NORGES BANK

Norwegian Ministry of Finance
Boks 8008 Dep.
0030 Oslo

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The fund in a changing world – consultation response

In 2021, the Ministry of Finance appointed a commission to consider which national and international economic and political developments might be relevant to the Government Pension Fund Global (GPFG) in the coming years, and their implications for the governance and management of the fund. The commission was headed by Ulf Sverdrup. The Ministry received the commission's report, *The fund in a changing world*, on 26 September 2022.[1]

The commission's report presents a detailed discussion of possible developments in Norway and abroad that could present a risk to the fund. The report provides a good starting point for increasing understanding of the risks faced by the GPFG, and the degree to which these risks can be addressed in the management of the fund.

The report was sent out for public consultation on 29 September 2022. Norges Bank's response follows in this letter. Our response concentrates on how possible developments might affect the investment strategy and Norges Bank's management of the fund.

General comments

The commission considers that the governance model with a clear division of duties between political authorities and operational management has functioned well and is the best point of departure in facing the risks outlined in the report. It notes that the fund has had a financial objective since its inception and is not a political instrument. It believes that the principle that the fund should be as broadly diversified as possible should be retained.

The commission writes that good financial returns and responsible investment are important for the fund's legitimacy, both nationally and internationally, but that it is important to have realistic expectations for what the fund can achieve. It considers that

[1] For further information, see Official Norwegian Reports NOU 2022:12 *The Fund in a changing world*.

POSTADRESSE
PB 1179 Sentrum,
0107 Oslo

BESØKSADRESSE
Bankplassen 2,
Oslo

Tel. 22 31 60 00
Faks 22 41 31 05
www.norges-bank.no
central.bank@norges-bank.no

Organisasjons-nummer
NO 937 884 117 MVA

the fund's reputation could be damaged if expectations are not met. For the GPFG to be a successful financial investor, the commission believes that the fund must be seen as a financial investor by investors and authorities outside Norway. The fund's objective must not therefore be watered down.

Norges Bank shares the commission's overall views. We manage the fund with the objective of the highest possible long-term return within the constraints laid down in the mandate from the Ministry of Finance. We place great emphasis on being a responsible investor. Responsible investment and active ownership contribute to long-term value creation and our objective of the highest possible return. By ensuring the greatest possible transparency about the management of the fund within the limitations imposed by responsible implementation of the management mandate, we aim to contribute to realistic expectations for what we can achieve.

The commission argues that, in principle, the GPFG is in a good position to face an uncertain future, but that its ability to deal with various changes and crises could be improved. We share the commission's view. We strive continuously to strengthen our situational understanding, develop our work on scenarios and stress testing, and improve our contingency planning so that we are better able to handle serious events and crises.

The commission writes that the expertise needed in an uncertain future goes beyond finance and investment management, referring in this context to problems in areas such as geopolitics, security, technology, ICT, machine learning and ethics. We recently published a strategic plan for the management of the fund over the next three years.[2] To achieve the goals in this plan, we will be strengthening our organisation in a number of areas to ensure capacity, quality and resilience. We strive continuously to attract talented personnel and develop our employees' skills in order to manage the fund as best possible.

Potential challenges

The first and second parts of the commission's report identify developments and risk factors that could affect the GPFG's ability to achieve its objective of the highest possible return with acceptable risk. This backdrop provides basis for a summary of possible scenarios for which the GPFG should be prepared. Finally, the third part of the report discusses how a new risk outlook could be handled.

The commission argues that the scenarios in the second part of the report illustrate the importance of:[3]

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[2] For further information, see Strategy 25 under Publications at www.nbim.no.

[3] The commission also mentions a number of other important factors. We have chosen here to discuss its points concerning the fund's operational management and investment strategy.

1. Broad political support for the management model, with the emphasis on a financial objective for the fund's investments.
2. Paying attention to the geographical distribution of the fund's investments.
3. Paying close attention to various aspects of increased operational risk in the management of the fund, including cyber risks, and securing an appropriate level of tolerance of operational risk on the part of the fund's owners.
4. Being transparent and honest about the fund facing some tricky dilemmas and challenging trade-offs.
5. Identifying whether there may be developments in the market that mean that the listed companies in which the GPFG is invested will not sufficiently capture returns on capital in the global economy.

