



NORGES BANK

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Government Pension Fund Global – Experience of the climate criterion

In its letter of 20 September 2021, the Ministry of Finance asks Norges Bank to discuss its experience of the climate criterion.

Background

The conduct-based climate criterion was incorporated into the Guidelines for Observation and Exclusion from the Government Pension Fund Global (GPFG) in 2016. Observation or exclusion may be decided on where there is an unacceptable risk of a company contributing to, or being responsible for, acts or omissions that, on an aggregate company level, lead to unacceptable greenhouse gas emissions.

The Council on Ethics sent its first recommendations for exclusion under the climate criterion to Norges Bank in 2017. The Executive Board considered the recommendations in October 2018 but did not reach any decisions. In a letter to the Ministry of 7 November 2018, the Bank wrote that there were differences in how the Council on Ethics and the Bank viewed how the conduct-based climate criterion should be applied, and asked the Ministry for more detailed clarification of certain aspects of its application. The Ministry discussed the criterion and clarified its application in Report to the Storting No. 20 (2018-2019).

On the basis of recommendations from the Council on Ethics and this clarification from the Ministry, the Bank announced its first decisions under the criterion on 13 May 2020.¹ Four companies with substantial production of oil from oil sands were excluded from the benchmark index and the fund's investment universe. The Council on Ethics has not made any further recommendations under the climate criterion.² The climate criterion

¹ The four companies in question were Canadian Natural Resources Ltd, Cenovus Energy Inc, Suncor Energy Inc and Imperial Oil Ltd.

² The Council on Ethics writes in its annual report for 2020 that it concentrates its efforts on extremely large individual emissions or business sectors and processes which, by their nature, generate high emissions, such as the production of cement and steel.



was introduced together with the product-based coal criterion. At present, 72 companies are excluded under the coal criterion. Most of these were excluded as early as 2016, which probably means that some companies that might have been excluded under the climate criterion had already been excluded from the benchmark index and the investment universe.

Premises for the application of the climate criterion

The Ministry has outlined a number of general premises for the application of the criterion. The threshold for exclusion is to be high, and the climate criterion is to be dynamic over time so as to take account of technological and regulatory developments. At the same time, the Ministry has stressed that the basis for exclusions should stand the test of time, so that decisions on exclusion do not need to be reversed after a short period. For a company to be assessed for observation or exclusion under the criterion, it must have high emissions in absolute terms, both at an aggregate company level and from the activity in question. The company must also have significantly higher relative emissions (emission intensity) than companies with which it would be natural to draw comparisons. The climate criterion is a conduct-based criterion. As such, the criterion does not define the certain products as grossly unethical in themselves. Individual companies' emission intensity on the other hand is seen as a consequence of conduct.

With the climate criterion, the ethical assessments are to be forward-looking. The aim is to assess the risk of the unacceptable conduct persisting. It is therefore very important whether the company has concrete and credible plans to cut emissions. It is difficult to assess how a company will behave in the future and what plans for reducing emissions are ethically acceptable. These assessments require the use of judgement. However, standards and methods are now being developed for how companies can set themselves emission targets in line with the goals of the Paris Agreement. In time, these may provide a better basis for our assessments. These frameworks are still in their infancy, however, and are not equally well developed in every industry.

Assessments under the climate criterion are also required to take account of whether companies' greenhouse gas emissions are subject to taxes, emission allowances or other regulatory mechanisms. The Ministry has stated that importance is to be given to these factors, even though it can be difficult to assess how strict a particular climate regime is. The Ministry has also clarified that the EU's Emissions Trading System, which is considered to be a strict climate regime, provides a good basis for comparison when assessing other climate regimes. Where companies are subject to a strict climate regime, there must be additional factors for their conduct to be considered unacceptable under the climate criterion. In Report to the Storting No. 20 (2018-2019), the Ministry lists a number of factors that may be relevant in this regard, including transferring production from countries with a strict climate regime to countries with no climate regulation, opposing or circumventing climate regulation, and inadequate climate reporting.



Norges Bank's experience

Norges Bank is of the opinion that the Ministry's clarification of the climate criterion in Report to the Storting No. 20 (2018-2019) provides a useful frame and a clear basis for the application of the criterion. The decisions to exclude four companies with substantial production of oil from oil sands illustrates the application of the criterion well. The companies were excluded on the basis of assessments of their relative emission intensity and whether they had concrete plans to reduce their emissions satisfactorily within a reasonable period. Assessments of the regulation of greenhouse gas emissions were part of the basis for these decisions.

Although there is now a clear basis for the application of the criterion, its application is complicated and relies on deep insight into climate risk, economic and regulatory regimes, and technology. It also requires assessments of complex circumstances at industry and company level, and access to detailed information on companies' operations and plans. The application of the criterion involves a considerable amount of comparison between companies. This differs from the other conduct-based criteria for observation and exclusion, which are more about violations of norms at company level that can be identified one by one.

Norms and references related to net zero emissions in 2050 provide a rather more robust basis than before for assessing companies' acts and omissions in terms of greenhouse gas emissions. In time, the Bank expects industry-specific criteria or thresholds for assessing greenhouse gas emissions, reduction plans and performance against these plans to become clearer, including as a basis for ethical assessments.

In its letter of 19 December 2021, Norges Bank discusses the various tools at its disposal for addressing the fund's climate risk. We argue that active ownership is the key tool in the fund's work on this risk. We nevertheless stress that if active ownership does not have the desired outcome, we may choose to divest from companies where we believe them to have particularly poor management of climate risk. Risk-based divestments of this kind are active investment decisions, and the companies remain in the fund's benchmark index and investment universe, unlike with ethical exclusions. As a result, risk-based divestment will generally only be an option for small companies, as this draws on the fund's limit for deviation from the benchmark index.

The Bank's work on climate risk and the Council on Ethics' work on the conduct-based climate criterion have different objectives. We nevertheless believe that there will often be some overlap between the companies looked at. The Council on Ethics reaches a similar conclusion in its annual report for 2020, where it writes: "With the guidelines that have been drawn up for the climate criterion, it is natural that the work of Norges Bank and the Council should overlap. Both institutions will prioritise sectors that generate substantial emissions, and the main focus will be on companies that perform below the



industry average. In this area, therefore, there is a particular need for close co-ordination to establish an effective division of labour.”

The degree of overlap will probably increase in the years ahead. In its letter of 20 December, the Bank writes that it plans to work actively to get the companies in which the fund is invested to steer their business towards net zero emissions. This means that our ownership activities will be more closely aligned with international climate goals.

Through this work, we will build up additional detailed information on companies’ climate risk and climate plans. This may mean that it is appropriate to have a more extensive exchange of information between Norges Bank and the Council on Ethics in their work on the climate criterion, including with a view to efficient use of resources and co-ordinated communication with companies.

Once we have gained experience of working with companies on net zero targets, the Ministry might consider whether Norges Bank should be permitted to 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.

Yours faithfully

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