NORGES BANK

Ministry of Finance
Akersgata 40, P.O. Box 8008 Dep
0030 OSLO

Date: 16.10.2020
Your ref.:
Our ref.: 20/01876

Consultation response, NOU 2020:7 Values and Responsibility

1 Background

Norges Bank manages the Government Pension Fund Global (GPFG) under a mandate from the Ministry of Finance. Since 2015, the Bank has been tasked with deciding on the observation and exclusion of companies in line with a set of guidelines. Official Norwegian Reports (NOU 2020:7) *Values and Responsibility* contains a review of and proposals for changes to these guidelines.

The objective of the investments in the GPFG is to achieve the highest possible return with an acceptable level of risk. The strategy of broad diversification contributes to reducing volatility in the GPFG's return and mitigating risk. At the same time, ownership stakes in 9000 companies provides broad exposure to various types of non-financial risk. This exposure cannot be reduced by diversification. The guidelines for observation and exclusion, which have been in place since 2004, are part of the management of such risks.

Norges Bank agrees with the Commission that the framework established 16 years ago has functioned well, and the Commission's proposals entail a continuation of the current model. The threshold for exclusion is to remain high. The criteria for observation and exclusion shall be based on "overlapping consensus", which means the guidelines build on fundamental ethical norms that enjoy broad support. They also provide a high threshold for adding new exclusion criteria. Companies will continue to be assessed individually, and the assessments are to be forward-looking.

The report contains a thorough discussion of the need for changes to the criteria for observation and exclusion. In Norges Bank's opinion, the fact that the criteria are now being assessed as a whole against the evolution of norms and new issues, is a strength in this work. This contributes to consistency across criteria. The report will be an important reference for Norges Bank's work going forward.

Section 2 below contains some general comments. Norges Bank's specific comments appear in Section 3 and follow the structure of the report.

2 General comments

2.1 Purpose
Norway's petroleum wealth is to benefit both current and future generations. As the Commission writes, managing the GPFG with the aim of "securing lasting value creation for current and future generations" is in itself an ethical obligation. The Act on the Government Pension Fund stipulates that "[t]he investment objective of the Government Pension Fund shall be the highest possible return at an acceptable level of risk. The Fund shall be managed responsibly and consistent with the said objective"[1]. The management mandate issued by the Ministry of Finance states that the management objective is to "seek the highest possible return, net of costs … within the applicable investment management framework".

At the same time, the GPFG is to avoid being invested in companies that contribute to or are themselves responsible for serious unethical conduct. The Commission proposes that this purpose be reflected in a separate purpose section, where it states that the purpose of the guidelines "is to prevent the Government Pension Fund Global (GPFG) from being invested in companies that cause or contribute to serious abuses of fundamental ethical norms, as set out in these guidelines…"[2]. In Norges Bank's opinion, this is an appropriate clarification and limitation.

2.2 Division of tasks
According to the Commission's proposed guidelines, before any decision to exclude a company or place it under observation, Norges Bank must consider whether the exercise of ownership rights could be a suitable way to reduce the risk of continued norm violations[3]. The Bank agrees with the Commission that the ambition should be an effective interaction of instruments, and that the aim is the effective use of the instrument best suited to each particular case.

Furthermore, Norges Bank shares the Commission's view that the Bank's working relationship with the Council on Ethics functions well, and takes a positive view of the proposed clarification of the requirement for coordination. At the same time, the Bank agrees that the assessments of the Council on Ethics and of the Bank must be made independently of one another. Information sharing and coordination can be combined with such independence.

As operational manager, it is the Bank's responsibility to exercise ownership rights on behalf of the Government (cf Section 1-3, second paragraph, of the management mandate). Over time, the Bank has developed an extensive system for exercising ownership rights. In the Bank's view, the Ministry of Finance might assess whether the guidelines should permit Norges Bank to follow up decisions to place companies under observation. Currently, this responsibility rests with the Council on Ethics, while Norges Bank is responsible for exercising the GPFG's ownership rights in the same companies. This question is discussed further in Section 3.4 below.

