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Keywords

Sovereign wealth fund, ESG investment, climate change

Disciplines

Economics

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Abstract

As the largest sovereign wealth fund (SWF) in the world, the Norwegian SWF's efforts to move in a more sustainable direction are often followed by other institutional investors. This chapter examines how the Norwegian SWF (officially, the Government Pension Fund – Global, or GPFG) has evolved into a responsible investor, balancing ethics, environment, social, and governance (ESG) risks with returns. The focus is mainly on its actions to address financial climate change risks. If the GPFG continues to evolve toward sustainable investment and acts on the latest International Energy Agency report that calls, among other things, for an end to all *new* fossil fuel production, it can serve as a good model for other institutional investors to deal with the challenge of climate change while remaining profitable.

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JEL codes: H5, Q51, Q54, Q56

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A decade and a half ago, Lord Nicholas Stern characterized climate change as 'the greatest market failure the world has ever seen' (Stern 2006: *viii*). We are slowly beginning to see the market address this failure, as a wide range of actors increasingly realizes that we need to internalize the greenhouse gas (GHG) externalities generated by burning fossil fuels. Many market actors now recognize what most scientists have known for decades: that the atmosphere does not have an infinite capacity to absorb the GHGs without leading to catastrophic heating of the planet. Without actually reducing the GHGs, we will not achieve the Paris Agreement's target of limiting global warming to below two degrees Celsius above pre-industrial levels (preferably, 1.5 degrees Celsius) (IPCC 2018), to avoid the worst of the climate change impacts (Paris Agreement 2015).

Stern's statement (2006: *vi*) that 'the benefits of strong and early action far outweigh the economic costs of not acting,' is becoming more persuasive as costly extreme weather events become increasingly common. The previous lack of renewable energy technology and its early high costs are no longer barriers to producing renewable energy, since the technology has been scaled up and its price has plummeted (IRENA 2021). Instead, it is more a question of *the will* to take climate action by politicians and other decisionmakers, including investors.

As the impacts of climate change become more visible, it is slowly but surely being recognized as constituting a financial risk (Reuters 2021a). At the ExxonMobil annual shareholder meeting on May 26, 2021, the company was forced to fill three board seats with pro-climate nominees (Krauss 2021). This was a strong manifestation that focusing on ESG, and climate change risk management, in particular, has become mainstream and that 'the market has now caught up' (Marsh and Kishan 2021). Furthermore, in their communique from the 2021 annual meeting of the G7, the member states expressed support for a move toward 'mandatory climate-related financial disclosures.' (G7 2021).

Sustainable development has become a legitimate concern for institutional investors, be they private or state-owned funds. This paper[1] examines how the Norwegian sovereign wealth fund (SWF),[2] officially, the Government Pension Fund - Global (GPFG), has evolved into a responsible investor. It can serve as a model for other institutional investors if the GPFG, while remaining profitable, continues to move toward sustainable investment. In the context of climate change, this means the Fund has to follow the pathway set out in the International Energy Agency (IEA 2021)'s report, *Net Zero by 2050*, to make certain its investment portfolio supports the goal of limiting the global temperature rise to 1.5 degree Celsius (Flood 2021).

Government Pension Fund - Global (GPFG)

In the last 50 years, Norway has transformed the revenue from its oil and gas resources into financial assets, providing savings for present and future generations. Formally established in 1990, the GPFG has managed to balance ethics and the high standards of ESG objectives with a steady investment return. The GPFG (also referred to here as the Fund) is the largest pension fund in Europe and the largest SWF in the world, now valued at over US $1.3 trillion (NBIM 2021a). The Fund is a universal investor holding diversified assets in the equity market with an average ownership participation of 1.5 percent of around 9,000 listed companies in 70 countries (NBIM 2019a).[3] The GPFG also has investments in fixed income, real estate, and infrastructure for renewable energy (NBIM 2020b: 24). The Fund is not allowed to invest in assets located in Norway (Ministry of Finance 2019: 2-1).[4]

The GPFG was created to reduce the effects of volatile oil prices on the Norwegian economy, to support the long-term management of petroleum revenues, and to facilitate government savings necessary to finance rising public pension expenditures (Ethics Committee

2020).[5] The name of the Fund was changed in 2006 from the Petroleum Fund to the GPFG, to emphasize this focus. Unlike most pension funds, however, GPFG has no explicit pension liabilities. The Fund is well known for being the most transparent of its type (Caner 2009).

