NORGES BANK

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Environment-related mandates and reporting in the Government Pension Fund Global

The Management Mandate for the Government Pension Fund Global (GPFG) requires Norges Bank to establish environment-related investment mandates. These mandates are normally to have a market value of between 30 and 120 billion kroner and are subject to the same performance requirements as the fund's other investments. The investments made under the mandates draw on Norges Bank's limit for relative volatility, and the Ministry of Finance has laid down additional reporting requirements for these mandates.

In its letter of 10 June 2021, the Ministry asks Norges Bank to review developments in the market for environmental investing, consider Norges Bank's reporting requirements in the light of international frameworks for sustainability reporting, and assess the pros and cons of extending the reporting requirements. Norges Bank's response follows in this letter.

We have chosen in this letter to focus on the environment-related equity mandates. On 30 June 2021, these accounted for more than 85 percent of the environment-related mandates. The remaining investments are in unlisted renewable energy infrastructure, which the Ministry decided in 2019 should be made within the scope of the environment-related mandates. In its letter of 29 October 2018, Norges Bank wrote that a large part of the limit for the environment-related mandates could end up being used for investments in unlisted renewable energy infrastructure in the longer term.

The market for environmental equity investments

In line with the management mandate, Norges Bank has concentrated its environment-related equity investments on companies in low-emission energy and alternative fuels, clean energy and energy efficiency technology, and natural resource management. These three main types of environmental activity support the UN Sustainable Development Goals for climate, clean energy and resource management respectively.

What makes a company environment-related is not clear-cut. The potential universe for such investments spans both large conglomerates with only a small part of their business in environmental activities, and small pure-play environmental companies. These companies can be found in different sectors with different characteristics. The specification of what constitutes an environment-related company must to some extent be based on judgement and is delegated to Norges Bank.

For companies to be included in the environment-related equity universe as we have defined it, at least 20 percent of their business must be in the three types of environmental activity mentioned above. As with the fund's other investments, the environment-related mandates are to contribute to the highest possible long-term return on the fund with acceptable risk.[1] The 20 percent threshold has been set to ensure that the investment universe covers the opportunity set for investments of this kind and is broad enough for us to construct a portfolio that meets the above requirement as regards return and risk. It is also the same as the threshold used by the fund's index provider.[2] In addition, it has been decided that the environment-related mandates may not be invested in oil and gas producers, coal companies or mining companies.[3]

The specification of the universe for environment-related equity investments is based on information from external data providers, companies themselves and industry specialists. Using this information, we seek to ascertain how much of a company's business is environmental, while also ensuring that it has limited involvement in activities with negative environmental and climate impacts.[4]

The universe for listed environment-related equity investments as we have defined it has grown from around 400 to around 5,000 billion dollars in the past ten years. By way of comparison, the market value of FTSE Russell's broad environmental index has increased from around 2,000 to around 10,000 billion dollars over the same period.[5] The difference is a result of FTSE Russell including more markets and having a somewhat wider definition of environmental activities.[6] All of the companies in the environment-related equity mandates and FTSE Russell's environmental index are included in the fund's broad equity benchmark.

[1] See the Ministry's letter to Norges Bank of 10 June 2021.
[2] FTSE Russell's broad environmental index, the FTSE Environmental Opportunities Index (EO).
[3] The following ICB sectors are not part of the environmental investment universe: 601010 (Oil, gas and coal), 551020 (Industrial metals and mining) and 551030 (Precious metals and mining). Upstream oil and gas companies (ICB sector 60101010) have been removed from the fund's investment universe and benchmark index.
[4] We have defined a negative environmental impact as emissions of greenhouse gases, other pollution and negative effects on biodiversity and natural resources.
[5] Companies included in the FTSE EO must derive at least 20 percent of their earnings from environmental activities.
[6] Because these are active mandates, there are limits on how many companies we can focus on. To achieve the desired exposure, we have therefore concentrated the universe on developed markets, where companies are often larger.