Our assessment of these factors follows below.

<u>1. Broad political support</u>
The fund's investment strategy has evolved over time. The numerous adjustments to the strategy have taken place following extensive scrutiny. Norges Bank's role has been to provide the Ministry of Finance with advice and analysis. The Ministry has reported on planned changes to the investment strategy in its annual white papers to the Storting. Norges Bank considers it important to have broad and deep support for major changes to the fund's investment strategy. This ensures that we can abide by key decisions in periods of turbulent markets.

<u>2. The fund's geographical distribution</u>
The fund's geographical distribution is a key element in the commission's report. The Ministry of Finance defines the fund's benchmark index. One important premise for the investment strategy is that the fund is to managed close to this index. The composition of the index is therefore very important for the fund's actual investments, and hence for its return and risk. The composition of the benchmark index is based largely on the index provider's categorisation of which markets should be included.[4] In 2021, the Ministry decided not to include more markets in the fund's equity index. Instead, it announced broad reviews of the framework for and composition of the benchmark index.[5]

The commission recommends that the Ministry carries out regular reviews of the geographical distribution of the fund's investments.[6] It writes that, as part of these regular reviews, risks should be assessed thoroughly, and the potential consequences of different choices must be presented clearly in the information provided to the Storting. In

[4] For a more detailed description of the index provider's methods and rules for including markets in the equity index, see Enclosure 1 to Norges Bank's letter to the Ministry of 22 August 2019.
[5] For further information, see Report to the Storting No. 24 (2020-2021) *The Government Pension Fund 2021*.
[6] Norges Bank presented advice on the geographical composition of the equity index in its letter to the Ministry of 21 August 2019. We have not performed a new assessment in connection with this letter.

the same way as for the fund's financial risk, it is important for risks along other dimensions to be properly understood and anchored. Norges Bank can assist the Ministry with such reviews in its role as adviser. In Report to the Storting No. 24 (2020-2021) *The Government Pension Fund 2021*, the Ministry wrote that it has historically performed such reviews at intervals of a few years. Norges Bank believes that the need for stability, a long-term horizon and predictability in the management of the fund argues in favour of continuing this practice.

The commission believes that broad geographical diversification leaves the fund less exposed to developments in individual countries. On the other hand, it notes that the goal of diversification can be expected increasingly to come into conflict with other political considerations. The commission writes that while partly or wholly restricting the fund from investing in certain countries or companies might be desirable for ethical, security or political reasons, it may also come at a cost in the form of the portfolio having weaker return and risk characteristics. Norges Bank believes that any restrictions on political, ethical and security grounds must be reflected in the fund's benchmark index.

A need to restrict the fund from investing in specific countries may arise because of a particular event or crisis. The decision to exclude Russia from the fund's benchmark index on 28 February 2022 is one example of this. The commission does not rule out the possibility of similar events occurring in the future. It is important to be aware that it is difficult to identify events of this kind before they occur or result in financial losses for the fund. Nor are we able to make significant changes to the portfolio if a crisis or serious event occurs suddenly.[7]

If a country or market is to be excluded from the fund's benchmark index, the Ministry should draw up a plan for phasing it out, as is the case today. The size of the fund means that these phase-outs can take a long time. The Ministry can also allow Norges Bank to deviate from the provisions of the mandate in special circumstances.[8] Norges Bank is therefore of the view that there is sufficient flexibility in the mandate.

The mandate requires the Executive Board to approve all markets and countries before investments may be made in them, whether or not they are included in the benchmark index. Norges Bank must have procedures for these approvals, including regular reviews of previously approved markets and countries. In addition to Norges Bank's approval process, countries and markets are monitored continuously in the operational management of the fund.

The first step in the approval process is to assess the market or country in question against the fund's investment strategy. This is followed by a broad review of relevant

[7] In a crisis, poor liquidity and other obstacles may make a sell-off very difficult. Our experience with equity investments in Russia illustrates this.
[8] See Section 8-1 of the mandate: "Scope for derogation from the provisions".

investment and operational risks, which is the minimum requirement for the fund to be permitted to invest in new markets and countries. Information on relevant risks is obtained from recognised international organisations and data providers.[9] However, the risk of future crises or serious events will only to a limited extent be captured by this approval framework.

