Egil Matsen: US Senate Democrats' Special Committee on the climate crisis

Opening remarks by Mr Egil Matsen, Deputy Governor of Norges Bank (Central Bank of Norway), at the meeting, Washington DC, 17 October 2019.

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Chairman Schatz, I thank you for inviting Norges Bank, together with other NGFS-member central banks, to the U.S. Senate Democrats' Special Committee on the Climate Crisis. I appreciate the opportunity to discuss climate-related economic and financial risks and relevant central bank strategies to address those risks.

Norges Bank's mission is to promote economic stability by conducting monetary policy and monitoring the financial system. Our central bank also has the responsibility for managing Norway's SWF, the Government Pension Fund Global (GPFG), in accordance with a mandate issued by the Ministry of Finance. A feature common to both of these mandated responsibilities is the identification and management of risk. In addressing these risks, we should always work within our mandates. For central banks that means taking a comprehensive view of factors impacting the economy and the risks we face, while upholding market neutrality and preserving our independence.

Climate risk, the economy and financial stability

The scientific basis for climate change is widely accepted. The physical impacts of climate change and measures to mitigate its impact, will affect all parts of the economy and have consequences for the financial system. Consequently, climate risk is a relevant consideration for central banks. There is a large degree of uncertainty among market participants about the magnitude and the timing of climate change, and about likely policy responses. This type of uncertainty may be a source of market failure.

Climate risk is a complex topic covering a broad field of issues being to a large degree outside the remit of central banks. Climate change is a global challenge. The prime responsibility and the most effective tools to mitigate climate risk lie with governments and with fiscal policy. It is important to use the market mechanism by pricing emissions to reflect the true costs of greenhouse gas emissions. However, the financial system must adapt to climate risk. Central banks and financial supervisory authorities can, within their mandates, promote financial stability by ensuring that financial institutions appropriately includes climate risk in their risk management. Climate risk is not fundamentally different from other risks facing the financial sector. Other types of risks may also be systemic and characterized by historical data having uncertain relevance for future risks. Both financial institutions and authorities must consider how a changing climate will affect financial risks. This must be integrated in the risk assessment and hence in the overall assessment of the capitalization and funding of financial institutions

Uncertainty with respect to the magnitude and impact of climate change can lead to simplified assessments of its risks. Authorities, including central banks, may contribute to a knowledge-based debate and reduce uncertainty by strengthening and refining reporting requirements. A common basis of information and analysis may facilitate assessment and comparison of climate risk in individual institutions, and lead to a more correct pricing of risk. International cooperation could be fruitful in this work, including in the NGFS context.

Responsible investment at Norges Bank

In its role as the GPFG's owner, the Norwegian Ministry of Finance specifies the investment universe, benchmark index, risk limits, and requirements. Norges Bank shall make investment decisions and exercise ownership rights independently of the Ministry. Within this framework, Norges Bank works on climate risk across the GPFG's three asset classes – listed equities, listed bonds, and unlisted real estate – within a general framework of objectives. By end-June 2019, the total market value of the fund was close to USD 1.1 trillion, corresponding to more than three times mainland GDP of Norway. The United States is by far the greatest receiver of funds, amounting to 41 percent of the total. To spread risks and capture global growth, the assets were invested in over 9,000 companies in more than 70 countries. We benefit from free and open markets that enable an efficient global allocation of resources.

The objective is to achieve the highest possible return with acceptable risk. Responsible investment supports this in two ways. First, it seeks to improve the long-term economic performance of the investments. Second, it seeks to reduce the financial risks associated with Environmental, Social and Governance (ESG) practices of companies in the portfolio. As such, the focus is on material ESG issues that impact the fund's long-term performance. These issues are captured in three responsible investment pillars.

First, establishing principles: A set of international principles and standards from the UN and the OECD provides a framework for the Bank's work with companies and other stakeholders. Priorities are based on the mandate and are characterised by formulating expectations of companies, guidelines for voting, and positions on governance issues. Documents communicate the Bank's priorities and ensure predictability.

Second, active ownership: Voting at annual general meetings is the most important tool for active ownership. Through its voting, the Bank seeks to strengthen governance, improve financial performance and promote responsible investment practices. The voting guidelines provide a principled basis for voting decisions, but also take account of company-specific factors. In the Bank's dialogue with the largest companies, governance and sustainability topics relevant to long-term return are raised. This includes risks and opportunities associated with climate change, and the Bank expects companies to integrate material climate risks into their strategies, risk management and reporting.

Third, investing sustainably: The Ministry of Finance has given us dedicated environment-related mandates. Going forward, these mandates will include investments in unlisted infrastructure for renewable energy. Next, in certain cases we divest from companies that impose substantial costs on other agents, with the aim of reducing the fund's exposure to unacceptable risks. Finally, our political authorities provide guidelines that specifies that certain investments should be excluded from the fund due to ethical concerns. These exclusions include companies responsible for large-scale environmental damages, and companies whose business models relies heavily on thermal coal. .

Specific central bank challenges in policy portfolio management

Aside from the GPFG, Norges Bank, as other central banks, also manages policy portfolios. The Bank's foreign exchange reserves amounted to USD 64 billion at end-June 2019, divided into a 80% fixed-income portfolio and a 20% equity portfolio. The equity portion is invested in around 1,500 companies worldwide, with a focus on the larger markets and currencies, and managed according to similar principles governing responsible investment in the GPFG.

The investment of the major part of the FX reserves is to a high degree determined by our central banking policy objectives. Consequently, we face specific challenges in any extension of responsible investment practices. First, this relates to respecting our legal policy mandate in the investment of our FX portfolio. Second, our investments must take due account of liquidity needs for monetary and financial stability purposes, as well as international financial commitments to the IMF. Third, we need to be vigilant to safeguarding independence and preventing conflicts of interest. And finally, while we are a transparent central bank, we need to strike a considered balance between transparency and remaining needs of confidentiality, to avoid undermining our primary policy objective.

International cooperation

To conclude, like in other policy areas, there is a crucial role to play for international cooperation also in the field of climate risk. Norges Bank became a member of the NGFS in December 2018. The primary objective of this network is to create an arena for central banks and financial supervisors to exchange experiences and share best practices in developing environment and climate risk management in the financial sector. We consider this network to be an important meeting place to arrive at a well-considered understanding of the role and activities of central banks in this field.