NORGES BANK

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EUROPEAN COMMISSION CONSULTATION ON THE RENEWED SUSTAINABLE FINANCE STRATEGY / Response from Norges Bank to the Ministry of Finance

The European Commission's consultation on the renewed sustainable finance strategy provides an opportunity to present Norwegian priorities in a broad context. We are positive to sustainability being promoted. The strategy's three areas – (i) foundations for sustainable investment, (ii) opportunities to have a positive impact on sustainability, and (iii) that climate risks will need to be fully managed and integrated – constitute a useful and relevant approach. Climate risk issues involve a wide range of factors that to a great extent lie outside the central bank's sphere of authority or direct influence. Norges Bank will in its response focus on some key topics of relevance for the central bank, at two levels: (i) input to an overall position on the basis for sustainable finance, and (ii) responses to selected technical expert questions.

Input to Norway's overall position based on the central bank's perspective

The COVID-19 pandemic and the resulting actions in public policy and private behavior have caused a major shock to the global economy. National authorities, including central banks, are fully preoccupied with responding to the COVID-19 developments and their economic and financial impact. Strong multilateral cooperation and coordination is paramount to address the global nature of the shock and leverage the impact of national policy action.

In this unprecedented situation we should be mindful of our longer term objectives. This comprise allowing for structural changes, and not losing sight of the crucial need to continue cooperation across nations to address the global challenge of climate change to meet agreed objectives.

International cooperation and mandate of institutions
Work on climate change and risk is a cross-cutting and cross-border effort. Recent networks in the climate risk area create arenas for national authorities and international institutions to exchange experiences and share best practices in developing environment and climate risk management in the financial sector. These networks focus on systematic learning and competence-building. At the same time, there is much we still do not know, including market dynamics and risk patterns for "green" compared with "non-green" investments. The new networks constitute meeting places where the objective is to arrive at a good understanding of reasonable frameworks to promote sustainable finance.

At the same time, it is essential for the credibility of each institution to stick to its mandate, and cooperate with other institutions working in the same area to avoid undue overlapping work as well as leverage competence and knowledge. While it is the governments' role to pursue climate policy, central banks and the financial sector play an important role in knowledge-building and integration of climate risk into the overall analysis as basis for decisions, recognizing that one should not promise more than can be delivered.

Norges Bank's mission is to promote economic stability and to manage Norway's GPFG. A feature common to these mandated responsibilities is the identification and management of risk. Further efforts to make adequate data available to underpin responsible investment, and assessment of and integration of climate-related risks with other risk factors, form a crucial basis for proper market pricing of assets.

Financial stability perspective
Climate risk is of significance for financial stability. This risk is related both to the physical impact of climate change and the implications of the transition to lower greenhouse gas emissions. Climate change is a global challenge that must primarily be addressed by the political authorities, using instruments other than those available to central banks. The financial system must at the same time adapt to climate risk. Climate risk may expose the financial system to credit losses, and uncertainty about climate risk exposure may result in funding problems.

Central banks and supervisory authorities can, within their mandates, promote financial stability by helping to pave the way for the financial sector to include climate risks in overall risk assessments and communicate relevant information and by ensuring that financial institutions have adequate capital to support all risks. For Norwegian banks and financial markets, transition risks, particularly related to the oil and gas industry, may be important in the years ahead.

Investment management perspective
The Climate Risk Commission's report (NOU 2018:17) highlighted the central role played by the financial sector in a market economy. The transition to a low-emission economy requires large-scale investments, and a substantial share of these investments will be channelled through financial markets. If financial market participants have a good understanding of the risk associated with climate change, investors and the financial industry could contribute to the transition through good corporate governance, credit provision and the development of new products and instruments.

Norges Bank would emphasise that, in general, the transition to a greener and more sustainable economy will make substantial demands on businesses and investors, but will also provide opportunities. Technological advances and innovations are a necessary part of the process towards more sustainable economies. At the same time, climate change exposes businesses to a new type of risk. As the ways in which firms prepare for possible future restructuring will affect expected return and risk, many investors impose requirements on firms' reporting on climate-related issues. Financial investors must manage climate risk on a par with other types of risk.