The commission writes that Norges Bank's capacity not to approve an equity market or an issuer of government bonds in the benchmark index are constrained by the risk limit for active management. Not approving a market or country that is part of the fund's benchmark index, and is of a certain size, could result in this risk limit being exceeded. Norges Bank shares the commission's view. If a country or market does not satisfy our approval criteria, Norges Bank can advise the Ministry to amend the benchmark index outside the scope of its broad reviews of the framework for and composition of the benchmark index.[10]

3. Operational risk

Operational risk is the risk of an unwanted event occurring as a result of human error, failure of processes or systems, events caused by third parties, or other external factors. The commission argues that, in principle, the GPFG is in a good position to face an uncertain future, but that it could be made more robust to various structural changes and crises.

We agree with the commission and believe that insight into external threats and good situational understanding are essential for operational risk management. In managing operational risks, it is necessary for internal risk management and control functions to have a good understanding of vulnerabilities, and to have the ability to take targeted and cost-effective action to maintain an acceptable level of risk.[11] Regular assessment and reporting of operational risks, and follow-up of incidents, contribute to this, ensuring that issues are reported and addressed as quickly as possible, and helping us to learn from any mistakes made.

The management mandate requires the Executive Board to set a limit for operational risk. The Executive Board has made it a requirement that its operational risk tolerance is reviewed regularly. The commission writes that it may become more challenging to maintain low levels of operational risk. For example, the fund could be hit by various forms of cyberattack. More extensive sanction regimes and various investment restrictions are also increasing the risk of exceeding the limit for operational risk.

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[9] For a more detailed account of our procedures for the approval of financial instruments, markets and government bond issuers, see www.nbim.no.
[10] In Report to the Storting No. 24 (2020-2021) *The Government Pension Fund 2021*, the Ministry wrote: "The Ministry, like Norges Bank, believes that, in special circumstances, it should be possible to assess markets in the benchmark index outside these broad reviews."
[11] Our guidelines for operational risk management can be found at www.nbim.no.

Norges Bank shares this view. On the other hand, it is important to stress that not all operational risk can be eliminated. There are also costs associated with reducing operational risk. These costs may be direct, such as recruiting additional staff or purchasing new system solutions, or indirect, through the organisation becoming more rule-bound and less flexible. The commission writes that a balancing act is required so that the organisation does not become too risk averse. These different considerations need to be weighed up in our work on operational risk.

Addressing digital threats

Digital threats are a significant risk factor for the fund. We may be hit by cyberattacks on systems and activities kept in-house at Norges Bank or on suppliers or the financial infrastructure. The commission focuses particularly on two factors that make digital threats a prominent risk for the fund. First, investment management is a digital business that is vulnerable to such threats. Second, the fund may be a target given its size and importance for Norway. The commission also points out that the more political attention the fund attracts, the more of a target it will be for activists and national actors. It stresses that the fund needs to have the best systems, good processes, expertise, and a strong security culture if it is to manage this risk. Norges Bank shares the commission's views.

Security is an integral part of our operational risk management. It is important that this work is continuously developed in a world where organised cybercrime is becoming more specialised, sophisticated, and well-financed. We have long worked systematically on building a strong security culture. This requires considerable effort and investment over time. We have paid particular attention to building expertise and developing robust controls and processes. We have also procured specialist services in information security. We set security requirements for our suppliers and follow them up. We will continue to strengthen our security management and security controls in our processes. This will put us in a better position to react to cyberattacks and restore systems and processes more quickly following such attacks.

Norges Bank depends on key functions in financial markets and various suppliers in its management of the fund. The commission presents potential scenarios where key functions and institutions in financial markets are hit by massive cyberattacks. Such scenarios could have major consequences for our performance and are largely beyond our control.

Contingency planning

Norges Bank has drawn up contingency plans for the management of the fund in the event of serious events and crises. We conduct regular contingency exercises. Crises affecting the fund may need to be managed in close co-ordination with the Ministry of Finance. There should therefore be clear processes in place for managing crises, with a clear division of responsibilities between Norges Bank and the Ministry. Further work should be done on the implementation of joint contingency exercises for relevant crisis scenarios.

4. Communication and transparency

Transparency is important for the fund's legitimacy. The commission writes that a high degree of transparency is practised today, and that this is important for confidence in the governance model and management of the fund.

