Submission to the XRB on NZ CS1: Guidance to MIS Managers

1.0. Scope

1.1. The comments in this submission are limited to the sector-specific guidance provided for Registered Managed Investment Scheme (MIS) Managers as detailed in the NZ CS1: Guidance for MIS Manager (July 2022 - Working draft) document, issued by the XRB for public comment.

1.2. This submission makes no direct comments on the merits of other Taskforce on Climate-related Disclosure (TFCD) based New Zealand Climate Standards (NZCS) disclosure proposals.

2.0. Synopsis

2.1. While well intended, the current draft guidance for MIS Managers can only be described as naïve and rudderless, and consequently fails to provide suitable sector guidance. The shortcomings in the guidance as currently drafted stem from:

- Unrealistic assumptions concerning disclosure, and climate related information and data.
- A failure to recognise that investment funds have a very different character, to the corporate or sovereign entities that they invest in.
- A reluctance/failure to provide any meaningful guidance on the real-world complexities relating to emissions and climate.

2.2. The haste to "get something on paper" has undermined the quality and wisdom of the guidance produced to date. Accordingly, I would recommend that the XRB withdraw the current guidance for MIS Managers, and seek more time to develop sound and sustainable guidance.

In creating a temporary carve-out from mandatory Climate-related Disclosure (CrD) for MIS Managers, the XRB (and associated interested parties) should focus their energies on improving corporate (or industry) entity CrD, particularly the disclosure of corporate and sovereign emissions reduction transition and/or adaptation strategies (i.e., future investment opportunities). This would recognise the natural "horse and cart" relationship that exists in the investment world (i.e., investment decisions are contingent on information produced by (or for) corporate/sovereign entities) and avoid the potential disclosure shambles that will likely arise from promulgating mandatory disclosure solutions, simultaneously for industry and the funds management sector.

2.3. Further, the MIS Manager sector should not be forced into an experimental and poorly fitting TFCD inspired CrD framework, as the current proposed guidance reflects little understanding of how the sector operates and poorly serves the interests of investors.

3.0. Unrealistic assumptions concerning disclosure and information

3.1. The draft guidance for MIS Managers constantly makes the claim that primary users (investors) "will want to know …." as the pre-text for expounding detailed CrD recommendations. This assumption that investors want more information is tenuous at best, noting:

- Most investment decisions are based on sentiment, not laborious analysis of competing disclosures.
- Available evidence[1] of primary user (investor) sentiment does not translate into retail investor demand for additional, complex CrD. The current (and falling) use of existing

[1] The FMA's June 2022 Investor Confidence Research

mandatory financial disclosures (i.e., those contained in SIPO, PDS, IMO or Fund Updates) indicates that retail investors take comfort from simple, standardised, and verifiable representations when making investment decisions. This proven, "basic and bland" investor disclosure preference is a far-cry from the technically complex, voluminous, incomplete, and largely unverifiable disclosure proposals currently presented in the draft guidance for MIS Managers.

- The XRB notes in its approach to producing this guidance section that it will need to "evolve as the requirements and expectations of primary users and preparers becomes clearer." This can only be interpreted as the XRB having no compelling evidence (arguably - other than selective opinion) on what investors really want in terms of CrD.

The intension of the above observations is not to belittle the XRB's earnest attempt at sector guidance, but rather to make the point that there is no obvious, immediate, and overwhelming, demand from primary users for CrD. And, that this provides an opportunity to move in a more considered (slower) fashion down this path.

3.2. The XRB should be under no illusions that achieving any form of TFCD based fund-related disclosure will be very, very, difficult to accomplish, primarily because of the current (poor) state of the underlying corporate entity information and emissions data.

Russell Investments (a large, US-based fund manager and investment advisory entity with USD 469b AUM) produced its inaugural TFCD report in early 2022. This was a sincere and honest attempt at CrD, by a well-resourced MIS Manager, who fell significantly short in providing meaningful CrD investment insights, noting:

- Russell could only aggregate 45% of its AUM for analysis because it did not have confidence in the emissions data available on the remaining 55% of corporate and sovereign entities/assets.
- No GHG Scope 3 (i.e., indirect/supply chain emissions) data was presented. Russell noted this was something for the future but with no indication of when this might be possible.
- Investment insights from extensive and competent analysis of fund related emissions data, merely confirmed what is commonly known in the investment community. For example; equity markets are currently not pricing in future carbon emission transition costs, and emerging equity markets have significantly higher emissions than either developed equity markets or global bond indexes.

