NORGES BANK

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Work on climate risk in the Government Pension Fund Global

The Ministry of Finance has initiated an extensive programme of work to increase our understanding of how climate risk should be addressed in the management of the Government Pension Fund Global (GPFG). In this context, the Ministry has received analyses and assessments from Norges Bank in our letter of 2 July 2021, and the report "Climate risk and the Government Pension Fund Global" from the expert group looking at the implications of climate risk for the GPFG. In its letter of 13 September 2021, the Ministry asks Norges Bank for its assessment of the expert group's recommendations and how they might be implemented in the management of the fund.

The expert group recommends that Norges Bank's responsible investment is given an overall long-term goal of net zero emissions from the companies in which the fund is invested. Norges Bank supports such a goal. A long-term goal for the Bank's responsible investment will give clearer direction to our ownership activities and our work in on climate issues.

The expert group recommends that the long-term goal for Norges Bank's responsible investment is supplemented with intermediate targets for individual companies' emissions. We will strengthen our work on analysing decarbonisation pathways for individual companies in which the fund is invested and use these analyses in our follow-up of companies. The information obtained may also be of use in active investment decisions and risk management.

Key principles and conclusions common to the expert group and Norges Bank
Both the expert group's and Norges Bank's recommendations are based on the objective for the fund's investments being the highest possible return within the constraints imposed by the management mandate. The management of climate risk in the fund is therefore rooted in the fund's role as a financial investor.

Norges Bank shares the expert group's assessment that climate risk is an important financial risk factor for the fund, but also one of many risk factors to which the fund is exposed. In addition, neither find that there is sufficient evidence to claim that climate risk is systematically mispriced. The key features of the investment strategy and the benchmark index should therefore remain in place.

The principle of having a broad spread of investments is an important starting point for the investment strategy for the GPFG. The expert group concludes that this broad diversification means that the fund is relatively resilient to moderate climate change and to climate policies that bring about an orderly transition to a low-carbon economy. In our letter of 2 July, we noted that around 80 percent of the market value of the fund's equity portfolio is in the group of companies classified by analysis firm MSCI as having neutral exposure to transition risk.

Active ownership is singled out by the expert group as the most important tool for addressing climate risk in the fund. Norges Bank shares this view. Ownership activities go straight to the main source of the fund's climate risk, namely the companies we invest in. Data availability and quality are highlighted by both the expert group and Norges Bank as a challenge for work on mapping climate risk at the companies in which the fund is invested. The expert group therefore believes that Norges Bank should contribute actively to the development of standards for climate reporting. Norges Bank's letter of 2 July refers to international standards and initiatives that we are supporting and participating in actively with a view to improving corporate climate reporting.

The expert group writes that the management of the fund has provided inspiration and had a normative impact on investors in Norway and abroad for a number of years, but that there is now a need to advance its work on climate risk. The group concludes that the ambition should be for the GPFG's work on climate risk to be world-leading. Norges Bank shares this ambition, and in our strategy for 2021-2022 we state that the fund should be a global leader in responsible investment.

When it comes to concrete proposals for changes to the management mandate, the expert group writes: "Climate risk in financial markets is a field undergoing rapid development, and best practice internationally for dealing with such risk is changing quickly. The mandate from the owner should consequently be overriding and principle-based, without micromanaging practices that will in any case have to be further developed as the knowledge base is bolstered." Norges Bank shares this view.

The expert group recommends changes to the management mandate in four main areas: a set of principles for managing climate risk, a long-term goal for responsible investment of net zero emissions from the companies in which the fund is invested, further development of Norges Bank's ownership activities, and provisions on measuring, managing and reporting climate risk. We consider these recommendations below.

Principles for managing climate risk

The expert group recommends the introduction of a set of general principles for the management of climate risk in the GPFG. The group argues that these principles should be general to ensure that they stand the test of time and ensure that the management of climate risk is anchored in the owner's preferences. Norges Bank is of the opinion that general principles of this kind should be issued by the Ministry of Finance.

The expert group also recommends that the Ministry makes it a requirement that the principles for responsible investment management also reflect the need for sound management of climate risk. The management mandate currently contains a requirement for the Executive Board to establish principles for responsible management of the investment portfolio.[1] Norges Bank supports the expert group's recommendation.

