Norges Bank Investment Management

Annual Report 2007

Government Pension Fund – Global
Norges Bank's foreign exchange reserves
Government Petroleum Insurance Fund

NBIM
Norges Bank Investment Management

Overviews of holdings of equities and fixed income instruments are available on our website www.nbim.no

Government Pension Fund – Global. Key figures 2007

Market value in billions of NOK at 31.12.2007

Total portfolio	2 018.6
Equity portfolio	957.9
Fixed Income portfolio	1 060.7

Transfers from the Ministry of Finance in 2007 (in billions of NOK)

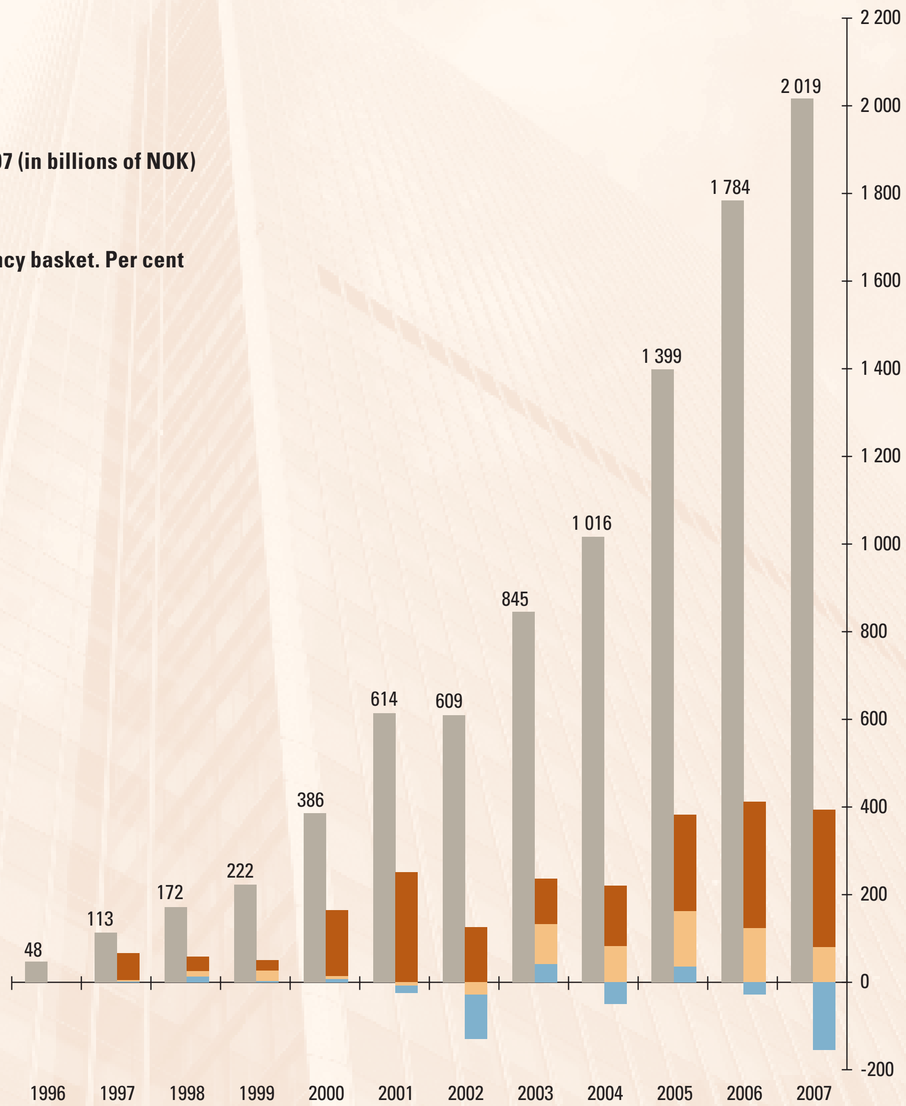
313.6

2007 return measured in international currency basket. Per cent

Total portfolio	4.26
Equity portfolio	6.82
Fixed Income portfolio	2.96

Gross excess return

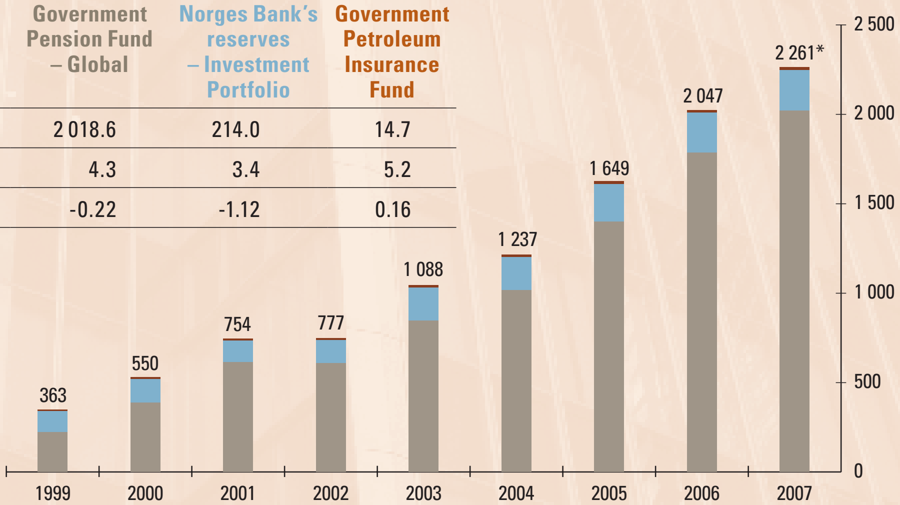
-0.22 percentage point



Transfers
Return in international currency
Effect of changes in the NOK exchange rate
Market value at 31.12

Total assets under management. Key figures 2007

	Government Pension Fund – Global	Norges Bank's reserves – Investment Portfolio	Government Petroleum Insurance Fund
Market value at 31.12.2007 (in billions of NOK)	2 018.6	214.0	14.7
2007 return in currency market (%)	4.3	3.4	5.2
Excess return (percentage points)	-0.22	-1.12	0.16



Government Petroleum Insurance Fund
Norges Bank´s Investment Portfolio
Government Pension Fund – Global

* Including the foreign exchange reserves buffer portfolio, with a market value of NOK 14.1 billion at 31.12.2007.

The first ten years

This is the tenth Annual Report to be published by Norges Bank on the management of the Government Pension Fund – Global. In January 1998, the Bank created a new unit – Norges Bank Investment Management (NBIM) – and large-scale purchases of equities in the global capital market began in line with a new strategy issued by the Ministry of Finance and approved by the Storting (Norwegian parliament).

The average annual real return on the fund after management costs during the first ten years was 4.3 per cent. There was a nominal return of 7.0 per cent on equities and 5.1 per cent on bonds. In absolute terms, there was a total return of NOK 504 billion – including NOK 302 billion from equity investments, which accounted for around 40 per cent of the portfolio until 2007.

NBIM's results are measured relative to a benchmark portfolio defined by the Ministry of Finance. The average annual excess return during the first ten years was 0.40 percentage point. Active management did not increase the fund's market risk. These results were achieved at the same time as investing new capital of NOK 1 756 billion in the markets and building up the investment management organisation.

NBIM's most important roles are to invest new capital as cost-effectively and safely as possible in the capital markets, establish the strategic portfolio chosen by the capital's owner, and attempt to generate a slightly higher return through active management. Since the introduction of new Ethical Guidelines for the management of the fund in 2004, the exercise of ownership rights has also been a priority. In addition, NBIM provides input to the Executive Board of Norges Bank with its recommendations on investment management strategy to the Ministry of Finance.

In 2007, NBIM opened an Asian office in Shanghai. It now operates from four offices, the others being in Oslo, London and New York. This internationalisation process is also reflected in NBIM's workforce: its approximately 180 permanent employees hail from 20 different countries.

The nominal return on the Government Pension Fund – Global in 2007 was 4.3 per cent, which is below the average for the first ten years. NBIM's active management made a negative contribution for the first time. The negative excess return in 2007 was 0.22 percentage point.

This Annual Report presents NBIM's global investment management operations. In addition to the Government Pension Fund – Global, NBIM manages the bulk of Norges Bank's foreign exchange reserves and the Government Petroleum Insurance Fund. Special mention is given to work on exercising ownership rights, and there is a separate feature article looking back at NBIM's first decade.

We hope that this Annual Report gives the reader a good basis for assessing how Norges Bank conducts its investment management activities in global financial markets.

Svein Gjedrem
Governor of Norges Bank

Yngve Slyngstad
Executive Director of NBIM

1 – Key figures 2007

Government Pension Fund – Global

The Government Pension Fund – Global is a continuation of the Government Petroleum Fund, which was established in 1990.

The purpose of the Government Pension Fund – Global is to support government savings to fund public pension expenditures, and to promote long-term considerations in the application of government petroleum revenues. The Ministry of Finance owns the fund and has delegated its operational management to Norges Bank. Norges Bank Investment Management (NBIM), a separate business area within Norges Bank, is responsible for the operational management of the fund.

Key figures 2007

The return on the Government Pension Fund – Global in 2007 was 4.3 per cent measured in international currency. The return on the equity portfolio was 6.8 per cent, while the return on the fixed income portfolio was 3.0 per cent. Measured in NOK, the return on the fund was -3.9 per cent in 2007. The difference between the return in international currency and the return in NOK is due to movements in the krone exchange rate, which have no effect on the long-term international purchasing power of the fund.

The return achieved by Norges Bank was 0.22 percentage point lower than the return on the benchmark portfolio defined by the Ministry of Finance. There were positive contributions from both internal and external equity management, but these were outweighed by negative contributions from both internal and external fixed income management. 2007 was the first year since 1998 with a lower return on the actual portfolio than on the benchmark portfolio.

The market value of the fund was NOK 2 019 billion at the end of 2007, an increase of NOK 235 billion since the beginning of the year.[1] New capital of NOK 314 billion was transferred to the fund from the Ministry of Finance, and the return on investment increased the market value of the fund by NOK 75 billion. The value of the currencies in which the fund is invested fell against the Norwegian krone, reducing the NOK value of the fund by NOK 154 billion.[2]

Returns in the period 1997-2007

The return on the Government Pension Fund – Global is shown in Table 1-1. Since 1997, the average annual nominal return has been 6.29 per cent measured in international currency. The return has been positive in nine of these years and negative in two. In 1997, the fund was invested only in government securities. Since 1998, the portfolio has consisted of

[1] There is a difference between the market values used in the return calculations and the accounts to 31 December 2007. This is due to different valuation methods for money market investments.

[2] When measuring returns, the exchange rate effect is calculated on the basis of the benchmark portfolio's currency composition at the beginning of each month and associated exchange rate movements. The exchange rate adjustments in the accounts are calculated on the basis of the fund's actual composition. Revenues and expenses are converted at the exchange rate prevailing on the transaction date, and assets and liabilities are converted at the market rate prevailing at the end of the month. These adjustments will therefore differ from the estimated exchange rate effect in the return calculations.

Table 1-1: Nominal and real annual return measured in terms of the fund's currency basket 1997-2007. Per cent

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1997–2007
Nominal return												
- Equity portfolio	-	12.85	34.81	-5.82	-14.60	-24.39	22.84	13.00	22.49	17.03	6,83	7,00*
- Fixed income portfolio	9.07	9.31	-0.99	8.41	5.04	9.90	5.26	6.10	3.82	1.93	2,96	5,12*
- Total portfolio	**9.07**	**9.26**	**12.44**	**2.49**	**-2.47**	**-4.74**	**12.59**	**8.94**	**11.09**	**7.92**	**4,26**	**6,29**
Price inflation**	1.75	0.92	1.28	2.02	1.17	1.91	1.57	2.37	2.33	2.13	3,09	1,87
Real return	**7.19**	**8.26**	**11.02**	**0.46**	**-3.59**	**-6.53**	**10.85**	**6.41**	**8.57**	**5.67**	**1,14**	**4,34**
Management costs***	0.04	0.06	0.09	0.11	0.07	0.09	0.10	0.11	0.11	0.10	0,09	0,09
Net real return	**7.15**	**8.20**	**10.93**	**0.35**	**-3.66**	**-6.62**	**10.75**	**6.30**	**8.46**	**5.57**	**1,05**	**4,25**

* 1998-2007.
** Weighted average of consumer price inflation in the countries included in the fund's benchmark portfolio during the years in question.
*** Costs include fees to external managers for excess return achieved.

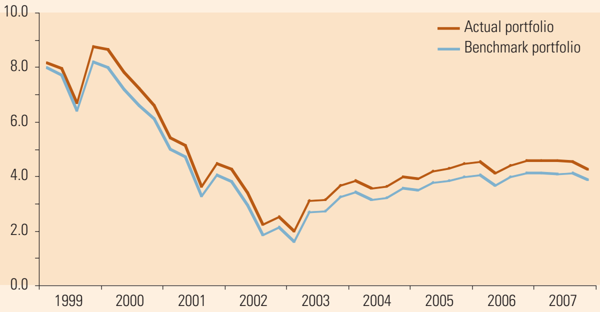


Chart 1-1: Average annual net real return on the Government Pension Fund – Global since 1997. Per cent

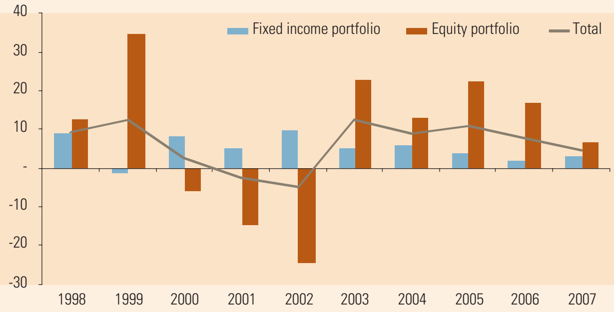


Chart 1-2: Annual return measured in terms of the fund's currency basket. Per cent

both equities and fixed income instruments. The average annual nominal return on the equity and fixed income portfolios in the period 1998-2007 was 5.12 and 7.00 per cent respectively.

The real return is the nominal return adjusted for inflation. For the fund as a whole, the annual real return since 1997 has been 4.34 per cent. On average, management costs have amounted to 0.09 per cent of assets under management. The annual real return since 1997 net of management costs has therefore been 4.25 per cent.

Chart 1-1 shows developments in the average annual net real return on the actual portfolio and the benchmark portfolio. The difference between the two curves expresses the excess return attributable to NBIM's management.

Chart 1-2 shows the annual percentage return on the equity and fixed income portfolios since 1998 measured in the fund's international currency basket. A positive return was recorded on the equity portfolio in seven of these ten years, and on the fixed income portfolio in all years except 1999.

The fund's cumulative return in international currency in the period from 1 January 1998 to 31 December 2007 was NOK 504 billion. This is indicated by the shaded area in Chart 1-3. The equity portfolio, which has made up just over 40 per cent of the fund, accounted for NOK 302 billion, or 60 per cent, of the cumulative return on the fund.

The red line in the chart shows the cumulative return on the equity portfolio. Between August 2001 and November 2003, the cumulative return on the equity portfolio was negative. The strong upswing in equity prices over the last four years is behind the positive return on the fund. The average purchase price for equity investments was 23.9 per cent lower than their market value at the end of 2007.

The blue line in the chart shows that the return on the fixed income portfolio has been far more stable. The cumulative return on the fixed income portfolio was NOK 202 billion at the end of 2007. This corresponds to 40 per cent of the aggregate cumulative return during the period. The average purchase price for fixed income investments was 15.4 per cent lower than their market value at the end of 2007.

The excess return for each quarter since 1998 is shown in Chart 1-4. NBIM has generated a positive excess return in 28 of the 40 quarters since the fund was first invested in equities. Since 1998, the cumulative return on the benchmark portfolio has been 72.6 per cent, whereas the actual return has been 79.4 per cent. The cumulative gross excess return has been 6.8 percentage points, or NOK 23.5 billion. The average annual excess return since 1998 has been 0.40 percentage point.

Norges Bank's foreign exchange reserves

The foreign exchange reserves shall be available for intervention in the foreign exchange market in connection with the implementation of monetary policy or to promote financial stability. The reserves are divided into a money market portfolio and an investment portfolio. In addition, a buffer portfolio is used for the regular foreign exchange purchases for the Government Pension Fund – Global. The investment portfolio and the buffer portfolio are managed by NBIM, while the money market portfolio of approximately NOK 8 billion is managed by Norges Bank Monetary Policy.

Key figures 2007

The return on the investment portfolio in 2007 was 3.4 per cent measured in international currency. The return on the equity portfolio was 4.4 per cent, while the return on the fixed income portfolio was 2.7 per cent. Measured in NOK, the return on the overall portfolio was -4.7 per cent. The difference between the return in international currency and the return in NOK is due to movements in the krone exchange rate, which have no effect on the long-term international purchasing power of the portfolio.

The return achieved by NBIM was 1.12 percentage point lower than the return on the benchmark portfolio defined by Norges Bank's Executive Board. There were negative contributions from both fixed income and equity management in 2007.

The market value of the portfolio was NOK 214 billion at the end of 2007, a decrease of NOK 10.5 billion since the beginning of the year. No capital was transferred to or from the investment portfolio during the year. The return on investment increased the value of the portfolio by NOK 7.5 billion, while a stronger krone reduced the NOK value of the portfolio by NOK 18.0 billion.

Returns in the period 1998-2007

The percentage return on the investment portfolio since 1998 is shown in Table 1-2. Until the end of 2000, the entire portfolio was invested in government fixed

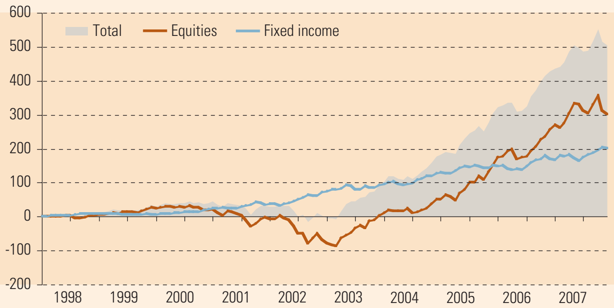


Chart 1-3: Cumulative return on the Government Pension Fund – Global 1998-2007. NOK billion

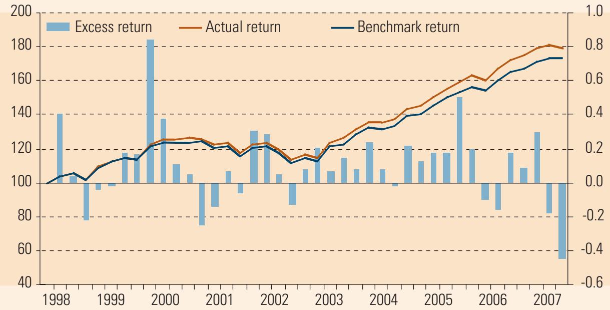


Chart 1-4: Index for cumulative actual return and benchmark return (31.12.97=100, left-hand scale) and quarterly gross excess return in percentage points (right-hand scale). Government Pension Fund – Global, 1998-2007

Table 1-2: Nominal and real annual return measured in terms of the investment portfolio's currency basket 1998-2007. Per cent

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Average 1998-2007
Nominal return											
- Equity portfolio	NA	NA	NA	-14.80	-26.36	20.48	11.85	20.53	17.03	4.39	3.18*
- Fixed income portfolio	9.78	-1.14	8.49	5.11	10.14	4.51	6.15	4.12	1.83	2.68	4.90*
- Total portfolio	**9.78**	**-1.14**	**8.49**	**2.44**	**2.17**	**8.28**	**7.75**	**9.08**	**7.30**	**3.37**	**5.69**
Price inflation**	0.94	1.35	2.11	1.33	2.03	1.51	2.41	2.37	1.99	3.09	1.91
Gross real return	**8.76**	**-2.45**	**6.24**	**1.10**	**0.14**	**6.67**	**5.21**	**6.56**	**5.21**	**0.27**	**3.71**
Management costs***	0.06	0.06	0.07	0.07	0.07	0.06	0.06	0.06	0.06	0.07	0.06
Net real return	**8.70**	**-2.51**	**6.17**	**1.03**	**0.07**	**6.61**	**5.15**	**6.50**	**5.15**	**0.20**	**3.65**

* 2001-2007.
** Weighted average of consumer price inflation in the countries included in the benchmark portfolio during the years in question.
*** Costs include fees to external managers for excess return achieved.

income securities. Since 2001, the portfolio has included equities, and the allocation to equities was increased from 30 to 40 per cent in 2006. Since 2002, the portfolio has also included non-government-guaranteed fixed income securities. The average annual nominal return on the portfolio since 1998 has been 5.69 per cent measured in international currency. In the seven years of equity investments, the average annual return on the equity portfolio has been 3.18 per cent. During the same period, the average annual return on the fixed income portfolio has been 4.90 per cent.

