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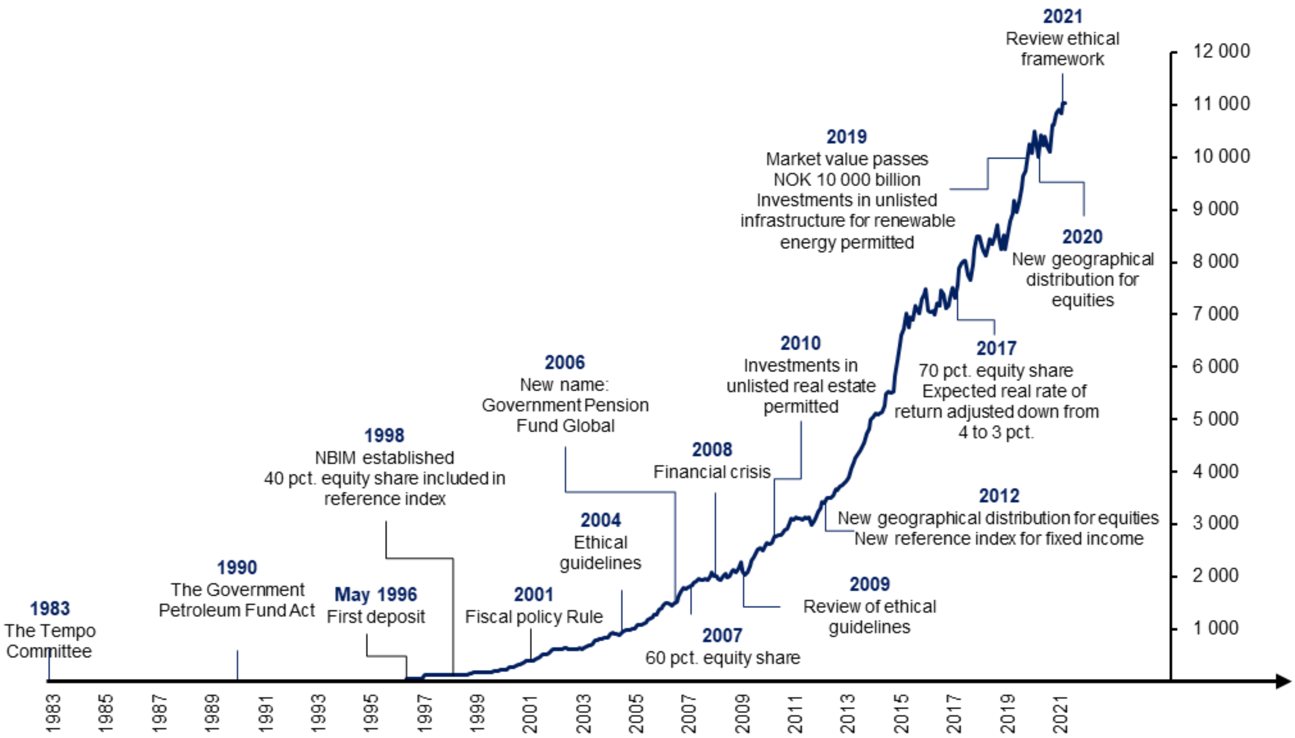
Mandate for the Committee reviewing long-term perspectives for the Government Pension Fund Global (updated 9 November 2021)

1. Background

Introduction

International developments and developments in financial markets may entail changes of significance to the Government Pension Fund Global (GPFG). In order to establish a comprehensive basis for the Ministry of Finance's decision-making, an external committee has been appointed to review both which developments may be of relevance for the GPFG in the coming years (part 1) and what significance these developments may bear for the management and governance of the Fund (part 2).

Key decisions and advances made through Fund's history are illustrated in the figure below. The purpose of the Committee is to provide input and analysis which may constitute a basis for further development of the management of the Norwegian people's common financial wealth held in the GPFG, in line with changes in the Fund's external environment and within the established financial objective.



The requirement for such a review is also reflected in a remark from the Standing Committee on Finance and Economic Affairs during the parliamentary deliberation of the 2021 white paper on the Government Pension Fund (Meld. St. 24 (2020–2021)), see Innst. 556 S (2020–2021). The Committee noted, inter alia, that national and global development constitutes an important foundation for the environment in which the GPFG operates, and that the years ahead will bring new and further challenges for the Fund.

Context

Under the Government Pension Fund Act, the Ministry of Finance has been given the responsibility for the management of the Fund. The operational fund management is carried out by Norges Bank, under a mandate stipulated by the Ministry of Finance. Key choices have been endorsed by the Storting. The investment strategy for the Fund, as established by the Ministry of Finance, is based on long-term considerations of financial risk and return. The strategy is founded on the Fund objective of achieving the highest possible financial return, given an acceptable level of risk. It rests on assumptions that the financial markets are efficient and well-functioning. It builds on the Fund's distinctive characteristics, such as being state owned and with a long investment horizon. The strategy is not based on any given market view or attempt to predict future developments. Contrarily, considerable emphasis has been put on diversifying investments between different markets, sectors, companies and financial instruments. This provides diversification benefits and reduced chance of loss compared to a strategy where investments are concentrated in single markets, sectors or companies.