Long-term goal of net zero emissions from companies in which the fund is invested

The expert group recommends adding to the management mandate a provision that gives Norges Bank's responsible investment an overall long-term goal of net zero emissions from the companies in which the fund is invested, in line with international climate agreements to which Norway has acceded.[2]

Responsible investment is an integral part of our management of the fund. The management mandate requires this work to be based on environmental, social and corporate governance considerations. Within these three main areas for responsible investment, we work on a number of themes, including climate risk. Climate risk differs from many other issues addressed in our responsible investment. The economic consequences could be huge, climate change will affect different sectors and economies differently, and uncertainty increases the further ahead we look. As a long-term and global investor with holdings in thousands of companies, we have a financial interest in companies adapting well to the risks and opportunities presented by climate change. This may indicate that Norges Bank's responsible investment has a long-term goal of working towards net zero emissions from the companies in which we are invested.

Norges Bank therefore supports the expert group's recommendation and will, in line with this and through active ownership, be a driving force for the companies in the portfolio to align their business models towards a long-term goal of net zero emissions.

At the same time, we believe that it is important for the Ministry to communicate clearly that such a goal for Norges Bank's responsible investment does not mean that the investment portfolio should be managed with a view to achieving goals other than achieving the highest possible return. The group's recommendation is not the same as

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[1] For further information, see "Executive Board documents" at www.nbim.no.

[2] If such a provision is included in the management mandate, it will be important to specify that the long-term goal is *net* zero emissions.

setting a target for the portfolio's estimated carbon footprint.[3] One important premise for the investment strategy set by the Ministry is that the fund is to be managed close to the benchmark index. This means that return and risk, including exposure to climate risk, will largely mirror the benchmark index. The investment portfolio's estimated carbon footprint will also largely follow the benchmark index. As we stated in our letter of 2 July, developments in the portfolio's carbon footprint will depend partly on a number of factors over which the Bank has little control. If the companies in the benchmark index – and the world in general – are not on track to net zero emissions, it is unrealistic to expect a portfolio managed close to that index to be on track to net zero emissions.

Active ownership will play a key role in work on managing the fund's climate risk. It is important to note here that this does not mean that Norges Bank should automatically divest from a company if active ownership does not have the desired outcome. We do not believe that this is the expert group's intention either.[4] In its letter of 2 July, Norges Bank argues that exclusion of companies or sectors is an unsuitable tool for bringing about changes in corporate behaviour. In some cases, however, it may be appropriate to divest from a specific company, especially if we believe that the company has particularly poor management of climate risk and so presents an elevated financial risk.

Further development of Norges Bank's work on responsible investment

The expert group recommends further development of Norges Bank's ownership work. Several different recommendations are made, including that we should require companies to stress-test their business models against various climate scenarios, collaborate with other investors, prioritise capital discipline at companies, and evaluate the results of ownership activities regularly.

Norges Bank supports the expert group's recommendations and the further development of our ownership work. Through active ownership, we will encourage the companies we invest in to be sustainable. To be sustainable, companies must be profitable.

<u>Standard setting</u>

Active ownership begins with setting clear expectations. Our expectations of the companies we invest in are expressed in our expectation document on climate change. This document was first published in 2009 and has been updated as new knowledge and practices emerge. Several of the expert group's recommendations are already part of our expectation document on climate change. For example, we expect companies to have a climate strategy, set emission targets that take account of the Paris Agreement, and

[3] For further information on climate-related targets on the portfolio, see Norges Bank's letter of 2 July 2021.

[4] The expert group writes: "Altering the composition of the portfolio may be a way of capturing climate-related investment opportunities, but a large and long-term investor will be not able to neutralise climate-related threats to a significant extent through investment decisions alone." The expert group also writes that the main features of the current investment strategy should remain in place. Large-scale and automatic divestments would depart from this.

stress-test their business models against various climate scenarios. We will make it clear that we also expect companies to have a goal of net zero emissions and to report on progress towards this at regular intervals.

International standards contribute to consistency across markets and set the bar for all companies. Norges Bank contributes actively to the development of such standards.[5] In our work on contributing to and supporting the development of international standards, we prioritise initiatives that aim to improve companies' climate disclosures. Better corporate climate reporting will improve the functioning of financial markets, in that relevant information will become available and be reflected in the prices of financial assets. Good corporate reporting on climate risk will put us in a better position to assess companies' prospects, prioritise our ownership work, and make investment decisions.

We have long supported the voluntary climate reporting framework from the Task Force on Climate-related Financial Disclosures (TCFD). This framework is a good starting point for climate reporting and has been incorporated into reporting requirements in a number of markets. We will work towards both listed and unlisted companies being required to report on the basis of this framework.

We will work towards good standards for reporting on indirect emissions in companies' value chains (Scope 3). In many sectors, this is particularly important for gaining a better understanding of companies' climate risk. We will also work on other climate-related issues where it might be appropriate to contribute to the development of international standards. One topical example might be companies' use of various types of climate quota to offset their emissions.

