

Preliminary and unofficial translation of chapters 1 and 2.

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The Management of the Government Pension Fund in 2013

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approved by the Council of State on the same day.*

Preliminary and unofficial translation

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1 Introduction

The Government Pension Fund comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The Fund has no governing bodies or employees of its own, and is not a separate legal entity. The GPFG and the GPFN are managed by Norges Bank and Folketrygdfondet, respectively, under mandates set by the Ministry of Finance.

In this report, the Ministry of Finance presents management performance and assessments of the Government Pension Fund for 2013. Further development of the investment strategy of the Fund is discussed, and an account is given of the management framework follow-up.

The idea of a savings fund

After Norway discovered oil in the North Sea in 1969, it soon became apparent that the values involved might be significant. It was also acknowledged that the revenues from the petroleum activities are not revenues in the ordinary sense, as these are partly offset by the extraction of a non-renewable resource. It was further acknowledged that the revenues would fluctuate significantly with the oil price. It was therefore important, in order to ensure balance in the economy in the short and the long run, to manage the spending of the petroleum revenues of the State. The so-called Tempo Committee (NOU 1983: 27 green paper), chaired by Hermod Skånland, launched the idea of establishing a petroleum fund in 1983. The proposal called for the establishment of a fund that could smooth out the spending of petroleum revenues over a limited number of years. However, the Committee had limited confidence in the ability of the State to develop a savings fund – and not only a stability fund. It wrote:

«The political bodies must themselves decide whether such fund accumulation to forestall future revenue reduction is realistic. The Committee chooses, on its part, not to apply such an assumption.»

The idea of a government petroleum fund matured in the 1980s. The Willoch Government advocated the establishment of a fund in the Long-Term Programme published in the spring of 1986, cf. Report No. 39 (1985–86) to the Storting. The Act relating to the Government Petroleum Fund was enacted in 1990 on the basis of a proposition from the Syse Government.

In the beginning, the fund structure was predominantly a bookkeeping exercise. It highlighted the fact that the petroleum revenues were spent on an ongoing basis: The government petroleum revenues were allocated to the Fund, but the entire amount was returned to the fiscal budget to make up part of the non-oil deficit. In line with the improvements in the Norwegian economy during the 1990s, the first net allocation to the Fund was made in May 1996, cf. figure 1.1.

The Government Pension Fund has over time become an important financing source for government expenditure. In the fiscal budget for 2014, the transfer from the GPFG to cover the non-oil deficit is estimated at NOK 139 billion. This corresponds to 10 percent of total expenditure via government budgets. It is estimated that the importance of the Fund as a financing source for government expenditure will increase over the next few years. For 2020, the expected real return on

the GPFG is estimated, on an uncertain basis, to correspond to 8¾ percent of Mainland GDP. If expenditure remains at the current level, measured as a proportion of value added in the mainland economy, the Fund may then be financing more than 15 percent of government expenditure. The said proportion will however decline again in the longer run, since the Fund will not grow in line with the gross domestic product of the mainland economy. The reduction in the financing contribution from the GPFG is concurrent in time with an estimated steep increase in government expenditure, especially on pensions, health and care.

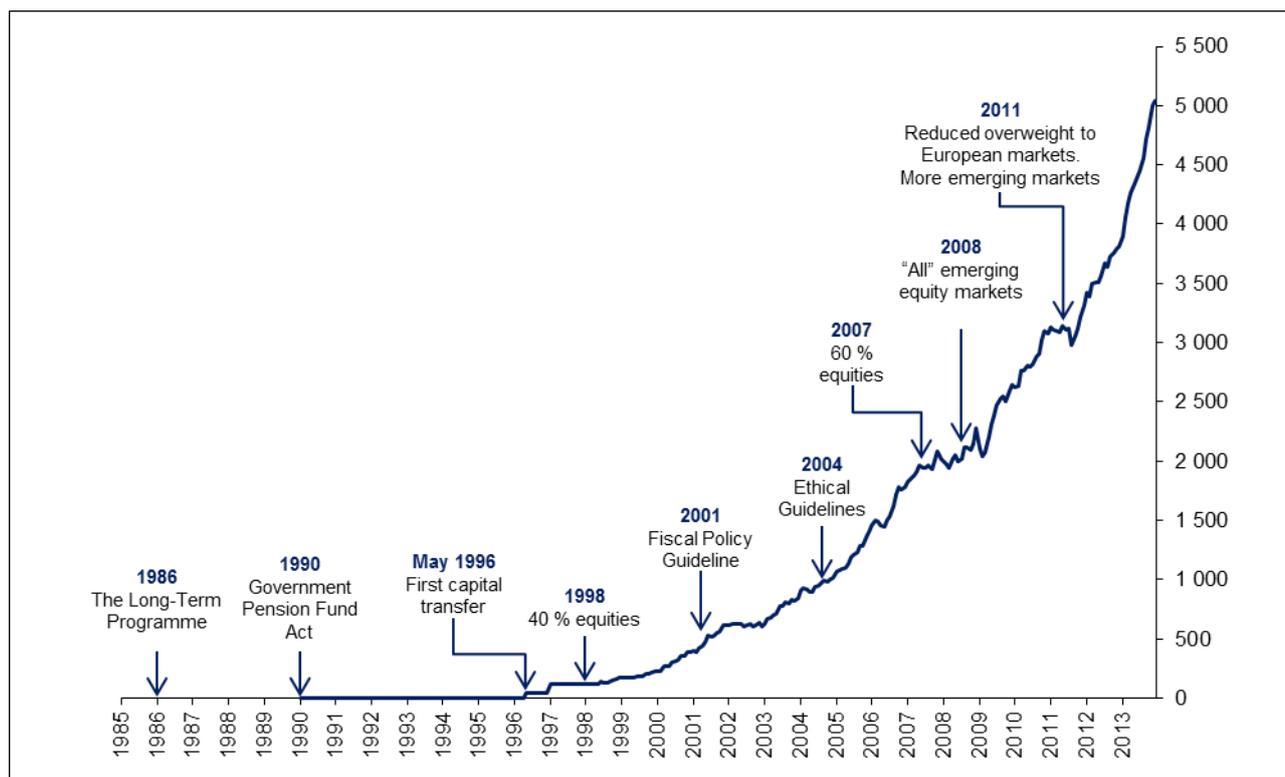


Figure 1.1 Historical development of the market value of the Government Pension Fund Global. NOK billion.

Sources: Ministry of Finance and Norges Bank

Good results in 2013

The Government Pension Fund performed well in 2013. The return on the GPFG was 15.9 percent as measured in foreign currency and the return on the GPFN was 15.7 percent as measured in Norwegian kroner, before asset management costs. This is one of the best results over the lifetime of the Fund. Norges Bank's active deviations from the benchmark index made a positive contribution to the return on the Fund, whilst the management at Folketrygdfondet delivered a negative excess return. At yearend, the overall value of the Government Pension Fund was about NOK 5,206 billion, reflecting an increase in value of NOK 1,245 billion over the year.

Last year, the asset management costs of the GPFG and the GPFN accounted for 0.07 percent and 0.09 percent of average fund assets, respectively. The Ministry is committed to cost-effective management of the Government Pension Fund over time. Comparisons with other funds show that the

asset management costs of both the GPFG and the GPFN, measured as a portion of assets under management, are low.

The good performance in 2013 reflects the positive developments in global stock markets. Stock prices appreciated over the year as the result of, *inter alia*, the US Federal Reserve continuing to provide liquidity to the economy. Developed stock markets experienced a general upturn. The return on the equity portfolio of the GPFG was 26.3 percent. The high return was fuelled by the developed market investments. The return on the fixed income investments of the Fund was about nil in 2013.

From January 1998 to December 2013, the average annual return was 5.7 percent for the GPFG and 7.1 percent for the GPFN, before asset management costs. Returns have fluctuated significantly over this 15-year period.

The average real return on the GPFG from January 1997 to December 2013 was just below 3.9 percent, net of inflation and asset management costs, compared to just over 3.2 percent measured at yearend 2012. This is slightly below the 4-percent real rate of return expected in the long run. The return is nonetheless close to long-term expectations, given normal fluctuations in average returns over periods of 15 years.

The return on the Fund varies significantly from year to year, although the recurring income from equities, bonds and real estate in the form of dividends, coupons and rent is more stable. At present, the recurring income of the GPFG amounts to around NOK 130 billion per year, or about 3 percent of the fund capital. The recurring income of the GPFN amounts to just over NOK 6 billion, or about 4 percent of its capital.

Accrued returns account for NOK 1,799 billion of the overall value of NOK 5,038 billion of the GPFG as at yearend 2013. Consequently, more than a third of the value of the Fund is attributable to return on the investments, as measured in international currency. Close to 70 percent of the achieved return is due to return on the equity investments, whilst about 30 percent is generated by the fixed income investments.

The return on the Government Pension Fund has in both 2012 and 2013 been very favourable, relative to the expected rate of return over time. The Ministry notes that one needs to be prepared for significant fluctuations in the value of the Fund in coming years. Returns have fluctuated considerably over the lifetime of the Fund. Over the period 1998–2013, the annual return on the GPFG has varied between -23 percent and 26 percent. Corresponding fluctuations would, at current Fund values, represent a decline in the Fund value of about NOK 1,200 billion or an increase in value of NOK 1,300 billion.

Established principles for the management of the Government Pension Fund

The Sundvolden platform states that «the Government will continue to build on the framework established for the management of the GPFG».

The overarching objective for the investments is to achieve the maximum possible return, given a moderate level of risk. This enables more welfare to be financed over time via the return on the Fund.

Asset management shall be premised on transparency and ethical awareness. A responsible investment system has been established, with companies that violate certain ethical criteria being excluded from the investment universe of the Fund, including serious human rights violations, gross corruption and severe environmental damage. Norges Bank integrates considerations of environmental and social issues in the asset management, and has divested from companies whose business model it has considered to be unsustainable in the long run. Such divestment takes place within the limit for permitted deviations from the benchmark index. The exercise of ownership rights is based on internationally recognised principles and standards laid down by, *inter alia*, the UN and the OECD. Responsible investment is discussed in section 4.5.

The investment strategy of the GPFG has been developed gradually over time on the basis of comprehensive professional assessments. Such assessments also underpin the broad support for the strategy of the Fund in the Storting. The long-term investment strategy stipulates a fixed equity portion of 60 percent. The equity portion largely determines the risk level of the Fund. Since the Fund has a good ability to absorb risk, the strategy is not predicated on minimising the volatility of returns. Such a strategy would generate a significantly lower expected return over time. The role of government bonds in the Fund is primarily to reduce the volatility of Fund returns. Their expected return is not high. The equity investments, which give us ownership stakes in companies worldwide, are expected to generate the main contribution to return over time. The investments, in equities, bonds and real estate, provide recurring income in the form of dividends, interest payments and rent.

The investments are diversified across a large number of individual equities and bonds, as well as, more recently, a number of properties. By diversifying the investments in a portfolio, the overall risk will be lower than the sum total of the risk of each individual investment. The Ministry has adopted a benchmark index for the GPFG, which implies that the composition of investments in equities and corporate bonds adheres to the principle of market weights, whilst the composition of investments in government bonds is based on the sizes of countries' economies, as measured by gross domestic product (GDP weights). The benchmark and the global mandate for real estate investments contribute to investments being diversified across countries and regions.

Over time, most of the risk of the Fund originates from developments in general stock and bond markets, as reflected in the benchmark index. Norges Bank may nonetheless, in its operational asset management implementation, deviate somewhat from the benchmarks, within certain risk limits defined in the mandate from the Ministry. The contribution to the risk of the Fund from Norges Bank's deviations from the benchmark index has been moderate over time.

Section 2.1 of this report outlines the main features of the investment strategy of the GPFG. The investment strategy of the GPFN is discussed in section 3.1. The governance structure of the two parts of the Government Pension Fund is discussed in chapter 5.

Further development of the investment strategy

Good long-term management of the Government Pension Fund is premised on widespread support for, and confidence in, the way in which the Fund is managed. The Ministry is therefore committed to assessing, on a regular basis, how the management of the Fund can be developed further. This will be guided by the principle that any changes made to the investment strategy shall be based on

comprehensive professional assessments and analyses. Any material changes to the management of the Fund are submitted to the Storting.

This year's report discusses several themes, including a comprehensive review of Norges Bank's management of the GPFG, in line with the periodical reviews previously notified to the Storting. The provisions governing the rebalancing of the equity portions of both the GPFG and the GPFN are discussed. Furthermore, there is a discussion about the investments of the GPFG in oil and gas stocks. Previous analyses are updated and expanded in this report. Moreover, the report discusses the advice from the Strategy Council for the Government Pension Fund Global regarding responsible investments. A number of specific measures are also presented in following up on the Sundvolden declaration on investments in emerging markets and poor countries, as well as investments in renewable energy. Finally, there is a discussion on addressing climate issues in the management of the GPFG.

The investment strategy of the Government Pension Fund is premised on the purpose of the Fund, assumptions regarding the functioning of the financial markets, as well as the special characteristics and comparative advantages of the Fund. The investment strategy is characterised by seeking to exploit the long horizon of the Fund and profiting from investments that offer risk premiums over time. Other key elements are broad diversification of the investments, responsible investment practice, cost-effectiveness, moderate limits for deviations from the benchmark index and a clear governance structure.

When the Storting deliberated Report No. 10 (2009–2010) to the Storting – The Management of the Government Pension Fund in 2009, it was proposed that Norges Bank's management of the GPFG be examined on a regular basis. The background to this is the need for widespread support, also for the operational implementation of the management of the GPFG. The Ministry emphasises that the risk assumed by Norges Bank in its asset management needs to be managed and communicated well.

The Ministry has, in line with this, commissioned a review of the asset management performance of the Bank. The Ministry has also addressed how further delegation of asset management tasks to Norges Bank may improve the ratio between expected return and risk. Both Norges Bank and a group comprising three internationally recognised experts were therefore requested to present such analyses.

Section 2.2 discusses various types of asset management activities that may improve the ratio between return and risk compared to that of the benchmark index established by the Ministry. A limit for deviations from the benchmark index offers scope for improved diversification of the risk in the Fund, and an expected improvement in the ratio between risk and return. However, the contributions will vary over time, and deviations from the benchmark may also deliver negative contributions to the performance of the Fund. Thus far, the management performance of the Bank has been good. Gross excess return currently stands at about NOK 90 billion on top of the return on the benchmark index. The deviations from the benchmark have over time had a moderate impact on absolute risk. The Ministry does not at present propose any changes to the limit on deviations from the benchmark index, measured by so-called tracking error, but will revert to this issue in the report in the spring of 2015.

Market fluctuations will result in the equity portion of the Fund deviating from the strategic weight of 60 percent. A higher (or lower) equity portion will change the return and risk characteristics of the Fund. Rebalancing is intended to restore the strategic weight, thus ensuring that the risk of the Fund does not over time deviate materially from that implied by the long-term allocation across asset classes adopted for the Fund. Rebalancing may, at the same time, exhibit certain countercyclical properties, inasmuch as the Fund sells assets that have appreciated in value, in relative terms, and purchases assets that have declined in value. The rebalancing provisions are discussed in section 2.3. It is proposed that tracking error upon rebalancing be excluded from the limit for permitted deviations from the benchmark.

Section 2.4 discusses return and risk in oil and gas equities. The main policy measure for reducing the oil and gas price risk of the State is the reallocation of wealth from oil and gas on the continental shelf to financial investments in the GPF. The Ministry has analysed whether there is reason to expect that the oil price risk can be further reduced by changing the composition of the investments in the GPF. No changes to the benchmark index are proposed on the basis of these analyses.

The Ministry is committed to that the Government Pension Fund shall be managed in a responsible manner. Considerable experience has been gained in this area in the last decade, and the responsible investment strategy has been developed over time. The ethical guidelines were introduced in 2004. The guidelines were evaluated in 2009. 2010 saw the establishment of a new responsible investment mandate for Norges Bank and new guidelines on the observation and exclusion of companies in which the Fund may invest.

It is the ambition of the Ministry that all aspects of the management of the Government Pension Fund shall be in line with best practice internationally. In January 2013, the Ministry therefore requested the Strategy Council for the GPF to assess how the collective resources and competencies of the Ministry of Finance, the Council on Ethics and Norges Bank can best be utilised to further strengthen responsible investment in the GPF.

The report of the Strategy Council was submitted in November 2013 and has been circulated for public consultation. Section 2.5 discusses the recommendations of the Strategy Council, the consultative comments received and the follow-up of the Ministry. In this White Paper the Ministry announces a number of changes that will, in the view of the Ministry, strengthen responsible investment. Among the proposed measures are the integration of all the responsible investment tools in Norges Bank.

Section 2.6 of this report discusses the follow-up of the statements in the Sundvolden platform, in which it is declared that:

«The Government will establish an investment programme within the GPF, with management requirements of the same scope as for the other investments made under the GPF, but with the aim of investing in sustainable enterprises and projects in less affluent countries and emerging markets. Furthermore, the Government will consider drawing up a separate mandate in the field of renewable energy, with management requirements of the same scope as for other investments made by the GPF. »

In the report, the Ministry proposes, *inter alia*, that the mandate given to Norges Bank be amended such as to expand the investments in renewable energy.

Previous assessments have concluded that the active ownership and advocacy vis-à-vis coal and petroleum companies will be a more effective strategy for addressing climate issues and effecting changes than to exclude companies from the Fund. The report outlines the follow-up of the request from the Storting for the appointment of an expert group to examine whether these conclusions remain viable, as well as shed light on the implications of climate change for the GPFG in general.

Transparent management and a strategy with widespread support

Widespread support for the main principles underpinning the management of the Government Pension Fund makes an important contribution to enabling us to adhere to the long-term strategy, even during times of market volatility. Good long-term management is necessary to ensure that the revenues from the petroleum resources will benefit both future and current generations.

The Ministry emphasises that the risk in the management of the Fund must be managed, controlled and communicated in a clear and effective manner. Nonetheless, experience shows that it is challenging to uncover all types of risk in advance. Section 4.4 addresses verifications of return data and independent assessments of frameworks and processes for the management and control of risk.

Transparency is a prerequisite for securing widespread confidence in the management of the Government Pension Fund. The Ministry seeks to facilitate a broad-based debate on important aspects of the investment strategy of the Fund. Material changes to the strategy are submitted to the Storting. A thorough decision-making process is one of the strengths of the investment strategy.

Alongside the ongoing reporting of Norges Bank and Folketrygdfondet, this report is intended to contribute to transparency and broad-based debate concerning the management of the Fund.

2 The investment strategy of the Government Pension Fund Global

2.1 The background to the investment strategy

2.1.1 Purpose and characteristics

The Government Pension Fund comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). Operational management of the two parts of the Government Pension Fund is carried out by Norges Bank and Folketrygdfondet, respectively, and is governed by mandates laid down by the Ministry of Finance. The mandates define the long-term investment strategy of the Fund. This chapter discusses the investment strategy of the GPFG. The investment strategy of the GPFN is discussed in chapter 3.

The purpose of the GPFG is to facilitate government savings to finance pension expenditure under the national insurance scheme and support long-term considerations in the spending of government petroleum revenues. This is stipulated in the the Government Pension Fund Act. Sound long-term management of the Government Pension Fund contributes to ensuring that the petroleum wealth will benefit all generations.

Government revenues from the petroleum activities are transferred to the GPFG. This represents a fairly swift reallocation of wealth. In 2000, the value of expected future revenues from the petroleum sector was close to four times value added in the mainland economy. In 2030, it is expected to be about 50 percent of mainland GDP. Over the same period, the GPFG is expected to expand from about 30 percent of the mainland economy to about 240 percent.

The objective of the investments in the GPFG is to maximise the international purchasing power of the capital over time, given a moderate level of risk. The mandate of Norges Bank stipulates, inter alia, an upper limit on the Bank's deviations from the benchmark index defined by the Ministry. The benchmark index provides a detailed description of how the Fund shall, as a main rule, be invested, down to allocations across individual companies and bonds. The overall risk in the Fund is predominantly determined by the strategic allocations for equities, bonds and real estate in the benchmark index of the Fund.

The Fund shall, within its role of financial investor, pursue a responsible investment practice that promotes corporate governance and takes environmental and social considerations into account. The Ministry has adopted a set of ethical criteria for the exclusion of companies based on their activities. The criteria are based on a comprehensive review of overlapping consensus in the Norwegian population and recognised international standards.

By diversifying the investments of the Fund across equities, bonds and real estate in a global portfolio, the Fund earns recurring income in the form of dividends from companies, interest payments

from bond issuers, as well as rent from properties. By holding a portion of companies worldwide, the Fund can over time reap a return close to the overall return in global capital markets.

The expenses of the Fund are in the form of transfers to the fiscal budget to cover the non-oil budget deficit. The transfers from the Fund are determined by the fiscal policy guideline – which calls for the spending of petroleum revenues over time to correspond to the expected real return on the Fund, estimated at 4 percent.

With a responsible fiscal policy and the inflow of petroleum revenues expected to continue, it is anticipated that the Fund will continue to grow. The Fund has a very long time horizon. Its special characteristics are of relevance to its investment strategy. Many other funds may risk that return fluctuations result in the owner effecting large withdrawals, but such is unlikely to be the case with the Government Pension Fund. This means that the Fund has a high ability to absorb risk. The ability to withstand major fluctuations in the value of the Fund in the short and medium run facilitates commitment to an investment strategy that delivers a higher expected return over time.

The management of the petroleum revenues and the GPFG are characterised by a high degree of transparency. This is a prerequisite for widespread support for the fund concept and for good long-term management.

It is the ambition of the Government that the Government Pension Fund shall be the best managed fund in the world. Such an ambition implies the identification of best practice internationally in all aspects of the management and the adoption of said practice.

2.1.2 Main features of the investment strategy

The development of the investment strategy of the GPFG is premised on seeking to maximise the international purchasing power of the fund assets, given a moderate level of risk. The strategy is based on assessments of expected return and risk in the long run and is derived from the purpose of the Fund, the special characteristics of the Fund, the strengths of the asset manager, as well as assumptions regarding the functioning of the financial markets. The main features of the investment strategy are discussed below. Some key assumptions regarding the functioning of the markets are discussed in box 2.1.

Box 2.1 Assumptions regarding the functioning of the markets

Well-functioning markets

The investment strategy of the GPFG is based on the premise that the financial markets are largely well-functioning (efficient) in the sense that any new information in the public domain is quickly reflected in financial asset prices.

Risk premiums

The risk associated with developments in the overall stock market is often labelled market risk. Investors who are willing to accept market risk expect to get paid in the form of a higher return

than the return on more secure investments. The expected excess return is called the stock market risk premium. The market risk premium is the key risk premium for equities.

A number of equity return patterns have been uncovered over time. Research shows that several properties of equities appear to affect developments in their value over time. It is common to look at properties like *value*, *size*, *momentum*, *liquidity* and *volatility*. These properties have turned out to contribute to the explanation of historical returns on a broad range of equities and therefore tend to be called systematic risk factors. See the discussion in Report No. 27 (2012–2013) to the Storting – The Management of the Government Pension Fund in 2012.

Economies of scale

The size of the Fund is expected to give rise to economies of scale in asset management. All else being equal, asset management costs measured as a portion of the fund capital will be lower for a large fund than for a small fund. Economies of scale also facilitate the development of expertise in all aspects of asset management, which will be of benefit if the investments of the Fund are eventually expanded to include new markets, countries and financial instruments.

Size limitations

A large fund may find it difficult to expand the scale of its positions in small asset classes, as well as certain investment strategies. The implication is that certain strategies are not viable for the Fund. It may also be more challenging for a large fund to change course within a short space of time.

