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Report to the Storting (white paper)

The Management of the Government Pension Fund in 2014

Preliminary and unofficial translation from Norwegian.

For informational purposes only.

1 Introduction

The Government Pension Fund comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The Funds are managed by Norges Bank and Folketrygdfondet, respectively, under mandates set by the Ministry of Finance. The asset managers make investment decisions and exercise ownership rights independently of the Ministry, within the limits defined by the mandates.

In this report, the Ministry presents management performance and assessments of the Government Pension Fund for 2014. Further development of the investment strategy for the Fund is discussed. An account is also given of the management framework follow-up.

Strong performance in recent years

The Government Pension Fund performed well in 2014. The nominal return before asset management costs was 7.6 percent for the GPFG, as measured in foreign currency, and 10.7 percent for the GPFN, as measured in Norwegian kroner.

This performance reflects positive price developments in stock and bond markets, both internationally and in Norway. Last year, asset management at Norges Bank delivered a negative excess return relative to the benchmark index adopted by the Ministry for the GPFG. Assets management at Folketrygdfondet contributed a positive excess return. At the end of 2014, the overall value of the Government Pension Fund was about NOK 6,616 billion, reflecting an increase in value of NOK 1,411 billion over the year.

From January 1998 to December 2014, the average annual nominal return was 5.8 percent for the GPFG and 7.3 percent for the GPFN, before asset management costs. At the same time, return fluctuations have been significant. Norges Bank and Folketrygdfondet have achieved average annual gross excess returns in their asset management of 0.25 and 0.53 percentage points, respectively, over the said period.

In 2014, the asset management costs of the GPFG and the GPFN accounted for 0.06 percent and 0.08 percent of fund assets, respectively. The Ministry is committed to cost-effective asset management. Comparisons with other funds show that the asset management costs of both the GPFG and the GPFN are low, measured as a portion of assets under management.

The fiscal policy guideline calls for the petroleum revenues to be phased gradually into the Norwegian economy, more or less in line with developments in the expected real return on the GPFG. The *expected* long-term annual real return on the GPFG is estimated at 4 percent. The average *actual* annual real return on the Fund, i.e. the nominal return adjusted for inflation and asset management costs, has been 4.0 percent from January 1997 to December 2014. Since 1998, when equities were included in the benchmark index, the average annual real return has been 3.8 percent.

Whilst the overall return on the investments of the Government Pension Fund fluctuates considerably from year to year, the recurring income in the form of dividends, coupons and rental income is more stable. In 2014, the recurring income of the GPFG was just below 3 percent of fund assets, whilst it was just below 5 percent of fund assets for the GPFN.

The overall value of the GPFG has increased by NOK 3,119 billion over the last three years, cf. figure 1.1. The achieved return accounts for NOK 1,683 billion of this increase, whilst the net inflow of petroleum revenues increased the value of the Fund by NOK 670 billion. Depreciation of Norwegian kroner has, when taken in isolation, increased the value as measured in Norwegian kroner by NOK 774 billion, but changes in value as the result of Norwegian kroner exchange rate fluctuations do not affect the international purchasing power of the Fund. Total asset management costs over these three years were about NOK 8 billion.

Considerable uncertainty as to developments in the value of the Fund over the next few years

Returns in recent years have been very favourable, relative to the expected rate of return over time. This reflects strong growth in the prices of both equities and bonds. A number of factors serve to highlight the significant uncertainty as to developments in the value of the Fund over the next few years.

Bond yields are currently very low, also for bonds with a long maturity. In the short and medium run, the expected real return on the fixed-income portfolio of the Fund will be influenced by the currently observed real yields. The low market yields mean that coupon return is low. The scope for further capital gains on the bonds in the portfolio is limited, whilst the scope for capital losses in the event of rising interest rates is significant. Since large portions of the GPFG and the GPFN are invested in bonds, it must be expected that the low current market yields will reduce the overall return on the Fund for a time. Favourable long-term bond returns will require reinvestment of the portfolio at higher market rates.

In addition to the return on investments, developments in the value of the GPFG will depend on the inflow to the Fund. Net inflow, i.e. gross inflow less outflow to cover the non-oil deficit in the fiscal budget, has declined gradually in recent years. In 2014, the net inflow of new capital to the GPFG was the lowest for a decade. Inflows in coming years depend on, inter alia, oil price developments, which are subject to considerable uncertainty. Section 2.5 of this report discusses long-term projections for the real value of the GPFG and net inflow, as well as the uncertainty associated with these two variables.

The GPFG has over time become an important source of government expenditure funding. For 2015, it is estimated that the transfer from the Fund will cover about 11 percent of total expenditure via government budgets.

In the autumn of 2014, the Ministry of Finance appointed a committee to consider the application of the fiscal policy guideline. The mandate to the committee identifies a number of challenges facing the Norwegian economy and public finances. The mandate also notes that one may experience a period of somewhat lower capital returns. The value of the Fund has increased steeply in recent years, and its assets currently correspond to about 2½ years of value added in the mainland economy, as measured by trend GDP for Mainland Norway. Consequently, fluctuations in the value of the Fund and in the return on the Fund may be significant relative to the magnitude of other government revenues and the size of the Norwegian economy, and especially relative to underlying growth in the mainland economy from one year to the next. The committee shall submit its report by the end of June 2015.

One needs to be prepared for significant year-to-year fluctuations in the return on the Government Pension Fund. Norges Bank has calculated that expected fluctuations in the value of the GPFG, as measured by the standard deviation of annual nominal returns, are equivalent to 8.2 percent or about NOK 530 billion based on the market value of the Fund as at yearend 2014. Alternatively, one may look at the lowest and highest percentage annual nominal returns experienced thus far, which are -23 percent in 2008 and 26 percent in 2009, respectively, as measured in the currency basket of the Fund. Based on the value of the Fund as at yearend 2014, this corresponds to an annual decrease in value of close to NOK 1,500 billion or an annual increase in value of almost NOK 1,700 billion.

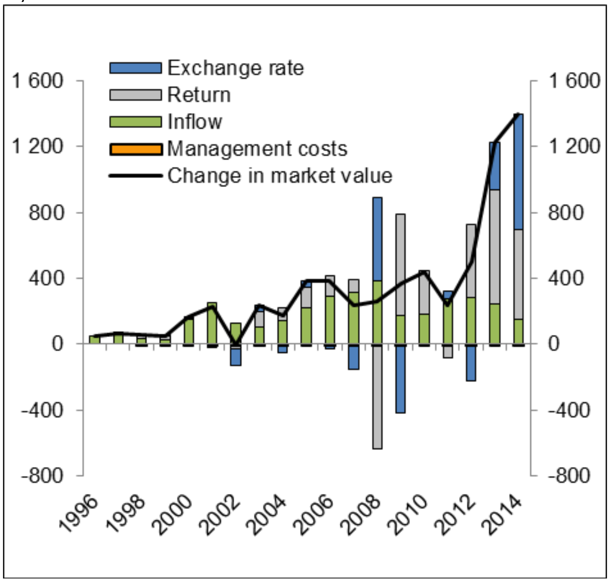

Figure 1.1 Developments in the market value of the GPFG over the period 1996–2014, attributed to inflow, return, exchange rate and asset management costs. NOK billion

Sources: Norges Bank and the Ministry of Finance.

Changes to the investment strategy

It is the ambition of the Government that the Government Pension Fund shall be the best managed fund in the world. This means aiming for the adoption of best practice internationally in all aspects of asset management. The investment strategy of the Fund has, in line with this, been developed gradually over time and is based on thorough professional assessments and analyses. Any material changes to the management of the Fund are submitted to the Storting. Such an approach provides a robust basis for sound long-term management of the Government Pension Fund.

The Ministry's development of the investment strategy is premised on how different investment choices are assumed to influence the long-term relationship between expected return and risk. Individual investment strategy decisions may have a major impact on the actual return on the Fund. The Ministry has attached considerable weight to anchoring the investment strategy in financial theory, research and accumulated experience. The Ministry also receives advice and commissions analyses from international experts on a regular basis. Moreover, Norges Bank and Folketrygdfondet have both a right and a duty to advise the Ministry on any need for changes to the management of the Fund.

Report No. 19 (2013-2014) to the Storting – The management of the Government Pension Fund in 2013, summarised a review of Norges Bank's management of the GPFG, based on advice and analyses from Norges Bank and a group of experts. The Ministry stated, inter alia, that it would revert to the issue of the limit on Norges Bank's deviations from the benchmark index adopted by the Ministry. Section 2.2 discusses the need for some scope for deviations from the benchmark index. Such scope for deviations provides the asset manager with an opportunity to improve the composition of the Fund's investments. The Ministry proposes, in this report, that the limit on deviations as measured by expected tracking error be increased from 1 to 1.25 percentage points. This is a cautious increase which may somewhat improve the performance of the Fund over time, but which may at the same time somewhat increase return fluctuations. This higher limit will be accompanied by new requirements in the mandate for the GPFG on, inter alia, supplementary reporting of the risk involved in asset management. However, it is no longer intended that tracking error as the result of rebalancing of the equity portion should be excluded from the limit, cf. Report No. 19 (2013-2014) to the Storting and section 2.4.

In 2008, the Ministry of Finance decided to permit investment of up to 5 percent of the GPFG in real estate, cf. Report No. 16 (2007–2008) to the Storting – The management of the Government Pension Fund in 2007. As at yearend 2014, 2.2 percent of the Fund was invested in real estate. Norges Bank has stated, in its strategy plan for 2014-2016, that it has an objective to invest one percent of the Fund in real estate each year for the next two years. This implies that such investments will approach the 5-percent upper limit within a few years. In December 2014, the Ministry announced that it would carry out a review of whether the upper limit on real estate investments should be changed, and whether the Fund should be permitted to invest in unlisted infrastructure. Section 2.3 discusses this review. The Ministry will consider how real estate and infrastructure investments may serve to improve the ratio between expected return and risk in the GPFG. Furthermore, the Ministry will assess the manner in which such investments can be regulated in the mandate of Norges Bank. If unlisted infrastructure investments are permitted on a general basis, investments in unlisted renewable energy infrastructure and in unlisted infrastructure in emerging markets will also become part of the investment universe of the GPFG.

Last year's report proposed an increase in the renewable energy investments of the GPFG by expanding the range for environment-related investment mandates to NOK 30–50 billion. This was endorsed by the Storting, cf. Recommendation 200 (2013–2014) to the Storting. It was also stated in the report that the Ministry would initiate an assessment of the effects of further expansion of the investments within renewable energy, and that such assessments would be based on these investments being subject to the same asset management requirements as apply to other investments of the GPFG. This is discussed in section 2.6, which proposes that the scope for environment-related investment mandates be expanded to NOK 30–60 billion. Reference is also made to the assessment of whether investments in unlisted infrastructure, including renewable energy infrastructure, should be permitted, cf. section 2.3. A major part of the renewable energy investment opportunities are in the unlisted market.

In April 2014, the Ministry of Finance appointed an expert group to assess the investments of the GPFG in coal and petroleum companies and the policy instruments used vis-à-vis such companies. The mandate referred to Recommendation No. 141 (2013–2014) to the Storting and to the Storting's deliberation of the said Recommendation. The expert group was requested to evaluate whether the exclusion of coal and petroleum companies appears to be a more effective strategy than the exercise of ownership rights and the exertion of influence. The group was also requested to advise on potential criteria for the exclusion of this type of companies. The report of the expert group was submitted in December 2014 and has been circulated for consultation. Section 2.7 outlines the advice from the group, the consultative comments and the Ministry's assessments. The Ministry proposes, inter alia, the introduction of a new conduct-based criterion, aimed at the greenhouse gas emissions of companies, in the Guidelines for Observation and Exclusion. In addition, the Ministry proposes strengthening the follow-up of Norges Bank's active ownership and risk assessments in relation to climate change.

