocation of government programs. While the former is the focus of this Review, the latter is a broader consideration in understanding NSW Treasury's wider ESG awareness and focus.

> "The Government recognises the importance of ESG factors in pursuit of longer-term sustainable financial returns alongside delivering a healthier economy, society, and environment."
>
> - Box 6.1, Budget Paper No. 1

The 2022-23 NSW Government Budget[6] includes the Government's commitment to taking a *"sustainable approach to balance sheet management"*. This entails aligning its financial activities (including investing, issuing bonds, and procuring and stewarding resources) with more sustainable outcomes through a variety of initiatives. These initiatives include a longer-term focus on ESG risks and opportunities, which will support the Government's commitment to reduce carbon emissions to 50% below 2005 levels by 2030 and net zero emissions by 2050. Further, it includes integrating ESG principles into TCorp's investment decision-marking and active ownership approach.

The NSW Government has flagged it is developing a NSW Sustainable Finance Framework (SFF) to ensure that the Government's financial activities are aligned with its environmental and social priorities. While the SFF is intended to encompass financial activities of the Government (i.e., beyond its investment portfolios), its development could also help guide a more consistent and comprehensive approach to ESG considerations within the investment portfolios. One of the key areas is to ensure that ESG-related risks are incorporated into NSW government investment management processes through TCorp, and that public finances are directed as much as possible to investments and activities which are aligned with the Government's social and environmental priorities. TCorp is represented on the Treasury-led Sustainable Finance Steering Committee (SFSC), which comprises members from other NSW Government entities including the Office of Environment and Climate Change (OECC) and icare. The SFSC was established in 2020 to drive the State's Sustainable Finance agenda and hence, has input and visibility into the development of the Sustainable Finance Framework.

In recent years, asset owners and investment managers have experienced rising expectations and action from a wide range of stakeholders in terms of how ESG factors are being managed and considered. It is important for investors to be aware of such pressures as increased scrutiny on how ESG risks are managed can and do impact their reputation. TCorp, via the NSW Government, has had to increasingly address this reality in recent times. In terms of ESG considerations, as well as the Government's strategy for managing its fiscal priorities, some criticisms were directed at certain investments in emerging markets countries and centred on the NSW Generations Fund. For example, exposure to Russian assets within institutional investment portfolios prior to the Ukraine invasion were very common, so in no way were the funds TCorp manages an outlier in this respect[7]. In isolation these exposures were effectively immaterial to the investment performance of the overall portfolio. However, there was a general sense from some stakeholders that such exposures were not appropriate from an ESG perspective, although "not appropriate" was not clearly defined. It is reiterated that the primary purpose of responsible investment is to better manage financial risks and opportunities arising from ESG factors and not to reflect specific values necessarily or always.

[6] NSW Government, 'Budget Paper No 1 Budget Statement', June 2022.
[7] Aussie ETFs scramble to dump Russian holdings (afr.com, 4 March, 2022)

NSW Treasury relies on TCorp investment management practices for advice and management of investment stewardship issues. As such, the day-to-day responsible investment function is the TCorp's responsibility, with ad hoc input from, or engagement with, NSW Treasury. Based on interviews conducted as part of this Review, NSW Treasury seeks to rely on, and respects, TCorp's expertise in responsible investment to deliver a leading practice service and believes TCorp is best placed to determine the most appropriate approach or practices.

icare

icare provides insurance and care services to businesses, people, and communities of NSW, across both the private and public sectors. In 2014, the then NSW Treasurer and Minister for Finance and Services announced the amalgamation of icare and STC's funds management activities under TCorp. A Master Financial Services Agreement (MFSA) sets out the services to be provided by TCorp to four of icare's funds (Workers Compensation Insurance Fund, Workers Compensation (Dust Diseases) Fund, Lifetime Care and Support Authority Fund and Sporting Injuries Fund). These services include investment advisory, custodial relations, responsible investment input and advice, and fund management services. icare and Treasury have also appointed TCorp to provide investment advisory and investment management services for the Treasury Managed Fund.

icare has several scheme funds under its administration for which icare's independent Board has a level of responsibility. Several of the scheme funds, such as the Treasury Managed Fund, require approval by the NSW Treasurer on investment strategy, investment objectives and risk appetite. Those funds outside the Government-managed fund schemes, such as the Workers Compensation Insurance fund, are solely the responsibility of the icare Board. However, all fund schemes are managed by TCorp and therefore for the purposes of this Review, we treat icare as a single client. Broadly, icare's focus is on its end users, namely participants in insurance schemes and the employers it serves, and this is the lens through which decisions are made.

Like NSW Treasury, icare's sole investment manager is TCorp (except for one fixed income asset class), including integration of investment stewardship. Currently, responsible investment is monitored by icare's Investment & Asset Committee, a subcommittee of the Board, on an ad hoc basis. icare has limited capacity to monitor TCorp's responsible investment activities, stating it is highly reliant on TCorp to keep it updated. During discussions icare described TCorp as a long-term, strategic partner and its trust in TCorp's ability to fulfil its MFSA obligations was evident. As a result of both the commercial and collaborative nature of the relationship with TCorp, icare believes it can raise issues or concerns regarding responsible investment with TCorp.

Over time, icare has recognised the increasing prominence of responsible investment in the industry, and therefore plans to enhance its own governance of, and approach to, responsible investment in future. This appears likely to include developing its own responsible investment policy to articulate its approach to stakeholders. icare has recognised it will be critical to engage with TCorp on this and is confident TCorp will be willing and able to accommodate icare's increasing requirements.

STC

STC is the Trustee of three Superannuation schemes, whose funds have been combined into the STC Pooled Fund. The Pooled Fund includes both the Defined Benefit and Defined Contribution funds. This review focusses on the Defined Benefit component, which comprises around 80% of the total Pooled Fund and which TCorp services. The services TCorp provides are set out in a MFSA which is reviewed and negotiated annually. These services include investment advisory, custodial relations, responsible investment input, advice and reporting, and fund management services.

STC has long had a focus on responsible investment, establishing its first Responsible Investment policy in 2009 and becoming a signatory to the United Nations-supported Principles for Responsible Investment (PRI)[8] in 2011. This compares to TCorp's shorter history of responsible investing, which began in earnest in 2016 and which is discussed further below. STC's efforts in, and approach to, responsible investment has intensified further in recent years with the on-boarding of full-time dedicated responsible investment staff, and the increasing acknowledgement of STC's Board members that ESG is a driver of enhanced long-term financial outcomes, and therefore part of their fiduciary duties.

STC is among the largest and more actively engaged of TCorp's clients. As a Trustee of superannuation assets, its Board is very cognisant of its fiduciary duties and accountability to its members, aspiring to be compliant with the prudential requirements under the Superannuation Industry (Supervisory) Act 1993 to the best of its endeavours. These duties form a key part of STC's engagement on responsible investment with TCorp, which has a broader set of stakeholders to consider.

The mandated nature of most assets[9] managed by TCorp is pertinent to its beliefs, approach, and efforts regarding responsible investment. Other institutional investors, such as superannuation funds, are typically competing for members or clients (i.e., fund inflows) with their peers. As ESG issues have increasingly been recognised as important to long term returns, the competitive environment has driven an uplift in sophistication of responsible investment efforts across the investment industry. This dynamic is less influential for TCorp, whose assets under advice/management are stable by virtue of legislation or government mandates. Therefore, the need to continually improve its responsible investment function must come from alternative sources (both internal and external), including whole-of-government considerations, client requirements and community expectations.

TCorp has a symbiotic relationship with its key clients, where it benefits from understanding its clients' needs, and its clients benefit from an up-lift in TCorp's investment stewardship capabilities to meet those needs. Crucial to this dynamic, however, is genuine collaboration between the two groups, which should be continually fostered in the future. As TCorp exists to service its clients, they are an important influence into the development of its responsible investment efforts. TCorp's largest clients cannot easily terminate TCorp as their investment manager, as other asset owners can. However, clients can seek and should be encouraged to work with TCorp to enhance investment stewardship performance, typically driven by their

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[8] The United Nations-supported Principles for Responsible Investment (UN PRI) is a network of investors working to promote sustainable investment through the incorporation of environmental, social and governance into their investment and ownership decisions: https://www.unpri.org/

[9] As at 30 June 2022, STC, icare and NSW Treasury comprised 93% of TCorp's FUM. The remaining 7% is managed on behalf of other TCorp clients.

own set of objectives, circumstances and needs. Managing these sometimes-competing client requirements is a key challenge for TCorp, but one that is integral to its purpose. TCorp's ability to incorporate a net zero strategy for STC is a good recent example of TCorp working collaboratively with a client in tailoring its offering for that client's specific requirements.

6.2 Alignment with government policy and intent

TCorp's current approach to responsible investment is broadly consistent with relevant NSW Government policy and stated intent. One example is the references to ESG contained within the NSW Government Budget Statement 2022-23, which describes current NSW government policy and objectives, including "to help ensure the Government can remain at the forefront of ESG investing". [10]

Examples of how this policy is implemented include how the Government applies ESG considerations to its balance sheet, via its Green and Sustainability Bonds and Social Impact Investment initiatives.

Other areas of government ESG-related policy include:

- Net Zero Plan Stage 1: 2020–2030, involving targets of a 50 per cent emissions reduction on 2005 levels by 2030 and to achieve net zero emissions by 2050.
- The Government has flagged development of a New South Wales Sustainable Finance Framework which will align the NSW Government's financial activities with its environmental and social priorities. This will include embedding these considerations investment activities and other financial decision-making by the State, which in turn aligns with TCorp's approach to responsible investment. By incorporating ESG considerations into investment activities TCorp seeks to help manage the impact of, and exposure to, ESG factors risk across portfolios while facilitating the drivers of more sustainable, long-term returns.

Below is a summary of TCorp policy documents that reference both Commonwealth and NSW Government policy, legislation and/or regulation that they relate to investment stewardship activities:

TCorp's Board Policy - Investment Management

This policy confirms that in undertaking its investment management activities, TCorp **"must"**:

- Comply with relevant laws and instruments, such as the Government Sector Finance Act 2018 (NSW), Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth), client specific legislation as well as relevant NSW Government Approvals, Orders and Directions.
- Be mindful of reputational risk(s) attaching to TCorp, its clients, and/or the NSW Government in the selection and management of investments. TCorp will assess this risk on an ongoing basis.

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[10] Budget Statement 2022-23 - Chapter 6: Managing the State's Assets and Liabilities, June 2022

TCorp's Investment Stewardship Beliefs and Principles

One of TCorp's three core Principles is to be effective stewards of its entrusted assets, '*thereby supporting the NSW government in delivering on its promises to the people of NSW*."

It also explicitly states that TCorp will take into consideration 'TCorp's reputation, always being mindful of its government ownership'.

An investment exclusion provision explicitly requires TCorp to:

- Be "*consistent with NSW Government policy applicable to all NSW agencies*" by excluding tobacco investments across all portfolios. This requirement must be passed through to TCorp's investment managers
- "*Implement the exclusion of other activities or exposures based on direction provided by the NSW Government*"

TCorp's Active Ownership Guidelines

- TCorp uses best practice corporate governance principles to guide active ownership decision-making to protect and enhance long term investor value, being mindful of TCorp's government ownership
- The Guidelines seek close alignment with NSW Government's policies and priorities on environmental, social and governance (ESG) matters such as:
    - NSW Climate Change Policy framework and the Net Zero Plan Stage 1: 2020-2030[11]
    - NSW Government Resource Efficiency Policy[12]
    - Premier's Priorities including World Class Public Service and Better Environment[13]
    - NSW Modern Slavery Act 2018.[14]

TCorp's 'TCorp as Investment Manager Policy'

- On proxy voting, TCorp is to apply certain principles, including that 'TCorp's reputation is managed carefully being mindful of its government ownership'
- On securities lending, the program is to be informed by TCorp's Investment Beliefs, the most relevant of which includes *'understanding and managing ESG issues is critical'*

The above references are a recognition by TCorp of both its legal obligations and stakeholder responsibilities stemming from government ownership and the associated mandated provision of investment management services to government entities.

Regarding government intent the following examples are considered to evidence the extent of current alignment between TCorp and NSW Government (either directly or through NSW Treasury), both where these are positive and where there are opportunities for improvement.

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[11] NSW Government, 'Net Zero Plan Stage 1:2020-2030', March 2020.
[12] NSW Government, 'NSW Government Resource Efficiency Policy', February 2019
[13] NSW Government, 'World-Class Public Service', 'Greener Public Spaces' July 2022
[14] NSW Government, 'Modern Slavery Act 2018', July 2018

Positive alignment

TCorp's Investment Stewardship Beliefs and Principles framework seeks to align its stewardship practices with the adoption of TPA to investment management.

TCorp's main business units (investment management (IM) and Financial Markets (FM)) are increasing their collaboration internally based on the belief that TCorp's ESG expertise can have beneficial long-term impact for the NSW government by:

- Promoting NSW Government awareness of evolving sustainability expectations, and the impact of these expectations on the NSW balance sheet.
- Promoting NSW bond investors' awareness of NSW sustainability credentials.

Examples of this collaboration and alignment include:

- TCorp participating in the Sustainable Finance Steering Committee to drive, support and develop the State's overall Sustainable Finance Agenda, respond to ESG risks and opportunities, and assess the impact of climate-related risks on the State's investment funds via regular reporting.
- TCorp's CEO establishing the ESG Working Group, bringing together management from both the financial markets (mainly the bond issuance business) and investment management teams.

Opportunities for improved alignment

There are opportunities to improve alignment between TCorp and NSW Government policy more broadly in some high-visibility ESG areas:

- The NSW Government has a target of a 50% reduction by 2030 of 2005 emissions levels and net zero emissions by 2050 across the NSW economy. Any actions that TCorp takes to decarbonise or implement net zero across the portfolios it manages will be aligned with Government's broader net zero intent. This may be particularly the case where TCorp is invested in businesses that are either domiciled or operate in New South Wales.

  In terms of TCorp implementing a net zero policy across its portfolios, the approach, timing and specific strategies are likely to differ from fund to fund (due for example to different portfolio exposures). We understand NSW Treasury's perspective is that a consistent (industry-leading) approach to net zero strategy, targets and implementation across all TCorp-managed funds is preferred. However, this will be challenging for TCorp to manage as decarbonisation strategies are implemented going forward. In response, TCorp may need to lead client understanding on acknowledging the need for flexibility in adopting different strategies to achieve a balance between commonality and bespoke requirements. This is further discussed in Section 7.9.

Detailed Analysis: Current management of NSW Government Funds with respect to ESG

7 Current management of NSW Government Funds with respect to ESG

In this section, each of the key elements making up TCorp's current investment stewardship framework are reviewed in detail. Each of these elements has been assigned a specific subsection as follows:

- Governance arrangements
- Resourcing and capability
- ESG Investment Risk Framework
- Application to TCorp's managed investments
- Application to investment managers
- Application to real assets
- Application to active ownership (engagement and proxy voting)
- Decarbonisation and net zero
- Reporting and transparency
- Potential impediments to implementation of leading practice

Each subsection has the same structure including:

- Introduction – providing contextual comments
- Key observations – summarising the most important observations
- Overall approach – a description of TCorp's current approach
- Client observations (where available) – highlighting TCorp's clients' experiences
- Peer Insights – a summary of peer practices and TCorp's alignment
- Recommendations – expected to support TCorp's progress to leading practice

7.1 Historical evolution of TCorp's investment stewardship

It is valuable to understand the historical evolution of TCorp's capabilities in responsible investment, and particularly with respect to the broader evolution of TCorp's investment management business.

While TCorp was established in 1983, it was only the 2015 amalgamation of the investment management activities of STC and icare with TCorp's that truly catalysed the development of an institutional-grade responsible investment capability. TCorp noted that this was a needs-based evolution for them as assets under management increased significantly at that time to more than $70 billion, as did the diversity of the client base. TCorp's growth has been rapid since that time with its total assets under management reaching $101 billion as at June 2022.

> As convenient as it might sound, a "leading practice", institutional responsible investment capability cannot simply be "parachuted", fully formed and functional, into an organisation.

As convenient as it might sound, a "leading practice", institutional responsible investment capability cannot be simply parachuted, fully formed and functional, into an organisation. This is due to the evolving nature of stewardship, the complexities, the inconsistency of data and information available and emerging practices. As with any other institutional investor, TCorp has developed its responsible investment capabilities incrementally over time, and importantly, has done so while considering any prevailing objectives, preferences, and constraints (as well as those of its clients) at any given point through that journey.

Having established a responsible investment function in 2016, TCorp would not be considered a "first mover" in a global sense, but neither is it a newcomer relative to other Australian investors of commensurate scale. Since that time, TCorp has steadily and deliberately taken steps to build out what it terms its "investment stewardship" function.

> "In the context of the relatively short timeframe and period of heightened change and activity at TCorp, the progress made to date on investment stewardship is commendable."

TCorp is viewed as having taken a thoughtful and measured approach to date in building out its investment stewardship capabilities. Examples of steps taken include:

- Establishing a dedicated Investment Stewardship team including hiring experienced specialists
- Engaging specialist responsible investment consultants
- Encouraging a whole-of-firm culture of ownership with respect to investment stewardship
- Prioritising more material investment stewardship functions
- Investing in a range of data sources and systems to support its teams
- Seeking to ensure investment stewardship aligns with TCorp's total portfolio approach
- Engaging with peers and industry groups to share ideas on developing better practices

TCorp's investment management business has evolved substantially since the amalgamation of funds. Most notably, TCorp determined that a "Total Portfolio Approach" (TPA) investment model was the most suitable to service its varied client base and has spent several years executing development and roll out phases. The investment stewardship function has been built out concurrently with the TPA investment model. Based on representations from TCorp, this added meaningful complexity and challenge to the process, relative to say, a long-standing investment manager or asset owner that sought to integrate ESG into a well-established investment model.

In the context of the relatively short timeframe and period of heightened change and activity at TCorp, the progress made to date on investment stewardship is commendable. Importantly, it is expected to provide a sound foundation for TCorp to continue building out its capability in this area into the future. Leading practice in responsible investment is not static, but rather necessitates a firmwide culture of intentional and continual improvement. This characteristic is a cornerstone conclusion of this Review and reflects responsible investment being an evolving issue that needs continual adaptation to emerging risks and opportunities.

7.2 Governance arrangements across TCorp managed investment funds

7.2.1 Introduction

This section describes the relevant investment stewardship governance arrangements applying to TCorp's management of NSW Government funds, focussing on the three key clients.

Due to the different nature of each client, the governance arrangements are independent of one another, and hence vary according to each organisation's legal structure, governing documentation (and/or legislation) and purpose. These variances include the fact that each key client has ultimate responsibility for its own fund's objectives, including the underlying investment parameters designed to achieve those objectives. This creates intricacies for TCorp in managing its key clients' respective investment pools, particularly where one approach does not neatly suit all clients' responsible investment approaches, policies and expectations for the management of ESG factors.

7.2.2 Key observations

Regarding TCorp's governance arrangements:

- Accountability for investment stewardship lies ultimately with the TCorp Board. The Board has delegated the oversight role of investment stewardship to the Board Investment Committee (BIC). The BIC reviews the Investment Management Board Policy, which includes TCorp's Investment Stewardship Beliefs and Principles and recommends revisions to the Board for approval.

- TCorp management and particularly the CIO, has delegated responsibility for a broad range of ongoing investment stewardship processes and receives advice on ESG risks facing new investment opportunities through the Management Investment Committee (MIC).

- There is a dedicated Investment Stewardship team which reports to the Chief Investment Officer (CIO).

- In October 2021, the CEO established an internal ESG Working Group, comprising key members of the senior leadership team from Investment Management and Financial Markets including, among others, the CEO, CIO and Head of Investment Stewardship. The Working Group's monitors the changing ESG landscape and informs TCorp's senior leadership team of the changing environment.

There are several Board and management-level policy documents that cover ESG integration and investment stewardship.

7.2.3 Overall approach

Purpose

TCorp's purpose is articulated in the primary applicable New South Wales legislation which comprises:

- The Treasury Corporation Act 1983 (TCorp Act), which establishes New South Wales Treasury Corporation as the central financing authority for the New South Wales public sector. Under this act, TCorp's principal objective is "to provide financial services for, or for the benefit of, the New South Wales government, public authorities and other public bodies"

- The Government Sector Finance Act 2018 (GSF Act) which provides, amongst other things, the framework for government sector financial management in New South Wales, including mandating TCorp as funds manager for relevant government sector agencies, unless exempted by the Treasurer

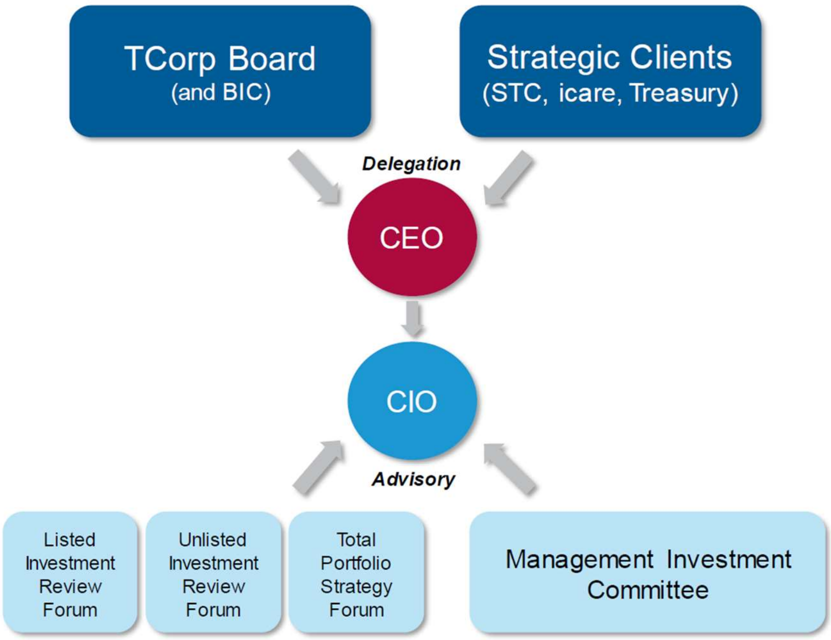
- The Public Finance and Audit Act 1983 which contains the requirements for a general audit of TCorp's annual financial report by the NSW Audit Office.

Pursuant to this legislative framework, TCorp effectively enjoys a competitive advantage in the provision of investment advisory and management services to NSW Government agencies. This positioning brings with it both organisational benefits (e.g., scale, process efficiencies, consistency of portfolio approaches to ESG) and potential challenges which require careful management (e.g., divergence in member/stakeholder interests, how to service different clients having regard to their specific interests, ESG sophistication levels and relative operational autonomy).