Principal-agent problems

There is not always a complete concurrence of interests between the person for whom an assignment is performed (the principal) and the person who performs such assignment (the agent). In situations characterised by information asymmetries, the agent may make choices that are not necessarily in the interest of the principal. In the capital markets, principal-agent problems may generally arise both between capital owners and asset managers, as well as between asset managers and the managers of the companies in which they invest. Active ownership in accordance with recognised corporate governance principles may serve to reduce principal-agent problems by narrowing the gap between the interests of a company and its owners.

End of box

The long-term investment strategy of the GPFG stipulates a fixed equity portion of 60 percent. The fixed income portion may be no less than 35 percent and the real estate portion no more than 5 percent. This allocation is reflected in the strategic benchmark index of the Fund, which forms part of the management mandate from the Ministry to Norges Bank. The mandate is available on the Ministry website (www.government.no/gpf).

The investment strategy is based on the premise that one needs to assume risk in order to achieve a satisfactory expected return over time. This expected additional return is called a *risk premium*.

Equities are, for example, more risky than bonds. Investors will expect compensation for this in the form of a higher expected return on equity investments. The magnitude of such expected additional return, or equity premium, is uncertain, and the additional realised return will vary over time.

The choice of equity portion is the one decision with the main impact on the overall risk in the Fund. Other risk premiums are, inter alia, related to the maturity of bonds (term premium) and the risk that the borrower defaults on its obligations (credit risk). Operational risk is another type of risk; the risk of loss as the result of inadequate or deficient internal processes or systems, human error or external events. Operational risk needs to be weighed against investment risk within the relevant limits stipulated in the mandate and by Norges Bank.

When *investments are diversified* in a portfolio of investments, the overall risk may become lower than the sum of the risk of each individual investment. The investments of the Fund have been diversified across several asset classes over time, and the Fund is currently invested in equities, bonds and real estate. Furthermore, the equity and bond investments of the Fund are diversified across markets in many countries. Moreover, in each market the investments are diversified across a number of individual companies and issuers.

The GPFG holds *long-term* investments. The equity investments are expected to contribute substantially to the return over time. They do, at the same time, result in increased fluctuations in fund performance. The Fund has a high ability to absorb risk, thus enabling it to adhere to a long-term strategy despite considerable fluctuations in returns from year to year. Besides, the GPFG is exploiting its long investment horizon by investing in assets that are expected to generate excess return because these may, for short or long periods of time, be less liquid.

The Fund shall pursue a *responsible investment practice*. It is assumed that sustainable development in economic, environmental and social terms, as well as well-functioning, legitimate and efficient markets, supports the long-term performance of the Fund. Weight has also been attached to using the available responsible investment tools in a coordinated, predictable and consistent manner. The role of the Fund as a responsible investor is discussed in sections 2.5 and 4.5.

The mandate stipulated for Norges Bank requires the Bank to seek to maximise the return net of *costs*. This is consistent with the stated aim of exploiting economies of scale in asset management. Comparisons with other large funds show that Norges Bank's management costs are low. Over time, management costs as a proportion of the fund capital have declined, cf. the discussion in section 4.1.

The mandate for the GPFG defines an asset management framework in the form of equity and fixed income benchmark indices. The risk in the Fund is principally the result of developments in these benchmark indices over time. Hence, fluctuations in the return on the Fund are predominantly determined by general market developments. At the same time, the mandate of Norges Bank also specifies the scope for moderate *deviations from the benchmark indices*. See section 2.2 for a review of Norges Bank's management of the GPFG.

The management of the GPFG is premised on a *clear governance structure*, in which the Storting, the Ministry of Finance, the Executive Board of Norges Bank, as well as internal and external asset

managers all have different roles and responsibilities. Duties and authorisations are delegated downwards through the system, whilst reports on results are passed upwards, cf. chapter 5.

2.2 Review of Norges Bank's management

2.2.1 Introduction

The Ministry announced, in Report No. 10 (2009–2010) to the Storting – The Management of the Government Pension Fund in 2009, that it intends to assess Norges Bank's management of the GPFG on a regular basis. The report emphasised that the estimated future returns resulting from the Bank's active deviations from the benchmark index are uncertain. It was noted, moreover, that the limit for deviations from the benchmark index over time needs to be considered on the basis of the performance track record. One prerequisite for continuing to give Norges Bank scope for deviations from the benchmark index is comprehensive assessments of the Bank's management on a regular basis. It was stated that the resulting conclusion may be an upwards or downwards adjustment to the limits for deviations from the benchmark index. It was emphasised that it was important to examine whether gross excess return continued to be representative of the value added in Norges Bank's asset management. Another issue mentioned as worthy of attention is whether Norges Bank exploits potential interactions between its active ownership activities and its investment activities.

The Ministry has, in line with this, commissioned a review of the Bank's management of the GPFG, cf. the discussion in the National Budget for 2014. The purpose is to address how further delegation of asset management duties by way of limits to deviations from the benchmark index adopted by the Ministry of Finance, can be expected to improve the ratio between risk and return. An assessment of the performance achieved over the history of the Fund thus far is an integral part of this.

The Ministry has requested Norges Bank to submit its own analyses and assessments of the implementation of the management of the GPFG, as well as to examine whether the current management framework is appropriately designed and tailored to the asset management strategies in actual use.

Moreover, the Ministry has requested a group comprising three internationally recognised experts (Professor Andrew Ang of Columbia Business School, Professor Michael Brandt of Fuqua School of Business, Duke University, and David Denison, former President and CEO of the Canada Pension Plan Investment Board, CPPIB) to analyse the asset management performance of Norges Bank. The group has also examined how further delegation of management tasks to the Bank can be expected to improve the ratio between risk and return compared to the benchmark index adopted by the Ministry.

Section 4.4 of this report discusses an independent review conducted by the Supervisory Council of Norges Bank, with the assistance of the Bank's auditor, of the risk management and compliance framework for the Bank's active management.

2.2.2 Background

Experience illustrates that widespread support for the operational implementation of the management of the GPFG is also needed. The Ministry emphasises that the risk assumed by the Bank in its asset management needs to be managed and communicated in a clear and sound manner.

Norges Bank's management of the GPFG was last examined in 2009. This included analyses and assessments from Professors Andrew Ang, William Goetzmann and Stephen Schaefer. The analyses showed that the volatility of returns on the Fund could be almost fully explained by the fluctuations in the return on the benchmark index, although Norges Bank's management had nonetheless contributed to improving the performance of the Fund. They also showed that a considerable portion of the overall return achieved for the Fund by the Bank could retrospectively be explained by exposure to so-called systematic risk factors. Systematic risk factor is a common term for various return patterns in the equity or fixed income portfolio. One example of such a factor is «value», which reflects the observation that companies with low valuations have over time delivered higher returns than companies with high valuations.

The Ministry noted, in Report No. 10 (2009–2010) to the Storting, a number of considerations suggesting that some scope for deviations from the benchmark index is needed, including, inter alia, that Norges Bank should have the freedom to exploit weaknesses in the benchmark index and that the special characteristics of the Fund offer a potential for excess returns over time. These assessments were endorsed by a majority of the members of the Standing Committee on Finance and Economic Affairs, cf. Recommendation No. 373 (2009–2010) to the Storting.

In Report No. 10 (2009–2010) to the Storting, the Ministry decided, at the same time, to change the limit for permitted deviations from the benchmark index; the so-called expected tracking error. The upper permitted limit of 1.5 percent in the mandate was changed such as to require Norges Bank to organise asset management with a view to keeping the expected tracking error within 1 percent. It was stipulated that the expected tracking error could in extraordinary circumstances exceed the 1-percent limit. The method for calculation of tracking error was also changed to make the expected tracking error more responsive to changes in the active positions of the Bank, and less responsive to whether the markets in general are experiencing a period of high or low return volatility. These changes may, generally speaking, reduce the need for keeping well below the upper limit. The report noted that when the upper limit on tracking error was made less absolute, it was also appropriate to reduce the limit on expected tracking error. It was noted, moreover, that the decisive factor in determining the scope for active management is the overall restrictions on the risk in active management. It was therefore an important change that the Ministry required the Executive Board of Norges Bank to stipulate a number of supplementary risk targets in addition to expected tracking error, including limits on overlap between the actual portfolio of the Fund and the benchmark index, credit risk, liquidity risk, counterparty exposure, leverage, etc. The changes implied, inter alia, that the Bank could not use leveraging to increase the risk of the Fund in the same way as before. These changes to the framework governing the risk of the Fund were based, inter alia, on limits already adopted by the Bank in its internal regulations, cf. Report No. 10 (2009–2010) to the Storting.

Report No. 10 (2009–2010) to the Storting also outlined a number of measures implemented to strengthen control and supervision of the management of the GPFG. The supervision function of the Supervisory Council of Norges Bank was reinforced. New audit arrangements were introduced for Norges Bank, and new regulations on risk management and internal control in the Bank were enacted, together with new regulations on annual financial statements, etc. The Ministry also adopted a new Mandate for the Management of the GPFG. A majority of the members of the Standing Committee on Finance and Economic Affairs noted, in connection with the Storting's deliberation of Report No. 10 (2009–2010) to the Storting, that the amendments made to the mandate of Norges Bank and the measures to strengthen the control and supervision of asset management are targeted measures intended to limit the risk in active management.

In recent years, the Ministry has, against the background of the evaluation in 2009 and the recommendations from, inter alia, Professors Ang, Goetzmann and Schaefer, analysed and examined various aspects of the strategy of the Fund. It has examined, inter alia, whether the Fund can improve the ratio between risk and return by tilting the composition of the equity portfolio towards systematic risk factors, as well as what decisions should be delegated to the asset manager.

Report No. 17 (2011–2012) to the Storting – The Management of the Government Pension Fund in 2011, discussed the changes to the fixed income benchmark index implemented in 2012. The Ministry noted that the use of market weights implies that the countries with the largest debts carry the most weight in the benchmark index. It was observed that the size of a country's economy, measured by its gross domestic product (GDP), provides a better measure of sovereign ability to pay. Hence, the fixed income benchmark index was changed to weigh the government bonds of the various countries on the basis of the GDP of such countries. It was noted, at the same time, that the size of a country's economy is not a precise measure of the ability or willingness to repay sovereign debt. The Ministry concluded that the mandate of Norges Bank shall require the management of government bonds to take differences in fiscal strength into account. Since fiscal strength cannot be measured precisely, Norges Bank is best placed to make such adjustments.

Moreover, last year's report discussed an analysis commissioned by the Ministry from the index and analytics provider MSCI. The said analysis examined the effects of tilting the composition of large equity portfolios towards various systematic risk factors like value, size, momentum, liquidity and low volatility by way of simple rule-based strategies, cf. Report No. 27 (2012–2013) to the Storting – The Management of the Government Pension Fund in 2012. The Ministry concluded that any exploitation of systematic risk factors in asset management should take place within the scope of the Norges Bank management framework. The Ministry noted that the Bank may design factor strategies based on the characteristics and advantages of the Fund, including the long time horizon and size of the Fund, and that the design of such strategies forms an important part of the management mission of the Bank. In its deliberation of the report, the Standing Committee on Finance and Economic Affairs unanimously endorsed the delegation of this type of decision to Norges Bank, cf. Recommendation No. 424 (2012–2013) to the Storting:

«The Committee notes the Ministry of Finance's assessments regarding systematic risk factors in the equity portfolio. The Ministry concludes that «tilts towards systematic risk

factors in the equity portfolio [are] best achieved as part of the operational management, rather than through a change in the Fund's benchmark index». The Committee agrees with the assessment of the Ministry and notes that Norges Bank has chosen to introduce an operational reference portfolio for equities that implies, inter alia, a certain degree of tilt towards the risk factors value and size.»

Besides, the Ministry has noted in previous reports that indices from leading index providers are more tailored to the average investor than to an investor with the special characteristics of the GPF, such as a long time horizon and a limited liquidity need, cf. box 2.2. As noted by the Ministry in Report No. 10 (2009–2010) to the Storting, some scope for deviation from the benchmark index adopted by the Ministry of Finance is needed to enable Norges Bank to exploit these weaknesses and ensure cost-effective adaptation to the index. There has been broad political support for these assessments, cf. above.

Box 2.2. Index weaknesses

The Ministry of Finance has in previous reports to the Storting explained that indices from leading index providers like FTSE, MSCI, Barclays, etc., generally suffer from a number of weaknesses as a result of the way in which these indices are composed, cf. Report No. 10 (2009–2010) to the Storting and Report No. 17 (2011–2012) to the Storting. Indices are designed to meet a number of requirements, including, inter alia, to represent the investment opportunities in a specific market from the perspective of the average or typical investor. This implies that the index needs to be constructed such as to ensure a broad diversification of risk, but also such as to include securities that are liquid, thus making the index investable or replicable. Consequently, the criteria determining what equities or bonds to include in indices are laid down in comprehensive regulations adopted by index providers. The criteria selected differ somewhat between index providers. This implies, for example, that two equity indices for the same region will not necessarily include the same equities with the same weighting between such equities. There may also be differences in terms of which countries or markets are included in the indices.¹

For an investor with the special characteristics of the GPF, it may be appropriate to deviate from a rigid adherence to the index in order to ensure efficient asset management implementation. Examples of such deviations are:

- Academic studies show that security prices are influenced by large transactions. There is, for example, a tendency for equities adopted for inclusion in an index to increase in price on the day of such inclusion because many large investors are simultaneously acquiring the relevant equities. This indicates that there will be costs associated with rigid replication of the benchmark index on the part of the GPF. Such costs can be avoided by deviating from the index weighting. Moreover, it may be preferable for the Fund to retain credit bonds that are downgraded, rather than to automatically sell bonds when these are removed from the benchmark index. Correspondingly, it may be appropriate to refrain from buying upgraded securities.

- It is not always possible, or desirable, to hold all securities included in the fixed income benchmark index. The Fund is large and the liquidity of individual securities may vary over time. Norges Bank may therefore opt for putting together a portfolio with approximately the same properties as the benchmark index, instead of acquiring all of the securities included in the index.
- Benchmark index weights do not reflect any other borrowings of a bond issuer. This means that an index weight is not necessarily representative of the overall liabilities of an issuer. A passive asset manager will in principle have to accept the index weights. An asset manager that can deviate from the index may refrain from investing in the bonds of an issuer, or invest less than suggested by its index weight, based on an assessment of the overall liabilities of such an issuer.
- When rebalancing the equity portion it is operationally straightforward to trade entire equity portfolios via so-called programme trades. In the fixed income portfolio, however, one must to a larger extent rely on selling and purchasing individual securities as the result of many fixed income securities being less liquid. Hence, deviations from the fixed income reference portfolio as the result of rebalancing may exceed the deviations from the equity reference portfolio.
- An asset manager conforming rigidly to the index will, for example, incur high transaction costs when there are frequent changes to the fixed income index. Moreover, an asset manager that is not permitted to deviate from the index must in principle divest a bond when its term to maturity is less than one year.

¹ By way of illustration, Ang, Brandt and Denison have in their report calculated that the difference between a global index from the index providers FTFS and MSCI may represent a tracking error of about 0.5 percentage points, although both indices are aiming to capture developments in global stock markets.

End of box

2.2.3 The analyses and assessments of Norges Bank

Norges Bank has, in a letter of 13 December 2013, forwarded four reports in which the Bank discusses performance and risk in the management of the GPF, experience from the real estate investments, experience from the environment-related mandates and an evaluation of the strategic plan for the period 2011–2013. Furthermore, Norges Bank has in a letter of 31 January 2014 submitted advice concerning the future management framework for the GPF. The letters from Norges Bank are enclosed as appendices 3 and 4 to this report. In a letter of 12 March 2014, Norges Bank submitted updated reports based on final results for 2013. The letter and the four reports are published on the Ministry's website (www.government.no/gpf).

Management performance and risk

The Bank has analysed risk and return over the period from January 1998 to December 2013, with an emphasis on the last five years. The analyses show that the average annual nominal return on the Fund over the said period was 5.70 percent, of which achieved excess return represents 0.31 percentage points. The average nominal return on the Fund over the last five years was 12.04 percent, whilst the achieved excess return was 1.16 percentage points. The figures are not adjusted for asset management costs. The Bank notes that asset management has contributed to an improved ratio between risk and return, relative to the benchmark index. The analyses show that there is some degree of correlation between the achieved excess return and the return on various systematic risk factors, for example volatility and credit. For the entire period as a whole, the systematic factors retrospectively explain 37 percent of the fluctuations in the achieved excess return. The Bank finds it difficult to draw any clear conclusions from these analyses because the correlation varies considerably over time.

Norges Bank has also examined whether gross excess return remains a good measure of the results from the Bank's active deviations from the benchmark index, i.e. whether it adequately expresses the excess return compared to a management scenario in which the index is replicated exactly, net of all costs. Such return difference may be termed *net value added*. The most common measure is nonetheless the difference between the gross return on the Fund (return before asset management costs) and the return on the benchmark index. This may be termed gross excess return. Whilst gross excess return can be obtained from the annual reports of the Fund, net value added needs to be estimated, since this involves comparing actual returns with theoretical index replication. In order to estimate net value added one would, inter alia, have to take into account the transaction costs incurred in the actual portfolio when phasing in new capital and adapting to changes in the benchmark index, the income earned by the Fund from securities lending, as well as the fact that index replication generally involves lower asset management costs. Since estimated index replication income and costs are based on a considerable element of discretionary assessment, the estimated net value added will also be subject to uncertainty. Norges Bank's calculations confirm that gross excess return appears to remain a robust approach to the measurement of value added in asset management.

Experience with the management of the real estate portfolio

The Bank notes that the Ministry decided in 2010 that up to 5 percent of the GPFG shall be invested in real estate. In 2011, the Bank implemented the first unlisted real estate investments, and at yearend 2013 the real estate investments accounted for 1.0 percent of the overall investments of the Fund, with a value of NOK 52 billion. The average annual return achieved since inception of the real estate investments in 2011 until yearend 2013 was 4.6 percent, measured as time-weighted annual rate of return. The report from Norges Bank provides a comprehensive overview of the investments and the Bank's organisation of these activities, including the governance model and company structures. The Bank notes in the report that investments in unlisted real estate differ significantly from investments in listed equities and bonds. The strategy of the Bank in the introductory phase was to invest in properties in the core markets, first in Europe and thereafter in the US. The Bank has focused on investing alongside local partners via so-called joint ventures. It is noted that such partners have local market knowledge and that they are currently responsible for the op-

eration of the properties. Internally at Norges Bank, there has been a commitment to making investment decisions within a structure based on the delegation of powers. Moreover, the Bank has focused on establishing an investment organisation for real estate that is similar to how the other parts of asset management are organised, rather than on establishing an organisation that follows up on external management mandates. All the unlisted real estate investments of the Fund have been implemented via subsidiaries of Norges Bank. The Bank has been committed to allowing plenty of time for the phase-in of real estate into the Fund, and believes that the implementation has been characterised by the prudent development of resources, systems and frameworks.

Experience from the environment-related mandates

In its letter of 13 December 2013, Norges Bank notes that the Ministry decided to establish a specific programme for environment-related mandates in connection with the evaluation of the ethical guidelines in 2008–2009. Since 2009, the Bank has allocated internal and external management mandates that are specifically focused on environment-related investments. These investments are subject to the same profitability requirements as the other investments of the Fund. The report from Norges Bank notes that the Bank has thus far chosen to concentrate the investments on equities in listed companies. It is noted that the investment universe for this type of mandate is complex, and that environment-related companies can be found in a number of industries, each of which may have very different characteristics. The Bank therefore notes that such investments involve a number of definition problems. The risk in this part of the market relates, according to Norges Bank, especially to swift technological development, rapid inflow of new market players and unpredictable framework conditions. The period since the establishment of the environment-related mandates has overlapped with a global financial crisis. The Bank notes that the crisis contributed to increased volatility in this part of the market, and had a negative impact on investors' appetite for risk. Norges Bank notes that this market segment is relatively small, but is of the view that the Bank can handle the current volume of investments in environment-related mandates. It is stated that the overall return on the environment-related mandates of the Fund was 13 percent over the period 2009–2013, whilst general stock market returns, as measured by the equity benchmark index of the Fund, was 54.1 percent over the same period. The Bank is of the view that environment-related investments are well suited for active management, although these have not contributed to the healthy return on the Fund over the period 2009–2013.

Evaluation of the strategic plan for 2011–2013

Norges Bank notes that the strategic plan for the period 2011–2013 was adopted by the Executive Board on 15 December 2010 and forwarded to the Ministry for information, in compliance with the requirements in the mandate. The main objectives for the period were the implementation of an investment strategy premised on the special characteristics of the Fund, simplification of the organisational and technological infrastructure and strengthening of the investment culture at the Bank. The Bank's report shows that the organisation has been changed to focus more on high returns in the long run. Moreover, Norges Bank has simplified the portfolio structure and technological infrastructure, and also reduced the number of external service providers. This has, according to Norges Bank, resulted in lower management costs. The Bank has also strengthened its investment culture

through better and more focused investment analysis. Public reporting on the management of the Fund has also been strengthened.

Interaction between active ownership and active management

Norges Bank notes that it is using a number of responsible investment tools. It promotes international principles and standards, expresses expectations as owner and exercises ownership rights through voting and engagement with companies. Corporate governance, environmental and social considerations are integrated in the investment process and in risk management. The Bank notes that this may result in portfolio adaptations, such as decisions to divest, or to refrain from acquiring, certain securities. The Bank believes that there are interactions between the various ownership tools and the investment activities in general.

The active ownership involves the analysis and accumulation of knowledge about matters that may be of relevance to the long-term returns of companies. It is noted that corporate governance, environmental and social considerations can have an impact on investment returns and risks. The Bank is of the view that the anticipated benefits from divestment of companies should be weighed against the interest in being invested in a large number of companies. It is noted that large-scale divestment may impose costs on the Fund in the form of a lower degree of risk diversification.

The Bank also notes that knowledge accumulated as a basis for investment decisions may benefit active ownership. Norges Bank meets representatives of the companies in which the Fund is invested, on a regular basis, through its investment activities. The Bank notes that this forms the basis for a good dialogue on ownership issues. Moreover, the Bank accumulates, through the investment activities, knowledge about many of the companies in which the Fund is invested. Such knowledge contributes to ensuring that its active ownership activities are relevant and premised on a comprehensive understanding of individual companies and issues. This may, according to the Bank, improve the scope for positive results from active ownership.

In prioritising its ownership activities, the Bank takes the composition of the Fund into account. The Bank has experienced that it is especially important to consider active ownership and investment decisions in the context of each other in companies where the Fund is a major owner. The Bank also takes into account whether an issue can be said to be of material importance at the company level, and whether it may have an impact on the valuation of the company. The Bank is of the view that the dialogue with companies becomes more consistent when active ownership is considered in the context of investment decisions.

Advice on the management framework

In a letter of 31 January 2014, Norges Bank has submitted advice relating to the GPFM management framework, including the limit for deviations from the benchmark index adopted by the Ministry. Norges Bank is proposing a number of adjustments to the mandate for the GPFM, including that the Bank should be given somewhat more freedom of action in its implementation of the management mission by way of the responsibility for laying down detailed provisions being, to a larger extent, delegated to the Bank. The Bank believes, inter alia, that requirements for the assessment of credit risk in the fixed income portfolio and for establishing appropriate limits for this type of risk should be the responsibility of Norges Bank. Moreover, the Bank proposes a number of simplifica-

tions and a new structure for the mandate. The Bank notes that the risk management measure expected tracking error suffers a number of weaknesses as a management parameter for risk taking in the implementation of operational asset management. The Bank believes that one should in the longer run consider whether to instead base the management of the Fund on a measure of absolute risk. If the risk measure for the management of the Fund shall continue to be based on a limit on expected tracking error, the Bank is of the view that such limit should be increased from the current limit of 1 percent to 2 percent.