The Ministry announced, in last year's report, that it intended to launch, during the course of 2014, an initiative to shed additional light on the risk to the long-term return on the Fund posed by climate change. The Ministry's analysis of climate risk is discussed in section 2.8.

The Ministry has previously noted that it intends to evaluate Folketrygdfondet's management of the GPFN on a regular basis, as is also done for the GPFG. Section 3.2 presents a review of the management of the GPFN. The review shows that Folketrygdfondet has achieved good performance over time in its management of the GPFN. No changes are proposed to the scope for deviations from the benchmark index for the GPFN, which is defined by a 3-percentage point limit on expected tracking error.

It was noted, in connection with the publication of Report No. 19 (2013-2014) to the Storting, that the Ministry would consider whether it should be permitted to invest parts of the GPFN in unlisted real estate and infrastructure. Section 3.3 outlines advice and assessments received by the Ministry from Folketrygdfondet. The Ministry will continue to examine this issue and consider how investments in unlisted real estate and infrastructure may potentially be regulated in the mandate given to Folketrygdfondet.

The Ministry will perform a corresponding assessment for the GPFG, cf. section 2.3. One aspect of such assessment will address the outline of the mandate given to Norges Bank and the scope for managing unlisted investments on the basis of a so-called opportunity cost model. This is also the model recommended by Folketrygdfondet for real estate and infrastructure in the GPFN. The Ministry intends to revert with assessments of investments in unlisted real estate and infrastructure for both the GPFN and the GPFG in the report on the Government Pension Fund in the spring of 2016.

Responsible investment

The Government is committed to transparency and ethical awareness in the management of the Government Pension Fund. The Fund shall, in line with this, be a responsible investor within its overarching financial objective. The Ministry operates on the assumption that good long-term return depends on sustainable development in economic, environmental and social terms, as well as on well-functioning and legitimate financial markets. The emphasis on integrating environmental, social and corporate governance considerations in the investment activities of Norges Bank and Folketrygdfondet has increased over time. Ethical guidelines for the management of the GPFG were introduced in 2004. These have since been updated and revised.

The division of responsible investment roles and responsibilities between the Ministry of Finance, Norges Bank and the Council on Ethics in relation to the GPFG has changed with effect from 1 January 2015. This results from a process to strengthen the long-term responsible management of the Fund, and follows up on the Storting's deliberation of last year's report on the Government Pension Fund, cf. Recommendation 200 (2013–2014) to the Storting. Decisions on the observation and exclusion of companies from the GPFG are now made by Norges Bank, based on advice from the Council on Ethics. The members of the Council on Ethics are appointed by the Ministry of Finance at the recommendation of Norges Bank. The new framework and the new division of responsibilities facilitate improved integration of the responsible investment tools, such as standard setting, active ownership, risk management and the exclusion of companies. Moreover, the framework facilitates communication and coordination between the Council on Ethics as advisor and Norges Bank as asset manager and decision maker. The amendments to the framework are discussed in section 5.2.

The criteria for observation and exclusion are determined by political authorities. Some of the criteria are based on which products companies produce, such as cluster munitions and nuclear arms. Other criteria are based on the conduct of companies, such as an unacceptable risk that a company contributes to, or is itself responsible for, serious human rights violations, gross corruption or severe environmental damage. As at the end of February this year, 60 companies were excluded and one company was placed under observation on the basis of these criteria.

The active ownership activities of Norges Bank and Folketrygdfondet are based on internationally recognised standards from, inter alia, the UN and the OECD. Norges Bank has in recent years divested from 114 companies whose business models is considered unsustainable in the long run. Such divestment takes place within the stipulated limit on deviations from the benchmark index. Section 4.4 discusses the responsible investment practices of the Government Pension Fund.

Transparent management and a strategy with widespread support

Transparency is a prerequisite for securing widespread confidence in the management of the Government Pension Fund. It follows from the mandates of Norges Bank and Folketrygdfondet that management shall be subject to the greatest possible degree of transparency within the limits defined by a sound execution of the investment mandate. The GPFG is considered one of the most transparent funds in the world.

Reporting on the management of the Government Pension Fund has been enhanced over time. Norges Bank and Folketrygdfondet report quarterly on asset management performance for the GPFG and the GPFN, respectively. Norges Bank and Folketrygdfondet publish monthly return data in connection with their quarterly reporting, and report on the utilisation of the risk limits defined by the Ministry, the Executive Board of Norges Bank and the Board of Directors of Folketrygdfondet, respectively. Norges Bank publishes quarterly analyses of how asset management is informed by systematic risk factors. Moreover, Norges Bank publishes its voting in the general meetings of individual companies, whilst Folketrygdfondet publishes any votes cast against proposals submitted by the company boards of Norwegian companies on an ongoing basis. From 2015, Norges Bank publishes a separate annual report on responsible investment, whilst Folketrygdfondet has chosen to integrate this into its regular annual report.

Financial reporting for both the GPFG and the GPFN is based on the International Financial Reporting Standards (IFRS), which require, inter alia, extensive and detailed notes. Public reporting on the purpose of the Fund and its management performance is in line with the so-called Santiago Principles for sovereign wealth funds, which are endorsed by Norway.

The Ministry is committed to further development of the reporting on the management of the Government Pension Fund. Section 2.2 refers, for example, to new reporting requirements. It is important, at the same time, to ensure that enhanced transparency does not impose unnecessary costs on the Fund, for example as the result of other market participants seeking to profit from the transparency characterising the management of the Fund. Consequently, there is not full transparency in advance of changes to the Fund's investments or concerning ongoing dialogues with individual companies.

The main principles underpinning the management of the Government Pension Fund reflect a broad political consensus. The Ministry seeks to facilitate a broad-based debate on important aspects of the investment strategy of the Fund. Material changes to the strategy are submitted to the Storting. A thorough decision-making process is a particular strength of the investment strategy. Widespread support for key aspects of the management strategy makes an important contribution to enabling us to adhere to the long-term strategy, even during times of financial market volatility. Sound long-term management is necessary to ensure that the revenues from the petroleum resources will benefit both future and current generations.

The investment strategy is premised on the necessity of taking risk to achieve a satisfactory expected return over time. The asset manager makes a number of choices in its operational implementation of asset management, concerning, inter alia, the composition of the actual investments of the Fund, to realise the objective of maximising returns. In retrospect, some of these choices may appear to have been favourable, whilst others may appear to have been less so. Nor can it be expected that the asset manager's deviations from the benchmark index will serve to increase the return on the Fund in all sub-periods. The emphasis of the Ministry, in its follow-up of the management of the Government Pension Fund, is on developments in *overall* performance and costs over time. The Ministry commissions, for purposes of such assessments, analyses of the returns and costs in the management of the GPFG and the GPFN, relative to other funds internationally, cf. above. Regular asset management review by the Ministry of Finance also increases the focus on, and understanding of, performance in the management of the two funds.

The Ministry emphasises that the risk in the management of the Fund must be managed, controlled and communicated in a clear and effective manner. It is, at the same time, not possible to measure risk by means of only one single figure or one single risk model. Experience shows that it is challenging to identify all forms of risk. The mandate from the Ministry therefore requires Norges Bank and Folketrygdfondet to establish supplementary risk limits in addition to the limit on deviations from the benchmark index. Moreover, it is a requirement that risk measurement shall seek to capture all relevant market risk. Section 4.3 addresses verifications of return data and independent assessments of the framework and processes for the management and control of risk.

Key principles and current developments

Overall responsibility for the GPFG lies with the Ministry of Finance, whilst operational management is effected by Norges Bank under a mandate set by the Ministry and endorsed by the Storting. The Supervisory Council appointed by the Storting supervises the activities of the Bank, including its management of the GPFG.

The overarching objective for the investments is to achieve the maximum possible return, given a moderate level of risk. This enables more welfare to be financed over time via the return on the Fund. There is a broad political consensus that the Fund is not a foreign-policy or environmental-policy instrument. The experts Ang, Brandt and Denison, who last year reviewed Norges Bank's management of the GPFG, noted that instructions to pursue non-financial objectives in asset management may entail costs in the form of impaired welfare for future generations. This is substantiated by experience from other funds.

The management of the GPFG is undergoing continuous development. The Fund is growing and has over time become a significant owner in many companies. A number of stakeholders have expectations as to how such ownership role should be exercised in the best possible manner. Unlisted real estate investments further involve a higher degree of delegation to the asset manager. Moreover, the Ministry has commissioned an assessment as to whether unlisted infrastructure investments should be permitted. The Government is committed to ensuring that the governance and control structure for Norges Bank is developed in line with the duties of the Bank.

2 The investment strategy for the Government Pension Fund Global

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2.2 The framework for Norges Bank's management

2.2.1 Introduction

Report No. 19 (2013-2014) to the Storting – The management of the Government Pension Fund in 2013, presented a review of Norges Bank's management of the GPFG. The review was based on, inter alia, advice and analyses obtained by the Ministry from a group of internationally recognised experts (Andrew Ang, Michael W. Brandt and David F. Denison), as well as from Norges Bank. The advice from the experts and Norges Bank was discussed in the report and is available on the Ministry's website. Both the experts and Norges Bank recommended an increase in the limit on deviations from the benchmark index adopted by the Ministry, as measured by so-called expected tracking error.[1] It was noted that a higher limit would offer the Bank more scope for improving the composition of investments, relative to the benchmark index, which in the view of the expert group would improve the ratio between return and risk.

The advice received by the Ministry included a proposal for a so-called opportunity cost model. Such model would see the current equity and fixed-income benchmark being used as a benchmark index for all investments of the Fund, including unlisted real estate. The experts recommended that the scope of Norges Bank for taking significantly more or less market risk than the benchmark index should be restricted through a tracking error limit. The Ministry's follow-up of this proposal is discussed in section 2.3.

The experts recommended that the overall limit on deviations be increased to 1.75 percentage points. Norges Bank proposed increasing the limit to 2 percentage points.

The Ministry wrote, in last year's report, that it would follow up on the advice received, including the limit on deviations, and revert to the matter in the report om the Government Pension Fund in the spring of 2015. The Ministry held, as part of such follow-up, a seminar in the autumn of 2014, where the report from Ang, Brandt and Denison was presented and discussed, with participation from both international and national experts.

The presentation below will address the background to the division of responsibilities between the Ministry and Norges Bank, considerations of relevance to the preferred limit on deviations from the benchmark index, the reporting on Norges Bank's deviations from the index, as well as the Ministry's assessments.

2.2.2 The division of responsibilities between Norges Bank and the Ministry of Finance

The Ministry of Finance has adopted a strategic benchmark index comprising listed equities and bonds, as well as real estate, cf. section 2.1. The benchmark index rests on a solid professional foundation, and reflects a desired long-term allocation of capital across asset classes, geographical areas and currencies.

The benchmark index is comprised of readily available and leading market indices for equities and bonds, prepared by recognised index providers. These indices are standardised products, reflecting a number of subjective choices and priorities made by the index providers as to how markets and securities shall be represented in the indices. One such choice is that investors shall be able to purchase a stake in the securities in the index without incurring large transaction costs. This implies that readily tradable securities are accorded priority in composing the indices. Consequently, such indices can, as a main rule, be closely mimicked by investors at low cost. Investments in line with indices of this type offer broad diversification of risk and will, in general, constitute a good basis for measuring the value added by the asset manager for the capital owner by deviating from the index.

