Management of the Government Pension Fund Global

Central Bank Governor Svein Gjedrem. Introductory statement at the hearing before the Storting's Standing Committee on Finance and Economic Affairs on 18 May 2010

Please note that the text below may differ from the actual presentation.

I thank the Chairman and would also like to express my gratitude for giving me the opportunity again this year to report on Norges Bank's management of the Government Pension Fund Global (GPFG) in connection with the Storting's (Norwegian parliament) deliberations on the report to the Storting on the management of the GPFG.

The Government, under the auspices of the Ministry of Finance, has mandated Norges Bank to perform the operational management of the GPFG. The management mandate is further defined in the appurtenant regulation and supplementary guidelines issued by the Ministry of Finance. The Ministry of Finance defines a benchmark portfolio for equities and for bonds, which Norges Bank is to track fairly closely. A management agreement has also been concluded. This model, which will now be further developed, provides for a clear division of responsibility, transparency and high level of management expertise.

The Executive Board is the executive authority of Norges Bank and defines the framework for the Bank's operational management of the GPFG. In recent years, the Executive Board has reinforced its oversight of the GPFG. We have chosen a model where the Bank's investment management unit – Norges Bank Investment Management (NBIM) – has a somewhat different position from the other two departments in Norges Bank: monetary policy and financial stability. The director of NBIM has a clear role as executive director of NBIM and reports to the Executive Board in accordance with this. The central bank governor and deputy governor function as working board chairmen.

The Executive Board establishes risk management principles for investment management. Under these principles, different risks are divided into one of four categories: market risk, credit risk, counterparty risk and operational risk. The principles further specify different and complementary risk measurement methods, and risk management criteria.

The principles are supplemented by more concrete limits for individual investment mandates. These limits are partly a tightening of the rules established by the Ministry of Finance. For example, the Executive Board has set the upper limit for allocation to equities at 60 per cent plus/minus 2.5 percentage points (1), while the Ministry allows up to 10 percentage points. Moreover, the Executive Board has reduced the Ministry's limit of 1.5 percentage points for a measure of the normal deviation (2) between the return on the fund and the benchmark portfolio to 1.1 percentage points.

Risk measures estimated on the basis of fairly short-term fluctuations in market prices did not capture market fluctuations when the crisis hit. The Executive Board has therefore set out limits in the investment mandate in areas that are not regulated by the Ministry. Limits have for example been set for how closely the actual portfolio shall track the benchmark portfolio. The Executive Board has also defined rules that limit leveraging and the sale of equities and bonds with delayed settlement. There are rules for lending of securities. Variables of this type are suited for regulation at board level.

NBIM reports monthly to the Executive Board. The reporting reflects its investment mandate.

The description of the post of executive director of NBIM specifies his professional and administrative responsibilities and sets out requirements as to systems, control and reporting.

The Executive Board has appointed an advisory committee composed of international investment management experts. The committee and the Executive Board hold full-day meetings four times yearly.

The Executive Board has established two committees responsible for preparing audit and remuneration matters. The audit committee was established in 2006 concurrently with the establishment of the Bank's internal audit. The audit committee is composed of three external members of the Executive Board. The committee prepares risk management and internal control matters for the Executive Board.

In 2009, the Executive Board set up a remuneration committee as a preparatory body for the Executive Board. One of the tasks of the committee is to draw up a recommendation to the Executive Board concerning remuneration of the executive director of NBIM and of senior managers reporting directly to the executive director. As from autumn 2009, all NBIM senior managers will receive remuneration in the form of fixed salaries. The deviation from industry practice is based on the consideration that we want our senior managers to operate with a long time horizon.

Other NBIM employees are remunerated partly based on performance, preferably over an extended period. The remuneration committee draws up an annual recommendation to the Executive Board on compensation and overall compensation limits.

We follow the principles for compensation recently drawn up by the Financial Stability Board.

We seek to set compensation at levels that facilitate recruitment of highly skilled employees whom we can retain over an extended period. The level of remuneration is therefore set on the basis of the level employees could obtain in other organisations. The Bank does not want to act as a wage leader, however.

As you are well aware, the Supervisory Council consists of 15 members appointed by the Storting. The Council oversees compliance with the regulations governing the Bank's activities and approves the Bank's budget and accounts.

In 2009, the Storting adopted amendments to the Norges Bank Act, including changes to the audit and supervisory arrangements applying to the Bank. As from 2010, the Supervisory

Council appoints an external auditor. The Supervisory Council has selected the international audit firm Deloitte as financial auditor for Norges Bank and the GPFG.

