NORWEGIAN MINISTRY OF FINANCE

Report No. 20 (2008–2009) to the Storting

On the Management of the Government Pension Fund in 2008

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On the Management of the Government Pension Fund in 2008

Report No. 20 (2008–2009) to the Storting

Recommendation of 3 April 2009 from the Ministry of Finance,
approved by the Council of State on the same date.
(The Second Stoltenberg Government)

Part I
Main aspects of the management of the Government Pension Fund

1 Main aspects of the management of the Government Pension Fund

1.1 Background and purpose of the fund

The Government will pursue a policy based on sound, long-term management of Norway's petroleum wealth. Such management reflects a fundamental social perspective and is an overarching priority for the Government. Our job is to ensure that this wealth can benefit all generations, whilst at the same time making an important contribution to stability in output and employment.

The Government Pension Fund comprises the Government Pension Fund – Global and the Government Pension Fund – Norway. It was established with effect from 1 January 2006 as a superstructure encompassing two former funds: the Government Petroleum Fund and the National Insurance Scheme Fund (Folketrygdfondet). The purpose of the Government Pension Fund is to support government savings to finance the pension expenditure of the National Insurance Scheme and long-term considerations in the spending of government petroleum revenues.

The savings of the Government Pension Fund take the form of general fund accumulation. The Fund is integrated with the Fiscal Budget, so that growth in the Fund reflects an actual accumulation of financial assets for the State. Consequently, there is no requirement that the assets of the Pension Fund shall at all times represent a certain share of the pension liabilities of the State under the National Insurance Scheme.

Under the Act of 21 December 2005 no. 123 relating to the Government Pension Fund (the Pension Fund Act), the Ministry of Finance has been charged with managing the Fund. The Ministry determines the general investment strategy for the fund and the ethical guidelines, and also follows up its operational management. The task of carrying out the operational management of the two parts of the Government Pension Fund has been delegated to Norges Bank and Folketrygdfondet respectively. The Government Pension Fund does not have its own Executive Board or administrative staff.

The Government's ambition is for the Government Pension Fund to be the best managed fund in the world, entailing that best international practice must be sought for in all aspects of the management. The goal for the management of the Government Pension Fund is to achieve maximum financial return with moderate risk. In this way, we can help ensure that future generations will be able to draw the maximum possible benefit from our savings.

By virtue of our long-term investments in a large number of the world's companies, we have a responsibility for and an interest in promoting good corporate governance and safeguarding environmental and social concerns. The Government will therefore give priority to being a responsible investor in its management of the fund.

In Report no. 24 (2006–2007) to the Storting, the Government announced it would be making an evaluation of the ethical guidelines for the Government Pension Fund – Global. The objective of this evaluation is to ensure that the ethical guidelines are functioning as intended, as well as to maintain broad support for the guidelines and collect input that can help strengthen the ethical profile of the Fund. This process was initiated in January 2008, and the results of the evaluation are presented in a separate chapter in this Report.

This Report consists of two parts: Part I provides an overall description of the main aspects of the management of the Government Pension Fund, with a focus on giving the presentation a non-technical form as far as is possible. Part II contains a more detailed analysis of themes discussed in Part I. The Ministry has also prepared documentation memoranda of a more technical nature, which will be published on the Ministry of Finance's website (www.government.no/gpf).

Part I is organised as follows: Section 1.2 discusses the investment strategy for the Fund, including proposals for further development of the strategy for the Government Pension Fund – Global and a new review of whether – and if so, to what extent – active management is to be contin-

ued. Section 1.3 discusses responsible investments and provides a more detailed description of the ownership effort in Norges Bank and Folketrygdfondet and the results of the evaluation of the ethical guidelines for the Government Pension Fund – Global. Section 1.4 provides an overview of the management performance of the Government Pension Fund, with a special focus on performance developments during 2008, while Section 1.5 presents the work on developing the management framework.

In Part II, Chapter 2 contains a more detailed account of the Ministry's efforts relating to the investment strategy for the Government Pension Fund. Chapter 3 contains a report on the work done on the ethical guidelines for the Government Pension Fund in 2008, and Chapter 4 discusses the evaluation of the ethical guidelines for the Government Pension Fund – Global. Chapter 5 provides detailed analyses of the return and risk associated with the Government Pension Fund. Chapter 6 describes the framework and follow-up regime for the management of the Fund.

The Act relating to the Government Pension Fund, the regulations relating to the management of the Fund, with supplementary provisions, and the respective management agreements are appended to this Report. The annual reports of Norges Bank and Folketrygdfondet are appended by reference (see www.norges-bank.no and www.ftf.no). The Council on Ethics' annual reports are available on www.etikkradet.no. The recommendations and assessments of Norges Bank and the Strategy Council regarding the proposed changes to the investment strategy for the Government Pension Fund – Global, and the consultative statements submitted in connection with the evaluation of the ethical guidelines for the Government Pension Fund – Global are available on the Ministry of Finance's website (www.government.no/gpf).

1.2 The investment strategy for the Government Pension Fund

1.2.1 About the investment strategy

What constitutes a good investment strategy for the Government Pension Fund is determined by the characteristics of the Fund, the purpose of the investments, the owner's (the people of Norway, represented by the political authorities) tolerance of risk, and assumptions about how the financial markets work. See Chapter 2 for a more detailed discussion.

The purpose and characteristics of the Fund

The Government Pension Fund is an instrument for general savings on the part of the State and, unlike traditional pension funds, is not ear-marked for specific liabilities. In view of the prospects of continued high petroleum revenues in the years to come and a responsible fiscal policy, the Fund is set to grow and have a very long investment horizon. The Fund is not subject to short-term liquidity requirements. Against this background, the Government Pension Fund will therefore, generally speaking, have a higher risk-bearing capacity than other funds that it is reasonable to compare it with.

There is broad political support for the Fund to be managed with a view to achieving the maximum possible return, at a moderate level of risk, so as to enable future generations to derive the maximum possible benefit from the wealth as well. The Government Pension Fund shall therefore have broad diversification of risk and a clear financial objective. There is also broad support for the ethical framework for responsible management of the Fund. Broad political support for the investment strategy for the Fund provides a democratic underpinning and represents an important contribution to maintaining the investment strategy over time, including in periods of major market fluctuations.

The investment strategy for the Government Pension Fund is developed with a view to maximising the overall return on the assets of the Fund, given the owners' risk tolerance, the size and characteristics of the Fund, sound investment practice and fundamental governance principles (see Chapter 2).

The Fund as a responsible investor

The goal of good financial returns is closely linked to the wish to be a responsible investor. This responsibility entails ensuring that the Fund is managed in a way that promotes better functioning, legitimate and efficient markets and sustainable development in the broadest sense. A broadly diversified investor – often referred to as a universal owner – will benefit from making sure that good corporate governance and environmental and social issues are safeguarded. It follows from the task of manager of the public's funds that widely shared ethical values must be taken into account. In some cases, the concerns of ensuring long-term financial returns and taking widely sha-

red values into account will coincide, but not always. For example, the Fund will not invest in companies that are in gross breach of fundamental ethical norms, regardless of the effect this will have on returns.

The goal is for the Government Pension Fund – Global to be managed responsibly in a manner that takes good corporate governance and environmental and social issues into account. The Government requires that responsible management of the Fund is arranged in such a way that support is ensured among the population of Norway and legitimacy among market participants. One goal in the role as a responsible investor is to promote sustainable development in economic, environmental and social terms, and this is regarded as a precondition for good financial returns over time. The Government wants the Government Pension Fund – Global to promote good corporate governance in companies the Fund has an ownership stake in and to encourage the companies to respect fundamental ethical standards. The Government will continue to refrain from investing in companies that are in serious or systematic breach of fundamental ethical norms.

To meet these goals, the Ministry wants to integrate the goals of good corporate governance and consideration of environmental and social aspects into all parts of the management. This is in keeping with the United Nations' Principles for Responsible Investments (PRI) that the Ministry of Finance as formal owner of the Fund has now adopted. Norges Bank, as operational manager, has been involved in the development of these principles and has supported them since they were launched in spring 2006.

However, the Fund is not suitable for safeguarding all the ethical commitments we have as a nation. The State has other political, regulatory and financial instruments at its disposal that in many cases will be better suited to ensuring fulfilment of these kinds of obligations than laying down constraints on the management of the Fund. We have the greatest chance of success, in the sense of exerting a positive influence, if the focus and instruments target the role the Fund has as a financial investor. This also means that the Fund shall not be used as a development aid or foreign policy instrument.

The benchmark portfolios

The investment strategy for the Government Pension Fund is expressed through the composition of the Fund's strategic benchmark portfolio. The current benchmark portfolio consists primarily of listed equities and investment grade bonds. Equity investments represent ownership interests in

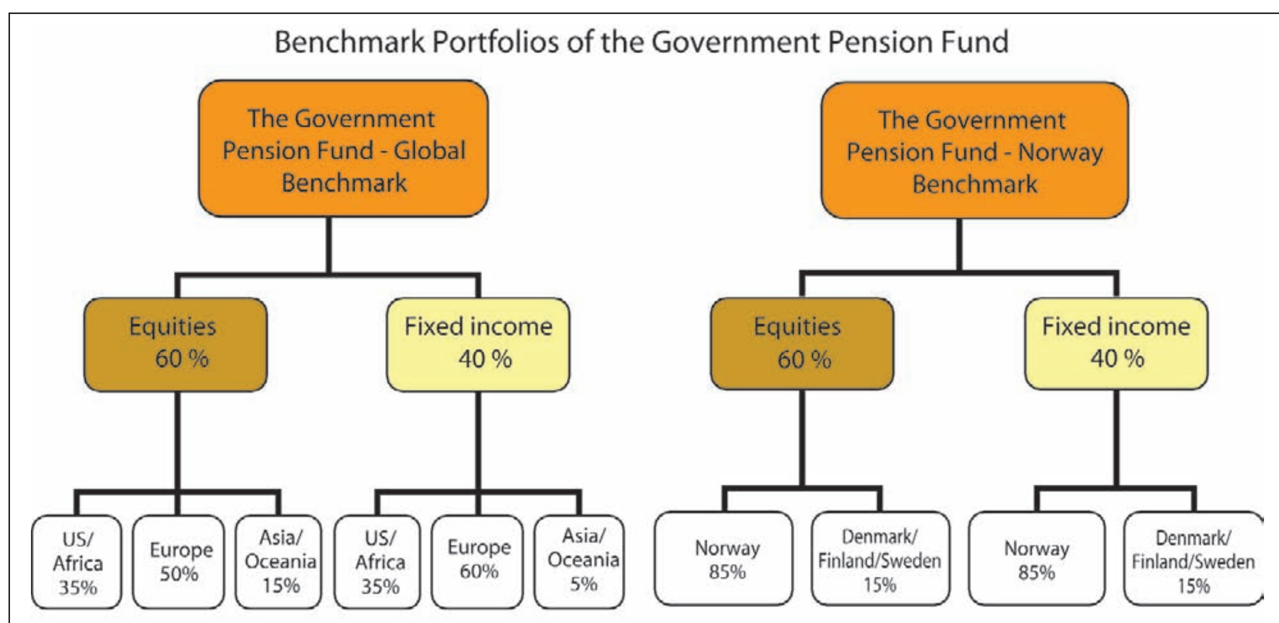

Figure 1.1 Strategic benchmark portfolio for the Government Pension Fund[1]

[1] The Ministry of Finance has determined a benchmark portfolio for the Government Pension Fund – Global and the Government Pension Fund – Norway. It has been decided to raise the equity portion of the Government Pension Fund – Global to 60 per cent, and it is currently being increased to that level. It has also been decided to invest up to 5 pct. of the Fund's capital in real estate, which will result in a corresponding reduction in the fixed income portion.

Source: Ministry of Finance

the production of goods and services, and the value of such investments will therefore reflect expectations as to the future profits of businesses. Bond investments are investments in transferable loans that shall be redeemed by the issuer on a certain date together with a predetermined interest rate.

The Ministry of Finance has formulated a long-term investment strategy based on the assumption that the portions to be invested in various asset classes and geographical regions can be determined on the basis of assessments of expected long-term returns and risks. Importance has been attached to the premise that contributions to the diversification of the risk associated with the investments improve the risk-adjusted return. The Ministry of Finance has therefore chosen a broad representation of the world's stock and bond markets in the benchmark portfolio it has set for the Government Pension Fund – Global (see Figure 1.1). The indices making up the benchmark portfolio for the Fund include a representative selection of securities, and developments in these largely reflect market developments in the relevant countries.

The benchmark index for equities in the Government Pension Fund – Global comprises almost 7,700 companies across 46 countries, whilst the benchmark index for bonds comprises more than 10,000 individual securities across approx. 1,600 issuers in the currencies of 21 countries. By way of comparison, the benchmark index for equities in the Government Pension Fund – Norway comprises 196 companies in 4 countries, whilst the benchmark index for bonds comprises 270 individual securities across 62 issuers in the currencies of 6 countries.

Assumptions about the way the markets work and active management

In Report no. 16 (2007–2008) to the Storting, the Ministry described its fundamental assumptions about the way the markets work that underpin the Fund's investment strategy. For example, the Ministry assumes that financial markets are largely "efficient", both at any given point in time and over time. This means that market prices generally reflect relevant information about the securities. Furthermore, consistent with generally accepted theory and practice, it is assumed that it is normal to expect a higher average return over time on equities than on investments in fixed income instruments, because the risk associated with equities is higher. However, the magnitude of this excess return remains uncertain. Because the returns in different markets and segments do not move in line with each other, the Ministry also assumes that it may be possible to achieve a better trade-off between return and risk by spreading investments across several markets and market segments. This is the background against which the benchmark portfolio for the Government Pension Fund is spread across a broad range of geographical regions, countries, sectors and companies.

It follows from the guidelines laid down by the Ministry of Finance for management of the Government Pension Fund that Norges Bank and Folketrygdfondet may also invest in other securities and instruments than those included in the respective benchmark portfolios. At the same time, an upper limit has been established for permitted deviation from the benchmark portfolio in active management. It is the responsibility of Norges Bank and Folketrygdfondet to assess how the risk allowance can best be used to generate excess returns. By making investments in securities and instruments that fall outside the scope of the benchmark portfolio, and by investing other portions of the Fund in certain securities than are implied by the benchmark portfolio, Norges Bank and Folketrygdfondet are drawing on their permitted tracking error for the purpose of achieving an excess return.

With financial markets that are generally efficient, it is difficult for active managers to achieve a return in excess of the market return. In keeping with this, the framework for the management of the Fund has been designed such that developments in the return on the Fund over time largely follow developments in the benchmark portfolio that the Ministry of Finance has defined.

However, deviation from the benchmark portfolio will seldom be zero, partly because pure index management is not a relevant option. This must be seen in connection with the following factors, among others:

- The composition of the benchmark portfolio is constantly changing. It is not rational for the manager to set up an actual portfolio that is at all times identical to the benchmark portfolio.
- The manager must have the necessary flexibility to be able to strike a balance between the concern for cost efficiency and the need to follow the index closely.
- It will be necessary to deviate from the composition of the benchmark portfolio when it is dif-

ficult to get hold of the individual securities in the index. In this case, the permitted tracking error will have to be used to invest in other securities that provide approximately the same exposure.
- The manager must have the opportunity to exploit any weaknesses in the way the index has been constructed.
- The manager must have the opportunity to invest in individual securities in markets that for various reasons it is not appropriate to include in the benchmark portfolio.

In a letter to the Ministry of Finance dated 14 March 2009, Norges Bank voiced a number of opinions concerning active management. The letter is enclosed as Appendix 2 to this report. In this letter, Norges Bank assumes that the markets the Fund is invested in are largely efficient and that it is therefore challenging to create consistent value added by forming expectations about developments in the prices of various financial assets. The bank points out that strategies to achieve excess returns in general must be founded on exploiting the characteristics of the Fund, such as, for example, its size, low costs and long time horizon. In this context, the bank attaches particular importance to the following:
- Active management provides an opportunity to achieve exposure to systematic risk factors that it can be difficult to represent properly in the benchmark portfolio.
- A long-term investor with a capacity for risk ought to be able to benefit from the fact that risk premiums for the different asset classes vary over time.
- The size of the Fund constitutes an advantage because it permits the Fund to assume relatively large positions in individual situations without any material effect on the risk in the management. As a large investor, the bank will be able to achieve favourable terms in the primary market for equities, while the Fund as a passive investor will only buy shares when they are included in the benchmark index and in a situation where the size of the Fund can affect the price. These constitute opportunities that are not available to the average investor.
- The bank has a considerable advantage through the opportunity it has to implement its investment strategy with significantly lower costs than the average investor.
- As the investment universe and the benchmark portfolio of the Fund are gradually expanded, exposure increases to markets where there is less grounds to believe that the hypothesis of market efficiency holds true.

Norges Bank also believes that if major investors, such as the Government Pension Fund – Global work exclusively on the assumption that other participants ensure efficient price formation, this can undermine the functioning of capital markets. Furthermore, the bank points out that it is important that large institutional owners like Norges Bank are not passive, but protect their rights as a minority shareholder. The bank writes that:

> “Overall, an element of active management is necessary for Norges Bank to have legitimacy when carrying out important parts of the management assignment.”

The Ministry shares the bank’s view that the markets the Fund operates in are largely efficient and that a strategy aimed at achieving excess return must be based on exploiting the characteristics of the Fund. A certain framework for active management is also in keeping with practice in large international funds.

The Ministry also agrees that maintaining the legitimacy of the Fund is important and that this requires that Norges Bank has an organisation with sufficient weight and credibility to safeguard the financial interests of the Fund vis-à-vis individual companies.

The legitimacy of the active management strategies must be based on an explicit, credible strategy for achieving excess returns that exploits the characteristics of the Fund. In its letter, Norges Bank writes that the scope of active management over time will depend on the results that can be achieved.

For investments in new asset classes such as real estate, infrastructure and unlisted equities, performance will depend more on active investment choices, since passive indexing is not an alternative. An organisation with competence in active management in general, for example, competence linked to evaluating external managers, will be an advantage in the further development of the Fund.

In connection with using external consultants with specialist expertise, the Ministry will assess experiences in active management in Norges Bank. See the more detailed discussion in Box 1.3.

1.2.2 Evolvement of the investment strategy for the Government Pension Fund – Global

Introduction

The Government Pension Fund – Global has grown rapidly since the Fund received its first capital allocation in 1996. Over the years, the Fund has grown to become one of the largest funds in the world. The fund capital has significantly outgrown the levels envisaged for the first few years after the initial capital allocations were made.

There has been a gradual evolvement in the investment strategy for the Government Pension Fund – Global. The Fund has invested in equities since 1998. In 2000, emerging markets were included in the benchmark portfolio for equities, whilst in 2002 the benchmark portfolio for bonds was expanded through the inclusion of non-government-guaranteed bonds (i.e. corporate bonds and mortgage-backed bonds). In 2006, the investment universe was further expanded. It was decided, following the Storting's deliberation of Report no. 24 (2006–2007) to the Storting, to include the small-cap segment in the benchmark portfolio for equities and to increase the equity portion of the benchmark portfolio from 40 per cent to 60 per cent. In 2008 it was decided to start work to build up a portfolio of property investments (cf. Report no. 16 (2007–2008) to the Storting). It was also decided to expand the benchmark portfolio by including more emerging stock markets. In addition, the limit on ownership stakes for equity investments in individual companies was raised from 5 per cent to 10 per cent.

The evolvement of the investment strategy for the Government Pension Fund – Global reflects the fact that many important strategic choices have already been made, such as concerning the distribution between equities and fixed income instruments and the scope of the equity and fixed income portfolios. The Ministry's future efforts to evolve the investment strategy will be premised on how to achieve a further improvement in the trade-off between return and risk by further spreading the investments and better utilising the characteristics of the Fund without any significant changes to the overall level of risk. Decisions that involve more comprehensive changes to the investment strategy that are expected to have a material impact on the overall risk associated with the Fund will be submitted to the Storting prior to the implementation of any changes.

The sources of the return on the Government Pension Fund – Global have thus far been focused, in particular, on the fact that through ownership of equities and bonds, it is possible to reap returns by assuming market risk in relatively liquid markets. The benchmark portfolio of the Fund has been gradually expanded.

The goal of the investments in the Government Pension Fund – Global is to achieve maximum financial return with moderate risk. The Government Pension Fund – Global has several special characteristics that distinguish it from a number of other funds (cf. Report no. 16 (2007–2008) to the Storting). The Fund is large in terms of its market value, it has large inflow of capital, the investments are highly diversified over a broad investment universe, and it has a long investment horizon. Nor are there any concrete commitments linked to the asset pool, meaning the short-term liquidity requirement is limited. It is natural for the future work on evolvement of the investment strategy to be focused on determining a strategy that makes best possible use of these characteristics of the Fund.

Natural types of evolvement of the investment strategy may thus be:

- further diversification of risk by, for example, including more countries or asset classes in the benchmark portfolio of the Fund, and
- considering investments that benefit from the Fund's size, long-term perspective, and ability to hold less liquid assets. It is particularly pertinent to consider changes to the strategy that can provide compensation in the form of somewhat higher expected returns in exchange for reduced tradability (liquidity).

This kind of evolvement of the investment strategy for the Government Pension Fund – Global may result in an asset allocation that is more similar to the composition of other international funds.

A basic premise in the work to evolve the strategy is the need for adequate limits on other types of risk than market risk as well, such as operational risk. Another requirement will be the need for follow-up of the operational management that helps ensure that the interests of the managers are aligned with the objective of the general investment strategy for the Fund.

Below is a brief discussion of new assessments linked to emerging bond markets, high yield bonds, the regional and currency distribution, and investments that can promote the goals of

consideration of environmental and social aspects and good corporate governance (known as ESG factors). See Chapter 2 for a more detailed discussion.

High yield bonds and emerging bond markets

It may now be natural in the work to further develop the Fund's investment strategy to look more closely at the composition of the benchmark portfolio for fixed income instruments. This ensues partly from the fact that the Ministry stated in Report no. 16 (2007–2008) to the Storting that it would embark on an evaluation of emerging bond markets at a later stage in light of the fact that these markets were already included in the actual portfolio. Furthermore, there may be grounds to consider whether there are other aspects of the composition of the benchmark portfolio that ought to be reviewed in more detail, including whether it is appropriate to expand the portfolio to also include corporate bonds with high credit risk (i.e. higher than investment grade).

To this end, the Ministry invited Norges Bank and the Strategy Council to shed light on and give advice on the composition of the benchmark portfolio for interest bearing instruments. In a letter dated 3 November 2008, Norges Bank states that it is natural to consider including bond investments in emerging markets and corporate bonds with high credit risk in the benchmark portfolio. After an overall assessment that identified a number of major operational challenges, among other things, Norges Bank recommends not expanding the benchmark portfolio in these areas for the time being.

In a letter dated 20 March 2009 to the Ministry of Finance, the Strategy Council writes that in principle expanding the benchmark portfolio to also include high yield bonds and bonds issued in emerging markets is consistent with the desire to ensure further risk diversification and the desire to reap liquidity premiums.

However, the Council also points out that high yield bonds have some undesirable risk properties in periods of economic downturn in that the return tends to follow the return on equities, and run counter to the yield on government bonds. Including high yield bonds in the benchmark portfolio for fixed income securities might weaken the ability of the fixed income benchmark to protect the fund capital in periods of recession. Against this backdrop, and in light of the reputational risks, the Strategy Council recommends that the fixed income benchmark not be expanded to include high yield bonds at this point in time.

With regard to the issue of whether the benchmark portfolio for interest bearing securities should be expanded to include bonds issued in emerging markets (in local currencies), the Strategy Council refers to the fact that limited data makes it difficult to assess the historical return and risk of these kinds of investments. It is also pointed out that investment in emerging bond markets entails a number of operational challenges. Against this backdrop, the Strategy Council recommends not expanding the fixed income benchmark with bonds issued in emerging markets in local currencies at this juncture. At the same time, the point is made that the matter should be reconsidered when more information is available.

The Ministry has taken note of Norges Bank's and the Strategy Council's recommendations and that for the time being it is not recommended to expand the benchmark portfolio for interest bearing instruments with high yield bonds and bonds issued in emerging markets. The Ministry is therefore working on the assumption that it is not pertinent to implement this type of change in the imminent future. These issues will be reassessed, and the Storting will be informed of the findings at a later date.

The letters from Norges Bank and the Strategy Council have been published on the Ministry of Finance's website (www.government.no/gpf).

The regional and currency distribution

Another topic that the Ministry would like to review in more detail is the regional and currency distribution in the benchmark portfolio for the Government Pension Fund – Global. The distribution here is based on the goal of preserving the international purchasing power of the Fund in the best possible way. Norway's import pattern has been an important reference, along with the consideration of the broadest possible spread of the Fund's risk and the Fund's role as a financial investor with emphasis on low transaction costs.

The Ministry will continue to work on these issues. Regardless, any plans for changes in this area will be some way off in the future. Since this area is of strategic importance for the Fund, any changes will be presented to the Storting before they are implemented.

New investment programmes

In Report no. 16 (2007–2008) to the Storting, the Government announced that it would consider

the financial and ethical effects of so-called positive screening as a tool to earmark a small portion of the funds in the Government Pension Fund – Global for investments in environmental technology or developing countries. The question of ear-marking was raised in the public consultation document about the evaluation of the ethical guidelines for the Government Pension Fund – Global:

> "The Ministry will study in more detail the possibility of setting a small part of the Fund aside for ear-marked investment purposes within, for example, such as environmental technology or developing countries."

Many of the bodies consulted have commented on this point and are generally positive to this kind of ear-marking.

The long investment horizon and the broad ownership both suggest that the Government Pension Fund must adopt a broader perspective on the consequences of positive or negative repercussions than is required by investors and corporate management who have a shorter investment horizon and portfolios with less risk diversification.

At the same time, the special characteristics of the Government Pension Fund – Global suggest that investments in unlisted markets such as real estate, infrastructure and unlisted equities should be increased. Other comparable funds emphasise in particular parts of their unlisted investments as examples of investments that can both yield an attractive financial return and contribute to positive social and environmental ripple effects.

The size of the Government Pension Fund – Global means that it is possible over time to build up specialised competence and increase risk diversification, at the same time as more cost-effective investments are made than are possible for smaller investors. At the same time, size is a general challenge in unlisted markets, because there are clear capacity constraints linked to how much that can be invested and how quickly. Consequently, it will necessarily take some time before the Government Pension Fund – Global can have such large investments in these markets that they have a significant impact on the Fund's total return and risk.

Most comparable funds invest in unlisted equities through fund-like structures. Unlisted equity funds can be divided into two main categories: start-up funds (venture capital), which invest in relatively new enterprises with a potential for rapid growth, and acquisition funds (buyouts), which buy control of a company and then restructures the company and improves its profitability. Acquisition funds manage far more capital than venture capital funds.

Investments in infrastructure, such as electricity and water supplies, toll roads, airports and telecommunications, have traditionally constituted a very limited market. However, increasing private participation and the growing need for private funding have made these kinds of investments interesting for long-term financial investors. The market for this type of investments is expected to grow in the years to come. The return on and the risk associated with infrastructure investments will vary widely among the different projects, but it is normal to assume that the return and risk of developed projects will resemble the return and risk associated with investments in real estate. As is the case for real estate, investments in infrastructure will also contribute to diversifying the risk in the Government Pension Fund and to reaping gains over time by investing in less liquid assets.

In Recommendation no. 283 (2007–2008) to the Storting, a majority of the Standing Committee on Finance stated that the Government Pension Fund – Global should be allowed to invest in infrastructure. The majority referred to the fact that infrastructure is a rapidly growing asset class among institutional investors, partly as a result of the large needs for infrastructure investments in emerging economies. It was also pointed out that a fund that aims to represent best international practice in all aspects of its management must develop investment competence in the asset classes that major institutional investors are active in. The Committee also underlined the need to uphold the requirements concerning quality and verifiability of the fund management performance.

In this Report to the Storting, the Ministry proposes that a new investment programme be established aimed at environment related investment opportunities. Work will also be continued on assessing whether it is pertinent to establish an investment programme aimed at sustainable investment opportunities in emerging markets. In this respect, the Ministry is following up the suggestions made in connection with the consultation concerning the evaluation of the ethical guidelines.

In contrast to ear-marking money for a particular fund, the Ministry intends the new investment programme to run across asset classes and that the scope of the investment will vary according to the opportunities at any given time.

On the basis of the characteristics of the Fund, the Ministry is assessing various investment alter-

natives for the investment programme. For the environmental programme, sub-markets in the areas infrastructure and unlisted equities, environmental bonds and placement of parts of the listed equities portfolio based on an environmental index are most relevant. The investments must be aimed at eco-friendly assets or eco-friendly technology that is expected to yield indisputable environmental benefits, such as climate-friendly energy, improving energy efficiency, carbon capture and storage, water technology and management of waste and pollution. It has been decided that any infrastructure investments will have to target climate-friendly energy in particular. In the unlisted markets, any such investments will be made through funds, but it may be demanding to identify funds that focus exclusively on environmental projects. In these kinds of cases, a minimum framework must be defined for the funds' environmental exposure.

Future assessments of a possible investment programme aimed at sustainable growth in emerging markets will consider investments in unlisted equities and infrastructure in emerging markets, among other things. These assessments will attach importance to finding a system for these kinds of investments that constitutes an appropriate and natural evolvement of the strategy of the Fund and that safeguards the need for good risk management. This will be more demanding in emerging markets than in the established markets that will make up most of the investments in the environmental programme.

There will normally be capacity constraints on investments in unlisted markets, and especially on investments in emerging economies and sub-markets for eco-friendly technology and energy. The size of the markets and access to good managers and funds represent capacity constraints. The Ministry is therefore estimating that the entire amount for the environmental programme and the possible investment programme aimed at sustainable growth in emerging markets will constitute around NOK 20 billion, invested over a five-year period. However, there is uncertainty linked to the capacity of the unlisted markets. NOK 20 billion will entail substantial investments in terms of the size of the markets and investments in other, comparable funds internationally.

Like the other investments in the Government Pension Fund – Global, the investment programme shall contribute to attainment of the goal of the highest possible financial return with a moderate level of risk.

Any unlisted investments might be in small sub-markets that it is difficult to get exposure to and where the risk is higher than for investments with a higher degree of risk diversification. Although the risk is higher than for other investments, the Ministry believes there are reasons to assume that these sub-markets will grow considerably in the long term and that they ought to be included as part of the Fund's investments. Before investment can commence, a number of matters must be clarified, including assessments of environmental criteria, the expected return and risk of the investment alternatives, and the size and accessibility of the markets. Large parts of the investments will be able to be made through new asset classes, entailing among other things that satisfactory ways of measuring and evaluating return and risk must be found. In addition, required rates of return, risk limits, provisions for responsible management and reporting requirements must be defined to ensure fulfilment of the Ministry's objectives for the investments.

The Ministry will present the Storting with a more concrete plan for the future work in this area in the National Budget for 2010.

1.2.3 Status of adopted changes to the strategy

Emerging equity markets

During 2008, two previously adopted changes in the investment strategy for the Government Pension Fund – Global were implemented through the benchmark portfolio for equities being extended to include small listed companies and more emerging markets. At year-end 2008, the benchmark portfolio for equities contained just under 7,700 companies, compared with 2,400 companies before the changes, and the number of markets in the benchmark portfolio classified as emerging markets has increased from 5 to 23. The implementation of these changes is discussed in more detail in Chapter 2.

Equity portion

It was previously decided to increase the equity portion of the benchmark portfolio from 40 per cent to 60 per cent. In consultation with Norges Bank, it has been decided to make a gradual transition to the new benchmark portfolio based on striking a balance between expected returns and transaction costs. Lower returns on equities than bonds in 2008 and historically large transfers

to the Fund throughout last year led to major purchases of shares in 2008. Shares have generally been purchased at prices that are much lower than when the decision to increase the equity portion was adopted in summer 2007.

The gradual increase in the equity portion and the simultaneous drop in the market value of the world's stock markets have resulted in a large increase in the Fund's average ownership stake in the stock markets. In the space of one year, this share has risen from approx. 0.5 per cent to 0.75 per cent. This means that in 2008, the Fund has acquired rights to a share in all the future profits from another 0.25 per cent of the world's listed companies.

However, the major drop in share prices in stock markets around the world towards the end of 2008 meant that at year-end, the equity portion was barely 50 per cent, compared with 53 per cent at the end of September 2008. The raising of the Fund's equity portion will continue in 2009. The Fund's holdings in the world's listed companies will thus probably increase further.

Real estate investments

Following the Storting's deliberation of Report no. 16 (2007–2008) to the Storting, the Ministry has continued to work on the plans to invest up to 5 per cent of the Fund in real estate.

The majority of the property investments are expected to be made through unlisted instruments. This poses challenges linked to a number of aspects, including the measurement and assessment of return and risk, and it is therefore necessary to establish special required rates of return, risk limits and reporting requirements to ensure fulfilment of the Ministry's objectives for the investments in real estate.

In connection with the work on compiling regulations for real estate investments in the Government Pension Fund – Global, the Ministry has been advised by the U.S. company Partners Group. The advice from Partners Group is based on best practice for similar funds internationally. The Ministry is aiming to finalise the new regulations in 2009.

In 2008, the global real estate market had poor returns and suffered a significant drop in turnover. The Ministry is not intending to lay down a fixed investment plan for the coming years, as the phasing-in will have to be adapted to the market conditions and capacity. In the first few years, the investments will probably be concentrated in a number of chosen areas, and it will take time to build up a global real estate portfolio with a high degree of risk diversification. The Ministry assumes it will take several years before the real estate portfolio constitutes 5 per cent of the Fund.

The rules for investments in real estate will be included in a new regulation governing the management of the Government Pension Fund – Global. See the more detailed discussion of this in Section 1.5.4 and Chapter 6.

1.3 Responsible investments

1.3.1 Reporting on the work on the ethical guidelines in 2008

The ownership efforts of Norges Bank

Norges Bank is responsible for exercising the ownership rights of the Government Pension Fund – Global. The overall goal for the exercise of ownership is to safeguard the Fund's financial interests. The ethical guidelines for the management of the Fund are premised on high returns over time being dependent on sustainable development, in the financial, environmental and social sense.

Norges Bank bases its exercise of the ownership rights of the Fund on the belief that it is better and more effective to concentrate on a few important topics than to spread the resources thinly over many areas. Norges Bank has therefore sought to identify a few concrete areas of commitment for its exercise of ownership. Importance is attached to ensuring that the topics are relevant for investors in general and for the Fund in particular, and that the topics are suitable for dialogue with companies and/or regulatory bodies, as well as increasing the prospects for real results. The topics must also be justifiable in light of the financial requirements. Pertinent areas of commitment include good corporate governance, children's rights and protection of the environment.

Good corporate governance is important in order to ensure the Fund's financial return over time and is a necessary condition to ensure that shareholders have real influence and dialogue with the companies. In this way, it is also a prerequisite for work on social and environmental issues. At the end of 2008, Norges Bank had established or continued dialogue with 16 companies concerning issues linked to corporate governance and shareholder rights.

A shareholder's primary means of expressing his opinion is by voting at general assemblies. In 2008, Norges Bank took part in 7,871 general assemblies and voted on almost 70,000 issues. Norges Bank publishes its vote in each individual matter and has established principles for how it votes. Norges Bank has generally voted in favour of the proposals forwarded by the management of the companies in 2008, but voted against 11 per cent of the proposals. Norges Bank has voted against candidates for the board of directors if the board as a whole does not satisfy the bank's expectations concerning sufficient independence from the company's management or dominant owners. The bank also votes against managerial salary schemes in cases where there is no obvious link between performance and reward.

Norges Bank has prepared a document "NBIM Investor Expectations on Children's Rights", to clarify to companies what expectations the bank as an investor has concerning children's rights. The document is aimed, in particular, at companies that operate in areas or sectors where there is a high risk of children's rights being violated. In 2008, efforts in this area have concentrated on four markets: India, Brazil, China and West Africa. At year-end 2008, Norges Bank was in dialogue with 130 companies and involved in 19 corporate commitment projects linked to child labour, risk management in the supplier chain and the board's competence in issues related to child labour. A commitment project with a company is far more extensive than a dialogue. Dialogue may be limited to making contact with the company, without any meetings being held, whereas a commitment project entails entering into a process with the company with defined goals and time limits. Commitment projects with companies will often run for several years.

Norges Bank regards it as important for a long-term investor to influence how companies work with or against government authorities when it comes to establishing binding climate legislation that can result in significant reductions in greenhouse gas emissions. The bank therefore takes steps to ensure that relevant companies that the Fund has a stake in have defined strategies that support sustainable economic and ecological development. The ownership work in this area is aimed especially at the energy sector and energy intensive sectors. In 2008, Norges Bank has focused in particular on the conduct of certain companies in connection with the national climate change regulations in the USA. Norges Bank has continued seven established commitment projects with U.S. companies, holding a total of 15 meetings with these companies. Norges Bank is part of the Carbon Disclosure Project (CDP) – an independent organisation that gathers and publishes information about companies' emissions of greenhouse gases. Through its involvement in CDP, Norges Bank encourages transparency in the companies and in this way is also a catalyst in efforts to reduce emissions of greenhouse gases.

In November 2008, Norges Bank announced that the bank is taking part in a new petition by 135 funds calling for wealthy nations to reduce their emission of greenhouse gases by 25–40 per cent by 2020, calculated on 1990 levels, in keeping with the recommendations of the UN Intergovernmental Panel on Climate Change (IPCC).

Norges Bank also participates in other forms of collaboration and contact with other investors. For example, the Bank supports the development of new accounting standards (IFRS) concerning "country-by-country reporting" for companies engaged in extractive industries. These kinds of standards will serve to simplify valuation of the companies and counteract corruption and illegal use of closed jurisdictions ("tax havens" or "closed jurisdictions"). Norges Bank has also contributed to the development of the UN-initiated Principles for Responsible Investment (PRI). This is an important international platform that focuses on the investor role. The bank bases its exercise of ownership and interaction with other investors on these principles. The Ministry of Finance as formal owner of the Fund has adopted these principles. The principles are described in more detail in Chapter 3.

The ownership efforts of Folketrygdfondet

Folketrygdfondet is responsible for exercising the ownership rights through management of the Government Pension Fund – Norway. The Executive Board of Folketrygdfondet has laid down guidelines for the exercise of ownership in the Fund pursuant to which the overarching objective is to safeguard the financial interests of the Fund. Folketrygdfondet has defined ethical principles for its investment activities. These principles are an integrated part of the guidelines for Folketrygdfondet's exercise of ownership, in order to help promote long-term wealth creation. Good corporate governance and corporate management shall promote the rights of owners and other stakeholders in relations with the companies, as well as en-

sure that the management mechanisms of the companies work appropriately.

In order to safeguard shareholder value, Folketrygdfondet deems it important to follow up the managerial salary policies of the companies. This involves evaluating whether managerial salary schemes are structured in such a manner as to actually contribute to more effective and performance-oriented corporate management, etc. Folketrygdfondet also examines any option schemes, and what these imply in terms of value transfer from the shareholders to companies' management teams.

In order to ensure the most objective and precise assessment of the ethical attitudes and actions of the companies, Folketrygdfondet gathers information from open sources such as annual reports, the media and the Internet. Folketrygdfondet also gathers information directly from the companies through a survey of all the Norwegian companies in which the Fund holds ownership interests. The survey relates to the integration and handling of environmental and social concerns and was first carried out in 2006. Companies that do not respond to the survey or that provide unsatisfactory answers are followed up individually. Folketrygdfondet has a consistently positive impression of the level of attention, standards and practices in the companies that have taken part in this survey so far.

Folketrygdfondet has been involved in the development and launch of the project Bærekraftig verdiskaping (Sustainable Value Creation) – a collaboration between 12 of the largest institutional investors in Norway. Through this collaboration, these investors have carried out a questionnaire survey among the companies that were admitted for listing on the main index of the Oslo Stock Exchange in 2008. The findings of the survey were presented on 10 December 2008. The goal of the project is to influence Norwegian listed companies to work towards sustainable development and long-term value creation.

Exclusion of companies

The Council on Ethics for the Government Pension Fund – Global is an independent advisory body charged with submitting recommendations to the Ministry of Finance on the screening and exclusion of individual companies, on the basis of the ethical guidelines for the Fund. The Ministry decides whether a company is to be excluded from the Fund and bases its decisions on the Council's recommendations, among other things, but will normally also seek Norges Bank's assessment as to whether the Bank is able, through its exercise of ownership, to reduce the risk of contribution to grossly unethical conduct. The Council on Ethics has five members and maintains its own seven-person secretariat. The secretariat conducts surveillance of the companies the Fund owns shares in and investigates and prepares matters for the Council.

Companies may be excluded from the Fund pursuant to the ethical guidelines for the Government Pension Fund – Global through:

- negative screening to identify companies producing weapons that violate fundamental humanitarian principles in their normal use, or that sell weapons or military material to states mentioned in the supplementary guidelines for management of the Fund, and
- exclusion of companies if an investment entails an unacceptable risk of contributing to actions or omissions that must be deemed grossly unethical.

So far 32 companies have been excluded from the investment universe of the Fund. Of these, 22 were excluded because they contribute to the production of inhumane types of weapons. The other ten companies were excluded to avoid an unacceptable risk that the Fund will contribute to serious or systematic human rights violations or severe environmental damage. In 2008, the Ministry excluded a total of six companies, of which one was excluded because the company produces cluster weapons that are prohibited pursuant to the Convention on Cluster Munitions. The Ministry also excluded one company that sells military materiel to Burma. In addition, the Ministry has excluded four companies on the basis of an assessment that the companies' operations contribute to severe environmental damage.

1.3.2 Evaluation of the ethical guidelines for the Government Pension Fund – Global

Introduction

The main aim of the evaluation of the ethical guidelines is to assess whether the guidelines are fulfilling their intended purpose, and maintain broad political support for the ethical guidelines, as well as to gather any feedback that may contribute to strengthening the profile of the Government Pension Fund – Global as a responsible investor.

Box 1.1 General overview of the results of the evaluation of the ethical guidelines for the Government Pension Fund – Global

The results of the evaluation process and the changes and new measures being planned for, can be summarised by the following main points:

- Highlight the Government Pension Fund – Global's position as a responsible investor by
  - clarifying the overall objective for work as a responsible investor,
  - establishing a new investment programme on environment, and assessing a new investment programme for development in emerging markets,
  - initiating a broad study to assess how the challenges of climate change can affect the financial markets and how investors ought to act in light of this, and
  - the Ministry adopting the UN Principles for Responsible Investment (PRI) and participating directly in international initiatives so as to be involved in putting on the agenda how the concerns of good corporate governance and environmental and social responsibilities can most efficiently be safeguarded within the role of financial investor.
- Continue the high ambitions in the operational management by
  - requiring that Norges Bank integrates the consideration of good corporate governance and environmental and social responsibilities into its operations with regard to several parts of the management of the Fund, in keeping with the bank's adoption of the PRI principles,
  - asking Norges Bank to prepare more documents outlining its expectations. The Ministry will ask for expectations documents within the areas environmental protection and corporate governance. With regard to environmental protection, a document regarding companies' strategy to combat climate change is regarded as particularly relevant. A document regarding transparency and reporting on payment flows in companies may help counteract use of secrecy jurisdictions to hide illegal actions,
  - carrying out public consultations in connection with major changes in the priority areas for the exercise of ownership, and
  - laying down new requirements concerning transparency and reporting linked to the exercise of ownership.
- Further develop the exclusion mechanism by
  - excluding tobacco manufacturers from the Fund's investment universe,
  - clarifying which issues the Ministry believes should be given priority when making decisions on exclusion, including the expected impact of this kind of decision,
  - making the content of the various criteria for exclusion more available to the companies and others,
  - facilitating a description of the Council on Ethics' work methods and publication of a description of the principles for selecting companies that are to be studied more closely, and
  - ensuring that a procedure be devised and published for how cases pertaining to reinclusion of excluded companies in the portfolio will be handled.
- Improve the interaction between the instruments by
  - making sure that any assessment of whether a company should be excluded considers whether there are other instruments better suited to achieving the Fund's main goals as a responsible investor,
  - establishing a watch list of companies as a new instrument, and
  - facilitating a system for interaction and coordination between the Council on Ethics and Norges Bank.

As part of the evaluation process, the Ministry has carried out a number of activities to gather information and views from Norwegian and international stakeholders alike. This includes a public consultation process where more than 50 bodies gave feedback consisting of proposals for changes and improvements to the current system to ensu-

re that ethical concerns are safeguarded in the management of the Fund.

The main conclusions from the evaluation show that the ethical guidelines are based on a solid foundation and have proven to be robust over time. Many important aspects can therefore be maintained. In light of international developments and experiences with the ethical guidelines so far, the Government is proposing some changes and adjustments to the current goals and instruments (see Box 1.1). At the same time, a number of additional measures are being proposed in order to bolster and refine the efforts to ensure the Fund is a responsible investor.

A broad approach

To maintain the Fund's solid position as a responsible investor, the Ministry proposes that good corporate governance and environmental and social factors shall be integrated to a greater degree as relevant factors in the overall work on management of the Fund. This is in line with international developments and will entail a raised ambition level in this area. The role as responsible investor will be one of the premises for the Ministry of Finance's work on investment strategy for the Fund (see the more detailed description in Chapter 2). Furthermore, the Ministry will demand that such considerations shall be safeguarded at other stages of the investment process, in accordance with the PRI principles.

According to the current guidelines, there are three tools for promoting the Fund's ethical obligations: exercising ownership rights, negative screening and exclusion of companies from the universe of permitted investments. The new approach will provide more tools in the role of responsible investor. The new tools will be added to the existing tools and are not intended to undermine their significance.

Clarifying an overarching objective

The ethical guidelines do not specify overarching goals or targets that apply to the guidelines as a whole. The two mechanisms – exercise of ownership rights and the exclusion mechanism – are based on different objectives, respectively ensuring the long-term financial interests of the Fund and avoiding involvement in grossly unethical acts or omissions. The Ministry proposes clarifying the overarching objective for the Fund as a responsible investor (see the more detailed description in Section 4.3.2 and Box 4.2).

The overarching objective will guide the work as a responsible investor and the instruments that can be employed on behalf of the Fund. In relation to the current guidelines, the proposal represents stronger emphasis on the desire to contribute to positive changes in sustainability issues and with respect to companies' conduct in corporate governance and social and environmental matters.

Continuing and adjusting the exclusion mechanism

The Ministry wants to continue its policy that the Fund must not have investments that entail contribution to companies' serious or gross violations of fundamental ethical norms, pursuant to the same criteria as today. In addition it intends to exclude tobacco producers from the Fund's investments (see below). There are also plans to further clarify the issues that the Ministry believes ought to be given priority when making a decision on exclusion. For example, the Ministry believes that it must be possible to attach importance to the expected effects of an exclusion when using this instrument, beyond the fact that the aim is to avoid contribution to grossly unethical activity. The exclusion mechanism ought not to be regarded in isolation, detached from other work on responsible management.

The Fund's increased investments in emerging markets will entail new challenges for application of the ethical guidelines. This is discussed separately. The same applies to application of the ethical guidelines in war and conflict zones.

Measures are going to be introduced to ensure predictability for the companies in the portfolio. The Ministry will work to make the interpretation and the content of the various criteria for exclusion more readily available by amending the way it organises information. The Ministry believes publication of the Council on Ethics' methods and principles for selecting companies that are to be studied more closely, is an appropriate measure. The Ministry will also ensure that a procedure for reinclusion of excluded companies in the portfolio is prepared and published.

Negative screening of companies from the portfolio on the basis of the companies' products

The Ministry is intending to continue negative screening of companies that manufacture weapons that violate fundamental humanitarian prin-

ciples in their normal use and companies that sell weapons or military material to states mentioned in the supplementary guidelines for management of the Fund. At present, this means Burma. In addition, a new screening criterion is being planned to cover companies that produce tobacco.

Negative screening of companies that produce tobacco has been considered on several occasions. Several commenting bodies have said that tobacco should be included in the screening mechanism. Negative screening of entire product groups is a very powerful tool and ought to be restricted to exceptional cases where it can be shown that there is clear consensus among the population of Norway. There have been developments in the period after the Graver Committee proposed the current ethical guidelines, both internationally through a convention dedicated to tobacco control (which came into force in February 2005) and nationally through restrictions of the Smoking Act in 2004, which must be deemed to represent such a clear shared set of values relating to screening of tobacco producers. With respect to questions of excluding other unhealthy or socially unbeneficial services from the Fund's investment universe, including alcohol, there has not been the same degree of norm development that can provide a similarly clear anchoring nationally or internationally. In addition, tobacco is a product in a class by itself in that it can cause serious health problems when used as intended.

In the Ministry's opinion, it is the *production* of tobacco that shall form the basis for screening. Thus, selling tobacco will not be encompassed by this criterion. The Ministry will study in more detail different methods for delimiting screening of companies that produce tobacco. Trying to operate with zero tolerance for all tobacco production may prove to entail particular challenges, although this will be the starting point when the criterion is formulated. Screening of companies that produce tobacco from the Government Pension Fund – Global is discussed in more detail in Chapter 4.

Exercise of ownership rights

The Ministry intends to continue the main principles of the current ethical guidelines as far as exercising ownership rights is concerned. In addition to the work that is already being done in this area, the Ministry is planning a number of new measures that will support a high level of ambition and a high degree of transparency concerning how ownership rights are safeguarded. The Ministry will formally require that Norges Bank integrates the consideration of good corporate governance and environmental and social responsibilities into its operations with regard to several parts of the management of the Fund, in keeping with the PRI principles that the bank has adopted. The bank will also be subject to new formal requirements concerning transparency and reporting on work linked to the ownership efforts.

Norges Bank has selected a number of focus areas for exercising ownership rights. The Ministry supports this. Choosing focus areas is an important issue, and the Ministry proposes introducing a process whereby it is consulted in advance about important changes to or expansion of focus areas. The Ministry may decide that significant changes must be subject to a public consultation process before a final decision is made. In the Ministry's opinion, publication of the document detailing the bank's investor expectations on children's rights has been very successful, and the bank ought to compile more publications outlining its expectations. An important area in this context will be expectations linked to environmental issues. A document on companies' strategies to combat climate change is deemed particularly relevant. The Ministry is also going to ask Norges Bank to prepare an expectations document regarding transparency and reporting on payment flows in companies. Clear expectations from investors like the Government Pension Fund – Global in this area can counteract use of closed jurisdictions to conceal unlawful acts, such as corruption, money laundering and tax evasion, etc., and in this way contribute to better functioning, legitimate markets. Publication of more expectations documents would help create transparency about the work related to ownership rights and also safeguard the companies' need for predictability.

Interaction between the various instruments

In line with what has been said above about an overarching objective for working as a responsible investor, the Ministry believes that there is a need to coordinate the use of instruments to a greater degree than the current system provides. The same applies to the activities of Norges Bank and the Council on Ethics.

The Ministry is planning a new provision whereby before deciding to exclude a company, it must be assessed whether other instruments might be better suited to achieving the Fund's ob-

jective as a responsible investor. This is already partly in place in that on receiving a recommendation on exclusion of a company, the Ministry asks Norges Bank whether the exercise of ownership might be used to reduce the risk of new breaches of the guidelines. This will yield a more targeted use of the instruments as a group and will help ensure that exclusion really is the last option when other measures have been considered. The Ministry is also planning to formalise the use of a watch-list as a new instrument. In some cases, the decision to put a company under observation may be a good alternative, as it can be assumed that this will encourage the company to amend its conduct or will prompt the company to provide more information to clarify the situation. It is thought that the use of a watch-list will be particularly apt in cases where there is great uncertainty about future developments.

Closer collaboration and coordination will necessitate adaptations in the mandates and methods of both Norges Bank and the Council on Ethics. Once the Storting has considered the results of the evaluation, the Ministry will continue to work on the details of a new system in dialogue with the Council on Ethics and Norges Bank.

Other topics and measures

In its capacity as a major international owner and investor, the Ministry can help put important issues on the agenda in terms of *research and international work* that affects how environmental and social issues and good corporate governance can be safeguarded as effectively as possible by a financial investor. The Ministry of Finance wants to increase its commitment in this area.

Many of the bodies consulted have pointed out that Norway's oil wealth gives the country a special responsibility to investigate problems linked to carbon emissions and climate change. For an investor with the characteristics of the Government Pension Fund – Global in terms of its long-term perspective and breadth of investments, it will also be in the Fund's own interests to find out how climate change can affect developments in the financial markets.

The Stern Review[1] provided important knowledge about the impact of climate change on the general economic development globally, and similar work could be done to shed light on the effect on financial markets more specifically. Against this backdrop, the Ministry is aiming to initiate a study to assess how the challenges of climate change can affect the financial markets and how investors ought to act in light of this. This ought to be an international project that could be carried out in collaboration with other investors. The Ministry will present a more detailed assessment and plan for this project in the National Budget for 2010.

In general, the Ministry wants to contribute to the development of best international practice in the area of responsible investments, and in this context will assess various measures that can support this. For example, this might be membership in selected international investor organisations, collaboration with UN bodies that are active in this field and greater contact with international experts.

Norges Bank and Folketrygdfondet have both signed the UN Principles for Responsible Investment (PRI). The Ministry of Finance wants to express its further support of these principles by the Ministry also signing them on behalf of the Government Pension Fund.

The Ministry would also like to refer to the fact that a new investment programme is being prepared aimed at environment related investment opportunities (see the discussion in Section 1.2 above).

In 2007, a new provision was introduced in the management framework that the Fund may not be placed in interest bearing instruments issued by the state of Burma. Several consultative comments have been submitted concerning the wish to expand the scope of the ban on investing in certain nations' *government bonds*. The Ministry continues to believe that excluding a country's government bonds from the investment universe of the Fund due to the actions of the country's authorities constitutes a drastic foreign policy step. Burma is different in many respects, but the main issue in this connection is the scope of the international measures against Burma. Currently, no other sanction regimes or measures endorsed by the Storting has the same scope as the measures against Burma. Without this kind of international anchoring, using the threat of exclusion from investment as a general instrument in Norwegian foreign policy is out of the question.

Secrecy jurisdictions (so-called tax havens) can help canceal economic crime, among other things. The Government takes a serious view of the negative effects that ensue from the harmful practices employed in such secrecy jurisdictions.

[1] "The Economics of Climate Change – The Stern Review" (2006)

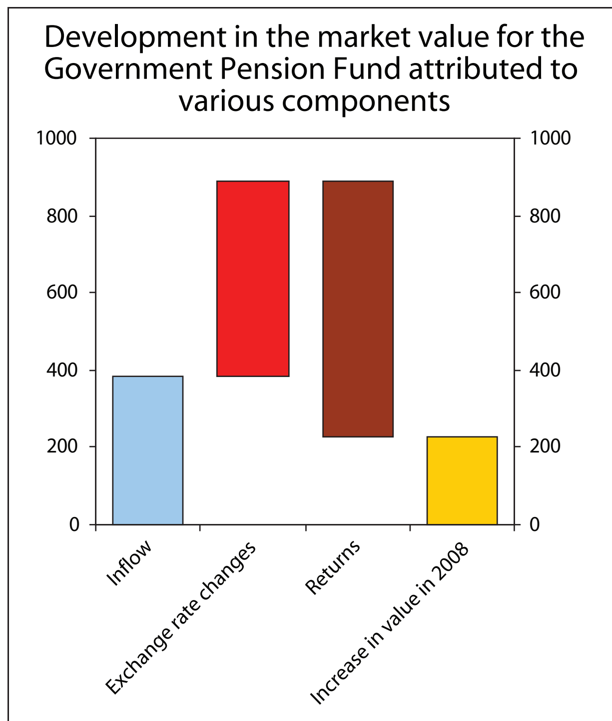

Figure 1.2 Development in the Market value of the Government Pension Fund during 2008, as attributed to various components. NOK billion

Source: Ministry of Finance, Norges Bank and Folketrygdfondet

The legislation and regulations in each individual country determines whether it can be classified as a secrecy jurisdiction. Efforts to combat so- called tax havens must therefore target these nations' authorities, as is already the case on a large scale.

It will not be pertinent to use investments in secrecy jurisdictions as a separate exclusion criterion in the equity portfolio. It is assumed that this would have little effect and would entail huge problems of delimitation.

Restrictions have been placed with respect to the Fund's real estate investments so that unlisted real estate companies and funds cannot be established in secrecy jurisdictions. In its role as investor, the Government plans to strengthen its efforts against secrecy jurisdictions through the Fund's equity investments. Norges Bank already supports the Extractive Industries Transparency Initiative (EITI) – an international initiative that promotes transparency about revenue flows in extractive industries. Norges Bank furthermore supports the development of new accounting standards (IFRS) concerning "country-by-country reporting" for companies engaged in extractive industries (mining, oil etc.). Tightened requirements for transparency and reporting by companies concerning revenue flows and tax matters can counteract the effect of the secrecy offered by the tax havens and be a suitable measure in combating corruption. Through broad measures such as those described, the work is directed in a targeted manner on the actual playing rules and "infrastructure" of the financial markets, as opposed to making it a question of the Fund as an investor assessing whether individual companies in the portfolio have legitimate grounds for activities in so-called tax havens. Norges Bank will be asked to prepare an expectations document aimed at companies' transparency and reporting requirements concerning payment flows. Clear expectations from investors such as the Government Pension Fund – Global in this area can counteract use of secrecy jurisdictions to conceal unlawful acts, such as corruption, money laundering and tax evasion, etc. and in this way contribute to more efficient, functional markets.

1.4 Management performance

1.4.1 Developments in the market value of the Government Pension Fund

At year-end 2008, the total market value of the Government Pension Fund was NOK 2,363.2 billion. This represents an increase of NOK 227.2 billion since year-end 2007, some of which (NOK 384 billion) is due to inflow of petroleum revenues. At the same time, the very poor returns on the Fund's investments reduced the value of the Fund by roughly NOK 663 billion. A significant depreciation of the Norwegian krone, as measured against the currency basket of the Government Pension Fund – Global through the year, entailed, when taken in isolation, an increase in the market value of the Fund by NOK 506 billion, but changes to the Norwegian krone exchange rate are not relevant as far as developments in terms of international purchasing power are concerned. Figure 1.2 breaks the increase in the total market value of the Government Pension Fund in 2008 down into the various components.

The assets of the Government Pension Fund have grown rapidly since the mid-1990s (see Figure 1.3). The value of the Fund at year-end 2008 represented over NOK 1 million per household in Norway. The market value of the Government Pension Fund – Global was NOK 2,275.4 billion at year-end 2008. This represents an increase of NOK 256.8 billion since year-end 2007. The value

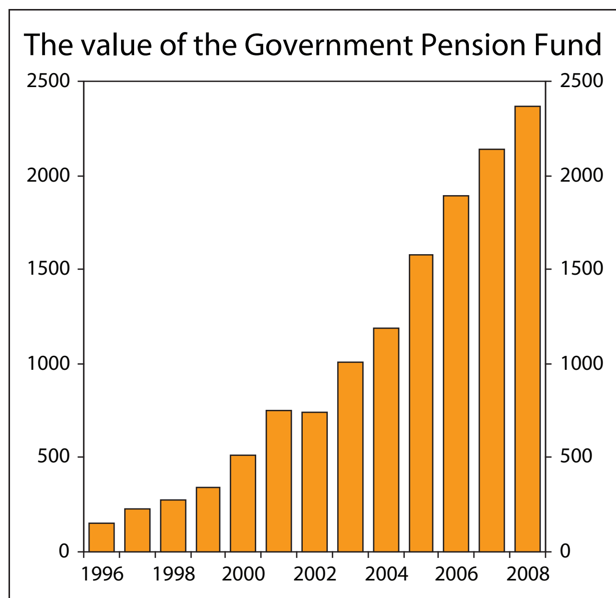

Figure 1.3 The market value of the Government Pension Fund. [1] 1996-2008. NOK billions.

[1] The Government Pension Fund was created in 2006 as a superstructure encompassing the Government Petroleum Fund and the National Insurance Scheme Fund. The value of the two Funds has, for purposes of illustration, been aggregated for previous years as well.

Source: Ministry of Finance

of the equity portfolio at year-end was NOK 1,128.9 billion, whilst NOK 1,146.5 billion was invested in fixed income securities. Total inflow to the Fund was NOK 2,141.8 billion over the years 1996-2008.

The market value of the Government Pension Fund – Norway was NOK 87.8 billion at year-end 2008, which is NOK 29.6 billion less than at the beginning of the year. At year-end, the value of the equity portfolio and the fixed-interest portfolio was NOK 46.5 billion and NOK 41.3 billion respectively.

Market developments

The Ministry's assessment in last year's report on the management of the Fund was that the development in the market value of the Government Pension Fund over the previous five years (i.e. 2003–2007) was very positive, taken as a whole, despite the fact that performance in 2007 was affected by the turmoil in the international financial markets in the second half of the year (see Chapter 1 of Report no. 16 (2007–2008) to the Storting). This reflected both strong average returns on the benchmark portfolio of the Fund and that excess returns had been generated in active management. The development in the value and management performance of the Fund in 2008 changes this picture significantly.

After a period of strong growth in the world economy (see Figure 1.4a), major difficulties in the financial markets since summer 2007 have contributed to a sharp decline and deterioration of the economic outlook internationally. In several countries, the authorities have implemented comprehensive measures in recent months in an attempt to stabilise the financial markets and dampen the impact of the financial crisis on the economy. Despite significant monetary policy and financial policy actions and other special measures in many countries aimed at providing capital for the banks, it seems that the growth in the world economy in 2009 will be weaker than for many decades.

The international financial crisis has had serious repercussions. After several years with a broad upturn in stock markets, share prices have plummeted during the last year (see Figure 1.4b). Further, the gradual tightening of American and European monetary policy in the years 2005 to 2007 has now been more than reversed, and bond yields have fallen significantly in 2008, (see Figure 1.4c). The premiums in the international money market have risen steeply as a result of a lack of confidence in the financial system, and it has become much more expensive for banks and other, non-financial enterprises to get long-term funding. The financial crisis has led to a sharp increase in the compensation required by investors when investing in securities involving credit risk (see Figure 1.4d).

The volatility that we have seen in the international financial markets for almost two years now has meant that many banks and financial institutions have had to post huge losses on securities and lending. This development reflects the fact that the widespread use of new, complex financial instruments made it difficult to ascertain who had incurred a loss, and confidence among banks and financial institutions has thus been severely undermined. The financial crisis entered a more serious phase in mid-September 2008, with the bankruptcy of the American investment bank Lehman Brothers. The credit flow in the money and credit markets slowed up, and many banks faced problems refinancing their loans. The situation has become so difficult for many financial institutions in the USA and Europe that the authorities have had to implement rescue packages to ensure continued operation.

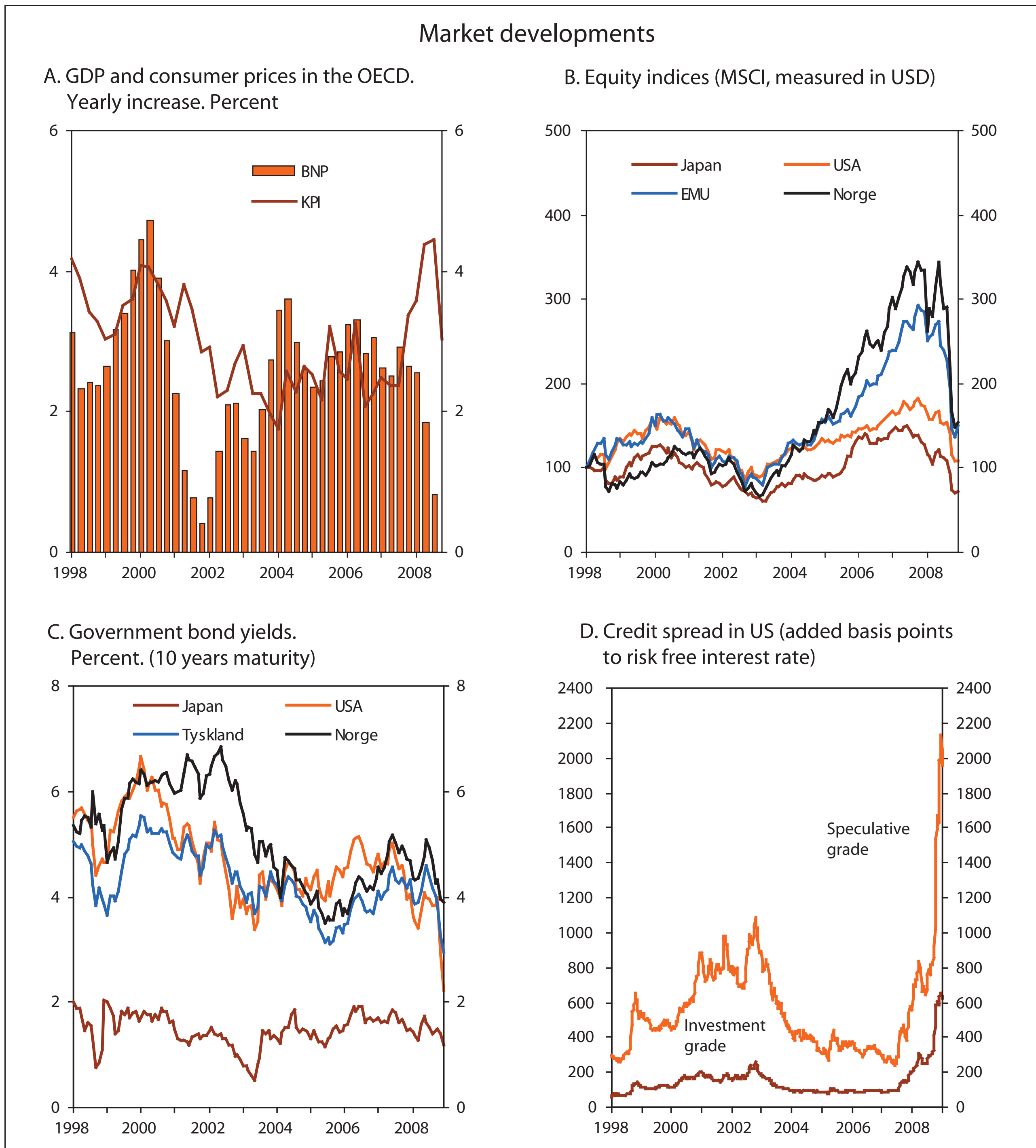

Figure 1.4 Market developments

Source: EcoWin

1.4.2 The return on the Government Pension Fund

It is the real return on the Government Pension Fund in international currency that is relevant for purposes of measuring developments in the purchasing power of the Fund. According to Table 1.1, the real return (after the deduction of management costs) on the Government Pension Fund – Global's investments in 2008 was -24.4 per cent, when measured in local currency. This is the poorest performance since the Fund was established. The Government Pension Fund – Norway achieved a real return of -28.8 per cent last year – again the weakest result in the Fund's history.

Table 1.1 Annual real returns on the Government Pension Fund – Global[1] and the Government Pension Fund – Norway[2], less management costs. 1997-2008. Per cent.

Net real return	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	1997-2008
Pension Fund – Global	7,15	8,20	10,93	0,35	-3,66	-6,62	10,75	6,30	8,46	5,57	1,05	-24,38	1,50
Pension Fund – Norway	5,60	-2,29	6,24	3,08	0,97	0,49	13,31	10,12	7,28	8,55	8,43	-28,77	2,12

[1] Geometric real return in international currency calculated on the basis of a weighted average of consumer price growth in the countries included in the benchmark portfolio on the Fund.
[2] Geometric real return in Norwegian kroner.

Source: Norges Bank, Folketrygdfondet og Ministry of Finance

Average annual net real return on the Government Pension Fund – Global since the beginning of 1997, which was 4.3 per cent at year-end 2007, had dropped to roughly 1.5 per cent at year-end 2008 (see Table 1.1).

In Report no. 16 (2007–2008) to the Storting, the Ministry stressed that there is considerable uncertainty linked to estimates of return, and historically, experience shows that return fluctuates widely. The risk associated with the return on the Fund is discussed in more detail in Box 1.2. It is stated here that there have been significant fluctuations in realised real returns, even when measured over longer periods of time. In the Ministry's opinion, the experience we have now does not provide grounds for changing the estimate of 4 per cent real return as a reasonable expectation for long-term return. This estimate is based on assumptions that the Strategy Council has previously described as reasonable and appropriate for analyses of long-tern return and risk. In this context, the Strategy Council referred to estimates from other funds, among other things.

The subsequent discussion of the management performance is based on nominal return data, since the goal is to compare results achieved with the return on a benchmark portfolio. Not much information would have been added by adjusting the return data for inflation for this purpose.

The return on the Government Pension Fund – Global

The nominal return on the Government Pension Fund – Global was -23.3 per cent in 2008, as measured in foreign currency. This is the weakest result achieved in the entire period (see Table 1.2). Measured in Norwegian kroner, the return on the Fund was -6.7 per cent in 2008. The fact that the return in kroner is considerably less negative than the return measured in the Fund's currency basket is due to the depreciation of the Norwegian krone against the currencies in the Fund's currency basket in 2008.

The nominal returns on the sub-portfolios of the Government Pension Fund – Global since the beginning of 1998 are illustrated in Figure 1.7.

The risk associated with the Government Pension Fund – Global, as measured by the standard deviation of returns, was roughly 14 per cent in 2008, when measured nominally in local currency. By comparison, the average level of risk for the last five years was 7.8 per cent (see Table 1.2).

Table 1.2 Average annual return and annual standard deviation of returns on the Government Pension Fund – Global, as measured in the Fund's currency basket, 1998-2008. Per cent and percentage points.

	Entire period	Last five year	2008
Benchmark portfolio (currency)			
Average return per year	2,98	3,16	-19,93
Standard deviation	6,42	7,00	12,60
Actual portfolio (currency)			
Average return per year	2,94	2,74	-23,30
Standard deviation	6,88	7,81	14,01
Excess return (NOK)			
Average return per year	-0,04	-0,43	-4,10
Standard deviation (tracking error)	0,76	1,03	1,84

Source: Norges Bank and Ministry of Finance.

Box 1.2 The risk associated with the return on the Government Pension Fund – Global

Over time, a higher return is expected on the equity investments in the Fund than on the investments in fixed income securities, because the risk associated with equities is higher. This higher risk manifests itself in large fluctuations in the return on the Fund. The choice of equity portion is largely a choice of the degree of fluctuation that can be accepted on the return of the Fund and how this risk is weighed up against the higher expected returns in the long term.

In Report no. 16 (2007–2008) to the Storting, the risk associated with the return on the Government Pension Fund's investments was described in three ways: a simulation model was used to describe potential future developments in the Fund; historical returns in the equity and bond markets were used to describe fluctuations in returns over the last hundred years; and historical returns in previous financial market crises were used to illustrate what the return on the Fund would have been in these periods.

The various approaches were used to produce an estimate of normal fluctuations in the Fund, expressed in the form of statistical measures of the uncertainty linked to expected and historical average return. Developments in both the equity and the fixed income market in 2008 were unusual. At the same time, these analyses show that the negative real return observed in 2008 is within the range of what must be expected, on rare occasions with the current equity portion. However, it is uncertain how seldom this kind of event is as it is difficult to model rare events, and because even with 100 years' historical data, we have few observed falls in value of this magnitude.

Using simulations based on the same parameters as described in Report no. 16 (2007–2008) to the Storting, it is estimated that such a poor result as was achieved in 2008 can be expected to occur very seldom: roughly once every 350 years. However, calculations based on historical returns indicate that such low returns can occur more frequently. Historical real returns on a portfolio that resembles the portfolio the Fund has had in the last year would have been lower than -21.0 per cent in two of the years since 1900 (1920 and 1974). The reason that the estimate based on a model simulation deviates so widely from the historical data is partly that the distribution of probability on which the simulations are based underestimates the frequency of sharp drops in the financial markets. However, the simulations presented in the two previous reports to the Storting on the management of the Government Pension Fund have had the goal of shedding light on return and risk over longer time horizons than one year (horizons of 15 years have been chosen). The model will work better over longer time horizons. The models and the underlying assumptions will be documented on the Ministry's website (www.government.no/gpf).

Greater annual fluctuations in returns are a natural outcome of increasing the equity portion to 60 per cent. At the same time, expected long-term real return will also increase. The estimates of long term risk (volatility) and real return (geometric) shown in Report no. 16 (2007–2008) to the Storting, are 9.2 per cent and 4.2 per cent respectively, measured in local currency. It has been calculated that the probability of the real return over a 15-year horizon being lower than 4 per cent is roughly 46 per cent, whereas the probability of the real return being less than zero over a 15-year period is around 4 per cent. Similarly, a 68 per cent probability has been calculated for the real return over a 15-year period being between 1.8 and 6.7 per cent, while there is a 95 per cent probability that it will be in the range -0.5 to 9.3 per cent. Figure 1.5 illustrates these probability intervals and compares them with the average real return over rolling 15-year periods since 1900 of a global portfolio consisting of 60 per cent equity and 40 per cent bonds and with a regional distribution similar to the one in the Government Pension Fund – Global. Historical return over these rolling 15-year periods is generally within the simulated 95 per cent probability intervals, but there are also periods with higher and lower returns. The figure demonstrates that the fluctuations in the simulated 15-year returns are slightly less extreme. Over even longer periods of time, historical real return is seldom outside the simulated probability intervals, see Figure 1.6, which shows rolling 30-year rates of real return. The return for the period is outside the 95 per cent interval in only three years (2004, 2006 and 2007), and then it is higher. This indicates that the model calculations are consistent with historical real returns, assuming a long investment horizon.

Box 1.2 (cont.)

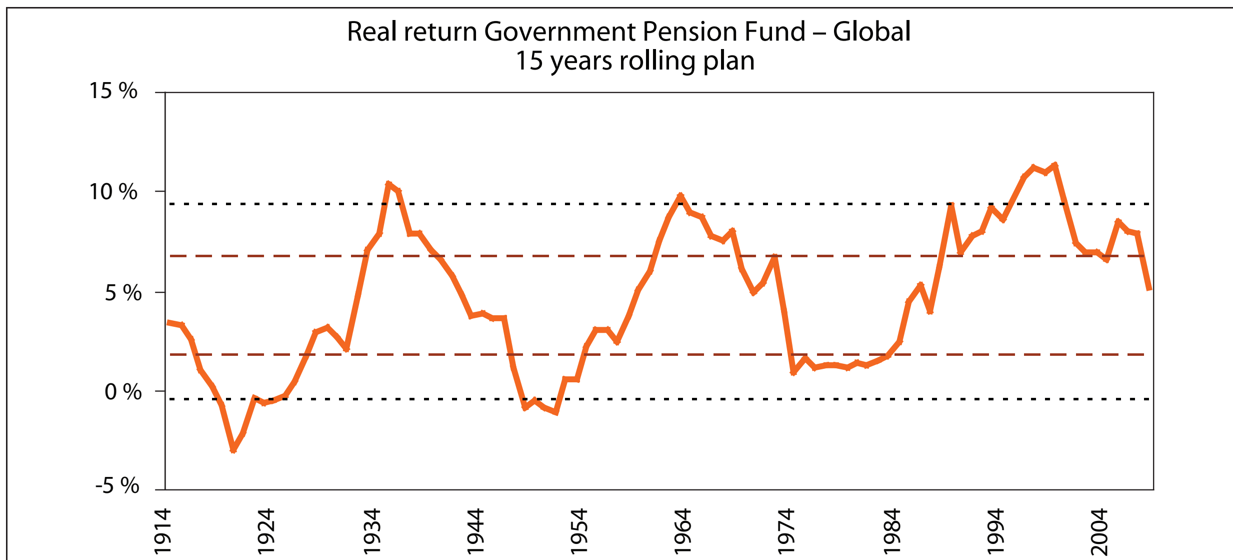

Figure 1.5 Annualised (geometric average) real return over rolling 15-year periods since 1900 of a global portfolio consisting of 60 per cent equity and 40 per cent bonds and with a regional distribution similar to the one in the Government Pension Fund – Global.[1, 2]

[1] The dotted lines indicate probability intervals calculated using a simulation model based on the assumption concerning return and risk described in Report no. 16 (2007–2008) to the Storting and reproduced in tables 2.2 and 2.3 in Chapter 2 of this report. There is a 68 per cent probability that future geometric real return will be inside the brown dotted lines. Similarly, there is a 95 per cent probability that future geometric real return will be inside the black dotted lines.

[2] See Section 2.3.1 on historical simulation in Chapter 2.

Source: Ministry of Finance and Dimson, Marsh and Staunton (2008)

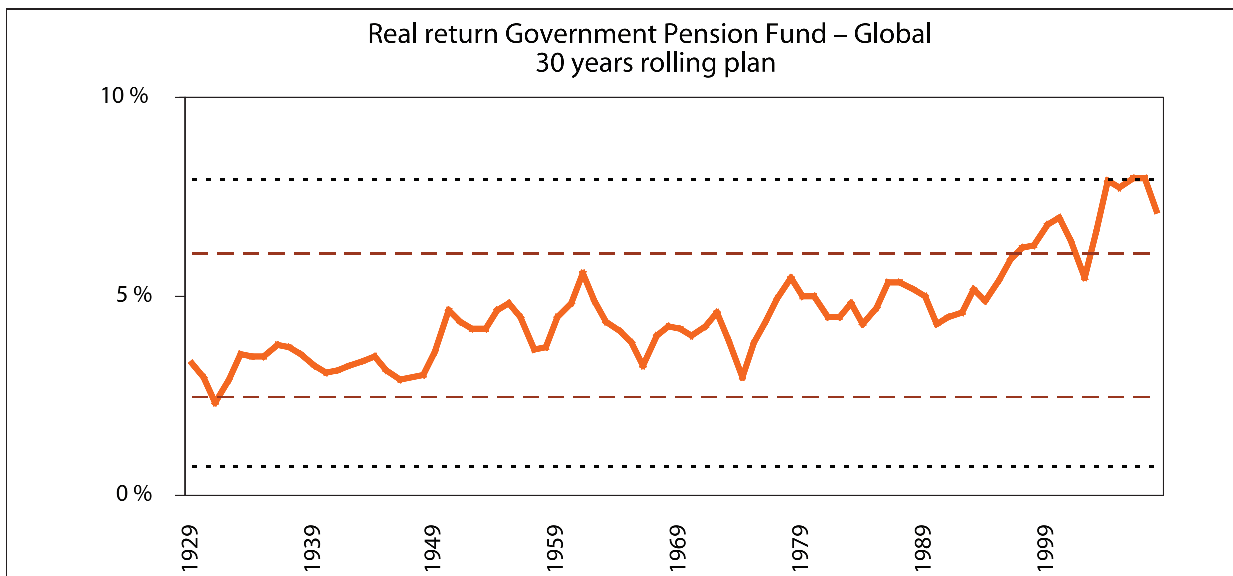

Figure 1.6 Annualised (geometric average) real return over rolling 30-year periods since 1900 of a global portfolio consisting of 60 per cent equity and 40 per cent bonds and with a regional distribution similar to the one in the Government Pension Fund – Global.[1, 2]

[1] The dotted lines indicate probability intervals calculated using a simulation model based on the assumption concerning return and risk described in Report no. 16 (2007–2008) to the Storting and reproduced in tables 2.2 and 2.3 in Chapter 2 of this report. There is a 68 per cent probability that future geometric real return will be inside the brown dotted lines. Similarly, there is a 95 per cent probability that future geometric real return will be inside the black dotted lines.

[2] See Section 2.3.1 on historical simulation in Chapter 2.

Source: Ministry of Finance and Dimson, Marsh and Staunton (2008)

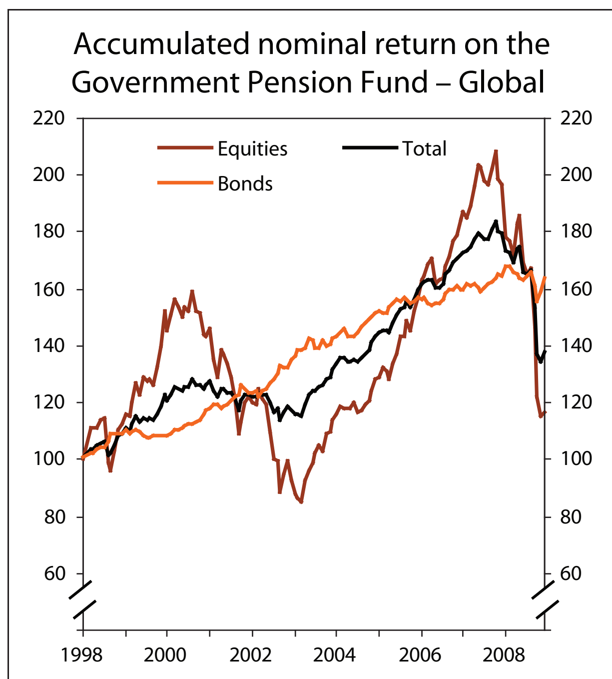

Figure 1.7 Accumulated nominal return on the sub-portfolios of the Government Pension Fund – Global, as measured in the Fund's currency basket. Index as per yearend 1997 = 100

Source: Ministry of Finance and Norges Bank

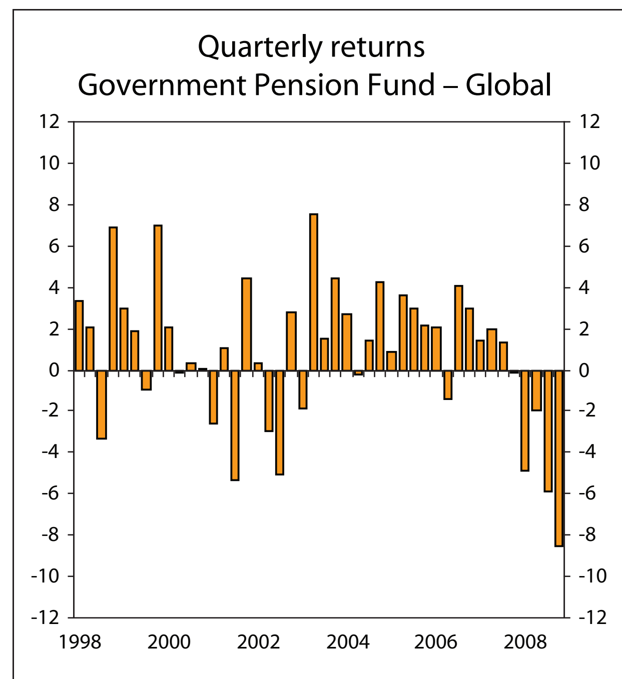

Figure 1.8 Quarterly nominal returns in the Government Pension Fund Global's benchmark portfolio

Source: Ministry of Finance

2008 was a dramatic year for the financial markets. The international stock markets saw their value almost halved, and there has not been another single year with such poor returns in the last 100 years as 2008. These factors are also reflected in the performance of the Government Pension Fund – Global.

According to the calculations of the risk associated with the return on the overall benchmark portfolio for the Government Pension Fund – Global, such poor results as were achieved in 2008 will occur very rarely (see Box 1.2).

As illustrated in Figure 1.8, there have been relatively large fluctuations in the returns on the Fund in the past too. The figure shows the fluctuations in quarterly returns on the benchmark portfolio for the Fund, demonstrating that the spikes in the best quarters match or are bigger than the slumps in the worst quarters, with the exception of the fourth quarter 2008. However, what distinguishes the developments last year from those in previous periods is the number of quarters in a row with negative returns. The fluctuations underline the importance of measuring performance over a long period.

The investments in the Government Pension Fund have a long-term perspective. The Government Pension Fund is large and will have a long lifespan. In contrast to other pension funds, the assets are not ear-marked for specific liabilities, and the capital of the Fund is fully funded by equity. There is little risk that the owner of the Fund will have to make large withdrawals over a short period of time. There is therefore little risk of negative returns alone leading to the Funds having to sell its assets. The situation is thus very different to that of many other international investors, who have had to sell risky assets at low prices because of the financial crisis and capital adequacy requirements. Against this backdrop, the Government Pension Fund – Global is well positioned to bear the risk the Fund is currently facing. At the same time, the slump in share prices in the international stock market in 2008 also entails that the shares being purchased as a result of the decision to raise the Fund's equity portion are being bought at much lower rates than predicted when the decision to increase the equity portion of the Fund was made (see Section 1.2.3). The Fund's average stake in the international stock markets is now more than 0.75 per cent, which is a large increase

on the year before. This yields a correspondingly larger right to future profits from listed companies all over the world.. Norges Bank may, in its management of the Government Pension Fund – Global, deviate from the benchmark portfolio stipulated by the Ministry, within a limit for expected tracking error of 1.5 percentage points (see Section 1.2). The contribution from such active management is measured on an ongoing basis by way of developments in the value of the Fund being compared to developments in the benchmark portfolio. In 2008, the return on the Government Pension Fund – Global was 4.1 percentage points less than the return on the benchmark portfolio, measured in Norwegian kroner. This corresponds to NOK 88 billion. Measured in the Fund's currency basket, excess return was -3.4 per cent. Return measured in the Fund's currency basket provides the best expression of the change in the international purchasing power of the Fund. In the past, the difference between the excess return as measured in kroner and in foreign currency was relatively minor. In the past, the Ministry of Finance has reported excess return in Norwegian kroner and is continuing to do so in this Report, to ensure comparison with previous years. The Ministry will consider whether the measuring principle ought to be changed in the future.

From 1998 until the end of 2008, Norges Bank has had an annual average negative excess return of 0.04 percentage points. Active management in 2008 achieved its poorest results since the Fund was established.

Up until 2006, Norges Bank had reported an excess return compared with return on the benchmark portfolio for nine years running. In the two years 2007 and 2008, active management produced a negative excess return. The excess return achieved in the years 1998–2006 is outweighed by the negative excess return from active management in the last two years. At the same time, there have been sizeable differences in the results achieved by the management of the equity and fixed income assets. Although both equity and fixed income management produced a negative excess return in 2008, the largest share of the total negative excess return came from the management of the fixed income assets. Taken over a longer period, Norges Bank has achieved a positive excess return in its equity management, but a negative excess return on fixed income management.

The disappointing results within fixed income management are primarily due to the fact that Norges Bank's active bond investments have generally been exposed to the same level of underlying systematic risk (liquidity risk and credit risk). Large positions that were built up in a situation where the risk premium on liquidity and credit was low fell in value simultaneously when the market was driven by major adjustments in valuations of these risk factors. In its report on the management of the Government Pension Fund – Global in 2008, Norges Bank writes that the crisis in the financial system revealed that risk-taking in the various mandates for fixed income management was not sufficiently independent and that many of the management mandates in the bank had a combined exposure to liquidity and credit risk that was not observed in normal market conditions. The bank's report provides a more detailed account of the decomposition of the negative excess return on different management strategies (see the discussion in Box 5.3 in Chapter 5 of this report).

Table 1.3 Average annual return (nominal) and annual standard deviation of returns on the Government Pension Fund – Norway, measured in kroner 1998-2008. Per cent.

	Entire period	Last five years	2008
Benchmark portfolio			
Average return per year	3,54	1,00	-28,79
Standard deviation	8,53	11,70	21,79
Actual portfolio			
Average return per year	4,18	1,96	-25,09
Standard deviation	7,90	10,86	20,55
Excess return			
Average excess return per year	0,64	0,96	3,70
Standard deviation (tracking error)	1,46	1,69	2,46

Source: Ministry of Finance and Folketrygdfondet.

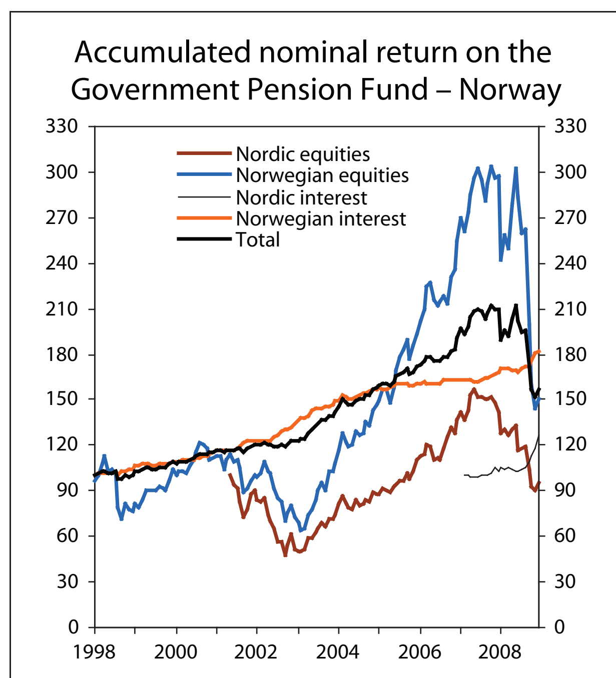

Figure 1.9 Accumulated nominal return on the Government Pension Fund – Norway, measured in NOK. Index as per yearend 1997 = 100

Source: Ministry of Finance and Folketrygdfondet

The Ministry has previously described the developments in the excess return achieved in the fixed income portfolio, pointing out that seen over a longer period, Norges Bank has reaped liquidity and credit premiums, which is analogous to selling insurance against liquidity and credit crises (see Report no. 16 (2007–2008) to the Storting). The crisis in the credit markets that started in autumn 2007 has led to large falls in the value on these positions and can be compared with an insurance company having to pay out insurance to policyholders in connection with an accident.

The realised losses on the investments in the fixed income portfolio still constitute a small part of the total negative excess return. The current yield is high, which not only reflects that credit risk has increased, but also high liquidity and risk premiums in the markets. The valuation of these bonds is an estimate of their real value in the current market conditions. Estimates will be subject to change, reflecting developments in the markets. Norges Bank states that they are expecting to hold most of these securities until maturity. The face value will be received on maturity for all the securities that have not defaulted.