Governance of TCorp's Investment Stewardship

Accountability for investment stewardship lies ultimately with the TCorp Board. The Board has delegated the oversight of investment stewardship to the Board Investment Committee (BIC). There is a dedicated Investment Stewardship function of five with the Head of Investment Stewardship reporting to the CIO. In October 2021 the CEO established an internal ESG Working Group comprising nine members of the senior leadership team from both Investment Management and Financial Markets, including the CEO, CIO and Head of Investment Stewardship. Various Board- and management-approved policies provide the framework for implementation of investment stewardship activities.

TCorp Investment Management Governance Structure



Source: TCorp

Board of Directors

TCorp's Board

TCorp's current Board comprises independent Chair Michael Dwyer, AM, the NSW Treasury Secretary and Deputy Secretary, TCorp's CEO (the only executive director) and 6 independent directors appointed by the NSW Treasurer following Cabinet approval.

As discussed above, responsibility for the oversight of investment stewardship rests with BIC (see further below). The Board receives reporting on active ownership activity through a six-monthly "Active Ownership Report".

The Investment Management Board Policy includes minimum standards which describe compliance obligations regarding Board policies, relevant laws/Instruments, and contractual obligations. It also requires the Board “to be mindful of reputational risk(s) attaching to TCorp, its clients, and/or the NSW Government in the selection and management of investments”.[15] Arguably, TCorp’s management and mitigation of reputation risk associated with the NSW Government, compared to non-government entities, can add operational complexity versus other single-purpose investors (such as a superannuation fund). Reputation risk is heightened around ESG, considering the broad range of ESG factors applicable (refer table in Section 4), a greater diversity of stakeholders and differing community expectations.

The Investment Management Board Policy was last approved by the Board in September 2020 and the next review is scheduled for May 2023.

One area of governance overlay which is quite unique to TCorp as an investment manager stems from TCorp being subject to the control and direction of the NSW Treasurer. While TCorp can request such directions be reviewed, in the event of an inconsistency between a direction given by the Treasurer and a direction given by the Board, the Treasurer’s direction prevails. While this differentiates TCorp from its market peers in terms of investment governance, to date there is no evidence showing that Ministerial direction has led to a significantly different ESG approach or practice, for example through portfolio construction divergences. There have only been two directions to TCorp from the Treasurer to date:

- TCorp’s exclusion of tobacco equities was implemented in 2012 pursuant to a direction, which represented a reasonably common policy position at the time.
- TCorp’s more recent exclusion of Russian assets was very much in-line with the broader market response to the Russian invasion of Ukraine in early 2022.

Based on interviews with the Chairman, other ESG matters addressed by the TCorp Board includes monitoring the events occurring in Russia in the context of implementing the Treasurer’s Direction relating to Russian assets.

TCorp advises that its Board meets with its key clients periodically on ESG issues.

The Board’s current observable mix of skills comprises significant investment management, superannuation, insurance, banking, and commercial experience. It is generally more difficult to assess ESG skills as opposed to other skills identified above, however ESG skills are observable as part of the investment management skill set.

Companies listed on the Australian Securities Exchange (ASX) are required to disclose annually in the corporate governance statement a skills matrix. A recommendation is for the TCorp annual report to include such a skills matrix which would also identify ESG skills of directors to demonstrate the Board has the capabilities to discharge its oversight duties with respect to investment stewardship.

Responsible Investment is dynamic, with emerging issues as well as changes in data, information and approaches. The TCorp Board would benefit from a process to ensure it has regular information sessions on relevant and material ESG topics. This would improve the Board’s overall ESG capabilities to help guide its objectives of continuing improvement and maintaining leading market practice.

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[15] TCorp, Board Policy – Investment Management, Approved 25 September 2020

Board Investment Committee (BIC)

The TCorp Board has delegated the oversight role, inter alia, of investment stewardship to the BIC. All investment activities undertaken by TCorp in its capacity as trustee, investment manager, advisor and/or agent on behalf of another Government entity are subject to oversight by the BIC.

The BIC Chair, Greg Cooper, was appointed a Director of TCorp in 2018 and BIC Chair in 2019. He has over 26 years' global investment industry experience, including 12 years as CEO of Schroder Investment Management Australia. His initial priority was to deepen the Committee's investment management and financial markets expertise, and this has largely been achieved. One change in approach, implemented over time was to replace the Committee's independent members with TCorp Board directors. This is considered a positive for the purposes of consistency across governance and decision-making, particularly as it relates to a multi-faceted area such as ESG. TCorp directors are best placed to fully understand the organisation's investment management ESG priorities and risks, hence those on the BIC are best placed to govern related implementation decisions.

The BIC Chair also advised the BIC has reviewed and strengthened certain investment practices applied by TCorp, including both an increased focus on ESG and transitioning to TPA (acknowledged as a major exercise). The BIC Chair expects stewardship policy and governance development, involving both the Board and BIC, to continually evolve.

Under the Board Policy on Operating Authorities and Delegations, BIC approval is required for new TCorp real asset investments with an equity value above A$600 million. It appears there is no explicit policy or procedural requirement for an ESG assessment by the BIC itself as part of this approval. Instead, it is left to the relevant asset class team (e.g., Infrastructure or Property) and/or the Investment Stewardship team to determine whether an ESG assessment should be formally undertaken by BIC. However, as discussed in more detail below, the procedures used by the Management Investment Committee (MIC) flow to the BIC's assessment processes, including investment stewardship considerations. To ensure consistency of the assessment of stewardship as well as other relevant investment criteria for real asset investments which require BIC approval, it is recommended that a template along the lines of that used by the MIC be developed for the BIC. Such a template should be specifically designed to capture those issues that are specific to large real asset investments, including investment stewardship.

CIO and the Management Investment Committee (MIC)

The CIO has delegated responsibility for a broad range of ongoing investment stewardship processes. Under the delegated authority from the CEO, TCorp's CIO has sole decision-making authority for proposed listed manager appointments, including internally managed mandates for liquid assets (no delegation constraint) and real assets investments (under A$600 million). As shown in the governance structure chart earlier, the CIO is supported, as needed, by the MIC, the Listed Investment Review Forum, Unlisted Investment Review Forum, and the Total Portfolio Strategy Forum.

The MIC was established by the Chief Executive (CEO) as an advisory body to assist the CIO, in discharging their responsibilities in relation to governance of investment activities and decisions undertaken by TCorp in its capacity as trustee, manager, advisor and/or agent. The MIC is an advisory committee rather than a typical investment committee (in which all members vote).

The MIC’s role is to provide advice to the CIO in respect of investment management model oversight, advice, and investment approvals (including recommendations to the BIC for their approval of investment management decisions), investment performance reporting and periodic external management oversight. Members of the MIC are the CIO (Chair), and the Heads of Cash and Fixed Income, Implementation and Exposure Management, Investment Advisory, Investment Stewardship, Portfolio Construction, Portfolio Delivery and Real Assets and Private Markets. The CIO is under no formal obligation to take the MIC’s advice, although it is understood that in practice, the CIO considers MIC input (and that of the other investment forums) regularly as part of the decision-making process. The CIO to date has not gone against the advice of the MIC.

For each MIC meeting to consider an investment opportunity, a standard memo template is populated by the opportunity lead (typically the Head of the relevant investment team) to articulate the process taken to assess the opportunity. Investment stewardship considerations are a standing component of a “Key risks and mitigants/relevant controls” table, alongside other risk types such as investment and operational risks. Investment stewardship is also considered as part of key issues of compliance, being a standing element in the memo’s “Compliance Checklist”. Alignment with TCorp’s investment beliefs is also addressed, including how the proposal aligns with TCorp’s beliefs on investment stewardship. Accordingly, investment stewardship considerations are formally documented for the CIO as part of the MIC meeting. A member of the Investment Stewardship team will at a minimum, review (and may actively contribute to) the components of each memo relating to stewardship.

While the memo is the final and formal documentation of the investment team’s investment thesis, the processes to identify and assess material investment stewardship issues are varied over the course of the due diligence process. The CIO is involved in initial discussions about the opportunity with the relevant investment personnel and Investment Stewardship as the investment case is established. Material stewardship issues are also considered as part of the Listed and Unlisted Investment Review Forums, which the CIO attends. Stewardship issues may also be discussed at the Total Portfolio Strategy Forum. Overall, TCorp’s approach presents as seeking to leverage wide-ranging collaboration and socialisation of stewardship issues for a given investment opportunity, all of which informs the CIO’s ultimate assessment. Case studies referenced by TCorp highlighted that the resultant diversity of perspectives on stewardship matters is the primary mechanism for ensuring the range of potential ESG-related risks and opportunities considered is sufficient for each investment opportunity.

In October 2021 the CEO established an internal ESG Working Group, comprising senior leaders from both the Investment Management and Financial Markets functions to:

- Propose or consider proposals for ESG concepts and initiatives to be pursued by TCorp that support TCorp’s strategic goals
- Define responsibilities and consider resource requirements for the delivery of such proposals
- Keep abreast of investor expectations and the NSW Government’s agenda and actions relating to ESG

- Idea development and testing relating to:
  - TCorp's and the State's ESG narrative
  - Financial Markets and Investment Management product offerings, with a focus on implementable strategies for TCorp and the NSW Government
  - ESG advice to the NSW Government to achieve impact over the long-term to create a stronger NSW, with a focus on:
    - Balance sheet risk, including climate risk management; and
    - Market expectations and best practice in ESG disclosure and transparency
  - Inform and ensure appropriateness and consistency of TCorp's ESG narrative and messaging to the NSW Government and investors
  - Update TCorp's Executive Committee on key developments.

The Investment Stewardship team developed the ESG Investment Risk Framework (discussed later) which the CIO approved.

7.2.4 Peer Insights

TCorp's governance structure regarding responsible investment is generally in line with those of the peer group. In all cases relating to peers, the Board approved an Investment Stewardship Beliefs and Principles or equivalent. Some had executive level committees focussed on sustainable investing.

7.2.5 Recommendations

- TCorp's annual report to include such a skills matrix which would also identify ESG skills of directors to demonstrate the Board has the capabilities to discharge its oversight duties with respect to investment stewardship.

- Establish a continuing professional development plan available to all directors covering relevant ESG issues to keep directors informed of the changing ESG landscape, including how TCorp compares with leading peers.

- For large transactions referred to the BIC, develop a template suitable for assessing investment opportunities and risks for investments in significant real assets, which includes a dedicated section for investment stewardship. Such a process will ensure consistent consideration of relevant matters, including ESG risks and opportunities and bring the BIC assessment process into line with other investment functions.

7.3 Resourcing and capability

7.3.1 Introduction

This section considers TCorp's investment stewardship resourcing. A leading responsible investment practice must employ appropriate resources to execute an effective strategy. Resourcing in this context includes specialist and experienced investment stewardship personnel, and any externally sourced inputs such as specialist ESG data and services.

7.3.2 Key observations

Regarding TCorp's current resourcing and capability:

- The size, depth and experience of **TCorp's specialist Investment Stewardship team is broadly in line with industry peers**.
- TCorp's incorporation of specialist ESG data and analytics directly into its centralised portfolio management system is viewed as being current leading practice.
- Technical knowledge on ESG outside the Investment Stewardship team is mixed and may result in **less efficient and consistent ESG integration** relative to peers.
- TCorp's ambition to foster a **culture of ESG ownership** across the organisation is positive but current levels of knowledge and experience vary between different business divisions. A nascent investment stewardship "champions" initiative across investment teams is in line with leading peers and expected to enhance knowledge going forward.

7.3.3 Overall approach

Since the establishment of the stewardship function in 2016 TCorp has progressively built its resources. During the formative stages of this process, TCorp engaged an investment consulting firm to advise on establishing the foundational elements of an investment stewardship function. This included the inaugural Investment Stewardship Beliefs and Principles and developing roadmaps to implement the Investment Stewardship Beliefs and Principles, including resource planning.

As the investment stewardship function grew in scale and complexity, in March 2018 TCorp established the position of Head of Investment Stewardship. Further responsible investment resources were added over time, both in terms of personnel and technology, supplemented by ongoing use of external consultants and data providers for specific projects and needs.

Today, TCorp's Investment Stewardship team consists of five full time personnel, covering the following functions:

- Active ownership, focused on corporate engagement and proxy voting
- Oversight and support of ESG integration across the various TCorp investment teams
- ESG risk monitoring and reporting
- Client engagement and support for ESG strategy and implementation

While the current members of TCorp's Investment Stewardship team are all relatively new, having joined between 2020 and 2022, each brings suitable experience to their positions from prior roles.

There is currently a spectrum of knowledge and experience levels across TCorp Investment Management with respect to ESG. In general, higher levels of ESG understanding and autonomy are seen in investment teams where ESG has been dealt with over a longer period of time (e.g., listed equities). For example, more hands-on involvement of ESG integration is observed in the Partner Selection team relative to the Cash and Fixed Income team. The former has an established stewardship framework in place along with access to supporting ESG data and analysis, whereas these support resources are still being developed for the latter. As a further illustration of this dynamic, feedback from TCorp's Real

Assets and Private Markets (RAPM) team included optimism over the recent introduction of a purpose-designed stewardship framework to support ESG integration for direct asset investments. It is expected that this framework will meaningfully enhance stewardship practice in the RAPM team.

Leading institutional practitioners of responsible investment typically have an integrated approach meaning that responsibility for this function is not siloed exclusively with a dedicated ESG team but is more broadly integrated throughout the organisation. Such an approach helps to ensure the firm is applying a consistent approach on investment stewardship issues, and minimises conflicts between different internal functions, to allow more informed decision-making. This approach also supports more effective ESG integration as the specialists undertaking ground-level investment activity are simultaneously considering material ESG factors and can bring their expertise to the process. For example, a direct property investment specialist will typically have a deeper understanding of a given prospective asset than a generalist responsible investment officer, and so has a more informed context when considering ESG factors when building an overall investment case. For this approach to work investment personnel also need the requisite technical knowledge of ESG matters. Currently, levels of knowledge vary widely across the investment teams.

While TCorp appears to be progressing steadily toward a more fully integrated approach, there is currently still some tendency for less-knowledgeable investment personnel to defer ESG considerations to the Investment Stewardship team given their expertise. Positively, TCorp has initiated a program whereby investment teams appoint stewardship “champions” who are charged with driving an ESG culture within their teams and leading ESG integration enhancements by maintaining close dialogue with the Investment Stewardship team. This initiative is viewed as an example of leading practice by TCorp.

To facilitate TCorp’s progress towards improving the skills sets of the various investment teams to ensure greater consistency regarding ESG integration, consideration should be given to a more structured approach for ongoing professional development on ESG issues. At present, professional development for TCorp personnel on investment stewardship matters is relatively unstructured, with the Investment Stewardship team running internal training sessions on specific topics and leveraging relationships with external parties (e.g., fund managers) on an as-needs basis. There is scope to elevate this process to take a more structured approach to ESG professional development.

Alongside building out its human resource capabilities, TCorp has also invested in ESG-related data from specialist providers and its internal systems which support its investment stewardship efforts. Most notably, TCorp has integrated ESG into its primary portfolio management and enterprise risk systems, which since 2020 has been “Aladdin” (provided by BlackRock Solutions). Aladdin is widely used across the investment management industry and is therefore supported by the provider to an institutional level. TCorp’s centralising of ESG data in this way is a leading approach in terms of identifying, evaluating, and managing ESG exposures across the entire portfolio. It is further used to produce both internal and external reporting on investment stewardship activity and outcomes. To populate Aladdin with ESG data, TCorp sources a range of metrics and analytics from well-known, specialist providers.

A demonstration of ESG-related outputs from the Aladdin system highlighted that TCorp’s Investment Stewardship and other investment management teams can readily source decision-useful, security-level ESG analysis including carbon emissions (absolute and intensity metrics) and concentrations of potential human rights risks, modern slavery and other ESG controversies[16]. These can be viewed at a whole-of-fund level, then broken down by client, asset class/investment, manager, and individual security level. Emphasis is placed on tracking metrics over time to flag and identify when meaningful trends are manifesting in a given area.

At present, security, and asset-level portfolio coverage of key ESG metrics is a work in progress. While MSCI[17] provides appropriate coverage for TCorp's needs in listed asset class exposures, TCorp is in the process of sourcing specific data for unlisted assets not covered by MSCI. As such, visibility across all portfolios from a bottom up ESG perspective is not uniform. Currently, such data limitations relating to unlisted and other alternative assets is an issue for any Australian institutional investor with large and highly diversified portfolios. TCorp's current progress in terms of ESG data is typical of the experience of other institutional investors. Both the availability and quality of ESG data across a range of asset classes continues to improve. TCorp needs to monitor this area and be guided by materiality, coverage, utility and costs. TCorp appears to be mindful of such limitations and is monitoring availability of new sources of data.

Client requirements and stakeholder expectations are expected to increase in both scale and complexity over the coming years, as is the availability of appropriate data and technology. It is therefore recommended that additional resourcing, both human- and technology-based be brought on when needed to meet these demands and opportunities.

7.3.4 Client observations

Generally, each of TCorp's key clients acknowledged the increased importance of the role of investment stewardship. One client noted TCorp was on a similar evolution to what it had experienced itself several years earlier. Clients also noted how observed progress made on responsible investment at TCorp was linked to resourcing quality, highlighting noticeable improvements following the 2018 establishment of the Head of Investment Stewardship position.

7.3.5 Peer Insights

TCorp's resourcing for the Investment Stewardship function is broadly aligned with peers. Further, the appointment of stewardship "champions" is aligned with current leading peer practice. Also, its use of data and analytics and ability to break down whole-of-fund level ESG analysis into its component parts are aligned with examples of current leading practice.

7.3.6 Recommendations

- To build out investment stewardship knowledge across investment teams, develop a program to offer teams structured and ongoing professional development on investment stewardship topics.
- Resourcing should be monitored on a regular basis in terms of human resources as well as technology requirements. Particularly in relation to the latter, sources of data are increasing, with both the quality and currency of data continuing to improve, providing opportunities for TCorp stewardship activities.

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[16] MSCI's ESG controversies ratings seek to identify companies involved in major ESG controversies and assess performance versus international norms and principles
[17] MSCI ESG Research, LLC

7.4 TCorp's ESG Investment Risk Framework

7.4.1 Introduction

This section reviews TCorp's ESG Investment Risk Framework (Framework). Well-structured frameworks support clarity of purpose and consistency of implementation for ESG integration in the investment process. Responsible investment frameworks should align with an organisation's responsible investment policy and set out how the investor will achieve its objectives. The Framework was developed by the Investment Stewardship team in 2021 and was approved by the CIO.

7.4.2 Key observations

Regarding TCorp's current ESG Investment Framework:

- The Framework details the activities that TCorp's investment management function needs to undertake to systematically consider integration of ESG in its investment activities and be an effective steward of the assets managed.
- TCorp's ability to understand the aggregate portfolio's ESG complexion is viewed as **demonstrating current industry leadership**.
- The Framework has likely accelerated TCorp's consideration of ESG factors in more challenging areas relative to peers.
- Given the Framework's recent development, the **way high level analysis informs ESG integration at the investment team level is in a state of development.**
- TCorp has not explicitly incorporated identification or measurement of the environmental and/or societal impacts of its capital allocation decisions. This is an area of increasing interest among asset owners and other stakeholders and an area of development with respect to measurement.

7.4.3 Overall approach

In 2021, TCorp developed an **ESG Investment Risk Framework** which aims to assist in the identification, evaluation, management and reporting of the exposure and impact of ESG characteristics across portfolios.

The ESG Investment Risk Framework interacts with the broader Investment Risk Framework (and TCorp's investment risk principles) as TCorp views investment risk to be multi-dimensional, with ESG being one of those dimensions. The ESG Investment Risk Framework enables TCorp's investment management function to systematically consider ESG risks alongside other investment risk types such as credit, inflation, liquidity etc.

The Framework is underpinned by TCorp's investment stewardship beliefs and principles as follows:

Investment beliefs:	Understanding and managing environmental, social and governance (ESG) issues is critical to achieving sustainable investment outcomes.
Principles:	We are effective stewards of the assets entrusted to us, thereby supporting the NSW Government in delivering on its promises to the people of NSW. We identify, evaluate and manage the exposure and impact of ESG factors to drive better risk-adjusted returns. We are "active owners" of our investments in order to protect and enhance long-term value.

The establishment of the ESG Investment Risk Framework is consistent with the transition of TCorp's TPA model and the related development of its broader Investment Risk Framework.

The objectives of the ESG Investment Risk Framework are to:

- Provide the ESG dimension of total portfolio quality and risk
- Evaluate the ESG exposures of investment opportunities
- Enhance the ongoing management of portfolio ESG exposures

The Framework is broadly (but not exactly) aligned with TCorp's Investment Stewardship Beliefs and Principles. The Framework identifies five pillars of what is titled the Investment Stewardship Framework which are as follows:

TCorp's Five Stewardship Pillars

Integration	Engagement	Proxy Voting	Collaboration	Disclosure
Integrate ESG factors into investment decision making	Engage with entities to ensure investment and ESG risks and opportunities are being managed	Exercise ownership rights	Work with industry participants to strengthen the system	Transparency for our clients and stakeholders

Source: TCorp website

All the above topics are referred to in the Investment Stewardship Beliefs and Principles.

The four high-level elements of the ESG Investment Risk Framework, are consistent with elements of responsible investment frameworks of peers. The processes underpinning each of the four high-level elements are briefly described as follows:

1. Identify

> "[TCorp is in the] process of building out a country governance risk assessment framework which will likely require a given country to have a minimum risk score to be investible in real assets and bonds (and monitored with caution in equities). It is expected that this will ultimately be integrated into the identification element.

TCorp employs a "bottom-up" and "top-down" approach[18] to identify those ESG factors most important to a portfolio. TCorp uses the Sustainability Accounting Standards Board (SASB) materiality mapping framework to map portfolio holdings to ESG factors by industry/sector from a bottom-up perspective. This is augmented by overlaying commonly cited top-down ESG factors (including any which are prioritised due to client expectations). This process presents as fit-for-purpose and consistent with TCorp's Total Portfolio Approach. We note TCorp continues to evolve all its ESG practices, including the current process of building out a country governance risk assessment framework which will likely require a given country to have a minimum risk score to be investible in real assets and bonds (and monitored with caution in equities). It is expected that this will ultimately be integrated into the identification element.

2. Evaluate

TCorp then evaluates which of the ESG factors identified as important are most material to the total portfolio from an investment perspective, and therefore should be prioritised in terms of managing. This prioritisation is expressed via a "portfolio impact matrix" in which the impacts of ESG factors are classified as either "direct" or "systematic" (the latter relating to ESG factors indirectly impacting the portfolio due to their broad economic/societal influence). A four-point rating is determined for each portfolio impact (Very High, High, Medium or Low) which feeds into TCorp's processes for prioritising further action.

