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Your ref.:
Our ref.:

Amendments to the mandate for the Government Pension Fund Global

In its letter of 10 December 2015, the Ministry of Finance proposes amendments to the management mandate for the Government Pension Fund Global (GPFG). The Bank's remarks on the proposed amendments are presented below.

Background

In *Report to the Storting No. 21 (2014-2015)*, the Ministry announced plans to increase the limit for expected deviation between the return on the GPFG's equity and fixed-income investments and the benchmark index, as measured by expected tracking error. The Ministry also proposed introducing new requirements for Norges Bank to set supplementary risk limits for large losses that are expected to occur infrequently, and to report in greater detail on the risk taken in its investment management.

The mandate for the GPFG should be general in nature and based on limits. Norges Bank offered advice and views on the introduction of a supplementary risk limit for the GPFG and on extended reporting on risks and returns in its letter of 29 September 2015.

Requirement for supplementary risk limit

Norges Bank proposed to expand section 3-6 (1) of the mandate to include a new sub-paragraph that requires the Bank to set a limit for large negative deviations that are expected to occur infrequently. The limit shall not include the fund's real estate investments. The Ministry is now proposing to update the wording of the mandate in line with the Bank's advice, and we have no comments on the text of the mandate in this regard. In line with

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section 3-6 (3), the limit will need to be presented to the Ministry before being implemented. The Bank will present a proposal once the Ministry has amended the mandate.

The Ministry emphasises that the limit for expected extreme deviations is intended to supplement the limit for expected tracking error. The Bank will design the limit for expected extreme deviations in a way that endeavours to take account of this. The Bank's design of the limit will contribute to effective measurement and control of extreme deviation risk, while also providing leeway to avoid unfavourable portfolio adjustments and allow the fund to pursue strategies that exploit its characteristics and strengths in extreme market situations. We would also refer to the discussion in our letter of 29 September.

Requirement for more detailed reporting

Norges Bank attaches great importance to transparency about the management of the fund. In our public disclosures, we aim to provide the information required for a high degree of openness about, and public insight into, the fund's management.

In *Report to the Storting No. 21 (2014-2015)*, the Ministry writes that the GPFG is regarded as one of the world's most transparent funds. This is reflected in section 6-1 of the current mandate, which requires "the greatest possible degree of transparency within the limits defined by a sound execution of the management assignment".

The Bank publishes quarterly and annual reports on the fund's management. These reports consist of an accounting part and a descriptive part. Through these reports, the Bank aims to provide the broadest possible account of the results of its management. The financial statements are prepared in accordance with International Financial Reporting Standards (IFRS). The reports present information on the policies used to value instruments in the portfolio, the measurement methods that we use, our investment results and an assessment of risk in the management of the fund. The reports contain detailed information on matters such as liquidity risk, credit risk, market risk and risk concentration.

The annual report's descriptive part provides a detailed account of the fund's management. Besides presenting absolute and relative risk in both the fund's currency basket and Norwegian kroner, it sets out the most important contributors to both absolute and relative returns. Since the fund's inception, we have reported on the risk characteristics of relative returns using the risk measure set out in the mandate for the management of the fund (tracking error).

In addition to these annual and quarterly reports, the Bank also provides extensive information on various aspects of its management on www.nbim.no. For example, we publish time series for returns on the fund's equity and fixed-income portfolios with the associated benchmark indices and time series for relevant exchange rates. We also publish information on the fund's factor exposures, holdings, voting and external managers.

Norges Bank intends to develop and improve its reporting further in line with the objective set out in the mandate. In addition to the ordinary annual report, the Bank will also be publishing an extended, special report on risks and returns in the fund, a report on responsible investment and a separate, new report on the fund's unlisted real estate investments. Collectively, these will give the public a true and fair view of changes in fund value, costs, management strategies, value added through operational management, and relevant risk in the management of the fund.

In the extended report on risks and returns in the GPFG, we plan to explain the key components of the internal reference portfolio and the general strategies deployed in the fund's management. We will endeavour to ensure that the methods we use for decomposing risks and returns can be verified externally. In addition, we will report separately on excess return and risk in the environment-related management mandates, and on the effects of other requirements in the mandate. The report will also look more closely at the estimates and calculations of extreme deviations. The design of the new report will draw on advice from an expert group appointed by the Executive Board on how the Bank can develop its reporting of risks and returns.