Financial markets are characterised by intense competition, and it is challenging to add value on top of broad market indices. Since the indices are tailored to typical investors, the special characteristics of the GPFG, such as size and a long investment horizon, suggest that there is some scope for deviations

[1] Expected tracking error is a statistical measure of expected fluctuations in differential return between the GPFG and the benchmark index adopted by the Ministry. The risk measure says something about the extent to which the return on the GPFG is expected to deviate from that on the benchmark index.

from the benchmark index. The special characteristics mean that the GPFG is better positioned than many other investors to exploit economies of scale in asset management and to take risk that requires a long investment horizon. Moreover, the size of the Fund makes it challenging to implement large changes to its investment composition in order to adapt the portfolio to ongoing changes in the index.

Improving the investment composition beyond the benchmark index adopted by the Ministry requires specialist expertise, proximity to markets and an organisation capable of making time-critical decisions. Norges Bank is better placed to make such adaptations than the Ministry, and responsibility for improving the composition of the Fund is therefore delegated to Norges Bank, within the limits in the mandate set by the Ministry. The limit on deviations from the benchmark index as measured by expected tracking error restricts the scope of Norges Bank for taking significantly more or less market risk in its asset management than is implied by the benchmark index. At the same time, the limit on deviations shall ensure that Norges Bank has sufficient leeway to improve the composition of the Fund beyond the benchmark index.

Norges Bank has a focus on analysing how the return and risk characteristics of the GPFG can be improved. Such analyses are documented in the form of a series of discussion notes published on the Bank's website (www.nbim.no). Norges Bank employs various operational management strategies to improve the ratio between expected return and risk. These include strategies to:

– ensure cost-effective adaptation to the benchmark index;
– diversify investments more broadly than the benchmark index; and
– exploit factor strategies and make good security selections.

Cost-effective adaptation to the benchmark index

Norges Bank seeks to outperform the benchmark index through cost-effective execution of the management mission. Ongoing changes to indices result, for example, in high trading volumes for the securities affected by such changes, which may influence the prices of the said securities in the short run. Norges Bank may prevent the Fund from incurring unnecessary costs by implementing portfolio changes at a different time than the actual index changes. Moreover, it is not necessarily appropriate for an investor to hold the complete set of securities in the index at all times. Such an assessment must be based on a trade-off between the costs of acquiring a stake in all the loans of a bond issuer or holding all the equities in an industrial sector and the gains from somewhat greater diversification of risk.

Improved diversification of the investments

Some markets are not sufficiently developed or mature to meet the requirements applied by index providers for inclusion in the broad market indices. These include so-called frontier markets, which are less developed than other emerging markets. The requirements for inclusion in the indices are, inter alia, related to tradability, market place infrastructure and minority shareholder rights, cf. section 2.1. The mandate for the GPFG allows the Bank to invest in markets that are not included in the benchmark index. However, the Bank is required to approve all markets in which investment is made. Norges Bank has invested, after thorough assessment, in a number of less developed emerging markets (frontier markets). The Bank has also chosen not to invest in other markets on the grounds that these are held to be insufficiently developed and that making investments in these markets would involve too much risk. Assessment of individual markets requires specialist expertise and proximity to such markets.

Factor strategies

The composition of the equity benchmark is primarily based on market weights. This means that the equities with the highest market value are accorded the most weight in the index. The composition of market-weighted indices reflects the market's pricing of equities. Hence, the indices represent the capital available for purchases and sales. Research has demonstrated that market-weighted indices have been outperformed by investing more in assets with specific characteristics, such as low market value, price and tradability. Such characteristics are referred to as factors, and systematically tilting investments towards such characteristics is called factor strategies. The excess return from factor strategies can reflect higher risk, but also incorrect pricing in the market as a result of the institutional setting and certain behavioural patterns amongst market participants. The Ministry has previously received advice from leading international experts that to the effect that the Fund should seek to reap excess returns from factor strategies.

In Report No. 27 (2012-2013) to the Storting – The management of the Government Pension Fund in 2012, the Ministry presented extensive analyses of the returns and risks from pursuing various factor strategies for large equity portfolios. The analyses showed, inter alia, that such strategies can entail long periods of outperformance or underperformance relative to the benchmark indices, and significantly underperform benchmark indices during periods of market slump. The analyses showed, at the same time, that factor strategies have historically improved the ratio between return and risk for an investor like the GPFG. The Ministry concluded that the special characteristics of the GPFG make the Fund well suited to exploit factor strategies, although such strategies should not be incorporated into the benchmark index from the Ministry. The Ministry emphasised that it is necessary to tailor such strategies to the Fund, because its size may give rise to large transaction volumes and transaction costs. It was noted that it is challenging to identify the most suitable adaptations, and also that the adaptations deemed most suitable may change over time. The conclusion was that the Ministry's compilation of the benchmark index for the GPFG is not a suitable process for making such decisions. The Ministry also stated the following:

> «To the extent that systematic risk factors are to be exploited, it should therefore be done within the scope of Norges Bank's management framework. The Bank may design factor strategies based on the characteristics and advantages of the Fund, including the size and long time horizon. The design of such strategies forms an important part of the management mission of the Bank.»

These assessments were endorsed by the Storting, cf. Recommendation No. 424 (2012–2013) to the Storting.

Security selection

Considerable research has been conducted into whether asset managers can add value through security selection. Research on historical data indicates that performance in this type of active management is influenced by, inter alia, competition in the specific markets in which investments are made. Since competition varies between markets and over time, the scope for achieving excess returns may also vary.

Norges Bank has focused such part of asset management on those markets it believes offer the best prospects for generating excess returns. Such assessments require specialist expertise and proximity to markets, and should be made by Norges Bank. The scope for deviations from the benchmark index enables the Bank to make these assessments.

Andrew Ang, William Goetzmann and Stephen Schaefer noted, in their report prepared for the Ministry in 2009, that US equity funds have historically outperformed their chosen benchmark indices, although such funds have retained a major part of such excess returns for themselves by charging their customers generally high fees and costs. Norges Bank has significantly lower costs than the average equity fund. This suggests that the Bank may be better placed to realise excess returns after costs than are other investors. Ang, Brandt and Denison also note, in their report from 2014, that the long time horizon of the Fund enables Norges Bank to establish long-term management strategies, without the risk of having to divest securities at unfavourable times. They are of the view that a well-qualified management organisation, low costs and good trading systems are prerequisites for generating excess returns from security selection over time. Ang, Brandt and Dension note, at the same time, that Norges Bank, as a government body, may be subject to restrictions that affect its ability to attract expertise when compared to, for example, investment banks and private equity funds.

2.2.3 Norges Bank's management strategies

Norges Bank has, in letters of 13 December 2013 and 31 January 2014, respectively, as well as in the strategy plan for the period 2014–2016, described how the Bank performs its management mission.

The Bank emphasises, in the strategy plan, that it will increase the diversification of risk in the Fund by, inter alia, investing in equities in additional emerging markets and expanding the number of currencies in the fixed-income portfolio relative to the benchmark index. The Bank will also further develop the asset management by tilting the composition of the Fund's investments towards certain factors. Norges Bank intends to expand capacity within equity and credit analysis, both to increase the number of companies that are analysed thoroughly and to explore opportunities within new credit market segments.

The Bank has in recent years developed internal reference portfolios aimed at, inter alia, improving the return and risk characteristics of the benchmark index adopted by the Ministry, as well as diversifying risk and profiting from factor strategies. The Bank has documented the professional basis for a number of these strategies in designated discussion notes that, inter alia, identify the challenges posed by standard market indices.

Norges Bank's internal reference portfolios are tools used in composing the best possible portfolio. The Bank's strategies for security selection are measured against the internal reference portfolios. The Bank has also established a number of different securities strategies intended to exploit the Fund's long time horizon, large capital base and scope for accumulating special expertise. The security selection strategies are concentrated on markets and sectors deemed by the Bank to offer the best excess return prospects.

Ang, Brandt and Denison express support, in their report, for Norges Bank's orientation of its management of the GPFG. They also note that the Bank has made a number of changes in the wake of the financial crisis, including a significant reduction in the use of leverage and derivatives within fixed-income management. The experts also approve of Norges Bank's development of internal reference portfolios, and believe this to represent an important asset management improvement.

Norges Bank recommends, in a letter of 31 January 2014, a limit on expected tracking error of 2 percentage points, which includes deviations from the benchmark index as the result of real estate investments. Such a limit will, according to the Bank, enable it to perform its management mission in a manner that exploits the Fund's special characteristics and supports the overarching asset management objective.

Norges Bank notes that expected tracking error suffers from a number of weaknesses as a management parameter. The Bank believes that one should in the longer run consider whether to instead base the management of the Fund on a measure of absolute risk.

2.2.4 The limit on deviations from the benchmark index

Scope for deviations from the benchmark index enables Norges Bank to seek to improve the return and risk characteristics of the GPFG. Consequently, the limit on deviations from the benchmark index should be considered from the perspective of expectations as to excess return and risk.

The limit on deviations should further be tailored to the advantages of Norges Bank and its prospects for generating excess return. A limit that fails to adequately reflect such advantages will entail costs in the form of a lower expected return over time.

The ability of an asset manager to generate excess return through deviations from the benchmark index is often measured by the information ratio (IR). IR is calculated as the ratio between excess return and tracking error. A high IR is interpreted to mean that the asset manager has achieved a high excess return by deviating from the benchmark index, and may indicate that the asset manager offers advantages and prospects for generating excess return also in future.

Norges Bank has over the period 1998–2014 achieved an average annual gross excess return of 0.25 percentage points and an information ratio of 0.34. This means that the Fund has for each percentage point tracking error on average been compensated by a return that is 0.34 percentage points higher than that on the benchmark index, before the deduction of asset management costs. The expert report from Ang, Brandt and Denison (2014) notes that Norges Bank is well positioned to achieve an annual information ratio of 0.35-0.5 in the long run. This is based on a review of its asset management and historical performance from January 1998 to June 2013. The experts recommend that the limit on deviations from the benchmark index should be increased from 1 to 1.75 percentage points. This suggests an annual average excess return of about 0.4-0.6 percentage points if the exploitation of the limit remains at about the average level historically. The future excess return estimate of the expert group corresponds well with the historical performance of Norges Bank, and would at the current value of the Fund have amounted to an annual gross excess return of about NOK 30-40 billion.

The limit on deviations also needs to be considered from the perspective of how deviations are expected to influence overall risk in the Fund. There has historically been a close correlation between fluctuations in the return on the GPFG and fluctuations in the return on the benchmark index, cf. the discussion in section 4.1. It was calculated in the report from Ang, Brandt and Denison that more than 99 percent of the fluctuations in the return on the Fund over the period from January 1998 until the end of June 2013 could be explained by fluctuations in the return on the benchmark index. This means that the Bank generally traces the index closely in its management of the Fund. Historically, fluctuations in the return on the Fund have been slightly larger than that of the return on the benchmark index, as measured by standard deviation. This illustrates that a higher limit on deviations from the benchmark index may result in somewhat higher volatility in the overall return on the Fund.

A higher limit on deviations will result in a slightly higher risk of periods of underperformance relative to the benchmark index. As with other aspects of the investment strategy, the risk of negative excess return must be considered against the expected excess return over time and the uncertainty of such estimates.

The report from Ang, Brandt and Denison notes that the current limit on deviations from the benchmark index is very low. The experts expect, against the background of their review of Norges Bank's performance and asset management strategies, that a higher limit on deviations, in addition to generating significant excess return, will also improve the ratio between absolute return and risk in the GPFG.

The experts recommend the continued use of a limit on expected tracking error to regulate Norges Bank's scope for deviations from the benchmark index. However, they propose that an increase in the tracking error limit should be accompanied by supplementary risk limits that are more suited for curtailing the risk of large losses that are expected to incur infrequently. The experts also recommend expanded reporting on the risk assumed in asset management.