Norges Bank notes that several provisions in the investment mandate of the Bank have been amended in recent years in a way suggesting that there may be a need for increasing the limit on deviations from the benchmark index. The most important of these are the rule on how to rebalance the equity portion, the requirement for taking differences in fiscal strength between countries into account in determining the composition of the government bond investments and the requirement for establishing specific environment-related investment mandates.

The Bank notes, moreover, that it has established, through modification of the operational reference portfolio, a more tailor-made basis for its asset management. The deviations between the operational reference portfolio and the benchmark index adopted by Ministry of Finance count towards the limit for expected tracking error. It is also noted that asset management has in recent years evolved towards harvesting systematic risk premiums through, inter alia, modification of the operational reference portfolio. Norges Bank believes that the limit for expected tracking error must be designed such as not to force the Bank to reverse positions at a non-optimal time because it exceeds the limit.

The real estate investments are currently exempted from the calculation of expected tracking error. Norges Bank notes that if one abolishes a fixed real estate allocation, and instead construes such allocation as a deviation from a benchmark index comprised of equities and bonds only, the limit for expected tracking error should be increased.

2.2.4 Report from the expert group

The expert group presented its review of Norges Bank's management of the GPFG in a report of 20 January 2014. The report is published on the Ministry website.¹ The report identifies a number of developments in the Bank's management of the GPFG. It mentions, in particular, that management has been simplified in recent years, with less use of leveraging and complex financial instruments, and that the discretionary element has been reduced as the result of a lower limit on deviations from the benchmark index. The experts highlight, moreover, the Bank's development of internal, more tailor-made, indices for use in the Bank's own management; operational reference portfolios, as very positive. The operational reference portfolios contribute to further diversifying the risk of the Fund, and to exploiting systematic risk factors and weaknesses in the index. The expert group believes that there is a sound professional basis for the Fund to be engaged in such management

¹ www.government.no/gpf.

activities. They note, at the same time, that this is best achieved within the scope of operational management, rather than by the Ministry changing the benchmark index of the Fund.

The analyses of GPFG performance show that risk is dominated by the benchmark index adopted by the Ministry, and that the Bank's deviations from the benchmark index have been very moderate. More than 99 percent of the volatility in Fund returns can be explained by the volatility of benchmark index returns. The statistical analyses show that Norges Bank's management has made a positive contribution to the return on the Fund, with an average annual gross excess return of just over 0.3 percentage points. All in all, equity management has outperformed fixed income management. The expert group has also analysed the correlation between achieved excess return and the return on various so-called systematic risk factors. They find that 60 percent of the fluctuations in the excess return achieved for the period as a whole can be explained by developments in such risk factors. The expert group interprets the high degree of correlation as a strength, and notes that if the Bank's management activities provide, directly or indirectly, the Fund with characteristics that are in line with systematic risk factors, positive return contributions can be expected in future as well.

In its report, the expert group notes that there are, generally speaking, four activities that contribute to value added:

- diversification of risk
- rebalancing (including less rigid adaptation to index changes)
- systematic risk factors
- selection of individual equities and bonds (traditional active management)

The Fund is engaged in all of these activities at present. The Bank's development of internal operational reference portfolios represents a more systematic approach to the first three types of activities.

The expert group recommends that the Fund should report more comprehensively than at present on the contributions from the various value added activities to the return on the Fund. They believe that increased transparency concerning the various contributions to the return on the Fund will contribute to a more robust investment strategy. Figure 2.1 illustrates that the investments of the GPFG are based on many choices made by the Ministry of Finance and Norges Bank.

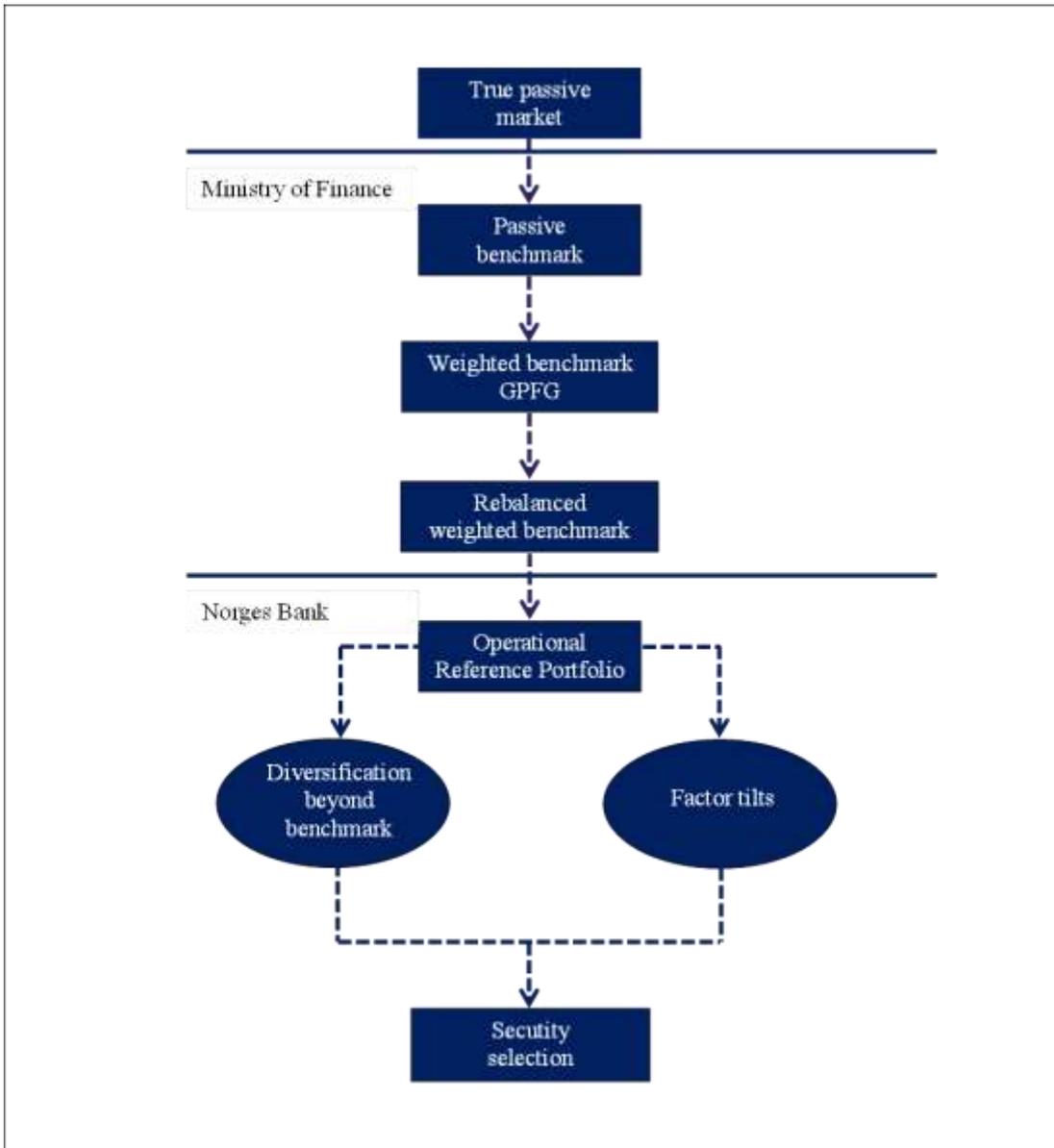


Figure 2.1 Illustration of different types of active choices made by the Ministry of Finance and Norges Bank

Sources: Ministry of Finance and Ang, Brandt and Denison (2014).

In its report, the expert group discusses a specific model for delegation to the asset manager used by other large funds, including, inter alia, CPPIB (Canada) and GIC (Singapore). It implies that there is no fixed portion of the Fund that can be invested in real estate and other unlisted markets, and that it is instead delegated to the asset manager to assess such investments, in each individual case, against what the Fund could alternatively have achieved by investing in a portfolio (for example 60/40) of listed equities and bonds. The experts note that the advantage of such a model is that it can be used across asset classes and that one seeks, to a greater extent than in a model involving fixed allocations between different asset classes, to exploit the comparative advantages of

the Fund. These advantages are partly structural properties of the Fund, such as size and time horizon, but also those developed over time by the asset manager as a professional, focused organisation. The report emphasises that the model is challenging to implement, and that a clear and sound governance structure is a prerequisite. The expert group recommends that the Fund introduce this model and believes that the Fund is well placed to implement it in a sound manner. The group does not address how the model should be introduced in practice. Reference is made, in this context, to Report No. 27 (2012–2013) to the Storting, in which the Ministry discussed real estate return objectives chosen by other investors. The Ministry discussed analyses comparing listed real estate equities to unlisted real estate, and concluded that it ought to be up to the asset manager to choose between listed and unlisted investments in the real estate portfolio.

The expert group recommends an increase in the scope for deviations from the benchmark index, as measured by expected tracking error. They believe that a moderate increase would be from 1 percent to 1.75 percent. They take the view that a higher limit on deviations from the index will contribute to improved diversification of risk, and offer scope for exploiting systematic risk factors. The expert group believes that this will increase the long-term return on the Fund, and notes that the Bank has historically achieved good management performance. The expert group also notes that the inclusion of real estate in the calculation of expected tracking error would necessitate an increase.

The expert group notes, at the same time, that expected tracking error is designed to measure typical deviations from the benchmark index, as measured by standard deviation. The group notes that standard deviation makes no distinction between negative and positive deviations from the index, whilst investors will typically have different preferences between positive and negative outcomes. Investors will typically be concerned about the entire statistical distribution of the deviations from the index, and they will be especially concerned about negative outcomes (losses). The expert group therefore recommends that the Fund introduces supplementary risk measures to capture deviations with a low probability, but major consequences (so-called «tail risk»).

2.2.5 The Ministry's assessment

Evaluation of operational asset management implementation on a regular basis is of importance to the Ministry's further development of the strategy for the Fund. The Ministry takes the view that any major changes to the strategy for the management of the GPFG shall be premised on thorough professional assessments, which also form the basis for widespread support in the Storting. The Ministry is committed to exploiting the special characteristics of the Fund and its ability to absorb risk.

The purpose of the review of Norges Bank's management of the GPFG in this report is to discuss how further delegation of asset management duties to Norges Bank may improve the ratio between risk and return, within a risk level that shall remain moderate.

The Ministry has noted that the expert group emphasises, in its report, that the actual portfolio of the Fund will be the result of a number of active choices, even if there is limited scope for deviations from the benchmark index. It is only through such decisions that the composition of the investments will be tailored to the purpose of the Fund and its special characteristics, as well as to the

assumptions of the Ministry regarding the functioning of the markets. Both the expert group and Norges Bank note the need for tailoring the composition of the actual portfolio of the Fund. Some of these adaptations should be made by the Ministry of Finance, and others by Norges Bank.

Index providers stipulate rules defining which markets and companies shall be included in their indices. Indices are, for example, rebalanced on a regular basis as the result of companies entering or exiting an index. Norges Bank may exploit this by adjusting the composition of the Fund portfolio to such ongoing changes to the indices in a more cost-effective manner than investors that are restricted to adhering more rigidly to the indices. This may contribute to the Fund achieving a better ratio between expected return and risk than the index. The Ministry is of the view that it is appropriate for Norges Bank to develop internal reference portfolios that deviate from the strategic benchmark index of the Ministry of Finance in such respects.

Norges Bank may invest in markets or companies that are not included in the benchmark index. The Bank may refrain from approving markets that are included in the index, and may also approve markets that are not included in the index. This enables the asset manager to perform a more tailored assessment as to which investments offer adequate security for the Fund, including the safeguarding of ownership rights. Such adaptation may in the long run contribute to diversifying the risk of the Fund, although it may at times have a negative impact on the return on the Fund.

The Ministry also believes that it may be appropriate for a long-term investor like the GPFG to seek to influence expected return and risk by tilting the composition of the Fund towards various systematic risk factors. This topic was discussed in last year's report on the Government Pension Fund. The assessment was that such decisions should, to the extent that systematic risk factors are to be exploited in asset management, be made by Norges Bank within its management framework, cf. the discussion in Report No. 27 (2012–2013) to the Storting. The Storting endorsed these assessments, cf. Recommendation No. 424 (2012–2013) to the Storting.

The Ministry has noted that Norges Bank is seeking, through its development of internal reference portfolios, to further diversify the risk of the Fund, to exploit weaknesses in the indices, as well as to profit from systematic risk factors. The Ministry has noted that the expert group is of the view that there is a sound professional basis for concluding that the Fund should do this. The Ministry has also noted the conclusion of the expert group that such asset management activities are best performed in an operational management context.

The Ministry agrees with the conclusion that there is a sound professional basis for the Bank's development of internal reference portfolios. The special characteristics of the GPFG distinguish the Fund from the average investor. Norges Bank exploits these special characteristics and other advantages in an attempt at achieving an improved ratio between expected risk and return, compared to the benchmark index. The Ministry is of the view that it is most appropriate for this type of decision to be delegated to the Bank. Any deviations between the benchmark index and the operational reference portfolios count, at the same time, towards the limit on deviations from the benchmark index. The Ministry is of the view that the limits laid down in the mandate should offer Norges Bank some scope for evolving and implementing this type of strategy. The intention is to improve the ratio between risk and return by exploiting the special characteristics of the Fund. It is neither

desirable, nor possible, for the Ministry to make all such strategic choices by changing the benchmark index of the Fund.

The analyses of both Norges Bank and the expert group confirm that asset management has made a positive contribution to the return on the Fund, whilst the deviations from the benchmark index have been moderate. The Ministry agrees with the conclusion that the performance achieved in recent years is good, but also notes that this must be considered in the context of the recoupment in the wake of the financial crisis. The Ministry noted that more than 99 percent of the fluctuations in the return on the Fund can be explained by developments in the benchmark index adopted by the Ministry of Finance. Hence, the Fund is managed close to index. The Ministry also notes that even minor return contributions resulting from Norges Bank's deviations from the index will, given the size of the Fund, represent considerable amounts over time. Historical return data show that the average annual gross return on the Fund exceeds that of the benchmark index by more than 0.3 percentage points.

The statistical analyses of the expert group show that the risk in the equity portfolio has over time been somewhat higher than that implied by the benchmark index, whilst the risk in the fixed income portfolio has generally been in line with that of the benchmark index.² There have, nonetheless, been deviations between the risk of the GPFG and that of the benchmark index in certain sub-periods, including, inter alia, during the financial crisis. The risk exceeding that of the benchmark index implies, generally speaking, that one can normally expect somewhat higher volatility of returns than would be implied by general market developments.

The Ministry has noted that the Bank has updated the calculations that form the basis for the conclusion that gross excess return remains a good indicator of the results of the Bank's deviations from the benchmark index. Although the calculations are subject to uncertainty, it would appear that gross excess return remains a robust approach to measuring the value added from activities that involve deviations from the benchmark index.

The Ministry has noted, moreover, that the expert group recommends an increase in the limit on deviations from the benchmark index, as measured by expected tracking error. The group believes that a moderate increase in the limit would be an upwards adjustment from 1 percent to 1.75 percent

The Ministry has noted that Norges Bank is also recommending an increase in the limit for deviations from the benchmark index. The proposal from the Bank calls for an increase from 1 percent to 2 percent in the tracking error limit, and is based on the reasoning that a number of changes have

²The statistical analyses show that the exposure of the equity portfolio to the market; so-called beta, for the period from January 1998 to June 2013 is estimated at 1.02. This means that the systematic risk in the actual equity portfolio has on average exceeded that of the «market», as represented by the benchmark index, by 2 percent. A portfolio with an equity composition that results in a beta in excess of 1 will on average generate a higher expected return than the benchmark index during periods of positive price developments in the markets, with the reverse being the case during periods of negative market developments. The analyses show that the beta of the fixed income portfolio was 1.00 over same period, which means that the risk in the actual portfolio has on average been the same as that of the benchmark index.

been made to the mandate for the GPFG in recent years, all of which count towards to current 1-percent limit. The Bank notes that the limit should be sufficiently high to enable rebalancings to be carried out in an effective manner. It is also noted that the development of operational reference portfolios will draw on the limit. The Ministry has also noted that the Bank believes that there is a need for sufficient freedom of action to perform asset management in a way that exploits the special characteristics of the Fund and supports the overarching asset management objective.

The Ministry agrees with the expert groups and Norges Bank that it is appropriate for a large, long-term investor like the GPFG to develop a more tailor-made asset management benchmark than those implied by the general indices from leading index providers. The latter suffer from a number of weaknesses that should, in the view of the Ministry, lend themselves to exploitation by the GPFG.

However, the Ministry has concluded, based on an overall assessment, that further examination of the issue of the appropriate limit on deviations from the benchmark index is necessary before reaching a conclusion with regard to the advice received. The limit, in the form of expected tracking error, was imposed in 2009 in the wake of the financial crisis. The Ministry is of the view that it is appropriate to further examine the scope of deviations from the benchmark index before again changing the limit. Some of the strategies that may be developed in response to a higher limit may imply a tilting of the investments towards systematic risk factors. Such strategies were addressed in last year's report, cf. section 2.2.2 of Report No. 27 (2012–2013) to the Storting. Whether to increase the limit on deviations to allow more scope for the said strategies comes down to a trade-off between expected risk and return. A higher limit may result in larger fluctuations in excess returns, which fluctuations may in some years be large. The new rebalancing rules also imply that the scope for other deviations from the benchmark index will, when taken in isolation, be somewhat expanded, cf. the discussion in section 2.3. Other advice from the expert group also merits further examination. The group recommends that real estate investments and, if applicable, other unlisted investments should be included in the limit for deviations from the benchmark index. Moreover, the expert group recommends the Ministry of Finance to introduce a limit that also expresses a maximum tolerance for losses that will occur rarely. The Ministry will examine these issues in more detail, together with the limit on deviations from the benchmark index, and aims to revert on these in the report to be published in the spring of 2015.

2.3 Rebalancing of the equity portion

2.3.1 Rebalancing of the benchmark index

The long-term strategy of the Ministry of Finance for the management of the GPFG stipulates a fixed 60-percent allocation for equities. Market fluctuations will result in the equity portion of the benchmark index deviating from the said strategic weight. An increase in stock prices relative to bond prices will, for example, result in an increase in the equity portion. A higher (or lower) equity portion will change the return and risk characteristics of the Fund. It is therefore important to have arrangements for reverting the weights of the benchmark index back to the chosen strategic weights.

Report No. 17 (2011–2012) to the Storting discussed experience from the rebalancing of the GPFG. The Ministry emphasised that the purpose of rebalancing is to ensure that the risk of the Fund over time does not deviate materially from that implied by the long-term allocation across asset classes. The Ministry noted, at the same time, that rebalancing is somewhat countercyclical in nature, inasmuch as the Fund will sell assets whose value has increased in relative terms, and purchase assets whose value has declined. The Ministry concluded that rebalancing of the GPFG should continue, although further review of the detailed rules was called for. The National Budget for 2013 announced the new rules for the rebalancing of the GPFG, cf. Report No. 1 (2012–2013) to the Storting. The rules imply that when the equity portion of the benchmark index at the end of a month deviates from 60 percent by more than 4 percentage points, the equity portion of the benchmark index is reverted to 60 percent at the end of the following month.

The first rebalancing of the benchmark index of the GPFG under the new rules took place in the autumn of 2013. The Ministry has re-examined some of the rebalancing provisions on the basis of this experience.

2.3.2 Rebalancing of the actual portfolio

Rebalancing of the actual portfolio of the GPFG is delegated to Norges Bank. The Bank can normally be expected to spend a long time to rebalance the actual portfolio in an appropriate and cost-effective manner. In performing its assessment, the Bank may attach weight to, inter alia, the market situation and market liquidity.

Norges Bank may, in its management of the actual portfolio, deviate from the equity portion of the benchmark index. How large such deviations can be is predominantly determined by the limit on deviations from the index; so-called expected tracking error.

The difference between the equity portion of the actual portfolio and of the benchmark index may be large during a period when the Bank is carrying out rebalancing. Simulations conducted by the Ministry show that the difference between the equity portions may during periods of major market turbulence be more than ten percentage points just after the benchmark index has been rebalanced. This may result in negative or positive excess return and a high expected tracking error.

A low limit on tracking error may result in Norges Bank having to rebalance the actual portfolio at a different speed from that deemed appropriate by the Bank on the basis of considerations relating to cost-effective adjustment. The Ministry has therefore examined how the rebalancing rules can be modified to account for the effects on expected tracking error.

The current rules for rebalancing of the benchmark index are in the public domain. Knowledge of how Norges Bank rebalances the actual portfolio may be market sensitive, and constitutes information that may be exploited by other market participants to profit at the expense of the GPFG. If one were to amend the rules for the rebalancing of the benchmark index such as to bring these closer to how Norges Bank rebalances the actual portfolio, it would probably be necessary to make part of the rules confidential.

2.3.3 The Ministry's assessment

The Ministry believes that the rules should remain public, since transparency is an importance objective in the management of the Fund.

Moreover, the Ministry holds cost-effective implementation of the rebalancing to be an important consideration. The rules must provide clear and firm guidelines as to how the benchmark index shall be adjusted. Norges Bank should, at the same time, be able to consider what is the appropriate way of carrying out any given rebalancing and have the freedom to decide how, and at what speed, the actual portfolio can and should be adjusted. This suggests that the mandate of Norges Bank should be modified.

The current guidelines imply that the Bank needs to «reserve» part of the limit on expected tracking error for future rebalancings. The Ministry has therefore examined whether the limit should be increased to account for the fact that rebalancings do, to a varying extent, count towards the limit. The simulations of the Ministry of Finance show that the limit on expected tracking error would have to be significantly higher than at present in order to accommodate periods of major market turbulence. The Ministry is of the view that this would not be appropriate. Such a solution might provide unintentionally wide scope for other deviations from the benchmark index during periods without major stock market fluctuations.

The Ministry is instead proposing that variations in expected tracking error as the result of rebalancing should not be subject to the limit. This implies that if the expected tracking error is in excess of the limit, but Norges Bank can demonstrate, on the balance of probabilities, that this was caused by an ongoing rebalancing exercise, this will not be construed as a violation of the mandate.

Rules on rebalancing of the equity portion are intended to ensure that the equity portion of the benchmark index does not move far from the chosen equity portion of 60 percent. The Ministry has examined whether not to subject rebalancing to the limit may result in the Bank not being provided with sufficiently strong incentives to carry out rebalancings during periods of turbulence. However, the difference in equity portions between the actual portfolio and the benchmark index will have a significant impact in terms of negative or positive excess return, which has to be reported. This may imply, when taken in isolation, that Norges Bank will wish to limit any differences in equity portions between the actual portfolio and the index. The amendment proposed here is conditional upon detailed reporting from Norges Bank regarding the implications in terms of tracking error and excess return.

2.4 Oil and gas equities in the GPF

2.4.1 Introduction

The fund structure, including the GPF and the fiscal policy guideline, was created to shelter the mainland economy from large and variable petroleum revenues and ensure the smooth phase-in of government petroleum revenues. The GPF is, at the same time, an instrument for long-term government savings. The assets accumulated abroad by Norway through the financial investments in the Fund shall finance future imports, cf. the discussion in section 4.2. The investment strategy of

the Fund is therefore aimed at achieving the maximum possible financial return – as measured in international purchasing power – given a moderate level of risk. The Fund is invested in a wide range of equities, bonds and real estate in many countries. This contributes to the diversification of risk. No special modifications have been made to the investment strategy in relation to oil and gas equities.