3. Manage

The action taken in managing a material ESG factor's impact depends on the nature of the exposure. TCorp's Investment Stewardship team designates an action from the following:

- Enhance – increase exposure to an ESG opportunity
- Manage – through strategy design, active management or active ownership
- Monitor – track ESG exposure over time
- Avoid – exclude or avoid investments in certain areas

The Investment Stewardship team will collaborate with the relevant investment team or teams to facilitate the required action.

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[18] "Top-down" involves considering high level factors and issues (e.g. climate change) that may impact on a portfolio overall. "Bottom-up" involves considering how these factors and issues may impact individual investments, which then aggregate up to the overall portfolio (compare the kind of analysis involved when considering financial performance: https://www.investopedia.com/ask/answers/193.asp)

4. Report

Reporting under the Framework covers a portfolio's exposure to, and management of, ESG issues. Reporting includes internal reports covering investment stewardship and portfolio delivery and external reports to clients and governance forums.

The development and adoption of the ESG Investment Risk Framework is viewed positively based on several key potential benefits:

- It helps communicate and integrate a firm-wide culture of considering material ESG risks as financial risks and opportunities.
- It provides for systematic application to mitigate the risk of material ESG risks at the total fund level being overlooked.
- It provides consistent high-level guidance on ESG integration across all investment teams.

> "…because of TCorp's objective of tracking portfolio quality at a whole-of-fund level, it is already quite well progressed in understanding aggregate ESG complexion and in this specific area, is viewed as demonstrating industry leadership"

It is notable that the ESG Investment Risk Framework has likely accelerated TCorp's consideration of ESG factors in more challenging areas/asset classes relative to other investors. A more commonly observed "bottom up" progression of an approach to ESG assessment by a given investor would typically begin with the listed equities sector, which is often seen as simpler in terms of ease in accessing ESG data, analysis, and management strategies. The investor would then gradually build out its assessment approaches by asset class, with the intention to eventually cover the whole portfolio. Often, institutional investors have yet to meaningfully account for ESG risks in asset classes such as sovereign bonds or alternatives/hedge funds due to data limitations. In contrast, because of TCorp's objective of tracking portfolio quality at a whole-of-fund level, it is already quite well progressed in understanding aggregate ESG complexion and in this specific area, is viewed as demonstrating current industry leadership.

At a granular level, there is flexibility for nuanced consideration of specific ESG factors depending on the need identified e.g., highly localised ESG risks for a new real asset opportunity. In such cases, it is not clear how the principles from the high level ESG Investment Risk Framework subsequently inform ESG integration being undertaken at the underlying investment team level. This process is likely to be in an evolving state given the recent development of the ESG Investment Risk Framework.

While the notion of "impact" is incorporated into the ESG Investment Risk Framework to the degree that ESG factors influence portfolio outcomes, at an investment industry level, the terminology of "impact" is crystallising as a further aspect of investing (along with return and risk). In this context, "impact" refers to the environmental and/or societal consequences (both positive and negative) of capital allocation decisions. Increasingly, institutional investors are seeking to identify and measure such impacts in response to growing interest from a wide range of stakeholders. A member of a super fund may choose to leave that fund if they conclude that its investment activities are having certain negative impacts which conflict with the member's own values or beliefs. To date, TCorp has not explicitly integrated identification or measurement of these types of impact into its Framework. It is important for TCorp to be aware of this developing area, including the development in processes to measure such impact on behalf of clients going forward.

7.4.4 Client observations

One client has observed "separation" (i.e., limited integration) between investment teams and the Investment Stewardship team at TCorp. While this is still reasonably common among institutional investors and asset owners that have dedicated responsible investment resources, such separation is less conducive to effective and efficient ESG integration.

7.4.5 Peer learnings

Like TCorp, several peers are in the process of developing, or have developed, frameworks for assessing ESG risks and opportunities at the portfolio ("top-down") level. Overall, TCorp's approach aligns with current leading practice in this area.

7.4.6 Recommendations

- The Investment Stewardship Beliefs and Principles and ESG Investment Risk Framework could be better aligned in terms of the five investment stewardship activities identified in the ESG Investment Risk Framework.

- TCorp should monitor the development of processes and methods to measure environmental and societal impacts in portfolios and consider other forms of measurement to assess the effectiveness of investment stewardship on behalf of clients going forward.

7.5 Application to TCorp managed investment funds

7.5.1 Introduction

In this section, the integration of investment stewardship within three areas of TCorp's investment processes are reviewed:

- Establishing client investment objectives and risk appetite statement
- Portfolio construction
- Cash and fixed income

Each of these areas has a specific role within TCorp's overall investment management model and is undertaken by specific teams.

7.5.2 Key observations

Regarding TCorp's managed investment funds:

- Central to current leading practice among peers is **absolute clarity on each asset owner's objectives, preferences, and expectations with respect to investment stewardship**. In this regard, TCorp's "Discovery" process to develop client objectives and risk appetite represents an opportunity for in-depth discussion **to understand client requirements on investment stewardship**.
- The formal inclusion of investment stewardship in assessment of portfolio quality is viewed positively as it demonstrates TCorp's belief that ESG considerations are financial in nature and must be balanced against other financial considerations.
- Effectively integrating ESG factors (and particularly climate change) into capital market assumptions and portfolio construction is still a developing area at an industry level, providing an opportunity for TCorp to prioritise this area in its own portfolio construction process.
- Recent efforts to Integrate investment stewardship into the TCorp Cash and Fixed Income team's functions are positive and provide a solid foundation to meaningfully uplift ESG integration.

7.5.3 Overall approach

Establishing Client Investment Objectives and Risk Appetite Statement

TCorp provides investment advice and implementation for various clients with different requirements. While each client is connected by virtue of being a NSW Government entity and therefore subject to certain common requirements, it is also the case that each has a particular purpose (e.g., superannuation, funding insurance claims, funding NSW infrastructure etc). Clients also run multiple investment vehicles/portfolios, each with its own distinct purpose, return target, risk tolerance and time horizon. This heterogeneity extends to their requirements with respect to responsible investment. TCorp engages annually with each client to understand their holistic requirements with the goal of developing both a risk appetite statement and investment return objective, which ultimately guide how every client's portfolio is built.

TCorp's Investment Advisory function is responsible for this process (known as "Discovery") within the firm's investment model. TCorp uses a combination of a risk appetite questionnaire and client discussion to build its understanding of a given client's requirements. While the primary focus of this process is to determine the client's return/risk targets and tolerance levels for volatility, losses, and illiquidity etc., TCorp also seeks to elicit any objectives or constraints the client may have around ESG. It is unclear how systematic, granular, or proactive this latter dimension currently is on TCorp's part, although it does appear that its more detailed/complex engagements on ESG matters during Discovery to date have typically been in response to client-initiated requirements.

The most prominent example was in assisting STC on its decision to establish a net zero target and strategy. This required TCorp to understand the client's needs in detail, including how to quantify climate change risk, develop decarbonisation milestones and balance climate change considerations with achieving investment objectives. While this engagement process was extensive, it was viewed as very instructive by the Investment Advisory unit.

Such learnings enhance TCorp's ability to support its other clients with respect to decarbonisation (noting that these will need to be tailored to each Fund's requirements).

More proactively, TCorp noted that it has led an ongoing dialogue to gauge client interest in excluding controversial weapons from portfolios. Alongside tobacco, controversial weapons are very common exclusions undertaken by Australian institutional investors. Not all clients have taken this step, so dialogue is continuing.

TCorp states that the way it currently accounts for client-specific requirements on investment stewardship is distinct from its existing approaches to integrating ESG into investment advice and implementation. Ideally, leading practice for TCorp as a service provider would involve better facilitating a continuous "feedback loop" between client-led requirements on ESG and ESG integration across its investment teams while also ensuring these are closely aligned rather than distinct.

TCorp should incorporate investment stewardship in a more systematic fashion as part of the Discovery phase by ensuring that material ESG factors (e.g., net zero and decarbonisation requirements) are explicitly addressed with each client at every annual review. Incorporating investment stewardship questions into the questionnaire is likely to facilitate an enhanced dialogue in this regard.

Portfolio Construction

TCorp's Portfolio Construction Team is responsible for building portfolios for each client based on their specific requirements as determined in the Discovery phase. Proposed portfolios are subsequently recommended by Investment Advisory to the client. The key deliverables in this phase are the Reference Portfolio (or "liquid beta portfolio") which is designed to meet the client's investment objectives, and the Recommended Target Portfolio which, depending on the risk appetite of the client incorporates additional value-adding investments to enhance outcomes over and above the liquid beta portfolio. Each client then considers and approves the recommendations from Investment Advisory.

Once approved by the client, the Portfolio Construction Team works with TCorp's other investment teams in developing the "access points" through which the portfolios are implemented. A given access point represents a particular configuration of investment exposures, including asset classes and managed funds that enables TCorp to generate a return stream of a particular nature. Access points are then combined to implement the total portfolio.

The portfolio construction process uses capital market assumptions (return and risk forecasts) developed in-house. At this time, ESG considerations are not explicitly integrated into the development of TCorp's capital market assumptions. TCorp is in the process of investigating how this may be done in the future, particularly with respect to climate change.

TCorp does, however, run climate change scenario modelling and stress testing for client portfolios, leveraging the Aladdin portfolio management system. Climate change scenario modelling and stress testing are quickly crystalising as core activities in the climate change financial risk management strategies of institutional investors. A key catalyst for this was the 2021 release of the Australian Prudential Regulation Authority's (APRA) Prudential Practice Guide CPG229 on Climate Change Financial Risks, which highlights the importance of climate scenario analysis.

STC's decision to establish a net zero strategy represented a significant project for the Portfolio Construction team, which was heavily involved in the process, including working with an independent specialist consultant. To support STC's strategy both the Portfolio Construction and Investment Stewardship teams had to develop capabilities in various areas, including in identifying, assessing and managing potential risks arising in a portfolio subject to decarbonisation targets.

The headline measure TCorp monitors for a given client's total portfolio is "portfolio quality". As a general concept, any proposed change to a given client portfolio must result in an improved portfolio quality measure. Portfolio quality is assessed based on seven elements, including investment stewardship. The stewardship element is measured as an aggregation of stewardship ratings awarded to each access point as determined by the Investment Stewardship team which assigns a rating of 1, 2 or 3 based on a range of inputs. Formally embedding stewardship into the determination of a client's portfolio quality firmly entrenches TCorp's view that ESG is a contributor to investment performance.

"The formal incorporation of stewardship within the measurement of portfolio quality is viewed positively given it highlights the clear focus TCorp seeks to maintain on ESG considerations being financial in nature and balanced against other financial considerations."

An example of this in action was TCorp's decision to transition its developed market international equities to be benchmarked against a low carbon index. In this instance, the improvement in overall portfolio quality arose from a higher stewardship rating for the relevant access points.

However, it is possible that approval is given if a portfolio's overall quality improves due to other factors, even if the stewardship rating falls. This possibility demonstrates that ESG is one of a range of investment factors being considered by TCorp in aggregate and is in keeping with its stated stewardship philosophy.

The degree to which investment stewardship considerations influence TCorp's high level portfolio construction decisions is continuing to develop. Relative to broader industry trends this is not unusual, as most responsible investment activity has focused on ESG integration within the implementation phases of the investment process. It is therefore viewed positively that TCorp is investigating how ESG/climate factors may be incorporated into its capital market assumptions. It is recommended that this investigation, particularly with respect to climate change, is prioritised in the context of TCorp moving towards leading practice as it would intuitively align with its total portfolio approach to risk management. TCorp is further encouraged to explore how its climate scenario analysis and stress testing may tangibly influence its portfolio construction approach.

The formal incorporation of stewardship within the measurement of portfolio quality is viewed positively given it highlights the clear focus TCorp seeks to maintain on ESG considerations being financial in nature and balanced against other financial considerations.

Cash and Fixed Income

TCorp's internal Cash and Fixed Income team is a specialist, internal investment management capability. It manages approximately $12 billion in fixed income and cash portfolios, and futures as part of an interest rate overlay. The team consists of six investment professionals – the Head of Cash and Fixed Income, four portfolio managers and a dealer. The team currently runs five different active portfolios investing in high grade government, semi-government, supra national and credit fixed income securities, as well as cash instruments. The Cash and Fixed Income team does not manage fixed income or cash mandates by default but is appointed by TCorp's Partner Selection team if successful through the partner selection process for a given mandate.

The benchmarks for each of the portfolios are assigned by TCorp's Portfolio Construction team and significantly guide the investment management approaches taken by the Cash and Fixed Income team just as would be expected of any external fixed income fund manager.

In terms of investment stewardship considerations, the Cash and Fixed Income team has started developing processes to work with TCorp's Investment Stewardship team to identify, assess, and manage ESG factors that could materially impact credit risk for a given issuer of corporate debt. The Cash and Fixed Income team looks to embed ESG considerations into its internal credit assessment through reliance on widely available, external sources of data regarding ESG risk, namely credit rating reports produced by credit rating agencies such as Moody's, and Standard and Poor's. These reports highlight potential ESG concerns which the team considers when making investment decisions, but as these are commercially available reports, they do not offer unique or bespoke insights to TCorp alone. While perhaps not leading therefore, the significance of this is not overly concerning given the focus on high quality credit in the portfolios. Typically, materiality of ESG risks is higher at the lower end of the credit quality spectrum (e.g., high yield or "junk" bonds). Nonetheless, TCorp has previously divested certain credits due to ESG concerns that were thought to materially impact confidence in an issuer's ability to repay.

One area of potential differentiation for the Cash and Fixed Income team is by virtue of TCorp's active approach to corporate engagement as part of managing exposure to ESG factors in its listed equities portfolios. By virtue of the team's mandate, there is meaningful exposure to major Australian debt issuers, such as the country's four major banks. The Cash and Fixed Income team can gain insights into company specific ESG factors through engagement activity undertaken by TCorp's Investment Stewardship team and will occasionally participate in discussions with the companies themselves.

Beyond corporate debt, integration of ESG considerations is more limited with TCorp noting that this is an evolving skillset within the Cash and Fixed Income team. At present, ESG is not actively considered in most investment due diligence on government debt. TCorp flagged that the expected development of a sovereign risk framework by the Investment Stewardship team will be welcome. Some work was done by TCorp in 2021 to assess climate change risks associated with various state-issued bonds because of the increase in focus on climate risks by STC and the resource-heavy economies of certain Australian states. This is viewed as an example of critical thinking on TCorp's part and "playing to strengths" on stewardship matters in an investment area where TCorp has gained specialist knowledge over time. Ideally, this risk assessment will continue to be enhanced and broadened over time.

The practical integration of investment stewardship by the Cash and Fixed Income team therefore currently presents as being nascent. There appears a genuine intent to enhance this process going forward. In keeping with TCorp's tendency to favour building a clear, evidence-based investment case for a given action, it has been historically challenging to build alignment within the Cash and Fixed Income team for greater effort on investment stewardship. This is due to less data-led analysis supporting causality between ESG factors and performance of fixed income investments relative to say, listed equities at this time. Historically there has been some scepticism amongst the team, however a recent external review[19] of the team's overall capabilities made a key recommendation to enhance investment stewardship. It appears that this has crystallised unity across the team on the importance of ESG integration. Intended enhancements include:

- Designating two "ESG champions" within the team
- Developing an ESG Investment Framework for fixed income together with Investment Stewardship
- Upskilling team members by leveraging insights from other external managers

7.5.4 Client observations

A client acknowledged a high level of collaboration with TCorp when considering its net zero strategy. This instance highlights TCorp's ability to tailor to clients' requirements but also the complexity of such endeavours through which all parties can learn and develop their capabilities.

The exclusion of certain stocks on ESG grounds (for example, within a certain business line such as Tobacco) is a common practice among TCorp's peers and the wider investments industry. Like its peers, TCorp may take such action following analysis into the likely impact of a particular exclusion on its investment objectives including returns. Unlike most of its peers TCorp is also subject to directions set out by the NSW Treasurer to make exclusions or divestments. In turn, when such exclusions are being considered, TCorp's clients are often consulted but ultimately do not have the ability to reject the exclusions. So far, the two exclusions in place (tobacco and Russian assets) were supported by the clients' Boards following their own assessment of the merits of the exclusions within the context of their independent objectives. However, the client raised a potential conflict with regards to its fiduciary duties to members, for example, if a proposed exclusion meant a potentially adverse financial outcome was likely. While the consultative approach to exclusions is positive, a more transparent and comprehensive framework for considering exclusions would be beneficial. Such a framework would mean potential exclusions are sufficiently considered from an investment perspective, including the impact on performance and risk of the portfolio. This would also help clients' understanding of the potential impact on beneficiaries and stakeholders.

7.5.5 Peer Insights

The incorporation of broad ESG factors into capital market assumptions, and subsequently, investment strategy and asset allocation, was not widely cited to be used by TCorp's peers. However, climate change is increasingly being integrated into these activities, albeit gradually.

Most peers identify fixed income and cash as a challenging area to integrate ESG relative to asset classes where there is more data or a longer history of ESG integration, such as listed equities, property, and infrastructure. One peer stated that its external cash managers are not monitored from an ESG perspective, in contrast to the remainder of its managers managing other asset classes. Another domestic peer believes ESG factors impact the operational and financial performance of bond issues. It screens for ESG factors and

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[19] NSW Treasury Corporation: Review of internal cash & fixed income capabilities. July 2022 WTW

integrates ESG into all aspects of credit research (using the SASB materiality framework) and portfolio management and engages with issuers to try and influence change.

7.5.6 Recommendations

- Incorporate investment stewardship more explicitly in "discovery" questionnaires and dialogue when developing client investment objectives and risk appetite statements
- Prioritise work to formally integrate ESG, particularly climate change risk and scenario analysis insights into the portfolio construction process including development of capital market assumptions.
- In consultation with stakeholders, develop a transparent framework which guides consideration of material portfolio exclusions (e.g., considerations around potential trade-off of client preferences and risk-adjusted returns over the shorter term) to facilitate collective understanding of both financial and reputational impacts which may result.

7.6 Application to investment managers

7.6.1 Introduction

TCorp's Partner Selection team (PS team) identifies and engages quality managers to form aligned and enduring partner relationships. Under the Total Portfolio Approach (TPA) model, the PS team chooses investment managers based on guidance from the Portfolio Construction team about the types of access points required to meet portfolio needs.

7.6.2 Key Observations

Regarding TCorp's application to investment managers:
• TCorp has formally integrated ESG considerations into its Partner Selection Framework. TCorp's approach to factoring in ESG considerations when selecting and monitoring its investment managers broadly aligns with those used by peers. • From 2018 TCorp has applied a range of investment criteria when assessing prospective managers, who are rated at the time of appointment and then reviewed periodically. The questions asked of managers for stewardship integration and alignment seem quite broad though focused on ESG integration, exclusions and high-level ESG risk management considerations. All managers appointed prior to 2018 have since been rated. All manager ratings, including stewardship, are reviewed every two years. • The formal incorporation of stewardship within the measurement of portfolio quality is viewed positively given it highlights the clear focus TCorp seeks to maintain on ESG considerations being financial in nature and balanced against other non-financial considerations.

7.6.3 Overall Approach

Since 2018 the Partner Selection team has used a selection framework to evaluate prospective managers. Managers are assessed for their:

- Core investment competencies,
- Organisational alignment, and
- Operational rigour.

Through this process potential managers are also assessed and scored on their stewardship credentials, among other capabilities. TCorp considers a manager's ESG policies, resourcing, and activities (e.g., active ownership) and how well these align to its purpose and beliefs. Assessments involve questionnaires, interviews, and other forms of due diligence, complemented by external service provider of ESG ratings. Both the PS and Investment Stewardship teams are involved in this assessment, though the former is responsible for each manager's overall rating.

A prospective manager does not need to achieve a minimum stewardship score to be engaged. Where TCorp thinks a manager is suitable overall, but does not meet stewardship expectations, TCorp may not proceed with the appointment.

Once a manager is engaged, they are subject to regular monitoring by the Partner Selection team. This involves quarterly engagement, where discussions include stewardship activities and initiatives, with the Investment Stewardship team also participating where feasible. Managers report regularly to TCorp on the following:

- A summary of material ESG-related financial risks identified, and integration of these factors as part of the investment decision-making processes
- The application of active ownership rights through proxy voting and engagement,
- Carbon reduction objectives of the portfolio where applicable,
- Update on governance, including policies, processes, staff training and any breach of the investment mandate, and
- Annual report on modern slavery risk management within portfolios

For incumbent managers, the partner ratings, including stewardship integration and stewardship alignment, are reviewed every two years. TCorp has updated the ratings using information from manager meetings and reports, rather than the questionnaire. TCorp also engages with incumbent managers and where it is found they are not meeting TCorp expectations in relation to stewardship, plans are put in place to assist with improving practices.

7.6.4 Client observations

One key client noted TCorp's improvement in its assessment of managers and has a high degree of confidence in TCorp's process and capabilities. It believes that TCorp follows an intensive due diligence process.

7.6.5 Peer Insights

TCorp's approach to factoring in ESG considerations in the selection of external investment managers broadly aligns with peers. Further, like peers, TCorp is increasingly embedding requirements to improve ESG performance into manager mandates and engagement.

7.6.6 Recommendations

- Develop asset class specific ESG questionnaires, which are systematically used as a part of the pre-investment due diligence process and aligned with TCorp's ESG Investment Risk Framework.

7.7 Application to real assets

7.7.1 Introduction

TCorp real assets are an essential part of investment diversification. Its foundational exposure to direct property and infrastructure was gained from the 2015 fund amalgamation process. After the NSW Generations Fund was established in late in 2018, TCorp decided to focus on its capabilities to more effectively tap into long-term real assets opportunities. The present strategy and operating model were developed in 2020 and the appropriate capability populated since then. Importance was placed on the effective integration of the Real Assets and Private Markets (RAPM) function into TCorp's Total Portfolio Approach.

7.7.2 Key observations

Regarding TCorp's application to real assets:

- The RAPM team indicated that they have generalist knowledge of ESG issues however, they defer to the Investment Stewardship team as the ESG specialist to advise on ESG integration.
- TCorp is in the process of integrating a climate risk assessment framework to assess the climate risk and resilience of the real assets within its portfolio. It appears to be a leading step in managing climate risks compared to peers.
- TCorp's Property and Infrastructure teams are both signed up to the Global Real Estate Sustainability Benchmark (GRESB), which is a positive step towards assessing external managers' ESG integration approaches. However, GRESB (or similar framework) data has not been systematically used as part of benchmarking and engagement approaches as some of TCorp's peers have done.

7.7.3 Overall approach

Initially, the Investment Stewardship team undertook a top-down ESG analysis on investment opportunities the RAPM team was considering. However, given the greater prominence of ESG over time, TCorp recognised the need for a more detailed approach and to upskill the team.