2.2.5 Reporting

The Ministry has in the mandate for the GPFG stipulated that there shall be the greatest possible degree of transparency in the management of the GPFG within the limits defined by a sound execution of the investment mandate. Transparency serves to ensure widespread support for the fund structure, as well as for its management, and reinforces the basis for adhering to profitable strategies during periods of negative excess returns. It is therefore important to report on the risk of loss in both the short and the long run. Developments in the benchmark index adopted by the Ministry almost fully explain the risk in the Fund, as measured by the volatility of returns. Consequently, the benchmark index is a very important basis for assessing the Fund's performance. Moreover, the reporting on the Fund's performance should include the risk of, and returns from, Norges Bank's deviations from the benchmark index. The Ministry reports on risks and returns in the annual report on the management of the Government Pension Fund and has stipulated a number of requirements as to the contents of Norges Bank's public reporting, including a requirement for the reporting to provide a true and fair summary of fund performance, asset management costs, asset management strategies, value added in operational management and relevant risk in asset management, including the utilisation of risk limits. Norges Bank publishes quarterly and annual reports, data, analyses, etc., on its website (www.nbim.no).

The benefits from detailed and ongoing asset management reporting must, at the same time, be balanced against the costs of such reporting. Costs may, for example, be related to other investors exploiting the asset management transparency to profit from the Fund's transactions or otherwise place restrictions on Norges Bank's asset management implementation. Besides, transparency may carry a cost if too detailed and continuous reporting results in performance being evaluated on the basis of data or methods that are not relevant.

A long time horizon may give the GPFG an advantage over other investors, cf. above. However, investment strategies that seek to exploit a long time horizon, such as factor strategies, may involve periods of underperformance relative to the general market. Such may, in particular, be the case during periods of market turbulence and major slumps in financial markets. Performance reporting and assessment should therefore focus on developments over time, and not exclusively on performance in individual years. Frequent performance reporting may in some situations result in excessive attention being paid to short-term fluctuations, and may prevent the asset manager from choosing profitable long-term strategies.

Deviations from the benchmark index imply, at the same time, that some investments will have turned out to be profitable, and others unprofitable, in retrospect. Consequently, performance reporting and assessment should focus on presenting aggregate performance rather than highlighting gains or losses on individual investments.

The Ministry annually reviews and presents assessments of risks and returns in the management of the Government Pension Fund, cf. chapter 4. In addition, the Ministry conducts asset management reviews on a regular basis, during which advice and analyses are obtained from independent professional experts internationally.

Performance reporting should provide insight into whether the asset manager has generated a higher return than could alternatively have been achieved by the capital owner itself, for example by increasing risk through adjustments to the benchmark index. Ang, Brandt and Denison refer to the mandate given to Norges Bank and argue in favour of evaluating the Bank's asset management on the basis of excess return as measured against the benchmark index. The report includes, at the same time, several analyses of the relationship between excess return and various factors. There exists no single model or set of assumptions that unambiguously explains how risk has influenced returns. Financial research therefore uses several approaches and models, all of which are premised on different assumptions and deliver different outcomes. This suggests that caution should be exercised in interpreting estimates from such models, and that several approaches should be used to shed light on performance.

The report from Ang, Brandt and Denison notes that the high degree of transparency in the management of the GPFG is one of the strengths of the Fund. It is noted that the GPFG is one of the most transparent funds in the world, with extensive asset management reporting. Norges Bank's asset management reporting is close to that proposed by the experts, but it is suggested that the reporting could be more detailed with regard to return and risk relative to the benchmark index adopted by the Ministry. It is suggested, as an example, that the reporting of excess return and risk may distinguish between contributions from factor strategies and increased diversification of risk in the internal reference portfolios as the result of additional selection of securities.

2.2.6 The Ministry's assessments

In 2014, the Ministry was advised by Norges Bank and a group of internationally recognised experts (Andrew Ang, Michael W. Brandt and David F. Denison) that Norges Bank should be offered somewhat more scope for improving the composition of the Fund's investments. They therefore proposed an increase in the limit on deviations from the benchmark index adopted by the Ministry. The experts are of the view that the special characteristics of the Fund should be exploited more extensively through index refinement, systematic tilting of the portfolio towards certain factors, as well as improvement on the index portfolio through security selection. This type of asset management focus requires specialist expertise, proximity to the market and an organisation capable of making time-critical decisions, and should thus fall under the auspices of Norges Bank, and not of the Ministry. Norges Bank recommends an increase in the limit and notes that this will enable the Bank to perform the management mission in a manner that exploits the special characteristics of the Fund and furthers its overarching asset management objective.

Ang, Brandt and Denison note that Norges Bank has historically achieved good performance and that the Bank is, in their view, well placed to add significant value to the Fund if the limit on deviations is increased. The investments in question would improve the ratio between return and risk beyond that achievable by the Ministry by modifying the composition of the benchmark index. A higher limit on deviations may, at the same time, slightly increase the volatility of Fund returns. Historically, emerging market investments, factor strategies, as well as stock and bond picking by Norges Bank, have resulted in somewhat larger fluctuations in Fund returns, relative to the benchmark index, especially during periods of stock market slumps. There have also been several periods of underperformance relative to the benchmark index. A higher limit on deviations from the benchmark index means that one needs to be prepared for such volatility. However, its long time horizon makes the Fund well positioned to withstand such short-term risk.

The scope for the environment-related investment mandates was almost doubled with effect from the beginning of the year, and this report proposes a further expansion of the mandates. The mandate for the GPFG was further amended in 2012 to require the Bank to take account of fiscal strength in the management of the government bond portfolio. These provisions reduce, when taken in isolation, the scope for additional deviations. Increasing the maximum tracking error compensates for the restrictions on the Bank's room for manoeuvre otherwise implied by the said provisions. Furthermore, the Ministry noted, in last year's report, that new rules on rebalancing of the equity portion implied, when taken in isolation, a slight increase in the scope for other deviations. The changes outlined in section 2.4 mean that such will no longer be the case. New rebalancing rules imply that the Bank will to some extent need to take into account that rebalancing may reduce the residual tracking error limit. Norges Bank's divestment of holdings in individual companies based on sustainability risk assessments will also reduce the scope for additional deviations.

The Ministry proposes, in this report, to increase the limit on deviations from the benchmark index as measured by expected tracking error from 1 to 1.25 percentage points. The mandate stipulates that Norges Bank shall organise asset management with a view to keeping expected tracking error within the limit. The somewhat higher limit on expected tracking error facilitates a cautious increase on the part of the Bank in the deviations from the benchmark index in the equity and fixed-income portfolios. This will be accompanied by a slight increase in the Ministry's excess return expectation. The higher limit may, at the same time, somewhat increase return discrepancies, also over multi-year periods. The Ministry will, simultaneously with the expansion of the scope for deviations, introduce new provisions requiring Norges Bank to define supplementary risk limits for large losses that are expected to occur infrequently and to report in more detail on the risk assumed in asset management. Ang, Brandt and Denison recommend such supplementary risk limits, but identify a number of technical and operational challenges in that regard. They note, inter alia, that it will be difficult to calculate this type of risk and that such supplementary limits will not necessarily restrict the Bank's asset management in a suitable manner, beyond the current tracking error limit. The experts believe, at the same time, that reporting of such risk is important.

Reference is made to the ongoing assessment of unlisted real estate and infrastructure investments, including the issue of whether such investments should be made within the limit on deviations from the benchmark index, cf. section 2.2.1 and section 2.3. The Ministry will consider a further increase in the limit on deviations at a later stage. One will then also be able to draw on experience from the expansion of the limit from 1 to 1.25 percentage points and the new requirements as to reporting and risk measures.

[…]

2.7 Investments in coal and petroleum companies, and related policy tools

2.7.1 Introduction

On 4 April 2014, the Ministry of Finance appointed an expert group to assess the GPFG's use of exclusions and ownership strategies in coal and petroleum companies.

The mandate referred to Recommendation No. 141 (2013–2014) to the Storting, as well as to the Storting's deliberation of such Recommendation. The expert group was requested to evaluate whether the exclusion of coal and petroleum companies is a more effective strategy for addressing climate issues and promoting future change than the exercise of ownership rights and exertion of influence. The group was also requested to advise on possible criteria for exclusion of these types of companies.

Martin Skancke, MSc (Econ), chaired the group. The other group members were Professor Elroy Dimson (London Business School), Professor Michael Hoel (University of Oslo), Dr Magdalena Kettis (Global Child Forum), Dr juris Gro Nystuen (International Law and Policy Institute) and Professor Laura Starks (University of Texas).

The expert group held individual meetings with Norges Bank, the Council on Ethics and Folketrygdfondet, as well as with experts on climate change, economics and finance. In June 2014, the group convened an open meeting with external stakeholders to get their input. Some follow-up meetings were held in August 2014. Written input received at these meetings is available on the Ministry's website.

The group submitted its report on 3 December 2014. The report was circulated for consultation on 17 December 2014, with a deadline of 6 February 2015 for submitting consultative comments. The Ministry has received 27 sets of consultative comments in total.

2.7.2 Key observations from the report of the expert group

The responsible investment strategy for the GPFG

The expert group discusses, in its report, developments in Norges Bank's active ownership, including key policy instruments and priorities, as well as the strategy as formulated in the Bank's strategy plan for the period 2014–2016. The expert group notes that Norges Bank has clearly stated that the long-term return on the GPFG depends on sustainable development in economic, environmental and social terms, and that responsible investment and active ownership are accorded priority in the management of the GPFG. The expert group notes, inter alia, that climate change was established as a focus area for ownerships activities in 2006, and refers to the preparation of a separate expectation document addressing how companies should manage risk associated with climate change.

The report reviews the Bank's preparation of sector compliance reports for the sectors in which company risk relating to climate change is considered to be highest, the development of international standards for company reporting on climate risk and research collaboration within responsible investment. The expert group also refers to the portfolio adjustments based on analyses that seek to identify business models deemed to be unsustainable and unprofitable over time. Norges Bank's responsible investment report, which was published on 5 February this year, shows that the Bank divested its holdings in 114 companies based on such considerations over the period 2012–2014, cf. section 4.4.

The expert group also discusses the recommendations of the Council on Ethics as to whether the Fund's investments in individual companies are in compliance with the Guidelines for Observation and Exclusion. The report describes, inter alia, the Council on Ethics' portfolio monitoring, its exclusion advice based on the conduct-based criterion of severe environmental damage, as well as its focus on specific environmental issues.

Fossil fuel extraction, carbon risk and the Norwegian economy

It is noted in the report from the expert group that the road to reduced global greenhouse gas emissions will be longer and less direct in the absence of a global tax or quota system with sufficiently high carbon prices. The group believes that today's carbon markets are incomplete and subject to market failure. Carbon prices are in most cases far below the levels needed for a path towards the so-called two-degree target. The group notes, at the same time, progress on several fronts. One example is that countries which have implemented or announced carbon pricing mechanisms account for about 20 percent of global emissions. The report also notes that the share of global emissions subject to some form of national legislation or reduction strategy rose from 45 percent to 67 percent from 2007 to 2012.

The expert group uses the term «carbon price risk» to denote political risk relating to the probability of the emergence of international climate agreements or national policies in the absence of such agreements. The group observes that the timing and extent of agreements will largely determine when and which financial assets are affected. In addition to carbon price risk, investors' long-term expectations about developments in specific sectors will be influenced by considerable technological uncertainty. The expert group identifies a clear trend towards comprehensive climate legislation in a large part of the world and technological progress towards cheaper renewable energy and operational technology for carbon capture and storage (CCS). The report notes that these developments are already affecting the relative prices of fossil and non-fossil fuel sources.