The GPFG is owned by the Norwegian people (Government Pension Fund Act 2005). The Norwegian Ministry of Finance establishes the overall investment strategy for the fund based on the framework set by the Norwegian Parliament ('Storting'), while operational management is delegated to the Central Bank ('Norges Bank') (Government Pension Fund Act 2005).

The Fund is managed by Norges Bank Investment Management (NBIM), the asset management unit of Norges Bank (Government Pension Fund Act 2005).[6] The Ministry determines the Guidelines for Observation and Exclusion from the Fund (also referred to as Guidelines) that must be followed by an independent Council on Ethics when making recommendations to exclude individual companies from the Fund or place them under observation (Ministry of Finance 2014).

The goal of the GPFG is to invest the funds to achieve the highest possible return with an acceptable level of risk based on sound long-term management, contingent upon sustainable development (Government Pension Fund Act 2005). The long-term investment horizon is meant to ensure that this wealth can benefit all generations (present and future), that is, intergenerational equity or justice between generations (Brown Weiss 1989: 17-18). The GPFG's mandate specifically states that 'good long-term return is considered to depend on sustainable economic, environmental and social development as well as on well-functioning, legitimate and efficient markets' (Norwegian Ministry of Finance 2019: 1-3).

Since receiving its first funds in 1996, the GPFG has gradually built the world's largest single-owner global portfolio of listed companies, focused on diversifying its risk. The starting point for the Fund's equity investments is the FTSE Global All Cap stock index, the benchmark index applied by the Ministry of Finance (NBIM 2020b: 39). In its first 21 years, GPFG saw an investment return averaging 1.1 percent per annum over the benchmark with an excess return totaling 87 billion kroner (US$10 billion) (NBIM 2021b: 43).

Drawing on the Graver Committee's Report (Graver 2004), the Storting approved a set of Guidelines for Observation and Exclusion from the Fund[7] in 2004 based on a broad international and national (Norwegian) consensus reflecting fundamental ethics norms (Ethics Committee 2020). Essentially, the GPFG has two primary ethics obligations, to attain 'a good return for future generations and, at the same time, to avoid being invested in companies that contribute to grossly unethical conditions' (Ethics Committee 2020: 2).

Active Investor and ESG Matters

Once the shares in companies are purchased by the GPFG, NBIM manages the Fund as an active and responsible investor: it seeks to reduce the long-term risks, recognizing the broader potential environmental and social consequences of company operations (NBIM 2020c: 67). As an active investor, NBIM uses several approaches to influence corporations. It exercises its ownership rights by setting standards, voting on shareholder proposals at the annual general meetings (AGMs), and engaging companies in dialogue (NBIM 2020c: 67). It also meets with regulatory authorities and collaborates with other investors. The NBIM may also divest from a company based on ESG risk assessments (NBIM 2020c: 85).

NBIM began publishing some of the standards, specifically expectation documents in 2007, to inform companies how the Fund expects them to manage the environmental and social impacts of their company's operations, supply chains, and other activities. These investor expectations align closely with the UN Sustainable Development Goals (NBIM 2021a). Seven expectation documents are made public: Climate Change, Children's Rights, Human Rights, Water Management, Ocean Sustainability, Anti-corruption, and Tax and Transparency. These disclosure documents aim to promote positive changes on sustainability issues. The expectation document on climate change, for instance, requires companies to consider the possible transition and physical risks and opportunities that climate change represents, by integrating these elements into their corporate policy, strategy, risk management, and reporting (NBIM 2021c). This approach is in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD 2017: 22). In response to the expectation documents, companies are to self-report on their GHG emissions and actions they take to address climate change (NBIM 2020d: 59).