Additionally, Standard & Poor's (S&P) have noted that currently around one third of companies report erroneous (emissions) data, although not on purpose. Consequently, S&P are forced to model emissions to check this data – because auditors do not.

Leaving aside the not insubstantial question as to whether enhanced CrD will change the current trajectory of global GHG emissions[2], the experience of Russell Investments and S&P should cause the XRB to question: -

- Is the current underlying emissions related information and data currently in a "fit for purpose" state for use by the New Zealand MIS Manager sector?
- Where is the value to local investors in compelling (general small) NZ fund managers to produce emissions related disclosures and insights when much larger and better

[2] And the associated issue that changing the ownership of "brown assets" has no impact whatsoever on actual GHG emissions.

resourced global fund managers' struggle (or currently fail) to produce anything more than lengthy statements of future good intensions?

3.3. The proposed guidance for MIS Managers appears to countenance to use of partial information in making climate related disclosures. Despite the recent Reserve Bank of New Zealand (RBNZ)[3] endorsement of the "some information is better than none" presumption, and the associated conceit that "what gets measured get managed," this approach is most likely to increase investor uncertainty and angst over investment decisions. Moreover, disclosure of partial information sets the stage for selective interpretation of available information and increases the opportunity for "greenwashing" type claims, which currently bedevil the ESG investment agenda and regulators.

It is suggested that rather than endorse/permit disclosure of partial information by the MIS Manager sector, the XRB's CrD efforts should prioritize encouraging full and accurate disclosure by the corporate (industry) and sovereign entities whose activities directly or indirectly generate GHG emissions. This would help reduce the hazards associated interpreting partial data faced by the MIS Manager sector and retail investors.

3.4. The proposed guidance for MIS Managers has adopted a broad-spectrum disclosure approach (i.e., the full TFCD inspired governance, strategy, risk management and metrics domains approach). Unfortunately, the disclosure proposals a largely silent on the key (investment) issue of emissions comparability and coherence for funds. Without a common metric, investment considerations cannot be valued or compared. Arguably in not producing clear, actionable guidance on this matter the XRB has not fulfilled its mandate to provide sector guidance.

3.5. The headlong rush to collar the local investment sector with an experimental/untested TFCD based mandatory climate-risk disclosure regime would appear to be driven by panic rather than informed strategy. This "timetable to mandatory disclosure approach" is potentially dangerous and dismissive of i) the huge complexities associated with forecasting and modelling emissions and understanding their potential impacts (with any degree of confidence), and ii) the fact that there is still a lot of work currently being undertaken both globally and locally to better understand the emissions problem, its impacts, and mitigation options.

To the casual observer, it is both telling and ironic that the RBNZ has yet to issue climate-risk related guidance for its own sector, that includes banks that can be both large fund managers, but also generate the assets (i.e., equities or debt securities) in many domestic managed investment funds. In short, the conduct of banks (locally and globally) in managing climate-risks is likely to have a bigger impact on actual emission levels than the actions of individual local funds.

The RBNZ recognises that along with the FMA, they still need to undertake a considerable amount of work (including consultation) to build an understanding of the prudential implications of climate change. This should signal to the XRB that there is still time to pause and reconsidered the proposed mandatory disclosure guidance for MIS Managers.

4.0. Character of investment funds

4.1. The XRB's efforts to shoe-horn investment funds into the TFCD four domain (i.e., governance, strategy, risk management and metrics) framework is ill-advised, as it fails to recognise that

[3] A speech delivered by Adrian Orr, at the Climate Change and Business Conference 2022.

investment funds have a different character and purpose to that of the emission generating corporate and sovereign entities in which they may be invested.

Managed investment funds are best thought of as investment vehicles, used to pool assets. They are not companies and they generally do not employ a conventional corporate organisational structure. Further, investment funds grow to different sizes (i.e., AUM or FUM), and at different rates depending on their investment appeal, and on average have a shorter lifespan than a corporate entity. These characteristic make the TFCD four domains framework (which was primarily designed for corporate entities) a tenuous/poor fit for a fund-centric CrD regime.