Oil and gas price developments are, at the same time, of importance to the petroleum sector, which represents a large portion of the Norwegian economy, and the State continues to hold large oil and gas reserves on the continental shelf. The Ministry has therefore previously examined whether these circumstances suggest that the oil and gas sector should be excluded from the investments of the GPFG. This was last discussed in Report No. 20 (2008–2009) to the Storting – The Management of the Government Pension Fund in 2008. The analysis at that time led to the conclusion that there were no weighty reasons to change the strategy of good diversification of the investments across global stock and bond markets. It was therefore proposed that the oil and gas sector should remain included in the benchmark index of the Fund. This was endorsed by the entire Storting, cf. Recommendation No. 277 (2008–2009) to the Storting.

The Ministry has now updated the analysis from 2009, and taken a closer look at the relationship between the oil price and the return on oil and gas equities in both the short and the long run. The analyses are not based on assumptions concerning any specific future price path for oil. By examining historical return data, one may shed light on, inter alia, differences between short-term and long-term relationships. This is discussed in section 2.4.3.

In order to examine whether there are any robust relationships between the oil price and financial market returns, the Ministry has reviewed the findings from research on the relationship between financial markets, the oil price and the macro economy. If such relationships exist, these may be invoked as arguments in favour of changing the composition of the GPFG with a view to reducing the effect of oil price changes on the assets of the State. This is discussed in section 2.4.4.

2.4.2 The exposure to petroleum price reductions is declining over time

The petroleum sector currently accounts for about one third of government revenues and more than half of total Norwegian exports, cf. figures 2.2A and B. Since oil and gas price developments are important for petroleum sector earnings and activities, these are also important for the Norwegian economy.

The remaining oil and gas reserves also form part of national wealth, which constitutes the basis for future consumption opportunities. Nonetheless, the petroleum wealth represents a minor part of overall national wealth, whilst the value of our current and future manpower represents the predominant part, cf. figure 2.2C. Hence, high labour force participation and productivity are the decisive factors in determining prosperity and welfare developments. Nevertheless, strong public finances and the petroleum wealth distinguish Norway from other countries that it would otherwise be appropriate to compare us with.

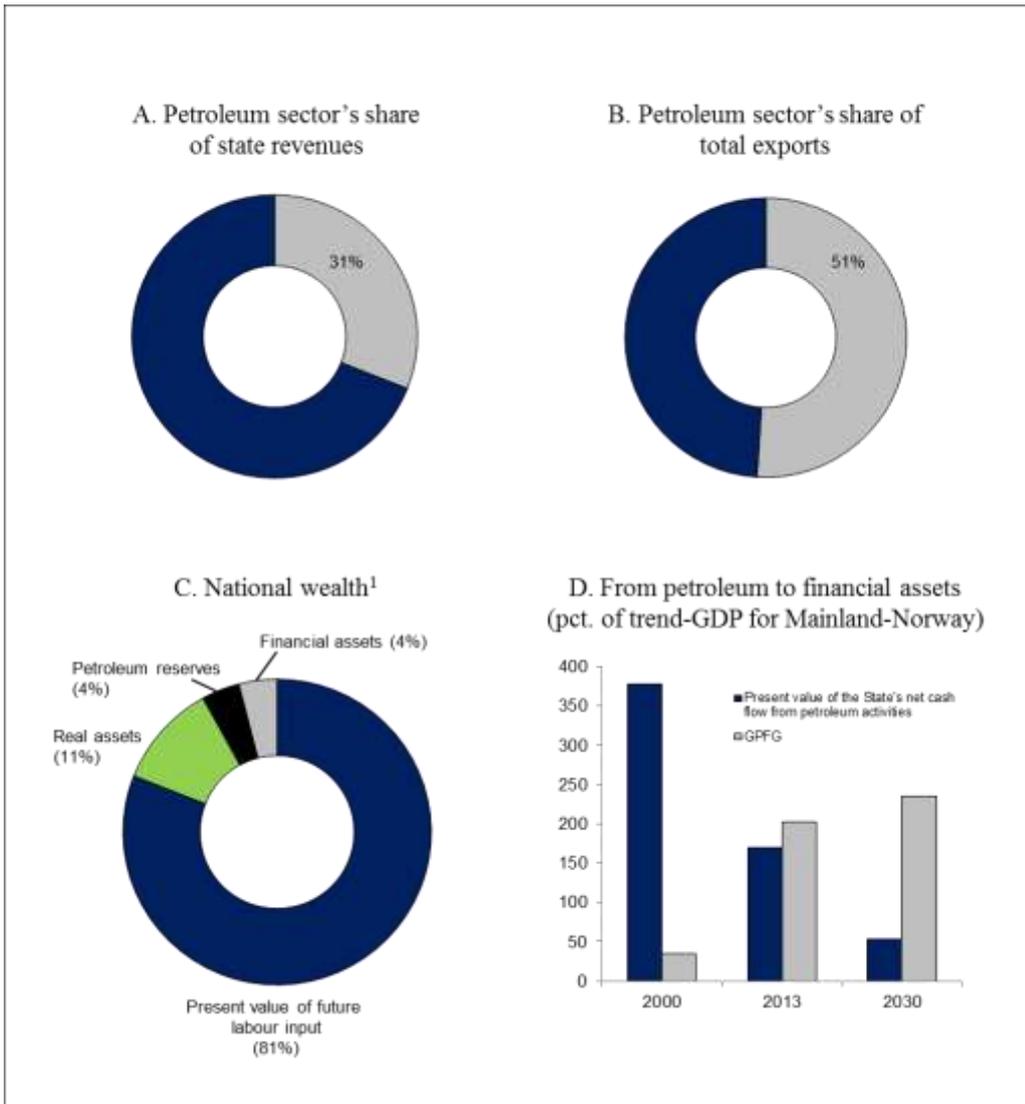


Figure 2.2 The petroleum sector and the Norwegian economy

¹ Net national wealth per capita. Petroleum reserves are calculated as the present value of future economic rent per capita. The GPFG is included in the financial capital. See Report No. 12 (2012–2013) to the Storting, Long-Term Perspectives on the Norwegian Economy 2013.

Sources: Statistics Norway and the Ministry of Finance.

Figure 2.2D shows developments in the value of the extractable resources remaining on the Norwegian continental shelf and of the financial assets of the GPFG. The value of the petroleum reserves is considerably more exposed to oil and gas price developments than is the value of the Fund, since the investments of the GPFG are diversified across many regions and asset classes.

By allocating the ongoing revenues from the extraction of oil and gas to the GPFG, and limiting the outflow from the Fund in line with the fiscal policy guideline, we reduce the effects of oil price changes on the Norwegian economy. This reallocation is taking place at a fairly high pace. Figure 2.2D shows that the present value of net government cash flows from petroleum activities was almost four times Mainland GDP in 2000, whilst it is expected to only amount to 50 percent in 2030. The petrole-

um reserves as measured in this way have been more than halved over only the last 15 years. Assets have, during the same period, accumulated in the GPFG.

The reduction in oil price risk resulting from reallocation of the petroleum wealth into investments in the GPFG may be reinforced by the fact that a large portion of global oil reserves and oil companies are not represented on global stock exchanges. Figure 2.3 illustrates that the largest listed oil companies only hold a small share of global oil reserves. Consequently, listed companies as a whole are large net purchasers of oil. Countries that are net importers of oil and gas have, at the same time, a large portion of global financial markets. Hence, a lower oil price implies a transfer of wealth from oil-producing countries to the companies and countries in which the major part of the GPFG portfolio is invested. Investments in global financial markets therefore offer some protection against long-term declines in oil and gas prices.

The current fund model, involving fairly rapid reduction of the reserves and a clear distinction between ongoing petroleum revenues and the spending of such revenues, as well as financial investments in the GPFG, therefore serves, in itself, to reduce the effects of oil price changes on the Norwegian economy. Consequently, the intention behind the analyses in sections 2.4.3 and 2.4.4 is to examine whether the Fund can contribute to a further reduction of the vulnerability of the State to oil and gas price changes.

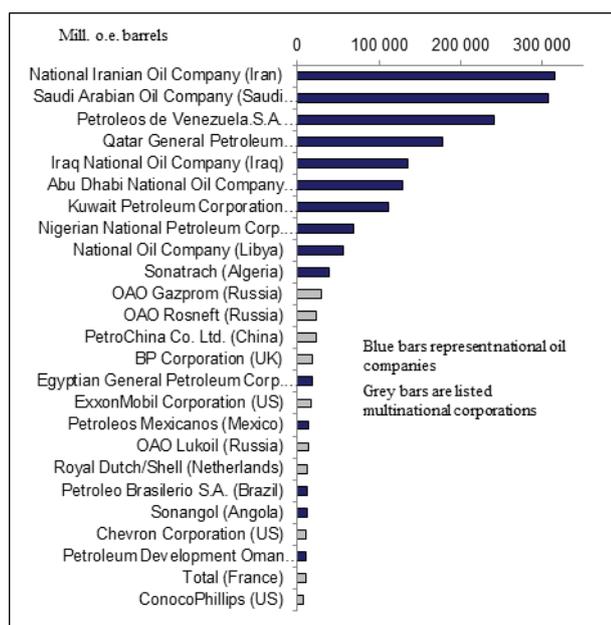


Figure 2.3 The world’s 25 largest oil companies measured by oil reserves

Source: PetroStrategies, Inc. February 2012.

2.4.3 Oil equities and oil price

The effects of not including oil and gas equities in the GPFG equity benchmark will depend, inter alia, on whether the ownership of oil equities is deemed equivalent to the ownership of oil resources.

Analyses of historical returns show that there is a difference between the ownership of equities in the oil and gas sector and the ownership of oil reserves, especially in the long run. Economic policy is focused on the efficient utilisation of national resources throughout the business cycle. This suggests that the long-term effects, and not the short-term fluctuations, are the most relevant for purposes of assessing the effect on overall oil price risk from including oil and gas equities in the GPFG.

The analyses of the Ministry show that oil and gas equities are, in the short run, more sensitive to oil price changes than are equities in other sectors, see box 2.3. In the longer run, however, general stock market returns appear to have a larger impact on the oil and gas companies than do oil price developments. This is also illustrated in figure 2.4. The figure shows 10-year rolling annual average returns on a portfolio of five large integrated oil companies³, on an index of the US stock market and on oil over the last three decades. These simple observations may, when taken in isolation, indicate that there is not a particularly strong correlation between the return on oil equities and the oil price in the longer run.⁴



Figure 2.4 Rolling annual return over ten years. Geometric average. Monthly observations. 31 December 1974 – 31 December 2013. USD. Percent

Source: Thomson Reuters Datastream.

Oil and gas companies are invested in a number of activities whose value is less susceptible to oil and gas price developments, such as for example refining, transportation, supply, marketing and retailing. The activities of the companies are also spread across energy markets, whose value may

³ Oil and gas companies may be engaged in anything from oil exploration, oil extraction, oil refining and transportation to supply, marketing and retailing. A company involved in all parts of the petroleum industry is called an integrated oil company.

⁴ See also El Hedi and Fredj (2010), who reached a similar conclusion based on more sophisticated statistical analyses of oil prices and oil and gas equities in the European market.

develop differently from that of the Norwegian petroleum deposits. Hence, investments in oil and gas equities are not the same as owning petroleum resources on the Norwegian continental shelf.

In the long run, the profitability of the investments made by oil and gas companies in new oil and gas reserves is of importance to stock price developments. High profitability means that companies turn a larger profit on each Norwegian krone invested. Oil price changes affect profitability in the short run, but the long-term profitability of oil companies has been more similar to the profitability of other listed companies, see figure 2.5. It is therefore reasonable to assume that the return on oil equities will in the long run develop more in line with the general stock market than with the oil price.

There are sound theoretical arguments in favour of such a relationship. The listed oil and gas companies do not, generally speaking, own the oil and gas deposits, and instead offer the landowner services within the exploration, extraction and production of petroleum deposits. Normally, the landowner will only want to offer the oil companies terms that give these the same profitability as in other industries. Any excess profitability, i.e. the economic rent, the landowner will want to keep. Figure 2.5 shows that the profitability of oil companies has historically not differed materially from that of other listed companies.

In practice, the landowner will often compensate oil and gas companies by granting them a share of the income from the resources they develop, or ownership of a share of the oil reserves, instead of cash payment. Consequently, the profitability of oil companies is affected by the oil price in the short run, and a higher oil price may result in returns in excess of ordinary profitability. In the longer run, however, it is reasonable to expect the landowner to modify the terms such as to ensure that economic rent predominantly accrues to the landowner, and not to the oil companies. The same applies if the oil price declines steeply. The landowner will then have to improve its terms to ensure that investments in the development of the landowner's deposits offer oil companies ordinary profitability. Much of the long-term oil price risk will therefore be assumed by the landowner.

There may also be other reasons why the correlation between the oil price and the return on oil and gas equities is weaker in the long run than in the short run. Oil price changes may be caused by changes in extraction costs. In such case, price changes will have little impact on company profits. The costs of oil companies have increased steeply over the last 10–15 years. Consequently, the large oil price increase over this period has not resulted in a corresponding increase in the profits of oil and gas companies.

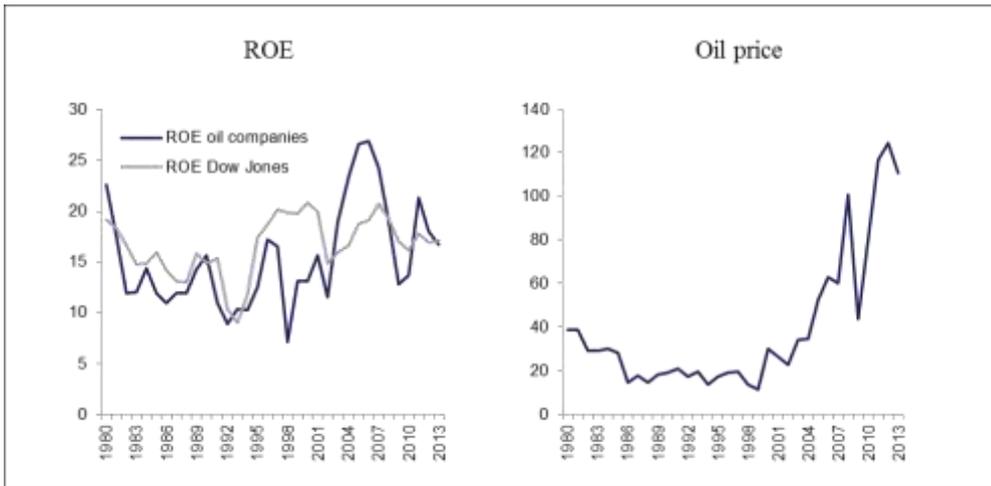


Figure 2.5 Return on equity (ROE) and oil price. Five large oil companies (Exxon Mobil, BP, Royal Dutch Shell, Chevron, ConocoPhillips) and the Dow Jones index. Annual observations. 1980-2013.

Source: Thomson Reuters Datastream.

Box 2.3 Are oil and gas equities especially sensitive to the oil price?

In order to shed light on the issue of whether the returns of oil and gas companies are more sensitive to oil price fluctuations than those of companies in other sectors, the Ministry of Finance has performed a statistical analysis; so-called regression analysis, in which one has sought to explain historical returns in various stock market sectors by an equity pricing model; the so-called Fama-French (F-F) model. The model seeks to explain developments in the returns on industrial sectors by general stock market developments and two other known systematic risk factors. Oil price change has been added as an extra explanatory variable. The analysis has been performed for the US stock market, for which data availability is deemed to be best. Total returns in USD are analysed on the basis of monthly time series for the period December 1993 – August 2013.

Table 2.1 presents the findings. In order to simplify the table, it only shows the calculated values for two out of the four explanatory variables (the stock market and the oil price). The explanatory power measured by the adjusted R^2 shows what portion of the return variations can be explained by developments in the four variables. Which estimated values are statistically significant is indicated by «*».

The table shows that oil and gas is by far the sector most sensitive to oil price variations in the short run. The estimated value of the correlation with oil price change is 0.25 and statistically significant, which indicates that a monthly oil price reduction of 10 percent is accompanied by a monthly sector return of -2.5 percent, all else being equal.

The table also shows that it is only for the oil and gas sector that the explanatory power of the model is significantly increased by adding the oil price as an extra explanatory variable. As far as

the other sectors are concerned, the oil price makes little or no difference in terms of explanatory power. This is another indication that the oil and gas sector is more sensitive to oil price variations than are other sectors in the short run. The analysis confirms, at the same time, that other factors than the oil price explain a larger portion of the fluctuations in oil and gas sector returns. A Fama-French model without the oil price explains no less than 41.8 percent.

A corresponding analysis of more long-term effects would have required considerably longer historical time series. Recent research demonstrates that the stock market reacts differently to oil price changes depending on the cause of such price changes, see box 2.4. The calculations in table 2.1 were performed for a period that was characterised, until the financial crisis, by increasing oil prices as the result of strong demand growth from emerging markets.

Table 2.1 How much of the variations in the returns on US industrial sectors can be explained by systematic risk factors (Fama-French model; F-F) and oil price fluctuations? Monthly observations over the period December 1993 – August 2013

	FTSE USA Oil & Gas	FTSE USA Basic mat.	FTSE USA Indust.	FTSE USA Cons. goods	FTSE USA Health care	FTSE USA Cons. serv.	FTSE USA Tele- com	FTSE USA Utili- ties	FTSE USA Finan- cials	FTSE USA Tech.
Market	0.72*	1.15*	1.11*	0.92*	0.67*	1.01*	0.85*	0.50*	1.29*	1.29*
Oil price	0.25*	0.06*	0.00	-0.07*	-0.04*	-0.07*	-0.06*	0.03	-0.06*	0.01
Explanatory power (adjusted R ² , percent)	58.0	66.2	81.4	59.0	53.0	81.5	49.1	28.8	85.0	81.6
Explanatory power, pure F-F model (adjusted R ² , percent)	41.8	65.6	81.5	57.8	52.3	79.8	48.2	28.7	84.2	81.7

Sources: Thomson Reuters Datastream, Kenneth R. French – Data Library and the Ministry of Finance

End of box

2.4.4 The oil price and the financial markets

If there are robust long-term relationships between oil and gas prices and the return on investments in international financial market, one might consider other ways of composing the investments of the GPFG in order to reduce the vulnerability of the State to oil price developments:

- An increase in the equity portion of the GPFG might be an example of a tool to further reduce the vulnerability of the Norwegian State to a sustained oil price decline.
- Another example might be to tilt the financial investments towards companies, countries or currencies whose returns have a low or negative correlation with oil price changes, i.e. whose returns do not change in line with, or change in the opposite direction of, the oil price.

A number of studies have been made of the relationship between the oil price, the macro economy and the financial markets, cf. box 2.4. Despite a general consensus that the oil market is of major importance to the world economy, there is no agreed understanding as to the relationship between the oil price and macroeconomic variables, or between the oil price and stock prices. An important reason for this is that the effects of a higher oil price on the macro economy and the stock markets appear to depend on the underlying cause of such price change. Higher aggregate demand for all industrial goods, for example as the result of an international economic recovery, results in both a higher oil price and higher equity prices, whilst a higher oil price only results in lower equity prices. Changes in oil supply also affect the stock market, but such effects appear to be weaker than the effects of changes in demand.

Consequently, it is not surprising that the correlation between the global stock market and the oil price has varied considerably over time, cf. figure 2.6. The figure shows the five-year rolling correlation between oil price and the FTSE world index for equities over the period from December 1993 to December 2013. Nor is the correlation between the oil price and oil and gas sector returns stable over time. The lack of robust relationships has a number of implications:

- Changing the composition of the GPFG with a view to reducing the oil price risk of the State is challenging and unlikely to be particularly accurate over time.
- Since the relationship between the oil price and securities changes over time, adjustments will have to be made dynamically. Such adjustments may involve high transaction costs for a large fund like the GPFG, especially if stock prices are affected by purchases and sales.



Figure 2.6 5-year rolling correlation between the oil price (Brent Spot) and the FTSE world index. Monthly observations. December 1993 – December 2013.

Source: Thomson Reuters Datastream.

2.4.5 The Ministry's assessment

Financial reserves are accumulated via the GPFG in step with the extraction of the petroleum reserves. By investing such ongoing revenues from the extraction of oil and gas in the GPFG, and restricting outflows from the Fund in accordance with the fiscal policy guideline, Norway's vulnerability to oil price risk is reduced continually.

The GPFG shall safeguard long-term savings. The investment strategy is therefore focused on achieving the maximum possible financial return – as measured in international purchasing power – given a moderate level of risk. Good diversification of risk is ensured by investing the capital broadly across asset classes, industrial sectors and countries. Oil and gas equities are not subject to any special arrangements under the investment strategy.

The long-term effects of holding oil and gas equities are of particular relevance. Observed positive relationships between the oil price and the equity sector would appear to apply primarily in the short run. The analyses of the Ministry in this report show no clear relationship between the return on oil equities and oil price developments in the long run. The oil and gas sector has in the long run behaved more like the rest of the stock market than like the oil price. The profitability of oil companies has in the long run been more closely aligned with the profitability of the rest of the stock market.

A more general question is whether a different strategy for the GPFG may reduce the oil price risk.

A prerequisite for reducing the oil price risk of the State through changes to the composition of GPFG investments is the existence of robust long-term relationships between changes in financial market values and oil price developments. However, a review of research on historical relationships

between the oil price, the macro economy and the financial markets in general shows that there is no clear understanding of such relationships.

Deciding not to include an entire sector in the investments of the Fund should, in the view of the Ministry, be based on weighty arguments, and the strategy for the Fund must be premised on robust relationships.

The conclusion of the Ministry is that the analyses of the relationship between the oil price and financial market investments do not justify changing the current benchmark index.

The relationship between the oil market and the financial markets is a theme that it is appropriate for the Ministry to continue to monitor. If the strategy of the GPFG is to be adjusted on the basis of such relationships, it would have to be based on thorough professional assessments. Reference is made to the discussion in section 2.7.

Box 2.4 Research on the relationship between the oil price, the macro economy and the financial markets

There is an extensive literature on the relationship between oil price changes, macroeconomic variables and financial market developments. This box summarises the findings from important studies within the field.

Despite a broad consensus that the oil market is of major importance to the world economy, researchers disagree about both the relationship between the oil price and macroeconomic variables, and the relationship between the oil price and equity prices. One complicating factor is that oil price changes may influence the macro economy through several channels. A study from the IMF (2000) mentions five such channels:

- Income transfers from oil consumers to oil producers.
- Pressure on profit margins as the result of increased production costs.
- Steep oil price increases may provide incentives to postpone investment decisions.
- Changes to the structure of the energy market as the result of changes in relative prices.
- Effects on the price level and on inflation.
- Direct and indirect effects on the financial markets.

Another complicating factor is that the oil market and the economy may influence each other mutually (two-way causality). Macroeconomic variables may influence the oil price and vice versa, see for example Kilian (2009).

Hamilton (1983) is the classic contribution on the relationship between the oil price and macroeconomic variables. Hamilton notes that the oil price has increased in advance of all US recessions over the period 1945–1973, and investigates potential explanations for this correlation. Hamilton's conclusion is that oil price changes have driven recessions in the US. Using an expanded set of data, Mork (1989) finds no statistically significant correlation between oil price reductions and GDP growth. One explanation for the difference in the effects of price reductions and price in-

creases may be that the negative effect of an oil price increase is caused by the postponement of investment decisions.

Lee et.al (1995) examine data covering a prolonged period of major oil price fluctuations. The authors find that a major change in the oil price has more of an impact on real GDP growth during periods when the oil price is generally stable than during periods when the oil price is highly volatile. The authors explain their findings by noting that there are costs associated with the reallocation of resources between sectors. If an oil price shock is large relative to current price fluctuations, it triggers a costly reallocation of resources, and thus lower economic growth.

