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Government Pension Fund Global – Guidelines for investments in government bonds

In Recommendation 326 S (2015-2016), the Standing Committee on Finance and Economic Affairs discusses the fund's investments in government bonds and raises a number of issues in this context, including that of guidelines for the fund's investments in government bonds. In a letter of 29 June 2016, the Ministry asks for Norges Bank's comments on these issues as input for the Ministry's own assessments. The Bank's comments follow below.

The current guidelines for investments in government bonds

The fund's investment universe is defined in section 3-1 of the mandate, which states that the fund may be invested in all tradable government bonds with the exception of "fixed-income instruments issued by governments or government-linked entities in the exceptional cases where the Ministry has barred such investments based on particularly large-scale UN sanctions or other international initiatives of a particularly large scale that are aimed at a specific country and where Norway supports the initiatives".[1] At present, only two nations are excluded from the investment universe under this rule: North Korea and Syria.

Approval of markets and instruments
Section 4-10 of the fund's management mandate requires the Bank to approve all markets and instruments the fund is invested in.[2] As part of this process, the Bank conducts a thorough due diligence review of aspects such as legislative frameworks, the rule of law, corruption, tax systems and any restrictions on the repatriation of assets in the relevant country. This comes in addition to assessments of market, instrument and operational risks. The purpose of the Bank's process for approving markets and instruments is to ensure that the fund's assets are sufficiently safeguarded. Any risk that the legitimacy of government debt could be questioned will emerge in this context.

[1] Norway has endorsed UNCTAD's *Principles on Promoting Responsible Sovereign Lending and Borrowing*. The restrictions on the investment universe in the mandate for the fund conform to the sixth of these principles.
[2] The CEO of Norges Bank Investment Management has issued guidelines on how this process is to be implemented. See https://www.nbim.no/globalassets/documents/governance/policies/policy---investment-universe.pdf.

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In our work on approving a new market or instrument, the Bank draws on a number of external sources, including the World Bank's Worldwide Governance Indicators[3], Verisk Maplecroft, the Economist Intelligence Unit, UNCTAD's Investment Policy Hub, the Heritage Foundation/Wall Street Journal Index of Economic Freedom, and Transparency International's Corruption Perceptions Index. The Bank also obtains information from independent legal advisers in the relevant country.

The process for approving markets and instruments is the same whether it is for government bonds in a new country, investments in equities or the approval of a new financial instrument. The list of approved markets and instruments is subject to review. At the end of the third quarter of 2016, the Bank had approved 31 currencies in 44 countries for investments in government bonds. The number has been unchanged since the first quarter of 2013.

Credit ratings

Section 3-5 (3) of the mandate reads: "The Bank shall organise the management with the aim that high-yield bonds (credit rating lower than investment grade) do not exceed 5 per cent of the market value of the bond portfolio. A credit rating is required for investments in debt instruments."[4]

External credit ratings from the three largest rating agencies are currently available for all of the fund's investments in government bonds.[5] The agencies' weighting of institutional quality is particularly relevant to the issues on which the Bank is being asked to provide input.[6] Both Moody's and Fitch assess institutional quality on the basis of indicators from the World Bank.[7] All three agencies attach importance to transparency, stability, predictability and accountability in public processes and the quality of fiscal management. Moody's also considers it particularly important whether public power is used for private gain. S&P looks at whether the legitimacy of debt issued by former authorities could be questioned. Where this is the case, the country is automatically assigned the lowest score in the assessment of institutional quality. Bonds issued by countries in this category will be considered high-risk by S&P.

Fiscal strength

The government part of the fund's benchmark index for bonds is based on GDP weights. In a market-weighted index, a country that issues more debt will be assigned an increasing weight, whereas its weight in a GDP-weighted index will vary with its economic output, all else equal. The credit rating agencies also attach importance to fiscal strength in their ratings. Metrics such as government debt to GDP, government debt to revenue, interest

[3] See http://info.worldbank.org/governance/wgi/index.aspx#home for a detailed account of how these indicators are produced.
[4] Bonds with a credit rating lower than investment grade accounted for around 2 percent of the bond portfolio at the end of 2015, based on current ratings. See the enclosure for more information on the government bond portfolio.
[5] The three largest rating agencies are Standard & Poor's (S&P), Moody's and Fitch.
[6] See *Sovereign Rating Criteria*, Fitch Ratings, July 2016; *Rating Methodology Sovereign Bond Ratings*, Moody's Investor Service, December 2015; *Sovereign Rating Methodology*, S&P Global, June 2016.
[7] Worldwide Governance Indicators (WGI).

expense to revenue receipts, debt dynamics, debt structure and other contingent liabilities are important in this regard.