The expert group recommends that the management mandate includes a requirement that Norges Bank's work on the development of relevant international standards prioritises the development of standards for the analysis and management of climate risk. Norges Bank already prioritises this area and will continue to do so in future. It is therefore our assessment that it is not necessary for the mandate to make such a requirement.

Ownership activities

Norges Bank has a chain of tools for managing the fund's climate risk. The key tool is active ownership, but we may also decide to divest from companies if dialogue and voting prove unsuccessful. We present the various tools below.

We plan to grow our ownership activities, in both breadth and depth. We intend to step up our work with the highest-emitting companies in the portfolio and pay particular

[5] For further information on the standards and initiatives that we support, see Norges Bank's letter of 2 July and our responsible investment reports at www.nbim.no.

attention to companies that have not published climate plans and companies with weak climate reporting. We will also strengthen our ownership activities aimed at the financial sector. This is a sector that is mainly exposed to climate risk indirectly, which can make it more challenging for the markets to price this risk.

One important aim of our dialogue with companies on climate risk is understanding their strategic choices and the rationale for them, including assumptions about future carbon pricing and the need for transition strategies. We will encourage companies to set themselves goals for emissions, with concrete targets for the short, medium and long term. One important part of this work will be to ensure that these goals are transparent and credible, for example that companies' investment plans are consistent with the emission targets they themselves have set.

Dialogue with companies will not have the desired result in every case. We can then hold boards accountable for their decisions through our voting. One option is to vote against the re-election of board directors at a company if we believe that the board's management of climate risk is particularly poor – for example, if the company does not have a convincing transition strategy.

So far this year, we have voted against the re-election of board directors on the grounds of poor climate risk management in six cases. We are considering how we can use this tool to a greater extent than today. Another voting-related tool is filing shareholder proposals, either independently or together with other investors. Shareholder proposals in the climate area are something we will consider in the future.

We are the world's largest single shareholder and among the top ten shareholders at nearly half of the more than 9,000 companies in which the fund is invested. The fund's size gives us good access to company boards. Based on our experience from being an active owner for many years, Norges Bank believes this makes it reasonable to assume that our ownership activities have an impact. We will work on documenting the effect of our ownership work in the future.

When ownership activities are not successful, we may decide to divest from companies where we believe that they have particularly poor management of climate risk and so present an elevated financial risk. Norges Bank already makes risk-based divestments on climate-related grounds. These are active investment decisions and cover companies with very poor management of climate risk, companies with a high emission intensity, and companies that contribute to deforestation. We plan to further reduce our exposure to companies with unsustainable business models in the coming years.[6]

[6] See our strategy for 2021-2022 at www.nbim.no.

One important premise for the investment strategy set by the Ministry is that the fund is to be managed close to the benchmark index. As a result, risk-based divestments will generally only be an option for small companies. With larger companies in the benchmark index, we have limited room to manoeuvre, because divestments would draw more on the limit on deviations from the benchmark index. Where companies are linked to severe environmental damage or unacceptable greenhouse gas emissions, observation or exclusion under the conduct-based climate criterion may be an alternative approach. It is the Council on Ethics that recommends whether companies should be placed under observation or exclusion based on the conduct-based climate criterion. Based on the Council on Ethics' recommendation, it is the Executive Board of Norges Bank that makes the final decision on observation or exclusion.

At present, four companies are excluded under the conduct-based climate criterion. Going forward, Norges Bank will work actively to get the companies we invest in to steer their business towards net zero emissions. Through this work, we will build up detailed information on companies' climate risk. As Norges Bank writes in its letter 20 December 2021, once we have gained experience of the effects of this work, the Ministry could consider whether Norges Bank could take decisions on observation and exclusion under the conduct-based climate criterion on its own initiative, as is currently the case with the coal criterion.

<u>Responsible investment</u>

Responsible investment is an integral part of our management of the fund. There is close co-operation between our equity managers and the ownership department. All relevant information is shared through a common data platform. Our equity managers carry out in-depth research into individual companies. This work is important for how we prioritise our ownership dialogue, in terms of both which companies we contact and which topics we raise. Our managers also provide input for our voting.

This close co-operation between equity managers and the ownership department is especially relevant when it comes to sectors and companies facing particular challenges in the transition to a low-carbon economy. We will look to help these companies succeed in the transition by having specific plans for following up these companies. In this way, we can actively support the low-carbon transition. Different companies and sectors will play different roles in the transition to a low-carbon economy. The more companies and sectors that are involved, the greater their combined contribution to the transition will be.