TCorp's RAPM team has now adopted the RAPM Investment Stewardship Assessment document, recently developed by the Investment Stewardship team, to adopt a more consistent approach to assessing ESG factors for new investment opportunities. The Investment Stewardship Assessment document lists relevant ESG factors for both infrastructure and property. While there is some crossover of issues, nuances around ESG metrics which are different between these sectors are also apparent. Discussions highlighted that the RAPM team appears to take comfort from having a "checklist for ESG assessment", which results in a clear audit trail to demonstrate they have taken ESG into account systematically.

> "…we are in the process of developing TCorp's climate risk assessment framework led by the IS team to measure climate risk resilience of the assets based on six input measures, which is a positive step towards integrating ESG into the thinking and overall investment approach." – TCorp's RAPM team
>
> - TCorp's Property Team

TCorp's Property and Infrastructure teams are both signed up to GRESB which is viewed as a positive step towards systematically integrating ESG considerations into investment opportunities on an ongoing basis. Given the decision to acquire GRESB data is reasonably recent, TCorp has yet to fully utilise it.

Adopting the GRESB benchmark provides data and tools to establish comparable benchmarks across different managers within the same asset class. This creates an avenue to identify areas of opportunities and risks within TCorp's RAPM portfolio.

7.7.4 Client Observations

Clients noted that real assets have been less of a focus for TCorp in terms of investment stewardship relative to equities and fixed income from a responsible investment perspective. It acknowledged this is likely a function of the somewhat more heterogeneous nature of real assets relative to equities.

7.7.5 Peer Insights

TCorp's recent joining of GRESB is positive and aligned with the practices of peers. It is noted that peers are using GRESB benchmarking to assess the ESG performance both of their managers and their overall property and infrastructure portfolios. There is an opportunity for TCorp to engage with peers who are currently using GRESB to learn how to better use it.

7.7.6 Recommendations

- Further use the GRESB process to monitor and drive continuous improvement in the RAPM portfolio. This could be further enhanced by taking note of the way more advanced peers have effectively used GRESB.

7.8 Application to active ownership (engagement and proxy voting)

7.8.1 Introduction

Until 2018, TCorp's proxy voting was outsourced to its investment managers. The active ownership function was then brought in-house to have a more consistent approach across portfolios. Over the next four years, a previously narrow focus on high-profile contentious issues or material holdings was elevated and broadened in Australian securities. The focus has since expanded into international equities, and more recently to include collaborations with the RAPM and Cash and Fixed Income Teams. In mid-2020 TCorp allocated senior resourcing in the Investment Stewardship team to manage the active ownership strategy.

7.8.2 Key observations

Regarding TCorp's active ownership:
• TCorp's active ownership activities have broadened over the last few years starting with bringing the proxy voting of Australian securities in house and the development of a targeted investee company engagement strategy. • TCorp votes international equities using an external proxy advisor for voting recommendations and execution, and a third party to conduct company engagement work. • TCorp's current active ownership activities are aligned with peers.

7.8.3 Overall approach

As per its Active Ownership Guidelines, TCorp adopts the following objectives to guide its active ownership strategy:

- Exercise ownership rights to protect and enhance long term value
- Build long term mutually beneficial relationships with investee companies
- Identify and assess ESG related risks and opportunities
- Inspire and secure change to address and manage ESG related risks and opportunities
- Provide transparent reporting of impact for clients and stakeholders

TCorp receives voting recommendations and uses a voting execution platform from one, well-established external proxy advisory service, Glass Lewis for both domestic and international listed equities.

For Australian listed equities, TCorp votes all its Australian listed securities shares. It tracks 40-50 companies as part of its engagement and proxy voting program, and actively focuses on 20-25 companies for in-depth engagement.

For all international proxy voting, TCorp adopts recommendations from its external proxy advisor but retains the option to override the recommendation and instruct a vote in the best interests of TCorp clients. To support constructive engagement with international listed companies TCorp uses a reputable engagement service provider.

As part of its engagement program, TCorp applies a three-tier approach based on materiality of ESG risk from higher to lower. For Tier 1, approximately 5-6 companies with the highest materiality are selected for direct and active engagement. Tier 2 includes higher portfolio exposures but slightly lower ESG risks, followed by Tier 3 with lower ESG risks and lower portfolio exposure. For Tier 2 and 3 engagement priorities, TCorp has developed a partnership approach to leverage expertise of external managers. The managers are given an engagement template for their engagement objectives to ensure they are aligned with TCorp's view and provide regular reporting to TCorp on engagement progress and outcomes.

TCorp notes its engagement extends beyond listed securities, with efforts to incorporate active ownership in the RAPM and Cash and Fixed Income teams. The collaboration between the Cash and Fixed Income Team and the RAPM Team regarding engagement with investees appears to be at an early stage. There has been some high-level collaboration in which a member of the Investment Stewardship team participates in debt-related investee company meetings. The Investment Stewardship team notes the RAPM team has recently begun including 'quality questions' as part of their engagement on ESG matters with investee companies.

The above processes apply to listed equities only. For several significantly high value, non-listed real assets, TCorp may appoint directors to the boards of such entities. In these cases, TCorp-appointed directors provide feedback on material ESG issues periodically to TCorp.

Collaborative initiatives

Collaborative initiatives can be a source of useful information on stewardship issues and can provide leverage of influence for issues, in particular climate change, and company engagements. TCorp currently uses a small number of initiatives including the Investor Group on Climate Change, and the Thinking Ahead Institute. Prioritising which organisations to join or which initiatives to sign up to requires a significant degree of assessment to ensure that the benefits of any membership outweigh the costs and that TCorp can deliver on any commitment signed on to.

7.8.4 Client observations

One client noted TCorp's strong commitment to communications with respect to voting activity.

The information clients receive from TCorp is set out in various service agreements which are renegotiated annually. As the resources, capabilities and expertise within TCorp's Investment Stewardship team grow over time, so to have the demands from clients seeking further information on stewardship activities relating to their portfolios.

One key client has a dedicated senior manager role for responsible investment. This client would like disclosure of how TCorp intends to vote on its behalf for controversial resolutions only (expected to be a very low number). Providing clients with such information would be considered leading practice in Australia.

For such a process to be implemented efficiently, TCorp would need to work with the client to develop a definition for "controversial resolutions" and timing for notification for TCorp to commence the appropriate actions, which may include company engagement.

7.8.5 Peer Insights

TCorp's active ownership activities are broadly aligned with peers. Some Australian peers leverage detailed voting guidelines from representative organisations instead of developing in-house guidelines for Australian listed securities. Outsourcing of proxy voting and engagement for non-Australian investee companies is aligned with peers of similar size.

Leading practice is for disclosure of voting outcomes for both domestic and international equities. Internationally large pension funds have begun disclosing how they intend to vote ahead of meetings. This practice is not yet seen in Australia.

7.8.6 Recommendations

- Public disclosure of proxy voting statistics for both domestic and international equities on an annual basis.
- Enhance the current process for providing voting intentions of controversial meetings to clients before the shareholder meeting noting TCorp and clients would need to agree to a practical process.

7.9 Decarbonisation and net zero

7.9.1 Introduction

TCorp has flagged that work is underway to further develop its capabilities to provide decarbonisation services within its investment management functions. The purpose of this section is to highlight considerations for TCorp as it advances its approach in this area.

The trend of institutional investors seeking to decarbonise their portfolios has grown significantly in the past several years[20]. Most of TCorp's peers have set, or are in the process of setting, portfolio-wide decarbonisation (typically net zero) targets. Approaches to setting such targets and the strategies to achieve them vary widely, and like any investment strategy, must be aligned with the investor's unique set of objectives, stakeholders, and constraints. Given peer progress, as well as the NSW Government's own net zero ambitions, the question of whether TCorp should set such a strategy and importantly, how, has naturally been raised throughout this Review and the findings have been included across several investment areas.

7.9.2 Key observations

Regarding TCorp's approach to decarbonisation and net zero:

- Following requests from several clients, **TCorp has made progress in developing its capabilities to provide decarbonisation services for clients**.
- A desire to align with the **NSW Government's net zero ambitions, and growing client and community expectations** provide impetus for TCorp to further advance its capabilities. TCorp has flagged it has plans to do so.
- The process for establishing its decarbonisation or net zero service should be ideally underpinned by a roadmap.
- Leading practice by some of TCorp's peers includes the establishment of a net zero or climate change strategy and increasing analysis of net zero pathways into investment analysis.

[20] https://igcc.org.au/wp-content/uploads/2021/08/ASPIRATION-TO-ACTION_FINAL_17AUG2021.pdf

7.9.3 Discussion

In March 2020 the NSW Government released a document entitled '*Net Zero Plan Stage 1: 2020-2030*'[21] announcing a goal of net zero greenhouse gas emissions by 2050 together with an interim target of a 35% reduction in emissions versus 2005 levels by 2030. This was followed up in September 2021 by Government announcing a new interim target of 50% reduction in emissions compared to 2005 level by 2030[22]. Adding to the Government's stated ambition on net zero, community expectations have also grown significantly in relation to the actions of governments, investors and companies regarding their net zero efforts. TCorp having a position on decarbonisation or net zero approach is expected to be in broad alignment with both community expectations as well as the NSW Government's own targets.

Following the setting of STC's net zero target and strategy, TCorp collaborated with the client to assess the implications of this target within STC's portfolios. Further, TCorp has begun providing NSW Treasury with climate metrics for the purposes of reporting on its net zero goal within the NSW Government's balance sheet, including investment assets. It is likely that interest from TCorp's other clients to incorporate net zero considerations into investment management activities will continue to grow.

TCorp has recognised the evolving interests of clients by implementing decarbonisation strategies for all of its portfolios. These include the change of benchmark for its international equities portfolios to a low carbon index and acquiring forward-looking emissions data to augment backward-looking analysis.

It is appropriate for TCorp to develop a comprehensive approach to support its clients on their respective decarbonisation/net zero journeys, leveraging its progress made to date.

The complexity in developing a decarbonisation strategy should not be understated, and the process should be completed in a considered manner. While several of TCorp's peers have the advantage of having just one set of net zero targets to consider, TCorp may need to consider the potentially differing targets and investment time horizons of its clients. This is not necessarily to suggest that TCorp should tailor all elements of a net zero strategy for each client for the sake of it. There may be actions which can best be conducted for all clients in the same manner. Nonetheless, by engaging with each client on their expectations with respect to decarbonisation will promote clarity of purpose and approach for all parties.

Ideally, TCorp should establish a roadmap to guide its activity over an extended period (noting that peers' net zero targets are mostly aligned with a 2050 date). Key milestones/actions forming the roadmap may vary by client, but would be expected to include elements such as:

- Foundational support to facilitate client understanding of, and commitment to a decarbonisation/net zero strategy, including education
- Alignment with industry recognised net zero frameworks
- Assistance in defining and setting decarbonisation/net zero targets
- Incorporating climate change into portfolio construction and portfolio scenario analysis
- Historical and forward-looking analytics on portfolio alignment with net zero

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[21] NSW Government Department of Planning, Industry and Environment, 'Net Zero Plan Stage 1: 2020-2030', March 2020.
[22] https://www.nsw.gov.au/media-releases/nsw-set-to-halve-emissions-by-2030

- Identifying partners and investments which further progress to net zero
- Engagement with partners and companies, focused on aligning activity with net zero
- Suitably informative reporting on progress against decarbonisation/net zero targets.

7.9.4 Peer Insights

As stated above, most of TCorp's peers are further ahead on their decarbonisation efforts.

7.9.5 Recommendations

- TCorp to consult with key clients and determine the appropriate pathway to achieve net zero across all portfolios by 2050 to align with NSW Government Policy.

7.10 Reporting and transparency

7.10.1 Introduction

Transparent reporting is recognised as a key element of leading practice investment stewardship as it provides evidence of how the application of policies translates into investment and engagement outcomes. There is a growing expectation of stakeholders including clients, the NSW Government, and the community for a greater understanding of how TCorp integrates ESG issues into its investment activities. Like most aspects of investment stewardship, reporting is another area that continues to develop and evolve. Reporting and transparency facilitate the following:

- Communication of responsible investment beliefs, policies, and objectives
- Demonstrating progress towards those objectives, including on key metrics (e.g., emissions)
- Showing ESG impact made with client capital through analysis and case studies
- Facilitating constructive dialogue with stakeholders on priority ESG concerns
- Providing an avenue to educate both internal and external stakeholders on important ESG matters
- Contributing to broader industry efforts to uplift responsible investment

Notably, transparent reporting to clients and other stakeholders can and does encourage improvement with respect to the core ESG integration capability through greater sharing of information and demonstration of accountability.

7.10.2 Key observations

Regarding TCorp's reporting and transparency:

- TCorp's investment stewardship and active ownership reports present as reasonably informative and concise and will continue to evolve.
- The recent development of a quarterly, quantitatively driven report for STC is an important evolution and is more reflective of reporting observed from peers.
- There was clear evidence of the changing expectations of clients with regards to reporting on investment stewardship activities and TCorp's willingness to work with clients to meet these needs. It is another example of TCorp's approach to continual improvement.
- **Comprehensive public reporting on responsible investment** is standard practice amongst peers, with the detail of reporting increasing over time.

7.10.3 Overall approach

Reporting is a key element of TCorp's ESG Investment Risk Framework. TCorp has a dedicated function responsible for client reporting on investment stewardship performance, which is done by the Investment Advisory team. The team works with all TCorp's investment management teams to compile and produce client reports, as well as internal investment stewardship reporting to the MIC and BIC. Client reporting requirements are reflected in MFSA and Investment Service Agreement (ISA) documents which are reviewed and re-negotiated with clients annually.

Currently, there are two investment stewardship reports produced on a six-monthly cycle for TCorp's three key clients:

- Active Ownership Report (proxy voting and engagement)
- Investment Stewardship Report

One client receives a quarterly Client ESG report which arose from that client's work with TCorp on net zero. Non-client specific excerpts from the Active Ownership and Investment Stewardship reports were provided and reviewed as part of this exercise.

The Active Ownership Report provides a summary of voting and engagement activities which are two of the five pillars of the ESG Investment Risk Framework. Information is disclosed separately for Australian and international equities. The report provides an analysis of engagement activities by topics such as business model and innovation, leadership and governance, social capital, environment, and human capital. For Australian equities the number of engagements for the reporting period and comparative prior period is also disclosed. Also included for meetings held with companies on the priority list are details of change objectives and progress. For international equities information is provided on a percentage of assets under management basis.

Voting statistics are provided for both Australian and international equities in terms of number of proposals voted, with a breakdown of votes for and against as well as proposal type such as governance, climate and social. The report also includes an analysis of how TCorp voted on proposals put forward by shareholders.

The Investment Stewardship Report provides a summary of progress on investment stewardship activities over the six-month reporting period, reporting against the five stewardship pillars detailed in the ESG Investment Risk Framework. For each pillar, TCorp provides highlights of actions undertaken to advance its objectives in that area. Examples of updates may include activities undertaken on behalf of a specific client, new data/processes being sourced by the Investment Stewardship team, and recent collaborative efforts within the broader industry.

Reporting for one client has evolved over the last few years. As mentioned above the reporting obligations of TCorp to the client are detailed in the MFSA which is subject to an annual renegotiation.

7.10.4 Client observations

One client has been working with TCorp in a collaborative manner to receive increased transparency around investment stewardship activities. The success of this collaboration is evidenced in the changing and increasing nature of information provided to. It is expected that this process will continue. The client commented that it would like to see TCorp share more thought leadership topics covering asset classes in addition to listed equities with them as this would enhance their own knowledge on evolving stewardship issues.

TCorp's Investment Stewardship team meets regularly with members of NSW Treasury's Sustainable Finance team, where TCorp's work on investment stewardship is discussed. Further, TCorp's representation on the Sustainable Finance Steering Committee means they are kept abreast of NSW Treasury's progress and expectations with respect to its sustainable finance agenda.

From a purely responsible investments perspective, however, another client advised it does not receive regular updates from TCorp. While it receives a monthly investments update, this tends to be centred on investment performance. This client also noted that TCorp responded in a satisfactory way to requests for additional information. This dynamic is partly explained by the evolution of NSW Treasury's mandate, which was initially focused more so on portfolio performance though has evolved to include consideration of ESG risks to the State's balance sheet. Overall, this client believes it would benefit from being regularly updated by TCorp on its stewardship efforts, rather than on an ad hoc basis or reactively responding to queries. TCorp and the client are working together to determine the appropriate level/frequency of reporting to the client's various stakeholders.

Another client similarly does not have resources available to effectively monitor TCorp's ESG activities or performance although are kept abreast of important developments. While this client has not requested regular reporting from TCorp, it would also stand to benefit from a more structured dialogue on ESG and in particular how climate risk may impact on portfolio performance.

7.10.5 Peer Insights

TCorp's public reporting on its investment stewardship activities lags that of most peers'. Except for one peer, all are signatories to the PRI which requires the production of an annual public report on investment stewardship. There is increased scrutiny of asset owners and their sustainable investment activities. Most peers produced standalone investment stewardship reports annually with one producing information semi-annually. Annual reporting also included specific reporting on modern slavery and climate change reporting in line with the Taskforce on Climate related Financial Disclosures (TCFD).

7.10.6 Recommendations

- As seen from the review of peers, leading practice involves the publication of an annual stewardship report which demonstrates effective stewardship of assets under management. Such a report would include TCFD aligned reporting on climate change risks and opportunities.

7.11 Potential impediments to implementing leading practice

Several factors of a structural, commercial and/or cultural nature, may impede TCorp's pursuit of achieving leading practice on investment stewardship going forward. Awareness of these factors emerged in the process of conducting this Review and are discussed throughout the Report. In this section, these potential impediments are considered in aggregate. It is acknowledged that these issues are often complex and/or interrelated, however, none are assessed as being insurmountable. Rather, it is beneficial for TCorp to be cognisant of them so they can be better managed and/or mitigated.

Mandated nature of client engagements

In what is otherwise a highly competitive industry, the nature of the mandates underpinning much of TCorp's investment management business effectively provides high stability of assets under management. While this position may only marginally influence TCorp's organisational drive for continuous improvement of ESG integration, TCorp should not allow it to impact on the extent and timing of progression of its responsible investment practice and agenda in the future.

A nominal lack of competition for fund flows means TCorp is at least partly reliant on alternative, internal forces to avoid complacency and drive its ambition to develop and deliver leading investment stewardship practices for clients. As NSW Treasury has elevated its focus on sustainable finance initiatives since 2019, it is reasonable to expect greater clarity on NSW Government's expectation across a range of responsible investment issues going forward. The Board through its delegation to the BIC and the BIC's oversight responsibility in respect of all investment management activities undertaken by TCorp (which includes investment stewardship) is ultimately responsible for ensuring a culture of continuous improvement. Ensuring that policies are reviewed and updated on a regular basis is paramount to ensuring such a culture. The ESG Working Group is a critical part of the overall governance structure to assist TCorp staying abreast of the changing landscape and keeping the Board informed.

It is evident that balancing these requirements is an ongoing, intricate and multi-faceted operational challenge, the success of which can impact key client and stakeholder perceptions around the consistency and clarity of TCorp's ESG practice.

Public scrutiny

As a partner of the NSW public sector, TCorp is subject to public scrutiny on all its investment activities. However, investment stewardship is an area which is expected to garner heightened attention in the future. Often investment 'stewardship' is equated with concepts akin to ethical or values-based investing (or even "just doing the right thing") by a public unfamiliar with the crucial differences between these concepts.

For example, following the NSW Treasurer's direction in March 2022, TCorp divested Russian assets from the portfolio. These were very small exposures in the context of the overall portfolio and therefore these divestments had limited impact on performance outcomes. It may not always be the case however, that such directives would not have material consequences to TCorp's investment portfolios. This balancing-act between the expectations imposed by public scrutiny of TCorp’s portfolio versus compliance with its Investment Stewardship Beliefs and Principles could undoubtedly present as a hurdle to TCorp’s pursuit of leading practice at times. It is important that communications with stakeholders, particularly the public, are clear about what the purpose of its investment stewardship approach is (the pursuit of “sustainable investment outcomes” while being mindful of reputational issues), but perhaps more pertinently, what it is not (incorporation of all stakeholders’ “values” without consideration of other objectives including risk-adjusted financial returns).