The results achieved by Norges Bank's active management must be assessed over a long period, but in the Ministry's opinion performance in 2008 was not satisfactory. In this context, the Ministry refers to the measures that Norges Bank has implemented related to active management (see the more detailed discussion in Section 1.5).

The return on the Government Pension Fund – Norway

The Government Pension Fund – Norway adopts a long investment horizon. The fact that Folketrygdfondet, in its capacity as manager of the assets of the Fund, is a large player in a relatively small capital market may entail certain limitations as to the scope for large changes to the composition of the portfolio in the short term. In line herewith, the Ministry is focusing on performance developments over time in its follow-up of Folketrygdfondet's performance.

The return on the Government Pension Fund – Norway in 2008 was -25.1 per cent, measured in Norwegian kroner (see Table 1.3). This is the poorest performance achieved in the period 1998–2008, and is due to the crisis in the stock markets last year. The nominal returns on the sub-portfolios of the Government Pension Fund – Norway are illustrated in Figure 1.9.

The risk in the Government Pension Fund – Norway in 2008 was 20.6 per cent, as measured in kroner. This is almost a doubling of the risk level compared with the last five years as a whole. Some of the increased risk can be linked to the termination of the sight deposit arrangement in 2006.

Folketrygdfondet's active management achieved good results in 2008. The return on the Government Pension Fund – Norway was 3.7 percentage points higher than the return on the benchmark portfolio. This is the highest excess return achieved in the entire period 1998–2008. The Ministry is pleased with Folketrygdfondet's management performance in 2008.

1.4.3 Management costs

Norges Bank shall, pursuant to the management agreement entered into with the Ministry of Finance in respect of the Government Pension Fund – Global, be compensated for the actual management costs, up to a maximum limit, which for 2008 has been fixed at 0.10 per cent (10 basis points) of the average market value of the Fund. The maximum compensation limit is determined on the basis of a number of factors, including information on costs

associated with this type of management in funds of corresponding size. The Ministry of Finance commissions the Canadian company CEM Benchmarking Inc. to prepare the analyses on which these cost comparisons are based. In addition to the reimbursement of costs up to the maximum limit, Norges Bank is compensated for such part of the fees of external managers as are incurred as a result of the excess return achieved.

Management costs for 2008, exclusive of performance-related fees, were NOK 1,678.4 million. This represented an increase of 10.8 per cent over 2007. The average size of the Fund decreased by 12.9 per cent, implying that costs measured as a share of the average portfolio dropped from 0.08 per cent (8 basis points) in 2007 to 0.078 per cent (7.8 basis points) in 2008. Consequently, management costs exclusive of performance-related fees are well below the maximum limit. Including performance-related fees paid to external managers, costs amounted to NOK 2,165.2 million, which represents 0.11 per cent (11 basis points) of the average market value when calculated as an annual rate.

In addition to management costs, costs are also incurred linked to completion of the individual transactions. Norges Bank submits regular reports on transaction costs linked to management of the Government Pension Fund – Global. In this context, the Ministry would like to point out that Norges Bank has done a lot to improve the efficiency of the transaction process within equity management. In its annual report for 2007, the bank stated it had improved profitability by means of electronic trading and that it has used better access to trading data to reduce total trading costs in the Fund. According to Norges Bank's calculations average costs on share trading dropped from over 40 basis points in 2003 to roughly 25 basis points in 2007, entailing annual savings on transaction costs of several hundred million kroner. At the same time, the bank also points out that decreasing volatility in the markets is another important explanation for the drop in costs linked to trading shares.

The costs incurred by Folketrygdfondet in its management of the Government Pension Fund – Norway in 2008 represent NOK 85.7 million, or 0.084 per cent (i.e. 8.4 basis points) of the average assets, not including extraordinary pension costs and depreciation. The management costs are thus well within the defined limit for management fees (see Appendix 8 of Report no. 16 (2007–2008) to the Storting). The management costs associated with the Government Pension Fund – Norway are not entirely comparable to the costs associated with the management of the Government Pension Fund – Global. Norges Bank has opted to use external management mandates, which when taken in isolation are more expensive than internal management. Furthermore, the asset management carried out by Norges Bank is more extensive, partly because the assets of the Government Pension Fund – Global are spread across many more countries and companies than those of the Government Pension Fund – Norway. On the other hand, asset management is subject to economies of scale that Norges Bank benefits from.

There has been a significant rise in costs from 2007 to 2008 in Folketrygdfondet's management of the Government Pension Fund – Norway. Part of this increase can be ascribed to the fact that in connection with the implementation of the new management framework for the Government Pension Fund – Norway, more stringent requirements have been set regarding risk management, control and reporting (see Report no. 16 (2007–2008) to the Storting). Against this backdrop, large investments have been made in new control systems to meet the new requirements in the framework. Much of the increase in expenses from 2007 to 2008 are one-off outlays, but it must nevertheless be expected that the costs of managing the Government Pension Fund – Norway will be higher in the future than they have been in the past, partly as a result of the current expenses linked to operating the new control systems.

1.5 Development of the management framework for the Government Pension Fund

The Government Pension Fund consists of two portfolios: the Government Pension Fund – Global and the Government Pension Fund – Norway. The management framework for the Fund must be adapted to the special characteristics of each portfolio, including the size of the fund, inflow of capital, investment strategy and organisational aspects. The Ministry works constantly to refine and develop the provisions in the framework.

1.5.1 The management framework for the Government Pension Fund – Global

The Government Pension Fund – Global is regulated by the following sets of rules (see Appendix 1):

- Act of 21 December 2005 no. 123 relating to the Government Pension Fund
- Regulation of 22 December 2005 on Management of the Government Pension Fund – Global
- Guidelines for management of the Government Pension Fund – Global
- The management agreement between Norges Bank and the Ministry of Finance of 12 February 2001

Management is also affected by the Act on Norges Bank and the Monetary System of 24 May 1985 no. 28 (Norges Bank Act). This Act does not regulate management of the Government Pension Fund – Global directly, but lays down terms for the organisation of Norges Bank and the division of responsibilities between the bank's various governing bodies. It therefore defines an organisational framework for Norges Bank, which also applies to its capacity as asset manager.

The Ministry of Finance's investment strategy for the Government Pension Fund – Global covers both the strategic benchmark portfolio and limits on Norges Bank's deviation from the benchmark portfolio. In this Report, the Ministry states that in spring 2010 it will present the Storting with a review as to whether – and if so, to what extent – active management is to be continued.

Parallel to this work, the Ministry will continue to work on developing the management framework. It is challenging to ensure that the framework is continuously developed in keeping with the investment strategy, growth in the assets of the Fund and international developments in the framework and supervision methods for large asset managers. In last year's report, the Ministry described the results of a review of internationally recognised standards and best market practice for risk management within asset management (see Chapter 5 of Report no. 16 (2007–2008) to the Storting). The description of best market practice was based on a reference group consisting of several large funds and investment banks.

Common views on which institutions represent best practice for risk management within asset management are subject to change. Some of the institutions that were generally regarded as leading within risk management have since encountered serious problems and have been forced to ask for help from their respective authorities. It therefore seems likely that the international norms for risk management will continue to change in the future. This will also affect the Ministry's further development of the regulations for the management of the Government Pension Fund – Global.

Below is an overview of the Ministry of Finance's work linked to following up the requirements entailed by the framework regarding Norges Bank's risk management in connection with its management of the Government Pension Fund – Global and a description of ongoing and planned projects linked to work on the management framework (see Chapter 6).

1.5.2 Follow-up of the requirements in the framework concerning risk management and control

The responsibilities of Norges Bank's governing bodies

The current management framework for the Government Pension Fund – Global allows Norges Bank to invest in a way that deviates from a pure indexing of the benchmark portfolio (passive management), if it can be documented that the bank as a minimum is adhering to internationally recognised standards and methods of risk management for such positions (active management). For example, the management guidelines state:

> "Valuation, measurement of return and management, measurement and control of risk shall comply with internationally recognised standards and methods. The Fund shall not invest in markets, asset classes or instruments unless compliance with these requirements can be documented."

The operative management of the Government Pension Fund – Global has been delegated to Norges Bank and is carried out by a separate department in the bank: Norges Bank Investment Management (NBIM). The Executive Board has the executive authority in the bank (see Section 5, first paragraph of the Norges Bank Act). The Executive Board is responsible for making sure that asset management is practised in accordance with the framework defined by the Ministry of Finance. One of the Executive Board's main tasks within its operative asset management thus comprises constantly monitoring Norges Bank's ability

to measure and control risk, and ensuring that the allowed investment universe in terms of both markets / currencies and use of instruments is at all times delimited so that the qualitative requirements in the management framework for the Fund are satisfied.

Section 5, third paragraph of the Norges Bank Act reads

> "The Supervisory Council supervises the Bank's activities and ensures that the rules governing the operations of the Bank are observed."

The Supervisory Council must therefore also supervise that Norges Bank follows the instructions set out in the regulatory framework for the Government Pension Fund – Global. The Supervisory Council has 15 members, all of whom are elected by the Storting (see Section 7 of the Norges Bank Act). The Supervisory Council submits annual statements to Storting on the Executive Board's minutes of meetings and supervision of the bank.

The rules defined in the Norges Bank Act concerning the tasks of the bank's governing bodies are brief and general and do not define clearly what the executive authority of the Executive Board covers or what should be included in the Supervisory Council's supervision of the bank's operations. In the Ministry's opinion, the bodies' responsibilities for control and supervision need to be defined more clearly in the Act (see Section 1.5.3).

The Ministry of Finance's follow-up of Norges Bank's operational management of the Government Pension Fund – Global

According to Section 2 of the Act relating to the Government Pension Fund, the Ministry of Finance is responsible for managing the Government Pension Fund – Global. Operational management has been delegated to Norges Bank. In order for the Ministry of Finance to fulfil its management responsibility, it must have a robust framework and good follow-up routines vis-à-vis Norges Bank.

In connection with the changes in the framework that came into force on 1 January 2006, the Ministry of Finance stated that external consultants would also be used in the follow-up of Norges Bank's asset management. In the National Budget for 2006, it is stated that:

> "Norges Bank operates a specialised asset management regime. By imposing reporting requirements, the Ministry will be better placed to identify areas where, with the help of external expertise, it can evaluate Norges Bank's compliance with instructions set out in the regulatory framework. The Ministry plans regular due diligences of the fund, and particularly the bank's risk management, in collaboration with consultants possessing suitable expertise. The Ministry will be reporting on this to the Storting in suitable documents."

The first risk-based due diligence on the basis of the new requirements in the framework relating to Norges Bank's active management was initiated in autumn 2006. Following a competitive tender, the Ministry of Finance chose an international team from Ernst &Young to review Norges Bank's risk management and control procedures. The Ministry has described the content of the final report and the bank's comments in Report no. 16 (2007–2008) to the Storting. Here it was described how in the period 2006–2008 Norges Bank has undertaken a number of projects to further improve the bank's risk management, including:

- establishment of an Audit Committee for the Executive Board,
- establishment of a separate internal audit department,
- strengthening of external auditing through co-operation with Deloitte AS,
- reorganisation of NBIM,
- significant reinforcement of the independent risk management function (RPA)
- new framework for operational risk, and
- projects for the implementation of new systems for counterparty risk and for the pricing and verification of positions independently of those who make investment decisions.

In a letter dated 20 October 2008 to Norges Bank, the Ministry requested information about the status of the Executive Board's efforts to improve the bank's risk management in its asset management. The Executive Board's response is discussed in Chapter 6 and is appended to this Report as Appendix 3.

Norges Bank has done much to improve risk management in connection with its management of the Government Pension Fund – Global (see above). The Ministry is also positive towards the reorganisation of the bank's asset management that came into effect on 1 March 2008.

It follows from the letter from the Executive Board of Norges Bank dated 12 February 2009 that the bank has introduced new internal guideli-

Box 1.3 External review of risk management and active management in the Government Pension Fund – Global

The guidelines for the management of the Government Pension Fund – Global and the management performance have been discussed regularly in reports to the Storting since the Fund was established. There is broad political support for the guidelines for management of the Government Pension Fund – Global, which has allowed Norges Bank a certain degree of freedom to deviate from the benchmark portfolio for the Fund in its management of the Fund since 1998, when the Fund first started investing in equities. Throughout this period, the limit on tracking error has remained stable at 1.5 per cent. Within the limit on tracking error, there has been a gradual development in the way the external constraints on allowed investments have been regulated. See the more detailed discussions in the National Budget for 1998, the National Budget for 2001, the National Budget for 2006 and the annual reports to the Storting on the management of the Fund. There has not been disagreement in the Storting on the limits on active management in the deliberation of these reports.

In the discussion of the way the markets work and active management in Section 1.2, it was stated that both the Ministry of Finance and Norges Bank work on the assumption that the markets the Fund operates in are largely efficient and that a strategy for active management must therefore be based on exploiting the characteristics of the Fund. It is also stated that the framework for active management must be assessed in light of a number of factors, including the bank's defined strategies and performance.

The National Budget for 2006 described the Ministry's intention to introduce regular due diligences of Norges Bank's management of the Fund and particularly the bank's risk management, in collaboration with consultants possessing suitable expertise (see the discussion in Section 1.5.2). Report no. 16 (2007–2008) to the Storting describes the due diligence project consisting of an external review of Norges Bank's risk management systems (referred to as the Ernst & Young project). Chapter 6 contains a discussion of Norges Bank's account of the work done to strengthen risk management in the Fund. There is also an account of the Ministry's efforts to amend the Bank's regulatory system for active management, including the need to set supplementary limits for risk-taking in active management that go farther than the current upper limit on tracking error.

In its report on the management of the Government Pension Fund – Global in 2008, Norges Bank writes that the financial crisis has entailed major challenges for risk management and risk control as a result of the fact that historical correlations between various risk factors no longer held true, at the same time as the liquidity of most markets was reduced substantially. This has had an especially major impact on fixed-income management. Norges Bank therefore stresses that the bank is learning from these experiences and is strengthening its contingency measures related to risk management, including increased efforts to find complementary methods for measuring risk.

With use of external consultants with specialist expertise, the Ministry will reassess the status of risk management and the experiences in active management in Norges Bank. The Ministry will also ask Norges Bank to prepare a business plan with a more detailed description of the main strategies for achieving excess returns. Against the backdrop of the external due diligence and Norges Bank's plan, among other things, the Ministry will in spring 2010 present the Storting with more information and an assessment of whether or to what extent active management of the Government Pension Fund – Global ought to be continued.

In light of its poor performance in 2008, among other things, Norges Bank has implemented a number of changes in its active management of the Government Pension Fund – Global. The bank has established two main areas within its management of fixed-income assets: a portfolio for indexing and rebalancing and a portfolio containing large, illiquid positions. These positions will be reduced, at the latest when the bonds reach maturity. As the bank describes the current management of fixed income assets, the risk associated with the remaining deviation from the fixed income benchmark is linked to positions with substantially reduced tradability. Reduced tradability entails that the bank cannot make major changes in the portfolio in the short term. The Ministry is assuming that for the time being, and with the exception of the positions that are difficult to sell mentioned above, Norges Bank will manage the fixed income portfolio such that the actual portfolio closely resembles the benchmark portfolio.

nes with stricter limits on deviation from the benchmark portfolio along several new dimensions.

Under the current system, the Fund is managed by means of a simplified general framework for active management, supplemented with requirements that Norges Bank must prepare internal guidelines that ensure that the bank as a minimum adheres to internationally recognised standards and methods of risk management for active positions. In the Ministry's opinion, experience acquired over the last three years indicates that a more granular system is required to regulate risk in active management.

The discussion of the results achieved by active management in Section 1.4 points out that active management of fixed income assets was responsible for a large share of the total negative excess return. This must be seen in connection with the fact that Norges Bank's active bond investments have generally been exposed to the same level of underlying systematic risk (liquidity risk and credit risk) (see the discussion in Section 1.4). The active management strategies that have resulted in substantial negative excess return on the fixed income side have not drawn on the limit for their permitted tracking error to the same degree, reflecting that this measure of risk does not sufficiently capture risk linked to events that occur very rarely (but which can have huge consequences when they do occur). The Ministry will consider new requirements intended to limit risk in active management in the form of supplementary risk mesaures. At the same time, the regulations for active management must also necessarily be of a general nature to ensure that the responsibilities ascribed to the governing bodies of the bank are not transferred to the Ministry in practice. Norges Bank has been given a management role with a certain degree of freedom in how this role is executed, and it is neither appropriate nor desirable that this type of activity is subject to detailed regulation and ongoing management by the Ministry.

The National Budget for 2006 described the Ministry's plans to carry out regular due diligences of the Fund, and particularly the bank's risk management, in collaboration with consultants possessing suitable expertise (see the discussion above). To follow this up, Report no. 16 (2007–2008) to the Storting describes the completed due diligence project consisting of an external review of Norges Bank's risk management systems (referred to as the Ernst & Young project). The Ministry is now planning a new external due diligence (see the discussion in Box 1.3).

1.5.3 Proposition to the Odelsting on amendment of the Norges Bank Act

Parallel to this Report to the Storting, the Government is also submitting a Proposition to the Odelsting on a number of amendments to the Norges Bank Act. The Ministry has already described the need for amendments to the provisions in the Norges Bank Act concerning accounting and auditing (see the discussions in Report no. 16 (2007–2008) to the Storting and Report no. 19 (2007–2008) to the Storting). In June 2008, the Ministry circulated a consultation document on this to relevant bodies. In this Proposition to the Odelsting, the Ministry proposes imposing an obligation to keep accounts on Norges Bank pursuant to the Accounting Act. The need for a defined framework for registration and documentation of transactions etc. also suggests that it should be established in law that Norges Bank has a statutory bookkeeping obligation pursuant to the Bookkeeping Act. The Ministry also wants the possibility to lay down in regulations special rules concerning annual accounts, annual reports and bookkeeping for the bank that either complement or deviate from the provisions given in or pursuant to the Accounting Act and the Bookkeeping Act to regulate any special conditions associated with its operations as central bank.

There is broad consensus that the current audit arrangements, whereby the Supervisory Council appoints a Central Bank Auditor who is formally employed by the bank, are no longer satisfactory. The auditor should formally be entirely independent of the bank. In the Proposition to the Odelsting, the Ministry proposes a system whereby the Supervisory Council appoints an external auditor. In the consultative round, the Office of the Auditor General and the Norwegian Confederation of Trade Unions proposed that the Office of the Auditor General should take over the audit of Norges Bank. The Ministry has not been able to endorse this kind of arrangement for several reasons. Firstly, this would, in the Ministry's view, necessitate changes in the system whereby the Supervisory Council is the Storting's supervisory body in relation to the central bank. This system is anchored in Article 75, first paragraph, litra c) of the Constitution, where it is stated that:

> "It devolves upon the Storting to supervise the monetary affairs of the Realm."

The Supervisory Council approves the bank's accounts. It would be unnatural to separate this task

from the task of appointing an auditor. Secondly, it would, in the Ministry's opinion, be unfortunate if the Office of the Auditor General was to perform the financial audit of Norges Bank and also perform performance audits in the Ministry of Finance, in order to assess whether the Government Pension Fund – Global is being managed in accordance with the intentions of the Storting. The bank's audited accounts will be a material basis in connection with the Office of the Auditor General's assessment of whether the Ministry of Finance has managed the Fund in compliance with the intentions of the Storting. If it is the Office of the Auditor General that has audited these accounts, it would then have to judge the Ministry of Finance's management on the basis of accounts it had audited itself. An external auditor chosen by Norges Bank would therefore improve the Office of the Auditor General's ability to undertake an independent audit of the Ministry of Finance's management. On the grounds of these and similar arguments, the Storting decided in 2007 to transfer the responsibility for auditing Folketrygdfondet and the Government Pension Fund – Norway from the Office of the Auditor General to an external auditor chosen by the Ministry of Finance (see Section 13 of the Act relating to Folketrygdfondet and Recommendation no. 77 (2006–2007) to the Odelsting, pp. 1–2).

It would be natural for the Supervisory Council, in its capacity as responsible for the audit of the bank, to lay down an audit programme. This kind of programme would define priorities for the audit, over and above the financial audit, including a plan for so-called certification assignments. A typical certification assignment might be asking for an assessment of the efficiency and effectiveness of the bank's internal control. If the bank had an appointed, external auditor, the Ministry of Finance would be able to enter into dialogue with the Supervisory Council and make suggestions for the audit programme in order to ensure that the Ministry of Finance's follow-up needs vis-à-vis the Government Pension Fund – Global are safeguarded. If the Office of the Auditor General was going to audit the bank's accounts, the Ministry of Finance would be prevented from this as the Office of the Auditor General is also charged with auditing the Ministry of Finance. The Office of the Auditor General cannot audit the Ministry of Finance on behalf of the Storting and at the same time also perform audit tasks that the Ministry has asked the Supervisory Council to have done. An arrangement with an appointed, external auditor would thus serve to strengthen the overall follow-up of the Fund.

The Proposition to the Odelsting also proposes a more precise description of the tasks ascribed to the bank's governing bodies and a clarification of the division between the Supervisory Council's supervisory responsibilities pursuant to the Norges Bank Act, and the Ministry of Finance's follow-up responsibilities pursuant to the Act relating to the Government Pension Fund.

1.5.4 Review of the rest of the framework for management of the Government Pension Fund – Global

For some time now, the Ministry of Finance has been reviewing the regulations with the aim of refining them. The review was motivated by a number of considerations. There is a general need to review the regulations, which show signs of the fact that they have been continuously added to and amended over time, as the Fund has grown in value and complexity. In addition, the decision to invest up to 5 per cent of the Fund in real estate (see Chapter 2) and the evaluation of the ethical guidelines (see Chapter 4) necessitate revision of the guidelines.

The regulations should aim to regulate special risk factors within asset management in compliance with best international practice relating to risk measurement and management. The distribution of responsibility between the operational manager (Norges Bank) and the owner of the assets (the Ministry of Finance) must be clearly defined. The regulations must also ensure that there are clear reporting routines and transparency regarding management. The Ministry is basing its review on industrial and supervision driven standards of risk management.

In connection with the review of the regulations, the Ministry will impose stricter requirements on Norges Bank's management. For example, supplementary limits will be set for risk-taking in active management that go farther than the current upper limit on tracking error. This may entail stricter requirements for risk diversification for the active positions and that risk limits are established for a number of main categories of risk. The Ministry will also consider whether limits ought to be set for leverage and short positions.

The Ministry is aiming to complete its review of the regulations so that a new regulation governing the management of the Government Pension Fund – Global can enter into force on 1 January

2010. See also the more detailed discussion in Chapter 6. Reference is also made to the plans for a review of the active management (see Box 1.3). Any further changes to the guidelines as a result of this review will only be implemented once the Storting has considered the matter.

1.5.5 The Santiago Principles for management of sovereign wealth funds

Through its work in the International Working Group of Sovereign Wealth Funds under the direction of the IMF, the Ministry has contributed to the development of the Generally Accepted Practices and Principles for Sovereign Wealth Funds – known as the Santiago Principles (see the discussion in Report no. 16 (2007–2008) to the Storting and the National Budget for 2009). The Santiago Principles express good principles for management of sovereign wealth funds. For example, they express that the distribution of roles and responsibilities between the players involved must be clear, that the investment policy must be clearly and publicly expressed, and that the Funds should have ethical standards. The principles are to be treated as minimum standards, and the current framework for the Government Pension Fund – Global already satisfies all these standards. However, a number of the principles are only implied in the current regulations for the management of the Government Pension Fund – Global, and in its work on the new regulation on the management of the Fund, the Ministry will seek to ensure that the principles are stated more clearly.

When the Santiago Principles were presented in October 2008, a wish was voiced to explore the possibility of establishing a forum for sovereign wealth funds that could continue to further develop and refine these principles. Norway wants to support this work aimed at building confidence and contributing to the continuation of a stable, open international investment climate and financial markets that function smoothly.

1.5.6 Folketrygdfondet's management of the Government Pension Fund – Norway

Folketrygdfondet was established as a separate company by special statute with effect from 1 January 2008. Report no. 16 (2007–2008) to the Storting described the new framework for Folketrygdfondet's management of the Government Pension Fund – Norway. The new framework implies a clarification of the division of responsibility between the Ministry and the Board of Directors of Folketrygdfondet. The Ministry stipulates general investment limits, whilst the Board of Directors of Folketrygdfondet is responsible for the operational management of the Government Pension Fund – Norway. All the provisions governing the management of the Government Pension Fund – Norway are appended to this Report in Appendix 1.

Risk management and control procedures

The new management framework for the Government Pension Fund – Norway lays down much stricter requirements concerning, among other things, measurement, management and control of risk and reporting than previously. Against this background, Folketrygdfondet has been working on implementing new management and control systems in the management to ensure that the systems for risk management and control satisfy the requirements laid down in the new framework. The requirements are based on the premise that measurement, management and control of different categories of risk follow best international practice and internationally recognised methods. The Ministry expects that most of the work on implementation of new control systems as a result of the requirements laid down in the new framework will be finished during the course of this year.

Accounting rules

In Report no. 16 (2007–2008) to the Storting, the Ministry stated that it would be assessing the need for further regulations containing more detailed provisions about the accounting rules for the Government Pension Fund – Norway. The background for this is that the Act relating to the Government Pension Fund does not contain direct provisions on accounting rules.

Against the backdrop of the need to clarify the accounting rules for Folketrygdfondet and the Government Pension Fund – Norway, the Ministry published Regulation of 10 November 2008 no. 1264, which lays down detailed provisions concerning annual accounts, etc. for Folketrygdfondet including the Government Pension Fund – Norway (see Chapter 6).

The Ministry will present a more detailed assessment of the need to introduce international accounting standards (IFRS) for Folketrygdfondet including the Government Pension Fund – Norway once more experience has been acquired with the new management framework for the Fund.

Part II
Detailed presentation of the management of the Government Pension Fund

2 Investment strategy

The Government has high ambitions for the management of the Government Pension Fund. Work on the Fund's investment strategy aims for the best international asset management practice.

In this chapter we will discuss the fundamental basis for the Fund's investment strategy first, followed by a discussion of the most important areas for development of the strategy, as well as a section that illustrates the Fund's risk through retrospective and forward-looking simulations. Then there are two sections that deal with more operative changes to the investment strategy. First there is a review of recently adopted changes and then there is a discussion of ongoing work and planned changes.

2.1 Foundation of the Fund's investment strategy

What constitutes a good investment strategy will depend on the purpose and characteristics of the Fund, the owner's expectations and attitude towards the rate of return and risk, and views on how the financial markets work.

2.1.1 Purpose and characteristics of the Fund

As mentioned in Section 1.1, the Government Pension Fund is an instrument for general savings that is managed with a view to ensuring a good financial return. The Fund belongs to the people of Norway, and the Storting has resolved that the Ministry of Finance is responsible for the management of the Fund in the Act relating to the Government Pension Fund. Allocations to and withdrawals from the Fund are integrated with the Fiscal Budget. In view of the prospects of continued high petroleum revenues and a responsible fiscal policy, the Fund is set to grow and have a very long investment horizon.

The investment horizon is of great importance to the investment strategy, including the tolerance for variations in the value of the Fund in the short and long term, as well as work on responsible investments.

In addition to the Fund being large and having a long lifespan, it is not, unlike traditional pension funds, earmarked for specific liabilities. The capital of the Fund is fully funded by equity. In other words, the State has not borrowed to raise capital for the Fund. There is little risk that the owner of the Fund will make large withdrawals over a short period of time. Generally speaking, the Fund can therefore be said to have a greater risk bearing capacity than do other comparable funds. And while many investors may have a weaker capacity and willingness to take market risk after a period of negative returns, this will not be case for the Government Pension Fund to the same extent.

There is broad political support for the Fund's investment strategy, including the level of risk stipulated for the Fund's overall investments. In addition, there is broad political consensus that the Fund shall be broadly diversified, with a clear financial objective, as well as an ethical framework for responsible management of the Fund. The support for the investment strategy of the Fund provides a democratic underpinning, and represents an important contribution to actually maintaining the strategy over time.

The Fund is characterised thus as having a high risk-bearing capacity, a very long investment horizon and broad ownership in several thousand companies in a large number of countries. Due to the Fund's long-term perspective and breadth, i.e. the Fund's nature of being a universal owner, it is dependent on a good and sustainable global development; economically, environmentally and socially; to achieve a solid return over time. In addition, the performance of the Fund is dependent on well-regulated and well-functioning marketplaces, where the prices give the right signals, and well-managed companies where the management acts in accordance with the long-term interests of the owners. The very weak performance of the financial markets in 2008 can be attributed, for example, to an underlying failure in these fundamental areas. Work on integrating issues related to corporate governance, the environment and social factors is accordingly important to safeguard the financial interests of the Fund (see Chapter 4).

Investment activities are about assuming carefully calculated risk in order to achieve a return on invested capital. The challenge is therefore to facilitate the making of good investment decisions, at both the general and the more detailed level. The objective of the investments is to achieve the maximum possible return with a moderate level of risk. This can be formulated as maximising the overall return (measured in international currency for the foreign portion of the Fund and in Norwegian kroner for the domestic portion), taking into consideration:

- *Market risk that is acceptable to the owners*, who are the Norwegian people as represented by the political authorities. The Storting's support in 2007 of the Government's plans to increase the equity portion of the Government Pension Fund – Global gradually to 60 per cent is an important anchor for the assessment as to what constitutes acceptable market risk for the Fund. A broad underpinning has contributed to the successful maintenance of the Fund's long-term investment strategy, even under very demanding market conditions in 2008. This establishes a good foundation so that the Fund can achieve a good return over time.
- *Responsible investment and the Fund's ethical guidelines.* The aim of this work is to promote the financial interests of the Fund in the long term and avoid at the same time that investments are made that represent an unacceptable risk of the Fund contributing to unethical actions (see the discussion below).
- *Good control of operational risk*, i.e. the risk of financial loss or loss of reputation as the result of defective internal processes, human error, systems error or other loss caused by external circumstances that are not a consequence of the market risk associated with the portfolio.
- *Size and characteristics of the Fund.* These factors impose certain limitations on the opportunity to make swift changes to the general investment strategy and to active management practice, since a large player may influence the market prices and thereby make certain investments less profitable. On the other hand, the size of the Fund will represent an advantage in other contexts. Economies of scale imply, for example, that the costs incurred in spreading the investments of the benchmark portfolio represent a small fraction of their value. The size also entails an opportunity for effective ownership engagement with low costs in relation to the size of the Fund. The Fund's characteristics provide a good opportunity for having a long-term perspective on the investment activities. The size and long-term perspective of the Fund also make it easier for prioritised and focused messages to the regulatory authorities and companies in which the Fund is invested to have an impact.
- *Fundamental governance principles.* The actual organisation of the activities should be characterised by a clear distribution of responsibility in order to stimulate good decisions. Consequently, decisions concerning the management of the Fund have to be based on knowledge and professionalism. In addition, openness is a prerequisite for maintaining confidence in the current model for the management of the Fund, while making, at the same time, an important contribution to ensuring well-functioning financial markets – inasmuch as it means that there is no major uncertainty on the part of other market participants when it comes to the modus operandi of a large participant like the Government Pension Fund.

The Fund as a responsible investor

The investment strategy of the Government Pension Fund is formulated with a view to maximising the overall return on the Fund's assets. The goal of good financial returns is closely linked to the wish to be a responsible investor. This responsibility entails ensuring that the Fund is managed in a way that promotes well-functioning, legitimate and efficient markets and sustainable development in the broadest sense. A broadly diversified investor like the Government Pension Fund – Global (often referred to as a universal owner) will benefit from making sure that good corporate governance and environmental and social issues are safeguarded. It follows from the task of manager of the public's funds that widely shared ethical values must be taken into account. In some cases, the concerns of ensuring long-term financial returns and taking widely shared values into account will coincide, but not always. For example, the Fund will not invest in companies that are in gross breach of fundamental ethical norms, regardless of the effect this will have on returns.

The Government aims for the Government Pension Fund – Global to be managed responsibly in a way that ensures good corporate governance and consideration of environmental and social issues. The Government requires that responsible management of the Fund is carried out in

such a way that support is ensured among the population of Norway and legitimacy among market players. One aim of the responsible investor role is to promote sustainable development in economic, environmental and social terms. This is regarded as a precondition for good financial returns over time. The Government wants the Government Pension Fund – Global to promote good corporate governance in companies the Fund has an ownership stake in and to encourage the companies to respect fundamental ethical standards. The Government will continue to refrain from investing in companies that are in serious or systematic breach of fundamental ethical norms. To this end, it is important to monitor and contribute to development of best practice in the area of responsible investment. In keeping with the general rules that apply to the management of the Government Pension Fund – Global, priority must also be given to transparency, predictability and proper procedures in the area of responsible investment.

To meet these goals, the Ministry wants to integrate the goals of good corporate governance and consideration of environmental and social aspects into all parts of the management to a greater extent than they are at present (see the detailed discussion in Chapter 4). However, the Fund is not capable of safeguarding all the ethical commitments we have as a nation. The State has other political, regulatory and financial instruments at its disposal that in many cases will be better suited to ensuring fulfilment of these kinds of obligations than laying down constraints on the management of the Fund. We have the greatest chance of exerting a positive influence, if the focus and instruments target the role the Fund has as a financial investor. At the same time, the Fund is not intended to act as a development-aid or foreign-policy instrument.

For large, broadly diversified investors with a long-term investment horizon, the so-called universal owner hypothesis provides grounds for the promotion of integrating consideration of environmental and social aspects and good corporate governance (collectively known as ESG factors) into the management. One company shifting costs onto the environment, which can increase this company's returns in isolation, may have a negative impact on other companies in the portfolio. This can result in a weakening of the overall portfolio. This effect is particularly strong for a "universal owner", i.e. an owner who has interests in a broad selection of companies. In a global competitive economy, a company that lowers its requirements with respect to environmental management and working conditions can win competitive advantages in relation to companies that maintain high environmental standards and working condition requirements. A universal owner like the Government Pension Fund – Global will thus be served by national and international regulations that ensure fair competition and maintain high standards.

As an extension of this reasoning, the integration of ESG consideration into financial management can also be underpinned by a view that market regulation alone cannot ensure a good balance between different social considerations. For example, the limited liability that follows from the structure of a limited liability company, in relation to the opportunities for gains that lie in the company acting in a certain way, leads to social or environmental considerations not being safeguarded satisfactorily without special measures. An example here would be companies that risk causing environmental damage through their operations, which could have costly consequences that are not borne by the company itself.

2.1.2 Views concerning how the markets work

Financial theory is a rather young subject, and pricing in the financial markets does not adhere to established laws of nature. This means that a robust investment strategy has to be based on fundamental attitudes and assumptions as to how the financial markets work. The investment strategy of the Fund is premised on the following fundamental perspectives:

– *Market efficiency:* The Ministry assumes as a point of departure that the financial markets are largely efficient, both at any given point in time and over time. New information is reflected swiftly in the prices of financial assets and the prices are generally "correct". Studies of historical returns have identified so-called statistical irregularities that indicate inefficiency. However, it is uncertain whether such findings can be used to predict market movements in the future, so that a higher risk-adjusted return can be achieved than otherwise possible. See Box 2.1.
– *Diversification:* Since the returns between different investments do not move in step with each other, a better trade-off between return and risk can be achieved by spreading the investments more widely. This is the back-

Box 2.1 Academic studies of market efficiency and active management

In order for the financial markets to fill their role and contribute to an efficient allocation of resources, it is a prerequisite that the markets have information-efficient pricing of financial assets. This means that the prices reflect the information available on the companies' future earnings and the market's required rate of return for such investments. Efficient resource allocation can be achieved then, and this means that investments are made where the highest risk-adjusted return can be achieved and where the risk associated with such investments is borne by those that have the greatest tolerance for risk.

From a theoretical perspective, there is reason to believe that the financial markets are reasonably efficient. A large number of the players are active on the financial markets for the purpose of maximising the returns on their investments. The competition is hard and the reward systems in the financial sector attract many of the most skilled people. Information on the companies' future outlook is relatively readily available and there is little reason to believe that some investors have better access to information and analysis tools than other investors. Therefore the financial market is said to be essentially a free competition market. In such a market competition forces the profit down to a level where a return is achieved over time that compensates precisely for the risk borne, and this means that it would be difficult for an investor to actively manage investments and achieve a return in excess of the ordinary market return.

Financial theory operated originally with three forms of efficiency – weak, semi-strong and strong – which was closely linked to the type of information reflected in the prices.

In an article from 1970, Fama pointed out that the following three conditions were adequate, but not necessary, for market efficiency: 1) no transaction costs, 2) all information is available free of charge, and 3) all the players agree on the importance of the information with respect to the current price and spread in the future price.

Grossman and Stiglitz (1980) pointed out that adequate profit opportunities (inefficiencies) had to exist to compensate for the trading costs and costs associated with the collection and analysis of information. This is necessary for the existence of incentives to collect information on the companies and carry out information-based trades, which are prerequisites for a well-functioning market. A more modern variant of the efficiency hypothesis is therefore that investors cannot achieve an extraordinarily good return after an adjustment is made for the costs related to the collection and analysis of information and trading costs.

Researchers in this area are often divided into two main camps: efficiency theorists and behavioural theorists. The first camp assumes that the market players have rational expectations and that the pricing in the markets is efficient. The second camp believes that the players' adaptation is not always marked by rational choices and that the market prices are driven by various psychological mechanisms.

Academic studies indicate that future returns can be predicted to a certain extent on the basis of historical rates of return and indicator variables (such as price/dividends and price/earnings). Behavioural theorists explain this by the fact that the investors' adaptation is driven by various non-rational mechanisms. The efficiency theorists point out on their side that the predictability cannot be exploited to achieve an extraordinarily high return after the transaction costs are taken into account, that the predictability is not stable over time, that there are several problems related to the methods used for the statistical tests, and that the predictability can be linked to time variation in the required rate of return.

One point that is made is the risk that reported studies do not provide a satisfactory picture of reality. When an adequate number of researchers work actively with specific data, it can be expected that structures are identified that are actually random and sample specific. Reference is also made to the fact that studies that indentify unusual findings are often preferred for publication, which can lead to publication bias since studies confirming rationality and efficiency are not published as often as studies that identify efficiency violations.

Box 2.1 (cont.)

Fama (1991, 1998) contains a review of event studies and market efficiency. He points out that more studies are published that identify irregularities or deviations in relation to what would be expected in efficient markets. Fama's analyses indicate, however, that these studies do not provide grounds for rejecting the market efficiency hypothesis, and point out that the irregularities can appear to be driven by chance events, which is what would be expected in efficient markets. In addition, the results are not robust, because the irregularities disappear when simple changes are made to the measurement methods.

If the market prices are determined by irrational investors, regularly deviate from fair value and it is easy to identify systematic patterns in the development of the returns, then it would be expected that professional portfolio managers of mutual funds, pension funds, insurance companies, etc. would have achieved an extraordinarily high return. Cochrane (1998) points out instead:

> "Some mutual funds seem to outperform simple market indexes, even after controlling for risk through market betas. Fund returns are also slightly predictable: Past winning funds seem to do better than average in the future, and past losing funds seem to do worse than average in the future. For a while, this seemed to indicate that there is some persistent skill in active management. However, multifactor models explain most fund persistence: Funds earn persistent returns by following fairly mechanical styles, not by persistent skill at stock selection. Again, these statements are not dogma, but a cautious summary of a large body of careful empirical work. (…)"

On average the returns on mutual funds have been lower than the return that would have been achieved by investing in index funds (Malkiel 2007, Sharpe 1991). French (2008) estimates the costs related to active management relative to pure index management in the US equity market to be 0.67 per cent per year for the period from 1980 to 2006. The article points out at the same time that society's active management costs would be lower than this, since active managers play an important role by contributing to price discovery and better resource allocation. After adjustment for survival bias in the base data, tests show that it is not probable that funds that do well in one year perform correspondingly well in subsequent years (Malkiel 2007).

In financial theory a distinction is also made in some cases between macroefficiency and microefficiency. Macroefficiency concerns whether the market manages to correctly price broad asset classes, for example, whether the pricing of the aggregate equity market is reasonable in relation to the companies' aggregate future earnings and shareholders' required rate of return, while microefficiency concerns whether various securities are priced reasonably in relation to each other. Samuelson (1998) argued that the equity market was microefficient, but macroinefficient. Shiller (2003), who is a critic of the market efficiency hypothesis and one of the key academics behind the development of behavioural finance, also expressed that support could be found in the literature that the markets were reasonably microefficient.

Malkiel (2003), who defines efficient markets as markets where investors cannot achieve a return over the average without assuming above-average risk, argues for his part that the markets can be efficient in this sense even if the price level is set incorrectly in general (such as in equity bubbles). It is pointed out in particular how sensitive the price level is to changes in the investors' required rate of return. We also find this argumentation with Cochrane (2004).

When evaluating to what extent a violation of efficiency provides grounds for successful active management aimed at achieving an extraordinary risk-adjusted return, academics also point out the challenges related to incentives. It is generally demanding to ensure that a manager's interests are aligned with the interests of the owner, and at the same time a manager has a stronger interest to engage in active management than the owner.

ground against which the benchmark portfolio of the Government Pension Fund is spread across a broad range of geographical regions, countries, sectors and companies. See Box 2.2.

- *Risk premium:* In accordance with the generally accepted theory and practice, a higher average return is expected on equity investments than on investments in fixed-income securities, because the risk associated with equities is higher. However, the magnitude of this excess return remains uncertain. See Box 2.3.
- *Active management:* With financial markets that are generally efficient, it is difficult for active managers to achieve a return in excess of the market return. As discussed in Section 1.2.1 there are also certain considerations that make it appropriate to allow a certain degree of deviation from the benchmark portfolio. The framework for the Government Pension Fund has accordingly been formulated so that the risk associated with the Fund over time largely follows the benchmark portfolio that the Ministry of Finance has defined. Reference is also made to the planned efforts to evaluate active management. See Box 1.3.
- *Manager and market liquidity:* Experience shows that the selection of, and control over, the manager is of greater importance if portions of the investments are made in less liquid markets, where it is not easy to trade securities without influencing prices. It will normally be relatively straightforward for an investor to achieve the market return in liquid markets, while performance in illiquid markets depends, to a significantly higher extent, on the skills of the manager. It will therefore be necessary, when transferring the Fund's investments from liquid to less liquid markets, to attach more weight to the quality of control systems and the structuring of incentives, for example in relation to fees.
- *Responsible investments:* The integration of so-called ESG considerations into the management is partly due to the possibility of market failure that is in the financial interest of the Fund to counteract. Good corporate governance to help ensure that companies operate in accordance with the long-term interests of owners, and efforts to promote well-functioning and well-regulated markets, are examples of this. As a long-term and broadly diversified investor, sustainable development in the long term will also be decisive.
- *Time-critical decisions:* The types of changes to the Fund's investment strategy that are submitted to the Storting are subject to a decision-making process which contributes to ensuring a robust strategy. The decision-making process is, at the same time, time-consuming and therefore less suitable for decisions where time is of the essence. When it is assumed that the financial markets are largely efficient (see the discussion in Box 2.1), it is uncertain at the same time to what extent a greater number of time-critical decisions in the Fund's investment strategy would strengthen the financial performance. The size of the Fund also limits how swiftly major adjustments to the composition of the Fund can be implemented without the market repercussions imposing considerable transaction costs on the Fund. Changes to the general investment strategy of the Fund will therefore not be based on an expectation that periods where markets or market segments subsequently emerge as "cheap" or "expensive" can be defined in advance.

On the one hand, the desire to seek consensus on the investment strategy of the Fund may reduce the return on the Fund. This will, for example, be the case if the Fund is systematically late when it comes to investing in new market segments or in markets in which it turns out, in retrospect, that investors could have reaped a premium by making early investments.

On the other hand, the desire for consensus may also represent an advantage in purely financial terms, if it results in the strategy being based on fundamental views concerning the market. Broad-based support for the strategy means that the strategy can be maintained in times of unrest, which is an important contribution to avoiding the classical trap of "buying the top and selling the bottom".

The Ministry reports to the Storting on a regular basis, with the primary emphasis being on the annual Report to the Storting in the spring. One purpose of the annual reviews of the strategy is, from the perspective of the Ministry, to serve the need for maintaining the strategy. The strategic choices shall be made at the same time on the premise that such choices are to remain unchanged for a long period of time. More frequent reviews of the investment strategy are therefore not considered to be appropriate.

2.2 Exploitation of the Fund’s characteristics

2.2.1 Fundamental features

Many important choices have been made with respect to the investment strategy for the Government Pension Fund in recent years. A risk tolerance level has been established for the Fund’s strategic benchmark portfolio through stipulation of the Fund’s equity portion, and this risk level will remain broadly unchanged in the coming years. The Government Pension Fund – Global represents about 95 per cent of the overall Fund, and this share will increase with the inflow of future petroleum revenues. It will therefore be natural that it is the evolvement of the strategy for the Global part of the Fund that will be the most extensive.

In the future the Ministry’s work on developing the investment strategy for the Government Pension Fund – Global will be based on how the trade-off between return and risk can be improved by further diversification of the investments. Exploiting the characteristics of the Fund better without any significant changes to the overall risk level is an additional objective. The investment strategy will be developed accordingly through a number of additional, smaller decisions.

Some of these decisions will be of a more technical and operational nature, such as questions related to the continued phase-in of the increased equity portion, and the formulation and establishment of control systems for new asset classes, such as real estate. Other decisions may entail minor adjustments to the investment strategy, but without them making any significant changes to the Fund’s overall risk or being expected to conflict with the role of the Fund as a responsible investor. As mentioned in Report no. 16 (2007–2008) to the Storting, this type of decision falls within the scope of the general framework as defined on the basis of deliberations by the Storting. Decisions relating to the investment strategy that are more comprehensive in scope, and that are expected to have a material impact on the risk associated with the Fund, will be submitted to the Storting the same as before prior to the implementation of any changes.

The sources from which the return and risk associated with the Fund have originated thus far are related primarily to the fact that a market return has been reaped with a benchmark portfolio consisting of relatively liquid equity and bond markets. The benchmark portfolio has been gradually expanded and diversified.

It is appropriate for future work on the investment strategy to focus on evolving the strategy so as to exploit the special characteristics of the Government Pension Fund in the best possible manner, see the discussion above. Natural evolvement of the investment strategy may entail further diversification and investments that benefit from the Fund’s size, long-term perspective, and ability to hold less liquid assets. It is particularly pertinent to consider changes to the strategy that can provide compensation in the form of somewhat higher expected returns in exchange for reduced tradability (liquidity). These key topics for evolvement of the Fund’s strategy are discussed in more detail in Sections 2.2.2–2.2.4 below.

A comparison of the investments in the Government Pension Fund – Global with other large funds internationally shows that these funds often have a lower percentage of nominal bonds and that parts of the capital are often invested in alternative asset classes such as real estate, unlisted equities, etc. Evolvement of the investment strategy in accordance with what has been outlined above may result in a distribution of the asset classes that is more like the composition of these funds.

A basic premise of the evolvement of the strategy will accordingly be the need for adequate control of risk other than market risk, such as operational risk. Evolvement of the strategy must also take into consideration the Fund’s role as a responsible investor, and the significant need to build up competence that will arise if new investment areas are chosen. Another requirement will be the need for the follow-up of the operational management to help ensure that the interests of the managers are aligned with the objective of the Fund’s general investment strategy.

2.2.2 Better risk diversification

Box 2.2 shows how greater risk diversification can improve a portfolio’s relationship between return and risk. For a long-term investor such as the Government Pension Fund, it is the effect of risk diversification over long investment horizons that is of the greatest importance. The estimates for the expected return, risk and correlations in Tables 2.2 and 2.3 in Section 2.3.2 are thus adapted to a long horizon. Over shorter investment horizons, such as one year, other estimates

Box 2.2 Diversification and measures of risk

The ratio between the expected return and risk for a portfolio can normally be improved by including a greater number of assets in the portfolio. The different assets not fluctuating completely in step with each other is a prerequisite for improving the ratio. The ratio can, however, only be improved to a certain point, at which the portfolio is said to be efficient or optimally diversified. An efficient portfolio is characterised by the expected return being the highest possible for a given risk (alternatively, the expected risk being the lowest possible for a given return). There are of course many efficient portfolios, which collectively form a so-called efficient frontier.

To illustrate the effect of diversification, we can use two asset classes as our point of departure: equities and bonds. A portfolio consisting exclusively of bonds will have a particular expected return and risk. If the bond portfolio is well-diversified, through a global bond index that covers the most important bond markets, for example, then this portfolio in itself can be close to or on the efficient frontier for global bond markets.

The same applies to a globally diversified portfolio of equities.

Even if individual bond and equity portfolios may be well-diversified, the ratio between the expected return and risk can, however, be improved further by constructing a portfolio consisting of both equities and bonds. As mentioned, it is a prerequisite that the returns on the two portfolios are not expected to vary completely in step.

The global bond and equity portfolios of the Government Pension Fund – Global, where the strategic weights are 40 per cent bonds and 60 per cent equities, are a real-life example. This gives a more well-diversified portfolio than is represented by the two sub-portfolios individually.

Based on the long-term estimates for the expected real return, volatility and covariation of these two portfolios, which are stated in Section 2.3.2, the curve illustrated in Figure 2.1 can be constructed. This curve illustrates the opportunity set for the expected real return and volatility when the two portfolios are combined with different weights in a global portfolio of equities and bonds. The fact that the curve is concave (bends downward) shows that diversification is beneficial, in the sense that for a given level of expected return, the expected volatility is lower than the weighted average of the volatilities for bonds and equities.

If a risk-free investment exists, a unique optimal portfolio can be identified on the curve as the tangential point of a straight line from the risk-free rate of interest on the y-axis where the expected volatility is zero (see Figure 2.1). This line is called the capital market line (CML).

This unique portfolio on the curve can be calculated. If a risk-free real interest rate of 2 per cent is assumed and the assumptions in Section 2.3.2 are applied, the result of the analytical formula shows that it is optimal to have around 30 per cent in bonds and 70 per cent in equities. These weights are not far from the strategic weights in the benchmark portfolio for the Government Pension Fund – Global (of 40 and 60 per cent, respectively). However, it is important not to attach too much importance to this, since the solution is dependent on the risk and return assumptions in Section 2.3.2, and since the risk-free real interest rate does not exist in practice for long time horizons.

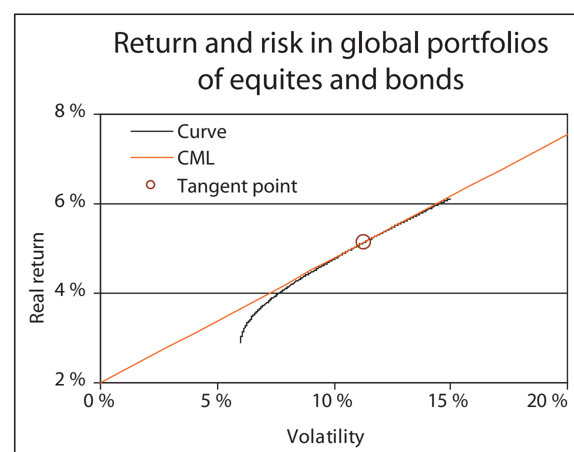

Figure 2.1 Expected real return and risk for an equity and bond portfolio

Source: Finansdepartementet

Box 2.2 (cont.)

Volatility, which is a measure of risk, is the standard deviation of the rate of return. If we assume a risk-free real interest rate of 2 per cent and apply the assumptions in Section 2.3.2, the so-called Sharpe ratio can be calculated for the portfolio of bonds and equities as a function of their weights in the portfolio. The Sharpe ratio is the ratio between the expected real rate of return less the risk-free real interest rate and the expected volatility. The Sharpe ratio is thus a measure of the trade-off between the expected real rate of return beyond the risk-free rate of interest and volatility. The tangential point in Figure 2.1 is an example of an optimal portfolio that has the highest attainable Sharpe ratio (given the aforementioned assumptions).

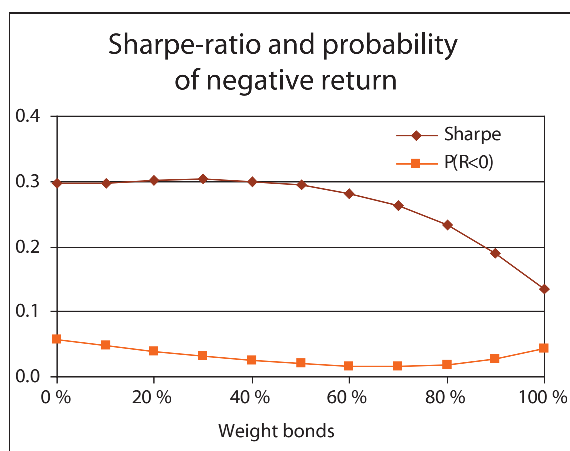

Figure 2.2 Sharpe ratio and the probability of a negative real return as a function of the percentage of bonds in the portfolio

Source: Ministry of Finance

Figure 2.2 illustrates how the Sharpe ratio varies with the weights in the portfolio (given here by a bond weighting ranging from 0 to 100 per cent). The Sharpe ratio is highest for a bond weight of around 30 per cent, which represents the tangential point in Figure 2.1. This portfolio gives the best trade-off between the expected real rate of return and risk.

There are, however, other measures of risk, which include the risk of a negative return or large losses over a specific period of time. Figure 2.2 shows an example of such a measure, defined as the probability of a negative real rate of return over an investment horizon of 15 years, illustrated by P(R<0) in the figure. It should be noted that the portfolio that is optimal based on the criterion of the highest possible Sharpe ratio (tangential portfolio in Figure 2.1 with around 30 per cent bonds) does *not* minimise the probability of a negative real rate of return over a period of 15 years. The portfolio that minimises the probability of a negative real rate of return in Figure 2.2 has a bond allocation of 60 to 80 per cent.

Another measure of the risk of loss, or downside risk, is the lowest rates of return that are expected to occur with a given probability over a given period of time. This measure is a percentile measure that has similarities with the Value-at-Risk measure, which is used a great deal for the management and control of financial risk.

What measures of risk an investor attaches the greatest importance to will depend, for example, on the investor's risk preferences and whether the assumed rate of return distribution is normally distributed.

might apply, which may typically reflect the current market conditions. It is well-known, for example, that the correlations between the returns of the various asset classes vary over time, and under financial crises such correlations will often increase significantly. The year 2008 is an example of this. With the exception of government bonds, which yielded a very good return and had thus good risk diversification characteristics, all the other asset classes fell substantially in value.

With long-term (expected) return characteristics as its point of departure, the Ministry of Finance has formulated an investment strategy that aims at diversifying the benchmark portfolio of the Government Pension Fund – Global. This has taken place gradually after extensive studies.

The increase in the strategic equity portion from 40 to 60 per cent is expected to result in a higher real return on the portfolio over time, see Report no. 24 (2006–2007) to the Storting. At the same time the annual volatility is expected to increase since equity returns fluctuate more than bond returns. The ratio between return and risk, measured by the so-called Sharpe rate, is

expected, however, to increase a little (see Figure 2.2).

The expansion of the benchmark portfolio in recent years to include new asset classes, such as non-government guaranteed bonds, shares in small-cap companies, shares in new emerging markets and real estate, can be illustrated in a figure such as 2.1 by moving the curve – the efficient frontier – up. The background for this is the fact that the returns on the asset classes are not expected to vary in step with each other. It is possible then to establish a set of portfolio weights that increase the expected return without changing the expected risk (alternatively that the expected risk is reduced without changing the expected return). The desire to improve this ratio will also be the point of departure in the future for the evaluation of new segments of asset classes for the Fund.

2.2.3 Multiple risk premiums

The Government Pension Fund – Global is a broadly diversified fund. This is in accordance with the most important recommendation from modern portfolio theory. Security specific, or non-systematic, risk is not accompanied by a higher expected return, and it does not, therefore, make much sense for a global investor to bear this type of risk. Attention is directed, therefore, to diversification to eliminate non-systematic risk, which one does not get paid for, and reaping instead premiums associated with systematic risk.

Box 2.3 provides a more detailed review of some known forms of systematic risk premiums to which investors often seek exposure. The most important and well-known is the general equity market premium, but there is also statistical evidence of special risk premiums in the equity market associated with small-cap companies, value companies and so-called momentum effects. Many people will also point out that there is a systematic risk premium associated with investments in emerging markets and real estate, as well as a risk premium associated with liquidity variations. Below is a review of how we have evaluated some of these risk premiums in connection with the management of the Government Pension Fund – Global. Reference is also made to Norges Bank's report on the management of the Government Pension Fund – Global in 2008, where there is a discussion of the active management's exposure to such risk factors.

Equity premium: The Fund's benchmark portfolio has undergone several changes during the history of the Fund, the greatest and most important of which in recent times was the decision in 2007 to gradually increase the equity portion from 40 to 60 per cent. The expected return in the equity market is higher than the bond market, because the systematic risk of equities is higher. It is difficult to estimate the size of this equity premium, but the Ministry's projections assume 2.5 percentage points (see Table 2.2).

Small-cap companies: A decision was made to include small-cap companies in the Fund's benchmark portfolio in 2007. The reason for this was the fact that small-cap companies represent an important segment in the so-called global market portfolio, which consists of all financial assets (equities, bonds, real estate, infrastructure, etc.). An additional diversification benefit is achieved by investing in small-cap companies. In accordance with the discussion in Box 2.3 concerning risk premiums, it can also be argued that such investments give a risk premium beyond that which follows from the general market exposure. During the period from 1998 to 2008, the return on investments in small-cap companies was significantly higher than that of large-cap companies.

Value companies: Typical value companies can be found among both large-cap and small-cap companies. With the inclusion of small-cap companies in the benchmark portfolio we achieved at the same time a portfolio with the same exposure to value companies (and growth companies) as the exposure that the world's equity markets have to these factors.

Emerging markets: In 2008 a decision was made to expand the benchmark portfolio to include all the emerging stock markets in the FTSE equity indexes ("advanced emerging markets and secondary emerging markets"). This expansion resulted in further diversification in the Fund's investments and exposure to the growth potential of emerging economies. The performance of emerging stock markets is particularly sensitive to global and national real economic and financial crises. In global crises very low returns in emerging stock markets and reduced consumption in the rest of the world will coincide. This makes investments in emerging stock markets systematically risky for investors. In well-functioning markets it would be expected that this risk would be compensated for in the form of a special risk premium for such investments. Empirical surveys also indicate that there

is a liquidity risk premium associated with investments in emerging stock markets. During certain periods the returns in emerging stock markets have been substantially higher than in developed markets. At times of crisis the opposite has been true.

Real Estate: Real estate represents a substantial portion of the global market portfolio, and comparable funds have substantial investments in this asset class. In 2008 a decision was made to invest up to 5 per cent of the Government Pension Fund – Global in real estate. It was pointed out that such investments may give better diversification of risk in the Fund, and that real estate as real assets will provide better protection of the real value of the Fund in the long term. In addition, it was emphasised that the Fund could achieve a higher return if it were exposed to a priced real estate factor and by reaping a liquidity risk premium.

Liquidity: Somewhat simplified, liquidity is a measure of how costly it is to trade a security. Sources of illiquidity include transaction costs (such as broker fees and costs related to the processing of orders) and market impact costs. This means that the purchase or sale in itself is of importance to the price that has to be paid for the securities. In addition, there is the fact that liquidity costs vary over time, and typically rise significantly during periods of market unrest, which gives rise to a risk premium (see Box 2.3). Investors who do not need to sell their securities are better equipped to reap liquidity risk premiums than the average investor. Decisions to expand the benchmark portfolio for the Government Pension Fund – Global to include small-cap companies, emerging stock markets and real estate have partly been based on a desire to reap a liquidity premium.

The average investor in the securities markets must by definition hold the market portfolio. This means that the average investor's portfolio has the same percentage of equities, same percentage of real estate and same percentage of bonds, etc., as the market portfolio. By investing in the global market portfolio, the same exposure to priced risk factors (equity market, small-cap companies, value companies, emerging economies, real estate, liquidity) as the average investor is achieved.

An important issue is whether one is different from the average investor by, for example, having a different investment horizon or risk tolerance. If the answer is, for example, that one is less sensitive to recessions, then the portfolio should be weighted more towards the recession factors than the average investor. This can mean that the benchmark portfolio will be composed so that it contains a greater percentage of small-cap companies, a greater percentage of value companies, a greater percentage of emerging markets and more exposure to the liquidity factor than the market portfolio.

For the Government Pension Fund – Global the question is whether the risk tolerance is such that increased exposure to priced factors gives an expected excess return that more than compensates for the costs associated with increased future variation in our consumption opportunities. The Fund does not yet have a strategy of substantial exposure to real estate, infrastructure, unlisted equities and portions of the bond market, and it deviates accordingly from the average investor on these points. Work has started to build up a real-estate portfolio, but this will take time. In other areas, the aforementioned issues are under evaluation (see the discussion in Section 2.5).

2.2.4 Exploiting the Fund's long-term investment horizon

Work on the investment strategy for the Government Pension Fund – Global is based on long-term analysis in accordance with the Fund's long life. The investment horizon is, under certain assumptions, of great importance to the investment strategy, including the tolerance for variations in the value of the Fund in the short and long term.

If we go back in time to the development of the capital asset pricing model in the 1960s, the clear recommendation was that the optimal portfolio had the same composition for all investors and that it was identical with the market portfolio. The portfolios of the various investors only deviated from each other with regard to what percentage of the total assets were invested/borrowed at a risk-free rate of interest and what percentage was placed in the risky portfolio. The investment horizon was of no significance in this model.

The original theory was based on three assumptions that were problematic in practice:

– The simplification that individual investors are only interested in the portfolio's expected rate of return and the standard deviation of this rate of return. This is only consistent with a certain type of risk tolerance among the investors

Box 2.3 Risk premiums

The risk that remains in a well-diversified portfolio is referred to as systematic risk, while the diversifiable risk is referred to as security-specific or idiosyncratic risk. The systematic risk reflects the inherent uncertainty of the economy. Investors cannot diversify away economic downturns, credit crunches, inadequate liquidity and market collapses, etc. An investor can, however, refrain from investing (or only invest a smaller portion) in securities such as equities, for example, which fall relatively more in value in bad times.

Since most investors are risk adverse, and because systematic risk is inextricably associated with investments in securities, the investors demand compensation for this risk in the form of a higher expected return. Important insight from the theory indicates that the required rate of return for an equity or bond is linked to the investment's contribution to the portfolio's systematic risk and not the risk of the security in isolation.

A key problem is how to measure the contribution to systematic risk by an investment in a security. In the first (2-period) models that were developed in the mid-1960s, the financial theorists assumed that the systematic risk of a security follows the covariation between the return on the security and the return on the market portfolio, measured by the so-called beta. Securities with a beta greater than one are more risky than the market in general, and they will have a correspondingly higher required expected return than the required rate of return for the market portfolio.

In the 1970s a consumption-based capital asset pricing model was developed, in which it was assumed that investors desire stable consumption over time and that the potential variations in future consumption at a given point in time also imposes a cost on the investor in the form of uncertainty concerning the level of future consumption. Securities that normally have a high rate of return when future consumption is low are worth more than securities that have a low rate of return when future consumption is low. This is due to the fact that securities for which the rate of return is negatively correlated with growth in consumption contribute to a reduction in the variation (risk) associated with consumption and, therefore, hedges consumption.

The original capital asset pricing model can be operationalised relatively readily. The definition of systematic risk is unambiguous and relatively easy to calculate. This model is also intuitive. The greatest weakness is the fact that it has been derived from a set of fairly unrealistic assumptions, and it has been proven that it does not provide a particularly good description of reality. It is unfortunately the case that different market betas do not explain much of the difference in the rates of return between different types of equities, for example. The consumption-based capital asset pricing model from the end of the 1970s has not proven to be an empirical success either.

The capital asset pricing model does not, for example, take into account the following:

- Small-cap companies have proven to outperform large-cap companies with regard to their rate of return, and this cannot be attributed to differences in the companies' market betas.
- The capital asset pricing model does not explain either why companies with a high book equity relative to their market value (value companies) have had a higher average rate of return than companies with a low book equity relative to the market value of their shares (growth companies).
- Empirical studies also show that companies that have had a high rate of return over the last 12 months have had a tendency to have a high rate of return during the subsequent 12-month period. This momentum effect cannot be explained either by different market beta exposure.

The first two effects (small-cap companies and the value effect) are linked in financial theory to the consumption-based capital asset pricing model. The intuition is that small-cap companies and value companies are companies that are more exposed in times of crisis. In economic downturns it is assumed that it is easier for companies like this to go bankrupt or suffer severe financial problems than other companies. The rate of return for such companies will thus be particularly poor under such market conditions and significantly poorer than what the companies' market beta exposure would indicate. Such companies have accordingly a particularly poor rate of return during periods when the level of consumption is already low (and the marginal utility of consumption is high). Instead of securing stability, they contribute to reinforcing the fluctuations in consumption. In accordance with the reasoning from the consumption-based capital asset pricing models, the expected return on such equities will be higher than that of the average equity. Many theorists believe that this is a credible explanation.

Box 2.3 (cont.)

No corresponding theory to explain the momentum effect has been developed. Some behavioural theorists explain the momentum effect by the investors underreacting to good company news, for example.

There is some evidence in empirical studies supporting the existence of a uniquely priced risk factor linked to direct investments in real estate, even if the data makes such studies difficult. In the studies that have been made, it is stressed that this factor contributes to explaining the rate of return on real estate beyond what follows from equity and bond factors. Unfortunately these studies do not indentify this factor in more detail. It emerges thus as a statistical factor, which is not so easily explained intuitively.

Liquidity is another important factor. Since this varies over time, it entails that there is uncertainty related to future transaction costs. Liquidity also affects price levels, and liquidity fluctuations may, therefore, also affect the price volatility. Both of these circumstances entail that liquidity variations represent an extra risk in addition to the ordinary risk related to fluctuations in the companies' future earnings. Securities that are relatively illiquid when the rate of return in the market is generally low are particularly risky for investors, because they contribute to reinforcing variation in the consumption. This must be compensated for through a higher expected return.

Empirical surveys support that the liquidity risk is priced and can explain portions of the difference in the average rate of return between different investments. A survey of US equity market data suggests a risk premium of 1.1 percentage points per year, while a survey of the risk premium in emerging stock markets suggests as much as 0.85 percentage points per month. Studies of US bond market data estimate the annual risk premium to be 0.5 percentage points for bonds with a long maturity and high credit rating and 1.0 percentage points for bonds with a poor credit rating.

Direct investments in real estate are generally significantly less liquid than investments in the equity market. Direct transaction costs are higher and the information asymmetry and search costs are greater. There is a great deal of uncertainty related to the time of the sale, which is in addition to risk related to the price that is obtained. Surveys show that there is a clear relationship between illiquidity in the real estate market and economic cycles. It can be argued that the variation in illiquidity is greater for direct real estate investments than for listed equity investments. Empirical studies of the rate of return in the real estate market indicate a risk premium linked to liquidity variations of 0.5 to 1.0 percentage points. There are several problems related to the methods used for measurement of the rate of return for direct real estate investments, so that the results from empirical surveys are less robust than for the equity market.

and/or a normally distributed probability distribution for the rate of return on the securities.

- The condition that the investor does not have income other than income from investments in securities ignores the fact that most investors have other income (such as wage income).
- The assumption that investors only consider single-period investment decisions entails that there is no distinction between short and long investment horizons.

During the further development of the capital asset pricing model in the early 1970s there was an explicit transition to model multiple periods to take into account the fact that investors may desire to change the composition of their portfolios over time in accordance with changing circumstances or investment opportunities.

When the investment opportunities are not constant over time, illustrated, for example, by variations in the real interest rate, there may be major differences between what portfolio choices an investor with a short investment horizon should make and what choices a similar investor with a longer investment horizon should make. For example, the price of an inflation-protected bond will vary with changes in the real interest rate and be risky for an investor with a short investment horizon, while such an investment would yield a stable real rate of return and thus more predictable consumption opportunities for an investor with a long time horizon. Investments in bank deposits will similarly represent risky investments for investors with a long investment horizon, because the interest rate that investors can reinvest these funds at as the

short-term instruments mature will vary over time.

Empirical studies give some statistical evidence supporting that a high rate of return in the equity market for a period of time is followed by a low rate of return in the following period (mean reversion), that the expected risk premium on equities varies over time, and that changes can be predicted to a certain extent by means of various indicator variables. These effects have three implications for optimal portfolio choices:

- Firstly, it can be argued that the length of the investment horizon is relevant to the portfolio choices. Empirical studies indicate a mean reversion in the equity market over periods of time ranging from one to five years. This means then that equities are less risky in the long term than in the short term. The risk for an investor with a 20-year investment horizon is less than 20 times the annual risk (variance). It can be proven then that the optimal equity portion is higher for an investor with a long investment horizon than an investor with a short horizon, everything else being equal, but there is a great deal of uncertainty related to how much higher this percentage should be.
- Secondly, it is in principle optimal to time the market by having a higher percentage of equities when the expected future return is high and a lower percentage when the expected return is low. Such a strategy introduces, however, its own form of uncertainty. Investors must purchase equities at the bottom when no one else is buying and sell at the top when no one else is selling. There are few buy and sell signals, they occur with several years' interval, and there is a great deal of statistical uncertainty related to the profitability of such a strategy. For investors with a short investment horizon, it will not be relevant to time the market.
- Thirdly, conservative, long-term investors should increase the average percentage of equities if the actual return is negatively correlated with the expected future return. Given the mean reversion in the equity market, equities will have a built-in form of intertemporal consumption hedging. After several years of a low rate of return and reduced prices, a higher future return can be expected. These characteristics provide protection against reinvestment risk. For investors with a short investment horizon, this protection characteristic is not relevant.

A number of institutional investors are subject to accounting and capital adequacy rules that can contribute to a reduction in the actual investment horizon, in spite of the fact that the investments are made initially to meet long-term obligations. The investment horizon of the Government Pension Fund – Global is, however, very long and probably longer than the average investor's horizon. If we assume that mean reversion applies to the returns on the equity markets, the Fund's long investment horizon implies, everything else being equal, that the Fund's equity portion should be higher than for the average investor. The increase in the Fund's equity portion from 40 to 60 per cent is consistent with the empirical studies that conclude that equities are somewhat less risky in the long term than in the short term, even though the decision was not dependent on such an assumption.

The Ministry's assessments concerning the Fund's investment strategy have not been based on an expectation of timing the market strategically, even though there are some aspects of timing in connection with the rebalancing and transition regime. If the equity market falls a great deal in value relative to the bond market, the monthly transfers to the Fund will be used to purchase equities. If the actual equity portion falls under a certain level, provisions have been made to sell from the bond portfolio to increase the Fund's equity portion towards the strategic weight of 60 per cent. Both of these cases entail that equities are purchased when the price of the equities is low. Sometimes this will coincide with periods when the expected return on the equity market is correspondingly high. Rebalancing back to the strategic weights is consistent with the assumptions in Section 2.1 that the Government Pension Fund is able to maintain its capacity and willingness to take market risk after periods of poor market returns. The most important reason for the rebalancing regime, however, is to avoid that the portfolio deviates too much from the desired strategic composition of asset classes and regional distribution, see a more detailed discussion in Section 2.5.

2.3 Risk associated with the return on the Government Pension Fund

The risk associated with the return on the investments of the Government Pension Fund can be described in various ways. This section illustrates the risk associated with the Fund on the basis of

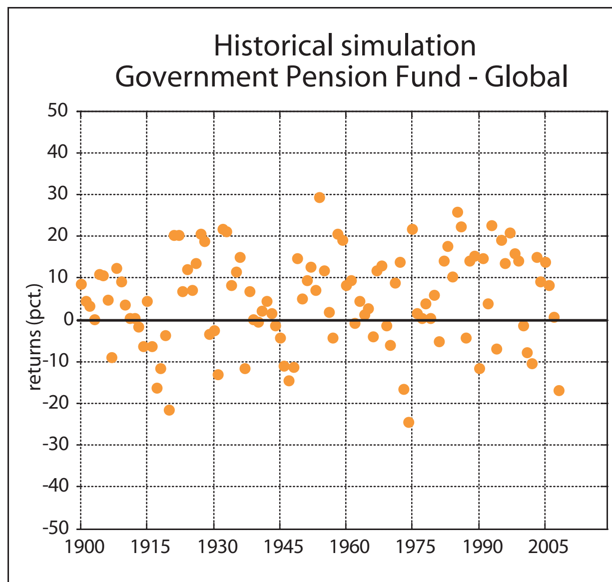

Figure 2.3 Historical simulation for the Government Pension Fund – Global. Annual real rates of return measured in the Fund's currency basket. Per cent

Source: Ministry of Finance and Dimson, Marsh and Staunton

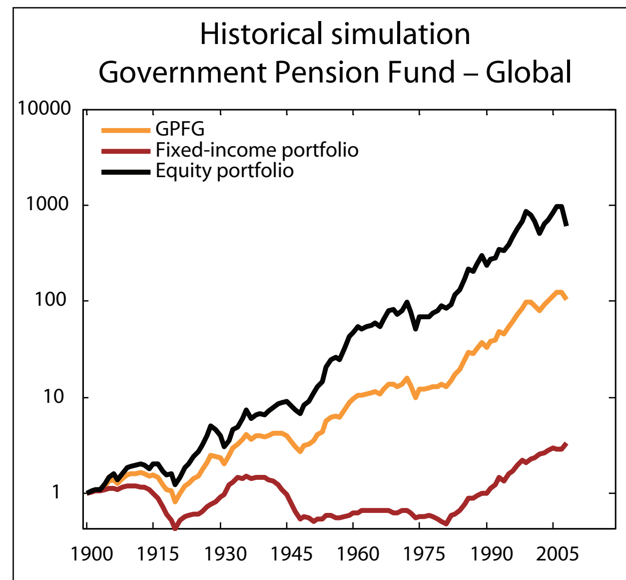

Figure 2.4 Historical simulation for the Government Pension Fund – Global. Real rate of return measured in the Fund's currency basket. Index

Source: Ministry of Finance and Dimson, Marsh and Staunton

both historical returns in the equity and bond markets and a simulation model that describes potential future developments for the Fund.

The analysis of historical returns in Section 2.3.1 is referred to as *historical simulation*. The purpose is to illustrate what fluctuations in the Fund's return can be expected within a one-year time horizon. The *model-based simulations* in Section 2.3.2 are based on estimates for expected returns, volatility and correlations between various asset classes over long horizons. These calculations focus primarily on the real rate of return over time. A third method, referred to as historical scenario generation, was described in Box 1.2 in Report no. 16 (2007–2008) to the Storting. What the Fund's return would have been in specific historical crises was calculated here.

2.3.1 Historical simulations

One way of describing the risk associated with the Government Pension Fund is to use the returns on the equity and bond markets in the previous century and calculate what return the Fund would have had and how much this return would have varied during the period. The historical simulations that are referred to here are calculated on the basis of annual real rates of return for the period from 1900 to 2008. The data set that the calculations are based on is somewhat different from the data set that is used to calculate the rate of return on the Fund's benchmark portfolio. We do not, for example, have return data for many of the emerging markets, because they did not exist for large parts of the previous century. In addition, only data for government bonds with a long term to maturity are available for the period from 1900, while the Fund's benchmark portfolio also contains corporate bonds and bonds with a short term to maturity.

The strategic benchmark portfolio of the Government Pension Fund – Global is assumed to consist of 60 per cent equities and 40 per cent bonds, distributed across a large number of countries and currencies. Figure 2.3 illustrates what annual rates of return such a portfolio would have had for the period from 1900 to 2008. The previous century was marked by a number of crises, but the performance of the financial markets as a whole was very good. The rate of return would have been positive in most of the years, and the highest rates of return in the good years are higher than the negative rates of return in the bad years. The figure illustrates that the simulated real rate of return for 2008 was calculated to be around -20 per cent, which is one of the poorest simulated outcomes for the entire 109-year period.

Table 2.1 Historical simulation for the Government Pension Fund – Global. Annual average arithmetic real rate of return and risk measured in the Fund's currency basket. Per cent.

	Bond portfolio	Equity portfolio	Government Pension Fund – Global
Rate of return	1.5	7.4	5.0
Standard deviation	8.9	15.6	11.1

Source: Ministry of Finance and Dimson, Marsh and Staunton

The simulated real rate of return on the equity market was around minus 40 per cent in 2008. This year is the poorest year for the equity market in the entire period.

Figure 2.4 illustrates the historically simulated index performance (logarithmic scale) for the equity and bond portfolios, respectively, and the Fund overall. For the entire period as a whole, the performance of the equity markets has been significantly better than the bond markets. For the period from 1998 to the end of 2008, which corresponds to the actual history of the Fund, the rate of return on the bond market was, however, higher than the rate of return on the equity market.

Table 2.1 shows the simulated historical average annual return and the standard deviation of this return for the equity and bond portfolios, and the Fund overall. The historical simulated standard deviation for the Fund is calculated to be just over 11 per cent. At the end of 2008 the market value of the Fund was around NOK 2300 billion. A change in the Fund's value of NOK 250 billion in the course of a year will accordingly be consistent with the historical price fluctuations in the securities markets (if we ignore the currency fluctuations). The fall in value for the benchmark portfolio in the simulation model can be estimated for 2008 at around NOK 550 billion when we ignore the development of the krone exchange rate. This is somewhat more than double of what the change in value would have been in a normal period, but it is nevertheless not an outcome that is completely unexpected, given the underlying risk associated with the securities markets.

Figure 2.5 illustrates the simulated rates of return plotted in a histogram, which also includes a plot of the normal distribution with the same average rate of return and standard deviation as in the historical simulations. Both

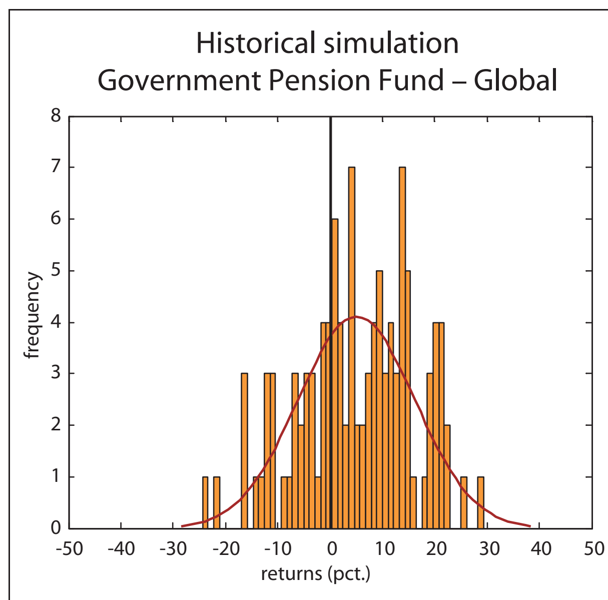

Figure 2.5 Historical simulation for the Government Pension Fund – Global. Annual real rates of return measured in the Fund's currency basket. Per cent and frequency (number of years)

Source: Ministry of Finance and Dimson, Marsh and Staunton

the figures and the test results indicate that the empirical distribution is somewhat skewed to the left, but, based on standard statistical tests, the hypothesis that the annual simulated rates of return for the Fund are normally distributed cannot be rejected. The simulated standard deviation of 11 per cent can thus provide a satisfactory illustration.

Figure 2.6 illustrates the empirical cumulative probability distribution for the simulated annual rates of return for the equity and bond portfolios, and the Fund overall. The minimum rate of return on the Fund is calculated to be around -25 per cent and the maximum annual return to be around 30 per cent. The variance of the equity portfolio is considerably higher, while the variance of the bond portfolio is considerably lower. From the figure we also see that the simulated return in 10 per cent of all years has been lower than -11 per cent, and the rate of return has been negative in 30 per cent of the years.

The investment horizon of the Government Pension Fund – Global is very long. Figure 2.7 illustrates the average annual rate of return and risk for overlapping periods of 15 years. At year-end 2008 the average annual simulated rate of return for the last 15-year period was almost 6 per cent, and the standard deviation was just under 12 per cent. The figure illustrates that there are few

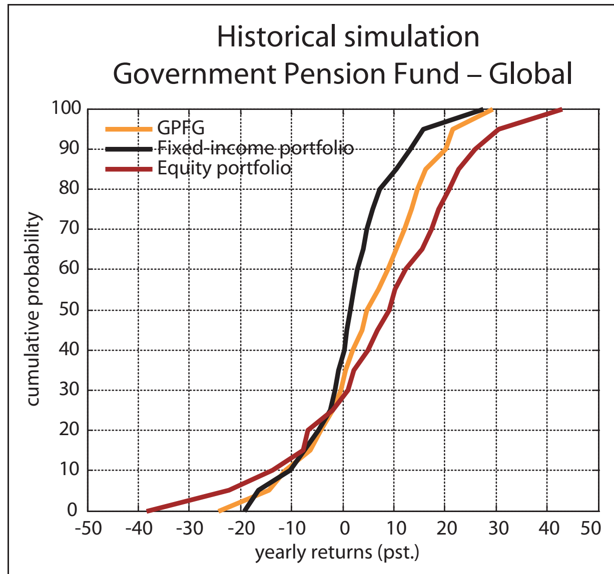

Figure 2.6 Historical simulation for the Government Pension Fund – Global. Cumulative probability distribution for the simulated annual rates of return. Per cent and cumulative probability

Source: Ministry of Finance and Dimson, Marsh and Staunton

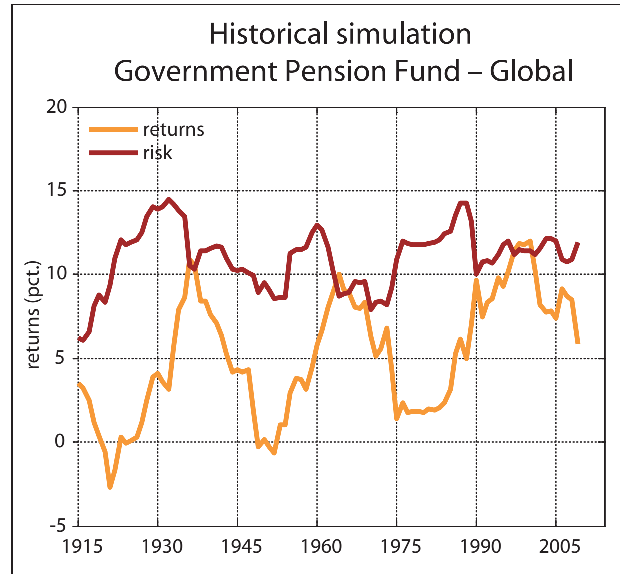

Figure 2.7 Historical simulation for the Government Pension Fund – Global. Average annual rate of return and standard deviation (risk) for overlapping 15-year periods. Per cent

Source: Ministry of Finance and Dimson, Marsh and Staunton

15-year periods where the average annual rate of return has been negative, and the period after the Second World War has been more positive than the period before the war. In a long-term perspective the rate of return for the last 15-year period has been somewhat better than the average rate of return, while the risk has been more or less average.

Figure 2.8 illustrates that the risk associated with the equity market varies over time. While the average for the last 109 years is close to 15 per cent, the average annual standard deviation for the last 15 years was over 20 per cent at year-end 2008.

2.3.2 Market expectations and simulation for the Government Pension Fund – Global

The Ministry of Finance's analysis of the future rate of return and risk is based on assumptions concerning the rate of return and risk associated with the equity and bond markets that were reviewed in detail in Report no. 16 (2007–2008) to the Storting. The national and regional markets are represented by a single global market for equities, bonds and real estate, respectively, measured in the benchmark portfolio's currency basket. In addition, no adjustments have been made for any imbalances in the market prices, so that it is the long-term expectations that are reported.

Tables 2.2 and 2.3 sum up the assumptions for the expected long-term real return (net of management costs) and risk, as well as the correlations between equities, bonds and real estate. The

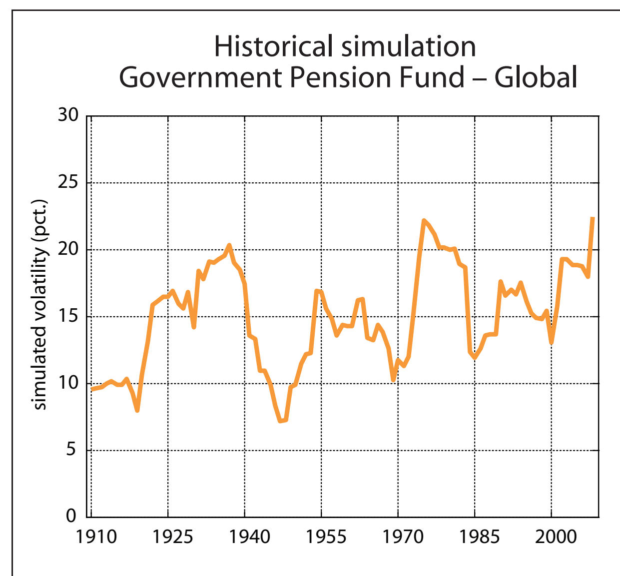

Figure 2.8 Historical simulation for the equity portfolio of the Government Pension Fund – Global. Annual standard deviation for overlapping 15-year periods. Per cent

Source: Ministry of Finance and Dimson, Marsh and Staunton

Table 2.2 Point estimates for the expected long-term real return and risk for global bonds, real estate and equities (geometric).[1] Per cent

	Bonds	Real Estate	Equities
Rate of return	2.7	3.5	5.0
Standard deviation	6.0	12.0	15.0

[1] Global bonds include corporate bonds with approximately the same percentage as in the bond portfolio of the Government Pension Fund – Global. The expected real rate of return for government bonds is 2.5 per cent.

Source: Ministry of Finance

Table 2.3 Specific estimates for long-term correlations between the real rate of return on global bonds, real estate and equities.[1]

	Bonds	Real Estate	Equities
Bonds	1	0.3	0.4
Real Estate		1	0.6
Equities			1

[1] Global bonds include corporate bonds with approximately the same percentage as in the bond portfolio of the Government Pension Fund – Global.

Source: Ministry of Finance

estimate for the risk associated with bonds is significantly lower than the estimate based on the historical simulations in Table 2.1. This is due to the fact that the Fund's fixed income benchmark has a significantly shorter term to maturity than the historical simulations. It is emphasised that there is considerable uncertainty regarding the specific estimates. In actual fact, specific estimates represent the midpoint for a confidence interval or a given probability distribution. This estimate uncertainty is to some extent taken into consideration in the model simulations of the expected real return and risk associated with the Fund.

The characteristics of the benchmark portfolio for the Government Pension Fund – Global has been analysed on the basis of these assumptions by means of a stochastic simulation model (see Section 3.3. in Report no. 16 (2007–2008) to the Storting for a more detailed discussion of the assumptions underlying the model simulations). Table 2.4 shows the expected (geometric) real rate of return on, and risk associated with, the benchmark portfolio of the Government Pension Fund – Global over a 15-year period, under the assumption of an asset composition featuring 60 per cent equities and 40 per cent bonds. The simulation results show that an average geometric annual real rate of return on the Fund of 4.2 per cent (6.3 per cent nominal) is expected. An expected volatility of 9.2 per cent entails that fluctuations around the expected rate of return will range from -9.2 per cent to +9.2 per cent with 68 per cent probability (i.e. this can be expected to be the case in two out of every three years).

As illustrated in Section 2.3.1, the volatility of the financial markets will vary over time. Norges Bank estimated the risk of the actual portfolio to be 22.2 per cent in its report on the management of the Government Pension Fund – Global in 2008, given the unusually high volatility at that point in time (cf. Note 9 in the financial report). This means that the nominal return in Norwegian kroner in two out of three years is expected to vary around the mean from +22.2 per cent to -22.2 per cent, based on the actual portfolio and market conditions at this point in time. The corresponding estimate for year-end 2007 was 8.6 per cent.

2.4 Execution of adopted changes

2.4.1 Investments in real estate

In Report no. 16 (2007–2008) to the Storting the Ministry stated its intention to invest up to a maximum of 5 per cent of the capital in the Government Pension Fund – Global in real estate, and that the real-estate investments shall be offset by a corresponding reduction in the bond weighting. A unanimous Standing Committee on Finance supported the plans to invest portions of the Fund in a separate real-estate portfolio in Recommendation no. 283 (2007–2008) to the Storting.

In the National Budget for 2009, the Ministry advised that it continued to work on the preparation of guidelines for real estate investments. The majority of the investments are expected to be made through unlisted instruments. This poses challenges linked to a number of aspects, including the measurement and assessment of return and risk, and it is therefore necessary to establish special required rates of return, risk limits and reporting requirements to ensure fulfilment of the Ministry's objectives for the investments in real estate.

In its work on the preparation of guidelines for real estate investments the Ministry has received advice from the firm Partners Group. The advice from Partners Group is based on best practice for similar portfolios internationally. In light of this

advice, for example, the Ministry aims to complete new guidelines by the end of 2009. The work is challenging, especially with regard to the selection of key targets related to the rate of return and risk diversification, as well as the adoption of guidelines for the phasing-in process.

In 2008, the global real estate market showed poor returns and a reduction in sales. The Ministry is not intending to lay down a fixed scope of investment for the coming years, as the phasing-in will have to be adapted to the market conditions and capacity restrictions. In the initial years the investments will probably be concentrated in a few areas, while a more diversified global real estate portfolio can be achieved over time. The Ministry still assumes that it may take many years before the real estate portfolio accounts for as much as 5 per cent of the Fund.

The rules for investments in real estate will be included in a new unified regulation governing the management of the Government Pension Fund – Global. See the more detailed discussion of this in Chapter 6.

2.4.2 Equity portion

The work that started in the summer of 2007 to increase the equity portion of the Government Pension Fund – Global from 40 to 60 per cent continues.

