The Government Pension Fund Global (GPFG)
Legal framework and checks & balances

Björn G. From
23 September 2015
Outline

Petroleum revenues and fund mechanism

Governance
Investments
Fund performance
Responsible management
Petroleum Revenue Management - Executive Summary

1. Exploration/Extraction (high tech, capital intensive, incentives)

2. Oil price (volatility)

3. Total cash flow
   - multinationals
   - national oil company
   - taxes/royalties

4. Government take (percentage, policy mix, risk profile)

5. State budget (fiscal and monetary policy => spending rule to keep non-oil economy fit?)

6. Petroleum fund? (revenues or asset swap?, time structure and volatility, investments abroad?)
The framework for petroleum revenue management has developed over time

1971    Production started. First petroleum income added to public finances
1973    Division between total and non-oil economy introduced in macroeconomic forecasts
1977    Petroleum taxes specified in budget documents
1990    Establishment of the Government Petroleum Fund
1996    First net transfer to the Fund
2001    New fiscal policy guidelines adopted by Parliament
2004    Ethical guidelines for investments
2006    Fund renamed the Government Pension Fund Global
2010    More integrated responsible investment strategy
GPFG is fully integrated with fiscal policy

**Fiscal policy guideline**
Over time spend Fund real return (estimated at 4 percent)
Spending of oil revenues contingent upon prevailing economic conditions

Source: Ministry of Finance (Revised National Budget 2015)
Sharp increase in public pension expenditures coincides with declining funding contribution from the GPFG – a long term challenge to government finances

Number of elderly (67 years and above) in proportion to the number of people of working age (20 – 66). Percent

- Norway
- EU-28
- Denmark
- Sweden

Percent of trend GDP for mainland-Norway

- State’s net cash flow
- Structural budget deficit
- Estimated real return

Source: Ministry of Finance (Revised National Budget 2015)
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Responsible management
Governance structure marked by clear lines of responsibilities

The Storting – Norwegian Parliament

- Government Pension Fund Act
- National Budget
  - Annual Report to the Storting
  - Material changes presented to Parliament prior to implementation

Ministry of Finance

- Management mandate
  - Regulation on risk management and reporting Guidelines
  - for observation and exclusion
- Quarterly and annual reports
- Investment strategy advice

Norges Bank (NBIM)

Operational manager of GPFG
Hierarchy of management documents governing the management of the GPFG

- The Storting:
  - The Government Pension Fund Act

- Ministry of Finance:
  - Management mandate for the GPFG
  - Regulation on risk management and internal control at Norges Bank
  - Regulation relating to the Annual Financial Statements etc. of Norges Bank

- Executive board of Norges Bank:
  - Strategy plan
  - Investment mandate for the GPFG
  - Principles for Risk Management in NBIM
  - Principles for Ownership Management in NBIM
  - Principles for Organisation and Management of NBIM
  - CEO Job Description

- CEO of NBIM:
  - Job descriptions
  - Internal guidelines
  - Investment mandates
Hierarchy of regulation, supervision and reporting

The Storting
Supervision: Auditor General

Ministry of Finance

The Executive Board of Norges Bank
Supervision: Supervisory Council and External Audit

Norges Bank Investment Management (NBIM)
Supervision: Executive Board and Norges Bank Internal Audit

Internal and external managers
Supervision: NBIM Compliance and Control

Regulation and delegation of authority

Reporting of performance and risk

Governance
High degree of transparency in Fund management

➢ Prerequisite to ensuring broad support for and trust in the management of Fund

➢ Management mandate states; *greatest possible degree of transparency within the limits defined by a sound execution of the management assignment*

    → Reporting
    → Holding lists
    → Voting records

➢ Contributes to a robust investment strategy

    → Anchoring of risk profile with stakeholders
Outline

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Responsible management
Investment strategy premised on Fund objective, investment beliefs and Fund characteristics

Highest possible long-term financial return within a moderate level of risk.

The investment strategy is in particular characterized by:

- Diversification
- Harvesting risk premiums
- Exploitation of the Fund's long-term horizon
- A moderate degree of active management
- Responsible management
- Cost efficiency
- A clear governance structure
The investment strategy of the Fund has been developed gradually:

- **1998**: 40% equities
  - Some emerging equity markets*
- **2000**: Non-government bonds
- **2002**: Inflation-linked bonds
- **2004**: More emerging markets**, Ethical guidelines
- **2005**: High-yield bonds, Commodity derivatives, New risk management requirements
- **2006**: 60% equities, small-cap
  - First investment in real estate
- **2007**: Real estate
  - All emerging equity markets*
- **2008**: 60% equities, small-cap
- **2011**: New geographical distribution for the equity and bond index
- **2012**: Adjusted framework for responsible management
- **2014**: High-yield bonds, Commodity derivatives, New risk management requirements

*Benchmark index
**Investment universe
The investment strategy

GPFG strategic benchmark index

- Global Equities (excl. Norway)
  «Market weights»
  60%
  - FTSE Group
    Index vendor
    Global All-Cap

- Global Fixed Income (excl. Norway)
  70% Gov. (GDP weights)
  30% Corporates (Market weights)
  35-40%
  - Barclays
    Index vendor

- Global Real Estate (excl. Norway)
  0-5%
  - IPD
    Index vendor
    Global Property Benchmark

- Global Aggregate
- Global Inflation-Linked
Broad geographical distribution of Fund investments

Actual investments at yearend 2014

Source: Norges Bank
The Fund holds significant ownership shares in global markets
Year-end 2014

Average holdings in equity markets
- Developed markets
- Emerging markets
- Total

Average holdings in fixed income markets
- Government & Government related bonds
- Corporate bonds (including securitized)
- Total