Norges Bank agrees on the importance of good corporate governance. The main focus of the Bank's active ownership activities in relation to the GPFG's investee companies is profitability. Given this overriding perspective, active ownership is an instrument in the Bank's efforts to ensure that the companies in the investment portfolio are well prepared for the transition to a low-carbon society. Norges Bank, in its management of the GPFG, expects investee companies to assess how exposed their long-term business strategy and profitability are under future climate risk scenarios.

Responses to selected technical expert questions of relevance to Norges Bank

Question 6: *What do you see as the three main challenges and three main opportunities for mainstreaming sustainability in the financial sector over the coming 10 years?*
□ *[BOX, 2000 characters].*

Response:

Challenges:
- Investors may assume that investments with lower climate risk will generate higher returns. A green security does not, however, necessarily feature lower risk. Some green securities are linked to new technology, which historically have entailed high risk.
- For the green securities market to function well over time, formal and standardised requirements that can be evaluated should be introduced. The absence of such requirements can create uncertainty about whether green financing is actually used for climate-friendly projects.
- There may currently be limited volume of sustainable projects available. This may lead to high prices on those projects, and introduce particular price risk on sustainable investments.

Opportunities:
- Sustainable investments may support diversification of risk.
- Green securitisations may be a significant opportunity for the financial industry if adequate requirements are implemented.
- Investors, corporations and authorities are all seeking to achieve climate goals, which may support sustainable investments. The pandemic may further increase the focus on locally made and environmentally friendly projects.

Question 7: *Overall, can you identify specific* ***obstacles*** *in current EU policies and regulations that hinder the development of sustainable finance and the* ***integration and management of climate, environmental and social risks in financial decision-making****?*
- *Please provide a maximum of three examples [BOX max. 2000 characters].*

Response:

An important obstacle that hinders the integration of environmental and social risks in financial decision-making is the current state of corporate sustainability reporting, which does not fully meet the needs of investors. Companies' disclosures are often incomplete and/or not comparable. The format, the disclosed information and the methodologies used for both qualitative and quantitative data vary substantially. Investors need better information on risk exposure (to determine whether a company is exposed to a specific sustainability issue), on risk management (to understand how companies manage relevant sustainability risks and opportunities) and on performance (through relevant, comparable and reliable key performance indicators, using recognised calculation methodologies). Improved coverage and standardised underlying data would in turn lead to a more consistent basis for the ESG data providers' models and offerings (as discussed under question 18). The planned revision of the Non-Financial Reporting Directive represents an opportunity to address this obstacle.

[For more information, please see Norges Bank Investment Management, Asset Manager Perspective, Corporate Sustainability Reporting, 01.2020 https://www.nbim.no/contentassets/f49fab899158490ab3fd095e5d859ad8/assetmanagerperspective_1-20_corporatesustainabilityreporting.pdf]

Question 18: *How would you rate the comparability, quality and reliability of* ***ESG data*** *from sustainability providers currently available in the market?*

- *Please express your view by using a scale of 1 (very poor) to 5 (very good). If necessary, please explain the reasons for your answer. [BOX, 2000 characters]*

Response: 2.

The quantity and quality of ESG data available from sustainability data providers has increased in recent years, both amongst the larger, more established data providers and smaller, more specialized data providers.

There are, however, still challenges with the breadth of data coverage required for a large, international portfolio. Another issue is the lack of comparability between data providers. This, combined with ESG ratings models that are often not fully transparent, means ESG data users have few opportunities to verify that the data they are receiving correctly reflects the situation at the portfolio company; they are reliant on their data providers for this. Furthermore, given the many different methodologies used by various ESG data providers, switching from one data provider to another could cause a re-rating of companies in portfolios constructed based on a previous rating. Increased transparency of methodologies and increased comparability between ESG datasets would make it easier for users of data to verify its validity and to switch between data providers.

An underlying issue which should be highlighted is the current state of corporate sustainability reporting (please see response to question 7). The data published by companies is often incomplete and/or not comparable. Significant gaps in disclosures include a lack of information to assess companies' exposures to sustainability risks (such as information on supply chain, operations, assets or customers), incomplete disclosures on companies' management and performance, in particular on social issues (e.g. human rights and corruption), and insufficient forward-looking information. These gaps are then reflected in the quality of ESG data from sustainability providers.