As part of exercising its ownership rights, in the last year alone, NBIM attended nearly 3,500 company meetings, voted at over 11,000 shareholder meetings (NBIM 2020c: 47), and now publicizes its intended vote five days before the meetings take place (NBIM 2021d).[8] It also gives an explanation in cases where it disagrees with a board's recommendation. NBIM has published voting guidelines and principles available on its website (NBIM 2021e). At Chevron's AMG, the Fund supported the shareholder proposal over the board's objection, calling for the company to reduce emissions from its products (both upstream and downstream) (NBIM 2021f). This action correlated with the expectation document NBIM has published on climate change (NBIM 2021c: 3).

The Fund engages in dialogue with both the large companies as well as those that are weakest on disclosing ESG issues. Because of its relatively large ownership in any one company, the GPFG has much easier access to the board and management of a company compared to other small shareholders, and as such, it may influence company behavior.

Environment-related investment mandates. As part of the GPFG's investments, the Ministry of Finance introduced environment-related mandates in 2009 (NBIM 2020c: 37). These are earmarked for eco-friendly assets or technology expected to yield indisputable environmental benefits, such as low-emission energy, clean energy, improving energy efficiency, carbon capture and storage, water technology, and the management of waste and pollution (NBIM 2020c: 36). The Fund's environment-related equity mandates promote sustainable companies ahead of others in the investment universe, which could be interpreted as a form of positive screening. In 2020, the GPFG invested in 98.9 billion Norwegian kroner (US $11.8 billion) in environmental investments (NBIM 2020d), which generated a 34.3 percent return on this portion of the total equity portfolio.

Recently, the Fund added unlisted renewable energy infrastructure projects to the environmental mandate. With the new mandate in place, the Fund can now make investments that promote use of renewable energy around the world. NBIM has published a guidance document for its investment partners and asset managers, outlining its approach to responsible management of unlisted renewable energy infrastructure (NBIM 2020e). Last April, the Fund bought its first unlisted energy infrastructure, specifically, 50 percent of the Offshore Wind farm (off the coast of the Netherlands) for around US$1.63 billion. The other half is owned by the Danish company Ørsted which will continue as the operator (Frangoul 2021).

ESG risk-based divestment. In order to reduce its exposure to unacceptable risk, the GPFG integrated environmental, social, and governance issues into its financial risk management (NBIM 2020d: 82). In addition, the Fund developed a strategy for risk-based divestments in 2010 (NBIM 2020c). As part of being a responsible investor, the GPFG may divest from companies where it sees elevated long-term risks, that is, companies that impose substantial costs on other companies and society as a whole and are not considered long-term sustainable (NBIM 2020c: 26). Hence, these are considered financial risks, not ethics risks. Examples of activities that are unsustainable are business models that do not conform to prevailing technological, regulatory, or environmental trends (NBIM 2020c). The GPFG chooses not to invest in these companies. Risk-based divestment is one way to allocate capital to companies with more sustainable business models (NBIM 2020c).

This is a dynamic approach, which is evolving over time. The Fund identifies relatively small companies in the portfolio whose business models are not sustainable given their high environmental (e.g., high carbon emissions) or social risks, and where other actions are not considered suitable (NBIM 2020c). By divesting from them, the GPFG has reduced its exposure to unacceptable risks (NBIM 2021h). It has carried out 282 risk-based divestments since it began this practice in 2012 (NBIM 2020b). For instance, GPFG has divested from coal (Carrington 2015), palm oil, and soy producers (operating in areas of tropical deforestation), as well as oil and gas producers (upstream only) (NBIM 2020c). The Fund is not required to explain its rationale for risk-based divestments, but it is transparent about the criteria it uses for these decisions (NBIM 2021c). The GPFG does not publish which companies it has divested from; however, the list of companies in which it is invested, and its holdings in them, are publicly accessible (NBIM 2021c).

