Financial Law Insight – keeping it green

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On 26 September 2019 the FMA released a Consultation Paper setting out proposals to introduce regulatory guidelines for green bonds and other responsible investment products. The Consultation Paper comes hot on the heels of the FMA's review of default KiwiSaver providers, which included a focus on responsible investment practices by default providers. It is clear that the FMA is increasingly scrutinising the transparency and quality of New Zealand's responsible investment offerings. In this Financial Law Insight we highlight the main features of the Consultation Paper, and consider its potential implications for market participants.

In recent years New Zealand has seen the gradual emergence of a domestic green bonds market, and an exponential increase in the value (and proportion) of assets being managed – or purported to be managed – in accordance with responsible investment principles.

Public awareness of responsible investment practices is slowly increasing, and the climate crisis continues to dominate headlines. These factors are encouraging the responsible investment equivalent of an "arms race". Financial service providers are increasingly prominent in their marketing of "green" or otherwise socially responsible investment products and approaches.

Against this backdrop, it was inevitable that the FMA would consider issuing guidance for market participants, given the absence of a statutory recognition or framework for green bonds and other responsible investment products. It is clear from the Consultation Paper that the FMA's underlying concern is the potential for "greenwashing" – the misrepresentation or overstatement of a financial product's "green" credentials to potential investors.

Green bonds

The past 12-18 months have seen green bonds introduced to the New Zealand debt markets. This included the first green bond issuance by a domestic issuer in June 2018, when Auckland Council issued a NZ$200 million green bond to fund the purchase of electric rolling stock for its rail network. Contact Energy Limited and Argosy Property Limited have since followed suit, using the proceeds of their green bond issuances to fund investment in renewable energy and energy-efficient commercial buildings respectively.

Green bond programmes are generally established under one of two international frameworks — the Green Bond Principles (backed by the International Capital Markets Association) or the Climate Bonds Initiative (an international non-profit organisation). These frameworks (and their external certification and verification mechanisms) are intended to provide prospective investors with a level of confidence that the proceeds of a green bond issue will be used in a "green" way.

However, the Green Bond Principles and the Climate Bonds Initiative frameworks are voluntary, and contain no sanctions if the issuer does not adhere to the frameworks. In addition, an 'event of default' does not generally occur if an issuer does not apply the proceeds of a green bond issuance as intended, although that may obviously have reputational and investor relations consequences.

New Zealand regulation doesn't really do much to bolster the voluntary nature of these frameworks. The Financial Markets Conduct Act 2013 ("FMC Act") does not define "green bonds". Instead, they just fall under the general FMC Act definition of a "debt security".

That means we are left with the general "fair dealing" provisions of Part 2 of the FMC Act, which are likely to apply to more egregious acts of greenwashing. The Consultation Paper helpfully sets out a number of factors the FMA would consider when assessing the adequacy of disclosure for green bonds, including:

- Does the "greenness" relate to a specific asset or project, and if so how does that relate to the overall greenness of the issuer?
- Is anything preventing the issuer from trading away this greenness through the use of derivatives, such as virtual asset swaps, or the sale of emissions units or carbon offsets?
- Can the payment obligations under the bond be met from non-green sources (noting that while that is likely to be positive in terms of the credit quality of the bond, it could compromise the claim of greenness)?

Without going into much detail, the Consultation Paper suggests that the FMA wants greater regulatory certainty around the design and promotion of green bonds. We support this in principle. Formalising FMA's expectations will help avoid unpleasant surprises for market participants. The challenge will be to design a framework that gives investors confidence that debt securities offered as "green bonds" are truly green, without stifling innovation or the growth of New Zealand's debt markets.

Responsible investment

According to the Responsible Investment Association Australasia, over NZ$180 billion of assets were professionally manged in accordance with responsible investment principles in New Zealand in 2018, up from only NZ$58 billion five years earlier. This represents approximately 72% of all funds under professional management in New Zealand.