8 Appendix

8.1 Appendix A - Peer Analysis

Key aspects of stewardship	TCorp	Peer 1	Peer 2	Peer 3	Peer 4	Peer 5	Peer 6
FUM (A$B)[1]	101	0-100	0-100	100-300	300+	0-100	0-100
Governance	• Subject to state legislation • Board of directors comprising a majority of independent directors, an independent chairman all of whom are appointed by the Treasurer • The TCorp Board is responsible for determining TCorp policies, providing direction in relation to TCorp's operations and oversight of its governance framework • The Board Investment Committee (BIC) supports the Board in discharging its investment governance responsibilities in respect of managing funds on behalf of the NSW Government All activities undertaken by TCorp in its capacity as Trustee, investment manager, advisor and/or agent on behalf of another government entity are subject to oversight by the BIC	• Subject to state legislation • Board of directors comprising a majority of independent directors, an independent chairman all of whom are appointed by the responsible minister • The Board has delegated authority to the CEO to achieve the Corporation's objectives and perform its functions • Board approves the Investment Stewardship policy	• Subject to state legislation • Board of directors comprises solely independent directors appointed by the responsible minister • Board approves the sustainable investment policy and has delegated the task of integrating ESG matters into business and investment practices to its sub-Board and management committees and to management	• Subject to government legislation • Board of directors comprises solely independent directors appointed by the responsible minister • Board approves the ESG Policy and is responsible for its oversight	• Subject to state legislation • Board of directors comprises solely independent directors appointed by responsible minister • Sustainable investment policy approved by the Board	• Subject to New Zealand Superannuation and Retirement Income Act 2001 • Operates on a commercial basis with all investment decisions made independently of the Government • Board members are appointed by the responsible Minister based on recommendations from an independent nominating committee • Board members must have investment/ financial expertise • Minister must consult with other political parties on appointments • Board approves the responsible investment policy	• The board has an independent chair, one independent director and equal representatives from employers and members • There is an Investment Committee comprising board members • The overall role of the Committee is to assist the Board in its implementation of the Fund's Investment Governance Framework, including developing, selecting, managing and monitoring the Fund's investments and investment strategies

	• The Management Investment Committee (MIC) is an advisory committee which recommends to the CIO in respect of investment management model oversight, advice, and investment approvals (including recommendations to the BIC for their approval of Investment Management decisions), investment performance reporting and periodic external management oversight						
FTE resources dedicated to stewardship	5	Not disclosed	5	4	16	5	Not disclosed
Approach to ESG integration	• Integrated approach to ESG across all stages of the investment model • Expects managers to demonstrate commitment to ESG integration and active ownership consistent with its own approach. This is included in (Investment Management Agreements (IMAs) • Expects real assets partners to understand, assess, manage and report on material ESG issues • ESG Investment Risk framework facilitates the identification, evaluation, management and reporting of exposure and impact of material ESG factors	• Integrates ESG considerations into the investment decision making process, including assessments of ESG and reputational risk issues for all new investments • Whole portfolio approach • Multi-disciplinary ESG Champions Program further integrates ESG by upskilling one representative from each asset class • Developed a Sustainable Bond Assessment Framework to ensure consistent and robust evaluation of new sustainable bond issuances • GRESB framework reporting for Property and Infrastructure	• Each investment team has established asset class specific ESG processes, guided by SI Policy • In addition to dedicated ESG team of 5, has 4 full time ESG Resources embedded in investment teams • Proprietary 'Sustainable Investment Classification Framework' to determine the Sustainable Investment classification for a given investment (from Unsustainable through to Positive Impact), intended to guide decision making and monitoring for each portfolio and asset over time	• Integrate ESG into the processes for considering investment proposals and investment manager appointments including a formal manager review framework that tailors the due diligence requirements to potential ESG risks of the particular asset class and investment strategy • For direct investments, a detailed evaluation of ESG and reputational risk factors is undertaken internally with support from external experts • Investment teams heavily involved in ESG integration	• ESG factors are incorporated into investment and asset management activities, through all stages of the investment process • Aspiration to integrate ESG into all asset classes • Use fit-for-purpose proprietary tools to expand capability, e.g., industry-level materiality framework and a public company ESG database • Informal Sustainability Virtual Team for knowledge sharing, with representatives from all investment teams	• RI integrated into investment of the Fund through the RI Framework • ESG issues incorporated into investment analysis and decision-making including pre-investment diligence and post-investment management • Consider investments for their social returns in addition to the required financial return • Developing a sustainable finance strategy, shifting focus from responsible investment to sustainable finance (assess the portfolio's impact on the environment and society)	• RI applies to all investment activities including across all investments • ESG risk is part of enterprise risk framework • "Enhancing approach to ESG integration" is a near-term focus • Seeks to be a leader in RI for each asset class for internally managed portfolios • Within infrastructure, use the SASB sector level materiality framework • Put a contractor and consultant selection protocol around fair work and the new green economy • ESG dashboard can be drilled down to individual investment level

	• Supports Total Portfolio Approach and allows consideration of ESG risk alongside other investment risk types			• The Board has integrated modern slavery into its existing ESG framework		• When considering a new investment, ESG team will work with investment teams • RI team embedded within wider investment team	• Developed analytical tools to view each manager on ESG
Oversight of external managers	• New managers assessed on stewardship credentials as part of Partner Framework. Includes questionnaires, interviews and other forms of due diligence. • Regular monitoring program for managers involving direct and regular (quarterly) engagement, including stewardship activities and initiatives • Receives regular reporting from managers on areas including application of active ownership rights, carbon reduction objectives, modern slavery risk management and other areas	• Seeks to be an active owner by periodically engaging with external fund managers on a range of ESG related matters. Further, as part of ESG integration, it seeks to monitor how external managers are considering ESG	• Sustainable investment policy states the organisation will engage with external managers directly or through collaborative engagement where required as part of ongoing monitoring. It benchmarks the performance of each manager on an ongoing basis and adjusts investments where required. • Details of process not disclosed	• A formal manager review framework is in place that tailors the due diligence requirements in line with the potential ESG risks associated with a particular asset class and investment strategy • This process is underpinned by dedicated and ongoing engagement with investment managers and supported by relevant analytics	• Due diligence questionnaire and benchmark evaluate how General Partners (GPs) and external managers integrate sustainability-related considerations into policies and processes, due diligence, monitoring and reporting, and their commitment to providing resources for those activities • Insights from the questionnaire enable the benchmarking of performance and best practices, allowing, in turn, to better engage with GPs on areas of opportunity and value creation	• Evaluate external investment managers in two ways: 1.'Conviction' - confidence in the manager's competence to execute an investment opportunity and the general quality and 'fit' of the organisation 2.Operational Due Diligence - the manager's regulatory, operational, organisational and financial processes and procedures • Each evaluation is done by separate teams with different reporting lines • If a manager does not pass the Operational Due Diligence review, they are not used. Once invested, if there are operational concerns, they are acted on immediately (including termination if appropriate)	• No disclosure of the process but part of obligation as a signatory of industry-based stewardship code which requires an oversight process
Proxy voting approach – domestic equities	• "Active Ownership Guidelines" document outlining TCorp's approach to proxy voting and has the following objectives: 1 Exercise ownership rights to protect and enhance long term value	• Has a comprehensive proxy voting policy, which provides guidance as to how the asset owner may vote • Votes meetings for companies in the ASX 300 • High level reporting of vote outcomes	• Proxy voting is delegated to external managers and monitored by the asset owner through a third-party provider	• ESG Policy contains ten corporate governance principles. • Proxy voting is undertaken in-house ~80% of domestic holdings in line with corporate governance principles and internal voting guidance	• Has comprehensive principles and guidelines which indicate how the asset owner may vote • Voting done in-house • Disclose how the asset owner intends to vote prior to each shareholder meeting	• High level voting guidelines • Uses a third-party provider for guidelines relating to climate change issues • Details on a meeting basis of proxy voting outcomes accessible on website	• Uses guidelines developed by the Australian Council of Superannuation Investors (ACSI) supplemented by a policy on Key Voting Decisions • Voting is undertaken in-house

	2 Build long term mutual beneficial relationships with investee companies 3 Identify and assess ESG related risks and opportunities 4 Inspire and secure change to address and manage ESG related risks and opportunities 5 Provide transparent reporting of impact for clients and stakeholders • The document articulates expectations of TCorp with respect to corporate governance standards • Voting of Australian listed equities undertaken inhouse • Use an external provider for proxy voting research which is used as an input into the voting process • Voting is overlayed with company engagement		• External managers are instructed to exercise proxy voting rights to vote on all resolutions (except where practical or financial impediments prevent participation) • All resolutions that fall into ESG non-negotiables list (climate change, modern slavery, tobacco etc.) are individually assessed by a central ESG team to understand whether the proposal has merit. In some instances, this team may choose to override the external managers initial vote. • High level reporting of vote outcomes	• Voting activity is linked to corporate engagement activities • Reporting of voting statistics summarised by topic on the asset owner's website • Detailed reporting of voting outcomes for domestic holdings is also provided on the asset owner's website			• Details on a meeting basis of proxy voting outcomes accessible on website
Proxy voting approach – international equities	• Voting of international equities is outsourced to a third-party service provider with option to override proxy advisory recommendation and instruct the vote	• No proxy voting policy for international equities • Voting is conducted by an external proxy voting service provider • This provider votes in accordance with its own policy on behalf of the asset owner • Voting activity is monitored by the asset owner, and they maintain authority to override these arrangements and instruct voting • High level reporting of vote outcomes	• Proxy voting is delegated to external managers and monitored by the asset owner through a third-party provider • External managers are instructed to exercise proxy voting rights to vote on all resolutions (except where practical or financial impediments prevent participation)	• Proxy voting is delegated to external manager • The approach of external managers in exercising ownership rights on behalf of the asset owner is assessed as part of the due diligence process prior to the appointment of the manager and subject to annual monitoring • Reporting of voting statistics summarised by topic on the asset owner's website	• Has comprehensive principles and guidelines which indicate how the asset owner may vote	• Outsourced to elected proxy voting agency • Details on a meeting basis of proxy voting outcomes accessible on website	• Subscribes to an external service provider • Details on a meeting basis of proxy voting outcomes accessible on website

			• All resolutions that fall into ESG non-negotiables list (climate change, modern slavery, tobacco etc.) are individually assessed by a central ESG team to understand whether the proposal has merit. In some instances, this team may choose to override our external managers initial vote. • High level reporting of vote outcomes				
Company engagement – domestic equities	• Company engagement is a key plank of TCorp's approach to investment stewardship • There is a process to identify 40-50 Australian stocks where TCorp's holding is material in terms of financial exposure • Leverage the expertise of external managers and collaborate with them on specific companies • The approach to voting and engagement by external managers is monitored to ensure alignment with TCorp policy	• Engages both directly and with a collaboration partner	• Portfolios and assets are monitored and assessed on an ongoing basis, and where required, this peer will engage with portfolio companies and external managers directly or through collaborative engagement and exercise of ownership rights	• Engage directly with key investee entities on pertinent ESG issues where this may promote better practice and yield long term value creation. This direct engagement is conducted mainly with Australian-domiciled companies, given the size and influence of this peer's domestic investments and practical considerations • Partner with investment managers on occasion to coordinate engagement activities with investee entities to ensure that a consistent and mutually reinforcing approach is communicated	• Custom engagement heatmap is a visual interface that allows analysis of the public portfolio companies, where significant positions are held, to determine and engage on: 1. Opportunities for alignment with this peer's Proxy Voting Principles and Guidelines, 2. Alignment of reporting to SASB Standards and TCFD, and 3. Sustainability-related disclosure and performance gaps based on this peer's proprietary materiality framework These public company sustainability-related insights also help better assess private assets, including ones where initial public offerings are potential exit options	• Engagement with investee companies is conducted directly and/or via domestic investment managers	• Engagement undertaken in-house as well as with a collaborative partner • Have a materiality-based process

Company engagement international equities	• Engagement with international investee companies is outsourced to a third-party service provider since July 2021	• Not disclosed	• Same for domestic engagement	• International investment managers undertake engagement on behalf of the asset owner with engagement thematics subject to annual review and discussion	• Same for domestic engagement	• Engagement with investee companies outsourced to a third-party provider, supplemented by collaborative engagements with other asset owners/ investors and occasional direct engagement	• International engagement undertaken by a third-party service provider
Reporting activities	• TCorp produces an annual report which includes a section detailing stewardship activities	• Semi-annual Responsible Investment update disclosed publicly outlining its recent approach to ESG issues such as priority ESG themes • Standalone Investment Stewardship section of Annual Report covering: 1 Approach 2 Key ESG issues	• Produces a TFCD report annually • Produces standalone section on Responsible Investment within Annual Report, covering updates on key ESG initiatives undertaken throughout the year	• In the annual report for the fund there is a section covering stewardship which provides a high-level summary of activities undertaken during the year including: 1 Approach 2 Governance 3 ESG integration 4 Climate 5 Modern slavery 6 Exclusions 7 Proxy voting and engagement 8 Industry collaboration	• Produces an annual standalone comprehensive report on sustainable investing covering: 1 Approach 2 Net zero commitment 3 Active ownership 4 Engagement and wellbeing of employees	• Produces an Annual Report for the fund and its operations including a section on stewardship • Produces an annual standalone report on climate change which is in line with the TCFD framework • Publishes equity holdings bi-annually. • Publishes a list of excluded companies under Board approved exclusion categories	• Produces an annual standalone Responsible Investment Supplement covering: 1 Commitment to responsible investment 2 Integration 3 Cultural heritage risk management 4 Modern slavery 5 Stewardship (covering engagement, voting and advocacy) 6 Climate change 7 TCFD report 8 Independent limited assurance report to the Board
Exclusions	• Directives from the Treasurer prevent investments in tobacco manufacturers (November 2012) and Russian assets (March 2022)	• Tobacco manufacturers, cluster munitions (as defined by the Criminal Code (Cth), Division 72, Subdivision C and thermal coal (companies primarily involved in the production and mining of coal related to the production of energy)	• At times specific company products or activity will be considered for exclusions in a manner that is consistent with this peer's commitment to Responsible Investing and client mandates • Securities involved in the manufacture of cluster munitions, landmines, and tobacco These exclusions are applied as far as is practically possible and do not apply to derivative indices and pooled investment vehicles	• There is a list published on the asset owner's website naming companies excluded from the portfolio. • Economic activities excluded include tobacco manufacturers and selected controversial weapon manufactures. • The asset owner's ESG Policy articulates exclusions policy and process	• As a long-term investor, it is preferred to actively engage with and attempt to influence companies when there is disagreement with a position taken by management or a board of directors of active holdings. There is the ability to be a patient provider of capital and to work with companies to bring about change. However, this asset owner may conclude not to pursue or maintain investments in companies for reasons including:	• Exclusion categories: A company may be excluded where there is belief that there is a serious breach of standards of good corporate practice and that exclusion is the right course of action. Specific industries or activities: Companies that are directly involved in the following products/ activities are excluded from the portfolio, based on specific criteria contained in this peers exclusions policy:	• Companies involved in the manufacturing of controversial weapons, and tobacco products. The Investment Committee must approve any proposed exclusions

					1. It is concluded that management's strategy or lack of engagement with ESG issues undermines the long-term sustainability of the business 2. Where brand and reputation considerations from ESG factors may generate risk impacts beyond expected risk-adjusted returns 3. Legal considerations • The policy does not apply to exposure to companies through broad based indices	Manufacture of cluster munitions Manufacture or testing of nuclear explosive devises Manufacture of anti-personnel mines Manufacture of tobacco Processing of whale meet Recreational cannabis Manufacture of civilian automatic and semi-automatic firearms • For sovereign bonds the RI Framework states that sovereign bonds will be excluded where government bonds of any nation state where there is widespread condemnation or sanctions by the international community and the peer's home country has imposed meaningful diplomatic, economic or military sanctions at that government. Currently 14 countries are on the exclusion list	
Approach to collaboration	• Will collaborate with peers to encourage development of continuing leading practice in investment stewardship • Investor Group on Climate Change (IGCC), Thinking Ahead Institute (TAI) and NSW Sustainable Finance Steering Committee	• Collaborates with other investors to influence change across the market at a systematic level. • Work to strengthen the industry as a whole through sharing information with clients, peers and industry groups.	• Active member of several industry initiatives and organisations and engages in strategic partnerships to learn about, develop and adopt best practice in sustainable investment strategies and practice	• Acquire and share knowledge and access quality investment ideas in pursuit of international best practice investment • Global network includes investment managers, investment institutions, pension funds, sovereign wealth funds etc.	• Identifies around 22 collaborative partners. • Collaborative sustainability-related efforts include: seeking to improve transparency and standards, conducting research, participating in regulatory consultations, promoting governance practices, and advocating for long-term thinking in the investment and corporate worlds	• Collaborates with a range of relevant international investor groups to stay in touch with best practices. • Regional leadership, benchmarking performance and working collaboratively with other investors to help them achieve better ESG outcomes	• Actively collaborates with a range of stakeholders and market participants to improve management of systemic ESG risks and market transformation • Plays active role in various initiatives, networks and investor groups

		• Work with investment managers, investee companies, institutional investors to capture, integrate and monitor positive ESG impacts of investments				• Collaboration through membership organisations including UN PRI, One Planet Sovereign Wealth Fund Initiative, Carbon Disclosure Project, ICGN, RIAA, IGCC • Social media collaborative engagement to engage three largest social media companies to strengthen controls to prevent the dissemination of objectionable content	
Approach to climate change	• Has developed a Climate Action Plan which includes: analysis across portfolios of climate-related risk such as climate transition risk, carbon footprint, climate policy developments, exposure to climate solutions, and climate stress testing against two scenarios; embedding climate change and just transition into it active ownership program; and engaging with managers on their climate risk management and decarbonisation plans • Introduced a carbon reduction strategy across Developed Market equity portfolio (~20% of total portfolio) with objective to be 50% less carbon intensive than the benchmark • One client has implemented a Net Zero carbon in portfolios by 2050, with TCorp's help	• Committed to achieving net zero carbon in portfolios by 2050 • Reports in line with TCFD	• Reports in line with TCFD • Net zero by 2050 portfolio commitments across various asset classes including real estate and infrastructure • Disclosed a stylised pathway for net zero by 2050 for infrastructure target with key decarbonisation drivers • Furthering work on the measurement of Scope 3 emissions from portfolios	• Climate change is a part of portfolio construction (alongside other investment risks) and integration is owned by the portfolio construction and sector teams, with Head of ESG acting as a key stakeholder giving specialised advice • Has not implemented a net zero target, but is focused on markets that are expected to generate attractive risk-adjusted returns as economies decarbonise • Supports investments in managing their climate risks via dialogue and engagement • Assesses transition and physical risk • Has not prepared a report aligned with TCFD but engages with external managers and investee companies to advocate for the adoption of TCFD	• Committed the portfolio and operations to being net zero of greenhouse gas (GHG) emissions across all scopes by 2050 • Has five climate change principles: 1. Invest for a whole economy transition required by climate change 2. Evolve our strategy as transition pathways emerge and global standards for decarbonization materialize 3. Exert influence to create value and mitigate risk 4. Support a responsible transition based on our investment beliefs and expertise 5. Report on our actions, their impacts and our portfolio emissions • Reports in line with the TCFD	• Adopted a multifaceted climate change strategy to establish resilience to climate change investment risk over the long-term. Progress is reported via annual Climate Change Report • Completed a framework for incorporating climate change considerations into asset valuations • In 2022, achieved targets of reducing carbon intensity by -40% and fossil fuel reserves by -80% by 2025 • Expanded its environmental investment strategy this year to include opportunities related to decarbonisation and climate-transforming industries, including climate technology • Committed to Net Zero Asset Owners Commitment	• Has a climate change position • Have a portfolio commitment to net zero greenhouse gas by 2050 in line with the Paris Agreement • Has published a Climate Change Roadmap showing objectives, including the commitment of 1% of FUM to a Climate Change Solutions strategy • Developing a stranded asset framework to apply across the portfolio • Developing a dashboard to monitor carbon emissions and track progress over time • Disclosing scope 3 emissions (as well as 1 & 2) across equities portfolio • Had net zero commitment independently assessed by a third party

					• "Decarbonisation investment approach" supports high emitting companies that are committed to lowering emissions • Climate change security selection framework for assessing climate change risk		

Source: Fund websites and interviews.

1. As of 30 June 2022

8.2 Appendix B - ESG Landscape Review

Executive Summary

The purpose of this report is to provide a foundational background on ESG considerations within an investment context. The principles and considerations in this report will directly inform subsequent practical recommendations to enable NSW Treasury's alignment with "leading" responsible investment practice.

Critically, each investor has both its own unique circumstances and stakeholders. ESG investing must therefore mean different things to different investors. This is a key theme informing this review, particularly that there is no one 'best practice'.

Leadership in ESG investing is most constructively expressed through a principles-led mindset whereby the investor "owns" the responsible investment approach and ensures it is fit-for-purpose based on its unique set of objectives, preferences and constraints.

- The United Nations encouraged integrating environmental, social and governance (ESG) factors into the decision-making of financial markets some 20 years ago. ESG factors are numerous, vary widely, and are continually evolving. Some are well-known (for example, occupational health & safety), while others (such as Just Transition as it relates to climate change) are more emergent, hence the understanding of their financial impact is still evolving.

- ESG investing or responsible investment has evolved and grown in importance significantly over time. The Principles for Responsible Investment[23] defines responsible investment as '…a strategy and practice to incorporate ESG factors in investment decisions and active ownership'. Responsible investing focuses on managing ESG risks and identifying ESG opportunities that can materially impact financial returns, especially over the longer term, on a risk-adjusted basis. By identifying relevant ESG-related inputs and integrating these appropriately with more traditional sources of information and data, an investor can make a more informed decision to help achieve their objectives. This approach can also mitigate broader risks such as those stemming from the increased scrutiny on how ESG risks are managed which in turn can impact the entity's reputation and indeed its 'social license to operate'.

- Taking a long-term investment approach (and eschewing short-termism) can facilitate an investor's pursuit of two fundamental objectives:
    - securing long-term financial stability for beneficiaries (e.g., pensioners who may be vulnerable to poverty in their retirement phase),
    - securing a better future through the integration of ESG risk considerations for the whole society and economy more broadly.

- ESG matters continue to rise in broader prominence across the investment industry, often generating diverse perspectives and approaches. Equally, institutional investors often have a range of stakeholders, which can go beyond immediate beneficiaries - this often requires balancing differing expectations in a commercially pragmatic, efficient and competitive manner. Being overly reactive to vocal stakeholders with specific agendas

[23] The Principles for Responsible Investment (PRI) is a UN supported global network of investors promoting sustainable investment practice, representing over 4000 investors and US$120 trillion in assets under management.

can compromise the focus on the main goal of meeting their fiduciary obligations so investors must find a way to balance these competing interests and expectations.

- A key challenge to ESG investing is the varied availability of relevant, consistent and predictive ESG data. This means the quantification of ESG returns and risks may not be easily quantifiable. Yet if not considered or managed effectively can lead to reputation damage, regulatory intervention and loss of stakeholders' trust, all of which impact financial outcomes.

- The legislative and regulatory environment can have a meaningful influence on the degree to which ESG factors impact investment performance. Investors may well seek to be leaders on responsible investment but unsupportive regulation may limit benefits for the investor. Of particular interest from an Australian perspective are developments in global policy and regulation on ESG issues. Public policy can critically influence the ability of institutional investors to generate sustainable returns and create value, the sustainability and stability of financial markets and social, environmental and economic systems. Policy engagement by institutional investors is arguably therefore a necessary extension of its responsibilities and fiduciary duties to the interests of beneficiaries. The rapid growth in number and breadth of global responsible investment policies reinforces that responsible investment is now mainstream. Equally, that policymakers and regulators understand that the role of private finance will be crucial to meet sustainability goals.

- As each regulator has a particular jurisdiction, standards and guidance may not formally apply to the NSW Government and its agencies. A common regulatory thread however is an emphasis placed on the understanding and analysis of ESG factors, establishing sound governance structures and ensuring responsible investment practice is fit-for-purpose to each investor. We consider how regulation is evolving more broadly in Australia including significant industry-level changes to behaviour and norms around ESG.

- In terms of implementation, there are various approaches for incorporating ESG into investment analysis and decision-making. This report describes the spectrum of key ESG investing approaches including ESG integration and active ownership strategies. Such approaches vary in sophistication and effectiveness across different investment styles and asset classes highlighting that ESG investing continues to evolve and mature.

- Today, the market focus emphasises the importance of investment stewardship, which requires an investor mindset as the owner-operator of the business or asset as a going concern. Examples include direct engagement with company management, collective actions among institutional investors and voting proxies at shareholder meetings. The ongoing management of ESG issues through stewardship processes is essential for institutional investors to manage long-term investment risks.

Introduction and purpose

NSW Treasury, on behalf of the State of NSW, has engaged Pru Bennett to lead a review of Government-managed funds managed by NSW Treasury Corporation (TCorp), to ensure they are invested consistently with environmental, social and governance ("ESG") principles and promote a better future. Fronter Advisors have been engaged to provide expert technical support to the review.

The review will consist of two reports: an interim report (this report), and a final report.

The purpose of this interim report is to provide a **foundational background on ESG considerations within an investment context**, consistent with Part 1 of the ESG Review's Terms of Reference. The principles and considerations in this report will directly inform the production of the final report, in which the primary focus will be to provide practical recommendations to enable NSW Treasury's alignment with "leading" responsible investment practice, per parts 2 and 3 of the Terms of Reference.