Guidelines for Observation and Exclusion from the Fund

The GPFG is renowned for its Guidelines for Observation and Exclusion from the Fund.[9] Some nations hosting SWFs worried that the investment decisions by SWFs would be made for political or strategic reasons, rather than strictly financial or economic ones (Backer 2009). Hence, there were calls to have special regulations for SWFs. The international community responded by agreeing to the Generally Accepted Principles and Practices (GAPP), often referred to as Santiago

Principles (GAPP 2008). These principles allow for considerations other than economic and financial ones, as long as they are clearly set out in the investment policy and made public (GAPP 2008: Princ.19.1).[10]

The GPFG is the world's largest investor using ethics assessments (Mestad 2011). The independent Council on Ethics recommends exclusion or observation of individual companies (not countries), for breach of fundamental ethics principles as stipulated in the Guidelines for Observation and Exclusion from the Fund (Ministry of Finance 2014). The Executive board of Norges Bank makes the final decision on whether any given company should be excluded, placed under observation, or addressed using active ownership (e.g., dialogue).

The Guidelines are meant to ensure that the Fund avoids making investments which constitute an unacceptable risk of contributing to a violation of fundamental ethics principles. There is a high threshold for the use of exclusions, and a high probability of future violations is required (NBIM 2020c). The Fund is not meant to be a political tool. The product-based criteria of the Guidelines encompass production of tobacco, certain kinds of weapons (e.g., cluster bombs), or companies with operations based on coal (Ministry of Finance 2014). This is considered negative screening. The conduct-based criteria (acts or omissions) encompass serious violations of human rights, individuals' rights in armed conflict, gross corruption, severe environmental damage, and unacceptable greenhouse gas emissions (on an aggregate company level) (Ministry of Finance 2014).

GPFG is the only institutional fund in the world whose Council on Ethics publishes thorough explanations for its recommendation to exclude companies or place them under observation (Council on Ethics (2020a). The recommendation is given to the Executive Board of

Norges Bank which makes the final decision. These are specific to each individual company. Since 2004, this negative screening has led to a total of 148 exclusions (NBIM 2020c).

Using the product-based coal criteria, the Executive Board of Norges Bank has also excluded thermal coal mining companies (or those with considerable coal-related operations) on its own initiative without a recommendation from the Council on Ethics (NBIM 2020c: 97). Since 2002, seventy-three coal companies were excluded from the Fund and seventeen were placed under observation (NBIM 2020c: 25).

The Council on Ethics first applied the conduct-based climate exclusion (for unacceptable greenhouse gas emissions) in 2020. Four Canadian companies with a substantial output of oil from oil sand resources were excluded (Council on Ethics 2020b).

There is some overlap between the exclusions recommended by the Council on Ethics and responsible investment practices carried out by NBIM. By exercising its ownership rights (e.g. dialogue, voting), NBIM contributes to compliance with respect to the criteria in the Guidelines against which the Council on Ethics assesses companies in the Fund's portfolio (Ethics Committee 2019: 3). This leads to a gradual decrease in the number of companies that warrant exclusion from the Fund (Ethics Committee 2019: 4). The complementary relationship between NBIM's responsible management activities, for example use of expectation documents, and the Council on Ethics' application of the Guidelines is particularly evident in the climate area, and it shows the importance of a holistic approach. The various measures addressing climate change can reinforce each other (NOU 2020: 8).

Challenges

Some finance experts believe that that the GPFG could be better managed if the overall strategy were overseen by an independent board rather than a team of bureaucrats at the Ministry of Finance. For instance, Kapoor (2017) claims that the current structure causes the Fund to lose greater moneymaking opportunities. Nevertheless, since the Fund is the 'savings account' owned by the Norwegian people, it must maintain political backing; accordingly, major changes to the GPFG's overall investment strategies must be made by the Ministry of Finance and presented to the Storting before being implemented by Norges Bank (Government Pension Fund Act: 2005). All of this, of course, takes time.

This process played out in the case of approving investments in unlisted renewable energy infrastructure mentioned above. By the time the mandate was amended, the assets being considered had become too expensive (Taraldsen 2021).