Climate risk is one of a number of types of risk that our portfolio managers consider when investing in individual companies. Our investment decisions are based on assessments of the outlook for different sectors and companies' future earnings. In some sectors, carbon price developments, new technology and companies' transition plans are a key part of these assessments. One example is the energy sector, where we pay particular attention to developments through active mandates.[7]

We have also developed expertise in environmental technology through our management of the environment-related equity mandates. The first such mandates were established in December 2009. The environment-related mandates have brought positive learning effects in several parts of our organisation. In future, we will draw more on the expertise of the managers of the environment-related mandates in other areas of our management. This is particularly relevant to other internal mandates for security selection on the equity side.

Assessments of climate risk are also an integral part of our management of the unlisted real estate portfolio. Unlisted real estate investments have a long investment horizon. We enter into long-term leases, and renovations and improvements to the properties we own are long-term decisions. Climate change is therefore an important factor when evaluating existing properties and when making investment decisions. We will work towards a goal of net zero emissions from the properties we own in 2050 by engaging with the partners we invest with and by working on reducing emissions from properties we own alone.

External co-operation

We work with others to achieve our aims when it comes to responsible investment. Working with standard setters is particularly important to ensure well-functioning markets and good corporate governance. We have a regular dialogue with other investors to exchange knowledge and develop a common understanding of key aspects of responsible investment. Co-operation and co-ordination ensure that companies face the same expectations from a broad set of investors.

The expert group writes that the fund's size and clear voice on sustainability issues mean that numerous investor initiatives want to have the fund on board, and that it is necessary to prioritise participation in a selection of them. The group believes that decisions on this should be left to Norges Bank, but that the reporting on its ownership work should provide information on the principles and assessments underlying these decisions.

Before we decide to take part in an initiative, we consider whether membership would be a more efficient use of our resources than acting alone. We are cautious about participating in initiatives that demand, or might come to demand, the setting of goals that are not consistent with the investment strategy set out in the management mandate. As a large sovereign fund, we are also wary of participating in initiatives that target other countries' climate policies.

[7] In it's letter of 2 July Norges Bank writes that many of the companies in the energy sector have the ambition to be among tomorrow's most important producers of renewable energy. According to a study by Cohen, Gurun, and Nguyen (2020) are US oil and gas companies among the most important developers of green patents.

One initiative singled out by the expert group is Climate Action 100+. This is a network of investors working together to improve corporate climate disclosures and engage effectively with a select group of companies. Although the fund is one of the world's largest shareholders, working with others can increase the impact of our ownership efforts. We have therefore started a dialogue with Climate Action 100+ to see how well the initiative aligns with our management mandate, what resources this co-operation might require, and what role we would be expected to play. We regularly carry out similar assessments of other initiatives.

Provisions on measurement, management and reporting

The expert group recommends separate provisions on the measurement, management and reporting of climate risk. For example, it recommends that Norges Bank regularly stress-tests the portfolio against various climate policy pathways and reports on decarbonisation pathways for the companies in which the fund is invested.

Decarbonisation pathways for individual companies

The expert group recommends that the long-term goal for active ownership described above is supplemented with intermediate targets for emission reductions at companies that are updated and reported on regularly.

Such intermediate targets for emission reductions at individual companies will be a key tool for following up companies through our ownership work. We will analyse decarbonisation pathways for individual companies we invest in. Over time, these analyses can also be used in active investment decisions, and in our risk management. This work will require increased resources in several parts of our organisation. For it to be a success, we will need to use and build skills in the risk department, among our internal sector managers, and in the ownership department. Close co-operation between different parts of the organisation will ensure a holistic approach.

One key question is how we are to prioritise work on decarbonisation pathways. The fund is currently invested in more than 9,000 companies. It is not possible to analyse and monitor decarbonisation pathways for all of the companies we invest in. We will begin by concentrating on a selection of companies in the highest-risk sectors, and then gradually expand this work.

Another key question is which methods we should use. There are various external initiatives for calculating decarbonisation pathways, all based on different assumptions. It is important that assumptions, measurement errors and implications at the company level are properly understood before we start making demands of companies in our ownership work. Other important questions are what time horizon and climate scenario we should use, what approach we take to carbon offsets, and how the pathways should be adjusted if companies do not hit their targets.

At present, there is no single method that suits all companies. We are closely monitoring developments in the various initiatives and have a regular dialogue with external data providers and academic networks on the various methods' strengths and weaknesses. We are currently carrying out a pilot project together with an academic institution to compare the different methods. Much work still needs to be done to address the methodological issues, and so it is not appropriate to commit to a particular type of metric or method at this stage.