Norges Bank would like to point out that the Bank's exercise of ownership rights is a key part of the way companies are followed up. Exclusions are justified on the grounds that their purpose is to prevent the GPFG from being invested in companies that commit

[1] Section 2 of the Act on the Government Pension Fund.
[2] Section 1 of the Commission's proposed guidelines for observation and exclusion.
[3] Section 6 (5) of the Commission's proposed guidelines for observation and exclusion.

serious norm violations. At the same time, contact with the company ceases, and thus also the ability to influence the company's conduct more directly. Influence through the exercise of ownership rights gives the companies a chance to change their conduct, so that the norm violations cease. It is not until this procedure is no longer appropriate or cannot be expected to have the desired effect that exclusion should be considered.

2.3 The line between company and state

The guidelines for observation and exclusion pertain to companies, not countries. However, the Commission was asked to assess the line between company and state, including "[e]thical considerations relating to the GPFG's investments in countries whose statutes and regulations violate internationally recognised conventions and standards" and whether "current guidelines are adequate in connection with investments in such countries".

Against this background, the Commission discusses situations where companies meet conflicting standards and writes inter alia: "Since the guidelines for observation and exclusion assumed thorough, public recommendations, there is a risk in such case that the recommendations are marked by or be perceived as criticism of the authorities".

The Commission's assessment is that ethical guidelines should not be formulated in a way that generally precludes investments in individual countries, business sectors or general company characteristics. This is in line with advice and assessments that Norges Bank has previously given to the Ministry of Finance[4].

The Commission discusses how investments in countries operating with divergent norms can instead be dealt with by adapting the use of instruments and in the formulation of the Council on Ethics' recommendations. The Commission writes, for example, that the recommendations in such cases could be less comprehensive than usual, and they could be based on assessments of ethical risk, where risk assessments of both the country and business sector might be given weight. The Commission continues: "This means, however, that there will be less focus on the recommendation on the specific norm violation, even if it must also be cited as a key part of the basis of assessment."

In Norges Bank's view, there are good reasons to continue to adhere to the principle that the recommendations must be thorough, with specific assessments of companies. The recommendations are to be aimed at companies, not countries. As a large global investor, the GPFG benefits from free and open markets, without special restrictions on its investments. Today, the GPFG has a clear financial objective. Norges Bank's work on responsible investment supports this objective. A change to the ethical guidelines that blurs the distinction between company and state may raise doubts about the GPFG's role. In the event, a considerable risk to the return on the GPFG may arise further out.

In its discussion of companies operating in countries with divergent norms, the Commission also provides a number of assessments of Norges Bank's process for approving markets. The Commission writes inter alia (Section 19.4): "The Commission assumes in this regard "that assessments of environmental and social risk, as well as access to information, may also be important for decisions to enter new markets".

---

[4] Norges Bank's letter to the Ministry of Finance of 22 August 2019 "Equity investments in emerging markets".

Norges Bank can confirm this, but at the same time would underscore that approval of instruments and markets are a part of the investment process that is governed by the entire objective of investment management as it is expressed in the mandate. Under the mandate, Norges Bank's Executive Board shall approve all markets the GPFG invests in. This requirement applies irrespective of whether the equity market is included in the benchmark index.

The purpose of the approval process in the Executive Board, in line with the mandate's requirements[5], is to ensure that all relevant risks are identified and assessed, that all operational matters can be dealt with and that the decision to approve a new market is in line with the GPFG's overarching investment strategy. Norges Bank described the approval of individual markets in a letter to the Ministry of Finance on 22 August 2019. The Bank performs a broad review of the types of risk in the market in question, including "legislative quality, the legal system, the extent of corruption and other social issues in the country"[6]. Once a market satisfies the Bank's approval criteria, it would be difficult for Norges Bank to exclude that market on a separate basis.

The line between company and state is also relevant in assessing the Commission's recommendation for a new criterion for exclusion of companies on the basis of the sale of weapons. This issue is discussed further in Section 3.3.3 below.

3 Specific comments

3.1 Scope (Section 2)

The Commission proposes that advice and decisions under the product criteria also apply to companies included only in the benchmark index, but not in the GPFG's portfolio.