The annual gross real return since 1998 has been 3.71 per cent. On average, management costs have amounted to 0.06 per cent of assets under management. The annual net real return since 1998 has therefore been 3.65 per cent.

The fund's cumulative return in international currency in the period from 1 January 1998 to 31 December 2007 was NOK 86 billion. This is indicated by the shaded area in Chart 1-5. Equity investments have accounted for NOK 32 billion, or 38 per cent, of the cumulative return on the investment portfolio since it was first invested in equities on 1 January 2001.

The red line in the chart shows the cumulative return on the equity portfolio. From January 2001 to September 2004, there was a negative cumulative return on equity investments. The blue line in the chart shows that the return on the fixed income portfolio has been far more stable. The cumulative return on the fixed income portfolio was NOK 53 billion at the end of 2007. This corresponds to 62 per cent of the aggregate cumulative return during the period. During the time in which the investment portfolio has included both equity and fixed income investments, the cumulative return on fixed income investments has been NOK 33 billion, or 51 per cent of the aggregate cumulative return on the investment portfolio since 2001.

Since 1998, the investment portfolio's gross excess return has been positive in 29 out of 40 quarters (see Chart 1-6). During the same period, the cumulative return on the benchmark portfolio has been 73.1 per cent, whereas the actual return has been 74.0 per cent. The cumulative gross excess return measured in terms of the currency basket has been a total of 0.9 percentage point. Measured in NOK, the figure is NOK -0.45 billion, as the negative excess return occurred primarily in the last part of the period when the value of the portfolio was at its highest.

Buffer portfolio

The buffer portfolio is part of Norges Bank's foreign exchange reserves. The purpose of the portfolio is to ensure an appropriate supply of new capital to the Government Pension Fund – Global. The portfolio is built up continuously through foreign exchange transfers to Norges Bank from the State's Direct Financial Interest in petroleum activities (SDFI) and through Norges Bank's own foreign exchange purchases in the market to meet the foreign exchange requirements of the Government Pension Fund – Global. No particular benchmark portfolio has been defined for the buffer portfolio. With the exception of December, capital is normally transferred to the fund each month. The return on the buffer portfolio in 2007 was -2.4 per cent measured in NOK. The

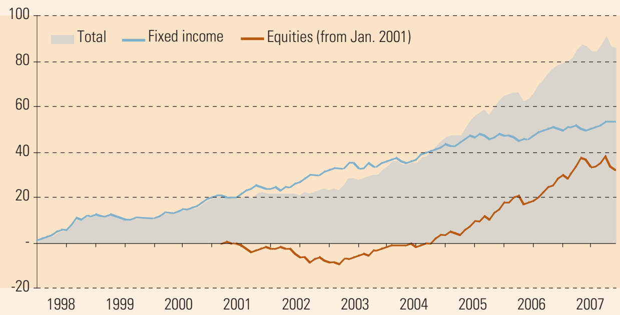


Chart 1-5: Cumulative return on the investment portfolio 1998-2007. NOK billion

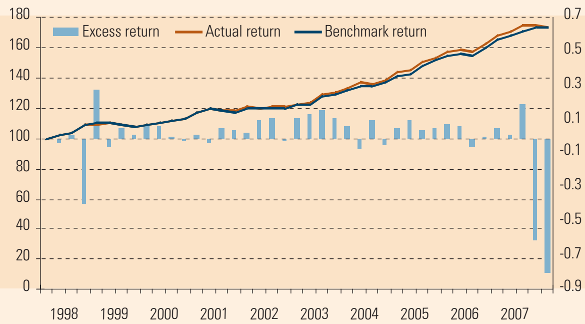


Chart 1-6: Index for cumulative actual return and benchmark return (31.12.97=100, left-hand scale) and quarterly gross excess return in percentage points (right-hand scale). Investment portfolio, 1998-2007

market value of the portfolio was NOK 14.1 billion at the end of the year.

Government Petroleum Insurance Fund

The purpose of the Government Petroleum Insurance Fund is to provide a reserve for payments to cover losses and liability associated with the State's Direct Financial Interest in petroleum activities (SDFI). The Ministry of Petroleum and Energy owns the fund. Pursuant to the Government Petroleum Insurance Fund Act, Norges Bank is responsible for the operational management of the fund.

Key figures 2007

The return on the Government Petroleum Insurance Fund in 2007 was 5.2 per cent measured in international currency. Measured in NOK, the return on the fund was -3.1 per cent. The difference between the return in international currency and the return in NOK is due to movements in the krone exchange rate.

NBIM achieved an excess return of 0.16 percentage point relative to the benchmark portfolio defined by the Ministry of Petroleum and Energy. The fund is invested only in fixed income instruments, and the entire fund is managed internally.

The market value of the fund was NOK 14.7 billion at the end of 2007, a decrease of NOK 0.5 billion since the beginning of the year. Premiums paid in by the government totalled NOK 1.1 billion. Claims payments also came to NOK 1.1 billion.

Table 1-3: Return measured in NOK and risk as at 31 December 2007. Annualised

	Last 2 years	Last 3 years	Last 5 years	Last 7 years	Since 1998
Pension Fund					
Portfolio return, per cent	0.88	5.16	7.71	1.51	4.90
Benchmark return, per cent	0.93	4.86	7.31	1.17	4.49
Excess return, percentage point	-0.05	0.30	0.40	0.34	0.40
Standard deviation, per cent	7.72	7.51	8.36	8.66	8.35
Tracking error, per cent	0.54	0.51	0.42	0.38	0.42
Information ratio	-0.09	0.60	0.96	0.88	0.96
Investment portfolio					
Portfolio return, per cent	0.13	4.03	6.08	2.32	4.60
Benchmark return, per cent	0.66	4.29	6.12	2.27	4.55
Excess return, percentage point	-0.53	-0.26	-0.03	0.05	0.05
Standard deviation, per cent	7.86	7.43	8.07	7.37	7.13
Tracking error, per cent	0.62	0.52	0.43	0.37	0.36
Information ratio	-0.86	-0.50	-0.08	0.13	0.15
Insurance Fund					
Portfolio return, per cent	-0.91	1.54	4.26	2.94	2.73
Benchmark return, per cent	-1.01	1.43	4.13	2.80	2.64
Excess return, percentage point	0.10	0.11	0.13	0.14	0.09
Standard deviation, per cent	7.80	7.04	7.76	6.87	6.64
Tracking error, per cent	0.10	0.09	0.08	0.09	0.15
Information ratio	0.95	1.28	1.61	1.66	0.57

- Calculations of the returns on the actual and benchmark portfolios are based on monthly returns which are linked together using geometrical methods. The figures are percentages and have been annualised. The excess return is calculated using arithmetical methods.
- The standard deviation is a measure of variations in the return/excess return during a period. Each monthly return/excess return is compared with the mean for the period. The higher the standard deviation. the greater the variations relative to the mean and the higher the risk.
- Tracking error is explained in Section 3.1.6.
- The information ratio (IR) is a measure of risk-adjusted return and is an indicator of skill in investment management. It is calculated as the ratio of excess return to the actual relative market risk to which the portfolio has been exposed. The IR indicates how much excess return has been achieved per unit of risk.

Negative excess return of NOK 7.8 billion overall in 2007

NBIM's investment management performance is measured against benchmark portfolios defined by the funds' owners. One important goal for its investment management is to generate a higher return over time on the actual portfolios than on the benchmark portfolios. In 2007, there was a negative excess return on the management of both the Government Pension Fund – Global and the investment portfolio in Norges Bank's foreign exchange reserves, while there was a positive excess return on the management of the Government Petroleum Insurance Fund. Overall, there was a negative excess return of NOK 7.8 billion.[3]

Chart 1-7 shows the cumulative excess return since the formation of NBIM in January 1998. The aggregate excess return during the period is NOK 23.2 billion. This breaks down into NOK 23.5 billion on the Government Pension Fund – Global, NOK -0.4 billion on the investment portfolio, and NOK 0.1 billion on the Government Petroleum Insurance Fund.

Table 1-3 provides an overview of risk and return since 1 January 1998 for the portfolios managed by NBIM.

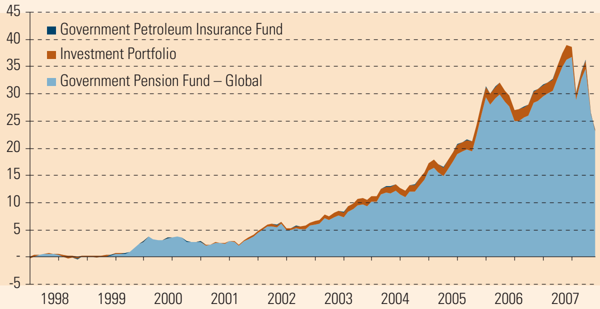


Chart 1-7: Cumulative gross excess return. NOK billion

[3] Allowance has not been made for NBIM's costs for phasing in new capital and implementing adjustments decided on by the clients. For 2007, these costs are estimated at NOK 1 498 million.

2 – Market developments in 2007

2.1 Macroeconomic developments

There was further strong growth in the global economy in 2007. However, there were clear signals towards the end of the year that growth was slowing, especially in the US. Economic data from the US revealed weaker growth in manufacturing output, a continued decline in the housing market, an increase in unemployment, and reduced growth in consumption. The latter part of the year also brought slower growth in Japan and Europe, and indicators revealed a generally less optimistic view of the economic outlook.

In emerging economies such as China, India and Russia, growth was still robust at the end of 2007. Domestic demand and growth in exports of food and energy remained strong.

However, there was considerable uncertainty about the global economic outlook at the end of the year, and much to suggest that the upswing of recent years is drawing to a close. The upswing period has generally featured rising commodity prices, interest rates and capacity utilisation. Unemployment has fallen in recent years, while wage growth and core inflation have been moderate. However, the prices of commodities such as energy and food have increased substantially. To reduce the risk of knock-on effects on other prices and wages, central banks in a number of countries have raised their key rates in recent years.

The downturn in the US housing market continued during 2007, and sales of both new and existing homes fell. Besides significantly lower sales volumes than before, houses took longer to sell, and housing starts were lower than in 2006. Despite the housing market becoming weaker and weaker, growth in private consumption held up during 2007. This was probably related to a strong labour market during most of 2007, although there were certain signs of weakness towards the end of the year. Growth in employment slowed, while unemployment increased only moderately towards the end of the year. Employment in the construction sector fell less than might have been feared given the downturn in the housing market. This was due to high levels of commercial construction activity.

A weaker dollar contributed to a solid performance from the US export industry and probably put a damper on import growth. Unlike in previous years, foreign trade made a positive contribution to GDP growth.

The US consumer price index rose by 4.1 per cent in 2007, due primarily to higher energy and food prices. Excluding these two product groups, inflation was more moderate at 2.4 per cent.

After the financial turmoil worsened in the second half of the year, the Federal Reserve cut the discount rate by 50 basis points on 17 August, and both the federal funds rate and the discount rate by 50 basis points on 18 September. Both rates were lowered by a further 25 basis points at each of the Federal Reserve's meetings at the end of October and in mid-December. Thus the federal funds rate was reduced by a total of 1 percentage point to 4.25 per cent during the second half of the year.

There was strong economic growth in the euro area in 2007, although there were signs of a moderate downturn towards the end of the year as a result of the turmoil in credit markets and lower growth in the US. High corporate earnings, strong growth in exports (especially to emerging markets) and an upswing in private consumption contributed to economic growth. Employment rose during the year, and unemployment was at its lowest for more than a quarter of a century at the end of the year.

Consumer prices increased during the year and were 3.1 per cent higher in December than a year earlier. The rising rate of inflation was due to an increase in energy and food prices during the autumn. The European Central Bank raised its key rate to 4 per cent in June and kept it unchanged for the rest of the year.

The upswing in the UK economy continued in 2007 despite higher interest rates and a stronger pound. Growth was driven particularly by domestic demand. It was primarily investment which contributed to growth, but private consumption also picked up. After raising its key interest rate earlier in the year, the Bank of England lowered the key rate from 5.75 to 5.50 per cent at the beginning of December. The rate cut was probably due to signs of slightly weaker economic growth and to the turbulence in financial markets having led to tightening in credit markets.

Brisk domestic demand and strong

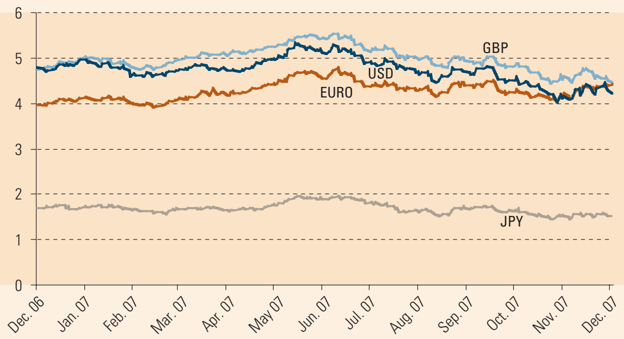


Chart 2-1: Movements in the major fixed income markets in 2007. Yields on ten-year government securities. Per cent per year
Source: Morgan Markets

Chart 2-2: Credit spread between corporate* and government securities in the US over the past eight years. Basis points
* Corporate securities with a credit rating of AAA from Standard & Poor's. Source: Lehman Brothers

growth in export sectors were major contributors to growth in Japan. Unemployment was low, and there was a shortage of labour in parts of the economy. Inflation remains low in Japan, although there was a slight increase towards the end of the year. This increase was probably related to the rise in the prices of imported commodities. The Bank of Japan has not changed its key rate since a 25 basis point increase in February 2007.

There was strong economic growth in many emerging markets in 2007. In China, there was strong growth in manufacturing output and exports, although growth did slow slightly during the year. The trade surplus widened substantially relative to 2006, and retail sales data suggested strong growth in consumption towards the end of the year. Price inflation was just below 7 per cent at the end of the year, due primarily to higher food prices. The People's Bank of China therefore tightened monetary policy by increasing its primary reserve requirements, raising interest rates, and allowing the yuan to appreciate.

2.2 Developments in fixed income markets

Over the year as a whole, ten-year government bond yields fell by 0.6, 0.3 and 0.2 percentage point respectively in the US, the UK and Japan, but increased by 0.4 percentage point in the euro area. Chart 2-1 shows how ten-year yields trended upwards during the first half of the year and downwards during the second.

The first half of 2007 brought news of solid economic growth globally and stable development in many financial markets, including in long-term yields. Low volatility led investors to invest more in high-risk assets, including high-yielding bonds and loans with a low credit rating. There was therefore only a small credit spread between safe government bonds and riskier high-yielding bonds. The low risk premiums were a reflection of investors feeling secure in the prevailing macroeconomic climate.

However, the picture changed during the summer of 2007, with growing turbulence in financial markets. The second half of the year brought major price fluctuations in financial markets the world over. The turbulence was triggered by rising defaults on sub-prime mortgages in the US. Many of these mortgages were sold on from the original lenders in the form of securities backed by a portfolio of mortgages. The US mortgage market has a complex structure with many different players involved. Uncertainty about the scope and implications of losses led to a rapid increase in the credit spread between government bonds and bonds with credit risk (see Chart 2-2).

Investors' sales of securities with high credit risk and purchases of more secure investments, such as government bonds, led to a downturn in long-term government bond yields. In the US, long-term government bond yields decreased by more than 1 percentage point during the second half of the year.

Chart 2-3 shows movements in the Lehman Global Aggregate government bond indices in 2007. The return in 2007 was 9.0 per cent in the US, 1.2 per cent in Europe and 2.0 per cent in Asia.

Due to the turmoil in credit markets, the second half of the year brought major differences in returns between the different parts of the US bond market. As can be seen from Chart 2-4, the return on the index for inflation-linked bonds was highest at 11.6 per cent, while corporate bonds produced the lowest return of 4.4 per cent. The return on securitised debt, which consists mainly of mortgage-backed securities issued by US Federal Agencies, was 6.9 per cent.

Chart 2-5 shows the return on fixed income markets each year since 1980. The average annual return during this period was 8.4 per cent. The return in 2007 was 4.3 per cent. In the early 1980s, inflation and interest rates were unusually high. In recent years, both inflation and interest rates have been low, which explains why nominal returns on fixed income instruments have been lower than they were early in the period.

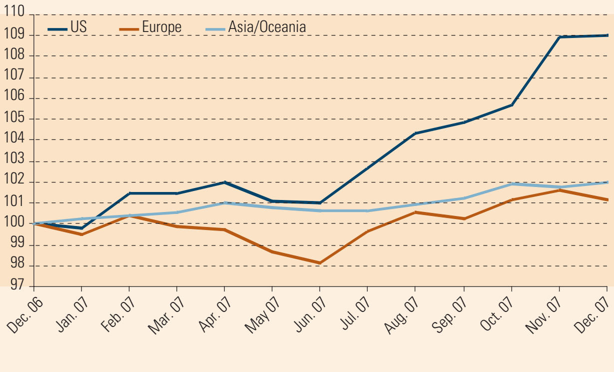


Chart 2-3: Movements in the Lehman Global Aggregate government bond indices for the main markets in 2007 (31.12.06=100)
Source: Lehman Brothers

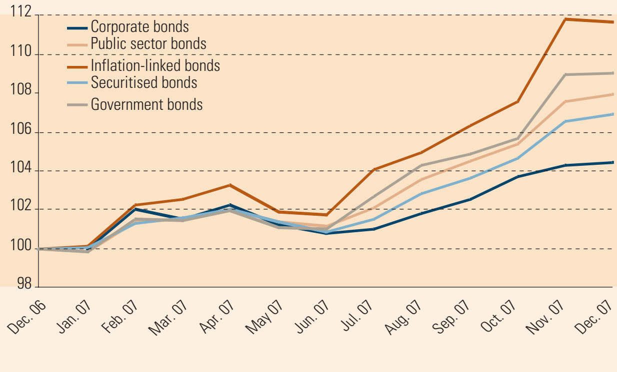


Chart 2-4: Movements in the Lehman Global Aggregate sub-indices for the US in 2007 (31.12.06=100)
Source: Lehman Brothers

The liquidity crisis in fixed income markets in 2007

There was strong growth in the issuance of mortgages to borrowers with low credit scores – sub-prime mortgages – in the US in 2005 and 2006. This increase can probably be explained by general changes in the US credit market which began a few years earlier.

In mid-2004, the Federal Reserve began to raise interest rates in well-advertised increments of 25 basis points. This led to lower spreads between short-term and long-term bonds, and lower risk premiums in the fixed income market. It was therefore less attractive for banks to issue ordinary mortgages. Traditionally, banks held a portfolio of mortgages funded through short-term borrowing, and banks' net revenues derived from an interest margin which reflected partly the spread between long-term and short-term interest rates and partly a credit or liquidity spread.

Low spreads between short-term and long-term interest rates and between government bonds and bonds with credit risk was probably one of the most important factors behind the growth in the sub-prime market. The issuance of securities and associated structuring[1] were profitable for banks in themselves due to the associated commission income. In addition, banks took on exposure by investing directly in the AAA-rated tranches of collateralised debt obligations (CDOs) and by undertaking to extend lines of credit to off-balance-sheet money market vehicles.

This type of risk exposure can best be viewed as a way of issuing options on credit (direct exposure) and liquidity (credit lines). As the exposure initially comes with a AAA rating, the options are "way out of the money" – there is little likelihood of them being exercised. The return on these options will be a relatively linear function of time as long as the market remains within "normal" parameters. The issuer of the options will then derive income from the option premiums, while the costs will be relatively low in the form of small losses in the portfolio. This AAA exposure through options behaves like high-quality credit. However, if we move outside these parameters on the negative side (higher defaults and greater correlation), these losses can increase exponentially. This results in a high probability of a relatively modest positive outcome and a low probability of a very negative outcome (tail risk). This risk profile is important to bear in mind when attempting to understand the repricing of credit and liquidity in 2007.

