

Ministry of Finance
Postboks 8008 Dep.
0030 Oslo

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Your ref.:
Our ref.:

Consultation – Report of the Expert Group on the Government Pension Fund Global’s use of instruments and investments in coal and petroleum companies

We refer to the Ministry of Finance’s letter and consultation paper of 17 December 2014. The consultation paper is based on the report of the Expert Group on the Government Pension Fund Global’s investments in coal and petroleum companies of 3 December 2014. Norges Bank has been invited to comment on the Expert Group’s recommendations.

We would like to begin by referring to the amendments made to the management mandate for the GPFG and the guidelines for exclusion and observation that entered into force on 1 January 2015. Following these changes, Norges Bank will now take the decisions on the use of instruments in matters of exclusion. The changes also pave the way for improved interaction between different instruments and greater coordination between the Bank and the Council on Ethics. The aim is to create a complete chain of instruments and a greater degree of integration in work on responsible management. We assume that the introduction of any changes to the framework for responsible investment will take account of this aim. It would also, in our opinion, be natural for the operationalisation of any changes to reflect the new division of roles when it comes to responsible investment.

The Expert Group’s report contains a broad review of financial and ethical issues associated with greenhouse gas emissions from companies’ operations. Norges Bank believes that the recommendations are consistent with the objective set for the fund’s management and the fund’s role as a financial investor. The Expert Group’s recommendations include proposals for how Norges Bank can develop its ownership activities. These activities and our wider work on responsible investment are constantly evolving. In this letter, we provide a little more background on parts of our work on issues discussed by the Expert Group, including our work with standard setters, active ownership and risk management, and environment-related investment mandates. We also comment on various aspects of the proposal to include a separate climate criterion for conduct-based exclusion from the fund in the guidelines for the observation and exclusion of companies from the GPFG.



We have had climate change as a focus area since 2006. We have developed our work over time to integrate relevant aspects of climate change in the management of the GPFG. This work is ongoing. In our Responsible Investment Report for 2014 published today, we account for our work on responsible investment in one place for the first time.

The fund's objective and role

The fund's investment strategy has evolved over time and is based on rigorous analysis. Its strategy for responsible investment must be rooted in the fund's objective and role. The same applies to investments in coal and petroleum companies. The purpose of the Government Pension Fund Global is government saving. The investment objective is to obtain the greatest possible international purchasing power for the capital in the fund with moderate levels of risk. The investment strategy for the fund is predicated partly on financial markets largely being efficient in the sense that new and publicly available information is reflected in prices for financial assets. The strategy is also based on an assumption that investors who are willing to accept market risk can expect a higher return than on safer investments. Departures from this general starting point for the investment strategy should be contemplated only where there is clear theoretical justification and sound empirical support.¹

The Expert Group writes that the fund has to be considered an ineffective tool for solving global climate problems. It also warns against moving in the direction of seeing the fund as a political instrument. Over time, this could reduce the diversification of risk in the fund and lead to uncertainty about the fund's financial objective, which would be detrimental to its management. Norges Bank has noted these conclusions and shares the Expert Group's view that uncertainty about the fund's financial objective would result in a less clear investment strategy. To move in this direction would not be in keeping with the fund's investment objective.

An active approach to climate issues in the operational management of the fund may nevertheless be accommodated within the bounds of the fund's financial objective, as is reflected in both the Expert Group's report and Norges Bank's work. The Bank has long had a spotlight on the risk that climate change poses for the fund. Norges Bank aims to be a leading investor globally when it comes to responsible investment, including the management of climate issues. For a long-term financial investor like the fund, global climate challenges can have a bearing on ownership strategies. Climate issues may also be relevant in work with standard setters and in other aspects of the investment process, such as risk management, analyses of companies in sectors particularly exposed to climate risk, and portfolio adjustments.

¹ Other than a few restrictions such as ethically motivated exclusion of companies in line with the guidelines for observation and exclusion.



The Expert Group's report also picks out a number of issues to do with the fund's oil & gas investments from a national wealth perspective, but states that it is beyond its remit to advise on this. The fund turns oil & gas resources into rights to future revenue from a broadly diversified global portfolio of companies, fixed-income instruments and real estate. The strategy for the GPFG concerns the fund in isolation. This is the basis for all the strategic advice Norges Bank gives the Ministry of Finance.

Instruments in Norges Bank's work on relevant climate issues in the management of the GPFG

In this section, we discuss how relevant climate issues may have a bearing on our work with standard setters and risk management. Active ownership and the option of divestment through portfolio adjustments are discussed in separate sections later in the letter.