In the context of climate change, the road has been a long one. As an example, in 2014, the ruling parties in the Storting agreed to study whether to exclude coal, oil, and gas from the Fund. By 2016, after first being turned down in Parliament, the GPFG was able to add certain coal producing companies to its list of product-based exclusions in the Guidelines for Observation and Exclusion from the Fund (NBIM 2016). In addition, it added climate change to the conduct-based criteria. Then, in 2018, the Fund excluded companies with substantial revenue from coal-fired power production from its investment universe. Furthermore, in 2019, the Fund did the same with companies which exclusively explored and produced oil and gas (NBIM 2020c).

With regard to investments, Nicolai Tangen, the CEO of NBIM, has said that the Fund will continue to track the reference index, but 'should be more selective when choosing stocks' (Reuters 2021b). He also said that 'NBIM can do more on negative selection, get rid of things which are bad' (Reuters 2021b). Accordingly, the GPFG will begin screening all new companies in which the Fund invests (about 500-600 per year), not just the large ones, even if they are included in the index. By running them through an automated data system (a 'washing machine' of sorts), the Fund will weed out the companies that are unsustainable (Langved 2021). This could be an improvement over the current approach.

In addition, the Storting has approved the Ministry of Finance's recommendation to reduce the number of companies in which the GPFG invests (especially the smaller ones), from around 9,000 companies down to 6,600 (Milne 2021). This could save costs and likely make the Fund more manageable, increasing its ability to follow its investments more closely (Katz 2021). Since the smaller companies targeted for divestment amount to only two percent of the Fund's value, divesting from them would have little effect on the Fund's diversity (Katz 2021).

Critics have called for the Fund to change its mandate in order to utilize positive screening at the front end, being proactive by not investing in companies which overlook ESG issues (Rapp Nilsen et al. 2019). The 2020 report from the committee reviewing the Guidelines for Observation and Exclusion from the Fund stated that there were no suitable indices for a filtering or a rule-based delimitation of investments towards countries or industries (Ethics Committee 2020: 6). Furthermore, positive screening could worry some host nations as to whether the Fund, a SWF, was going beyond its stated financial objective and moving into politics (Backer 2009).

Another approach could be that the Fund continues being as a universal investor yet uses its new method of weeding out 'bad' companies once they are bought, as mentioned above. Since the GPFG considers climate change and other ESG issues as financial risks, it is already strengthening its sustainable investments.

Several additional changes might be beneficial, such as increasing its staff at the Council on Ethics, and allowing the Guidelines for Observation and Exclusion from the Fund to be implemented more forcefully to exclude more of the high GHG emitters from the investment universe, rather than focusing only on the worst ones. This would clearly demonstrate that such behavior is no longer acceptable in the transition to a green economy.

IEA's report: net zero by 2050. On May 18, 2021, the IEA (2021) announced that the energy industry must put a stop to all new fossil fuel production projects beginning *this year* if global CO2 emissions are to reach net zero by 2050, thereby limiting the rise in global temperature to 1.5 degrees Celsius. Furthermore, the agency set out clear milestones for what needs to happen, and when, to 'transform the global economy from one dominated by fossil fuels into one powered predominantly by renewable energy like solar and wind' (IEA 2021: 3). This report has major implications for all market actors. It also states that 'net zero means a huge decline in the use of fossil fuels', reducing the amount from four-fifths to one-fifth of the total energy supply by 2050 (IEA 2021: 18).

As the world now starts to get more serious about transitioning to renewable energy, which will entail a sharp drop in fossil fuel demand, investors can avoid investing in companies with potentially 'stranded assets' by steering clear of energy companies that are not taking climate change into account. The GPFG has already taken steps in this direction, adding coal companies to its product-based exclusion criteria. It has also added unacceptable GHG emissions to the conduct-based exclusion criteria of its Guidelines, and divested from companies that exclusively explore and produce fossil fuels—the upstream companies—to reduce the total oil price risk to the Norwegian economy (NBIM 2019).