Norges Bank supports standards and initiatives that we believe are particularly relevant for the development of decarbonisation pathways. Key initiatives in this work include the TCFD and the Transition Pathway Initiative (TPI). We have a regular dialogue with the TCFD and sit on the TPI's steering group. We will consider involvement in other initiatives in this area.

Reporting on climate risk

The expert group recommends that the overall reporting on the fund should be viewed in the light of the EU's taxonomy. In our letter of 25 October 2021, we wrote that once we have gained experience of the taxonomy and reporting directive, we will be able to consider whether it might be appropriate for taxonomy information and exposure to environmental activities to be included in the fund's reporting where relevant. The expert group reaches the same conclusion. We are closely monitoring developments in this framework, and have provided input on a number of occasions to help improve standards and market practices.[8]

We stress-test the equity portfolio against various climate scenarios. The scenarios we use are based on the same outcomes as the scenarios presented in the report of the Climate Risk Commission and reproduced in the expert group's report.[9] We will be able to report this information in future in line with the expert group's recommendation. Transparency around the methodology and underlying assumptions will be important. Scenario analyses can contribute to a better understanding of climate risk in the longer term, but cannot be taken as a prediction of future developments.

We will report in line with the TCFD framework in our annual reports on responsible investment. This reporting will gradually be developed further as new knowledge and practices emerge.

We will include information on our real estate management in our TCFD reporting where relevant. For example, we will be able to stress-test the real estate portfolio against decarbonisation pathways through to 2050 developed by the Carbon Risk Real Estate

[8] See consultation responses of 8 March 2019, 9 July 2020 and 31 August 2021 at www.nbim.no.
[9] For further information, see Official Norwegian Reports NOU 2018:17 "Klimarisiko og norsk økonomi" [Climate risk and the Norwegian economy] and Norges Bank's letter of 2 July 2021.

Monitor (CRREM) project.[10] We support and contribute to standards and knowledge networks for sustainable real estate, including CRREM and the Better Buildings Partnership (BBP). We currently use the Global Real Estate Sustainability Benchmark (GRESB) to assess and report on the sustainability of the real estate portfolio.

Concluding remarks
Norges Bank believes that the expert group's recommendations form a sound basis for our future work on climate risk and climate-related investment opportunities. Many of the recommendations entail formalising and further developing Norges Bank's existing work.

This formalisation and a gradual expansion of our reporting will contribute to greater knowledge about Norges Bank's work on climate risk and climate-related investment opportunities. Greater knowledge will provide a basis for effective follow-up of our work in this area. Work on climate risk in the fund has evolved over the past 15 years and will continue to evolve based on new insights. The management mandate should therefore be overarching and principles-based. It it's letter of 13 September 2021, the Ministry writes that they will consider how the expert group's recommendation should be followed up in the 2022 White paper of the fund. Norges Bank assumes that, following the White paper, we will be able to return to the Ministry with how the GPFG's work on climate risk should be reflected in the management mandate.

Active ownership will play a key role in work on managing the fund's climate risk. One key recommendation from the expert group is including in the management mandate a provision that gives Norges Bank's responsible investment a long-term goal of net zero emissions from the companies in which the fund is invested. Norges Bank supports such a goal for the fund's responsible investment. Our assessment is that a long-term goal for our responsible investment, and work on decarbonisation pathways that are followed up with companies regularly, will help our ownership activities to be more focused in future.

At the same time, we believe that it is important that the Ministry clearly communicates that such a goal for our responsible investment does not mean that the investment portfolio should be managed with a view of achieving goals other than highest possible return. It is also important not to create an expectation that Norges Bank will automatically divest from companies that do not comply with a given decarbonisation pathway.

We have experience and expertise in all of the areas highlighted in the expert group's report. Norges Bank will, however, need to strengthen this work. More resources will be needed for this higher level of ambition. It is also important that this work does not

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[10] We are supporting CRREM, a research project which in 2020 published decarbonisation pathways through to 2050 in line with the Paris Agreement for various real estate markets. We are using the tool in our wider work on measuring transition risks in the real estate market.

impinge on other activities, as climate risk is one of many risk factors to which the fund is exposed.

Increased climate-related resources in several parts of our organisation could also put us in a better position to understand companies’ exposure to climate risk and climate-related investment opportunities. The information we obtain may be of use in active investment decisions and risk management, and so contribute to the fund’s financial objective.

Yours faithfully

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