Report no. 24 (2006–2007) to the Storting on the management of the Government Pension Fund in 2006 gave an account of the expected return and risk from an increased equity portion of the short and long terms. The analysis was based on extensive historical data set, as well as simulations of the future return and risk based on given expectations for future equity premium and risk in the equity and bond markets. A significantly lower equity premium than the historically observed premium was used in the simulations. The Ministry concluded that an increase in the equity portion of the benchmark portfolio for the Government Pension Fund – Global from 40 to 60 per cent represented a good balance between the expected rate of return and risk in the long term for investments in the Fund.

In Recommendation no. 228 (2006–2007) to the Storting the majority of the Standing Committee on Finance, all the members except the members from Fremskrittspartiet (the Progress Party), noted this and supported the Government's assessment of increasing the equity portion of the benchmark portfolio for the Government Pension Fund – Global to 60 per cent.

With regard to the execution of this change, the Ministry stated in Report no. 24 (2006–2007) to the Storting that the consequences of the increased equity portion were based in general on how it could affect the portfolio's rate of return and risk in the long term. It was pointed out at the same time that there was a great deal of uncertainty related to the short-term performance of the market. The risk related to increasing the equity portion at a point in time that could subsequently emerge as more or less favourable was reduced through spreading the increase in the equity portion out over time. The considerations behind the chosen plan to increase the equity portion are described in somewhat greater detail in Report no. 16 (2007–2008) to the Storting.

A poorer return on equity investments compared with bond investments and record high petroleum revenues have contributed to large

Table 2.4 Expected long-term real rate of return and risk associated with the benchmark portfolio of the Government Pension Fund – Global.[1]

Portfolio (per cent of equities/ bonds)	Average real rate of return (geometric) over 15-year periods (per cent)	Standard deviation of annual real rate of return (per cent)	Standard deviation of average real rate of return over 15 years (per cent)	Probability of negative accumulated real rate of return after 15 years (per cent)	Probability of annual (geometric) real rate of return < 4 per cent	Sharpe ratio[2]
60 / 40	4.2	9.2	2.4	3.7	46.8	0.29

[1] A composition of 60 per cent equities and 40 per cent bonds is assumed over an arbitrary 15-year period.
[2] The Sharpe ratio is calculated as the ratio between the expected arithmetic real rate of return (not shown in the table) beyond the risk-free real interest rate (estimated at 2 per cent) and volatility (measured by the standard deviation of the annual real rate of return).

Source: Ministry of Finance

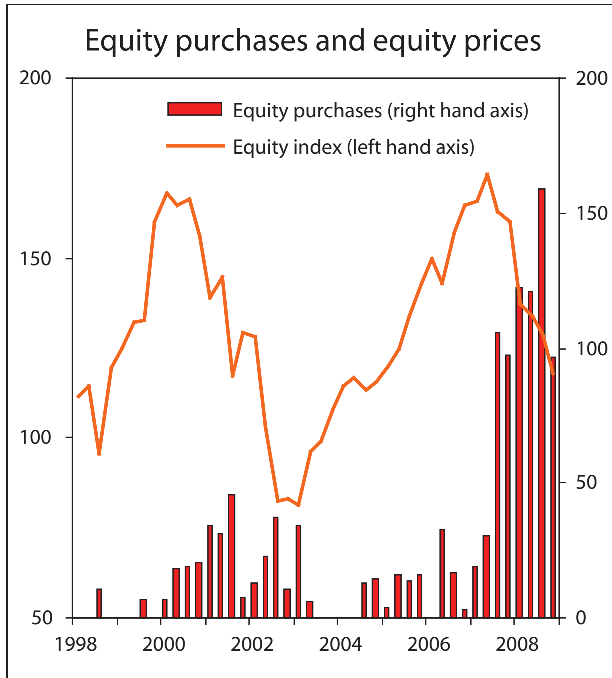

Figure 2.9 Equity prices and purchases. Index and NOK billion

Source: Norges Bank

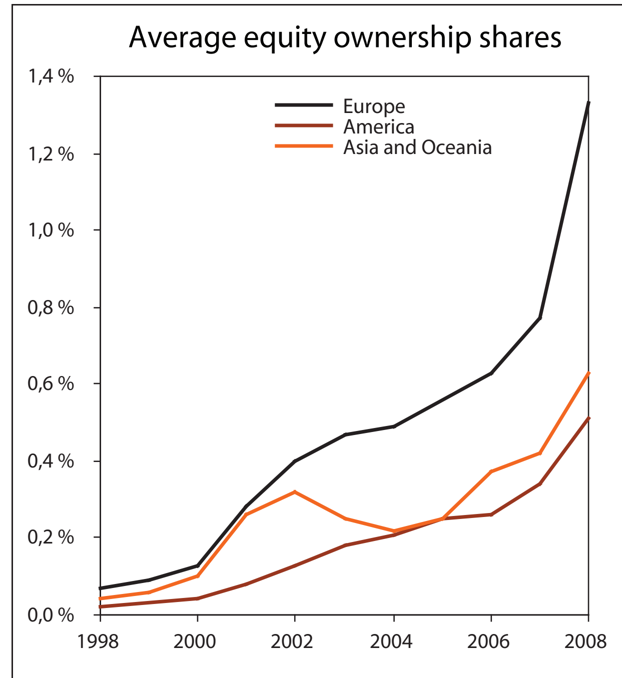

Figure 2.10 Holdings in the equity markets. Per cent

Source: Norges Bank

equity purchases throughout 2008 (see Figure 2.9). Of the equities currently owned by the Fund, 40 per cent were purchased in 2008. The equities have been purchased in general at much lower prices than when the increase in the equity portion was adopted in the summer of 2007. The gradual increase in the equity portion and the simultaneous substantial fall in the market value of the world's equity markets have resulted in a large increase in the Fund's average ownership interest. In the space of one year, this percentage has risen from around 1/2 per cent to 3/4 per cent (see Figure 2.10). This means that in 2008, the Fund has acquired rights to a share in all the future earnings from another 1/4 per cent of the world's listed companies.

However, the major drop in share prices on stock markets around the world towards the end of 2008 meant that the equity portion was 50 per cent at year-end 2008, compared with 53 per cent at the end of September 2008. The work to increase the Fund's equity portion will continue in 2009 according to the same principles as previously. The Fund's ownership interests in the world's listed companies will thus probably increase further.

2.4.3 Emerging equity markets

The exposure of the benchmark portfolio to emerging equity markets has until recently been limited to a relatively small number of countries (Brazil, Mexico, South Korea, Taiwan and South Africa). In Report no. 16 (2007–2008) to the Storting, a new assessment was made of what emerging equity markets should be included in the Fund's benchmark portfolio and what principles should apply to the selection of these markets.

A unanimous Standing Committee on Finance supported the planned expansion of the Fund's benchmark portfolio to include new, emerging markets in Recommendation no. 283 (2007–2008) to the Storting. Following the Storting's deliberation on the recommendation, the Ministry adopted a resolution to change the benchmark portfolio.

As stated in the National Budget for 2009, the Ministry stated its intention to gradually phase in the new markets in consultation with Norges Bank to limit the transaction costs, since equities were to be purchased in markets where the liquidity is poorer than in the developed markets in which the Fund is already invested. There was at the same time a desire to achieve the new exposure to the new markets within a reasonable

period of time. In Norges Bank's report on the management of the Government Pension Fund – Global in 2008, the bank writes:

> "NBIM assesses on an independent basis how well suited the country is for our investments, with a view to the fact that the country must have markets that are open to foreigners, the country must have legislation that protects the rights of investors, and the country must satisfy certain minimum requirements for settlement systems. NBIM does, therefore, not invest in all the countries in the benchmark portfolio. The inclusion of 19 emerging equity markets entailed that the benchmark portfolio for equities was expanded by just under 1000 companies. The expansion was implemented during the period from September to November 2008."

After the implementation of this change, the benchmark portfolio consists of equity markets in 46 countries, and countries classified as emerging markets represent around 10 per cent of the overall market value.

2.4.4 Listed small-cap companies

The Ministry stated in Report no. 24 (2006–2007) to the Storting that it intended to include small-cap companies in the Fund's benchmark portfolio. The original equity benchmark consisting of large and medium-sized companies covered around 85 per cent of the overall value of the equity markets in the world index of the index provider FTSE. The inclusion of small-cap companies will increase this percentage to around 95 per cent. The equity benchmark will thus be more representative of the investable portion of the equity market. Together with the inclusion of emerging markets, which is discussed in Section 2.4.3, close to full coverage is achieved. This spreads the risk associated with the Fund further, and it is reasonable to assume that the trade-off between the rate of return and risk will improve.

Following the Storting's deliberation of Report no. 16 (2007–2008) to the Storting, the Ministry of Finance decided, in consultation with Norges Bank, to implement a gradual transition to a new benchmark portfolio in which listed small-cap companies were included. This adaptation was carried out during the period from October 2007 to the end of the first quarter 2008. At the end of the phase-in period the bank had invested around NOK 120 billion spread across more than 4500 companies. The small-cap companies represent around 12 per cent of the market value of the new benchmark index, which consists of close to 7,700 limited companies. Norges Bank estimates that the overall transaction costs related to the phasing in of small-cap companies in the portfolio totalled NOK 1.1 billion or 0.95 per cent of the transaction value. There is a more detailed review of the adaptation to the new equity benchmark in Norges Bank's report for the 2nd quarter of 2008 on the management of the Government Pension Fund – Global.

2.5 Ongoing work to develop the strategy

As mentioned in Section 2.2.1, the Ministry's work on developing the investment strategy for the Government Pension Fund – Global will be based on how the trade-off between return and risk can be improved. One goal is to exploit the Fund's characteristics better. Natural evolvement of the investment strategy may entail further diversification and investments that benefit from the Fund's size, long-term perspective, and ability to hold less liquid assets. It is particularly pertinent to consider changes to the strategy that can provide compensation in the form of somewhat higher expected returns in exchange for reduced tradability (liquidity). More details of this work are provided in Sections 2.5.1–2.5.3. This is followed by an account of rebalancing and oil price risk.

2.5.1 Investment areas related to ESG issues

In Report no. 16 (2007–2008) to the Storting, the Ministry announced that it would consider the financial and ethical effects of so-called positive selection as a tool to earmark a small portion of the funds in the Government Pension Fund – Global for investments in environmental technology or developing countries. The question of earmarking was raised in the public consultation paper that was drafted in connection with the evaluation of the ethical guidelines for the Fund. The consultation paper states:

> "The Ministry will study in more detail the possibility of setting a small portion of the Fund aside for earmarked investment purposes, such as environmental technology or developing countries."

Several of the bodies consulted who have commented on this believe that the management of

the Government Pension Fund – Global should focus more on the environment, social issues and good corporate governance (ESG considerations). There are, however, also bodies consulted who have voiced objections and pointed out special challenges associated with moving in such a direction.

Several large institutional investors have integrated ESG considerations into their investment decisions to a greater extent than the Government Pension Fund – Global. The scope of the earmarked investments is nevertheless modest. In a report from the research firm Innovest (which is attached as an appendix to the consultative comments from the WWF) it is stated, for example, that less than 0.1 per cent of the capital of the underwriters of the CDP (Carbon Disclosure Project) is controlled by an investment strategy that explicitly and systematically attaches important to the challenges associated with climate change.

In the opinion of the Ministry, the long investment horizon and the broad ownership both suggest that the Government Pension Fund must adopt a broader perspective on the consequences of positive or negative repercussions than would be adopted by investors and corporate management who have a shorter investment horizon and portfolios with less risk diversification.

At the same time, the special characteristics of the Fund suggest that investments in unlisted markets, such as real estate, infrastructure and unlisted equities should be increased.

Against the backdrop of the Fund's special characteristics and input from the public consultation process for the ethical guidelines, the Ministry is planning the establishment of a new investment programme for the Fund that will focus on environmental investment opportunities. For the environmental programme, sub-markets in infrastructure and unlisted equities, so-called environmental bonds, and the opportunity to invest portions of the listed equities portfolio based on an environmental index appear to be the most relevant. The investments must be aimed at eco-friendly assets or technology that is expected to yield indisputable environmental benefits, such as climate-friendly energy, improving energy efficiency, carbon capture and storage, water technology, and the management of waste and pollution. It has been decided that any infrastructure investments will have to target climate-friendly energy in particular. In the unlisted markets, any such investments will be made through funds, but it may be challenging to find funds that focus exclusively on environmental projects. In these kinds of cases, minimum limits must be defined for the funds' environmental exposure.

Work will also continue on assessing whether it is pertinent to establish an investment programme aimed at sustainable investment opportunities in emerging markets. This will include, for example, an evaluation of investments in unlisted equities and infrastructure in emerging markets.

On the environmental programme

The environmental programme shall focus on eco-friendly assets or technologies that are expected to yield indisputable environmental benefits. The eco-friendly investments that are expected to be the most prevalent in the years to come are investments related to the reduction of greenhouse gas emissions. According to the UN Intergovernmental Panel on Climate Change (IPCC), substantial and rapid emission reductions are required if we are to manage to stabilise the concentration of greenhouse gases in the atmosphere at levels that do not entail a major risk of extensive global environmental problems.

Energy is responsible for more than 60 per cent of the annual CO_2 emissions to the atmosphere. The emission reductions will require a complete restructuring of the world's energy consumption and supply. There is a great deal of uncertainty concerning the size of the investments that are required to achieve the necessary restructuring. The Stern Review estimates the costs to be 1 per cent of the world's GDP if the concentration of greenhouse gases in the atmosphere is to be stabilised at 550 ppm CO_2 equivalents in 2050. The International Energy Agency (IEA) estimates in the annual energy forecast "World Energy Outlook 2008" that around USD 550 billion must be invested annually in renewable energy and the improvement of energy efficiency until 2030 if the concentration of greenhouse gases in the atmosphere is to be stabilised at 450 ppm CO_2 equivalents.

Investments in climate-friendly energy and technology are showing strong growth. As is illustrated in Figure 2.11, investments in climate-friendly energy and technology that contribute to improved energy efficiency, excluding investments in nuclear power plants and large hydropower plants increased from USD 33 billion in 2004 to USD 148 billion in 2007. These investments represent around 10 per cent of the overall global energy investments.

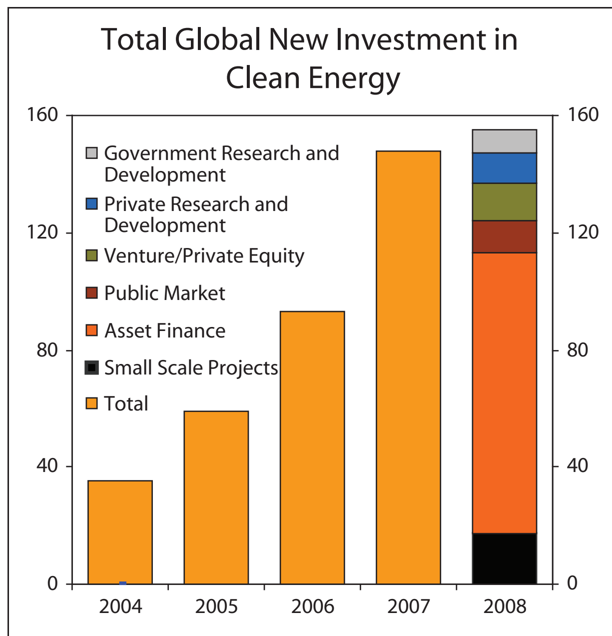

Figure 2.11 Global investments in climate-friendly energy and technology, 2004–2008, USD billion.

Source: New Energy Finance

Figure 2.11 also shows that the majority of the investments are project financing of climate-friendly energy and technology and small-scale projects. These projects are primarily infrastructure projects that are financed by both equity and loans. The second largest investments are made by listed companies that invested USD 10 billion in research and development and USD 11 billion directly in climate-friendly energy and technology in 2008. Unlisted equity investments through funds totalled around USD 13 billion in 2008.

Renewable energy has become less and less expensive to produce in recent years, and thus it has become more competitive in relation to non-renewable energy. A global price for carbon emissions should be able to make renewable energy more competitive. Until such a price is established, the profitability of investments in renewable energy are dependent on whether the authorities give renewable energy advantages that other forms of energy do not have through other systems, such as regulations or direct financial support. Various forms of subsidies exist in most well-developed markets. When profitability is dependent on public support schemes and not just ordinary market mechanisms, such investments are much more exposed than other investments to changes in the political priorities. One example is the subsidisation of biofuels and other bioenergy in the USA and EU, which has been criticised for not being sustainable. The criticism has been aimed at the fact that the cultivation of bioenergy on land that would have otherwise been used for the production of food is not among the best measures to reduce greenhouse gas emissions, and that the subsidies contribute to increasing global food prices and thus impact the poorer segments of the population. If such subsidies are suddenly eliminated, investors with investments in technology or infrastructure with high development and production costs and a long repayment horizon will incur large losses.

In addition to the subsidies, the profitability of investments in climate-friendly energy and technology will depend on the development of prices for non-renewable energy. Listed indexes that consist of companies that are only engaged in climate-friendly energy and technology, such as Wilderhill New Energy Global Innovation Index (NEX), have been highly correlated with the price of oil. This is due to the fact that the value of alternative, climate-friendly energy is higher when the value of fossil fuels is higher. NEX fell 70 per cent in 2008 measured in USD, while the price of North Sea oil fell 58 per cent measured in USD. In comparison the equity market as a whole fell 39 per cent, measured by the FTSE All World in USD. In addition to the general fall in the equity market and the fall in energy prices throughout 2008, companies engaged in climate-friendly energy and technology have been impacted in particular by the fact that investors now appear to demand a greater risk premium for investments in companies that have high capital investments and are exposed to technology risk.

Other large funds that it is reasonable to compare the Government Pension Fund – Global with have made eco-friendly investments in a number of asset classes, such as environmental bonds, listed equities, unlisted equities and infrastructure.

The largest comparable allocation in listed equities was made by the USA's largest pension fund, CalPERS, where the board of directors earmarked USD 500 million for positive selection based on environmental criteria. CalPERS has granted an active management mandate to four external managers. Several other funds have smaller ESG mandates, which are managed passively or actively. The Dutch pension fund PGGM, which has granted an active mandate to an external manager and also manages a portion of the portfolio internally in accordance with the FTSE4Good index, is an example of this.

Most of the other funds emphasise in particular unlisted equity investments in eco-friendly energy and technology. CalPERS's board of directors has, for example, earmarked USD 600 million for unlisted investments in environmental technology. The two largest pension funds in Europe, the Dutch funds ABP and PGGM, have both allocated EUR 500 million to shared infrastructure investments in sustainable energy and EUR 500 million to shared unlisted equity investments in clean technology. CalPERS, ABP and PGGM all have unlisted investments in sectors other than eco-friendly energy and technology, and this means that their unlisted environmental investments are also the result of large allocations to broad markets for unlisted equities and infrastructure. It is also important to note that these funds have gradually built up their allocations to unlisted markets and that they have thus had an opportunity over a long period of time to acquire the necessary management experience and market knowledge.

All the forms of eco-friendly investments that are made by other funds are also relevant in principle for the Government Pension Fund – Global. When we take into account the Fund's existing investments and special characteristics, sub-markets in infrastructure and unlisted equities, environmental bonds, and the opportunity to invest portions of the listed equity portfolio based on an environmental index appear to be the most relevant.

FTSE Environmental Opportunities All-Share Index is an example of an environmental index of listed equities. This is an index that is composed of a selection of companies that are included in the benchmark portfolio for the Government Pension Fund – Global. The selection criterion is whether the companies have more than 20 per cent of their earnings from environmental activities related to energy, water, pollution and waste. The companies in the FTSE Environmental Opportunities All-Share Index represent just over 6 per cent of the value of the Fund's benchmark index for equities. This illustrates that a not-insignificant portion of the equity benchmark index for the Government Pension Fund – Global already has a "green" profile.

A tailor-made environmental index can also be composed for the Government Pension Fund – Global, which would make it possible to invest in companies that are more environmentally oriented and not already included in the current benchmark portfolio.

If portions of the equity portfolio are managed in accordance with the environmental index, this would entail a decision to overweight eco-friendly companies at the expense of other companies. From a financial perspective, the overweighting of individual companies or sectors has similarities with an active investment decision.

Up until today the investment strategy of the Government Pension Fund – Global has essentially been based on the principle that the weight of the companies or sectors is determined by the market capitalisation. A separate allocation to an environmental index will entail a deviation from this principle, which is based on the hypothesis of near market efficiency. It is assumed that efficient markets will price in all the relevant available information (see Box 2.1).

The information on which the composition of such environmental indexes is based will essentially be publically available. As a point of departure, a higher rate of return than the equity market in general should, therefore, not be expected through the overweighting of such companies. Only if the companies' eco-friendly production or products prove to acquire a higher value in the future than the financial markets currently assume will the investments be able to yield an excess return in relation to the rest of the portfolio. Since an environmental index will contain a smaller number of companies than the ordinary equity portfolio, somewhat higher risk must be expected. The differences in the rate of return will depend on how the environmental index is composed.

The environmental index's selection and reporting criteria can impact the companies' behaviour if a large portion of the capital is invested in accordance with the environmental index, or if the companies value being included in such indexes. Since the listed companies supposedly have a major influence on the environment, the impact of any behavioural changes could have a great effect. Investments based on an environmental index will closely match the existing management of the Government Pension Fund – Global and be relatively cost-effective and not very demanding operationally.

It can be questioned how strong the environmental effects of investments in accordance with the already established environmental indexes would be. Since a number of environmental indexes already exist, a possible allocation will not entail the development of a new product. The investments will not be of any great significance

to the companies' supply of capital, since they will primarily take place on the secondary markets where shares are purchased from other investors.

Another alternative is to invest in bonds that finance environmental projects. This market is very small at present, with just a few securities issued, but it should grow in the future. A number of the same objections that apply to investing in a listed environmental index will also apply to environmental bonds. One difference, however, is that we can participate in the development of a new market.

Several comparable funds emphasise in particular their eco-friendly investments in unlisted equities and infrastructure. These are asset classes that the Government Pension Fund – Global has not been invested in earlier, which would thus entail an expansion of the Fund's investment universe. Investments in unlisted shares through a start-up fund can help finance new eco-friendly technology directly. In addition to the injection of capital, the start-up funds contribute as a rule to the transfer of competence and skills, so that the companies are better equipped to succeed with the development of technology for commercial products.

Infrastructure investments will be able to finance the establishment of eco-friendly investment projects directly, or they may be made in established climate-friendly energy projects, such as windmills, solar cells, hydropower, geothermal plants, carbon capture and storage, or other climate-friendly infrastructure, such as improving the electrical power grid, for example. The demand for investments in eco-friendly infrastructure and the demand for private capital make this an interesting market with substantial growth potential. One opportunity is to cooperate with other major institutional investors, such as major pension funds and other national reserve funds, on the development of instruments that will better meet the needs of the largest funds.

In the unlisted markets, it may be challenging to find funds that are oriented exclusively towards environmental projects. In these kinds of cases, it will be relevant to define minimum limits for the funds' environmental exposure.

On a possible programme for sustainable growth in emerging markets

It will be natural to evaluate investments in unlisted equities and infrastructure in emerging markets, for example, for a possible investment programme for sustainable growth in these markets. This has to do, for example, with the access to listed investments is more restricted here, relatively speaking, than in more developed markets. Sustainability is defined here as environmental, financial and developmental sustainability.

There is no unambiguous set of criteria that define emerging markets. For investments in listed equity markets, it is common to use the classifications of index providers, such as FTSE. FTSE's classification of emerging markets is based on the gross national income per capita and how the listed equity market is regulated, developed and functions. The equity benchmark for the Government Pension Fund – Global has recently been expanded to include all the emerging markets that are part of the world index from the index provider FTSE (mentioned in Report no. 16 (2007–2008) to the Storting).

Emerging markets for unlisted investments are defined here as all countries with a low to average gross national income per capita, and the least developed countries with strong economic growth.

The emerging markets represent 85 per cent of the world's population, while only 28 per cent of the world's gross national product. This imbalance has improved in recent decades through higher average economic growth in emerging market. This higher growth is attributed primarily to the fact that the emerging economies have accumulated capital and increased their workforce at a far faster tempo than the industrialised countries. These economies may also have higher economic growth than the developed economies in the future. In the long term, the average growth will be determined primarily by access to production factors and how efficiently they are exploited.

Most large institutional managers invest parts of their equity portfolios in unlisted equities. Many of these funds have allocated portions of the unlisted equity portfolio to emerging markets in recent years. The investments are made indirectly through various fund structures. Of the comparable funds, it is the three US pension funds, CalPERS, Washington State and Oregon State, which have the largest investments in unlisted emerging equity markets of USD 2.6 billion, USD 1.5 billion and USD 1.2 billion, respectively. CalPERS started with unlisted equity investments in emerging markets in 1996, and these investments represented 17 per cent of all the unlisted equity investments at year-end 2007. In comparison, the Emerging Markets Private

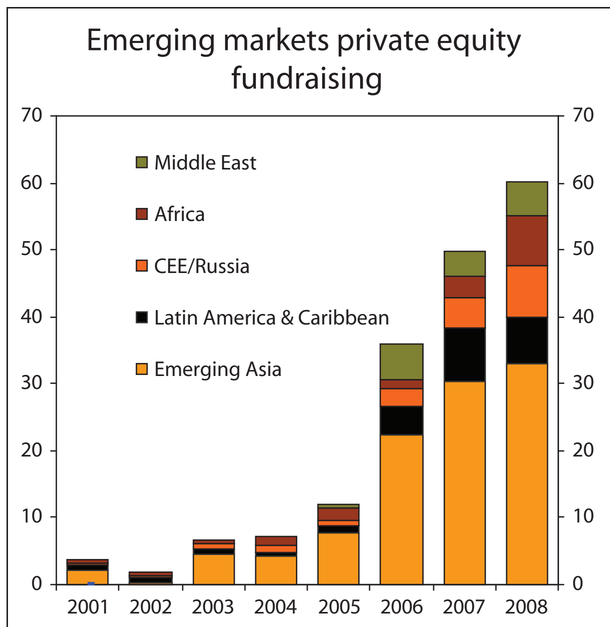

Figure 2.12 Private equity investments in emerging markets, broken down by region, 2003–2008, USD billion.

Source: EMPEA

Equity Association (EMPEA) estimates that the combined unlisted equity investments in emerging markets represented 13 per cent of the world's total investments in unlisted equities in 2007. As is illustrated by Figure 2.12, the total private equity investments in emerging markets have shown strong growth in recent years.

Figure 2.12 illustrates that Asia is the region from among the emerging markets that has received the largest unlisted investments. In this region the largest investments have been in China and India. The region with the least investments is sub-Saharan Africa, which represented 8 per cent of the total unlisted investments in 2008. South Africa has clearly been the largest market in this region. Africa is also the region with the lowest gross national product.

Analysis of the relationship between the equity market's return and the country's economic growth provides little support for the hypothesis that high growth automatically results in a high return. Nevertheless, the listed emerging stock markets have experienced both high growth and a high return for several years up until 2008. The return has, however, fluctuated much more than the rest of the market. This was particular evident in 2008, when the world's emerging equity markets fell substantially more than the rest of the listed equity market.

The major changes that have taken place in emerging markets over recent decades, and the absence of good data for unlisted equity funds, make comparisons between the return on listed and unlisted emerging equity markets difficult. Cambridge Associates LLC possesses one of the best data sets for unlisted funds. Comparisons based on their data show that listed emerging equity indexes have had a clearly higher return than the average for unlisted funds invested in emerging markets over recent decades until the end of the 3rd quarter of 2008. The difference has, however, lessened towards the end of this period.

Cambridge's data also shows that there is a substantial difference in the returns between the various regions, and that unlisted funds that have invested in Eastern Europe have shown the highest return during this period. The data for the regions is, however, limited, and it is only based on a small number of funds for some of the regions. The data from Cambridge also shows that there is a big difference in the returns between the various funds in emerging markets.

Even though there are major differences between the various emerging markets, the investments in these markets are in general very challenging. Investor rights are often not protected as well through legislation and supervisory authorities as in more developed markets. In addition, transparency and corporate governance in emerging markets is often weaker than in more developed markets. Fund managers that invest in such markets often have the transfer of competence and better corporate governance as key elements in their management strategy. Another factor that entails increased risk is the fact that there is often a high level of country specific risk associated with macroeconomic and political factors in emerging markets.

When investors were asked how much compensation they expected from investments in unlisted emerging equity markets compared with unlisted investments in North America, they responded in a survey conducted by EMPEA (2008) that they expected an excess return of almost 7 per cent annually on average.

Even though many of these risk factors can be reduced through diversification of the investments and choosing high quality managers with experience from the markets, the Government Pension Fund – Global must also demand compensation for the extra risk associated with unlisted investments in emerging markets.

Investments in emerging markets also entail challenges for the implementation of the ethical guidelines. Access to information is often poor, and there can be a greater risk at the same time for human right violations, environmental pollution and corruption. These factors, combined with the fact that unlisted investments are often not very liquid and have accordingly limited opportunities to be sold at a reasonable price, mean that it is important to conduct a detailed review of the fund manager before investing. An important requirement will be that the fund has established good guidelines for responsible investing.

A substantial portion of the investments in investment programmes for the environment, and possibly sustainable growth in emerging markets as well, may be in unlisted equities (private equity) and infrastructure. These are markets and instruments that lie beyond the universe of the permitted investment alternatives for the Government Pension Fund – Global. The investment alternatives, unlisted equities and infrastructure, are discussed, therefore, in more detail below.

Unlisted markets in general

Investments in unlisted markets raise new problems related to the size of the Fund and capacity restrictions in the market, as well as the management structure and an appropriate regulation of unlisted investments. Reference is made to a discussion of these problems related to the Fund's real estate investments in Report no. 24 (2006–2007) to the Storting.

Most large institutional managers invest parts of their equity portfolios in unlisted equities. CEM Benchmarking has defined a reference group for the Government Pension Fund – Global, comprising 19 of the largest pension funds in the world. All of these funds, with the exception of the Government Pension Fund – Global, were invested in unlisted equities in 2007. The funds' median allocation was 5.9 per cent, while the highest allocation to unlisted equity markets was 20.5 per cent. Seven of the funds were invested in infrastructure in 2007. The highest allocation was 8.5 per cent, while the median allocation was 1 per cent.

Most comparable institutional managers invest in unlisted equities through fund-like structures. Unlisted equity funds can be divided roughly into two main categories: Start-up funds (venture capital), where the fund invests in relatively new enterprises with a potential for quick growth, and acquisition funds (buyouts), where the fund buys control of a company and then restructures the company and improves its profitability. Acquisition funds manage far more capital than venture capital funds.

In unlisted markets there is no investable benchmark index, which means that passive index management is not possible. It also makes it difficult to test whether unlisted equities have yielded a better risk-adjusted return than listed markets.

The data available for funds invested in unlisted equities is not very suitable for drawing robust conclusions about the expected return and risk associated with such investments. There are relatively few studies on the historical return on investments in unlisted equities, which is probably due to the lack of good data. Some studies, such as Cochrane (2005) and Kaplan and Schoar (2005), have found that the average net return (after costs) on investments in unlisted equities does not deviate a great deal from listed equities. Other studies, such as Phalippou and Zollo (2005), have found that the net return on investments in unlisted funds has clearly been poorer than the return on the listed equity market. They also point out that investments in unlisted equity funds are illiquid and that the return on the funds has a positive correlation with listed equities. They question why investors have allocated so much to unlisted equities when the historical return has been low.

It seems probable that many of the return drivers for unlisted equities in the long term will be the same as for the listed markets. Like listed companies, the earnings of unlisted companies will have exposure to both economic activity in general and the sectors they are a part of. Valuation measures, such as the ratio between fair value and earnings, will also probably be correlated with the performance of the equity market as a whole, because, for example, the goal of the funds is to list the companies they have invested in or sell them to listed companies.

Even though many of the drivers will be the same for listed and unlisted markets, there will be sectors and products in the unlisted equity market that will distinguish them from the listed market.

Empirical studies show that there are greater differences in the returns between funds that invest in unlisted equities than those that invest in listed equities. This means that the selection of a manager is of greater importance than in listed markets. If we manage to identify in advance and obtain access to the best managers, then we can

obtain a higher return on the unlisted equity market in the long term. It can be argued that individual institutional investors and groups of institutional investors should have better prerequisites for success with investments in unlisted equities than others because it is easier for them to obtain access to the best managers. Lerner, Schoar and Wongsunwai (2007) have found great differences in the returns between various institutional investors in the USA. They found, for example, that funds chosen by US university funds yielded good returns, while funds selected by banks and consultants yielded poorer returns.

The management costs for unlisted investments will be significantly greater than listed investments. It is common that the funds charge 1.5 to 2.5 per cent of the managed funds in running management costs and around 20 per cent of returns over a specific level. The performance-related fees do not normally fall due until the fund has sold the investments, and they are intended, therefore, to give the fund managers incentives to achieve good results and to align the interests of the manager with those of the investors.

Investments in unlisted equities can of course provide an opportunity to achieve an excess return through the selection of capable managers, and to reap benefits over time by investing in less liquid assets. Investments in infrastructure projects, such as electricity and water supplies, toll roads, airports and telecommunications, have traditionally constituted a very limited market. However, increasing private participation and the greater need for private funding have made these kinds of investments more relevant for long-term financial investors. The market for these types of investments is expected to grow in the coming years. The return on and the risk associated with infrastructure investments will vary widely among the different investments, but it is normal to assume that the return and risk of developed projects will resemble the return and risk associated with investments in real estate. As is the case for real estate, investments in infrastructure will also contribute to diversifying the risk associated with the Government Pension Fund and to reaping gains over time by investing in less liquid assets.

In Recommendation no. 283 (2007–2008) to the Storting, a majority of the Standing Committee on Finance, all the members except the members from Fremskrittspartiet (the Progress Party), stated that the Government Pension Fund – Global should be allowed to invest in infrastructure. The majority referred to the fact that infrastructure is a rapidly growing asset class among institutional investors, especially due to the great needs for infrastructure investments in emerging economies. It was also stated that a fund that aims to represent the best international practice in all aspects of its management must develop investment competence in the asset classes that major institutional investors are active in. At the same time the requirements concerning quality and verifiability of the management performance must be maintained.

The Ministry's assessment of investments in unlisted markets

The desire to diversify the investments of the Government Pension Fund – Global further and the ability to invest in assets with reduced tradability suggests consideration of both unlisted equities and unlisted infrastructure investments, which are currently beyond the scope of the Fund's investment alternatives. Investments in unlisted markets will also be in accordance with common practice internationally. A comparison of the investments of the Government Pension Fund – Global with other large funds internationally shows that these funds often have a lower percentage of nominal bonds and that parts of the capital are often invested in alternative asset classes such as unlisted equities and infrastructure, etc.

New investment areas raise at the same time new problems. A basic premise of the evolvement of the strategy will be the need for adequate control of risk other than market risk, such as the operational risk. Evolvement of the strategy must also take into consideration the Fund's role as a responsible investor, and the significant need to build up competence that will arise if new investment areas are chosen.

Several comparable funds that have started with investments aimed in particular at the environment and emerging markets in recent years have allocated a major portion of these investments to unlisted markets. Corresponding investments by the Government Pension Fund – Global would entail starting with possible investments in infrastructure, unlisted equities, etc., in specialised segments for the environment and emerging markets. Given that the Fund is not invested in unlisted markets already, it might be more obvious to start with investments in the most developed segments of these markets, and then evolve

the strategy to include special sub-markets for the environment and emerging markets.

The Ministry has attached importance here to a desire to achieve broader exposure to the environmental sector, an issue that several of the consultative bodies also addressed. This is a sector where high growth can be expected over time. Future assessments of a possible investment programme aimed at sustainable growth in emerging markets will consider, for example, investments in unlisted equities and infrastructure in these markets. These assessments will attach importance to finding a system for these kinds of investments that constitutes an appropriate and natural evolvement of the Fund's strategy and safeguards the need for good risk management. This will be more demanding in emerging markets than in the developed markets that will make up most of the investments in the environmental programme. Following a comprehensive assessment, the Ministry aims to establish an investment programme for environmental investment opportunities, which can also be a first step towards investing in unlisted equities and infrastructure. The scope of such investments will be small in relation to the Fund's total capital, and it can possibly contribute to building up useful competence for evolvement of the Fund's investment strategy in more general terms.

Further work

The Ministry intends to study additional issues related to an environmental programme before any investments are made. This applies, for example, to a closer evaluation of the environmental criteria and the expected return and risk of the various investment alternatives, as well as the size of the market, availability and other operational challenges. While investments that are already part of the Fund's investment universe, such as listed environmental indexes and environmental bonds, can be made quite quickly, any investments in unlisted equities and infrastructure will take more time. Such investments require that the operational manager possess special competence, and they create challenges related, for example, to the measurement and evaluation of the return and risk. In addition, there is a need to establish required rates of return, risk limits, provisions related to responsible management and reporting requirements to ensure fulfilment of the Ministry's objectives for the investments.

There are clear capacity restrictions for investments in unlisted markets in general and for investments in submarkets like eco-friendly technology and energy in particular. Based on the size of the market, which is also limited by the access to capable managers and funds, the Ministry finds that the combined amount for the environmental programme and a possible investment programme aimed at sustainable growth in emerging markets can be around NOK 20 billion, invested over a five-year period. However, there is uncertainty related to the capacity of the unlisted markets. This will entail substantial investments in terms of the size of the markets and the investments made by other comparable funds internationally.

The Ministry will work further on these issues and return to them in the National Budget for 2010.

Need for a more detailed assessment of the consequences of climate challenges on the global financial markets

Thorough assessments from various research firms of how the portfolios can be adapted to a future low carbon economy were received in the consultative round (see Section 4.3). Methods have been developed that attempt to identify factors that will influence the value of companies in the future, which these research firms assume are not taken into account in the current value of these equities.

Given that carbon emissions will be priced in accordance with a new international climate agreement, the sum of the companies' emissions may mean increased costs. Certain sectors, such as power production and metal production will be exposed in particular to higher carbon pricing. On the other hand, an overweighting of low carbon sectors may substantially increase other forms of risk in the portfolio. Banks and financial institutions, for example, have very low carbon emissions. However, these companies give exposure to important risk factors such as credit and liquidity, which the developments in recent months have illustrated.

A general assumption made for the management of the Fund is the fact that the financial markets are basically efficient in the sense that the pricing reflects the information available. The uncertainty related to what the future prices will be for carbon emissions is accordingly not different in principle from other types of uncertainty that is also incorporated into the prices of financial assets. In the opinion of the Ministry, it is, there-

fore, uncertain whether it will be appropriate to make major changes to an investment strategy based on well-diversified investments and a high degree of index management in light of the climate challenges.

The Ministry sees, nevertheless, based on the great deal of uncertainty that is represented by the climate challenges, that there is a need to evaluate more closely the consequences of the climate challenges for the world's financial markets. Climate change and the regulatory measures that are adopted to counteract the development (in the form of quota markets, for example) may have an impact on the return on the Government Pension Fund – Global.

In such an analysis there is a need to evaluate how the world's financial markets can be impacted by the challenges associated with climate change and what investors by the virtue of their role can do to counteract unfortunate trends. Thereafter there is a need to evaluate whether strategies can and should be established for making active choices for protection against possible incorrect pricing in the market related to carbon emissions. In this context, there should be a critical review of the various methods for such active choices.

The Stern Review ("The Economics of Climate Change" from 2006) provided important knowledge about the impact of climate change on overall global economic development in the world, and work of a similar nature can shed light on more specific effects on financial markets. Against this backdrop, the Ministry of Finance is aiming to initiate a study to assess how the challenges associated with climate change can affect the financial markets and how investors ought to act in light of this. This ought to be an international project and can if necessary be carried out in collaboration with other investors. The Ministry will present a more detailed plan for this in the National Budget for 2010.

2.5.2 Work on the fixed income benchmark

Over the last few years, important strategic decisions have been made concerning increasing the risk and expected return associated with the Government Pension Fund – Global by raising the equity portion, through the inclusion of small-cap companies and emerging markets in the benchmark portfolio for equities, and allowing the build-up of real estate investments.

It may now be natural in the work to evolve the Fund's investment strategy to look more closely at the composition of the benchmark portfolio for interest-bearing instruments. This follows partly from the fact that the Ministry stated in Report no. 16 (2007–2008) to the Storting that it would return to an evaluation of emerging bond markets in light of the fact that emerging equity markets were already included in the portfolio. Furthermore, there may be grounds to consider whether there are other aspects of the composition of the benchmark portfolio that ought to be reviewed in more detail, including whether it is appropriate to expand the portfolio to also include corporate bonds with high credit risk (i.e. higher than investment grade).

To this end, the Ministry invited Norges Bank and the Strategy Council to shed light on and give advice on the composition of the benchmark portfolio for interest-bearing instruments. In a letter dated 3 November 2008, Norges Bank states that it is natural to consider including bond investments in emerging markets and corporate bonds with high credit risk in the benchmark portfolio. After an overall assessment that identified, for example, a number of significant operational challenges, Norges Bank recommends not expanding the benchmark portfolio in these areas for the time being.

In a letter dated 20 March 2009 to the Ministry of Finance, the Strategy Council writes that expanding the benchmark portfolio to include high-yield bonds and emerging markets is consistent in principle with the desire to ensure further risk diversification and reap liquidity premiums. However, the Council points out that high-yield bonds have some undesirable risk properties in periods of economic downturn, due to the fact that the return tends to follow the return on equities, and goes in the opposite direction of the return on government bonds. Including high-yield bonds in the benchmark portfolio for fixed income instruments might weaken the ability of the benchmark interest rate to protect the fund capital in economic downturns. Against this backdrop, and in light of the need to ensure the good reputation of the Fund, the Strategy Council recommends that the fixed income benchmark not be expanded to include high-yield bonds.

With regard to the issue of whether the benchmark portfolio for fixed income instruments should be expanded to include bonds issued in emerging markets (in local currencies), the Strategy Council refers to the fact that limited data make it difficult to assess the historical return and risk associated with such investments. It is also

pointed out that investments in emerging bond markets entail a number of operational challenges. Against this backdrop, the Strategy Council recommends not expanding the fixed income benchmark with bonds issued in emerging markets in local currencies at this point in time. At the same time, the point is made that the matter should be reconsidered when more information is available.

The Ministry has taken note of Norges Bank's and the Strategy Council's recommendations and that for the time being it is not recommended to expand the benchmark portfolio for fixed income instruments with high-yield bonds and bonds issued in emerging markets. The Ministry is therefore working on the assumption that it is not pertinent to implement this type of change in the imminent future. These issues will be reassessed and the Storting will be informed of the findings at a later date.

2.5.3 Regional and currency distribution

Another topic that the Ministry would like to review in more detail is the regional and currency distribution in the benchmark portfolio for the Government Pension Fund – Global. The distribution here is based on the goal of preserving the international purchasing power of the Fund in the best possible way. Norway's import pattern has been an important reference, along with the consideration of the broadest possible diversification of the Fund's risk and the Fund's role as a financial investor with emphasis on low transaction costs.

Initially the Ministry aims to shed light on the issues. Regardless, any plans for changes in this area will be some way off in the future. Since this area is of strategic importance for the Fund, any changes will be presented to the Storting before they are implemented.

2.5.4 Rebalancing

The strategic benchmark portfolio the Ministry of Finance defines for the Government Pension Fund – Global and the Government Pension Fund – Norway reflects the owner's preferences between the expected return and risk in the long term, and it represents thus the most important decision in the formulation of the investment strategy.

The strategic benchmark portfolio defines what percentages shall apply to investments in the various asset classes and geographic regions. The weights of the various asset classes will, however, fluctuate over time in accordance with the performance of the market. A distinction is therefore made between the strategic benchmark portfolio, with fixed weights, and the actual benchmark portfolio, with floating weights.

The actual benchmark portfolio will thus deviate from the strategic portfolio, and it will then no longer reflect the owner's original preferences between the expected return and risk. It is, therefore, common to have a rebalancing mechanism to bring the weights in the actual benchmark portfolio back to the strategic weights, before they start to float again.

The manager's performance will be compared with the actual benchmark portfolio. A rebalancing of the benchmark portfolio will normally entail that the manager chooses to adapt the actual portfolio. A rebalancing triggers, therefore, transaction costs, which the owner is willing in principle to bear to restore the portfolio's strategic weights.

The Government Pension Fund – Global receives new funds every month, and these funds are invested so that the weights in the actual benchmark portfolio are brought back to the strategic weights as far as possible. This injection of new capital contributes, therefore, to a partial rebalancing of the actual benchmark portfolio, and it results in a reduced need for full rebalancing, where the weights are restored completely to the strategic weights. Partial rebalancing through the injection of new capital is a very cost-effective rebalancing strategy. For a fund like the Government Pension Fund – Norway, which does not have a regular injection of new funds, the costs associated with rebalancing will typically be higher.

Even with partial rebalancing, the weights of the actual benchmark portfolio may, however, deviate significantly from the strategic weights. Detailed rules have, therefore, been formulated for when and how full rebalancing is to take place. The actual benchmark portfolio is subjected to a full rebalancing if certain conditions concerning the deviation of the asset classes from the strategic weights are met. Conditions have also been defined in this connection to avoid unnecessarily frequent and small rebalancings, which are costly. For example, the very poor performance of the equity markets in recent times has triggered a rebalancing of the Government Pension Fund, and equities have been purchased to restore the portfolio to the strategic weights.

In general, the accumulated transaction costs over time in connection with full rebalancing increase with the frequency of the rebalancings. Frequent rebalancings also incur operational costs. If the ongoing injection of new funds decreases in relation to the value of the Fund, the partial rebalancing from the injections will be less effective and full rebalancings will in isolation be more frequent. If such circumstances are expected, it may be cost-effective to adjust the conditions for full rebalancing, so that the frequency of future full rebalancings is limited. However, this must be weighed up against the disadvantages of permitting the asset weights in the actual benchmark portfolio to move further away from the "optimal" strategic weights.

The Ministry of Finance has recently analysed the rebalancing regime for the Government Pension Fund – Global. The reason for the analysis was the fact that the injection of new capital is expected to decrease in relation to the value of the fund. In addition, the Fund's equity portion has increased, which entails higher expected volatility and thus more frequent full rebalancings. The Ministry has, therefore, evaluated whether it is appropriate to adjust the conditions for full rebalancing, or to allow the portfolio weights to float a little more freely, to reduce the expected rebalancing costs over time.

The analysis is based on a portfolio simulation model, where the estimates for the expected long-term return and volatility for the various asset classes are those referred to in Section 2.3.2. The fiscal policy assumptions are retrieved from the Ministry's budget publications. The simulation model generates a large number of paths for the value of various asset classes over time horizons from 5 to 20 years. The current rebalancing regime and alternative regimes are simulated in the model, and this results in estimates of the expected number of full rebalancings over the time horizon, accumulated transaction costs in connection with the rebalancings, and the portfolio's expected return and risk throughout the period.

The results of this analysis can be summed up as follows. If the current rebalancing regime is continued, then a slight increase in the number of full rebalancings over the next five years in relation to the last five years must be expected. The number is nevertheless low. A further, but moderate, increase in the number of full rebalancings is expected thereafter. The associated transactions costs will, therefore, increase somewhat, but from a low level.

If the current regime is adjusted, so that the asset class weights are allowed to float more, then the expected number of full rebalancings will be reduced, as well as the accumulated transaction costs. This must be weighed up against the disadvantages. Firstly, the actual benchmark portfolio will deviate over time somewhat more from the strategic benchmark portfolio, which represents the owner's desired exposure to the capital markets. Secondly, the expected risk, in the form of portfolio volatility and probability for large losses ("downside risk"), will increase marginally because the equity portion will be permitted to rise a little more over time. Thirdly, the expected return will be reduced marginally, in spite of the transaction costs saved, partly due to the lower diversification return.

After an overall assessment, the Ministry of Finance has decided to continue the current rebalancing guidelines for the time being. The analysis and experience will, however, evolve over time. The Ministry will, therefore, reconsider this issue at a later point in time.

2.5.5 On oil price risk

The question of whether the Government Pension Fund – Global should reduce its equity holdings in the international oil and gas sector has been raised from time to time. The argument is that the State assumes an unnecessarily high oil price risk through financial investments in this sector, in the sense that the value of the Fund will be too highly correlated with the value of the State's revenues from oil and gas in the North Sea and the level of activity in the economy in general.

The argument is based on the observation that the return on equities in the oil and gas sector is relatively highly correlated with the variation in the price of oil. This is illustrated by Figure 2.13, which shows the development of the value of a broad-based portfolio of oil and gas shares (FTSE All-World Oil&Gas index, in a basket of local currencies) since 1994, compared with the development of the price of oil (normalised at 100 in 1994). The portfolio value and price of oil follow each other closely. The figure also illustrates the performance of a global equity index for all sectors (FTSE All-World), which is not so closely linked to the price of oil.

Another way of illustrating this is to calculate the correlation (covariation) between the variation in the price of oil and total rate of return for the global sector indexes that are included in the

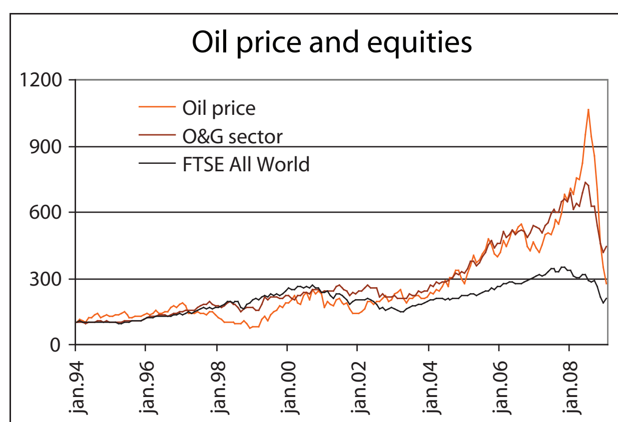

Figure 2.13 Development of oil price, a global equity index for the oil and gas sector, and a broad global equity index

Source: Datastream

global equity index FTSE All-World. The correlation coefficients are based on monthly figures since 1994 and are illustrated in Table 2.5. The closer the correlation coefficients are to 1, the higher the covariation. The correlation between the price of oil and rate of return is clearly the greatest for equities in the oil and gas sector (coefficient 0.52), and significantly higher than the equities in the broad-based global index FTSE All-World (0.18).

The table also illustrates the average (geometric) annual total return and volatility (standard deviation of the return) over the same period. It should be noted that it is the oil and gas index in the FTSE All-World index that has performed the best since 1994, in spite of the sharp fall in the price of oil recently. For this sector the average geometric rate of return for the 15-year period has been as much as 10.5 per cent. This is more than double the rate of return for the broad-based FTSE All-World index. In comparison, for example, the financial sector yielded an average rate of return of only 3 per cent.

Equities in the oil and gas sector are in other words relatively highly correlated with the price of oil. It may, therefore, be interesting to study the effect of omitting this sector from a broad-based global equity index. The outcome of these calculations is illustrated in Table 2.6. The correlation between the variation in the price of oil and total rate of return for the calculated equity index excluding companies in the oil and gas sector ("FTSE All-World-ex-Oil&Gas") falls to 0.14 (from 0.18 for FTSE All-World). However, the average rate of return also falls over the last 15 years by 0.7 percentage points to 4.2 per cent, while the volatility increased by 0.3 percentage points to 15.1 per cent.

Hence, according to the historical data since 1994, the covariation of the Government Pension Fund – Global with the price of oil can be reduced a little by excluding oil and gas companies from the equity portfolio, but from an already low level (correlation coefficient of 0.18 for the equity portfolio, while the bond portfolio's correlation is even lower). There are, however, costs associated with this small reduction in covariation in the form of a lower rate of return and higher volatility.

The reduction in the rate of return is related to the strong development in the value of oil and gas equities relative to a broad market index, a development that accelerated in 2003–2004, when the price of oil was still low (see Figure 2.13). The increase in volatility, which is noteworthy since a sector with relatively high volatility (18.2 per cent) is excluded, is due to the fact that the equity portfolio is less diversified when companies in the oil and gas sector are excluded. This shows that this sector has had very favourable diversification properties, since the rate of return has been rela-

Table 2.5 Annual rate of return (geometric) and risk (standard deviation) in per cent, as well as the correlation with the price of oil for the global sector specific indexes since 1994 (local currency).

	FTSE Oil & Gas	FTSE Basic mat.	FTSE Indust.	FTSE Cons. goods	FTSE Health care	FTSE Cons. serv.	FTSE Tele com	FTSE Utilities	FTSE Finan-cials	FTSE Tech.	FTSE All-World
Correlation with price of oil	0.52	0.25	0.19	0.12	-0.08	0.05	0.04	0.16	0.05	0.17	0.18
Rate of return	10.5	5.4	5.4	4.1	8.0	2.6	5.8	6.7	3.0	5.2	4.9
Standard deviation	18.2	18.6	17.0	17.1	12.1	15.0	16.8	11.8	18.5	28.5	14.8

Source: Datastream

Table 2.6 Rate of return, risk (volatility) and correlation with the price of oil for global equity indexes with and without the oil and gas sector since 1994 (local currency)

	FTSE All-World	FTSE All-World-ex-Oil&gas
Correlation with oil price	0.18	0.14
Rate of return (per cent)	4.9	4.2
Standard deviation (per cent)	14.8	15.1

Source: Datastream

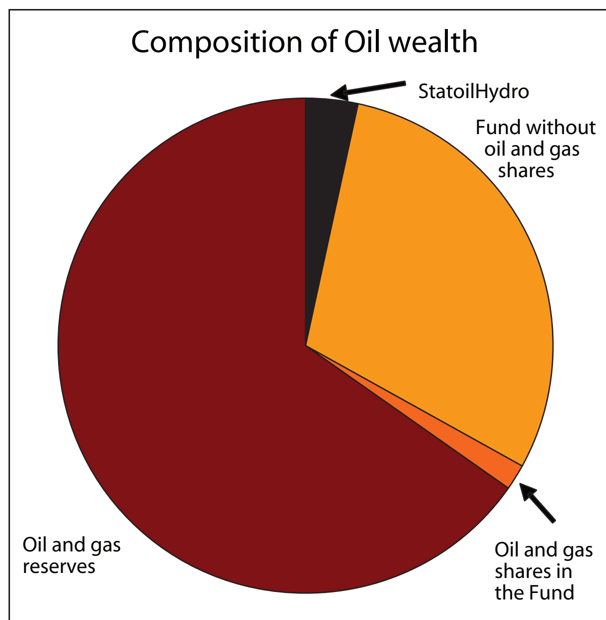

Figure 2.14 Composition of the State's petroleum wealth (defined as the sum of the net present value of the State's net cash flow from petroleum activities, State ownership in StatoilHydro and the Government Pension Fund – Global)

Source: Ministry of Finance

tively lowly correlated (0.59) with the global equity portfolio without oil and gas equities (FTSE All-World-ex-Oil&Gas).

If, instead of looking at the correlation of the price of oil with the equity portfolio of the Government Pension Fund – Global, we calculate the correlation of the price of oil with the Fund as a whole (with 40 per cent bonds), combined with the value of the remaining Norwegian oil and gas reserves, we find that the effect of excluding oil and gas sector equities lessens. To simplify this analysis we make the assumption that this "petroleum wealth" consists of 50 per cent financial assets (Government Pension Fund – Global) and 50 per cent oil and gas reserves. One finds that the correlation between the monthly variation in the price of oil and the value of the petroleum wealth is very high (0.97). When equities in the oil and gas sector are excluded from the Fund, the effect of this correlation is hardly measurable (correlation falls from 0.972 to 0.970).

In reality, however, the remaining oil and gas reserves represent an even greater share of such defined petroleum wealth, and the value of State ownership in StatoilHydro comes in addition to this, so that the effect of excluding the oil and gas sector from the Fund's equity portfolio becomes even smaller. Figure 2.14 illustrates the composition of this petroleum wealth, and it is evident here that the value of the Fund's equities in the oil and gas sector represent a very small share (1.7 per cent).

This analysis does not provide weighty grounds for changing the current investment strategy, which entails a broad and well-diversified exposure to the world's equity and bond markets across the various countries and sectors. This strategy builds on the principle that the weight of the companies or sectors in the three regions (Europe, America and Asia/Oceania) is determined by their market value. This principle is based on a hypothesis that the pricing of securities in developed markets is relatively efficient over time (see the earlier discussion in this chapter). Excluding equities in the oil and gas sector would represent a violation of this strategy, especially because this sector currently represents a significant portion of the equity markets' capitalisation. Figure 2.15 illustrates that the oil and gas sector's share of the broad-based FTSE All-World index has been on the rise and is over 11 per cent now.

The effect of excluding such a large portion of the equity market would be a significant increase in the weight of the other sectors (where the financial sector is still the largest sector, even though this sector's percentage fell to around 20 per cent at year-end 2008). Somewhat less exposure to the price of oil would be achieved, but there would be greater exposure to other sectors and risk factors.

There are also more qualitative arguments to continue the current investment strategy. Several oil companies are, for example, active in the research and development of renewable energy, which is a sector that shows strong growth. Long-

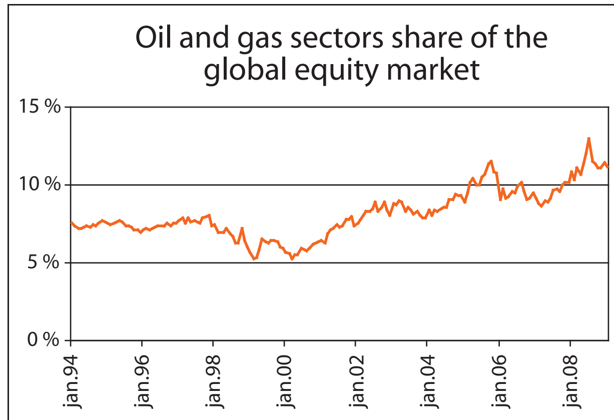

Figure 2.15 Oil and gas sector share of the broad-based global equity index FTSE All-World

Source: Datastream

term ownership in oil companies provides exposure to these sectors.

The more fundamental question of how the State handles the price of oil risk, however, is a question that can be answered primarily through the management of the petroleum resources. The most important parameters here are the strategy for the production and sale of oil and gas resources, the tax system, the State's ownership in the petroleum sector, as well as the fiscal policy guidelines on the use of the petroleum revenues. By having a good policy in these areas, we contribute to a stable and sustainable economic development in the long term, and we thus avoid the pitfalls that so many petroleum-producing countries have experienced. By investing revenues from the production of oil and gas in the Government Pension Fund and limiting withdrawals from the Fund in accordance with the fiscal policy guideline, an important reduction is achieved in Norway's exposure to the oil price risk. Financial assets in the Government Pension Fund are built up to meet the challenges of tomorrow in step with the extraction of the petroleum reserves.

3 Reporting on the work on the ethical guidelines for the Government Pension Fund in 2008

3.1 Introduction

The Government Pension Fund – Global and the Government Pension Fund – Norway are subject to ethical guidelines. The Ministry of Finance laid down ethical guidelines for the Global part of the Fund on 19 November 2004, based on a report and proposal by the Government-appointed Graver Committee (NOU 2003: 22). The same year, the Executive Board of Folketrygdfondet introduced ethical guidelines for the domestic part of the Fund. The guidelines for the two parts of the Government Pension Fund may largely be characterised as founded on a shared ethical platform. At the same time, the tools deployed are somewhat different in view of differences in terms of the size and investment strategies of the two funds, among other things.

The Government Pension Fund – Global is in its entirety invested in securities abroad. The investment strategy of the Fund is reflected in a benchmark portfolio comprising broad equity and bond indices. At year-end 2008, the Fund held equity investments in approx. 7,900 companies. Norges Bank's average ownership stake in these companies is about 0.8 per cent. The tools used to integrate the ethical concerns are adapted to this strategy. The current ethical guidelines of the Government Pension Fund – Global prescribe active exercise of ownership and the exclusion of companies as tools to promote the financial interests and the ethical commitments of the Fund (see the more detailed discussion in Section 3.2).

The Government Pension Fund – Norway is primarily invested domestically. The benchmark index for the equity investments of the Fund comprises the main index of the Oslo Stock Exchange and the Nordic equity index VINX Benchmark. At year-end 2008, the Fund had holdings in a total of 51 companies listed on the Oslo Stock Exchange and 123 companies in Denmark, Finland and Sweden. Folketrygdfondet's average ownership stake in Norwegian companies is about 6.1 per cent. Its average ownership stake in other Nordic companies is about 0.25 per cent.

In its management of the Government Pension Fund – Norway, Folketrygdfondet emphasises positive selection of the companies in which its assets are to be invested, and thereafter the exercise of ownership rights in the same companies. This has to do with the fact that the investment universe is well-defined and comprised of a relatively limited number of companies.

In this chapter, the Ministry reports on the main points in its work on the ethical guidelines for the Government Pension Fund in 2008. The results of the evaluation of the ethical guidelines for the Government Pension Fund – Global are discussed in Chapter 4.

Exercise of ownership

The basic principles for exercise of ownership are the same for the Government Pension Fund – Global and the Government Pension Fund – Norway (see Box 3.1). Norges Bank and Folketrygdfondet have formulated their own principles for the exercise of ownership rights, which are founded on these basic principles. The ownership efforts of Norges Bank and Folketrygdfondet are discussed in more detail in Section 3.2.

Exclusion of companies

Companies shall be excluded from the investment universe of the Government Pension Fund – Global, pursuant to the ethical guidelines for the Fund, if they are involved in production or undertakings that imply an unacceptably high risk that the Fund contributes to grossly unethical activities. Since 2002, the Ministry of Finance has excluded 32 companies pursuant to the criteria stipulated in the ethical guidelines, based on recommendations from the Council on Ethics. The basis for exclusion of companies is discussed in more detail in Box 3.3 below.

Box 3.1 Basic principles for the exercise of ownership

The principles governing the exercise of ownership rights as part of the management of the Government Pension Fund are based on the UN Global Compact, the OECD Principles of Corporate Governance and the OECD Guidelines for Multinational Enterprises. Using these international principles as a basis, Norges Bank and Folketrygdfondet have defined their own principles for their exercise of ownership rights. Both Norges Bank and Folketrygdfondet have adopted the UN Principles for Responsible Investment (PRI), and report to the PRI secretariat each year on their compliance with the principles.

The UN Global Compact

The UN Global Compact defines a total of ten universal principles derived from the Universal Declaration of Human Rights, the ILO Declaration on Fundamental Principles and Rights at Work and the Rio Declaration on Environment and Development. The principles are general in nature and say that businesses should respect human rights and not be complicit in human rights abuses, uphold the freedom of association and collective bargaining, as well as eliminate all forms of forced and compulsory labour, child labour and discrimination in respect of employment and occupation, support a precautionary approach to environmental challenges, as well as promote greater environmental responsibility and the development and diffusion of environmentally friendly technologies, work against all forms of corruption, including extortion and bribery.

4,700 companies and organisations in more than 130 countries have joined the UN Global Compact. The members are encouraged to report annually on their own compliance with the principles.

OECD Principles of Corporate Governance

These principles are very extensive and mainly address the basis for effective corporate governance, the rights of shareholders and key ownership functions, equitable treatment of shareholders, transparency and disclosure, and the responsibilities and liabilities of boards of directors.

OECD Guidelines for Multinational Enterprises

These guidelines are voluntary principles and standards for responsible business practices in different areas in accordance with laws applicable to multinational companies. The OECD guidelines for multinational companies represent the only multilaterally recognised and detailed regulatory framework that governments are obliged to promote. They contain recommendations on a number of matters, including public disclosure of company information, working environment and employee rights, environmental protection, combating bribery, consumer interests, the use of science and technology, competition, and tax liability.

The UN Principles for Responsible Investment

The UN Principles for Responsible Investment are an initiative in partnership with the United Nations' Environment Programme Finance Initiative and the UN Global Compact. The initiative is aimed at the owners of assets, asset managers and their professional service partners, all of whom are encouraged to sign the principles. The principles can help raise awareness in the financial markets in areas that need protection, as part of the work to ensure adequate, long-term wealth creation in business. The principles cover aspects linked to being a responsible and active owner by incorporating environmental, social and corporate governance issues (ESG) into management work and exercise of ownership. This kind of integration will also have consequences for what type of information investors request from companies and what the companies are expected to report on. The members of PRI have a duty to report on their own compliance with the principles on an annual basis.

3.2 Reporting on the exercise of ownership rights

3.2.1 Ownership activities in Norges Bank

Norges Bank's exercise of ownership builds on the basic principles laid down in the ethical guidelines for the Government Pension Fund – Global. These basic principles are of a very overarching nature and lay down general requirements concerning the content of the exercise of ownership through reference to the UN Global Compact and the OECD guidelines on corporate governance and multinational enterprises (see Box 3.1). Ownership work is rooted in a document approved by Norges Bank: "*Principles for exercise of ownership and safeguarding financial wealth.*" The bank's principles imply that a number of requirements are imposed in relation to the companies in which the Fund is invested, as far as responsible business conduct and transparency are concerned. Furthermore, the principles imply that there are requirements as to the companies' form and management structure, as well as to their long-term sustainability, inasmuch as the companies need to take into account effects of their own activities on the environment and on society in general.

Norges Bank was involved in the development of the UN-initiated "Principles for Responsible Investment" (PRI). This is an important international platform targeting the investor role. The bank bases its exercise of ownership and interaction with other investors on these principles. The principles are described in more detail in Box 3.1.

Norges Bank has invested considerable resources in establishing solid, target-oriented ownership activities. The bank's goal is to be recognised as one of the world's most prominent and serious active owners.

The objective of the exercise of ownership is to safeguard and build financial wealth for future generations by promoting good corporate governance and by striving towards high ethical, social and environmental norms in the companies. Norges Bank uses its position as a shareholder to raise topics relating to traditional shareholder rights such as the shareholders' right to equitable treatment and influence, etc. At the same time, the bank emphasises topics that affect developments and the framework conditions for the companies' input factors. This applies to both human resources, such as future labour force, and natural resources, such as access to clean water and clean air.

The tools at Norges Bank's disposal in its ownership efforts are linked to the ownership position the bank has in many companies. A shareholder's primary means of expressing his opinion is by voting at general assemblies. In 2008 Norges Bank voted at 7,871 general assemblies on almost 70,000 issues. Since 2007, Norges Bank has published its vote in each individual case. The bank has established principles for how it votes. Norges Bank is working actively to contribute to more efficient processes for global voting, and aims to vote at all the general assemblies in the companies the Fund has holdings in.

Other tools Norges Bank makes use of include dialogue with individual companies, collaboration with other investors, participation in international networks and organisations, input to regulatory authorities, research and public communication of opinions and expectations.

When choosing between several possible instruments, Norges Bank considers what will have the greatest impact in relation to resource use, among other things. Sometimes it is most expedient to strive to exert an influence through regulations, as they will have an impact on all the companies in a segment. In other cases, change can be achieved through dialogue with one or more companies. There has been an increase in this type of activity.

The bank has given priority to a handful of areas of commitment that are regarded as key in promoting the Fund's interests as an investor, and where there is a close connection between ethics and long-term financial return. These areas of commitment are deemed to be of relevance to investors in general, and to the Fund's portfolio in particular. The areas of commitment are also well suited for dialogue with companies and regulatory bodies, which improves the prospects for achieving results in individual cases.

Areas of commitment

Norges Bank has chosen three main focus areas in its ownership work: topics linked to traditional corporate governance; children and children's rights; and the way companies deal with the external effects of their activities and the natural resources in the value chain, including questions related to long-term changes to the natural environment.

Corporate governance

Good corporate governance is important in order to ensure the Fund's return over time and is

necessary to ensure that the owners have real influence and dialogue with the companies. It is also a prerequisite for work on social and environmental issues.

Norges Bank aims to achieve fair financial treatment of all shareholders and strives to exert influence over the people who have been chosen to run the company on behalf of the shareholders. The bank works along two axes in its efforts to achieve this goal: it targets standard setters and organisations in order to affect the framework and regulations for the capital markets, and it targets the companies and their conduct and strategy.

Since Norges Bank wants an investor profile that can provide long-term influence, the bank focuses on ensuring the company's trust in the market and the board's role, routines and responsibilities. At the end of 2008, Norges Bank had established or continued dialogue with 16 companies concerning issues linked to good corporate governance and shareholder rights. A central topic that the bank has raised with many companies is the board's independence. This applies to the chair of the board and central executive committees. It is also expected that the majority of the directors are independent of dominant owners and the company's management. In addition, voting rights and transparency in corporate information have been discussed with some of the companies.

In matters related to corporate governance, Norges Bank has generally voted in favour of the proposals forwarded by the management in 2008. However, in 11 per cent of the cases, the bank deemed it right to vote against the management's proposals. Norges Bank has voted against candidates for the board of directors if the board as a whole does not satisfy the bank's expectations concerning sufficient independence from the company's management or dominant owners. The bank has also voted against managerial salary schemes in cases where there is no obvious link between performance and reward.

In 2008, Norges Bank in collaboration with other investors contributed information and experiences acquired in its role as fund manager for preparation of a new financial market regulation in Germany. The goal was to avoid an unintended narrowing of investors' opportunities for constructive dialogue concerning companies. Norges Bank also took part in a process to develop new International Financial Reporting Standards (IFRS) for companies engaged in activities within extraction of natural resources (oil, gas and minerals). The opinion has been voiced by a number of parties that the new accounting standard must require that companies in the extractive industry report on value streams paid to authorities on a country-by-country basis. Norges Bank has supported this. These kinds of standards would help simplify valuation of the companies and counteract corruption. See the more detailed discussion in Section 4.4.

Child labour

The battle to safeguard the rights and health of children is of relevance to the financial return of an investor with a long time horizon. This issue is also closely related to the international standards on which the corporate governance efforts of the Fund are based. Efforts in this area are per se a moral imperative. In many countries, national legislation, and compliance therewith, is inadequate when it comes to child labour and protection of children's rights, making the measures adopted by companies in this respect especially important. The rights and health of children is an issue that has not received much investor attention in the past. The reputational and economic risks of failing to safeguard the rights and health of children can, at the same time, be considerable.

Norges Bank has prepared a document *NBIM Investor Expectations on Children's Rights*, to clarify to companies what expectations the bank as an investor has in respect of children's rights and child labour in particular. The document is based on the UN Convention on the Rights of the Child, as well as ILO conventions on child labour.

In 2008, NBIM has concentrated on implementing this expectations document, as an analysis tool and in the bank's dialogue with the portfolio companies. The target group for the strategy area children's rights consists of companies engaged in activities in sectors and regions where there is a high risk of child labour. Over 500 companies involved in production of genetically modified seeds, chemicals, cocoa, mining, the iron and steel industry and the textile industry have been systematically analysed using the criteria laid down in the expectations document. In 2008, efforts in this area have focused on four important markets: India, Brazil, China and West Africa. In connection with its annual report for 2008, Norges Bank has published information on how the various sectors meet the bank's expectations concerning child labour on the basis of these analyses. In the future Norges Bank is going to report on an

annual basis on the various sectors' compliance with the bank's expectations in this area.

At year-end 2008, Norges Bank was in talks with 130 companies and involved in 19 corporate commitment projects linked to child labour, risk management in the supplier chain and the board's competence in issues related to child labour. A commitment project with a company is far more extensive than a dialogue. Dialogue may be limited to making contact with the company, without any meetings being held, whereas commitment projects with companies will often be processes that run over several years and have long-term objectives. The purpose of a commitment project is to communicate Norges Bank's expectations and assist the companies in evaluating and improving their corporate governance processes. Norges Bank is currently involved in a commitment project with the company Monsanto, for example, related to use of child labour in the cotton seed industry in India. This is discussed in more detail in Section 3.3.2.

The environment

In line with the ethical guidelines for the Government Pension Fund – Global, it is natural to consider the economic impact of environmental sustainability for a long-term global investor, not least in view of the threat of climate change. There is growing scientific consensus that the costs of implementing effective measures against global warming will be lower than the detrimental effects on the global economy of continuing without more measures than are currently in place. National and international regimes for limiting greenhouse gas emissions, such as pricing or quota mechanisms and technological development, are necessary instruments for reducing or eliminating this threat. Norges Bank has chosen, for purposes of contributing to this process, to focus on corporate lobbying of government authorities as far as long-term climate change is concerned. This approach may also be of relevance to other environmental issues.

In 2008, Norges Bank has focused in particular on the conduct of certain companies related to the national climate-change regulations in the USA. In 2008, Norges Bank has continued seven established commitment projects with US companies, holding a total of 15 meetings with these companies.

The commitment projects have dealt with the extent to which proposals to reduce emissions of greenhouse gases affect the companies' business and investment strategy, and what main issues the companies in their turn discuss with the legislators. A bill concerning widespread regulation of greenhouse gases was discussed in the US Senate in 2008. In connection with this, Norges Bank has strengthened its commitment projects with relevant US companies. The bank's objective for this contact has been to communicate its and other long-term investors' expectations of the companies and the need for an effective solution to the problem of climate change. The companies that Norges Bank has been in dialogue with are major players in the energy sector in the USA, which are assumed to have a great deal of influence on US legislation in the areas of climate change and environmental protection.

Norges Bank has chosen to coordinate its work in the area of climate change with other investors. Two important initiatives were taken in 2008. Firstly, Norges Bank joined the Carbon Disclosure Project. CDP is an independent, non-profit organisation that seeks to gather and publish information on corporate emissions of greenhouse gases and other information relating to corporate handling of greenhouse gas issues. The Carbon Disclosure Project approaches listed companies and asks them to complete a questionnaire that among other things covers their emissions of greenhouse gases, the companies' position on the effects of possible climate change, and what they are doing to reduce their emissions. At present, just under 400 investors have signed the CDP's information request. The results may be able to provide a basis for following up companies through ownership work and can also be used in assessments in connection with investment decisions. As a long-term, financial investor, the Government Pension Fund will benefit from access to information about different companies' environmental strategies.

Secondly, in November 2008 Norges Bank took part in a statement to heads of governments and climate negotiators from more than 130 investors with total assets of USD 6,400 under management that future climate agreements must be strong and binding. The statement declares that investors care about climate change because it will affect the global economy and the investors' investments. According to scientific assessments, major global reductions in emissions are necessary until 2050. The Statement reads:

> "Private capital is essential to achieving the transformation to a low-carbon economy and

for contributing to the delivery of mitigation and adaptation measures. Through the allocation of capital, and by engaging with companies in our portfolios, investors can influence how companies respond to climate change. &…;

A strong global agreement will underpin investor confidence in the direction that regional and national climate policy will take and will support investors in their engagement with companies."

The Statement calls for continuation of existing and planned quota trading, and the hope is expressed that an extended, more liquid global carbon-trading market will be introduced in 2012, with links between the regional quota markets. Incentives are also required to encourage investments in low-carbon technologies.

3.2.2 Ownership activities in Folketrygdfondet

The Executive Board of Folketrygdfondet has laid down guidelines for exercising ownership rights on the part of the Government Pension Fund – Norway. The guidelines are based on the *Norwegian Code of Practice for Corporate Governance* and the UN Global Compact, as well as the OECD principles for corporate governance and for multinational companies. In 2008, Folketrygdfondet formally adopted and signed the UN-initiated Principles for Responsible Investment (PRI). These principles are described in more detail in Box 3.1.

The overarching objective of the exercise of ownership by Folketrygdfondet is to safeguard the financial interests of the Fund. In order to help promote long-term wealth creation, Folketrygdfondet has defined ethical principles for investment activities that have been integrated into the guidelines for Folketrygdfondet's exercise of ownership.

Key aspects of exercise of ownership

Good corporate governance and corporate management shall promote the rights of owners and other stakeholders in relations with the companies and also ensure that the companies' management mechanisms work appropriately. Important principles underpinning Folketrygdfondet's corporate governance effort are:

- Ensuring the establishment of clear ethical principles and ethical guidelines
- Ensuring the equal treatment of the shareholders
- Safeguarding the rights of shareholders and their scope for promoting corporate governance
- Ensuring that the appointment of directors is well prepared, related to defined competency requirements and vested in the shareholders
- Ensuring the establishment of remuneration models that are goal-oriented and prudent, and which do not impair shareholder value

In following up the ethical principles, Folketrygdfondet attaches particular importance to examining whether the company does itself, or through entities controlled by it, produce weapons that violate fundamental humanitarian principles in their normal use. It also examines whether the company bases its business on actions or omissions that involve the violation of human rights, child labour, environmental damage, corruption and other violations of fundamental ethical norms. During such examinations Folketrygdfondet looks at a number of factors, including what production methods are used, where production takes place and the company's customer relations, the company's corporate culture and management culture, the company's ownership structure, and the company's ownership interests.

In December 2007, the Executive Board of Folketrygdfondet adopted new ethical principles for the management of the Government Pension Fund – Norway, based on the ethical principles that were stipulated in 2004 (see the description in Report no. 16 (2007–2008) to the Storting).

Folketrygdfondet submits a report on its exercise of ownership rights each year. The reports give an account of the activities carried out by Folketrygdfondet for purposes of attending to its ownership interests and address the following, among others:

- Special matters deliberated in the shareholders' meetings
- Relevant matters Folketrygdfondet has raised with the companies
- The number and type of offices held by employees of Folketrygdfondet

In order to safeguard shareholder value, Folketrygdfondet deems it important to follow up the managerial salary policies of the companies. This involves evaluating whether managerial salary schemes are structured in such a manner as to actually contribute to more effective and performance-oriented corporate management, etc. Folketrygdfondet also examines any option schemes,

and what these imply in terms of value transfer from the shareholders to companies' management teams.

Information gathering and company dialogue

In order to ensure the most objective and precise assessment attainable of the ethical attitudes and actions of the companies, Folketrygdfondet has adopted a methodology based on a combination of open sources such as annual reports, information in the media and on the Internet, and information gathered directly from the companies through a survey of all the Norwegian companies in which the Fund has a holding.

The first phase of the assessments reviews companies' own reporting in the form of annual reports, sustainability reports, Internet searches, etc. On the basis of this information, Folketrygdfondet tailors its standardised questionnaire to each company, before the questionnaire is sent to the company for completion. This questionnaire addresses matters pertaining to the company's general principles and guidelines on ethical issues, its distribution of responsibility, communication and organisation of its ethics work, as well as the senior management's attitudes concerning the environment, human rights, corruption and unethical conduct. Good corporate management is deemed to be premised on the interplay between attitudes, principles and guidelines, within a framework defined by a clear distribution of responsibility and control systems. Consequently, Folketrygdfondet attaches particular weight to these three main aspects when contacting the companies.

In autumn 2006, Folketrygdfondet distributed a questionnaire to 41 Norwegian companies in which the Fund has a stake. Folketrygdfondet received responses from 32 of the companies. The findings are discussed in Folketrygdfondet's Ownership Report for 2007. In 2008, Folketrygdfondet introduced a new initiative aimed at the companies that did not respond to the questionnaire in 2006, and the questionnaire was sent to the companies that had not been in the portfolio in autumn 2006. Three companies responded to the information request from Folketrygdfondet, but their answers do not alter the previous assessments of the survey findings.

The survey and Folketrygdfondet's assessments of the ethical aspects of the companies' corporate management and practice give a generally favourable impression of the attention levels, standards and practices on the part of the companies that responded to the questionnaire. A significant part of the variance in companies' responses to the various questions can be attributed to the nature and size of the companies and the challenges facing them. For example, companies within the energy sector with extensive global activities have more well-developed standards and practices in respect of corruption, human rights and child labour than do service-providing companies in the technology sector.

Folketrygdfondet will follow up the companies' further efforts and developments relating to the integration and handling of environmental and social matters, and will initiate additional discussions should the need arise.

Instruments

Folketrygdfondet's ethical guidelines apply to the entire investment portfolio. However, different methods are used in the follow-up of the various sub-portfolios.

Folketrygdfondet's investment philosophy entails that exercise of ownership is the most appropriate instrument for following up the Norwegian equity portfolio. If a situation arises that gives grounds to query the conduct of a company in which the Fund is invested, the issue shall be raised with the company. In this way, an attempt is made to influence the company to correct unacceptable conditions and actions. The investments in fixed-income securities do not yield the same ownership rights as the investments in equities and thus neither do they entail the same responsibilities as owner. Nevertheless, Folketrygdfondet relates to ethical and other issues linked to its fixed-interest investments, and if a violation of Folketrygdfondet's investment principles is found, relevant steps will be considered and initiated. For Norwegian companies where there are both equity and fixed-income investments, these measures will affect both forms of investment.

As far as investments in Nordic equities or fixed-income securities are concerned, Folketrygdfondet follows the decisions made by the Ministry of Finance on the basis of the recommendations rendered by the Council on Ethics for the Government Pension Fund – Global. This means that if the Ministry of Finance decides that the Government Pension Fund – Global should not invest in some companies, these companies are also removed from the investment universe of the Government Pension Fund – Norway.

Table 3.1 Overview of companies that have been excluded from the investment universe of the Government Pension Fund – Global on grounds of production of certain types of weapons

Product	Date	Company
Anti-personnel land mines	26 April 2002	Singapore Technologies Engineering
Cluster munitions	31 August 2005	Alliant Techsystems Inc, General Dynamics corporation, L3 Communications Holdings Inc., Lockheed Martin Corp., Raytheon Co., Thales SA
	30 November 2006	Poongsan Corporation
	31 December 2007	Hanwha Corporation Textron Inc.
	31 December 2008	Textron Inc.
Nuclear arms	31 December 2005	BAE Systems Plc, Boeing Co., EADS Co[1], EADS Finance BV, Finmeccanica Sp. A., Honeywell International Corp., Northrop Grumman Corp., Safran SA., United Technologies Corp
	31 December 2007	Gen Corp. Inc. Serco Group Plc.
Sale of weapons and military material to Burma	28 February 2009	Dongfeng Motor Group Co Ltd.

[1] The company EADS was initially excluded on 31 August 2005 on the grounds of its involvement in production of cluster munitions. EADS no longer produces cluster munitions; however, the company is involved in production of nuclear arms, and on the grounds of this, the Ministry of Finance upheld the company's exclusion on 10 May 2006.

Source: Ministry of Finance

Following up individual companies

Folketrygdfondet continuously monitors the equity and fixed-income portfolio by means of Internet searches in editorial sources around the world. This means that over 80,000 editorial sources are monitored and more than half a million new items are scanned each day. The searches are systematic, and Folketrygdfondet is notified if companies in the portfolio are associated with key ethical topics such as corruption, human rights, child labour and environmental issues. This makes it possible to check up on whether the company is complying with its own guidelines concerning ethical issues. A similar monitoring system has also been established for the investments in bonds.

Cases that received much media attention in 2008 include the management of Eltek being charged with insider trading and Telenor's activities in Bangladesh.

Folketrygdfondet has followed up these matters pursuant to the ethical principles for the Fund. The companies have given an account of the problems and described the measures they have taken. Folketrygdfondet has taken note of this for the time being.

Participation in international initiatives and collaboration with other investors

In 2008, Folketrygdfondet formally adopted and signed the UN Principles for Responsible Investment (PRI) (see Box 3.1). By signing the UN Principles for Responsible Investment, the organisation commits to a "comply or explain" approach. Folketrygdfondet's Ownership Report for 2008 describes how Folketrygdfondet follows up the UN principles.

In 2008, Folketrygdfondet took part in a collaborative project with the largest investors in Norway called *Bærekraftig verdiskaping* (Sustainable Value Creation) – an informal investor collaboration to promote sustainable development and long-term value creation in Norwegian companies listed on the stock exchange. The objective of the project is to actively influence Norwegian companies listed on the stock exchange to develop sustainably and at the same time create long-term value for their owners. In this context, "sustainable value creation" means that the companies must create economic, environmental and social value. The interests of the companies' stakeholders must also be safeguarded in a responsible manner. Good corporate governance and corpo-

Table 3.2 Companies that have been excluded from the investment universe of the Government Pension Fund – Global on grounds of conduct

Activity that entails complicity in:	Date	Company
serious or systematic human rights violations	31 May 2006	Wal-Mart Stores Inc. and Wal-Mart de Mexico SA de CV
severe environmental damages	31 May 2006	Freeport McMoRan Copper & Gold Inc.
	31 March 2007	DRD Gold Ltd.
	31 October 2007	Vedanta Resources Plc., Sterlite Industries Ltd. Madras Aluminium Company
	30 June 2008	Rio Tinto Ltd. and Rio Tinto Plc.
	30 November 2008	Barrick Gold Corp

Source: Ministry of Finance

rate management are important elements in order to ensure sustainable value creation.

Through the project, the investors sent out a questionnaire to all the companies listed on the main index of the Oslo Stock Exchange. The companies were asked to answer questions about whether they have guidelines covering key elements of responsible and sustainable business operation, whom these guidelines apply to, where they are anchored, how they are implemented, and reporting on compliance. The board's responsibility for these areas was also covered in the survey.

The survey revealed wide variation in how far the companies have come in their efforts to ensure responsible and sustainable business operations. Health, safety and environment (HSE) and responsible business operations are areas that most companies deal with on the board level, and most companies believe they have board members who have specialist knowledge in this field. HSE is also the area where most companies have some degree of management system, control routines, defined targets, and where non-compliance affects the management's pay. Human rights is the area where the companies together have the lowest score.

The Sustainable Value Creation project has helped initiate a number of positive processes. Many of the companies that did not respond stated they wanted to review their internal systems first and would respond to next year's survey. Many of the companies that reported that they do not have guidelines for follow-up routines stated that they are planning to make improvements in this area.

3.3 Reporting on the exclusion mechanism for the Government Pension Fund – Global

3.3.1 Exclusion of companies through screening and exclusion

Pursuant to the ethical guidelines for the Government Pension Fund – Global, the Fund shall not undertake investments that represent an unacceptable risk of the Fund being involved in unethical actions as defined in the ethical guidelines. The guidelines for exclusion are presented in Box 3.3. As per March 2009, the Ministry of Finance has excluded a total of 32 companies from the investment universe of the Government Pension Fund – Global on the basis of recommendations from the Council on Ethics. These companies are listed in Tables 3.1 and 3.2.

The Council on Ethics for the Government Pension Fund – Global renders recommendations on screening and exclusion, but the final decision as to whether a company shall be excluded lies with the Ministry of Finance. The Ministry of Finance bases its decision on, among other things, the Council's assessment, but will normally also attach weight to Norges Bank's views as to whether the Bank may, through ownership efforts, reduce the risk of grossly unethical conduct.

The Council on Ethics deliberates matters of its own accord or at the behest of the Ministry of Finance. When the Ministry of Finance requests the assessment of a specific case, the Council will always render a recommendation for or against the exclusion of the company. Cases assessed at the Council's own accord will as a main rule only result in a recommendation to the Ministry of

Box 3.2 Criteria for exclusion from the Government Pension Fund – Global

Screening

Companies shall be excluded from the Government Pension Fund – Global if they:

- produce weapons that violate fundamental humanitarian principles in their normal use, or
- sell weapons or military material to states mentioned in article 3.2 in the supplementary guidelines for management of the Fund (currently: Burma).

The Revised National Budget for 2004 provides an exhaustive list of weapons that are currently classified as screening criteria: chemical weapons, biological weapons, anti-personnel mines, undetectable fragmentation weapons, incendiary weapons, blinding laser weapons, cluster munitions and nuclear arms. The Fund shall not invest in companies that develop or produce key components for these types of weapons.

In Report no. 16 (2007–2008) to the Storting, the Government ruled that the Government Pension Fund – Global shall not invest in companies that sell weapons or weapon technology to regimes on the list of nations whose government bonds the Fund is prohibited from investing in. This means that the Fund must not invest in companies that sell weapons to Burma.

The Ministry of Finance has excluded 22 companies from the Fund under the screening criteria. One of these companies sells military material to Burma.

Exclusion

Companies shall be excluded from the Fund if their acts or omissions imply an unacceptable risk of the Fund contributing to:

- Serious or systematic human rights violations, such as, for example, murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other child exploitation
- Serious violations of individuals' rights in situations of war or conflict
- Severe environmental damage
- Gross corruption
- Other particularly serious violations of fundamental ethical norms

Ten companies have been excluded from the Government Pension Fund – Global to avoid an unacceptable risk of the Fund contributing to serious or systematic human rights violations and severe environmental damage.

Finance if the Council finds that there are grounds for recommending exclusion of the company from the Fund.

The Council on Ethics has five members and maintains its own seven-person secretariat. The secretariat conducts surveillance of companies and prepares matters for the Council.

A closer look at screening

The Revised National Budget for 2004 lists what types of weapons the Fund shall not contribute to the production of. These include weapons that are prohibited pursuant to international law and nuclear arms. The technical definition of cluster munitions in the new Convention that was negotiated and formally adopted in 2008 is slightly stricter on certain points than the definition the Council on Ethics originally based its assessment of cluster munitions on. The Council on Ethics decided to adopt the Convention's definition, resulting in one more company being excluded on grounds of production of cluster weapons.

In 2008, the screening criteria were also extended, so that companies will be excluded if they sell weapons or weapon technology to regimes on the list of nations whose government bonds the Fund is prohibited from investing in. At present, this means that the Fund must not invest in companies that sell weapons to Burma. So far, this has led to one company being excluded from the Fund.

Two external consultancies review the Fund's portfolio for the Council on Ethics each quarter and report on companies that may be engaged in activities that violate the screening criteria. In addition, the Council in collaboration with other investors has engaged the company Jane's Strategic Advisory Services to draw up a list of companies that produce cluster weapons. When the

Council deems it likely that a company produces weapons that would merit screening, the company is approached and asked to comment on the Council's assessment. If the company confirms the information invoked by the Council, the Council will render an exclusion recommendation. Companies that do not reply when approached are recommended for exclusion if the documentation in the possession of the Council shows that there is a high probability that the company produces weapons that violate the screening criteria.

This procedure offers a reasonable degree of assurance that companies producing weapons that violate the screening criteria will be excluded from the Fund. Nevertheless, it cannot be guaranteed that all companies will at all times be correctly screened by the Council's monitoring system.

