How the Norwegian SWF Balances Ethics, ESG Risks, and Returns: Can this Approach Work for Other Institutional Investors?

DR. ANITA MARGRETHE HALVORSSEN, LLM, JSD

DIRECTOR, GLOBAL LEGAL SOLUTIONS, LLC

AMHALVORSS@AOL.COM

INTRODUCTION

OVERVIEW:

- Norwegian Sovereign Wealth Fund (SWF) - Government Pension Fund Global (GPFG or ‘the Fund’)
- The GPFG and ESG (focus on climate change)
- Climate Emergency leading to financial risk
- What is Climate Risk?
- Climate risk and the GPFG

Norwegian SWF - Government Pension Fund Global (GPFG)

- GPFG is the largest SWF in the world and one of the largest institutional investors (establ. 1990 - first allocations in 1996)

  Current assets over US $1.1 trillion (June 21, 2022)

- A **universal diversified fund** - owns average 1.5% **equity** in over 9,000 <u>foreign</u> companies (70 countries), also **fixed income**, **real estate**, and **unlisted investments in infrastructure for renewable energy** -

GPFG

- The Fund has **no liabilities** ulike other pension funds
- The GPFG is fully funded
- The money Norway receives from high taxes on oil & gas companies drilling off its coast and its 67% stake in Equinor goes directly to the Fund – to avoid the Dutch Disease, harming the broader economy
- **3% of the Fund’s value**, goes into the Government’s budget **(Fiscal Rule), expected return** on investment, thus preserving the principle

GPFG is:

- **Owned** by the **NORWEGIAN PEOPLE**,
- **Ministry of Finance (**formal responsibility for the management) decides on the overall **investment strategy** for the Fund based on the **framework** set by the **Norwegian Parliament**
- **Operational management** is delegated to the **Central Bank** (Norges Bank). Ministry determines the Ethics Guidelines
  - **Managed** by **Norges Bank Investment Management (NBIM)**, the investment management division at Norges Bank.
- GPFG only invests abroad – all assets invested outside Norway

GPFG - Goal

- To invest the funds to achieve the **maximum possible return with moderate risk based on sound, long-term management**
- Contingent on **sustainable development**
- **Long term investment horizon**
- **Intergenerational** to ensure that this wealth can benefit all generations (present and future)

The Fund is **transparent**, **responsible** and has **ethics guidelines**

GPFG and ESG 1/1

- **ESG DISCLOSURES -** contribute to positive changes in sustainability issues
  - **NBIM has issued Climate Change Expectations –** (also expectations on Children's Rights, **Human Rights**, Water Management, Ocean Sustainability, **Anti-corruption,** Tax and Transparency)
  - **Based on international standards and principles from the UN and OECD.**

GPFG and ESG 2/2

- **ENGAGEMENT - OWNERSHIP STRATEGIES:**

  ACTIVE INVESTOR - 2021:
  - The Fund had **2,628 company meetings**
  - **Screened all its investments against the Expectations**
  - **Dialogue** with the large companies and the ones that are weakest on disclosing ESG issues
  - **Voted** at over **11,500 AGM meetings.** Voting was **disclosed** – posted ahead of vote to get more support (disclosure of intentions)

GPFG - INVESTING SUSTAINABLY

- **Assessment, investment, divestment**
- **Began Pre-screening in 2021 - 443 companies**, did **not invest in 9** of them
- **Environment-related investment mandate** – Low-emission energy, alternative fuels, clean energy, energy efficiency technology, and natural resource management.

- New asset category - **Unlisted renewable energy projects**

The first project: April 2021 **Offshore wind farm –** 50% stake ($1.6 billion), in Ørsted's Borssele 1 & 2 off the Dutch coast. (Ørsted is Danish). **Power for the equivalent of 1million households' annual power consumption in the Netherlands.**

GPFG's Ethics Guidelines 1/2

- Negative screening (implemented in 2004)

- **CONDUCT:** GPFG should not make investments which constitute **unacceptable risk** that the Fund may contribute to unethical acts or omissions -
  - violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental degradation, etc.
  - **New criteria** in 2016: Acts or omisions that, on an **aggregate company level,** lead to **unacceptable greenhouse gas emissions**
- **PRODUCTS**: not make investments in tobacco, certain weapons (such as nuclear weapons, cluster bombs), coal (if it consists of 30% or more of the company's income), etc.