There are a variety of international climate initiatives targeting companies and investors. Norges Bank supports standards and initiatives that we believe are particularly relevant to our activities and monitors developments at relevant regulatory authorities, standard setters, trade associations and investor initiatives to further the fund's long-term interests. We are a member of CDP (formerly known as the Carbon Disclosure Project) in order to promote corporate reporting on climate risk. The information obtained through initiatives such as CDP is useful in our management of the fund. In 2014, we submitted a consultation response to the Climate Disclosure Standards Board (CDSB), which is developing a reporting framework for climate-related risk. Norges Bank discusses its work with international standard setters and initiatives in its Responsible Investment Report for 2014 and in a separate letter to the Ministry of Finance dated today.

Climate information can be used as an element in our risk management. We have been collecting information on greenhouse gas emissions from companies in the portfolio for some time. This is a work in progress. One general challenge is that there is no standard method for performing such calculations. Access to data also varies, and different data suppliers use different calculation methods. One additional challenge is that we have a very broad portfolio of investments. We have been working with external suppliers to improve the coverage of emission data for our investments. We have also worked to increase our understanding of the quality of the information available and the various models that data suppliers use when calculating greenhouse gas emissions at company level.

However, information about companies' greenhouse gas emissions alone does not paint a complete picture of potential climate risk at company or portfolio level. Nor is this information sufficient to be used directly for investment purposes. Risk and investment assessments need to take into account a broader set of parameters, such as companies' operations and plans, industrial structures and market conditions. We assume that analyses and methods in our work on climate issues will evolve over time. We will continue to report on the progress of our work in our reporting on the management of the GPFG. We present the initial results of



our work on mapping the portfolio's total greenhouse gas emissions in the Responsible Investment Report for 2014.

Through its environment-related investment mandates, Norges Bank invests in companies developing technologies that can help solve climate challenges. The Ministry of Finance has increased the scope of these investments to 30-50 billion kroner with effect from 1 January 2015. These investments include companies in renewable energy, energy efficiency, water and waste management, and pollution control, and are presented in detail in the Responsible Investment Report for 2014.

In 2015, we plan to sponsor academic research on financial risk associated with climate change. Research can be a particularly useful instrument in areas where there is considerable uncertainty and a need to shed light on problems both theoretically and empirically. We discuss the matter of research in a separate letter to the Ministry of Finance dated today.

Active ownership and climate issues

Active ownership and interaction with companies in line with the fund's financial objective can, as the Expert Group points out, be very suitable instruments for addressing climate issues of relevance to the fund. In its expectations document on climate change management, Norges Bank has expressed a clear expectation that companies should integrate climate risk in the management of their business. Our expectations documents are general in nature and, in principle, aimed at all companies in the portfolio. We are particularly interested in companies' governance processes, reporting and transparency. The climate expectations document was first published in 2009 and was updated in 2012. We have begun the process of revising the document once again during the first quarter of 2015 and plan to obtain external input in this work. Our work with these expectations documents, including our follow-up of companies' performance through sector risk assessments, can lead to more targeted ownership activities or analysis.

At company level, it is crucial that companies have an adequate strategy for addressing the risks and opportunities that climate change may bring. The fund's position as a long-term investor may help lend extra weight in the ownership dialogue on long-term problems such as climate change. However, Norges Bank cannot require companies to behave differently to how they themselves and their shareholder base consider is financially appropriate. Given the role of the state and international expectations of sovereign wealth funds, it could also be detrimental for Norges Bank itself to start lobbying authorities alongside other Norwegian initiatives and policies. We may nevertheless ask companies to ensure that their position on climate-related regulation does not conflict with the interests of their shareholder base, and we may openly express our views on relevant regulatory changes.



We do not engage in close dialogue with all the companies in the portfolio at all times. Our interaction with companies and fundamental analysis focus primarily on large investments. Norges Bank prioritises ownership activities that we expect will have the greatest positive effects on the portfolio in the form of a higher expected return or lower risk. Shareholder rights, board composition, carbon emissions/disclosure and transparency on sustainability were priority topics in our dialogue with companies in 2014. For example, we asked a number of oil & gas companies to improve their reporting on their work on climate change. In 2015, we have sent out letters asking power companies about their plans for transitioning to less emission-intensive energy systems, and to mining companies requesting their views on a possible move in the industry towards hiving off their coal-mining operations.

Our dialogue with companies is to help improve our understanding of companies' operations and plans and ensure that companies are aware of our expectations of them. Norges Bank has gradually built up internal capacity for fundamental analysis of individual companies. One key element in our interaction with companies in the portfolio is asking them about their strategic choices, including decisions on capital allocation and the quality of investment decisions. This dialogue might include the assumptions companies are making about future carbon pricing in their financial plans, or their views on strategies for transitioning to a low-carbon economy. At the same time, it would not be natural for Norges Bank to take a position on operational adjustments by companies at micro level. The essential thing from Norges Bank's point of view is to understand the background to key activities, as this puts us in a position to manage the portfolio effectively.