The expert group notes, in its report, that extraction of all of the world's identified coal and petroleum reserves by way of current technologies is incompatible with the two-degree target. The term «stranded assets» is used in this context to denote coal, oil and gas that cannot be profitably extracted at carbon prices that are compatible with sustainable emission levels. The group refers, inter alia, to an analysis from Rystad Energy.[2] The group is of the view that there is nothing inherently new about such stranded assets. The group notes that all businesses face various degrees of political and/or technological risk that can have a significant impact on the demand for, and thereby the value of, their products and facilities.

The report notes, furthermore, that recent years have seen more of a focus on climate change, and that significantly more information about company risk in relation to climate change has become available over time. The expert group does not find evidence to support the assertion that the market is not capable of pricing risk relating to stranded assets. Exclusion of a whole sector from the benchmark index based on assumptions about mispricing of risk is, in the view of the group, not compatible with a general investment strategy premised on the concept that financial markets price all other types of risk in a fairly efficient manner. The group believes that one should, as a result of this, expect the market prices of coal and petroleum companies to reflect an expected return that adequately compensates for investment risk. The group emphasises, at the same time, that the stranded assets debate is of importance to investors. To the extent that this is a topic that should be incorporated into decisions on allocations of assets, it is , in the assessment of the group, best done on a company-by-company level as part of an active management strategy. Moreover, the potential for stranded assets and financial risk connected with them may , in the view of the group, be usefully addressed through active ownership.

The group also raises the question of whether the importance of the petroleum sector for the Norwegian economy should have implications for the investment strategy of the GPFG. It notes that a full analysis of this issue is not covered by the mandate and falls well outside the scope of the report. It notes, at the same time, that it would be useful to carry out further work on this issue. It proposes, in this context, several extensions to the Ministry's analyses of the role of oil and gas equities in the GPFG, as presented in Report No. 19 (2013-2014) to the Storting – The management of the Government Pension Fund in 2013. The group is of the view that the proposed extensions may provide a more complete

[2] The report is available on the website of the Ministry of Climate and Environment.

picture of the national wealth perspective and a more solid basis for discussing the role of petroleum producers in the Fund's portfolio, potentially also with a view to addressing the overall oil price risk for the Norwegian economy.

Proposal for exclusion based on severe harm to the climate

The group states that as access to energy is a key determinant of economic development worldwide, taking part in the global economic system also means contributing to climate change. It notes that a transition to a «low-carbon economy» will not happen overnight, and assumes that fossil energy sources will remain part of the energy mix for many decades to come, even in a scenario with sustainable emission levels within the two-degree target. The group believes, against this background, that fossil fuel companies' energy production, energy use or CO_2 emissions cannot *per se* be said to be contrary to generally accepted ethical norms. The group notes, in addition, that it is difficult to see how an all-encompassing criterion for the exclusion of fossil energy could be consistent with other Norwegian policies and commitments, including the government's own investments in both coal and petroleum extraction.

The group does not, against this background, propose a product-based criterion for the exclusion of all petroleum companies or all coal companies from the GPFG. The expert group takes the view that it would neither be better for the climate, nor for the Fund, if these equities were to be sold to other investors who, in all probability, have less ambitious ownership strategies than the GPFG.

Furthermore, the expert group has considered whether there may be cases in which the conduct of companies might qualify for exclusion on an individual basis. The group notes that companies cannot be excluded for conduct related to greenhouse gas emissions under the Guidelines for Observation and Exclusion. This follows not from the wording of the guidelines themselves, but from the preparatory work. NOU 2003: 22 – Investments for the Future, specified that contributions to climate change should not be considered under the existing environmental criterion. Such specification was, inter alia, based on the requirement for a direct link between the conduct of a company and environmental damage, and the observation that such a link is difficult to establish for climate change. The group notes that it may be difficult to establish a direct causal link between the conduct of individual companies and climate change, but believes that there should nevertheless be an expectation that companies in the Fund's portfolio meet certain minimum standards with regard to how their business activities impact the climate.

The expert group recommends that the Guidelines for Observation and Exclusion be amended to include an additional criterion under severe environmental damage, authorising the exclusion of companies if there is an unacceptable risk that the company contributes to or is itself responsible for *«acts or omissions that, on an aggregate company level, are severely harmful to the climate.»*

The expert group proposes that the interpretation and application of the criterion be left to the Council on Ethics, but recommends that the following elements be considered in that regard:

- An underlying basis for the existing exclusion mechanism is that it only targets the worst forms of conduct breaching fundamental ethical norms. The group is of the view that the threshold for excluding companies based on conduct with regard to greenhouse gas emissions should reflect this.
- In considering the severity of a breach of ethical norms in this area, the group holds that it seems reasonable to focus on emission intensity, not necessarily on absolute emissions.
- The group proposes that the Council on Ethics should under this new criterion apply a more holistic approach to company activities than has been the case for the application of other ethical criteria.
- It is noted that one specific issue for carbon emission relates to the location of emissions. Systems for curbing CO_2 emissions and limiting global climate change are based on the underlying supposition that activities in one area can be offset by activities in other areas, for example by the trading of quotas. The expert group notes that this is a fundamental difference from the suppositions underpinning the existing criteria on which the guidelines are premised.
- The group believes that the assessments of the Council on Ethics should remain forward-looking.
- Information that the company actively lobbies against international agreements aiming at reducing greenhouse gas emissions or otherwise hinders the development towards a global strategy on climate change could be one element in making such assessments.

The group notes that operationalization of such a criterion will require considerable resources and efforts on the part of the Council on Ethics, inasmuch as such analyses will most likely involve, inter alia, the Council on Ethics assessing companies' activities along several dimensions. It is also noted that increased communication with Norges Bank is likely to be needed.

The expert group states that the criterion it proposes is, in principle, not directed at specific sectors, and that it is irrelevant what sector the greenhouse gas emissions emanate from. However, the group expects the Council on Ethics to focus, for reasons of practicality, on companies within industry sectors characterised by significant absolute levels of emissions.

Climate-related ownership strategies

The expert group holds active ownership to be the primary policy instrument for handling risk relating to climate change. The group proposes that Norges Bank should principally strengthen its active ownership through further dialogue with the companies in which the Fund is invested, as well as with regulators, organisations and other investors. The group is of the view that this should take place within the current active ownership framework, which is premised on the Fund's role as a financial investor.

The group argues that active ownership is especially well-suited for addressing climate risk in the Fund's investments, not least in carbon-intensive sectors. Active ownership may, in the view of the group, facilitate more transparency on the part of companies, including more realistic assessment of investment risk and more robust financial analyses. It may also, in the assessment of the group, prompt companies to identify more climate-friendly business models.

In order to strengthen existing climate-related active ownership, the expert group proposes that Norges Bank:

- Undertake analyses of the financial implications of climate change by, inter alia, drawing on the expertise of the Norwegian Finance Initiative (NFI). The group believes that research findings should be published so that these may also be of benefit to other investors.
- Engage with companies on the robustness of their analyses of new investments in fossil energy and their strategy for a transition to a low-carbon economy.
- Increase transparency about the criteria it uses to assess the sustainability of companies' business models.
- Within its role as a financial investor, support international efforts to establish a consensus on climate policy, including carbon pricing.
- Prepare a revised expectation document on climate risk for use in its enhanced active ownership. Progress in active ownership should be published in the annual reports on the management of the GPFG.
- Report on the Fund's exposure to climate risk, for example so-called carbon footprint and robustness in various climate scenarios.

Synergies and spillover effects

The expert group notes that it is reasonable to expect, in view of Norges Bank's new role as decision maker for the exclusion of companies from the GPFG under the Guidelines for Observation and Exclusion, that exclusion and active ownership will in future work together in a more integrated manner. The group believes that such an integrated chain of tools is particularly appropriate in addressing a global problem like climate change, encompassing both financial and ethical aspects. The group emphasises that such approach requires proper coordination and information exchange between Norges Bank and the Council on Ethics to ensure that the Fund speaks with "one clear voice," and states that formal arrangements for the coordination of company dialogue should be established between Norges Bank and the Council on Ethics.

Exclusion and active ownership as climate policy instruments

The expert group believes that maintaining the role of the Fund as a financial investor with financial objectives is important in its own right. The group believes that this is not just key to achieving a clear governance structure that fits the Fund's purpose, but also to avoiding developments towards using the Fund to address political ambitions that do not make it through the Storting's ordinary budget processes.

The expert group is of the view that it is not desirable for Norges Bank to strike a balance between climate considerations and the objective of achieving the maximum possible return, given a moderate level of risk. The group notes that it would be challenging to follow-up on such asset management in a good manner. The group observes that such trade-offs may result in investments that are not optimal from a financial perspective, and that it would be difficult to determine whether the asset manager performs well on either objective. The group emphasises, more generally, that it will in any case be unfortunate and ineffective to use the GPFG as a climate policy instrument beyond what is compatible with the Fund's financial objective.

The expert group argues that climate change is high on the agenda of investors, companies, other stakeholders and central policy makers alike. One may therefore, in the assessment of the group, hypothesise that active ownership could affect the climate positively over time. Norges Bank should, in the view of the group, prioritise measures considered most likely to affect Fund return, as well as company and industry behaviour.

Climate change and climate policies can, in the view of the group, have significant implications for the Fund's risk and return going forward. An active ownership strategy supplemented by an exclusion criterion can, in the assessment of the group, have a positive spillover effect on carbon emissions. The group emphasises that the primary purpose of the exclusion mechanism should remain to avoid investments in companies that are complicit in unethical activities, and that the primary purpose of active ownership should remain to safeguard the long-term financial performance of the Fund.

2.7.3 Consultative comments

Norges Bank refers, in its consultative comments, to the amendments to the mandate for the management of the GPFG and the new Guidelines for Observation and Exclusion, which entered into effect at the beginning of this year with the objective of establishing a unified chain of policy tools and a more integrated approach to responsible investment. Norges Bank assumes that any changes to the framework will pay heed to the said objective.

Norges Bank holds the recommendations in the report from the expert group to be in line with the asset management objective and the Fund's role as a financial investor. The Bank notes that active ownership and, more generally, responsible investment are in continuous development. In Norges Bank's responsible investment report for 2014, which was published on 5 February 2015, the Bank provided, for the first time, unified responsible investment reporting in a separate report. The integration of relevant climate change issues into the management of the GPFG is under development. Norges Bank will continue to integrate climate change considerations into asset management and to further evolve its analyses and processes in this area.

Norges Bank states, in its consultative comments, that the responsible investment strategy needs to be premised on the purpose and role of the Fund, and that this also applies to investments in coal and petroleum companies. It is noted that the purpose of the GPFG is government savings, and that its investments are aimed at maximising the international purchasing power of the fund assets, given a moderate level of risk.

Norges Bank aims to be a leading investor internationally in relation to responsible investment, including the handling of climate issues. The Bank believes that climate issues are of relevance to asset management in several respects, including standard setting, active ownership, risk follow-up and portfolio adjustments. Norges Bank notes that it divested, in 2014, its holdings in 22 companies engaged in coal extraction, oil sand extraction, cement production and coal power on the basis of such considerations. Moreover, the Bank divested from an additional 27 companies as the result of other environment-related considerations, etc. The Bank emphasises that decisions to refrain from investing in a company are active decisions made within the active management framework. The Bank notes that invoking a financial rationale to exclude entire sectors at the general level would not be in conformity with the fundamental premise of the current investment strategy, i.e. that markets are predominantly well-functioning and that diversification of the investments across different sectors gives rise to a better long-term ratio between return and risk. The Bank notes, at the same time, that financial risk arising from climate change may potentially have a systematic impact on the portfolio, and that it will therefore continue to expand its analysis efforts in this area.

Norges Bank believes that using the GPFG as a climate policy instrument beyond what is compatible with the Fund's role as a financial investor would have very negative asset management implications. The Bank notes, moreover, that developments in such a direction would not be in line with the financial asset management objective and would, over time, result in a less clear investment strategy and, inter alia, reduced diversification of risk in the Fund.