A closer look at exclusion on the basis of conduct

Whilst screening relates to the products of the companies, exclusion relates to the production methods and conduct of the companies. The Council therefore conducts its own investigations to identify companies that may be involved in violation of human rights, environmental damage, corruption and other violations of ethical norms.

The Council on Ethics has engaged a firm of consultants to perform daily Internet searches of news websites for all the companies in the portfolio. Each month, the consultancy compiles a report with an overview of the companies that can be linked to severe environmental damage, complicity in human rights violations, corruption or other infringements of ethical norms. This report generally picks up around 30–40 companies a month. The majority of the Council on Ethics' investigations are initiated as a result of these reports. The Council on Ethics is also contacted by people or organisations requesting that the Council assesses topics or individual companies. The Council on Ethics also monitors companies or sectors of its own accord, especially in the event of a situation that suggests that the Council needs to be extra vigilant.

In its selection of cases, the Council on Ethics will attach weight to how serious the violations of norms are, whether a company is accused of several counts of unethical conduct, whether it is likely that such conduct will continue, and the scope for documenting the conduct of which the company is accused, etc. The intention is to identify companies where there is an unacceptable risk that violations of the ethical guidelines are taking place and are expected to continue. In many cases, several companies are accused of similar norm violations in the monthly reports. In order to identify the most serious norm violations, the Council on Ethics considers these cases together. In some cases, the Council on Ethics even reviews entire sectors in the portfolio.

Weight is attached to a number of factors in the more detailed assessment of a company. The degree of severity of the norm violation is assessed again, and the Council also investigates whether the violation is systematic and whether norm violations have been reported in several of the company's operations. The Council also evaluates how serious the norm violation is compared with conduct in other companies with similar operations and in relation to other companies in the same country or region. It is essential that the norm violation can be documented and that there is factual evidence to support the accusations levelled at the company. Further, there must be an unacceptable risk that the norm violations will continue. In many cases, a closer investigation reveals that the accusations are less serious than initially assumed, that they are old events that have been reported again, or that the company has already implemented measures to remedy the situation. In these kinds of cases, the Council does not pursue the matter unless new information is received suggesting that the company ought to be reassessed.

In some cases, the Ministry of Finance asks the Council to investigate individual companies. In these cases the Council always makes a recommendation, even if the recommendation is not to exclude the company.

There is often a need for supplementary information to shed light on cases beyond what is available from publicly access sources. In this work, the Council on Ethics makes use of consultancy firms, research institutions and voluntary organisations, and these are often based in the country where the alleged violations of norms are taking place. This may involve fieldwork and assessments of companies' documentation. The Council attaches considerable weight to ensuring quality and confidentiality in this work.

Companies that the Council on Ethics believes ought to be excluded will, in accordance with the guidelines, be requested to comment on the grounds on which the exclusion recommendation is based. The companies may also be asked to answer specific questions. The Council on Ethics

emphasises describing in detail the grounds underpinning the exclusion recommendation and the provision of thorough documentation. Any allegations made are supported by specific source references, often from several sources. When approached, companies will also be informed of the ethical guidelines, and of the fact that the company in question is being considered for exclusion pursuant thereto. The companies are asked to respond within a specific deadline. In several cases, the secretariat of the Council has attended meetings with companies that have wished to provide additional information.

The Council on Ethics routinely assesses whether the grounds for excluding a company still exist and may, in light of new information, recommend that the Ministry of Finance reverse an exclusion ruling.

It is unrealistic to expect to be able at all times to identify all companies that are complicit in serious violations of norms worldwide. Nor is it the case that a company can be excluded immediately on the basis of stories in the media, for example, even if they are serious and credible. It is essential that the ethical guidelines are implemented in a predictable and credible manner over time. This means that the Council on Ethics must be allowed sufficient time to complete processes and evaluations in relevant cases, and that the companies have to be given the opportunity to present their version of the matter, or to adopt the necessary measures. Only through such thorough processes will the ethical guidelines be able to carry weight with and have impact on other investors, and thus take on relevance beyond the direct effect on the Fund's own investments

The Fund's investments in emerging markets have increased as a consequence of all the countries in the index provider FTSE Group's global equity index being included in the benchmark index in 2008. The number of companies in the portfolio increased by approx. 800 companies last year. The Council on Ethics has reported that experience so far indicates that there is less information available about companies domiciled in these markets. In order to improve its access to information about companies in emerging markets, the Council on Ethics will gather information using special regional news searches. Nevertheless, the expansion of the portfolio poses a challenge for the Council. The possibilities for gathering information are limited in several of the countries that are now included in the benchmark portfolio. It can be very demanding to gather concrete, reliable documentation from countries that do not practise transparency in the government administration or where it may be illegal or dangerous to spread information about companies' activities.

3.3.2 The Ministry of Finance's processing of cases that do not result in exclusion

In the period 2006–2008, the Ministry has considered two cases that were based on recommendations on exclusion from the Council on Ethics, but where it was concluded that exclusion was not the most appropriate reaction. The cases were published in September 2008 and March 2009.

In its deliberation of these cases, the Ministry deemed that excluding the companies was not an appropriate reaction, holding that other instruments might yield a more positive impact. These cases also illustrate a general need for a broader set of tools for use in cases where it is particularly difficult to assess the risk of future norm violations. The Ministry has attached importance to assessments of objectives and pertinence that are considered to be in line with the intentions underpinning the current regulations in order to resolve these cases in this way (see the discussion below). At the same time, there is a need to formulate clear rules for the processing of similar cases in the future, to ensure the system is transparent, comprehensible and predictable.

The Ministry is proposing amendments to the current ethical guidelines that meet these needs. This is consistent with several of the consultative inputs the Ministry has received in connection with the evaluation of the ethical guidelines (see the more detailed discussion in Chapter 4). Rules that are currently laid down in the ethical guidelines for the Government Pension Fund – Global, along with proposals for new rules that amend and supplement these guidelines will be incorporated in a new regulation for the management of the Fund. The regulation will lay down the entire management framework for the Government Pension Fund – Global in a single document (see the more detailed discussion in Chapter 6). Chapter 4 discusses the results of the evaluation and proposals for changes to the current ethical guidelines.

Child labour case

In November 2006, the Council on Ethics recommended to the Ministry of Finance that Monsanto Co. be excluded from the investment universe of

the Government Pension Fund – Global. The Council's recommendation was based on an assessment that, at that time, the Fund owning shares in the company constituted an unacceptable risk of contributing to the worst forms of child labour. In light of input from Norges Bank in spring 2007, the Ministry of Finance decided that it would be appropriate to use ownership influence for a limited period to see if this could reduce the risk of contribution to grossly unethical activities.

Against the background of new assessments of the Monsanto case by both the Council on Ethics and Norges Bank in spring 2008, the Ministry ruled that improvements had been made and that Norges Bank's continued ownership influence in Monsanto would do much to rectifying the problems. The Ministry therefore decided to maintain its ownership in the company and that Norges Bank as an active owner would continue to collaborate with Monsanto in order to combat serious forms of child labour.

Norges Bank reported on its plans for and subsequently the results of its ownership activities in meetings and correspondence with the Ministry of Finance in 2007 and the first half of 2008. In its contact with Monsanto, the bank has attached importance to ensuring constant improvements in the conditions for children employed in the company's activities.

Parallel to the dialogue with Monsanto, Norges Bank has taken the initiative to start a collaboration between several multinational companies involved in production of cotton and vegetable seed. The goal is to contribute to the establishment of a common standard for dealing with child labour issues in the entire sector, not just in one company. Norges Bank believes that a common standard for multinational companies is the most effective way to ensure long-term improvements. The bank also believes that Norges Bank in its capacity as an investor is in a unique position to organise this kind of process. An initial meeting was held with several companies, including Monsanto Co., in June 2008.

For its part, the Council on Ethics carried out a number of investigations in different parts of Monsanto's cotton seed production in India in the period after the Council's first recommendation and up until spring 2008. The Council was aware of the work the bank was doing and took this into account when it made its final recommendation to the Ministry on maintaining ownership in the company. The Council on Ethics recognised that, seen in isolation, there is still a situation that must be characterised as "the worst forms of child labour", and thus a situation that in theory qualifies the company for exclusion from the investment universe of the Fund. However, the Council on Ethics also recognised that Monsanto had achieved significant improvements, in some geographical areas more than others, in terms of reducing the scope of use of child labour. Further, the Council on Ethics has voiced the opinion that Norges Bank's continued exercise of ownership in Monsanto, and therefore also maintenance of the investment in the company, appears to be a prerequisite for any improvements in the situation.

This case is complex and serves to illustrate the challenges a financial investor with an ethical profile faces in connection with issues that are tightly interwoven with socio-cultural circumstances, like child labour. It is hardly possible to prove that investors benefit from companies stopping using child labour, at least in the short term. At the same time, selling the holding in the company when such a serious situation as this one comes to light, is not a satisfactory solution either. Perhaps the shares will be bought by people who are less concerned about child labour and how children are treated.

Seen in its entirety, the Ministry regards it as correct to adopt a more long-term perspective in this matter and to grasp the opportunity to influence the company to make changes in a positive direction. It is also important that the companies that are contacted through exercise of ownership and other tools, including possible exclusion, experience that the rules are predictable. Norges Bank has drawn up a document outlining its expectations related to the child labour strategy (see the description in Section 3.2.1). This will help improve predictability for companies the Fund is invested in.

Both Norges Bank and the Council on Ethics are going to continue to follow developments in Monsanto and their operations in India closely in the years to come.

Corruption case

On 15 November 2007, the Council on Ethics recommended that the Ministry of Finance exclude the German company Siemens AG from the investment universe of the Government Pension Fund – Global. In the Council on Ethics' view, there was an unacceptable risk of the Fund

through its investment in Siemens contributing to gross corruption. In May 2008, in light of new information that became available after the recommendation had been rendered, the Ministry asked the Council on Ethics to reassess Siemens. In a letter dated 3 September 2008, the Council on Ethics upheld its original conclusion. This is the first recommendation from the Council on Ethics based on the corruption criterion.

Subsequent to the Council on Ethics' first recommendation in November 2007, further information became available on the enterprise's anticorruption measures in the company's annual report for 2007. In its second assessment, summarised in a letter dated 3 September 2007, the Council on Ethics stated that this information did not alter the Council's conclusion. Siemens then entered into settlements with German and US authorities on 15 December 2008. As part of these settlements, the company must pay more than NOK 11 billion in fines. Theodor Waigel, a former German Minister of Finance and the appointed contact between the company and the U.S. Securities and Exchange Commission, will oversee the company's anticorruption efforts over the next four years and check that it is not involved in any more acts of corruption.

In its assessment of this case, the Ministry finds it clear that the matters that have been revealed in Siemens merit the title of gross corruption. The acts of corruption are numerous, they have been systematic, and large amounts of money are involved. However, on the basis of the view that the guidelines, including the exclusion mechanism, shall have a forward-looking perspective, the Ministry has found it difficult to conclude that exclusion is appropriate in this case.

The case clearly contains a number of dilemmas. After an overall assessment, the Ministry has decided to attach most importance to the following elements: Siemens has put efforts to combat corruption high on the agenda and introduced many different measures. The company has entered into settlements with German and US authorities under which a trusted third party has been charged with the task of monitoring the company. The company is also the subject of close scrutiny from inspection authorities, shareholders, the press and others. In this kind of situation, the company is under extreme external pressure to comply with the measures it has said it will implement to combat corruption. This alone will help reduce the risk of future norm violations, which is the relevant assessment criterion.

Against this backdrop, the Ministry has ruled that Siemens should be kept under observation for up to four years, so that the Ministry has a better basis for being able to assess whether the measures that have been implemented, combined with all the pressure on the company, are yielding positive results. The threshold for excluding Siemens will be low if new cases of gross corruption are discovered in the company. The Ministry assumes that publishing its decision to keep Siemens under observation may provide further incentive for Siemens to intensify its effort to combat corruption.

Corruption is a criterion in the ethical guidelines, and the Ministry regards it as a point in itself that this case can be used to focus on corruption as a problem. At the same time, the spotlight is being turned on a major player that has implemented extensive measures to combat the culture of corruption in its activities. This also sends a message out to other companies about what the management of the Government Pension Fund – Global expects of companies when they come up against these kinds of problems.

The Ministry finds it generally necessary to introduce observation of companies as a supplementary tool, alongside ownership work and exclusion. A watch list would be especially well suited to companies that are in the grey zone in terms of exclusion, but where, for various reasons, it is necessary to follow developments over time before a final conclusion can be drawn. This measure is described in more detail in Chapter 4.

4 Evaluation of the ethical guidelines for the Government Pension Fund – Global

4.1 Contents and executive summary

4.1.1 Introduction

The results of the evaluation of the ethical guidelines for the Government Pension Fund – Global are presented in this chapter. The evaluation was announced in Report no. 24 (2006-2007) to the Storting. A description of the current system is given in Chapter 3 above, together with an account of the work done on the ethical guidelines in 2008.

The ethical guidelines were adopted in the autumn of 2004 following a proposal from a Government-appointed committee headed by Professor Hans Petter Graver (NOU 2003: 22 Forvaltning for fremtiden (Management for the future)). These ethical guidelines have been viewed by many as a great leap forward with respect to carving out and specifying guidelines for ethical and responsible investment practices.

The Government wishes to maintain its high ambition level for the work on responsible investing. Consequently, it made sense to carry out an evaluation now that a few years of experience have been gained with the ethical guidelines. At the same time this provides an opportunity to absorb the considerable national and international progress made in this field. An evaluation during the present Storting period is also in line with the Soria Moria declaration.

The Government wants the Government Pension Fund – Global to be managed responsibly in a manner that takes good corporate governance and environmental and social issues into account. The Government requires responsible management of the Government Pension Fund – Global to be structured so as to give it legitimacy among the Norwegian population and market players. One goal is to promote sustainable development in economic, environmental and social terms. This is regarded as a precondition for good financial returns over time. The Government wants the Government Pension Fund – Global to promote good corporate governance in portfolio companies and to encourage the companies to respect fundamental ethical standards. It will continue to refrain from investing in companies that seriously or systematically breach fundamental ethical norms. At the same time the Ministry will emphasise looking at the exclusion mechanism in connection with the other work on responsible management. It is important to monitor and contribute to development of best practice in the area of responsible investments. As with the general management of the Government Pension Fund – Global, priority must also be given to transparency, predictability and proper procedures in this area.

The work on responsible management shall be anchored in the Fund's role of financial investor. This means that the division of work between the Fund and the Fiscal Budget will be continued. This also means that the government will continue the principle that the Fund shall not be used as a foreign or development aid policy instrument. A further description of the role as financial manager and what this involves is provided in Chapter 2 and below in Section 4.2.2.

4.1.2 Summary – the most important results of the evaluation

The main conclusions of the evaluation show that the ethical guidelines are based on a solid foundation and have proven to be robust over time. Many important aspects can therefore be maintained. In light of international developments and the experiences gained with the ethical guidelines so far, the Ministry is proposing some changes and adjustments concerning existing goals and instruments. At the same time, the Ministry is proposing a number of additional measures to bolster and refine efforts in the area. An overview of the results of the evaluation is given in Box 1.1, in Part I of the report.

Both current guidelines that will be continued and new rules will be incorporated in a new regulation concerning the management of the Govern-

ment Pension Fund – Global, in addition to other requirements regarding the investment management. This regulation will combine all the rules for the Fund that are currently divided among a variety of documents. See the discussion in Chapter 6.

A broad approach

To maintain the Fund's solid position as a responsible investor, the Ministry proposes that good corporate governance and environmental and social factors shall be integrated to a greater degree as relevant factors in the overall work on management of the Fund. This is in line with international developments and will entail an increased ambition level in this area. The role as responsible investor will be one of the premises for the Ministry of Finance's work on investment strategy for the Fund, see the more detailed description in Chapter 2. Furthermore, the Ministry will demand that such considerations shall be safeguarded at other stages of the investment process, in accordance with the PRI principles.

According to the current ethical guidelines, there are three tools for promoting the Fund's ethical obligations: exercising ownership rights, negative screening and exclusion of companies from the universe of permitted investments. The new approach will provide more tools in the role of responsible investor. The new instruments will be added to the existing instruments and are not intended to undermine their significance.

Clarifying an overarching objective

The ethical guidelines do not specify overarching goals or targets that apply to the guidelines as a whole. The two mechanisms – exercise of ownership rights and the exclusion mechanism – are based on different objectives, respectively ensuring the long-term financial interests of the Fund and avoiding involvement in grossly unethical acts or omissions. The Ministry proposes clarifying the overarching objective for the Fund as a responsible investor, see the more detailed description in Section 4.3.2 and Box 4.2.

The overarching objective will guide the work as a responsible investor and the instruments that can be employed on behalf of the Fund. In relation to the current guidelines, the proposal represents stronger emphasis on the desire to contribute to positive changes in sustainability issues and with respect to companies' conduct in corporate governance and social and environmental matters.

Continuing and adjusting the exclusion mechanism

The Ministry will continue its policy that the Fund must not have investments that entail contribution to companies' serious or gross violations of fundamental ethical norms, pursuant to the same criteria as today. In addition, it intends to exclude tobacco producers from the Fund's investments, see below. There are also plans to further clarify the issues that the Ministry believes ought to be given priority when making a decision on exclusion. For example, the Ministry believes that it must be possible to attach importance to the expected effects of an exclusion when using this instrument, beyond the fact that the aim is to avoid contribution to grossly unethical activity. The exclusion mechanism ought not to be regarded in isolation, detached from other work on responsible management.

The Fund's increased investments in emerging markets will entail new challenges for application of the ethical guidelines. This is discussed separately. The same applies to application of the ethical guidelines in war and conflict zones.

Measures are going to be introduced to ensure predictability for the companies in the portfolio. The Ministry will work to make the interpretation and the content of the various criteria for exclusion more readily available by amending the way it organises information. The Ministry believes publication of the Council on Ethics' methods and principles for selecting companies that are to be studied more closely, is an appropriate measure. The Ministry will also ensure that a procedure for reinclusion of excluded companies in the portfolio is prepared and published.

Negative screening of companies from the portfolio on the basis of the companies' products

The Ministry is intending to continue negative screening of companies that manufacture weapons that violate fundamental humanitarian principles in their normal use and companies that sell weapons or military material to states mentioned in the supplementary guidelines for management of the Fund. At present, this means Burma. In addition, a new screening criterion has been proposed to cover companies that produce tobacco.

Negative screening of companies that produce tobacco has been considered on several occasions. Several commenting bodies have said that tobacco should be included in the screening mechanism. Negative screening of entire product

groups is a very powerful tool and ought to be restricted to exceptional cases where it can be shown that there is a clear consensus among the population of Norway. There have been developments in the period after the Graver Committee proposed the current ethical guidelines, both internationally through a convention dedicated to tobacco control (which came into force in February 2005) and nationally through restrictions of the Tobacco Act in 2004, which must be deemed to represent such a clear shared set of values relating to screening tobacco producers. With respect to questions about excluding other unhealthy or socially unbeneficial services from the Fund's investment universe, including alcohol, there has not been the same degree of norm development that can provide a similarly clear anchoring nationally or internationally. In addition, tobacco is a product in a class by itself in that it can cause serious health problems when used as intended.

In the Ministry's opinion, it is the *production* of tobacco that should form the basis for screening. Thus, selling tobacco will not be encompassed by this criterion. The Ministry will study in more detail different methods for delimiting screening of companies that produce tobacco. Trying to operate with zero tolerance for all tobacco production may prove to entail particular challenges, although this will be a starting point when the criterion is formulated.

Exercise of ownership rights

The Ministry intends to continue the main principles of the current ethical guidelines as far as exercising ownership rights is concerned. In addition to the work that is already being done in this area, the Ministry is planning a number of new measures that will support a high level of ambition and a high degree of transparency concerning how ownership rights are safeguarded. The Ministry will formally require that Norges Bank integrate good corporate governance and environmental and social responsibilities into its operations with regard to several parts of the management of the Fund, in keeping with the PRI principles the Bank has adopted. The Bank will also be subject to new formal requirements on transparency and reporting on work linked to the ownership efforts.

Norges Bank has selected focus areas for the exercise of ownership rights. The Ministry supports this. Choosing focus areas is an important issue, and the Ministry proposes introducing a process whereby it is consulted in advance about important changes to or expansion of focus areas. The Ministry may decide that significant changes must be subject to a public consultation process before a final decision is made. In the Ministry's opinion, publication of the document tetailing the bank's investor expectations on children's rights has been very successful, and the bank ought to compile more publications outlining its expectations. An important area in this context will be expectations linked to environmental issues. A document on companies' strategies to combat climate change is deemed particularly relevant. The Ministry is also going to ask Norges Bank to prepare an expectations document regarding transparency and reporting on payment flows in companies. Clear expectations from investors like the Government Pension Fund – Global in this area can counteract use of closed jurisdictions to conceal unlawful acts, such as corruption, money laundering and tax evasion, etc. and in this way contribute to better functioning, legitimate markets. Publication of more expectations documents would help create transparency about the work related to ownership rights and also safeguard the companies' need for predictability.

Interaction between the various instruments

In line with what has been said above about an overarching objective for working as a responsible investor, the Ministry believes that there is a need to coordinate the use of instruments to a greater degree than the current system provides. The same applies to the activities of Norges Bank and the Council on Ethics.

The Ministry is planning a new provision whereby before deciding to exclude a company, it must be assessed whether other instruments might be better suited to achieving the Fund's objective as a responsible investor. This is already partly in place in that on receiving a recommendation on exclusion of a company, the Ministry asks Norges Bank whether the exercise of ownership might be used to reduce the risk of new breaches of the guidelines. This will yield a more targeted use of the instruments as a group and will help ensure that exclusion really is the last option after other measures have been assessed. The Ministry is also planning to formalise the use of a watch-list as a new instrument. In some cases, the decision to put a company under observation may be a good alternative, as it can be assumed that

this will encourage the company to amend its conduct or will prompt the company to provide more information to clarify the situation. It is thought that the use of a watch-list will be particularly apt in cases where there is great uncertainty about future developments.

Closer collaboration and coordination will necessitate adaptations in the mandates and methods of both Norges Bank and the Council on Ethics. Once the Storting has considered the results of the evaluation, the Ministry will continue to work on the details of a new system in dialogue with the Council on Ethics and Norges Bank.

Other topics and measures

In its capacity as a major international owner and investor, the Ministry can help put important issues on the agenda in terms of *research and international work* that affects how environmental and social issues and good corporate governance can be safeguarded as effectively as possible by a financial investor. The Ministry of Finance wants to increase its commitment in this area.

Many of the bodies consulted have pointed out that Norway's oil wealth gives the country a particular responsibility to investigate problems linked to carbon emissions and climate change. For an investor with the characteristics of the Government Pension Fund – Global in terms of its long-term perspective and breadth of investments, it will also be in the Fund's own interests to find out how climate change can affect developments in the financial markets.

The Stern Review[1] provided important knowledge about the impact of climate change on the general economic development globally, and similar work could be done to shed light on the effect on financial markets more specifically. Against this backdrop, the Ministry is aiming to initiate a study to assess how the challenges of climate change can affect the financial markets and how investors ought to act in light of this. This ought to be an international project that could be carried out in collaboration with other investors. The Ministry will present a more detailed assessment and plan for this project in the National Budget for 2010.

In general, the Ministry wants to contribute to the development of best international practice in the area of responsible investments, and in this context will assess various measures that can support this. For example, this might be membership in a selected international investor organisations, collaboration with UN bodies that are active in this field and greater contact with international experts. Norges Bank and Folketrygdfondet have both signed the UN Principles for Responsible Investment (PRI). The Ministry of Finance wants to express its further support of these principles by the Ministry also signing them on behalf of the Government Pension Fund.

The Ministry would also like to refer to the fact that a new investment programme is being prepared aimed at environment-related investment opportunities, see the discussion in Section 1.2 above.

In 2007, a new provision was introduced in the management framework that the Fund may not be placed in interest-bearing instruments issued by the state of Burma. Several consultative comments have been submitted concerning the wish to expand the scope of the ban on investing in certain nations' *government bonds*. The Ministry continues to believe that excluding a country's government bonds from the investment universe of the Fund due to the actions of the country's authorities constitutes a drastic foreign-policy step. Burma is different in many respects, but the main issue in this connection is the scope of the international measures against Burma. Currently no other sanction regimes or measures endorsed by the Storting has backed have the same scope as the measures against Burma. Without this kind of international anchoring, using the threat of exclusion from investment as a general instrument in Norwegian foreign policy is out of the question.

Secrecy jurisdictions (so-called *tax havens*) can help conceal economic crime, among other things. The Government takes a serious view of the harmful effects that ensue from the harmful practices employed in such secrecy jurisdictions. The legislation and regulations in each individual country determines whether it can be classified as a secrecy jurisdiction. Efforts to combat so-called tax havens must therefore target these nations' authorities, as is already the case on a large scale.

It will not be pertinent to use investments in secrecy jurisdictions as a separate exclusion criterion in the equity portfolio. It is assumed that this would have little effect and would entail huge problems of delimitation.

Restrictions have been placed with respect to the Fund's real-estate investments so that unlisted

[1] *"The Economics of Climate Change – The Stern Review"*, Nicholas Stern, published by Cabinet Office – HM Treasury 2006

real estate companies and funds cannot be established in secrecy jurisdictions. In its role as investor the Government plans to strenghten then its efforts against secrecy jurisdictions through the Fund's equity investments. Norges Bank already supports the Extractive Industries Transparency Initiative (EITI), an international initiative that promotes transparency about revenue flows in extractive industries. Norges Bank furthermore supports the development of new accounting standards (IFRS) concerning "country-by-country reporting" for companies engaged in extractive industries (mining, oil etc.). Tightened requirements for transparency and reporting by companies concerning revenue flows and tax matters can counteract the effect of the secrecy offered by secrecy jurisdictions and be a suitable measure in combating corruption. Through broad measures such as those described, work is directed in a targeted manner on the actual playing rules and "infrastructure" of the financial markets, as opposed to making it a question of the Fund as an investor assessing whether individual companies in the portfolio have legitimate grounds for activities in so-called tax havens. Norges Bank will be asked to prepare an expectations document aimed at companies' transparency and reporting of payment flows. Clear expectations from investors such as the Government Pension Fund – Global in this area can counteract use of secrecy jurisdictions to conceal unlawful acts such as corruption, money laundering and tax evasion, etc. and in this way contribute to more efficient, functional markets.

Relationship to the Government Pension Fund – Norway's ethical guidelines

The Executive Board of Folketrygdfondet has laid down guidelines for exercising ownership rights on the part of the Government Pension Fund – Norway. The management of the Government Pension Fund – Norway is different from the management of the Government Pension Fund – Global in many important areas. The largest portion of the portfolio (80-90%) has been invested in the Norwegian market and larger stakes are permitted (up to 15% in Norwegian companies). Because it is limited to Norwegian and Nordic companies, it also has a far smaller investment universe than the Government Pension Fund – Global.

A manager's investment strategy will largely affect the efficacy of planning work with questions about responsibility and ethics in the management process. The differences between the Government Pension Fund – Global and Government Pension Fund – Norway suggest that the guidelines for ethics and exercising ownership rights do not need to be harmonised more than they are today. The two Funds' rules for ethics and responsible management are based on the same basic principles but are adapted to the role and the characteristics they have as manager. In its consultative statements Folketrygdfondet said that further harmonisation is unnecessary. Among other things, Folketrygdfondet emphasises that compared with companies abroad, the Norwegian government has other means for influencing Norwegian companies. The Ministry agrees and believes that in the current situation there are no strong arguments suggesting further harmonisation of the two Fund's ethical guidelines.

4.1.3 Purpose, background and process

The main aim of the evaluation of the ethical guidelines is to assess whether the guidelines are fulfilling their intended purpose of ensuring broad political support for the ethical guidelines and gathering any feedback that may contribute to bolstering the image of the Government Pension Fund – Global as a socially responsible investor.

As part of the evaluation process, the Ministry of Finance has carried out a number of activities to gather information and views, from Norwegian and international stakeholders alike.

In January 2008 the Ministry of Finance, in cooperation with Norges Bank and the Council on Ethics for the Government Pension Fund – Global, held a large international conference in Oslo entitled "Investing for the Future". The conference gathered representatives from academics, financial institutions, non-governmental organisations, companies and investors to discuss the challenges relating to addressing good corporate governance and environmental and social factors in the role of financial investor. This conference simultaneously marked the start of the evaluation process.

The Ministry has obtained two external reports for use in the evaluation. One of the reports was prepared by Professor Simon Chesterman of the New York University School of Law, Singapore Programme, and The Albright Group, a U.S. consulting firm. The report concerns the work Norges Bank and the Council on Ethics have carried out using the guidelines. The other report has been prepared by Professors Thore Johnsen and Ole Gjølberg. This report is an

updating of their earlier report “Evaluering av etisk forvaltning: metode, resultat og kostnader” (Evaluation of ethical management: methodology, results and costs) from 2003. In particular, the new report concerns the use of positive selection as an investment strategy for the Government Pension Fund - Global. Both reports are available from the website of the Ministry of Finance[2].

The Ministry of Finance held an information meeting for the consultative bodies on 18 June 2008 in connection with the distribution of the consultation memorandum on evaluation of the ethical guidelines. Also present at this meeting were Norges Bank and the Council on Ethics, who gave briefings on their activities.

Joseph E. Stiglitz, a professor at Columbia University in the U.S. and 2001 winner of the Nobel Prize for Economics, was invited to Norway by the Minister of Finance in August 2008. In this connection he held a speech open to the public entitled “Responsible Investments in a global, long-term perspective”.

The Ministry of Finance has also held meetings with UNEP FI, IFC, World Business Council for Sustainable Development and other major asset managers such as APG in the Netherlands and TIAA-CREF in the United States, for the purpose of discussing issues relating to responsible investments. Several meetings were also held with the Council on Ethics and Norges Bank at which work on ethical guidelines and further development of them was discussed. The Swedish Government is currently working on an assessment of how the Swedish AP funds have carried out requirements for taking environmental protection and ethics into consideration in their management activities. The Ministry met with the Swedish committee that contributed to this effort before submitting its recommendation in SOU 2008:107.

4.1.4 Main contents of consultation memorandum

On 18 June 2008 the Ministry of Finance circulated a consultation memorandum on the evaluation of the ethical guidelines for the Government Pension Fund – Global for comment to a broad group of Norwegian institutions and organisations. The consultation memorandum was also presented to a sample of international experts in the field.

In the consultation memorandum the Ministry found that the ethical guidelines have in general worked well. It was shown that Norway was an early adopter of developing ethical guidelines applying to the entire body of financial assets, not just parts of it. The system is characterised by great transparency and has produced visible results in a relatively short period. See Section 4.1 of the consultation memorandum.

However, the Ministry found that efforts to be a responsible financial investor have to evolve over time. The Ministry therefore raised several key issues for discussion in the consultation memorandum.

The Ministry discussed issues relating to the excercise of ownership rights, including whether it is possible to achieve a greater effect from ownership activities. Furthermore, the Ministry raised the issue of whether the exclusion criteria are as they should be and raised the question of whether the Council on Ethics should be given more policy instruments. The Ministry showed that the Fund’s investments in emerging markets will increase, and requested the commenting bodies’ view of the special challenges that can arise relating to the application of the ethical guidelines in new countries and companies. Furthermore, the Ministry discussed whether the instruments can work together in a manner that increases the efficiency of the ethical guidelines.

The question of positive selection for a smaller portion of the portfolio was discussed in particular. The Ministry referred to the fact that other investors that can be compared with the Government Pension Fund are increasingly setting aside smaller portions of the assets under management to investments with special objectives. It was underlined that for an investment of this type there will also be an overarching requirement for financial returns over time. The Ministry asked for input on whether it will be right to take such a course and, if so, the objectives worth taking a closer look at.

4.1.5 Main points in the consultative comments

The time limit for comments expired on 15 September 2008. By the end of the period allowed for comments, more than 50 consultative comments with substantive remarks had been received. The consultative comments are available at www.regjeringen.no.

[2] http://www.regjeringen.no/nb/dep/fin/tema/andre/Etiske-retningslinjer.html?id=446948

The consultative comments are extensive in several cases and provide many constructive ideas. Many commenting bodies attach reports that they have prepared or commissioned from external consultants. The main impression is that the commenting bodies largely have a positive view of the ethical guidelines and believe that it is important to continue and strengthen the work.

Several commenting bodies support excluding tobacco from the Government Pension Fund – Global.

Many raised questions relating to the use of the current instruments and their interaction.

The climate challenges and how the management of the Government Pension Fund – Global should be changed in this light are key in many consultative comments.

Certain commenting bodies, including the Office of the Auditor General, advocate harmonising the ethical guidelines for the Government Pension Fund – Global and Government Pension Fund – Norway.

In the review of the evaluation in Section 4.3 below, the consultative inputs are quoted where they thematically belong.

4.2 Responsible investments – important starting points

4.2.1 Responsible investments – theory, practice and international developments

Growth of ethical and responsible investment practice

Ethical guidelines for management of capital can be traced as far back as the 1600 and 1700s. The earliest examples are found in connection with various church and religious groups that on account of their beliefs have wanted to avoid investments in certain activities such as slave trading, followed by gambling, tobacco and alcohol. Through the 1970s ethical considerations became a subject for other investors too. For example, investments in companies that profited from the Vietnam War or the apartheid regime in South Africa were excluded by certain funds and investors.

Other methods and principles were also developed to support socially and ethically grounded proposals at companies' general meetings and general guidelines for how social and ethical considerations could be integrated into business decisions. Eventually indices consisting of companies satisfying more specific requirements stipulated by the index provider have also been established. Examples of such indices are the Dow Jones Sustainability Index and FTSE4Good. A number of funds with specific investment strategies based on various social or environmental criteria also exist.

In recent years, questions relating to social responsibility and ethics in different sectors of business and industry and other economic activities have received steadily increasing attention. The term Corporate Social Responsibility (CSR) describes companies' integration of social and environmental standards into daily operations. From an investor or manager standpoint, SRI (Socially Responsible Investments) has been used as a term for investing for financial returns while simultaneously taking ethical and environmental requirements into account. A term that is becoming more common is *Responsible Investment - RI*. The term Responsible Investment is related to incorporation of *ESG (Environmental, Social and Governance) issues* in management work. Some people refer to such considerations as *extra-financial*. This usually means factors that can have a financial effect in the long term, but which cannot so easily be identified by established measurement methods, e.g., through common methods for analysing accounts or through corporate financial reporting requirements.

The increased attention given to these subjects has resulted in various initiatives that directly or indirectly have an impact in areas that have a bearing on issues relating to integration of ESG issues in financial management. Reference is made to UN initiatives: UNEP Finance Initiative (UNEPFI), UN Global Compact and Principles for Responsible Investments (PRI). See further discussion in Chapter 3.

Internationally, there has been a debate on the value of CSR/RI efforts. Box 4.1 provides a brief overview of some important viewpoints.

Instruments for a responsible investor

Commonly used instruments in socially responsible investing are:

– Exclusion of companies from a portfolio or an investment universe: This can take the form of excluding entire sectors due to one product, such as weapons, alcohol, tobacco or exclusion of companies from the portfolio on account of a company's conduct.

Box 4.1 Various views of the value of CSR/RI work

Critical viewpoints have emerged from various quarters in regard to the expectation that business and industry must emphasise social responsibility. One view, usually linked to the American libertarian economist Milton Friedman, is that businesses will discharge their social obligations best by concentrating on running their operations as well as possible.[1] When economic actors pursue their own interests, the invisible hand of the market will produce the best end result. Taking considerations other than financial ones will therefore contribute to economic inefficiency.

As an extension of this reasoning it can be claimed that someone who manages money on behalf of others does not have the opportunity to incorporate considerations in the management process that are not viewed as completely financial in the traditional sense. Anglo-American legal tradition uses the term "fiduciary duties" to describe a manager's obligation of loyalty to the party for whom the assets are managed. Does the loyalty requirement vis-à-vis owners permit the manager to take ESG considerations into account in the management process? Even if the manager conducts himself in line with his loyalty requirements, issues can arise during various ESG initiatives vis-à-vis a company if the board of the company cannot follow up the initiatives due to loyalty obligations towards other stakeholders. A study published by the UNEP Financial Initiative concludes that ESG initiatives can largely be justified in various jurisdictions.[2] In a statement from the autumn of 2008 a representative of the British government also supported the view that pension funds can emphasise social and ethical issues in the management process in addition to purely financial considerations.[3] On the other hand, it has been reported[4] that in its interpretation the U.S. Department of Labor has adopted strict limitations with respect to factoring ESG issues into its management of pension funds.

One viewpoint from another side of the political spectrum on encouraging companies to be socially responsible can be formulated as follows[5]: The energy spent on CSR diverts and distorts the attention that should be paid to establishing politically adopted rules that promote the common good. Binding laws should prevent oil discharges and protect human rights. Such duties should not be imposed on private companies.

Although this can be a factor in certain developing countries, the practical situation for companies that have been established in many countries will be that "just" following the law in a number of situations is not satisfactory. As long as there are no binding international rules and a number of jurisdictions have poorly functioning laws, many companies (and investors that have invested in them) see a need to make an effort beyond what is strictly according to the law. One result of globalisation can be an increase of cases where companies operate in areas with weak social regulation ("*governance gaps*")[6]. The alternative will not be political regulations, but no regulation at all. Voluntary efforts from companies can be the best solution. Many questions relating to companies' CSR are discussed in Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Social responsibility of business and industry in a global economy).

[1] See the article "*The Social Responsibility of Business is to Increase its Profits*," from New York Times Magazine 1970. Freidman's view is usually distilled as follows: "The Business of Business is Business".

[2] The topic has been studied in Freshfield Bruckhaus Deringer's 2005 study "*A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*", published by the UNEP Financial Initiative (UNEPFI). By and large, the report concludes that the incorporation of ESG issues is consistent with a manager's "fiduciary duty".

[3] "*How the UK Government finally settled the RI fiduciary duty debate*" Hugh Wheelan Responsible Investor, 16 October 2008.

[4] *"SRI in the Rockies, US investor concerns on fiduciary duties",* Responsible Investor 3 November 2008

[5] President Clinton's Secretary of Labor, Robert Reich, has argued in this manner, see for example "*How capitalism is killing democracy*", Foreign Policy September/October 2007.

[6] The expression is used in an April 2008 UN Human Rights Council report *"Protect, Respect and Remedy: A Framework for Business and Human Rights"* prepared by John Ruggie, special representative on the issue of human rights and transnational corporations and other business enterprises.

- Exercise of ownership rights implies the use of rights provided by the ownership of shares in a company to attempt to influence the company to act in a manner desirable from an investor's point of view. Exercise of ownership rights will often be based on a dialogue between owner and company, and will in many cases be kept confidential.
- Positive selection means that investment objects that satisfy more specific requirements or standards within environmental or social factors are sought.

It has become increasingly common to integrate ESG issues in the investment process through requirements relating to strategy, reporting, relationship with external managers and investment process.

The report "*Responsible Investment in Focus: How leading public pension funds are meeting the challenge*"[3] provides a review of the work of responsible investments in 15 funds, including large funds such as CalPERS[4], TIAA-CREF[5], ABP[6], PGGM[7] and Caisse de dépôt et placement du Québec[8]. Based on this report and other sources, it can be said that all of the funds mentioned use voting and company dialogue as instruments. Four of them use negative and positive screening, four of them have an opportunity to use exclusion, three have ESG issues integrated in the investment process and four of them have special ESG investments. The report stated that many funds use a broad spectrum of instruments in their work as responsible investors.

A main theme in the report at hand is the proposals to expand and strengthen the instruments employed in responsible management of the Government Pension Fund – Global.

UN PRI, which Norges Bank prepared together with other investors, is discussed above in Box 3.1. The first principle of PRI is that ESG issues shall be incorporated in investment analyses and decision-making processes. The 2008 UN PRI report [9] on the development in the implementation of the six principles for Responsible Investment says that the interpretation of the first principle varies among the various investors. How much ESG means in practice for various funds' investment practice may be unclear.

4.2.2 Responsible management of the Government Pension Fund – Global

Investor role

The starting point for the ethical guidelines for the Government Pension Fund – Global is the investor role, i.e. the role as an owner of the companies in the portfolio. The tools available are those that follow the position of shareholder. The responsibility for broad national and international social development initially lies with the national authorities and with international agencies to which they have delegated authority or have established to carry out specific tasks. The expectations one can have to a company's social responsibility or responsible investment practice as a tool for a better world must be viewed in the light of this division of roles. Political efforts, where rules are formed to ensure important human interests, will be the chief priority of the Government. At the same time the activities of the companies have a large impact on global social development. This was discussed in Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Social responsibility of business and industry in a global economy) which points out that, because companies influence social development in the countries in which they operate, they have a responsibility that goes beyond creation of value.

Through our investments in a large number of the world's companies, see the discussion of the importance of universal ownership in Section 2.1, we have both a responsibility and an interest in safeguarding environmental and social concerns beyond that imposed through binding rules.

In the main the Government Pension Fund – Global is managed with a broad and limited ownership in a large number of companies in a large number of countries. Strategic control and management of the companies in which the Fund has invested is not an aim. In contrast to the role as

[3] 2007 report prepared in cooperation between the United Nations Environment Programme Finance Initiative and The United Kingdom Social Investment Forum

[4] California Public Employees Retirement System is the largest pension plan in the US, with total assets in August 2008 of just over USD 180 billion.

[5] Teachers Insurance and Annuity Association, College Retirement Equities Fund supply pension products in the US to academics etc. At the end of 2007 TIAA-CREF had just over USD 360 billion under management.

[6] ABP is a public pension fund in the Netherlands that in September 2008 had about EUR 195 billion under management.

[7] PGGM manages capital for a pension fund in the health and social sector in the Netherlands and has total assets of EUR 88 billion.

[8] Caisse de dépot et placement du Quebec manages capital mainly from public and private pension and insurance schemes in Quebec and had about CAD 120 biilion under net management at the end of 2008.

[9] *PRI Report on Progress 2008* from UNEP Finance Initiative

strategic investor, the role of financial investor influences both how ownership can be exercised and how the development of the world economy affects the return on the Fund.

Responsibility for managing the Fund has been assigned to the Ministry of Finance. This responsibility involves establishing the main features of the investment strategy, deciding risk limits in operative management and following up operational management. This also means that the Ministry of Finance is responsible for the overarching strategy including the Fund's role as responsible investor. Norges Bank has been assigned the task of operational management. See more detailed discussion of investment strategy and role as responsible investor in Section 2.

Government Pension Fund – Global as our shared savings for the future

The Government Pension Fund – Global is owned by the Norwegian people and is managed on behalf of present and future generations of the population. This means that fund management requirements will have to deviate from management of funds where individuals inject capital on their own behalf. The managers that offer fund investments for individuals can offer various types of funds with various degrees of risk and different emphasis on ethical values. If there is dissatisfaction with the direction of a certain fund, the fund shares are sold and invested in a different fund. No such opportunity is given the owners of the Government Pension Fund – Global. As residents of the Norwegian state each individual is an obligatory co-owner of the Government Pension Fund – Global. Its management must be justified to future generations of Norwegians too. There is therefore an ethical obligation to manage for the benefit of future generations. This provides an obligation to organise management so that the return is good and the risk level is moderate. At the same time this entails a need for an ethical foundation and shared values for the management that safeguards the obligatory co-ownership.

The Graver Report introduced the term "overlapping consensus" as an expression meaning that ethical guidelines have to build on stable normative lines, taking both the pluralism of the Norwegian society and uncertainty of the ethical standpoints of future generations into consideration.

The Ministry finds that the ethical principles of the management of the Fund must be based on obligatory co-ownership and the interests of future generations. Furthermore, the fact that the Fund is a large actor in the international financial market should be taken into account.

The following main principles underpin the ethics behind the management of the Fund.

- The ethical basis must be accepted by broad groups in society and be stable over time. Individual demonstrations of what the majority believes at any one time do not provide a basis for changing the content of the Fund's ethical principles. Cases in which minority interests have particular weight are also conceivable.
- In the assessment of how extensive the exclusion mechanism should be, the desire to avoid contribution to ethical norm violations must be appropriately weighed against ethical obligations to ensure financial returns over time so that future generations receive a reasonable share of the oil wealth.
- It makes sense to choose as a point of departure international principles on companies' relation to environment, human rights, employee rights and corporate governance as expressed in the UN Global Compact and OECD guidelines. The UN has also prepared its own principles aimed at the investor role, UN Principles for Responsible Investment (PRI), covered in Box 3.1. These principles must be regarded as key and relevant for further work on integration of good corporate governance and safeguarding of environmental and social matters in management of the Fund. The more this work is anchored in universal principles, the more legitimacy, opportunity for cooperation and greater influence are attainable.
- On the basis of these assessments and the fear of political misuse of investment power (see the international debate on sovereign investment funds) the Fund's management should not be a tool for specific political prioritising of the government in power at any one time and is thus not a tool of foreign policy.
- The ethical obligations must be reconcilable with the role of financial investor. It is fundamentally important to distinguish between the question that concerns ethical management of the financial wealth built up, and questions that in reality concern the use of oil money. The division of labour between the Fiscal Budget and the management of the Government Pension Fund suggests that the Government Pension Fund shall not be used to fund purposes

> that do not meet the priorities of the Fiscal Budget. This dividing line must remain in place. In addition, it is important to maintain credibility in the role of financial investor to be able to work with other investors, and thereby have an even greater impact.

Relationship to the state's other roles and instruments

The Graver Committee was instrumental in clarifying the role of the Government Pension Fund in relation to the state's other roles. The Graver Committee discussed this in relation to the state's role as purchaser and licence issuer (NOU 2003: 22 p. 18 et seq.). Reference was made to the fact that freedom of action is different in different roles. The Graver Committee also wrote that as a purchaser the state is far more regulated through international rules than it is as a financial investor. Different associations can also be judged differently in terms of ethics. For example, it was shown that the purchase of defence material is not necessarily inconsistent with the exclusion of companies that produce weapons. The former is for defence purposes, the latter to make money. With respect to the state's freedom of action as a licence issuer, the Graver Committee showed that this was limited by EEA agreement rules on the right to start companies, which does not automatically permit requirements for the ethical practice of companies as a condition for the licence.

The issue of coherence was also discussed on p. 24 of Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Corporate social responsibility in a global economy), which states:

> "Questions have been raised about whether the ethical guidelines for the Government Pension Fund should also apply to companies with state ownership. However, it is uncertain whether it is right or appropriate for the government, in its role as an owner broadly speaking, to follow the particular model made for the Government Pension Fund – Global.
>
> The ethical guidelines for the Government Pension Fund – Global have been adapted to the Fund's role of financial investor and minority shareholder in thousands of companies around the world. There are important differences between this role and the role the government has as a large, strategic owner in a number of Norwegian companies. These differences affect the way ethical concerns are integrated and the instruments that are available. In managing the Government Pension Fund – Global the government has far wider powers to sell or not to sell holdings in various companies than it has through direct, strategic ownership of Norwegian companies. The direct state ownership is exercised in accordance with established principles for corporate governance,…" [Preliminary translation]

The Graver Committee clearly stated that the Fund is not suited to meeting all the ethical obligations of the Norwegian people. The Committee showed that Norwegian authorities have many other instruments at their disposal and that many of the obligations we have can obviously be handled better by using other instruments. The Graver Committee showed that the situation could be such that making ethical requirements of a company through the Fund is not very effective as compared with more direct influence through legislation or other political means. It would then seem unethical with respect to future generations of Norwegians to impose costs on the Fund solely in order to carry out symbolic, ethically grounded measures in support of policies best promoted by other means.

It was also pointed out that it will not be appropriate for the Fund to pursue a large number of goals. Ethical guidelines will be the most effective if they pursue goals that point in the same direction. The obligation to use the Fund as an instrument will be stronger in situations that facilitate the use of the Fund to meet ethical requirements. For example, the Committee mentioned situations where ethics and sustainable development complement long-term financial returns.

4.2.3 Climate change as a challenge

The Graver Committee established that sustainable development is a precondition for the long-term returns of the Pension Fund. There is broad agreement that the world faces major challenges relating to climate change. Global warming can have a major impact on living conditions. The world economy will be affected by an increase in the world's mean temperature in the 21st century. The returns of the Government Pension Fund – Global may be affected by this change too.

In the Government's view it is important to take these challenges to the future of the Government Pension Fund – Global seriously.

A majority of the commenting bodies have raised questions relating to the consequences of human-created climate change. The assessments

in the consultative comments can be divided into two main groups of arguments:

1) The Pension Fund should be developed into an important tool for preventing detrimental climate change.

2) The returns of the Pension Fund will be affected by climate change, and for this reason the Pension Fund should match both the exercise of ownership rights and the investments to attempt to reduce risks relating to returns in the long term.

A number of the consultative comments emphasise the first factor and highlight an ethical obligation to use the Fund actively to meet climate challenges. Other comments largely emphasise financial interests to justify that the Fund should adjust its course.

What role can and should the Government Pension Fund – Global play in climate policy?

In its fourth main report the UN Intergovernmental Panel on Climate Change (IPCC) concluded that human-created greenhouse gas emissions are the main reason for global warming over the last 50 years. The anticipated climate changes may cause serious harm to humans and the environment. Poor countries will likely be hit particularly hard by flooding and reduced access to drinking water.

The goal of the global effect through the United Nations Framework Convention on Climate Change (UNFCC) is to stabilise the concentration of greenhouse gases at a level that is low enough to prevent harmful human-created impacts on the climate system. The Government wants Norway to be a leader in climate policy and a driving force in the work on a new and more ambitious international climate agreement. The Government has decided that Norway, like the EU, shall work to keep the global temperature increase to below 2 °C compared with the preindustrial level.

The Government has a three-tiered strategy for reaching its climate policy goals. A *better international climate treaty* is the first and most important element. Norway is participating in the European Emissions Trading Scheme (EU ETS) market and will work for a system where carbon emissions are priced globally. Such a price should be included in investment and production decisions for companies in the entire world and will provide incentives for switching to low-carbon production. The second element is that *Norway must contribute to emissions reductions in developing countries and rapidly growing economies* such as China, India etc. Norway has initiated an important initiative against deforestation in developing countries. The 2009 budget includes an allocation of NOK 1.5 billion for measures to combat deforestation and forest deterioration in developing countries. Beyond this further allocations of NOK 1.5 billion have been approved for forest measures.

The third is that efforts to *reduce emissions in Norway will be intensified.*

In the Government's view it is an ethical obligation for Norway to assume its share of necessary obligations to avoid destructive climate change. Norway's goal is to be a leader in climate policy.

As pointed out by the Graver Committee, the Government Pension Fund – Global is not suited to meeting all the ethical obligations of the Norwegian people. In addition to the Pension Fund the Norwegian authorities have many instruments available to them. Other instruments will be the most efficient way of promoting the three main climate policy strategies.

In the role of financial investor, the Government Pension Fund – Global can still help avoid detrimental climate change, see below. The starting point will then be climate-related measures that coincide with the objective of ensuring long-term returns.

The Government Pension Fund – Global: Why is it important to meet the long-term climate challenges

Even though the Government Pension Fund – Global has a delimited role with respect to preventing detrimental climate change, many of the distinctive features of the Fund indicate that climate challenges are key to the management of the Fund. This is also further specified in Chapter 2.

The Fund is a long-term investor. There are challenges both in the short- and long term relating to funding the country's pension obligations and meeting the challenges of caring for an ageing population. Today, the Pension Fund contributes to funding such obligations and will continue to fulfil an important function in the future too. In the 2009 Perspective Report, see Report no. 9 (2008-2009) to the Storting, the Government illuminated these challenges. To ensure a well-functioning welfare society for future generations it is important to have a functioning world economy with security for investments and sound returns. The climate chal-

lenges are important for a long-term investor interested in a functioning world economy not just in 2010, but also in 2050 and 2100.

The Fund spreads its investments. Over time the Fund's investment opportunities have been expanded to many different types of investments and different geographic regions. The Fund is in the process of entering into real estate, and by expanding the benchmark index to more emerging markets, the Fund will be exposed even more than before to the development of the entire world economy. On the basis of this global investment strategy it is important for the Fund that a global climate treaty be established and measures be implemented to protect against the consequences of global warming.

The Fund is a universal owner affected by ripple effects. The returns of a universal owner are affected by the scope of positive and negative ripple effects of other companies' activities, see also Section 2.1. So far, consumers and producers who emit CO2 gas pay only a limited amount of the real costs of emission. The emission of carbon gases may be the largest negative ripple affect facing the world economy. The Pension Fund will have a long-term interest in climate challenges being met by global initiatives and binding standards. The Pension Fund will benefit from efficient, global pricing of carbon emissions that can make climate technology more profitable and bring forth production patterns with lower carbon emissions.

4.3 Evaluation and further development of ethical guidelines

4.3.1 Introduction

General starting points

The ethical guidelines have worked for nearly four years. On the one hand this is a relatively short period for assessing whether the intention behind the guidelines has been appropriately addressed. On the other hand, practice with respect to socially responsible investments is a field that is rapidly evolving internationally. Regular evaluation is necessary for ensuring that work on responsible investments reflects best international practice.

For the time being it must be acknowledged that it is difficult to document the long-term effect on the surroundings of the Fund's efforts as a responsible investor through ownership input and effect of the exclusion mechanism. In general it is difficult to isolate and measure the effects ensuing from better company practices or more sustainable development. Measurement methodologies and parameters are currently not very well developed in these areas. These circumstances suggest that we must accept making choices we believe are correct, even though the effects cannot be measured in the same manner as financial return/risk. This can be compared with other fundamental views about how markets work on which formulation of the Fund's investment strategy is based, see coverage in Section 2.1 above.

Beyond this, considerable data show that decisions made pursuant to the ethical guidelines are accorded weight by others in specific situations. For example, it is known that many managers and Funds are withdrawing the same companies as the Government Pension Fund – Global from their portfolios. There are also examples of cases where the Fund's involvement has contributed to specific results, see more specifics under Section 3.3.2.

4.3.2 Goal of work on responsible management

Introduction

The ethical guidelines do not specify paramount goals or targets that apply to the guidelines as a whole. There are two *premises* for the ethical guidelines in Section 1, see also coverage in Chapter 3.

First of all, the Fund is an instrument for ensuring coming generations a reasonable share of the country's oil riches. These financial assets must be managed so that they provide good returns in the long term, which depends on sustainable development in an economic, ecological and social sense. This basis is the starting point for the work on the exercise of ownership rights. The paramount goal of the exercise of ownership rights is to ensure the financial interests of the Pension Fund, see the ethical guidelines in Section 3.1. The Fund's financial interests shall be strengthened by using the Fund's ownership positions to promote sustainable development. Report no. 24 (2007-2008) to the Storting reads as follows, on page 68:

> "The Ministry takes the view that there is a linkage between sustainable economic development and sustainable social and environmental development. This means that the Government Pension Fund in the long run will ben-

> efit from companies respecting fundamental ethical norms.”

Accordingly, the purpose of the exercise of ownership rights is to strengthen the Fund’s financial interests by seeking to influence companies, their operating conditions or environment to business conduct that in the long term supports sustainable development.

The other principle in Section 1 is that the Fund shall not undertake investments that represent an unacceptable risk of the Fund being involved in unethical actions or omissions such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental degradation.

The way the grounds for the exclusion mechanism are formulated has a different purpose than the exercise of ownership rights, namely avoiding the Fund contributing to grossly unethical acts.

Views of commenting bodies

Many commenting bodies are of the opinion that the paramount goal of the ethical guidelines should be to contribute to more responsible business and industry.

In its consultative input the *Norwegian Centre for Human Rights* asks the question: what is the main purpose of the ethical guidelines? They give two alternative responses: preventing complicity or influencing the company in the right direction. The centre assumes that the use of instruments under the ethical guidelines should be focused on the latter element: influencing companies.

Given a goal of contributing to long-term and sustainable development in individual companies and society in general, *KLP* assumes that the most efficient route is to combine the exercise of ownership rights and exclusion.

In its input *Storebrand* wrote that exclusion by itself is of little value. Not until the mechanism is linked with exercising ownership rights can asset managers really achieve results in social responsibility, as experienced by Storebrand.

Norwegian Church Aid, Bob Pozen and *Carlos Joly* advocate that the overriding goal of the ethical guidelines should be to influence companies and help change practice in the direction of a more responsible business and industry. Other commenting bodies, including *Attac,* pointed out the lack of clarity between the relationship between the goals behind the current instruments, and the possible conflict between them.

The Forum for Environment and Development is of the opinion that, where financial interests collide with human rights and environmental considerations, the latter shall take precedence.

The *Council on Ethics* believes that the main purpose of the exclusion mechanism should still be to avoid the Funds contribution in particularly gross violations of norms, and not to affect companies. The Council on Ethics believes that it must continue to evaluate the worst violations of norms, and the mandate must be clear here. The Council on Ethics believes this has shown itself to function operationally during the time the Council has been in operation.

Furthermore, the Council on Ethics points out that even though recommendations of exclusion in some cases may also lead to influencing of companies, such influence should not be the purpose of the exclusion mechanism. In reality such an arrangement will limit the Council on Ethics’ opportunity to work with the companies contributing to the worst violations of norms. It could also lead to difficult overlaps with Norges Bank’s exercising of ownership rights.

The Ministry’s assessment

On the basis of inputs in the consultation round and experiences with the ethical guidelines so far, the Ministry is considering whether it may be appropriate to clarify the overarching goal for the work on ethics and responsibility in the management process. In particular, this will have an impact on the understanding and development of the Ministry’s role in the ethical guidelines. The purpose is that the various instruments that the system gives instructions for shall work together to support the overriding purpose.

Under the current ethical guidelines, exercising ownership rights and exclusion each have different objectives, respectively ensuring the long-term financial interests of the Fund and avoiding contribution to grossly unethical acts or omissions. Both instruments are individually well suited as rules for the work of Norges Bank and the Council on Ethics. However, few instructions are provided in the ethical guidelines or in the Graver Report for whether or how the instruments are to be viewed together. As the ultimate authority for practising the guidelines and making decisions on whether companies should be excluded, it will be appropriate for the Ministry to work via an overriding goal of a somewhat broader format. This will provide guidelines for

the Ministry's strategy and priorities in the future. The Ministry's role furthermore indicates that in specific cases the Ministry will have to weigh the use of the individual instruments and how they can support each other if applicable. Accordingly, the Ministry will have to take more interests than those of Norges Bank and the Council on Ethics into consideration. In such a light an overriding formulation of goals will be able to provide guidance for weighting various interests in an overall assessment and for the use of and the relationship between the available instruments.

In its evaluation work the Ministry has examined the practices of various other investors with whom it is natural to compare itself, and seen that the work of a responsible investor often has the goal of influencing portfolio companies and markets in a positive direction.

Furthermore, the Ministry has noted that the international trend is now headed in the direction of an emphasis on good corporate governance, environmental and social factors throughout management work. Such a viewpoint is motivated by a belief that a responsible handling of such concerns will also have an impact on long-term financial returns. This is also reflected in the principles for responsible investing laid down by UN PRI, the development of which Norges Bank has contributed to and supported since they were launched in the spring of 2006. The Ministry of Finance wishes to mark its further support for these principles by also signing them on behalf of the Government Pension Fund. As of today, the Ministry regards PRI as a well-developed international platform for questions relating to the integration of good corporate governance and environmental and social factors into financial management. In the role as the ultimate entity responsible for the Fund's framework, the Ministry considers it important that the principles are made visible in all parts of the management of the Fund.

As stated in Chapter 2 above, the Ministry finds that the integration of good corporate governance, environmental and social factors in the management process is partly due to the possibility of market failure that is in the financial interest of the Fund to influence. Good corporate governance that helps companies operate in line with the long-term interests of owners, and efforts to promote well-functioning and well-regulated markets, are examples of this. Sustainable development in the long term will also be important for the Government Pension Fund – Global. This can be warranted particularly for two reasons: Firstly, the size and investment strategy of the Fund, which means that the Fund is invested in a very large share of listed companies above a certain size divided into markets and regions throughout the world. Secondly, the Fund's very long-term investment horizon. The "universal owner" hypothesis can form a theoretical foundation for emphasising sustainable development. See the discussion in Chapter 2 above. The content of said principles for responsible investments, UN PRI, looks to the very dimension that a long-term, responsible investor would wish to incorporate.

The Ministry still wants the Fund to avoid investments in companies that act highly unethically. However, the design of the current exclusion mechanism could lead to according too little weight to the assessments of opportunities to influence a company or comprehensive assessments. This can lead to a somewhat more unnuanced use of this instrument and present challenges over time. The Ministry believes that our interest in having "clean hands" cannot release us from our responsibility for undertaking a broader assessment, so that as an investor, alone or together with others, we can use our ownership power to effect positive changes. Reference is made to further discussion in Section 4.3.4 below.

In light of this, the Ministry wishes to clarify that it has an overarching goal for the instruments it has at its disposal at any given time in its role of responsible investor. In this way it can continue to build on the work that has been done and utilize the power already inherent in the separate instruments, while simultaneously helping to ensure the credibility, legitimacy and clout of the system in the future.

The Ministry plans to clarify the paramount goals it is pursuing in its work as responsible investor. See Box 4.2. This objective will guide our work as responsible investor, and for instruments that can be employed on behalf of the Fund. However, not all instruments will be equally suitable for achieving the various subgoals that are listed. A specific assessment must be taken of what is appropriate. In relation to the current guidelines the proposal represents a greater emphasis on the desire to contribute to positive changes in sustainability issues and companies' conduct with respect to good corporate governance and social and environmental factors.

Box 4.2 Paramount goals for responsible management

The Government Pension Fund – Global must be managed so that it provides good returns in the long term, which depends on sustainable development in an economic, environmental and social sense along with well-functioning, legitimate and effective markets.

The Fund shall be managed in a responsible manner that takes factors relating to corporate governance, environmental and social matters into due consideration. The instruments the Fund has at its disposal shall be used with a view to:

- promoting good corporate governance and greater awareness of social and environmental issues among companies in which the Fund has holdings
- helping companies in the portfolio respect fundamental ethical norms
- promoting sustainable development in an economic, environmental and social sense
- promoting good corporate governance and organisation of financial markets that safeguard the Fund's interest as a financial investor
- precluding the Fund from having investments that conflict with Norway's obligations under international law
- avoiding investments that represent an unacceptable risk that the Fund will become involved in unethical acts or omissions such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental degradation.

4.3.3 Exercise of ownership rights

4.3.3.1 Introduction

As the Fund's manager it is Norges Bank who is responsible for exercising ownership rights ensuing from the Fund's position as shareholder in the portfolio companies. Chapter 3 provides a description of Norges Bank's corporate governance activities and the results in this area in 2008.

The question of whether the ethical guidelines in this area have worked as planned must be answered by assessing the work that has been done so far against the objectives and intentions stipulated in the guidelines.

4.3.3.2 Consultation memorandum

Under Section 3.3 the consultation memorandum states:

> "The main objective of Norges Bank's ownership activities is to protect the long-term financial return on the Fund, as premised on a sustainable development perspective. The start-up of ownership activities on the part of Norges Bank has been a pioneering effort, and the initial phase was characterised by a focus on establishing an organisation, acquiring the required knowledge and developing a strategy for the exercise of ownership rights. The Executive Board determined the NBIM active ownership strategy in 2006. It is obvious, given the short period of implementation, that it is too early to draw any definite conclusions concerning the degree to which the Norges Bank ownership activities have contributed to protecting the longterm return on the Fund. This is reinforced by the challenges involved in measuring the results of ownership activities, as also pointed out in the Graver Report. It may take time to achieve improvements, and companies may opt to present changes as the result of their own initiatives, rather than efforts on the part of their owners. Norges Bank's ownership activities must therefore, for the time being, be evaluated by reference to other parameters."

The consultation memorandum subsequently addressed the same four assessment topics as the Chesterman and Albright Group Report: organisation and resources, Norges Bank's interpretation and implementation of the ethical guidelines, the question of the effect of corporate governance activities and reporting.

With respect to *organisation and resources*, the report believes that the ownership group in Norges Bank appears to have reasonable access to resources and focus from the management. It points out that good communication between the ownership group and external managers is important. This makes it possible to communicate the Bank's guidelines to external managers, so that if needed they can give notice of problems in specific companies. Similarly, problems the ownership group uncovers in corporate governance topics can give managers advance warning of bigger problems in the operation of a company and therefore have an impact on investment decisions.

Under the topic Norges Bank's *interpretation and implementing* of the ethical guidelines, the report discusses whether it has been right of Norges Bank to make specific priorities and then

discusses the choice of the priorities. In the report the first question is answered in the affirmative. Reference is made to the fact that the principles in the guidelines for the UN Global Compact and OECD guidelines for multinational enterprises are broadly formulated so that they cannot be used directly. The report furthermore states that the focus on certain areas protects the Fund's returns because the resources set aside for corporate governance activities are used effectively. Even though Norges Bank has chosen priority areas, other subjects will also be relevant to the ethical guidelines. For example, the report mentions the challenges related to supplier chains. The Bank can deal with these as the issues emerge, or it can choose to work more closely with other investors on various subjects to benefit from a division of work between investors.

With respect to the process of choosing focus areas, the report points out that very thorough work was done. However, it was stated that the process was closed in the sense that it was not subject to public debate or hearings before the principles were adopted. The report points out that, particularly with respect to social and environmental subjects, a broader array of viewpoints is advisable to make priorities viable over time and through changing political views, changes in management of the Fund or refocusing of the public on new subjects.

Following a further review of Norges Bank's priorities, the main conclusion of the report is that the implementation is "clear, professional and appropriate".

With respect to the traditional corporate governance themes, the report states that Norges Bank's selected subjects are well known and suited to protecting investors' access to information and will be a counterweight to the companies' administration.

In regard to the focus areas of child labour and climate, the report shows that they are based on a connection between sustainable markets and long-term financial results. Negative external effects of climate change and social effects of child labour will be detrimental for the portfolio in the long term in light of Norges Bank's role as a universal investor with a long-term perspective.

According to the report, Norges Bank's work aimed at the protection of children's rights is pioneering. Formulating and publishing expectations in a separate document[10] bolsters its impact with respect to dialogue with the companies. With respect to the focus area of environmental protection and lobbying, the report finds that the Bank's strategy is somewhat narrow. It was stated that the strategy should preferably be expanded to cover measures aimed at influencing the companies to increase the information level of the companies with respect to effects and risks related to climate change and furthermore that the Bank can direct its corporate governance activities at the companies' handling of regulatory and physical risks arising from climate change and cooperate with other investors on these subjects.

With respect to the *effects of corporate governance activities*, the report points out that many preconditions have to be met for the exercise of ownership rights to have an effect. It was stated that ownership cannot be said to be successful until the realities on the grass roots level are changed, not just the internal guidelines of companies. Norges Bank should therefore seek to confirm that reported measures are in fact carried out. It is pointed out that the verification of third parties will have great value, especially with respect to child labour.

Furthermore, it is pointed out that Norges Bank must develop instruments in case ownership processes are not successful. In some cases the nature of violations will be such that a sell-off should be the outcome. As of today Norges Bank has no clear system for concluding when an ownership process has been unsuccessful, or its consequences. The report concludes that a schedule for measuring progress should be created for each ownership process. Furthermore, the ownership department should be able to give recommendations to the investment officers about changes in the portfolio based on the results of ownership processes. According to the report it must be ensured that sell-off decisions resulting from assessments related to corporate governance activities do not cause disadvantages for managers.

The report points out that Norges Bank has largely chosen to act on its own after holding a dialogue with companies. The report concludes that the effect of the exercise of ownership rights can be increased if Norges Bank aligns itself to a greater degree with other investors, with respect to subjects that fall within and outside their own priority areas.

In regard to Norges Bank's *reporting* of its own corporate governance activities, the report pointed out that the annual report for 2007

[10] NBIM Investor Expectations on Children's Rights

marked a big step forward with respect to Norges Bank's transparency and communication.

4.3.3.3 Views of commenting bodies

The input of commenting bodies with respect to exercising ownership rights has generally concentrated on the following main subjects: desire for increased disclosure and transparency in Norges Bank's work on the ethical guidelines, proposals for greater commitment in EITI and ongoing work on a new accounting standard for the extractive industries ("country-by-country reporting"), proposals for expectations documents in more fields patterned after the child labour document, and pointing out the importance of setting aside sufficient resources for work. In addition, there are many viewpoints on corporate governance activities aimed at climate challenges.

In its consultative comments *Norges Bank* said that exercising ownership rights is an important instrument for protecting ethical considerations in managing equities. Norges Bank writes:

> "The Fund's long-term view, size, geographic coverage and growth, the increased number of companies in the portfolio and the increasing number of companies where the Fund has relatively large holdings, strengthens the meaning of exercising ownership rights. Since the yardstick of the Fund is a global market portfolio the Fund will most likely be a long-term investor in most large listed companies. It is therefore in the Fund's interest to strengthen the governance structure and ability to create value in these companies. It is also in the Fund's interest to have markets that are well functioning, open and well regulated to counteract serious market failure and that are subject to reasonable behaviour standards so that they contribute to sustainable development."

Norges Bank believes that the ownership activities must be based on the Fund's financial interests to be effective and have legitimacy. The Bank believes it is correct to have high ambitions for what the exercise of ownership rights can achieve, and emphasises:

- that effects will be evident in the long term, but only rarely in the short term.
- that even though Norges Bank increasingly belongs to the group of major shareholders in a company and often has access to decision makers, the holdings will not be larger than that the exercise of ownership rights must meet understanding and respect from other actors in the financial market to become particularly effective,
- that the exercise of ownership rights must be based on the fact that the role as investor is different from the roles played for instance by authorities and special interest organisations, but that the actors can in some cases pull in the same direction, and
- that companies usually will describe changes as their own initiatives and not as a reaction to the wishes of investors. Results of owner activities is therefore not always easy to document.

Furthermore, Norges Bank believes that the mandate for the exercise of ownership rights – promoting the Fund's financial interests by contributing to sustainable development – specifies a clear direction for the work. There is a need in the exercise of ownership rights to choose focus areas deriving from this mandate. The focus areas also build on an assessment of the type of cases best suited to dialogue with companies and standard setters. By choosing focus areas influence can be increased by expertise and alliances and by creating expectations in the companies. This demands a long-term view and predictability. The focus areas contribute to a division of work among institutional investors.

The exercise of ownership rights is aimed at promoting the Fund's interests by influencing portfolio companies and market standards. Norges Bank refers to the fact that a number of tools are used in its exercise of ownership rights. The work processes are under development, and robust procedures will be established to conclude company dialogues if they fail to produce the desired result.

In contrast to small niche investors and other social actors who attempt to affect companies in individual cases, Norges Bank said it is essential to protect an investor profile that can provide long-term influence. To safeguard this, Norges Bank will avoid micromanaging companies. The Bank said that it must be careful not to be marginalised as an investor who raises questions that mean little for the companies' creation of value. Norges Bank will therefore direct attention to the management structures, procedures and issues that are of overarching significance for the company and that boards and senior management are expected to deal with.

SIGLA says that active ownership is a well-recognised method used by many investors and asset managers. At the same time it can be demanding

to achieve and document results, particularly in the short- and medium-term. Norges Bank should be given the space to continue to develop its work without major changes or new demands. At the same time it is reasonable to expect that results will be communicated to a greater extent and detail in the years to come since this work will have greater weight. It will be desirable for Norges Bank to prepare examples of how it has succeeded in influencing companies to adopt more sustainable strategies and how this has affected the financial return.

Martin E. Sandbu believes that, even though it can be practical to avoid publicity while a process is under way, Norges Bank should be able to publish details of processes that have either been successful or have failed. Sandbu believes it is part of the public administration's responsibilities to the population to document how it manages what explicitly is to be the population's overlapping consensus in ethical questions.

In his consultative comments *Robert A.G. Monks* points out that achieving results in corporate governance activities will depend on a carefully worked out strategy, and setting aside sufficient resources. Cooperation with other investors can be useful in some cases, but Monks is more uncertain whether permanent connections with other investors will be productive. The Fund must be careful not to let its reputation become unfavourably influenced by the conduct of others.

In practice, effective corporate governance activities will according to Monks require Norges Bank to take a leading position and let others rally to its banner. The Fund's owner must decide whether this is appropriate, particularly in light of the debate about sovereign wealth funds. If Norges Bank is to assume a leadership role, Monks believe that far more than 10 persons will be necessary. He refers to a far higher number of persons engaged in active ownership in companies that he regards as leaders, CalPERS and Hermes, and says that the programmes of these institutions are less ambitious than those of Norges Bank. *Forum for Environment and Development* recommends that the Ministry strengthen its capacity and increase the resources of the Corporate Governance group in Norges Bank.

KLP refers to the fact that the exercise of ownership rights is often criticised because it is difficult to measure the effects of the work. KLP believes it will be easier to assess the results of the work if the ethical guidelines' criteria for exclusion are also used for the exercise of ownership rights. To work actively to avoid any exclusion or to reinclude a company will strengthen the measurability of the exercise of ownership rights. KLP praises Norges Bank for its 2007 annual report and transparency about its work in the area. KLP nevertheless believes that Norges Bank should consider greater transparency about the ownership processes. This can have a disciplinary effect, strengthen the results and increase confidence and credibility.

KLP believes that Norges Bank should not use more resources to verify actual changes in the companies. KLP recommends its own model where the company itself must ensure that independent third parties verify actual changes.

KLP believes that it may have been a good idea for Norges Bank to establish focus areas to take a leadership role in these fields. However, KLP believes that such a large and respected actor as the Government Pension Fund – Global should have fundamental international norms with respect to having human rights, employee rights, environmental protection and anti-corruption on the agenda in both dialogue and the exercise of ownership rights vis-à-vis the companies. The companies that violate the ethical guidelines' criteria for exclusion should be a part of Norges Bank's dialogue universe.

James P. Hawley and *Andrew T. Williams* believe that Norges Bank's active ownership has been handled in an efficient and expedient manner. They agree with the point made in the Chesterman and Albright Group Report that the focus area in climate work is somewhat narrowly designed, but still believe that the Bank must carefully assess the expansion of the focus areas. For active ownership to work, it should be closely connected to the Bank's role as financial investor. For example, expectations relating to corporate reporting on effects and risks relating to climate change can be a practical expansion of the Bank's existing focus area. Other expansions of the Bank's focus areas should only be done following thorough assessments. Hawley and Williams agree that the Bank should develop guidelines for when an engagement has failed and a clear specification of its consequences. Exclusion should be just one of many reactions, including continued observation, cooperation with other investors or non-governmental organisations or reduction or freezing of assets. The Bank must monitor whether actual changes take place, either with the help of own resources or third parties.

Hawley and Williams are furthermore of the opinion that cooperation with other investors is important not only for communicating successfully with companies, but also for establishing Norges Bank as a leading actor in selected fields. However, this should not pose any obstacle to direct one-on-one communication with relevant companies. Hawley and Williams underline the importance of clear external communication, and emphasise in that respect the level of annual reporting for 2007.

The Norwegian Financial Services Association (FNH) underlines the importance of the Government Pension Fund – Global cooperating with other investors on influencing the development of companies in line with the intentions of the ethical guidelines. It points out that this can be done through Principles for Responsible Investment (PRI) in which FNH believes that the Government Pension Fund – Global can play a more active role.

Many, including *Changemaker, Norwegian Church Aid, Save the Children* and *Publish What You Pay* want Norges Bank to contribute to increased transparency about payment flows of companies through its corporate governance activities. In particular they mention work on new accounting standards for companies in extractive industries, which will require reporting of payment flows to a country's authorities, including costs and production data, broken down by country. Furthermore, EITI is mentioned as a separate measure of greater transparency on the part of companies and Norges Bank should promote this work.

Kristian Alm and Save the Children point out that it is not impossible to exercise active ownership based on ownership of bonds, and believes that the exercise of ownership rights and the ethical guidelines only have a bearing on the equity portfolio. *Forum for Environment and Development* expressed similar viewpoints.

Several viewpoints on corporate governance activities relating to the climate challenge were submitted during the consultation round.

Bellona presents an extensive environmental strategy that also includes ownership involvement. In the same way as Norges Bank has published expectations relating to child labour (which according to Bellona have become a standard for other investors), the Fund should develop a similar expectations document for use not only in ownership activities but also in screening the portfolio. This document should include requirements for uncovering emissions, guidelines to assess current and future risks and opportunities for companies relating to climate change, guidelines for how various price scenarios for CO_2 should be used in company investment decisions and, finally, guidelines for developing emission reduction plans.

The *Future in Our Hands (FIOH)* proposes strengthening the climate profile in the Pension Fund. Ownership activities in the Pension Fund is viewed as good, but the focus should be expanded in relation to the current emphasis on undesirable climate lobbying.

Greenpeace emphasises the importance of becoming involved in corporate governance. As a long-term investor the Government Pension Fund – Global should persuade company managements to overcome shortsightedness and carry out climate strategies to switch to a low-carbon economy that will have an impact long after the current management have left. In the same way as the Government Pension Fund – Global has set up expectations for companies to avoid child labour, expectations relating to climate change should also be developed. Greenpeace itself presents a framework for "*Corporate Governance for Climate Change*".

Changemaker emphasises how the Pension Fund should expand its ownership activities relating to climate.

4.3.3.4 The Ministry's assessment

General

An assessment of the instrument of active ownership should naturally be based on the division of labour between the Ministry of Finance and Norges Bank. Through the establishment of ethical guidelines the Ministry of Finance has established the framework for the exercise of ownership rights, and specified sustainable development as an important premise. Furthermore, the Ministry has laid down work requirements of a very overarching nature, by specifying that the exercise of ownership rights shall be based on the UN Global Compact and OECD Guidelines for Corporate Governance and Multinational Enterprises. The specific formulation of the content of this instrument is largely left to Norges Bank, see the Section 3.1 of the ethical guidelines.

With respect to the opportunities to assess and measure the effects of ownership activities, the Ministry refers to what was stated in Section

4.3.1 above. It can be added as a general point that ownership initiatives will be enjoyed by all investors, not just those who get involved. In many cases, ownership activities relating to industry initiatives and regulatory initiatives will be directed at "lifting the market", i.e. getting it to function better, not to "beat the market", i.e. ensuring excess returns for one's own portfolio compared with the rest of the market. Consequently, it will not be easy to measure the outcome of the work in the absence of a control group with which it can be compared. It should be kept in mind that companies will often be interested in emphasising corporate governance improvements resulting from their own initiatives so that an investor's impact is not necessarily clearly evident.

Certain commenting bodies have been concerned that the ethical guidelines are not applicable to the bond investments because bonds do not provide a basis for exercising active ownership. First of all, the Ministry wishes to point out that the exclusion mechanism potentially applies to all companies in the portfolio, regardless of whether the Fund owns equities, bonds or both types of securities in a company. Furthermore, in many cases the Fund will own both equities and bonds issued by the same company. Active ownership will have indirect application on the bond portfolio inasmuch as active ownership is exercised on the basis of shareholdings in a company in which bonds are also owned.

Implementing the exercise of ownership rights – Norges Bank's work

A description of Norges Bank's work on exercising ownership rights is given above in Chapter 3. On the basis of the Chesterman and Albright Group Report, consultation inputs and own observations the Ministry finds that Norges Bank has done a good job of preparing and implementing ownership activities in relation to the mandate.

Some important fundamental starting points for active ownership were formulated in the Graver Report. The Graver Committee considered that the exercise of ownership rights is primarily suitable as an instrument where ethics and long-term financial proceeds take the same direction (NOU 2003: 22 p. 25):

> "The themes that receive most attention in the public debate on ethics will not necessarily coincide with the priorities that major asset managers focus on to protect the long-term interests of shareholders. In a number of issues where there is strong ethical involvement by various pressure groups, the link between ethics and financial return will be more tenuous than in the more classic ownership issues, such as requirements for accounting information and independence between boards and management. Because of the need to balance resource use against expected long-term gains, it is likely that issues where the aim of protecting the long-term interests of shareholders seems to be clearest will be given priority. In cases where the connection between ethics and long-term return is either unclear or negative, the exercise of ownership rights will not be an appropriate instrument for promoting ethical considerations. In other words, the exercise of ownership rights to achieve long-term return will not be the answer to all the ethical challenges Norway faces through its ownership shares in international business and industry, nor will it cause politically or ethically based criticism of the activities of the Petroleum Fund to cease. There will always be grounds for debate on the formulation of guidelines for the exercise of ownership rights and for managers' behaviour within these guidelines".

The Ministry adopted this view in the 2004 revised National Budget (p. 64). It further states:

> "The ordinary division of responsibilities between a company's owners, management board and administration should also be observed. The owners' natural tasks are to appoint the board of directors and decide overarching strategic issues. It is neither feasible nor desirable for the Government Petroleum Fund to go into the minutiae of company administration."

Certain commenting bodies have said that it is important for ethical considerations to take precedence in the exercise of ownership rights if there is a conflict between ethical and financial interests.

In many cases *the Ministry* assumes there will be no conflict between ethical and financial concerns, particularly if the financial assessment is long-term. However, to the extent there is a conflict between these interests, it will not be very likely that Norges Bank will gain acceptance for viewpoints at the expense of a company's long-term financial returns. If Norges Bank acts in a manner that is inconsistent with its role as financial manager, it can cause a risk that the Fund can be viewed as a political tool. This may be undesir-

able because it can weaken the Fund's reputation internationally as a financial investor and thus potentially limit the Fund's investment opportunities, see the international debate about sovereign investment funds.

The Ministry assumes that the latitude for what Norges Bank can legitimately raise with a company through dialogue can widen if a good relationship has been built with the company or by collaboration and division of work with other investors. Several owners characterised as universal owners may raise issues that for their overall portfolio will be favourable, but in the short term will be considered negative for the individual company. This may provide an opportunity to widen the breadth of the dialogue to subjects that in the short term have relevance for financial return prospects. It is difficult to specify clear guidelines for such cases. It must be left to the judgment of the manager in the specific case. The view of what is natural for a financial manager to raise with companies can also change over time. The Ministry views it as important that Norges Bank assess this issue on an ongoing basis.

The Ministry takes a positive view of the fact that Norges Bank has developed several different instruments and approaches for its ownership activities, see description in Chapter 3 above.

The Ministry believes that Norges Bank has chosen working forms and instruments that align well with its role as shareholder and financial manager. In accordance with the ethical guidelines, the Bank has prepared internal guidelines for its corporate governance activities (2004). It is specified here that the guidelines are dynamic and that the work will be a process in continuous development. The Ministry will particularly emphasise the importance of the work done to specify expectations for the companies through Norges Bank's expectations document on child labour and voting principles (2008). In the Ministry's view, these documents are well suited to strengthening the predictability of the exercise of ownership rights. It is important for ensuring the legitimacy of the ethical guidelines, both vis-à-vis the companies in the portfolio and the Norwegian public. At the same time it provides a good basis for other investors to follow up the same principles as those observed by Norges Bank.

The Ministry will also emphasise the resource-intensive and rather complicated work done in combination with Norges Bank's voting, and not least that the voting process and its guidelines are made public. This provides a good occasion for the public to gain insight into Norges Bank's work in the area.

The Ministry finds it positive that the Bank directs its efforts not only at certain companies but also against influencing markets and market conditions. For such a large and diversified investor as Norges Bank, the effect of regulatory factors may be the means that have the most effect in that it will cover many of the companies in the portfolio.

With respect to direct contact with companies, the criteria for selecting companies for dialogue as described in the 2007 annual report are deemed appropriate. These appear to provide a basis for a good assessment of the relationship between resource efforts and benefits, including in the form of potential effect on other companies. The Ministry notes with satisfaction that Norges Bank can also discuss matters that arise on a more ad hoc basis with companies, for example through news stories and the like.

It is a natural starting point for an investor of Norges Bank's size to direct efforts mainly at corporate boards, and it is positive that Norges Bank seems to have good access to corporate managements.

The Chesterman and Albright Group Report raised two issues of importance for the effect of Norges Bank's work. This applied firstly to questions relating to how results of ownership processes should be verified. Secondly, the report pointed to an absence of clear processes with respect to criteria for when an ownership process should be deemed unsuccessful and the effects it may have. The Ministry refers to the fact that Norges Bank is currently preparing a plan for all ownership processes covering the objective of the dialogue, schedule, the resources to be set aside etc. The Ministry assumes that factors relating to independent verification of information and possible unsatisfactory outcomes of a process will be included in such a plan.

Above, the Ministry has described PRI, which Norges Bank has endorsed, and where the first principle is that ESG issues shall be integrated into investment analyses and decision-making processes. The Ministry intends to lay down requirements for Norges Bank's internal strategic plan in how the Bank plans to integrate considerations relating to good corporate governance, environmental and social matters in the management of the Fund. Among other things, it will include further details of the resources set aside and of the priorities the Bank will make etc.

Several commenting bodies want a larger degree of transparency about Norges Bank's corporate dialogues. The Ministry has noted that Norges Bank emphasises confidentiality in dialogue with individual companies as a precondition for a good and efficient process with the company. The Ministry believes it is important that Norges Bank, in its ownership processes, deals with what are generally accepted procedures among financial investors regarding corporate contact. However, it is an important consideration that the public receives sufficient information in order to form a picture of the scope and quality of Norges Bank's work. Other reputable investors appear in an increasing degree to be demonstrating transparency about their active ownership. The Ministry will regularly discuss the scope of information about active ownership with Norges Bank. Norges Bank should assess the possibilities of publishing individual cases in ongoing corporate dialogues on a case-by-case basis, and particularly when a process is deemed to be concluded. Furthermore, the Ministry will regulate various aspects of Norges Bank's ordinary reporting of ownership activities in the regulations about the administration of the Government Pension Fund – Global, see the section about reporting below.

Norges Bank's ownership activities are performed fully for the account and risk of the Ministry of Finance. To the degree that a trade-off must be undertaken between the efficiency of the ownership activities on the one hand and the legitimacy on the other, this assessment must ultimately be undertaken by the client.

As covered in Chapter 3, Norges Bank has chosen *focus areas* for the exercise of ownership rights. This applies to four focus areas in traditional corporate governance. Under social and environmental factors the Bank has chosen child labour and children's rights and corporate lobbying of national and supranational authorities in issues relating to long-term environmental changes.

The Ministry endorses the view of the Chesterman and Albright Group Report that it has been a correct strategy to concentrate efforts on selected areas. In the Ministry's view, the Bank has chosen topics that are consistent with Norges Bank's role and the long-term goal of healthy financial returns. In addition, the subjects are per se very important from an ethical perspective.

Within traditional corporate governance the Bank has chosen subjects that are crucial for a shareholder's ability to exercise influence in proportion to its holding in a company. The Ministry considers that these questions relate directly to the prospects of long-term good financial returns, while good corporate governance is simultaneously a precondition for a good approach to work on social and environment-related issues.

In general, the Ministry would point out that measures that increase transparency and access of analysable data will be positive. This will help improve the market's efficiency and reduce mispricing in the market. This will be an advantage for a broad index manager such as the Government Pension Fund – Global. Better information access will also be important for factors other than purely financial ones, for example with respect to reporting on social and environmental matters. Reference is made to special coverage of environmental reporting in Box 4.3.

The Chesterman and Albright Group Report is very positive in regard to Norges Bank's work on child labour and refers inter alia to the fact that the Bank has formulated clear expectations of companies, and made them public. This increases the possibility of affecting not only the companies but also other investors. Furthermore, the report shows that in its work on the expectations document the Bank has worked with other investors and non-governmental organisations. Many of the commenting bodies have also emphasised Norges Bank's work in this area. The Ministry endorses the positive view. The Ministry also refers to the specific results of the process covering child labour in India based on the business activities of the Monsanto company, see coverage in Chapter 3 above.

The Ministry believes that through its environmental focus area Norges Bank will make an important effort relating to the climate challenge. The starting point for the Bank's work is a growing view in many sectors and industries that there is a need for greater safety around future legislation and operating conditions.

It is in the interest of the Fund to avoid the worst climate change scenarios and this represents an important premise for Norges Bank's corporate dialogues in this field. At the same time it is in the Fund's interest for the authorities in the individual countries, including through international collaboration, to choose the most cost-effective solutions. This will serve the Fund's earnings and sustainability in the long term.

Among other things, the voting guidelines for Norges Bank usually call for supporting proposals that ask companies to report emissions of green-

Box 4.3 On corporate environmental reporting

A precondition for efficient allocation of capital and sustainable development in the long term is access to information so that hidden costs and risks in companies and markets can be uncovered. A goal for the Ministry of Finance is to work for more transparency in the markets and achieve better pricing of costs to prevent companies from passing costs on to others.

From an environmental point of view it is important that information is available about how well the various companies are prepared for various environmental consequences, such as a trend of putting strict limitations on carbon emissions. This has a bearing on the efficiency of the markets and correct pricing of the companies.

Measuring and reporting environmental impact is a necessary basis for integrating ESG issues. More general use of open environmental management systems shall ensure that investors who wish to incorporate environmental considerations into management will have a more reliable basis of comparable data. A number of funds have already integrated environmental criteria into their investment decisions and exercise of ownership rights.

The Norwegian Accounting Act contains provisions on environmental reporting. For a more detailed assessment see Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Social responsibility of business and industry in a global economy). Established Norwegian policy recommends that companies endorse the global environmental reporting schemes through the Global Reporting Initiative (GRI).

Open, comparable and reliable environmental reporting, well integrated with the company's daily operation, will generally be positive for financial investors. In both direct dialogues and through voting it is therefore important to emphasise communicating information connected with risk factors relating to the climate and other issues.

The Ministry considers this to be in line with the long-term interest of the Government Pension Fund – Global. To avoid different reporting requirements from many different investors it is important to coordinate reporting requirements. The Carbon Disclosure Project is an example of just such a coordinated reporting initiative supported by Norges Bank.