House prices in the US began to fall from mid-2006. Around the same time, default rates in the sub-prime segment began to rise. At the beginning of 2007, the value of the BBB segment in the ABX sub-prime index began to fall. In February, UK bank HSBC was the first to announce larger losses than expected on a portfolio of sub-prime mortgages. The BBB index fell from 95 to 75 over a two-week period (par is 100). The AAA index was largely unchanged. During this period, the model functioned as intended: the first losses were covered by bonds with lower priority, while the high-quality segment was unaffected.

The default rate continued to rise during the spring of 2007, at times with growing momentum. In June, two hedge funds managed by Bear Stearns collapsed. The BBB index, which had climbed back to 80, now began to fall again. The AAA index and other indicators of stability in the funding market were unaffected. The credit spread between the interbank rate (LIBOR) and the federal funds rate was stable around 12 basis points.

In July, the value of the BBB segment in the ABX index dropped from 70 to 45. The value of the AAA segment now began to be affected, falling from 98 to 92, and the price sensitivity of the options banks had written relative to the default rate now became very clear. On 30 July, German bank IKB reported losses on its sub-prime exposure. The spread between the LIBOR and the federal funds rate widened to around 20 basis points. On 9 August, the spread leapt to 43 basis points. This reflected an increased need for liquidity in the banking sector. A week later, we received an indication of the reason for this when the Federal Reserve announced that the volume outstanding of asset-backed commercial paper (ABCP) had decreased substantially. The spread between the LIBOR and the federal funds rate widened further to 70 basis points, and liquidity in the market was greatly reduced.

The underlying factor was the option structure in the banking system. Investors in the market for ABCP were uncertain about the value of the underlying collateral in the money market vehicles, and pulled out their investments. Banks now needed funding to cover their liquidity options. At the same time, they were reluctant to lend to one another, because they were uncertain about the counterparty's exposure to both the liquidity and credit options. The market for debt financing backed by securities was limited to government bonds and equivalent instruments, as there was so much uncertainty about the value of other types of collateral, such as mortgage-backed bonds. As a result of this, there was a classic "flight to quality", where virtually all high-risk assets fell in price relative to lower-risk assets. The correlation between asset classes increased substantially.

On 17 August, the Federal Reserve cut the discount rate by 50 basis points. Liquidity was still very tight. About USD 300 billion had been pulled out of the market for ABCP, a reduction of around 25 per cent in the volume outstanding. UK bank Northern Rock requested a liquidity support facility from the Bank of England. On 18 September, the Federal Reserve cut both the discount rate and the federal funds rate by 50 basis points.

However, the underlying situation in the sub-prime segment of the housing market continued to deteriorate. In addition, it became very difficult for borrowers to refinance, which meant that the expected negative value of aggregate defaults increased. The BBB segment fell in value from 48 in mid-September to just under 20 at the end of November. This meant that the credit option in the AAA segment increasingly moved "in the money" (high probability of exercise). The value of the AAA segment in the ABX index dropped to 80 at the end of November.

Several banks and financial institutions were now announcing substantial write-downs. It was clear that there was a capital crisis on top of a fresh liquidity crisis. Paper and instruments with direct exposure to the sub-prime market were hit hardest, but liquidity also dried up in the other bond markets. Correlations increased in the same way as in August. The spread between the LIBOR and the federal funds rate climbed to more than 100 basis points.

In December, there were several indications that the market was in the process of finding a solution to parts of the capital crisis. Several banks raised equity capital from new investors, and central banks took action to safeguard the supply of liquidity through forward facilities. The spread between the LIBOR and the federal funds rate fell back to 70 basis points. The value of the AAA segment in the ABX index recovered to 87, while the BBB segment held around 20. This indicated that the liquidity situation was slightly easier, but that the underlying solvency situation in the housing market was far from being resolved.

1) When mortgages are securitised, they may be structured into different tranches with different credit ratings depending on how the credit rating agencies (Moody's and Standard & Poor's) rank the probability of the various tranches being repaid. One umbrella term for structured products of this kind is collateralised debt obligations (CDOs).

2.3 Developments in equity markets

After a long period of low volatility and rising prices, equity markets fell back sharply at the end of February 2007. The downturn was triggered by a steep dip in prices on the stock exchange in Shanghai. At their lowest, prices were approximately 6 per cent down in developed markets and almost 10 per cent down in emerging markets. After a brief period of stability, equity prices rallied, and much of the downturn was reversed in the second half of March. Over the first half of the year as a whole, there was a positive return in all of the main markets. Emerging markets performed particularly well, gaining 17 per cent. Strong economic growth globally, increased globalisation of the markets for both goods and labour, and a weaker US dollar were factors which contributed to the strong growth in equity prices in many emerging markets. Companies in the Oil & Gas and Basic Materials sectors performed best in the first half of the year.

Developments in global equity markets in the second half of the year were greatly influenced by the turmoil in credit markets. Equity prices fell sharply globally from mid-July to mid-August. The slide was triggered by falling house prices and growing problems with defaults on mortgages in the US. Since banks and investors outside the US were also exposed to these loans, global markets were soon affected. Once the central banks in Europe, the US and, eventually, the UK injected liquidity into the banking system, the equity market stabilised.

In the latter half of October and in November, however, several US and European banks reported heavy losses, which led to fresh turmoil in credit markets. The attention surrounding the problems in money and credit markets, together with expectations that these

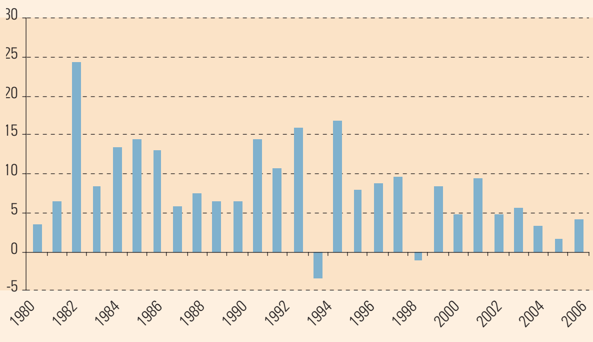


Chart 2-5: Annual percentage return in fixed income markets measured in terms of an international currency basket*
* The currency basket has the same composition as the benchmark portfolio for the Government Pension Fund – Global.

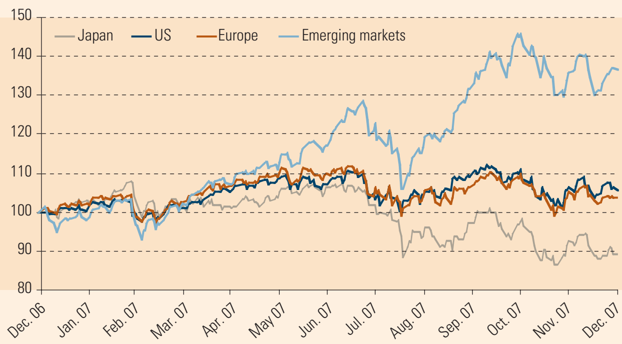


Chart 2-6: Movements in the FTSE equity indices for the main markets in 2007 (31.12.06=100)
Source: FTSE

would impact negatively on the real economy, led to a downturn in equity markets worldwide. With the exception of emerging markets, prices in all of the main markets fell over the second half of the year as a whole.

The return on an equity portfolio with the same composition as the benchmark index for the Government Pension Fund – Global was 5.7 per cent in 2007, against 17.1 per cent in 2006. As in 2006, the strongest upswing in equity prices was in emerging markets. An index of 24 emerging markets increased by 36.7 per cent in 2007, while prices in the US and Europe increased by 5.7 and 3.8 per cent respectively. In Japan, meanwhile, prices fell by 10.7 per cent. Price movements were most pronounced in the second half of the year in connection with the turmoil in credit markets (see Chart 2-6).

Table 2-1 shows that most of the main sectors turned in a positive performance in 2007. Basic Materials and Oil & Gas performed best, while Financials, Consumer Services and Health Care performed worst.

Chart 2-7 shows the return on the equity market each year since 1980. The average annual return during this period was 14.3 per cent. The return in 2007 was 5.7 per cent, which is well below the average.

Table 2-1: Percentage return on the FTSE All-World Index in 2007. Measured in USD, NOK and an international currency basket

	USD	NOK	Currency basket*
Oil & Gas	32.24	15.16	24.93
- of which Oil & Gas Producers	29.83	13.06	22.65
Basic Materials	46.78	27.82	38.67
Industrials	20.64	5.06	13.98
Consumer Goods	12.99	-1.61	6.74
Health Care	2.46	-10.77	-3.20
- of which Pharmaceuticals & Biotechnology	-1.02	-13.80	-6.49
Consumer Services	2.10	-11.09	-3.54
- of which General Retailers	-2.91	-15.45	-8.27
- of which Media	-1.43	-14.16	-6.88
Telecommunications	24.04	8.02	17.18
- of which Fixed Line Telecommunications	20.72	5.13	14.05
Utilities	14.91	0.07	8.56
Financials	-0.49	-13.34	-5.99
- of which Banks	-4.05	-16.44	-9.35
- of which Nonlife Insurance	5.66	-7.99	-0.18
- of which General Financial	-1.59	-14.30	-7.03
Technology	15.79	0.84	9.40
- of which Software & Computer Services	12.96	-1.63	6.72
- of which Hardware & Equipment	17.23	2.09	10.75
Total**	**12.58**	**-1.82**	**6.51**

* The currency basket has the same composition as the benchmark portfolio for the Government Pension Fund – Global.
** The composition of the Pension Fund´s benchmark portfolio differs from the FTSE All-World Index, and therefore the return on it will also be different.

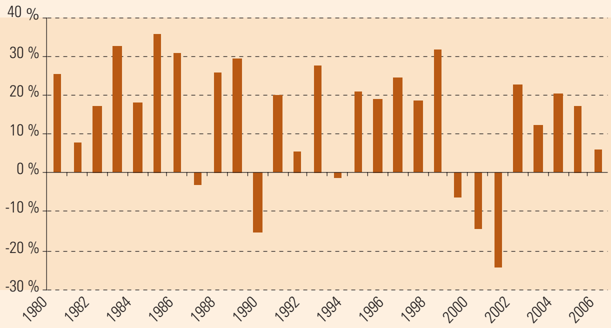


Chart 2-7: Percentage return in equity markets 1980-2007 for the equity benchmark portfolio measured in terms of an international currency basket*
* The currency basket has the same composition as the benchmark portfolio for the Government Pension Fund – Global.

3 – Fund performance

3.1 Government Pension Fund – Global

3.1.1 Mandate

The Government Pension Fund – Global is a continuation of the Government Petroleum Fund, which was established by the Storting (Norwegian parliament) in 1990. The first capital transfer of NOK 2 billion was made in 1996. The name was changed on 1 January 2006.

The fund is administered by the Ministry of Finance pursuant to the Government Pension Fund Act. The operational management of the fund has been delegated to Norges Bank. The management mandate is stipulated in a regulation and written guidelines issued by the Ministry. A management agreement, which further regulates the relationship between the Ministry of Finance as client and Norges Bank as operational manager, has also been drawn up. The guidelines and management agreement are available on Norges Bank's website (www.norges-bank.no).

The Government Pension Fund – Global is a financial investor with a long investment horizon. The fund's assets are invested in equities issued by companies in many different countries and in fixed income securities issued by governments, public institutions and companies, as well as securitised debt and short-term money market instruments. The fund's assets can also be invested in derivative financial instruments such as options and futures.

The Ministry of Finance has set key limits for the fund's investments, such as the allocation between equities and fixed income instruments, the maximum ownership interest in individual companies, and limits for active management by Norges Bank (see Table 3-13 in Section 3.1.7).

In 2007, the Ministry of Finance decided, with the Storting's approval, to increase the fund's allocation to equities to 60 per cent. The allocation to equities had stood at 40 per cent since 1998. The Ministry also decided to extend the number of companies in the equity benchmark portfolio by including the small-cap segment. The Ministry of Finance has adopted a plan for implementing these changes on the basis of a recommendation from Norges Bank. The Ministry has also revised the rules on approved countries and markets. Previously the Ministry issued a list of countries, but the new rules require certain criteria to be met before investments in new countries are permitted.

The Ministry of Finance has adopted ethical guidelines for the fund's investments. These guidelines require that ethical issues be addressed through three mechanisms: the exercise of ownership rights to promote long-term financial returns, negative screening, and exclusion of companies to avoid complicity in unacceptable violations of fundamental ethical norms. Norges Bank is responsible for the exercise of ownership rights in accordance with the guidelines issued by the Ministry. The Bank's Executive Board has adopted a set of principles governing this work. Section 4.1 contains an account of Norges Bank's active ownership practices. The government has appointed a Council on Ethics to advise the Ministry of Finance on negative screening and company exclusions. The Ministry takes the final decision on the exclusion of companies and instructs Norges Bank accordingly. Section 4.2 includes an overview of the companies excluded from the investment universe at the end of 2007.

Composition of the benchmark portfolio

The fund's benchmark portfolio reflects the Ministry of Finance's neutral investment strategy. The two asset classes – equities and fixed income instruments – are represented in the benchmark portfolio by indices in different countries and currencies. These indices in turn are made up of individual stocks and bonds in such a way as to reflect movements in the equity and fixed income markets respectively. The benchmark portfolio is important as a basis for managing the risk associated with operational management and for assessing NBIM's management performance.

The strategic benchmark portfolio for the Government Pension Fund – Global is composed of FTSE equity indices for companies in 27 countries and of Lehman Global Aggregate fixed income indices in 11 currencies (see box with actual benchmark portfolio). The equity portion of the benchmark consists of equities listed on stock exchanges in Europe (50 per cent), the Americas and Africa (35 per cent), and Asia and Oceania (15 per cent). The regional distribution of the fixed income benchmark is 60 per cent Europe, 35 per cent Americas and 5 per cent Asia and Oceania.

Asset classes and regional weights change continuously as a result of changes in market prices for the securities in the benchmark portfolio. Up to and including 2001, the weights in the benchmark were always restored to the original strategic weights in connection with the quarterly transfers of new capital to the fund. From January 2002, the Ministry of Finance amended the guidelines, and new capital is now transferred monthly. The monthly transfers are to be used to bring the asset classes and regional weights back as close to the strategic weights as possible, provided that this does not require any disposals of existing portfolio assets. Thus, even after the transfer of new capital, the strategic benchmark portfolio described above may differ somewhat from the actual benchmark. The latter provides the basis for managing risk and measuring the performance of the fund.

A substantial difference between the actual benchmark and the strategic benchmark over time will trigger full rebalancing. There was no such rebalancing in 2007, and the Ministry of Finance has suspended these rules until the increase in the allocation to equities to 60 per cent is complete.

Documentation on the Internet

The Government Pension Fund Act and the regulation and supplementary provisions and guidelines issued by the Ministry of Finance are available on Norges Bank's website (www.norges-bank.no). All reports published on the management of the fund, as well as background material concerning the fund's strategy and the organisation of investment management at Norges Bank, are also available on the website.

The Ministry's regulation requires Norges Bank to seek to achieve the highest possible return within the constraints set out in the regulation. The Bank's strategy for achieving an excess return has been presented in previous annual reports.[1]

Norges Bank informs the Ministry of Finance about the management of the fund in quarterly and annual reports which are also publicly available.

The Ministry of Finance has specified the countries and currencies which are to be included in the fund's benchmark portfolio. The benchmark portfolio consists of specific equities and fixed income instruments, and reflects the Ministry's investment strategy for the fund. The benchmark portfolio provides an important basis for managing risk in the operational management of the fund and for evaluating Norges Bank's management performance. The composition of the benchmark portfolio and how it has changed are described in a separate box.

Table 3-1 shows the weights in the actual benchmark portfolio as at 31 December 2007. The weights in the fixed income benchmark are based on the currency in which the securities are issued, and so the weight for each country in the euro area is not listed.

1) See, in particular, the Annual Reports for 1999 and 2003.

Table 3-1: Benchmark portfolio 31 December 2007. Per cent

	Equities		Fixed income instruments	
Country for equity benchmark Currency for fixed income benchmark	Strategic benchmark portfolio	Actual benchmark portfolio	Strategic benchmark portfolio	Actual benchmark portfolio
Asset class weights	**60.0 ***	**47.2**	**40.0**	**52.8**
Belgium		0.8		
Finland		1.2		
France		8.2		
Greece		0.6		
Ireland		0.5		
Italy		3.0		
Netherlands		2.1		
Portugal		0.3		
Spain		3.4		
Germany		6.6		
Austria		0.4		
Euro area		*27.2*		*47.5*
UK		15.3		9.7
Denmark		0.7		0.8
Switzerland		4.7		0.5
Sweden		1.8		1.2
Total Europe	**50.0**	**49.6**	**60.0**	**59.7**
US		30.7		32.9
Brazil		1.2		
Canada		2.5		2.3
Mexico		0.5		
South Africa		0.7		
Total Americas and Africa	**35.0**	**35.6**	**35.0**	**35.3**
Australia		2.6		0.2
Hong Kong		1.7		
Japan		7.3		4.6
New Zealand		0.1		0.1
Singapore		0.5		0.2
South Korea		1.6		
Taiwan		1.1		
Total Asia and Oceania	**15.0**	**14.8**	**5.0**	**5.1**

* Once the phasing in of the increased allocation to equities has been completed (see discussion in Section 3.1.1), the strategic benchmark portfolio will consist of 60 per cent equities and 40 per cent fixed income instruments.

3.1.2 Returns in 2007

The market value of the Government Pension Fund – Global was NOK 2 019 billion at the end of 2007, an increase of NOK 235 billion since the beginning of the year. New capital of NOK 314 billion was transferred to the fund from the Ministry of Finance, and the return on investment increased the value of the fund by NOK 75 billion. The value of the currencies in which the fund is invested fell against the Norwegian krone, reducing the value of the fund by NOK 154 billion. Changes in the krone exchange rate have no effect, however, on the fund's international purchasing power. Table 3-2 shows the size of the equity and fixed income portfolios at the end of each quarter of 2007.

The return on the fund in 2007 was 4.3

Table 3-2: Market value of the fund in 2007. Millions of NOK

	31.12.06	31.03.07	30.06.07	30.9.2007	31.12.2007
Equity portfolio	725 922	752 636	819 466	878 143	957 895
Fixed income portfolio	1 057 761	1 123 561	1 120 018	1 054 135	1 060 749
Total portfolio	**1 783 683**	**1 876 197**	**1 939 484**	**1 932 278**	**2 018 643**

per cent measured in terms of the currency basket corresponding to the country weights in the benchmark portfolio. With the exception of the fourth quarter, when there was a sharp fall in global equity prices, the return was positive in each quarter of 2007 (see Table 3-3). The return on the fund was particularly high in the second quarter. The last column of Table 3-3 shows the difference between the actual return and the benchmark return. There was a positive excess return in the first half of the year, but a negative excess return in both the third and fourth quarters. Over the year as a whole, there was a negative excess return of 0.22 percentage point. This is equivalent to approximately NOK 5.2 billion.

In investment management, it is usual to look at excess return over a time horizon of more than one year. The red line in Chart 3-1 shows developments in three-year rolling excess returns over the past three years. At the end of 2007, the annualised excess return based on figures for the past three years was 0.30 percentage point.

Both internal and external equity management produced very good results in 2007 (see Table 3-4), while both internal and external fixed income management had a poor year, and their negative contributions to excess return outweighed the positive results from equity management. Overall, therefore, the return on the fund was lower than the return on the benchmark portfolio for the very first time in a calendar year.

Chart 3-2 shows each internally and externally managed mandate's contribution in NOK to excess return in 2007. The red columns denote externally managed mandates, and the blue columns internally managed mandates. A majority of internally managed mandates made a negative contribution to excess return in 2007.