Question 19: *How would you rate the quality and relevance of* ***ESG research*** *material currently available in the market?*

- *Please express your view by using a scale of 1 (very poor) to 5 (very good). If necessary, please explain the reasons for your answer. [BOX, 2000 characters]*

Response: 4.

There is much high quality, relevant ESG research now available in the market, produced by investment banks, specialist data providers and initiatives, and some non-governmental organisations.

Question 20: *How would you assess the quality and relevance of* ***ESG ratings*** *for your investment decisions, both ratings of individual ESG factors and aggregated ones?*

- *Individual: Please express your view by using a scale of 1 (very poor quality and relevance) to 5 (very good).*
- *Aggregated: Please express your view by using a scale of 1 (very poor quality and relevance) to 5 (very good).*
- *If necessary, please explain the reasons for your answer. [BOX, 2000 characters]*

Response:

- Individual: 3
- Aggregated: 2

The individual ESG factors are generally more straightforward, granular and less prone to subjective assessments of importance than the aggregated ESG ratings are. Much of the divergence in ratings between the different ESG data providers may be due to how they weight individual ESG factors in the aggregated rating, as well as to modelling choices. Given the lack of comparability between different ESG data providers and the difficulty in verifying the validity and materiality of ESG data points (as discussed in our response to question 18), we are hesitant to base investment decisions on such ratings. By looking at the individual factors directly, the investor can determine how relevant this specific data point is for a given company. This approach enables the investor to assess the information, based on its own knowledge and mandate.

Ratings of individual and aggregated ESG factors can provide interesting information and help identify companies for further analysis. ESG ratings, for example, can provide relevant signals and be integrated by the investor in its own analysis and research.

Question 22: *The TEG has recommended that verifiers of EU Green Bonds (green bonds using the EU GBS) should be subject to an accreditation or authorisation and supervision regime. Do you agree that verifiers of EU Green Bonds should be subject to some form of accreditation or authorisation and supervision ?*

☐ *Yes, at European level*
☐x Yes, at a national level
☐ *No*
☐ *Do not know*
☐ *If necessary, please explain the reasons for your answer [BOX 2000 characters]*

Response:

Verifiers should be subject to some form of supervision/authorisation by national authorities. There should be common regulations for authorization of verifiers in EU/EEA.

Question 38: *In your view, which recommendation(s) made in the ESAs' reports have the highest potential to effectively tackle short-termism? Please select among the following options.*
□ Adopt more explicit legal provisions on sustainability for credit institutions, in particular related to governance and risk management;
□ Define clear objectives on portfolio turn-over ratios and holdings periods for institutional investors;
□x Require Member States to have an independent monitoring framework to ensure the quality of information disclosed in remuneration reports published by listed companies and funds (UCITS management companies and AIFMs);
□ Other, please specify. [box max. 2000 characters]

Question 40: *In your view, should there be a mandatory share of variable* ***remuneration*** *linked to non-financial performance for corporates and financial institutions?*

- *Yes/No/***Do not know.** *If yes, please indicate what share. [box 2000 characters]*

Response:

Concerning the remuneration of companies' Chief Executive Officers (CEOs):

Introducing a mandatory share of variable remuneration linked to non-financial performance is likely to add to the complexity and opacity that can be sometimes observed in current remuneration practices.

Indeed, the common practice of long-term incentive plans, with a series of performance conditions over many years, may result in unbalanced outcomes. Our observation is that these plans tend to have complex and opaque metrics that are open to discretion, and boards often adjust, supplement and rebalance metrics during the measurement period. This may also be the case with non-financial metrics, if the chosen criteria are not challenging, measurable and comparable.

Performance conditions may be more appropriate in the CEO's short-term variable remuneration, reflecting strategic, operational and financial achievements in the previous year. As part of these conditions, the board may decide to include non-financial performance conditions – depending on the company's business model and exposure to sustainability risks.

Concerning the remuneration of other executives and employees, incentives should generally support the strategy and current objectives of the company. It is good practice for the company to regularly consider whether their remuneration and incentive systems promote sustainable business practices and support the long-term profitability of the business.