The Ministry has assessed the benefits of a coordinated review of the environmental reporting of the companies in the portfolio. In that case its benefits must be weighed against the considerable work effort that will be necessary to summarise the environmental development of nearly 8,000 companies. During the consultation round several respondents said that they desire an overall portfolio review of the Government Pension Fund – Global relating to companies' CO_2 emissions and associated risks for the returns. The Ministry aims to conduct a review of such issues, see discussion in Sections 2.5 and 4.3.6.

house gases and adaptation strategies when the existing reporting is not satisfactory and publishing will be in the shareholders' interest. Proposals about climate change and business strategy will be evaluated on a case-by-case basis. Better reporting about companies' climate challenges and strategies will provide a better basis for informed investment decisions.

Several respondents in the consultation round believe that corporate governance activities should be somewhat more broadly aimed at the climate issue. It is important to underline that Norges Bank is involved in working with other investors in this area too. Two important initiatives were taken in 2008. Norges Bank became involved in the Carbon Disclosure Project, an independent, non-profit organisation that gathers and publishes information about companies' emissions of greenhouse gases and other information relating to companies' handling of greenhouse gas issues. In November 2008 Norges Bank took part in a petition sent to heads of governments and climate negotiators from more than 130 investors with total assets of USD 6,400 under management, stating that future climate agreements must be strong and binding. The initiatives are described in more detail in Chapter 3.

New opportunities to incorporate climate issues in the management process are opening up now that the Government Pension Fund – Global

is to invest in real estate. Through large ownership interests in parts of the real estate management Norges Bank, as manager, will be able to exert greater influence on the requirements made of the underlying assets in the portfolio than through the management of the equity and fixed income portfolio. This supports taking special environmental considerations in real estate management. The Government Pension Fund – Global should therefore adhere and contribute to the development of best practise in integrating environmental concerns in the management of real estate. The Ministry intends to require Norges Bank to participate actively in the efforts pursued internationally to develop special environmental considerations in real estate investments.

The Ministry underlines the importance of well-functioning ownership activities related to the climate challenge. By virtue of being a long-term and global actor with investments in many companies that will be affected by climate challenges, it is important to influence companies to prepare for a future economy where emissions of carbon will be very costly and will be reduced.

All in all, the Ministry is satisfied with the subjects Norges Bank has chosen to focus on in its corporate governance activities. At the same time the Ministry sees that the documents that the ethical guidelines specify as the basis for the exercise of ownership rights, the UN Global Compact and OECD guidelines for multinational companies and corporate governance, cover in terms of topics more factors than what Norges Bank's work has focused on so far. As part of the high ambition level the Ministry believes is right to use as the basis for the Government Pension Fund as a responsible investor, the Ministry believes the breadth of Norges Bank's corporate governance activities should be gradually broadened. The Ministry considers that further development of Norges Bank's ownership activities should take place through preparation of expectations documents in other subjects, and will ask Norges Bank to prepare more of these documents, including in the environmental field. Many commenting bodies said that Norges Bank should prepare an expectations document in the climate field. The Ministry believes this could be appropriate and assumes that this could cover expectations relating to companies' strategies and risk analyses relating to climate challenges and restrictions in climate policies. Reference is also made to Section 4.4.2 below where an expectations document about the corporate transparency and reporting is discussed. The Ministry otherwise sees that it is important that work on new expectations documents in many areas takes place in step with the acquisition of skills and good utilisation of resources within Norges Bank.

As stated under Section 4.3.3.2 the Chesterman and Albright Group Report emphasised that the process of choosing priority areas was closed, and that particularly with respect to social and environmental issues it is especially advisable to have a broader range of viewpoints to make priorities viable over time. The Ministry believes that as the Fund's owner it is natural for the Ministry of Finance to be presented with questions about major changes before the Bank makes the final decision in the case. The Ministry can decide that Norges Bank shall present its proposals in advance to interested parties at an open hearing. The Ministry aims to implement this by including a decision about this in the regulations governing the management of the Government Pension Fund – Global.

The Ministry is positive to Norges Banks' *cooperation with other investors and participation in investor initiatives.* Individual investors can increase their impact on companies or regulatory authorities, and it can also provide latitude for an appropriate division of work and utilisation of resources. Norges Bank has a size and resources entailing special expectations that the Bank could play a leading role within relevant initiatives that other and smaller investors cannot be expected to take. At the same time it is important that the Bank is careful about what it gets involved in, precisely to obtain the best utilisation of resource inputs. The Ministry also considers it likely that as the Fund's owner the Ministry of Finance should consider direct participation in certain initiatives. Reference is made to the fact that the Ministry has endorsed PRI, see Section 4.3.2 above.

An important precondition for good corporate governance, environmental and social factors in active management is that *external portfolio managers* can follow up Norges Bank's strategy in the area. Norges Bank has described its relationship to external managers in a letter dated 6 June 2008 to the Ministry of Finance. The Ministry is taking this information into consideration and believes that Norges Bank appears to have a conscious relationship to how such issues are addressed through contact with external managers. The Ministry will emphasise the importance of the relationship between Norges Bank's external

managers in this area, and intends for the regulations concerning the management of the Government Pension Fund – Global to contain a provision that a relevant factor in selecting new external managers is that they can document that they have systems to take good corporate governance, environmental and social issues into consideration in line with Norges Bank's strategy in the area.

Resource access, resource use and reporting

Ten persons currently work on the exercise of ownership rights in Norges Bank. Resource use is divided into approx. 50 per cent traditional corporate governance and approx. 50 per cent social and environmental subjects. The use of resources in the exercise of ownership rights is decided by Norges Bank itself, but the costs are covered through the management fee the Bank receives.

As mentioned above, the Ministry assumes a positive connection between corporate governance activities and the Fund's long-term financial returns. In line with this the Ministry presumes that over time Norges Bank will increase resource efforts in this area.

The strong focus on the Bank's results in the form of excess returns may indirectly lead to ownership activities being given lower priority than what is desired because ownership activities by nature have a much longer time horizon than the financial returns that are measured from one quarter to the next. It is a challenge for the Ministry to establish an assessment system that sufficiently ensures adequate priority of active ownership efforts. The Graver Report discussed this question and showed that requirements for reporting ownership activity will give the manager incentives to give priority to this work.

> "In the current model, the Ministry of Finance is responsible for the Fund's absolute and long-term return since it defines the benchmark portfolio and risk limits for the management of the Fund. Norges Bank is responsible for relative return, that is, return that exceeds or falls below the benchmark portfolio return as a result of active management or deviations from the benchmark for cost effectiveness reasons. Frequent reporting of the results, which is both desirable and necessary, gives the Bank a natural incentive to focus on generating results, defined as an excess return compared with the benchmark index. Resources are allocated to Norges Bank to cover actual management costs up to a maximum limit, and the Bank prioritises these resources within this limit. The management structure should be designed to provide strong enough incentives for Norges Bank to give priority to the long-term exercise of ownership rights rather than engaging in other activities when the upper cost limit is reached.
>
> One way of achieving this is for the Petroleum Fund's owner to stipulate requirements for the manager's reporting on how a mandate for the active exercise of ownership rights is fulfilled. By following up the manager and showing that the exercise of ownership rights is a central issue, the owner will be giving the manager a stronger incentive to give priority to the exercise of ownership rights in the manager's own organisation."

According to current ethical guidelines Norges Bank shall report annually about ownership activities. The Ministry believes it is desirable to increase the frequency of reporting on these activities to quarterly reporting. The Ministry will organise the reporting routines concerning ownership activities so that it is consistent with what applies to the Bank's general activities.

Internal incentive structures in Norges Bank can also have a bearing on how the goal of integration can be met concerning good corporate governance, environmental and social factors. The Ministry will assess how such factors can be safeguarded through principles for performance-based pay in the new regulations concerning management of the Government Pension Fund – Global.

4.3.4 Exclusion of companies

4.3.4.1 Introduction

An evaluation of the ethical guidelines and work on this must be connected with the provisions that cover it in the ethical guidelines. The ethical principles for excluding companies are that the Fund shall not undertake investments that represent an unacceptable risk of the Fund being involved in unethical actions or omissions, such as serious or systematic violation of human rights, gross violations of individual rights in war or conflict situations, gross corruption, severe environmental damage or other particularly gross violations of fundamental ethical norms. A more complete description of the exclusion mechanism is presented in Section 3.3 above.

Furthermore it is natural in an evaluation to see what *actually* has been achieved through

excluding companies. The preparatory works say little about the effects an exclusion has or can have. The Graver Report establishes that such a mechanism is a defence mechanism to avoid becoming an accessory. Little attention is therefore paid to what happens after the shares in the company have been sold. Nor is it the case that there is an attempt to influence companies in a certain direction through this instrument. Nevertheless it can be assumed that the mechanism has had certain effects, which the Council on Ethics also presupposes in its consultative comments. In such case this is unintended in principle. In the Ministry's view, the challenge is therefore to assess how the use of an exclusion mechanism – and the real effects it has – can be integrated better as part of the whole that the ethical guidelines represent. A natural step in such a process has been to clarify the overarching objective for all instruments used. The exclusion mechanism must be seen in connection with this overriding objective, which can have an impact on the assessment of when it is right to decide on an exclusion. These issues are discussed in more detail under the Ministry's assessment in Section 4.3.4.4 and in Box 4.5.

4.3.4.2 Consultation memorandum

Achievement of objective

Under 3.2 the consultation memorandum states:

> "The objective of the measures mentioned in Section 4 of the ethical guidelines is to prevent contributions to serious or systematic violations of ethical norms, as specified in more detail in Section 4 of the guidelines. This measure is, as discussed in Section 2.2, based on a deontological approach. The assessment as to the risk of contribution shall be forward looking.
>
> The Ministry assumes, when it comes to the screening of companies on the basis of the weapons criterion, that the monitoring services used by the Council on Ethics are effective. It can be deemed likely that companies producing the relevant weapons or parts for such weapons are in fact excluded from the portfolio.
>
> The Ministry is of the view that the companies excluded on the basis of their behaviour, are indeed covered by the exclusion criteria, i.e. that the risk of continued serious ethical violations has been and remains unacceptable. Reference is made to the thorough fact gathering, deliberations and recommendations of the Council on Ethics. However, one cannot operate on the assumption that there are no companies in the portfolio that are engaged in activities that somehow represent serious ethical violations. It will not be possible, with 7,000 companies in the portfolio, which also change their conduct over time, for the Council on Ethics to be aware of what all the companies are doing at any given time. The use of external reporters and tips from the general public will be of decisive importance in this regard."

Council on Ethics' work

The Chesterman and Albright Group Report, which has evaluated the work of the Council on Ethics, is covered in the consultation memorandum. The report shows that the work done by Norges Bank and the Council on Ethics has established Norway as a leading actor with respect to ethical issues in the global economy. As for the Council on Ethics, it is particularly pointed out that the thorough recommendations have been published. The report points out that criticism of the Council on Ethics has largely fallen into three categories: First, disagreement about the justification of certain recommendations. Second, that the Council was to have made more recommendations, either on the basis of existing guidelines or an expansion (the report does not take a position on any expansion of the guidelines to include additional factors). Third, it emphasises a point that has not been very visible in public debate: whether the Council on Ethics has used its resources in an efficient manner. On this basis the report formulates three main issues: the question of whether the Council on Ethics has been fair, effective and efficient.

In discussing fairness the report raises questions relating to the Council on Ethics' relationship to the companies in the portfolio. The report discusses three specific topics where there may be room for change: The Council on Ethics' method for choosing which companies are to be investigated, the collection of information from the companies by the Council and the method for how an excluded company can apply to be reinstated in the portfolio.

The discussion under effectiveness is particularly about how the Council on Ethics' recommendations can have an impact beyond the specific company that is affected. This is discussed both in the significance of the signal effects of "naming and shaming", but questions are also raised about whether the Council on Ethics should prepare

and publish summaries of its decisions in a manner that is suited to guiding companies in various points relating to meeting the guidelines.

With respect to efficiency the report believes that the efforts of the Council on Ethics can be made more effective. An important part of the discussion under this point applies to structuring the Council on Ethics' process forward to any recommendation differently than today. Among others this relates to ways of making the Council on Ethics' priorities and work that does not lead to recommendations to exclude companies more visible and accessible to the public.

In the consultation memorandum the Ministry writes that, on the basis of the report and own observations, it finds that the Council on Ethics has carried out the duties following from the ethical guidelines and its mandate in an appropriate manner. The Council on Ethics currently has one instrument at its disposal, namely a recommendation of exclusion. The Ministry is aware that in many cases the Council on Ethics finds information about companies that shows that the companies have room for improvement with respect to matters that are relevant according to the guidelines, but the behaviour is not of a nature that qualifies for exclusion. The consultation memorandum pointed out that a goal of the evaluation could be to equip the Council on Ethics with a few more instruments so that its information could still be useful.

Criteria for exclusion

In the consultation memorandum the Ministry pointed out the importance of ensuring that the ethical guidelines reflect in the best way possible an overlapping consensus among the Norwegian people so that it can be assumed that the owners of the Fund are behind the guidelines. Under Section 3.2 the Ministry writes that it will

> "…await feedback from the bodies included in the public hearing before taking a view on whether other or more exclusion criteria should be introduced. The Ministry will, in its assessment of such feedback, continue to emphasise that one aims to have a regulatory framework that reflects, in the best possible manner, an overlapping consensus in the Norwegian people."

4.3.4.3 Views of commenting bodies

The input of commenting bodies concerning the exclusion mechanism has concentrated on the following main subjects: the general use of the exclusion mechanism and criteria for exclusion, the Council on Ethics' work and instruments at the disposal of the Council. Many have also commented that the Council on Ethics' relationship to Norges Bank and the need for a greater degree of coordination and cooperation between the two bodies. This subject is discussed in greater detail under Section 4.3.5 below.

General information about the purpose of the exclusion mechanism.

In its consultative comments the *Council on Ethics* stresses that the main purpose of the exclusion mechanism should still be to avoid contribution, not to influence companies. If the purpose of exclusion is to affect change, it will limit opportunities for the Council to assess the worst companies, the Council says. At the same time the Council on Ethics points out that exclusion has the power to influence, in that the Fund is a major actor, that there is a high threshold for excluding a company, and that recommendations of exclusion are public, thorough and well documented.

Some of the commenting bodies warn against the use of exclusion, unless it is connected with other instruments such as dialogue and attempts to influence through the use of ownership rights. Some of the commenting bodies also ask what a sale of shares in a company leads to. In many cases the consequence is that the influence on the situation that would have been retained through ownership in the company will be lost, and in the worst case those affected by the company's activities will be even worse off. In its comments *Norwegian Church Aid* writes that excluding a company does not release it from responsibility for the victims and interests of the victims. The organisation proposes that compensation be incorporated as an element of the exercise of ownership rights to protect the victims' needs in a direct way.

In its consultative comments *Norges Bank* writes that exclusion due to conduct is a demanding instrument. It is difficult to be consistent. Furthermore, it will be a risk that the exclusions could affect companies that are generally ambitious or leading in their industries also in regard to avoiding grossly unethical acts in which the Fund is to avoid contributing to. Norges Bank furthermore states that exclusion is not the same as condemnation, but that it can be viewed as such, depending on the way the exclusion decision is

announced. The Bank comments that exclusions should be presented as administrative decisions.

In its consultative comments *KLP* writes that exclusion is a strong instrument that should be used as a crowbar for dialogue and which will put the spotlight on reprehensible situations in public discourse and internally in the companies. Dialogue can continue even after a company has been excluded, as is the practice at KLP. In their joint consultation input, *Andrew T. Williams* and *James P. Hawley* say that exclusion is a blunt instrument that is not necessarily the most efficient way to achieve the goals envisioned for the Council.

In its consultative comments the *Norwegian Savings Banks' Association* writes that the exclusion mechanism should be used so that it results in fewer exclusions. In other words: Exclusion is not the final objective, but correction of behaviour is.

Application of exclusion criteria and development of norms

Norwegian Centre for Human Rights sought a more detailed clarification of what is meant by the term "human rights" in the guidelines. Bob Pozen underlines some of the same in his comments when he wrote that there is a need to clarify the demands made of companies with respect to human rights preceding any exclusion. The *American Chamber of Commerce in Norway* expressed similar views.

The *Council on Ethics* says it has emphasised expanding its understanding of the individual points in the guidelines, particularly in the first recommendations in each of the criteria. Qualification of the criteria (gross, serious etc.) provides, together with the preparatory works, clear guidelines about how strictly the guidelines shall be practised. The Council on Ethics points out that it often starts with conventions, international law, national laws of different countries or other non-binding sets of norms as reference points for the various assessment subjects.

The consultative comments from the *American Chamber of Commerce in Norway* claim that since exclusions are based on available information a large degree of transparency will increase the chance of being considered for exclusion. There is a built-in "selection problem", in that companies that are excluded do not necessarily need to be the largest norm violators but are selected because they report openly or operate in parts of the world where information is easily available. The consultative comments from *BI* contained similar reasoning. There is a risk of journalists and non-governmental organisations focusing on the weaknesses of the "best" companies while the companies that are actually worst receive no attention. There can be a division in the world economy where activities in ethically grey zones are carried out by lesser-known companies operating below "the ethical radar screen".

Some of the commenting bodies have commented on the Council's interpretation of the concept of contribution. The concept of contribution is a key part of the grounds for excluding companies, see the preparatory works (the Graver Report). *The Norwegian School of Theology* believes the probability of positive change in the company has to be decisive. *Martin E. Sandbu* proposes that the Council on Ethics take into consideration a new aspect in assessing whether the Fund can be deemed to contribute to grossly unethical activity: a company must be deemed guilty of previously committed norm violations if the company does not make amends in an adequate manner for the same norm violations. If a company fails to make amends, it can be claimed that the norm violations are ongoing and that it continues to profit from the damage inflicted. *The Norwegian Burma Committee* believes it is problematic that the ethical guidelines do not require companies to make amends for damage resulting from a company's past activities. The *Forum for Environment and Development* is of the same opinion.

HSH believes that, given the way the Council on Ethics' role has been defined, a considerable asymmetry has been established between the legal nature of the Council's decisions and the economic nature of the managers' decisions. HSH furthermore states:

> "…; In many respects the Council acts like a court without having such decision-making powers. It is probably not too strong to say that both the Council and the Ministry of Finance base themselves on the Norwegian self-image of having considerable ethical authority and power. …;"

Criteria for exclusion:

Many of the commenting bodies, including the *Confederation of Norwegian Enterprise (NHO)* and *KLP*, point to the importance of the criteria for exclusion being clearly anchored in international norms and rules, in addition to being an expression of an overlapping consensus among the Nor-

wegian people. In its consultative comments KLP said the following:

> "We believe that the exclusion mechanism is served by criteria largely consistent with international norms. International norms are the closest the world comes to a common set of values regardless of country or actor. This provides legitimacy, opens opportunities for cooperation and provides greater influence."

In their consultative comments, six commenting bodies (*Directorate of Health, Norwegian Cancer Society, Norwegian Heart and Lung Association, Norwegian Asthma and Allergy Society, Norwegian Church Aid* and *Tobacco-Free*), proposed that tobacco producers should be automatically excluded from the Government Pension Fund – Global through a screening mechanism.

The main thrust of the argument from these commenting bodies is that Norway supports the WHO Framework Convention on Tobacco Control, which entered into force in 2005, i.e. one year after the current ethical guidelines were introduced. The convention was ratified by 160 countries, including Norway as the very first. States that support this convention are obligated to fighting globalisation of what the convention calls the *tobacco epidemic*. This concept refers in turn to the very serious and extensive health, social, environmental and negative economic consequences of tobacco use and production of tobacco across the world.

The Directorate of Health refers to the fact that smoking is one of the main risk and causal factors in cardiovascular disease, lung and respiratory infections and many forms of cancer. It is estimated that around 6,700 people die of smoking-relating diseases each year in Norway. On a world basis, nearly five million people die each year due to tobacco use. This is expected to climb to eight million in 2030, of which 80 per cent of the deaths will occur in developing countries.

The Norwegian Cancer Society has a long discussion of the WHO Framework Convention on Tobacco Control. According to the Norwegian Cancer Society the background of the convention is a strong international desire to combat the spread of the tobacco epidemic. "The Convention also reflects an acknowledgement that the international society must combat a very determined, powerful and speculative tobacco industry that is increasingly focusing on the weakest links in the world community."

The *Norwegian Heart and Lung Association (LHL)* believes that when Norway actively invests in the tobacco industry this violates the intention of the tobacco convention. LHL believes that as a whole the tobacco industry conducts itself in a manner that is not consistent with the values and ethics we believe should be present in the companies in which the State invests. The tobacco industry aggressively markets its products in developing countries. It is also working intensively to prevent these countries from adopting tobacco use restrictions like those in industrialised countries and in the western world. According to LHL, investing in the tobacco industry while the health authorities are working to achieve a tobacco-free country at home and through international cooperation can be described as a governmental double standard.

Tobacco-Free argues that tobacco is the only legal product that causes death when used as intended. If the government decided to screen out tobacco producers, it would not create a precedent for other potentially harmful products that do not have such dramatic consequences from normal use. Furthermore, Tobacco-Free believes that tobacco products would have been prohibited had they been introduced today. Tobacco is exempt from the legislation covering other consumer goods. Exclusion based on a review of the conduct of individual companies is not a suitable tool since the tobacco products themselves are the main problem, plus the fact that they are not very different from other companies with respect to violations of conduct criteria under the current ethical guidelines.

Norwegian Church Aid encourages the Ministry of Finance to undertake an ongoing assessment of the criteria that should be used for Government Pension Fund – Global investments in the alcohol industry. They note that alcohol is one of the main causes of cancer and a number of other illnesses and health hazards. From a poverty perspective, the Ministry is encouraged to take a closer look at the health-related and socioeconomic consequences of alcohol consumption. Norwegian Church Aid writes further that there is an established connection between alcohol consumption and violence, particularly gender-based violence. On this basis the organisation recommends that the Ministry prepare clear ethical criteria for Government Pension Fund – Global investments in the alcohol industry, both with respect to exercising ownership rights and the exclusion mechanism. *FORUT, Campaign for*

Development and Solidarity, also recommends that the Government Pension Fund – Global should not invest in multinational alcohol companies. FORUT points to the fact that exclusion of alcohol producers is much used for what are called social or ethical fund investments. FORUT refers to the fact that this is grounded in the problems alcohol inflicts on individuals, family, communities and nations in the form of health, social and economic problems. Lifestyle illnesses caused by alcohol in combination with tobacco, lack of physical activity and a high-fat diet, represent the world's biggest health challenge. FORUT appends a report where several factors relating to alcohol are discussed, including health and economic problems, unfortunate economic ripple effects, undesirable effects and aggressive marketing in emerging markets and the occurrence of political lobbying. FORUT believes that Norway will take the lead and be an example for other investors if the alcohol industry is excluded from the investment universe.

According to *Future in Our Hands*, the exclusion basis should be expanded to exclude companies that work against international agreements and undermine long-term sustainable development.

Bodø Graduate School of Business argues that Norges Bank must lay down stricter climate requirements for the individual company. If this is not followed up, the exclusion mechanism should be used. Climate change is the most severe environmental damage in history and the school cannot understand why some companies have not already been excluded for this reason. *Greenpeace* and *Changemaker* also advocate excluding "climate offenders" from the investment universe.

The work of the Council on Ethics – more instruments

Many of the commenting bodies cite thoroughness and transparency as important and very positive elements of the Council on Ethics' work. As it has evolved, the exclusion mechanism has also been referred to as pioneering, i.e. related to the work done on exclusion of weapons manufacturers. The Council on Ethics' work is recognised internationally as an important element in the subsequent process of establishing a new international convention against cluster munitions.

Many commenting bodies are of the opinion that the overarching goal of the ethical guidelines, including the use of exclusion as an instrument, is to contribute to more responsible business practices. In light of this it is claimed that specific requirements relating to the various exclusion criteria must be made of the companies and communicated to them and the public. A majority believe this clarification must be made in advance of any exclusion of a company.

Many commenting bodies seek an inclusion procedure for companies that have been excluded. In its comments, *KLP* writes that the government should actively seek to influence excluded companies. They furthermore comment that specific demands must be made of the companies which are communicated to them and to the public, and that the companies' willingness and desire for change must play a role in the assessment. This view has the support of *Andrew T. Williams* and *James P. Hawley*, who underline the importance of the Council on Ethics giving clear indications to the companies of what is needed for them to be reinstated after an exclusion. The Council can do this with the use of either internal or external expertise. In its consultative feedback the Council on Ethics writes that they have discussed the question of what is needed for inclusion in the Fund's universe of individual companies. However, the Council regards it as *"not very appropriate to introduce a general requirement to describe criteria for reinstating the companies that are excluded"*.

Some commenting bodies seek an even greater degree of transparency about the work that is done. *Martin E. Sandbu* proposes that the Council on Ethics' reports that do not lead to exclusion should be made public. He claims that this is something Norwegian citizens have a right to know. On the other hand, in Sandbu's opinion, the companies have no right to protection from transparency. They may even be expected to see being given a public 'clean bill of health' as positive.

Asa and Sirith Kasher believe that the Council on Ethics should carry out comparable examinations of companies in the same sector as part of an investigation into the conduct of individual companies.

A majority of the commenting bodies that have expressed an opinion on the Council on Ethics' work regard it as appropriate that the Council provide *dialogue opportunities* with the companies beyond what is provided by the current system. Many believe the Council should enter into dialogue earlier in its assessment process and that the contact should have a more open form than through the presentation of an exclusion recommendation. Many recommend that basing a

recommendation of exclusion only on written correspondence with a company should be avoided.

NHO says that the assessment of the opportunities for dialogue must take place in light of the entire company's activities. The organisation writes furthermore that it is an advantage to attempt dialogue. However, it does not take a position on whether the dialogue with companies is to take place through Norges Bank, or directly through the Council on Ethics.

Professors Andrew T. Williams and *James P. Hawley* propose giving the Council on Ethics more instruments that can be used in the spectrum between dialogue and exclusion. In its comments, the *Norwegian School of Theology* also writes that the Council on Ethics should have more instruments beyond recommendation of exclusion. The School considers that information about the improvement potential of companies may be valuable even though their ethical conduct falls short of exclusion.

In his consultative comments *Martin E. Sandbu* writes that a regular process is desirable to give companies a chance to change their behaviour. One solution is a multi-phase process that Simon Chesterman and The Albright Group propose in their report. Another will be that the Ministry, when it receives a recommendation for exclusion of a company, routinely does not decide exclusion, but instead provides NBIM with a set time limit, for example one or two years, to work with the company.

Both the *Council on Ethics* and *Norges Bank* write in their consultative comments that the Council should be given more room for dialogue at an earlier stage of the report process. The purpose of such a dialogue will primarily be to collect information, not to engage in influencing company behaviour, writes the Council on Ethics in its comments. Norges Bank also emphasises the opportunity for greater information through dialogue, but also writes that such dialogue can provide scope for the company to correct its behaviour.

Many commenting bodies propose various forms of *observation* of companies as a further instrument the Council on Ethics should possess. These comments are shown in Section 4.3.5.

Several respondents advocate a *greater degree of collaboration* between the Council on Ethics and Norges Bank. See further details under Section 4.3.5 concerning coordination of the instruments.

4.3.4.4 The Ministry's assessment

General

The Ministry of Finance finds on the basis of the report by Simon Chesterman and The Albright Group, consultative inputs and own observations that the Council on Ethics has performed the tasks ensuing from the ethical guidelines and its mandate in a proper manner. In its start-up phase, the Council on Ethics was quick to begin operations and has been very productive and identified a variety of issues. It must also be recalled that only a relatively small part of the combined work of the Council on Ethics and its secretariat is visible to the public. The Ministry wishes to underline that a good basis has been established so that the exclusion mechanism can continue to function in a reliable and satisfactory manner. Criteria that must be met before a sell-off can take place have been refined and supplemented and the administrative procedures that are followed are systematic.

The exclusion mechanism has been in use for four years. This is a relatively short period of time. Still, the Ministry believes it is possible to provide individual assessments of the effects of the exclusion mechanism. Box 4.4 refers to the effects of exclusion from Government Pension Fund – Global equity investments on the benchmark portfolio's return. Box 4.5 covers the expected other effects of excluding companies from the portfolio.

Purpose of the exclusion mechanism

According to the current ethical guidelines the goal of excluding companies from the Fund's investment universe is to avoid investments that represent an unacceptable risk of the Fund contributing to specific unethical actions or omissions. In principle, exclusion is not meant to be used as a means of influencing the behaviour of companies, see page 24 of the Graver Report. The Committee meant that exercising ownership rights could be more efficient for influencing a company's behaviour. Still, it cannot be ruled out that exclusion can also have indirect effects on the conduct of companies, see the discussion below.

The way in which contribution is used in the ethical guidelines includes in reality two different factors. To start with, the company's contribution to the unethical situation must be assessed. However, the Graver Committee also considered that owning shares or bonds in a company that can be

Box 4.4 The financial effects of exclusion since 2005

In NOU 2003: 22 Forvaltning for fremtiden (Management for the future), the Graver Committee wrote that negative screening and exclusion on a certain scale could have financial consequences in the form of reduced risk-adjusted returns, reduced opportunities to engage in active management and higher transaction costs. Below, one of these effects is discussed: the effect on the returns of the Fund's benchmark portfolio.

When companies are excluded from the benchmark portfolio in the Government Pension Fund, all other companies in the same geographic region are given a higher weight than otherwise. Consequently, since the Fund's benchmark portfolio has a somewhat different composition than the original index, returns and risk may also be different.

The effect of the exclusion will increase with the excluded companies' relative share of the Fund's combined investment universe. By year-end 2008, 31 companies were excluded from the investment universe in the Government Pension Fund – Global. The value of these companies represented about two per cent of the benchmark index for the world stock market. Some of the excluded companies are of considerable size. At the beginning of 2009 the value of the three largest excluded companies equalled over 40 per cent of the market value of all companies excluded from the equity benchmark. These three companies were Wal-Mart Stores, Rio Tinto and United Technologies.

Seventeen of the excluded companies are from the aviation and defence sector, which represents about 1 per cent of the world index for equities. More than 3/4 of this sector, measured by the companies' value in the index, has been excluded from the Fund's benchmark portfolio. This is because producers of certain types of weapons are automatically excluded from the Fund.

In figure 4.1 the performance of the three largest excluded companies is compared with the performance of broad market indices in markets where companies are listed. The comparison has been done for the period after each exclusion. The figure shows that the exclusions of United Technologies and Wal-Mart until the end of 2008/beginning of 2009 lowered the return on the benchmark portfolio, while the exclusion of Rio Tinto at this time contributed to a higher return on the benchmark portfolio.

Figure 4.1 also compares the aviation and defence sector in the world index with the entire market. This shows that the aviation and defence sector produced a higher return than the overall market during this period. Since a large part of this sector has been excluded from the Fund, it has contributed to reducing the return on the Fund's benchmark portfolio.

To estimate the combined effect of the Fund's benchmark portfolio since 2005, the Fund's actual benchmark portfolio during this period has been compared with the benchmark portfolio return the Fund would have followed without exclusions due to ethical guidelines. These calculations were done by Norges Bank.

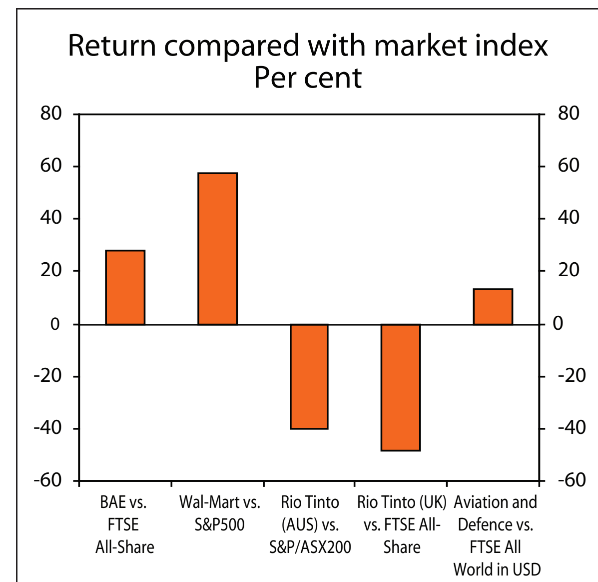

Figure 4.1 Return in companies or sectors compared with relevant market index since exclusion. Per cent

Source: Bloomberg/Ministry of Finance

Box 4.4 (cont.)

Figure 4.2 shows the effect of the exclusion on the return on the benchmark portfolio since 2005. The figure shows the overall effect on the equity benchmark, bond benchmark and on the Fund's entire benchmark portfolio. Overall, the effect of the exclusions until year-end 2008/2009 has been marginally positive (0.03 percentage points) for the Fund's overall benchmark portfolio. The return difference has varied over time, and the variations are largest in the equity benchmark. For example, since August 2005 the exclusions have provided a return on the equity benchmark that is 0.06 percentage points higher than without exclusion. But as late as August 2008 the result was the opposite, then with a negative excess return of 0.19 percentage points.

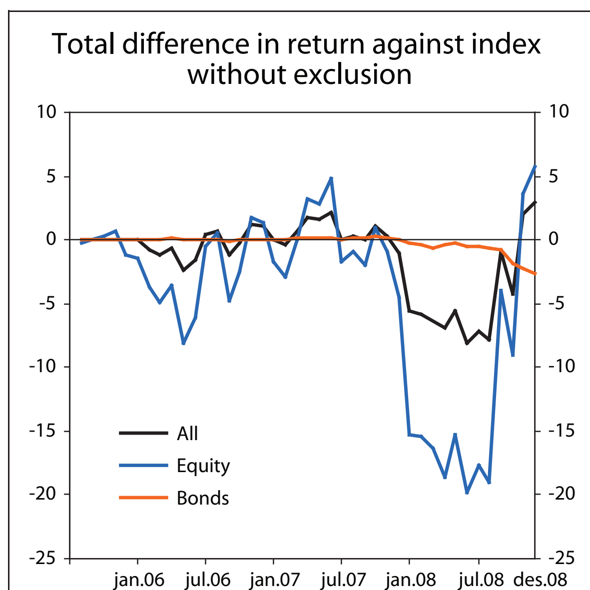

Figure 4.2 Total return difference. Government Pension Fund – Global benchmark portfolio compared with benchmark portfolio without exclusion. Basis points (1/100 per cent.)

Source: Norges Bank/Ministry of Finance

Table 4.1 summarises the results for the benchmark portfolio for equities. The table shows that the return and risk were about the same before and after exclusion in the period August 2005 to December 2008. Both annual return and annual risk measured by standard deviation are 0.02 percentage points higher after exclusion than before.

The exclusions from the Fund's investments have taken place over time and some of the exclusions have affected the portfolio's return for just a few months. It would be hard to draw any general conclusions on the basis of these exclusions. There is still reason to assume that the effect of the exclusions will increase if the excluded companies represent a high relative share of the total benchmark portfolio. If the exclusions are concentrated on individual sectors that particularly contribute to spread the risk in the Fund's combined portfolio, it can also affect how the Fund's risk-adjusted return is affected.

Table 4.1 Effect of exclusion on benchmark portfolio for equities. Per cent

	After exclusion	Before exclusion
Annual return[1]	-5,86	-5,88
Risk[2]	15,75	15,73
Relative vol.[3]	0,14	

[1] Annualised (geometric) average return.
[2] Risk measured by annual standard deviation.
[3] Relative volatility is an expression of the risk that exclusion will lead to a return different from the benchmark portfolio.

Source: Norges Bank/Ministry of Finance

expected to commit grossly unethical acts can per se be considered contribution to these acts on the part of the Fund.

The liability of companies is increasingly emphasised internationally by investors and non-governmental organisations. Among others, the UN special representative for human rights and business enterprises has taken a closer look at this in relation to human rights. See the discussion on page 35 et seq. in Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Social responsibility of business and industry in a global economy).

The Fund's concept deviates from the concept of complicity known in criminal or tort law. In other contexts the complicity concept will often require a different degree of closeness, control or involvement than what ownership interests in a company can lead to per se. In this connection reference is also made to the Council on Ethics' consultative comments, which read:

> "The terms *complicity* and *contribute to* are used synonymously and are based on a general linguistic interpretation, with no particular legal or other guidelines with respect to their interpretation. The Council on Ethics interprets the Graver Report to mean that avoiding complicity is equal to ensuring having "clean hands"; the Norwegian people, through ownership, do not wish to contribute to highly unethical acts."

Under the current system exclusion can be interpreted as a means of providing the opportunity to distance oneself, or avoid being associated with, companies with unethical practices. One can also envision this as a desire not to make money on grossly unethical activities, see page 14 of the Graver Report.

The idea that the Fund itself contributes to in the unethical acts of companies can result in a preference for exclusion as the correct reaction. In this way, the Fund's connection to the situation would immediately cease. Even though the Graver Report had little faith in exclusion as a mode of influence, the Ministry believes that it cannot disregard the fact that this instrument has certain actual effects. As stated in Box 4.5 exclusion will be an instrument that one can assume that companies will wish to avoid. An important question is therefore whether also in exclusion decisions the expected effects of the decision should be taken into account, even though in principle this instrument is justified from a deontological approach. This can apply in the specific case that the company may wish to change its conduct to avoid exclusion or be reinstated in the portfolio. But it can also be assessed in a broader and more long-term perspective, where other companies' awareness that exclusion may be invoked, can make them more willing to change their behaviour in a positive direction.

The Ministry refers to Section 4.3.2 above in which the Ministry clarified the objective of the work on responsible management. The Ministry believes that the exclusion mechanism should not be seen as detached from other work on responsible management. The state will continue to keep the premise that the Fund shall not contribute to specific grossly unethical acts. But the Ministry should also emphasise expected consequences of exclusion in its exclusion decisions. On the basis of an overall view cases can be envisaged where the ethically preferable choice would be to retain ownership interests in companies that largely act responsibly, despite the existence of serious violations of norms in a certain area. For example, there will be cases where through exercising ownership rights or dialogue one can work to get the company to change its practice in the ethically problematic areas. In other cases a decision on exclusion will send the wrong signal to the company and its surroundings, for example if the company is in the process of changing its practice in a credible manner to remedy the unethical situation. This raises questions about the time horizon within which it is reasonable to look at a company's progress, see below.

Application of exclusion criteria and development of norms

The criteria for exclusion based on conduct as defined in Article 4.4 of the current ethical guidelines are formulated at an overarching level. The specific content must therefore be defined through an interpretation of the guidelines. The Council on Ethics has undertaken such an interpretation case by case based on the preparatory works (the Graver Report) and other relevant sources, such as international conventions in various areas. The decisions in individual cases will eventually help develop norms for the Fund's practice in various areas. For example, this applies to determining the content of the terms *unacceptable risk of contribution* and *severe environmental damage* or *gross violation of human rights*. For environmental cases a standard can

Box 4.5 Other assumed effects of excluding companies from the portfolio

The primary purpose of exclusion is to avoid contribution to violations of ethical norms, not to affect companies' behaviour and conduct. Nevertheless, this can be an outcome of exclusion. On the one hand, an exclusion of a company may mean that Norges Bank can no longer exercise its rights to influence the company as an owner, by exercising influence at general meetings and through direct contact. Less alert owners can become new owners with possible negative impact on the degree to which the company takes ESG issues into consideration. On the other hand, the threat of exclusion, as KLP writes in its consultative comments, is used as a crowbar for dialogue and strengthens opportunities to influence companies.

The threat of exclusion can affect a company's behaviour in several ways. A company that depends on having a good reputation to sell its products to consumers will be served by avoiding negative publicity resulting from exclusion decisions. The impact on reputation can be less important for companies that do not sell products to consumers, but for example sell the raw materials to industrial production. If due to ESG assessments a large share of potential investors will not invest in a company, this can entail higher capital costs for such a company. This is analysed in more detail by Koedick and Horst (2008). According to the analysis the effects on corporate conduct will depend to a considerable degree on the extent to which investors exclude the company. In most cases, exclusion of a company from the Government Pension Fund will result in only a very small sell-off of the total equity portfolio. Some investors follow exclusion decisions that are made and sell off as a consequence of the decision of the Government Pension Fund. Examples of this are KLP and the Italian insurance company Generali. It is nevertheless not the case that exclusion of companies leads to massive sell-off in the relevant companies.

Following exclusion the Ministry has registered some activity on the part of the companies to argue that the decision to exclude them was erroneous. This could indicate that companies emphasise avoiding exclusion. It is difficult to quantify the consequences this could have for companies' actual behaviour.

already be said to have been developed, in that riverine tailings disposals has in several cases been viewed as severe environmental damage and led to exclusion. The concept of contribution has also been given specific content in both environmental cases and with respect to human rights.

The general wording of the guidelines provides room for flexibility in individual cases and allows international developments in different areas to be taken into account. At the same time the claim can be made that the system provides little predictability from the standpoint of the company. Companies will have little ability to predict the elements that may lead to exclusion unless a sufficient number of similar previous cases are made public. This has also been pointed out in the Chesterman and Albright Group Report and in the consultation round.

The Ministry will work to make the interpretation and the content of the various criteria for exclusion more readily available to the companies and the public. This can be done by systematising information about exclusions already made and publishing this data in a different manner than today, see also the proposals in the Chesterman and Albright Group Report. Greater opportunities for the Council on Ethics to have a dialogue with the companies can also lead to greater predictability in the individual case, see the discussion below.

The way the ethical guidelines are formulated, exclusion can be decided for individual or limited matters in a company's operations, provided they are serious enough. The guidelines do not provide direct occasion to ask whether the company's practice is poorer or better than companies with which it is natural to compare itself on the basis of region or industry, for example. Nor do the guidelines make it necessary to undertake any assessment of whether the unethical practice represents a material part of the company's operation. It can be said that the assessment for which the guidelines provide directions will largely involve how the actual unethical situation is to be judged and characterised in relation to the criteria, and not have much to do with the overall activities of the company.

Overall and materiality considerations have nevertheless been relevant in the work on the exclusion cases. In an article in the 2008 annual report the Council on Ethics describes how they choose companies for further examination. Based on reports from consultant companies that monitor the portfolio the secretariat makes the initial assessment of how serious or systematic the violations of norms appear to be. An assessment is made whether the situation involves a single incident or repeated acts. Companies accused of similar violations of norms are viewed together to identify the more serious cases. In further examinations an emphasis is also placed on whether violations of norms are being reported in many of the company's operations. The severity of the norm violation compared with other companies with the same type of activity in the country or region is looked at. Nor is it uncommon for the Council, in assessing companies, to review the entire sectors in the portfolio.

According to the Council on Ethics' statement, the Council uses to some extent a broader assessment of a company's operation as relevant factors in the selection of companies. The Ministry agrees that this should be done. The Ministry believes that even if the overall activities of a company are not relevant for whether a certain unethical matter is to be judged as representing a gross, serious or systematic violation of the criteria in the ethical guidelines, it may have an impact on the ramifications of uncovering such a situation.

Once the Council on Ethics has uncovered the existence of a risk of future grossly unethical conduct in a company and submitted a recommendation, the Ministry will undertake an independent assessment of whether the company is to be excluded from the portfolio. Relevant elements in the Ministry's exclusion decision will be those that have been established through Council on Ethics practice, and adjusted to the form of norm violation in question. In cases that concern human rights there will be a probability of new acts or omissions representing violations of the criteria, the severity of the norm violations, the company's capacity to control or prevent the act or omission and whether the norm violations take place in the company's interest or facilitate matters for the company. A set of environmental criteria has been developed for what is to be considered severe environmental damage.

The Ministry is responsible for assessing the comprehensiveness of the Fund's investment practice, and is therefore also responsible for weighing the possibility of avoiding complicity in unethical conduct with the use of ownership initiatives and use of the exclusion mechanism. In deliberating an exclusion recommendation, this means that the Ministry must take a broader set of issues into consideration than the ones following from the Council on Ethics' mandate. Even though the Ministry in a specific case can agree with the Council on Ethics that a certain situation is to be characterised as a violation of the criteria, the Ministry should evaluate more actions than exclusion. The Ministry should first consider whether the exercise of ownership rights can be an appropriate instrument. This is in line with the established practice whereby Norges Bank is asked about any plans it has for exercising ownership rights in the company in question. The company's general standard with respect to guidelines for and work on safeguarding concerns relating to good corporate governance, environmental and social issues can have an impact on the degree to which the company will be receptive to investor pressure in the problematic areas. If the exercise of ownership rights does not provide results, the Ministry of Finance can decide to exclude the company.

Cases can also arise in which the Ministry may believe that it is appropriate to monitor the situation to look at the development of a company's practice. As stated above, excluding a company that is making progress despite serious ethics issues can send undesirable signals. In such cases, putting the company on a watch-list, see below in Section 4.3.5, may be an option. It must also be assumed that the increasing share of companies in emerging markets in the portfolio will open the practising of the ethical guidelines to new challenges. On the one hand, there is reason to be particularly attentive to companies that operate in countries with a poorly developed regulatory climate. On the other hand, there can be reason to adopt a somewhat longer time horizon if companies in regions with underdeveloped rules for corporate governance, environmental and social issues show a willingness and ability to deal with their own problematic issues. See the discussion in Box 4.6. This can play a role in an assessment of whether the company does what reasonably can be expected to reduce the risk within a reasonable time horizon. The Ministry can also apply a different time horizon to its assessment than the relatively short one used by the Council on Ethics in a number of cases.

Deliberations as discussed above are not simple but can provide a basis for a nuanced practice that supports the objective that the Ministry has described in Section 4.3.2 above. The Ministry will have to ensure it has systems that provide an adequate decision-making basis for its own assessments.

The Ministry will maintain a forward looking assessment, i.e. it is the risk of new acts or omissions that violate the ethical guidelines that is to be assessed. In line with the Graver Report, exclusion shall not be a sanction or punishment for earlier acts. Many advocate also taking into consideration whether a company has rectified damage or loss for those who have been affected by earlier acts for which the company is responsible. The Ministry finds that under current practice, failure to repair damage may, depending on the case, be a relevant element in the assessment that the Council on Ethics and Ministry of Finance are to undertake. This element should also have a bearing when there are questions about whether a company that has been excluded should be reinstated in the investment universe. See further discussion of this below.

Two cases have been published in 2008/2009 in which the Ministry of Finance has not followed the recommendation of the Council on Ethics, see discussion in Chapter 3 above. In the Monsanto case the Ministry decided to postpone the decision on exclusion due to Norges Bank's ownership activities vis-à-vis the company. In the Siemens case the Ministry of Finance decided not to follow the Council on Ethics' recommendation and to put the company on a watch-list instead. So far, the Ministry of Finance has not provided a separate reason for its decision, but referred to the recommendation of the Council on Ethics. The recommendations of the Council on Ethics have been published, and an independent reason on the part of the Ministry will in some cases contribute to further clarification of the basis for the exclusion, which will have an impact on subsequent cases. For example, it would be reasonable for the Ministry to clarify how it has weighted different instruments or actions in cases where there is a recommendation that is not followed up with a decision on exclusion. In general this will also increase transparency about the management of the Fund. Against this background, the Ministry of Finance aims to provide, where appropriate, brief grounds for its decisions made pursuant to the guidelines.

When an exclusion is published a company and its activities can be characterised in a manner that can be damaging. This makes high demands of the quality of the decision-making basis and on orderly and methodical procedure. This is underlined by the fact that the decision-making authority is vested in the ministry of a nation-state. This fact is pointed out in the Chesterman and Albright Group Report (p. 26). Suspicion should not be raised that exclusion decisions have been motivated by business or foreign policy considerations, both to ensure confidence in the markets and political support over time for the ethical guidelines. Clarification of general criteria and elements that the decisions are to be based on, and more transparency about the Ministry's own assessments, can help to ensure this.

Reference is made to the fact that several important factors covered in this report and that are also leading up to specific changes in the framework, will amplify and specify the interpretation of different parts of the exclusion decisions. Other measures, such as a possible collaboration with the UN Global Compact, will also lead to further specification of the norm basis.

On application of the ethical guidelines vis-à-vis companies operating in war and conflict zones

The experience with the ethical guidelines so far shows that questions arise with particular frequency about whether the Fund has investments affected by unrest in certain states or geographical areas. For example, reference is made to the attention paid to the conflicts and wars in Burma, Zimbabwe, Congo, Sri Lanka and Israel and the Palestinian area. It has often been an explicit desire of non-governmental organisations, private individuals or political communities that companies that are active in the relevant areas or are associated with one of the sides in a conflict must be sold out of the portfolio.

For one, the *Ministry* points out that the areas in question are characterised by very different types of conflicts. Only Burma has been given special treatment, in that the Fund cannot invest in government bonds issued by this state. Nor, in accordance with a change of the ethical guidelines in 2008, must the Fund be invested in companies that sell weapons and military materiel to states where the Fund is not permitted to buy government bonds. This means that the Fund must not invest in companies that sell such products to

Burma. Burma is different in many respects but the most important in this connection is the scope of the international measures against the country. Currently no other sanctions or measures like the ones Norway has backed have the same scope as the measures against Burma.

With respect to other conflict areas not covered by international sanctions backed by the Storting, the starting point is that the Fund is invested in companies and relates to companies. It is not automatic that a company that operates in a turbulent area neither makes products nor exhibits conduct subject to the criteria in the ethical guidelines. On the contrary, it will sometimes be the case that a company makes a positive contribution to the population in that it maintains economic activities, offers jobs, produces necessities and in some cases also provides, for instance, a certain degree of protection or social services, such as schools or medical services. If companies were to be excluded purely because of their presence in an area, or due to a certain nationality, without any further assessment of the company's specific activities, it would in reality represent a financial boycott of companies for reasons that otherwise are not part of the ethical guidelines. In that case, it would be tempting to view the Fund as a foreign policy instrument, which there is broad agreement should not be the case.

On the other hand there can generally be reason to pay extra attention to companies that operate in war and conflict situations. Such areas will typically be characterised by a high rate of violence and attacks, at the same time as important social institutions such as the police and court system do not exist or function poorly. See the discussion on page 45 et seq. in Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global* (Social responsibility of business and industry in a global economy). This suggests that the probability of companies becoming involved in, for example, violations of fundamental human rights, or corruption is increasing, or that the companies are improperly exploiting their position in another manner. At the same time it is to be expected that the availability of information in such areas is poor and difficult to verify, which presents additional challenges. Companies with activities in an occupied area pose special dilemmas. On the one hand it is ethically reprehensible to contribute to coercive power that maintains an occupation. On the other hand people in occupied areas need both a minimum of welfare services and physical infrastructure that the occupation force is under international law obligated to offer and which the occupation force cannot provide without outside help.

Application of the ethical guidelines in war and conflict zones is thus demanding. The Ministry will continue to work on the subject, and views it as natural to obtain viewpoints from the Council on Ethics, Norges Bank and other environments with relevant expertise. The Ministry has been asked to participate in a project together with the UN Global Compact to study issues relating to companies' activities in conflict areas. The Ministry of Finance is in principle in favour of this. It will also be natural to obtain assessments from non-governmental organisations with respect to this subject.

The Council on Ethics' work in general, including possible use of more instruments

As mentioned above, the Ministry is satisfied with the work the Council on Ethics has carried out. Below the Ministry will assess whether proposals for changes in work forms and instruments that have emerged in the evaluation process can further strengthen the work. As of today, the only instrument the Council on Ethics has at its disposal is to recommend the exclusion of a company. This affects how the Council selects companies, the contact it has with companies under review and the effect one can expect the work of the Council on Ethics to have.

Selection of companies. The Chesterman and Albright Group Report mentions that the way the Council on Ethics selects its companies and cases for further follow-up have not been clearly communicated to the public. The 2008 Council on Ethics report includes a description of its selection process. The Ministry believes it is a useful addition in relation to earlier years and is well suited to giving companies and the public more insight into the Council on Ethics' selection procedures. The Ministry plans to publicise a description of the Council on Ethics' methods and principles for selecting companies that are to be studied more closely.

Dialogue with companies. Many of the commenting bodies propose that the Council on Ethics should have more dialogue, and at an earlier stage, with the companies. The Ministry supports this view. The Ministry finds it positive that the Council on Ethics provides opportunities for meetings between the Council on Ethics and the relevant company, in addition to written correspondence. This helps strengthen the information

basis and to give the company a better chance to explain the situation in question.

In the Ministry's opinion, any dialogue between the Council on Ethics and relevant companies will also have other positive effects in that the companies, when applicable, can get signals about the type of conduct and measures necessary to prevent exclusion. This will clearly contribute to greater predictability for the companies and may also serve to help some companies change their behaviour. At the same time it must be expected that there are also a number of companies that either do not want dialogue or where the dialogue quickly shows that the company has no interest or willingness to deal with the relevant problems. However, it must be clear that the Council on Ethics cannot be expected to provide instructions in all cases, for example on how a company shall reduce its pollution.

The Ministry will organise a system whereby a decision to exclude a certain company is always communicated to the company in advance of the publication of the decision. In certain cases, some time may have elapsed between the time the company was initially contacted and the decision was made. The current ethical guidelines already allow this, but the Ministry believes this should be a permanent scheme, in line with the recommendations in the Chesterman and Albright Group Report.

Procedures for reinstating excluded companies. The Chesterman and Albright Group Report and several commenting bodies have pointed out the ethical guidelines should contain a clearer procedure for how a company can be reincluded in the portfolio. The Ministry agrees that there can be a need for a clearer procedure for this. It is assumed that dialogue after an exclusion can have a positive effect on a company's conduct. In certain cases the Council on Ethics will have ample opportunity to express specific expectations of a company. The Ministry will, in cooperation with the Council on Ethics, ensure that such a procedure is drafted and published.

Information and documentation. As the Council on Ethics points out in its consultative comments, it can be difficult to document violations of ethical guidelines in markets where the access to information is restricted. The importance of the lack of opportunity to document possible norm violations is covered in Box 4.6. The Ministry has noted that in its recommendations the Council on Ethics has in practice used a lack of willingness by a company to disclose information as an indication of the existence of unacceptable practices by the company. The Ministry will underline that a lack of information can play a role in the assessment of whether there is an unacceptable risk of contribution. If in reality it is impossible to obtain sufficient information to assess the risk of a violation of norms, this will per se be viewed as taking an unacceptable risk on the basis of the circumstances. For this reason, the norm violation documentation requirement should be nuanced in markets where such information in general is difficult to obtain. The lack of an ability and willingness on the part of companies to disclose information that can provide a basis for an assessment that the risk of contribution is unacceptably high, should there be other information in the case that supports meeting the criteria.

Watch-list. Under Section 4.3.5 below the Ministry proposes the establishment of a watch-list as a new instrument. The Council on Ethics may also use this as one of its instruments. Reference is made to the discussion under Section 4.3.5.

More or different criteria for excluding companies

The issue of whether negative screening of producers of tobacco, based on an assessment that normal use of the product has highly negative health and other consequences, is a key challenge that has emerged in the consultation round. This question has been raised many times since the establishment of the Government Pension Fund – Global.

In the revised 1999 National Budget, the Bondevik I Government submitted a proposal to ban investments in companies whose main activity is the production of tobacco products. The proposal failed to win a majority in the Storting.

The Graver Committee (NOU 2003: 22) argued both for and against tobacco being excluded through negative screening. On the one hand it cited international developments in the area through a new tobacco convention and on the other the fact that tobacco is a legal product.

In following up the Graver Committee in the 2004 revised National Budget, the Graver Committee proposal was followed up and excluding tobacco production was not proposed. However, during the Storting's deliberation, the SV and SP parties proposed screening for tobacco. Among other things this was seen in context with the implementation of the tightening of the Tobacco Act[11]. The proposal was voted down.

Box 4.6 Questions relating in particular to emerging markets

Report no. 16 (2007-2008) to the Storting proposed greater investment in emerging markets. This was supported in the Storting's deliberation, see Recommendation no. 283 (2007-2008) to the Storting. Increased investments in emerging markets will pose particular challenges, as pointed out in the Chesterman and Albright Group Report.

Information challenge: A recommendation on exclusion means assessments of gross violations of norms by the companies in question. Well-documented evidence for the decision is therefore important. At the same time it is important to underline that the evidentiary requirements are based on a risk evaluation related to future *norm violations*, and are not aimed at determining blame for past norm violations. This in turn depends on the risk level the Ministry is willing to accept on behalf of the Fund.

The availability of information in emerging markets is often limited. Through its recommendations the Council on Ethics has developed a high standard of documentary requirements and evidence of violations of human rights or environmental damage. It can be difficult to meet the same requirements in a number of emerging markets. The result can be that a company in a developed market in a western country and a company in an emerging market that, based on scope and degree of violations of the ethical guidelines, should be treated equally, can be treated differently because there are different degrees of opportunities to document the norm violations. This can lead to the exclusion of the "worst" companies in developed markets while "even worse" companies in emerging markets remain in the investment universe. The Ministry finds that a lack of information about a company's behaviour, and not least the willingness of the company to contribute information by itself, can lead to the risk of contribution to unethical conduct being regarded as unacceptably high. In practice this could mean that the same documentary requirements for justifying an exclusion cannot be made in less transparent markets, where facts can be more difficult to prove.

Different standards in different countries: Some will claim that, as an investor, the Government Pension Fund – Global should not invest in companies with environmental, employee rights or child labour standards different from those that can reasonably be made of Norwegian companies. The consequence of this could have been that capital from the Fund could have been invested only in developed markets. If all investors who wish to call themselves responsible investors ended up with such an investment restriction, it would obviously be unfortunate for access to capital in emerging markets, and thus for the economic development of, and living conditions for, people in these countries. Reference is made to the discussion on page 52 of Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Corporate social responsibility in a global economy), which states:

> "Aid alone does not create enduring development. Economic growth is a prerequisite. An active and dynamic private sector is the foundation for the creation of value that is essential for combating poverty and achieving the UN Millennium Development Goals. Economic development creates jobs and contributes to funding infrastructure and social services. Aid is and will continue to be important, particularly in the poorest countries. But without economic activity and value creation in the individual countries it will be impossible to realise the millennial goals." [Preliminary translation]

One cannot therefore say that investing in countries with lower standards in different areas is per se unethical. Reference is made to a somewhat parallel discussion on the part of companies in the above-mentioned Report to the Storting on page 42. However, we must be prepared to deal with various ethical dilemmas.

The ethical guidelines are based on internationally recognised norms and standards. One of the exclusion criteria, "gross violation of human rights", is directly based on the belief laid down in UN human rights conventions on universal standards for all people that are not to differ between countries with different cultures and different economic development levels. Furthermore, highly polluting operations, see the criterion on severe environmental damage, will not affect the environment less severely because they take place in a poor country.

However, the specific provision of social and economic rights in the individual countries will also have to take the economic level and political priorities in the individual country into consideration. This may also play a role in the assessment of various conditions based on an overarching ethical perspective. For example, polluting activities can affect both the environment and local population negatively. On the other hand, that same industry can be the economic pillar of a society with few opportunities for other income-providing work. Other factors, such as whether a company's activities contribute to oppression or exploitation of vulnerable groups, can add further nuance to the picture.

As the above shows, activities in emerging markets can offer trade-offs where one can to a limited degree build on experiences from business in developed countries and markets. The Ministry will thus face new challenges with respect to managing the ethical guidelines in an appropriate manner.

In the opinion of the Ministry, it is clear that some of the counterarguments against negative screening are now weaker.

In the 1999 debate it was argued that a possible consequence of excluding tobacco would be that other unhealthy products should also be excluded, and that the Fund would have fewer opportunities to spread its risk. There now appear to be good arguments for not expanding the group of exclusion criteria beyond tobacco to any other products harmful to health. Tobacco is in a class by itself with respect to risk of serious disease and death resulting from the intended use of the product.

One argument mentioned in the Graver Committee was that even if negative screening was not supported, individual companies could be excluded for unethical conduct. So far, the Council on Ethics has not submitted any recommendation on exclusion of tobacco companies. The Ministry finds that as long as the product itself is the problem, screening is the correct instrument.

Since the ethical guidelines were adopted in 2004 Norway has ratified the WHO Framework Convention on Tobacco Control. Many commenting bodies emphasise that this convention provides good arguments for the Government Pension Fund – Global to divest from all tobacco companies. The Ministry will point out that the Convention had been negotiated when the Graver Committee made its recommendation and that ratification by itself does not entail an obligation to implement negative screening for tobacco. At the same time it is a fact that an international convention is now in place to limit the use of tobacco, with support from many countries. It is natural to emphasise this development when evaluating the ethical guidelines for the Government Pension Fund – Global.

For an investor with a long-term perspective one may in some cases expect a concurrence between the investor's financial interest and what follows from taking ethical considerations, but not necessarily. Further analysis of the financial consequences of screening for tobacco is given in Box 4.7. The analysis shows that the consequences are probably negative in the form of poorer ratios between risk and expected return. However, this aspect cannot be decisive in relation to a decision that is based on an assessment of the ethical minimum norms that should be followed in the management process.

In the Ministry's opinion, it is the *production* of tobacco that should form the basis for screening. Thus, selling tobacco will not be encompassed by this criterion. The Ministry will study in more detail different methods for delimiting screening of tobacco producers. Trying to operate with zero tolerance for all production of tobacco in the portfolio may prove to pose particular challenges, although this will be a starting point when the criterion is formulated.

On this basis the Ministry plans to screen tobacco producers from the Government Pension Fund – Global.

Two commenting bodies have asked for the production of alcohol to form the basis for screening. Screening is a strong instrument that should be limited to special cases where a clear set of shared values can be deemed to exist in the Norwegian population. There have been developments in the period after the Graver Committee proposed the current ethical guidelines, both internationally through a convention dedicated to tobacco control (which came into force in February 2005) and nationally through restrictions of the Tobacco Act in 2004, which must be deemed to represent such a clear set of shared values relating to screening tobacco producers. With respect to questions about excluding other unhealthy or socially unbeneficial services from the Fund's investment universe, including alcohol, the same degree of norm development that can provide a similarly clear anchoring does not exist nationally or internationally. Above, the Ministry found that tobacco is in a class by itself with respect to risk of serious disease and death resulting from the intended use of the product. The same cannot be said for alcohol for instance.

For highly addictive products whose excessive use has major negative social consequences, the Ministry assumes that marketing that must be regarded as grossly unethical vis-à-vis minors will be assessed against the exclusion criteria "other particularly gross violations of fundamental ethical norms" in Article 4.4 of the ethical guidelines.

4.3.5 Interaction between the various instruments

4.3.5.1 Introduction

In Report no. 24 (2006-2007) to the Storting: *On the Management of the Government Pension Fund in 2006*, the Ministry describes the interaction

[11] Act no. 34 of 23 May 2003 amending Act no. 14 of 9 March 1973 relating to prevention of the harmful effects of tobacco.

Box 4.7 Performance of tobacco shares

Figure 4.3 shows the performance of tobacco shares and the overall stock market since 1993[1]. The figure shows that the return on tobacco companies has been considerably higher than for the market in all. A capital amount of NOK 100 invested in tobacco companies would have grown to NOK 805 at the end of January 2009. Similar investment in the entire stock market would have provided a final capital amount of NOK 192.

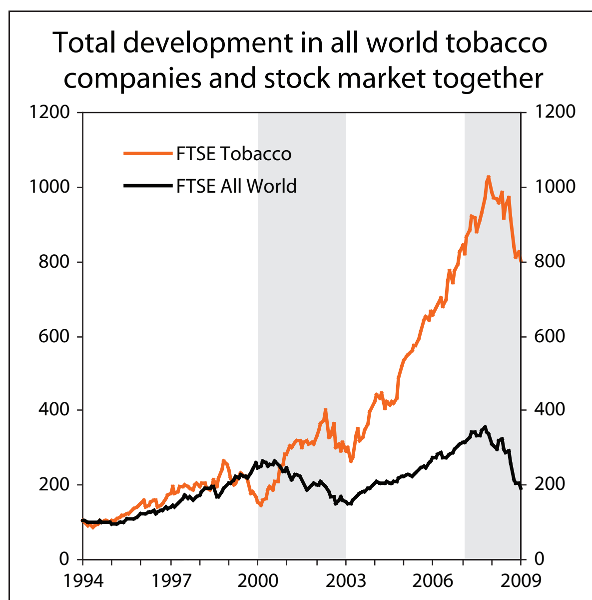

Figure 4.3 Index performance in the world index for shares (FTSE AllWorld) and the sector index for tobacco companies (FTSE AllWorld Tobacco). Local currency. Index. 31.12.1993 = 100

Source: Datastream/Ministry of Finance

Tobacco shares have provided higher returns than the world index in 13 of the last 15 years. Even though the risk measured by standard deviation will also be higher in tobacco, the ratio realised between return and risk is considerably higher in tobacco than for the market as a whole.

The stable consumption pattern created by consumers of tobacco through the habit that is formed may mean that the value of tobacco companies will not be very exposed to changes in the consumption patterns of people, connected for example to an economic downturn. Figure 4.3 provides support for such an assertion, since tobacco shares have provided better returns than the entire market in the two shaded periods, 2000-2002 and 2008-2009, which represent periods with declines in the world stock markets. Exclusion of the tobacco sector can therefore mean the exclusion of a sector that can have a dampening effect on the equity portfolio's losses in periods of declining world stock markets.

At the same time there is uncertainty about how the tobacco sector will perform in the future. Historical returns do not necessarily provide a good estimate of future developments.

[1] The world's equity market is represented by the FTSE All-World index, which includes large and medium-sized companies in FTSE's world index. Tobacco shares are represented by the tobacco sector in the same index. The return is measured in the index's currency basket (local currency).

and achievement of goals for the use of instruments under the current ethical guidelines. The instruments follow two different goals, while at the same time it was regarded as important that they complement each other in the best way possible and that the intention behind the guidelines is met. It was pointed out that an assessment of whether the Fund runs an unacceptable risk of contributing to grossly unethical circumstances will depend on whether one uses its ownership to bring the same circumstances to an end. The same subjects were covered in the next Report to the Storting about the Fund (Report no. 16 (2007-2008) to the Storting), which states that ownership influence to ensure respect for fundamental ethical norms should normally be included in an instrument chain where exclusion of a company is the last resort.

There is a need for good interaction between the instruments available at all times to the Fund in its role as responsible investor. Good cooperation will help strengthen both the function and the credibility of the system. In the opposite case there is the risk of the guidelines being fragmented, not very predictable and not very comprehensible. In turn, this will weaken the power and effect of the guidelines.

The challenges relating to the current system are not about the Council on Ethics and Norges Bank failing to discharge their duties in an appropriate manner. It primarily revolves around the fact that the instruments the two bodies are in charge of putting into operation pursue different objectives, which in turn places major constraints on the opportunity for coordination and cooperation.

The Ministry wishes to continue the use of both exercise of ownership rights and exclusion. But in light of the experiences so far and in light of the international development in the area there is a need to coordinate the instruments better and put them in a more comprehensive structure under an overarching objective. In addition, the spectrum of instruments must be expanded to create greater predictability for the companies. Many of the commenting bodies have given valuable input on this, see Section 4.3.4.3 above.

4.3.5.2 Consultation memorandum

The consultation memorandum under Section 3.4 states that the Ministry deems that there will be a certain amount of room for interaction between active ownership and exclusion of companies. It is important that the conditions best facilitate such interaction in cases where it is natural, and where one with probability can achieve better results compared to when the instruments are used separately. For example, it is conceivable that a system with a graded use of instruments, where the exercise of ownership rights is tested as far as possible to start with, while the exclusion of a company is a last resort.

The consultation memorandum refers to the fact that there are many indications that the current structure does not facilitate such interaction well enough. The responsibility for these two instruments lies in different organisations, which affects the opportunity for information flow and communication etc. The two organisations have also, on the basis of their assigned mandates, rather different approaches and work methods. This can make an efficient interaction between the instruments difficult.

The Chesterman and Albright Group Report provides many specific proposals. One of them is that a watch-list can be established of companies that give cause for concern, and that can be the subject of discussion between the Council on Ethics and Norges Bank. Furthermore, the report mentions that quarterly meetings should be held between the Council and the Bank to discuss individual cases and exchange information. Before the Council on Ethics submits a recommendation to exclude a company where the Bank has initiated a dialogue or plans to do so, the Bank and the Council must attempt to agree on some measures that the company should have initiated to avoid exclusion. Furthermore, the report proposes inter alia the following:

- The Council on Ethics and Norges Bank should agree to a process to verify whether positive changes that the company reports on actually have taken or will take place. In many cases, independent third-party studies may be necessary to ascertain this. It is particularly important to ensure unannounced visits to work sites etc. One cannot rely solely on information from the company or its consultants.
- Article 4.5 of the ethical guidelines should be changed so that a dialogue between the Council on Ethics and a company is specifically opened beyond the forwarding of a draft recommendation on exclusion.
- If a company is excluded, it should simultaneously be encouraged to change its behaviour so that it again can be reinstated in the investment universe. In that connection, Norges Bank and the Council on Ethics must share all relevant information about the company's conduct after an exclusion has taken place.

4.3.5.3 Views of commenting bodies

Most consultation comments that raise questions about the interplay between the instruments propose a greater degree of information exchange and coordination between Norges Bank and the Council on Ethics. Many of them seem to build on an implicit understanding of both instruments pursuing the same objective, i.e. affecting companies in a positive direction. It is furthermore a common feature of many inputs that the Council on Ethics and Norges Bank are encouraged to practice a high degree of cooperation at an early stage of a review so that they have a mutually agreed understanding of a case that comes to the Ministry of Finance for final decision.

In their statements, both *Norges Bank* and the *Council on Ethics* have emphasised keeping the Bank's and Council's roles clearly separate. They propose a relatively small degree of interaction and claim that the system will gain strength from keeping the instruments separate and pursuing different objectives.

Cooperation and exchange of information

Bob Pozen is one of those who advocates closer cooperation between the Council on Ethics and Norges Bank while a company is being examined. He furthermore proposes that the two bodies together should present a plan to the Ministry of Finance, or that they each make a recommendation based on an exchange of information and discussions at an early phase of a review. Pozen states that ownership activities must actually be tested before concluding that exclusion is the only solution in a specific case. This requires a larger degree of cooperation and consultation between the Council on Ethics and Norges Bank. In Pozen's opinion the Council on Ethics should also be able to recommend testing ownership.

Norfund also points to the need for better coordination between the Council on Ethics and Norges Bank during the process of examining cases. According to Norfund a risk of exclusion is losing influence on the situation and that in the worst case the conditions deteriorate for those who are affected. Norfund believes that exclusion should be reserved for those cases where it is obvious that the exercise of ownership will not lead to improvements of the situation.

In their consultation input *Norwegian Church Aid* says that there should be more information sharing and coordination between the Council on Ethics and Norges Bank in certain cases and in cases of a more strategic nature. *Forum for Environment and Development* believes extensive information exchanges between the Council on Ethics and Norges Bank should be a matter of course.

In its input, *KLP* writes that closer collaboration between the Council on Ethics and Norges Bank will be natural, in the sense that the two units should be coordinated and integrated in each other's work processes.

Andrew T. Williams and *James P. Hawley* write that Norges Bank and the Council on Ethics should be encouraged in the strongest terms to communicate as much as possible with each other and coordinate their activities in relation to companies both wish to monitor.

In its consultative comments the *Norwegian Confederation of Trade Unions (LO)* writes that it is important to distinguish between the Council on Ethics and Norges Bank as two independent actors. They write further that it is not an objective per se to sell shares. The primary objective must be to foster a better practice. In LO's view, it is possible to put more pressure on companies to achieve better development in operations by linking the exercise of ownership rights and exclusion.

In its input the *Council on Ethics* is positive to direct cooperation with Norges Bank, provided that both parties desire it. Furthermore, the Council proposes a mutual obligation to exchange information between the two entities in a way that does not guide the actual work. In cases where it is seen that a company has a dubious practice not necessarily captured by the criteria for exclusion, the Council on Ethics proposes that routinely sends such cases to Norges Bank.

In its consultation input *Norges Bank* writes that the Bank should not take part in the administrative procedure in exclusion cases. Clear division of roles is important here. The exercise of ownership rights shall ensure the Fund's long-term economic interests, and it is not the case that the Bank can guarantee the exercise of ownership rights in individual cases where there are problems and where exclusion is not appropriate. Furthermore, Norges Bank does not want any coordination of administrative procedure at the individual level. They otherwise do not see a need for using the Ministry of Finance's exclusion scheme as a threat in the exercise of ownership rights. The Bank deems that it has other opportunities to exert pressure on the companies. Norges Bank also points out the possibility that it itself can choose to sell its holding in a company. The exchange of information can take place by the Council on Ethics participating in meetings the Bank has with the Ministry of Finance.

The Norwegian Savings Banks' Association considers that there can be room for overlap between exclusion and the exercise of ownership rights. However, they are sceptical about whether this potential actually should be taken out and fear that closer cooperation could undermine the main purpose of the exercise of ownership rights, namely promoting long-term financial returns. *For its part, Rainforest Foundation Norway* expresses concern that active ownership will lead to less weight on the exclusion mechanism. They write that the exclusion mechanism must safeguard all parts of the guidelines, which exceeds Norges Bank's focus areas. If an existing practice in a company in the Government Pension Fund – Global's portfolio is found to be such a serious violation of the ethical guidelines so as to legitimise exclusion of a company, this could happen regardless of whether or not Norges Bank has an active dialogue with the company.

Watch-list

Many of the commenting bodies advocate various forms of observation of companies. When a company is put under observation it can be considered a warning, *Amnesty* said in its consultative feedback.

Andrew T. Williams and James P. Hawley propose establishing two watch-lists, one public and one internal. Both lists should be subject to regular discussion between the Council on Ethics and Norges Bank. The internal list will be for companies where the review process is in an early phase. The public list will apply to companies that are under ownership influence or where the Council has come far in its process of assessing the company's conduct. Williams and Hawley also point out the possibility that a special dialogue can take place with companies at risk of being moved from the internal to the public list. This could work as an incentive to better behaviour.

The *Council on Ethics* refers to the proposal in the Chesterman and Albright Group Report discussing establishment of different forms of watch-lists that are meant to increase the influence of the ethical guidelines, inter alia by Norges Bank and the Council on Ethics making a joint plan for each company on this list. The Council on Ethics says that a split list of this type between Norges Bank and the Council would require changing the Council's mandate to include exercising ownership rights. In principle the Council on Ethics believes this would be undesirable.

Furthermore, the Council on Ethics says that they always have an internal list of companies that are being assessed.

> "The list contains companies about which the Council has concerns and that are at different stages of the review process. A company lands on the Council on Ethics' watch-list if there are specific suspicions that the company is contributing to gross violations of the guidelines. This list is not suitable for publication because it consists of companies that have not been sufficiently studied for a recommendation to be given. A list that is made on the basis of insufficient information could cause considerable harm to a company's reputation without there necessarily being grounds for it. In addition, the credibility of the Council on Ethics and Ministry of Finance could be harmed. A watch-list that might be published will therefore in practice require for each company a review process nearly as large as for submitting a recommendation on exclusion. This would not be a desirable prioritisation of the Council on Ethics' use of resources."

Carlos Joly considers the proposal in the Chesterman and Albright Group Report about a supplementary instrument – a watch-list – to be reasonable. The starting point for such a list will in the context of the Government Pension Fund – Global be what companies must do to avoid being excluded. In contrast to Chesterman and Albright, Joly believes it is important that the list is public. This will bolster the signal to both the company and the market in general that a certain type of conduct is regarded as harmful. In Joly's view, withholding of information about the behaviour of companies will increase the risk of unacceptable conduct and market failure. In managing the Fund he believes that the Fund has a duty to contribute to increased responsibility and transparency at the companies, which can weigh more than the companies' need for protection against information critique coming out. Joly otherwise compares publication of both exclusions and observation with what the rating agencies do when they publish up and downgradings of shares or bonds.

4.3.5.4 The Ministry's assessment

The work on the ethical guidelines is divided between three different institutions, the Ministry of Finance, Council on Ethics and Norges Bank. The current ethical guidelines do not explicitly call for a coordination of Norges Bank and Council on Ethics activities, because they have different mandates that overlap to a relatively small degree. As mentioned above in Section 4.3.5.1 the Ministry has previously expressed an ambition to have an instrument chain where ownership is included and exclusion is the last resort.

The current manner of working in the Council on Ethics and Norges Bank is organised in accordance with current objectives and tasks and has, in the assessment of the Ministry, functioned satisfactorily given this starting point. The Ministry has received feedback from external environments, other managers, international organisations etc. that praise the manner in which Norges Bank and the Council on Ethics discharge their duties. This was also highlighted by many in the consultation round. On the other hand, viewpoints have also emerged in the consultation round to the effect that there should be more interaction between the instruments. Many believe that there

should be a greater degree of cooperation, consultation and information exchange between Norges Bank and the Council on Ethics and that they should coordinate their activities vis-à-vis individual companies. The Chesterman and Albright Group Report contains similar assessments. The viewpoint is that a larger degree of coordination can provide better information and stronger impact for each of the instruments, than if they are seen in isolation and used separately.

In light of these inputs and own assessments, the Ministry believes that there is reason to aim at a larger degree of coordination of the work of the Council on Ethics and Norges Bank in areas where their responsibilities overlap. Not least, clarification of the objective that the Ministry proposes above in Section 4.3.2 will have an impact on questions that apply to how the various instruments can best be used together and separately to help achieve the objective. The Ministry believes that the two instruments should be used so that they can reinforce each other and make better use of the combined expertise. The Council on Ethics and Norges Bank have the capacity and are building capacity that the present system does not appear to utilise to a sufficient degree.

The Ministry points to the fact that the questions raised under this point deal with a limited part of Norges Bank's work and partly also that of the Council on Ethics, namely with respect to assessment and follow-up of portfolio companies that behave in such a way that they can be considered as being covered by the exclusion criteria in the ethical guidelines. Besides this both the Council on Ethics and Norges Bank have activities that are not directly aimed at conduct in individual companies. The Council on Ethics deals with screening companies based on products, where dialogue or attempts to exert influence normally will not be a option. Norges Bank also aims its work at regulatory authorities, research and provision of information. In exercising ownership rights in individual companies Norges Bank can raise questions with companies that lie outside the mandate covered by the Council on Ethics. For example, this will apply to matters relating to good corporate governance and to the focus area concerning companies' lobbying activities against climate regulating measures.

The Ministry would point out that it cannot be the government's ambition for all reprehensible situations in different companies to trigger a certain reaction, or use of a certain instrument by the Fund as an investor. With holdings in eight thousand companies throughout the world it is unrealistic to envision this. Nor would it be appropriate – the instruments shall be used in a targeted manner where suitable. In many cases one must therefore accept that the Fund owns shares in companies where operations and corporate practice can give rise to criticism without triggering any obligation for the Fund to raise the matter with the company. For example, a company that the Council on Ethics is looking at will not always automatically be a candidate for Norges Bank's active ownership process. Nor can it be the case that a company for which Norges Bank has terminated an ownership process without succeeding will automatically be excluded.

However, the Ministry wishes to facilitate that the resources employed in the work of the Council on Ethics and Norges Bank are used so that they are as effective as possible, while simultaneously supporting the reputation of and public trust in the Fund as a responsible investor. The Ministry believes that it is appropriate to organise a system for interaction and coordination that respects the Council on Ethics and Norges Bank's different roles, but that addresses the following matters:

Predictability for the companies contacted on behalf of the Fund is an important element. The efforts vis-à-vis individual companies today will have a very different form depending on whether it is the Council on Ethics or Norges Bank that initiates and carries out a contact or review. Most companies expect representatives of the same holding to speak as one. In principle there is a risk under the current system of the Council on Ethics and Norges Bank saying different things to the same companies.

Opportunity for influencing individual companies shall be a part of the decision-making basis in exclusion cases too. Both with respect to the opportunity for exerting an influence and an assessment of risk ahead in time, the Ministry believes that both Norges Bank and the Council on Ethics will be able to provide important information and assessments.

Best possible use of information. The Ministry wants information, expertise and knowledge, both about general subjects and individual companies found respectively in Norges Bank or the Council on Ethics to be used in the best possible manner.

The Ministry will study in more detail how the above-mentioned concerns can best be safeguarded in cooperation with the Council on Ethics and Norges Bank. The Ministry assumes that important elements in a new scheme should include:

Routines for exchanging information. The Ministry assumes that the information the Council on Ethics has about companies can be of interest to Norges Bank, both from a purely financial viewpoint and as part of the work on exercising ownership rights. At the same time it will be of interest to the Council on Ethics to know how Norges Bank assesses the company and any possibility of influencing the company in a positive direction. Information routines should be organised so that they safeguard Norges Bank's need for confidentiality in company dialogue on a case-by-case basis, and proper handling of information that can be price sensitive.

Establishment of watch-list: Several other investors use observation of companies as one of their instruments, often combined with dialogue with the aim of influencing the company's conduct. A decision to put a company under observation may in certain cases be a good alternative, because it can be assumed that this will encourage the company to amend its behaviour or will prompt it to provide more information to clarify the situation. It is thought that the use of a watch-list will be particularly apt in cases where there is doubt about future developments. The Ministry points out that the Ministry has already made the decision to observe one company in 2009. The Ministry intends to formalise the use of a watch-list as one of the Fund's instruments.

Important questions that will emerge with the use of watch lists will be related to who can put companies on a watch-list, the criteria for deciding this, what is required to conclude that the company can be removed from the watch-list, who is to monitor the company during the process and the time horizon that is to be used. Another important question is whether the watch-list is to be public or kept internal. Opinions were divided on this in the consultation round. For example, Andrew T. Williams and James P. Hawley proposed a system of one public and one internal watch-list.

The Ministry believes that a public watch-list will be a suitable instrument for achieving positive change in the companies. As with exclusion, going public requires proper and thorough administrative routines. The Ministry will also consider an internal watch-list that can be made a subject for discussion between the Bank and the Council on Ethics. The specific organisation of such an internal list, including whether the companies shall be informed that they are on the list, will be one of the questions that has to be clarified.

Routines for administrative procedure in cases applying to the same company. With respect to companies on the watch-list, questions about the division of labour between the Bank and the Council will arise. This may also arise in other individual cases. This raises fundamental questions about the role of the Council on Ethics in relation to companies where Norges Bank is carrying out an ownership process. Furthermore, it can be asked whether the Council on Ethics should have the option of recommending dialogue with a company under the direction of Norges Bank. This will be in addition to any dialogue that the Council on Ethics may be able to carry out itself, see discussion under Section 4.3.4 above.

4.3.6 Assessments related to benchmark composition

4.3.6.1 Positive selection

Introduction

Positive selection means that an investor positively chooses investment objects that meet the investor's specific requirements for, for example, environmental or social considerations in business operations. Positive selection can assume many different forms and be used in different ways. For example, one portfolio can consist completely of investments selected on the basis of such criteria. Other investors use positive selection for parts of the portfolio. For an index-managed portfolio, positive selection as an instrument will not in principle fit in. However, the manager could have a certain amount of latitude to overweight or underweight companies in relation to what the index suggests if an active risk mandate exists, which within given constraints, permits deviations from the index.

There are also major variations with respect to the criteria underlying a positive selection.

If the investment strategy is to be restructured in the direction of positive selection it will be necessary to take a position on the areas and the extent this selection will be undertaken.

Consultation memorandum

The consultation memorandum discusses the question of whether the Pension Fund should invest on the basis of criteria other than those that follow from financial considerations, with positive selection or with pioneer investments.

Positive selection normally reflects the fact that an investor seeks investment opportunities on the basis of criteria other than financial considerations. This may be effected through, for example, selecting a specific share of the most ethical companies within an industry, or by overweighting investments in industries that are consistent with the investor's values. Positive selection of companies as part of an investment strategy was not recommended as a tool for the Fund when the Graver Committee submitted its proposal for the current ethical guidelines. The Committee deemed that active ownership was a better tool than positive selection for achieving positive changes within various areas.

The Ministry of Finance obtained an updating of an earlier assessment relating to the economic consequences of positive selection. The analysis was carried out by Professors Thore Johnsen and Ole Gjølberg. The analysis was appended to the consultation memorandum.

The analysis shows that positive selection provides scope for considerable discretion and arbitrariness. For example, one strategy with elements of positive selection will be investments in "best in class" companies or industries. Another strategy, referred to as "pioneer screening", involves investing in companies in environmental technology, renewable energy and the like. The authors of the analysis point out that different forms of positive selection will easily mean a considerable reduction of the investment universe. This will increase the Fund's risk.

The summary of the analysis states that:

> "…;During the economic upturn after 2003 SRI (Socially Responsible Investment) funds and indices have had clearly poorer risk-adjusted returns than conventional funds. The numbers show that this is particularly related to risk, which for many of the SRI funds and indices has been considerably higher than the case has been for conventional funds and indices. This in turn is due to the fact that screening, particularly more active and extensive positive screening, reduces the selection to one where large companies are heavily represented. In other words, the screening causes an imbalance in the composition, resulting in higher unsystematic risk."

On this basis the authors recommended that the strategy of negative selection in combination with exercise of ownership rights be maintained in managing the Government Pension Fund – Global.

The consultation memorandum concluded that the existing instruments – exercise of ownership rights and exclusion of companies – are well suited to the Fund's size and investment strategy. Still, the consultation memorandum raised the question of whether arguments can be raised for the use of such an instrument in the Fund's context, which can balance the counterarguments.

The Ministry announced in the consultation memorandum that it would take a closer look at the possibility of setting a small part of the Fund aside for earmarked investment purposes within, for example, environmental technology or developing countries. In this connection it may also make sense to take a closer look at what other international institutional managers have done in this area.

The Ministry underlined, in line with the overarching strategy for the Fund, that a financial return requirement would also be made for such investments. The use of State funds that do not have financial returns as an objective must be appropriated via the Fiscal Budget in the customary manner.

The Ministry desired the commenting bodies' view of whether it was right to take a course of setting aside money managed according to a particular mandate and if applicable, to what objectives.

General input on the consultation round on positive selection

In his consultative comments *Carlos Joly* critiqued the Johnsen and Gjølberg report.

In Joly's opinion it is not meaningful to consider SRI funds a special type of fund. It is meaningful to assess whether technology funds provide excess returns, but SRI funds have too little in common to measure the return from the class as such in a meaningful way. The expertise of the individual manager is key, as it is for other strategies in active management. According to Joly, the assessment of Johnsen and Gjølberg that a larger scope of positive screening would cause the Pension Fund to have to concentrate on larger companies and fewer markets is not consistent with the facts. Even if the number of companies in which shares were held were cut in half, it would still be a long way to an ownership limit of 10 per cent. The criteria of positive screening can be varied in many ways and does not need to entail a preponderance of large companies.

Joly further criticised the narrow risk definition said to be used in Johnsen and Gjølberg's

analysis. It is too narrow just to compare past returns of SRI funds with market indices. If we had assessed the risk of U.S. bonds before the financial crisis, the risk would have been assessed as being low. In reality, the risk was high. Similarly, Joly believes we face a systematic risk related to the environment that is insufficiently reflected in the share and bond markets. According to Joly the index management model of the Fund keeps the Fund tied to mispriced values.

> "Just as the market made a gigantic mistake in mis-pricing mortgage backed securities it is likely the market, or large parts of it, are making a gigantic mistake failing to recognize unsustainable companies and pricing them accordingly, with a deep discount. In protecting its capital, the GPF-G would not want to find itself saddled with a large chunk of assets that the market will one day realize are overvalued from a sustainability point of view. Conversely, in seeking good returns, it will want to recognize which of today's mid caps will become tomorrow's large caps."

In the main *(HSH)*, The *Federation of Norwegian Commercial and Service Enterprises* supports the Johnsen and Gjølberg analysis relating to problems with positive selection. However, HSH pointed out that it is reasonable to assume a stronger connection between long-term return and the ethical dimensions laid down in the guidelines (Global Compact and OECD guidelines) than what traditionally has been customary.

In its consultative comments *Niklas Kreander* at Telemark University College concludes there is a need for further studies on the use of positive investment criteria. Reference is made to the fact that many funds that have operated with such criteria claim to have achieved sound returns and that the expert arguments that have been raised against the use of positive criteria have methodological weaknesses and are thus not a sufficient decision basis. In a separate appendix, Associate Professor Niklas Kreander and Professor Ken McPhail criticised the Johnsen and Gjølberg analysis. Among other things, they noted that Johnsen and Gjølberg appear to have implied that the Government Pension Fund – Global should either continue as now or switch to positive selection. An obvious alternative is to use positive selection for a smaller portion of the Fund (1-10 per cent).

Norfund shows that the state's social responsibility as financial investor should be assessed on the basis of the state's combined financial portfolio, not just the Government Pension Fund – Global. This portfolio also consists of SPN, Norfund and Argentum. The latter three already employ positive selection. The state should be willing to also incorporate non-financial considerations in its combined portfolio, but not necessarily in each of the state's investment funds. Norfund says:

> "Johnsen/Gjølberg's study is relevant for large, well-diversified funds of SPU's type, but does not answer the question of whether the state in its total portfolio should have funds with completely different mandates like the ones that exist in the form of SPN. To the extent positive selection is desirable this will be a discussion of whether it is desirable to invest in funds or instruments with a more specified mandate than SPU. This is also Johnsen/Gjølberg's recommendation: 'To the degree the state for other reasons would want to undertake such investments, this should take place in separate funds or institutions outside the Government Pension Fund – Global and Norges Bank'. In Norfund's assessment the question for SP is not whether to use positive selection, because that's what SPN is doing already."

Norges Bank warns against changing the Fund's strategy:

> "A shift in the direction of positive selection of companies based on criteria other than expected return will represent a violation of the Fund's investment strategy, reduce the spread of the Fund's risk and increase the company-specific risk. Depending on the criteria that are used, positive selection will also increase the exposure against systematic risk factors. There is no reason to claim that a positive selection criterion can be connected with higher expected return. Norges Bank will advise against a change in the Fund's strategy in the direction of positive selection of investments based on normative assessments, since this will be in violation of the Fund's long-term financial objective."