The GPFG investment strategy has been developed over time. All changes have been based on professional recommendations, practical experience and thorough assessments. In recent years, a series of strategy, management and governance reviews have been completed or initiated, including reviews of the equity benchmark index, climate risk, the fixed income benchmark index, the equity share, energy equity investments, unlisted equity, responsible investment and the ethical guidelines, as well as the governance structure[1].

Investment strategy and responsible investment

The current investment strategy for the GPFG is reflected in a strategic benchmark index consisting of equity and fixed income securities. The equity share is 70 pct. of the index, whilst fixed income accounts for 30 pct. The reference index is based on broad, global indices from leading index providers. To a large extent, the reference index reflects the available investment opportunities in the global equity and fixed income markets. Through the endorsement of the equity share, the Storting has indicated what is considered an acceptable level of risk assumed in the management. The management style of the Fund may be characterised as enhanced indexing, and the development in the Fund's market value will to a large extent reflect the development in listed companies internationally. Historically, 99 pct. of the fluctuations in the return on the Fund may be explained by the reference index set by the Ministry of Finance and endorsed by the Storting. Norges Bank may deviate from the reference index within a limited risk limit stipulated in the mandate. The purpose of such deviations is to ensure cost effective management and to seek excess returns. Within a moderate limit, the Fund may be invested in

[1] In 2019, the Storting endorsed the Government's proposal in Meld. St. 7 (2018-2019) that the management of the Fund should remain with Norges Bank, see Innst. 165 S (2018-2019). The Central Bank Act Committee proposed in NOU 2017:13 that the management of the GPFG should be separated from the central bank and placed with a statutory corporation.

unlisted real estate and unlisted infrastructure for renewable energy. The GPFG is mainly invested in listed markets, and this is not presumed to change.

Within the limitations set by the requirement for sound and cost-efficient execution of the management of the GPFG, the highest possible degree of transparency shall be practiced. It is important for support and confidence in the Fund that the general public may follow how it is managed, which investments it makes, what risks are assumed and how the Fund value develops. It is emphasised that within the overarching financial objective, the Fund shall be managed responsibly. The mandate stipulated by the Ministry of Finance requires environmental, social and governance concerns to be fully integrated in the management of the Fund. Further on, the Ministry has established ethical guidelines for exclusion and observation of companies from the GPFG. The guidelines were introduced in 2004, based on the Official Norwegian Report NOU 2003: 22 *Forvaltning for fremtiden* (the Graver Committee). In 2019, the Government appointed a committee to review and propose amendments to the ethical guidelines for the Fund. In its report NOU 2020: 7 *Values and Responsibility*, the Committee concluded that the ethical framework has worked well but proposed certain adjustments in the guidelines for exclusion and observation and in the mandate to Norges Bank. In the white paper *The Government Pension Fund 2021*, the Ministry recommended most of the Committee's proposals to be implemented, albeit with certain adjustments, see Meld. St. 24 (2020–2021). The Storting supported the Ministry's recommendations, see Innst. 556 S (2020–2021).

Seen in conjunction, the mandate and the ethical guidelines entail that the political authorities have imposed restrictions on the Fund's investment universe, and requirements for the responsible investment and exercise of ownership in the companies where the Fund is invested. Concurrently, there is broad political consensus that the Fund is not a policy tool and that the threshold for excluding companies based on the ethical guidelines remains high.

Recently, an expert group has reviewed financial climate risk and climate related investment opportunities in the management of the Fund. The group concluded that the fundamental principles underpinning the GPFG investment strategy remains unaltered, and that the reference index is not a suitable tool for addressing climate risk in the Fund. Furthermore, the group considers it to be in the Fund's interest that the Paris Agreement targets are reached and that the transition to a low-carbon economy happens without sudden policy shifts. The expert group highlights the exercise of ownership as the central tool to support decarbonisation of the portfolio companies and recommends the ownership efforts should include a long-term target of net zero emission in the portfolio companies by 2050. The Ministry has further received advice and assessments from Norges Bank. Climate risk and climate related investment opportunities will be addressed in the white paper on the Fund due in the spring of 2022.

Changing environment and increased uncertainty in the years ahead

The figure above shows how the value of the GPFG has increased considerably since the first deposit was made in 1996. This is due to, inter alia, the production of oil and gas on the Norwegian continental shelf, which continued to increase for several consecutive years. China's participation in the WTO from 2001 provided impulses to the global economy. In the years following 2003, the oil price increased substantially. The increase in the Fund value also relates to significant growth in the Norwegian mainland economy during parts of this period. This provided solid tax revenues and contributed to curbing the non-oil fiscal deficit, and thus also the requirement for net transfers from the Fund. In addition, the Fund value has thus far increased as a result of strong returns on the invested capital. In 2016, the return on the Fund for the first time exceeded the net cash flow from the petroleum revenues. Going forwards, developments in the global financial markets will increasingly determine the development in the Fund value, and thus also the scope for transfers to the Budget.