The annualised excess return over the three years from 2005 to 2007 was 0.30 per cent (see Table 3-5). Equity management made a positive annual contribution to excess return of 0.41 per cent. Internal management contributed slightly more than external management. Fixed income management made a nega-

Transfers of capital to the Pension Fund

The Ministry of Finance first transferred capital to the Government Pension Fund – Global in May 1996 when the central government accounts for 1995 showed a surplus of NOK 2 billion. Since then, the central government accounts have shown a surplus every year, and capital equivalent to the projected surplus for each year has been transferred to the fund by the Ministry of Finance. When the central government accounts are final, several months into the following year, the next year's transfers to the fund are adjusted to take account of the discrepancy between the amount transferred during the year and the final allocation to the fund. The allocation in the central government accounts varied between about NOK 26 billion in 1999 and more than NOK 298 billion in 2006. Actual transfers in 2007 totalled NOK 314 billion, which is the highest annual amount transferred to the fund. A total of NOK 1 756 billion was transferred to the fund in the period 1995-2007.

The right-hand column of the table shows the share of the central government's net cash flow from petroleum activities remaining in the fund. In 2000 and 2001, almost the entire cash flow remained in the fund, whereas in the years 2002-2004 this share was equivalent to about two-thirds of the cash flow. This share increased to more than 80 per cent in 2005 and 2006 and to almost 100 per cent in 2007.

Financial year	Actual transfers during the year*	Final allocation in central government accounts	Share of government petroleum revenues remaining in the fund. Per cent
1995	-	1 981	5
1996	47 476	44 213	63
1997	60 900	64 019	71
1998	32 837	27 982	62
1999	24 423	26 133	59
2000	149 838	150 519	94
2001	251 189	257 017	99
2002	125 354	115 828	68
2003	103 911	110 819	64
2004	138 162	132 539	65
2005	220 286	221 276	80
2006	288 298	298 005	84
2007	313 649		98**
Total 1995-2007	**1 756 323**		

* Less management remuneration to Norges Bank for the previous year.
** Preliminary figures based on new balanced central government budget for 2007.

Table 3-3: Return on the fund by quarter and for 2007 as a whole. Per cent

	Return measured in terms of the benchmark portfolio´s currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	1.48	1.39	-0.05	-0.15	0.09
Q2	2.23	1.93	-0.19	-0.49	0.30
Q3	1.15	1.33	-4.20	-4.03	-0.17
October	1.76	1.66	2.40	2.30	0.10
November	-1.87	-1.47	1.42	1.84	-0.41
December	-0.50	-0.37	-3.17	-3.04	-0.13
Q4	-0.64	-0.20	0.56	1.01	-0.45
2007	**4.26**	**4.50**	**-3.90**	**-3.68**	**-0.22**

tive annual contribution of 0.11 per cent.

The information ratio is the ratio of excess return to market risk. It shows the amount of excess return achieved relative to the amount of risk taken. Table 3-6 shows the information ratio, or risk-adjusted excess return, for the various types of management in the period 2005-2007.

The gross excess return is comparable with the performance reported by other managers. However, it does not provide a measure of Norges Bank's net contribution to management performance. The fund could have been managed passively, with a portfolio kept extremely close to the benchmark at all times. Instead, Norges Bank has chosen to engage in active management. Costs are higher, but so are the expected returns.

The value added by active management is an estimate of the net contribution from this strategy to the fund's return in 2007. The estimated net value added by active management is shown in Table 3-7. The starting point is the fund's gross excess return. With passive indexing, transaction costs accrue when the benchmark portfolio's composition changes. The normal annual transaction costs associated with indexing are estimated at about 0.04 per cent of the total portfolio.

When calculating the gross excess return, account is not taken of costs relating to phasing new capital into the markets, adjusting the actual portfolio when

Table 3-4: Contributions to gross excess return in 2007. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity management	0.26	0.18	0.44	1.06
Fixed income management	-0.20	-0.46	-0.66	-1.19
Total	**0.06**	**-0.28**	**-0.22**	

Table 3-5: Annualised contributions to gross excess return 2005-2007. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity management	0.19	0.22	0.41	1.05
Fixed income management	-0.05	-0.06	-0.11	-0.22
Total	**0.14**	**0.16**	**0.30**	

Table 3-6: Information ratio 2005-2007

	External management	Internal management	Total
Equity management	0.50	1.10	1.12
Fixed income management	-0.53	-0.04	-0.46
Total	**0.31**	**0.49**	**0.60**

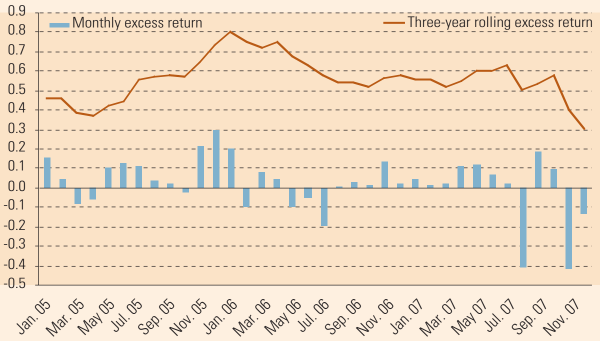


Chart 3-1: Monthly and annualised cumulative excess return over the past 36 months. Per cent

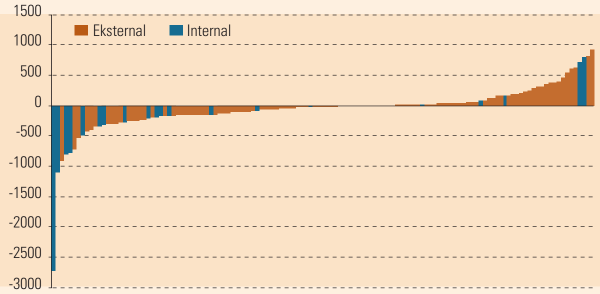


Chart 3-2: The contribution of individual mandates to excess return in 2007. Millions of NOK

Table 3-7: Estimated net value added by active management. Percentage points

Gross excess return	**-0.22**
+ Transaction costs associated with indexing	0.04
+ Other transaction costs	0.07
- Additional costs for active management	0.07
- Lending income associated with index management	0.05
= Value added by active management	**-0.22**

Table 3-9: Total return in 2007 measured against various currencies. Per cent

Return measured in terms of:	Total portfolio
Benchmark portfolio´s currency basket	4.26
Import-weighted currency basket	1.84
USD	10.20
EUR	-0.61
NOK	-3.90

Transaction costs

NBIM estimates transaction costs related to phasing new capital into the fund and changes in the benchmark portfolio as decided by the Ministry of Finance. New capital is transferred to the fund in the form of cash. When the capital is invested in securities (equities and fixed income instruments), both direct and indirect costs will be incurred. In line with normal market practice, Norges Bank has used a model that calculates direct and indirect transaction costs individually since the beginning of 2005. Indirect transaction costs have three main components: liquidity costs, market impact and opportunity costs. NBIM's model calculates transaction costs in the fixed income portfolio using the full spread between the bid and ask curves. Indirect transaction costs in the equity portfolio are estimated using StockFactsPro®. Market impact in the fixed income market is a combination of sector, market conditions, transaction size, the size of the loan issued and the liquidity of the issuer. In most cases, contributions from these variables can be ignored.

the Ministry of Finance excludes companies from the investment universe, or other changes in the benchmark portfolio. The methodology for calculating these costs is described in a feature article published in connection with the Annual Report for 2004 and in a separate box in this section of the Annual Report.

Total transaction costs in 2007 are estimated at 0.08 per cent of the fund's average market value. The cost of phasing in new capital amounted to around NOK 923 million, and the cost of disposals in connection with the exclusion of companies was around NOK 13 million. The Ministry of Finance also decided in 2007 that the allocation to equities should gradually be increased to 60 per cent, that small-cap companies should be included in the equity benchmark, and that the weights in the fixed income benchmark portfolio should be altered. The cost of adjusting the portfolios is estimated at NOK 562 million.

Passive indexing of the fund would also involve some management-related operating costs. The normal annual management costs associated with indexing are estimated at 0.02 per cent of the total portfolio. In 2007, total management costs actually amounted to 0.09 per cent of the portfolio, which means that costs associated with active management came to an estimated 0.07 per cent.

On the other hand, passive management would also have generated some income from lending out securities in the portfolio. An estimated return of approximately 0.05 per cent would have been achieved with pure index management.

These estimates indicate that the net value added by active management was -0.22 percentage point in 2007 (see Table 3-7). In absolute terms, this equates to negative value added of NOK 5.2 billion.

Norges Bank's average net contribution to value added during the period 1998-2007 was 0.39 percentage point (see Table 3-8). This is equivalent to NOK 21.3 billion.

The fund's return measured in various currencies is shown in Table 3-9. The return was 4.3 per cent measured in terms of the currency basket but -3.9 per cent in NOK. The difference is due to an increase in the krone exchange rate of around 8.2 per cent relative to the investment currencies during the course of 2007. A change in the international value of the krone has no effect, however, on the fund's international purchasing power. Calculated in EUR, the return was -0.6 per cent, whereas in USD it was a full 10.2 per cent. This is because the dollar depreciated against most other currencies in 2007.

Chart 3-3 shows the fund's average ownership interests in listed companies

Table 3-8: Norges Bank´s contribution to the return on the fund 1998-2007. Percentage points

Total	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-2007
Excess return	0.20	1.25	0.28	0.15	0.25	0.59	0.53	1.10	0.14*	-0.22	0.40
Value added by active management	**0.19**	**1.18**	**0.20**	**0.11**	**0.21**	**0.54**	**0.49**	**1.05**	**0.11**	**-0.22**	**0.39**

* In 2006, Norges Bank used incorrect tax rates for some countries, which meant that the excess return reported for the fund was slightly higher than was actually the case. Based on the correct figures, the excess return for 2006 was 14 basis points, not 15 as originally reported.

Methodology for the calculation of returns*

The return calculations are based on internationally recognised standards.

The valuation of the fund is calculated according to the market value principle – in other words, the opening and closing values of the portfolios are set at market price at the beginning and end of the calculation period. Index suppliers' prices are generally used for securities in the benchmark indices.**

Interest expenses and income, dividends and withholding tax are accounted for on an accrual basis when calculating returns. Income and expenses relating to transactions awaiting settlement are recognised on the trade date.

Transfers to the fund and between the equity and fixed income portfolios are normally made on the last business day of each month, but can also take place during the month. The monthly return is calculated by looking at the change in market value from one month to the next, adjusted for incoming and outgoing payments. The geometrical return is used for longer periods, such as quarterly, annual and year-to-date returns. This means that the return indices for each sub-period are multiplied. This return is thus a time-weighted return based on the returns for the individual months.

The return is calculated in both NOK and local currency. The NOK return is calculated on the basis of market values in local currency translated into NOK using WM/Reuters exchange rates.***

The return in local currency is calculated as the geometrical difference between the fund's return in NOK and the return on the currency basket. The currency basket corresponds to the currency weights in the benchmark portfolio, and the return indicates how much the krone has appreciated/depreciated against the currencies in the benchmark portfolio.

The excess return emerges as an arithmetical difference between the returns on the actual portfolio and the benchmark portfolio.

Returns are calculated in a separate system and then reconciled with the accounting system. Differences between market values calculated in the return models and market values in the accounts are primarily due to different valuation principles for money market investments. Provisions are also made in the accounts to cover remuneration to NBIM.

* A more detailed presentation of the calculation of returns can be found in the article "Performance measurement methodology" published in 2000 in connection with the Annual Report for 1999.
** Lehman Global Aggregate (LGA) and FTSE for fixed income and equity instruments respectively.
*** WM/Reuters Closing Spot Rates, fixed at 4 p.m. London time.

in three geographical regions, calculated as a percentage of the market value of the companies in the FTSE index for the countries in which the fund is invested. At the end of 2007, the fund's average ownership interest was 0.77 per cent in Europe, 0.34 per cent in the Americas, and 0.42 per cent in Asia and Oceania.

Chart 3-4 shows the fund's ownership interests in the various fixed income markets in each of the three geographical regions,[2] calculated on the basis of the securities in the Lehman Global Aggregate index in the currencies in which the fund has been invested. The fund's ownership interests are highest in Europe, where the fund owned 1.09 per cent of all securities outstanding at the end of 2007. Its ownership interests in the Americas and in Asia and Oceania were 0.63 per cent and 0.27 per cent respectively.

3.1.3 Internal and external management

NBIM's management of the fund's assets is based on an investment philosophy where excess returns are to be achieved by means of a large number of individual decisions which are as independent of one another as possible. This investment philosophy is described in more detail in feature articles published in connection with the Annual Reports for 1999 and

[2] Frem til og med 2001 besto referanseporteføljen kun av statsobligasjoner. Fra og med 2002 ble referanseporteføljen langt "bredere" sammensatt ved at også ikke-statsgaranterte delindekser ble inkludert. Dette førte til et kraftig fall i eierandel i forhold til den nye referanseporteføljen i 2002. Med veksten i renteporteføljen har Norges Banks eierandel økt de påfølgende årene.

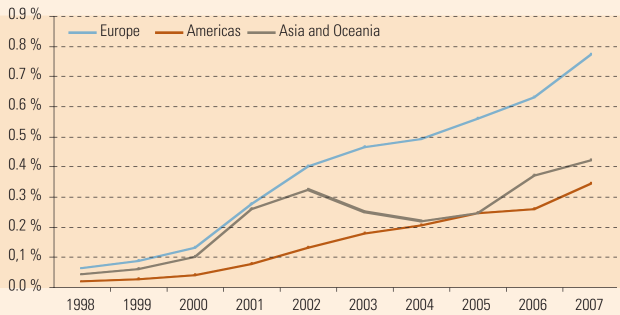


Chart 3-3: The fund's ownership interests in equity markets as a percentage of market capitalisation in the FTSE indices
Source: FTSE and Norges Bank

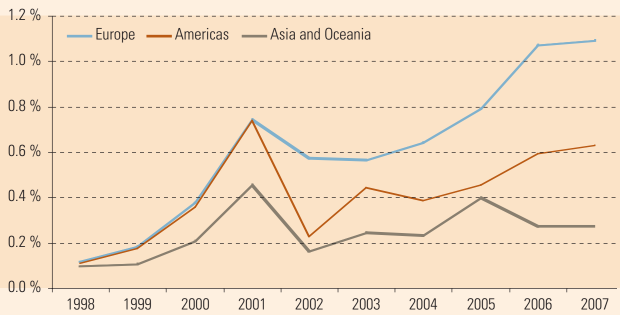


Chart 3-4: The fund's ownership interests in fixed income markets at year-end as a percentage of market capitalisation in the Lehman indices
Source: Lehman Brothers

2003. The fund's assets are managed by both internal and external portfolio managers. Decisional authority is delegated to individuals internally and, in the form of investment mandates, to external management organisations. The choice between internal and external management is governed by expected profitability. NBIM allows external managers with specialist expertise to take responsibility for just over half of overall active risk, while the Bank, through its internal management, seeks to take advantage of the economies of scale inherent in the fund's size and engages in active management in selected areas.

On average, about 80 per cent of the fund was managed internally by NBIM in 2007. Internal management costs accounted for about 47 per cent of total management costs. External management is more expensive than internal management. Management costs amounted to 0.25 and 0.05 per cent respectively of assets under management. Internal managers were responsible for about 45 per cent of the overall risk associated with active management. There is no absolutely correct method for calculating the distribution of active risk. The distribution shown in Chart 3-5 is based on summation of the Value-at-Risk (VaR) for internal and external mandates, taking no account of correlation between the different mandates.

Chart 3-6 shows how the number of external mandates increased in 2007. At the end of the year, 47 different external managers held a total of 92 different management mandates.

Table 3-10: Fixed income return by quarter and for 2007 as a whole. Per cent

	Measured in terms of the benchmark portfolio´s currency basket		Measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	0.74	0.67	-0.78	-0.85	0.07
Q2	-1.19	-1.23	-3.53	-3.57	0.04
Q3	2.10	2.59	-3.29	-2.83	-0.46
Q4	1.30	2.20	2.53	3.44	-0.91
2007	**2.96**	**4.26**	**-5.09**	**-3.90**	**-1.19**

3.1.4 Fixed income management

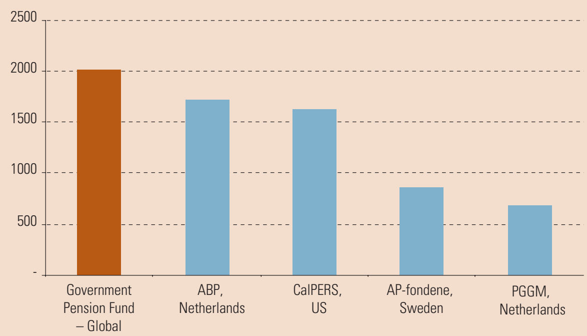
The market value of the fund's fixed income portfolio rose by NOK 3 billion to NOK 1 061 billion in 2007. The return on the fixed income portfolio in 2007 was 2.96 per cent measured in terms of the fund's currency basket (see Table 3-10). The return was negative in the second quarter, but positive in the other three quarters. The third-quarter return was particularly high.

Active management generated a positive excess return in the first half of 2007, but there was a significant negative excess return in the second half. Overall, the return on the fixed income portfolio was 1.19 percentage points lower than the return on the benchmark portfolio. This return figure has not been adjusted for transaction costs in connection with indexing and transition costs for phasing new capital into the markets. About 30 per cent of the negative excess return was attributable to external management, and about 70 per cent to NBIM's internal management. External managers managed NOK 128 billion or 12 per cent of total assets under management. These managers accounted for approximately 25 per cent of the active risk in fixed income management. Specialist man-

Size of the fund compared to other funds

Based on assets under management, the Government Pension Fund – Global is one of the world's largest pension funds. In the chart below, the fund is compared with the largest pension fund in the US, the two largest funds in Europe and the combined assets of the Swedish National Pension Funds (AP Funds). At the end of 2007, the Government Pension Fund – Global was somewhat larger than both the largest European pension fund (ABP in the Netherlands) and the largest US pension fund (CalPERS in California).

However, the fund is far from being one of the biggest when it comes to the world's largest asset managers. At the end of 2006, the world's largest asset manager (UBS in Switzerland) had total assets of more than USD 2 450 billion. The world's largest pension fund is the Japanese Government Pension Investment Fund, which invests a high proportion of its assets in Japanese bonds (primarily government bonds) and had total assets of USD 970 billion at the end of March 2007. A number of central banks also invest substantial assets in global capital markets through their foreign exchange reserves. At the end of 2007, the People's Bank of China had foreign exchange totalling USD 1 528 billion. Of the world's oil funds, Abu Dhabi Investment Authority is believed to be the largest, with assets under management estimated at USD 500-875 billion.



Capital in large international funds in 2007. In billions of NOK
Source: The funds' websites and Norges Bank

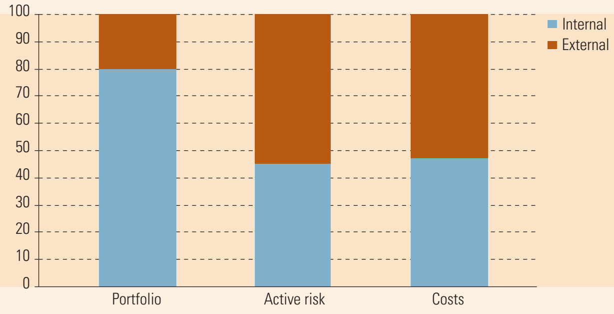


Chart 3-5: Distribution of portfolios, management costs and active risk between internal and external management. Per cent

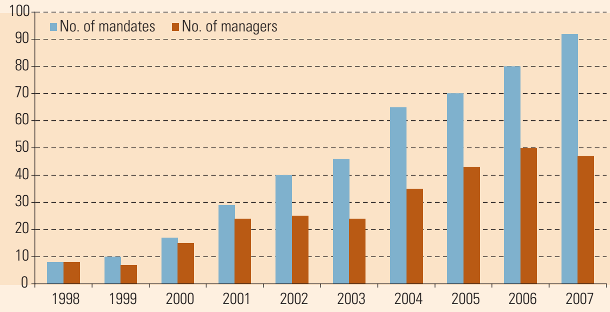


Chart 3-6: Number of external managers and external management mandates

dates for US securitised debt accounted for 40 per cent of external mandates and for NOK 4 billion or 90 per cent of the total negative excess return from external management, and 30 per cent of the negative excess return from fixed income management as a whole.