Kilian (2008) provides a broad discussion of the economic effects of major changes in energy prices. The standard approach in the literature has been to study large oil price shifts via their effects on production decisions in the economy. Kilian argues that the demand side of the economy is a much more important channel for passing on effects of major changes in energy prices than is the supply side, i.e. that a major shift in energy prices has more of an impact on the demand for a company's products than on the costs of producing these. Oil price shifts caused by concern about future reduction in oil supply may, unlike shifts that have other causes, have immediate and large effects on the US economy. Kilian also argues that there are weaknesses in the empirical foundation for concluding that the effects of oil price changes depend on whether prices are increasing or declining.

Kilian (2009) studies effects on the oil price, real growth and inflation in the US from three different types of price shocks in the global oil market:

- major shift in oil supply, as measured by percentage changes in global oil production;
- major shift in global demand for all types of industrial goods, as measured by an index of global economic activity; and
- major shift in global demand for oil.

The model is estimated on US data over the period 1973–2007. An important finding is that the effects on both the real price of oil and the US economy depend on the type of price shock. The study brings out the two-way cause-and-effect relationship between oil prices and macroeconomic variables. It also illustrates that the events driving the oil price may have both direct effects on the US economy and indirect effects via their impact on the oil price. This may explain the instability of traditional regression analyses. It may also explain how strong economic growth and rising stock markets may be accompanied by higher oil prices.

The number of analyses of the relationship between oil prices and macroeconomic variables that adopt a long-term perspective is small. An exception is Berk and Yetkiner (2013), which study the long-term relationship between general energy prices and economic growth. The analyses are based on annual data from 1978 to 2011 for 15 countries. The study finds a negative long-term correlation between energy price changes and GDP and energy consumption per capita. The authors do not examine the relationship between energy prices and financial market returns.

Some studies directly address the relationship between the oil price and the stock markets. Chen et.al (1986) examine whether oil price variations constitute a systematic risk factor. The analysis implicitly assumes that the cause-and-effect relationship is from the macro economy to the stock

market. This simplified the analysis by permitting equity returns to be modelled as a function of the macro variables. The variables examined are interest rate differences between loans with a short and long term to maturity, expected and unexpected inflation, industrial production, interest rate differences between loans with and without credit risk, as well as the oil price. The analysis does not find that differences in companies' sensitivity to oil price changes give rise to return differences. In other words, it would appear that oil price risk is not priced into the market. The absence of such a relationship may be caused by a high correlation between the oil price and industrial production, thus implying that the effect of oil price changes may be included in the effect of changes in industrial production. Other explanations may be that the oil price was very stable over the time period under examination (1953–1983) or the problem of reverse causality.

Jones and Kaul (1996) test whether major oil price changes are rationally captured by earnings and return expectations in stock markets. The findings indicate that oil price changes influence most macroeconomic series, and that such changes have a negative impact on GDP and equity returns. Jones and Kaul also find that the effect of oil price shocks on US equities can in its entirety be explained by the effect on company cash flows in real terms.

Driesprong et.al (2008) find that oil price changes predict equity returns. Investors react with a time lag and underestimate the effects of oil price changes on the economy. These findings are most pronounced for emerging markets and for a global market index. The authors argue that it is unlikely for the prediction effect to be caused by time variations in the risk premium of investors. Firstly, the prediction effect is brief. Secondly, there is little correlation between the oil price and economic variables that are assumed to predict variations in the risk premium. Thirdly, higher oil prices predict lower equity returns, which is difficult to reconcile with oil price changes as a signal of higher economic risk.

Kilian and Park (2009) examine the relationship between oil price changes and stock market returns. The effects of oil price changes on the stock market also differ very considerably depending on the underlying cause of such price changes. A higher oil price only results in lower returns for demand shifts that are specific to the oil market. Positive shifts in the aggregate demand for industrial goods result in both a higher oil price and higher equity prices in the first year following such shift. Major shifts in global oil production also influence the stock market, but such effects are weaker than the effects of major demand shifts. Unlike Jones and Kaul (1996), Kilian and Park find that the effect of major price changes in the oil market on equity returns partly reflects changes in expected returns and partly changes in expected dividend growth.

End of box

2.5 The responsible investment strategy

2.5.1 Background

In January 2013, the Ministry of Finance requested the Strategy Council for the GPFG to assess how the joint resources and competencies of the Ministry of Finance, the Council on Ethics and Norges Bank can best be exploited to strengthen responsible investment practice. The mandate called on the Strategy Council to build on the previous responsible investment experience of the GPFG, as well as to compare it to other funds. The Council was instructed to examine how one might eliminate any deviation from best international practice, thus making the Fund a driving force for responsible investment development. The mandate allows for the Strategy Council to propose any changes it believes may strengthen responsible investment practice, including operational and institutional changes.

The Strategy Council for 2013 was chaired by Professor Elroy Dimson (London Business School and Cambridge Judge Business School). Other members were Idar Kreutzer (Chief Executive Officer of Finance Norway), Rob Lake (consultant, former Director of PRI), Hege Sjo (Senior Advisor at Hermes Fund Management) and Laura Starks (Professor of Finance at the University of Texas).

The Strategy Council organised a broad-based and transparent process in which various stakeholders were invited to submit perspectives and proposals. It held, inter alia, two responsible investment conferences at the University of Cambridge and BI Norwegian Business School, respectively. The conference in Cambridge had a special focus on academic research within the field, whilst the conference at BI was convened to invite non-governmental organisations, etc. to present their views on the responsible investment practices of the Fund. The Strategy Council has also held discussions and meetings with other funds, portfolio managers, consultants, researchers, non-governmental organisations, etc. and participated in international responsible investment meetings.

The Strategy Council submitted its report on 11 November 2013. The report was then circulated for consultation. The Ministry of Finance announced, in its consultation paper, that it would examine how responsible investment tools can be coordinated to ensure the integrated use of such tools. The Ministry has received 27 sets of consultative comments.

2.5.2 The current framework

The overarching objective for the investments of the GPFG is to achieve the maximum possible return over time, given a moderate risk level. Furthermore, it is emphasised that the Fund shall adhere to responsible investment practices. The Ministry states in its mandate to Norges Bank that good long-term returns are assumed to depend on sustainable development in economic, environmental and social terms, as well as on well-functioning, legitimate and efficient markets.

The Ministry introduced ethical guidelines for the management of the GPFG at an early stage, compared to many other funds. Over time, more weight has been attached to integrating corporate governance, environmental and social considerations in the investment activities.

Figure 2.7 illustrates the current responsible investment framework of the GPFG. The Council on Ethics adheres to the *Guidelines for Observation and Exclusion* adopted by the Ministry of Finance. The Council on Ethics advises the Ministry on individual companies that merit observation or exclusion from the Fund. The criteria stipulating what norm violations shall qualify for exclusion are decided by political bodies. Any decisions to exclude or observe companies from the investment universe of the Fund are made by the Ministry. Norges Bank manages the Fund on the basis of the *Mandate for the Management of the GPFG*, laid down by the Ministry. The mandate stipulates that the ownership rights of the Fund are managed by Norges Bank and that the Bank shall integrate corporate governance, environmental and social considerations in such management, cf. box 2.5. Reference is made to section 4.5 for a more detailed treatment of the ongoing responsible investment effort..

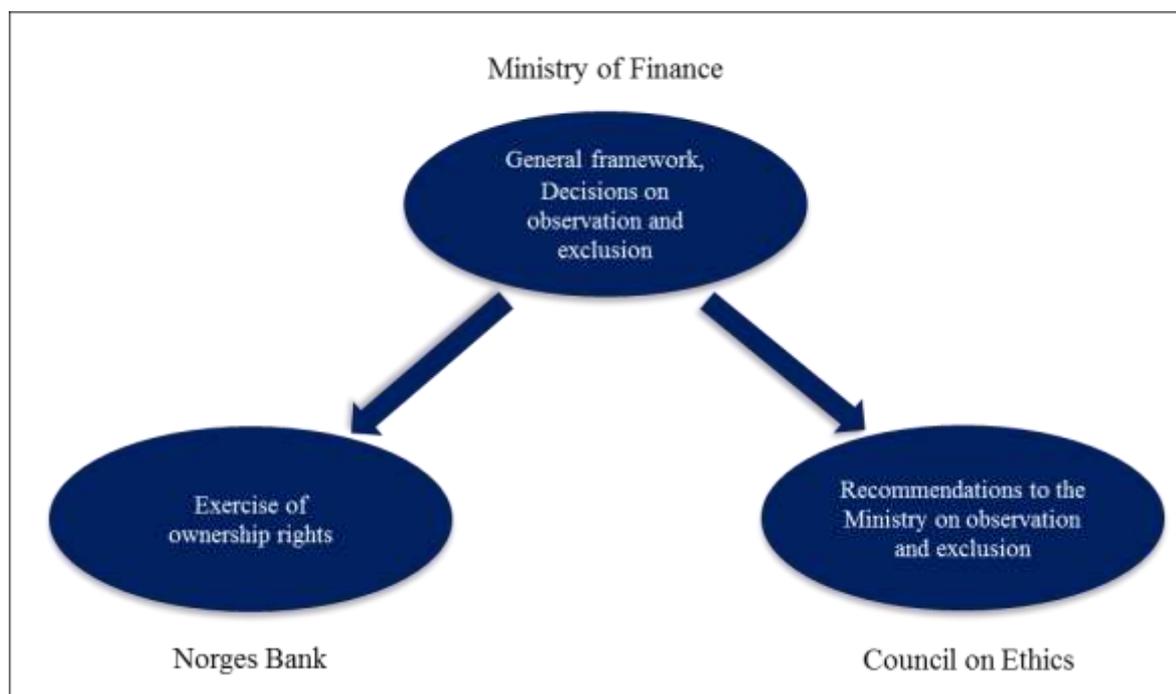


Figure 2.7 The responsible investment framework of the Government Pension Fund Global

Source: Ministry of Finance

2.5.3 The recommendations of the Strategy Council

In its report, the Strategy Council provides an overview of the responsible investment objectives and strategies of other large funds internationally, and outlines responsible investment research, cf. the discussion in boxes 2.5 and 2.6. Furthermore, the report presents a review of the current responsible investment system.

The Council has considered the practices of comparable funds, relevant research, feedback from stakeholders, issues of relevance to responsible investment and the current governance structure. The Strategy Council recommends, based on these assessments, that the Ministry of Finance changes the Mandate for the Management of the GPFG, which it has issued to Norges Bank. Fur-

thermore, the Strategy Council recommends changes to the division of responsibilities between the Ministry, the Council on Ethics and Norges Bank.

The Strategy Council makes a total of ten recommendations on how the Ministry can strengthen responsible investment in the GPF. The recommendations are based on three pillars, cf. below.

Box 2.5 What can we learn from the practices of other funds?

The report of the Strategy Council shows that many funds are attaching weight to their roles as responsible investors, although their motivations for this vary. Nor is there one specific strategy pursued by other funds in this regard. The report shows, at the same time, that responsible investment approaches and strategies share certain common features. Several funds have, for example, expressed a belief that attaching weight to environmental, social and corporate governance considerations (so-called ESG factors) is of importance to long-term value creation.

The report notes that clear responsible investment principles serve to underpin the active ownership strategies. Such principles elucidate the expectations of funds vis-à-vis the companies in which they are invested.

All funds examined by the Strategy Council have, for example, signed up to the *Principles for Responsible Investment* (PRI). These principles focus on how investors can take environmental, social and corporate governance considerations into account in asset management. There are also other sets of principles, guidelines and codes addressing how investors should conduct themselves.¹

Funds based themselves on international standards for what expectations should be placed on companies, such as, inter alia, the *UN Global Compact* and the *OECD Guidelines for Multinational Enterprises*.

The funds examined by the Strategy Council generally make use of several responsible investment strategies. These include portfolio monitoring, voting, company engagement, collaboration with other owners, dialogue with regulators, submission of shareholder proposals, transparency, preparation of observation lists, as well as exclusions.

The funds hold transparency to be important for purposes of maintaining confidence in their asset management and their investments. The report notes that transparency considerations need to be attended to without thereby reducing the scope for realising the overarching objective. The Strategy Council observes that some funds are of the view that they will have greater influence by engaging with companies on a more private basis, whilst other funds disclose the names of companies they are engaging with.

The Strategy Council notes that other funds are using the exclusion of companies as an ownership tool to a varying extent. Those funds that exclude companies primarily do so on the basis of production of specific products, especially weapons and tobacco. The number of exclusions on the basis of conduct is small. The report notes that exclusion decisions vary between funds, depending on the specific characteristics of each fund. For funds whose assets are ultimately owned by a state, decisions on the exclusion of companies are made by the board of the entity with operational responsibility for the management of such fund – and thus at arm's length from the authorities. Other

funds integrate the exclusion of companies and active ownership. The Strategy Council also observes that active ownership is held to have more impact when a company can be excluded if company dialogue does not succeed.

Other funds have a focus on understanding the effects and outcomes of their responsible investment activities. Some funds collaborate with academics and consultants to systemise such knowledge. The report notes, however, that academic research in this field is limited. The Strategy Council believes that more research is needed to understand the financial implications of responsible investment strategies, and especially the effects of taking environmental and social considerations into account.

¹ For example the UK Stewardship Code and the International Corporate Governance Network's Principles for Institutional Investors.

End of box

Box 2.6 Lessons from research on responsible investments

Academic research on responsible investments is, according to the Strategy Council, lagging behind practices. Extensive research has been conducted on the benefits of good corporate governance («G»), but there is significantly less research into the effects of environmental («E») or social («S») factors.

Corporate governance theory suggests that well-governed companies should also have a higher market value. However, the findings from empirical analyses are more mixed. The Strategy Council notes that this may be because the causality is not clear, and that other factors are of relevance. The report notes, moreover, that there is limited research on the relationship between environmental and social factors and company values. Theory does not provide an unequivocal answer as to whether such relationship is positive or negative. The number of empirical analyses conducted is also small.

A number of studies have been conducted on the extent to which *active ownership* on the part of institutional investors may improve corporate governance. Empirical analyses show that the companies subjected to company engagement are also the companies where the need for changes, and the scope for success, is the greatest. The Strategy Council notes that such companies are often characterised by poor performance, weak corporate governance, high institutional ownership and small ownership stakes held by people associated with the company. Shareholders engaging in active ownership are, according to the Strategy Council, more likely to be able to change corporate governance if they collaborate with other institutional investors, or in cases when people associated with the company do not hold large ownership stakes.

Institutional investors may choose between public and private company engagement in specific cases, cf. the discussion in box 2.5. A form of public company engagement will, for example, be submitting a shareholder proposal in the general meeting of a company in which change is needed.

However, empirical analyses show that the extent to which public dialogue results in changes in companies, or creates value, is limited. Analyses of private company engagement show, on the other hand, that individual institutions have generally succeeded in attempts to effect changes in corporate governance and managerial decisions.

The report notes that there is limited research into the effect of a shareholder's company engagement on environmental and social factors. At the same time, the Strategy Council is of the view that there are indications that investors are more committed to raising such matters with company managers than before. The report also refers to research showing that institutional ownership generally contributes to improved corporate governance.

The Strategy Council notes that little research has been conducted on the costs and benefits of divesting or excluding companies. There is also little research on whether divesting companies affect the portfolio of an investor. The report notes that a portfolio from which a large number of equities have been excluded may have a different return and risk profile than implied by the original investment strategy. The Strategy Council notes that funds like the GPFPG pursue an investment strategy based on achieving a return and risk in line with general market developments. Consequently, the scope for deviating from the benchmark index, which is a description of the general market, is limited. Major deviations from the benchmark index as the result of the exclusion of companies or sectors will result in different return and risk characteristics of the fund than those on which the strategy was premised. The Strategy Council notes that this may again trigger a need for changing the investment strategy or focusing more on active management, to compensate for the changes to the return and risk characteristics of the portfolio. The Strategy Council notes that the strategic benchmark index adopted by the Ministry of Finance and endorsed by the Storting is not necessarily achievable within current risk limits if one were to exclude a large number of companies, or a small number of companies with high market value.

End of box

Pillar 1: Objective and strategies

The Strategy Council states that the purpose of Pillar 1 is to ensure consistency amongst the objectives, priorities and activities of the Fund. Ambiguous or conflicting objectives can lead to undesirable consequences and hinder the effective use of resources.

The Strategy Council recommends that the mandate given to Norges Bank is as clear as possible on three dimensions:

- The Ministry of Finance specifies the responsible investment objective.
- The Ministry of Finance requires Norges Bank to develop and communicate a set of overarching responsible investment principles.
- Norges Bank is asked to develop and apply ownership strategies that support the responsible investment objective and principles.

It is also recommended that the mandate from the Ministry requires Norges Bank to initiate research into issues of relevance to responsible investment that may have material effects on the return on the Fund.

Recommendation 1: Clarify the responsible investment objective

The Strategy Council recommends that the fundamental objective for the Fund's responsible investment practices captures the following three premises:

- i. The owner of the Fund is responsible for safeguarding its purchasing power for future generations through cost-effective asset management at a moderate level of risk.
- ii. The purchasing power available to future generations will depend on the total value created by the companies in which the Fund holds ownership stakes. The owner therefore needs to understand significant issues that may have an impact on the future value of the Fund. The priorities in responsible investment should be based on which initiatives are expected to have a material effect on the financial value of the Fund.
- iii. Based on assessments of overlapping consensus in the Norwegian population, it is the responsibility of the owner to impose certain restrictions on the investment strategy followed by the Fund.

The Strategy Council stresses that the objective of the Fund is to maximise return, given a moderate level of risk. The Fund's responsible investment activities should therefore be directed at value-enhancing activities. It should not be a vehicle for realising political objectives. The Strategy Council does, at the same time, see a need for principles and ethical considerations that impose certain restrictions on asset management, and that may not have positive financial effects on the performance of the Fund.

Recommendation 2: Responsible investment should be integrated and included in the Mandate for the Management of the Fund

The Strategy Council notes that there is a link between the investment strategy of the Fund and the effectiveness of the various ownership strategies. It is recommended that fundamental decisions regarding responsible investment be considered holistically and in tandem with the investment strategy. The Strategy Council notes that new insights about responsible investment issues will be gained in coming years. Such insights may lead one to consider changes to the allocation of the investments of the Fund. It is recommended that any such considerations be based on research into the effect of such changes on portfolio returns.

The mechanism whereby responsible investment is integrated into asset management will, according to the Strategy Council, vary with the orientation of the investment strategy. If the Fund pursues a strategy based on achieving excess return through deviating from a specific benchmark index, it is potentially useful to integrate ancillary issues into the investment decisions pertaining to individual companies. Conversely, if the investment strategy is based on index replication, then

general initiatives aimed at the functioning of the markets may be more relevant.⁵ A more segmented responsible investment strategy may be more appropriate to the extent that one pursues a mixture of different investment strategies.

Recommendation 3: Develop responsible investment principles and base ownership strategies on these

The Strategy Council recommends that the Fund be governed by one set of responsible investment principles. The principles should holistically cover all matters that influence the relationship between the companies in which the Fund is invested and the objective of maximising long-term value creation. The Council notes that the principles shall articulate the expectations the Fund has of the companies.⁶

The purpose of the ownership strategies should be to follow-up and develop the responsible investment principles. The Strategy Council recommends that the Fund should have principles for how and when to apply the different tools in the ownership strategy; including portfolio monitoring and verification, voting, company interactions and engagement, shareholder collaboration, the use of shareholder proposals, criteria for divestment and exclusion of companies, cf. figure 2.8. It also recommends reporting and assessment of the effects of these strategies.

The Strategy Council recommends that the Fund is governed by a principle stating that priorities should be on ownership strategies that are expected to have a material effect on the return and risk of the Fund.

Recommendation 4: Initiate research to elevate the understanding of return and risk

The Strategy Council notes that the Fund has a responsibility to develop an enhanced understanding of which issues may affect future returns, in line with the overarching objective of maximising return at a moderate level of risk. The Strategy Council believes that an investor as large as the Fund can gain disproportionately from research in this field.

The report notes that the Fund should have an interest in research that has the potential to fill the knowledge vacuum about the impact of ESG matters on real portfolio values.⁷ The Strategy Council is of the view that the Fund should prioritise investigations that may inform the long-term in-

⁵Examples are improved transparency in companies, promotion of fair business practices, pricing of externalities and improvement in the quality and efficiency of the capital markets.

⁶These include the business purpose, strategies, financiering, transparency, corporate governance and the management of key stakeholders and the environment.

⁷Examples are the stability and functioning of the financial system, the effects of climate change, resource scarcity and productivity, deforestation and biodiversity loss, human and labour rights, corporate tax strategies and tax regulation, and social trends like wealth disparities within and between countries.

vestment strategy of the Fund and enhance its value for future generations. Such research may result in new insights on, inter alia, allocation of the investments, how exposed the Fund is to risk in individual sectors, potential investments in new asset classes, etc.

Recommendation 5: The Fund should endorse regulations and new standards that enhance portfolio value

Based on research as described in Recommendation 4, the Strategy Council believes that the Fund should endorse new regulations that may enhance the future value of the Fund. It is recommended that the Fund prioritises initiatives that seek to improve corporate transparency, ensure fair business practices, improve the functioning of the capital market and endorses measures that seek to quantify costs imposed on the environment and society by companies.

Pillar 2: Transparency and accountability

Pillar 2 covers recommendations on transparency concerning the Fund's responsible investment framework. By framework the Strategy Council means what governs the process of determining objectives, and the development of principles and ownership strategies. The aims of this pillar are to facilitate learning and improvement of the framework, to secure public trust in asset management, and ascertain what level of transparency provides maximum effectiveness in implementing ownership strategies.

Recommendation 6: Disclose the responsible investment principles and ownership strategies

The Strategy Council notes that one challenge facing the Fund is to strike the appropriate balance between transparency and the need for discretion about operational matters.

It recommends openness about the Fund's responsible investment, including objectives, principles, guidelines and strategies, rather than openness about company-specific matters. The report notes that such openness would in practice involve, inter alia, describing the development of the responsible investment framework.

The Strategy Council believes that disclosure should emphasise principles and corresponding ownership strategies. It is recommended that this include the procedures for applying ownership strategies. The Strategy Council is of the view that the Ministry of Finance should in the mandate for the GPFG ask Norges Bank to develop and disclose principles for the application of the components in the ownership strategy. It is noted, at the same time, that public reporting on ongoing company engagements may be detrimental to future engagements. It is proposed, as a means of attending to the need for transparency, that Norges Bank report more aggregated information on ongoing company engagements.

Recommendation 7: Reporting on impacts of the responsible investment strategy

The Strategy Council notes that an understanding of the impacts of the ownership strategies is a prerequisite for improvements and for effective resource allocation. It may be necessary to change priorities if circumstances change or strategies are less effective than anticipated. The Strategy Council believes that disclosure and openness about such considerations can add to the trust in how the Fund manages ownership strategies. A culture of openness is, according to the Strategy Coun-

cil, necessary to ensure effective evaluation of the impact of the ownership strategies and to enable learning. The Strategy Council is of the view that the Fund, by sharing this type of insights, can take a leadership role within responsible investment.

Pillar 3: Integrate the Fund's responsible investment work

The Strategy Council states that the objective of Pillar 3 is to advise on how the responsible investment resources and competencies may best be utilised to achieve the objectives through the strategies and the principles proposed in Recommendation 1. The Strategy Council specifies that it by this means not only a cost-effective resource utilisation. More important is the ultimate impact of the principles and ownership strategies, as described in Recommendation 3. The Council is of the view that there is a need for organisational changes in the Fund's approach to its responsible investment practices in order to implement the recommendations in Pillars 1 and 2.

Recommendation 8: Exclusion decisions should become part of an integrated chain of ownership tools

The Strategy Council recommends that decisions on the exclusion of companies due to companies' conduct should be made on the basis of the responsible investment principles for the Fund, and that such decisions should be made after all other policy tools have been considered. It is noted that the current Guidelines for Observation and Exclusion of companies should therefore be integrated into the new responsible investment principles. The Strategy Council notes, at the same time, that ownership strategies are, generally speaking, not appropriate in case of product-based exclusions.