[For more information on Norges Bank Investment Management's views on CEO remuneration, please see our Asset Manager Perspective, CEO remuneration, 04.2017 https://www.nbim.no/en/publications/asset-manager-perspectives/2017/ceo-remuneration and position paper https://www.nbim.no/en/the-fund/responsible-investment/our-voting-records/position-papers/ceo-remuneration/]

Question 46: *Due regard for a range of* ***'stakeholder interests'****, such as the interests of employees, customers, etc., has long been a social expectation vis-a-vis companies. In recent years, the number of such interests have expanded to include issues such as human rights violations, environmental pollution and climate change. Do you think companies and their directors should take account of these interests in corporate decisions alongside financial interests of shareholders, beyond what is currently required by EU law?*

- *Yes, a more holistic approach should favour the maximisation of social, environmental, as well as economic/financial performance.*
- **Yes, as these issues are relevant to the financial performance of the company in the long term.**
- *No, companies and their directors should not take account of these sorts of interests.*
- *I do not know.*

(no text box)

Question 56: *Do you see the need for a dedicated regulatory and prudential framework for 'green securitisation'?*

☐ *Yes/***No***/Do not know.*

☐ *If yes, what regulatory and/or prudential measures should the dedicated framework contain and how would they interact with the existing general rules for all securitisations and specific rule for STS securitisations? [box max. 2000 characters]*

Response:

We do not see the need for a specific framework for green securitisation. The underlying challenge is to set criteria for defining assets as green (or on a scale of degrees of green), regardless of securitisation. The securitisation process itself should be subject to the same rules as any other securitisation.

Question 58: *Do you consider that public authorities, including the EU and Member States should support the development of digital finance solutions that can help consumers and retail investors to better channel their money to finance the transition?*

☐ *Yes/***No***/Do not know.*

☐ *If yes, please explain what actions would be relevant from your perspective and which public authority would be best-positioned to deliver it. Please list a maximum of three actions [BOX max. 2000 characters]*

Response:

Development of digital finance solutions is necessary for a variety of reasons, and not particularly to stimulate green finance. Government support or interventions must be based upon identified market failures.

Question 60: *The existing project pipeline (availability of bankable and investable sustainable projects) is generally considered to be insufficient to meet current investor demand for sustainable projects. Profitability of existing business models plays a role, with some projects (e.g. renewable energy), being more bankable than others (e.g. residential* *energy efficiency). Identifying the key regulatory and market obstacles that exist at European and national level will be key in order to fix the pipeline problem.*

What do you consider to be the ***key market and key regulatory obstacles*** *that prevent an increase in the pipeline of* ***sustainability projects****? Please list a maximum of three for each. (box max. 2000 characters).*

Response:

Concerning renewable energy, some market obstacles include:

1. Lack of (commercial and industrial) power purchase agreement (PPA) market in Europe. A well-functioning PPA market would help secure long-term volume and price certainty for renewable power project developers.
2. Lack of renewable gas purchase agreement (RGPA) market in Europe.
3. Low carbon price. The carbon price level must be high enough to incentivise switch from natural gas and oil products to green hydrogen in gas turbine, industry, heat and mobility/transportation (heavy duty), and from gasoline and diesel to electricity for light duty vehicles. In addition, the carbon price must be applied to all sectors.

Regulatory obstacles may be:

1. Charges and fees. For example, energy storage technologies in the form of batteries and power to gas (green hydrogen production) are sometimes subject to distribution grid charges or taxes, fees and levies that may hinder investment in such technologies.
2. Innovation and integration. Allowing all types of energy utility companies to build, own, operate and sell energy storage technologies (e.g. batteries and electrolysers) would help integrate these across the whole value chain of the energy system in the most efficient way. Ownership restrictions may hinder innovation and adoption of storage technologies, as well as increase the cost of the system.
3. Lack of renewable gas and fuel standards. Such standards could be introduced in mobility/transportation, industry, heat and energy storage, in the same way as renewable targets and standards for power. For example:
    a. A renewable gas standard could require gradual increase of green hydrogen gas blending in the energy system.
    b. Refuelling stations could gradually offer green hydrogen for fuel cell Electric Vehicles (EVs) and charging for battery EVs.
    c. Certificates of origin could be introduced for renewable gases.