Through our communication, we aim to promote a good understanding of our mission, how we invest, the risks we face, and how we exercise our rights as a shareholder in thousands of companies. We aim to contribute to increased knowledge about the fund in Norway and in different groups in society. This is done partly through extensive public reporting on the fund's results. We also offer guest lectures at universities on various aspects of investment management, responsible investment, and technology. We have regular editorial meetings with the largest Norwegian media houses, give interviews and write articles on topical issues. We give presentations at relevant seminars and conferences. We have given particular priority to making more of our experts visible in order to build confidence in us as an organisation.

The commission writes that emphasis should be given to providing clear information to the authorities and media in other countries about what the fund is and what it is not. The commission argues that the GPFG's ability to be a successful financial investor depends primarily on the fund being seen as a financial investor by investors and authorities abroad. Any doubts about the fund's role could undermine its ability to benefit from free and open capital markets without restrictions on its investments. Norges Bank shares the commission's view and will continue to work actively on raising awareness of the fund's role internationally.

The commission also notes that there may be limits to transparency, and that Norges Bank should be careful about expressing anything that could be taken as criticism of the authorities in other countries and thus touch on foreign policy. Norges Bank shares this view.

5. Value creation in the listed and unlisted equity market

The fund is not generally permitted to invest in unlisted equities. The commission writes that if a significant share of global value creation moves out of the listed market, consideration will need to be given to the implications for the fund's investment strategy.

Norges Bank closely monitors developments in both the listed and the unlisted equity market. We are seeing more and more indications that a larger share of value creation is taking place in the unlisted market. For example, the market for unlisted equities has grown in size in relation to the listed equity market. In 2017, an expert group appointed by the Ministry of Finance estimated that the unlisted market was 5 percent of the size of the listed market. The Bank's updated estimates suggest that this figure is now around 8 percent[12].

We have also seen that the number of listed companies worldwide has levelled off.[13] In large developed markets such as the US, the UK and the euro area, the number of listed companies has long been in decline. Companies listing are also older and larger than before. These trends may mean that the fund misses out on an increasing share of companies' value creation by waiting until they are listed and eventually enter the fund's benchmark index. Norges Bank believes it should be investigated whether the fund's investment strategy should reflect these trends, and whether unlisted equities in general should be included in the fund's investment universe.

A decision to permit the fund to invest in unlisted equities on a general basis would need to be preceded by a thorough assessment of the pros and cons, and of the appropriate orientation of such investments given the fund's characteristics. The introduction of unlisted equities would be a long-term decision requiring broad support.

Creation of an external council

The commission recommends that the Ministry of Finance considers setting up an independent council with members appointed for a fixed term, which is tasked with monitoring, examining and evaluating various aspects of the fund and making recommendations to the Ministry.

The Ministry of Finance is responsible for the fund's overall investment strategy set out in the management mandate. Norges Bank contributes to the development of the fund's overall investment strategy through its role as adviser to the Ministry.[14] Our experience from managing the fund and our proximity to the investment portfolio put us in a good position to provide the Ministry with strategic advice. We have a dedicated team working on advice and analysis relevant to the further development of the fund's strategy. We develop bespoke analytical tools and make extensive use of internal and external data sources. We collaborate with similar funds, academia, market participants and other external experts to develop and assure the quality of our work.

As part of the work on developing the investment strategy, the Ministry has also commissioned external expert groups to examine specific issues. If the Ministry decides to set up a permanent external council, Norges Bank believes that its role needs to be clearly defined. It should also be made clear how such a council differs from the Ministry's established processes for advice on the investment strategy. The creation of such a council should not compromise the clear lines of responsibility in the current

[12] Both the expert group's and Norges Bank's estimates are based on asset under management in private equity funds.
[13] World Bank Development Indicators.
[14] The Bank has a duty to advise the Ministry, as set out in Section 1-4 of the mandate.

governance model.

The management mandate
The fund’s investment strategy is set out in the management mandate issued by the Ministry of Finance. The mandate has become more extensive and more detailed over time. The commission recommends that the Ministry considers whether it might be appropriate to have a more general and principles-based mandate.

Norges Bank believes that it may be useful to conduct a fresh review of the management mandate for the GPFG in the light of the commission’s report.

Yours faithfully

Ida Wolden Bache Nicolai Tangen