The return figure includes the results of lending out fixed income securities. There was a negative contribution from securities lending activities of NOK 2.4 billion in 2007. This is because the instruments used for re-investment of the collateral for the loans (short-term money market investments) fell in value. A more detailed discussion of the lending programme and the valuation of re-investments can be found in the financial statements (Section 6.1). At the end of 2007, around 88 per cent of the fixed income portfolio was managed internally in Norges Bank. However, internal management's share of total risk-taking in fixed income management was lower than this, due to the bulk of the external mandates being active with higher levels of risk than in internal management.

An important part of active fixed income management involves taking positions on price discrepancies between securities with closely related risk characteristics. The value of these positions is typically driven by movements in the prices of specific securities and derivatives rather than macro factors such as interest rates. Another way of looking at this is that active management supplies the market with liquidity in return for a premium.

Behind each investment decision in this type of management is an analysis which steers positioning into instruments which deviate significantly from an expected equilibrium price. The dimensioning of these positions will typically depend on the size of this deviation. Often the risk will scale up and down as the level of deviation changes. When the position becomes cheaper in relative terms, we will increase our exposure, and when it becomes more expensive, we will reduce our exposure.

This form of management consists of a large number of positions in many different market segments and instruments. In a normal market situation, these positions will show little correlation, and returns will be determined by local factors related to supply and demand in the individual segments. If a manager consistently manages to identify positions which deviate from the equilibrium price, the return series will be relatively even (due to diversification) and rising.

However, there will be breaks which can lead to a systematic change in the equilibrium price in these positions. One example of such a break is the loss of liquidity from significant market players such as hedge funds (for example, the US hedge fund Long Term Capital Management in 1998) or the banking sector

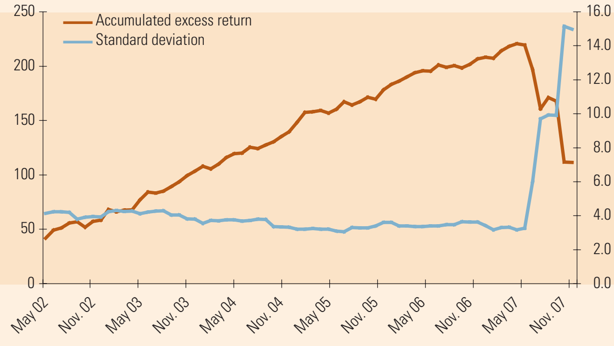


Chart 3-7: Movements in risk (basis points, right-hand scale) and returns in fixed income management (indexed, left-hand scale).

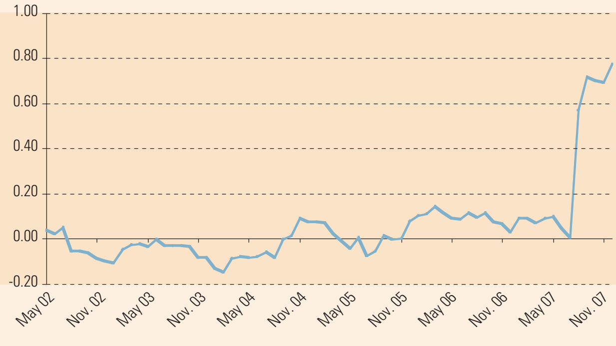


Chart 3-8: Movements in the average correlation between the main types of fixed income management

External fixed income managers as at 31 December 2007 (including funds)

At the end of the year, 22 external fixed income managers with 38 mandates managed total assets of NOK 128 billion.

- Advantus Capital Management Inc
- Aspect Capital Ltd
- Babson Capital Management LLC
- Barclays Global Investors NA
- Bridgewater Associates Inc
- Daiwa SB Investments (UK) Ltd
- Diversified Credit Investments LLC
- Ellington Global Asset Management LLC
- European Credit Management Limited
- Hyperion Brookfield Asset Management Inc
- Insight Investment Management (Global) Limited
- Lehman Brothers Asset Management LLC
- Logan Circle Partners LP
- Nomura Asset Management UK Ltd
- PanAgora Asset Management Inc
- Pareto Investment Management Ltd
- Putnam Advisory Company LLC
- Smith Breeden Associates Inc
- State Street Global Advisors
- TCW Asset Management Company
- Greylock Capital Management LLC (fund manager)
- Smith Breeden Credit Partners LLC (fund manager)

(as discussed in more detail in Section 2.2). This change in macro conditions in the market can cause correlations between positions to increase, as it now dominates the underlying supply and demand picture at micro level.

Whether management generates an excess return during such a break depends on how the active portfolio is positioned relative to the macro factor being repriced. This repricing generally leads to liquidity and credit becoming more expensive. The question in the longer term is then whether excess returns generated in a normal market will be sufficient to outweigh losses during a break.

We will now look more closely at how these factors impacted on active fixed income management in 2007. Chart 3-7 shows movements in risk and return since 2000 measured in basis points. We can see that the return climbed steadily through to August 2007 before falling sharply. This steep drop in return shows that the portfolio was short on liquidity risk and long on credit risk at the time when the liquidity and credit crisis in the market came to a head. The part of the return driven by micro conditions in the various segments to which the portfolio was exposed was dominated by the repricing of risk in the macro picture. A number of possible reasons why the portfolio had this exposure are outlined below.

As mentioned above, a dominance of macro factors can also lead to increased correlation between otherwise independent investment mandates. Chart 3-8 shows movements in the average correlation between three key management groups: enhanced indexing, relative value and external management. Until summer 2007, the correlation was not very significant and was largely in the interval between -0.1 and 0.1. In autumn 2007, the correlation shot up to more than 0.7, driven by the liquidity and credit crisis in the US. This significantly exacerbated the negative outcome.

Both the highly negative outcome of the return series and the increase in correlation indicate that both the portfolio as a whole and the individual managers had the same type of exposure to the macro factors of liquidity and credit. To try to analyse the dynamics of this exposure, it may be useful to look at two credit spreads which give an indication of how attractive the investment opportunities are within liquidity and credit.

Chart 3-9 shows movements in the credit spread between interest rate swaps and government bonds in the two-year segment in the US in 2007. This spread measures the difference in yield between unsecured bank loans and government securities. The spread rose steadily during the first half of the year, due largely to higher tax revenues than expected in April and correspondingly reduced issuance of short-term government paper. In July, the increased spread was more closely correlated with the growing prob-

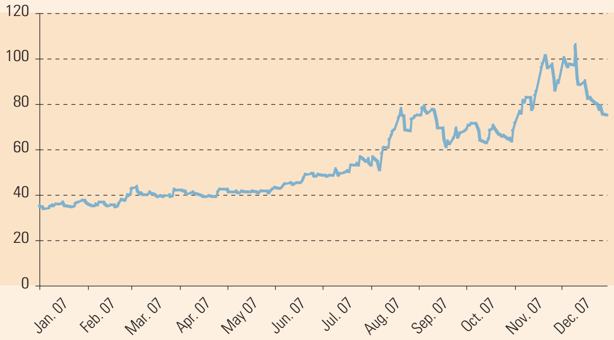


Chart 3-9: Movements in the credit spread between interest rate swaps and two-year government bonds in the US. Basis points

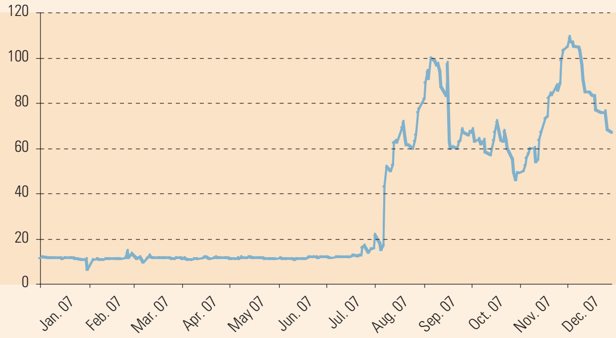


Chart 3-10: Movements in the spread between the three-month LIBOR and the federal funds rate in the US. Basis points

lems in the credit market, but it was difficult to see any signs of systematic risk in the financial sector based on market prices.

We can illustrate this by looking at a related credit spread. Chart 3-10 shows movements in the spread between the three-month LIBOR and the federal funds (overnight) rate in the US in 2007. This spread shows the difference in yield between secured and unsecured short-term loan financing in the banking sector, and is therefore a good indicator of the level of liquidity and credit problems in this sector.

Chart 3-10 shows that this spread was very stable until the beginning of August. For a fundamental investor, therefore, there were few danger signals in terms of systematic risk in a period of rising liquidity and credit premiums. As the chart shows, there was a dramatic repricing of risk in August. The spread which had normally moved within the interval of 12-15 basis points suddenly shot up to more than 100 in the course of a month. A longer time series for the credit spread (see Chart 2-2) between government bonds and interest rate swaps confirms the impression of a major systematic break.

The spread grew to its widest since 1989. The result was a rapid increase in liquidity and credit premiums and in the correlation between them. The fixed income portfolio was exposed to both factors and therefore made corresponding losses. In some parts of the portfolio, especially in the externally managed mandates for US securitised debt, the outcome was more pronounced.

Fixed income management at NBIM had little direct exposure to US sub-prime mortgages. The losses on investments in these and closely related instruments explain less than 10 per cent of the negative result in 2007. The losses incurred can be considered small in relation to total exposure. This reflects the fact that most of the securities are in the segment with the highest credit quality.

Norges Bank views the selection of external managers as an investment decision where different mandates are allocated capital or wound up on the basis of analyses of liquidity and expected future excess returns. At the end of 2007, the fund had 38 different externally managed fixed income mandates.

Chart 3-11 shows how the overall return on the fixed income portfolio breaks down between the currencies in which the fund's assets were invested. By far the largest positive contribution came from investments in the euro countries and the US. The contributions from the other currency areas were small.

3.1.5 Equity management

The market value of the equity portfolio increased from NOK 726 billion at the end of 2006 to NOK 958 billion on 31 December 2007. The return on the equity portfolio in 2007 was 6.82 per cent measured in international currency (see Table 3-11). There was a positive return of around 10 per cent in the first half of the year and a negative return of just over 3 per cent in the second.

Chart 3-12 shows the various markets' contributions to the return on the fund's equity portfolio in 2007 measured in terms of the currency basket. The countries of the euro area made the largest positive contributions.

Equities were managed along the same lines as before. With external equity management, NBIM awards mandates by geographical region (or country) and industrial sector (both global and regional). With internal equity management, most of the active mandates are for global industrial sectors. There are also some mandates for active indexing strategies. One key feature of management in 2007 was an increase in the proportion of the equity portfolio managed internally.

When it comes to internal equity trading, the focus on direct and indirect transaction costs was retained, and one

Table 3-11: Return on the fund´s equity portfolio by quarter and for 2007 as a whole. Per cent

	Return measured in terms of the benchmark portfolio´s currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	2.59	2.47	1.04	0.92	0.12
Q2	7.40	6.71	4.86	4.18	0.68
Q3	-0.30	-0.54	-5.57	-5.80	0.23
Q4	-2.77	-2.84	-1.59	-1.66	0.07
2007	**6.82**	**5.67**	**-1.54**	**-2.60**	**1.06**

Chart 3-11: Individual countries' contributions to fixed income returns measured in terms of the currency basket on 31 December 2007. Per cent

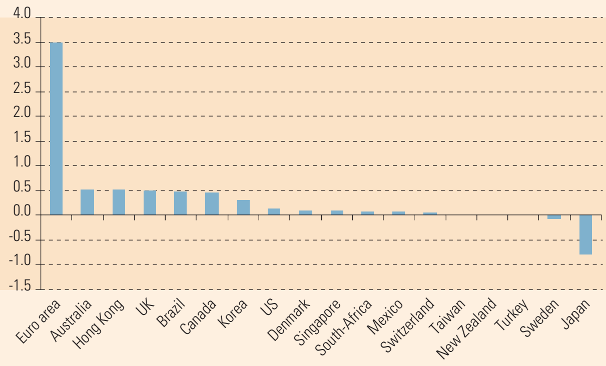


Chart 3-12: Individual countries' contributions to equity returns measured in terms of the currency basket in 2007. Per cent

important trend is for an increasingly large proportion of trading in securities to take place directly on an exchange rather than through brokers. The opening of the office in Shanghai (see discussion in Section 5.1) is particularly important for equity management. The office is located in a time zone which is close to all of the most important Asian markets, which allows an increased degree of presence and potentially more efficient execution of transactions.

The actual return on the equity portfolio was 1.06 percentage points higher than the return on the benchmark portfolio. This excess return equates to NOK 8.6 billion. The bulk of the excess return was generated in the second quarter, but there was a positive result in all four quarters. The actual portfolio incurs a number of costs which are not reflected in the return on the benchmark portfolio, such as transaction costs due to the exclusion of individual companies, and transition costs due to phasing new capital into the fund's equity portfolio. The most important costs in 2007 were for adjustment to a broader benchmark portfolio which includes companies with a smaller market capitalisation than before. The effect of these costs on the overall outcome was an estimated 0.15 percentage point. In other words, the transaction-adjusted excess return was 1.21 percentage points.

The excess return from externally managed portfolios was NOK 5.2 billion in 2007. This was a good result given the amount of capital allocated to this type of management, and made up for most of the loss on external management in 2006. Viewed over a longer period, externally managed mandates have made a major contribution to the excess return from equity management.

At the end of 2007, Norges Bank had 54 different externally managed equity portfolios distributed among 25 different managers. These mandates were regional or country-specific mandates, or within various industrial sectors. The market value of the externally managed equity portfolio fell from NOK 274 billion to NOK 217 billion. This meant that the proportion of the equity portfolio managed externally dropped from 37.7 to 22.7 per cent.

The organisation of internal equity management was retained in 2007 without any major changes. The bulk of internal active management is sector-based, focusing on global stock-picking in specific industries. There are also several mandates for active indexing strategies and relative value strategies. The relative value strategies produced a negative result of NOK 201 million. Internal management's share of the equity portfolio's overall risk exposure climbed from around 30 per cent in 2006 to 35 per cent in 2007.

In recent years, the internal management mandates have been characterised by a very high proportion of them having delivered positive excess returns. In 2007, the results were more mixed. Of the 21 mandates with sector-based strategies, 14 generated a positive excess return. The overall result was NOK 0.8 billion. Part of internal management also takes the form of decisions on allocation between different markets and to markets which are not part of the benchmark portfolio. This strategy made a major

External equity managers as at 31 December 2007

At the end of the year, 25 external equity managers with 54 mandates managed total assets of NOK 217 billion.

Regional mandates:

- Aberdeen Asset Management
- APS Asset Management Pte Ltd
- Altrinsic Global Advisors LLC
- Atlantis Fund Management Ltd
- Capital International Ltd
- Dalton Capital (Guernsey) Ltd
- Fidelity Pensions Management
- Gartmore Investment Limited
- GLG Partners
- Intrinsic Value Investors (IVI) LLP
- Janus Capital Management LLC
- Legg Mason Capital Management Inc
- NewSmith Asset Management LLP
- Primecap Management Company
- Scheer, Rowlett & Associates Investment Management Ltd
- Schroder Investment Management Ltd
- Sparx Asset Management Co Ltd
- T Rowe Price Associates Inc
- Tradewinds NWQ Global Investors LLC
- Wellington Management Company LLP

Sector mandates:

- BlackRock Capital Management Inc
- Columbus Circle Investors
- Janus Capital Management LLC
- Jupiter Asset Management Ltd
- OrbiMed Capital LLC
- T Rowe Price Associates Inc
- Tradewinds Global Investors LLC
- WH Reaves & Co Inc
- Wellington Management Company LLP

All external equity mandates are active mandates, and their objective is to achieve the highest possible return in relation to a benchmark portfolio. Benchmark portfolios and risk limits have been defined for each management mandate. The regional mandates have benchmark portfolios composed of the companies in the FTSE index in a geographical region, such as Continental Europe, the UK, the US and Japan. Sector mandates have benchmark portfolios in the finance, technology, health, pharmaceuticals, energy, oil and gas, mining, utilities and capital goods sectors.

contribution of NOK 1.5 billion to the overall result.

3.1.6 Risk

There are many risk factors associated with investing capital in international financial markets. Investment management is largely a question of handling this risk. Therefore, NBIM places considerable emphasis on measuring and managing risk factors. Part of the risk is a result of conscious investment decisions, and is desirable. Other risk elements are to be kept to a minimum, given the operating conditions inherent in being an investor in global capital markets.

Investments in global securities markets entail considerable market risk and a relatively high probability of wide variations in annual performance. For the Government Pension Fund – Global, the level of market risk is determined primarily by the composition of the benchmark portfolio. The most important elements of market risk are the level of equities in the portfolio, fluctuations in equity prices, exchange rates and general interest rate levels, as well as changes in the fixed income portfolio's credit risk.

In addition to the absolute level of market risk, which is determined by the investment strategy expressed by the benchmark portfolio, NBIM tries to achieve an excess return through active management. So far, NBIM's active management has led to only a limited increase in the fund's market risk. Market risk must be seen in relation to expected returns, and an increase in market risk means higher expected returns.

Besides market risk in the management of the fund, NBIM also faces a number of other risk factors. These include counterparty risk, liquidity risk and risks of a more operational nature. Operational risks include the risk of financial and reputational losses due to failures in internal processes, human error, system error, and other losses due to external factors which are not a consequence of the market risk in the portfolio.

Market risk

Most of the fund's market risk is determined by the benchmark portfolio's market risk. NBIM also takes on some risk through its active management. NBIM measures both absolute and relative market risk in the fund. Absolute risk is estimated on the basis of the actual portfolio, while relative risk is estimated as the standard deviation of the difference between the return on the actual portfolio and the return on the benchmark portfolio. Standard deviation is a statistical concept which provides some indication of the variations in return which can be expected in normal periods. Standard deviation is a standard measure of portfolio risk.

Absolute volatility

Chart 3-13 shows developments in the fund's absolute market risk over the past four years, measured as the expected volatility of returns. The level fluctuates with market volatility, but there is little difference between the risk in the actual portfolio and the risk in the benchmark portfolio throughout the period. At the end of 2007, the actual portfolio's absolute market risk, measured in NOK, was 8.6 per cent, which was higher than at the beginning of the year.

Chart 3-13 shows that there was a decrease in risk in the first half of the year, but a marked increase in portfolio risk in the second. The reason for the increase in risk in the second half was the financial turmoil in the market in 2007.

Besides increased volatility in both the fixed income and equity markets, the risk at fund level will depend on correlation between these markets. The correlation between the two markets has increased since the turn of the millennium and has been at relatively high levels in recent years, but there was a significant reduction in 2007. Thus, part of the increase in the markets' volatility in 2007 did not materialise in the fund's risk due to an increase in the diversification effect. Developments in the diversification effect are shown in Chart 3-14, which illustrates how reduced correlation between fixed income and equity markets has increased the diversification effect.

Relative volatility

Absolute market risk is determined largely by the fund's benchmark portfolio. The Ministry of Finance has set a ceiling for expected relative volatility – expected tracking error – which limits how far the fund's portfolio can deviate from the benchmark portfolio.

Expected tracking error must not exceed 1.5 percentage points (150 basis points) (see box on page 28). The fund's estimated tracking error increased during the year. August was especially volatile, due primarily to increased tracking error in the equity portfolio (see Chart 3-15).

While tracking error in the equity portfolio returned to a "long-term" average

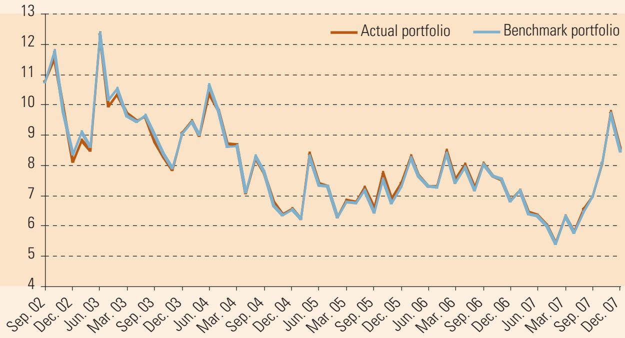


Chart 3-13: Absolute market risk in the Government Pension Fund – Global at month-end. Per cent

Chart 3-14: Movements in the diversification effect between equity and fixed income markets. Absolute risk. Per cent

by the end of the year, the fixed income portfolio's risk increased throughout 2007 and was at a historically "high" level at the end of the year. The high level of risk in the fixed income portfolio is due partly to market volatility in general having increased (see Chart 3-13). In addition, closer correlation between the returns on the different mandates was seen in 2007 than in previous years. The increase in correlation between mandates was strongest in the fixed income portfolios, but was also observed between the equity mandates. Other things being equal, increased correlation between mandates reduces the diversification effect and increases the risk.