Norges Bank's consultative comments refer to the existence of a number of international climate initiatives aimed at companies and investors. Norges Bank supports initiatives it believes to be of particular relevance to its activities. It is noted, furthermore, that the Bank has already for some time been gathering information on greenhouse gas emissions from portfolio companies, although this is still in a development phase and involves a number of challenges. Norges Bank invests, through the environment-related investment mandates, in companies that are active within, inter alia, technologies that may contribute to tackling the climate challenges. The Bank intends to launch, in 2015, an initiative to promote academic research into the financial risk resulting from climate change.

Norges Bank believes that active ownership and dialogue with companies in line with the financial objective of the Fund can be suitable policy tools for addressing climate issues of relevance to the Fund. The Bank also notes that preparation of the expectation documents may give rise to more targeted ownership activity or analysis. Norges Bank observes that the Fund's clearly defined status as a long-term investor may add to its credibility in an ownership dialogue on long-term issues like climate change, but emphasises, at the same time, that the Bank cannot require companies to act in ways that are not deemed financially viable by such companies and their shareholders. Norges Bank would like to give priority to those ownership activities expected to offer the most positive portfolio effects. The consultative comments note that a key aspect of the dialogue with portfolio companies is to question their strategic choices, including their capital allocation decisions and the quality of their investment decisions. Norges Bank has requested a number of oil and gas companies to improve the reporting of their climate change involvement. The Bank has also sent letters enquiring about the plans of power companies for the transition to a less emission-intensive energy system, as well as letters to mining companies about their views on potential industry developments towards the spin-off of coaling interests.

Norges Bank shares the view of the expert group that any new criterion in the Guidelines for Observation and Exclusion would need to be applied in conformity with the high exclusion threshold already established for exclusion under other criteria. The Bank intends to utilise spillover effects between ownership, exclusion and risk-based portfolio adjustments upon the introduction of any new climate criterion. If such a criterion is introduced, Norges Bank will initiate a process with the Council on Ethics to clarify how this may be organised.

The *Council on Ethics* agrees with the main principles in the report from the expert group, both in relation to the Fund's role in climate change initiatives and in relation to the follow-up of the companies in which the Fund is invested. The Council on Ethics endorses the advice of the expert group that greenhouse gas emissions should be included in the Guidelines for Observation and Exclusion.

The Council on Ethics notes, in its consultative comments, that there is a need for clarification and demarcation with regard to, inter alia, what types of activities fall within the scope of the exclusion criterion and what it means that the activities of companies shall be subjected to a more general assessment under the climate criterion than under the other criteria. The Council states that the implementation of the criterion needs to be developed over time as and when experience is gained with the gathering of relevant, verifiable and comparable data, as well as the establishment of standards and norms against which companies can be assessed.

The Council on Ethics proposes the following clarification to the wording for a new conduct-based exclusion-criterion:

> «Acts or omissions that, on an aggregate company level, to an unacceptable degree entail greenhouse gas emissions».

The expert group has proposed that weight should be attached to company acts and omissions on an aggregate company level. The Council on Ethics believes that it is obviously correct to consider the overall activities of a company, although it will be necessary to analyse and test the implications of various interpretations of the wording.

The Council on Ethics agrees with the expert group that greenhouse gas emissions shall form the basis for exclusion assessments. This implies, it is noted, that coal mines cannot be excluded on a general basis, whilst it may at the same time be relevant to exclude coal users, if these generate unacceptably large greenhouse gas emissions for one reason or another.

The Council on Ethics notes that the expert group has stipulated that the threshold defining what qualify as unacceptable emissions should be derived from generally accepted international standards. It is emphasised, in this context, that one can in most fields addressed by the Council on Ethics rely on established and recognised norms, whilst such standards have yet to be developed to any significant extent for greenhouse gas emissions. The Council on Ethics states that the establishment of such norms will require an extensive effort.

The Council on Ethics notes, moreover, that the Council examines individual companies, and that it is important for the guidelines to still reflect that individual companies may be excluded irrespective of industry. The Council on Ethics is of the view that it is to some extent possible to identify companies, installations or technologies that, relatively and specifically, generate large greenhouse gas emissions within the industries contributing the most to greenhouse gas emissions. The Council on Ethics mentions, as an example, that the best coal power plants are distinctly more efficient, and thus generate much lower greenhouse gas emissions, than the worst ones. The Council on Ethics notes, at the same time, that considerable challenges are involved in gathering adequate information about the actual situation, which information would have to form the basis for exclusion.

The Council on Ethics deems it appropriate to also attach weight to other greenhouse gases than CO_2, and notes that the proposed criterion can in principle be applied, in the assessment of the Council, to all types of greenhouse gases.

The Council on Ethics refers to the assumption of the expert group that exclusions only influence companies indirectly. The Council on Ethics is of the view that this assumption needs to be somewhat modified, as it is not uncommon for companies to change their conduct after the Council has initiated a process and that such changes may in some cases result in companies not being excluded after all.

The Council on Ethics mentions an example related to child labour in cottonseed companies to illustrate use of the full range of policy measures. The Council on Ethics agrees with the expert group that the use of measures under the climate criterion requires a strengthening of coordination and information exchange between Norges Bank and the Council on Ethics, and that enhanced transparency is needed, as proposed under the new guidelines.

Finally, the Council on Ethics notes that the expert group has concluded that the implementation of the new climate criterion will require extensive efforts and resources on the part of the Council on Ethics. In line with this, the Council recommends, that resources be made available for the procurement of consultancy services and computer equipment, as well as the hiring of additional staff.

The Ministry has received consultative comments from the following *non-governmental organisations, etc.*: Bellona, Carbon Tracker, Changemaker, Concerned Scientists Norway, Future in Our Hands, Greenpeace Norway, Norwegian Church Aid, the Church of Norway National Council, the Norwegian Society for the Conservation of Nature, the Norwegian Climate Network, Rainforest Foundation Norway, WWF Norway and ZERO.

The non-governmental organisations express a number of concurrent views. They offer broad support for the expert group's proposal for the introduction of a conduct-based exclusion criterion. Several organisations emphasise that evaluations of the climate conduct of companies should encompass lobbying and other efforts to oppose emission-reduction measures. Many of these also note that the proposal needs to be backed up by additional resources for the Council on Ethics, and that the implementation of the criterion will require close communication between the Council on Ethics and Norges Bank. The *Church of Norway National Council* is of the view that activities resulting in the emission of other greenhouse gases than CO_2 should also qualify for potential exclusion under the conduct-based criterion. *Concerned Scientists Norway* would like to see the extraction of fossil energy in particularly vulnerable areas, or by unconventional methods, being included as elements of interpretation in relation to conduct-based exclusion.

In addition, several organisations would like to see the introduction of a product-based exclusion criterion. *WWF Norway* states that the Government should propose the exclusion of coal production and coal power generation from the GPFG based on certain specified criteria, and that this would be a fairly simple, specific and targeted initiative to show that Norway believes coal to have no role to play in a long-term sustainable economy. *Norwegian Church Aid* and *Changemaker* take the view that the GPFG should divest its holdings in coal production companies. *Future in Our Hands* takes the position that the GPFG must divest its holdings in the entire coal sector and must in addition effect systematic exclusions from the oil sector. *Greenpeace Norway* also proposes criteria for exclusion of the most polluting and fossil-exposed companies from the GPFG portfolio, within both the coal sector and the oil sector. *Concerned Scientists Norway* proposes that coal-producing companies be excluded from the GPFG portfolio within four years unless they have adopted carbon capture and storage (CCS) technologies. The *Norwegian Society for the Conservation of Nature* would like to see the GPFG divesting from coal companies now, whilst at the same time announcing that the Fund will divest from fossil fuel companies by 2020.

The organisations that would like to see a product-based criterion for exclusion do not share the view of the expert group that the energy production, energy use or CO_2 emissions of coal and petroleum companies cannot *per se* be said to be contrary to generally accepted ethical norms. *WWF Norway* states that it is reasonable to argue, based on the implications of maintaining current activity within the extraction and burning of coal, in particular, that this is ethically irresponsible, although it may be argued that this is a structural challenge for society, and not primarily an individual responsibility for companies. The *Church of Norway National Council* calls for a fundamental ethical reflection on the need to curtail the extraction of fossil energy carriers. *Changemaker* states that Norway has an ethical responsibility to reduce greenhouse gas emissions, both nationally and internationally.

Most of the non-governmental organisations argue in favour of expanding the investments of the GPFG in alternative energy sources, and would like to see the Fund contributing to the further development of the market for green bonds. *Future in Our Hands*, *Greenpeace Norway, Norwegian Church Aid,* the *Norwegian Climate Network* and *ZERO* all take the view that the asset management strategy of the GPFG should be considered from a national wealth perspective, and that Norway should, from such a perspective, exclude petroleum companies from the investments of the GPFG.

The organisations differ in how they view the effects of active ownership as a policy tool, but most of them support the recommendations of the expert group on strengthening, and enhancing the transparency of, active ownership on the part of the GPFG. They also emphasise the importance of having a chain of policy tools, with divestment as a last resort. *Bellona* and *Carbon Tracker* endorse the position of the group that active ownership is preferable to exclusion. Bellona states that companies whose activities cause greenhouse gas emissions need to have a credible and genuine plan for reducing such emissions, in order for them to remain in the GPFG investment universe and portfolio. *Rainforest Foundation Norway* agrees that active ownership and influence can be highly effective, but states that such is only the case if these efforts are guided by a strategy that includes specific goals and deadlines, clear engagement principles and coordinated use of policy tools. *Carbon Tracker* believes that the GPFG is well placed, given its size, to pursue an effective dialogue with fossil fuel companies concerning the risk associated with their future investment projects, and that effective active ownership is the best way of avoiding stranded assets. *Future in Our Hands* believes that the expert group has overestimated the prospects offered by active ownership and systematically underestimated the scope for, need for, and effects of, exclusion. The organisation points to a lack of documentation that active ownership is an effective strategy and has contributed to solving climate issues. *WWF Norway* draws attention to a shortage of documentation and arguments from the expert group as to how active ownership might potentially have a significant impact on the core strategy of fossil energy companies. The *Norwegian Society for the Conservation of Nature* also questions the effect of active ownership and finds that there is a dearth of examples that active ownership through the GPFG has delivered results in other areas.

The Ministry has also received consultative comments from KLP Kapitalforvaltning, CICERO, Statistics Norway, as well as from the following organisations: the Norwegian United Federation of Trade Unions, the Confederation of Norwegian Enterprise, the Norwegian Society of Graduate Technical and Scientific Professionals and the Norwegian Confederation of Trade Unions.

KLP Kapitalforvaltning endorses the conclusions of the expert group in its predominant aspects. However, KLP is of the view that the mandate of the expert group was too restricted. Weighing active ownership against exclusion in terms of effectiveness is, in the view of KLP, unfortunate because these policy tools supplement each other and work best in tandem. Potential renewable energy investments should also, in the assessment of KLP, have been included in the mandate. KLP finds it reasonable for the demarcation of the scope for exclusion under the proposed conduct-based criterion to be entrusted to the Council on Ethics, and believes that this will offer flexibility with regard to future developments in global energy production, climate pollution and technology. KLP supports the climate criterion being applied on the basis of an overall assessment. KLP is of the view that open exclusion recommendations from the GPFG on the basis of activities that are harmful to the climate may have repercussions far beyond their effects on the companies themselves.

Statistics Norway states that the report from the expert group provides a sound professional foundation for political decisions in relation to these issues. Statistics Norway agrees with the assessment of the group that the exclusion of coal or petroleum producers from the Fund portfolio is unlikely to represent an effective climate policy strategy, that active ownership and influence are the most appropriate policy tools for addressing climate-related issues, and that a new climate-based criterion for the observation and exclusion of companies should be introduced. Statistics Norway also endorses the assessments of the group in the discussion as to whether the investment risk associated with coal and oil companies is priced correctly (stranded assets).