Fund managers' responsible investment practices gained increasing prominence in 2016, when it was revealed that a number of KiwiSaver providers had invested in cluster munitions and nuclear weapons. More recently, a number of providers have divested from tobacco companies and, in the wake of the Christchurch tragedy, civilian firearms manufacturers.

The KiwiSaver Act 2006 contains a limited requirement for KiwiSaver providers to include information on their responsible investment practices in the scheme's product disclosure statement. There are no broader requirements for fund managers to disclose their responsible investment practices, even though a large number of KiwiSaver providers and other fund managers in New Zealand market their products as being "responsible".

In our view, the key complexity (particularly for investors) is that responsible investment can mean very different things to different fund managers. Some managers (particularly those who have adopted a passive investment approach) primarily rely on "negative screening" of controversial investments, whilst some managers also adopt broader ESG (environmental, social, and governance) considerations into their investment decision-making. Recently, some managers have gone even further, launching so-called "ethical" or "impact" funds which aim to pro-actively invest in companies with demonstratable environmental or social benefits.

This state of affairs makes it quite difficult for the average retail investor to assess which product out of a range is more "virtuous". The Consultation Paper sets out a number of questions in this regard, including:

- What should disclosure for a responsible investment product include?
- How will this ensure investors are not misled about the nature, characteristics or suitability for purpose of a responsible investment product?
- What should be included in a Statement of Investment Policy and Objectives for registered MISs that have green, ethical or responsible funds?
- What best practice features should MIS managers include in disclosure to ensure investors properly understand the nature of underlying investments?

Dentons Kensington Swan’s (formerly Kensington Swan) submission on the default KiwiSaver provider review supported the introduction of a limited, standardised form of exclusions reporting in principle (by way of inclusion in the SIPO). We would support the extension of that reporting across all KiwiSaver and other retail managed investment schemes. That approach would give investors the ability to easily compare the screening practices of different funds.

Any broader regulation of responsible investment products (including disclosure requirements) will prove complex in practice. The inherent subjectivity in assessing what responsible investment really is (beyond exclusions required by legislation) represents a significant hurdle. The existing fair dealing provisions in the FMC Act should be sufficient to deter managers from over-selling the "responsible" features of their products. Many fund managers already publish comprehensive details of their responsible investment practices on a voluntary basis. Coupled with ongoing efforts by both the FMA and industry to educate investors on responsible investment, we think it is unnecessary to adopt an overly paternalistic approach with further regulation in this area, beyond standardised reporting of exclusions. That would simply impose additional compliance costs on financial service providers.

What next?

Submissions on the Consultation Paper close on Thursday 24 October. The FMA has promised to develop and publish guidance for issuers of green bonds and other responsible investment products after it has considered all submissions. The FMA is also likely to publish separate educational information for investors.

In our view, some form of specific regulatory recognition of green bonds is likely, including parameters for their promotion, given their increased prominence in New Zealand’s debt markets. We also expect the introduction of new responsible investment disclosure requirements for managed investment schemes. We can only hope that any new disclosure requirements will be limited and effective for the reasons set out above, and will not unduly stifle innovative practices in this emerging battlefield for attracting investors.

The FMA's response to the responsible investment aspects of the default KiwiSaver provider review will also be of interest in this regard. The FMA is likely to release in-principle decisions on this review later in 2019 or early in 2020, with the new cohort of default providers to be appointed with effect from 1 July 2021 – if indeed a new cohort of appointees is where we end up.

Precisely what place responsible investing will find in the default KiwiSaver provider criteria remains to be seen. The FMA's guidance issued in response to the Consultation Paper may well provide a strong steer.

Start a conversation

If you would like a specific briefing on the Consultation Paper, what it may mean for your business and the disclosures you make, or would like to discuss green bond offers or responsible investment products more generally, please contact Catriona Grover on +64 4 498 0816, David Ireland on +64 4 498 0840, Pauline Ho on +64 9 909 6345, or email the team at bankingandfinancialmarkets@kensingtonswan.com.

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