Part of the growth in the market value of environment-related equity investments is due to the general increase in share prices over the past decade. In addition, the definition of what counts as an environment-related company has been expanded. New additions include companies related to the sharing economy and companies developing solutions for working from home. There are also more companies developing technologies that contribute to environmental solutions than there were ten years ago. In particular, we are seeing conglomerates and utilities shifting away from more traditional activities towards new environmental activities and services. Environmental activities account for an ever greater share of these companies' earnings, and so more large companies are now classified as environment-related than before. The fund will often already have been invested in these companies, as they are part of the fund's broad equity benchmark.

There are also more small pure-play environment-related companies than there were a decade ago. However, these companies' market value makes up a smaller share of the universe for environment-related investments than before, because more large companies are now classified as environment-related. This change in the composition of the universe for environment-related investments has contributed to its risk characteristics converging on those of the wider equity market.

We are also closely monitoring developments in markets that are not defined as part of our focus area for environment-related equity investments. For example, China has set itself the goal of being a world leader in the development of environmentally friendly technology, and we are seeing the emergence of environmental activities in some areas in China. Where this takes place at listed companies, the fund will to a great extent be exposed to it through the broad equity benchmark. A large part of the fund's equity investments in China are managed actively through our strategies for internal and external security selection. Staff at Norges Bank Investment Management's Shanghai office are responsible for internal management.

Progress is also being made in sectors defined as being outside the environment-related universe, such as oil and gas. Some of the companies in that sector have a key role to play in the energy transition. A recent study finds, for example, that oil and gas companies in the US are among the most important producers of green patents that can help mitigate climate change.[7] We pay particular attention to developments in that sector through active mandates under our strategy for internal security selection. Climate and environmental issues need to be an integral part of the management of these mandates, because developments in climate regulation and new technology will be key factors when assessing companies' future earnings.

[7] See Cohen, Gurun and Nguyen (2020).

There is reason to believe that the trends described above will continue. In the long term, this means that a large proportion of the companies in the fund's broad equity benchmark will be classified as environmental as the index provider defines it today. Many companies will be affected by changes in climate policies and evolving consumer preferences during the transition to a low-carbon economy. This may mean that more and more companies alter their business models.

In the light of market developments, we regularly assess whether it might be appropriate to revise our definition of the universe for the environment-related mandates, for example by raising the threshold for how much of a company's earnings need to come from environmental activities. The purpose with such changes will be to ensure that the environmental investment universe covers the scope for this type of investment in a good way. Such assessments require proximity to, and familiarity with, the market and should be delegated to Norges Bank as they are today. As required by the mandate, we report annually on the criteria applied to define the environment-related mandates' equity universe.

The fund is exposed to developments in the market for environmental equity investments through the broad equity benchmark as well as through the environment-related mandates. Through the latter, the Ministry requires the Bank to invest more in environmental companies than would follow from the fund's benchmark index. On 30 June 2021, 12.6 percent of the equity portfolio was invested in companies classified as environment-related, breaking down into 11.5 percent invested through the fund's broad equity benchmark and 1.1 percent through the environment-related equity mandates.[8]

International frameworks for sustainability reporting

There are numerous voluntary standards and frameworks for sustainability reporting. The leading international reporting standards and frameworks are the Global Reporting Initiative (GRI), Task Force on Climate-related Financial Disclosures (TCFD), CDP (formerly the Carbon Disclosure Project) and the Value Reporting Foundation (VRF).[9] The various standards differ in purpose, scope, format and methods. Norges Bank supports standards and initiatives that we consider particularly relevant given our activities.[10]

The numerous different standards make comparisons across companies a challenge. Since sustainability reporting is still mainly principles-based and voluntary, it is up to companies themselves to decide which framework to use. In addition, some of the

[8] To identify environmental equity investments in the fund's broad equity benchmark we use the FTSE EO index.
[9] The VRF is the result of the merger of the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC).
[10] For further information on the standards and initiatives that we support, see Norges Bank's letter of 2 July 2021 and our annual reports on responsible investment at www.nbim.no.

standards are designed in such a way that companies can to a great extent decide for themselves what they report on.