CICERO is unable to see any clear, fundamental distinction between harm inflicted on current generations through the sale of tobacco and harm inflicted on future generations through climate change. CICERO proposes, in its consultative comments, a product-based criterion under which companies with the majority of their turnover from the extraction of coal or oil sand are excluded from the investments of the GPFG. CICERO also states that companies involved in actively opposing an effective climate policy, through lobbying and other methods, in contravention of internationally agreed commitments endorsed by Norway, should be excluded from the investments of the GPFG under a conduct-based criterion.

Furthermore, CICERO would like Norges Bank to develop a strategy for the purchase of green bonds and initiate research and studies into improved exclusion criteria and active management based on the risk associated with the long-term implications of climate change.

The *Norwegian United Federation of Trade Unions* believes that it is important to maintain a broad political consensus that the overarching objective of the investments in the GPFG is to achieve the maximum possible return, given a moderate level of risk. The Norwegian United Federation of Trade Unions supports the introduction of a new conduct-based criterion for the exclusion of companies engaging in activities that are severely harmful to the climate, but states that the Ministry needs to do more to clarify the interpretation and application of the criterion. The Norwegian United Federation of Trade Unions is also of the view that it is important for the Council on Ethics and Norges Bank to be provided with sufficient resources to comply with both this criterion and human rights considerations. As far as concerns product-based exclusion of companies based on climate considerations, the Norwegian United Federation of Trade Unions states that potential criteria for such exclusion would have to be examined in more detail.

The *Confederation of Norwegian Enterprise* endorses the position of the expert group that energy production cannot *per se* be said to be contrary to generally accepted ethical norms, that the GPFG should be a financial investor and that active ownership is the most appropriate policy tool for addressing climate-related issues. The Confederation of Norwegian Enterprise expresses scepticism with regard to the proposed conduct-based exclusion criterion. The Confederation of Norwegian Enterprise fears that the criterion, since it is discretionary in nature, may pave the way for using the Fund as a climate policy instrument. The Confederation of Norwegian Enterprise states that the organisation would expect active ownership and exclusion, if applicable, to be used together in an integrated manner.

The *Norwegian Society of Graduate Technical and Scientific Professionals* endorses the proposal for the introduction of a conduct-based criterion for observation and exclusion. The Norwegian Society of Graduate Technical and Scientific Professionals also agrees with the assessment of the expert group that broad product-based exclusion of coal and petroleum companies would not be appropriate at this stage, and that active ownership and active management should be the principal policy tools. However, the Norwegian Society of Graduate Technical and Scientific Professionals believes that product-based exclusions will become an appropriate policy tool in the longer run, when carbon-free energy alternatives are expected to account for a larger portion of overall energy supply. A path for future exclusion on climate grounds should, in the view of the Norwegian Society of Graduate Technical and Scientific Professionals, be announced and embedded in the objectives of the Fund. Moreover, the Council on Ethics should, in the opinion of the Norwegian Society of Graduate Technical and Scientific Professionals, gradually lower the threshold for conduct-based exclusion on climate grounds, and active management needs to be given sufficient scope for divestment based on climate considerations. The Norwegian Society of Graduate Technical and Scientific Professionals also states that the special environment-related investment mandates need to be strengthened beyond the increase proposed by the Ministry.

The *Norwegian Confederation of Trade Unions* states, in a letter of 23 February 2015 to the Ministry, that Norway has an independent and clear responsibility for contributing to solving the global climate problem. The Norwegian Confederation of Trade Unions approves of the introduction of a new conduct-based criterion based on activities that are severely harmful to the climate, and notes that such provision needs to be formulated and implemented in such a way as to have, together with reinforced active ownership, a real impact. The Norwegian Confederation of Trade Unions requests, in line with its climate strategy, that the GPFG divests from companies involved in activities that are severely harmful to the climate and invests more in renewable energy, renewable infrastructure, as well as CO_2 capture and storage.

The Ministry has also received consultative comments from a group of individuals of miscellaneous organisational affiliation. *Thamotheram et.al* are of the view that there is, from a financial perspective, scope for a considerable expansion of the environment-related investments of the GPFG. Both climate/green bonds and infrastructure are highlighted as attractive investment opportunities. The GPFG should also, in the view of the group, screen all companies according to science-based emissions thresholds that comply with the carbon budget. Comparable action can, in the assessment of the group, be taken at the portfolio level, across all sectors, using low-carbon indices. The group believes that such measures will act as a hedge against portfolio losses that will be incurred should there be accelerated carbon re-pricing. The group questions the assessment of the expert group that it can be left to the market to price climate risk in an adequate manner, and notes that the Norwegian population has very high exposure to fossil fuels. The group believes that the GPFG, as one of the world's largest investors, needs to take a leading role as an active investor in the climate area. The Fund may contribute, through engagement and exclusion, to significant reductions in the effects of climate change. The group lists several measures that would strengthen the GPFG's active ownership in this field. The group sees no conflict between the financial goal of the fund and the objective of averting dangerous climate change, especially given the intergenerational responsibility of the Fund. An area in which the GPFG may play a major role alongside other long-term investors, is to urge investee companies to stop lobbying against climate change measures, , both directly and via trade associations and think tanks.

A number of the persons who signed the statement from Thamotheram et.al have also submitted separate consultative comments. *William Michael Cunningham* emphasises the main observations in the group comments, noting that there is scope for a considerable expansion of the GPFG's environment-related investments, that the GPFG may make a clear contribution to reducing the effect of climate change through engagement and exclusion, and that the Fund should promote increased transparency in relation to corporate lobbyism and other methods used to actively oppose climate change objectives. *Robert Litterman* endorses the main conclusion of the expert group that active ownership and dialogue are the most appropriate policy tools for addressing climate issues, and invites the GPFG to participate in an ongoing project to reduce greenhouse gas emissions within the aviation sector. *Henrik Syse* supports the description of the expert group as to the importance of active ownership strategies for issues relating to climate change and the strategies of coal and petroleum companies. Henrik Syse emphasises the importance of such active ownership strategies in countering the lobbying of coal and petroleum companies against effective climate measures. Henrik Syse notes that there are examples, not least in the US, illustrating how effective such lobbying can be, and how much the results of such lobbying often have gone against the interests of the principals. *Raj Thamotheram* states that the report from the expert group is a serious and valuable piece of work, with which he concurs in many respects. However, he does not share the view of the expert group that the market can be assumed to price investment risk in an adequate manner. Ray Thamotheram is of the view that coal and petroleum companies, by promoting the use of fossil fuels, increase the risk of potentially severe financial loss in the portfolios of well-diversified investors.

2.7.4 The Ministry's assessments

Principles for the management of the GPFG and responsible investment practices

There is broad political consensus that the objective for the investments of the GPFG is to achieve the maximum possible return, given a moderate level of risk. The Ministry has noted the view of the expert group that it would be both unfortunate and ineffective to use the GPFG as a climate policy instrument beyond what is compatible with the Fund's financial objective. This view is endorsed by a number of those submitting consultative comments. The Ministry has also noted Norges Bank's observation that uncertainty about the Fund's financial objective will result in a less clear investment strategy. A clear objective for the investments is also in line with the international principles for sovereign wealth funds; the so-called Santiago Principles, which Norway has signed up to.

It follows from the mandate for the management of the GPFG that Norges Bank shall attach weight to the long time horizon of the Fund in its asset management, and that the investments shall be well diversified across the markets that make up the investment universe. The Ministry regards a good return in the long term as being dependent upon sustainable development in economic, environmental and social terms. Consequently, responsible investment activities are an integral part of the management of the Fund. Norges Bank exercises the ownership rights of the Fund and integrates environmental, social and corporate governance considerations in its investment activities. The Bank makes portfolio adjustments based on risk assessments relating to markets, sectors and companies.

The Guidelines for Observation and Exclusion stipulate that companies shall be excluded from the GPFG if these produce certain products or sell weapons to certain states (*product-based exclusion*). Companies may also be excluded if there is an unacceptable risk that they contribute to, or are themselves responsible for, grossly unethical activities (*conduct-based exclusion*). The purpose of the exclusion mechanism is to reduce the risk that the Fund is invested in companies that contribute to serious norm violations. Consequently, the exclusions from the Fund are ethically, and not financially, motivated.

A number of changes to the responsible investment framework of the GPFG entered into effect at the beginning of this year, cf. chapter 5. It is now Norges Bank, and no longer the Ministry, that makes decisions based on recommendations from the Council on Ethics on the observation and exclusion of companies. Furthermore, improved coordination between the Council on Ethics and Norges Bank is facilitated, along with a more unified chain of responsible investment tools. The Guidelines for Observation and Exclusion stipulate that Norges Bank shall consider the various measures at its disposal as a whole, and apply these in a coherent manner. It also follows from the Guidelines that meetings shall be held between Norges Bank and the Council on Ethics on a regular basis to exchange information and coordinate activities. Moreover, communications with companies shall be coordinated and shall aim to be perceived as unambiguous.

Norges Bank's active ownership and reporting

The Ministry has noted the view of the expert group that active ownership and dialogue are the main policy measures for addressing climate issues in the management of the GPFG. The expert group proposes measures to strengthen the activities of the Bank in this field, including increased transparency concerning the criteria for risk-based divestment, as well as a revised climate expectation document. The group proposes, moreover, that the Bank engage in a dialogue with companies on the robustness of their analyses into new fossil energy investments, as well as enhanced reporting on its engagement with portfolio companies and on the Fund's exposure to climate risk. Norges Bank is also encouraged by the group to expand its support for research into the financial implications of climate change, etc. These proposals have been broadly endorsed by those submitting consultative comments.

The Ministry has noted Norges Bank's observation that the Fund's role as a long-term investor may add to its credibility in ownership dialogues on long-term issues like climate change. The Bank has over time developed its capability to integrate matters of relevance to climate change in the management of the GPFG.

The Ministry has noted that Norges Bank issued a separate responsible investment report on 5 February this year, which shows that the Bank has now implemented a number of the changes proposed in the report from the expert group. The Bank has also signalled specific plans for additional research into financial risk resulting from climate change, cf. section 2.8. On 13 March this year, the Bank published an updated expectation document on companies' management of climate risk. Norges Bank states on its website that the document is of particular relevance to fossil fuel suppliers, power generators and businesses with an impact on tropical rainforests and agriculture. Furthermore, the Bank has published the first analyses from a survey of greenhouse gas emissions from the companies in which the Fund is invested. Norges Bank has in addition sent letters to several oil and gas companies, power companies and mining companies, requesting such companies to, respectively, improve their reporting on climate change-related involvement, outline their plans for the transition to a less emission-intensive energy chain, and explain their position on potential industry developments towards the spin-off of coaling interests.

The Ministry has noted that climate issues may be taken into consideration in a general risk assessment carried out by Norges Bank with regard to companies' business models and sustainability over time, and that the Bank has in recent years divested its holdings in, inter alia, a number of companies with interests in coal extraction, oil sand extraction, cement production and coal power, based on such assessments. Such divestment takes place within the scope for deviations from the benchmark index set by the Ministry.

The Ministry expects Norges Bank to continue its reporting, within the framework established by the mandate, on its integration of climate change considerations into asset management and its enhancement of analyses and processes within this field, including reporting on the criteria for risk-based divestment.

The Ministry will, as part of its follow-up of the report from the expert group, request Norges Bank to conduct and report on a specific risk-based review of portfolio companies whose involvement in coal extraction, coal power generation or coal-based energy conversion represent a significant part of their business.