GPFG's Ethics Guidelines 2/2

- **Independent Ethics Council** recommends **EXCLUSION AND OBSERVATION** of **individual companies (not countries),** for breach of fundamental ethical principles –
- **Final decision** made by **Executive Board of Norges Bank**

- **In Canada: Cenovus Energy Inc, Canadian Natural Resources Limited, Suncor Energy Inc**, and **Imperial Oil Limited** were all **excluded based on: Acts or omisions - unacceptable greenhouse gas emissions** - carbon emissions from production of oil from oil sands/ tar sands (2020)

GPFG's ESG Risk-based Divestment

- – if companies are **not cooperating or changing**, then **DIVESTMENT** by Norges Bank is the **final solution**

  - **If companies are not operating** with a **sustainable business model** or have **high carbon emissions – 43 companies - 2021**
  - **Divestment reduces the Fund's exposure to unacceptable risks.**

- **GPFG has divested from 366 since 2012, for example:**
  - **60 companies due to deforestation** (33 were palm oil companies),
  - **Over 100 oil and gas producers (upstream producers only)** due to the **oil price-risk (2019)**

We are now in a CLIMATE EMERGENCY

- In April **2022**, **UN Secr. Gen. Guterres**, referred to the Intergovernmental Panel on Climate Change, **IPCC report (AR6)** as **"Code Red"** and said:
- "We are on a pathway to global warming of more than double the **1.5°C limit agreed in the Paris [Agreement].** Some **Government and business leaders** are **saying one thing but doing another**."
- "Simply put, **they are lying**, and the results will be catastrophic," he said. "**Investing in new fossil fuels infrastructure is moral and economic madness**."
- "**Climate activists** are sometimes depicted as dangerous radicals. But the truly **dangerous radicals are the countries that are increasing the production of fossil fuels**."


We are spewing 162 million tons of manmade global warming pollution into the thin shell of our atmosphere every 24 hours — as if it were an open sewer.
(Al Gore – Climate Reality Project)
Photo © Peter Weber/Shutterstock

Mitigation vs. Resilience (Adaptation) - - We Need Both

- **Katharine Hayhoe, climate science professor at Texas Tech University, said:**
  - **"The world was heading for dangers unseen in the 10,000 years of human civilisation, and efforts to make the world more RESILIENT were needed but by themselves could NOT SOFTEN THE IMPACT ENOUGH."**
  - **"People do not understand** the **magnitude of what is going on,"** she said. "This will be **greater than anything we have ever seen in the past.** This will be unprecedented. **Every living thing will be affected."** *The Guardian*

We are already beyond the Carbon Budget

- We humans have pumped more than **36 BILLION** tons planet-warming carbon dioxide into the atmosphere **in 2021 alone**, more than in any other year.
- We have **510 GtCO2** left of the **carbon budget**
- **IPCC notes that: "[e]stimates of future CO2 emissions from *EXISTING* fossil fuel infrastructures *already exceed* remaining cumulative net CO2 emissions in pathways limiting warming to 1.5°C**
- Estimated future CO2 emissions from ***EXISTING** fossil fuel infrastructure alone are **660*** (460-890) **GtCO2** and from *existing **AND CURRENTLY PLANNED** infrastructure are **850*** (600-1100) **GtCO2**.

TIMING – What's the rush?

- **"Climate change is something that is going to happen 20-30 years hence," said** HSBC Bank Asset Management's head of responsible investment Stuart Kirk, speaking at the FT Live Moral Money Summit Europe conference.
  - **That doesn't line up with the IPCC's AR6**
  - **Kirk was suspended (*according to FT*).**
- **CLIMATE CHANGE IS ALREADY HERE!**
- Climate disasters have cost North America $415 billion in the last three years, much of that due to wildfires and hurricanes *(Morgan Stanley)*.
- **Could Cut World Economy by $23 Trillion in 2050 *(Swiss Re)***

Norwegian commission on Climate Risk and the GPFG

A Norwegian commission (led by Martin Skancke) appointed by the government presented its report in August 2021 addressing **how the green transition and climate risk will affect the GPFG**

Some of the following information on climate risk is from this Skacke report:

https://www.regjeringen.no/contentassets/fb49a0e957324d7caadb625c6ec4490c/en-gb/pdfs/r-0655-e-klimarisiko-og-oljefondet.pdf

Climate Change is a Market Failure

Sixteen years ago, **Lord Nicholas Stern** characterized **climate change as the result of** "the **greatest market failure the world has ever seen**" (Stern 2006: *viii*) - "Emitters generally do not pay". Not much better today

Skancke report:

- If climate ***policy*** is changed rapidly, it may lead to large transitional risks and **financial instability** – affecting **investments' value** – **GRADUAL DECARBONIZATION = LESS RISK**
- A **<u>well-functioning market</u> is essential for good management of the climate risk** – leading to **optimal distribution of risk in the market**–
- By diversifying, investors can reduce part of their climate risk
- **Late and rushed transition** – difficult to reduce climate risk through the spreading of it – **Early start means less instability**