4.2. In the investment world, the MIS Manager sector plays an intermediary role, in terms of guiding investor funds toward viable investment opportunities. These circumstances require that companies and sovereign entities start the investment process by making disclosures about their investment opportunities. Only then can MIS Managers start their role. This investment world "horse and cart" relationship simply means that investment decisions are contingent on information produced by (or for) corporate/sovereign entities.

In the context of CrD, corporate and sovereign entities must "move first" in terms of disclosing their emissions reduction transition or response plans (investment opportunities). Given earlier comments on the poor state of climate-related data, corporate and sovereign entities are still working on or developing their emission reduction strategies, and need time to further elaborate their plans.

The XRB risks generating an "investment shambles" through a simultaneous industry and investment sector launch of mandatory disclosure requirements. Clearly, these mandatory CrD initiatives should be sequenced, with the MIS sector following/responding to clearly disclosed industry climate response strategies (investment opportunities).

4.3. Both corporates and sovereign entities will need capital (debt and/or equity) to fund their future emissions reduction transition or adaptation strategies. Fund managers will play an important role in effectively channelling investor funds towards these climate strategies. In this context, MIS Manager CrD guidance that focuses on measuring the actual funding of strategic climate adaptation initiatives may be a better sectorial approach to disclosure, as opposed to the current, ill-fitting, inputs dominated, TFCD four domains framework.

4.4. Applying the TFCD four domain CrD framework to individual investment funds likely creates a false impression of the influence that MIS Managers possess in influencing GHG emissions. Apart from a few very large sovereign wealth funds (e.g., Norway's sovereign wealth fund AUM USD 1.3t) or the top 500 global asset managers, fund managers in New Zealand have very little ability to influence corporate (industry) emissions. This is due in part, to generally small portfolio size, but also to investment diversification factors (including indexation) that underpin most successful investment strategies. Consequently, there are few opportunities for local fund managers to adopt the "activist GHG shareholder" position.

5.0. Guidance on complexities relating to emissions

5.1. If the XRB persists with the current guidance for MIS Managers, then it will need to provide further detailed guidance and explanations on several climate or emissions complexities that fund managers will be expected to grapple with, including:

- Measuring/estimating short term economic and financial losses from extreme weather events associated with climate change.

- Estimating climate damage costs post 2050, noting the high degree of uncertainty inherent in any long-term projections.
- Measuring climate related financial risks, physical risks vs transitional risks, and the basis for estimating the effect of potential mitigation and offset risk taking.
- Guidance on quantifying risks, particularly credit risk, operational risk (from supply chain disruptions), and market risk (from financial instability and re-pricing equities, services, and commodities).
- Appropriate methodologies to assess climate exposures, noting Carbon foot-printing, and WACI (weighted average carbon intensity) are but two of many exposure methodologies.
- The importance of transition finance for the net-zero strategy.
- Plausible climate scenarios, noting most recent scientific climate modelling suggest that the 1.5^{o}C Paris Agreement target will almost certainly be exceeded.
- Guidance on addressing data gaps, both quality and quantity for proposed risk modelling and management related disclosures.

The above list of additional guidance is by no means exhaustive. It is presented to illustrate two simple points:

i. When it comes to CrD "the devil is in the detail."

ii. The more detailed/elaborate the disclosures, the further the investment sector moves away from producing a common, coherent metric(s), that permits investors to compare investment considerations.

6.0. The way ahead

6.1. The Managed Investment Scheme sector should not be forced into adopting the current, poorly designed, and experimental fund-related CrD proposals.

6.2. I would recommend that the XRB withdraw the current guidance for MIS Managers, and seek more time to develop sound guidance, that will better meet investor needs (not presumed needs).

6.3. I recognised that this submission could easily be classified as "petulant" and discarded. However, meaningful action on climate related issues, matters. Consequently, New Zealand needs to do better than the timid, "paint-by-numbers" approach embraced in the current draft MIS Manager sector guidance.

Gavin Weekes

25 September 2022