DET KONGELIGE
FINANSDEPARTEMENT

Royal Ministry of Finance

Norges Bank
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The fixed-income benchmark for the Government Pension Fund Global (GFPG)

Norges Bank was requested, in a letter of 12 February 2016, to assess the significance of the equity share in terms of index duration and the representation of corporate bonds in the fixed-income benchmark for the Government Pension Fund Global (GPFG). The Bank was requested, at the same time, to assess whether a change to the equity share should have consequences for the geographical composition of the benchmark index for the Fund. Norges Bank stated, in a letter of 1 December 2016, that it intended to revert to these issues when a decision had been made as to a potential change to the equity share.

The Ministry of Finance announced, in Report No. 26 (2016-2017) to the Storting, that it intends to review the fixed-income benchmark in connection with the increase in the strategic equity allocation. The Ministry noted that it would be appropriate to consider a number of factors in the context of such a review, including country risk, the number of countries invested in, as well as the mandate requirement that Norges Bank shall seek to take account of fiscal strength in the composition of the government bond investments.

The Ministry notes that the Storting has endorsed the Government's proposal in the report on the management of the Fund in 2016 to increase the equity share in the strategic benchmark index for the GPFG from 62.5 percent to 70 percent, cf. Report No. 26 (2016-2017) to the Storting and Recommendation No. 357 (2016-2017) to the Storting.

The purpose of the fixed-income investments of the Fund is to reduce the volatility of overall Fund returns, provide liquidity and exposure to risk factors such as interest rate risk and credit risk, cf. Report No. 23 (2015-2016) to the Storting. When the current fixed-income

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benchmark was established, weight was attached to highlighting the role of fixed-income instruments in the overall portfolio.

The fixed-income benchmark adopted by the Ministry is based on index products provided by Bloomberg, and is comprised of a government bond portion (70 percent) and a corporate bond portion (30 percent). The apportionment between the two sub-indices of the benchmark is fixed, with full monthly rebalancing back to the chosen weights. The fixed-income benchmark comprises investment grade securities only. The composition of the government bond portion of the fixed-income benchmark is based on the securities included in underlying indices at any given time, and consists of nominal government bonds, inflation-linked government bonds and bonds issued by supranationals. The corporate bond portion comprises corporate bonds and covered bonds issued in seven approved currencies[1]. Bonds from Norwegian issuers and bonds denominated in Norwegian kroner are not included in the benchmark index.

The management mandate issues by the Ministry stipulates an investment universe for fixed-income instruments that is broader than the benchmark index. Any deviation from the benchmark index in the composition of the actual portfolio draws on the mandated limit for expected tracking error of 1.25 percentage point. In addition, the Bank is required to lay down limits for the minimum overlap between the actual fixed-income portfolio and the fixed-income benchmark. In order to ensure that Norges Bank is not forced to immediately divest bonds omitted from the benchmark index as the result of their credit rating being downgraded below investment grade, it is permitted to invest up to 5 percent of the fixed-income portfolio in high-yield bonds.

The composition of the actual fixed-income portfolio is determined by Norges Bank within limits laid down in the mandate from the Ministry of Finance, cf. the above description of the investment universe, benchmark index, tracking error limit and minimum overlap requirement. The current fixed-income benchmark was defined in 2011 under the assumption that the equity share would be 60 percent. It was then considered appropriate to have a relatively broad index including a not insignificant element of corporate bonds and emerging market government bonds. In view of the increase of the equity share to 70 percent, with a corresponding reduction in the allocation to fixed-income, the Ministry requests the Bank to reassess the scope and weighting rules of the fixed-income benchmark. Furthermore, the Ministry requests an assessment as to whether it is appropriate to change the investment universe for fixed-income instruments. In particular, the Bank is requested to consider the following aspects in connection therewith:

- Liquidity requirement for the fixed-income benchmark, given expected withdrawals and rebalancings under a strategic equity allocation of 70 percent.
- Which fixed-income securities meet this liquidity requirement and what guidance, if any, the Ministry should provide on the liquidity of the actual fixed-income portfolio.
- Which index rules on currency composition and interest risk exposure best ensure that the fixed-income benchmark serves to reduce the volatility of Fund returns.
- Transaction costs of tracking the benchmark index.

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[1] USD, CAD, EUR, GBP, SEK, DKK, CHF

Moreover, the Bank is requested to assess the following issues:

- Appropriate exposure to other risk factors, such as credit and liquidity, in the actual fixed-income portfolio.
- To what extent such exposure should be reflected in the fixed-income benchmark.
- Mandate regulation of fixed-income investments that are not included in the benchmark index, including risk limitation and relevant basis for evaluating the performance of such investments.
- Whether the mandate requirement that Norges Bank shall seek to take account of differences in fiscal strength between countries in the composition of the government bond investments should be amended.
- The role of inflation-linked bonds in the fixed-income portfolio.

The Ministry of Finance requests Norges Bank to submit its analyses and assessments by 1 October 2017.

Yours sincerely,

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Director General

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Investment Director

This document has been signed electronically and it is therefore not signed by hand.