Chart 3-16 shows movements in the portfolio's tracking error relative to the benchmark portfolio since 1999. The chart uses two different measures of risk. Expected tracking error is calculated prospectively on the basis of expected future market dynamics (volatilities and correlations). This measure of risk has remained well below the upper limit of 1.5 percentage points throughout the period.

Actual tracking error is calculated retrospectively on the basis of variation in the actual return differential in the past 12-month period. With the exception of the year 2000, these measures show largely the same degree of risk exposure. In 2007, there is a mixed picture, with these measures showing very different levels of risk at times. This was due to unusually volatile markets and the special correlation between returns on different mandates during the period.

NBIM tests whether the actual excess return on the fund varies in line with what might be expected in the light of the risk model used. This is illustrated in Chart 3-17.

The points in the chart show the realised monthly excess return since October 2002 and the confidence interval at different confidence levels. The model indicates that the actual return should be within the interval formed by the green lines in approximately 68 per cent of cases, and within the intervals formed by the orange and red lines in 95 and 99 per cent of cases respectively. The chart indicates that, over the period as a whole, actual risk was in line with what might be expected given the risk model used. When it comes to 2007, and especially the second half of the year, it appears that the model underestimated the actual risk in the portfolio. The risk model estimates the size of the variations in return which can be expected in normal periods. In 2007, the market featured a number of factors which reduced the accuracy of this type of model. There is a time lag before factors such as rapid shifts in volatility and substantial changes in correlation between risk factors are reflected in the model. The model's strict normal market assumption when estimating risk is a weakness in this type of statistical (probability-based) model. It is therefore important to have complementary measures of risk which also (stress) test the portfolios in abnormal markets.

Expected tracking error

The Ministry of Finance has set the limit for relative market risk in the management of the fund in relation to the risk measure *expected tracking error*. This measure is defined as the expected value of the standard deviation of the difference between the annual return on the actual portfolio and the return on the benchmark portfolio. When deviations from the benchmark are controlled by means of an upper limit for expected tracking error, it is highly probable that the actual return will lie within a band around the return on the benchmark. The lower the limit for tracking error, the narrower the band will be. Given an expected tracking error of 1.5 percentage points or 150 basis points, the actual return on the portfolio will probably deviate from the benchmark return by less than 1.5 percentage points in two out of three years.

Credit risk

Credit risk arises partly in the fund's fixed income portfolio as a result of the Ministry of Finance's choice of investment strategy, and partly as a result of NBIM's active management (credit portfolio risk). In both the equity and the fixed income portfolios, NBIM is exposed to risk vis-à-vis counterparties in the execution of transactions, vis-à-vis custodian institutions with which securities are deposited, and vis-à-vis international settlement and custody systems (counterparty risk).

Table 3-12 provides an overview of fixed income securities from Moody's.

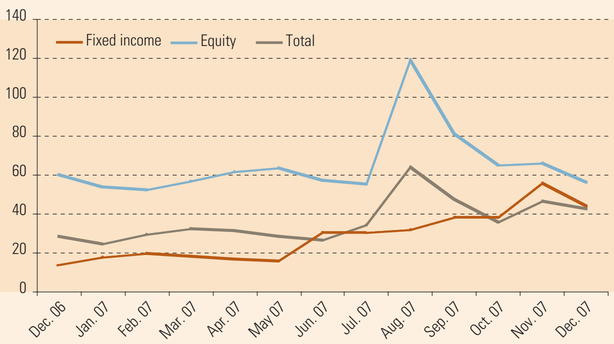


Chart 3-15: Expected tracking error at each month-end in 2007. Basis points

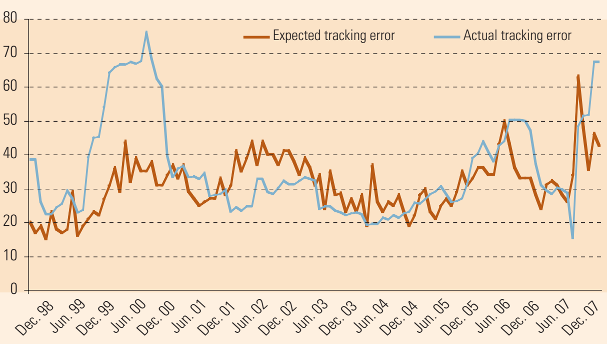


Chart 3-16: Expected and actual tracking error at each month-end 1999-2007. Percentage points

Table 3-12: Portfolio of fixed income instruments on 31 December 2007 by credit rating from Moody´s. Millions of NOK

	Aaa	Aa	A	Baa	Ba	Lower	P-1	No rating
Inflation-linked bonds	40 369	8 210	30 791	-	-	-	-	18 928
Securitised debt	382 811	13 810	2 558	1 268	389	839	-	43 033
Corporate bonds	21 058	87 150	89 743	70 435	5 306	2 023	-	15 342
Short-term certificates	-	-	-	-	-	-	4 198	164
Government and government-related bonds	114 568	98 381	32 126	8 039	1 272	752	-	26 976
Total bonds and other fixed income instruments	**558 806**	**207 551**	**155 218**	**79 742**	**6 667**	**3 614**	**4 198**	**104 444**

An equivalent overview based on ratings from Fitch and Standard & Poor's (S&P) can be found in the financial statements.

The equity and fixed income portfolios also include investments in unsecured bank deposits and unlisted derivatives. The Ministry of Finance has decided that no counterparties involved in such transactions may have a credit rating lower than A-, A3 or A- from Fitch, Moody's or S&P respectively. Credit risk limits are determined by the credit rating of the counterparty, where a higher rating results in a higher limit. There is no requirement for a credit rating from the rating agencies for the fund's portfolio of fixed income instruments.

Section 5.2 provides a more detailed presentation of how NBIM manages operational risk in its investment management.

Credit rating agencies

All fixed income instruments in the fund's benchmark index have a rating from one of the major credit rating agencies: Standard & Poor's (S&P), Moody's and Fitch.

All three agencies classify the issuers of fixed income instruments on the basis of their creditworthiness. A credit rating scale from AAA to D is used for long-term bonds. The highest rating is AAA from S&P and Fitch and Aaa from Moody's. The lowest investment grade ratings are BBB from S&P and Fitch and Baa from Moody's. Lower ratings are known as speculative grade. All bonds in the fund's benchmark portfolio have an investment grade rating.

The issuers pay these agencies to provide credit ratings. The agencies consider the issuer's ability to repay debt and at the general security for investors inherent in the terms of the loan. The agencies then assess the probability that loan obligations will be met and set credit ratings accordingly. These ratings may be changed during the life of the loan if the issuer's ability to pay or the loan collateral changes.

The agencies do not rate only corporate bonds. Most fixed income instruments in the market, including government bonds, have a rating from at least one of the agencies. Very few issuers have such high creditworthiness that debt instruments can be issued without a credit rating from one or more of the agencies.

Management guidelines

The Ministry of Finance has issued a number of guidelines for the management of the Government Pension Fund – Global. Table 3-13 summarises the risk exposure limits stipulated in the regulation on the management of the fund. The table shows that exposures at the end of each quarter were within the stipulated limits.

In 2007, there were no significant breaches of the guidelines issued by the Ministry of Finance. There were three minor breaches during the year, two of which were in the fourth quarter. For a brief period, two external managers had holdings in companies excluded from the investment universe.

3.1.7 Costs

Table 3-14 shows the costs of managing the fund in 2007. Fees to external managers and external settlement and custodian institutions are invoiced separately for each of the funds managed by Norges Bank. The other operating costs are overheads shared by all funds under management. These overheads are distributed among the three funds by means of a cost distribution key. Besides NBIM's direct costs, these overheads include the costs of support functions provided by other parts of Norges Bank. These latter costs

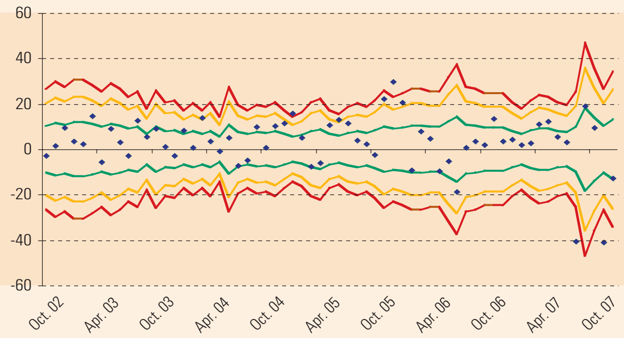


Chart 3-17: Confidence interval for risk and realised excess return. Basis points

Table 3-13: Risk exposure limits stipulated in the regulation

	Risk	Limits	Actual				
			31.12.06	31.03.07	30.06.07	30.09.07	31.12.07
§ 5	Market risk	Max. tracking error 1.5 percentage points	0.28	0.32	0.26	0.48	0.43
§ 4	Asset mix	Fixed income instruments 30-70%	59.3	59.9	57.7	54.6	52.6
		Equity instruments 30-70%	40.7	40.1	42.3	45.4	47.4
§ 4	Market distribution, equities	Europe 40-60%	49.7	49.7	49.7	50.1	48.8
		Americas and Africa 25-45%	35.0	35.0	35.1	34.4	36.4
		Asia and Oceania 5-25%	15.5	15.3	15.3	15.5	14.8
	Currency distribution, fixed income	Europe 50-70%	60.4	59.7	60.0	59.8	59.4
		Americas and Africa 25-45%	34.3	35.0	34.6	34.7	35.1
		Asia and Oceania 0-15%	5.3	5.3	5.4	5.5	5.5
§ 6	Ownership interests	Max. 5% of a company	4.5	4.5	5.0	5.0	5.0

Cost comparison with other funds

The Ministry of Finance has asked Norges Bank to deliver cost data to the Canadian consulting firm CEM Benchmarking Inc, which has a cost performance database for asset management at more than 260 pension funds. From this database, CEM selects a peer group consisting of the world's largest pension funds. The costs of this peer group of 18 pension funds are used as a basis for assessing the costs of managing the Government Pension Fund – Global.

The latest analysis received by the Ministry of Finance from CEM concerns management in 2006. It shows that Norges Bank's management costs were lower than the average costs in the peer group after taking into account differences in portfolio composition. See also the Ministry of Finance's website.

CEM costs 2003-2006. Basis points

Year	2003	2004	2005	2006
Government Pension Fund – Global	10.3	10.5	10.6	9.8
Peer group – median	13.1	12.0	13.4	10.8

are calculated in accordance with the guidelines which apply to business operations at Norges Bank.

The management agreement between the Ministry of Finance and Norges Bank establishes the principles for Norges Bank's remuneration for managing the Government Pension Fund – Global. For 2007, this remuneration is to cover the Bank's actual costs, provided that these costs are less than 0.10 per cent (or 10 basis points) of the average market value of the fund. In addition, the Ministry reimburses NBIM for performance-based fees paid to external fund managers. Norges Bank has entered into agreements on performance-based fees with the majority of external active managers, in accordance with principles approved by the Ministry of Finance.

Table 3-14: Management costs in 2007. Thousands of NOK and basis points of the average portfolio

	2007		2006	
	NOK 1 000	Basis points	NOK 1 000	Basis points
Internal costs, equity management	315 751		223 889	
Custody and settlement costs	110 400		95 689	
Total costs, internal equity management	**426 151**	**7.7**	**319 578**	**8.1**
Internal costs, fixed income management	290 616		184 178	
Custody and settlement costs	115 088		79 858	
Total costs, internal fixed income management	**405 704**	**4.1**	**264 036**	**3.2**
Minimum fees to external managers	513 442		431 829	
Performance-based fees to external managers	268 546		387 816	
Custody, settlement and monitoring costs	169 433		122 340	
Total costs, external management	**951 421**	**25.1**	**941 985**	**28.3**
Total management costs	**1 783 275**	**9.3**	**1 525 600**	**9.8**
Total management costs, excluding performance-based fees	**1 514 729**	**7.9**	**1 137 784**	**7.3**

Management costs totalled NOK 1 783.3 million or 9.3 basis points of the average portfolio under management in 2007, down from 9.8 in 2006. Excluding performance-based fees to external managers, Norges Bank's management costs came to NOK 1 514.7 million in 2007, a 33 per cent increase on 2006. The average size of the fund increased by 24 per cent, which means that these costs increased from 7.3 basis points of the average portfolio under management in 2006 to 7.9 basis points in 2007.

Costs can be distributed between internal and external management by using cost distribution keys for internal and custodian costs. Approximately 53 per cent of costs were related to external management, whereas only about 16 per cent of the fund's assets are managed externally. Unit costs for internal management were roughly 0.05 percentage point, compared with 0.25 percentage point for external management. This is partly attributable to the fact that index management is largely internal.

Performance-based fees to external managers as recognised in the financial statements fell by 31 per cent to NOK 268.5 million in 2007. The financial statements show the costs actually accrued in 2007. Most performance-based fees to external managers are based on the average excess return achieved over a period of several years, which means that there is no direct relationship between the costs recognised and the excess return achieved in a particular year. Although external managers contributed more to excess return in 2007 than in 2006, lower performance-based fees were paid than in 2006. This is largely because of the poor results achieved by external managers in 2006. The total costs of external management amounted to 25.1 basis points of the average externally managed portfolio.

3.2 Norges Bank's foreign exchange reserves

3.2.1 Mandate

The foreign exchange reserves are to be available for intervention in the foreign exchange market in connection with the implementation of monetary policy or to promote financial stability. The reserves are divided into a money market portfolio and an investment portfolio. In addition, a buffer portfolio is used for the regular foreign exchange purchases for the Government Pension Fund – Global. Within Norges Bank, the investment portfolio and buffer portfolio are managed by NBIM, while the money market portfolio is managed by Norges Bank Monetary Policy.

Norges Bank's Executive Board lays down guidelines for the management of the foreign exchange reserves and has delegated responsibility for issuing supplementary rules to the Governor. The Executive Board's guidelines are available on Norges Bank's website (www.norges-bank.no). In June 2007, the Exec-

Table 3-15: Benchmark portfolio on 31 December 2007. Per cent

	Equities		Fixed income instruments	
Country for equity benchmark Currency for fixed income benchmark	Strategic benchmark portfolio	Actual benchmark portfolio	Strategic benchmark portfolio	Actual benchmark portfolio
Asset class weights	**40.0**	**41.3**	**60.0**	**58.7**
Belgium		0.8		
Finland		1.3		
France		8.2		
Greece		0.7		
Ireland		0.5		
Italy		3.1		
Netherlands		2.3		
Portugal		0.3		
Spain		3.5		
Germany		6.6		
Austria		0.5		
Euro area		*27.6*		*48.4*
UK		15.7		9.9
Denmark		0.8		0.8
Switzerland		4.7		0.5
Sweden		1.9		1.2
Total Europe	**50.0**	**50.7**	**60.0**	**60.9**
US		29.3		31.8
Brazil		1.1		
Canada		2.5		2.3
Mexico		0.4		
South Africa		0.6		
Total Americas and Africa	**35.0**	**34.0**	**35.0**	**34.1**
Australia		2.7		0.2
Hong Kong		1.7		
Japan		7.5		4.6
New Zealand		0.1		0.1
Singapore		0.5		0.2
South Korea		1.7		
Taiwan		1.2		
Total Asia and Oceania	**15.0**	**15.4**	**5.0**	**5.0**

utive Board decided to extend the benchmark portfolio for equities to include small-cap companies. At the same time, the rules on approved markets and countries were revised. Previously, the Executive Board issued a list of countries, but the new rules require certain criteria to be met before investments in new countries are permitted. These changes corresponded to the changes introduced by the Ministry of Finance for the Government Pension Fund – Global. The change in the investment portfolio was implemented on 31 August 2007.

The Executive Board has laid down joint guidelines for the exercise of ownership rights in respect of the two funds, and has also ruled that companies which the Ministry of Finance has decided to exclude from the Pension Fund are also to be excluded from the foreign exchange reserves. Section 4.1 provides an overview of ownership activities in 2007, and Section 4.2 provides an overview of the companies which have been excluded from the investment universe.

The strategic benchmark portfolio for the investment portfolio is composed of FTSE equity indices for companies in 27 countries and of Lehman Global Aggregate fixed income indices in 11 currencies. Equities account for 40 per cent of the strategic benchmark portfolio, while fixed income instruments account for 60 per cent. The equity portion of the benchmark consists of equities listed on regulated marketplaces in Europe (50 per cent), the Americas and Africa (35 per cent), and Asia and Oceania (15 per cent). The regional distribution of the fixed income benchmark is 60 per cent Europe, 35 per cent Americas and 5 per cent Asia and Oceania.

Table 3-15 shows the weights in the actual benchmark as at 31 December 2007. The weights in the fixed income benchmark are based on the currency in which the securities are issued, and so the weight for each country in the euro area is not listed.

3.2.2 Returns in 2007

The investment portfolio's market value was NOK 214.0 billion at the end of 2007, a decrease of NOK 10.5 billion since the beginning of the year. No capital was transferred to or from the investment portfolio during the year. The return on investment was NOK 7.5 billion in 2007, while a stronger krone in relation to the investment currencies reduced the portfolio's market value by NOK 18.0 billion. The negative contribution from a stronger krone has no effect, however, on the international purchasing power of the foreign exchange reserves. Table 3-16 shows the size of the equity and fixed income portfolios at the end of each quarter of 2007.

Chart 3-18 shows movements in the portfolio's market value since 1998, measured in NOK.

The return on the investment portfolio in 2007 was 3.37 per cent measured in terms of the benchmark portfolio's currency basket and -4.69 per cent measured in NOK. The lower return in NOK is due to the appreciation of the krone against the currencies in the benchmark during the year, which meant that the portfolio's currency basket was worth less in relation to the krone.

Table 3-17 presents the return figures. The actual return in 2007 was 1.12 percentage points lower than the return on the benchmark portfolio. In absolute terms, this equates to NOK 2.6 billion. Table 3-18 shows that there were poor results from both equity and fixed income management in 2007.

Chart 3-19 shows the return on the investment portfolio since 1998 measured in international currency. There has been a positive return in 29 out of 36 quarters.

The gross negative excess return of 1.12 percentage points for the portfolio as a whole in 2007 is comparable with the performance reported by other managers. However, it does not provide a measure of NBIM's net contribution to management performance. The investment portfolio could have been managed passively, with a portfolio kept extremely close to the benchmark at all times. Instead, NBIM has chosen to engage in active management. Costs are higher, but so are the expected returns. The value added by active management, which is estimated in Table 3-19, is a measure of the net contribution from this strategy to the portfolio's return in 2007.

The starting point is the portfolio's gross excess return. With passive indexing, transaction costs accrue when the benchmark portfolio's composition changes. The normal annual transaction costs associated with indexing are estimated at about 0.04 per cent of the total portfolio.