Another step the GPFG can take on the path to net zero is to exercise its ownership rights to 'urge' fossil fuel companies, both upstream *and* downstream, to speed up their transition to predominantly renewable energy production.

The financial climate risk management approach will also need to be aggressively used, engaging with companies that are not reporting on their climate change efforts in accordance with the NBIM's expectation document. If the companies then fail to take action on climate change, they will be divested, as they no longer have a sustainable business model. This may require a change in the management mandate to allow for greater flexibility to divest also from the larger companies.

Voting on shareholder proposals is also an important tool of active ownership, as seen in the case of the ExxonMobil shareholder meeting mentioned above. In line with its stated goal of maintaining transparency, the Fund could explain why it did not support the seating of three pro-climate change nominees on Exxon's board (Fixsen 2021; NBIM 2021i), especially as a majority of the shareholders supported this shareholder proposal, including other large funds such as BlackRock and the California Public Employee Retirement System (CalPERS). This heightened transparency would provide more insight into how the voting principles of the GPFG are implemented (NBIM 2021d). NBIM could then decide if the principles or their implementation need to be adjusted, to move farther away from business as usual and transition more quickly to the green economy.[11]

The environmental mandate, which has led to profitable investments, should be a sector targeted for much stronger growth, especially since this together with the unlisted renewable energy infrastructure is hugely important as a funding mechanism on the path toward a green economy with the goal of net zero by 2050.

More diversification. Nicolai Tangen has also talked about diversifying the Fund's leadership group, increasing the number of women (NBIM 2020e). As the GPFG continues developing as a responsible pension fund, so too must its expertise shift to include more experts on environmental (climate change, etc.) and social issues (human rights, etc.). If the Fund intends to act in support of the goal of net zero by 2050, then the sustainability focus must be expanded at NBIM so that every portfolio manager picking new investments and managing those already held, sees climate change risk as a red flag, as important as the financial health of a company.

Conclusion

The Norwegian GPFG is considered a responsible investor, using its Guidelines for Observation and Exclusion from the Fund and its focus on ESG issues in the management of its investments, while remaining profitable. This paper has examined the GPFG with its varied approaches to ethics and ESG issues. There is no doubt that the Fund has taken steps to support sustainable development, yet there is still more to be done. This system will become a good model for other institutional investors, if it continues evolving in the direction the IEA report sets out. With a successful transition, by 2050, the GPFG will be a major player in the effort to reach the goal of net zero emissions. This will be critical in limiting global warming to 1.5 degrees Celsius and avoiding the worst impacts of climate change.

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Endnotes

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[1] This paper builds on Halvorssen (2011).

[2] Sovereign wealth funds (SWFs) are special purpose investment funds or arrangements that are owned by the general government. See Santiago Principles (GAPP 2008: 3).

[3] The Fund's shares in a listed company cannot surpass 10 percent (NBIM 2021).

[4] To avoid the 'Dutch Disease' that would occur if the economy were flooded with oil money.

[5] The Fiscal Rule ('handlings regelen') was introduced to limit the amounts of funds transferred from the GPFG to the national budget to no more than four percent (three percent after 2017) (NBIM 2021).

[6] The new CEO of NBIM is a Wharton alumnus—Nicolai Tangen (hired 2020), a Norwegian who was head of a London-based investment fund.

[7] In 2017, the name of the Guidelines was changed from Ethical Guidelines to Guidelines for Observation and Exclusion from the Fund.

[8] This is done in the interest of transparency for the companies and shareholders (NBIM 2020c).

[9] Referred to as the 'Gold Standard' by the EU Commissioner (VG, 2009).

[10] Backer (2009: 108) argues that this disclosure could suggest that such deviation might open that fund to special regulation.

[11] On another management recommendation to reject a shareholder proposal, the GPFG voted for the shareholder proposal entitled 'Report on Corporate Climate Lobbying Aligned with Paris Agreement' (NBIM 2021f). This was a positive move. For many years, fossil fuel companies have lobbied to block or delay governments' action on climate change. This proposal would counter such lobbying.