The Ministry proposes amending the wording of section 1-7 of the mandate such that it is the *Executive Board* that is to have a strategic plan for the execution of the Bank's management assignment. The Ministry writes in its letter of 10 December that this role *cannot be delegated*. In addition, the Ministry proposes new provisions in section 6-2 (1) on so-called *strategic reporting*.

The Bank recommends that the provisions in the proposed section 6-2 (1) are moved to section 1-7 (2). This would bring together the provisions on the Executive Board's strategic plan and the evaluation of the plan in one place. The Bank also recommends some rewording of the provision in section 1-7 (2) to ensure that the current split of roles and responsibilities in the management of the fund is maintained. Our proposal means that the Ministry does not provide detailed guidelines in the mandate on the management level at which the individual investment strategies for equities, bonds and real estate are determined. The Bank's strategic plan for the management of the GPFG is based on all key decisions being discussed and approved by the Executive Board. The Bank's proposed wording of the mandate is enclosed with this letter.

We have no comments on the Ministry's proposals concerning quarterly reporting. We do, however, recommend a few simplifications and adjustments to the provisions in section 6-2 on annual reporting, cf. the enclosure.

As regards the annual reporting requirements, we assume that the Executive Board's assessment of the results (cf. the proposed section 6-2 (3) letters b) and e)) will be fulfilled by the Executive Board's annual report within Norges Bank's annual report.

When it comes to the Ministry's proposal in section 6-2 (5) that the quarterly report be published no later than one month after the end of the quarter, we would refer to section 4-1 of the regulation on Norges Bank's annual financial reporting. The final paragraph of this section states that the quarterly financial reporting and the auditor's report on the review of the quarterly financial reporting for the investment portfolio must be published within two months of the end of the quarter. The Bank assumes that the shorter of the two deadlines is to apply. A complete report for the second quarter will not, however, be available until the first half of August.

Other provisions
We would also make the Ministry aware that section 1-6 (3) of the mandate needs to be amended to allow for possible withdrawals from the fund. In addition, section 3-1 (1) letter c) needs to be reformulated so that it does not impose different requirements for the execution of equity transactions in the real estate portfolio to those in the equity portfolio in letter a) of the same paragraph. We also suggest that the Ministry introduces an annual process for reviewing the weights in the government segment of the benchmark index for the bond portfolio, cf. section 3-2 (4) of the mandate.

Yours faithfully

Øystein Olsen　　　　　　　　Trond Grande

Enc.

Enclosure

Proposed wording of sections 1-7 and 6-2 of the Ministry of Finance's mandate

Section 1-7. Strategic plan for the Bank's management of the investment portfolio

(1) The Executive Board shall have a strategic plan for the execution of its management assignment. This plan shall be updated regularly and in the event of significant changes.

(2) The Executive Board shall evaluate at least every third year the extent to which the goals in the strategic plan have been achieved. Particular account shall be given of:

   a. The choice of strategies, the risk and return characteristics of these strategies, and how the strategies seek to take advantage of the fund's special characteristics and the Bank's strengths in investment management.
   b. Different investment strategies that can affect market risk and extreme deviation risk in the investment portfolio as a whole and in the equity and bond portfolios individually.
   c. The framework for the management and control of risk.
   d. The organisation of investment management, including the use of subsidiaries and external managers.

   […]

Section 6-2. Reporting requirements

(1) (To be moved to section § 1-7 as discussed above)

(2) (Requirements for quarterly reporting, no comments)

(3) In addition to the requirements in section 6-2 (2), the Bank shall report annually on, and account separately for, the following (annual reporting):

   a. The results of different investment strategies for equity and bond management respectively, including share of relative return, risk and management costs.
   b. The Executive Board's assessment of the results.
   c. The relationship between risk and return in the equity and bond portfolio. The Bank shall use multiple methods and metrics to report the risk characteristics of the relative return.
   d. Income from securities lending, internal and external management costs, tax costs and estimated transaction costs for the equity, bond and real estate portfolios respectively expressed as a percentage of assets under management.
   e. The management of the real estate portfolio, including an assessment of the results.
   f. Risks and returns for environment-related investments, cf. section 2-4, and a general overview of investments in emerging markets and renewable energy. This information shall include values, strategies and asset types.
   g. Work on responsible investment, cf. chapter 2, including the use of instruments and the results of ownership activities, and how responsible investment principles are integrated into investment management.