When calculating the gross excess return, account is not taken of costs relating to phasing new capital into the markets, adjusting the actual portfolio when companies are excluded from the investment universe, or other changes in the

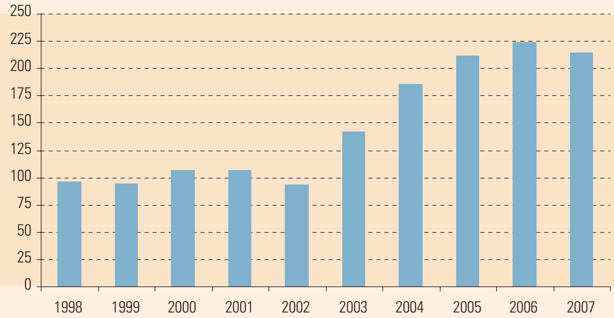


Chart 3-18: Market value of the investment portfolio 1998-2007. Billions of NOK

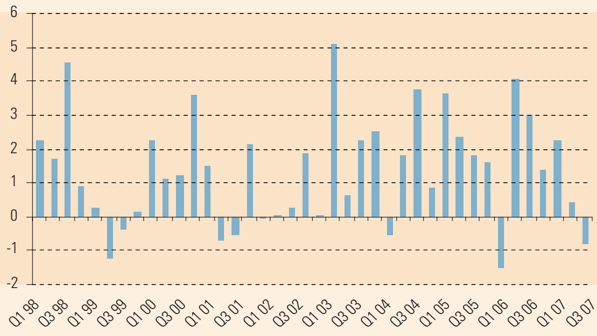


Chart 3-19: Quarterly returns measured in international currency 1998-2007. Per cent

benchmark portfolio. In 2007, the Executive Board decided to include small-cap companies in the equity benchmark. For 2007, NBIM estimates the cost of disposals in connection with the exclusion of companies at NOK 1 million, and the cost of changes in the benchmark portfolio at NOK 152 million. Total transaction costs in 2007 are therefore estimated at 0.07 per cent of the portfolio's average market value.

Passive indexing of the portfolio would also involve some management-related operating costs. For the investment portfolio, the normal management costs associated with indexing are estimated at 0.02 per cent of the total portfolio. In 2007, total management costs actually amounted to 0.07 per cent of the portfolio, which means that the additional costs associated with active management came to an estimated 0.05 per cent. On the other hand, passive management would also have generated some income from lending out securities in the portfolio, estimated at 0.05 per cent in 2007.

With these items included, net value added by active management in 2007 was an estimated -1.12 percentage points. In absolute terms, this equates to approximately NOK -2.6 billion.

The first line of Table 3-20 shows that the gross excess return in 2007 was -1.12 percentage points and that the annual average since 1998 is 0.07 percentage point.

The second line of the table shows net value added by active management. The method used to calculate this is described above. The average annual net contribution to excess return in the period 1998-2007 was 0.05 percentage point.

When evaluating the quality of active

Table 3-16: Market value of the investment portfolio in 2007. Millions of NOK

	31.12.06	31.03.07	30.06.07	30.09.07	31.12.07
Equity portfolio	92 143	92 860	97 443	90 900	88 953
Fixed income portfolio	132 374	131 408	126 535	122 211	125 033
Total portfolio	**224 517**	**224 268**	**223 978**	**213 111**	**213 986**

Table 3-17: Return on the investment portfolio by quarter and for 2007 as a whole. Per cent

	Return measured in terms of the benchmark portfolio´s currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	1.43	1.41	-0.11	-0.13	0.02
Q2	2.28	2.06	-0.13	-0.34	0.21
Q3	0.45	1.08	-4.85	-4.25	-0.60
October	1.84	1.68	2.48	2.32	0.16
November	-1.97	-1.35	1.33	1.98	-0.64
December	-0.64	-0.34	-3.31	-3.01	-0.30
Q4	-0.80	-0.03	0.41	1.20	-0.79
2007	**3.37**	**4.59**	**-4.69**	**-3.57**	**-1.12**

Table 3-18: Contributions to gross excess return in 2007. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity portfolio	-	-0.34	-0.34	-0.80
Fixed income portfolio	-0.32	-0.46	-0.78	-1.33
Total investment portfolio	**-0.32**	**-0.80**	**-1.12**	

Table 3-19: Estimated net value added by active management. Percentage points

Gross excess return	**-1.12**
+ Transaction costs associated with indexing	0.04
+ Other transaction costs	0.07
- Additional costs for active management	0.05
- Lending income associated with index management	0.05
= Value added by active management	**-1.12**

Table 3-20: Excess return from the management of the investment portfolio in 1998-2007. Percentage points

	1998	1999	2000	2001	2002	2003	2004	2005	2006*	2007	Average 1998-2007
Gross excess return	-0.03	0.13	0.12	0.15	0.32	0.58	0.08	0.35	0.13	-1.12	0.05
Value added by active management	-0.03	0.10	0.10	0.13	0.29	0.55	0.09	0.31	0.10	-1.12	0.05

* In 2006, Norges Bank used incorrect tax rates for a number of countries, which meant that the excess return reported for the fund was slightly higher than was actually the case. Based on the correct figures, the excess return for 2006 was 13 basis points, not 14 as originally reported.

management, it is also important to consider the market risk involved in achieving excess returns. The Executive Board's guidelines for the investment portfolio stipulate that market risk, defined as the deviation from the benchmark portfolio, must not exceed expected tracking error of 1.5 percentage points.

Fixed income management

The market value of the fixed income portfolio fell by NOK 7.3 billion to NOK 125.0 billion in the course of the year. NOK 0.3 billion was transferred from the fixed income portfolio to the equity portfolio. A stronger krone in relation to the investment currencies reduced the value of the portfolio by NOK 10.4 billion, while a positive return on investment increased its value by NOK 3.4 billion.

At the end of the year, about 87 per cent of the portfolio was managed internally by Norges Bank. The management strategies used include enhanced indexing, where the primary objective is to achieve market exposure in line with the benchmark portfolio, and active strategies designed to outperform the benchmark. Approximately 13 per cent of the portfolio is managed by external managers, who primarily employ active strategies designed to outperform the benchmark. Some mandates for the enhanced indexing of securitised debt in the US have also been assigned to external managers.

Table 3-21 shows the return on the fixed income portfolio in 2007. Measured in international currency, the return was 2.68 per cent. There was a negative gross excess return of 1.33 percentage points. There were negative contributions from both internal and external fixed income management.

External fixed income managers as at 31 December 2007

At the end of the year, ten external fixed income managers with 16 mandates managed total assets of NOK 24 billion.

- Barclays Global Investors NA
- Bridgewater Associates Inc
- Hyperion Brookfield Asset Management Inc
- Lehman Brothers Asset Management LLC
- PanAgora Asset Management Inc
- Pareto Investment Management Ltd
- Putnam Advisory Company LLC
- Smith Breeden Associates Inc
- State Street Global Advisors
- TCW Asset Management Company

Equity management

At the end of 2007, the market value of the equity portfolio was NOK 89.0 billion, a decrease of NOK 3.2 billion in the course of the year. There was a positive return on investment of NOK 3.9 billion, and NOK 0.3 billion was transferred to the equity portfolio from the fixed income portfolio, while a stronger krone in relation to the investment currencies reduced the value of the portfolio by NOK 7.4 billion.

Table 3-22 shows the return on the equity portfolio in 2007. Measured in international currency, the return was 4.39 per cent. There was a negative excess return of 0.80 percentage point relative to the benchmark portfolio. The entire equity portfolio is managed internally, largely using active indexing and relative value strategies. As with the Government Pension Fund – Global, relative value management in the investment portfolio produced poor results in 2007.

The figures for negative excess return do not take account of transaction costs associated with adjustment to a broader benchmark portfolio which also includes companies with a small market capitalisation. Nor has account been taken of transaction costs relating to the exclusion of individual companies. The effect of these costs is estimated at 0.14 basis points, which means that the transaction-adjusted negative excess return was 0.66 percentage point.

3.2.3 Risk

The Executive Board's guidelines define a limit for market risk in the actual portfolio relative to the benchmark portfolio. This relative market risk must always be less than expected tracking error of 1.5 percentage points. Chart 3-21 shows that relative market risk was well below this limit throughout 2007, even though there was a significant increase during the year. At the end of the year, expected tracking error stood at 0.56 percentage point.

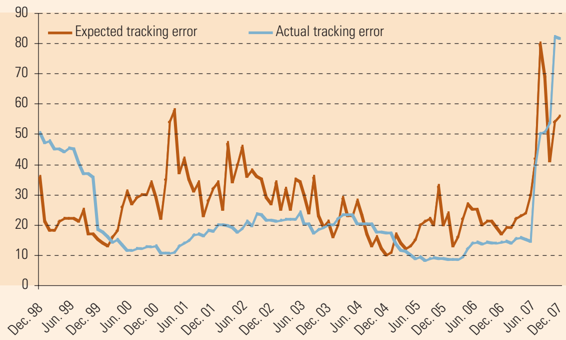


Chart 3-20: Relative market risk in the investment portfolio at each month-end 1999-2007. Basis points

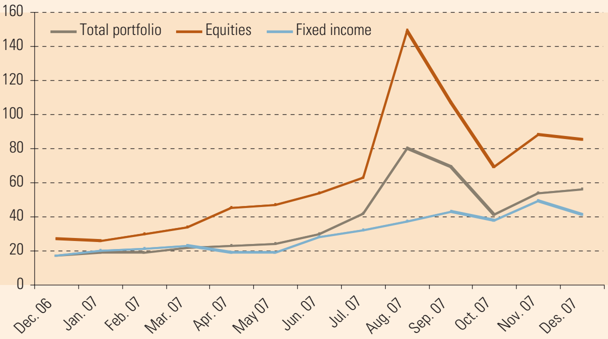


Chart 3-21: Expected tracking error at each month-end in 2007. Basis points

Chart 3-20 shows movements in the actual portfolio's market risk relative to the benchmark portfolio's market risk since 1999.

Two different measures of risk are used in the chart. Expected tracking error is calculated prospectively on the basis of market volatility during the past few years.

There was a significant increase in both expected and actual tracking error during the second half of the year. As with the Government Pension Fund – Global, this was due to volatile markets and the special correlation between returns on different mandates during the period.

The information ratio is an indicator of skill in investment management. It is calculated as the ratio of annual excess return to additional risk taken in relation to the benchmark portfolio (as measured by tracking error). In other words, the information ratio shows how much excess return is achieved for each unit of risk. In the period from June 1998 (when responsibility for the management of the portfolio was transferred to NBIM) through to the end of 2007, the average information ratio for the investment portfolio was 0.21. See also Table 1-3 in Section 1 for an overview of risk and returns in the portfolio in recent years.

Table 3-23 shows the composition of the bond portfolio (fixed income portfolio excluding cash) based on credit ratings from Moody's. In this table, government bonds and government-guaranteed bonds without their own credit rating have been given the credit rating of the issuing country.

Table 3-24 provides an overview of risk and market exposure in the investment portfolio during the course of 2007. The table shows that the portfolio was within the Executive Board's limits for market risk and ownership interests at the end of each quarter. There were no breaches of the Executive Board's guidelines in 2007.

Table 3-21: Fixed income return by quarter and for 2007 as a whole. Per cent

	Return measured in terms of the benchmark portfolio´s currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	0.80	0.65	-0.73	-0.88	0.15
Q2	-1.16	-1.26	-3.49	-3.59	0.10
Q3	1.97	2.55	-3.42	-2.86	-0.56
October	0.77	0.78	1.40	1.41	-0.01
November	0.47	1.23	3.86	4.64	-0.78
December	-0.17	0.15	-2.85	-2.54	-0.31
Q4	1.07	2.17	2.31	3.42	1.11
2007	**2.68**	**4.13**	**-5.33**	**-3.99**	**-1.33**

Table 3-22: Equity return by quarter and for 2007 as a whole. Per cent

	Return measured in terms of the benchmark portfolio´s currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	2.33	2.49	0.78	0.94	-0.16
Q2	7.14	6.75	4.62	4.24	0.38
Q3	-1.52	-0.84	-6.71	-6.07	-0.64
October	3.29	2.91	3.93	3.55	0.38
November	-5.17	-4.76	-1.98	-1.55	-0.43
December	-1.30	-1.02	-3.95	-3.67	-0.27
Q4	-3.33	-2.98	-2.14	-1.80	-0.35
2007	**4.39**	**5.26**	**-3.75**	**-2.95**	**-0.80**

3.2.4 Costs

The costs of managing the investment portfolio consist partly of fees to external managers, custodian institutions, providers of settlement services and other external service providers, and partly of Norges Bank's internal operating costs.

NBIM is responsible for managing the Government Pension Fund – Global and

Table 3-23: Portfolio of fixed income instruments on 31 December 2007 by credit rating from Moody´s. Millions of NOK

	Aaa	Aa	A	Baa	Ba	Lower	P-1	No rating
Inflation-linked bonds	5 784	1 163	2 634	-	-	-	-	2 027
Securitised debt	49 276	2 199	316	562	70	126	-	7 535
Corporate bonds	2 440	7 694	10 273	7 542	589	101	-	1 307
Short-term certificates	-	-	-	-	-	-	541	25
Government and government-related bonds	22 471	18 511	6 497	1 777	661	626	-	5 270
Total bonds and other fixed income instruments	**79 970**	**29 567**	**19 720**	**9 880**	**1 321**	**853**	**541**	**16 164**

Table 3-24: Key figures for risk and exposure

Risk		Actual				
		31.12.06	31.03.07	30.06.07	30.09.07	31.12.07
Market risk (percentage points)	Tracking error	0.17	0.22	0.24	0.69	0.56
Asset mix	Bonds	58.96	58.6	56.5	57.3	58.5
	Equities	41.04	41.4	43.5	42.7	41.5
Market distribution, equities	Europe	52.40	53.5	54.3	52.5	52.5
	Americas	34.61	33.3	32.5	33.1	33.5
	Asia and Oceania	12.99	13.3	13.3	14.5	14.0
Market distribution,bonds	Europe	59.70	60.2	60.7	60.1	60.6
	Americas	35.01	34.2	33.7	34.0	33.4
	Asia and Oceania	5.29	5.7	5.6	6.0	6.0
Ownership interests (per cent)	Max. 5%	1.23	2.29	4.53	4.94	4.62

Table 3-25: Transfers to and from the buffer portfolio in 2007. Millions of NOK

Period	Capital from SDFI	Foreign exchange purchased in the market	Transferred to Government Pension Fund - Global	Market value at end of period
Q1	38 791	34 429	93 419	3 205
Q2	37 642	30 581	67 542	3 497
Q3	35 457	40 136	75 878	2 857
October	11 552	20 233	30 243	4 523
November	14 235	27 491	46 569	280
December	13 973	-	-	14 052
Q4	**39 760**	**47 725**	**76 811**	**14 052**
2007	151 650	152 871	313 650	-

the Government Petroleum Insurance Fund as well as the investment portfolio and buffer portfolio in the foreign exchange reserves. Fees to external managers and external settlement and custodian institutions are invoiced separately for each fund. The other operating costs are overheads shared by all the funds and are distributed by means of a cost distribution key. These overheads include all support functions provided by parts of Norges Bank other than NBIM. These latter costs are calculated in accordance with the guidelines which apply to business operations at Norges Bank.

Management costs for the investment portfolio, including performance-based fees to external managers, totalled NOK 165.9 million in 2007. This is equivalent to 0.07 percentage point of the average portfolio under management.

3.2.5 Buffer portfolio

Table 3-25 provides an overview of transfers of capital to the buffer portfolio and from the buffer portfolio to the Government Pension Fund – Global in 2007. A total of NOK 151.6 billion was transferred to the portfolio from the State's Direct Financial Interest in petroleum activities (SDFI) during the year. In addition, foreign exchange totalling NOK 152.8 billion purchased by Norges Bank in the market was added to the portfolio.

A total of NOK 313.6 billion was transferred to the Government Pension Fund – Global in 2007.

The market value of the buffer portfolio was NOK 14.1 billion at the end of 2007, compared with NOK 23.7 billion at the end of 2006. The return on the buffer portfolio in 2007 was -2.4 per cent measured in NOK.

3.3 Government Petroleum Insurance Fund

3.3.1 Mandate

Pursuant to the Government Petroleum Insurance Fund Act, Norges Bank is responsible for the operational management of the fund. The management mandate is stipulated in a regulation and written guidelines issued by the Ministry of Petroleum and Energy. A management agreement has also been drawn up to regulate the relationship between the Ministry as owner and Norges Bank as operational manager. The guidelines and management agreement are available on Norges Bank's website (www.norges-bank.no).

The Ministry of Petroleum and Energy has established a strategic benchmark portfolio for the fund. The currency distribution of the benchmark portfolio is 50 per cent EUR, 15 per cent GBP and 35 per cent USD. The benchmark index consists of the Lehman Global Aggregate Treasury indices for the three currencies as well as a money market deposit to weight the interest rate risk, as measured by modified duration, in each currency to 4. During the year, the currency weights fluctuate with market

Modified duration

The Ministry of Petroleum and Energy has set the limit for interest rate risk in the management of the Petroleum Insurance Fund in relation to the risk measure *modified duration.* The duration of a bond is the average time it takes for all cash flows (coupons and principal) to fall due for payment. Modified duration also expresses how sensitive the value of the portfolio is to a change in interest rates, and expresses the percentage decline in the value of the portfolio if the interest rate rises by 1 percentage point for all maturities.

developments. However, at the beginning of July each year, the weights are reset to the strategic currency weights.

Table 3-26 shows the currency weights in the fund's strategic and actual benchmark as at 31 December 2007.

The Ministry of Petroleum and Energy has decided that market risk, defined as deviation from the benchmark portfolio, must never exceed expected tracking error of 0.75 percentage point. The Ministry has also decided that interest rate risk, as measured by the modified duration of the overall portfolio of fixed income instruments and related derivatives, must not exceed 5.

Table 3-26: Benchmark portfolio on 31 December 2007

Currency	Strategic benchmark portfolio	Actual benchmark portfolio
EUR	50.0	51.4
GBP	15.0	14.3
USD	35.0	34.3
Total	**100.0**	**100.0**

Table 3-27: Market value of the Petroleum Insurance Fund at the end of each quarter. Millions of NOK

	31.12.06	31.03.06	30.06.06	30.09.06	31.12.07
EUR	7 596	7 544	7 839	7 370	7 520
GBP	2 343	2 293	2 349	2 099	2 121
USD	5 248	5 246	5 492	4 968	5 044
Total market value	**15 187**	**15 084**	**15 680**	**14 437**	**14 686**

3.3.2 Returns in 2007

At the end of 2007, the market value of the Government Petroleum Insurance Fund was NOK 14.7 billion, a decrease of NOK 0.5 billion since the beginning of the year. Premiums of NOK 1.1 billion were paid in by the Ministry of Petroleum and Energy in 2007. Claims of NOK 1.1 billion were paid out during the year.

The market values of the fund's foreign currency portfolios at the end of each quarter of 2007 are shown in Table 3-27. The entire portfolio is managed internally by Norges Bank.

The portfolio is invested primarily in government bonds and other bonds included in the Lehman Global Aggregate index's "Government-related" subsector. In addition, the portfolio may be invested in German bonds issued against collateral in the form of loans to the public sector (Öffentliche Pfandbriefe), in short-term money market instruments and in unlisted fixed income derivatives.

The return on the fund in the second quarter of 2007 was 5.15 per cent measured in terms of the currency basket corresponding to the composition of the benchmark portfolio (see Table 3-28). Measured in NOK, the return was 3.12 per cent. The difference is due to the appreciation of the krone against the currencies in the benchmark portfolio in 2007, which meant that the fund's currency basket was worth less in relation to the krone. The actual return was 0.16 percentage point higher than the benchmark return. This is equivalent to approximately NOK 24.2 million.

The actual return figures include normal transaction costs associated with indexing the portfolio. These costs are not included when calculating the benchmark return. Norges Bank estimates that these costs amount to about 0.01 per cent of the value of the portfolio per year. On the other hand, the actual return includes income from lending out bonds in the portfolio, while the benchmark return does not. Securities lending operations are conducted both internally and through some of the external custodian institu-

Table 3-28: Return on the Government Petroleum Insurance Fund. Per cent

	Measured in terms of the benchmark portfolio´s currency basket		Measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	0.81	0.74	-0.67	-0.74	0.06
Q2	-0.54	-0.51	-2.72	-2.69	-0.04
Q3	2.64	2.55	-3.06	-3.15	0.09
October	0.67	0.66	1.27	1.25	0.02
November	1.32	1.30	4.82	4.80	0.02
December	0.18	0.16	-2.56	-2.57	0.01
Q4	2.18	2.13	3.44	3.39	0.05
2007	**5.15**	**4.97**	**-3.12**	**-3.28**	**0.16**

Table 3-29: Return on the Government Petroleum Insurance Fund in the period 1998-2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	Average 1998-2007
Actual return	3.27	-1.06	6.92	5.68	7.90	3.56	5.64	4.28	2.17	5.15	4.35
Benchmark return	3.38	-0.85	6.78	5.48	7.74	3.46	5.42	4.15	2.14	4.97	4.27
Excess return	**-0.11**	**-0.21**	**0.15**	**0.19**	**0.16**	**0.10**	**0.22**	**0.14**	**0.03**	**0.18**	**0.09**

tions. In 2007, income from this type of activity totalled NOK 14.7 million, which is equivalent to 0.10 per cent of the fund's average market value.

