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Mandate for the Government Pension Fund Global – framework for bond investments

In Recommendation 344 S (2018-2019), the Storting agreed that bonds issued by governments and companies in emerging markets should be removed from the benchmark index for bonds, and that a limit of 5 percent of the bond portfolio should be set for investments in such bonds. The Storting also agreed that the current weighting principle for government bonds based on gross domestic product (GDP) should be retained, with a few adjustments.

The Ministry proposes adjusting the management mandate to reflect these changes and asks in its letter of 26 June for the Bank's comments. The Bank is also asked to assess the rebalancing rule for the corporate bond subindex of the benchmark index and to propose a plan for phasing out bonds issued by governments and companies in emerging markets from the benchmark index. The Bank's comments on the proposed mandate changes, assessment and proposed phase-out plan follow below. The enclosure with the detailed plan for phasing out bonds are exempt for access.

The Bank's comments

General comments

The Ministry proposes that the provisions on emerging markets in the mandate are not updated until the phase-out of these bonds is completed. The Bank believes that it would be more appropriate for the strategic decision not to include bonds issued by governments and companies in emerging markets in the benchmark index for the bond portfolio to be reflected clearly in the mandate as of now. This will make it clear that the new country weights in the government bond portfolio will not apply to emerging markets, ensure that the mandate better reflects the strategic choices made, and be consistent with the procedure employed when the bond index was last modified in 2012. The Bank's comments in this letter presuppose such a procedure.

Specific comments

The new benchmark index for the bond portfolio will include only bond issuers in developed markets. The Ministry proposes that country and market classification should be based on the classifications used by the index provider Bloomberg L.P.

The index provider has set criteria for when a market is to be classified as emerging.[1] Developed markets are all those that are not classified as emerging, but this is not a classification used by Bloomberg. To avoid uncertainty about which markets are to be included in the government portfolio, we propose that a provision is added to the mandate stating that the subindex for government bonds includes securities that are part of the *Bloomberg Barclays Global Developed Treasury GDP Weighted* index. Alternatively, the Ministry could introduce a currency list also for the government subindex of the benchmark index in line with the Bank's letter of 1 September 2017.

The Ministry proposes assigning adjustment factors to issuers of government bonds. The mandate should state that the limit of twice market value is to be calculated on the basis of the market value of all three segments of the government subindex.

The Ministry proposes that the adjustment factors are updated in the event of changes in the market composition of the government subindex. To allow cost-effective adjustment to such changes, the Bank proposes that a provision is added to the mandate stating that the Ministry, in consultation with Norges Bank, is to establish a plan for how such changes are to be implemented in the benchmark index. These plans should reflect the size and liquidity of the market moving in or out of the index.

Bonds issued by companies domiciled in emerging markets are to be removed from the benchmark index. The corporate subindex of the benchmark index for the bond portfolio is currently defined on the basis of the currency in which the bonds are issued. The mandate needs to contain a new provision regulating where companies issuing bonds

[1] The criterion for classification as an emerging market is that the country is ranked by the World Bank as having low or middle income per capita or is not classified as advanced by the International Monetary Fund (IMF). Four countries are currently excluded from these criteria and classified as emerging markets: the Czech Republic, Israel, South Korea and Taiwan are all classified as countries with high income per capita by the World Bank, while the Czech Republic, Israel and South Africa are classified as advanced markets by the IMF.

may be domiciled. One possible approach is to specify that the subindex includes only securities issued by companies domiciled in countries included in the government subindex, and also in one of the seven permitted currencies. The country classification of companies mirrors that of the index provider.

In line with the current mandate provisions, the GDP weights in the government subindex are to be adjusted on 30 November 2019. To reduce transactions, we recommend that the updated provisions for the bond index enter into force from the same date. We assume that the adjustment factors will not apply to emerging markets.

Rebalancing of the corporate subindex

Corporate bonds will continue to make up 30 percent of the benchmark index for bonds. Currently, the corporate subindex is to be rebalanced monthly. The Ministry has asked the Bank to consider whether there is a need to amend this provision in order to reduce transaction costs.

We have compared the current rule with a number of alternative rules.[2] In all of the alternatives considered, corporate bonds are traded less frequently than with the current rule. This may serve to reduce transaction costs in the benchmark index. However, the amounts that need to be traded when rebalancing occur will be larger. Since the financial crisis, the Bank has found it more challenging to perform large transactions without impacting on market prices. The benefits of trading less frequently can therefore easily be outweighed by the costs of large transactions each time trades are made. On balance, the Bank recommends no changes to the current provision.

Phase-out plan from the benchmark index

At the end of June 2019, the index value of bonds issued by governments and companies in emerging markets was around 230 billion kroner. The benchmark index had an average ownership share in these markets of around 3 percent. Gradual adjustment of the benchmark index will facilitate a cost-effective phase-out.

The transaction pressure will be affected by market developments during the phase-out period. The portfolio currently has a different composition to the benchmark index. The Bank will manage the portfolio in such a way that bonds from selected emerging markets will remain part of the portfolio. This means that the need to buy and sell bonds will be slightly less than in the plan for phasing out emerging-market bonds from the benchmark index.

The Ministry proposes that a limit of 5 percent of the bond portfolio should be set for investments in bonds issued by governments and companies in emerging markets. The Bank assumes that this provision will not enter into force until the phase-out of emerging-market bonds from the benchmark index has been completed. This provision may, however, be included in the mandate now, cf. the Bank's general comments above.

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[2] The alternatives we have looked at include annual rebalancing, rebalancing when the equity share is rebalanced, and rules with different intervals for how far the corporate bond share may stray from the strategic allocation of 30 percent.

Yours faithfully

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