The GPFG is integrated into Norges Bank's accounts. The GPFG accounts have been modified in recent years to reflect adaptation to international standards and changes in standards. As from 2011, Norges Bank will be under the obligation to draw up accounts, in accordance with the Norwegian Accounting Act. The Ministry of Finance will draw up the appurtenant regulation. The Bank will fully adhere to International Financial Reporting Standards (IFRS). Only small changes will be needed to achieve this.

The GPFG is supervised and audited by two bodies appointed by the Storting: The Office of the Auditor General of Norway and the Supervisory Council. The bodies perform important functions. I assume that a rational framework will be elaborated for the division of tasks. (3)

This is the second year that Norges Bank appears before the Storting to report on the management of the GPFG. In 2009, the hearing took place directly after the GPFG had presented negative results for 2008. The decline in international equity markets had a particularly adverse impact on GPFG returns. Active management was marked by substantial book losses on bond investments.

Following the losses incurred in 2008, the Storting maintained the investment strategy of the GPFG. In the four quarters from the second quarter of last year to the first quarter of this year, the real return on the GPFG was 34.5 per cent after costs. Since its establishment in 1998, the average annual real return after costs has been 2.9 per cent. This figure is still marked by the financial crisis. We still consider a real return of 4 per cent as realistic over time.

At last year's hearing I indicated that unless the economic outlook went from bad to considerably worse, the GPFG would achieve substantial excess returns in the coming years. Even though there was probably an underlying fear of a collapse in the financial system, it was fairly clear that the main factor behind the fall in bond prices was limited market liquidity. Since the second quarter of last year, book values increased even faster than we could have expected. The GPFG continued its active management strategy through the crisis. It has proven to be important that active management could be pursued.

The recent weeks' turbulence surrounding sovereign debt in southern Europe shows that the crisis has many phases and facets. We have hardly seen all of them yet.

The GPFG now holds around 1 per cent of the world's listed equities. This gives us a responsibility as owner. We have concentrated the work on active ownership on a few select areas. We believe that this will yield better results than becoming involved in corporate governance, ethics and the environment on a broader basis.

The Executive Board has identified six focus areas for active ownership. Executive Director Yngve Slyngstad will report in more detail on this work, but allow me to touch on one area where we have had positive results: children's rights. In June last year, four large companies in which we are shareholders – the US companies DuPont and Monsanto, the German companies Bayer and the Swiss company Syngenta – announced a joint effort to combat child labour in seed production – a joint effort initiated by Norges Bank. The trade association CropLife published a plan for the industry setting out a common approach to eliminating exploitive child labour, also among suppliers and other partners in the industry.

In the first quarter this year, we published our second report on developments in children's rights in industries in which we have invested. The report revealed that a third of the companies that we contacted the previous year had improved their behaviour and reporting in this area. The number of companies stating that they assess the risk of child labour has tripled. There was also a strong increase in the number of companies publishing their guidelines. Some companies have action plans to prevent exploitive child labour, both in their own operations and in their supply chains.

As with our other ownership work, we deal with companies' boards, which are there to represent us, the shareholders. From time to time, the board and management of a company will have a different perception of the situation than other observers may have. This work is therefore an unending process. Companies should also know that we have expertise in the use of child labour, that we are expanding our expertise, and that we will follow up not just in one or two years but also in five, ten and 20 years.

Reporting on NBIM's activities and the GPFG's accounts has become even more transparent in recent years. We are providing additional and more detailed analyses of management results, and evaluating risk along more dimensions. The notes to the financial reporting are more extensive, especially with regard to risk and valuation. We publish the Executive Board's investment management rules, and disclose the GPFG's holdings and voting at general meetings. From April this year, we have published movements in the GPFG's market value on our website in real time.

To conclude: The strategy for the GPFG has proved to be robust, as has active management. Over the past decade, we have built up an investment management organisation that manages one of the world's largest funds in addition to most of the Bank's foreign exchange reserves.

I cannot hide that I am not only pleased but also somewhat proud that this organisation has managed to cope with the effects on the GPFG of one of the greatest financial crises in history.

Thank you for your attention.

Footnotes

1) The deviation applies in relation to the GPFG's actual benchmark portfolio.

2) The measure is defined as expected relative volatility for the GPFG's portfolio

3) See page 78 in Report no. 10 to the Storting (2009-2010) for an overview of the framework for the supervision of the management of the GPFG.