



**DET KONGELIGE  
FINANSDEPARTEMENT**

*Royal Ministry of Finance*

Norges Bank  
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Your ref

Our ref  
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**Government Pension Fund Global (GPFG) – Fixed-income investment framework**

Reference is made to the letter of 9 June 2017 from the Ministry of Finance in which Norges Bank was requested to analyse and assess the framework governing the fixed-income investments of the GPFG, as well as to the reply letter of 1 September 2017 from Norges Bank. The Ministry will in the present letter request additional analyses and assessments, as part of its effort to ensure a comprehensive basis for decision making.

***Background***

The Ministry of Finance refers to the report on the management of the Fund in 2015,<sup>1</sup> which outlines the key principles underpinning the structuring of the investment strategy for the GPFG:

*«The investment strategy for the GPFG is based on the assumption that total risk in the Fund can be reduced by spreading the investments across a large number of securities, i.e. through diversification. The benchmark indices chosen for the GPFG's equity and fixed-income investments are based on broad global indices and generally reflect the investment opportunities available in global equity and bond markets.»*

Furthermore, the Ministry noted in the said report that the equity and fixed-income benchmarks can generally be tracked closely and at low costs. This is not affected by the

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<sup>1</sup> Report No.23 (2015-2016) to the Storting, The Management of the Government Pension Fund in 2015.

amendment to the regulation of the unlisted real estate investments of the Fund from 1 January 2017.

The fixed-income benchmark and the limitations on the Bank's asset management, including the investment universe, the tracking error limit, the high-yield bond investment limit and the requirement that the Bank set supplementary limits and approve all instruments in the actual portfolio, are intended to ensure that the actual fixed-income portfolio exhibits, to the greatest possible extent, the desired characteristics. At the same time, a high degree of overlap between the investment universe and the benchmark index implies that the benchmark index is well suited for measuring the fixed-income management performance of the Bank.

### ***The fixed-income benchmark proposal of the Bank***

The changes to the composition of the fixed-income benchmark for the GPFG proposed by Norges Bank in its letter of 1 September 2017 imply that the deviation between the benchmark index and the investment universe would increase significantly. The Ministry requests Norges Bank to specifically address how it intends to control and manage risk-taking with a narrow benchmark index and a broad investment universe, as proposed by the Bank, cf. the letter of 9 June 2017 from the Ministry to Norges Bank.

Moreover, the Bank is requested to explain how strategies for exposure to risk factors in the fixed-income market will be implemented in asset management, as well as to assess any benefits from being able to consider the equity and fixed-income strategies as a whole. The Bank is also requested to explain how the performance of the actual fixed-income portfolio can be evaluated in an appropriate manner under the Bank's proposal.

The Ministry notes that the principles underpinning the structuring of the investment strategy for the GPFG imply that there should be a high degree of overlap between the investment universe and the benchmark index, cf. above. The Bank is requested, against this background, to assess its proposal for a new fixed-income benchmark from that perspective.

### ***Analyses of alternative benchmark index compositions***

As part of its assessment of the fixed-income investment framework, the Ministry would also like to obtain analyses of alternative compositions of the benchmark index that cover a broader range of currencies and sub-segments than the Bank's proposal. The Bank is requested to apply, for purposes of such analyses, the sub-segments included in the current benchmark index (nominal government bonds, inflation-linked government bonds, bonds issued by supranationals, corporate bonds and covered bonds). The implications of including/omitting emerging markets should be addressed.

The Ministry notes, moreover, that the index provider Bloomberg has developed an alternative GDP-weighted government bond index, in order to reduce the high transaction costs associated with full monthly rebalancing of GDP weights. This index differs from previous GDP indices in that the weights at the beginning of the year are set equal to the GDP

weights, and thereafter drift with market movements over the course of the year. The Ministry requests an assessment as to whether the weighting rules of the said index (market weights with adjustment factors) might be suitable for the government bond portion of the benchmark index. Norges Bank is requested to assess whether the size of the Fund poses challenges as far as the use of such weighting rules is concerned. In such case the Bank is requested to assess whether said adjustment factors should also take account of investability, in addition to the relative sizes of the economies as measured by GDP.

The Ministry also requests Norges Bank to analyse how the scope of other sub-segments than government bonds can be tailored such as to maintain credit exposure in the fixed-income benchmark at about the current level. An assessment is requested as to how an adjustment factor for the market weights of these sub-segments should be designed in order to achieve unchanged credit exposure.

Furthermore, the Bank is requested to assess whether there is a need for specific rules to ensure appropriate interest risk exposure (duration) under the alternative compositions of the fixed-income benchmark.

The Ministry of Finance requests Norges Bank to submit its analyses by 15 December 2017.

Yours sincerely,

Espen Erlandsen  
Director General

Bjørn Geir From  
Investment Director

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