What is meant by "ESG investing"?

ESG factors

The origin story of the now-familiar acronym "ESG" is typically traced back to the 2000s, when the United Nations (UN) sought to encourage integration of environmental, social and governance factors into financial markets. In essence, the term ESG was coined at the time as an attempt to succinctly encapsulate a wide range of issues or factors that had previously not been traditionally considered a standard part of holistic financial decision-making (i.e., capital expenditure or investment trade decisions etc.).

Central to the UN's thinking was that within an interconnected global economy, decisions driving financial flows were increasingly impacting substantive environmental, social and governance issues such as climate change and inequality. Such impacts subsequently had consequences for how effectively the UN could maintain international peace, security, and cooperation. Importantly, the relationship goes both ways, in that ESG factors may also impact financial outcomes.

ESG factors are numerous, vary widely, and are continually evolving. Some, like climate change, occupational health and safety, and executive alignment (i.e., how remuneration structures incentivise corporate behaviours) are well-known terms and their ability to impact financial outcomes are better understood. Others, such as biodiversity, just transition[24] and cyber security are more emergent ESG factors, and the understanding of their financial impact is still evolving.

[24] Defined by the International Labour Organization as "greening the economy in a way that is as fair and inclusive as possible to everyone concerned, creating decent work opportunities and leaving no one behind."

Examples of ESG factors are shown in the table following.

Environmental	Social	Governance
Climate change	Human rights	Corporate culture
Resource depletion	Labour standards	Board composition
Biodiversity	Modern Slavery	Cyber Security
Waste management	Supply chain	Executive alignment
Pollution	Equality	Regulatory environment
Water resilience	Just transition	Corruption
Deforestation	Local communities	Disclosure and transparency

ESG factors often cross over "columns" (e.g., poor labour standards can readily be associated with poor corporate culture) but can also overlap with "traditional" investment factors. For example, a company which inadequately manages its waste materials may face fines and higher costs of operation down the track.

Defining ESG investing (AKA "responsible investment")

For the purposes of this review (and importantly, for simplicity), the term "ESG investing" is considered to be interchangeable with "responsible investment". We observe that the latter is a somewhat more commonly used term amongst institutional asset owners and other relevant organisations globally, but both are widely recognised.

It is an unfortunate characteristic within often jargon-heavy responsible investment industry circles that there is a less-than-ideal standardisation of terminology and definitions. Such inconsistency can result in uncertainty and confusion for investors, as well as wasted time and resources. A practical way to mitigate these impacts is for investors to adopt terminology and definitions established as industry standards by credible sources.

The Principles for Responsible Investment (PRI) is a UN supported global network of investors promoting sustainable investment practice, representing over 4,000 investors and US$120 trillion[25] in assets under management. It is therefore considered a credible source from which to take guidance on foundational responsible investment concepts.

The PRI defines responsible investment as follows:

"…**a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership**."

Note that the above definition of responsible investment in-and-of-itself does not automatically imbue any qualitative sense of how much or how well ESG factors are incorporated into the investment process. As such, it is not nearly enough to only say that ESG investing or responsible investment is being undertaken and therefore it must be "good".

To credibly assess an investor's approach when incorporating ESG factors, we must understand how the investor is going about doing so, and crucially, whether the approach is fit-for-purpose. Through the course of this report, this concept will be explored in more detail as it is central to the framing of "leading responsible investment practice".

[25] Source: https://www.unpri.org/about-us/about-the-pri

Differentiating responsible investment from ethical/values-based investing

Further to the lack of standardisation in this area, it remains common for responsible investment to be equated with terms such as:

- Ethical investing
- Values-based investing
- Socially responsible investing

For the purposes of this review, it is important to establish that these terms should not be considered interchangeable with, and moreover, have a clear sense of the key differences from, responsible investment.

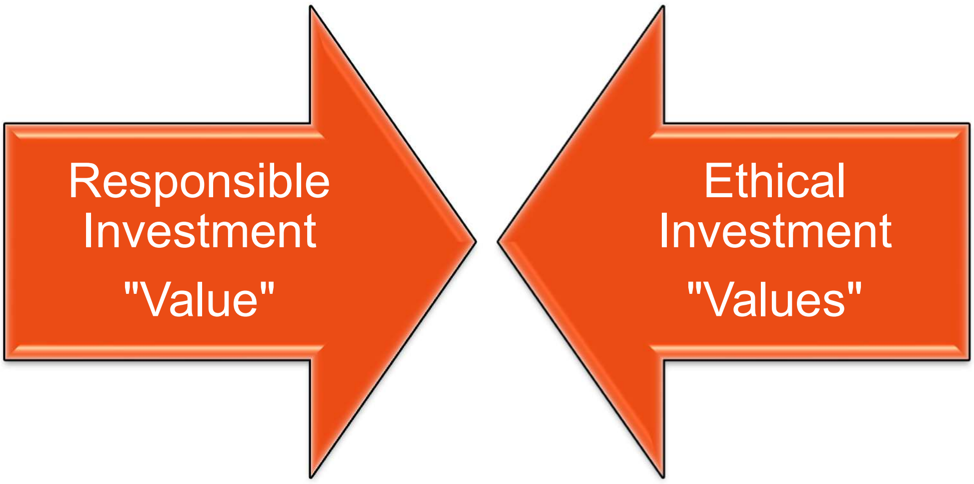
Incorporating ethical or values-based considerations into investment decisions is not a new idea. Ethical investment strategies were being offered well before the UN's push to integrate ESG factors into portfolios in the 2000s.

The general premise of ethical investing is that investment decisions reflect a specific set of values and/or beliefs (e.g., faith-based beliefs). Most commonly, such an approach would involve the exclusion of investments deemed incompatible with the values of the investor. An example may be the exclusion of securities in companies producing alcoholic beverages due to the faith-based investor's specific beliefs on alcohol. Other common historical examples of values-based exclusions or "screens" include tobacco, contraceptives, and controversial weapons.

It is understandable that ethical investing and responsible investing are often conflated in the mind of the layperson. Both investment approaches ostensibly incorporate non-traditional investment factors (i.e., ESG factors) into decision-making. The critical difference however, is that ethical investing is guided by the specific values and/or beliefs of the investor (and its stakeholders).

Notably, and despite its longer history, ethical investing never experienced the sweeping wave of industry growth such as we have seen in responsible investment over recent years. A likely reason for this is that ethical investing typically required the investor to accept some reduction in performance as a result of excluding certain investment types (e.g., alcohol and weapons companies can generate attractive investment returns). **In contrast, the case for pursuing responsible investment is centred on better managing risks and opportunities arising from ESG factors with the aim of enhancing performance outcomes (especially over the longer term), on a risk-adjusted basis**.

While highly simplistic, the graphic below provides a useful "mantra" to distinguish between these two categories of investment approach.

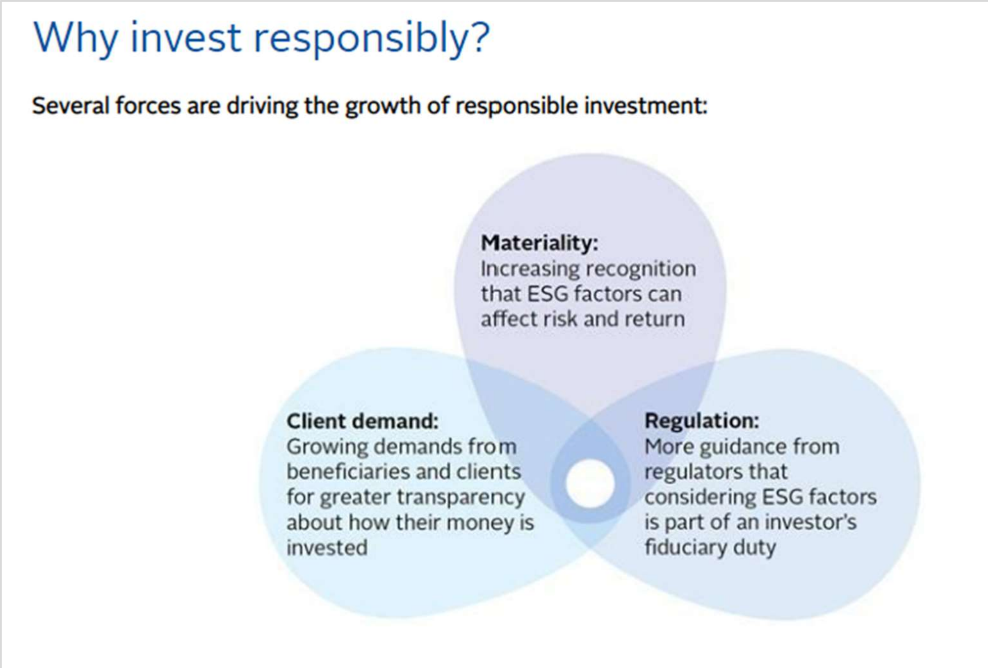


The two approaches can and very often are utilised by an investor simultaneously. Sometimes, these approaches might result in the same action. For example, some investors exclude tobacco companies on the basis that the product is misaligned with their values but equally, that the financial risks arising from exposure to that industry are too high relative to the expected return. At other times however, the investor will need to strike a balance between competing drivers of values and financial outcomes. This may result in one course of action being taken over another or perhaps a blended solution incorporating elements of both drivers. What is important is that the investor will need to determine this through careful consideration, and this is often not straightforward. Going through this process however, is vital to ensure that there is clarity of purpose and an ability to measure success.

Why ESG matters

Investors are required to make decisions, and they base those decisions on information and data. Generally, the better the information and data, the higher the likelihood the investor is to make decisions that achieve their desired outcomes. ESG factors are therefore important because they are sources of information and data that may impact the long-term value of a security. By identifying relevant ESG-related inputs and integrating these in an appropriate fashion together with more traditional sources of information and data, an investor can make a more informed decision to help achieve their objectives.

It is also important to acknowledge that investors exist in the real world and almost all are subject to forces beyond those directly related to the portfolio securities in which they invest. These additional forces can and do have material financial consequences for the investor and the way they might address ESG factors. The following graphic from PRI highlights the three forces driving growth in investor focus on responsible investment.



Source: PRI

In recent years, investors have experienced rising expectations and action from a wide range of stakeholders in terms of how ESG factors are being managed. Examples include:

- Rest Super: member-led litigation against the fund alleging a breach of obligations with respect to climate change risk management
- HESTA: member-led media campaign threatening to switch funds unless HESTA divests its fossil fuel holdings
- QSuper/SunSuper (now Australian Retirement Trust): member-led engagement accusing the funds of lagging peers on climate change risk management and transparency
- APRA: prudential regulator publishes CPG229 guidance for regulated entities on managing climate change financial risk

- ASIC: consumer regulator publishes INFO 271 guidance for financial entities on avoiding greenwashing risk[26]

It is important for investors to be cognisant of such forces as increased scrutiny on how ESG risks are managed can and do impact their reputation and “social licence to operate”[27]. Of course, reputational damage can ultimately result in a negative financial impact beyond the immediate portfolio (potentially even the viability of the investor as a going concern in extreme cases). Hence, the importance of an investor clearly understanding which of the above external forces are most material to achieving its wider financial outcomes and ensuring a strategy is in place to address these.

Addressing such forces does not necessarily mean acceding to every stakeholder’s specific demand as this is entirely unrealistic for any investor of scale[28]. **Each investor has finite resources so should look to apply a lens of materiality when considering how to integrate ESG factors. That is, only those drivers that are demonstrably substantive to meeting objectives should warrant specific action to manage**. While it is fair to say that it makes it easier to manage an issue if it can be measured, it is not also the case that just because something can be measured, that it has to be managed.

Critically then, each investor has its own unique circumstances, as well as its own unique set of stakeholders. This means ESG investing, or responsible investment must therefore mean different things to different investors. This is a key theme informing this review, particularly that there is no one “best practice” with respect to responsible investment. Just in the same way as investors consider financial data and information in different ways, there are no fixed rules for incorporating ESG data and information into the investment decision making process. Rather, leadership in this area must start by looking inward and identifying what is most material.

[26] 'Greenwashing' is the practice of misrepresenting the extent to which a financial product or investment strategy is environmentally friendly, sustainable or ethical, ASIC INFO271 (June 2022)

[27] The ongoing approval of an entity to operate within a community conferred by its broader network of stakeholders

[28] Institutional investors represent the interests of a wide range of beneficiaries and are therefore subject to a wide range of views from various stakeholders

Practical considerations regarding responsible investment

Role in long-term investment decision-making

Long-term nature of ESG risks

ESG issues such as climate change, biodiversity, scarcity of natural resources, human rights and wildlife extinction are examples of environmental and societal risks deriving from human business activities. In many cases, we are still **yet to see the worst of the negative impacts arising from such activities**, which can pose a challenge when trying to address them now, such that we “meet the needs of the present without compromising the ability of future generations to meet their own”[29]. In this way, ESG factors are often differentiated from more traditional, financial market-based risks.

For very short-term investors (e.g., high frequency traders), ESG risks may be of limited materiality relative to daily stock prices or company announcements. However, for institutional investors with long-term investment horizons such as pension funds, the long-term nature of such ESG risks means they cannot be ignored and must be managed on an ongoing basis.

Such ESG risks are becoming substantial, longer term, global threats affecting the broader economy, environment, and population. The field of ESG issues in investments continues to develop and evolve, as does investor awareness, knowledge, and practices on the ground. Institutional investors, regulators, Non-Government Organisations (NGOs) and wider communities now recognise that such risks, when not managed, can pose material financial and reputational risks. When making financial decisions therefore, investors seek information on organisations’ exposure to these risks in addition to understanding the mitigation or adaptation strategies those organisations intend to pursue. Considering ESG pragmatically and systematically provides investors with another “lens” through which to view, understand, and assess investee companies and investment managers.

Today, the focus at a market level has moved to emphasise the importance of **investment stewardship**, within which ESG is one area of activity. Rather than seeking to “get away” from ESG risks, stewardship instead requires the investor to approach its invested positions with a mindset as if they were the owner-operator of the business or asset as a going concern. It can take the form of direct engagement with company management, collective actions among institutional investors and voting proxies at shareholder meetings. Ongoing oversight of these ESG issues as part of investment management and decision-making processes is essential for institutional investors to manage long-term investment risks.

Short-termism in investments

Short-termism is the behavioural tendency to excessively focus on short-term results at the expense of long-term interests. It remains a common characteristic of the institutional investment industry. Individual incentive bonuses based on short-term financial performance and primarily drive the business model of mainstream investment managers who manage funds on behalf of asset owners (who in turn, have a strong desire to outperform their peers and meet client expectations). As a result, short-term measures of success (e.g., quarterly performance data) remain industry standard and investment manager behaviour will often tend to align to this cycle with less attention paid to longer term outcomes.

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[29] Brundtland Commission definition of sustainable development (1987)

Short-termism can be difficult to reconcile with the purpose of entities like pension funds and government organisations seeking to generate long-term performance for their beneficiaries. It is ultimately those beneficiaries who are likely to be impacted by the long-term ESG risks over a multi-generational payout.

Reflecting on the previously mentioned relationship between financial decisions and ESG factors, eschewing short-termism and taking a long-term investment approach can facilitate an investor's pursuit of two fundamental objectives being:

1. securing long-term financial stability for its beneficiaries (e.g., pensioners who may be vulnerable to poverty in their retirement phase); and

2. securing a better future through the integration of ESG risk considerations for the whole society and economy more broadly.

Building further on the idea of stewardship, engagement with investee companies can improve disclosures and risk management practices related to ESG factors and enhance financial outcomes. But this process typically requires many years of constructive engagement to achieve a meaningful outcome. The frequent turnover of traded assets that is more commonly associated with short termism, often underpinned by speculative investment models, can compromise the stewardship function and limit progress on ESG factors.

The 2019 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry highlighted how institutional investors are now expected to have a role as guardians of corporate governance through their stewardship function with a duty of care to their members. It also raised questions about the desire of investment managers and other institutional investors to challenge the business and investment models that fail to incorporate ESG risk considerations to protect the long-term benefits of their members on whose behalf they act.

Using ESG approaches to improve risk-adjusted returns

Increasing materiality of ESG in investment performance

ESG investing is premised on the central idea that firms that understand their exposure to ESG risks and manage such risks in a transparent manner are better positioned to withstand emerging risks challenges and capitalise on new opportunities. For example, a company with strong management of ESG factors may also provide a good indication of the quality of its board and management, and its governance approach, which may be difficult to observe directly. In comparison, companies with a poor ESG management control and compliance record may face a greater risk of financial uncertainty, regulatory actions, and litigation risk.

There has been a growing confluence of factors when it comes to considering ESG as part of investments, providing a "tailwind" for investors that pursue responsible investment:

- Recent events have seen the continued rise in prominence of ESG issues. For example, bushfires and floods, COVID-19, and recent wars have sharpened the focus on the management of ESG matters
- The emergence of a virtuous cycle whereby ESG considerations are increasingly important across economies/societies, and therefore has a tangible value which creates new market opportunities. This, in turn, raises awareness and a high level of interest from the general public, governments, corporates and finally, investors who then proceed to make better-informed capital allocation decisions. These dynamics over the longer-term are expected to result in greater divergence in relative financial outcomes between investors.

Therefore, considering material ESG risks as part of the investment decision-making process provides an investor with another lens through which to view, understand and assess investee companies and investment managers in order to manage risks and identify emerging opportunities. Ultimately, when done well, this is expected to improve risk-adjusted returns and the broader environment appears to be more conducive to this in the future.

Key challenges

Not everything that matters can be measured

There is no doubt that good quantitative analysis is a core skillset for institutional investors. The quantification of potential returns and risks permits the investor to make better decisions on whether a given action has a sufficiently high probability of meeting the desired risk-adjusted return outcome. As ESG has become a more prominent investment consideration, it is understandable that investors would want, and even expect, the same rigorous quantitative support on ESG factors to support their decision-making. However, many ESG-related considerations are not easily quantifiable. This can be and is a source of frustration for investors used to the comfort that quantitative analysis can provide. However, these ESG factors, when not considered and managed effectively by an investee company, can lead to reputation damage, regulatory intervention and loss of stakeholders' trust, all of which impact financial outcomes. As such, in certain circumstances, investors must find alternative ways to "gain comfort" that ESG risk exposures are being appropriately managed. Often, this boils down to more qualitatively led analysis such as direct engagement with investee company management or investment managers. By triangulating insights gained from both available quantitative and qualitative analyses, the investor can build a holistic investment case reflecting the connection between financial and non-financial risk management and disclosures.

Here, we provide some recent case study snapshots which illustrate how these broader, less quantifiable but nonetheless crucial dynamics on ESG have an increasingly important causal relationship with financial outcomes.

Case study 1: Rio Tinto - Cultural heritage and engagement with indigenous people

In May 2020, Rio Tinto's destruction of the Juukan George, two 46,000-year-old caves with significant aboriginal archaeological culture heritage, is an example of failure in governance.

Rio Tinto was given permission to blast the caves under section 18 of the *Aboriginal Heritage Act 1972* (WA), which allows for ministerial approval of the destruction of places with First Nations' cultural significance with or without condition as an exception.

This incident led to a parliamentary inquiry and long-lasting reputation damage to the company. Three Rio Tinto executives, including the CEO, were forced to leave the company by the shareholders for accountability.

A Federal inquiry into the causes of the destruction published in its report found that Rio Tinto's role in the destruction of the Juukan George was 'inexcusable', highlighting that just because something is legal, it is not always the right thing to do.

Case study 2: AMP Capital - Management of sexual harassment complaint

In 2020, a sexual harassment matter at AMP Capital demonstrated that investors and shareholders now demand higher standards when Directors fail to adequately consider ESG issues as part of their corporate governance. The cultural issue became a sharp focus for investors after an AMP Capital executive was promoted despite playing a role in the harassment of a female executive that resulted in substantial financial penalties.

As a result:

- The collective investors' actions in an extraordinary call to challenge the promotion resulted in changes to the Board where the Chair resigned less than two years into his appointment, and the executive was demoted back into his previous role.

- AMP Capital acknowledged that the organisation must consider significant changes to address investors' concerns and reset company culture coupled with the need to rebuild public confidence.

- AMP shares fell approximately 40% or $2.8 billion in market capitalisation over the period the matter played out. On this basis, it is reasonable to conclude the matter had some influence on the financial performance of the company.

For investors, case studies such as these can help inform forward-looking approaches to identifying ESG risks and taking action to manage these prior to the financial impact detracting value from the investment even when they are not strongly "data-led".

Data availability

Traditional financial "signals" that feed into quantitative investment models are well-established with a long history to support short and long-term forecasting. In contrast, many ESG-related signals are comparatively new, inconsistent, and still evolving. As such, they tend to have a higher level of uncertainty with respect to their "predictive power". For example, no one yet knows precisely what a low-carbon world would look like and how the market will evolve in response to regulatory and policy developments. While it is intuitively reasonable to expect, say, carbon price levels to have some relationship to how certain industries will perform with that backdrop, there is little in the way of past precedent on which to rely when making trades.

Notwithstanding that mainstream and specialised financial data providers have been the key players in increasing the availability of ESG data, the industry is still evolving and most problematically, can be inconsistent between providers. Data on 'E' factors is also more readily available at present compared to the 'S' and 'G' factors. It is expected that the consistency and reliability of the data will improve in the coming years as the consensus around these dimensions grows but it currently remains a challenge.

Integration of ESG at strategic level

It is reasonable to suggest that due to the nature of ESG factors, managing ESG risks (and identifying ESG opportunities) has, to date, been most readily applied at the granular, security level. While it also reasonable to expect that ESG risks should inform investment decisions at a more strategic level, modelling these remains challenging due to the dynamics between the economic variables and effects on the economic activities with the numerous dependencies. For example, it is intuitive that climate change will impact the long-term performance of certain asset classes more or less than others. But landing on reliable analysis that permits robust decision making at the strategic asset allocation level is difficult at present.

Investment manager BlackRock estimates a cumulative loss in economic output of about 25% over the next two decades in the absence of robust climate change mitigation measures.[30] This highlights the need for investors to consider the rapidly reshaping global economy at the strategic level and account for expected dynamics such as (1) differentiated returns and discount rates used to value securities, and (2) increased capital flows towards better managed assets from an ESG perspective attracting a premium.

It is observed that in Australia, current asset allocations have yet to change meaningfully due to ESG considerations.

Voluntary ESG disclosures

The legislative and regulatory environment can have a meaningful influence on the degree to which ESG factors impact investment performance. Investors may well seek to be "leaders" on responsible investment but if regulations are not yet supportive of this effort, there may be more limited dividends for the investor. For example, investing in domestic electric vehicle charging infrastructure would be expected to have more attractive prospects if there was regulation in place or plans for imminent phase out petrol vehicles.