The Strategy Council believes that applying a chain of ownership tools will support the motives behind conduct-based exclusions in a better way than at present, see figure 2.8. Moreover, the Strategy Council is of the view that one should avoid the duplication of resources between the Council on Ethics, Norges Bank and, to an extent, the Ministry of Finance. The Strategy Council is of the view that the resources and competencies of these institutions could be better utilised if combined.

A consequence would be the need to reorganise responsible investment and the related decision-making processes. The Strategy Council recommends that the Executive Board of Norges Bank should decide on the principles and ownership strategies, based on the mandate from the Ministry of Finance. The Executive Board should, in relation to this, also make the decisions on the exclusion of companies, within the framework governing the formal exclusion of companies. The Council believes that one favourable consequence of transferring the exclusion mechanism from the Ministry of Finance to Norges Bank is that one would achieve more effective exercise of ownership rights and avoid the problems of role overlap and the other challenges, including the operational risk, that are inherent in the current organisation and that are placing demands on the Ministry.

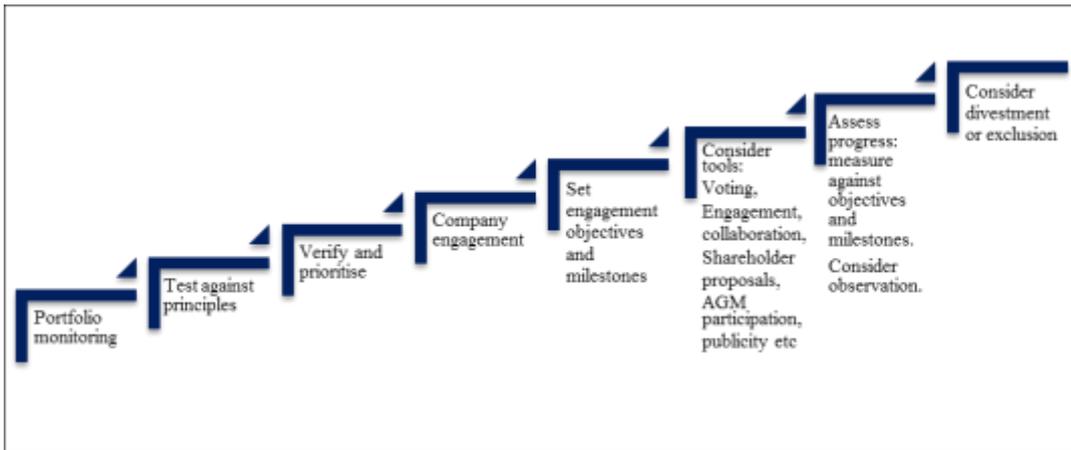


Figure 2.8 Illustration of chain of ownership tools

Source: Strategy Council for the GPF (2013).

Recommendation 9: Delegate exclusion decisions to Norges Bank

The Strategy Council notes that accountability requires a clear division of responsibilities and roles, a governance structure that ensures transparency on objectives, procedures and activities, and an effective reporting framework. Figure 2.9 illustrates how decisions may be delegated down through the system, with reporting taking place upwards.

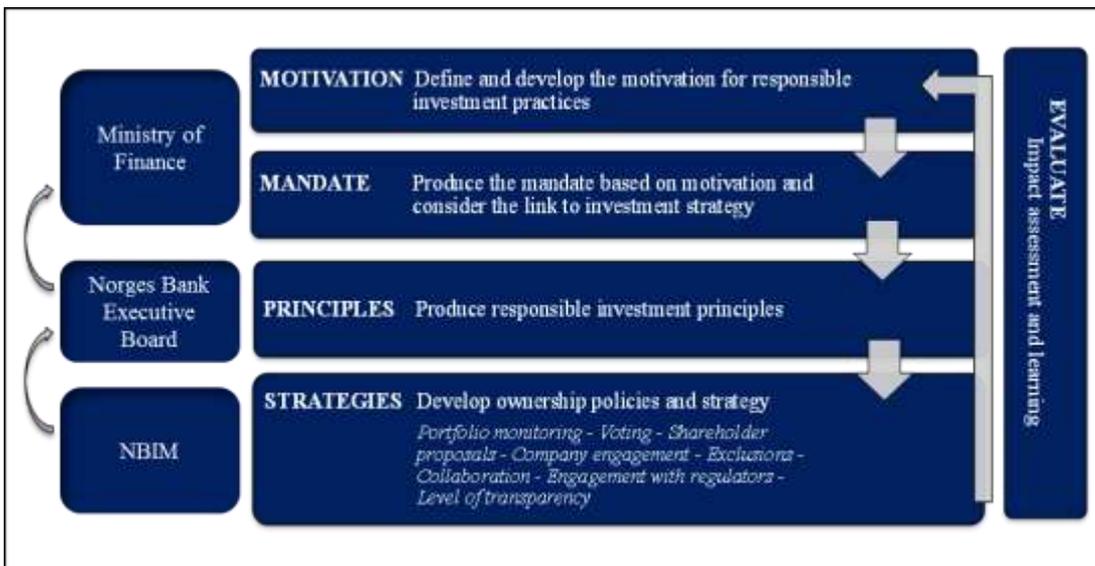


Figure 2.9 Responsible investment framework and reporting

Source: Strategy Council for the GPF (2013).

The Strategy Council notes that the Ministry of Finance, as the owner of the Fund is responsible for the overarching responsible investment framework for the GPF. The owner is responsible for, inter alia, the process of defining the objectives and understanding the link between the investment strategy and the objectives. Based on this understanding, the Ministry shall, according to the Strategy Council, produce a mandate for Norges Bank based on the objectives for responsible invest-

ment practices (Recommendation 1) and considerations about the impact on the investment strategy of the Fund (Recommendation 2).

The Strategy Council notes that decisions to divest or exclude companies affect the investment universe of the Fund and that the criteria for these decisions should therefore be explicitly stated in the mandate from the Ministry. The report notes that Recommendation 3 implies that the Ministry shall require Norges Bank to develop Responsible Investment Principles. These principles will form the basis for the ownership strategies of the Bank. The Strategy Council notes that the Bank shall in addition be required to incorporate the criteria for the ethical exclusion of companies into the Responsible Investment Principles.

It is also noted that the mandate from the Ministry should include requirements about reporting on both the application of the Responsible Investment Principles and impact assessment of the ownership strategies. It is further noted that Recommendation 4 proposes that Norges Bank shall initiate research on how responsible investment impacts the return on the Fund. The Strategy Council is of the view that such research would be of use in the process of evaluating the mandate from the Ministry and in assessments of the link to the remainder of the investment strategy. The Strategy Council believes that the Ministry of Finance, as the owner of the Fund, should report the results of such evaluations and assessments to the Storting.

The Strategy Council notes that the Executive Board of Norges Bank should be responsible for deciding strategies for asset management implementation, developing responsible investment principles and deciding on the application of ownership strategies (Recommendation 3). The Council notes that some of the responsible investment principles require supporting guidelines, and is of the view that these should be developed by Norges Bank Investment Management (NBIM).

It is noted in the report that the implication of Recommendation 9 is that the Executive Board of Norges Bank would have the responsibility for excluding companies and to decide an appropriate level of transparency regarding such decisions. The Strategy Council notes that the Bank will in some cases divest from companies that are in breach of the responsible investment principles, based on considerations about expected return and risk. Such decisions could, for example, be based on exclusion as the last link in a chain of ownership tools, cf. figure 2.8. The Strategy Council notes that a conclusion that the financial risk does not merit ownership of certain types of companies would fall under the general asset management responsibilities delegated to Norges Bank and reported at frequent intervals. It is noted that there could also be cases in which companies breach certain criteria specified in the mandate from the Ministry, and that such exclusions should be subject to decisions at the Executive Board of the Bank.

Recommendation 10: Ensure accountability and alignment of interest

The Strategy Council notes that Recommendations 8 and 9 imply that the Executive Board of Norges Bank would have extended responsibilities for managing the Fund. One implication of the recommendations is that Norges Bank will be required to make decisions that may reduce the return on the Fund, whilst there will be costs implications that are not value enhancing for the Fund. The Strategy Council notes, inter alia, that Norges Bank will need to add expertise and resources that are not currently represented in the Bank's organisation. In order to make sure that Norges Bank

has the right incentives to follow the provisions in the mandate from the Ministry of Finance effectively, the Strategy Council is of the view that the owner should make adjustments for non-financially motivated costs in its performance evaluation of the Bank. The Strategy Council believes that the owner should also specify that the Executive Board of Norges Bank needs the expertise to handle its new duties.

The report lists mechanisms that could enhance accountability and provide incentives to counter the inherent conflicts between the financial and non-financial objectives of the mandate:

- *Benchmark index adjustments:* The Strategy Council is of the view that the benchmark index should be adjusted to take into account exclusion of companies on the basis of non-financial criteria.
- *Measure resource:* The Strategy Council believes that one should measure the costs of analysing, verifying and preparing documentation on potential breaches of responsible investment principles, and that such costs should be excluded from the asset management costs of the Fund.
- *Relevant expertise:* The Strategy Council notes that the Council on Ethics possesses valuable expertise about issues that are currently governed by the Guidelines for Observation and Exclusion. It is recommended that these guidelines be integrated into the mandate from the owner to the Executive Board of Norges Bank. The Executive Board will have the responsibility to operationalise the mandate, and will therefore need to have relevant expertise. The Strategy Council is of the view that this could be accomplished, for example, by establishing a committee appointed by the Executive Board of Norges Bank that provides advice and recommendations in matters related to exclusions. Moreover, the Strategy Council believes that the knowledge and competence that has been accumulated in the secretariat of the Council on Ethics should be utilised and integrated into NBIM.
- *Apply effective oversight functions:* The Strategy Council notes that Norges Bank's work with the Fund's responsible investment principles and ownership strategies should be subject to internal controls in line with the general oversight functions of the Bank. The Strategy Council is of the view that reports from such controls should enable the Fund owner to assess whether its mandate is being followed appropriately.
- *Transparency and reporting:* The Strategy Council believes that increased transparency about how Norges Bank works with investment principles and subsequent ownership strategies will in itself provide accountability to the owner and to the public.

The Strategy Council believes that the recommendations in the report will further contribute to strengthening the work on responsible investment in the GPFG. It further believes that applying a more unified and holistic approach will give the Fund a more powerful and influential responsible investment strategy. This will, according to the Strategy Council, be achieved through integrating the resources and insights developed by the Council on Ethics and Norges Bank, by utilising one overarching set of responsible investment principles and by having one common procedure for ownership activities, including portfolio monitoring and analyses. The Strategy Council notes that the recommendation on initiating research into issues relevant to long-term return, and on initiatives to address regulatory issues will strengthen this approach further.

The Strategy Council believes that the recommendations will enable the Fund to stay at the forefront of responsible investment practices for large, highly diversified investors. Furthermore, that this should strengthen the legitimacy of the Fund amongst the Norwegian population and other stakeholders. The Strategy Council also believes that the recommendations will guide the Ministry of Finance and Norges Bank to pursue responsible investment practices that enhance the value of the Fund.

2.5.4 Consultative comments

Norges Bank states, in its consultative comments, that the main features of the recommendations of the Strategy Council are practicable and that these will foster a more integrated approach to active ownership. The Bank is of the view that the outlined developments will strengthen the profile of the Fund as a responsible investor. It supports the recommendation to clarify the responsible investment objective, including the description as to which premises this should be based on. Norges Bank believes that a mandate with a clear objective will facilitate effective goal attainment and reporting, and strengthen the scope of the Fund for conveying a clear profile to companies and countries in which it is invested.

The Bank agrees with the conclusion of the Strategy Council that the responsible investment focus of the Fund should be on value-enhancing activities, and not on serving as instruments for attaining other separate goals. It is noted, moreover, that the use of responsible investment tools needs to be considered in the context of the general investment strategy of the Fund and the composition of the portfolio. An integrated approach will, according to the Bank, facilitate realisation of the overarching asset management objective.

Norges Bank agrees with the recommendation to integrate the responsible investment framework in the mandate. The Bank also endorses the proposed development of responsible investment principles, with the ownership strategies being based on such principles. It is noted that the Bank is continually involved in the development of principles governing the use of responsible investment tools, as well as overarching principles that, inter alia, convey expectations to companies. The Bank agrees that such principles may support the conduct of the Fund as a predictable owner and investor, and may simplify communication with companies.

Norges Bank agrees that additional research may be needed to add to the understanding of what issues may affect future returns. The Bank states that it will contribute actively to this via, inter alia, the Norwegian Finance Initiative (NFI). Norges Bank also agrees that the Fund should support regulations and new standards that are assumed to enhance the value of the portfolio. The Bank notes, at the same time, the observation of the Strategy Council that although the relationship between corporate governance and financial value is documented in research, a corresponding relationship with regard to environmental and social factors has not been documented to the same extent.

Norges Bank endorses the recommendation to disclose the responsible investment principles and ownership strategies. The Bank agrees, at the same time, with the observation of the Strategy Council that public reporting of ongoing company engagements may be counterproductive and

detrimental to future engagements. Transparency considerations would therefore, according to the Bank, merit the reporting of aggregated information concerning such engagements.

Norges Bank agrees that information that can shed light on the effects of the exercise of ownership rights may promote the efficient use of resources. It is noted, at the same time, that it will in many cases be difficult to identify specific results from active ownership, for example because a company will typically present positive changes as having been initiated by the company itself, rather than resulting from investor pressure. The Bank states, nonetheless, that it will be focusing on analyses of the effects of responsible investment. Norges Bank aims for transparency about activities, processes and methods, and will expand its responsible investment reporting.

Norges Bank supports the recommendation that exclusion should become part of an integrated chain of ownership tools. The size of the Fund and its prominence as an investor has increased in recent years. The Bank notes that expectations from market participants, companies and host countries indicate that it is difficult to clearly separate the various ownership tools from each other. Exclusions as part of an integrated chain of ownership tools will, in the assessment of the Bank, strengthen the scope for long-term influence from the Fund.

The Bank also notes the observation of the Strategy Council that ownership strategies are not generally appropriate for product-based exclusions. Product-based exclusions may be effected by clearly specifying in the guidelines which products are held to be unacceptable. It must, moreover, be specified what is required to conclude that a company participates in the production of such products, which may be a difficult issue. Norges Bank is of the view that it is feasible to integrate the ownership tools in the operational management of the Fund. The Bank believes that such a solution is natural consequence of the assessments in relation to the Strategy Council's Recommendation 8, and that it is also more common within asset management in general and amongst other funds with which it would be reasonable to make comparisons.

Norges Bank assumes that any decision to integrate the ownership tools in the operational management of the Fund would pay heed to the general division of responsibilities and roles. It is noted that the Bank must have sufficient freedom to organise and execute the management mission in the most appropriate manner, including decisions concerning internal structures.

The Bank is of the view that the proposal of the Strategy Council that certain costs be excluded from the asset management costs is impractical, as it would involve unnecessary complexity. It is also less appropriate in an integrated model in which the purpose of the exercise of ownership rights is to contribute to the maximum possible long run return.

The Council on Ethics states that the consultative comments of the Council are predominantly focused on issues relating to the handling of individual companies in the Fund. The Council on Ethics notes, in its consultative comments, that public explanations have been one of the key elements of the current arrangement. The Council on Ethics is unable to see that the proposal of the Strategy Council will result in more transparency about the ethical considerations in the management of the Fund. It is noted, moreover, that the Strategy Council believes that the overarching financial objective of the Fund shall guide active ownership. The Council on Ethics is of the view that Norges Bank is likely, under such a mandate, to have little engagement with individual companies concerning ethical challenges, and questions whether this would be desirable.

The Council on Ethics is of the view that the exclusion of companies from the Fund has reduced the risk that the Fund contributes to serious norm violations. It is noted that the recommendations of the Council on Ethics are public and therefore thoroughly explained. The Council on Ethics believes that this has enhanced the legitimacy of the Fund and contributed to international norm development. The Council on Ethics is of the understanding that financial institutions, special interest organisations and others have confidence in the information disclosed in the recommendations of the Council and in the relevance of the cases addressed by the Council. A number of investors, both in Norway and internationally, adhere to the recommendations of the Council on Ethics, either by excluding the same companies or by using such recommendations as a basis for their own processes. Besides, non governmental organisations use the recommendations to influence companies. The Council on Ethics notes that the recommendations are also discussed in literature and research on corporate responsibility.

The Council on Ethics is of the view that the influential impact of exclusions and recommendations lies in the combination of the Fund being a large player, there being a high exclusion threshold with a relatively small number of clear criteria, the recommendations being thorough and well documented, and these being disclosed.

A challenge identified by the Council on Ethics is that it will often take a long time from the Council on Ethics issues a recommendation until a decision has been made by the Ministry of Finance, especially in conduct cases. This means that the recommendations are not up to date when disclosed, that companies remain too long in the investment universe of the Fund, and that the scope for influencing companies is not exploited whilst the recommendation is under consideration by the Ministry of Finance. Furthermore, the Council on Ethics is of the view that the guidelines are such as to create a grey area of cases that do not fully qualify for exclusion, but are not addressed by Norges Bank either out of consideration of the long-term return on the Fund. The Council on Ethics also notes the absence of coordination in the use of ownership tools, which would involve reaching an agreement as to how individual companies should be dealt with. The Council is of the view that the division of responsibilities between the Council on Ethics and Norges Bank is less clear now than when the arrangement was established.

The Council on Ethics is of the view that the Ministry of Finance should stipulate objectives for the exclusion of companies, for active ownership on an ethical basis, and for attending to climate considerations.

It is noted that the proposals of the Strategy Council imply a continuation of the current objective of maximising the return on the Fund, given a moderate level of risk, and avoiding certain investments on ethical grounds. The Council on Ethics is of the view that if the Ministry of Finance would like a larger number of individual companies to be addressed via active ownership, it would be inappropriate to maintain the same objective. The Council on Ethics believes that the main purpose of exclusions should continue to be preventing the Fund from contributing to particularly serious ethical norm violation. It is noted that it should still be the most serious norm violations that give rise to exclusion from the Fund, and that the mandate has to be clear about this. The Council on Ethics is of the view that one should retain the exclusion criteria, not only because these repre-

sent an overlapping consensus in Norway, but also because the criteria reflect a minimum standard that enjoys widespread support through international agreements and norms.

The Council on Ethics is of the view that the Ministry of Finance must decide whether the Fund shall address company-specific problems that would not, as a main rule, result in exclusion. In order to ensure consistency in the use of ownership tools between exclusion on ethical grounds and the broader exercise of ownership rights, the Council on Ethics is of the view that the Ministry of Finance must therefore explicitly require Norges Bank to address such issues through dialogue with individual companies. The Council on Ethics is of the view that the Ministry needs to stipulate a clear, separate objective for the Fund with regard to active ownership on ethical grounds, and that this will ensure that asset management is conducted in compliance with the ever-increasing international responsible management requirements.

The Council on Ethics also believes that the climate issues should be addressed in the process relating to the report of the Strategy Council. It is noted that it is difficult to attribute climate destruction to specific companies in the portfolio as long as international agreements are based on the premise that nation states shall decide how their emissions shall be allocated. Thus far, the Council on Ethics has not recommended exclusion of any company from the Fund on grounds of climate destruction alone, and notes that that this has only to a limited extent been invoked as a supplementary criterion.

The Council on Ethics believes that it seems reasonable to assume that climate destruction will have financial implications for the Fund, and notes that the Ministry of Finance has taken initiatives both to chart climate implications and to give investments a climate-friendly bias. The Council on Ethics is of the view that the Ministry of Finance must continue to clearly communicate that the Fund shall take the climate threat into consideration in making its investments. In order for this to be accorded the necessary weight, it is imperative for the Ministry to describe the relevant objective and strategy.

The Council on Ethics writes that the Strategy Council has proposed that public explanations for the exclusion of companies from the Fund shall no longer be given. The Council on Ethics believes that public explanations are important. The Council on Ethics is of the view that disclosure of the recommendations communicates to other companies how the Fund assesses various types of activity. The Council on Ethics believes that the current arrangement with thorough public explanations of exclusions from the Fund establishes norms. It is noted that a large number of guidelines and expectations addressing companies are in existence internationally, whilst the number of specific examples as to how such guidelines can be applied is small. The public recommendations contribute, according to the Council on Ethics, to the international debate on what expectations can be imposed on both companies and funds.

Concern for the legitimacy of the Fund also suggests, in the view of the Council on Ethics, that it needs to report on how principles and strategies are turned into specific actions that affect individual companies and problem areas of the portfolio. This implies disclosure of what companies Norges Bank is pursuing a dialogue with, which issues are raised in such dialogue, as well as explanations of exclusions from the Fund.

The Council on Ethics agrees that it is no longer necessary for the exclusion decisions to be made by the Ministry. The Council nonetheless believes that it is important for the exclusion decisions to be independent from the financial considerations. The Council on Ethics is of the view that this would not appear to be adequately safeguarded under the proposal to transfer the exclusion decisions to the Executive Board of Norges Bank. Independence from financial considerations can, according to the Council on Ethics, be safeguarded by the Ministry of Finance retaining responsibility for appointing a Council on Ethics with its own secretariat. The Council could provide advice to the Executive Board on exclusion cases.

The Council on Ethics is of the view that the Ministry of Finance needs to examine the organisation of responsible investment more thoroughly. If Norges Bank is given a mandate to engage in active ownership on ethical grounds, the Council on Ethics believes that it may be appropriate to incorporate the secretariat of the Council into the Bank. The Council on Ethics is of the view that the organisational model needs to ensure that the Bank has the expertise and incentives to comply with the mandate, and that it is necessary to establish a control system to ensure that the mandate is executed in conformity with intentions. It is noted that such control can be exercised by way of a Council on Ethics, appointed by the Ministry of Finance, submitting public annual reports to the Ministry regarding its activities. The Council on Ethics notes, furthermore, that if the Ministry does not believe that the Fund should address ethical problems in individual companies unless it does so in the furtherance of a financial responsible investment objective, then it would not be appropriate to incorporate the secretariat of the Council on Ethics into the Bank. In such case, the Council on Ethics might retain its present form, but submit its recommendations to Norges Bank instead of to the Ministry. Besides, the Council on Ethics agrees with the Strategy Council that these activities should, irrespective of the model, have a separate budget.

Furthermore, the Ministry has received consultative comments from the *asset managers* Storebrand, KLP and Folketrygdfondet. It follows from the consultative comments that the initiative for the further strengthening of responsible investment in the Fund is considered a very positive development. The Strategy Council is seen to have done a thorough job, in terms of both the process and the recommendations. Several asset managers have positive experiences with a number of the recommendations made by the Strategy Council. They also endorse the belief of the Council that a fundamental responsible investment framework (motivation, mandate, principles, strategies and evaluation) is very important for ensuring performance, predictability, clarity, consistency, legitimacy, etc.. The asset managers agree, at the same time, that there is a need for further research into financial effects of responsible investment strategies.

Storebrand encourages the examination of specific themes or indicators rather than general ESG effects. It notes that the number, weighting and quality of sustainability indicators vary considerably. Moreover, Storebrand notes that the implications, in terms of return and risk characteristics, of the exclusion of a large number of companies can, in its experience, be countered through modifications to the remainder of the portfolio. Storebrand finds it positive that the Council is emphasising openness about objectives, principles and strategies. The company believes that the positive implications of the sum total of the recommendations of the Council for an integrated and robust responsible investment model will clearly outweigh the recommended restriction regarding the

disclosure of company-specific matters. These positive implications are, moreover, assumed to reduce the need for such disclosure.