In Norges Bank's opinion, there are good reasons for the current provision to limit such advice to companies where the GPFG is actually invested. In this way, the work focuses on preventing the GPFG from being invested in certain companies, in line with the purpose. At the same time, the current limitation will have an unintended consequence if the GPFG invests in new companies that enter the benchmark index and that with a high degree of probability will lead to a decision of exclusion.

Norges Bank thus agrees that the Council on Ethics should be able to recommend the exclusion of companies under the product criteria in Section 3 that are not in the GPFG's portfolio. For example, there are a number of tobacco companies that are being introduced into the GPFG's benchmark index where the GPFG has not previously been invested. It will entail needless transaction costs if the Bank invests in such companies only to have to justify a recommendation for exclusion with subsequent sale.

The Commission has not recommended corresponding exclusion powers under the conduct criteria in Section 4. Assessments of the probability of future exclusion and divestment under the conduct criteria are considerably more complex. In nearly all cases, it will be difficult to know in advance whether a company will subsequently be considered for exclusion under the conduct criteria when it enters the benchmark index. In the Bank's assessment, this supports the principle to limit recommendations for exclusion to companies that are in the actual portfolio.

[5] Section 3-10 (2) of the Management mandate for the Government Pension Fund Global.
[6] The mandate from the Ministry of Finance was amended on 30 November 2019 to require the Executive Board's approval of markets, instruments and issuing countries.

3.2 Criteria for product-based observation and exclusion of companies (Section 3)

The Commission proposes a revision of the provision's wording so that it is clearly stated that it is intended to apply both to the production and *development* of weapons and to weapons and *key components of weapons*. The Commission writes (Section 12.9): "This will bring the criterion's wording into line with current practice". This revision of the wording is thus not intended in itself as an expansion of the current criterion for exclusion of weapons.

For the exclusion of producers of nuclear weapons, the Commission recommends a change in the way the guidelines are practised. The Commission is of the opinion that certain types of delivery platforms, which only can be used for nuclear weapons, should be encompassed by the criterion. Norges Bank has no comment on this recommendation.

The Commission further writes: "When the exclusion criterion has been operationalised, the practice has been that production or development of products with several purposes, one of which is related to nuclear weapons, has not been grounds for exclusion. In the view of the Commission, this main rule should remain unaltered. However, a trend may emerge where an increasing number of systems and products have several purposes, one of which is related to nuclear weapons. When the exclusion criterion is implemented in the future, it may be necessary to make certain exceptions from the main rule in consideration of assessment of components with several purposes". This could, in Norges Bank's view, require making demanding distinctions, and current practice should remain unaltered.

3.3 Criteria for conduct-based observation and exclusion of companies (Section 4)

3.3.1 Human rights

The Commission proposes to remove the examples of human rights abuse from Section 4 a), on the grounds that the criterion is not limited to the examples in the text. The Commission also writes that the examples only specify serious human rights abuse, while the criterion's wording encompasses both serious and systematic human rights abuse. The Commission writes (Section 13.2.1): "For example, a number of companies have been excluded on the basis of systematic abuse of labour rights, where the individual norm violation is not gross in itself, but where the extent of abuse is so significant as to represent a pattern of behaviour".

Norges Bank would point out that the threshold for exclusion should be high. The Commission's terms of reference from the Ministry state that "[e]xclusion is a powerful instrument that should be restricted to the most serious norm violations". This is also reflected in the Commission's proposed purpose section for the guidelines, where the purpose is to "…prevent the GPFG from being invested in companies that cause or contribute to serious abuses of fundamental ethical norms…". Norges Bank assumes that the changes in Section 4 a) are not intended to change the way the criterion is practised and is of the opinion that this can be further specified. Here the Bank would underscore that there is a relationship between the terms used in the criterion.

3.3.2 Corruption

In its discussion of the corruption criterion, the Commission writes in Section 13.7: “But since corruption is illegal and otherwise subject to sanctions in a different manner from complicity in human rights abuses or environmental law violations, companies will go to great lengths to keep any corrupt activity secret. The standard of evidence for the likelihood of future corrupt acts should be less strict in an exclusion assessment.”