Norges Bank refers to the Johnsen and Gjølberg analyses that show an undesirable performance for many SRI funds in 2002-2007.

Norges Bank believes that earmarking of investment funds to achieve other objectives in addition to long-term returns should take place through allocation resolutions in the annual budgets. Such funds should be managed by own managers and not through the Government Pension Fund.

Save the Children believes that the current model based on financial criteria for placing investments is far too defensive for a state investor that is to obtain legitimacy in the population.

> "The surplus should be invested to a greater degree in good causes for coming generations. For a fund with a 100-year perspective the shortage of resources and climate change must be relevant criteria on which to assess companies."

SAM (Sustainable Asset Management) is an investment company for sustainable investments and participates in the compilation of Dow Jones Sustainability Indexes. SAM disagrees in the Johnsen and Gjølberg assessment that SRI funds and indices have delivered risk-adjusted returns that are clearly poorer than ordinary funds. Since 1999, the Dow Jones Sustainability World Index has delivered better results than MSCI World. Furthermore, it is claimed that SAM Sustainable Global Fund has performed better than its benchmark index since its launch in 2004.

The *Confederation of Vocational Unions (YS)* points out that Norway's oil wealth is associated with major greenhouse gas emissions. Norway therefore has a greater moral responsibility to implement climate change-reducing measures. A separate environmental fund should therefore be established as part of the Government Pension Fund – Global. Even though the objective of this fund too is to have the best possible return, YS will recommend the environmental fund to have somewhat lower return requirement than what is otherwise assumed for the investments.

WWF (World Wildlife Fund) has prepared a report in cooperation with Innovest. Innovest is an analysis firm that helps investors construct portfolios that beat the market by using data on factors not included in traditional securities analyses. Innovest has prepared special expertise on the consequences of climate change. This report is referred to in the consultative comments. The report claims that the Government Pension Fund – Global is not a leader with respect to best practice in sustainable investments. The fund has a long way to go from being able to handle the effects of global warming in its investment strategy and portfolio management. A ranking in the report shows that the public pension funds ABP Nederland and CalPERS are leaders in the field while the Government Pension Fund lags considerably behind. The main reason for this is that the Pension Fund does not use positive screening and targeted environmental investments. According to WWF, the Fund's integration of climate change issues into its investment strategies and decisions seems limited, unsystematic and undeveloped. Sustainable investments can no longer be seen as an ethical exercise that reduces profit. In a world with increasingly larger shortages of resources, sustainable business models are an important indicator of long-term profitability and risk reduction. The report refers to a literature review undertaken by Innovest of studies in which a clear majority show a positive connection between taking ESG issues into consideration and financial returns.

Input in consultation round on focus areas for positive selection

Bellona recommends that the Government Pension Fund – Global invest in three new classes of assets: start-up funds for venture capital (such as clean tech), private equity in medium-sized companies and infrastructure projects (such as windmills). In addition, Bellona recommends the establishment of a separate company (separate from the Government Pension Fund – Global) which will develop clean energy.

Carlos Joly believes that the Fund should give priority to investing in private equity (unlisted companies) with an emphasis on integrating ESG issues and sustainable development in selection and management of companies.

The Future in Our Hands (FIOH) proposes strengthening the climate profile in the Pension Fund. A NOK 20 billion climate fund specialised in investing in renewable energy and green technology should be established. Furthermore, FIOH proposes increasing the Fund's investments in poor countries. The opportunities for investing in solar energy in countries to the south are highlighted in particular.

Greenpeace believes that the Ministry of Finance should set aside a large and growing share of the Fund to earmarked investments in renewable energy and energy efficiency.

Norwegian Church Aid argues that one per cent of the assets in the Government Pension Fund – Global should be placed in a fund for investments in low-income countries, particularly in Africa. In addition, it supports the conclusion of the report of the Development Committee about a positive selection relating to renewable energy and relevant climate technology. At least 10 per cent of the Fund's value should be invested in this sector over the course of a five-year period.

Kristian Alm argues that the solidarity of future Norwegians with the use of the fiscal policy guidelines should also be expanded to solidarity with the poor outside Norway's borders. Specifically it is argued that the Government Pension Fund should invest in microcredit, with not insignificant amounts.

Norfund proposes expanding the Government Pension Fund – Global's investment mandate to include a separate provision for private equity in both developing and developed economies. Norfund believes it can be right to build on the existing private equity environments in Norway today: Argentum and Norfund. A separate investment fund for renewable energy should also be considered.

In its consultative comments *Norges Bank* points out that it recommended the Ministry of Finance to include infrastructure investments in the Fund's investment universe because such an expansion will be able to improve the spread of risk and increase the return opportunities of the fund if operative management is carried out with sufficient quality.

SIGLA recommends that most of Government Pension Fund – Global management continue as now but that smaller portions be set aside for investments with a higher risk and a stronger development focus. Systematic learning from these smaller investments should be planned.

Among the recommendations from WWF is that the Government Pension Fund – Global moves in to positive selection of investments through a best-in-class strategy that assesses climate exposure. Furthermore, funds should be set aside for investments in environmental technology. WWF recommends that the Fund should promote and facilitate coordination among sovereign wealth funds (SWF) and public pension funds to promote strategic investments in the financial markets related to ESG.

The Ministry's assessments

On the basis of the feedback from the consultation the Ministry will propose the establishment of a programme for environment-related investment opportunities.

Sub-markets in infrastructure, unlisted equities, environmental bonds and the opportunity to invest parts of the listed equities portfolio based on an environmental index are particularly interesting. The investments are to be aimed at environmentally friendly assets or environments, water technology and treatment of waste and pollution.

Work will also continue on assessing whether an investment programme aimed at sustainable investment opportunities in emerging markets can also be established in an appropriate manner. Investments that will be looked into will include unlisted shares and infrastructure in emerging markets.

There will normally be capacity restrictions on investments in unlisted markets, and especially on investments in sub-markets such as eco-friendly technology and energy. Based on the size of the market, which is also limited by the availability of capable managers and funds, the Ministry finds that the combined amount for the environment programme and any investment programme aimed at sustainable growth in emerging markets may total about NOK 20 billion over a five-year period. However, there is uncertainty linked to the capacity of the unlisted markets. These investments will be substantial in terms of both the size of the markets and investments by other, comparable international funds. The Ministry will return to the matter in the 2010 National Budget. See further discussion in Section 2.5.

4.3.6.2 Portfolio review

Introduction

In this connection a portfolio review should be understood as an assessment of the risks relating to the climate challenges in the portfolio. Among other things the holdings may be mispriced because they do not fully take future higher pricing of carbon emissions into consideration. In light of such an evaluation it can be assessed whether the composition and weighting of the investments should be changed in light of such risk.

Input in the consultation round

In its consultative comments, *Bellona* proposes an extensive environmental strategy. Bellona believes that companies that significantly contribute to global warming can represent an increased long-term investment risk that can threaten the Fund's objective of sound long-term returns.

Given the potential effects of global warming, it can be financially wise for the Fund to act on the basis of these considerations. Bellona believes that the Fund should be in advance of the change

that inevitably will come. If we succeed in our battle against global warming, no carbon-intensive companies will exist in 2050. The Fund should develop an environmental strategy that includes corporate governance activities, negative screening and eventually also positive screening.

Bellona's vision for the Fund is:

> "By 2020 the Fund's portfolio will be comprised solely of investments in companies that will have sustainable business models following the transformation to a carbon-neutral and resource-efficient society."

An important element in Bellona's environmental strategy is to initiate a review of the entire Fund's portfolio to clarify the potential significance of climate development to the portfolio. One should start with the oil, gas and coal, air and sea transport, land transport, iron and steel, aluminium, cement and wood pulp and paper sectors. The portfolio should subsequently be adjusted. Bellona is not arguing for a dramatic change of the investment strategy or a compromise on the long-term return goal. But the use of environmental screening as part of the investment methodology should contribute to better returns in the long term. Based on an assessment of how companies can thrive in a future low-carbon world, companies that perform very poorly should be excluded from the portfolio. Bonds should also be evaluated. The Government Pension Fund – Global should consider excluding government bonds from countries that do not ratify a post-2012 global climate treaty. In addition to excluding the worst companies, the Government Pension Fund – Global should over time also increase investments in companies that score high on environmental criteria. Bellona sees that incorporating an environmental strategy in the portfolio strategy will demand adjustments in the traditional index strategy for a benchmark portfolio but does not go into detail.

Carlos Joly recommends that the Ministry of Finance assess the risk relating to and the implications of not actively integrating economic consequences of climate change in the Fund's benchmark indices. The Ministry should initiate a process to change the Funds benchmark portfolio to address risks relating to climate.

Even with investments in different alternative investment plans the return on the Government Pension Fund – Global will, according to the *Future in Our Hands* (FIOH), still depend on the major oil companies (that top the Fund's investment list) continuing to extract fossil reserves to which they have the rights. FIOH believes that whether and how this contrasts with the requirement of creating long-term sustainable development should be assessed in a separate study.

Greenpeace believes that Norges Bank should identify the exposure of the portfolio to carbon obligations and that it should have an optimal composition in relation to carbon obligations and rewarding carbon efficiency. A separate appendix to the comment prepared by the analysis company Trucost describes methods for such carbon optimalisation.

SUM (Centre for Development and the Environment) at the University of Oslo argues, both out of consideration to ethical and financial obligations, in favour of doing more to reduce the Fund's carbon-intensity and strengthen the positive climate effects of the investment portfolio. Due to a systemic environmental risk insufficiently considered in the share and bond markets, a carbon-intensive portfolio may represent a serious future financial risk for the Government Pension Fund – Global. An analysis of such financial risks should be implemented routinely by a "universal owner" like SPU. Among other things, the analysis should contain an analysis of different political and economic scenarios, as for example a post-Kyoto treaty that implements mandatory emission cuts for developing countries and the U.S. On the basis of the analysis the Government Pension Fund – Global should study the opportunities to invest more in companies that develop and continue low-carbon technology. In this connection SUM also refers to how other large funds (CalPERS, ABP and PGGM) have programmes to support eco-friendly energy production and climate funds.

The Ministry's assessments:

A portfolio review in light of the climate challenges will be an important element in the development of the investment strategy for the Government Pension Fund – Global. The question is therefore assessed above in more detail in Section 2.5. It is concluded that the Ministry sees the need to further assess the consequences of the climate challenges on the world's financial markets. The Stern Review provided important knowledge about the impact of climate change on the general economic development globally, and work of similar scope can shed light on more specific effects on financial markets. Against this backdrop, the Ministry of Finance is aiming to ini-

tiate a study to assess how the climate challenges can affect the financial markets and how investors ought to act in light of this. This ought to be an international project and can if necessary be carried out in collaboration with other investors. The Ministry will present a more detailed plan for this in the National Budget. Reference is otherwise made to an assessment in Section 2.5.5 about the risks relating to equity investments in oil companies etc.

4.4 Other topics

4.4.1 On government bonds in particular

When the list of approved markets and currencies was removed from the regulations for management of the Government Pension Fund – Global, a new provision was introduced in the second paragraph of Section 3 with the following contents: “The Fund cannot be invested in interest-bearing instruments issued by the following states: *Burma.*” The background for this was discussed in detail in Report no. 24 (2006-2007) to the Storting. In the consultation memorandum this amendment is discussed in Section 2.2.1.

Input from commenting bodies

Several opinions have been submitted concerning the wish to expand the scope of the ban on investing in certain countries’ government bonds.

Amnesty International Norway says that during

> “…; a time where the motto increasingly seems to be ‘I hear what you say, but show me your money and I’ll decide if you are worth listening to’, it would be irresponsible not to accept the consequences of the real effect and ethical and political signal effect of investing in government bonds in countries where gross and systematic violations of human rights take place, and/or in countries that take part in wars or themselves have a civil war-like situation.
>
> The money SPU invests in government bonds could be used to pay the actual perpetrators of the human rights violations: the police, security forces and the army of an oppressive regime. …;
>
> Amnesty recommends that it should be an overarching principle in the management of SPU that Norway is not to earn money on human rights violations, and that this must apply to both state and non-state actors. The same ethical guidelines underlying the management of the capital used to purchase shares must apply to the management of the capital used to purchase government bonds.”

Changemaker links the question about government bonds to the issue of cancelling foreign debt. If Norway is to practice a responsible lending policy, there are far more countries than Burma where it will be problematic to purchase government bonds. *SLUG – The Norwegian Coalition for Debt Cancellation* believes that the Pension Fund can cause illegitimate debt. According to SLUG, a debt is illegitimate if the loan has been raised by repressive regimes, raised for illegitimate purposes or given to failed projects that have caused environmental or social damage that should have been foreseen by creditors. SLUG encourages the Ministry to adopt the Eurodad Charter on Responsible Financing for further development of ethical guidelines for purchasing government bonds. *Norsk Tamilsk Forum* (Norwegian Tamil Forum) believes it is a paradox for Norway to invest in government bonds in Sri Lanka, given the treatment Norwegian peace negotiators and truce observers have been subjected to.

The Ministry’s assessments

The issue of exclution of bond investments was discussed by the Graver Committee. The Committee pointed out that when the purpose is to avoid contribution in the production of a certain product or unacceptable conduct it is difficult to see any fundamental ethical divide between equity and bond investments. Corporate bonds are therefore also excluded from the Fund in those cases where equities in the same company are excluded.

The Graver Committee made it clear that investments in bonds issued by national states and international organisations have to be treated separately. The Committee pointed out that Norway has economic and diplomatic relations with most countries in the world (p. 36):

> “With the exception of the countries to which international sanctions regimes apply, contact is maintained even if Norway disagrees with the country’s policies, for example in the area of human rights. Ordinary foreign policy channels are far more important for influencing foreign governments to change their policies in the desired direction than exclusion from the Petroleum Fund’s investment universe.”

Trade and contact can provide better channels of influence than isolation. The Committee also argues that it may be difficult to achieve general agreement in Norway to denounce a country as a whole and that this also weighs against a prohibition on investing in government bonds issued by certain countries.

In cases where the UN Security Council imposes sanctions on a country in the form of binding trade restrictions, etc., the sanctions will normally entail a prohibition against investment in the country concerned. To the extent such countries have issued bonds, the consequence would be their withdrawal from the investment universe. It is conceivable that agreement on UN sanctions will not be achieved in certain cases. However, the Ministry has also opened the possibility of excluding investments in government bonds if there are other comprehensive international measures against the country, which Norway has endorsed. In the Ministry's view there should be a very high threshold for excluding a country's government bonds from the Government Pension Fund. Like the Graver Committee, the Ministry believes that normal foreign policy channels are a far more important instrument for influencing the authorities of other countries in the desired direction. To avoid creating uncertainty about the purpose of the investments in the Fund, such decisions should reflect broad political agreement. The decision not to invest in the government bonds of certain countries should therefore primarily apply to countries on which the UN Security Council has imposed sanctions, or countries covered by other international measures supported by Norway. On this background it has been decided that the Government Pension Fund – Global cannot be invested in government bonds issued by Burma.

The Government finds that it would represent a dramatic boycott of a country to go so far as to exclude this country's government bonds from the investment universe. The Ministry would only take such a step if it ensued from international sanctions. It has not been Norwegian policy to introduce unilateral measures against countries engaged in war, civil war etc. It would also be perceived as a strong politicisation of the Fund and characterise it as being more of a foreign policy instrument. Another aspect of this is that in general, investments in government bonds can hardly be considered direct financing of war or conflict, but may just as well be spent on legitimate services provided by the state, such as education and health etc. Without an international anchoring as described above, using the threat of exclusion from investment as a general instrument in Norwegian foreign policy is out of the question.

Norway has an active human rights dialogue with specially selected countries. Extensive dialogue is now taking place with China, Indonesia and Vietnam on human rights. Political contacts are a key element in the dialogues. Facilitating network building between the public administration, judicial system, academics and non-governmental organisations is equally as important. The networks and the contact between different professional communities make it possible to exchange information, concerns and criticism through contacts based on trust. In such a context, it is in the opinion of the Government undesirable and inappropriate to use investment funds from the Government Pension Fund – Global as a tool for forcing changes. Human rights dialogues must be based on equality and belief in the persuasive power of dialogue.

Some commenting bodies advocate expanding the scope of the ban on investing in government bonds, or applying other criteria. In the light of what was said above, the Ministry believes that the current approach in the ethical guidelines should be continued with respect to the Fund's investment in government bonds. The Ministry would otherwise point out that debt cancellation and responsible lending are important areas for Norway in which several different measures have been implemented in recent years. A description is given in Section 6.4 of Report no. 13 (2008-2009) to the Storting: *Climate, Conflict and Capital*. In 2007, Norway cancelled, unilaterally and unconditionally, the remaining debts resulting from the Norwegian Ship Export Campaign from 1976-1980. Norway has worked with the World Bank to buy commercial debt in certain countries, thereby preventing "vulture funds" from purchasing old debt at reduced prices to exploit poor countries. Norway is the largest donor to the UN programme for debt managment capacity building. Furthermore, Norway has been involved in develop common guidelines for sustainable lending in the OECD. A major challenge is to arrive at a mutually agreed and operational definition of what can be described as illegitimate debt. As a follow-up to the Government's goal that Norway shall work to ensure that the UN reviews the criteria of what can be characterised as illegitimate debt, Norway has funded studies on such debt under the direction of the UN and the World Bank. Furthermore, the government has funded

conferences and meetings, and raised the issue in relevant fora such as the UN Financing for Development meeting in Doha last year, the Paris Club and the World Bank. Norway recently signed a four-year agreement with the UN (UNCTAD) whose goal is to prepare criteria for responsible lending and illegitimate debt.

4.4.2 Secrecy jurisdictions (so- called "tax havens")

Tax havens are characterised by three factors in particular: They have low or no taxes, they protect investors against foreign tax authorities, and they do not disclose information about the enterprises registered there. Due to the secrecy offered by such states, secrecy jurisdictions or "bank secrecy countries" attract both legal and illegal capital. The concept of "tax haven" is not precise and various communities and organisations may operate with different definitons. Secrecy jurisdictions are considered to be a major social problem because the secrecy they offer can help hide economic crime such as corruption, money laundering and tax evasion. Due to these undesirable consequences, international work is taking place in many different fora aimed at influencing states to relinquish their status as a secrecy jurisdiction.

In the consultation memorandum it was discussed whether the ethical guidelines should cover the Government Pension Fund – Global investments in secrecy jurisdictions. The Ministry found that combating secrecy jurisdictions must be directed at the authorities of these countries. But, the Ministry stated, it is nevertheless a question of whether corporate transparency on revenue flows and taxes can be promoted in a more systematic way in the corporate governance activities.

Input from commenting bodies

Several commenting bodies are interested in the relationship of the Government Pension Fund – Global to so-called tax havens.

Attac points out that the battle against tax havens is important, due to the fact that they enable tax flight on a large scale from developing countries and represent a big corruption problem at the same time. Attac believes it is unethical to operate through tax havens because it contributes to tax evasion, puts pressure on other countries to lower taxes, contributes to less transparency regarding the activities of companies and to corruption. Attac believes that rules must be adapted against investing in companies that operate through tax havens. The *Church of Norway National Council* also advocates avoiding investing in companies that operate in tax havens.

Several commenting bodies point to the importance of higher requirements for reporting and information access to combat the harmful effects of tax haven practices. *Amnesty*, *Publish What You Pay, Norwegian Church Aid*, *Changemaker* and *Save the Children* all recommend supporting the effort with a new accounting standard that will require the companies to report on a "country-by-country" basis. Norwegian Church Aid and Publish What You Pay propose that an expectations document be prepared on corporate transparency.

The Norwegian School of Theology believes more attention should be paid to work on tax havens in corporate governance activities.

The Ministry's assessment

The Ministry wants to underline that work against closed jurisdictions is very important and is given high priority.

Illegal capital flow and tax havens are discussed in Section 6.2 of Report no. 13 (2008-2009) to the Storting: *Climate, Conflict and Capital*, which states:

> "Each country is free to choose the tax level for the individuals and enterprises that choose to settle or register their business there. The problem arises when a state does not have a sufficient degree of rules and requirements that can prevent money laundering and criminal money or violations of the laws of other countries. By refusing transparency and disclosure or contributing to the establishment of fictitious companies whose purpose is to hide real ownership of capital, tax havens make it difficult for the tax and police authorities of other countries to investigate this form of crime. Government policy in this connection is to strengthen international rules that prevent capital that has been illegally tapped from developing countries from being hidden or laundered in tax havens.
>
> There are many opinions about which countries and areas are tax havens. International lists include different types of jurisdictions ranging from completely non-transparent to those that are relatively open and cooperative. Some of the best known tax havens are domiciled on small Caribbean islands. At the same time their operations often depend on

> activities in large international financial centres such as New York, London, Singapore and Hong Kong. Professional consultants that assist companies in evading national rules often operate from just such places." [Preliminary translation]

The Government has initiated a number of measures aimed at combating the detrimental effects of the practices of closed jurisdictions. Norway has headed an international working group that focuses in particular on the challenges relating to the illegal flow of capital from developing countries. The recommendations of the working group were presented at the Doha conference on Financing for Development, organised by the UN. To follow up this work Norway has decided to support the establishment of a Task Force on Financial Integrity and Economic Development launched in January 2009.

The Government has appointed a separate expert committee to examine illegal capital flight from developing countries and also evaluate investment of capital from Norway in tax havens. The recommendation from this work shall be given by 1 June 2009. The Committee will forward proposals on how to enchance transparency relating to capital flows to and from developing countries via tax havens, and also how capital flows can be curtailed when it involves the illegal flow of capital or laundering of money.

Further, reference is made to the statement in Report no. 13 (2008-2009) to the Storting: *Climate, Conflict and Capital*, that international rules aimed at corruption are continually being improved. New measures include OECD and Council of Europe conventions. A UN Convention against corruption entered into force in 2005. As many as 126 countries have already endorsed the convention. This is the first set of global rules against corruption. A global anti-corruption instrument represents an opportunity for further Norwegian activities against corruption. The UN convention represents a common platform and global standard that applies equally to all. Norway is promoting the establishment of an implementation mechanism so that the convention can be implemented in practice.

Issues relating to secrecy jurisdictions were also discussed in Section 7.4.1 of Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Social responsibility of business and industry in a global economy).

In addition to the measures described above, Norway, represented by the Ministry of Justice and Ministry of Finance, is active in international cooperative bodies that combat money laundering, and work for mutual transparency and compliance with international conventions and rules – such as the Financial Action Task Force (FATF), OECD and Interpol.

Relating to tax-matters, Norway is following in the OECD's lead in efforts vis-à-vis secrecy jurisdictions. This work involves negotiating agreements with such jurisdictions under which they are obliged to exchange information that enables member countries to establish the correct tax base for their taxpayers, thereby preventing tax evasion. A majority of the secrecy jurisdictions have now said that they are willing to cooperate, and many of them have signed or are in the process of signing agreements on the exchange of information in tax cases. Non-cooperating jurisdictions have been placed on the OECD's official blacklist of Harmful Tax Practices countries. The last three countries on this list (Liechtenstein, Monaco and Andorra), recently said that they will now exchange information in tax cases.

As a follow-up to the OECD's work, Norway is participating in a nordic project aimed at negotiating TIEAs under the direction of the Nordic Council of Ministers. The purpose of the project is to negotiate agreements with relevant secrecy jurisdictions on exchanging information, so that our tax authorities can gain access to information on the investments of its tax payers (bank deposits, holdings etc.) in and transactions through the individual country. This applies to jurisdictions that have declared to the OECD that they are willing to cooperate with OECD countries about such disclosure opportunities. Agreements have been signed with many countries including Jersey, Guernsey, the Isle of Man, the Cayman Islands and Bermuda, and new negotiations are well under way.

Some commenting bodies have advocated that the Government Pension Fund – Global should not invest in companies that operate through so-called tax havens.

With respect to real estate investments, restrictions have been placed on where unlisted real estate companies and funds can be established. These may only be incorporated in countries that are either OECD countries, or with which Norway has established tax treaties or other agreements that provide sufficient disclosure, or with which Norway has signed a special Tax Information Exchange Agreement ("TIEA") and, in addition, are not on the OECD's blacklist.

The reason unlisted real estate investments are treated separately are special factors relating to this type of investment. The fact that they are unlisted means the marketplace cannot be used as a delineating criterion. The place of incorporation has therefore been chosen as the delineating criterion. The place of incorporation for real estate companies and funds may be places other than where the properties are situated, and the tax regime can thus have a major impact on the cherice of place of incorporation. For this type of investments the Government has therefore found it appropriate to place restrictions on where the fund or company in question may be incorporated. Reference is made to the discussion in Section 3.5.4 of Report no. 16 (2007-2008) to the Storting.

The question is then whether the Government Pension Fund – Global can, or should, play a role with respect to combating closed jurisdictions through its equity investments too.

The Ministry will point out that exclusions based on operations in, establishment in or other dealings with closed jurisdictions will not be very enforceable because it will be very difficult to limit and practice. First of all, as stated above, views vary on which countries that fall under such a description. Depending on the view adopted, it must be assumed that a substantial share of the companies included in the indices by which the fund is invested have some form of connection to closed jurisdictions. This is not illegal per se. The degree to which the connection is legitimate will be virtually impossible to assess.

Reference is furthermore made to what was said above about the Graver Committee's view that it would be unethical with respect to future generations of Norwegians to impose costs on the Fund solely in order to carry out symbolic, ethically grounded measures in support of policies best promoted by other means. Norway is already working actively in many other arenas such as the OECD, UN and by signing bilateral agreements, to gain access to information in such jurisdictions.

Tax evation is only one of the problems relating to so-called tax havens. Other major concerns relates to that the secrecy these states offer can facilitate the concealment of other economic crime such as corruption and proceeds from criminal acts. One can ask whether it is possible to identify the worst forms of association to tax havens, connected for example to a criterion that a tax haven is used to hide serious crime. This would not be appropriate in the Ministry's opinion. The Council on Ethics has no opportunity to conduct investigations of possible crimes by the companies. This is a task for the police and prosecuting authorities. Economic crimes that are uncovered will as a rule be offences committed some time ago. Since the exclusion mechanism is forward-looking there will often not be any basis for exclusion on such a basis. As stated, exclusion shall not be a sanction against earlier violations. If economic crime exists in the form of corruption or is so serious that it involves a violation of the criteria of other particularly gross violations of fundamental ethical norms, and there is an unacceptable risk that this will continue over time, the company may, however, be excluded on the basis of already existing ethical guidelines.

Many commenting bodies have referred to the work on a new accounting standard for industries engaged in extracting oil, gas and minerals. It is the International Accounting Standards Board (IASB) that establishes the International Financial Reporting Standards (IFRS). The international accounting standards are decisive for the information contained in the accounts of listed companies. The opinion has been voiced by a number of parties that the new accounting standard must require that companies in the extractive industries report capital flows paid to authorities on a *country-by-country basis*. As mentioned in Chapter 3, Norges Bank has participated in this process. In its letter of 15 September 2008 to the IASB Extractive Activities Project, Norges Bank expressed its support of the work on the new standard. In the letter, Norges Bank underlined the importance of global, standardised reporting on companies' economic dealings with authorities, broken down by individual country. This will provide more opportunities to analyse financial matters. At the same time, increased reporting can have a beneficial effect on governance in many countries with ample resources, and it can reduce corruption. In addition to this work, Norges Bank supports the Extractive Industries Transparency Initiative (EITI). EITI is an international initiative that aims to promote transparency about revenue flows in extractive industries. The goal of EITI is that transparency about resource revenues shall be a global norm, and that a larger share of the world's revenues from natural resources shall promote social and economic development. See the discussion on page 48 et seq. in Report no. 10 (2008-2009) to the Storting: *Næringslivets samfunnsansvar i en global økonomi* (Social responsibility of business and industry in a

global economy). Norges Bank has signed EITI's investor initiative. The Ministry supports Norges Bank's work in these areas.

The Ministry refers to the fact that increased requirements for transparency and reporting by companies about revenue flows and taxes may counteract the effect of secrecy offered by secrecy jurisdictions. Through broad initiatives such as those described above, the work is directed in a more targeted manner on the actual playing rules and "infrastructure" of the financial markets, as opposed to making it a question of whether the Fund as an investor should assess whether individual companies in the portfolio have legitimate grounds for activities in tax havens.

The Ministry plans to strengthen its efforts against closed jurisdictions through greater efforts as an owner in the companies. It was mentioned above that the Ministry intends to ask Norges Bank to prepare more expectations documents within its main focus areas. Corporate governance is one of these areas. The Ministry will ask Norges Bank to prepare an expectations document aimed at companies' transparency and reporting of their payment flows. Clearer expectations from investors such as the Government Pension Fund – Global in this area can counteract use of secrecy jurisdictions to conceal unlawful acts such as corruption, money laundering and tax evasion, etc. and in this way contribute to better-functioning and legitimate markets. This will also be consistent with our interest as a financial investor.

5 Analysis of the return and risk associated with management of the Government Pension Fund

5.1 Introduction

For the evaluation of the management performance of the Government Pension Fund, a distinction is made between the return and risk resulting from general developments in the markets in which the Fund is invested, and the return and risk caused by the investment choices made by the manager's active management. The general investment strategy for Norges Bank's and Folketrygdfondet's management of the Government Pension Fund – Global and Government Pension Fund – Norway respectively is expressed in the form of a benchmark portfolio defined by the Ministry. Norges Bank and Folketrygdfondet are allowed to deviate from the defined benchmark portfolio within their permitted tracking error to generate excess return.

The objective of the Fund as a financial investor pertains to both the Government Pension Fund – Global and the Government Pension Fund – Norway. The investment universe for the Global part of the Fund is significantly broader than that of the Government Pension Fund – Norway, which is primarily invested in the Norwegian securities market. The fact that Folketrygdfondet, in its capacity of manager of the Fund's assets, is a large player in a relatively small capital market, may place certain restrictions on the ability to make major changes in the composition of the portfolio in the short term.

The Government Pension Fund has a long investment horizon and a well-entrenched investment strategy. Consequently, short-term market fluctuations are of minor importance. This is discussed in more detail in Chapter 2. The Ministry therefore emphasises performance developments for the Fund over time in its analysis.

The analyses in this chapter are based on nominal return data, since a comparison of the management performance with the rate of return on a benchmark portfolio is desired, and adjusting the return data for inflation would not provide much additional information. In consideration of the statistical analyses in the discussion of performance below, the average rate of return on the Government Pension Fund – Global and the Government Pension Fund – Norway is calculated as an arithmetic average, based on monthly return data. In Chapter 1 the return was calculated geometrically, in line with the return data reported in the annual reports from Norges Bank and Folketrygdfondet.

5.2 Management performance of the Government Pension Fund – Global

5.2.1 Developments in the benchmark portfolio for the Government Pension Fund – Global

The benchmark portfolio for the Government Pension Fund – Global is a broad-based portfolio of equities and bonds that are spread across many geographical regions and sectors. Consequently, the rate of return on the benchmark portfolio reflects the general price developments in the international securities markets. The actual composition of the benchmark portfolio consists of indices from the providers FTSE and Barclays Capital (previously Lehman Brothers) for equities and bonds, respectively.[1]

The return on the Government Pension Fund – Global can be measured in both Norwegian kroner and in the Fund's currency basket.[2] The rate of return measured in Norwegian kroner is influenced by the development of the Norwegian krone exchange rate relative to the currencies in

[1] The benchmark portfolio consists of equities included in the FTSE Global Equity Index Series All Cap. A modified version of this index, which encompasses 46 countries, is used for management of the Government Pension Fund – Global. In addition, the benchmark portfolio consists of bonds that are included in the Barclays Global Aggregate Bond Index and Barclays Capital Global Inflation Linked Index. The benchmark portfolio for bonds encompasses the currencies of 21 countries.

[2] When the rate of return is measured in a foreign currency, the rate of return in the individual currencies is weighted together with the weights in the Fund's benchmark portfolio.

Table 5.1 Average annual return (arithmetic)[1] and annual standard deviation of the rate of return on the benchmark portfolio for the Government Pension Fund – Global, measured nominally in local currency. 1998–2008. Per cent

	Entire period	Last five years	Last three years	2008
Benchmark portfolio				
Average rate of return per year	3.15	1.71	-3.08	-21.27
Standard deviation	6.42	7.00	8.41	12.60
Equity benchmark				
Average rate of return per year	2.16	1.17	-8.27	-46.88
Standard deviation	15.43	13.74	16.28	22.33
Fixed income benchmark				
Average rate of return per year	5.06	4.21	3.99	6.07
Standard deviation	3.38	3.45	3.90	5.78

[1] Calculated as an arithmetic average based on monthly rates of return (see in Section 5.1).

Source: Ministry of Finance and Norges Bank

which the Fund is invested. Since the international purchasing power of the Fund remains unaffected by fluctuations in the Norwegian krone exchange rate, the performance evaluation below focuses on the return measured in local currency.

Table 5.1 illustrates that the average rate of return on the benchmark portfolio for the Government Pension Fund – Global for the last five years was 1.7 per cent. In comparison the average rate of return for the last five years at year-end 2007 (i.e. the period from 2003 to 2007) was 8.3 per cent. The substantial fall in the average return is attributed to last year's exceptionally weak -21.3 per cent rate of return, which reflects essentially the sharp fall on the world's equity markets. The weak rate of return in 2008 also contributes significantly to a reduction in the average rate of return for the entire period from 1998 to 2008 as a whole (3.2 per cent, compared with 5.6 per cent at year-end 2007).

The performance of the equity benchmark has been very weak throughout the entire period as a whole. The average annual rate of return was 1.2 per cent for the last five years. The weak rate of return on the equity market during this period is attributed primarily to the substantial fall in equity prices in 2008. In comparison, the average rate of return on equities for the last five years was 14.8 per cent at year-end 2007.

The very poor performance of the world's equity markets last year contributed to an increase in the demand for financial instruments with lower risk, including government securities. This contributed to an increase in the five-year average rate of return on the benchmark portfolio for fixed income instruments from year-end 2007 to year-end 2008 (from 4.0 per cent to 4.2 per cent per year). For the entire period from 1998 to 2008 as a whole, the average annual rate of return on the bond market was almost 3 percentage points higher than the rate of return on the stock market.

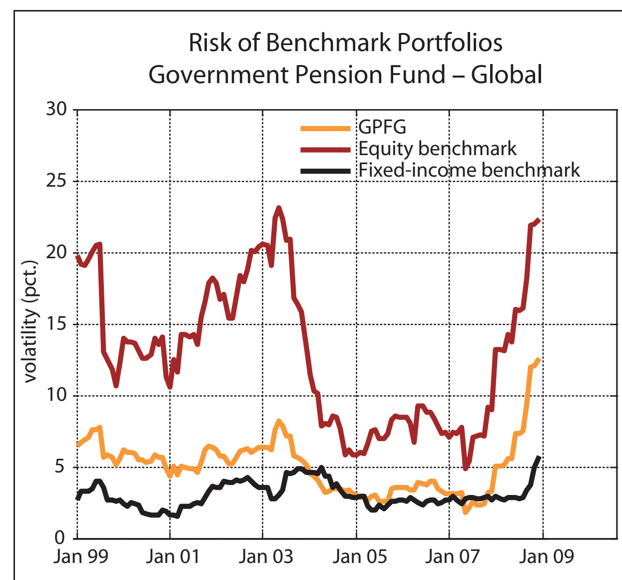

Figure 5.1 Risk associated with the benchmark portfolios for the Government Pension Fund – Global, measured by a rolling twelve-month standard deviation in local currency. Per cent

Source: Ministry of Finance and Norges Bank

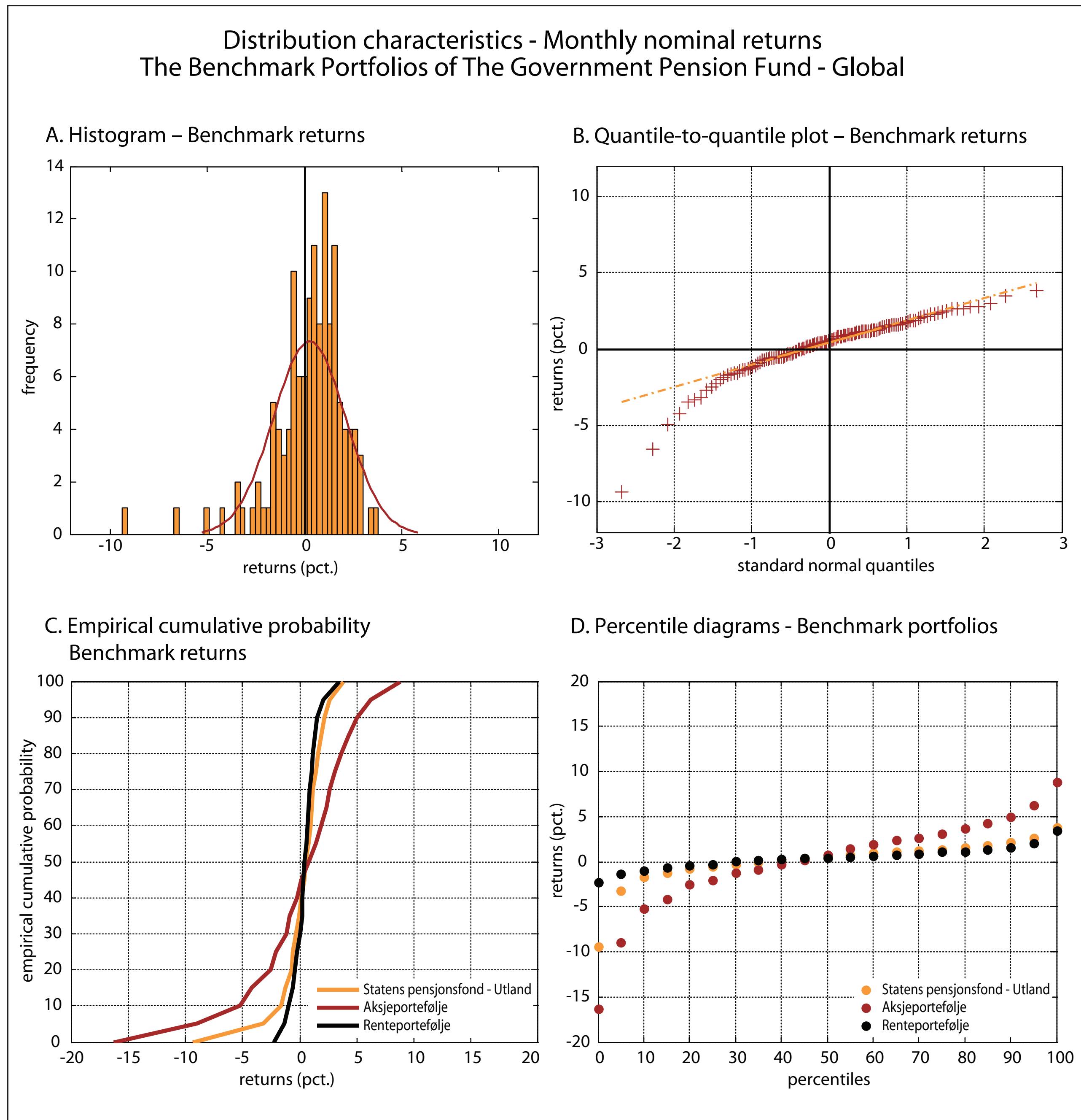

Figure 5.2 Distribution characteristics of the monthly rate of return (measured nominally in local currency) on the benchmark portfolio for the Government Pension Fund – Global

Source: Ministry of Finance and Norges Bank

At the same time as the rate of return on the benchmark portfolio for the Government Pension Fund – Global has been relatively low in recent years, the level of risk has been somewhat higher than normal (see Figure 5.1). As illustrated in Table 5.1, the average level of risk associated with the Fund's benchmark portfolio over the last five years was 7.0 per cent per year, as measured by the standard deviation of the rate of return. This is almost twice as much as at year-end 2007 and is attributed, for example, to a substantial increase in the risk associated with the equity benchmark. But it should also be seen in connection with the increase in the equity portion, a doubling of the volatility in the bond market in relation to the normal level, as well as increased covariation between the rate of return on securities due to the financial crisis.

The statistical characteristics of the rates of return on the benchmark portfolio are of key

importance to the performance evaluation with regard, for example, to an assessment of whether the standard deviation of the rate of return is a good measure of risk, so that probability statements can be associated with it. The actual volatility, as measured by the standard deviation of the rates of return, provides a complete description of the risk associated with the benchmark portfolio if the rates of return are normally distributed.[3]

Figure 5.2a indicates that the rates of return on the benchmark portfolio for the Government Pension Fund – Global are skewed to the left and have fat tails due to the fact that lower rates of return occur more frequently than would be expected if the rates of return were normally distributed. In addition there are indications that the assumption that the rates of return are normally distributed is not justified (see Figure 5.2b). If the rates of return are normally distributed, they would be expected to plot along a straight line from the lowest to the highest observed rate of return. The figure indicates that the assumption of a normal distribution is not justified due to the fact that the rates of return are below what would be expected.

Statistical tests show that the rates of return on the benchmark portfolio for the overall Fund and for the equity benchmark are skewed to the left for the entire period from 1998 to 2008 as a whole, and for the two sub-periods 2004–2008 (last five years) and 2006–2008 (last three years). In addition, there are indications that the rates of return on the fixed income benchmark are skewed to the right for the sub-period from 2006 to 2008. The results are statistically significant. In addition, the rates of return for the Fund overall and the equity benchmark have fat tails. There are also indications of fat tails for the fixed income benchmark for the last five years. Statistical tests (Jarque-Bera and Lilliefors) show that the hypothesis of normally distributed rates of return can be rejected for the Fund's benchmark portfolio and for the equity benchmark for the entire period as a whole and for the two sub-periods. An overall assessment suggests accordingly that caution should be exercised when basing probability statements concerning the risk associated with the Fund's benchmark portfolio and the equity benchmark on the standard deviation of the monthly rates of return. A more detailed explanation of the risk associated with the Fund over long time horizons is provided in Chapter 2.

In principle, one wants to use the full probability distribution of the rates of return to shed light on the risk associated with the Fund's benchmark portfolio. Figure 5.2c illustrates the empirical cumulative probability distribution of the rates of return on the benchmark portfolio for the Fund overall, as well as the equity and fixed income benchmarks. The Fund's minimum rate of return is estimated to be -9.4 per cent, and the maximum monthly return is estimated to be 3.8 per cent. The variance is considerably higher for the equity benchmark, while it is considerably less for the fixed income benchmark. The figure illustrates that the rate of return on the overall benchmark has been lower than around 2 per cent in 10 per cent of all the months.

The information in the figure above can also be presented in a percentile chart (see Figure 5.2d). The figure illustrates that the rate of return on the Fund's benchmark portfolio has been lower than or equal to -2 per cent in 10 per cent of the months. Correspondingly, the rate of return on the equity benchmark has been less than or equal to at least -5 per cent, and the rate of return on the fixed income benchmark has been less than or equal to around -1.5 per cent, in 10 per cent of the months. This can be expressed as a 2 per cent historical Value-at-Risk for the Fund, which corresponds to around NOK 45 billion based on the size of the Fund at year-end 2008. This implies that more than NOK 45 billion of the value of the portfolio would have historically been lost in one out of every ten months. In addition, there are the variations resulting from fluctuations in the value of Norwegian kroner relative to the value of the currencies held by the Fund.

The auto-correlation of the rates of return describes how the rates of return for the Fund's benchmark portfolio are related over time, i.e. whether a high (low) rate of return in a given month is followed by a high (low) rate of return over the subsequent months. The analysis of performance assumes that monthly risk figures, as measured by the standard deviation of the rates of return, can be annualised by using the square root formula. Such scaling implies that linear independency is assumed for the rates of return over time. Computations performed by the Ministry suggest that there is a relatively low degree of time dependency in the rates of return on the Fund's benchmark portfolio, as well as on the equity and fixed income benchmarks. Statistical

[3] A more detailed explanation of the various measures of risk can be found in Box 2.2 in Report no. 16 (2007-2008) to the Storting.

Box 5.1 Fluctuations in the krone exchange rate and the rate of return for the benchmark portfolio measured in Norwegian kroner

The rate of return on the benchmark portfolio for the Government Pension Fund – Global measured in Norwegian kroner (R_{nok}) is approximately equal to the rate of return on the benchmark portfolio measured in local currency (R_{lok}) plus the "rate of return" on the currency basket (relative to the Norwegian krone) (R_{fx}), see Equation (1).

$$R_{nok} \approx R_{lok} + R_{fx} \quad (1)$$

During certain periods there will be a significant difference between the rate of return on the benchmark portfolio measured in Norwegian kroner and in local currency. This difference was around 19 percentage points in 2008. The rate of return in Norwegian kroner based on the monthly rate of return was measured at -2 per cent, and in local currency it was measured at -21 per cent (arithmetic on the benchmark portfolio).

During the period from January 1998 to December 2008 the krone weakened in relation to the Fund's currency basket at 1.0 per cent per year on average. Up until the end of December 2007, however, the krone had strengthened by 0.75 per cent per year on average. This situation reversed in 2008, which represents an exceptional year with a very large fall in the value of the Norwegian krone.

Equation (2) illustrates the standard deviation of the rate of return measured in Norwegian kroner ($\sigma_{R,nok}$). The three key variables are the standard deviation of the rate of return in local currency, standard deviation of the rate of return on the currency basket, and the correlation between the rate of return on the benchmark portfolio measured in local currency and the rate of return on the currency basket (ρ).

$$\sigma_{R,nok} = (\sigma^2_{R,lok} + \sigma^2_{R,fx} + 2\,\sigma_{R,lok}\sigma_{R,fx}\rho)^{1/2} \quad (2)$$

The reduction in the value of the krone by around 19 per cent relative to the benchmark portfolio's currency basket corresponds to 2.6 times the normal variation in the value of the krone. The estimated probability that the value of the krone will weaken so much in the course of a year is in other words very low.

The volatility of the krone exchange rate is estimated to be 7.3 per cent annually, which is very high compared with the average change in the value of the krone. Statistically the average weakening in the value of the krone of 1.0 per cent per year is not significantly different from zero.

The "rate of return" on the currency basket has been skewed to the right, which implies that there have been more instances of a relatively major weakening than a relatively major strengthening of the krone. There are also indications of fat tails in the empirical distribution. The estimates are statistically significant at the 95 per cent level. The normal distribution assumption is rejected based on standard statistical tests. There are, however, no indications of significant autocorrelation in the development of the krone exchange rate, which implies that it has been difficult to forecast the fluctuations in the value of the krone based on earlier changes in value during this period.

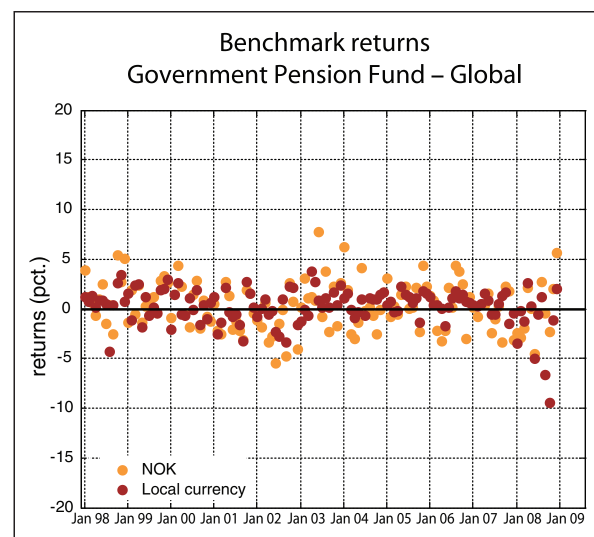

Figure 5.3 Rate of return on the benchmark portfolio for the Government Pension Fund – Global, measured nominally in local currency and Norwegian kroner. Monthly return data for 1998–2008. Per cent

Source: Ministry of Finance and Norges Bank

Box 5.1 (cont.)

Figure 5.3 shows the monthly rates of return on the benchmark portfolio measured in Norwegian kroner and local currency, respectively. The average rate of return for the period from January 1998 to December 2008 has been computed to be 4.1 per cent in Norwegian kroner and 3.1 per cent in local currency. The difference corresponds to the average fall in the value of the krone. The figure illustrates that the spread in the rate of return is greater when it is measured in Norwegian kroner than in local currency. This is due to the fact that changes in the value of the krone (krone volatility) have contributed to reinforcing the fluctuations in the rate of return on the benchmark portfolio measured in Norwegian kroner.

Figure 5.4 illustrates the development of the accumulated rate of return (index values) for the benchmark portfolio measured in Norwegian kroner and local currency. The figure illustrates two factors: Firstly, the fact that the accumulated rate of return measured in local currency has been less than the rate of return measured in Norwegian kroner to date. The index measured in Norwegian kroner has an end value of 151, while the index measured in local currency stops at 142. Secondly, there have been major fluctuations in the indices. It appears to be random whether the accumulated rate of return measured in Norwegian kroner at a given point in time is greater or less than the accumulated rate of return measured in local currency.

The annual standard deviation of the rate of return on the benchmark portfolio measured in Norwegian kroner is estimated to be 8.4 per cent for the entire period, while the standard deviation of the rate of return measured in local currency is estimated to be 6.4 per cent. The volatility of the benchmark portfolio in Norwegian kroner is less than the sum of the volatility of the local currency and the volatility of the krone exchange rate. This is due to the fact that the development of the krone exchange rate is not perfectly correlated with the rate of return on the benchmark portfolio in local currency. For the period as a whole, the correlation between the rate of return on the benchmark portfolio measured in local currency and the change in the krone exchange rate has been negative (-0.26).

The volatility of the benchmark portfolio varies over time. Measured in Norwegian kroner it has fluctuated from just over 5 per cent to around 12 per cent measured as a rolling twelve-month standard deviation, and in local currency it has fluctuated from 2 per cent to 12 per cent. The volatility of the krone exchange rate has varied between 3 per cent and 11 per cent during the same period.

The correlation between the change in the krone exchange rate and the rate of return on the benchmark portfolio measured in local currency has changed a great deal over time. The rolling correlation coefficients based on an observation window of twelve months has varied from -0.75 to 0.5.

In evaluating the performance the Ministry attaches importance to the fact that the rate of return measured in the Fund's currency basket is the best expression of the Fund's purchasing power. In the years to come, variations in the krone exchange rate may have a major impact on the rate of return measured in Norwegian kroner. In certain instances changes in the krone exchange rate will reinforce changes in the value of the benchmark portfolio measured in Norwegian kroner. In other instances, the opposite will be true. The size of the correlation between changes in the value of the krone and the performance of the securities markets is of decisive importance. There are no clear theoretical grounds providing a clear basis for determining the size of this correlation, or whether it is positive or negative.

A more detailed description will be provided in a separate documentation memorandum that will be published on the Ministry's website (www.government.no/spf).

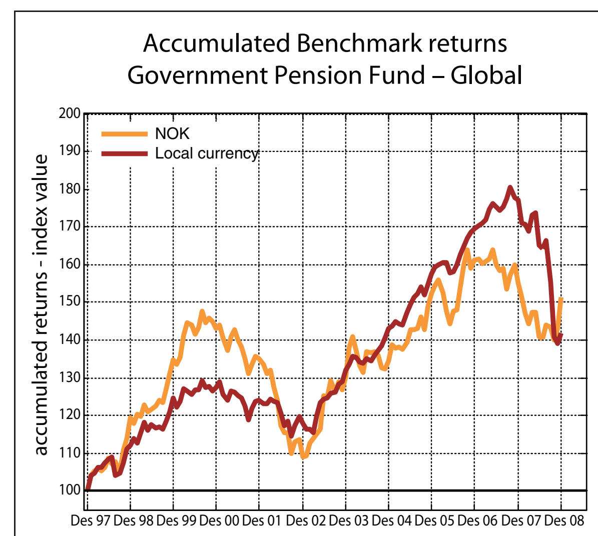

Figure 5.4 Accumulated rate of return on the Government Pension Fund – Global, measured nominally in local currency and Norwegian kroner. Index at year-end 1997 = 100

Source: Ministry of Finance and Norges Bank

tests for auto-correlation show that the hypothesis of linear independency over time for the rates of return cannot be rejected for any of the periods or sub-benchmarks.

Box 5.1 explains how variations in the value of the krone affect the rate of return on the Fund's benchmark portfolio measured in Norwegian kroner.

5.2.2 Performance of the actual portfolio of the Government Pension Fund – Global

The actual portfolio of the Government Pension Fund – Global deviates somewhat from the benchmark portfolio defined by the Ministry. The deviations reflect primarily active investment decisions by Norges Bank, the aim of which is to achieve a higher rate of return on the actual portfolio than the benchmark portfolio, within the scope of the expected tracking error of 1.5 percentage points. The return on and risk associated with the Government Pension Fund – Global may therefore deviate from the return on and risk associated with the Fund's benchmark portfolio.

Table 5.2 illustrates that the average annual rate of return on the actual portfolio of the Government Pension Fund – Global for the last five years was 1.2 per cent. In comparison the average rate of return for the last five years at year-end 2007 was 8.7 per cent. The substantial fall in the average rate of return from year-end 2007 to year-end 2008 is attributed to the extremely poor performance last year with a rate of return of -25.3 per cent. The main reason for this is the weak return on the equity investments (-48.5 per cent). The exceptionally weak rate of return in 2008 also affects the average rate of return for the entire period from 1998 to 2008 as a whole, which fell from 6.0 per cent at year-end 2007 to 3.1 per cent at year-end 2008.

The rate of return on the equity portfolio has been very low over the last five years, with an average annual rate of return of 1.6 per cent. In comparison, the average annual rate of return was 15.6 per cent at year-end 2007.

Tables 5.1 and 5.2 illustrate that the average rate of return on the actual portfolio is approximately the same as the rate of return on the benchmark portfolio for the entire period as a whole (see Figure 5.6). At the same time, the risk, measured by the standard deviation of the rate of return, has been somewhat higher for the actual portfolio than for the benchmark portfolio. The Fund's excess return, which is the difference between the rate of return on the actual portfolio and that on the benchmark portfolio, is discussed in more detail in Section 5.2.3.

Table 5.2 Average annual return (arithmetic)[1] and annual standard deviation of the rate of return on the benchmark portfolio for the Government Pension Fund – Global, measured nominally in local currency. 1998–2008. Per cent

	Entire period	Last five years	Last three years	2008
Actual portfolio				
Average rate of return per year	3.14	1.18	-4.45	-25.29
Standard deviation	6.88	7.81	9.39	14.01
Equity portfolio				
Average rate of return per year	2.69	1.60	-8.44	-48.46
Standard deviation	15.80	14.41	17.01	23.42
Fixed income portfolio				
Average rate of return per year	4.56	2.86	1.52	-0.33
Standard deviation	3.51	3.66	4.19	6.57

[1] Calculated as an arithmetic average based on monthly rates of return (see discussion in Section 5.1).

Source: Ministry of Finance and Norges Bank

Box 5.2 Inflation, nominal return and real return

What impact does inflation have on the statistical characteristics of the real rate of return? This question can be illustrated by comparing how the different statistical estimates are affected when the return data that are used in the calculations are changed from nominal to real terms.

The real rate of return is defined as the difference between the nominal rate of return and inflation, see equation (1).

$$(1) \quad R_{real} \approx R_{nom} - \Delta P$$

The standard deviation of the real return can be calculated as in Equation (2), but it is normally easier to calculate the standard deviation directly from a time series of real rates of return. Certain important relationships can, however, be read from the equation. Low, stable inflation entails that the second element on the right hand side of the equation (variance of the inflation) will be low (negligible) in relation to the variance of the nominal return (the first element). The third element, which expresses the covariance between the nominal return and inflation, will likely also be low, due to the fact that the inflation is low and stable. The combination of a particularly stochastic variable (nominal return) and a practically deterministic variable (inflation) in this context indicates low covariation. Based on this reasoning, it is expected that the standard deviation of the real return will be equal to the standard deviation of the nominal return.

$$(2) \quad \sigma_{real} = (\sigma^2_{nom} + \sigma^2_{\Delta P} - 2\rho\sigma_{nom}\sigma_{\Delta P})^{1/2}$$

Corresponding reasoning can be applied to the third element (degree of skewness) and fourth element (degree of fat tails, or excess kurtosis) of the real rate of return. Under the assumption of low, stable inflation, the third element of the real return will likely be approximately equal to the third element of the nominal rate of return. Correspondingly, the fourth element of the real return will likely be approximately equal to the fourth element of the nominal rate of return.

Based on the return data for the period from January 1998 to December 2008, the average annual inflation for the countries that are included in the benchmark portfolio for the Government Pension Fund – Global is estimated to be 1.8 per cent. The standard deviation of the annual inflation rate is estimated to be 0.4 per cent. There is a high degree of positive auto-correlation in the monthly inflation rates. The period on which the calculations are based is characterised by low, stable inflation. The correlation ( ) between the nominal rate of return measured in local currency and inflation is computed to be 0.18, which is low, but statistically significantly different from zero.

The average annual geometric nominal rate of return measured in local currency is estimated to be 2.9 per cent, while the annual geometric real rate of return is computed to be 1.1 per cent. The difference corresponds to 1.8 percentage points, which is equal to the average annual rate of inflation. The standard deviation of the real rate of return is approximately identical to the standard deviation estimate for the nominal rate of return of 6.9 per cent. The results also illustrate that the estimates for skewness and fat tails are not influenced much by whether the computations are based on the nominal or the real rates of return. This applies also to normality and time dependency (auto-correlation) tests.

Over time a not-insignificant difference will gradually develop between the accumulated real rate of return, even in low inflation regimes. The accumulated real rate of return at year-end 2008 was around 18 per cent lower than the accumulated nominal rate of return (both measured in local currency), see Figure 5.5. The index for the real rate of return has an end value of around 113, while the nominal rate of return has an end value of 138.

The analysis shows that low, stable inflation "eats up" the return, but it does not influence the various statistical measures of risk, such as the standard deviation, skewness of the distribution or degree of fat tails. These results do not necessarily apply in a regime with high, variable inflation. A more detailed explanation of the analysis is provided in a separate documentation memorandum, which will be published on the Ministry of Finance's website (www.government.no/gpf).

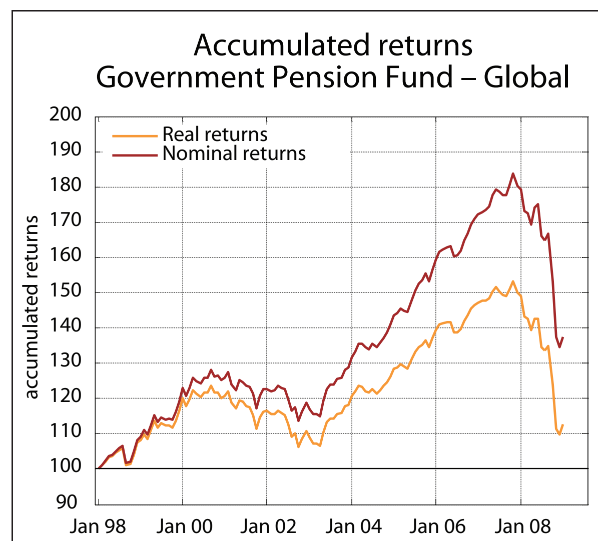

Figure 5.5 Accumulated rate of return on the Government Pension Fund – Global, measured nominally and in real terms in the Fund's currency basket. Index at year-end 1997 = 100

Source: Ministry of Finance and Norges Bank

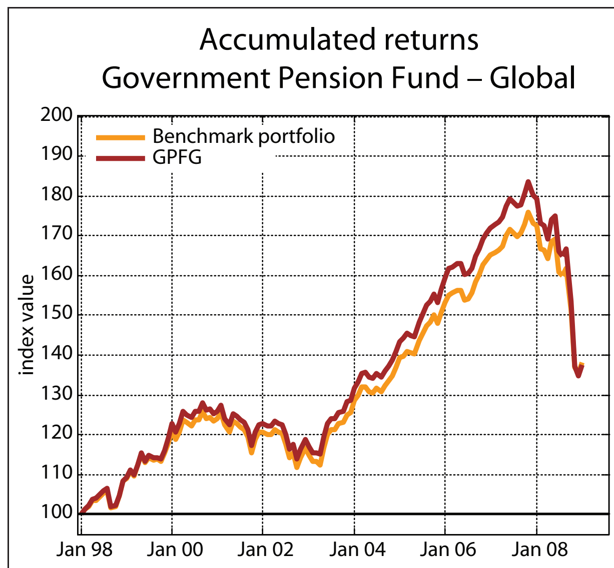

Figure 5.6 Accumulated rate of return on the Government Pension Fund – Global, measured in local currency. Index at year-end 1997 = 100

Source: Ministry of Finance and Norges Bank

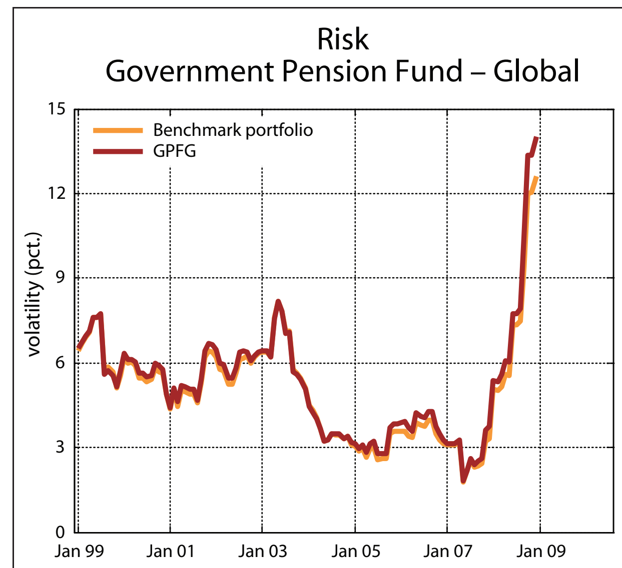

Figure 5.8 Rolling twelve-month standard deviation of the rate of return on the Government Pension Fund – Global and the Fund's benchmark portfolio, measured in local currency, 1998–2008.

Source: Ministry of Finance and Norges Bank

The high degree of correlation between the return and risk associated with the Fund, and the return and risk associated with the benchmark portfolio is illustrated in Figures 5.7 and 5.8. Both the level of the rate of return and variation in the rate of return are about the same for the two portfolios, with the exception of the last year and a half.

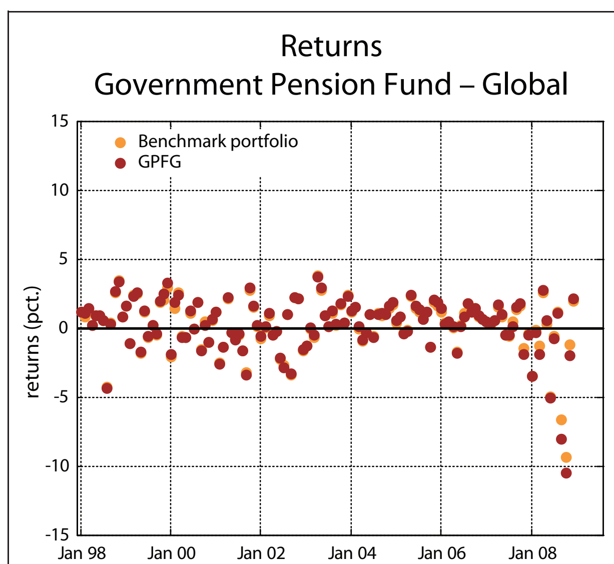

Figure 5.7 Rate of return on the actual portfolio of the Government Pension Fund – Global and the Fund's benchmark portfolio. Monthly return data, measured nominally in local currency. 1998–2008. Per cent

Source: Ministry of Finance and Norges Bank

The figures indicate that both the rate of return and the variation in the Fund's rate of return are mainly determined by the decisions relating to the establishment of the Fund's general investment strategy, which is operationalised through the definition of the benchmark portfolio. The analyses show that the Fund's rate of return can be attributed in full to the choices made by the Ministry in connection with the formulation of the Fund's investment strategy. In addition, the correlation between the rate of return on the Fund's actual investments and the rate of return on the benchmark portfolio has been very close to 1 (i.e. a perfect positive correlation), and the variations in rates of return on the benchmark portfolio have accounted for more than 99 per cent of the variations in Fund's rate of return during the period from 1998 to 2008.

With regard to the statistical characteristics of the rate of return on the actual portfolio, there are indications of skewness to the left and fat tails in the monthly rates of return for the Fund overall and for the equity and fixed income portfolios for the entire period as whole. Both tests for normality show that the hypothesis of normally distributed monthly rates of return for both the total portfolio and the equity portfolio for the entire

Table 5.3 Average annual rate of return (arithmetic) and annual standard deviation (actual tracking error) for the difference portfolio of the Government Pension Fund – Global, measured nominally in Norwegian kroner. Percentage points and per cent[1]

	Entire period	Last five years	Last three years	2008
Total portfolio				
Average excess return per year	-0.03	-0.57	-1.44	-4.22
Standard deviation	0.79	1.08	1.31	1.95
Information ratio	-0.03	-0.53	-1.10	-2.17
Equity portfolio				
Average excess return per year	0.52	0.39	-0.22	-1.70
Standard deviation	1.01	1.09	1.24	1.74
Information ratio	0.51	0.36	-0.18	-0.98
Fixed income portfolio				
Average excess return per year	-0.52	-1.40	-2.57	-6.67
Standard deviation	0.99	1.40	1.74	2.58
Information ratio	-0.53	-1.00	-1.48	-2.58

[1] The annual excess return is computed as the difference between the Fund's and benchmark portfolio's average monthly rate of return, annualised by multiplying by 12. This is referred to as percentage points in the table. The actual tracking error is computed as the standard deviation of the monthly excess return and annualised by multiplying by the square root of 12. The tracking error is listed in the table as a per cent.

Source: Ministry of Finance and Norges Bank

period as a whole can be rejected. In addition, statistical tests show no indications of auto-correlation in the rates of return on the actual portfolio.

The various statistical measures of risk associated with the fund mentioned above are influenced to a limited extent by whether the computations are based on nominal rates of return or real rates of return (see Box 5.2).

5.2.3 Performance o f the difference portfolio of the Government Pension Fund – Global

The rate of return on the difference portfolio of the Government Pension Fund – Global is defined as the rate of return on the Fund's actual portfolio less the rate of return on the benchmark portfolio. The excess return provides a measure of the magnitude of the contribution made by Norges Bank's active management to the Fund's overall return.

When using the rate of return on the benchmark portfolio to assess the performance of Norges Bank's active management, it should also be taken into account that the benchmark portfolio's rate of return would not have necessarily been achieved by just managing the Fund close to index. Pure index management would incur transaction costs whenever the composition of securities in the benchmark portfolio changed, when there was an inflow of capital to the Fund and when there were changes in the Fund's investment strategy. Index management may also generate relatively high lending income from securities in the portfolio. Such lending income can largely make up for the ordinary transaction costs associated with index management.

Table 5.3 illustrates the average excess return and the standard deviation of the excess return (actual tracking error) for the period from 1998 to 2008, measured in Norwegian kroner.[4] Norges Bank achieved an excess return for each individual year during the period from 1998 to 2006, but there has been a negative excess return for the last two years. Figure 5.9 shows the monthly excess rates of return for the period from 1998 to 2008. In 2008 the negative excess return was 4.2 percentage points, which is the poorest performance ever achieved in the entire history of the Fund. During the last five years Norges bank has achieved an average negative excess return of

[4] Table 5.3 shows the gross excess return. The gross excess return concept does, for example, not include transaction and management costs for index management, or extra management costs for active management.

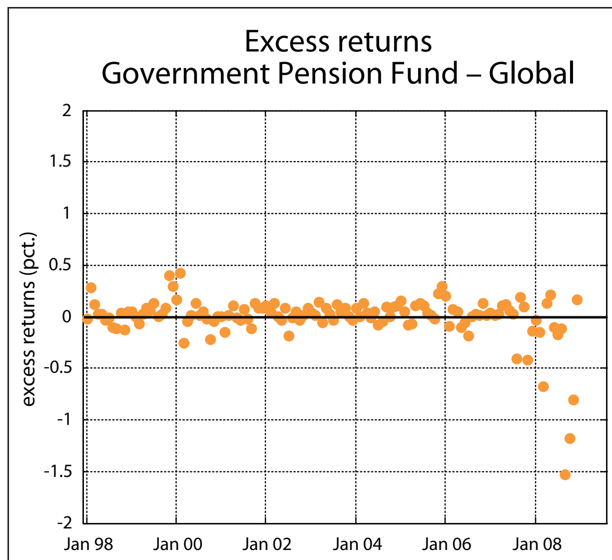

Figure 5.9 Excess return on the Government Pension Fund – Global. Monthly return data for 1998–2008. Per cent

Source: Ministry of Finance and Norges Bank

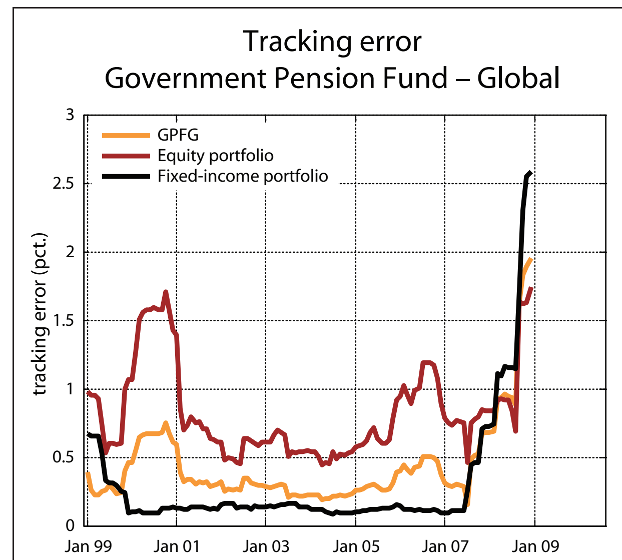

Figure 5.10 Development of the actual tracking error. Rolling twelve-month standard deviation of the excess return. 1998–2008. Per cent

Source: Ministry of Finance and Norges Bank

-0.57. The results are characterised to a large extent by the poor performance of active management in 2007 and 2008. For the entire period from 1998 to 2008 as a whole an average negative excess return of 0.03 percentage points has been achieved. In comparison an average excess return of 0.39 percentage points had been achieved for the entire period at year-end 2007.

The information ratio, as illustrated in Table 5.3, is calculated as the ratio between the average excess return and the actual tracking error. The information ratio is used as an indicator of the quality of active management in some contexts. The ratio expresses how large the excess return has been for each unit of risk involved, and it can be used for comparing different managers, and for assessing the performance of the same manager over time. According to the table the information ratio for the entire period from 1998 to 2008 was -0.03, which is a decline from 0.93 at year-end 2007. This result indicates that there has been a small negative excess return for each unit of risk involved.

The information ratio should be interpreted with care. A manager with a portfolio that does not deviate much from the benchmark portfolio will have a relatively low tracking error, and even a small excess return may result in a high information ratio. It is also the case that the information ratio would be expected to vary across different types of active management. An investor should primarily be concerned about maximising the excess return measured in Norwegian kroner or in percent at a given risk level, and not with maximising the information ratio. It also appears obvious that the information ratio is not very suitable as an evaluation criterion for the type of strategies that have characterised the fixed income management (see discussion below).

Figure 5.10 illustrates the developments of the actual tracking error. Since the summer of 2007 there has been a significant increase in the tracking error, and this can be attributed in part to the unrest in the financial markets, as well as the bank's positions in the active management. The increase is particularly pronounced for the fixed-income portfolio. The risk associated with the active management over the last five years, measured by the actual tracking error, is 1.1 per cent. The actual tracking error for the entire period as a whole is calculated to be 0.79 per cent.

The expected tracking error shall not exceed 1.5 per cent for the total portfolio, in accordance with the limit set by the Ministry. Use of the risk allowance has been relatively low for many years. Norges Bank's use of the risk allowance has, however, increased markedly since the summer of 2007.

The actual portfolio of the Government Pension Fund – Global can be regarded as consisting of two portfolios: the benchmark portfolio and the difference portfolio. Consequently, the risk asso-

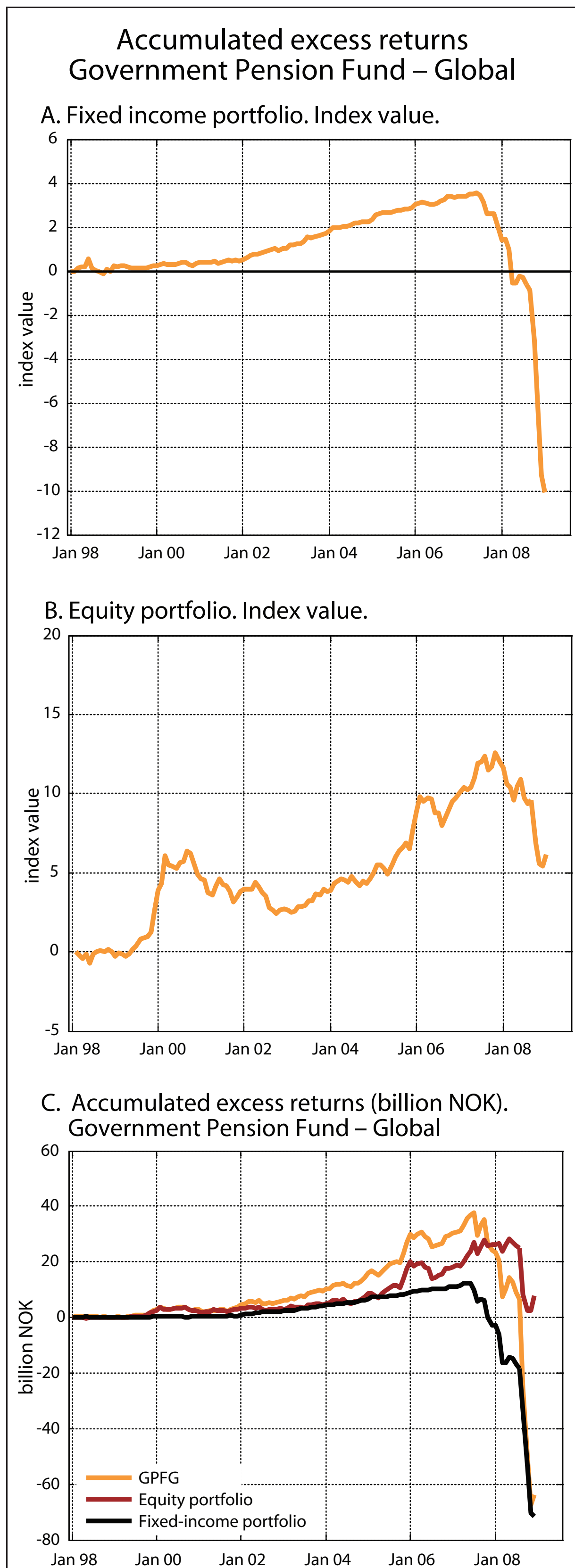

Figure 5.11 Accumulated excess return for the Government Pension Fund – Global.

Source: Ministry of Finance and Norges Bank

ciated with the Fund will depend on the risk associated with the benchmark portfolio, the risk associated with the difference portfolio (tracking error), and the covariation between the rate of return on the benchmark and difference portfolios.

There has been little difference between the absolute risk of the Fund and the absolute risk of the benchmark portfolio when we look at the entire period as a whole (see Figure 5.8). This is attributed, for example, to the fact that there has in general been a low correlation between excess return and the rate of return on the benchmark portfolio. For the entire period from 1998 to 2008, this correlation coefficient has been calculated to be 0.15. The correlation coefficient has been increasing during the last year and a half, and the rolling twelve-month correlation was 0.23 at year-end 2008.

Table 5.3 also illustrates the excess return from the equity and fixed income management, respectively. The excess return on equity management was -1.7 percentage points in 2008, which was the poorest performance ever since the establishment of the Fund. Equity management has delivered a positive excess return for the entire period as a whole (0.52 percentage points). The tracking error for equity management is calculated to be 1.01 per cent as an annual average for the entire period. The information ratio for equity management is estimated to be 0.51 per cent for the same period.

Last year there was a substantial negative excess return (-6.7 percentage points) for the active fixed income management, which was the poorest performance in the history of the Fund. This contributed greatly at the same time to the negative excess return for the Fund overall this year. The average annual excess return for the entire period has been negative (-0.52 percentage points). The tracking error for fixed income management has been calculated at the same time to be 0.99 per cent as an annual average. The information ratio for the entire period is estimated to be -0.53.

The development of Norges Bank's active fixed income management is illustrated in Figure 5.11a, which shows a substantial fall in the accumulated excess return since the second half of 2007. Figure 5.11c also illustrates that the accumulated value creation for fixed income management measured in Norwegian kroner was negative for the entire period as a whole by around NOK 70 billion. Figures 5.11b and 5.11c illustrate

Box 5.3 Norges Bank's decomposition of contributions to negative excess return by active management

Norges Bank's report on the management of the Government Pension Fund – Global in 2008 explains the distribution of the contributions to negative excess by the equity and fixed income management across the various management strategies. Norges Bank states that the negative excess return for equity management was 1.15 percentage points in 2008, measured in local currency, while the negative excess return for fixed income management is listed as 6.6 percentage points, measured in local currency. Norges Bank explains the contributions to negative excess return by active management below.

Equity management

Norges Bank points out in its annual report that the point of departure for equity management is an index portfolio that ensures that the Fund has the desired exposure to the equity market at any given time, with low costs and risk in relation to the benchmark portfolio. The bank bases its active management of the equity portfolio on four different strategies, which have made the following contributions to the negative excess return by equity management in 2008.

- *Enhanced indexing* strategies exploit the differences in value between closely related equities. Examples of such situations include companies with shares listed on different stock exchanges, or companies that have different classes of shares with different rights. As a result of the financial crisis the risk allowance for many investors who take positions like this were quickly restricted or rescinded. Many players desired to reduce their positions at the same time. A number of the Fund's positions in the enhanced indexing strategy experienced abnormally large price movements. The bank writes that the major movements resulted in investments of this type experiencing a negative contribution that represents around 35 per cent of the negative excess return by equity management.
- *Capital injections* are a strategy based on exploiting the size and long-term time horizon of the Fund. Norges Bank participated in six capital injections in 2008, two of which made a positive contribution. Combined, these positions can account for around 20 per cent of the negative excess return by equity management.
- *Internal sector mandates* are managed by specialists in the selected sectors. The so-called fundamental comparative analysis of individual companies in relation to similar companies in the same business sector forms the basis for investment decisions. As a result of the financial crisis investors changed from identifying companies that could give a positive surprise on the income side to avoiding companies that are dependent on a well-functioning credit market. This entailed a substantial change in what equities yielded the best relative return. Overall the internal sector mandates made a negative contribution that represents around 30 per cent of the equity portfolio's negative excess return. The majority of this loss was from positions in the banking sector and in the US.
- *External mandates* are managed by specialists for individual countries, regions or sectors. The investment decisions are based on fundamental analysis. Overall 19 per cent of the value of the equity portfolio is managed by external managers. The external equity management mandates made a negative contribution that represents around 15 per cent of the equity portfolio's negative excess return.

Fixed income management

The bank points out in its annual report that the fixed income portfolio was very underweight in government bonds. When the financial crisis evolved into a fundamental crisis of confidence in the financial system, the Fund was not properly positioned. The active management of the fixed income portfolio can be described through five different strategies, which have made the following contributions to the negative excess return by equity management in 2008.

Box 5.3 (cont.)

- Investments in *mortgage-backed bonds* contributed to around 40 per cent of the negative return by fixed income management in 2008. The financial crisis started with falling prices for securities issued with security in subprime US mortgage loans. The bank writes that fixed income management was only exposed to these securities to a limited extent. However, the bank had a great deal of exposure to the market for high quality mortgage-backed bonds. Housing prices fell sharply in the US throughout 2008, and the number of loans in default increased. Therefore the mortgage-backed bond market experienced a substantial fall in the value of the underlying assets last year.
- *Money market investments* represented around 10 per cent of the negative return by fixed income management in 2008. Norges Bank has lent out securities and reinvested cash that was furnished as security for such loans at higher interest rates through various money market investments. Parts of the underlying assets linked to these investments were linked to market segments that continued to fall sharply in value throughout 2008.
- *Investments in bank bonds* represent nearly a third of the negative excess return by fixed income management. At year-end 2008 Norges Bank had large positions in various portions of the banks' capital structure. Bonds with various functions in the capital structure have different rights if a bank goes bankrupt. Norge Bank's fixed-income management was particularly exposed to the riskiest segment of the banks' debt financing. Fixed-income management built up large positions linked to the bonds with pre-emptive rights segment. The investments were primarily made as an alternative to owning government bonds. The opportunity to trade these securities was significantly reduced throughout 2008.
- The *relative value* strategies represent around 10 per cent of the negative excess return by fixed-income management. At the start of 2008 fixed-income management had large positions in interest rate swaps. Norges Bank had essentially a structure where cash flows were swapped between government securities and other bonds with a very high credit rating. Such positions would show a running profit under normal market conditions. In 2008 the credit and liquidity premiums rose far higher than what was priced into the interest rate swaps.
- Investments in *real interest rate bonds* represent around 10 per cent of the negative excess return by fixed-income management. Fixed-income management has held large positions in a number of markets. Such positions have in particular accounted for a large portion of the fixed-income portfolio in Japanese yen. Real interest rate bonds fall in value when inflation expectations fall. The impact on the pricing of real interest rate bonds in Japanese yen was substantial in 2008.

correspondingly the development of the equity management. The figure illustrates that the events after the summer of 2007 had less impact on the accumulated excess return for the equity management, relatively speaking. The accumulated value creation for equity management measured in Norwegian kroner is positive for the entire period as a whole by around NOK 6 billion, which means that the accumulated value creation for the Fund overall is negative by NOK 64 billion for the entire period. The calculated negative excess return measured in Norwegian kroner must be viewed in the context of the fact that the greatest negative rate of return has occurred during the last two years, since the value of the Fund's assets has been higher than before.

Norges Bank's report on the management of the Government Pension Fund – Global in 2008 points out that the negative excess return last year was significantly greater than the bank had expected, based on an active management strategy with many small independent investments. It is also pointed out that the poor performance is attributed primarily to the fact that the risk diversification of the bond investments was less than the bank had assumed, and that too many investments had been made that had a shared exposure

to underlying systemic risk (liquidity risk and credit risk). Large positions that had been built up in a situation where the risk premium on liquidity and credit was low fell in value simultaneously when the market was driven by major changes in the valuation of these risk factors. The bank's report explains in more detail how the negative excess return for fixed income management breaks down across the various investments. The greatest contributions to negative excess return are from investments in mortgage-backed bonds and from investments in financial institutions, see Box 5.3.

The realised losses on these investments still represent a small portion of the total negative excess return. The current yield is high, which not only reflects that credit risk has increased, but also high liquidity and risk premiums in the markets. The valuation of these bonds is an estimate of their real value in the current market conditions. Estimates will be subject to change, reflecting developments in the markets. Norges Bank states that they are expecting to hold most of these securities until maturity. The face value will be received on maturity for all the securities that have not defaulted.

The Ministry described the development of the excess return achieved for the fixed income portfolio in Report no. 16 (2007–2008) to the Storting. It is pointed out therein that Norges Bank profited from liquidity and credit premiums over a long period of time, and that this is analogous to selling insurance against liquidity and credit crises. The crisis that occurred in the credit markets in the autumn of 2007 and continued in 2008 resulted in large losses in value on these positions. This is analogous to an insurance company that has to pay out insurance to policyholders when an accident occurs. This type of active management strategy illustrates the importance of adopting a long-term time horizon when evaluating the performance of the management. It also appears obvious that the information ratio is not very suitable as an evaluation criterion for strategies of this type.

Figure 5.12a indicates that the rates of excess return are skewed to the left and have fat tails. This impression is confirmed by Figure 5.12b, which shows that there are clear indications that the assumption of normally distributed rates of excess return is not justified, since rates of excess return are observed that are much lower than would normally be expected. Statistical tests confirm skewness to the left for the Fund overall and for the equity and fixed income portfolios for the entire period as a whole, and for the two sub-periods 2004–2008 and 2006–2008 (the values of the test observator are statistically significant). Statistical tests also show that the hypothesis of normally distributed rates of excess return can be rejected for the Fund overall and for the equity and fixed income portfolios for the entire period as a whole. Consequently, caution should be exercised when basing probability statements on the risk associated with the difference portfolio exclusively on the tracking error. When a risk allowance for active management is to be set, it will be natural to take into account any deviations from the assumption of normality (see the more detailed discussion in Section 1.5 and Chapter 6).

According to Figure 5.12c, which illustrates the empirical cumulative probability distribution of the rates of excess return, the Fund's minimum excess return is computed to be -1.5 per cent and the maximum monthly return is computed to be 0.4 per cent. The figure illustrates that the excess return has been lower than -0.2 per cent in 10 per cent of all months. The percentile chart in Figure 5.12d shows that the Fund's excess return in 10 per cent of the months has been less than or equal to -0.2 per cent. Correspondingly, the excess return on the equity portfolio has been less than or equal to -0.3 per cent, and the rate of return on the fixed income portfolio has been less than or equal to -0.1 per cent, in 10 per cent of the months.

The evaluation of active management performance and establishment of a risk allowance for active management (expected tracking error) are based on the assumption that the risk is linearly independent over time. It is therefore of key importance to investigate the extent to which the excess rates of return are correlated over time. Statistical tests for auto-correlation show that the hypothesis of independence over time in the rates of return can be rejected for the Fund overall and for the fixed income portfolio for the entire period as a whole and the last five years.

5.2.4 External evaluation of the management performance of the Government Pension Fund – Global

The Ministry receives annual reports from Mercer Investment Consulting, WM Company and CEM Benchmarking Inc. concerning the management of the Government Pension Fund – Global (see Boxes 5.4 and 5.5). The Ministry has com-

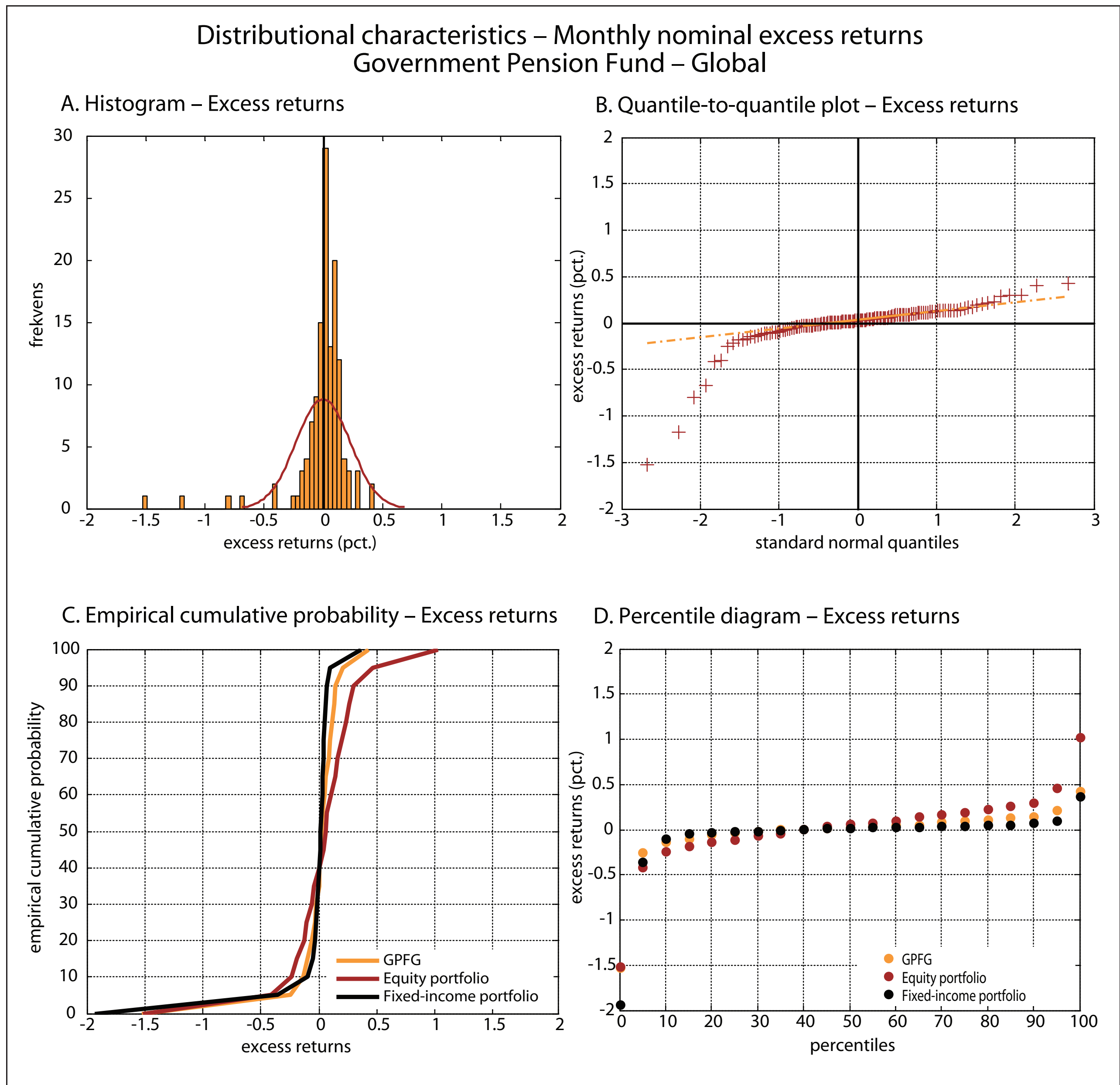

Figure 5.12 Distribution characteristics of the monthly excess return (measured nominally in Norwegian kroner) for the Government Pension Fund – Global

Source: Ministry of Finance and Norges Bank

missioned Mercer to verify and analyse the rate of return on the Government Pension Fund – Global. In the annual report for 2008, Mercer points out that its independent computations of the rate of return and market value for the Fund are in conformity with the computations by Norges Bank. In the instances where the return does not agree with Norges Bank's computations, the bank has provided a satisfactory explanation for the deviations.