Question 76: *Do you think the current level of global coordination between public actors for sustainable finance is sufficient to promote sustainable finance globally as well as to ensure coherent frameworks and action to deliver on the Paris Agreement and/or the UN Sustainable Development Goals (SDGs)?*

- *Please express your view by using a scale of 1 (highly insufficient) to 5 (fully sufficient).* **3**
- *For scores of 1-2, what are the main missing factors at international level to further promote sustainable finance globally and to ensure coherent frameworks and actions? [BOX max. 2000 characters]*

Response:

Norges Bank takes note of the fact that both national public authorities as well as several international institutions and networks in recent years have stepped up their work on climate-related risks to promote sustainable finance. These authorities and institutions, including central banks, undertake such efforts based on their respective mandates and time horizons.

In March 2020, Norway joined the International Platform on Sustainable Finance (IPSF)[1]. Norges Bank joined the Central Banks and Financial Supervisors Network for Greening the Financial system (NGFS) in December 2018. Norges Bank finds the work undertaken on climate-related risk by well-established international institutions (e.g. IMF, World Bank, BIS and the Basel Process) and the recently established networks (the financial-focused NGFS and the fiscal-focused Coalition of Finance Ministers) to be important in enhancing the knowledge and its dissemination in this field.

Climate risk and promoting sustainable finance is a cross-cutting and cross-border issue which requires international cooperation. The degree of cooperation between the various public actors appears to be fairly developed (3 of scale 1-5). There is room for improvement in coordination, to safeguard a resilient approach and as there is a risk of undue overlapping work going on, due to the number of institutions and networks involved. In this context, the IPSF is a useful addition to foster coordination. Moreover, recognizing that substantive work would need to be undertaken in the respective specialized fora, further direct and appropriate cooperation between relevant institutions, based on their respective mandates, is crucial.

Question 84: *Climate change will impact financial stability through two main channels: physical risks, related to damages from climate-related events, and transition risks, related to the effect of mitigation strategies, especially if these are adopted late and abruptly. In addition, second-order effects (for instance the impact of climate change on real estate prices) can further weaken the whole financial system. What are in your view the most important channels through which climate change will affect your industry? Please provide links to quantitative analysis when available.*
□□*Physical risks, please specify if necessary [BOX max. 2000 characters]*
□□*Transition risks, please specify if necessary [BOX max. 2000 characters]*
□□*Second-order effects, please specify if necessary [BOX max. 2000 characters]*
□□*Other, please specify [BOX max. 2000 characters]*

Response

In the short and medium term the most important channel for Norway is transition risk, especially related to the petroleum industry, see https://www.norges-bank.no/en/news-events/news-publications/Papers/Staff-Memo/2018/staff-memo-62018/ . There might also

[1] "The Norwegian government supports the objective of scaling up the mobilization of private capital towards environmentally sustainable investments. International harmonization of initiatives and the identification of best practices will deepen the impact of sustainable finance initiatives globally", says Minister of Finance Jan Tore Sanner.

be second-order effects for other industries due to reduced demand from petroleum related industries.

For the insurance industry, the most important effects are associated with physical risks. The negative effects for private insurance companies are partially dampened by the The Norwegian Natural Perils Pool, a compulsory insurance scheme to cover damage caused by natural perils established in 1980.

Question 86: *Following the financial crisis, the EU has developed several macroprudential instruments, in particular for the banking sector (CRR/CRDIV), which aim to address systemic risk in the financial system. Do you consider the current macroprudential policy toolbox for the EU financial sector sufficient to identify and address potential systemic financial stability risks related to climate change?*
□ *Please express your view by using a scale of 1 (highly inadequate) to 5 (fully sufficient).*
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□ *For scores of 1-2, what solution would you propose? Please list a maximum of three. [BOX max 2000 characters]*

Response:

In general, financial stability risks related to climate risks should be addressed alongside other risks within the same general framework. There is no need for a specific toolbox for climate-related financial stability risks alongside the current macroprudential policy toolbox.

Question 99: *In your opinion, should the European Commission take action to enhance the availability, usability and comparability of climate-related loss and physical risk data across the EU?*
□□*Yes/No/Do not know.* **No and yes**
□□*If yes, please select all that apply:*
- Loss data, please explain why [BOX max. 2000 characters]
- Physical risk data, please explain why [BOX max. 2000 characters]

Response:

We do not think the European Commission need to enhance the availability of loss data. This should be covered by accounting rules and supervision. However, we do believe it would be useful for the European Commission to enhance the comparability of physical risk data across the EU/EEA. By introducing common standards, data can be easier to interpret.