It can be challenging for institutional investors to allocate sufficient resources to manage these ESG risks in a world of competing priorities and limited regulatory support. In this context, the current, primarily voluntary nature of ESG risk disclosures and management approaches can lead to "adoption gaps", even for high-risk regions (e.g., developing markets) and sectors (e.g., commodities). More prescribed and meaningful disclosure of these risks would be a fundamental tailwind for regulators to better inform supervision of markets and support financial stability by improving the visibility of the system-wide implications of long-term ESG risks for all participants. An example of this is the recently established International Sustainability Standards Board (ISSB) which aims to deliver a comprehensive global baseline of sustainability disclosure standards.

Balancing different expectations

As noted previously, institutional investors often have a range of stakeholders to whom they are answerable. **These stakeholders go beyond the immediate beneficiaries, and this often requires balancing differing expectations in a commercially pragmatic, efficient and competitive manner.** ESG matters continue to rise in broader prominence across the investment industry, often generating diverse perspectives and approaches.

It is constructive for investors to proactively engage with their stakeholders regarding ESG matters, seeking to educate and involve them on issues that may be of specific interest in order to deliver sustainable long-term returns. ESG factors do not drive investment decision-making processes but rather are input into them. Long-term investors seek to influence positive change in the ESG risk management in their underlying investments where appropriate and feasible. **Being overly reactive to vocal stakeholders with specific agendas can compromise the focus on the main goal of meeting their fiduciary**

[30] BlackRock, *Portfolio Perspectives: Climate change – Turning investment risk into opportunity, Launching our climate-aware capital market assumptions and strategic portfolios* (February 2021)

obligations so investors must find a way to balance these competing interests and expectations.

Differences across asset classes

While it may be reasonably clear that the financial performance of companies (and therefore the equity and debt securities issued by those companies) are increasingly being impacted by ESG factors, diversified investment portfolios often include exposures to other asset classes. Managing ESG risks within different asset classes entails different approaches for various reasons, such as data availability, market perception and regulatory environment. In some asset classes like equities, corporate debt, direct property and infrastructure, investment managers have made significant strides to address ESG over recent years.

For other asset classes, consideration of ESG risks remains reasonably nascent and often problematic, including sovereign bonds, foreign currency, hedge funds and derivative-based strategies. ESG-related data and disclosures in these sectors is significantly more limited relative to listed equities making the determination of risk materiality more difficult. It can therefore present a challenge to investors seeking to manage ESG factors across the entirety of their multi-sector portfolios in the near-term. While progress is being made in addressing these challenges, there may be some ESG risk exposures that will only be realistically dealt with in the future.

Position of financial regulators (including APRA, ASIC and RBA)

As highlighted earlier, regulation is a significant driver of increased focus on ESG investing. Furthermore, the nature of the regulatory backdrop is important for investors to take into account when implementing a responsible investment approach. In this section, we look at the positioning of the key financial regulators in Australia with respect to responsible investment and the practical considerations arising for investors as a result.

Each regulator has a particular jurisdiction meaning that the standards and guidance arising may not formally apply to the NSW Government and its agencies. It is however, instructive to consider how regulation is evolving more broadly in Australia as it can drive significant industry-level changes to behaviour and norms around ESG.

The Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA) view climate change risk as being closely related to their respective mandates to implement monetary policy supporting price stability, and the stability of the Australian financial system more broadly. Hence ESG-related regulatory development by APRA and the RBA has primarily occurred on climate change to this point. The two regulators work closely with the Australian Securities Commission (ASIC) and the Commonwealth Government Treasury in doing so, collectively comprising the Australian Council of Financial Regulators agencies.

A notable point is that through the various standards and guidance provided by these regulators, a common thread is the emphasis they place on understanding and analysis of ESG factors, establishing sound governance structures and ensuring responsible investment practice is fit-for-purpose to each investor.

APRA

In its role as the prudential regulator, APRA has arguably contributed the most to Australian regulation and guidance regarding responsible investment for financial institutions. In 2017, APRA Executive Board member Geoff Summerhayes stressed that climate change risks are likely to have material, financial implications that should be carefully considered by asset owners and managers[31], foreshadowing APRA's strong intention to regulate ESG risk disclosures as part of financial institutions that has played out in recent years.

APRA's older *Prudential Practice Guide (SPG) 530 Investment Governance* aimed to assist registrable superannuation entity (RSE) licensees in complying with the formulation and implementation of investment strategy, including in relation to ESG considerations. Although SPG 530 is a guide only and not enforceable, its principles do articulate APRA's standard for 'industry best practice' on investment governance as a whole, inclusive of leading governance approaches that also may be applicable to a wider universe of non-superannuation financial institutions. Under "Investment objectives", paragraphs 34 to 36 of SPG 530 provides the following on ESG issues:

- An RSE licensee may take additional factors into account where there is not conflict with other requirements, including **the requirement to act in the best interests of the**

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[31] Speech, APRA Executive Board Member Geoff Summerhayes, "Australia's new horizon: Climate change challenges and prudential risk", February 2017

beneficiaries, such as offering an 'ethical' investment option[32] which typically has an added focus on ESG considerations.

- While ESG considerations may not be readily quantifiable in financial terms, APRA expects an RSE licensee would be able to **demonstrate a reasoned basis and appropriate analysis** to support the formulation of an investment strategy that has an ESG focus.

- A prudent RSE licensee would be mindful of exposing the interests of beneficiaries to undue risk stemming from matters such as a lack of diversification, where investment in some industries is excluded, or a positive weighting is placed on certain nonfinancial factors because of ESG considerations.

As shown, APRA places clear emphasis on ensuring the interests of beneficiaries are not compromised by consideration of ESG, reflecting the somewhat dated nature of SPG 530. Positively though, it acknowledges that each investor has a unique combination of objectives, preferences, values, and constraints and these are implemented differently by each investor. What is "fit-for-purpose" for one investor, may not be the right fit for another, and this applies to the context of ESG integration into investment decision making too.

More recently, a *Prudential Practice Guide (CPG) 229 Climate Change Financial Risks* (2021) was introduced. It was developed to provide greater clarity for APRA-regulated institutions of the regulator's expectations, and examples of better industry practices in managing climate-related financial risks, ultimately to assist them to comply with their broader risk management and governance requirements. It shows a marked increase in sophistication of APRA's approach from SPG 530.

The guide covers APRA's view of better practice in governance, risk management, scenario analysis and disclosures. It is flexible in encouraging each institution to adopt an approach that is appropriate for its size, customer base and business strategy. Guidance from CPG 229 includes:

- Climate risks should be understood and managed within an institution's overall business strategy and risk appetite appropriate to its size, business mix and complexity.
- A board should be able to identify, measure and evidence its ongoing oversight of these risks.
- A prudent institution may wish to set climate-related targets for its activities and develop capabilities in scenario analysis and stress testing.

APRA will shortly commence a climate risk survey of medium-to-large, regulated entities, asking them to self-assess how their current practices align to APRA's guidance on climate change. Participation in the survey is voluntary and APRA will incorporate insights from this into its supervisory approaches to addressing climate change financial risks.

Further, following the release of proposed revisions to SPS 530 in July 2022, various participants sought clarification around the management of ESG risk factors. In response, APRA acknowledged that ESG financial risk considerations extend beyond climate change (CPG 229) and intends to issue draft guidance on how a prudent RSE licensee can

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[32] According to APRA, typically characterised by an added focus or integration on ESG considerations, into the formulation of the investment strategy and supporting analysis.

demonstrate it has a clear understanding of ESG risks, reflects ESG considerations in the investment strategy and manages material ESG risks.

Finally, APRA is leading a climate vulnerability assessment (CVA) exercise with the five largest Australian banks, using as its basis the Network for Greening the Financial System (NGFS) scenarios adapted for Australian circumstances. The three objectives of the CVA are to assess potential financial exposure to climate risk; to understand how banks may adjust business models and implement management actions in response to different scenarios; and to foster improvement in climate risk management capabilities.

The NGFS is a voluntary group of Central Banks and Supervisors, that contribute to the development of environment and climate risk management in the financial sector to support the transition towards a sustainable economy. APRA, alongside the RBA, is among more than 50 international members of the NGFS that have made public statements on the important role of central banks and financial regulators in mitigating the physical, transition and liability risks of climate change in the finance sector.

RBA

The RBA's position on responsible investment to date manifests predominantly on climate change, given its systemic risks. In supporting the NGFS, the RBA is assisting APRA with the climate vulnerability assessment (CVA) exercise by participating in the steering committee and in the modelling working group.

The RBA has also committed to monitor the implications of climate change for the economy and transmission of monetary policy. Further, it has committed to bridging data gaps in relation to climate risks, in order to improve the ability of regulatory authorities and financial institutions to assess climate-related risks and opportunities.

Finally, along with APRA, the RBA will continue to draw attention to the financial stability and macroeconomic consequences of climate change through speeches and by publishing analytical work on climate change, as well as sharing knowledge based on their experience in climate-related topics with other central banks and regulatory agencies.

As part of this effort to raise awareness, former Deputy Governor of the RBA, Guy Debelle, gave a speech titled "Climate Change and the Economy" to highlight the impact of climate change on the objectives of monetary policy and financial stability, and challenges that arise in thinking about climate change[33].

ASIC

ASIC closely monitors developments in climate and sustainability reporting in Australia and internationally. It is a member of the IOSCO Sustainability Technical Experts Group, which works with the Technical Readiness Working Group (TRWG) to provide input to the International Sustainability Standards Board (ISSB). Domestically, ASIC is a member of the Council of Financial Regulators Climate Working Group.

[33] Speech by Guy Debelle, Deputy Governor, Reserve Bank of Australia, *"Climate Change and the Economy"*, March 2019.

In a speech in October 2021, ASIC Commissioner Sean Hughes reaffirmed the stance of ASIC commissioners on climate change-related disclosure and governance. The four core messages on climate change-related matters remain unchanged from those set out in 2018 under ASIC Report 593:

1. Directors and officers of listed companies need to understand and continually reassess existing and emerging risks that may be appliable to the company's business, including both physical and transitional climate risk.

2. Boards should develop and maintain strong and effective corporate governance to assess, manage and disclose climate risks and opportunities.

3. Directors of listed companies should carefully consider the statutory requirements and ensure material climate-related disclosures have been made and updated.

4. ASIC recommends listed companies with material exposure to climate risk consider reporting under the Task Force on Climate-related Financial Disclosures (TCFD) framework.

ASIC notably has placed an emphasis on governance. Climate change poses systematic risks, with these risks being dynamic, not static. Governance embeds the organisational structure and culture necessary to respond to and operate in such an environment.

In line with financial regulators globally, in 2021 ASIC announced it would conduct a review of "greenwashing" among both listed corporations and issuers of financial products. According to ASIC, greenwashing can distort investors' decision-making ability and hence poses a threat to a fair and efficient financial system.

In June 2022, ASIC released an information sheet, *INFO 271: How to avoid greenwashing when offering or promoting sustainability-related products*[34], which focuses on sustainability-related products issued by managed funds and superannuation funds. It reminds issuers of their current regulatory obligations when promoting their products, such as prohibitions against misleading and deceptive statements and conduct. In line with its advice to listed companies, ASIC encourages voluntary disclosure in line with the recommendations by the TCFD and for issuers to keep up to date with developments in the regulatory setting. Finally, INFO 271 sets out helpful questions which funds should consider when preparing communications and disclosures about their products.

ASIC is expected to provide further detail and guidance on greenwashing and sustainability-related disclosure in future, and overall, appears to be lifting the standard on such disclosures within Australia.

Council of Financial Regulators (CFR) Climate Working Group

CFR's Climate Working Group brings APRA, ASIC, RBA, and Treasury together and reports to the CFR as needed on international developments, regulatory gaps, and risks to the financial system in relation to climate change. In 2020/2021, the working group continued work in several areas, including measuring the exposure of financial institutions and the financial system to climate relates risks using scenario analysis, and monitoring the

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[34] ASIC, Information Sheet (INFO 271), "*How to avoid greenwashing when offering or promoting sustainability-related products*", June 2022.

development of taxonomies used to define what is a ‘sustainable’ activity or financial product.

In the near term, the working group is planning to complete the CVA and consider next steps to take in measuring and understanding the climate risk of regulated entities, strengthen the building blocks that will be needed to facilitate high-quality and comparable climate-related disclosures, and continue to examine the implications of emerging sustainable finance taxonomies.

Looking ahead, the working group will consider international approaches and how these could be adapted to meet Australian needs. All these regulators are involved in various approaches to achieve the common goal of a more economically sustainable future.

ESG investing approaches (and their limitations)

As with financial data and information, there are various approaches for incorporating ESG into investment analysis and decision-making. Investors will almost always employ multiple approaches within and across different asset classes. Importantly, no one approach is inherently superior to another; rather, the choice of approach is highly dependent on the needs of the individual investor, in turn depending on several factors, including the investor’s:

- investment objectives, including risk and return objectives
- investment time horizon
- responsible investment objectives
- social, ethical, and other values
- stakeholders’ requirements, particularly those of beneficiaries
- level of access to investment products aligned with the investor’s above requirements and other constraints such as size

In the following sections we explain the key ESG investing approaches. These are often thought of as a spectrum, from traditional investing with ESG integration, through to approaches with a stronger focus on real-world, sustainable outcomes. The following diagram outlines how the approaches differ by impact on performance and how the portfolio is constructed, noting this should be considered a guide only.

Responsible investment approach spectrum

Traditional investment — Philanthropy

Approach	ESG integration	Exclusions	Positive screening	Active ownership	Thematic investing	Impact investing
Main focus	Financial risk-adjusted returns, incorporating ESG factors into analysis and decision making	Avoiding certain sectors, businesses, activities, countries in line with values or ESG assessment	Tilting towards certain sectors, businesses, activities, countries in line with values or ESG assessment	Using ownership stake to influence investment outcomes	Targeting certain themes such as climate transition	Dual focus of financial risk-adjusted returns and sustainable outcomes
Impact on financial performance	Likely additive	Additive or detractive	Additive or detractive	Likely additive	Additive or detractive	Dependent on objectives. More likely detractive than additive
How approach impacts portfolio construction	Can range from immaterial to material, depending on emphasis placed on ESG factors	Can range from immaterial to material, depending on risk limits in place	Can range from immaterial to material, depending on risk limits in place	Typically nil to small impact. Can result in divestments or tilting as a result of active ownership efforts	Can range from immaterial to material, depending on allocation to thematic investments	Can range from immaterial to material, depending on allocation to thematic investments

Source: Frontier. Adapted from RIAA's responsible investment spectrum, as adapted from frameworks developed by Bridges Fund Management, Sonen Capital and Impact Management Project.

ESG Integration

The Responsible Investment Association of Australasia (RIAA) defines ESG integration as "explicitly including ESG risks and opportunities into financial analysis and investment decisions based on a systematic process and appropriate research sources."[35] This approach is often cited as the most commonly used responsible investing approach by investors. ESG integration is the approach most similar to traditional investing, in that the focus is wholly on the identification, assessment and selection of securities or assets for inclusion in a portfolio.

Here, ESG factors provide additional information which investors can utilise when assessing an investment's risks and opportunities. For this reason, it is believed to enhance risk-adjusted returns in that it enables investors to make better informed investment decisions. Investment manager AllianceBernstein, for example, describe their reason for implementing ESG integration below:

"ESG risks are financial risks. With strong ESG research, engagement and integration, we're better able to assess risks and identify opportunities—the path to improved investment decision-making."

Ways in which investors integrate ESG are wide ranging and account for the investor's objectives as well as the data available. ESG can be integrated via qualitative analysis such as evaluating a company's management team on ESG knowledge. Quantitative analysis can also incorporate ESG, via either financial statement analysis or valuation models. An example of the former includes incorporating expected legal costs from environmental damage into financial statement analysis when assessing a certain stock. Alternatively, the discount rate used in valuation models can be modified for an assumed systemic impact of climate change.

Investment strategies which integrate ESG factors can and do include investments which some may deem "unfriendly" from an ethical perspective. For example, an investment manager may invest in a high greenhouse gas-emitting company on the basis that its aggregate ESG risks have been appropriately priced in by the market, in line with the investment manager's process. Contrarily, while investors who integrate ESG do not necessarily employ a "divestments" approach, an investor may still divest if it perceives that its ESG risks are unlikely to be sufficiently rewarded.

Exclusions ("negative screening")

An exclusions approach, also known as "negative screening", is described by the RIAA as "the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria, such as what goods and services a company produces, or how inadequate a company or country response is to emergent risks."[36] The ESG criteria may be informed by ESG assessment (for example, assessing that companies owning thermal coal assets will eventually suffer financially due to the transition to a low carbon economy), or values (such as believing tobacco is a social harm).

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[35] Responsible Investment Association Australasia, "*Responsible Investment Explained*", retrieved July 2022
[36] ibid

Exclusions can be applied on the above basis in their entirety (i.e., no exposure at all) or by using thresholds such as a certain percentage of a company's revenues or profits derived from the undesirable activity. The use of thresholds will mean less of the investment is excluded as it limits the proportion of the portfolio companies which are eligible to be excluded, and therefore there will be less of an impact on benchmark-relative portfolio performance. However, it results in a less strict form of exclusions because the portfolio will retain a certain proportion (but not all) of the targeted factor. In November 2012, the NSW Government announced it would take immediate steps to ban all tobacco investments across government, including indirect and direct investments. The decision was made as part of reinforcing the NSW Government's "strong anti-smoking stance"[37].

An important consideration when applying an exclusions approach is that the investor does not have an ownership stake in the company it excludes, and therefore no "seat at the table" to influence the company to make positive changes. Company management has little or no reason or motivation to engage with non-shareholders without a proxy vote. Further, the investor misses out on any uplift in the company's ESG integration over time, driven either by the company itself or as influenced by other investors.

A further implication of using exclusions as part of ESG investing is that if the list of excluded companies is material it can have a meaningful impact on relative performance versus a portfolio without exclusions such as a standard, market capitalisation-based index (this relativity is referred to as "tracking error"). This is pertinent when portfolio performance is assessed against such indices, and the impact can be positive or negative. For example, a portfolio which excludes certain energy stocks will perform well versus a broad-based index when energy stocks perform poorly. However, in periods such as the 2022 financial year, portfolios which had such an exclusion suffered versus the benchmark, as energy stocks rallied.

Regarding implementation, investors may choose to apply exclusions and negative screening to their portfolio directly, or instead, track a benchmark which reflects the desired exclusions. There is an ever-growing list of indices which apply exclusions to standard indices, such as the MSCI All Country World (ACWI) ESG Screened Index, which is based on the standard MSCI ACWI but excludes companies which are associated with controversial weapons, tobacco, and other business activities.

Positive screening

Positive screening is "intentionally tilting a proportion of a portfolio towards solutions; or targeting companies or industries assessed to have better ESG performance relative to benchmarks or peers" according to the RIAA[38]. This approach can be considered the opposite to negative screening, with either values or ESG assessment driving whether an investment is included in the portfolio. Like negative screening, thresholds on revenue or some other measure may also be used in constructing the portfolio.

A sub-set of positive screening is (somewhat ambitiously) called "best-in-class screening". This is where investments are scored on ESG, and only those with superior scores versus peers are included in the portfolio. This approach to positive screening can help mitigate the impact of using more rigid screens that may exclude all holdings in a particular sector

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[37] Media Release, Mike Baird MP, Jillian Skinner, MP, NSW Government, "*NSW Government Bans all Tobacco Investments*", November 2012.

[38] Responsible Investment Association Australasia, "*Responsible Investment Explained*", retrieved July 2022

regardless of the relativities between the underlying companies. For example, an international equities manager may include all industries in its portfolio from the benchmark, but only invest in the top 60% of companies by ESG score within each industry.

Engagement and active ownership

Active ownership is a core element of the investment stewardship concept noted previously. It is the execution of "…shareholder rights and fulfilling fiduciary duties to signal desired corporate behaviours" according to the RIAA[39]. Active ownership includes engagement and voting at shareholder meetings. Active ownership has been rising in importance across institutional investors' responsible investment efforts, with 80% of investors expecting it to be at the centre, or a significant factor, in investment policies in the next two years[40].

Active ownership is a particularly critical ESG approach for investors in **passive investment products**. Such products track a pre-defined reference index, with no or limited discretion to deviate from that index and hence, cannot reflect ESG considerations into portfolio construction decisions through over or underweight positions. Historically, some passive fund managers used this as a reason to not consider ESG as part of their investment activities at all. However, it has now become an investor expectation that passive fund managers use their often significant and stable ownership rights to undertake constructive engagement with investee companies and participate in the proxy voting process.

Active ownership can be conflated with investor activism or "activist investing", however it is important to distinguish between the two. Active ownership tends to focus on generating long term, positive outcomes through the ongoing use of investors' ownership rights. On the other hand, activist investors tend to utilise tactics such as acquiring blocking stakes to influence or pressure a Board to make certain decisions that will lead to stock price moves from which they profit. Such actions tend to be public and aggressive in nature and aim to achieve short-term financial return without consideration of longer-term outcomes. Unlike active owners, typically once an activist investor has achieved its objective, it will exit the position. Active ownership tends to be the domain of asset owners with longer-term investment objectives such as pension funds and endowments, while activist behaviours tend to come from asset owners with a shorter investment horizon such as hedge funds.

The PRI defines engagement as "interactions between an investor and current or potential investees/issuers, in order to: improve practice on an ESG issue, change a sustainability outcome in the real world or improve public disclosure." It can range from 'light' engagement via ongoing, frequent conversations with a company, to 'heavy' or 'aggressive', usually in reaction to a certain event or thematic issue. Often, investors will collaborate on an issue in their engagement efforts, and this can be achieved via initiatives such as Climate Action 100+, where investors work to collectively influence the largest corporate greenhouse gas emitters to act on climate change. Several studies have shown the benefits of engagement (and particularly collective engagement) on shareholder value, including financial and non-financial benefits[41].

An example of investor engagement which led to tangible change is when a group of international investors, including Australian superannuation funds, engaged with Rio Tinto following its destruction of Juukan Gorge. As highlighted earlier in this paper the group

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[39] Responsible Investment Association Australasia, "*Responsible Investment Explained*", retrieved July 2022

[40] Robeco, "*How investors are taking on the risks and opportunities of climate change*", March 2022.

[41] Principles for Responsible Investment, "*How ESG engagement creates value for investors and companies*", 2018

discussed and influenced the company to improve its practices and disclosures on indigenous land rights.

Thematic investing

Thematic, or sustainability-themed investing, according to the RIAA, is "investment in themes or assets and programs specifically related to improving social and environmental sustainability."[42] Investors will often choose to invest in a theme for its long-term, forward-looking ability to outperform based on structural trends, but this is not always the case. Examples of themes include sustainable agriculture or safe and accessible water. Thematic investing has slightly less take-up among institutional investors versus impact investing[43], and is akin to a positive screening approach but with a narrower focus.