Sources: Norges Bank and Ministry of Finance
Real estate investments
Proportion, country and sector allocation at June 30th 2015

<table>
<thead>
<tr>
<th></th>
<th>Share of Fund</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>2.7</td>
<td>186 169</td>
</tr>
<tr>
<td>Unlisted real estate</td>
<td>141 909</td>
<td></td>
</tr>
<tr>
<td>List real estate</td>
<td>42 256</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>2 004</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Norges Bank and Ministry of Finance
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Responsible management
GPFG is among the largest funds in the world

Market value development 1996 - 2Q 2015. NOK billion (lha) and per cent of GDP Mainland Norway (rha)

Fund size as share of GDP for Mainland Norway (rha)

Sources: Norges Bank and Ministry of Finance
Fund performance continued

<table>
<thead>
<tr>
<th>Key figures at June 30th, 2015 (annualised data in currency basket)</th>
<th>Last 12 months</th>
<th>Last 3 years</th>
<th>Last 5 years</th>
<th>Last 10 years</th>
<th>Since 1.1.1998</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross annual return (percent)</td>
<td>6.91</td>
<td>12.10</td>
<td>9.92</td>
<td>6.12</td>
<td>5.90</td>
</tr>
<tr>
<td>...of which relative return on equity- and fixed income investments (percentage points)</td>
<td>-0.04</td>
<td>0.31</td>
<td>0.30</td>
<td>0.14</td>
<td>0.28</td>
</tr>
<tr>
<td>Annual price inflation (percent)</td>
<td>0.35</td>
<td>1.32</td>
<td>1.82</td>
<td>1.97</td>
<td>1.83</td>
</tr>
<tr>
<td>Annual management costs (percent)</td>
<td>0.06</td>
<td>0.06</td>
<td>0.07</td>
<td>0.09</td>
<td>0.09</td>
</tr>
<tr>
<td>Annual net real return on fund (percent)</td>
<td>6.48</td>
<td>10.59</td>
<td>7.89</td>
<td>3.98</td>
<td>3.90</td>
</tr>
</tbody>
</table>

Annual net real return since January 1997 is calculated at 4.08 percent (month-end June 2015).

Sources: Norges Bank and Ministry of Finance
Development in management costs
NOK million and basis points

Sources: Norges Bank and Ministry of Finance
Fund performance – some checks & balances

• External verification of performance figures by Spaulding Group Inc.
• Benchmarking of total return, policy return, excess return and management cost figures by CEM Benchmarking Inc.
• Benchmarking of real estate performance by IPD.
• Every 4 years external review of Norges Bank’s fund management
  • 2014 by Andrew Ang, Michael Brandt and David Denison
  • 2010 by Andrew Ang, William Goetzmann and Stephen Schaefer
Outline

Petroleum revenues and fund mechanism
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Responsible management
Strategy for responsible investment practices developed gradually over time

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>Exclusion on the basis of conflict with Norway’s commitments under international law. The Petroleum Fund’s Council on Ethics and International Law is established.</td>
</tr>
<tr>
<td>2003</td>
<td>NOU 2003: 22 “the Graver-report”.</td>
</tr>
<tr>
<td>2004</td>
<td>Ethical Guidelines for the GPFG. Includes the instruments exclusion and exercise of ownership. The Ethical Council is established.</td>
</tr>
<tr>
<td>2010</td>
<td>Exclusion on the basis of tobacco production. New Mandate for Responsible Investments in the GPFG. New Guidelines for Observation (new instrument) and Exclusion. Criteria for the exclusion of government bonds included in the mandate to Norges Bank.</td>
</tr>
<tr>
<td>2013</td>
<td>The Strategy Council drafts a report proposing 10 measures to further strengthen the strategy for responsible investments.</td>
</tr>
<tr>
<td>2014</td>
<td>Decision-making authority on exclusion and observation of companies transferred from the Ministry of Finance to Norges Bank*. Council on Ethics provides recommendations on exclusion and observation to Norges Bank*.</td>
</tr>
</tbody>
</table>

*Entered into force January 1st 2015
Framework for responsible management

Ministry of Finance

General framework on responsible management

Management framework & Guidelines

Guidelines

Reporting

Active ownership
Decisions on observation & exclusion

Exchange of information

Recommendations

Recommendations on observation & exclusion

Reporting

Norges Bank
(Central Bank)

Council on Ethics
Norges Bank – separate report on responsible investment

Standard setting
- International standards
- Expectations and principles
- Responsible investment research

Ownership
- Voting
- Interaction with companies
- Engaging with boards

Risk management
- Risk monitoring
- Industry initiatives
- Focus areas
- Environment-related mandates
- Risk-based divestment

Source: Norges Bank
Exercise of ownership rights

- Exercise of ownership rights is based on international recognised principles
- Overall purpose of active ownership is to safeguard the Fund’s financial values
- Strategic focus areas
  - well-functioning, legitimate and efficient markets
  - equal treatment of shareholders
  - shareholder influence and board accountability
  - children’s rights
  - climate change risk management
  - water management
Exclusion and observation of companies

- **Product-based exclusion**
  - produce weapons that violate fundamental humanitarian principles in their normal use
  - produce tobacco

- **Conduct-based exclusion** – serious or systematic violations of fundamental ethical norms
  - human rights including child labour
  - individuals’ rights in situations of war or conflict
  - gross corruption
  - severe environmental damage
  - other particularly severe violations of fundamental ethical norms
Contact details

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Links

Ministry of Finance
www.regjeringen.no/en/dep/fin

Government Pension Fund
www.government.no/gpf

Norges Bank Investment Management
www.nbim.no/en

Council on Ethics
www.etikkradet.no/en