As the Fund is broadly diversified in both developed and emerging markets, it takes part in the global economic growth. Closer economic integration and technological advances have for many years been important drivers of the development in the global economy. In production of consumer goods, international values chains have been driven by production relocating to where the cost of labour is lower, but increased digitalisation also contributes to the development in value chains. Additionally, more countries have gained access to the global markets. In combination, technological development and economic integration have boosted global productivity.

Such developments have provided a beneficial environment for listed companies that have gained access to new markets in emerging economies and to low-cost labour. More concentrated production and increased market power in several markets have contributed to high profitability, and growth in profits and dividends. Combined with interest rates falling to record low levels, this development has driven equity prices and the underlying valuation of stocks upwards. Falling interest rates have generated capital gains for investors, whilst at the same time involving lower expected returns on bonds going forwards. The low interest level was part of the reason the estimated expected real rate of return on the GPFG in 2017 was adjusted downwards, from 4 pct. to 3 pct. The low-interest environment must be considered in conjunction with, inter alia, inflation, demographic trends, productivity and monetary policy.

Several factors indicate that the development in the global economy going forwards is uncertain. The transitioning of the global economy towards a more sustainable trend following tighter climate policy in line with the Paris Agreement targes, provides both opportunities and challenges. Concurrently, research shows that climate change to a large extent could impact nature, societies and the economy in the years ahead. The low-interest environment coincides with increasing debt levels, both privately and in the public sector, and experience with the extraordinarily expansive monetary policy conducted by central banks in several countries is thus far limited. Productivity growth in the OECD is also substantially lower than is has been during most of the post-war period. Furthermore, uncertainty around future inflation has increased. Going forwards, these factors combined constitute multifaceted risks to the global economy and financial markets.

Concurrently, there are tendencies towards increased tensions, both internally in countries and in between countries. Globalisation has contributed to higher global income, but the benefits are unevenly distributed both between countries and internally in many countries. This provides breeding ground for increased protectionism, higher risk of political instability and weaker support for international cooperation. In addition, great-power rivalry has increased lately, and democracy and rule-of-law appears weakened. The global economy and the financial markets are closely interlinked, and problems in one market are easily transferred to other markets. This reduces the benefit of broad diversification and makes global investors more vulnerable, including to geopolitical developments.

Since the first deposit in 1996, the Fund has been exposed to both highs and lows in the financial markets. The downturns have included the period after the burst of the IT-bubble, the financial crisis and now recently the global pandemic. The investment strategy and governance structure has proved robust through these and other challenges. The external environment may however become more demanding, entailing bigger challenges for the GPFG in the next 25 years than in the previous 25. How the Fund is managed must therefore continuously be reviewed, and adjustments must be made when necessary. All changes are to be based on comprehensive, professional evidence and thorough analysis and assessments.

2. The Committee's assignment:

The Committee shall prepare a report on the following:

Part 1: Which future developments may be of relevance to the GPFG in the coming years?
The Committee shall, in light of the above mention background and context, describe how and to what extent developments in international relations and financial markets, including central drivers of such developments, may influence Fund risk and return. Relevant risk in this context is, inter alia, financial risk, reputational risk for the GPFG and Norway, and risks associated with security policy and foreign policy. Examples of relevant developments may be:

1. Important macroeconomic developments and central drivers, including economic integration, productivity and technological advances, climate change, the transitioning of the global economy in line with the Paris Agreement, investment return, interest rates and risk premia, as well as changes in institutional matters regarding financial markets and the importance of increased company market power.

2. Important political developments, including developments in governance, shifting powers and geopolitical rivalry, and vulnerability as a consequence of technological development.

The analysis may, inter alia, include illustrations of possible scenarios.

Part 2: What significance may such developments entail for the management and governance of the GPFG?
The Committee shall assess whether the matters discussed in part 1 may be of significance for:

1. The foundation for the Fund investment strategy, such as the emphasis on broad diversification of investments in order to reduce risk and harvest risk premia, and the role as a financial, responsible investor operating internationally and with a high degree of transparency about the Fund management. The Committee shall further discuss whether there are indications suggesting it necessary to revisit or review some

of the recent changes in the investment strategy of the Fund.

2. The governance of the Fund, including the management, assessment and control of risk, requirements for competence and the need to secure insight into and understanding of the risk assumed, and the division of responsibilities between asset owner and fund manager.

The Committee shall not propose specific changes to the GPFG investment strategy. The fiscal policy guidelines also fall outside the scope of the mandate.

The Committee shall submit its report by 1 October 2022.