Section 3-5 (4) of the mandate states: “The Bank shall seek to take account of differences in fiscal strength between countries in the composition of government bond investments.” For government bonds issued in euros, this requirement is currently implemented by means of special country factors which mean that countries with weak government finances are given a lower weight in the portfolio.

The Bank manages the fund within a limit for expected relative volatility (tracking error) of 1.25 percentage points. Significant differences in the currency composition of the portfolio and the benchmark index will utilise much of this limit. Like the benchmark index, the fund’s investments in government bonds are concentrated in major currencies such as the US dollar, pound sterling and Japanese yen. It has proved challenging to differentiate systematically between bonds issued in these currencies on the basis of differences in fiscal strength beyond that which results from the GDP-weighting of the government bond sub-index.

Guidelines issued by the IMF and OECD

The Ministry’s letter asks the Bank to look at whether frameworks developed by the IMF and OECD can be used to shed light on the issues raised by the Standing Committee on Finance and Economic Affairs in Recommendation 326 S. These guidelines have been drawn up primarily for issuers of government debt and entities responsible for public budgetary processes rather than investors in government bonds.

The aim of the IMF’s Guidelines for Public Debt Management is to ensure that government financing needs and payment obligations are met at the lowest possible cost over the medium to long run.[8]

Like the credit rating agencies, the IMF attaches importance to transparency and accountability in debt management and sets out principles for risk management and debt structure. The IMF stresses the importance of developing a market for domestic government securities, which is also a focus area in the Bank’s approval process. In addition, the IMF provides guidance on institutional frameworks and internal reporting procedures, but these parts of the guidelines appear less relevant to investors in government debt and will also be very difficult to verify.

The IMF and OECD have also developed guidelines for public budgetary processes.[9] The Bank’s view is that the relevant points in these guidelines are already addressed in its

[8] See *Guidelines for Public Debt Management*, IMF/World Bank, 2003; *Revised Guidelines for Public Debt Management*, IMF/World Bank, 2014.
[9] See *Recommendation of the Council on Budgetary Governance*, OECD, 2015; *Guidelines for Public Expenditure Management*, IMF, 1999.

approval of markets and instruments, and are reflected in the credit ratings for different issuers.

Yours faithfully

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Enclosure

- The fund’s investments in government bonds as at 31 December 2015 and credit ratings as at 30 November 2016

Enclosure

The fund's investments in government bonds as at 31 December 2015 and credit ratings as at 30 November 2016

Country	Holding in billions of kroner	Percentage of fund (ex real estate)	Percentage of bond investments	Median credit rating
United States	540	7.46	20.25	AAA
Germany	233	3.21	8.72	AAA
Japan	224	3.09	8.38	A+
United Kingdom	94	1.30	3.54	AA
Canada	69	0.96	2.60	AAA
France	66	0.92	2.49	AA
Mexico	62	0.85	2.32	A-
South Korea	57	0.79	2.13	AA
Spain	55	0.76	2.07	BBB+
Australia	42	0.58	1.57	AAA
Italy	41	0.57	1.55	BBB
Netherlands	35	0.48	1.31	AAA
India	33	0.46	1.24	BBB-
China	29	0.40	1.07	AA-
Turkey	27	0.38	1.03	BB+
Poland	24	0.33	0.91	A-
Brazil	23	0.32	0.87	BB
Sweden	23	0.32	0.87	AAA
Austria	21	0.29	0.79	AA+
Switzerland	18	0.25	0.68	AAA
Russia	17	0.24	0.65	BBB-
Indonesia	16	0.22	0.59	BBB-
Finland	14	0.20	0.54	AA+
Denmark	13	0.18	0.49	AAA
Belgium	11	0.15	0.42	AA
Malaysia	11	0.15	0.41	A-
Singapore	11	0.15	0.41	AAA
Chile	11	0.15	0.41	AA-
Israel	10	0.14	0.38	A+
South Africa	10	0.14	0.38	BBB
Thailand	10	0.14	0.37	BBB+
Colombia	10	0.13	0.36	BBB
Taiwan	9	0.13	0.34	AA-
Czech Republic	9	0.12	0.33	A+
Philippines	6	0.09	0.24	BBB
New Zealand	6	0.08	0.22	AA+
Slovenia	5	0.07	0.20	A-
Hong Kong	2	0.03	0.09	AA+
Hungary	2	0.03	0.07	BBB-
Lithuania	2	0.02	0.06	A-
Ireland	2	0.02	0.06	A
Slovakia	2	0.02	0.06	A+
Portugal	1	0.02	0.05	BB+
Latvia	1	0.02	0.04	A-

Table headings:
Country
Holding in billions of kroner
Percentage of fund (ex real estate)
Percentage of bond investments
Median credit rating