Climate Risk – is a financial risk

- **CLIMATE RISK** = **physical effect** of climate change impacts on companies (physical risk) and impacts of **policy** addressing climate change (transitional risks)

Skancke Report:

- **PHYSICAL RISK** – consequence of **climate change impacts** on the environment: fires, drought, flooding – **risk factors on companies - indefinite**
- **TRANSITIONAL RISK** - risk connected to the consequences of **climate policies, technologies** and preferences in the move to a low-carbon society **- temporary**
- The extent and **IRREVERSIBILITY OF THE CLIMATE CRISIS** is a **unique challenge** with **dramatic consequences and uncertainties**
- Climate crisis doesn't follow the normal economic and political timelines – it is **long term** and raises **fundamental ethical questions**
- An **effective and predictable** climate ***policy*** is **essential**

INVESTORS – in general

- **ESG investing globally**- nearly $2.77 trillion in assets under management
- 'E' in ESG – focuses on ***corporate impact on the environment*—.** ***Climate has become a major focus - CO2 emission, etc.***
- **Investors' climate risks arise from the risk to the corporations they are invested in**
- Investors need a clear view of **which companies will survive** given the environmental changes, regulations, new technologies, and customer behavior **- TCFD (Task Force on Clmate-related Financial Disclosure) –** has developed a **voluntary framework** for corporate disclosure – **focused on *impacts of climate change on the corporation***

TCFD (Task Force on Climate-related Financial Disclosure)

- Created by the Financial Stability Board (FSB)
- Companies need to transition to a low carbon economy
- The **investor needs relevant information**
- companies should **STRESS TEST** their **business models against climate policy scenarios in line with the 1.5 degrees of Paris Agreement - Will they still be profitable?**

3 Options for companies:

- Companies transition,
- Disappear **or**
- They are taken over by other companies that are transitioning to the green economy

GPFG and Climate Risk 1/2

- THE SKANCKE REPORT SUGGESTED ACTION:
  - Set of principles for managing the GPFG's climate risk
  - Amend the GPFG's mandate to **explicitly anchor climate risk in GPFG's mandate**.
  - Under the mandate, Norges Bank's responsible investments would be based on: **Net zero emissions by 2050**

GPFG and Climate Risk (Skancke) 2/2

- Using Norges Bank's **active ownership** to influence corporate behavior thereby strengthening the functioning of the markets through **better climate risk reporting**
- Increase the requirements to **strengthen the measuring, managing, and reporting of climate risk**
- **Norges Bank should report regularly** on the **scenario analysis** in line with the TCFD framework **shedding light on the climate risk in its own portfolio**

GPFG - Climate policy at the international and national level (Skancke)

- An ambitious and successful international climate policy **decreases** the **physical climate risk** for the GPFG

- A predictable **climate policy** and a **gradual decarbonization** of the economic system gives less of a risk of sudden changes in value of the Fund's investments and **less risk of financial instability.**

GPFG'S TOOLS TO AVOID CLIMATE RISK 1/2 (Skancke)

- **Spread the risk:** Diversify the investments
- **Active ownership -** directed at the corporations (the source of climate risks):
  - **Test the strength** of the **business model**
  - Ensure the corporation has capital discipline – **channeling funds** to profitable projects in the **transition to a low carbon economy**
  - **Strengthen the ability** of the **financial market** to set a **price on the climate risk**, primarily through company reporting

GPFG'S TOOLS (Skancke) 2/2

- **Taking advantage of being an active and responsible investor:**
  - Choose a **different composition of the portfolio than the benchmark index** to take advantage of climate related opportunities and risks
  - **If active ownership fails** and the company is deemed not to have a convincing transition strategy, but weak profitability, and invests in poor projects rather than paying dividends, **the bank can divest from the company.**

- **Observation or Exclusion (Ethics Guidelines**): if there is an unacceptable risk that the company is associated with serious environmental damage or leads to greenhouse gas emissions to an unacceptable degree.

IFRS* Sustainability Disclosure Standards - prototype issued

- Set by the International Sustainability Standards Board (ISSB)
- Global baseline of **sustainability-related disclosure standards** that **provide investors** with information about **COMPANIES' SUSTAINABILITY-RELATED RISKS and OPPORTUNITIES**
- How a company discloses information about sustainability-related factors that may help or hinder a company in creating value.
- There is also a **Climate-related Disclosures Prototype**
- Similar to the **TCFD**

* International Financial Reporting Standards (IFRS)

- Thank you very much!