New criterion for exclusion and observation

The criteria for exclusion and observation are established by the Storting – the Norwegian parliament – and are based on an understanding of the general ethical consensus among the Norwegian population. We note that the Expert Group writes that exclusion is not a suitable instrument for bringing about changes in corporate behaviour on climate issues. We also note that the Expert Group writes that the use of exclusion to promote changes in corporate behaviour would entail a new rationale for the exclusion mechanism. Finally, we note that the Expert Group believes that coal and petroleum companies' energy production, energy use and CO₂ emissions cannot themselves be said to be contrary to generally accepted ethical norms, and therefore does not recommend exclusion on the basis of the production of specific products.

Norges Bank shares the Expert Group's view that a new conduct-based exclusion criterion would need to be applied with the same high threshold for exclusion already established for the existing exclusion criteria. We would be looking to take advantage of the interplay between ownership and exclusion following the introduction of a climate criterion. If such a criterion is introduced, we will initiate a process with the Council on Ethics to clarify how this can be achieved in practice.



Norges Bank would add that the knowledge we obtain in our work on responsible investment can lead to portfolio adjustments and divestments from companies. Climate issues may form part of a broader assessment of companies' business models and the sustainability of their operations over time. As can be seen from our Responsible Investment Report for 2014, we divested from 22 companies involved in coal mining, oil sands, cement production and coal-fired power production during the year on the basis of such assessments. We also divested from a further 27 companies, due partly to other environmental considerations. In 2012 and 2013, we divested from 66 companies, mainly in the palm oil and mining sectors, partly as a result of an assessment that these companies' business models were closely linked to tropical deforestation.

At the same time, it is also important to stress that a decision not to invest in a company is an active decision and falls within the scope of active management. Using a financial argument at a general level to exclude whole sectors would contrast with the fundamental premise for the fund's current investment strategy, namely that markets are largely efficient and that a spread of investments across sectors will bring a better trade-off between risk and return in the longer term. Financial risk associated with climate change is nevertheless an area that has the potential to impact systematically on the portfolio. We will therefore, as mentioned earlier, continue to step up our analytical efforts in this area.

Summary

The Expert Group's report contains a broad review of financial and ethical issues associated with greenhouse gas emissions from companies' operations. Norges Bank believes that the recommendations are consistent with the objective set for the fund's management and the fund's role as a financial investor. We have developed our work over time to integrate relevant aspects of climate change in the management of the GPFG. We will continue this work on integrating aspects of climate change in our management of the fund, and we will further develop our analyses and processes in this area.

Norges Bank aims to be a leading investor globally when it comes to responsible investment. We believe that climate issues are relevant to the fund's management in a number of areas, including work with standard setters, active ownership, risk management and portfolio adjustments. Use of the fund as an instrument of climate policy beyond that which is consistent with the fund's role as a financial investor would be deeply detrimental to the fund's management. To move in this direction would not be in keeping with the financial objective for the management of the fund. Over time, this would result in a less clear investment strategy and could reduce the diversification of risk in the fund.

There are a variety of international climate initiatives targeting companies and investors. Norges Bank supports those that we believe are particularly relevant to our activities. We have also been gathering information on greenhouse gas emissions from companies in the portfolio for some time. Through its environment-related investment mandates, Norges Bank



invests in companies developing technologies that can help solve climate challenges. In 2015, we plan to sponsor academic research on financial risk associated with climate change.

Active ownership and interaction with companies in keeping with the fund's financial objective can be very suitable instruments for addressing climate issues of relevance to the fund. Working with expectations documents can lead to more targeted ownership activities or analysis. The fund's clear position as a long-term investor may help lend extra weight in the ownership dialogue on long-term problems such as climate change. Norges Bank aims to prioritise ownership activities that we expect will have the greatest positive effects on the portfolio. One key element in our interaction with companies in the portfolio is asking companies about their strategic choices, including decisions on capital allocation and the quality of investment decisions.

Norges Bank shares the Expert Group's view that a new conduct-based exclusion criterion would need to be applied with the same high threshold for exclusion already established for the existing exclusion criteria. We would be looking to take advantage of the interplay between ownership, exclusion and risk-based portfolio adjustments following the introduction of a climate criterion. If such a criterion is introduced, we will initiate a process with the Council on Ethics to clarify how this can be achieved in practice.

Yours faithfully

Øystein Olsen

Yngve Slyngstad