Impact Investing

Impact investing involves the intention to simultaneously generate positive, measurable social and environmental impact alongside a financial return, according to the Global Impact Investing Network (GIIN)[44]. This is a market gaining momentum among institutional investors, driven in part by increasing recognition of the need for private funding to progress certain environmental and social sustainability initiatives. In response, we have observed market developments including an increasingly robust taxonomy for classification (discussed further under "International Developments and Learnings" below) and a proliferation of tools for assessing impact strategies, practices, and performance. Notably, once again, each investor's approach to impact investing will vary widely, depending on their objectives and implementation approach.

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[42] Responsible Investment Association Australasia, "*Responsible Investment Explained*", retrieved July 2022
[43] Capital Group, "*2022 ESG Global Study*", May 2022.
[44] Global Impact Investing Network, "*Impact Investing*", retrieved July 2022.

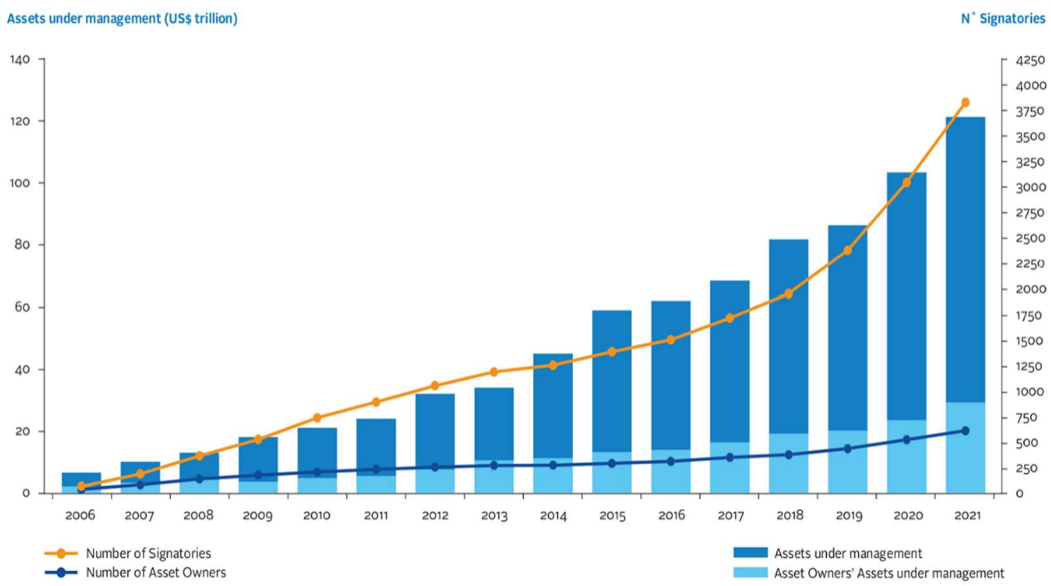
International developments and learnings

Globally, adoption of responsible investment is increasing and in some regions (particularly the Nordic countries and parts of Western Europe) is considered "normalised" as a component of investment management. Investors are refining and evolving their implementation approaches, augmenting basic screening methods and ESG integration with more sophisticated strategies, such as thematic and impact investing, and increasingly focusing on investment stewardship.

Arguably the most prominent example of a global ESG trend over the last two years has been the rapid rise of "net zero". Net zero is an objective whereby a given entity (such as a country, a company or investment portfolio) is no longer additive to global greenhouse gas emissions arising from human activity (e.g., carbon dioxide). The term is intrinsically linked to the 2015 Paris Agreement ambition of limiting global temperature increase to a maximum of 1.5°C above pre-industrial levels by the end of the century. A 2018 special report by the Intergovernmental Panel on Climate Change (IPCC) concluded the global economy would need to reach "net zero" by 2050 for the 1.5°C ambition to be achievable. Since that time, a huge range of entities have established decarbonisation targets and begun to implement strategies to support the global effort to reduce real world emissions.

The growth in importance of key responsible investment collectives is a further indicator of the spread of ESG investing. Having been established in 2006, the PRI has become a significant influence in financial markets due to its meaningful scale.

PRI Signatory Growth



Source: PRI

Early signatories included a range of public sector pension schemes, state-owned investors and sovereign wealth funds from Europe, North America, Asia, sub-Saharan Africa and Oceania.

Based on a global study of 1,130 global investors conducted in Q1 2022[45] a bias towards implementing ESG factors through "active" strategies is evident. Active investment managers use security selection to uncover ESG opportunities and active ownership to engage and influence investee companies. This sophistication is also evidenced in attitudes to the UN Sustainable Development Goals (SDGs), with almost a third stating the ability to report on specific SDGs is one of the most essential elements of fund sustainability reporting — nearly double last year's percentage. Significantly, fewer investors point to sacrificing returns as a hurdle to adoption of ESG investing.

Developments in global policy and regulation

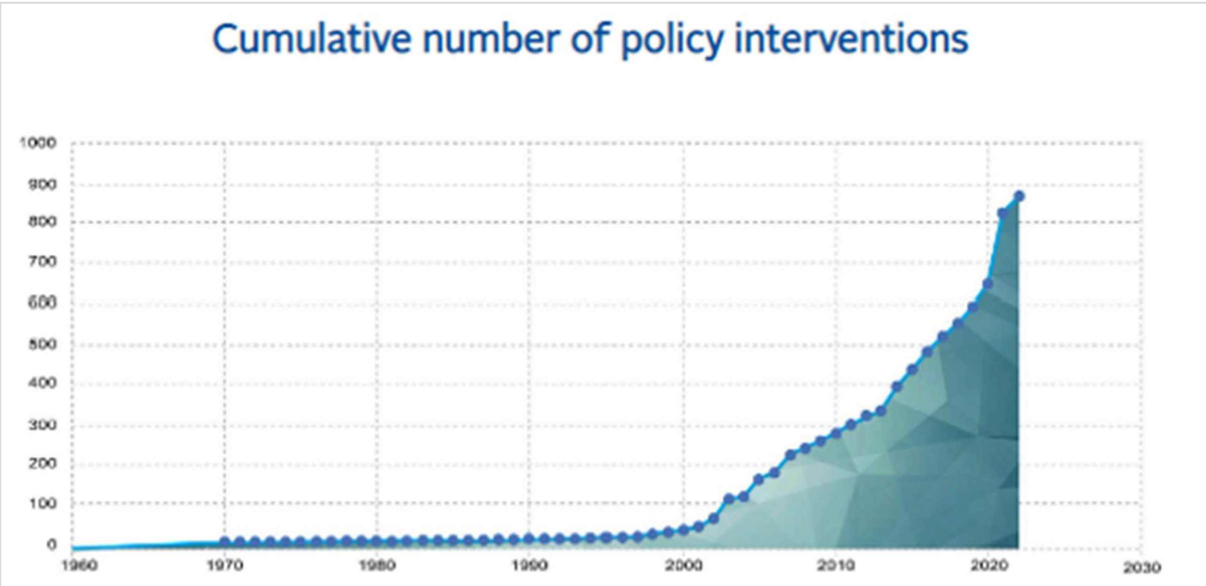
Of most interest from an Australian perspective are developments in global policy and regulation on ESG issues. Australian policy makers and regulators have typically lagged their overseas counterparts in this area but do look to Europe in particular for guidance as to how to evolve domestic standards.

Public policy can critically influence:

- the ability of institutional investors to generate sustainable returns and create value
- the sustainability and stability of financial markets
- social, environmental and economic systems

Policy engagement by institutional investors is arguably therefore a necessary extension of an investor's responsibilities and fiduciary duties to the interests of beneficiaries.

The PRI maintains a regulation database which identifies over 860 policy tools/guidance and more than 300 policy revisions which support, encourage or require investors to consider various long-term value drivers, including ESG factors. Its chart below reflects the significant increase in regulatory/policy activity over the last 20 years.



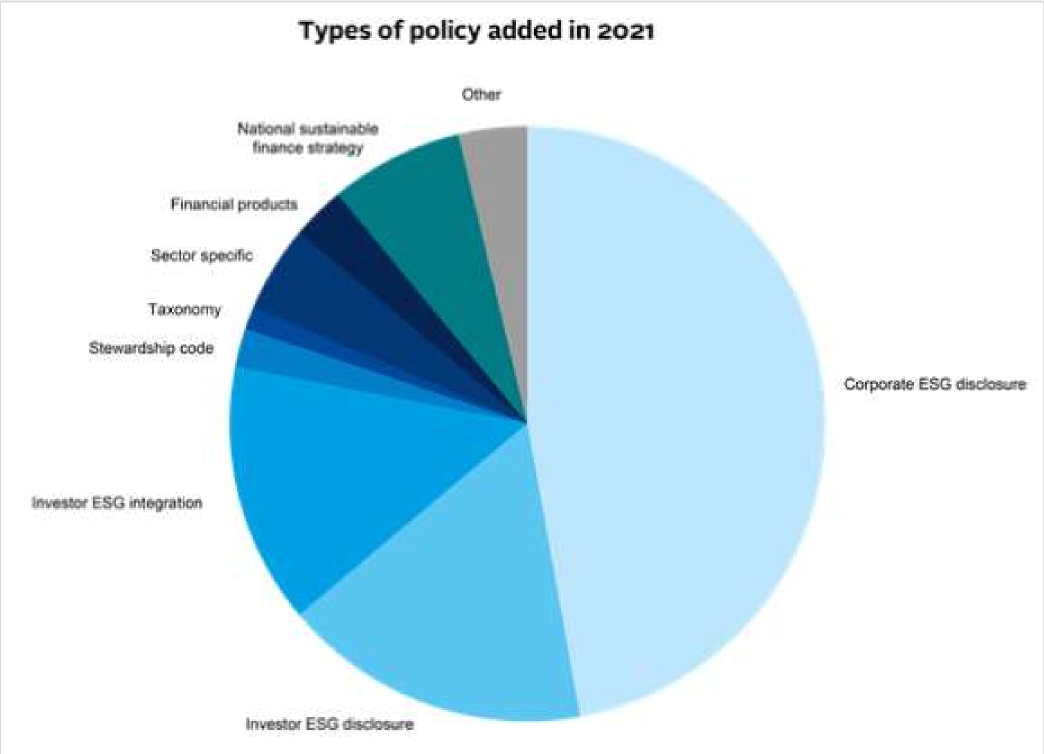
Source: PRI

In March 2021, PRI noted the rapid growth of global responsible investment policies, with over 120 new or revised policies established, "the highest number ever recorded and over

[45] Capital Group, "*2022 ESG Global Study*", May 2022.

30% more than in 2019"[46]. This increased to 159 by September 2021 (more than the annual total in 2020), covering 85 countries.

Of note, is that there have been signs of a slow-down in the growth of corporate ESG disclosure regulations (against the opposite trend for investor ESG policies). It is generally accepted however that corporate ESG disclosure is only one of five foundational sustainable investment policies and regulations. To support a full-scale transformation towards a sustainable financial system also requires stewardship, investor ESG duties, taxonomies and national sustainable finance strategies[47].

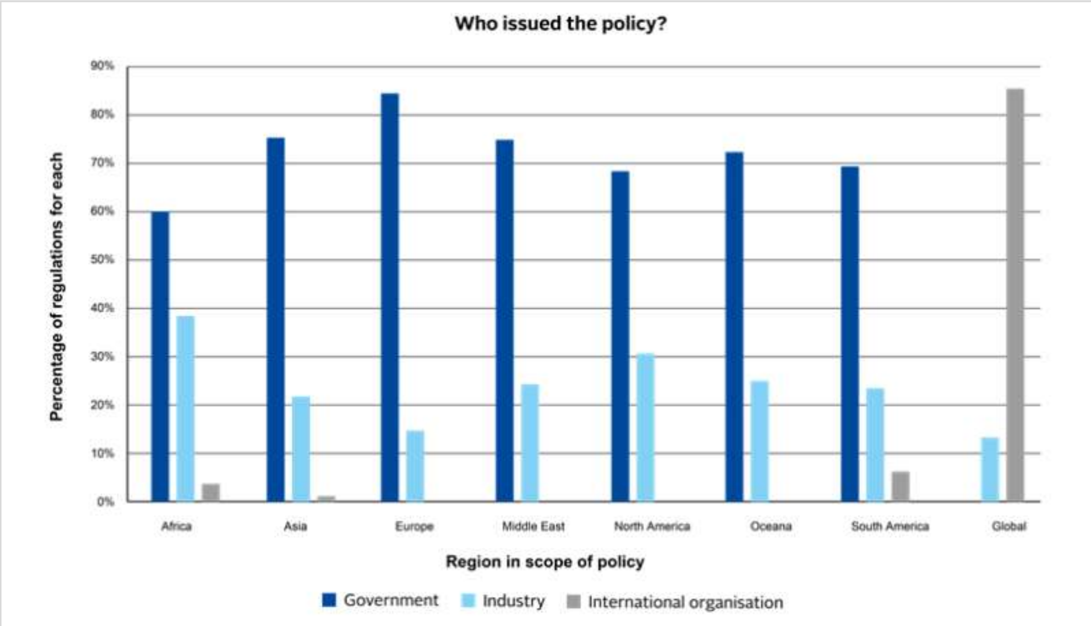


Source: PRI

For all regions, most policies originate from government. We note for example that the NSW State Government's Budget 2022/23 pointed to its coming release of a Sustainable Finance Framework aimed at aligning the government's financial activities with its environmental and social priorities, to facilitate "embedding these considerations across the finance sector and economy" and "to more effectively manage ESG-related risks and capture economic opportunities over the short and long term".

That said, industry-led polices do also make up a significant proportion - approximating 20% of regulations since 1995.

[46] PRI Blog, "*Regulation database update: the unstoppable rise of RI policy*", March 2021
[47] PRI Blog, "*88 new policies added to PRI's regulation database*", September 2021



Source: PRI

Regional policy developments

Europe

Europe continues to lead the way in terms of RI policies, increasing substantially following the release of the European Commission's sustainable finance package (April 2021) and the UK government's introduction of TCFD reporting requirements for pension schemes, publicly quoted companies, large private companies and LLPs.

A further major European development has been the *Sustainable Finance Disclosure Regulation (SFDR)*. It features the following:

- sets out transparency requirements for investors and financial advisers - creates disclosure requirements for sustainability risks
- Seeks to combat ambiguity around investor duties - considered a key barrier to systematic integration of ESG factors by investors
- Also encourages investors to identify, assess and mitigate adverse investment impacts on society and the environment

Sustainability disclosures are therefore a key pillar of the EU's sustainable finance strategy.

SFDR is linked to both the corporate sustainability reporting framework (CSRD) and the EU Taxonomy that benchmarks and defines environmentally sustainable economic activity. Ensuring consistency between these frameworks and standards is a key priority for the EU's ESG-related policy work.

United States

The previous Administration's plateauing of ESG policies in the US is disappearing under the influence of the new Administration and this trend is expected to consolidate further. Recent examples:

- The United States Securities Exchange Commission (SEC) has proposed a new Rule, the Enhancement and Standardisation of Climate-Related Disclosures for Investors, aimed at providing investors with climate-related financial information from issuers of public securities.

- The US Department of Labor has released a new proposed rule on proxy voting and ESG investing, inclusive of three examples of ESG issues that a fiduciary may consider in the evaluation of an investment if material:
    - Climate change-related factors, including a corporation's exposure to real and potential economic effects
    - Governance factors, including board composition, compensation and transparency and accountability in corporate decision-making
    - Workforce practices, including workforce diversity, inclusion training, equal employment opportunity and labour relations.

Taxonomies

As defined in the World Bank's 'policy toolkit', a sustainable taxonomy is one of five[48] priority areas for sustainable investment policy. A sustainable taxonomy is a classification system to help investors understand whether an economic activity is environmentally or socially sustainable and navigate the transition to a low-carbon, inclusive economy. Its purpose is to set a common language between investors, issuers, project promoters and policy makers, and to help investors assess whether investments both meet sustainability standards and are aligned with high-level policy commitments.

A taxonomy can therefore help guide capital to support the transition of an economy, financial portfolios, companies and economic activities in seeking to achieve climate, environmental and social objectives.

The UN Department of Economic and Social Affairs and the International Platform on Sustainable Finance[49] have found that over 20 jurisdictions have developed, are developing or are discussing the development of sustainable taxonomies. A key challenge in this process is to ultimately achieve convergence in their architecture at the international level, so to maximise impact, due to the global nature of financial markets.

[48] The other four are corporate ESG disclosures; stewardship (engagement and voting); investors' duties to incorporate ESG-related considerations in their investment decision-making, to provide sustainability-related disclosures and to report on their ESG incorporation policies and performance targets; and national/regional sustainable finance strategies that encourage and enable the low-carbon transition and the delivery of the Sustainable Development Goals.

[49] The International Platform on Sustainable Finance (IPSF) was set up by the European Commission in 2019. Its objective is to 'scale up the mobilisation of private capital towards environmentally sustainable investments'.

EU sustainable finance taxonomy

The EU's taxonomy sets disclosure requirements for financial market participants offering financial products in the EU and undertakings required to publish non-financial statements under the Non-Financial Reporting Directive. The purpose of the EU taxonomy is to help investors identify and finance environmentally sustainable activities, as well as to report on the levels of those investments. The EU taxonomy does not contain investing requirements for investors – instead, through disclosure obligations, it is aimed at stimulating investment into sustainable economic activities and encouraging engagement with investees to facilitate the transition to a low-carbon economy.

Australia's taxonomy

The Australian Sustainable Finance Institute (ASFI) Taxonomy Project is an industry-led initiative, working with government (including the NSW Government) and regulators, to develop an Australian sustainable finance taxonomy. The project seeks to leverage work done on sustainable finance taxonomies internationally, including by the EU, the Common Ground Taxonomy, Japan and in Singapore. A key objective is to identify what a sustainable finance taxonomy should look like in Australia to ensure international credibility and inter-operability while reflecting the Australian economy and context. It will coordinate with the development of taxonomies in other jurisdictions, for example New Zealand.

What leadership in ESG investing looks like

Providing foundational background on ESG investing sets the context within which TCorp's methods and practices will be reviewed, and recommendations will be proposed. The objective of those anticipated recommendations is to ensure that responsible investment integration by NSW government funds managed by TCorp can ultimately and authentically be viewed as leading practice.

As has been demonstrated in this interim report, the idea of ESG investing leadership for large, sophisticated asset owners with highly diversified portfolios is rarely limited to specific portfolio positions or "tilts", say an exclusion of a particular country, industry or company exposure.

Rather, leadership is more readily expressed through a principles-led mindset whereby the investor "owns" the responsible investment approach and ensures it is fit-for-purpose based on its unique set of objectives, preferences and constraints. This involves, among other actions:

- a clear understanding of the investor's specific set of material drivers on ESG
- development of specific responsible investment objectives for the investor
- identification of which responsible investment approaches will meet those objectives
- ongoing tracking of progress and periodic adjustments as new information arises
- open, transparent communication with the investor's key stakeholders

Such an approach is expected to enhance the investor's ability to meet its financial objectives, and importantly, enable the investor to readily articulate its rationale for its ESG investing strategy to all stakeholders.

8.3 Appendix C - ESG Review – Terms of Reference

In Scope Matters

The review will focus on State Government funds managed by NSW Treasury Corporation (TCorp) on behalf of NSW Government entities, unless elsewhere excluded.

1. **Assess leading practice ESG investment management principles, approaches and practical considerations**
   This part of the review will assess:

   (a) What is meant by ESG investing
   (b) Why ESG matters
   (c) Practical considerations regarding ESG investing:
      a. Role in long-term investment decision-making
      b. Using ESG approaches to improve risk-adjusted returns
      c. Position of financial regulators, including APRA and the RBA
      d. Limitations
   (d) Assessment of ESG investing approaches, including:
      a. Integration
      b. Exclusions
      c. Impact Investing
      d. Thematic investing
      e. Engagement and active ownership
      f. Other relevant principles or approaches
   (e) International developments and learnings
   (f) What leadership in ESG investing looks like

2. **Examine current management of NSW Government funds with respect to ESG principles**
   This part of the review will examine**:**

   (a) TCorp's current Investment Stewardship approach:
      a. Application to TCorp managed investment funds
      b. Application to investment managers
      c. Application to real assets
      d. Practical Implementation, including:
         i. Approaches
         ii. Governance
         iii. Capability
         iv. Processes
         v. Measurement and evaluation
   (b) Comparison of TCorp's approach to leading practice approaches and peers
   (c) Governance arrangements across TCorp managed investment funds, including any impediments to the implementation of a consistent leading-practice ESG approach across funds
   (d) Alignment with government policy and intent

3. **Provide recommendations for Improvement – building a better future**
   (a) Moving from current practice to leading practice
   (b) Strengthening the nexus between the incorporation of ESG factors into investment activities and meeting long-term, sustainable risk and return objectives
   (c) Implementation steps, including alignment of governance arrangements across NSW Government entities
   (d) Measuring and monitoring progress and performance

Out of Scope Matters

This review will not consider the following:

(a) Funds managed by other State Government entities on trust for private beneficiaries (e.g. those funds managed by NSW Trustee and Guardian and State Super (Defined Contribution component only))
(b) Investments in State Owned Corporations
(c) The Government's broader expenditure (i.e. recurrent and capital) program
(d) Asset resilience

Review approach

- The Review will be conducted by the Independent Reviewer with appropriate skills and background.
- The Review's focus will be on identifying gaps between current practice and leading practice and identifying recommendations for improvement, or otherwise identifying where TCorp is already undertaking a leading approach.
- Input from major clients and other stakeholders will inform the Review.

Methodology

- The Review will be carried out on the assumption of cooperation and full disclosure from the parties involved.
- The Review activities will be determined by the Independent Reviewer and are expected to include the following:
    - Desktop review of the literature regarding ESG investment management practices and related considerations
    - Interviews by the Independent Reviewer (supported by the Review Team) with representatives from TCorp and other stakeholders
    - Commissioning of external expert advice on specific topics, for consideration by the Independent Reviewer
    - Other activities as the Independent Reviewer thinks necessary to appropriately complete the review

Output

- The review will produce a report to the Treasurer outlining its findings and recommendations with respect to the above terms of reference.

Timing

- It is expected that the review will take around 6 months and be completed by end-October 2022.

Roles and Responsibilities

Independent Reviewer

- The review will be undertaken by Ms. Pru Bennett of Bened Pty. Ltd.

Review Team

- The Independent Reviewer, in consultation with NSW Treasury, will determine the level of support required. The Independent Reviewer will have available to them:
  - A Review Team comprised of staff from NSW Treasury
  - Additional support and resources as required, such as external expert advisors.

Role of TCorp

- As this will be an independent review TCorp has not been consulted on the terms of reference nor will they form part of the Review Team.
- However, TCorp will be a key contributor and will be consulted throughout the review.