Norges Bank agrees with the Commission on the need for thoroughness in the assessments of specific companies. In Section 19 of the report, the Commission writes: “The Commission agrees that exclusion and observation grounded in an ethical framework are powerful instruments through the assessments published in the Council on Ethics recommendations. Thoroughness in the assessment of a particular company is therefore necessary for the reliability of the assessments in the recommendations and for maintaining the legitimacy of the guidelines and the GPFG. In the Commission’s view, it is important that this practice continue.” Norges Bank is of the opinion that the same strict standard of evidence must apply for all criteria. The assessments must be done at a company level and they must be forward-looking.

Under the current guidelines, observation may be an alternative to exclusion in cases of doubt as to whether the conditions for exclusion are met. Norges Bank must also consider the exercise of ownership rights as an alternative to observation or exclusion. Norges Bank has prepared an expectations document on anti-corruption, and this is a topic the Bank regularly raises in its dialogue with companies. This dialogue can also be utilised to obtain information that is otherwise not available. The exercise of ownership rights can therefore be a relevant alternative to exclusion or observation in such cases.

3.3.3 Sale of weapons

The Committee proposes a new criterion for excluding companies that sell weapons to states that are engaged in armed conflicts and that use the weapons to commit serious and systematic violations of international rules.

The criterion is aimed at companies. At the same time, assessments under this criterion, which the Commission also discusses, will indirectly affect states that purchase weapons used to commit violations of humanitarian law and states choosing not to stop weapons exports despite such violations.

The Commission discusses how the Council on Ethics could identify which combatant states the criterion is to apply to. The Commission writes: “On the one hand, it is clear that the Council on Ethics is not intended to play a role in assessing states’ conduct. On the other hand, the crux of the assessment of a company’s activities may be precisely the question of the company’s complicity in a violation committed by a state”, The Commission also writes: “Descriptions of prolonged and systematic violations of the rules on the conduct of hostilities should, as mentioned, be based on a broad assemblage of authoritative sources from governmental and non-governmental institutions.”

Norges Bank would underscore that the guidelines are aimed at companies, not countries or their authorities (cf general comments in Section 2). If the proposed criterion is incorporated into the guidelines, this may border on a foreign policy assessment. This implies a need for particular care in the assessments. As the Commission writes, the assemblage of sources should be broad and authoritative. Before a decision to exclude a company is made, it should be established beyond reasonable doubt that the company is selling weapons into specific conflicts, where the company has knowledge of, or should be able to foresee, use that clearly violates international humanitarian law.

3.4 Observation

The Commission is of the opinion that observation as an instrument should be retained. Norges Bank concurs.

Observation cases are followed up by the Council on Ethics. This is established practice, but is not directly provided for in the guidelines. The division of tasks between the Council on Ethics and Norges Bank was not within the Commission's terms of reference[7], but Norges Bank has previously pointed out that, operationally, it is somewhat unclear where the observation instrument ends and the ownership instrument begins[8].

The Commission writes (Section 14.4): "If Norges Bank is in dialogue with companies that the Council on Ethics is following up through observation, this may create a lack of clarity about which institution is managing the ownership rights to the GPFG." The Commission adds that for that reason, proper coordination between the Council on Ethics and Norges Bank and good dialogue with companies are important.

Norges Bank shares the Commission's view of the need for coordination and dialogue and is of the opinion that the Ministry may consider whether the guidelines also may permit observation on the part of Norges Bank, based on recommendations from the Council on Ethics (cf the Bank's general comment in Section 2.2).

3.5 The importance of companies' failure to respond to queries

Norges Bank agrees with the Commission that, owing to failure to respond to queries, "[t]he Council on Ethics has no basis on which to refute its assumption that ethical risk is high". The assumption will then have to be based on other sources.

The Commission writes: "In situations where the risk of serious norm violations is sufficiently high, it is the Commission's view, in line with established practice, that a lack of information about the company, especially if the company shows unwillingness to elucidate the matter, may in itself contribute to the perception of an unacceptably high risk of complicity in unethical conduct." In its discussion of the proposed new conduct criterion for the sale of weapons to certain states, the Commission writes: "In such states, companies' failure to respond to queries or failure to share other information is given weight by the Council on Ethics in the assessment of future risk associated with an investment.»