Comparison of the performance of the Government Pension Fund – Global with the performance of other major institutional managers forms an important part of the analysis of Norges Bank's active management. According to the analyses from CEM and WM Company, the excess return on the Government Pension Fund – Global is somewhat lower than that of comparable funds. However, such comparisons are problematic because the opportunity to generate an excess return will vary with the investment limits and guidelines established in respect of the funds. Both the Government Pension Fund – Global and other funds have benchmark portfolios that do

Box 5.4 Comparison of the rate of return and costs of management of the Government Pension Fund – Global with major pension funds

The Ministry of Finance has commissioned CEM Benchmarking Inc. (CEM) to prepare an extensive annual report that compares the rate of return, excess return and management costs of the Government Pension Fund – Global with those of other large funds. This report is published in the second quarter annually. The most recently published report contains, therefore, only data up until 2007. The reference group consists of the largest funds in the CEM survey (12 US, 3 Canadian and 2 European funds). In addition, the Fund's rate of return is compared with the rate of return of 25 European funds. The median size of the reference group was around EUR 85 billion in 2007. The average market value of the Government Pension Fund – Global was EUR 240 billion in 2007. The data used are based on self-reporting by the funds that acquire services from CEM.

Excess return up until 2007

A comparison over time of the actual rate of return on the Government Pension Fund – Global and the rate of return on the benchmark portfolio shows the excess return generated by Norges Bank. Figure 5.13 illustrates the average excess return and tracking error for the five-year period from 2003 to 2007 for the Government Pension Fund – Global and the various reference groups. The figure shows that the Government Pension Fund – Global, like the majority of the other funds, has had a positive excess return during this period. It is also evident that the Government Pension Fund – Global distinguishes itself from most other funds by less variation in its excess return, i.e. less tracking error.

CEM has calculated that the Government Pension Fund – Global achieved an average annual excess return of 0.4 percentage points over the five-year period until 2007. In comparison, the most typical excess return (median) was 0.4 percentage points for the European funds and 1.2 percentage points for the reference group. The analyses also show that the excess return of the Government Pension Fund – Global has been achieved with considerably less tracking error than the other funds.

Both the reference group and the European funds have generated an excess return in asset classes in which the Government Pension Fund – Global is not invested. Comparison of the excess return from fixed income and equity management with the fixed income and equity management of other funds provides, therefore, a better illustration as to how Norges Bank has succeeded in comparison with other managers. The average excess return from equity management over the five-year period was 1.0 percentage points, while the median for the reference group was 0.6 percentage points. The average excess return from fixed income management over the period was 0.1 percentage points, while the median rate of return for the reference group was 0.5 percentage points. The analyses also show that the variation in the excess return from equity management for the Government Pension Fund – Global during the period up until 2007 is on par with what is normal for other funds, while the variations in fixed income management are somewhat less than what is typical for other funds.

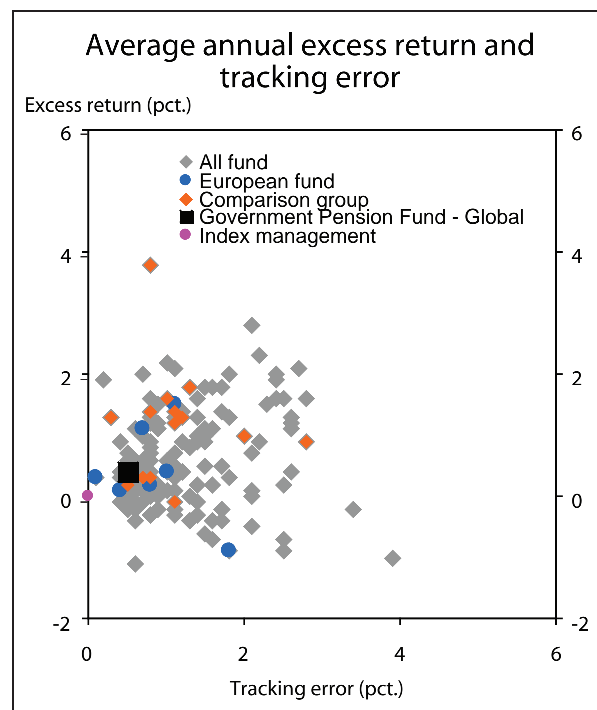

Figure 5.13 Average annual excess return and actual tracking error for the Government Pension Fund – Global and other funds. 2003–2007. Per cent

Box 5.4 (cont.)

Management costs up until 2007

The CEM report shows that Norges Bank's overall management costs in 2007 for the Government Pension Fund – Global were 0.094 per cent (i.e. over 9 basis points) of the average assets under management. With the exception of the Government Pension Fund – Norway, these represent the lowest management costs of all the funds from which CEM collects data. Since the overall management costs largely reflect the asset structure of the funds, which follows from the Ministry of Finance's investment strategy as far as the Government Pension Fund – Global is concerned, such comparisons do not fully clarify whether Norges Bank's management is cost effective.

CEM has, therefore, prepared a cost benchmark based on the asset structure of the Government Pension Fund – Global. The cost benchmark indicates what costs the reference group – the world's largest pension funds – would have incurred with the same asset structure as the Fund. The analysis shows that actual management costs in 2007 were 0.02 percentage points lower than the cost benchmark. This is primarily due to Norges Bank having chosen more internal management than the reference group. Internal management is considerably less expensive than external management. In addition, Norges Bank has paid less for external management than comparable funds.

Benchmark portfolio's rate of return up until 2007

The Ministry of Finance has established a benchmark portfolio for the Government Pension Fund – Global. The analyses by CEM show that the average annual rate of return on the benchmark portfolio for the Government Pension Fund – Global over the five-year period until 2007 was 8.5 per cent, measured by the currency basket of the benchmark portfolio. Correspondingly, the median return was 13.9 per cent and 10.2 per cent for the reference group and the European funds, measured by the home currency of each fund.

Comparison of the aggregate rate of return between funds is difficult because different funds have different currency compositions and different benchmark currencies. Exchange rate fluctuations imply that the rate of return will depend on the benchmark currency that is used. During the five-year period until 2007, for example, the rate of return on the Fund's benchmark portfolio measured in Euro was 7.5 per cent, while it was 12.7 per cent measured in USD.

The difference in the benchmark portfolio's rate of return will also be the result of differences in terms of asset classes and regional composition. Up until now the Government Pension Fund – Global has distinguished itself from other large pension funds by a smaller equity portion and the fact that the Fund has not invested in real estate and unlisted equities. CEM has calculated that if the other funds had featured the same asset class composition as the Government Pension Fund over the five-year period until 2007, their annual indexed rate of return would have been reduced by 1.7 percentage points for the reference group and 2.8 percentage points for the European funds. This difference is attributable primarily to the fact that other funds have featured higher allocations to listed and unlisted equities and real estate. In historical terms, this five-year period has been a good period as far as the real estate market is concerned. The Government Pension Fund – Global also distinguishes itself other funds by diversification over many markets and currencies, while most of the pension funds in the reference group hold the majority of their investments in their domestic markets.

The investment strategy underpinning the composition of the benchmark portfolio is based on trade-offs between long-term return expectations and risk in the capital markets (see Chapter 2). In such a perspective a five-year period is short. If the comparisons had been made for a different five-year period, the findings might have been different.

A summary of the analyses for 2007 is published on the Ministry of Finance's website (www.government.no/gpf). The report for 2008 will be published when it is available.

Box 5.5 Comparison of the excess return of the Government Pension Fund – Global with the excess return of other funds

WM Performance Services has prepared a report for 2008 that compares the excess return of the Government Pension Fund – Global with institutional funds. These funds include, pension funds, life insurance companies and government investment funds. The total market value of these funds was NOK 10,500 billion at year-end 2008.

The data used by WM Performance Service deviate from those used by the CEM survey. CEM does, for example, not cover funds in the UK, but UK funds represent the majority of the funds in the data used by WM Performance Services. Another distinction is the fact that the funds in the CEM survey have a far higher average market value.

Figure 5.14 illustrates the average excess return and tracking error for the Government Pension Fund – Global and other funds for the last three years. The figure also displays the results for the 15 and 50 largest funds. In 2008 these two groups had an average market value of NOK 320 billion and NOK 42 billion, respectively. In comparison the Government Pension Fund – Global had a market value last year, calculated as a monthly average, of NOK 2,063 billion.

The figure shows that the Government Pension Fund – Global, like the majority of the other managers, has had a negative excess return during this period. The Fund distinguishes itself from other funds by less variation in its excess return, i.e. less tracking error.

WM Performance Services has calculated that the most typical excess return (median) for all the funds in the survey is zero for both the three-year and five-year period until year-end 2008. For both of these periods the excess return of the Government Pension Fund – Global has been poorer than the average for other funds. This is a major change from year-end 2007 when the Fund's excess return was close to the 25 per cent best funds.

The relationship between the excess return and relative risk is often described by means of the information ratio (IR). WM Performance Services states that an IR of 0.5 is often characterised as good, and it indicates that the Government Pension Fund – Global has achieved an exceptionally high IR until recently. The rate of return for the last six quarters has, however, entailed a negative excess return of 1.4 percentage points and an increase in the tracking error from 0.3 per cent to 1.3 per cent. As a result of this the IR for the last three years is -1.1. WM Performance Services writes that the degree of negative excess return is surprising, viewed in the context of the Fund's size and degree of risk diversification over many different management mandates.

The report from WM Performance Services also contains a comparison of the excess return of the equity and fixed income portfolios with other funds. The analyses show that even if equity management had had a significant negative excess return in 2008, the equity portfolio has generated an excess return in both the three-year and five-year periods up until year-end 2008. In both these periods equity management has generated a higher excess return than the average for the other managers.

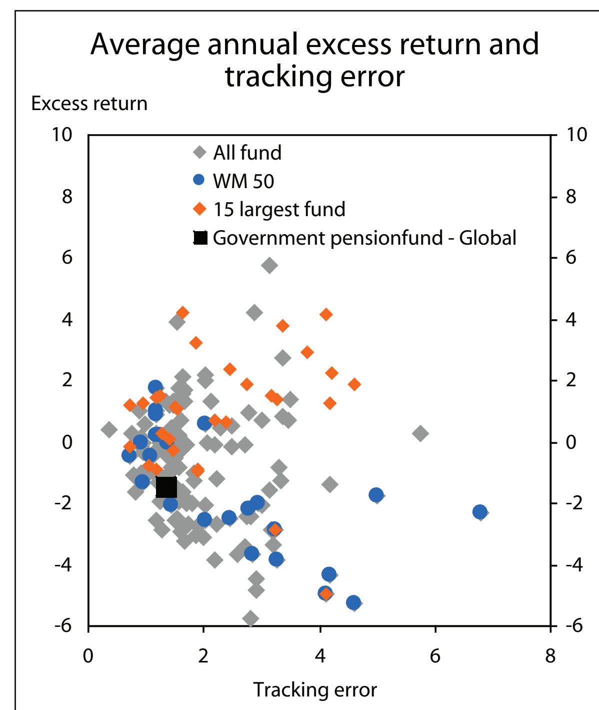

Figure 5.14 Average annual excess return and actual tracking error for the Government Pension Fund – Global and other funds. 2006–2008. Per cent

Source: Ministry of Finance and WM Performance Services

Box 5.5 (cont.)

It is the bond portfolio that is the primary source of the Fund's negative excess return. WM Performance Services points out that, taking into account the other funds, the size of the bond portfolio, and the diversification of the management mandates, the performance of the bond portfolio is very poor.

In comparison with other funds, WM points out that most major funds received less than 5 per cent of their value at the start of the year during a particular year, while the Government Pension Fund – Global received almost 20 per cent of its value at the start of the year in 2008. WM Performance Services points out that investing so much capital in both absolute terms and relative to the size of the fund makes it more difficult to generate an excess return.

The report for 2008 has been published on the Ministry of Finance's website (www.government.no/gpf).

not include all the types of assets in which the funds can possibly invest. Normally, it is easier to achieve excess return relative to such a benchmark than to measure the rate of return against a more comprehensive benchmark that more accurately reflects developments in the value of all types of assets in which the Fund can conceivably invest.

Comparable funds have generated an excess return in asset classes in which the Government Pension Fund – Global is not invested. Comparison of the excess return from fixed income and equity management with the fixed income and equity management of other funds provides, therefore, a better illustration as to how Norges Bank has succeeded in comparison with other managers. The average excess return from the equity management has been high compared with other funds until 2008. Analyses performed by WM Performance Services, which also cover 2008, show that even after substantial negative excess return in 2008 the performance of the equity portfolio is better than the average for others funds over periods of three and five years. It is the fixed income portfolio that is the primary source of the Fund's negative excess return. WM Performance Services states that, in relation to the other funds, the size of the fixed income portfolio and the diversification of the management mandates, the performance of the fixed income portfolio is very poor.

5.3 Performance of the Government Pension Fund – Norway[5]

5.3.1 Developments in the benchmark portfolio of the Government Pension Fund – Norway

The rate of return on the Government Pension Fund – Norway depends largely on market developments for the benchmark portfolio defined by the Ministry. The combined benchmark portfolio for the Government Pension Fund – Norway consists of four sub-benchmarks. The actual composition of the benchmark portfolio for equities consists of indices from the providers Oslo Børs VPS and VINX for Norway and the Nordic region (Denmark, Finland and Sweden) respectively.[6] In 2008, the benchmark portfolio for Norwegian fixed income investments consisted in part of a synthetic index that reflects the performance of the Norwegian bond market, and in part by fixed income instruments that are included in the Barclays Capital Global Aggregate Norway index. The benchmark portfolio for investments in Nordic fixed income instruments consist of bonds that are included in the Barclays Capital Global Aggregate Scandinavia index[7].

The rate of return on, and risk associated with, the Fund's benchmark portfolio, and the four sub-benchmarks are listed in Table 5.4. The average

[5] The performance analysis is based on data from Folketrygdfondet and computations using such data, carried out by the Ministry of Finance.

[6] The benchmark portfolio consists of the equities included in the Oslo Børs Benchmark Index (OSEBX) and VINX Benchmark (VINXV). The Nordic equity benchmark was established in 2007.

[7] Investments in Nordic fixed income securities started in February 2007.

Table 5.4 Average annual rate of return (arithmetic) and annual standard deviation of the rate of return on the benchmark portfolio for the Government Pension Fund – Norway, measured nominally in Norwegian kroner, 1998–2008. Per cent[1 2]

	Entire period	Last five years	Last three years	2008
Total benchmark portfolio				
Average rate of return per year	3.86	1.70	-4.77	-31.22
Standard deviation	8.53	11.70	14.21	21.79
Equity benchmark – Norway				
Average rate of return per year	4.91	9.13	-8.22	-65.94
Standard deviation	25.05	25.94	29.52	43.30
Equity benchmark – Nordic region				
Average rate of return per year	0.95	4.79	-6.08	-43.37
Standard deviation	22.87	18.06	19.58	24.19
Fixed income benchmark – Norway				
Average rate of return per year	5.74	4.44	3.85	7.61
Standard deviation	2.92	2.83	2.26	2.73
Fixed income benchmark – Nordic region				
Average rate of return per year	13.27	13.27	13.27	22.66
Standard deviation	8.59	8.59	8.59	9.98

[1] For equity investments in the Nordic region the period is from June 2001 to 2008. For fixed income investments in the Nordic region the period is from February 2007 to 2008.
[2] Calculated as an arithmetic average based on monthly rates of return (see in Section 5.1).

Source: Ministry of Finance and Folketrygdfondet

rate of return on the Fund's benchmark portfolio for the last five years was 1.7 per cent, which is significantly lower than the average rate of return for the last five years at year-end 2007 (11.3 per cent). This fall in the average annual rate of return reflects the very poor rate of return last year (-31.2 per cent) as a result of the sharp fall on the Norwegian and Nordic stock markets. The weak rate of return in 2008 also contributes significantly to a reduction in the average rate of return for the entire period as a whole, from 7.4 per cent at year-end 2007 to 3.9 per cent at year-end 2008.

For the last five years and the entire period as a whole the average rate of return on the Norwegian equity market has been more than 4 percentage points higher than the rate of return on the Nordic equity market. The rate of return on the Norwegian equity market for the last five years has been around 4¾ percentage points higher than the average rate of return on the Norwegian bond market. The high rate of return on the Nordic bond market in 2008 is due primarily to a weakening of the Norwegian krone throughout 2008 against the currencies that are included in the benchmark portfolio for the Nordic fixed

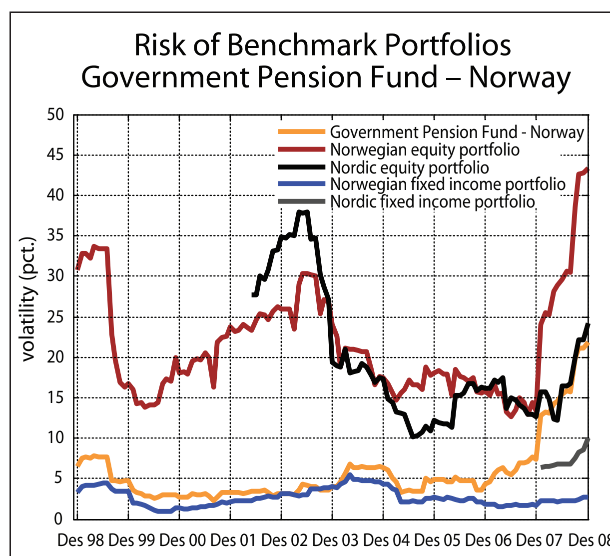

Figure 5.15 Risk associated with the benchmark portfolios for the Government Pension Fund – Norway. Rolling twelve-month standard deviation of the rate of return measured nominally in Norwegian kroner, 1998–2008. Per cent

Source: Ministry of Finance and Folketrygdfondet

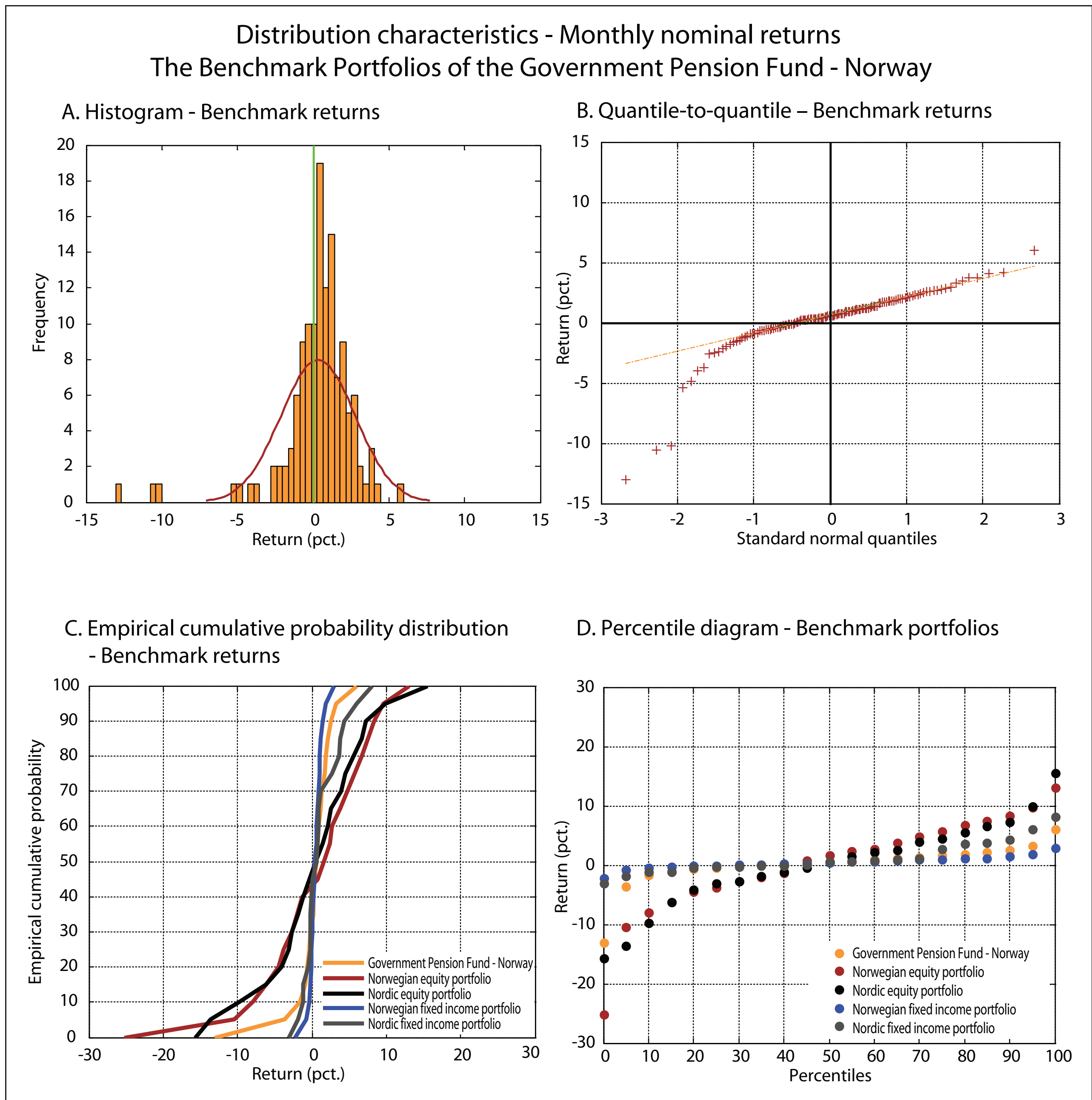

Figure 5.16 Distribution characteristics of the monthly return (measured nominally in Norwegian kroner) for the benchmark portfolios for the Government Pension Fund – Norway

Source: Ministry of Finance and Folketrygdfondet

income investments. The weakening krone has contributed correspondingly to the rate of return on the Nordic equity benchmark being significantly less negative than the rate of return on the Norwegian equity market.

The risk associated with the benchmark portfolio for the Government Pension Fund – Norway, measured as the standard deviation of the rate of return, has increased considerably in recent years (see Figure 5.15). For the most recent five-year period, the annual risk was 11.7 per cent. This is more than 3 percentage points higher than the level for the entire period as a whole. The volatility of the rate of return on the Fund's benchmark portfolio has primarily been driven by significant fluctuations on the Norwegian and Nordic stock markets.

Fluctuations in the Norwegian equity market have been somewhat higher than in the Nordic market for the entire period as a whole. This difference has become more pronounced in recent

years, and during the last five-year period the average risk in the Norwegian equity market was close to 6 percentage points higher than the Nordic market. This must be seen in connection with the significant weakening of the krone in 2008. The risk associated with the Norwegian fixed income benchmark has been relatively low throughout the entire period.

Figure 5.16a shows clear indications that the rate of return on the Fund's benchmark portfolios has been skewed to the left and has fat tails, while Figure 5.16b shows that the normal distribution assumption is not justified. The statistical tests confirm that the rates of return are skewed to the left and have fat tails for the entire period as a whole, as well as for the sub-periods 2004–2008 and 2006–2008. Both normality tests also show that the hypothesis of normally distributed rates of return can be rejected for the entire period as a whole, as well as for the two sub-periods (excluding the sub-period 2006–2008 for one of the tests). The auto-correlation tests also show that there is a relatively low degree of time dependency for the rates of return on the Fund's total benchmark.

In accordance with the empirical cumulative probability distribution in Figure 5.16c, the minimum rate of return on the Fund's benchmark portfolio is estimated to be around -13 per cent, and the maximum monthly rate of return is estimated to be 6 per cent. The variance is much greater for the Norwegian and Nordic equity benchmark, while it is less for the Nordic fixed income benchmark. The percentile chart in Figure 5.16d shows that the rate of return on the total benchmark in 10 per cent of the months has been less than or equal to -2.5 per cent. Correspondingly, the rate of return on the Norwegian equity benchmark has been less than or equal to -8 per cent and the rate of return on the fixed income benchmark has been less than or equal to -0.5 per cent.

5.3.2 Performance of the actual portfolio of the Government Pension Fund – Norway

The actual portfolio of the Government Pension Fund – Norway deviates somewhat from the benchmark portfolio, and this can be attributed primarily to active investment decisions on the part of Folketrygdfondet. The objective of such deviations is to achieve a higher rate of return on the actual portfolio than on the benchmark portfolio, within the defined risk limit for deviations from the benchmark portfolio. The rate of return

Table 5.5 Average annual return (arithmetic) and annual standard deviation of the rate of return on the Government Pension Fund – Norway, measured nominally in Norwegian kroner. 1998–2008. Per cent[1 2]

	Entire period	Last five years	Last three years	2008
Actual total portfolio				
Average rate of return per year	4.42	2.55	-2.09	-26.54
Standard deviation	7.90	10.86	13.44	20.55
Actual equity portfolio – Norway				
Average rate of return per year	6.62	9.88	-4.16	-57.62
Standard deviation	23.40	23.96	27.60	40.66
Actual equity portfolio – Nordic region				
Average rate of return per year	1.87	6.41	-3.34	-36.65
Standard deviation	22.36	17.19	18.28	22.20
Actual fixed income portfolio – Norway				
Average rate of return per year	5.50	4.09	4.21	8.35
Standard deviation	2.54	2.36	2.51	3.55
Actual fixed income portfolio – Nordic region				
Average rate of return per year	12.71	12.71	12.71	21.72
Standard deviation	8.33	8.33	8.33	9.55

[1] For equity investments in the Nordic region the period is from June 2001 to 2008. For fixed income investments in the Nordic region the period is from February 2007 to 2008.
[2] Calculated as an arithmetic average based on monthly rates of return (see Section 5.1).

Source: Ministry of Finance and Folketrygdfondet

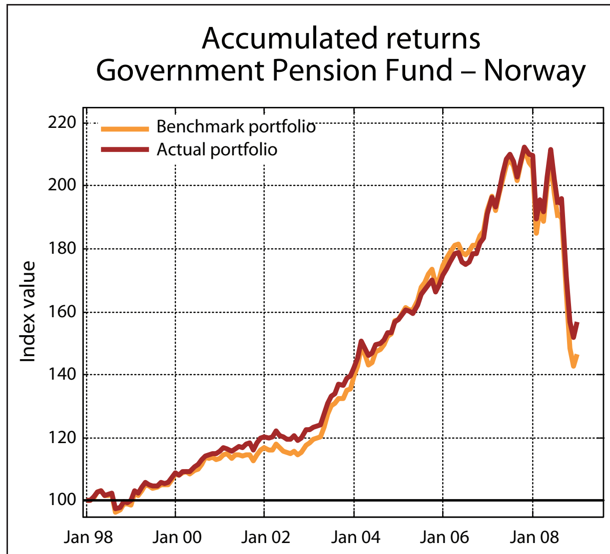

Figure 5.17 Accumulated total rate of return on the Government Pension Fund – Norway, measured nominally in Norwegian kroner. Index at year-end 1997 = 100

Source: Ministry of Finance and Folketrygdfondet

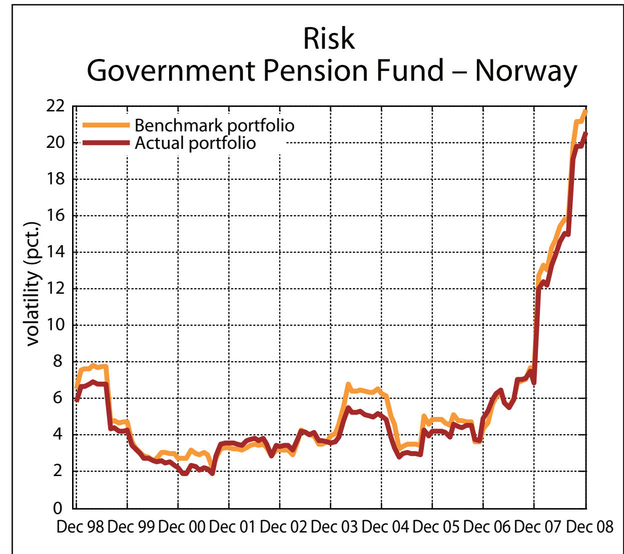

Figure 5.19 Rolling twelve-month standard deviation of the rate of return on the Government Pension Fund – Norway and the Fund's benchmark portfolio, measured nominally in Norwegian kroner. 1998–2008. Per cent

Source: Ministry of Finance and Folketrygdfondet

on and risk associated with the actual portfolio will, therefore, deviate somewhat from the rate of return on and risk associated with the benchmark portfolio. The Fund's rate of return and risk are presented in Table 5.5.

Tables 5.4 and 5.5 illustrate that the average rate of return on the actual portfolio has been

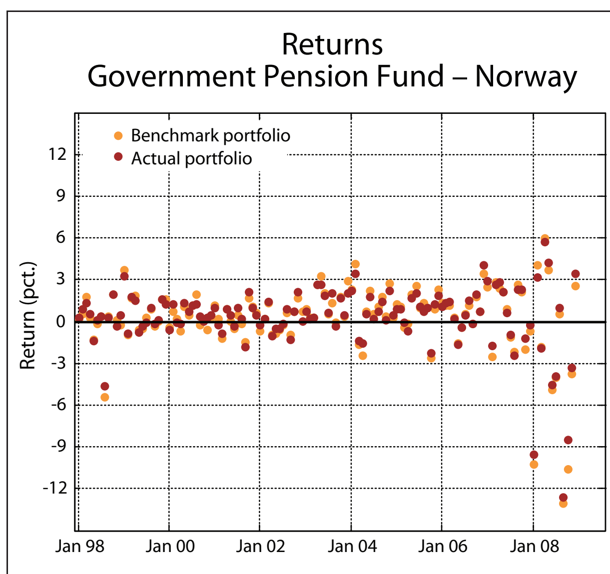

Figure 5.18 Rate of return on the Government Pension Fund – Norway and the fund's benchmark portfolio. Monthly return data, measured nominally in Norwegian kroner. 1998–2008, Per cent

Source: Ministry of Finance and Folketrygdfondet

somewhat higher than the benchmark portfolio for the entire period as a whole. This deviation has increased in recent years (see Figures 5.17 and 5.18). The risk associated with the actual portfolio has also been somewhat lower than the risk associated with the benchmark portfolio (see Figure 5.19). This reflects primarily that the risk associated with the Norwegian fixed income portfolio during this period has been significantly lower than the risk associated with the fixed income benchmark and the low beta profile for the Norwegian equity portfolio (see the more detailed discussion in Report no. 16 (2007–2008) to the Storting).

The figures indicate that the decisions relating to establishment of the Fund's general investment strategy, as operationalised through the definition of the benchmark portfolio, are the primary determinants of both the rate of return and the variation in the Fund's rate of return. The Ministry's computations show that just under 90 per cent of the Fund's return can be attributed to the choices made in defining the general investment framework for the Fund, while the remainder can be attributed to the investment choices made by Folketrygdfondet within the guidelines laid down by the Ministry.

Statistical tests show that there are clear indications of skewness to the left and fat tails for the

Table 5.6 Rate of return[1] (arithmetic) and standard deviation of the difference portfolio (actual tracking error) of the Government Pension Fund – Norway, measured nominally in Norwegian kroner 1998–2008.[2] Percentage points and per cent

	Entire period	Last five years	Last three years	2008
Total portfolio				
Average excess return per year	0.57	0.85	2.68	4.67
Standard deviation	1.46	1.69	1.70	2.46
Information ratio	0.39	0.51	1.58	1.90
Norwegian equity portfolio				
Average excess return per year	1.71	0.75	4.06	8.32
Standard deviation	4.55	4.03	3.93	4.59
Information ratio	0.38	0.19	1.04	1.81
Nordic equity portfolio				
Average excess return per year	0.92	1.63	2.74	6.73
Standard deviation	1.30	1.51	1.85	2.66
Information ratio	0.71	1.07	1.48	2.53
Norwegian fixed income portfolio				
Average excess return per year	-0.24	-0.35	0.36	0.75
Standard deviation	0.89	1.17	0.95	1.59
Information ratio	-0.26	-0.30	0.38	0.47
Nordic fixed income portfolio				
Average excess return per year	-0.56	-0.56	-0.56	-0.94
Standard deviation	0.41	0.41	0.41	0.52
Information ratio	-1.38	-1.38	-1.38	-1.82

[1] The annual excess return is computed as the difference between the Fund's and benchmark portfolio's average monthly rate of return, annualised by multiplying by 12. This is listed in the table as percentage points. The actual tracking error is computed as the standard deviation of the monthly excess return and annualised by multiplying by the square root of 12. The tracking error is listed in the table as a per cent.

[2] The data for the Nordic equity portfolio are for the period from May 2001 to year-end 2008. The data for the Norwegian fixed income portfolio are for the period from February 2007 to year-end 2008.

Source: Ministry of Finance and Folketrygdfondet

rates of return on the actual portfolio for the entire period from 1998 to 2008 as a whole and the two sub-periods 2004–2008 and 2006–2008. Both tests for normality also show that the hypothesis of normally distributed rates of return can be rejected for the entire period as a whole and for the last five-year period. In addition, there are no indications that the rates of return on the actual portfolio are correlated over time.

5.3.3 Performance o f the difference portfolio of the Government Pension Fund – Norway

Folketrygdfondet may, in its management of the Government Pension Fund – Norway, deviate from the benchmark portfolio within a defined risk limit for an expected tracking error of 3 percentage points. Both the rate of return and risk contribution from active management are measured on an ongoing basis. Table 5.6 shows the average excess return, the standard deviation of the excess return (actual tracking error) and the information ratio for various periods, in respect of the Fund overall, the equity portfolios for Norway and the Nordic region, respectively, as well as the Norwegian and Nordic fixed income portfolio.

The Government Pension Fund – Norway has a long investment horizon. The Fund is a long-term investor, and it will maintain a large portfolio of equities in the Norwegian market. The Ministry will focus accordingly on the excess return over time in its follow-up of Folketrygdfondet's performance.

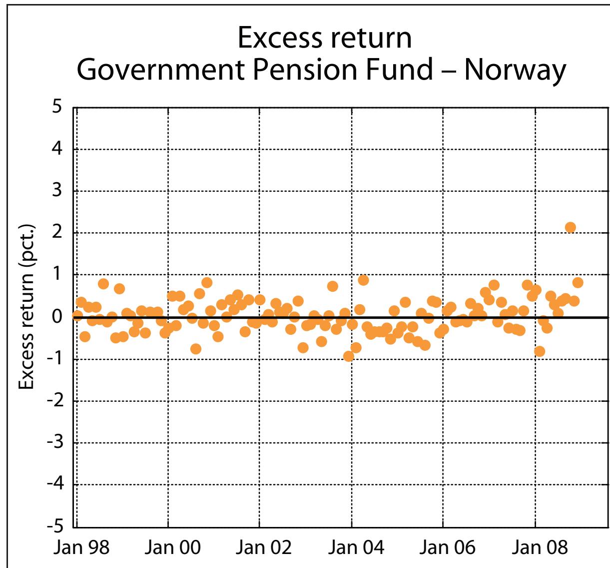

Figure 5.20 Excess return for the Government Pension Fund – Norway. Per cent

Source: Ministry of Finance and Folketrygdfondet

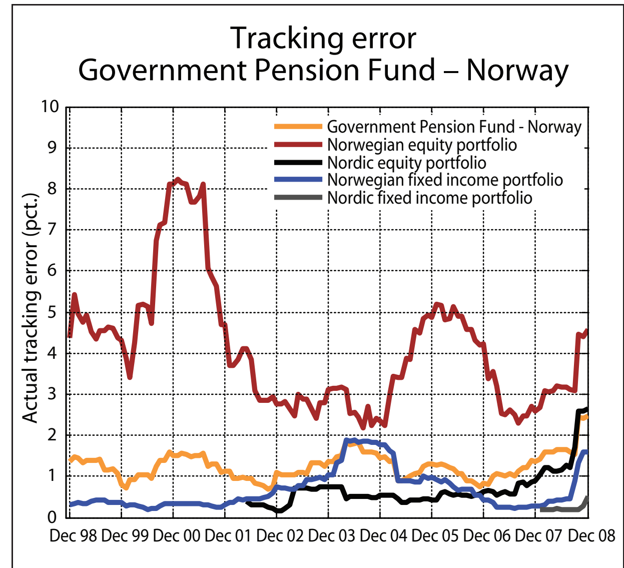

Figure 5.21 Development of the actual tracking error. Rolling twelve-month standard deviation of the excess return. 1998–2008. Per cent

Source: Ministry of Finance and Folketrygdfondet

Folketrygdfondet has achieved an average annual excess return of 0.57 percentage points for the period from 1998 to 2008 as a whole. There has been significant variation in the rates of excess return over time (see Figure 5.20). The excess return has been particularly high for the last three years, and this is attributed primarily to the good equity management performance.

Table 5.6 illustrates that the information ratio has been positive for the entire period as a whole (0.39), as well as the last five-year and three-year periods. It has been explained in more detail in Section 5.2.3 how caution needs to be exercised in interpreting the information ratio, and how it may vary across different styles of active management.

Since Folketrygdfondet started to invest in the Nordic equity market in 2001, its active management of the Nordic equity portfolio has contributed to a positive excess return overall. A negative excess return has been achieved by management of both the Norwegian and Nordic fixed income portfolio for the entire period as a whole and for the last five-year period, while a positive excess return has been achieved for the Norwegian fixed income portfolio for the last three-year period.

The development of the actual tracking error for the total portfolio is presented in Figure 5.21. The actual tracking error has varied between 0.8 per cent and 2.5 per cent. The highest level was achieved in 2008. The actual tracking error for the entire period as a whole is calculated to be 1.46 per cent. The figure illustrates that the level of the tracking error has been clearly highest for the Norwegian and Nordic equity portfolios. Much of this risk may be attributed to a beta that deviates somewhat from 1.0 for the Norwegian equity portfolio (see the detailed account in Report no. 16 (2007–2008) to the Storting).

The Fund's total tracking error for the entire period is lower than the weighted average of the tracking error for the equity and fixed income portfolios, and this is due to the relatively low covariation between the rates of excess return for the equity and fixed income management. The covariation between the excess return on the Norwegian equity portfolio and the Norwegian fixed income portfolio was 0.18 for the entire period as a whole, while the covariation between the excess return on the Norwegian and the Nordic equity portfolios was 0.36 for the same period. The covariation between the Norwegian fixed income management and the Nordic equity management has been relatively low (0.09) for the period. The covariation between the Norwegian and Nordic fixed income management was negative (-0.36).

The histogram in Figure 5.22a indicates that the Fund's excess return has been skewed to the right and has fat tails. Figure 5.22b illustrates that there are also indications that the assumption of normality is not justified. Statistical tests confirm skewness to the right and fat tails for the rates of

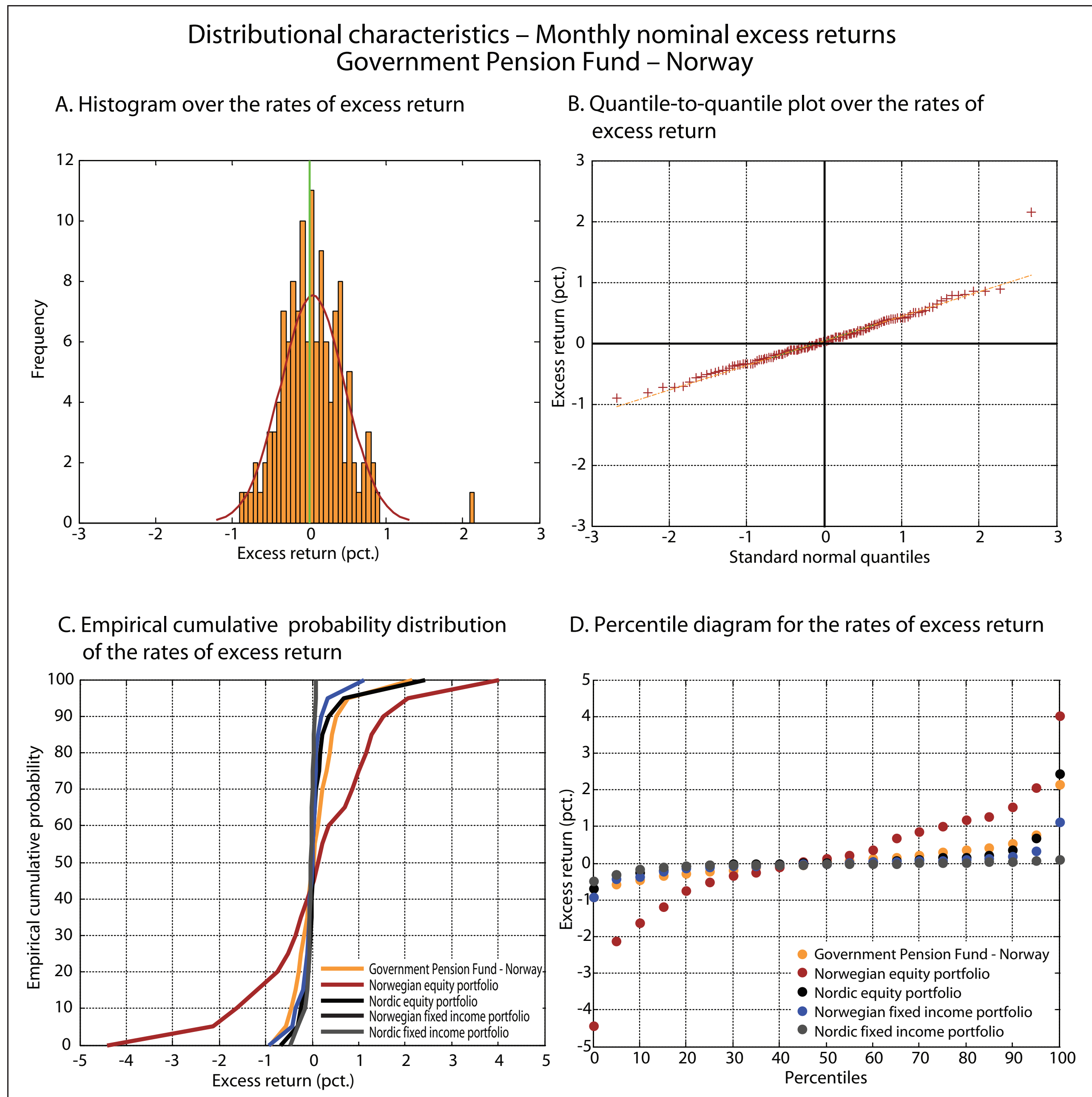

Figure 5.22 Distribution characteristics of the monthly excess return for the Government Pension Fund – Norway

Source: Ministry of Finance and Folketrygdfondet

excess return for the Fund overall for the entire period, as well as for the sub-periods 2004–2008 and 2006–2008. The results are driven primarily by a very high excess return in a single month (October 2008). One of the normality tests shows that the hypothesis of normally distributed excess rates of return can be rejected for the Fund overall. There are also clear indications that the assumption of normality for rates of excess return for the Nordic equity portfolio and both of the fixed income portfolios is not justified. Auto-correlation tests also show that the null hypothesis of independence over time for the excess rates of return cannot be rejected for any of the periods or sub-portfolios, with the exception of the Nordic equity portfolio for the sub-period 2004–2008.

Box 5.6 Comparison of the rate of return and costs of management of the Government Pension Fund – Norway with other pension funds

The Ministry of Finance has commissioned CEM Benchmarking Inc. (CEM) to prepare an extensive annual report that compares the excess return and management costs of the Government Pension Fund – Norway with those of other large funds. The reference group consists of pension funds of a similar size as the Government Pension Fund – Norway with respect to the size of the internal equity management (9 US and 8 European funds). In addition, the Fund's excess return is compared with 25 European funds. The median size of the reference group was around EUR 29 billion. The average market value of the Government Pension Fund – Norway was EUR 15 billion in 2007. The data used are based on self-reporting by the funds that acquire services from CEM. Because the Government Pension Fund – Norway distinguishes itself from CEM's other funds, primarily by being invested in Norway, it does not make sense to compare the Fund's total rate of return with other funds. Comparison of the management costs and excess return is also more difficult because the Government Pension Fund – Norway deviates from other funds in several areas.

Excess return up until 2007

A comparison over time of the actual rate of return on the Government Pension Fund – Norway and the rate of return on the benchmark portfolio shows the excess return created by Folketrygdfondet. CEM has calculated that the Government Pension Fund – Norway achieved an average annual excess return of 1.8 percentage points over the two-year period until 2007. In comparison, the most typical excess return (median) was 1.6 percentage points for the reference group and 0.6 percentage points for the European funds. Both the reference group and the European funds have created an excess return in asset classes in which the Government Pension Fund – Norway is not invested.

Management costs up until 2007

The CEM report shows that Folketrygdfondet's overall management costs in 2007 for the Government Pension Fund – Norway were 0.049 per cent of the average assets under management. These are the lowest management costs of all the funds from which CEM gathers data. Since the overall management costs largely reflect the asset structure of the funds, which follows from the Ministry of Finance's investment strategy as far as the Government Pension Fund – Norway is concerned, such comparisons do not fully clarify whether Folketrygdfondet's management is cost effective.

CEM has, therefore, prepared a cost benchmark based on the asset structure of the Government Pension Fund – Norway. The cost benchmark indicates what costs the reference group would have incurred with the same asset structure as the Government Pension Fund – Norway. The analysis shows that the actual management costs in 2007 were 0.079 percentage points lower than the cost benchmark. This is attributed primarily to the fact that the Folketrygdfondet's management is completely internal. Internal management is clearly less expensive than external management. In addition, Folketrygdfondet has lower management costs for internal management than other comparable funds.

A summary of the analyses for 2007 is published on the Ministry of Finance's website (www.government.no/gpf).

5.3.4 External evaluation of the management performance of the Government Pension Fund – Norway

From 2008 the Ministry will receive reports from CEM Benchmarking Inc. concerning the management of the Government Pension Fund – Norway (see Box 5.6). Comparison of the performance of the Government Pension Fund – Norway with the performance of other major institutional managers forms an important part of the analysis of Folketrygdfondet's active management. According to the analyses from CEM, the excess return on the Government Pension Fund – Norway is somewhat higher than that of comparable funds. However, such comparisons are problematic because the opportunity to generate an excess return will vary with the investment limits and guidelines established in respect of the funds.

6 Framework for management and supervision

The Government Pension Fund consists of two portfolios: The Government Pension Fund – Norway and the Government Pension Fund – Global. The management framework for the Fund must be adapted to the special characteristics of each portfolio, such as size of asset pool, inflow of capital, investment strategy and organisational aspects. The Ministry works constantly to refine and develop the provisions in the framework in line with the best international practices.

6.1 The management framework for the Government Pension Fund – Global

The Government Pension Fund – Global is regulated by the following sets of rules (see also Appendix 1):

- Act of 21 December 2005 no. 123 relating to the Government Pension Fund
- Regulation of 22 December 2005 on the management of the Government Pension Fund – Global
- Guidelines for the management of the Government Pension Fund – Global
- The management agreement between Norges Bank and the Ministry of Finance of 12 February 2001

Management of the Fund is also affected by Act on Norges Bank and the Monetary System of 24 May 1985 no. 28. This Act does not regulate management of the Government Pension Fund – Global directly, but lays down terms for the organisation of Norges Bank and the distribution of responsibilities between the bank's various governing bodies. It therefore defines an organisational framework for Norges Bank, which also applies to its capacity as investment manager.

Continuous improvements to the management framework for Government Pension Fund – Global and refinement of the investment strategy for the Fund are central aspects of the Ministry's work on the Government Pension Fund – Global. The Ministry of Finance's investment strategy for the Government Pension Fund – Global covers both the strategic benchmark portfolio and limits on Norges Bank's active management. The strategy is determined on the basis of the owners' risk tolerance and characteristics of the Government Pension Fund – Global, such as its long investment horizon, the large inflow of capital, its role as a responsible investor and the chosen organisational model (see Chapter 2). Since all the investments are made abroad, the management of the Fund must be adapted to the provisions that apply to the various overseas marketplaces.

It is very demanding trying to ensure that the framework evolves in keeping with the investment strategy, growth in the assets of the Fund and international developments in the framework and supervision methods for major asset managers. In last year's report on the management of the Government Pension Fund, the Ministry described the results of a review of internationally recognised standards and best market practice for risk management within asset management (see Chapter 5 of Report no. 16 (2007–2008) to the Storting). The description of best market practice was based on a reference group consisting of several large funds and investment banks.

Common views on which institutions represent best practice for risk management within asset management are subject to change. Some of the institutions that were generally regarded as leading within risk management have encountered serious problems in recent times and have been forced to seek help from their respective authorities. It therefore seems likely that the international norms for risk management will change in the future. This will also affect the Ministry's further development of the regulations for the management of the Government Pension Fund – Global.

In line with the discussion in the National Budget for 2006, a process has been chosen consisting of several steps to further develop both the framework for the Government Pension Fund – Global and the follow-up regime (see Box 6.1).

Box 6.1 Measures to further develop the framework for management and supervision of the Government Pension Fund – Global

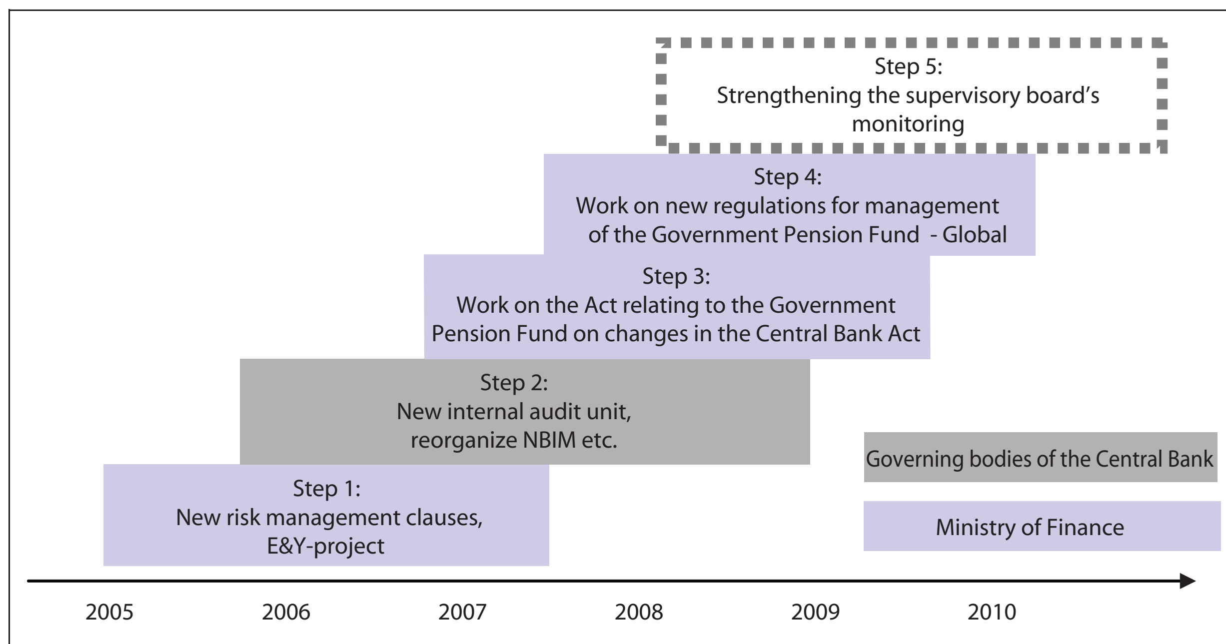

Figure 6.1 Overview of measures to further develop the framework for management and supervision of Norges Bank's management of the Government Pension Fund – Global

Table 6.1 More detailed description of the measures to further develop the framework for management and supervision of Norges Bank's management of the Government Pension Fund – Global

Phase	Measures
Phase 1 (the Ministry)	*Framework:* – New requirements regarding Norges Bank's valuation, performance measurement, and management and control of risk that were introduced with effect from 1 January 2006 (see the discussion in Section 3.5.2.4 of the National Budget for 2006). – The Ministry of Finance's review of best market practice for risk management given the scope of freedom for active management, in collaboration with an external consultant (Ernst & Young) (see the discussion in Section 5.3 of Report no. 16 (2007–2008) to the Storting). *Follow-up regime:* – The Ministry of Finance's review of Norges Bank's management of the Government Pension Fund – Global in collaboration with an external consultant (Ernst & Young) (see the discussion in Section 5.4 of Report no. 16 (2007–2008) to the Storting).
Phase 2 (the governing bodies of the bank)	*Organisation, internal control and audit / supervision:* – Establishment of the Audit Committee for the Executive Board, new internal audit under the Executive Board, appointment of the auditing firm Deloitte to improve the external audit of the bank's management of the Government Pension Fund – Global and the Supervisory Council's access to expertise in supervision of asset management, reorganisation of NBIM, new structure for inter-

Box 6.1 (cont.)

Table 6.1 (cont.)

Phase	Measures
Phase 2 (cont.)	nal investment mandates and a new framework for risk management internally in NBIM (see the section on the Supervisory Council and Executive Board in Norges Bank's annual report for 2007 and the section on the Executive Boards in the annual report on the bank's management of the Government Pension Fund – Global in 2008).
Phase 3 (the Ministry)	*Framework:* – Proposition to the Odelsting on amendments to the Norges Bank Act, including new accounting and auditing arrangements, new provisions concerning the bank's governing bodies, new regulations governing the bank's internal control, clarification of the division of roles between the Ministry and the Supervisory Council for follow-up of the bank's management of the Government Pension Fund – Global (see the discussion in Section 6.4 below and Proposition no. 58 (2008–2009) to the Odelsting on amendments to the Norges Bank Act. – Circulation of the proposed new regulations on accounting and bookkeeping rules for Norges Bank for comment in 2009. – New regulation on Norges Bank's internal control, which will be based on Kredittilsynet's regulation on risk management and internal control (22 September 2008 no. 1080). A public consultation round is being planned for 2009 (see also the discussion in Section 6.4). *Follow-up regime:* – Proposal that the Supervisory Council choose an external auditor with specialist expertise in asset management, so that the auditor can also carry out certification assignments as part of the Supervisory Council's supervision / the Ministry's follow-up (see the discussion in Section 6.4 and in Proposition no. 58 (2008–2009) to the Odelsting on amendments to the Norges Bank Act.
Phase 4 (the Ministry)	*Framework:* – New regulation on the management of the Government Pension Fund – Global with more precise risk limits for active management. The Ministry will define more stringent requirements concerning the bank's strategic plans and risk management for asset management and impose extended reporting requirements on the bank. The Santiago Principles for sovereign wealth funds will be incorporated into the framework (see the discussion in Section 1.5.5). – Circulation of the proposed new regulations on management of the Government Pension Fund – Global for comment in spring 2009. Planned entry into force: 1 January 2010. See also the discussion in Section 6.5.
Phase 5 (the governing bodies of the bank)	*Follow-up regime:* – Strengthening of the Supervisory Council's secretariat for follow-up. Formulation of concrete certification assignments for the bank's external auditor. The Ministry of Finance proposes that these kinds of assignments are formulated on the basis of the needs of both the Supervisory Council and the Ministry.

6.2 Follow-up of the requirements in the framework concerning risk management and control

The responsibilities of Norges Bank's governing bodies

The Executive Board has the executive authority in the bank (see Section 5, first paragraph of the Norges Bank Act). The operative management of the Government Pension Fund – Global has been delegated to Norges Bank and is carried out by a separate division in the bank: Norges Bank Investment Management (NBIM). The Executive Board is responsible for making sure that the assets are managed in accordance with the statutes, regulations and supplementary guidelines laid down by the Ministry of Finance.

The current management framework for the Government Pension Fund – Global allows Norges Bank to invest in a way that deviates from pure indexing of the benchmark portfolio (passive management), if it can be documented that the bank is adhering to internationally recognised standards and methods of risk management for such positions (active management):[1]

> "Valuation, measurement of return and management, measurement and control of risk shall comply with internationally recognised standards and methods. The Fund cannot invest in markets, asset classes or instruments unless compliance with these requirements can be documented (…)."

One of the Executive Board's main tasks within its operational asset management thus comprises constantly monitoring Norges Bank's ability to measure and control risk, and ensuring that the allowed investment universe (in terms of both markets / currencies and use of instruments) is at all times delimited so that the qualitative requirements in the management framework for the Fund are satisfied.

Section 5, third paragraph of the Norges Bank Act reads:

> "The Supervisory Council supervises the Bank's activities and ensures that the rules governing the operations of the Bank are observed."

The Supervisory Council must therefore also make sure that Norges Bank abides by the instructions set out in the regulatory framework for the Government Pension Fund – Global. The Supervisory Council has 15 members, all of whom are elected by the Storting (see Section 7 of the Norges Bank Act). The Supervisory Council submits annual statements to Storting on the Executive Board's minutes of meetings and supervision of the bank. In the period 1998–2002, the Supervisory Council only submitted statements on the Executive Board's minutes of meetings. From 2003 on, the Supervisory Council has also submitted an explicit statement on its supervision of the Bank's activities. The Supervisory Council has not discovered issues linked to the bank's activities that merited special mention in the annual statements.

The rules defined in the Norges Bank Act concerning the tasks of the bank's governing bodies are brief and general and do not define clearly what the executive authority of the Executive Board covers or what should be included in the Supervisory Council's supervision of the bank's operations. In the Ministry's opinion, the bodies' responsibilities for control and supervision need to be defined more clearly in the Act (see Section 6.4).

The Ministry of Finance's follow-up of Norges Bank's operational management of the Government Pension Fund – Global

The Ministry of Finance is responsible for managing the Government Pension Fund – Global pursuant to Section 2 of the Act relating to the Government Pension Fund. In order for the Ministry of Finance to fulfil this management responsibility, it needs to have a robust framework and good follow-up routines vis-à-vis Norges Bank.

In connection with the changes in the framework that came into force on 1 January 2006, including greater freedom for active management, the Ministry of Finance stated that external consultants would also be used in the follow-up of Norges Bank's asset management. In the National Budget for 2006 it is stated that:

> "Norges Bank operates a specialised asset management regime. By imposing reporting requirements, the Ministry will be better placed to identify areas where, with the help of external expertise, it can evaluate Norges Bank's compliance with instructions set out in the regulatory framework. The Ministry plans

[1] See the first paragraph of article 4 Requirements on valuation, measurement of return and management and control of risk in the Ministry of Finance's supplementary guidelines for management of the Government Pension Fund – Global.

> regular due diligences of the management, and particularly the bank's risk management, in collaboration with consultants possessing suitable expertise. The Ministry will be reporting on this to the Storting in suitable documents."

The first risk-based due diligence anchored in the new requirements in the framework relating to Norges Bank's active management was initiated in autumn 2006. The Ministry has described the content of the final report of the consulting firm Ernst & Young and the bank's comments in Report no. 16 (2007–2008) to the Storting. Here it was described how in the period 2006–2008 Norges Bank has undertaken a number of projects to further improve the bank's risk management, including:

- establishment of an Audit Committee for the Executive Board
- establishment of a separate internal audit department
- strengthening of external auditing through cooperation with the auditing firm Deloitte
- reorganisation of NBIM
- significant reinforcement of NBIM's independent risk management function
- new framework for operational risk, and
- projects for the implementation of new systems for counterparty risk and for the pricing and verification of positions independently of the people who make investment decisions.

In this context, reference is made to the letter from the Supervisory Council of 13 December 2007, where it is stated that:

> "As part of its supervision, the Supervisory Council will monitor the Executive Board's further work based on the report."

6.3 A closer look at the Ministry's risk-based supervision of Norges Bank's asset management in 2008

6.3.1 The Ministry's follow-up of the bank's projects to improve risk management

The Ministry follows up the operational management of the Fund through regular meetings with Norges Bank, among other things. As necessary, written reports are requested for certain areas of the bank's management of the Government Pension Fund – Global. In 2008, the Ministry has focused in particular on following up the status of the bank's ongoing projects to improve risk management in its asset management (see the more detailed discussion in Section 6.2). In a letter dated 20 October 2008, the Ministry of Finance requested a written presentation of the work in this area. In the letter, the bank was asked to comment specifically on the following aspects:

Valuation

The bank was asked to report on the status of the project "Independent valuation" in light of the bank's previous statements in its letter to the Ministry of Finance dated 19 December 2007 (see Appendix 6 in Report no. 16 (2007–2008) to the Storting):

> "NBIM is currently carrying out a project to make valuation as independent as possible of those who make investment decisions. As part of this project ("Independent Pricing"), NBIM is to ensure that all holdings are priced or verified by players independent of NBIM and extemal managers. RPA will nevertheless have the final say on valuations at month-end. NBIM has chosen a model where all holdings are channelled from the designated extemal accounting service prociders through a price coordinator. The price coordinator himself performs the valuation of instruments defined as "easy to price". Securities defined as "complex" are forwarded to one of he chosen extemal price providers. NBIM is aiming to finish drawing up contracts with relevant providers by he end of 2007. The mandates will then go into production in two waves during the coursee of 2008».

Delimitation of market, credit and counterparty risk

Norges Bank's letter to the Ministry of Finance of 19 December 2007 cites a passage from the bank's previous recommendation made in a letter dated 11 March 2005 on how credit risk ought to be managed:

> "Limits and measurement methods have already been established for market risk. Norges Bank proposes that parts of credit risk be managed implicitly by setting a limit for market risk and be measured accordingly. Norges Bank also proposes that management requirements for the remaining part of credit risk (counterparty risk) be established separately with an accompanying measurement method."

In a letter dated 20 October 2008, Norges Bank was asked to provide information as to whether the bank, in light of the current crisis in the international credit markets and the negative excess return achieved by the bank's active management of the bond portfolio over the last year, still recommends to the Ministry that all the potential credit risk within the current investment universe of the Government Pension Fund – Global, with the exception of counterparty risk, ought to be managed only implicitly through the defined market risk limit for expected relative volatility of 1.5 percentage points.

Credit risk

The Ministry asked Norges Bank to describe the measures that have been initiated and/or carried out to improve the internal management of credit risk (see the bank's letter to the Ministry of Finance dated 19 December 2007:

> "Norges Bank supports the recommendation of more detailed measurement parameters for credit risk in guidelines laid down by the Executive Director of NBIM. As the Fund's investment universe and the range of instruments in the Fund expand, it will be natural for supplementary risk indicators to be developed in the monitoring of credit risk, including stress tests."

Counterparty risk

In line with the bank's recommendations in the letter dated 11 March 2005, the Ministry has laid down the following requirements concerning how counterparty risk is treated (see section 4.2.2. of the supplementary guidelines for the management of the Government Pension Fund – Global that came into force on 1 January 2006):

> "Norges Bank shall have satisfactory routines and systems for selecting and evaluating counterparties. The monitoring system and measurement frequency employed for control of counterparty risk, including requirements on minimum credit rating and exposure limits, shall follow best practice in the area."

The Ministry asked Norges Bank to provide information about the status of and progress plan for its work on improving the system for measuring counterparty risk (see Norges Bank's letter to the Ministry of Finance of 19 December 2007):

> "RPA has also appointed a project group which is working on a new risk system for the measurement and management of counterparty risk. The system is to conform to best market practice. At present, RiskManager (RiskMetrics) is used to measure market risk, and the aim of the project is for the same system to be used to measure counterparty risk. However, it may also be appropriate to consider other systems. NBIM aims to complete the project during the first half of 2008. The new system will mean more extensive and timely monitoring of counterparty risk. In the opinion of Norges Bank, today's measurement and monitoring systems provide acceptable management of counterparty risk, but are not quite up to the standard of best practice internationally."

Operational risk

In its letter to the Ministry of Finance of 19 December 2007, the bank stated that it would be introducing the following measures:

> "During the course of 2008, Internal Audit will be auditing NBIM's system for the management of operational risk. The aim of this audit will be to confirm that the system now established conforms to best practice in the field."

The Ministry asked the bank to provide more details about whether this kind of audit of NBIM's system for operational risk had been carried out in 2008 and if so, whether the bank's internal audit department has confirmed that best practice in the field is being adhered to.

Regular self-assessments

Regular self-assessments are increasingly being used within risk-based supervision of asset managers. In this context, reference is made to the self-assessment form that Kredittilsynet (the Financial Supervisory Authority of Norway) uses in its risk-based supervision of Norwegian banks that are subject to the Internal Control Regulations. In connection with the Ernst & Young project, a self-assessment questionnaire was prepared for the bank to assess its management of the Government Pension Fund – Global. The Ministry asked the bank to state whether the Executive Board now performs regular self-assessments of the bank's asset management, using one of these forms mentioned above, for example.

6.3.2 Norges Bank's reporting to the Ministry

In a letter dated 12 February 2009 to the Ministry of Finance, Norges Bank provided an overview of the status of the bank's efforts to strengthen the bank's risk management within asset management.

Reorganisation and new management structure

In 2008, the bank has implemented a number of measures to improve the organisational and management structure of Norges Bank Investment Management (NBIM):

> "A new organisation for NBIM was introduced from 1 March 2008. The aim was partly to strengthen and focus its investment functions, and partly to strengthen the overarching control functions. We have drawn a clear distinction between departments responsible for investment decisions and departments responsible for operational and control functions. We have separated responsibility for executing transactions in the markets (trading) from the responsibilities of the portfolio managers, with the result that those taking investment decisions do not themselves perform trades in the markets. The division of roles at this level, with guidelines built into the trading systems, will provide an effective safeguard against the risk of error or irregularity at the level of the individual.
>
> NBIM has reinforced its control functions through recruitment and reorganisation. We have built up a unit for monitoring market risk, credit risk and counterparty risk across the investment units. This unit is now physically located closer to the employees responsible for active risk-taking in the Fund, whereas previously it had more the nature of a staff function. At present, around 20 employees work in this function.
>
> NBIM has also reinforced the control functions that are responsible for ensuring that NBIM complies with market regulations, monitor compliance with investment mandates, interpret investment guidelines, prepare instrument approvals, and have responsibility for the authorisation structure. This function has also been given a broader mandate to monitor NBIM's non-market risks. In practice, this entails a responsibility for ensuring that the other departments manage these risks, which comprise operational risk, IT/information risk and legal risk, as well as behavioural standards and reputational risk in the broad sense. At present, around 15 employees work in this function.
>
> NBIM has established a formal committee structure which draws on expertise from across the organisation. These committees are advisory and are used by NBIM's Executive Director to discuss relevant issues before decisions are taken. The committees also play an important role in the design of important guidelines for NBIM's operations. Currently NBIM has five committees: one for investment universe, one for credit and counterparty risk, one for business policies, one for investment risk, and one for valuation.
>
> Norges Bank has established a new investment mandate structure. The Executive Board has issued a new investment mandate for the Executive Director of NBIM and requirements for more extensive reporting (…). The content of NBIM's own mandates has also been overhauled. Risk limits are now issued along many more dimensions than before. First, there are quantitative model-based limits. There are also risk limits that are based not on models but on gross nominal exposures and the level of usage of derivatives. In addition, the new investment mandates contain clear guidance on desired liquidity and limits for systematic exposure to specific market factors."

Independent Valuation

The Independent valuation project was completed in October 2008. The bank described the project thus in its letter to the Ministry:

> "The aim of the independent valuation project was to establish a solution that ensures that all of the Fund's holdings are priced, quality-assured and verified by bodies independent of those taking investment decisions, both internally at NBIM and at external managers. Valuations are to comply with generally accepted accounting principles and the requirements set out by the Ministry in section 4.1 of the Guidelines for the Management of the Government Pension Fund – Global.
>
> The independent valuation project was completed in October 2008. New requirements were introduced for both NBIM and our external accounting service providers (currently JPMorgan Chase and Citibank). Further improvements are being made on an ongoing basis.
>
> NBIM's external accounting service providers play an important role in this solution. They have responsibility for pricing both externally- and internally-managed portfolios using

independent price sources. The accounting service providers are to use a pricing hierarchy established by NBIM. In the capacity of pricing coordinator, a control unit in NBIM's operations area is responsible for pricing the same instruments as the accounting service providers. This unit reconciles its own valuations with the prices received from the accounting service providers.

The control unit is responsible for conducting additional pricing checks at month-end to assure the quality of prices and ensure that the pricing hierarchy is being observed. Spot checks will also be made during the month. Where necessary, the internal control unit will enlist the support of external pricing specialists selected to assist with the pricing of particularly challenging instruments.

NBIM's valuation committee (…) is a forum for discussing significant pricing issues. The committee meets at least once a quarter ahead of the publication of the accounts. Central Bank Audit and its external partner will review price quality and price controls while the quarterly accounts are under preparation.

Norges Bank believes that this structure will ensure both quality and independence in the pricing and valuation of all financial instruments in the Fund."

Delimitation of market, credit and counterparty risk

In its letter to the Ministry, Norges Bank provided the following assessments linked to the quantitative limit on tracking error in all the Ministry's provisions governing management of the Government Pension Fund – Global:

"In the case of the Government Pension Fund – Global, market risk is measured as expected tracking error, which is the expected value of the standard deviation in the difference between the return on the actual portfolio and the return on the benchmark portfolio. However, no single measure of risk can capture all relevant risk factors for the Fund over time. In addition, the turbulent market conditions since summer 2007 have revealed weaknesses when it comes to predicting risk in such markets. (…)

It is important that the framework for risk management is designed in such a way as to provide as detailed a risk picture as possible. The Executive Board has therefore issued a new investment mandate for the Executive Director of NBIM (see section 6 below), which sets out limits for risk management based on the following main categories of risk:

- Deviation from the benchmark index, where the aim is to ensure that the measurement of exposures is not based on a quantitative model. Limits can be set for:
  - Deviation between the actual and benchmark portfolios broken down by asset class and geographical region
  - Sector deviation in the fixed income and equity portfolios
  - Minimum levels of overlap between the actual and benchmark portfolios for the two asset classes
  - Leveraging of the portfolios
- Risk from price history (volatility and correlation), which combines portfolio exposures and the markets' statistical properties. Limits can be set for:
  - Maximum utilisation of market risk as measured by expected tracking error under normal market conditions, so that there is a buffer when unexpected situations occur
  - Concentration risk in the portfolios
- Factor exposure, which describes to what extent the portfolio is systematically exposed to factors such as small-cap companies or emerging markets
- Liquidity exposure, to ensure that we have sufficient room to manoeuvre to be able to adjust exposure in our investment management, including the extent to which exposures are liquid and can be sold

In each of the above risk categories, there will also be different and complementary measurement methods. Multiple approaches to risk and complementary measurement methods are important to ensure an effective and robust structure for risk supervision.

Norges Bank believes that the constraints on market risk imposed by the Ministry should be small in number, robust, and easy to communicate. Our view, therefore, is that the current measure of risk (expected tracking error) is a sound measure which is also the industry standard, and that the Ministry should retain this measure as the sole measure of market risk established by the Ministry. In the current market situation, it appears that all traditional risk models have failed as predictors of developments in market risk. Norges Bank will therefore get back to the Ministry with an assessment of parameter-setting in the modelling of market risk in the RiskManager risk system.

We also believe that credit risk in the portfolio is well-modelled under "normal market

conditions". Previous formal restrictions, such as the requirement for a minimum credit rating, would not have improved risk management in the situation we have had since 2007. NBIM has found that the credit ratings from the three agencies Moody's, Standard & Poor's and Fitch have not been good enough.

Nevertheless, it is clear that no single measure can provide a complete picture of the risk to which the Government Pension Fund – Global is exposed. Instead of introducing new risk limits, we recommend that Norges Bank reports risk along more dimensions. These reports should cover deviation from the benchmark index, risk from price history, factor exposure and liquidity exposure (see discussion above of the limits that the Executive Board has established for NBIM). We therefore recommend that the Ministry receives a supplementary quarterly report as well as the public quarterly report. This supplementary report will present returns broken down by area and the status of all key quantitative requirements. The more detailed contents of the report can be agreed between the Bank and the Ministry. We assume that these requirements and the associated reporting will take care of the Ministry's supervision and oversight of the management of the Fund, and that there will remain a clear division of responsibility between the Bank and the Ministry."

Credit risk

In its letter to the Ministry, Norges Bank provided the following description of measures to improve its management of credit risk:

"NBIM has issued new guidelines for credit risk specifying how it is to be measured and monitored. As mentioned in section 2 above, we have set up a counterparty and credit risk committee, which is to ensure a multidisciplinary focus on all credit-related aspects of our investment management.

NBIM's credit risk guidelines provide clear guidance on how credit risk is to be managed at NBIM: from unambiguous definitions of terms to concrete methods and the scope of different measurement criteria. The guidelines require NBIM to establish a framework for measuring and verifying credit risk, both for individual issuers and for the overall portfolio of issuers, including correlations between issuers. Stress tests of credit risk are also to be performed to take account of possible extreme market situations. A concentration analysis for both absolute and relative credit risk is also to be performed for the overall portfolio of issuers with the aim of identifying potential large positions at different levels of the portfolio (sector, currency, region).

In addition, NBIM is to monitor movements in the market's credit rating for all issuers in the fixed income portfolio. The guidelines also require the establishment of procedures for situations where there is a defined credit event (default).

To meet the increasing requirements for the identification, measurement and verification of credit risk, NBIM has reinforced the department responsible for risk management with new staff with a broad and varied background in the field.

NBIM took a number of steps in 2008 to improve the quantitative model-based side of the measurement and analysis of credit risk. We have taken into use a new third-party model that can be used to monitor credit developments in large individual exposures in our investment portfolio. We are considering extending the use of this model to form the basis of internal modelling, or acquiring a separate system to measure and analyse credit risk for the entire portfolio as a supplement to today's modelling of market risk in our system for measuring that type of risk (RiskManager).

NBIM also plans to integrate standard stress tests into its periodic calculations of market risk. These tests will be based on defined historical periods with big swings in financial markets. The tests will also include periods where credit risk was high. These stress tests have been defined and are now being assessed. For other parts of the guidelines, processes are ongoing to establish a framework that addresses the different requirements at both company and portfolio level."

Counterparty risk

In its letter to the Ministry, Norges Bank provided the following description of the project to introduce a new system for handling counterparty risk:

"NBIM's project for improving and developing its systems for the management of counterparty risk was started up in 2007. We originally assumed that the current system for measuring market risk would also be used for measuring counterparty risk. In 2008, however, we again compared international practice with NBIM's business model and mapped alternative system solutions. We decided to conduct an international tender process. NBIM expects

to have a new framework in place during the first quarter of 2009 and a new system for measuring counterparty risk in place during the second quarter of 2009.

Based on the applicable monitoring and control structure, we have taken a number of steps to reduce counterparty risk, the most important being:

- NBIM has substantially reduced exposure to derivatives and repurchase agreements, and some complex unlisted products are no longer approved instruments
- Requirements that trading in unlisted derivatives can be performed only with counterparties with whom we have entered into a separate agreement, and which safeguard our rights, partly through the counterparty having to provide collateral in the form of securities and/or cash
- Changes in the process for approving counterparties following the reorganisation of NBIM, and closer supervision and monitoring of counterparties
- Decision to cease all new trading, terminate outstanding transactions and monitor developments at a number of key counterparties that ran into problems in 2008

We have focused particularly on credit and counterparty risk since the credit crisis erupted in July 2007. The new framework and system for measuring counterparty risk will be tailored to a narrower range of instruments and a general reduction in the complexity of investment management, especially in internal and external fixed income management."

Operational risk and use of self-assessment

In its letter to the Ministry, Norges Bank provided the following assessments linked to operational risk and the Executive Board's follow-up of the asset management:

"The Executive Board has reinforced its supervision of investment management at Norges Bank in recent years. In 2007, we established the Executive Board's audit committee and an internal audit unit. The audit committee comprises three of the Executive Board's external members and serves as a preparatory body for the Board on matters relating to its oversight functions and responsibility for risk management and internal control. The audit committee discussed eight matters concerning the Bank's investment management in 2008.

The Executive Board issued a new job description and investment mandate for the Executive Director of NBIM in 2008. The starting point is that the Executive Director of NBIM stands in the same position as the other Executive Directors at Norges Bank. However, the tasks assigned to NBIM are distinct from the Bank's other activities as a central bank, in the sense that the investment management operation has the characteristics of a commercial undertaking. The management of the Government Pension Fund – Global has been delegated to Norges Bank pursuant to a separate act of parliament and management agreement. There has also been an increasing tendency in recent years for NBIM to be treated as an independent area within the central bank.

The job description sets out the responsibilities and duties of the Executive Director of NBIM with respect to the general public and external relations, including interaction with Norges Bank's clients and the framework for the responsibility he has for the planning and organisation of NBIM's operations, supervision and control, etc.

The investment mandate for the Executive Director of NBIM sets out supplementary rules for the individual portfolios within the investment limits established by the Ministry. These cover the investment universe, investment constraints, the delegation of management responsibility, and reporting. The investment mandate also describes the risk profile for investment management that the Executive Board wishes to establish, including the principles and parameters for the management and measurement of risk as well as reporting requirements. We refer to the discussion of the investment mandate for the Executive Director of NBIM in section 5 above. The monthly reporting from NBIM to the Executive Board includes not only returns and any breaches of the investment guidelines laid down by external clients or the Executive Board, but also the status of the additional restrictions that the Executive Board has established for market risk. There are to be reports on deviation from the benchmark index (asset class, geographical region, sector, leveraging, overlap), risk from price history (maximum use of market risk under normal market conditions, concentration risk in the portfolios), factor exposure, and liquidity exposure.

On 1 January 1998, the Executive Board decided to establish a system of internal control based on the Norwegian financial supervisory authority Kredittilsynet's Internal Control Regulations. Internal control at Norges Bank is

defined as all measures, arrangements and systems initiated and implemented by the Executive Board and the Bank's management and employees in order that we can be reasonably certain of achieving our objectives.

With effect from 1 January 2009, the 1997 Internal Control Regulations were replaced with the new Regulations No. 1080 of 22 September 2008 on Risk Management and Internal Control. These new regulations make more stringent requirements of the role of the board in the design of structures for internal governance and internal organisation. The Executive Board is of the opinion that the principles for internal governance drawn up by the Committee of European Banking Supervisors (CEBS) form an appropriate basis for its assessments. However, the self-assessment form to which the Ministry refers in its letter of 20 October 2008 was developed for commercial banks etc. The Executive Board has therefore adopted principles for internal governance tailored to Norges Bank's operations as the basis for its annual assessments. These principles have been used in the Executive Board's assessment of risk management and control in the Bank with effect from the 2008 reporting year. Norges Bank believes that these measures satisfy the new regulations' requirement for the Executive Board to assess Norges Bank's risk management and internal control annually.

Internal Audit prioritised risk management and internal control at NBIM in 2008. Among other things, it reviewed the status of the follow-up of Ernst & Young's report. The aim of this was to provide the Executive Board with confirmation that action has been taken in accordance with Norges Bank's response to the Ministry.

Internal Audit concluded that NBIM's new organisational model results in a clearer division of roles and responsibilities in the organisation. Organisational units have been set up to measure and report risk independently of the investment line. Internal Audit considered that these are important organisational measures for ensuring good risk management and internal control.

The new organisation of NBIM's operations also entails extensive changes to working processes. NBIM is working on tailoring the management of operational risk to its new working processes, and Internal Audit will be monitoring this work closely in the time ahead. In December 2008, an audit was begun at the request of the Executive Board. The focus of this audit is on:

– NBIM's processes for identifying, prioritising and reporting operational risks
– NBIM's implementation of risk reduction measures

Norges Bank will keep the Ministry informed of any significant changes in risk management, organisation and supervision in relation to the Bank's management of the Government Pension Fund – Global."

6.3.3 The Ministry's assessment of the bank's measures

It is apparent from Norges Bank's letter to the Ministry dated 12 February 2009 that the bank has implemented extensive measures to meet some of the challenges in the bank's risk management that have been raised earlier, by both the bank itself and the Ministry (see for example the bank's annual report on the management of the Government Pension Fund – Global in 2008 and Chapter 5 of Report no. 16 (2007–2008) to the Storting).

For example, with effect from 1 January 2009, the Executive Board has introduced a new investment mandate for the Executive Director of Norges Bank Investment Management (NBIM), which sets limits for risk-taking along more dimensions than previously. In 2008, the management of NBIM has worked extensively to improve the bank's risk management. The Ministry is positive towards the bank's reorganisation of NBIM and strengthening of the control functions within the bank's asset management, through both recruitment and establishment of a formal committee structure. In this context, the Ministry refers to the fact that it is a fundamental principle for asset management organisations that there must be a clear organisational divide between the units that assume risk positions, the units that carry out transactions, and the units that monitor the risk-taking and transactions.

The Ministry has noted that the bank has found it necessary to withdraw permissions for previously approved instruments. The bank's new internal requirement that standard contracts must be signed with all counterparties before transactions can take place is, in the Ministry's opinion, in line with international practice. As a consequence of the current financial crisis, management of counterparty risk has become a much greater challenge for all asset managers.

It is stated in Norges Bank's letter that the bank is now going to limit deviation from the benchmark portfolio along a number of new dimensions in the bank's internal framework for asset management. Active management will also be subject to closer regulation in connection with the Ministry's new guidelines for the management of the Government Pension Fund – Global (see Section 6.5). In the Ministry's view, it helps to clarify the basis for the Supervisory Council's supervision if these kinds of supplementary limits are defined in the Ministry's framework and not only in the bank's internal rules. The Ministry will follow up the Executive Board's proposal concerning more extensive reporting from the bank to the Ministry along all the new dimensions in the Executive Board's new framework for risk management.

The National Budget for 2006 described the Ministry's plans to carry out regular due diligences of the Fund, and particularly the bank's risk management, in collaboration with consultants possessing suitable expertise (see the discussion above). Report no. 16 (2007–2008) to the Storting describes the completed external review of Norges Bank's risk management systems (referred to as the Ernst & Young project).

The Ministry will collect an updated third party opinion on the status of Norges Bank's risk management and its active management by using external consultants with specialist expertise (see the discussion in Box 1.3).

6.4 Proposition to the Odelsting on amendment of the Norges Bank Act

Parallel to this Report to the Storting, the Government is also submitting a Proposition to the Odelsting on a number of amendments to the Norges Bank Act. The Ministry has already described the need for amendments to the provisions in the Norges Bank Act concerning accounting and auditing (see the discussions in Report no. 16 (2007–2008) to the Storting and Report no. 19 (2007–2008) to the Storting). In this Proposition to the Odelsting, the Ministry proposes imposing an obligation to keep accounts on Norges Bank pursuant to the Accounting Act. The need for a defined framework for registration and documentation of transactions etc. also suggests that it should be established in law that Norges Bank has a statutory bookkeeping obligation pursuant to the Bookkeeping Act. In addition, the Ministry wants to ensure that there is opportunity to lay down special rules in regulations concerning annual accounts, annual reports and bookkeeping for the bank that either supplement or deviate from the provisions given in or pursuant to the Accounting Act and the Bookkeeping Act to regulate any special conditions associated with its operations as central bank.

There is broad consensus that the current audit arrangements, whereby the Supervisory Council appoints a Central Bank Auditor who is formally employed by the bank, are no longer satisfactory. The auditor should formally be entirely independent of the bank. In the Proposition to the Odelsting, the Ministry proposes a system whereby the Supervisory Council appoints an external auditor. In the consultative round, the Office of the Auditor General and the Norwegian Confederation of Trade Unions proposed that the Office of the Auditor General should take over the audit of Norges Bank. The Ministry has not been able to endorse this kind of arrangement for several reasons. Firstly, this would, in the Ministry's view, necessitate changes in the system whereby the Supervisory Council is the Storting's supervisory body in relation to Norges Bank. This system is anchored in Article 75, first paragraph, litra c) of the Constitution, where it is stated that:

> "It devolves upon the Storting to supervise the monetary affairs of the Realm."

The Supervisory Council approves the bank's accounts. It would be unnatural to separate this task from the task of appointing an auditor. Secondly, it would, in the Ministry's opinion, be unfortunate if the Office of the Auditor General were to perform the financial audit of Norges Bank and also undertake performance audits in the Ministry of Finance to discover whether the Government Pension Fund – Global is being managed in accordance with the intentions of the Storting. The bank's audited accounts will be a material basis in connection with the Office of the Auditor General's assessment of whether the Ministry of Finance has managed the Fund in compliance with the intentions of the Storting. If the Office of the Auditor General had audited these accounts, it would then have to judge the Ministry of Finance's management on the basis of accounts it had audited itself. An external auditor chosen by Norges Bank would therefore improve the Office of the Auditor General's ability to undertake an independent review of the Ministry of Finance's management. On the grounds of these kinds of arguments, the Stor-

ting decided in 2007 to transfer the responsibility for auditing Folketrygdfondet and the Government Pension Fund – Norway from the Office of the Auditor General to an external auditor chosen by the Ministry of Finance (see Section 13 of the Act relating to Folketrygdfondet and Recommendation no. 77 (2006–2007) to the Odelsting, pp. 1–2).

It would be natural for the Supervisory Council, in its capacity as responsible for the audit of the bank, to lay down an audit programme. This kind of programme would define priorities for the audit over and above the financial audit, including a plan for so-called certification assignments. A typical certification assignment might be asking for an assessment of the efficiency and effectiveness of the bank's internal control. If the bank had an appointed external auditor, the Ministry of Finance would be able to enter into dialogue with the Supervisory Council and make suggestions for the audit programme to ensure that the Ministry of Finance's follow-up needs vis-à-vis the Government Pension Fund – Global are safeguarded. However, if the Office of the Auditor General was going to audit the bank's accounts, the Ministry would be prevented from this as the Office of the Auditor General is also charged with auditing the Ministry of Finance. The Office of the Auditor General cannot audit the Ministry of Finance on behalf of the Storting and at the same time also perform audit tasks that the Ministry of Finance has asked the Supervisory Council to have done. An arrangement with an appointed external auditor would thus serve to strengthen the overall follow-up of the Fund.

The Proposition to the Odelsting also proposes a more precise description of the tasks ascribed to the bank's governing bodies and a clarification of the division between the Supervisory Council's supervisory responsibilities pursuant to the Norges Bank Act and the Ministry of Finance's follow-up responsibilities pursuant to the Act relating to the Government Pension Fund.

6.5 Review of the rest of the framework for the management of the Government Pension Fund – Global

The current regulations for the Government Pension Fund – Global show signs of the fact that they have been added to and amended over time, as the Fund has grown in value. The Ministry of Finance has therefore initiated a review of the regulations with the aim of further developing them.

The regulations should aim to regulate asset management in compliance with best international practice in terms of measurement and management of risk. The distribution of responsibility between the operational manager (Norges Bank) and the owners of the assets (the Ministry of Finance) must be clearly defined. The regulations must also ensure that there are clear reporting routines and transparency regarding the management. The Ministry is basing its review on industrial and regulator-driven standards of risk management.

It has been decided to include investments in real estate in the investment universe of the Fund (see Chapter 2). This entails a need to incorporate new rules about investments in real estate in the regulations. The evaluation of the ethical guidelines for the Government Pension Fund – Global also necessitates amendment of the management framework (see Chapter 4).

In connection with the review of the regulations governing the Government Pension Fund – Global, stricter requirements are going to be imposed on Norges Bank's active management. It is especially pertinent to lay down supplementary limits for risk-taking in active management that go farther than the current upper limit on tracking error. This may entail stricter requirements for risk diversification for the active positions and that risk limits are established for more main categories of risk. The Ministry will also consider whether limits ought to be set for implicit borrowing (leverage) and short positions. It may also be relevant to assess the limit on tracking error and whether it ought to be distributed, in light of the bank's future strategies for active management.

In this context, reference is made to the fact that Norges Bank has implemented a number of changes within its active management of the Government Pension Fund – Global, partly in light of the poor performance in 2008. The bank has established two main areas within its management of fixed-income assets: a portfolio for indexing and rebalancing and a portfolio containing large, illiquid positions. The reorganisation of the fixed-income management means that the bank has now discontinued several of the management strategies that were based on reaping liquidity and credit premiums and that contributed to major negative excess return within the active management. The positions in the portfolio for illiquid investments will be reduced, at the latest when the bonds reach maturity.

The Ministry is aiming to complete its review of the regulations so that a new regulation governing the management of the Government Pension Fund – Global can enter into force on 1 January 2010.

Reference is also made to the plans for a new review of the active management (see Box 1.3). Any further changes to the guidelines as a result of this review will only be implemented once the Storting has considered the matter.

6.6 The management framwork for the Government Pension Fund – Norway

Folketrygdfondet was established as a separate company by special statute with effect from 1 January 2008. Report no. 16 (2007–2008) to the Storting described the new framework for Folketrygdfondet's management of the Government Pension Fund – Norway. The new framework implies a clarification of the distribution of responsibility between the Ministry and the Board of Directors of Folketrygdfondet. The Ministry stipulates general investment limits, whilst the Board of Directors of Folketrygdfondet is responsible for the operational management of the Government Pension Fund – Norway. All the provisions governing the management of the Government Pension Fund – Norway are appended to this Report in Appendix 1.

Risk management and control procedures

The new management framework for the Government Pension Fund – Norway lays down much stricter requirements concerning, among other things, measurement, management and control of risk and reporting than previously. Against this background, Folketrygdfondet has been working on implementing new management and control systems in the asset management to ensure that the systems for risk management and control satisfy the requirements laid down in the new framework. The requirements are based on the premise that measurement, management and control of different categories of risk shall follow best international practice and internationally recognised methods. The Ministry expects that most of the work on implementation of new control systems as a result of the requirements laid down in the new framework will be finished during the course of this year.