New conduct-based criterion for the observation and exclusion of companies

The criteria under the Guidelines for Observation and Exclusion are ethically motivated. The Ministry agrees with the assessment of the expert group that there may be ethical aspects to greenhouse gas emissions. The Ministry does, at the same time, attach weight to the fact that energy is an input used in virtually all economic activity. Secure access to energy has contributed to economic development. Participation in the global economic system implies that one is contributing, both directly and indirectly, to greenhouse gas emissions. Fossil energy sources are expected to account for a significant portion of the global energy mix for a long time to come, also in a scenario of sustainable emission levels within the two-degree target. Consequently, the Ministry agrees with the assessment of the expert group that coal and petroleum companies' energy production, energy use or CO_2 emissions cannot *per se* be said to be contrary to generally accepted ethical norms. Hence, it would not be appropriate to introduce a product-based criterion for the exclusion of coal or petroleum companies.

The Ministry has also noted the assessment of the expert group that it would neither be better for the climate, nor have a positive effect on the Fund, if these stocks were to be sold to other investors who, in most cases, would have less ambitious ownership strategies than the GPFG. This is highlighted by the purpose of product-based exclusion under the Guidelines, which is not to promote changed corporate conduct as such, but to prevent the Fund from investing in companies that produce certain types of product.

Although coal and petroleum companies' energy production, energy use or CO_2 emissions cannot *per se* be said to be contrary to generally accepted ethical norms, the expert group believes that one must expect portfolio companies to meet certain minimum standards with regard to how their activities affect the climate. The expert group therefore recommends the establishment of a criterion for the exclusion and observation of companies whose conduct does not meet such expectations. The Ministry agrees with this and proposes the introduction of a new conduct-based criterion in the Guidelines for Observation and Exclusion, such as to specifically encompass climate-related conduct. The introduction of such a criterion enjoys broad support amongst those submitting consultative comments. Consequently, coal and petroleum companies may be excluded on ethical grounds, based on an overall assessment of their conduct.

A new criterion, as proposed here, will in the assessment of the Ministry be inherently dynamic. It will neither depend on industry or sector, nor on the type of greenhouse gas. It should reflect the consideration that norms in this field may develop over time in line with, inter alia, changes in energy production and technological developments.

The ethically motivated criteria in the Guidelines for Observation and Exclusion need to be considered in the context of the other asset management activities of Norges Bank. The Ministry notes that Norges Bank has already established a practice of risk-based portfolio adjustments. This involves the divestment by the Bank of holdings in companies based on an overall financial assessment, which includes environmental and social considerations. Such divestment takes place within the Bank's scope for deviations from the benchmark index of the Fund, cf. section 2.2. The Ministry has noted that Norges Bank intends to utilise spillover effects between engagement, exclusion and risk-based portfolio adjustments upon the introduction of a new criterion.

Details concerning the new criterion

The Council on Ethics has proposed the following wording for a new conduct-based criterion, calling for the exclusion of a company if there is an unacceptable risk that the company contributes to or is itself responsible for:

> «Acts and omissions that, on an aggregate company level, to an unacceptable degree entail greenhouse gas emissions».

The Ministry is of the view that such a formulation of the criterion reflects a number of important considerations. The first consideration is that greenhouse gas emissions shall form the basis for the overall assessment under this criterion. The wording *«entail greenhouse gas emissions»* shows that there must be a link between the acts or omissions of a company and the emission of greenhouse gases, and also that the criterion applies to greenhouse gases in general, and not only to certain greenhouse gases. Focusing on greenhouse gases as a whole will also make the criterion more flexible by allowing for the examination of a wider range of sectors and companies than if focusing exclusively on CO_2 emissions. The Ministry has noted that the expert group would expect the Council on Ethics to focus, in practice, on companies in industrial sectors with significant absolute emission levels, and that the expert group would consider it appropriate for the energy sector and electricity generation from fossil energy sources to form a key part of such focus. The Ministry has also noted that the expert group emphasises that it seems reasonable, in considering the severity of a breach of ethical norms in this area, to focus, as one of several considerations, on emission intensity, and not necessarily on absolute emission levels. By emission intensity is meant emissions relative to, for example, production or sales. The Ministry agrees with the group that it should be possible to evaluate comparable companies against each other, although it is difficult to establish absolute measures of emission intensity.

The proposed wording also makes clear that both *acts and omissions* may give rise to observation or exclusion under this criterion. It further accommodates a focus on the *aggregate company level*. Such a general company assessment is appropriate in view of the underlying premise of existing systems for curtailing greenhouse gas emissions and limiting global climate change, that activities in one area may be offset by activities in other areas, for example through trading in quotas. Excluding a company that operates in conformity with the guidelines of such a system might be counterproductive. It may, at the same time, be difficult to assess this, since many companies are engaged in activities in several countries with various degrees of regulation. *«An unacceptable degree»* shows that the proposed criterion is aimed at serious norm violations, in line with the established threshold for exclusion under the Guidelines for Observation and Exclusion. The Ministry has noted that the expert group states that serious norm violations should for this purpose be evaluated in the context of specific comparable operations, sectors and industries based on, for example, generally accepted international standards.

The Ministry has also noted that both the expert group and a number of those submitting consultative comments argue that actively opposing, for example, international agreements on the reduction of greenhouse gas emissions may be an element to which weight should be attached in the overall assessment under the criterion. It is also appropriate for such overall assessment to take into consideration whether the greenhouse gas emissions of companies are subject to taxes, mandatory quotas or other regulations.

The Ministry is of the opinion that a new criterion will need to be managed in line with the established practice for exclusion under the Guidelines for Observation and Exclusion, and that the assessments shall continue to be forward looking. Moreover, the established exclusion system is inherently dynamic, inasmuch as all excluded companies shall be reassessed on a regular basis to check whether the grounds for exclusion continue to apply.

The Ministry has noted the observation of the expert group that the application of such a criterion will require considerable resources and efforts on the part of the Council on Ethics, inasmuch as such analyses will most likely involve, inter alia, the Council on Ethics assessing companies' activities along several dimensions. Furthermore, the Ministry has noted that the Council on Ethics states that the implementation of the criterion needs to be developed over time as and when experience is gained with the gathering of relevant, verifiable and comparable data, as well as the establishment of standards and norms against which companies can be assessed.

The Ministry emphasises that the established division of responsibilities between Norges Bank and the Council on Ethics will also apply to assessments under the new criterion. The proposals from the expert group imply that the Council on Ethics, as an advisor to Norges Bank on the observation and exclusion of companies pursuant to the Guidelines for Observation and Exclusion from the GPFG, will play an important role in the operationalization of the criterion. It is, at the same time, Norges Bank that makes decisions on the observation and exclusion of companies, and is required under the Guidelines to consider the various measures at its disposal as a whole, and to use these in a coherent manner. The Ministry will, as with the other criteria in the Guidelines for Observation and Exclusion, follow up on how the criteria are practised over time. Furthermore, the Ministry will consider the resource requirements of the Council on Ethics relating to the operationalization of the new criterion.

The Ministry deems it important for the intention behind the new Guidelines for Observation and Exclusion of a chain of policy measures, to also be followed up for the new criterion. The Ministry has noted that Norges Bank and the Council on Ethics will initiate a process to clarify how this could be realised.

It follows from the Guidelines for Observation and Exclusion that the Council on Ethics shall establish and publish principles stipulating which companies are selected for closer examination, and that Norges Bank may prepare a set of expectations based on such principles. The Ministry notes that this will also apply to the proposed new criterion . It also follows from the Guidelines that the Bank may, in its assessment as to whether a company shall be excluded , inter alia, attach weight to the likelihood of future norm violations, and also consider the scope of the activities and governance of the company, including whether the company does what can reasonably be expected to reduce the risk of future norm violations within a reasonable time horizon.

Implementation

The Ministry intends to incorporate the new conduct-based climate criterion in the Guidelines for Observation and Exclusion from the GPFG after the Storting's deliberation of this report. Reference is made to the Ministry's discussion of the interpretation of the criterion above. The Council on Ethics and Norges

Bank will over time, through their duties of advising and deciding, respectively, on the observation and exclusion of companies from the GPFG, establish the detailed substance of the criterion. The Ministry will, in line with the stipulations made in Recommendation No. 200 (2013–2014) to the Storting, evaluate the new organisation of responsible investment practices in the annual reports on the Government Pension Fund. Moreover, the Ministry intends to present a review of the overall handling of financial risk resulting from climate change in the management of the GPFG in the report on the Government Pension Fund in the spring of 2017.

The stranded assets debate

Internationally, there is a discussion as to whether financial market participants are acknowledging the risk that large coal, oil and gas reserves cannot be profitably extracted at carbon prices consistent with sustainable emission levels. The Ministry has noted that the exclusion of an entire sector based on mispricing of risk would not, in the view of the expert group, be in conformity with the overall investment strategy for the GPFG. The expert group notes, on the other hand, that stranded asset considerations may be well suited as a basis for the asset manager's deviations from the benchmark index. The group also notes that the potential for stranded assets, and the associated financial risk, may be addressed through active ownership.

Some of those submitting consultative comments believe that investors systematically underestimate climate risk. Conflicts of interest are also noted between some owners and corporate management, on the one hand, and diversified, long-term investors like the GPFG, on the other hand. Those expressing such views in their consultative comments emphasise active ownership over product-based exclusion as the best policy tool for improving the market pricing of climate risk.

The Ministry agrees with the view that risk assessments relating to stranded assets should form an integral part of Norges Bank's operational management. If the Ministry were to overweight certain sectors and underweight others in the benchmark index for the Fund, it would amount to an active investment decision. Consequently, the strategy for the Fund is not based on such an approach. In order for such investment choices to be profitable, these would have to be based on the Ministry being privy to information about the future return on such investments that is not already reflected in current market prices. It should as a main rule be assumed, as noted by the expert group, that securities prices will by and large provide a reasonable compensation for investment risk.

Investments in environment-related activities, including renewable energy

A number of consultative comments refer to the importance of the GPFG being invested in environment-related activities, including renewable energy. The current investment strategy involves considerable investment in such activities, which will as a main rule expand if such companies' share of the global stock market increases. Moreover, a specific allocation has been established for environment-related investment mandates, with renewable energy being one of several sectors. This report proposes that the allocation for such specific mandates be expanded to NOK 30-60 billion, cf. section 2.6. However, a large portion of the renewable energy investment opportunities is in the unlisted market. The Ministry refers, in this context, to the evaluation as to whether unlisted infrastructure investments should be permitted in the GPFG, cf. section 2.3. The Ministry intends to address this issue in the report on the management of the Government Pension Fund to be submitted in the spring of 2016. If unlisted infrastructure investments are permitted on more general grounds, unlisted infrastructure investments in renewable energy will also be included in the investment universe of the GPFG.

The investment strategy for the GPFG in a national wealth perspective

The report from the expert group notes that the Norwegian economy is dependent on oil and gas, not only through petroleum revenues and the investments of the GPFG in the oil and gas sector, but also through links between the petroleum sector and the human capital component of national wealth. The group is of the view that this raises the issue of whether the investment strategy for the GPFG should be considered from a so-called national wealth perspective.

The expert group notes, in its report, that a complete analysis of this matter does not form part of its mandate and falls clearly outside the scope of its report. However, the group proposes a number of expansions to the analyses in Report No. 19 (2013-2014) to the Storting, which would, in the opinion of the group, provide a more robust basis for discussing the role of petroleum producers in the Fund portfolio, also with a potential view to addressing general oil price risk for the Norwegian economy. The Ministry has noted that a number of the consultative comments also agree that these issues merit further attention. The

Ministry is of the view that such issues are suitable for discussion in a white paper on long-term perspectives for the Norwegian economy, one of the purposes of which is to shed light on the long-term implications for the Norwegian economy of changes to key external variables.

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