As the Commission writes, a number of factors can explain a failure to respond to queries. The Commission cites inter alia variations in practices and culture for investment communication between various kinds of companies, where it is often observed that large international companies take a more professional approach than smaller, local companies. Other examples the Commission mentions are when companies refrain from responding or limit information owing to ongoing or potential legal processes, or the

---

[7] See Section 2, fifth bullet point, of "Terms of reference for the commission to review the ethical guidelines for the GPFG".
[8] See Norges Banks letter to the Ministry of Finance of 14 December 2018.

company may not have understood the Council on Ethics' role. Norges Bank agrees with this and is of the view that care should be taken when reacting to companies' failure to respond. Improved information sharing between Norges Bank and the Council on Ethics, for instance supplemented by exercise of ownership rights on the part of the Bank, may be suited to remedy any deficiencies in the assemblage of information.

3.6 Reassessments of the basis for observation or exclusion

Under the current guidelines, the Council on Ethics shall regularly assess whether the basis for observation or exclusion still exists[9]. The Commission proposes to replace this with: "The Council on Ethics shall *have routines for* assessing whether the basis for observation or exclusion still exists". Norges Bank assumes that the Council on Ethics will continue to be responsible for determining whether the basis for the decisions still exists.

3.7 Grounds for exclusion after the conclusion of an exercise of ownership rights

If an exercise of ownership rights does not have the intended effect, ie the risk of serious ethical norm violations is not deemed to have been sufficiently reduced through the exercise of ownership rights, Norges Bank will reassess its position in the matter. The Bank will then normally ask the Council on Ethics for an updated assessment of the matter.

3.8 Financial institutions

Norges Bank shares the Commission's view that "there should be a very high threshold for exclusion of banks on account of lending activities or similar commercial circumstances where the risk of norm violations pertains to the client's conduct, in the absence of concrete circumstances tying the bank's own conduct more closely to the norm violation."

3.9 Other comments

The Commission also proposes a number of changes to the mandate and guidelines that are based on established practice at Norges Bank. The Commission proposes, for example, inclusion of the publication *Responsible investment* or similar reporting as a requirement in the Bank's management mandate. Other examples are the proposal to refer to the UN Guiding Principles on Business and Human Rights (UNGP) in the requirement for Bank's principles for responsible investment, and requirements for an annual progress report on ownership matters under the guidelines. Norges Bank endorses these proposals.

3.10 Financial consequences

In its consultation response to Official Norwegian Reports (NOU 2003:22) *Management for the future*, Norges Bank wrote: "Extensive use of negative screening and exclusion may, in Norges Bank's view, entail substantial costs in the form of lower expected return or higher market risk and in the form of less transparency in assessing investment management."

The annual return on the benchmark index for equities in the period 2006-2019 was 0.04 percentage point lower than for a hypothetical benchmark index without exclusions from the GPFG[10]. Given the current size of the equity portfolio, this amounts to a "loss" of return on the order of NOK 2.8 billion annually.

---

[9] Section 5 (5) of the current guidelines for observation and exclusion.
[10] Section 7.2.2 of Official Norwegian Reports (NOU 2020:7).

Currently, 144 companies are excluded, 106 of which on the basis of product-based criteria. The negative excess return of 4 basis points[11] is attributable to product-based exclusions, which in isolation have resulted in an annual return that was 7 basis points lower than for a hypothetical benchmark index without these exclusions. This may be because the industries that are excluded may have other risk and return characteristics than the industries remaining in the benchmark index.

On the other hand, the effect of the conduct-based exclusions on the index return was positive in the period. The annual return on the benchmark index for equities was in isolation 3 basis points higher than on a hypothetical benchmark index without the conduct-based exclusions. Even though these exclusions are justified by ethics, they may also have reduced exposure to undesired financial risk.

As the Commission writes, historical effects will be influenced by the period observed. The results since 2006 are therefore not necessarily representative of effects of future exclusions.

Any increase in the scope of exclusions may amplify their effect on return and risk. The Commission writes that the Council on Ethics' secretariat has identified a handful of companies that could be excluded on the basis of the Commission's proposals. At the end of 2019, the GPFG had invested just over NOK 10 billion in these companies.

Sincerely,

Øystein Olsen

Birger Vikøren

[11] 1 basis point is equal to 0.01 percentage point.