In 2020, the Sustainability Accounting Standards Board (SASB), GRI, CDP and two other standard setters announced an intention to work together towards a more comprehensive framework for sustainability disclosure.[11] In addition, the International Financial Reporting Standards (IFRS) Foundation has plans to develop a global standard for sustainability reporting. This work is expected to build on existing voluntary standards.[12] Consistent requirements and standards will put us in a better position to assess the degree to which the companies in which we invest are sustainable. Standardisation and improved corporate disclosure will also contribute to better-functioning markets.

The frameworks and standards mentioned above say nothing about whether a company or its operations are sustainable, even if the information reported may be relevant to such an assessment. The EU, however, is developing a classification system, or taxonomy, to establish a common understanding of what economic activities can be considered sustainable in the context of the EU's long-term climate and environmental targets. To qualify as sustainable under this taxonomy, an economic activity must contribute substantially to at least one of six specific environmental objectives.[13] Science-based criteria are to be set for deciding what counts as a substantial contribution. In addition, the activity must not significantly harm any of the six environmental objectives. There are similarities between this taxonomy and the way we have chosen to define the universe for environment-related equity investments, in terms of both the activities that qualify and the requirement that companies have limited activities with negative environmental and climate impacts.

The taxonomy was launched in 2020 and is a pillar of the EU's action plan on sustainable finance. The action plan also requires providers of investment products marketed as green or sustainable to provide information on what proportion of the underlying investments is classified as sustainable under the taxonomy.[14] The idea behind these pan-European criteria is to make it easier to compare investment opportunities across countries and sectors, and to help reduce the risk of

[11] The other two standard setters being the Climate Disclosure Standards Board (CDSB) and IIRC.
[12] A Sustainability Standards Board is to be set up within the organisation with the aim of developing a common standard.
[13] The taxonomy defines six environmental objectives: climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystems.
[14] The Norwegian financial supervisory authority Finanstilsynet's consultation paper on the implementation of the EU rules on sustainable finance states: "The Disclosure Regulation, which is founded in the need for investor protection, will not be relevant to the Government Pension Fund Global."

“greenwashing”, where investments are presented as green without having demonstrable climate or environmental benefits.

From 2022, large companies in the EU will be required to report information in line with the first two environmental objectives in the taxonomy – climate change mitigation and climate change adaptation. Companies will need to state to what extent their revenue and investments are compatible with the taxonomy. The criteria for the other four climate objectives are expected to be adopted in the first half of 2022 and apply from 2023. There are also plans for the disclosure requirements under the taxonomy to be integrated into a new sustainability reporting directive.[15] This directive will initially apply to all large companies in the EU, but the intention is for it also to apply to small- and mid-cap listed companies in the longer term. The first draft of the directive is due in mid-2022, and the first financial year for reporting under the new standards is expected to be 2023.

The taxonomy is expected to increase the quantity and quality of sustainability data. However, it is important to realise that while the requirements of the taxonomy are fairly specific, they are not exhaustive.[16] Investments can be labelled as sustainable even if they are not covered by the taxonomy as it currently stands. This could, for example, apply to companies in transition which have few qualifying activities today but will contribute over time to the EU’s climate and environmental targets. The EU estimates that only between 1 and 5 percent of economic activity and investment portfolios are currently aligned with the taxonomy.[17]

The taxonomy will not apply to companies worldwide, but similar moves are being made in markets outside the EU. In the US, the Securities and Exchange Commission (SEC) has recently conducted a public consultation on climate change disclosures. In Asia, sustainability reporting is often driven by the stock exchanges, which have published various frameworks for environmental, social and governance (ESG) reporting. The companies we invest in are subject to different reporting requirements depending on the jurisdictions in which they operate.

In time, the IFRS initiative may result in more standardised information globally. It does not, however, include guidelines for what counts as a sustainable activity, and so investors will still need to obtain their own information on the activities of the companies in which they invest. The taxonomy can provide useful guidance, although it is not necessarily directly transferable to industries and companies outside the EU.