KLP emphasises that decisions concerning the level of transparency about company-specific matters should not be left to the Executive Board of Norges Bank. The asset managers support the proposed delegation of exclusion decisions to Norges Bank and believe that an integrated chain of ownership tools will contribute to more flexible and effective responsible investment practices. Storebrand notes that exclusion can, in its experience, be a highly effective tool in engaging with companies when it is the last link in a chain of ownership tools. It was observed that one should refocus the core of the debate from the small number of companies that are excluded to the quality of the actual holdings of the Fund. KLP notes that its experience with modifying the benchmark index in response to the exclusion of companies on the basis of non-financial criteria is uniformly positive. Folketrygdfondet specifically notes that if the responsibility for exclusions is assigned to Norges Bank, it will be necessary to perform a thorough assessment of what implications this will have for the holdings of Folketrygdfondet in companies within the same investment universe.

The Ministry has also received consultative comments from individuals in different *academic institutions*: Rector Eva Liljeblom of Hanken School of Economics and Professor Paul Ehling of BI Norwegian Business School. Furthermore, the Norwegian Centre for Human Rights at the University of Oslo has submitted consultative comments.

Rector Liljeblom supports the proposed framework (motivation, mandate, principles and strategies). With regard to the size of the Fund and the lack of research into ESG effects, support is expressed for the proposal to accord active ownership priority on the basis of presumed importance in terms of portfolio return and risk. Rector Liljeblom notes that one must avoid making the decisions political, and that these should therefore be made as «mechanical» as possible. It is noted that one should seek to report the return on the benchmark index both with and without exclusions, in order to facilitate follow-up of any cost and risk implications of a responsible investment strategy. Both Rector Liljeblom and Professor Ehling note that allowing for delegation of the exclusion decisions to Norges Bank is an important prerequisite for implementing the proposed responsible investment strategy.

Professor Ehling is of the view that it is not necessary, and in all likelihood not possible either, to aim at best practice and being at the forefront under as general a heading as responsible investment practices. Best practice is difficult to define and its contents depend on the motivations behind such practices. Furthermore, it is noted that ESG is difficult to measure. It should, in any case, suffice to report index performance, modified index performance (adjusted for excluded companies) and actual fund performance.

The Norwegian Centre for Human Rights is of the view that human rights considerations, including the international obligations of Norway and how these shall be complied with, have been accorded relatively low priority in the assessments of the Strategy Council. The Centre for Human Rights takes the view that it needs to be clarified whether Norges Bank will attend to human rights considerations in a satisfactory manner before the proposal for the abolition of the independent role of the Council on Ethics with regard to exclusion can be endorsed. The Council on Ethics or another control mechanism must, according to the Centre for Human Rights, be given the mandate, expertise,

power and resources necessary to ensure independent monitoring of whether Norway complies, through its management of the Fund, with its international obligations.

The Ministry has received consultative comments from *other business and social stakeholder groups*: the Norwegian Confederation of Trade Unions (LO), the Confederation of Norwegian Enterprise (NHO), Finance Norway, the FAFO Institute for Applied International Studies, the Norwegian United Federation of Trade Unions (Fellesforbundet) and the Finance Sector Union of Norway (Finansforbundet). *NHO* endorses the recommendation of the Strategy Council. *NHO* emphasises the importance of continued commitment to the financial purpose of the Fund. *NHO* states that the responsible investment activities of the Fund should be focused on value-enhancement, and not serve as an instrument for realising political objectives. *NHO* supports the proposed organisational changes, both for reasons of resource use and to reduce the risk that operational decisions are perceived externally as expressing the position of the Norwegian State with regard to a company or country. *LO*, on its part, cautions against the institutional proposals and believes that decision-making responsibility must remain with the Ministry of Finance. *LO* states that this will contribute to maintaining the necessary expertise within the Ministry. *Fellesforbundet* believes that the ethics efforts are fundamentally political and that the Fund shall «use its power to comply with the ethical guidelines, not only in its own asset management, but also on a global level». *Fellesforbundet* favours a higher degree of transparency at the company level. *Fellesforbundet* agrees that it might be beneficial to have closer contact between the government bodies involved in responsible investment, but cautions against abolishing the current arrangement with a Council on Ethics.

Finansforbundet has no comments in relation to the recommendations of the Strategy Council, but would like to see «a closer integration of labour rights in the future investment strategy of NBIM». *FAFO* is of the view that the recommendations of the Strategy Council are not based on the UN Guiding Principles on Business and Human Rights. It is noted that the Fund needs to respect human rights. *FAFO* states, furthermore, that the current structure, with a separate and independent Council on Ethics, should be retained, although it might be appropriate to give the Council on Ethics the power to make decisions. Moreover, *FAFO* is concerned about openness about exclusions and explanations for these. Finally, *FAFO* is of the view that Norges Bank should be given a clear mandate to develop tools in accordance with international norms, as part of its risk management and active ownership involvement.

Finance Norway endorses the recommendations of the Strategy Council and believes that these can contribute to the Fund becoming a better and more active owner, as well as offer protection against «populist initiatives». *Finance Norway* states that the Fund needs to be measured on the basis of financial returns. In addition, the organisation emphasises that active ownership should be subject to transparency, at times also at the company level. *Finance Norway* states, moreover, that exclusion decisions need to be disclosed and explained and that the criteria for ethical exclusions are a political responsibility and must be determined by the Ministry of Finance. *Finance Norway* proposes the establishment of an advisory committee with independent expertise to assist the Bank in this regard.

The Ministry received consultative comments from the following *non-governmental organisations*: Bellona, Changemaker, FIAN, the Forum for Environment and Development (ForUM), the Future

In Our Hands (FIOH), Norwegian Church Aid, Norwegian People's Aid, the Norwegian Climate Foundation, Publish What You Pay Norway (PWYP Norway), Rainforest Foundation Norway, WWF Norway and Zero. The non-governmental organisations present many overlapping views. They are, generally speaking, in favour of clarifying the responsible investment objective. They emphasise that it needs to be made clear that such objective is not exclusively financial, and that weight also needs to be attached to sustainability and ethical considerations. Many of the organisations also emphasise that such considerations need to be invoked independently of the Fund's ownership stake in a company. The organisations are in favour of research into issues within this field. They also support, in the main, a strengthening of the responsible investment involvement of Norges Bank. Many organisations are also in favour of increased responsible investment integration, but they believe that the Council on Ethics needs to be an independent body. Some organisations believe that Norges Bank could make the exclusion decisions if certain conditions are met, including, inter alia, independence for a Council on Ethics, but the majority of the organisations are opposed to this.

The organisations highlight the importance of transparency in such regard, and appreciate that this is emphasised by the Strategy Council. They express, at the same time, concern as to whether the solutions proposed by the Strategy Council will, all in all, contribute to more transparency. The organisations favour active ownership reporting at the company level. Some organisations note that such reporting would not necessarily need to be very detailed, but should cover active ownership issues and objectives. Some organisations refer to the reporting format of the Swedish AP funds⁸. There is also a general view that the ethical exclusion decisions shall be transparent. Many organisations highlight the contribution to the development of norms. Many organisations also emphasise the importance of the independence of the Council on Ethics, and that this adds to its ethical credibility.

Some organisations would like climate considerations to be integrated into the mandate to a greater extent, both in the exercise of ownership rights and as an exclusion criterion.

Not many organisations argue in favour of maintaining the current system in which decisions are made by the Ministry of Finance, but many of the non-governmental organisations favour a solution in which the Council on Ethics is authorised to make decisions in ethical exclusion or observation matters. A number of consultative comments note that some exclusion cases appear to take a very long time to process under the current system. One consultative comment argues that the exclusion criteria need to be changed in the direction of positive screening.

⁸In its annual report, the Swedish Ethical Council reports on activities focused on a sector or an issue, but company information is included at times. General reporting on selected dialogues is done at the company level.

2.5.5 The Ministry's assessment

The Ministry believes that it is important to assess, on a regular basis, how to further develop the management of the GPFG. The report of the Strategy Council and the consultative comments provide useful input on how to strengthen the responsible investment practices.

The Ministry introduced ethical guidelines for the management of the GPFG in 2004. When the ethical guidelines were introduced, these were by several held to represent best practice. Responsible investment is, at the same time, a field in continuous development. Consequently, what is deemed to represent leading practice, as well as the practices of other international players, in this field has changed significantly since 2004. Moreover, expertise and experience have been accumulated by the Council on Ethics, Norges Bank and the Ministry of Finance over the almost ten years since the introduction of the ethical guidelines.

The Ministry is of the view that the report from the Strategy Council provides useful proposals on how responsible investment in general can be made as effective and targeted as possible. The report does not, however, make a clear distinction between what already forms part of the responsible investment strategy of the GPFG and the recommended future strategy. The Ministry has noted that the Strategy Council observes that the current system for the exclusion of companies poses a number of challenges, one of which is that the current organisation of the exclusion process may result in the Fund being perceived as a foreign policy tool. The Ministry has also noted that the Strategy Council has not proposed changes to the ethical restrictions that are already applicable to the investments of the Fund and that are laid down in the current Guidelines for Observation and Exclusion.

A clearer objective

The Ministry agrees with the recommendation of the Strategy Council that the responsible investment objective should be made even clearer. The overarching objective for the management of the GPFG is currently stipulated in chapter one of the mandate of Norges Bank, and implies that the Fund shall be managed with a view to achieving the maximum possible return, given a moderate level of risk. Chapter two of the mandate observes that a good long-term return is held to be conditional upon sustainable economic, social and environmental development, as well as well-functioning, legitimate and efficient markets. The report of the Strategy Council observes that no clear relationship has been documented between, on the one hand, attaching weight to environmental and social considerations and, on the other hand, financial returns. The report may therefore be perceived as indicating that there may be a conflict between the overarching objective of the Fund in chapter one of the mandate and the sustainability assumption adopted in chapter two.

The Ministry is of the view that the reference in chapter two of the mandate to the relationship between sustainable development and good long-term returns should be interpreted as a clarification within the scope of the overarching objective of maximum possible return. The said relationship needs to be considered from the perspective of the very long time horizon of the Fund and the broad diversification of its investments.

The Ministry is of the view that environmental and social considerations should continue to form an integrated part of asset management and be approached from the perspective of the overarching

objective. The Ministry notes, at the same time, that the relationship between the statement of objective in chapter one of the mandate and the assumption in chapter two has been perceived as unclear. It is therefore proposed that the relevant provisions be combined in chapter one of the mandate, in the form of a new statement of objective comprising the following elements:

- a. The GPFG shall be managed with a view to achieving the maximum possible return, given a moderate level of risk and subject to the provisions governing asset management.
- b. The GPFG shall not be invested in companies that violate certain ethical minimum standards.
- c. Good long-term returns are assumed to be conditional upon sustainable economic, social and environmental development, as well as well-functioning, legitimate and efficient markets.

This statement of objective represents the motivation behind the exercise of the ownership rights, as well the exclusion and observation mechanisms, of the GPFG. The Ministry is of the view that it also constitutes a good foundation for initiating research to elevate the understanding of how social or environmental matters may impact on future returns, and for endorsing general initiatives for the development of new standards or regulations in this field that will enhance the value of the portfolio, as recommended by the Strategy Council. The Ministry will seek to reflect these recommendations in the mandate of the GPFG as well.

The Ministry is of the view that these changes and clarifications to the mandate will make the relationship between the responsible investment objective, motivation and priorities clearer than at present. These may also strengthen the Fund's contribution to the development of responsible investment practice.

A clear financial purpose for the investments is also in line with the international principles for sovereign investment funds, the so-called Santiago Principles, which are endorsed by Norway. These principles have been formulated to prevent the investments of sovereign investment funds from being subjected to different, and more restrictive, regulations than those of other investors.

Integrating the responsible investment tools

The evaluation of the ethical guidelines in 2009 proposed increased interaction between the exercise of ownership rights and the exclusion of companies. This intention has only been realised to a certain extent, largely because the responsible investment tools are managed by separate institutions. The Ministry is of the view that the interaction and use of resources in the work on responsible investment should be strengthened.

The Ministry has noted that the Strategy Council deems it necessary to make institutional changes to strengthen the responsible investment practice, and that such changes need to be considered in the context of the recommendations to clarify the objective and increase transparency. The Ministry agrees with the observation of the Strategy Council that Norges Bank and the Council on Ethics are increasingly pursuing similar issues, and that this can be expected to become more pronounced in coming years. This is the result, inter alia, of the Bank having focused, since the evaluation in 2009, on integrating environmental and social considerations in asset management. The Bank is

also engaging with companies on topics that may touch on the exclusion criteria. Uncertainty as to which body is in actual fact attending to the interests of the Fund within a field reduces its responsible investment impact. Consistency and predictability in the use of various tools in the management of the Fund are also important. Integrating the responsible investments tools would facilitate a more holistic approach.

It is the experience of the Ministry, as also emphasised by the Strategy Council, that the current system for excluding companies from the GPFNG entails an inherent operational risk. The Council on Ethics receives information about companies through other information channels than Norges Bank. This may result in the Council on Ethics, in examining a case, being unable to draw on all the sources of information that are normally available to an owner. Furthermore, the current organisation may result in a failure to register any changes to the basis for exclusion that take place whilst the case is under consideration by the Ministry, or after a decision has been made. This may entail a risk of legal steps.

Experience from the present system shows that it is very challenging for a ministry to make operational decisions on the exclusion of individual companies from the GPFNG. There is a risk, as noted by the Strategy Council, that the decisions of the Ministry are perceived as expressing the position of the Norwegian State with regard to a company or a country. It is noted that such risk must be expected to increase in coming years. One must also expect, according to the Strategy Council, that the growth of the Fund will be accompanied by increased public interest in individual investments. The Ministry is therefore of the view that such decisions should, also against this background, be made on an arm's length basis from political bodies, as is also the case with other funds in which a state is the ultimate owner of the capital. Integrating all responsible investment tools in Norges Bank might, in the view of the Ministry, serve to clarify that the exercise of ownership rights in individual companies and the exclusion of companies are not expressing the position of the Government with regard to a specific company or country, but the implication of the ethical restrictions governing asset management. This will also reduce the risk that the actions of the Fund are interpreted as reflecting a desire to exercise political influence over companies or markets in which the Fund is invested.

The Ministry agrees with the conclusion of the Strategy Council that it would be appropriate to locate all the responsible investment tools within Norges Bank. The Bank is already responsible for the exercise of the ownership rights of the Fund, and has accumulated comprehensive experience and expertise in that field. By placing the responsibility for the exclusion of companies with Norges Bank, one will establish an integrated chain of responsible investment tools, including ethics tools. This offers improved scope for attending to considerations of operational risk, independence, consistency, predictability and comprehensiveness. Such integration will make it easier to benefit from any interactions between exclusion and other ownership activities, and will improve internal consistency in the management of the Fund.

The Ministry has concluded, based on an overall assessment, that all of the responsible investment tools, including observation and exclusion, should be concentrated in Norges Bank. The criteria for what types of production and conduct give rise to exclusion shall, however, continue to be laid down by the Ministry of Finance and endorsed by the Storting.

Norges Bank shall follow up companies

In order to ensure a focus on the upholding of ethical considerations in asset management, the Ministry intends to implement the recommendation of the Strategy Council for a unified and integrated description of the responsible investment framework in the mandate for the management of the GPFG issued by the Ministry to Norges Bank. This is also an implication of all the relevant tools being concentrated in Norges Bank. The Ministry proposes, against this background, incorporation of the criteria under the current Guidelines for Observation and Exclusion and other relevant parts of the Guidelines for Observation and Exclusion into the mandate for the GPFG. The exclusion and observation criteria will thereby be maintained. This implies that monitoring of the portfolio and the potential exclusion of companies if the investments violate ethical criteria corresponding to the present ones will form part of the duties of Norges Bank. When the criteria for the exclusion of companies are incorporated into the mandate of the Bank, it is also expected that Norges Bank will follow up on the companies in which the Fund is invested on the basis of the ethical restrictions governing asset management.

The Ministry is of the view that a continuation of the ethical criteria, and the incorporation of these into the mandate of Norges Bank, will ensure that Norges Bank pays sufficient attention to ethical matters in its management of the Fund. This will be further supported by the requirements imposed by the Ministry regarding the *ex post* reporting on the follow-up of the exclusion criteria and evaluation of Norges Bank. All in all, the Ministry is of the view that these mandate and organisational changes will increase the weight attached to ethical considerations in the management of the GPFG.

By integrating the criteria for exclusion and observation into the mandate of Norges Bank, the ownership activities of the Bank will be broader in scope than at present. This is in line with the recommendation of the Strategy Council that Norges Bank should develop an overarching set of responsible investment principles, and that the ownership strategies shall be based on these principles. The Ministry is of the view that this will result in more clarity, predictability and transparency about what ownership strategies and tools are available and used in the follow-up of asset management in practice, as well as what are the expectations of Norges Bank vis-à-vis the companies in which the Fund is invested. It is reasonable to expect that the principles and expectations of the Bank will receive attention from companies and other investors.

Reporting on dialogues and exclusions

The Ministry agrees with the Strategy Council that transparency concerning the responsible investment framework of the GPFG is important. The Ministry is of the view that Norges Bank shall disclose the responsible investment principles and the strategies pursued in its exercise of ownership rights. Moreover, the Ministry is of the view that Norges Bank should report on the effects of its active ownership. In order to attend to transparency considerations, the use of active ownership tools, including on dialogues with individual companies, shall be reported in a suitable manner.

It is important to prevent the asset manager from modifying its investment universe in a manner that is not implied by the criteria for the exclusion of companies. The Strategy Council notes in its report that it should be left to Norges Bank to assess the level of transparency and public documentation in individual cases concerning the exclusion of companies. The Ministry has noted, at the

same time, that a number of those submitting consultative comments are of the view that such decisions should be disclosed and explained to ensure asset management transparency.

The Ministry has concluded, based on an overall assessment, that Norges Bank should report on the follow-up of the company exclusion criteria, and that the names of excluded companies and explanations for the exclusions made under the ethical criteria shall be disclosed.

The importance of legitimacy in ethical matters

A number of consultative comments draw attention to the importance of having an independent Council on Ethics. This would appear, in particular, to be premised on the need to ensure a sufficient focus on, and resources for, ethical matters. Some stakeholders also take the view that the Council on Ethics should serve as a supervisory body. Also, non-governmental organisations and the Council on Ethics itself emphasise that disclosure of the recommendations of the Council contribute to the development of norms, including the use of such recommendations by companies and other parties with an interest in the environmental and social history of companies.

The Ministry notes that the Council on Ethics has not served as a supervisory body, but as a professional advisory board under the Ministry of Finance, which has examined whether the activities of companies are such as to merit exclusion of said companies based on the criteria in the guidelines. The Ministry has made the decisions and considered the appropriate use of active ownership, observation or exclusion. Control and supervision have been carried out by the Office of the Auditor General (in relation to the Ministry of Finance) and the Supervisory Council appointed by the Storting (in relation to Norges Bank), respectively. By transferring responsibility for decisions on the exclusion of companies to Norway Bank, the exclusion process will be made subject to the established management, control and supervision system of the Bank. Besides, the Ministry assumes that the Supervisory Council will assess the need for devoting additional resources once responsibility for the exclusion of companies has been formally delegated to Norges Bank.

The Ministry is of the view that it is important, out of consideration for the legitimacy of asset management, for the Bank to have access to relevant knowledge and expertise when new duties are assigned to it. It is, at the same time, important for Norges Bank, within the general framework defined by the Ministry, to be granted the freedom to choose the organisation it believes will be best placed to perform such new duties in a good manner. This will also contribute to making the Bank accountable for its performance of the said duties. This is in conformity with the principles governing the delegation of other asset management duties to the Bank.

The Ministry assumes that Norges Bank will have access to independent external expertise with the relevant competencies relating to the assessment of the exclusion of companies. The Ministry notes that Norges Bank has sourced high-calibre international expertise also on previous occasions. One example is its establishment of a Corporate Governance Advisory Board in 2013.

The Ministry is of the view that conducting independent asset management assessments on a regular basis is important to ensure widespread confidence in such management. In order to ensure the legitimacy of Norges Bank's responsible investment activities, the Ministry proposes the establishment of an independent board of experts to assess Norges Bank's performance of its role as a responsible investor, including the exclusion of companies according to the criteria in the mandate.

The board of experts shall issue public reports on its assessments. The Ministry is of the view that such reports will provide a basis for comprehensive discussion of responsible investment in the GPFG. The board of experts shall not be endowed with any formal supervision or control function, but contribute assessments that will form part of the basis for the Ministry's follow-up of the management of the GPFG.

Furthermore, the Ministry is of the view that the benchmark index shall be adjusted for companies that are excluded from the investment universe on the basis of the chosen exclusion criteria relating to production and conduct. It is intended that the mandate for the GPFG shall specify that procedures for this shall be established. Moreover, the Ministry is of the view that further adjustment of the index for costs incurred in excluding companies under the ethical criteria will add unnecessary complexity, as also noted by Norges Bank, since these costs are fairly limited compared to the other asset management costs. The Ministry will nonetheless discuss the costs incurred in the performance of these management duties with the Bank on an ongoing basis.

Summary

The Ministry is of the view that the report of the Strategy Council and the consultative comments have identified changes that may strengthen responsible investment and contribute to the Fund maintaining its position as a leader within this field. The Ministry is proposing, on the basis of the received feedback, changes that will, all in all, strengthen the responsible investment strategy of the GPFG. The proposed changes will contribute to a higher degree of consistency and predictability in responsible investment, improved resource utilisation, as well as reinforcement of positive interactions between the ownership tools. The changes will also contribute to increased transparency on responsible investment, partly by continued openness about the companies excluded from the GPFG according to the criteria in the mandate and explanations for these exclusions, and partly by Norges Bank reporting more comprehensively on its activities than at present. Moreover, the establishment of a separate board to assess how Norges Bank has performed in its role as a responsible investor will support the legitimacy of the responsible investment practices of the Fund. All in all, this will, in the view of the Ministry, contribute to good long-term management of the GPFG. The Ministry notes that the changes are premised on the current responsible investment strategy. Both the responsible investment motivation and the responsible investment tools remain unchanged. The Ministry is of the view that the proposed changes are fully consistent with the established objective of the Fund, the ethical restrictions and the fundamental ethical commitment to accumulate savings for the benefit of future generations.

The Ministry intends to amend the mandate for the GPFG in line with the assessments outlined in this section with effect from 1 January 2015, cf. the discussion in section 5.2. The institutional changes will also enter into effect from the same date. The Ministry will inform the Storting about the implementation of these changes.

2.6 Investments in renewable energy and emerging markets

2.6.1 Introduction

The Government announced, in the Sundvolden platform, that it will establish a separate investment programme in the GPFPG to invest in sustainable businesses and projects in low-income countries and emerging markets. The programme shall be subject to the same asset management requirements as other investments of the GPFPG. In addition, the Government announced that it will consider the establishment of a separate renewable energy mandate, which shall also be subject to the same asset management requirements as other investments of the GPFPG.

The Ministry has received professional advice and reports concerning such investments. Some of the said advice is discussed in section 2.6.2. Section 2.6.3 summarises experience from investments in the former Environmental Fund and the current special environment-related mandates. Section 2.6.4 discusses potential ancillary effects of earmarked investments in addition to their effect on the return and risk of the GPFPG. Section 2.6.5 discusses the financial effects of such investments and section 2.6.6 addresses unlisted investments in renewable energy and emerging markets. Section 2.6.7 presents the Ministry's assessment.

2.6.2 External assessments of special responsible investment mandates

Over time, the Ministry has received advice and reports pertaining to the further development of the strategy for the GPFPG, which are of relevance to the follow-up of the statements on investment programmes in the Sundvolden platform.