Accounting rules

In Report no. 16 (2007–2008) to the Storting, the Ministry stated that it would be assessing the need for further regulations containing more detailed provisions on the accounting rules for the Government Pension Fund – Norway. The background for this is that the Act relating to the Government Pension Fund does not contain direct provisions on accounting rules.

Against the backdrop of the need to clarify the accounting rules for Folketrygdfondet and the Government Pension Fund – Norway, the Ministry published Regulation of 10 November 2008 no. 1264, which lays down detailed provisions concerning annual accounts, etc. for Folketrygdfondet including the Government Pension Fund – Norway.

The new regulation comprises the following main points:

- The regulation applies to Folketrygdfondet including the investments for the Government Pension Fund – Norway. It must be seen in context with Section 1 of the Act of 29 June 2007 no. 44 relating to Folketrygdfondet, which stipulates that Folketrygdfondet is charged with managing the counter-value of the capital contribution in the Government Pension Fund – Norway in its own name. The preliminary studies carried out in connection with the Act relating to Folketrygdfondet indicated that the capital contribution shall be entered as a liability item in Folketrygdfondet's balance sheet, whereas the assets that correspond to the counter-value of the capital contribution shall be posted as assets (see Proposition no. 49 (2006–2007) to the Odelsting). Folketrygdfondet's accounts will therefore include items concerning the investments for the Government Pension Fund – Norway.
- All the investments for the Government Pension Fund – Norway must be measured at fair value. In accordance with the general rules in the Accounting Act, the classification will determine the evaluation principles for financial investments. The rules in the regulation always assume evaluation at fair value for the investments for the Government Pension Fund – Norway.
- The profit and loss statement for Folketrygdfondet must include a separate line in the accounts with one income item that is equal to the profit or loss for the year of the Government Pension Fund – Norway and one expense

item equal to the change in the Government's capital contribution. The balance sheet for Folketrygdfondet must include a separate line in the accounts with one assets item that is equal to the investments of the Government Pension Fund – Norway and one liabilities item equal to the Government's capital contribution to the Government Pension Fund – Norway.

- Special profit and loss and balance sheet statements must be prepared for the investments for the Government Pension Fund – Norway.

The Ministry will present a more detailed assessment of the need to introduce international accounting standards (IFRS) for Folketrygdfondet including the Government Pension Fund – Norway once more experience has been acquired with the new management framework for the Fund.

The Ministry of Finance

r e c o m m e n d s :

Recommendation of 3 April 2009 from the Ministry of Finance on the Management of the Government Pension Fund in 2007 is submitted to the Storting.

Appendix 1

Provisions on the Management of the Government Pension Fund

Government pension fund Act (No. 123 of 21 December 2005)

Section 1 The Government Pension Fund shall support central government saving to finance the National Insurance Scheme's expenditure on pensions and long-term considerations in the application of petroleum revenues.

Section 2 The Government Pension Fund is managed by the Ministry of Finance. The Fund comprises the Government Pension Fund – Global and the Government Pension Fund – Norway.

The foreign portion is deposited in an account at Norges Bank. The countervalue is managed under further rules laid down by the Ministry, see section 7.

The domestic portion is placed as a capital contribution to Folketrygdfondet. The countervalue is managed under further rules laid down by the Ministry, see section 7.

Section 3 Income of the Government Pension Fund – Global consists of the cash flow from petroleum activities, which is transferred from the central government budget, the return on the Fund's capital, and the net results of financial transactions associated with petroleum activities.

The cash flow is the sum of

1. total tax revenues and royalty deriving from petroleum activities collected pursuant to Petroleum Taxation Act (no. 35 of 13 June 1975) and the Petroleum Activities Act (no. 72 of 29 November 1996),
2. revenues deriving from tax on CO2 emissions due to petroleum activities on the continental shelf,
3. revenues deriving from tax on NOx emissions due to petroleum activities on the continental shelf,
4. revenues deriving from the State's Direct Financial Interest in petroleum activities, defined as operating income and other income less operating expenses and other direct expenses,
5. central government revenues from net surplus agreements associated with certain production licences,
6. dividends from Statoil ASA,
7. transfers from the Petroleum Insurance Fund,
8. central government revenues deriving from the removal or alternative use of installations on the continental shelf,
9. any government sale of stakes representing the State's Direct Financial Interest in petroleum activities,

less

1. central government direct investments in petroleum activities,
2. central government expenses in connection with the Petroleum Insurance Fund,
3. central government expenses in connection with the removal or alternative use of installations on the continental shelf,
4. any government purchase of stakes as part of the State's Direct Financial Interest in petroleum activities.

Net financial transactions associated with petroleum activities are gross revenues from government sale of shares in Statoil ASA less

1. any government purchase of shares in Statoil ASA, defined as the market price paid by the government for the shares,
2. government capital contributions to Statoil ASA and companies attending to government interests in petroleum activities.

Section 4 Income of the Government Pension Fund – Norway consists of the return on the capital under management.

Section 5 The capital of the Government Pension Fund may only be used for transfers to the central

government budget pursuant to a resolution by the Storting (Norwegian parliament).

Section 6 The Government Pension Fund itself has no rights or obligations vis-à-vis private sector entities or public authorities, and may not institute legal proceedings or be subjected to legal proceedings.

Section 7 The Ministry may issue supplementary provisions to implement this Act. The Ministry may also lay down further provisions concerning the administration etc., Folketrygdfondet.

Section 8 The Act enters into force at such time as the King decides. The King may bring the individual provisions into force at different times. The Ministry may make transitional rules.

Provisions on Folketrygdfondet laid down pursuant to the National Insurance Act section 23-11 fourth paragraph apply until otherwise prescribed pursuant to section 7.

Section 9 The following amendments to other Acts become effective as from the entry into force of this Act:

1. Repeal of the Government Petroleum Fund Act (no. 36 of 22 June 1990).

Regulations on Management of the Government Pension Fund – Global

Laid down by the Ministry of Finance on 22 December 2005 pursuant to the Government Pension Fund Act (no. 123 of 21 December 2005).

Section 1 Management of the Government Pension Fund – Global

Norges Bank manages the Government Pension Fund – Global (hereafter termed "the Fund") on behalf of the Ministry of Finance. The Bank may use other managers.

Norges Bank shall prepare an annual report and quarterly reports for the Fund. The reports shall be public.

Section 2 Investment of the Fund

The Fund shall be placed on separate account in the form of krone deposits with Norges Bank. Norges Bank shall invest this capital in its own name in financial instruments and cash deposits denominated in foreign currency.

The actual portfolio shall be composed through extensive use of diversification.

Norges Bank shall seek to achieve the highest possible return on the investments in foreign currency within the investment limits set out in these regulations and guidelines issued under these regulations.

Section 3 Accounting return

The value of the Fund's krone account shall be equivalent to the value of the portfolio of financial instruments and cash deposits in foreign currency. Norges Bank's book return on the portfolio, less remuneration to Norges Bank, shall be added to the Fund's krone account on 31 December each year.

Section 4 Investment universe

The Fund shall be invested in accordance with the following asset allocation:

- Fixed income instruments 30 – 70%
- Equity instruments 30 – 70%

Financial instruments, including derivatives, which are naturally related to asset classes as mentioned in the first paragraph may be utilised. Commodity-based contracts and fund units are also eligible. Commodity-based instruments shall not be taken into account when calculating the asset allocation under the first paragraph.

The portfolio of fixed income instruments shall be invested in accordance with the following currency and regional distribution:

- Europe 50 – 70%
- The Americas and Africa 25 – 45%
- Asia and Oceania 0 – 15%

The Ministry of Finance may lay down further rules on the exclusion of fixed income instruments from the investment universe.

The portfolio of equity instruments shall be invested in equity instruments that are listed on a regulated and recognized market place in accordance with the following currency and regional distribution:

- Europe 40 – 60%
- The Americas and Africa 25 – 45%
- Asia and Oceania 5 – 25%

Investments in securities issued by Norwegian enterprises are not permitted. "Norwegian enter-

prises" means any enterprise whose head office is in Norway.

Section 5 Benchmark portfolio and tracking error

The Ministry of Finance establishes a benchmark portfolio for the Fund.

The expected difference in return between the actual portfolio and the benchmark portfolio measured by tracking error on an annualised basis shall not exceed 1.5 percentage points.

Section 6 Equity holdings

The investments may not be placed such that the Fund attains a holding of more than five per cent of the shares of a single company that confer voting rights.

Norges Bank shall exercise voting rights for the Fund. The Ministry of Finance may issue supplementary guidelines for Norges Bank's exercise of ownership. The overall goal of exercise of ownership is to safeguard the Fund's financial interests.

Section 7 Risk systems and risk management

Norges Bank shall ensure that satisfactory risk systems and control routines are in place in regard to instruments used in the management of the Fund. The same applies in regard to the handling of counterparty risk and operational risk.

Section 8 Screening and exclusion

The Ministry of Finance establishes Ethical Guidelines for the Fund and decides whether specific issuers shall be excluded from the Fund's investment universe. An ethics council shall be appointed to advise on whether investment opportunities in financial instruments issued by specified issuers are contrary to the Ethical Guidelines.

The Ministry of Finance may lay down further rules for the ethics council, its activities and organisation.

Section 9 Commencement

These regulations shall come into force on 1 January 2006.

Guidelines for management of the Government Pension Fund – Global

These guidelines lay down supplementary provisions to the Government Pension Fund Act and the Regulations on Management of the Government Pension Fund – Global ("the regulations").

Contents:

1. Benchmark portfolio
2. Rebalancing of the benchmark portfolio
3. Tracking error and additional constraints
4. Requirements on valuation, measurement of return and management and control of risk
5. Ethics

1. Benchmark portfolio – section 5 of the regulations

1.1 The strategic benchmark portfolio

The composition of the strategic benchmark portfolio is 60 per cent fixed income and 40 per cent equities.

1.2 Benchmark portfolio for fixed income instruments

The strategic benchmark portfolio for fixed income instruments has the following composition:

– 60 per cent of the portfolio shall consist of Barclays Capital Global Aggregate Bond Index (BCGA) and Barclays Capital Global Inflation Linked Index (BCGI) in Europe except for Norwegian kroner (NOK) and with the addition of domestic government bonds that are included in Barclays Capital Swiss Franc Aggregate Bond Index. This section of the benchmark portfolio consists of the following currencies: Euro, British pound, Swiss franc, Swedish krona and Danish krone.
– 35 per cent of the portfolio shall consist of BCGA and BCGI in the United States and Canada with adjusted sector weights in accordance with table 8.1. This section of the benchmark portfolio consists of the following currencies: Canadian dollar and US dollar.
– 5 per cent of the portfolio shall consist of domestic government bonds from developed markets in BCGA and BCGI in Asia/Oceania (Australia, Japan, New Zealand and Singapore). Japan's share is calculated based on a factor of 25 per cent of the market capitalisation value of Japanese bonds.This section of the benchmark portfolio consists of the following

Table 1.1 Within the section of the benchmark portfolio based on LGA and LGR in the United States and Canada the sector weights are adjusted by multiplying market capitalization weights with the following factors:

	Currency	Sector	Region	Factor
NB CAD ABS	CAD	Securitised	AMERICA	1.0
NB CAD Agency	CAD	Government Related	AMERICA	1.0
NB CAD CMBS	CAD	Securitised	AMERICA	1.0
NB CAD Covered Bonds	CAD	Securitised	AMERICA	1.0
NB CAD Financial	CAD	Corporate	AMERICA	1.0
Global Inflation-Linked: Canada	CAD	ILB	AMERICA	1.0
NB CAD INDS SR	CAD	Corporate	AMERICA	1.0
NB CAD Local Authority	CAD	Government Related	AMERICA	1.0
NB CAD MBS	CAD	Securitised	AMERICA	1.0
NB CAD Sovereign	CAD	Government Related	AMERICA	1.0
NB CAD Supranational	CAD	Government Related	AMERICA	1.0
NB CAD Treasury	CAD	Treasury	AMERICA	1.0
NB CAD Utility	CAD	Corporate	AMERICA	1.0
NB USD ABS	USD	Securitised	AMERICA	0.5
NB USD Agency	USD	Government Related	AMERICA	0.5
NB USD CMBS	USD	Securitised	AMERICA	0.5
NB USD Covered Bonds	USD	Securitised	AMERICA	0.5
NB USD Financial	USD	Corporate	AMERICA	1+x
Global Inflation-Linked: U.S. TIPS	USD	ILB	AMERICA	1+x
NB USD INDS SR	USD	Corporate	AMERICA	1+x
NB USD Local Authority	USD	Government Related	AMERICA	1+x
NB USD MBS	USD	Securitised	AMERICA	0.5
NB USD Sovereign	USD	Government Related	AMERICA	1+x
NB USD Supranational	USD	Government Related	AMERICA	1+x
NB USD Treasury	USD	Treasury	AMERICA	1+x
NB USD Utility	USD	Corporate	AMERICA	1+x

The variable x is to be calculated monthly in such a way that total market capitalization in USD is unaffected by the adjustments.

currencies: Australian dollar, Japanese yen, New Zealand dollar and Singapore dollar.

At each month-end the composition of the benchmark portfolio is revised in line with the changes in composition carried out by Bardays Capital.

If new currencies that otherwise form part of the benchmark portfolio are included in BCGI, such instruments shall be included in the benchmark portfolio as from the date decided by the Ministry of Finance.

1.3 Benchmark portfolio for equity instruments

The strategic benchmark portfolio for equity instruments is based on tax-adjusted FTSE All-Cap indices (large and medium-size and small companies) and shall have the following composition:

- 50 per cent FTSE All-Cap Europe in which the following countries are included: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Sweden, Spain, Switzerland and United Kingdom.
- 35 per cent FTSE All-Cap Americas/FTSE All-World Africa in which the following countries are included: Brazil, Canada, Mexico, South Africa and United States.
- 15 per cent FTSE All-Cap Asia Pacific in which the following countries are included: Australia, Hong Kong, Japan, New Zealand, Singapore, South Korea, and Taiwan.

The allocation within each region are determined on the basis of market capitalization weights with daily rebalancing of country weights within each region.

2 Rebalancing of the benchmark portfolio – section 5 of the regulations

This item is exempt from the public domain.

3 Tracking error and additional restrictions – sections 4 to 6 of the regulations

3.1 Limit on tracking error

A general requirement is that expected (ex ante) tracking error shall be calculated using a system which models risk associated with the most important financial instruments in which the Fund invests. In cases where the system does not model financial instruments in which the Fund invests, the approach shall employ conservative estimates and methods making it more likely that expected tracking error will be overestimated than underestimated in relation to actual tracking error. The system shall aggregate risk across asset classes and financial instruments in a satisfactory manner.

An important objective for the risk system is that risk attending financial instruments should be calculated in such a way as to ensure that, over time, estimated risk in the Fund deviates as little as possible from actual risk. Moreover, some degree of stability in the choice of system for calculating risk is appropriate.

3.2 Restrictions on investments in certain fixed income securities issued by sovereigns

The Fund may not be invested in fixed income securities issued by the following sovereigns: Burma (Myanmar).

3.3 Requirements on the approval process for new markets and currencies

Prior to the implementation of investments in new countries, a thorough process must have been completed, which in each individual case provide the bank with an overview of relevant issues relating to valuation, return measurement, as well as the management and control of risks associated with investments in each individual market and currency. Such effort is required to include an assessment against the requirements implied by the Regulations and the supplementary guidelines, and to be documented.

4 Requirements on valuation, performance measurement and management and control of risk – section 7 of the regulations

Valuation, performance measurement and management and control of risk shall comply with internationally recognised standards and methods. The Fund cannot invest in markets, asset classes or instruments if compliance with these requirements cannot be documented. See also 3.1.

4.1 Valuation and measurement of return

The method used to establish the value of financial instruments shall be verifiable and shall indicate with reasonable assurance the true value of the Fund's assets at the time of measurement. Valuation shall take place at least monthly and shall be based on market prices or, in cases where market prices cannot be observed, on generally recognised price models.

4.2 Management, measurement and control of risk

4.2.1 Market risk

Market risk shall be measured in such a way that compliance with the limit on relative risk in the Pension Fund can be documented. Best practice in the area shall be employed in regard to measuring methods, decomposition and measurement frequency.

4.2.2 Counterparty risk

Norges Bank shall have satisfactory routines and systems for selecting and evaluating counterparties. The monitoring system and measurement frequency employed for control of counterparty risk, including requirements on minimum credit rating and exposure limits, shall follow best practice in the area.

Counterparties for unsecured deposits and trading in unlisted derivatives shall have a long-term credit rating of at least A-/A3/A- from at least one of the following three agencies: Fitch, Moody's or Standard & Poor's. Norges Bank may make exemption from this minimum requirement in regard to a central counterparty. When such

exemption is granted, the Ministry of Finance shall be informed thereafter.

Norges Bank must lay down such supplementary requirements on credit rating, provision of security and exposure limits as are appropriate in the operative management, and shall measure overall exposure to counterparties using internationally recognised methods that meet necessary requirements as to verifiability and accuracy.

Norwegian banks can be used as counterparties in currency trading and when making bank deposits, provided the currency involved is included in the investment universe.

4.2.3 Operational risk

Identification and measurement methods shall comply with internationally recognised standards for the various dimensions of operational risk. Operational risk shall be identified and shall be measurable and controllable before new activities (e.g. investments in new countries, instruments, asset classes, counterparties, external service providers, IT systems etc) are started.

4.3 Reporting

Annual reports prepared by Norges Bank under section 1 of the regulations shall contain:

- Norges Bank's strategic plan and the investment strategy for the Fund
- A list of all significant external service providers, including a complete list of external managers
- An account of the standards employed by Norges Bank for the purpose of valuation (accounts), measurement of return, along with management, measurement and control of identified risk factors (market risk, counterparty risk and operational risk)
- A report on the Fund's return, including absolute and relative return measured in Norwegian kroner and the Fund's currency basket, real return, decomposition of return on asset class and internal/external management
- A report on costs related to the phasing in of new capital, exclusion of companies and other changes resulting from any decision by the Ministry of Finance to change the Fund's benchmark portfolio
- A report on the Fund's absolute and relative market risk (volatility), monthly figures – in the aggregate and distributed on asset classes
- The composition of the fixed income portfolio by main categories of credit rating grade
- An overview of new countries, currencies and instruments in which the portfolio has been invested
- An overview of the Fund's investments in relation to the regulations' quantitative provisions
- An account of the exercise of ownership rights in accordance with the ministry's Ethical Guidelines, see 5.3.2
- A list of companies that are excluded from the investment universe
- A report on the accounts in accordance with Norges Bank's accounting principles
- A complete list of equities and bonds as of 31 December
- An account of the organisation and operating expenses of Norges Bank Investment Management

Quarterly reports prepared by Norges Bank shall contain:

- A report on the Fund's return, including absolute and relative return in Norwegian kroner and the Fund's currency basket, real return, and a description of important contributions to relative return
- A report on the Fund's absolute and relative market risk (volatility), monthly figures – in the aggregate and distributed on asset classes
- The composition of the fixed income portfolio by main categories of credit rating grade
- An overview of the Fund's investments in relation to the regulations' quantitative provisions
- A list of companies that are excluded from the investment universe
- A report on the accounts in accordance with Norges Bank's accounting principles

Any breach of the regulations' cap on maximum holdings that is reversed within 10 trading days does not constitute a formal breach of the regulations and shall not be reported to the ministry.

5 Ethical guidelines – section 8 of the regulations

5.1 Basis

The Fund's Ethical Guidelines are based on two premises:

- The Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations. The financial wealth must be managed with a view to

generating a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense. The Fund's financial interests should be consolidated by using the Fund's ownership positions to promote sustainable development.
- The Fund should not make investments that entail an unacceptable risk that Fund is contributing to unethical acts or emissions, serious violations of fundamental humanitarian principles, gross violations of human rights, gross corruption or severe environmental degradation.

5.2 Mechanisms

The ethical basis for the Fund shall be promoted using the following three mechanisms:
- Exercise of ownership rights to promote long-term financial returns based on the United Nations Global Compact and the OECD Guidelines for Corporate Governance and for Multinational Enterprises
- Negative screening from the investment universe of companies which, themselves or through companies they control, produce weapons whose normal violates fundamental humanitarian principles
- Exclusion of companies from the investment universe where there is deemed to exist a considerable risk of contributing to:
  - Gross or systematic violations of human rights, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other child exploitation
  - Gross violations of individual rights in war or conflict situations
  - Severe environmental degradation
  - Gross corruption
  - Other particularly serious violations of fundamental ethical norms.

5.3 Exercise of ownership rights

5.3.1

The primary objective of Norges Bank's exercise of ownership rights for the Fund is to safeguard the Fund's financial interests. The exercise of ownership rights shall be based on a long horizon for the Fund's investments, and broad investment diversification in the markets that are included in the investment universe. The exercise of ownership rights shall primarily be based on the United Nations Global Compact and the OECD Guidelines for Corporate Governance and for Multinational Enterprises. Norges Bank's internal guidelines for the exercise of ownership rights shall stipulate how these priniciples are to be integrated in the exercise of ownership rights.

5.3.2

Norges Bank shall report on its exercise of ownership rights in connection with its ordinary annual reporting. An account shall be provided of how the Bank has acted as owner representative – including including a description of the work to promote special interests relating to the long-term horizon and diversification of investments in accordance with section 5.3.1.

5.3.3

Norges Bank may delegate the exercise of ownership rights to external managers in accordance with these guidelines.

5.4 Negative screening and exclusion

5.4.1

The Ministry of Finance shall make decisions on negative screening and exclusion of companies from the investment universe based on the recommendations of the Fund's Advisory Council on Ethics. The recommendations and decisions are to be made public. The ministry may in certain cases postpone the time of public disclosure if this is deemed necessary in order to ensure a financially sound implementation of the exclusion of the company concerned.

5.4.2

The Fund's Advisory Council on Ethics shall be composed of five members. The Council shall have its own secretariat. The Council shall submit an annual report on its activities to the Ministry of Finance.

5.4.3

The Council shall issue recommendations at the request of the Ministry of Finance on whether an investment may be in violation of Norway's obligations under international law.

5.4.4

The Council shall issue recommendations on negative screening of companies that:

- produce weapons that through their normal use violate fundamental humanitarian principles; or
- sell weapons or military materiel to states mentioned in Clause 3.2 of the supplementary guidelines for the management of the Fund.

The Council shall issue recommendations on the exclusion of companies from the investment universe because of acts or omissions that constitute an unacceptable risk of the Fund contributing to:

- serious or systematic human rights violations, such as murder, torture, deprivation of liberty, forced labour, the worst forms of child labour and other forms of child exploitation,
- serious violations of individuals' rights in situations of war or conflict,
- severe environmental damages,
- gross corruption; or
- other particularly serious violations of fundamental ethical norms.

The Council shall raise issues under this provision on its own initiative or at the request of the Ministry of Finance.

5.4.5

The Council shall gather the necessary information on an independent basis and ensure that a matter is elucidated as fully as possible before a recommendation concerning screening or exclusion from the investment universe is issued. The Council can request Norges Bank to provide information as to how specific companies are dealt with in the exercise of ownership rights. All enquiries to such companies shall be channelled through Norges Bank. If the Council is considering an exclusion recommendation, the draft recommendation, and the grounds for it, shall be submitted to the company for comment.

5.4.6

The Council shall review on a regular basis whether the grounds for exclusion still apply and can on receipt of new information recommend that the Ministry of Finance reverse the exclusion decision.

5.4.7

Norges Bank shall receive immediate notification of the decisions made by the Ministry of Finance in connection with the Council's recommendations. The Ministry of Finance can request that Norges Bank inform the companies concerned of the decision taken by the Ministry of Finance and the reasons for the decision.

5.5 Exclusion of individual companies

The list of companies that are excluded from the investment universe of the Government Pension Fund – Global is available on the website of the Ministry of Finance.

Temporary guidelines - transition periodes

This item is excempt from the public domain

Management agreement between the Ministry of Finance and Norges Bank

The Ministry of Finance and Norges Bank entered into the following Management Agreement for the Government Pension Fund – Global on 12 February 2001. It was most recently amended on 22 December 2005:

1. The contents of the agreement etc.

The State, represented by the Ministry of Finance, has delegated responsibility for the operational management of the Government Pension Fund – Global ("the Fund") to Norges Bank. The management of the Fund is subject to the Government Pension Fund Act (no. 36 of 20 December 2005), Regulations on the Government Pension Fund – Global and guidelines with supplementary provisions that have been or may be adopted by the Ministry of Finance. This Agreement, together with the Act and Regulations regulations mentioned, governs the relationship between the Ministry of Finance and Norges Bank in connection with the management of the Fund.

All communication referring to this agreement shall be in writing and shall be signed. Such communication shall be sent to Norges Bank Investment Management and to the Economic Policy Department of the Ministry of Finance.

2. Norges Bank's obligations

2.1 Norges Bank's responsibilities

Norges Bank shall manage the Fund in accordance with the law, the Regulations for Financial Management in the Government Administration, regulations and other decisions and guidelines that apply to the Fund (cf. Clauses 1 and 3.1). Matters of special importance shall be submitted to the Ministry of Finance.

Quarterly and annual reports on the management of the Fund which are issued by Norges Bank (see section 1 of the regulations), shall be certified by Central Bank Audit. Norges Bank shall without undue delay notify the Ministry of significant changes or expected significant changes in the value of the Fund. Norges Bank shall provide the Ministry of Finance with information as requested by the Ministry, including information in machine-readable form to companies that assist the Ministry in evaluating Norges Bank's management of the Government Pension Fund – Global.

Norges Bank is liable to pay damages to the State for losses arising as a result of negligence or intent on the part of the Bank, external managers or external service providers with whom the Bank has entered into an agreement (see Clause 2.2 first paragraph of the Agreement).

2.2 Management of the Fund

Norges Bank may use external managers and external service providers in the management of the Fund. Such managers must have satisfactory internal Ethical Guidelines for their activity. Norges Bank is party to agreements with such service providers, and shall oversee their activity on behalf of the Fund.

The Ministry of Finance shall be informed of the choice of external service providers that are of major importance to management and of the grounds for the choice. The Ministry shall receive copies of the annexes relating to remuneration in new management agreements entered into by Norges Bank with external managers in connection with the management of the Fund. Remuneration to external managers shall be such that the Fund retains the major part of the increase in excess return. The Ministry of Finance may require Norges Bank to submit to the Ministry all contracts entered into in connection with the management of the Fund.

2.3 Amendments to regulations, guidelines etc.

At the request of the Ministry of Finance, Norges Bank shall provide the Ministry with advice regarding amendments to the framework conditions for management, including regulations, decisions and guidelines laid down by the Ministry. Norges Bank may also submit its own proposals for changes in the framework conditions if the Bank considers it appropriate.

2.4 Exclusion and screening of financial instruments

At the request of the Ministry of Finance or the Fund's Advisory Council on Ethics, Norges Bank shall obtain information from specified issuers and give this information to the Council.

If the Ministry of Finance decides to exclude particular financial instruments from the investment universe of the Fund, Norges Bank shall normally be allowed a period of eight weeks in which to complete the sale of these instruments.

Norges Bank shall notify the Ministry of Finance when a sale has been completed. The Ministry of Finance shall consider whether to announce the assessments of the Council and the Ministry of Finance on a case-by-case basis (cf. the Royal Decree of 19 November 2004). If management considerations so indicate, the Ministry shall endeavour to postpone announcement until after it has been notified that a sale has been completed.

2.5 Information

Norges Bank shall, within the framework of the Freedom of Information Act and the Public Administration Act, and in accordance with further guidelines issued by the Ministry of Finance, provide information to the public concerning the performance of the management assignment.

3. The obligations of the Ministry of Finance

3.1 Regulations, guidelines, etc.

Norges Bank shall have the opportunity to express its view before any changes are made to regulations, decisions or guidelines on management, and shall be given reasonable notice to make changes in the portfolio.

3.2 Remuneration

Remuneration shall be in compliance with Annex 1 to this Agreement. Up to 1 December each year both parties may request changes in the method of calculating remuneration for the subsequent calendar year.

Remuneration shall be deducted from the Fund's gross return before the net return is transferred to the Fund's krone account on 31 December each year. Norges Bank shall submit its remuneration calculations to the Ministry of Finance as early as possible and no later than one week before finalising the accounts.

3.3 Crediting

The Ministry of Finance shall make any transfers of capital from the Treasury to the Fund's krone account in Norges Bank. The deadline for notifying Norges Bank and the final krone amount to be credited shall be in accordance with the prevailing "Guidelines for rebalancing the Fund".

3.4 Debiting

The Ministry of Finance shall notify Norges Bank in due time before making any deductions from the Fund to allow the Bank to make portfolio adjustments. The Ministry of Finance shall notify Norges Bank of the account to which the transfer is to be credited.

3.5 Tax issues

The Ministry of Finance shall contribute to providing the documentation necessary to clarify the tax position of the Fund's investments abroad.

4. Amendments and termination

4.1 Amendments

The Agreement shall be amended when changes in laws or regulations, decisions or guidelines so indicate. This Agreement and the annex thereto shall not otherwise be amended without written approval from both parties.

4.2 Termination etc.

If neither party has given written notification by 31 December in a given year that the agreement is to be terminated as from 31 December of the following year, the agreement will continue to apply for a further year at a time until such notification is given.

The Ministry of Finance will lay down further rules and instructions regarding termination of the management assignment, including severance pay and other remuneration to Norges Bank in connection with the termination. Clause 3.1 shall apply to a corresponding extent.

Oslo, 22 December 2005

For the Ministry of Finance
For Norges Bank

Annex 1:

Remuneration for management of the Government Pension Fund – Global

The remuneration shall cover Norges Bank's costs associated with management of the Fund. For 2008, however, costs over and above 10.0 basis points of the Fund's average market value will not be covered. Calculation of the average amount shall be based on the market value of the Fund's portfolio measured in Norwegian kroner at the start of each month in the calendar year. In addition to coverage of costs up to the upper limit, Norges Bank shall receive remuneration for performance-based fees to external managers.

Act No. 44 of 29 June 2007 relating to Folketrygdfondet

Section 1 Objective

By order of the Ministry, Folketrygdfondet shall manage, in its own name, the equivalent of the capital contribution of the Government Pension Fund – Norway; cf. section 2 of Act of 21 December 2005 relating to the Government Pension Fund. Folketrygdfondet shall also perform other management tasks assigned to it by the Ministry.

Section 2 Owner

The Government is the sole owner of Folketrygdfondet.

Section 3 Legal status

Folketrygdfondet is a separate legal entity.

Section 4 Statutes

Folketrygdfondet shall have statutes that are laid down by the Ministry.

Section 5 Registration in the Register of Business Enterprises

Folketrygdfondet shall be registered in the Register of Business Enterprises.

Section 6 Relationship with other legislation

The Public Administration Act does not apply to Folketrygdfondet. However, the Public Administration Act's provisions concerning bias and duty of confidentiality apply to Folketrygdfondet's representatives, employees, and others who provide services to or work for Folketrygdfondet. The duty of confidentiality does not apply in relation to the Ministry.

Folketrygdfondet is considered a public body under the Archives Act of 4 December 1992 No. 126, section 2, paragraph (g).

Section 7 Government equity contribution and liability

Upon the establishment of Folketrygdfondet, the Government shall make an equity contribution. The Ministry may determine changes in the contribution and the application of the profit thereof.

The Government is not liable for Folketrygdfondet's obligations.

Section 8 The Executive Board

Folketrygdfondet shall have an Executive Board comprising nine members, who, together with their personal alternates, are to be appointed by the King for four years at a time, until the accounts have been closed for the fourth year after the appointment.

When discussing administrative matters, the Executive Board is to be supplemented by one additional member and one observer elected from amongst the employees.

Members and alternates may step down before the end of their term of appointment with reasonable prior notice to the Ministry.

Upon the resignation or death of a board member or alternate during the term of their appointment, a new member or alternate shall be appointed for the remaining term.

The King appoints the chairperson of the Executive Board. The Executive Board elects the vice chairperson from amongst its members.

Board members and alternates shall receive remuneration as stipulated by the Ministry.

Section 20-6 of the Companies Act is equally applicable to Folketrygdfondet.

Section 9 The management and supervisory responsibility of the Executive Board

The management of Folketrygdfondet falls within the scope of the Executive Board.

The Executive Board shall make sure the entity is properly organised. The Executive Board shall keep itself informed of Folketrygdfondet's activities and is obliged to ensure that the operation, including accounts and asset management, is subject to adequate control.

The Executive Board shall supervise the administrative staff's management of Folketrygdfondet and the operation in general.

Section 6-17 of the Companies Act is equally applicable to Folketrygdfondet.

Section 10 Managing director

The managing director of Folketrygdfondet is appointed by the Executive Board. The managing director's remuneration and pension are determined by the Executive Board with notification to the Ministry.

The managing director is in charge of the daily running of Folketrygdfondet's activities and shall observe the guidelines and instructions issued by the Executive Board.

Day-to-day management does not include matters of an unusual nature or of great importance.

The managing director shall ensure that Folketrygdfondet's accounts comply with the requirements laid down in section 12 of this Act and that the asset management is adequately organized.

Section 6-17 of the Companies Act is equally applicable to the managing director of Folketrygdfondet.

Section 11 External representation

The Executive Board represents Folketrygdfondet externally and signs on its behalf.

The Executive Board may authorize board members or the managing director to sign on behalf of Folketrygdfondet. Such powers may be prescribed by the statutes, which may also limit the Executive Board's authority to sign on behalf of Folketrygdfondet.

The managing director represents Folketrygdfondet externally in matters that fall within his or her mandate under section 10 of this Act.

In the case that anyone who represents Folketrygdfondet by acting on its behalf oversteps his authority, the transaction is not binding on Folketrygdfondet if the other contracting party realized or should have realized that the authority had been exceeded and that it would therefore be contrary to honesty to invoke the transaction.

Section 12 Annual accounts and annual report

Folketrygdfondet is required to prepare accounts under the Accounting Act and to keep books and records under the Bookkeeping Act. The Ministry's regulations may supplement or deviate from the provisions in the Accounting Act with regard to Folketrygdfondet.

The annual accounts and annual report shall be approved by the Ministry and reported to the Storting.

Section 13 Auditing

Folketrygdfondet shall have an auditor elected by the Ministry. The Ministry may lay down auditing rules in the regulations.

The auditor's remuneration shall be approved by the Ministry.

The Executive Board shall appoint Folketrygdfondet's internal audit department. The Executive Board shall approve the resources and plans of the internal audit department on an annual basis. The internal audit department shall report to the Executive Board.

Section 14 Inspection by the Office of the Auditor General

The Office of the Auditor General supervises the management of Government interests and may carry out inspections of Folketrygdfondet under Act No. 21 of 7 May 2004 relating to the Office of the Auditor General and directives issued by the Storting.

Section 15 Supplementary provisions

The Ministry may establish regulations for Folketrygdfondet containing more detailed rules.

Section 16 Effective date and amendments to other Acts

The Act will enter into effect on the date determined by the King.

From the time the Act enters into effect, the following amendments will be made to other Acts:

1. The following amendments will be made to Act No. 14 of 26 March 1999 relating to Capital and Income Taxation (the Taxation Act):

   Section 2-30, subsection (1), paragraph (e), no. 7, shall read:

   7.Folketrygdfondet

   Section 2-30, subsection (1), paragraph (f), shall read:

   f. Folketrygdfondet

2. Section 7, second clause, of Act No. 123 of 21 December 2005 relating to the Government Pension Fund is repealed.

Section 17 Transitional provisions

The transfer of obligations associated with the administrative body Folketrygdfondet to the separate legal entity Folketrygdfondet releases the Government. Creditors and other rightful claimants cannot oppose the transfer or claim that the transfer constitutes a reason for cessation of the legal relationship.

Act No. 3 of 4 March 1983 relating to Civil Servants etc. (Civil Service Act), section 13, subsection 2-6, concerning the preferential right to other posts and severance pay, shall still be applicable to employees of the administrative body Folketrygdfondet who are dismissed on the grounds cited in the Civil Service Act, section 13, subsection 1, paragraphs (a), (b), and (c), and who were covered by these rules before the Act entered into effect. The preferential rights to other posts and severance pay pursuant to the previous clause expire three years after the Act has entered into effect.

Other transitional provisions are determined by the King.

Regulations relating to the management of the Government Pension Fund – Norway

Legal authority: Laid down by the Ministry of Finance on 7 November 2007 under and in pursuance of section 15 of Act No. 44 of 29 June 2007 relating to Folketrygdfondet.

Section 1 Management of the Government Pension Fund – Norway

Folketrygdfondet shall manage the Government Pension Fund – Norway (hereinafter referred to as the «Pension Fund») on behalf of the Ministry of Finance.

Section 2 Investment of the Pension Fund

The Pension Fund is a capital contribution to Folketrygdfondet. Folketrygdfondet shall reinvest, in its own name, this capital in financial instruments and cash deposits.

The Executive Board of Folketrygdfondet is responsible for ensuring that the Pension Fund's capital is invested with a view to achieving the best possible return over time in Norwegian kroner within the framework of laws, regulations, and supplementary guidelines governing the management.

Section 3 Accounting return

The value of the Pension Fund shall be equivalent to the value of the portfolio of financial instruments and cash deposits. The book return on the portfolio, with the deduction of payments to Folketrygdfondet, is added to the capital as of 31 December each year.

Section 4 Investment universe

The Pension Fund shall be invested in an equity and fixed income portfolio according to the following distribution:

Equity instruments 50-70 pct.
Interest-bearing instruments 30-50 pct.

Equity instruments include shares, primary capital certificates, convertible bonds, and bonds with warrants for shares listed on a regulated market place. In the management of the equity and fixed income portfolio, financial instruments may be used, including derivatives. Folketrygdfondet may enter into sale and repurchase agreements relating to equity instruments and interest-bearing instruments whereby the purchaser of the instruments is obliged under the agreement to return these to the seller.

The portfolio of equity instruments shall be invested in equity instruments listed on a regulated market place in accordance with the following distribution:

Norway 80-90 pct.
Denmark, Finland, and Sweden 10-20 pct.

The fixed income portfolio shall be invested in interest-bearing instruments whose issuers are domiciled in Denmark, Finland, Sweden, and Norway, or have listed equity on regulated market places in these countries, according to the following distribution:

Norway 80-90 pct.
Denmark, Finland, and Sweden 10-20 pct.

Up to 2.5 pct. of the Pension Fund capital may be invested in Norwegian shares that have not been listed on a regulated market place if the company has applied for or has specifically planned to apply for a listing on such a market place.

Folketrygdfondet may retain shares in Norwegian companies that change their status to become foreign companies in connection with acquisitions, mergers etc.

The Ministry of Finance may decide to exclude companies from the investment universe of Folketrygdfondet.

Section 5 Benchmark portfolio and tracking error

The Ministry of Finance determines a benchmark portfolio for the Pension Fund.

The expected discrepancy between the return on the actual portfolio and that on the benchmark portfolio, measured by expected tracking error on an annualized basis must not exceed 3 percentage points. Foreign currency positions shall not be taken in the active management of the Pension Fund.

Section 6 Share ownership

Folketrygdfondet may hold up to 15 per cent of the share capital or the primary capital of one single company in Norway. Folketrygdfondet may hold up to 5 per cent of the share capital or the primary capital in one single company in Denmark,

Finland, and Sweden. A company's ownership of its own shares shall not be taken into account under this provision.

Section 7 Risk management

The Executive Board shall ensure that adequate risk management and control routines are adopted in the management of the Pension Fund.

Section 8 Exercise of ownership rights and ethics

The primary objective of Folketrygdfondet's exercise of ownership rights is to safeguard the Pension Fund's financial interests.

Folketrygdfondet shall have Ethical Guidelines for the management of the Pension Fund.

Section 9 Annual and semi-annual reports

Folketrygdfondet shall prepare annual and semi-annuals reports on the management of the Pension Fund.

Section 10 Supplementary provisions

The Ministry of Finance may prescribe more detailed provisions in order to supplement and implement the rules. In special cases, the Ministry of Finance may deviate from sections 4 – 6.

Section 11 Effective date

The Regulations enter into effect on 1 January 2008, repealing, from the same date, Regulations No. 1419 of 1 December 2006 relating to the Management of the Government Pension Fund – Norway.

Guidelines for the management of the Government Pension Fund – Norway

These guidelines provide supplementary provisions to the Act relating to the Government Pension Fund and Regulations relating to the Government Pension Fund – Norway («Regulations»).

Contents:

1. Benchmark portfolio and investment universe
2. Rebalancing of the benchmark portfolio
3. Requirements for valuation, return measurement, and risk management and control
4. Reporting
5. Exercise of ownership rights and ethics
6. Transitional provisions

1. Benchmark portfolio and investment universe – Sections 4-5 of the Regulations

1.1 Strategic benchmark portfolio – asset classes

The strategic benchmark portfolio consists of 40 pct. fixed income instruments and 60 pct. equity instruments.

1.2 Strategic benchmark portfolio for fixed income instruments

The strategic benchmark portfolio for fixed income instruments has the following composition:

- 85 pct. of the portfolio shall comprise Lehman Global Aggregate (LGA) Norway. This part of the benchmark portfolio may consist of loans issued in the following currencies: NOK, EUR, GBP, USD, SEK, and DKK. The benchmark portfolio shall include a private section and a government section with the following composition:
  - The government section of the index (Lehman Global Treasury Norway) shall be weighted at 30 pct. of total index value for LGA, measured at the end of each month (i.e. the date Lehman uses for index adjustments).
  - The private section of the index (Lehman Global Aggregate Norway) shall be weighted at 70 pct. of the total index value for LGA, measured at the end of each month (i.e. the date Lehman uses for index adjustments).

  This part of the benchmark portfolio shall be hedged against Norwegian kroner.

- 15 pct. of the portfolio shall consist of Lehman Global Aggregate Scandinavia (ex Norway). This section of the benchmark portfolio may include loans issued in the following currencies: DKK, SEK, EUR, GBP, and USD.

  This part of the benchmark portfolio shall not be hedged against Norwegian kroner.

At the end of each month the composition of the benchmark portfolio is altered according to the compositional changes carried out by the Lehman Brothers.

1.3 Strategic benchmark portfolio for equity instruments

The strategic benchmark portfolio for equity instruments has the following composition:

- 85 pct. of the portfolio shall consist of the Oslo Stock Exchange main index (OSEBX).
- 15 pct. of the portfolio shall comprise VINX Benchmark (CMVINXBXINN) dividend-adjusted for investors with a Norwegian tax position. Companies that are listed on the stock exchanges of Iceland and Norway are not included in the index basis. The company and regional distribution within the Nordic countries (ex Norway and Iceland) is established on the basis of the index supplier's rules for the equity index VINX Benchmark. The benchmark portfolio shall not be hedged against Norwegian kroner.

1.4 Investment universe and market place

When a limited company included in the portfolio of the Government Pension Fund – Norway is delisted, Folketrygdfondet shall sell the shares within three months of the delisting of the company.

The rule of the first clause does not apply to Norwegian limited companies listed on the Oslo Stock Exchange that are subject to acquisitions, mergers, or similar.

2. Rebalancing of the benchmark portfolio – section 5 of the Regulations

This item is exempt from the public domain.

3. Requirements for valuation, return measurement, and risk management and control – sections 5 and 7 of the Regulations

Valuation, return measurement, and risk measurement, management and control shall comply with internationally recognized standards and methods. The Fund shall not be invested in markets, asset classes or instruments if the fulfilment of these requirements cannot be documented.

Folketrygdfondet shall establish principles for risk measurement and management, as well as for the company's internal control. Moreover, Folketrygdfondet shall prescribe limits for market risk, credit risk, counterparty risk, currency risk, and operational risk. The limits shall be consistent with those given in laws, regulations, supplementary guidelines, and be based on best international practice.

A structure shall be established for delegating responsibility and reporting to the different parts of the organisation. This structure shall contribute to an effective division of work and a satisfactory division of responsibilities between controlling functions and the front office of the organisation. The structure shall reduce undesirable effects of potential conflicts of interest and ensure independence and control in the monitoring of the investment management.

3.1 Measurement and management of market risk

Principles shall be laid down concerning the measurement and management of the market risk of the Government Pension Fund – Norway. These principles shall be consistent with laws, regulations, supplementary guidelines, and best international practice.

The estimate of expected (ex ante) absolute volatility and tracking error shall be calculated using a system that models the market risk associated with the financial instruments in which the Fund invests. Best practice in the area shall be employed with regard to instrument modelling, measurement methods, decomposition, and measurement frequency. The market risk shall be measured so that it can be documented that the limit on relative risk in the Government Pension Fund – Norway is observed at all times.

The system shall aggregate risk across asset classes and financial instruments in a satisfactory manner. This implies that absolute and relative risk associated with the four asset classes (Norwegian and Nordic equities, and Norwegian and Nordic fixed income securities) shall be modelled in an integrated system and that the system shall treat similar instruments consistently.

The risk measurement system shall facilitate the decomposition of absolute and relative risk across relevant dimensions such as individual positions, portfolios, asset classes, instrument types, countries, and sectors.

The risk measurement system shall be flexible in the sense that the risk can be estimated by means of several methods, such as parametric methods, historical simulations, and Monte Carlo simulations. Furthermore, the system must be able to calculate absolute and relative VaR for random confidence intervals for the three methods, in addition to standard calculations of absolute volatility and tracking error.

The risk associated with the securities portfolios shall be calculated in such a way that the estimated risk of the Fund over time shall deviate as little as possible from the variations in actual absolute return and excess return. On a regular basis and at least once a month, Folketrygdfondet shall compare the risk predictions with actual return (backtest/validation).

Absolute and relative risk for the Fund and sub-portfolios shall be measured and reported to the Folketrygdfondet's management at least once a week. The decomposition of absolute and relative risk shall be measured and reported to the Fund's management at least once a month.

Documentation of the risk system's structure shall be available (including flow chart showing the data flow), and procedures for the running of the system shall be drawn up. Moreover, a log shall be kept containing information on the number of positions in the portfolio, the number and types of uploaded positions to the risk measurement system, the number and types of positions that are imported to the system with errors, and the number and types of positions that are excluded from the risk measurement.

Folketrygdfondet shall inform the Ministry of Finance of the choice of system and of a possible later system change. The grounds for a change of risk measurement system shall be given. Furthermore, the Ministry of Finance shall be informed of the choices made by Folketrygdfondet (or determined by the system) with regard to a "calibration" of the system, including the length of historical time series that form the basis for estimating volatility, correlations, the return frequency in these series, the use of decay factors, and the risk prediction horizon.

In specific cases Folketrygdfondet may enter into financial contracts/derivatives that the risk measurement system does not handle in a satisfactory way. The scope of such contracts shall be limited, and a separate overview of the instruments shall be registered. This overview shall cover power of attorney to handle the instrument, number of signed contracts, permitted counterparties, estimated market value, description of method for market valuation, estimated risk, description of method for risk estimation, established risk limits, and accumulated loss/profit. The Ministry of Finance shall be informed of such contracting/instruments in follow-up meetings between the Ministry of Finance and Folketrygdfondet.

In cases where the system does not model the risk associated with the financial instrument, estimates of the risk associated with the instrument shall be aggregated to the risk associated with the modelled section of the portfolio. The aggregation shall be based on conservative estimates and methods so that it is more probable that the expected absolute volatility and tracking error is overestimated than underestimated. The aggregation method and underlying assumptions shall be documented.

At least once a year written evaluations of the Executive Board's management of market risk shall be prepared. These shall be subject to discussion between the Executive Board and the management.

3.2 Measurement and management of credit risk

Principles shall be established for the measurement and management of credit risk associated with the bond portfolio of the Government Pension Fund – Norway. These principles shall be consistent with laws, regulations, supplementary guidelines, and best international practice.

Credit risk is associated with the probability that an issuer may go bankrupt or for other reasons not pay interest and principal when due. The least sophisticated systems for market risk measurement do not capture credit risk, whereas the more advanced systems measure the risk associated with variations in the difference between interest on corporate and government bonds (credit spread).

In this context credit risk is to be understood as the part of the credit risk associated with the bond portfolio, which is not detected by the market risk measurement system.

Credit risk shall either be measured using a portfolio credit risk system or a system designed for estimating default probabilities. Limits and authorizations shall be established in relation to the credit risk measurement system.

3.3 Measurement and management of counterparty risk

Principles shall be established for measuring and managing the counterparty risk of the Government Pension Fund – Norway. These principles shall be consistent with laws, regulations, supplementary guidelines, and best international practice.

Folketrygdfondet shall have satisfactory routines and systems for selecting and evaluating counterparties. Monitoring systems and measure-

ment frequency for control of counterparty exposure and counterparty risk, including requirements for minimum credit rating and exposure limits, shall follow best practice in the area.

Counterparties for unsecured deposits, trading in unlisted derivatives, and other kinds of contracts that place a counterparty risk on Folketrygdfondet shall have a long-term credit rating of minimum A-/A3/A- from at least one of the three agencies: Fitch, Moody's or Standard & Poor's. Folketrygdfondet may place unsecured deposits and trade unlisted derivatives etc. with Norwegian counterparties that are not rated by any of the three agencies. In such cases Folketrygdfondet shall carry out a credit rating of the counterparty in question before unsecured deposits are made or unlisted derivatives are traded. The assessment shall be documented and be repeated regularly, at least once a year, and otherwise when incidents occur in the market in general or relating to the counterparty in particular that are relevant to the assessment of the counterparty's ability to honour its obligations. No unsecured deposits shall be made, no unlisted derivatives trading or other kinds of contracts shall be entered into with a counterparty unless the result of Folketrygdfondet's credit rating indicates that the credit risk associated with the counterparty is no bigger than the one implied by credit rating agencies' requirements to enterprises that are given at least a A-/A3/A-rating. In specific cases Folketrygdfondet may grant exemptions from these minimum requirements to an existing central counterparty. If such exemption is granted, the Ministry of Finance shall be informed afterwards.

Folketrygdfondet must lay down such supplementary requirements on credit rating, provision of security, exposure limits, collateral handling, and netting arrangements as are appropriate in the operative management, and shall measure overall exposure to counterparties using internationally recognized methods that meet the necessary requirements as to verifiability and accuracy.

Foreign banks can be used as counterparties in currency trading, derivatives trading and when making bank deposits, provided the counterparty is legally domiciled in the USA, Great Britain, Denmark, Finland, France, Italy, Holland, Spain, Sweden or Germany.

Documentation shall be available of the system for estimating counterparty exposure and risk (including flow chart which shows the data flow), and procedures shall be prepared for the running of the system. It shall be documented that all relevant instruments and positions are included in the calculations of counterparty exposure and risk.

It is assumed that Folketrygdfondet informs the Ministry of Finance of the structure of the current system and of possible later changes to the system. Changes to the system for measuring counterparty risk and exposure shall be justified.

At least once a year written evaluations of the Executive Board's management of counterparty risk shall be prepared. These shall be subject to discussion between the Executive Board and the management.

3.4 Measurement and management of currency risk

Principles shall be laid down for measuring and managing the currency risk in the Government Pension Fund – Norway. These principles shall be in line with laws, regulations, supplementary guidelines, and best international practice.

Folketrygdfondet shall not take explicit currency positions as part of the active management of the Government Pension Fund – Norway, neither relative to the Nordic benchmark sub-portfolios nor against Norwegian kroner.

As a result of the active management, the currency distribution in the actual portfolio may deviate from the currency distribution in the benchmark portfolio. In such cases Folketrygdfondet shall seek, through a practical approach, to neutralise the currency exposure.

Over time the Fund shall not be consistently over- or underweighted with regard to the currency weightings in the benchmark portfolio.

At least once a year written evaluations of the Executive Board's management of currency risk shall be prepared. These shall be subject to discussion between the Executive Board and the management.

3.5 Measurement and management of operational risk

Principles shall be established for measuring and managing the operational risk of Folketrygdfondet.

The framework for operational risk management shall be established in accordance with laws, regulations, statutes and guidelines, as well as best international practice.

Folketrygdfondet shall define and delimit the meaning of the term operational risk. The defini-

tion shall at least include the following operational occurrences: 1) internal fraud, such as misreporting of positions, theft, and insider trading; 2) external fraud, such as robbery, forgery, and computer hacking; 3) misuse of confidential information, non-authorized transactions and purchase/sale of unauthorized instruments; 4) damage to physical assets as a result of terrorism, vandalism, fire, etc.; 5) discontinuity in running operations and system errors as a result of errors in hardware/software or telecommunications, power failures, etc.; and 6) entry of wrong data, insufficient quality assurance of data, inadequate collateral handling, incomplete legal documentation, disagreement with suppliers, etc.

Operational risk factors shall be identified, assessed according to probability and consequences, monitored and controlled/handled. Decisions not to close possible gaps between Folketrygdfondet's practice and best practice in the area shall be documented and justified.

The operational risk shall be identified and documented as well as being measurable and controllable before new activities (such as the investment in new instruments, asset classes, counterparties, external service providers, IT systems etc.) are initiated.

At least once a year written evaluations of the Executive Board's management of operational risk shall be prepared. These shall be subject to discussion between the Executive Board and the management.

3.6 Valuation and return measurement

Principles shall be established for pricing and performance measurement of various financial instruments.

Shares, bonds, and other financial instruments shall be accounted for by using market values.

The valuation shall occur daily and be based on market prices. In cases where there is no access to listed prices, Folketrygdfondet may obtain price estimates from market makers and brokers, and employ an average of these prices in the valuation of the portfolio. When neither stock exchange prices nor brokers' estimates are available, the valuation may be based on recognized pricing models.

In cases where market prices cannot be observed, the method for establishing the market value of financial instruments shall be based on best practice, be verifiable, and express the fair value of the Fund's assets at the time of the valuation.

Folketrygdfondet shall establish written procedures for the valuation of financial instruments. These procedures shall contain a pricing hierarchy for the different instrument types. The methodology that the different pricing models are based on shall be documented in writing and key assumptions shall be pointed out. There shall be consistency in the use of methodology and assumptions.

At least once a year written evaluations shall be prepared of the entity's procedures for valuation of the portfolio market value and return. These shall be subject to discussion between the Executive Board and the management.

3.7 The entity's internal control

Principles shall be laid down for the entity's internal control, covering such factors as the division of responsibilities between the Executive Board, the management, and other controlling functions.

The internal control shall be established in accordance with laws, regulations, statutes and guidelines, as well as best international practice.

The Executive Board and the management shall make sure the internal control is carried out, monitored, and documented. Updated information shall be available regarding what control measures have been established with reference to instructions, authorizations, and work/procedural descriptions.

Before giving its internal approval to investments in new markets, instruments, and currencies, Folketrygdfondet shall go through a thorough process of describing how the Fund in each case will handle problems associated with valuation, performance measurement, risk management and control for investments in the individual market, instrument, and currency. The procedure shall include an assessment vis-à-vis the requirements presented in sections 3.1 to 3.6 of the Supplementary Guidelines. Such assessments shall be documented.

At least once a year written evaluations of the internal control system shall be prepared. Such evaluations shall be subject to discussion between the Executive Board and the management.

4. Reporting – section 9 of the Regulations

The annual reports prepared by Folketrygdfondet under section 9 of the Regulations shall include:

– Folketrygdfondet's strategic plan and investment strategy for the Fund.

- A description of the key elements of the company's internal control and risk management.
- A list of all significant external service suppliers, including a complete list of external managers.
- An account of the standards employed by Folketrygdfondet for the purpose of valuation (the accounts), performance measurement, as well as management, measurement, and control of identified risk factors (market risk, counterparty risk, and operational risk).
- A report on the Fund's absolute and relative return measured in Norwegian kroner, monthly figures – in the aggregate and distributed across asset classes and the four sub-portfolios.
- A report on expenses associated with the Ministry of Finance's decisions regarding changes in the Fund's benchmark portfolio.
- A report on the Fund's absolute and relative market risk (volatility, monthly figures – in the aggregate and distributed across asset classes and the four sub-portfolios).
- The composition of the fixed income portfolio by main categories of credit rating. Corresponding reporting for the fixed income benchmark portfolio.
- An overview of new instruments in which the portfolio has been invested.
- An overview of the Fund's investments in relation to the quantitative provisions of the Regulations.
- A list of companies that are excluded from the investment universe.
- A report on the accounts in accordance with Folketrygdfondet's accounting principles.
- A complete list of equity and bond holdings as of 31.12.
- An account of the distribution of operating expenses in Folketrygdfondet.

The semi-annual reports issued by Folketrygdfondet shall include:

- A report on the Fund's absolute and relative return measured in Norwegian kroner – in the aggregate, across asset classes, and the four sub-portfolios. A description of important contributions to relative return.
- A report on the Fund's absolute and relative market risk (volatility), monthly figures – in the aggregate and broken down by asset classes and the four sub-portfolios. A description of important contributions to relative risk.
- The composition of the fixed income portfolio by main categories of credit rating grade.
- An overview of the Fund's investments in relation to the quantitative provisions of the Regulations.
- A list of companies that are excluded from the investment universe.
- A report on the accounts in accordance with Folketrygdfondet's accounting principles.

5. Exercise of ownership rights and ethics – section 8 of the Regulations

5.1 Ethical foundations

The Ethical Guidelines for the management of the Government Pension Fund are based on two premises:

- The Government Pension Fund is owned by the Norwegian people and coming generations of Norwegians. This financial wealth must be managed with a view to a favourable return in the long term, which is contingent on sustainable development in economic, ecological, and social terms. The Fund's financial interests shall be consolidated by using the Fund's ownership positions to promote such sustainable development.
- The Government Pension Fund shall not make investments that constitute an unacceptable risk of the Fund contributing to unethical acts or omissions, such as violations of fundamental humanitarian principles, gross human rights violations, gross corruption, or serious environmental damage.

5.2 Mechanisms designed to integrate ethical considerations

The following mechanisms shall promote the Fund's ethical foundations:

- The exercise of ownership rights to promote long-term financial gains based on the UN Global Compact, the OECD Principles of Corporate Governance, and the OECD Guidelines for Multinational Enterprises.
- Negative screening and exclusion of companies following decisions from the Ministry of Finance in accordance with provision 5.4.1.

5.3 Exercise of ownership rights

5.3.1

The primary objective of Folketrygdfondet's exercise of ownership rights for the Government Pen-

sion Fund – Norway is to safeguard the Fund's financial interests. The exercise of ownership rights shall be founded on the Fund's long investment horizon. The exercise of ownership rights shall primarily be based on the UN Global Compact, the OECD Principles of Corporate Governance, and the OECD Guidelines for Multinational Enterprises, as well as the Norwegian Code of Practice for Corporate Governance. Folketrygdfondet's internal guidelines shall outline how these principles are to be integrated in the exercise of ownership rights.

5.3.2

Folketrygdfondet shall report annually on its exercise of ownership rights in accordance with the Ministry's guidelines for the exercise of ownership rights and ethics.

5.4 Negative screening and exclusion

5.4.1

If the Ministry of Finance, pursuant to the Ethical Guidelines for the Government Pension Fund – Global, point 4.1, makes a decision regarding negative screening or exclusion of a company that the Government Pension Fund – Global is invested in, the decision will have the same effect on the investment possibilities of the Government Pension Fund – Norway.

6. Transitional provisions to the Guidelines given in sections 1 – 5

This item is exempt from the public domain.

Management agreement between the Ministry of Finance and Folketrygdfondet

The Ministry of Finance and Folketrygdfondet have, on 17 December 2008, entered into the following agreement for the management of the Government Pension Fund – Global.

1. Background

Folketrygdfondet shall be in charge of the operational management of the Government Pension Fund – Norway ("Pension Fund"), cf. Act No. 44 of 29 June 2007 relating to Folketrygdfondet. The Pension Fund is a capital contribution to Folketrygdfondet that Folketrygdfondet shall reinvest, in its own name, in a separate portfolio of financial instruments and cash deposits in accordance with laws, regulations, and supplementary guidelines.

Together with the Act of 21 December 2005 relating to the Government Pension Fund, the Act of 29 June 2007 relating to Folketrygdfondet, and Regulations for the Government Pension Fund – Norway including Supplementary Guidelines and Provisions, this agreement governs the relationship between the Ministry of Finance and Folketrygdfondet with regard to the management of the Pension Fund.

2. The Pension Fund

2.1 Capital contribution

The Pension Fund is invested as a capital contribution (liability, not equity) in Folketrygdfondet.

At all times the value of the Pension Fund is set as equal to the value of Folketrygdfondet's separate portfolio of financial instruments and cash deposits.

2.2 Return

The Pension Fund's return is equal to the return on Folketrygdfondet's separate investments. The return on the investments is continually added to the Pension Fund. The remuneration to Folketrygdfondet may be deducted from the Pension Fund's return according to clause 4.1 of the agreement.

3. Folketrygdfondet's obligations

3.1 Management of the Pension Fund

Folketrygdfondet is required to manage the Pension Fund in accordance with this agreement and within the framework established by or pursuant to the laws, regulations, statutes, and supplementary guidelines for the management of the Pension Fund.

3.2 Information requirement

Folketrygdfondet has a duty to give the Ministry of Finance the information it requests, including information in digitally legible form to the Ministry of Finance and its external service providers. Folketrygdfondet shall give the Ministry of Finance information as specified in Appendix 1 to this agreement.

Folketrygdfondet shall immediately notify the Ministry of Finance if particular circumstances have resulted in, or are expected to result in, significant changes in the value of the Pension Fund.

Folketrygdfondet shall through annual and semi-annual reports inform the public of the execution of the management assignment. More detailed requirements relating to these reports are given in the Supplementary Guidelines.

3.3 Use of external managers etc.

In the management of the Pension Fund, Folketrygdfondet may only use external managers and other external service providers (outsourcing) in accordance with the provisions of this agreement.

In the case of outsourcing, Folketrygdfondet maintains the full responsibility towards the Ministry of Finance for meeting Folketrygdfondet's obligations under this agreement.

In the case of outsourcing, Folketrygdfondet has a duty to:

1. ensure that the internal control and the ability to monitor compliance with the obligations under this agreement are not impaired or impeded;
2. ensure that the service provider has the necessary competence, capacity, and the licences required to perform the tasks in question;
3. ensure that the service provider supervises the outsourced functions and handles the risk associated with the task;
4. at all times have competence, resources, and adequate procedures to continuously monitor the service provider, ensure that outsourced tasks are satisfactorily performed, and handle the risk associated with the outsourced activities;
5. take sufficient measures if the service provider does not perform the task in accordance with the rules laid down in laws and regulations or if the performance is otherwise unsatisfactory;
6. ensure that the service provider notifies Folketrygdfondet of changes or occurrences that may noticeably influence the service provider's possibility to perform its tasks;
7. ensure that the outsourcing contract can be terminated by Folketrygdfondet without influencing the continuity and the quality of Folketrygdfondet's services;
8. ensure that Folketrygdfondet and the service provider have a contingency plan for continued activity in case of possible unexpected incidents and that regular tests of the service provider's procedures for back-up copies are performed if this is relevant for the outsourced activity;
9. ensure that Folketrygdfondet and the auditor have actual access to information related to the outsourced activity and to the service provider's premises;
10. ensure that the service provider treats confidential information relating to Folketrygdfondet in a satisfactory manner.

The first time external managers and other external service providers of significance for the management of the Pension Fund are selected, the Ministry of Finance shall be informed of the process and the criteria that form the basis for this, including the choice of suppliers relating to the implementation of new management systems, and later significant changes in such procedures for the selection of external managers and other external service providers. The Ministry of Finance shall also be informed of other changes in the procedures for the selection of external managers and other external service providers. The Ministry of Finance shall be informed of the remuneration model used in the management contracts that Folketrygdfondet signs with external managers in connection with the management of the Pension Fund.

3.4 Consultation etc.

At the request of the Ministry of Finance, Folketrygdfondet shall give the Ministry of Finance advice on changes to the management framework. Folketrygdfondet may also on its own initiative give input to the Ministry of Finance regarding the management framework.

3.5 Exclusion and negative screening of individual financial instruments

If the Ministry of Finance makes decisions regarding the exclusion of companies under sections 4 and 8 in the Regulations relating to the Management of the Government Pension Fund – Norway, Folketrygdfondet shall normally be given a time limit of eight weeks to carry out a possible sell-off.

Folketrygdfondet shall notify the Ministry of Finance once the sale has been concluded.

4. The Ministry of Finance's obligations

4.1 Remuneration

The Ministry of Finance shall remunerate Folketrygdfondet for the management of the Pension Fund. The remuneration shall be in accordance with Appendix 2 to this agreement. Until 1 December each year both parties may request that the method for calculating the remuneration be renegotiated for the following calendar year.

The remuneration is to be deducted from the Pension Fund's gross return in accordance with Appendix 2.

4.2 Tax position

The Ministry of Finance shall contribute to present the necessary documentation in order to clarify the tax position of Pension Fund investments abroad.

4.3 Regulations, guidelines, etc.

Folketrygdfondet shall have the opportunity to present its opinion before amendments are made to the regulations, decisions or guidelines pertaining to the management and shall receive reasonable prior notice in order to make possible changes to the portfolio.

5. Changes and limitations to the management assignment in particular cases

In so far as it is deemed necessary and suitable in order to prevent or mitigate loss or risk of loss, whether this is owing to a breach on the part of Folketrygdfondet or other factors, the Ministry of Finance may impose the following changes and/or limitations on the mandate given to Folketrygdfondet under this agreement:

1. restrictions relating to holdings and/or acquisitions of certain types of financial instruments, or instruments within specific sectors or from specific countries or market places;
2. extended reporting requirements and/or reporting formats on a temporary or permanent basis; or
3. other such measures that remedy the loss or the risk of loss that has been detected.

Changes that have been determined pursuant to this provision shall enter into force from the date established by the Ministry of Finance.

6. Liability for damages

Folketrygdfondet is liable to pay compensation for losses inflicted on the government as a result of involuntary or intentional breaches of the provisions of this agreement. This applies equally to actions committed by Folketrygdfondet's employees, as well as external managers and other service providers that the Folketrygdfondet makes use of, cf. clause 3.3, regardless of whether such actions constitute a breach of the contractual duties to which the one who commits the action is subject.

7. Effective date etc.

7.1 Effective date

This agreement enters into effect 1.1. 2009.

7.2 Amendments

The agreement shall be amended when changes in laws and regulations so indicate. This agreement and its appendices cannot be amended without written consent from both parties.

The Ministry of Finance gives more detailed rules and instructions regarding termination of the management assignment, including severance pay and other remuneration to Folketrygdfondet in connection with the termination. Clause 3.4 shall apply to a corresponding extent.

8. Communication

All communication referring to this agreement shall be in writing and signed. Such communication shall be forwarded to Folketrygdfondet c/o Managing Director and to the Asset Management Division of the Ministry of Finance.

This agreement is issued in 2-two copies, of which both parties retain one copy each.

Oslo, 17 December 2008

On behalf of the Ministry of Finance On behalf of Folketrygdfondet

Tore Eriksen, Secretary General, Olaug Svarva, Managing Director

Appendix 1 Reporting to the Ministry of Finance

This item is exempt due to space limitations.

Appendix 2

Remuneration for the management of the Government Pension Fund – Norway

The remuneration shall cover the expenses incurred by Folketrygdfondet relating to the management of the Fund. For 2009 the running expenses (excl. depreciations) for the management of the Fund will be covered at up to NOK 100 mill. Additionally, investments are covered within a total limit of NOK 9,5 mill.

Both parties may request a renegotiation of the management fee for 2009 until 31 August 2009, provided a significant increase or decrease in consumption is expected with regard to the conditions forming the basis for the stipulation of the management fee for 2009 in accordance with the above paragraph.

Appendix 2

Active management of the Government Pension Fund – Global

Letter from Norges Bank to the Ministry of Finance of 14 March 2009

In connection with the Ministry's work on its annual Report to the Storting (Norwegian parliament) on the management of the Government Pension Fund – Global, Norges Bank would like to comment on certain matters concerning active management.

The markets in which the Government Pension Fund – Global invests, especially the liquid equity and fixed income markets of Europe and the US, are nearly efficient. This means that market prices will at all times reflect all relevant information about the securities in question, and it will be hard to generate consistent added value by forming expectations as to how market prices will move in the future.

This insight forms the foundation for the operational management of the Government Pension Fund – Global. When we develop our investment strategies, we begin with the Fund's unique characteristics. The most important are its size and long-term investment horizon. Our potential to achieve results as an investor lies in turning these factors to the Fund's benefit through active strategies, and our most important advantage is the possibility of implementing these strategies at low cost. Over time, the level of active management will depend on the results that can be achieved.

Our view of the role as a large financial investor

Efficient capital markets depend on a sufficient number of market participants actively participating in price formation. Were large institutional investors such as the Government Pension Fund – Global to rely exclusively on other participants to ensure efficient price formation, this could undermine the function of capital markets. The Fund is now probably the largest equity investor in Europe. Exclusively pursuing a passive strategy and not contributing to efficient price formation would not be compatible with this role.

There are great expectations for the Fund's active ownership activities. It is important that large institutional investors such as Norges Bank are not passive but exercise their rights as minority shareholders. In our dealings with companies, our legitimacy and influence depend on us being seen as a long-term investor pursuing financial interests. In our dealings with national authorities in the countries in which we invest, it is also important that we are perceived as pursuing financial interests when we take up our active ownership agenda. All in all, an element of active management will be essential for Norges Bank's legitimacy in the implementation of important parts of its management mandate.

Aspects of the investment strategy

The Fund's long-term investment horizon is the starting point for its investment strategy and for its benchmark portfolio and asset allocation. Risk premiums on different asset classes in capital markets vary over time. An investor with a sufficient time horizon and risk capacity should be able to exploit this and collect risk premiums that are not fully reflected in the benchmark portfolio. A sharp distinction between overarching investment strategy and operational management may be inappropriate. Our strategic advice to the Ministry must be based on analyses of these risk premiums and be taken into account when important strategic decisions are made.

Possibility of adding value through active management

The aim of active management is to make a positive contribution to the return on the Fund over time. The Fund differs from the average investor through its size and long-term approach. Our active strategies must have this as their basis.

The Fund's size can be an advantage in its management, because it makes it possible to take relatively large positions in specific situations without a significant change in the risk in its manage-

ment. An active manager is able to participate in the primary market for equities, based on specific insight and expertise. A large investor in particular will be able to achieve favourable terms in this market. As a passive investor, the Fund would not purchase equities until they are included in the benchmark index at a later, arbitrary point in time, and in a situation where our size may impact on prices.

The Fund's long-term approach means that we have a better basis for riding out fluctuations in the return on the Fund. This risk capacity sets us apart from the average investor. Our positions are leveraged to only a small degree. We are not forced to realise losses in the short term if funding falls away. Unlike some other large institutional investors, we are not subject to rules forcing us to make adjustments to the portfolio in critical phases. Also important is that the Fund has a long-term owner that does not make significant changes in the management framework in situations with unusual or stressed markets.

Our approach to the composition of active investment strategies is based on diversification, specialisation and delegation, and aims to ensure the best possible trade-off between risk and return in active management. Over time, we have had good experience of this approach.

The Fund has a broadly diversified portfolio which largely mirrors the size of the various sub-markets. The risk in the management of such a well-diversified global portfolio will, in the first instance, depend on volatility in these broad markets and covariance between them. Active management in itself will not serve to increase the Fund's market risk, provided that it does not expose the Fund to structural risk factors.

One important reason why, on average, active management does not add value for investors is high fees and management costs. Low costs are an important advantage for NBIM. This gives us greater potential to generate excess returns than the average investor.

Now that the Fund's investment universe and benchmark portfolio are gradually being expanded, there is growing exposure to markets where there is little reason to expect the efficient markets hypothesis to hold. This increases the potential to add value through active management.

Conclusion

As manager and adviser, Norges Bank can combine theoretical insight, proximity to the markets and a knowledge of individual investments. Management costs are low. Given the Fund's size and long-term approach, few investors are better placed to exploit the fact that many markets are not totally efficient.

Yours faithfully
Svein Gjedrem Yngve Slyngstad

Appendix 3

Risk-based supervision of Norges Bank's management of the Government Pension Fund – Global

Letter from Norges Bank to the Ministry of Finance of 12 February 2009

1 Background

We refer to the Ministry of Finance's letter of 20 October 2008 on risk-based supervision of Norges Bank's management of the Government Pension Fund – Global, in which the Ministry refers to Ernst & Young's review of investment management at Norges Bank in 2007 and Norges Bank's response to Ernst & Young's report, and raises a number of issues in this context.

In this letter, Norges Bank outlines the changes made to the Bank's organisation of investment management over the past year. We also comment on specific projects on which the Ministry requests a status report, and we discuss, on a general basis, the framework and guidelines for the management of market risk in the Government Pension Fund – Global. Finally, we address a number of issues relating to the supervision of the Bank's investment management unit, Norges Bank Investment Management (NBIM), by the Executive Board and Internal Audit.

2 Organisation and oversight of investment management at Norges Bank

The organisation and oversight of investment management at Norges Bank were changed in a number of significant respects in 2008. The Executive Board issued a new job description and investment mandate for the Executive Director of NBIM with additional reporting requirements (see section 6 below).

Until 2008, NBIM was organised into two relatively independent business areas: one for equities and one for fixed income instruments. A variety of central staff functions – including project management, budgeting, IT and a number of reporting and control functions – had gradually been transferred out to the two business areas. As NBIM's activities grew in size and complexity, however, we saw a need for a greater degree of centralised supervision and control.

The appointment of a new Executive Director of NBIM in 2008 made it natural to review its organisation. At the same time, the global financial crisis had led to a number of changes in the oversight and supervision of the activities. We would like to stress that NBIM will review the organisation of its operations regularly, which means that the description of its organisation below must not be regarded as static.

A new organisation for NBIM was introduced from 1 March 2008. The aim was partly to strengthen and focus its investment functions, and partly to strengthen the overarching control functions. We have drawn a clear distinction between departments responsible for investment decisions and departments responsible for operational and control functions. We have separated responsibility for executing transactions in the markets (trading) from the responsibilities of the portfolio managers, with the result that those taking investment decisions do not themselves perform trades in the markets. The division of roles at this level, with guidelines built into the trading systems, will provide an effective safeguard against the risk of error or irregularity at the level of the individual.

NBIM has reinforced its control functions through recruitment and reorganisation. We have built up a unit for monitoring market risk, credit risk and counterparty risk across the investment units. This unit is now physically located closer to the employees responsible for active risk-taking in the Fund, whereas previously it had more the nature of a staff function. At present, around 20 employees work in this function.

NBIM has also reinforced the control functions that are responsible for ensuring that NBIM complies with market regulations, monitor compliance with investment mandates, interpret investment guidelines, prepare instrument approvals,

and have responsibility for the authorisation structure. This function has also been given a broader mandate to monitor NBIM's non-market risks. In practice, this entails a responsibility for ensuring that the other departments manage these risks, which comprise operational risk, IT/information risk and legal risk, as well as behavioural standards and reputational risk in the broad sense. At present, around 15 employees work in this function.

NBIM has established a formal committee structure which draws on expertise from across the organisation. These committees are advisory and are used by NBIM's Executive Director to discuss relevant issues before decisions are taken. The committees also play an important role in the design of important guidelines for NBIM's operations. Currently NBIM has five committees: one for investment universe, one for credit and counterparty risk, one for business policies , one for investment risk, and one for valuation.

Norges Bank has established a new investment mandate structure. The Executive Board has issued a new investment mandate for the Executive Director of NBIM and requirements for more extensive reporting (see discussion below). The content of NBIM's own mandates has also been overhauled. Risk limits are now issued along many more dimensions than before. First, there are quantitative model-based limits. There are also risk limits that are based not on models but on gross nominal exposures and the level of usage of derivatives. In addition, the new investment mandates contain clear guidance on desired liquidity and limits for systematic exposure to specific market factors.

Many of the risk systems based on quantitative models have not provided useful signals during the global financial crisis that erupted in summer 2007. Our experience is that models or stress tests alone are not sufficient for assessing risk. A combination of different quantitative and qualitative measures and limits should underlie the management of all types of risk in financial management. We believe that the new structure of the investment mandates provides a solid foundation for delegating and verifying more aspects of market risk.

The Executive Board's supervision and control of NBIM's operations is discussed in section 6 below.

3 Status of key projects

The following looks at two important projects on which the Ministry requests a status report: independent valuation and measurement of counterparty risk.

3.1 Independent valuation

Norges Bank has agreed with the Ministry that the accounts for the Government Pension Fund – Global are to be prepared in accordance with the Bank's accounting policies and the 1998 Accounting Act, with a few exceptions. These policies were presented in Norges Bank's annual report for 2007 and NBIM's own annual report for 2007. From this starting point, NBIM has introduced more detailed valuation policies, which are to apply to both the preparation of accounts and the measurement of returns.

The aim of the independent valuation project was to establish a solution that ensures that all of the Fund's holdings are priced, quality-assured and verified by bodies independent of those taking investment decisions, both internally at NBIM and at external managers. Valuations are to comply with generally accepted accounting principles and the requirements set out by the Ministry in section 4.1 of the Guidelines for the Management of the Government Pension Fund – Global.

The independent valuation project was completed in October 2008. New requirements were introduced for both NBIM and our external accounting service providers (currently JPMorgan Chase and Citibank). Further improvements are being made on an ongoing basis.

NBIM's external accounting service providers play an important role in this solution. They have responsibility for pricing both externally- and internally-managed portfolios using independent price sources. The accounting service providers are to use a pricing hierarchy established by NBIM. In the capacity of pricing coordinator, a control unit in NBIM's operations area is responsible for pricing the same instruments as the accounting service providers. This unit reconciles its own valuations with the prices received from the accounting service providers.

The control unit is responsible for conducting additional pricing checks at month-end to assure the quality of prices and ensure that the pricing hierarchy is being observed. Spot checks will also be made during the month. Where necessary, the

internal control unit will enlist the support of external pricing specialists selected to assist with the pricing of particularly challenging instruments.

NBIM's valuation committee (see section 2 above) is a forum for discussing significant pricing issues. The committee meets at least once a quarter ahead of the publication of the accounts. Central Bank Audit and its external partner will review price quality and price controls while the quarterly accounts are under preparation.

Norges Bank believes that this structure will ensure both quality and independence in the pricing and valuation of all financial instruments in the Fund.

3.2 Counterparty risk

Norges Bank's framework for the evaluation and monitoring of counterparty risk has been built up in accordance with the requirements laid down by the Ministry in section 4.2.2 of the Guidelines for the Management of the Government Pension Fund – Global.

When selecting and evaluating counterparties, an external credit rating from the credit rating agencies Moody's, Standard & Poor's and Fitch is required. Higher ratings are required for unsecured credit exposure than for secured credit exposure (i.e. exposure secured against other securities or cash). Changes in counterparties' credit ratings are monitored continuously by an independent control unit.

NBIM's project for improving and developing its systems for the management of counterparty risk was started up in 2007. We originally assumed that the current system for measuring market risk would also be used for measuring counterparty risk. In 2008, however, we again compared international practice with NBIM's business model and mapped alternative system solutions. We decided to conduct an international tender process. NBIM expects to have a new framework in place during the first quarter of 2009 and a new system for measuring counterparty risk in place during the second quarter of 2009.

Based on the applicable monitoring and control structure, we have taken a number of steps to reduce counterparty risk, the most important being:

NBIM has substantially reduced exposure to derivatives and repurchase agreements, and some complex unlisted products are no longer approved instruments

Requirements that trading in unlisted derivatives can be performed only with counterparties with whom we have entered into a separate agreement, and which safeguard our rights, partly through the counterparty having to provide collateral in the form of securities and/or cash

Changes in the process for approving counterparties following the reorganisation of NBIM, and closer supervision and monitoring of counterparties

Decision to cease all new trading, terminate outstanding transactions and monitor developments at a number of key counterparties that ran into problems in 2008

We have focused particularly on credit and counterparty risk since the credit crisis erupted in July 2007. The new framework and system for measuring counterparty risk will be tailored to a narrower range of instruments and a general reduction in the complexity of investment management, especially in internal and external fixed income management.

4 Credit risk

NBIM has issued new guidelines for credit risk specifying how it is to be measured and monitored. As mentioned in section 2 above, we have set up a counterparty and credit risk committee, which is to ensure a multidisciplinary focus on all credit-related aspects of our investment management.

NBIM's credit risk guidelines provide clear guidance on how credit risk is to be managed at NBIM: from unambiguous definitions of terms to concrete methods and the scope of different measurement criteria. The guidelines require NBIM to establish a framework for measuring and verifying credit risk, both for individual issuers and for the overall portfolio of issuers, including correlations between issuers. Stress tests of credit risk are also to be performed to take account of possible extreme market situations. A concentration analysis for both absolute and relative credit risk is also to be performed for the overall portfolio of issuers with the aim of identifying potential large positions at different levels of the portfolio (sector, currency, region).

In addition, NBIM is to monitor movements in the market's credit rating for all issuers in the fixed income portfolio. The guidelines also require the establishment of procedures for situations where there is a defined credit event (default).

To meet the increasing requirements for the identification, measurement and verification of credit risk, NBIM has reinforced the department responsible for risk management with new staff with a broad and varied background in the field.

NBIM took a number of steps in 2008 to improve the quantitative model-based side of the measurement and analysis of credit risk. We have taken into use a new third-party model that can be used to monitor credit developments in large individual exposures in our investment portfolio. We are considering extending the use of this model to form the basis of internal modelling, or acquiring a separate system to measure and analyse credit risk for the entire portfolio as a supplement to today's modelling of market risk in our system for measuring that type of risk (RiskManager).

NBIM also plans to integrate standard stress tests into its periodic calculations of market risk. These tests will be based on defined historical periods with big swings in financial markets. The tests will also include periods where credit risk was high. These stress tests have been defined and are now being assessed. For other parts of the guidelines, processes are ongoing to establish a framework that addresses the different requirements at both company and portfolio level.

5 Market risk

The Regulations on the Management of the Government Pension Fund – Global currently establish a maximum limit for relative market risk:

The expected difference in return between the actual portfolio and the benchmark portfolio measured by tracking error on an annualised basis shall not exceed 1.5 percentage points.

The Ministry has also established additional requirements in section 4.2.1 of the Guidelines for the Management of the Government Pension Fund – Global:

Market risk shall be measured in such a way that compliance with the limit on relative risk in the Pension Fund can be documented. Best practice in the area shall be employed in regard to measuring methods, decomposition and measurement frequency.

In the case of the Government Pension Fund – Global, market risk is measured as expected tracking error, which is the expected value of the standard deviation in the difference between the return on the actual portfolio and the return on the benchmark portfolio. However, no single measure of risk can capture all relevant risk factors for the Fund over time. In addition, the turbulent market conditions since summer 2007 have revealed weaknesses when it comes to predicting risk in such markets. In this context, we also refer to the Bank's four letters to the Ministry between November 2008 and January 2009 on the measurement of tracking error in the fourth quarter of 2008.

It is important that the framework for risk management is designed in such a way as to provide as detailed a risk picture as possible. The Executive Board has therefore issued a new investment mandate for the Executive Director of NBIM (see section 6 below), which sets out limits for risk management based on the following main categories of risk:

- Deviation from the benchmark index, where the aim is to ensure that the measurement of exposures is not based on a quantitative model. Limits can be set for:
  - Deviation between the actual and benchmark portfolios broken down by asset class and geographical region
  - Sector deviation in the fixed income and equity portfolios
  - Minimum levels of overlap between the actual and benchmark portfolios for the two asset classes
  - Leveraging of the portfolios
- Risk from price history (volatility and correlation), which combines portfolio exposures and the markets' statistical properties. Limits can be set for:
  - Maximum utilisation of market risk as measured by expected tracking error under normal market conditions, so that there is a buffer when unexpected situations occur
  - Concentration risk in the portfolios
- Factor exposure, which describes to what extent the portfolio is systematically exposed to factors such as small-cap companies or emerging markets
- Liquidity exposure, to ensure that we have sufficient room to manoeuvre to be able to adjust exposure in our investment management, including the extent to which exposures are liquid and can be sold

In each of the above risk categories, there will also be different and complementary measurement *methods*. Multiple approaches to risk and complementary measurement methods are important to ensure an effective and robust structure for risk supervision.

Norges Bank believes that the constraints on market risk imposed by the Ministry should be small in number, robust, and easy to communicate. Our view, therefore, is that the current measure of risk (expected tracking error) is a sound measure which is also the industry standard, and that the Ministry should retain this measure as the sole measure of market risk established by the Ministry. In the current market situation, it appears that all traditional risk models have failed as predictors of developments in market risk. Norges Bank will therefore get back to the Ministry with an assessment of parameter-setting in the modelling of market risk in the RiskManager risk system.

We also believe that credit risk in the portfolio is well-modelled under "normal market conditions". Previous formal restrictions, such as the requirement for a minimum credit rating, would not have improved risk management in the situation we have had since 2007. NBIM has found that the credit ratings from the three agencies Moody's, Standard & Poor's and Fitch have not been good enough.

Nevertheless, it is clear that no single measure can provide a complete picture of the risk to which the Government Pension Fund – Global is exposed. Instead of introducing new risk limits, we recommend that Norges Bank reports risk along more dimensions. These reports should cover deviation from the benchmark index, risk from price history, factor exposure and liquidity exposure (see discussion above of the limits that the Executive Board has established for NBIM). We therefore recommend that the Ministry receives a supplementary quarterly report as well as the public quarterly report. This supplementary report will present returns broken down by area and the status of all key quantitative requirements. The more detailed contents of the report can be agreed between the Bank and the Ministry. We assume that these requirements and the associated reporting will take care of the Ministry's supervision and oversight of the management of the Fund, and that there will remain a clear division of responsibility between the Bank and the Ministry.

6 Supervision of investment management by the Executive Board and Internal Audit

The Executive Board has reinforced its supervision of investment management at Norges Bank in recent years. In 2007, we established the Executive Board's audit committee and an internal audit unit. The audit committee comprises three of the Executive Board's external members and serves as a preparatory body for the Board on matters relating to its oversight functions and responsibility for risk management and internal control. The audit committee discussed eight matters concerning the Bank's investment management in 2008.

The Executive Board issued a new job description and investment mandate for the Executive Director of NBIM in 2008. The starting point is that the Executive Director of NBIM stands in the same position as the other Executive Directors at Norges Bank. However, the tasks assigned to NBIM are distinct from the Bank's other activities as a central bank, in the sense that the investment management operation has the characteristics of a commercial undertaking. The management of the Government Pension Fund – Global has been delegated to Norges Bank pursuant to a separate act of parliament and management agreement. There has also been an increasing tendency in recent years for NBIM to be treated as an independent area within the central bank.

The job description sets out the responsibilities and duties of the Executive Director of NBIM with respect to the general public and external relations, including interaction with Norges Bank's clients and the framework for the responsibility he has for the planning and organisation of NBIM's operations, supervision and control, etc.

The investment mandate for the Executive Director of NBIM sets out supplementary rules for the individual portfolios within the investment limits established by the Ministry. These cover the investment universe, investment constraints, the delegation of management responsibility, and reporting. The investment mandate also describes the risk profile for investment management that the Executive Board wishes to establish, including the principles and parameters for the management and measurement of risk as well as reporting requirements. We refer to the discussion of the investment mandate for the Executive Director of NBIM in section 5 above. The monthly reporting from NBIM to the Executive Board includes not only returns and any breaches of the investment guidelines laid down by external clients or the Executive Board, but also the status of the additional restrictions that the Executive Board has established for market risk. There are to be reports on deviation from the benchmark index (asset class, geographical region, sector,

leveraging, overlap), risk from price history (maximum use of market risk under normal market conditions, concentration risk in the portfolios), factor exposure, and liquidity exposure.

On 1 January 1998, the Executive Board decided to establish a system of internal control based on the Norwegian financial supervisory authority Kredittilsynet's Internal Control Regulations. Internal control at Norges Bank is defined as all measures, arrangements and systems initiated and implemented by the Executive Board and the Bank's management and employees in order that we can be reasonably certain of achieving our objectives.

With effect from 1 January 2009, the 1997 Internal Control Regulations were replaced with the new Regulations No. 1080 of 22 September 2008 on Risk Management and Internal Control. These new regulations make more stringent requirements of the role of the board in the design of structures for internal governance and internal organisation. The Executive Board is of the opinion that the principles for internal governance drawn up by the Committee of European Banking Supervisors (CEBS) form an appropriate basis for its assessments. However, the self-assessment form to which the Ministry refers in its letter of 20 October 2008 was developed for commercial banks etc. The Executive Board has therefore adopted principles for internal governance tailored to Norges Bank's operations as the basis for its annual assessments. These principles have been used in the Executive Board's assessment of risk management and control in the Bank with effect from the 2008 reporting year. Norges Bank believes that these measures satisfy the new regulations' requirement for the Executive Board to assess Norges Bank's risk management and internal control annually.

Internal Audit prioritised risk management and internal control at NBIM in 2008. Among other things, it reviewed the status of the follow-up of Ernst & Young's report. The aim of this was to provide the Executive Board with confirmation that action has been taken in accordance with Norges Bank's response to the Ministry.

Internal Audit concluded that NBIM's new organisational model results in a clearer division of roles and responsibilities in the organisation. Organisational units have been set up to measure and report risk independently of the investment line. Internal Audit considered that these are important organisational measures for ensuring good risk management and internal control.

The new organisation of NBIM's operations also entails extensive changes to working processes. NBIM is working on tailoring the management of operational risk to its new working processes, and Internal Audit will be monitoring this work closely in the time ahead. In December 2008, an audit was begun at the request of the Executive Board. The focus of this audit is on:

- NBIM's processes for identifying, prioritising and reporting operational risks
- NBIM's implementation of risk reduction measures

Norges Bank will keep the Ministry informed of any significant changes in risk management, organisation and supervision in relation to the Bank's management of the Government Pension Fund – Global.

Yours faithfully
Svein Gjedrem Yngve Slyngstad

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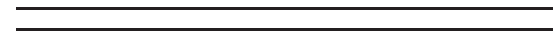

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