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[15] Corporate Sustainability Reporting Directive (CSRD).

[16] See Norges Bank’s consultation response of 6 January 2021 on the proposed new Sustainability Disclosure Act.

[17] For further information, see: “Frequently asked questions: What is the EU taxonomy and how will it work in practice?”.

All in all, work on standardising sustainability reporting internationally is still in its infancy. Although more and more companies are disclosing some information of this kind, it is generally not readily available company information. The coming taxonomy and reporting directive are, however, expected to change this.

Reporting requirements for the environment-related investment mandates
The management mandate currently sets out detailed requirements for public reporting on Norges Bank's management of the fund. There are specific requirements for annual information on the environment-related investment mandates, including scope, strategy, asset type and the criteria used to define the investment universe for the mandates. Norges Bank is also to report on their performance measured against several alternatives, including relevant environmental indices and the assets Norges Bank sold to fund the investments.

In its letter of 10 June, the Ministry asks Norges Bank to consider how the reporting requirements for the environment-related mandates might be extended to include the climate and environmental impacts of the companies and projects included under the mandates, and the mandates' aggregate exposure to environmental activities. The Ministry notes that the basis for its assessment is that the GPFG, including the environment-related mandates, has a clear financial objective. Norges Bank is of the opinion that the additional reporting on the mandates should reflect this objective.

The information that is needed to assess climate and environmental impacts is challenging to obtain and is currently subject to limited availability. Such reporting will therefore be, at best, imprecise. It is difficult for individual companies to measure the climate and environmental impacts of their activities, and it is not currently possible to report consistently and systematically on climate and environmental impacts at the portfolio level.

Once we have gained experience of the taxonomy and reporting directive, we will be able to consider whether it might be appropriate for taxonomy information and exposure to environmental activities to be included in the fund's reporting. This should then apply to all investments where relevant, and not just the environment-related mandates. The expert group looking at the importance of financial climate risk for an investor such as the GPFG reaches a similar conclusion.[18] We are closely monitoring developments in the taxonomy and the reporting directive, and have provided input on a number of occasions to help improve standards and market practices.[19]

The expert group also mentions the environment-related mandates. Its conclusion is that a special focus on selected themes such as the environment in the management of the

[18] See the report from the expert group appointed by the Ministry of Finance, "Klimarisiko og Oljefondet" [Climate risk and the oil fund], 20 August 2021.
[19] See consultation responses of 8 March 2019, 9 July 2020 and 31 August 2021 at www.nbim.no.

fund could have learning benefits for the management organisation that impact positively on the fund's return and risk over time. The group also argues, however, that lines of responsibility may be blurred when the asset owner issues instructions in the mandate on how the manager is to depart from the benchmark index. According to the group, it is also slightly unclear what effect the current rules on the environment-related mandates have, since the companies included under the mandates are also included in the rest of our equity management.

The expert group recommends that the Ministry considers a different solution for regulating the environment-related mandates and increases the visibility of environment- and sustainability-related investments in the fund as a whole. It notes that if a more ambitious approach is taken to climate risk management and reporting for the overall fund, it would be natural to consider whether there is still a need for separate environment-related mandates.

In its letter to Norges Bank of 13 September 2021, the Ministry writes that it will consider how to follow up the expert group's recommendations in its 2022 white paper on the fund. Norges Bank is also asked to give its assessment of the expert group's recommendations. For example, the group proposes separate provisions on the measurement, management and reporting of climate risks and the development of standards in this area. Norges Bank will submit its assessment to the Ministry before the deadline of 20 December 2021.

Norges Bank is of the opinion that it is not appropriate to extend the additional reporting requirements for the environment-related mandates at this time. This needs to be seen in the light of the Ministry's consideration of how the expert group's recommendations should be followed up, the fact that standards for sustainability reporting are still in their infancy, and the mandates' financial objective.

Yours faithfully

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