In 2003, Professors Ole Gjølborg and Thore Johnsen evaluated literature analysing so-called Social Responsible Investments (SRI). They noted that the return differences between SRI strategies and developments in the general market will normally be small, but pointed out that such strategies may entail considerable risk. The professors stated, inter alia, the following:

«If SRI restrictions are imposed on an asset manager by the owners of a fund, then all parties should acknowledge that such restrictions may entail significant downside risk. The magnitude of such risk will depend on the strictness of the restrictions imposed on the sample space.»

In November 2013, the Strategy Council for the GPFPG submitted a report with recommendations on how the Ministry of Finance can further strengthen responsible investment in the Fund, cf. the discussion in section 2.5. In its report, the Strategy Council summarises research findings within this field. It is noted that while there is some evidence to suggest that good corporate governance has a positive effect on the value of companies, less research has been conducted into whether funds managed pursuant to SRI or Environmental, Social and Corporate Governance (ESG) strategies have delivered higher returns than the market. The Strategy Council notes that some studies have found that such funds have underperformed the market, whilst other studies have found that returns are more or less in line with general market returns. It is noted in the report that we have

limited knowledge of the effects of environmental and social factors, as well as responsible investment practices, on real long-term portfolio values.

An expert group comprising Professor Andrew Ang, Professor Michael Brandt and a former head of the Canadian pension fund Canada Pension Plan Investment Board (CPPIB), David Denison, has evaluated Norges Bank's management of the GPFG in a report of January 2014, cf. the discussion in section 2.2. In their report, the experts note that if the Ministry of Finance excludes companies or imposes restrictions on active management that cannot be justified on financial grounds, it may result in a loss of investment opportunities and hence lower expected return than in the absence of such restrictions. They state, moreover, that as the Fund grows larger it will become more tempting to channel capital to investments that cannot be justified on financial grounds. The experts refer to examples of US funds that they believe to have been partly managed on the basis of political considerations. They also review academic studies concluding that politically motivated investment choices in US pension funds and sovereign investment funds have delivered inferior risk-adjusted returns.

The authors discuss the current special environment-related investments of the GPFG, which also involve restrictions on Norges Bank's asset management. They highlight the weak performance achieved for the environment-related investments over the period 2010-2013, and note that the asset management costs are high compared to those of the remainder of the Fund.

2.6.3 Experience from the Environmental Fund and environment-related investment mandates

In 2001, the Ministry of Finance established a separate Environmental Fund as a separate equity portfolio in the GPFG. The Environmental Fund had somewhat higher risk and delivered a return that was about 2.4 percent lower than the return on a comparable benchmark index over the period of its existence, from January 2001 to December 2004. The Environmental Fund was discontinued in connection with the establishment of ethical guidelines for the GPFG in the autumn of 2004. At the time, weight was attached to the absence of any financial arguments in favour of having a separate environmental portfolio, as well as the difficulty of substantiating any significant environmental implications from a continuation of the Environmental Fund.

In 2009, the Ministry of Finance introduced a requirement for Norges Bank to establish environment-related investment mandates in the management of the GPFG. This has formed part of the responsible investment strategy ever since, cf. the discussion in section 4.5. The mandate issued by the Ministry to Norges Bank states that the value of the environment-related investment mandates shall normally fall within the NOK 20-30 billion range. The investments shall be subject to the same return requirements as the other investments of the Fund. In a letter of 13 December 2013, Norges Bank has provided an account of its experience with the environment-related investments, cf. the discussion in section 2.2. Norges Bank states that it has thus far chosen to make the investments in listed companies engaged in activities within renewable and alternative energy, energy efficiency, water infrastructure and technologies, pollution control, as well as waste management and technologies. The Bank notes that the investment universe is not unambiguously defined, and that such investments involve a number of demarcation problems. It is also stated in the letter that

the market segment is relatively small, although the Bank can handle the current volume of investments. Norges Bank emphasises that environment-related investments are well suited for active management, although these have not contributed to the healthy return on the Fund over the period.

The market value of the environment-related investment mandates was NOK 31.4 billion as at yearend 2013. The investments have delivered an overall return of 12 percent over the period 2010–2013, whilst the general stock market has generated a return of about 54 percent over the same period. If one assumes that the environment-related investment mandates amounted to NOK 25 billion over the entire period, the return would have been about NOK 10 billion less than if such capital had been invested in the general stock market. The environment-related investment mandates have been in existence for a limited period of time, which has coincided with a global financial crisis. Norges Bank notes that the crisis resulted in increased volatility in this part of the market, and had a negative impact on the risk appetite of investors. However, returns rebounded somewhat in 2013, which was a good year for the environmental investments. Although these investments have only existed for a short period of time, they nonetheless illustrate that such earmarking may entail a significant risk of negative excess return.

2.6.4 Potential ancillary effects

The Ministry has previously noted that the environmental contribution from the environment-related investment mandates will be difficult to measure, cf. Report No. 15 (2010–2011) to the Storting – The Management of the Government Pension Fund in 2010. Apart from the fact that it is difficult to measure such contribution, it is uncertain whether it can be expected to be positive.

The motivation behind a separate investment programme is often that one would like, in addition to a favourable financial return, to achieve certain positive ancillary effects, for example environmental benefits or poverty reduction. However, it is uncertain whether investments within specific areas in well-developed markets, in which a large number of other investors are also purchasing and selling equities and participating in any capital increases, can be expected to result in such ancillary effects. In financial markets, equities will for example be priced relative to other equities on an ongoing basis. Consequently, if markets are well-functioning, the activities of the GPFG will not influence prices over time or have any significant impact on companies' cost of capital or access to capital.

If the investment programmes are implemented within the current investment limits, such programmes will result in the investments being biased in favour of sectors or countries in which the Fund is invested from before. The GPFG is already holding considerable investments within fields that can be defined as environmentally friendly or located in emerging markets.

As at yearend 2013, the equity benchmark chosen by the Ministry for the GPFG comprised 46 countries. 22 of these are defined as emerging markets by the index provider FTSE. The fixed income benchmark comprised 21 currencies, of which 10 currencies are from emerging markets. As at yearend, the value of emerging markets accounted for about 9 percent and 7 percent, respectively, of the equity benchmark and the fixed income benchmark. In addition, Norges Bank has chosen to invest more outside the developed markets than would be implied by the benchmark index. As at yearend 2013, fixed income investments had been made in 10 emerging market

currencies that are not included in the benchmark index. The equity benchmark encompasses all the markets defined as emerging markets by the index provider FTSE. In addition to the investments in emerging markets, Norges Bank has invested in 15 less developed emerging markets defined as «frontier» markets by the index provider FTSE.

Moreover, a significant portion of the Fund can be characterised as environmentally friendly. About 6 percent of the value of the GPFGE equity benchmark, corresponding to about NOK 180 billion, is already accounted for by companies that derive more than 20 percent of their earnings from environment-related activities, and which therefore meet the environmental requirements in the FTSE Environmental Opportunities All-Share Index. This is a recognised environmental index developed by the index provider FTSE in cooperation with Impax Asset Management, which is an environmental technology specialist.

The magnitude of the investments in individual countries and companies are predominantly determined by market size. This means that the investments in companies in emerging stock markets and in renewable energy companies will increase in coming years if the portion of global stock markets accounted for by such companies increases.

2.6.5 Historical return and risk characteristics of investments in developing countries and renewable energy

Investments in renewable energy companies and in companies in developing countries have historically been characterised by high risk. Figure 2.10 shows developments in the total return on an index that covers less developed markets in Africa (S&P AFRICAN FRONTIERS⁹) and an environmental index (FTSE ET50)¹⁰ over the period 1996–2013, compared to a broad global index (FTSE All World).

⁹As at yearend 2013, S&P African Frontiers comprised 113 companies in the countries Botswana, Côte d'Ivoire, Ghana, Kenya, Mauritius, Namibia, Nigeria and Zambia

¹⁰FTSE ET50 is a global index comprising 50 companies that derive more than 50 percent of their earnings from environment-related activities

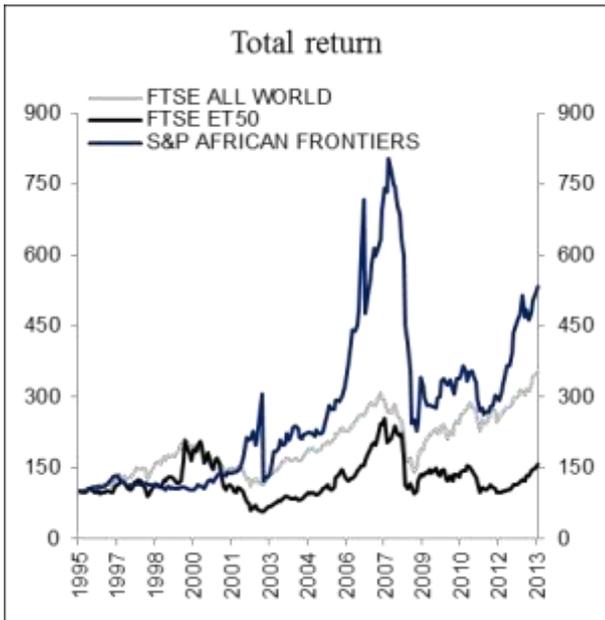


Figure 2.10 Total return on S&P African Frontiers, FTSE ET50 and FTSE All World. Index 31 December 1995 = 100

Source: Thomson Reuters Datastream.

One will note from Figure 2.10 that returns on emerging market investments and environmental investments have been much more volatile over the period and declined much more during certain periods of high turbulence than has been the case with a broad global equity index. Moreover, returns over this period have been high in the less economically developed African countries, whilst the environmental investments have performed considerably weaker.

Table 2.2 shows that although investments in the least developed emerging markets have generated a higher return than the broad global index over the period 1996–2013, such investments have also entailed higher risk.

Table 2.2 Annual return and risk for S&P African Frontiers, FTSE ET50 and FTSE All World. 1996–2013

	FTSE ALL WORLD	S&P AFRICAN FRONTIERS	FTSE ET50
Return (percent)	8.4	14.3	6.3
Standard deviation (percent)	16.2	29.0	27.2
Return per unit of risk, measured by standard deviation	0.52	0.50	0.23
Maximum drawdown (percent)	-55	-72	-73

Sources: Thomson Reuters Datastream and the Ministry of Finance.

The return and risk characteristics of investments in both less developed African markets and in environment-related equities have varied considerably over time, which implies that average figures should be treated with caution. The fact that these investments may at times involve high risk is also illustrated by the decline of more than 70 percent in the indices from the beginning of 2007 to the beginning of 2009, whilst the decline in the general stock market was significantly less.

The high risk involved in investing in companies in less developed African markets and in environment-related equities implies that investors will also demand high returns as compensation for this risk. Higher return requirements may be explained by such equities declining more in value when the entire stock market slumps, by the companies being smaller in size, by these being less liquid and by these being more exposed to political risk than investments in global indices that are dominated by large companies in highly developed markets. Consequently, one should expect higher returns from such investments over time. However, this is not a decisive argument in favour of overweighting these companies relative to the value put on them by the market. If it is desirable to increase the expected return on the Fund by accepting somewhat higher risk, this can be achieved in several ways. Hence, expanded investments in emerging markets need to be evaluated against the alternatives.

The Ministry of Finance has required Norges Bank to establish specific environment-related investment mandates. These mandates are subject to the same return and risk requirements as the Fund in general. Since the returns on companies that can be defined as environmentally friendly, such as renewable energy companies, have fluctuated much more and, moreover, not in step with the general stock market, a provision requiring the Fund to invest in such mandates will reduce the residual limit on so-called tracking error. Simulations performed by the Ministry of the effects on tracking error from investing 1 percent of the GPFG in environment-related equity mandates, which would have corresponded to about NOK 50 billion at the present value of the Fund, show that it would have resulted in a realised annual tracking error of about 0.3 percentage points for the period 1998–2013. The return on the environmental index FTSE Environmental Technology 50 has been used as

an estimate of the return on the environment-related investment mandates. If one had increased the environmental investments to 2 percent, corresponding to NOK 100 billion, the tracking error would have increased to 0.6 percentage points on average for the entire period. During the most turbulent periods, like during the financial crisis and the dot-com bubble, it would have presented much more of a drain on Norges Bank's available allowances for deviations from the benchmark index.

The market risk of unlisted investments cannot be measured on an ongoing basis. It is therefore common to illustrate the risk of unlisted investments by analysing corresponding listed investments. It is, at the same time, commonly assumed that the risk of unlisted investments is higher than that of listed investments. It was noted in Report No. 20 (2008–2009) to the Storting – The Management of the Government Pension Fund in 2008, that the average return on the unlisted funds that were invested in emerging markets over the preceding decade was lower than the corresponding return on the listed stock market. The analyses show, at the same time, that return differences were particularly large between the funds invested in emerging markets. This means that the risk of incurring a loss on such investments is high.

2.6.6 Unlisted investments

In Report No. 15 (2010–2011) to the Storting – The Management of the Government Pension Fund in 2010, the Ministry of Finance presented a broad review of investments in unlisted equities and infrastructure. The conclusion at the time was that a strategic allocation for, or a general authorisation, of such investments was not called for. It was noted, at the same time, that the special characteristics of the GPFG make it appropriate to revert to the issue later.

A general authorisation of investments in unlisted markets would not necessarily result in an increase in the investments of the GPFG within renewable energy and companies in developing countries. It is not necessarily the case that these areas account for a larger share of the institutionally investable unlisted market than of the listed market. Within renewable energy, for example, it would appear that many of the technology companies are listed. The listed utility companies also own a lot of power generation capacity within hydro, sun and wind.

Although developing countries may have large unlisted stock markets, it is not necessarily the case that the authorisation of investments in unlisted equities and infrastructure will result in the GPFG investing in these markets. It would appear, for example, that investments in developing countries do not account for a large share of the unlisted equity and infrastructure investments of globally invested pension funds. One reason for this may be that such investments are operationally challenging and involve high risk.

Although there are large differences between developing countries, investments in these markets are generally very challenging. The rights of investors are often not as well protected by legislation and supervisory bodies as in more developed markets. Besides, transparency and corporate governance are often weaker than in more developed markets. Another factor that leads to elevated risk is that there is often high country-specific risk relating to macroeconomic and political factors.

Funds with which it would be reasonable to make comparisons have not started out with unlisted investments in the least developed markets either. It is only after they have gained experience in the

more developed markets that they have, if at all, embarked on investments in the less developed, emerging markets. A corresponding approach has been adopted for the investments in the listed equity portfolio and the real estate portfolio of the GPFG.

2.6.7 The Ministry's assessment

In principle, the investments of the GPFG can be earmarked for specific areas by changing the benchmark index or by issuing instructions to Norges Bank regarding its asset management focus. However, both of these solutions are hard to justify on financial grounds.

The current benchmark index is premised on the objective of the maximum possible return, given a moderate risk level. The composition of the equity and fixed income benchmark indices of the Fund is based on, inter alia, the relative sizes of the markets and the economies. These are robust principles reflecting market pricing and the ability of countries to repay loans.

If the Ministry were to overweigh, via investment programmes, certain sectors or countries at the expense of others, this will represent active investment decisions. There is nothing in economic literature to suggest that biasing the portfolio away from the market portfolio and towards theme-based investments can be expected to contribute to improved performance of the GPFG over time. In order for such investment choices to be profitable, these would have to be based on the Ministry being privy to information regarding the future return on such investments that is not already reflected in current market prices. There is no reason to expect that the Ministry will be able to acquire such information, and hence the strategy of the Fund has not been based on such an approach either.

The Mandate for the Management of the GPFG authorises Norges Bank to make investments that deviate from the benchmark index within specific limits, including tracking error. If the Ministry were to expand the investments of the GPFG in renewable energy or in individual countries by instructing Norges Bank to overweigh certain market segments or countries, it will amount to placing restrictions on the Bank's asset management. This may curtail the scope of Norges Bank for generating excess return.

The GPFG is already holding major investments within fields that may be defined as environmentally friendly, as well as in emerging market companies. The equity benchmark index adopted by the Ministry for the GPFG included 46 countries as at yearend 2013. In addition, Norges Bank may invest in countries that are not included in the benchmark index. The mandate requires the Bank to have internal procedures for the approval of new markets and countries. Norges Bank has, following thorough assessment, invested in a number of less developed emerging markets, so-called frontier markets, but has also chosen to refrain from investing in other markets because these are held to be insufficiently developed and too high risk. Such assessments require specialist expertise and proximity to the markets. Norges Bank is better placed to perform such operational assessments than is the Ministry.

The Ministry is supportive of Norges Bank's approach of investing, as part of its active management, in emerging markets that are not included in the benchmark index. The Ministry believes that

Norges Bank should retain responsibility for approving investments in such markets. Reference is made to the discussion of the Bank's various deviations from the benchmark index in section 2.2.

In order to highlight the asset management of the Bank and the investments of the GPFG in emerging markets and renewable energy, it is intended for Norges Bank to report specifically on such investments.

The GPFG is not an instrument for furthering the investments of the State in developing countries or renewable energy. The Norwegian Investment Fund for Developing Countries (Norfund) was established to make high-risk investments in the least developed countries. The Ministry is of the view that a good follow-up of the Sundvolden platform would be to invest in sustainable businesses and projects in low-income countries via ordinary appropriations to, for example, Norfund. The Government will revert to this in the fiscal budgets.

The Ministry also is proposing an increase in investments in renewable energy by expanding the scale of the environment-related investment mandates, of which companies engaged in renewable energy activities constitute one of five sectors. The mandate issued by the Ministry stipulates that the environment-related investment mandates shall normally be in the range of NOK 20-30 billion. It is in this report proposed that this be increased to NOK 30-50 billion. The investments shall be subject to the same return and risk requirements as the other investments of the Fund. In assessing the scale of the environment-related investment mandates, weight has been attached to the fact that Norges Bank identifies such investments as well suited for active management. Hence, the expanded range will contribute to enhancing the asset management expertise of Norges Bank within a field that the Bank holds to be well suited for such management. A higher range would, at the same time, represent a restriction on the scope of the Bank for deviating from the benchmark index that would be difficult to justify financially.

The Ministry will initiate an assessment of the effects of further expansion of the investments within renewable energy. Such assessments will be based on these investments being subject to the same asset management requirements as the other investments of the GPFG.

2.7 The GPFG and the climate

Global climate change may affect the future return on the GPFG. The potential return implications of climate change may be referred to as climate risk.

Norges Bank has for some time had a special focus on climate change in its management of the GPFG. The climate expectation document issued by the Bank to the portfolio companies has been followed up by a number of sector reports. In 2012, this expectation document was revised to include, inter alia, companies' handling of deforestation in tropical areas as a topic. The Bank also divested its holdings in a number of palm oil companies in 2012. Norges Bank has subsequently divested its holdings in several mining companies. In addition, the Bank actively supports the Carbon Disclosure Project (CDP), a leading international initiative for promoting, inter alia, company measurement and reporting of greenhouse gas emissions and other environmental information.

Climate change has also been a key consideration in the Ministry's follow-up of the management of the Fund for a considerable period of time. It was an issue when establishing the ethical guide-

lines in 2004 and when evaluating the guidelines in 2009. In the autumn of 2009, the Ministry initiated a collaboration with the consultancy firm Mercer to examine long-term implications of climate change for the global capital markets in general, and for the portfolio of the GPFG in particular. This project was also supported by 13 other large institutional investors in Europe, North America, Asia and Australia.

Mercer studied implications of climate change for global capital markets until 2030 based on, inter alia, economic assessments from the Grantham Research Institute on Climate Change and the Environment at the London School of Economics.

The analyses of Mercer did not give reason to believe that climate change will have a major impact on growth in the world economy until 2030. Expected effects on returns in global capital markets were also held to be moderate over this time horizon. A recurring theme in the report was that global warming will increase the uncertainty of expected future returns. Mercer therefore recommended, inter alia, that investors closely monitor relevant risk developments. Moreover, it recommended dialogue with governments, companies and asset managers to reduce, if possible, such uncertainty in the long run.

The fossil energy investments of the Fund have been discussed in 2013 and 2014. Some stakeholders have argued that the Fund should divest such investments, on both financial and environmental grounds. The Ministry believes that any changes to the investment strategy of the Fund should be founded on thorough professional assessments and widespread support in the Storting. This report to the Storting discusses, for example, the return and risk characteristics of equities in the oil and gas sector, cf. the discussion in section 2.4.

2.7.1 Future climate risk initiatives

The Strategy Council discusses, in its report for 2013, an interrelationship between investment strategy and responsible investment, cf. the discussion in section 2.5. The Council recommends that any decisions on changing the investment strategy be based on research on the expected effect on Fund returns and risks. The Strategy Council notes, moreover, that a review of research and current practices amongst other funds indicate a considerable shortfall in our understanding of the effects of responsible investment practices on returns. The Strategy Council recommends that the Fund initiates and supports independent research to add to our knowledge in this field.

One aspect of this is the need for an improved understanding of whether social and environmental factors may influence financial returns. The equity investments of the GPFG are based on the premise that the Fund holds a small share of the global stock market. This implies that we expect return and risk to develop in line with developments in the general stock market in the long run. The Ministry is of the view that weighty arguments are required to deviate from this strategy. As discussed in section 2.6, economic theory or empirical findings do not support that biasing the portfolio away from the market portfolio in favour of individual companies or sectors to address, for example, climate risk, can be expected to improve the performance of the GPFG over time. In order for such investment choices to be profitable it would be necessary for the Ministry to have information regarding the future return on such investments that is not already reflected in current market prices. The Ministry is of the view that it must be assumed that one is not in a better posi-

tion than the market to know how individual sectors will develop in future. Consequently, the strategy of the Fund has not been based on such an approach.

Research and development have long been part of the responsible investment tools of the GPF. In 2014, the Ministry intends to initiate work to shed additional light on the risk to the future return on the Fund posed by climate change. This initiative will not be restricted to any specific sector or product. The Ministry notes that the issues involved are complex and subject to considerable uncertainty, and it aims to revert to the matter in its future reports on the Government Pension Fund.

2.7.2 Assessment of relevant policy instruments

Certain types of fuels and certain methods of production are more greenhouse gas intensive than others. Thus far, greenhouse gas emissions have not been a separate criterion for ethical exclusion, cf. the Guidelines for Observation and Exclusion. The report prepared prior to the establishment of the ethical guidelines in 2004, the NOU 2003: 22 green paper “Management for the Future”, states, inter alia, the following:

«The Committee is of the view that negative screening to exclude companies that produce coal power or petroleum from the Fund would not be appropriate. The Committee deems active ownership and advocacy to represent a more effective strategy than exclusion for addressing climate issues and effecting change».

It is now just over a decade since the NOU 2003: 22 green paper was published. Reference is made to Recommendation No. 141 (2013–2014) to the Storting, in which the Standing Committee on Finance and Economic Affairs advised the Storting to pass the following resolution:

«The Storting requests the Government to appoint an expert group. The group shall examine whether the exclusion of coal and petroleum companies may be considered a more effective strategy than active ownership and exertion of influence for addressing climate issues and effecting future change. The expert group shall also advise on criteria for the potential exclusion of this type of companies. The recommendations of the expert group shall form part of the basis for the Report to the Storting on the management of the Government pension fund in the spring of 2015.»

The Ministry of Finance will, in line with the resolution passed by the Storting, appoint an expert group to examine whether the exclusion of coal and oil companies may be considered a more effective strategy than active ownership and advocacy for purposes of addressing climate issues and effecting future change. The expert group shall also advise on possible criteria for the potential exclusion of this type of companies. The members and the mandate of the group will be published on the Ministry website. The recommendations of the expert group will be submitted in the autumn of 2014 and will be subjected to open discussion. The recommendations and the feedback from the open discussion will form part of the basis for the Report to the Storting on the management of the GPF in the spring of 2015.

Appendix 1

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