Table 3-29 shows the return and excess return on the Government Petroleum Insurance Fund each year since 1998. The average annual excess return in the period of 0.07 percentage point is equivalent to NOK 78.8 million.

3.3.3 Risk

Market risk

The guidelines from the Ministry of Petroleum and Energy establish a limit for market risk in the actual portfolio relative to the benchmark portfolio. This relative market risk must always be less than expected tracking error of 0.75 percentage point. Relative market risk remained below this limit throughout 2007 (see Chart 3-22).

According to the guidelines from the Ministry, the average modified duration for each currency is to be 4 in the benchmark portfolio and no higher than 5 in the actual portfolio as a whole. Table 3-30 shows the modified duration of the portfolio on 31 December 2007.

Table 3-30: The portfolio´s modified duration by currency on 31 December 2007

Currency	Actual portfolio	Benchmark portfolio
EUR	3.84	3.92
GBP	4.11	4.08
USD	4.06	3.97
Total	**3.95**	**3.96**

Table 3-31: Portfolio on 31 December 2007 by credit rating Market value. Millions of NOK

Credit risk based on rating from Moody´s	Aaa	Aa	A	No rating	Total
Securitised debt	1 107	794	-	135	2 036
Government and government-related bonds	6 459	2 044	723	354	9 580
Total bonds and other fixed income instruments	**7 567**	**2 838**	**723**	**488**	**11 616**

Table 3-32: Risk exposure limits stipulated in the regulation and guidelines

Risk	Limits	Actual				
		31.12.06	**31.03.07**	**30.06.07**	**30.09.07**	**31.12.07**
Market risk	Max. tracking error 0.75 percentage point	0.06	0.16	0.22	0.45	0.53
Interest rate risk	Modified duration max. 5	3.93	4.00	4.01	3.91	3.95

Credit risk

Table 3-31 shows the composition of the bond portfolio based on credit ratings from Moody's. In the table, the agency's detailed subdivisions have been grouped together – for example, Moody's Aa includes the sub-ratings Aa1, Aa2 and Aa3. Government bonds and government-guaranteed bonds without credit ratings have been assigned the credit rating of the issuing country.

Compliance with the regulation

Table 3-32 provides an overview of the limits for risk exposure set out in the regulation and guidelines, and shows the portfolio's actual exposure in relation to these limits at the end of each quarter. There were no breaches of the Ministry's guidelines in 2007.

3.3.4 Costs

The management agreement between the Ministry of Petroleum and Energy and Norges Bank establishes the principles for Norges Bank's remuneration for managing the Petroleum Insurance Fund's portfolio. For 2007, a remuneration rate of 0.06 per cent of the average market value of the portfolio was stipulated. Total remuneration in 2007 was NOK 9.2 million.

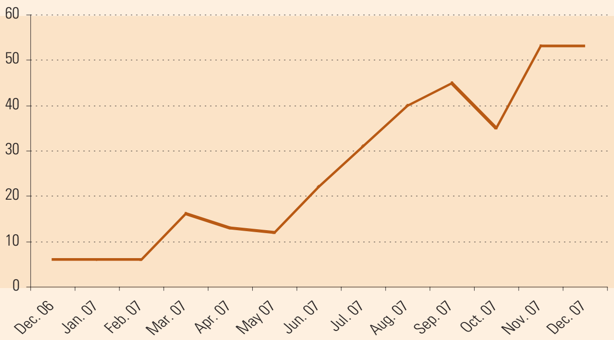


Chart 3-22: Expected tracking error over the past 12 months. Basis points

4 – Ownership and ethics

4.1 Exercise of ownership rights

The exercise of ownership rights concerns how we use the rights associated with the shares we own, and how we influence other players in the equity markets. In line with the Ethical Guidelines for the Government Pension Fund – Global, the objective for the exercise of ownership rights is to promote long-term financial returns. The exercise of ownership rights is an integral and ever growing part of our investment management. At the end of 2007, the equivalent of ten full-time employees were working on the exercise of ownership rights, compared with six in 2006.

One of the most important characteristics of the investments made by NBIM is the long time horizon. The Government Pension Fund – Global is, in practice, a reserve fund for the future where the underlying capital is not to be consumed and a positive return is to be assured for many generations to come. With such a long time horizon, combined with highly diversified investments in the markets, NBIM as an investor is exposed to trends in the markets about which more short-term investors or investors with a more concentrated portfolio would normally be less concerned. This applies both to the way in which the markets are governed and to issues of a social and environmental nature – in other words, issues which are crucial to the markets' future functionality and legitimacy, and which are often brought together under the umbrella of "ethics". Against this background, it is natural for NBIM to exercise its rights as a shareholder in ways which take account of these issues, precisely so as to safeguard its long-term earning capacity.

NBIM exercises its ownership rights in a number of different ways: by using its voting rights, engaging in dialogue with individual companies, cooperating with other investors, assisting the regulatory authorities, conducting research, and communicating publicly. In all of these areas, NBIM is increasingly an active player internationally.

A decade ago, very few investors of NBIM's type actively exercised their ownership rights. It was not considered cost-effective to allocate extensive resources to this work with such small holdings in each individual company. This attitude has changed considerably, partly because long-term investors have realised that their concerns will not necessarily be voiced by others if they do not voice them themselves. An expectation has also emerged among the owners of such funds – in our case, the Norwegian people and their political representatives – that the fund managers should act responsibly and look after their financial assets in an ethically acceptable way. Both of these considerations are reflected in the Ethical Guidelines for the Govern-

Ethical rules and corporate governance

In 2004, the Ministry of Finance laid down Ethical Guidelines for the Government Pension Fund – Global. Norges Bank's Executive Board has decided that equivalent rules are to apply to the Bank's own foreign exchange reserves. The Ethical Guidelines are based on two fundamental principles:

- The fund is an instrument for ensuring that a reasonable share of Norway's petroleum wealth benefits future generations. This financial wealth is to be managed in such a way as to generate a solid return in the long term, which is contingent on sustainable development in an economic, environmental and social sense. The fund's financial interests are to be strengthened by using the fund's ownership positions to promote such sustainable development.
- The fund must not make investments which entail an unacceptable risk of the fund contributing to unethical acts or omissions, such as violations of fundamental humanitarian principles, gross violations of human rights, gross corruption or severe environmental degradation.

The ethical basis for the fund is to be promoted through the following three mechanisms:

- Exercise of ownership rights in order to promote long-term financial returns, based on the UN Global Compact and the OECD Principles of Corporate Governance and Guidelines for Multinational Enterprises
- Negative screening from the investment universe of companies which, either themselves or through entities they control, produce weapons whose normal use violates fundamental humanitarian principles
- Exclusion of companies from the investment universe where there is considered to be an unacceptable risk of contributing to serious or systematic violations of human rights, gross violations of individuals' rights in situations of war or conflict, severe environmental degradation, gross corruption, or other particularly serious violations of fundamental ethical norms

The exercise of ownership rights is Norges Bank's responsibility, and the Bank's Executive Board has adopted a set of principles governing this work. Decisions concerning negative screening and company exclusions are taken by the Ministry of Finance, not Norges Bank. The government has appointed an independent Council on Ethics, which issues recommendations to the Ministry of Finance about negative screening and exclusions. The Ministry then issues instructions regarding exclusions to Norges Bank.

The government has announced a consultation process concerning the Ethical Guidelines in 2008 as the basis for an evaluation of the Ethical Guidelines for consideration by the Storting in 2009. Norges Bank will provide input into this process.

ment Pension Fund – Global.

Nevertheless, there are still many investors with a long time horizon and with an interest in a better-regulated market and more responsibly managed companies who make little use of their ownership rights. In this context, NBIM aims to be a leader in active ownership and develop strategies and priorities which can win the support of others.

Norges Bank's Executive Board has established principles and a strategy for NBIM's work on the exercise of ownership rights. A separate feature article in this Annual Report looks at the thinking behind, and activities in, two of the six priority areas which Norges Bank has chosen for its active ownership work: child labour and children's rights in the value chains of multinational companies, and companies' lobbying of national and supranational authorities on questions related to long-term environmental change.

NBIM wishes to be as open as possible about its exercise of ownership rights. Previous Annual Reports have presented the priorities, principles, working methods and scope of this work. Starting this year, we will also be disclosing all our voting by publishing our voting activity during the previous year on the Internet at the same time as the Annual Report (see www.nbim.no and separate box). NBIM also takes part in the public debate – including the academic debate – about active ownership internationally. However, details of our engagement with individual companies will not normally be disclosed, in order to protect confidences in the dialogue and ensure good and effective processes. This is standard procedure among institutional investors in Norway and abroad, and also among publicly owned fund managers.

4.1.1 Activities in 2007

NBIM began to build up its own active ownership expertise in 2003 through voting in the internally managed portfolio. In 2004, the Executive Board decided on a set of Principles for Corporate Governance for NBIM. This was, inter alia, a follow-up to the newly introduced Ethical Guidelines for the Government Pension Fund – Global (then the Government Petroleum Fund). From 1 January 2005, all voting (including in externally managed portfolios) was taken over by NBIM, and a separate corporate governance group was set up to work on the exercise of ownership rights later that year. In 2006, the Executive Board approved NBIM's corporate governance strategy, and consequently the Bank enlarged its direct dialogue with companies in the portfolio, concentrated around priority issues.

In 2007, this activity was stepped up significantly. All in all, NBIM initiated or carried on contact with 93 companies in the portfolio during the year as part of its active ownership work, primarily on issues related to its priority areas or to follow up voting. There was direct dialogue with around 30 companies in the form of meetings between representatives of NBIM and, normally, the chairman and/or other members of the company's board of directors or representatives appointed by them. This activity comes on top of the extensive ongoing dealings with companies which NBIM's internal and external portfolio managers already have.

NBIM also exercised its voting rights at 4 202 companies, voting on 38 862 proposals.

Public communication and publicising of principles

In 2007, representatives of NBIM contributed to a variety of conferences and panel debates, and gave lectures, both in Norway and abroad, published articles for both laymen and specialists, gave interviews to newspapers, magazines and broadcasters, and in other ways made known our principles and strategy.

There is to be the greatest possible openness about the basis for NBIM's work on the exercise of ownership rights, including the principles observed and priorities set. This is reflected in NBIM's external activities. The 2006 Annual Report, which included both an account of active ownership practices and two feature articles on the exercise of ownership rights, has been available both in printed form and on the Internet, and has been used actively in external communication.

NBIM's openness about the priority areas for its portfolio, both through its Annual Reports and through its other communication with companies and the public, is also intended to create the highest possible degree of predictability in the exercise of ownership rights.

So why does NBIM not also publish the names of the individual companies with which we have engaged in dialogue? The need for openness and trust within the dialogue itself is a major consideration here. Most companies believe that a dialogue accompanied by publicity will be different and less credible than a confidential dialogue. In addition, the dialogue itself will normally involve material which is privileged from the company's point of view. Nevertheless, NBIM has decided to publish its voting activity starting this year. In some cases, it may be appropriate to publish the results of individual dialogues, including the companies' names, after the event. We cannot expect, however, that the results to which we have contributed will be published by companies with explicit reference to NBIM and its contribution.

In its dialogue with companies, NBIM presents its Principles for Corporate Governance and aims to promote recognition of long-term investors' ownership interests in general. In several cases, dialogues initiated to address one particular issue have also made it possible for other issues to be discussed on the basis of NBIM's Principles for Corporate Governance.

Voting

Voting at the general meetings of companies is an important instrument in the exercise and protection of our fundamental ownership rights. Voting is performed on the basis of the Principles for Corporate Governance and helps NBIM to live up to the obligations set out in the Ethical Guidelines: to protect the financial interests of the portfolios' owners by, among other things, promoting sustainable development in an economic, social and environmental sense, as this is crucial to long-term returns.

Voting is an important foundation for other ownership activities. First, dealings with companies outside general meetings will be more credible if they are based on judicious voting. Second, our work on voting helps build up a knowledge of the individual company and its operations, as well as the regulation and functioning of different markets.

Voting is based on guidelines drawn up in accordance with the general Principles for Corporate Governance.

NBIM uses a number of sources to obtain information and analyses of companies and issues which are to be considered at general meetings. However, it is important for NBIM to perform independent analyses and concentrate its resources on the largest holdings and on controversial issues (in other words, complex issues which demand more in-depth analysis). In 2007, NBIM voted at a total of 4 202 general meetings, or 89 per cent of the meetings held by our portfolio companies. A more detailed description of voting in 2007 is given in Section 4.2. NBIM's website contains information on all voting in 2007. The guidelines underlying this voting can also be found there.

Contact with companies

In 2007, NBIM contacted close to 90 companies as part of its active ownership work. This comes on top of the meetings which our portfolio managers, both internal and external, regularly hold with companies, and the contact which NBIM has with companies through its voting. The majority of these cases concerned the six priority areas specified in NBIM's strategy. The following looks at general aspects of this contact with companies; more specific information about the individual priority areas can be found in Section 4.1.2.

With such a large number of equity investments, it is essential for NBIM to have clear criteria and systems for choosing which companies it is to engage in dialogue. Companies are selected on the basis of analyses initiated by NBIM, external events, or matters arising at general meetings.

The priority areas adopted in the strategic plan for 2007–10 form the basis for analyses performed by NBIM itself. The market value of the company and the size of the fund's holding in the company also play a role. The other selection criteria depend on their relevance to the various priority areas, but account is generally taken of financial key figures, market factors and sector-dependent factors. Issues falling outside the priority areas may also be raised by NBIM in its dialogue with companies – for example, to follow up matters arising at general meetings.

In some cases, NBIM may contact a company following a news item, or after we have become aware in some other way of a particular event related to that company's activities. This might, for example, be a takeover situation or revelations of child labour in the company's supply chain. In such cases, NBIM may contact the company to express its opinion with a view to steering the company in the right direction, or to request information on how the company is dealing with the event in question.

Voting also serves as a starting point for company contact. NBIM's goal is to vote at the general meetings of as many of its portfolio companies as possible. Votes falling within NBIM's priority areas are often followed up through direct contact with the company, especially in cases where a relevant proposal gains relatively strong support from shareholders but where we cannot see the company having followed this up. In particularly important cases, NBIM can also contact companies before a vote in order to express our viewpoint.

Once NBIM has identified a company which we wish to influence, an action plan is prepared which specifies the aim of the dialogue, the schedule for it, the resources to be allocated, and so on. The plan may be revised along the way, but serves as a basis for the evaluation of the individual dialogue.

In its dealings with a company, NBIM will communicate primarily with the board of directors, first and foremost the chairman. The directors are shareholders' representatives and are the people whom shareholders can hold accountable. However, NBIM will contact a company's management – generally its investor relations officers – if the enquiry is purely a matter of obtaining information, or if the board refers us to representatives of the company's management. By and large, NBIM is granted access to directors and can hold meetings with key officers of the companies. However, there are differences between markets and corporate cultures in terms of the willingness to engage in dialogue with shareholders. Generally speaking, it is easier to initiate a dialogue with companies operating in countries with market regulations demanding transparency and disclosure, and companies with a tradition of communicating with their owners.

Exercising ownership rights and influencing companies can be a long-term process which runs for a number of years. Each dialogue will normally demand considerable resources and an in-depth knowledge of the company and sector, and ideally also of the market or markets in which the company operates.

In our communication with companies, we attach importance to NBIM being a long-term investor which uses its ownership rights as an instrument to safeguard and build financial assets and promote good corporate governance and high ethical, social and environmental standards at companies. Given its long time horizon and its strategy for the current four-year period, NBIM has an opportunity to be perseverant in its work and its processes for influencing companies. This is an important requirement if the engagements are to make a real difference.

NBIM endeavours always to act judiciously and predictably as an owner. This is important if NBIM's portfolio companies and other investors are to have confidence in its ownership practices. For NBIM, it is therefore also important to be able to point to the results of its ownership work. Given that NBIM is prioritising major and often complex issues, several years may pass before results can clearly be discerned. Nevertheless, it

Examples of NBIM's ownership dialogues in 2007

The following are some examples of the type of dialogue NBIM had with companies on ownership issues in 2007. Many of these dialogues will continue over a number of years, and in most cases it is too early to draw firm conclusions about the kinds of results which can be achieved. However, it is possible to discern both movement and concrete results in several of the dialogues.

- A multinational company, which is one of the world's largest in its sector and which did not previously report on the risk of child labour, is now reporting on the steps it has taken to detect and prevent child labour among its suppliers, and presenting quantitatively the incidence of child labour over a number of years. The company says that the dialogue with NBIM has been important in prioritising this issue at the company.

- In its dialogue with another multinational, NBIM urged management to quality-assure its processes for combating child labour and ensure local monitoring of children taken out of work. The company has reported back to NBIM on how this has been done, and NBIM has had a dialogue with representatives of the company in some of the areas where the risk of violating children's rights is greatest.

- NBIM held a meeting with a Latin American company with a high risk of child labour in its supply chain. As part of this dialogue, NBIM asked the company to sign up to the UN Global Compact. Shortly afterwards, the company announced that it had indeed signed up to the Global Compact. Another company, with which NBIM has had a similar dialogue, has stated that it is considering signing up to the Global Compact and increasing transparency about its monitoring of child labour.

- During a meeting with a North American energy company, NBIM asked the company to reconsider its practice of long, overlapping election periods for its directors (staggered board), which can reduce shareholder influence and prevent takeovers. The company's representative defended this practice, but also said that there had been mixed views on the board. Six months later, the company announced that the practice was to be abandoned in favour of annual election of all directors.

- A large technology company contacted NBIM after NBIM and other shareholders voted against a pay package for its senior management. Following these discussions, the company proposed a new package which requires more before benefits accrue and is more closely linked to the company's performance. NBIM has continued its dialogue with the company with future pay packages in mind.

- NBIM visited a large multinational energy company to ask it to abandon its system of a ceiling on voting rights and double votes for long-term shareholders after this unequal treatment of shareholders encountered opposition at a general meeting. The company has acknowledged the problem and announced that it has embarked on a review of the future of this system.

- Following an international merger, the board of a telecommunication company retained one of the original companies' system of a voting ceiling, which can act as protection against hostile takeovers. NBIM was part of a movement of investors which succeeded at a general meeting in getting the company to treat shareholders equally.

- NBIM visited the chairman of a large power producer at its head office to discuss, among other things, developments in climate legislation. The chairman, who is also the CEO and in active contact with legislators, subsequently came to Oslo on his own initiative to continue these discussions with NBIM's management. This dialogue is continuing, and is just one of around 20 ongoing dialogues on climate legislation.

- The chairman of a family-controlled cosmetics company received NBIM to discuss the composition of its board, transparency and other steps to improve the protection of minority shareholders' interests. The chairman had not previously had any dealings with international institutional investors on issues of this nature, and announced that the board had appointed a nomination committee for the very first time shortly before the meeting. This dialogue is continuing in 2008.

may be possible to point to significant progress in several of the dialogues even at this relatively early stage of NBIM's ownership work. Examples of this can be found in a separate box.

Contact and collaboration with other investors

Many large, internationally diversified investors have similar views on the key principles of good corporate governance practices. These views are reflected in the design of local and international guidelines, such as the OECD Principles of Corporate Governance. However, ownership activities to further develop market standards and follow them up with portfolio companies are resource-intensive. The costs are borne by the investors carrying out these activities, whereas the results they achieve will benefit all shareholders. Although NBIM aims to be a leader in corporate governance and is willing to act alone and embark on independent initiatives where necessary, NBIM believes it important to bring other investors on board in this work wherever appropriate.

Broad global and regional networks provide platforms for establishing contact, exchanging views, spreading information and formulating representative standpoints vis-à-vis the regulatory authorities, other standard-setters in the markets and companies themselves.

NBIM is a member of the International Corporate Governance Network (ICGN), a worldwide network for investors and service providers in the field of ownership rights and corporate governance. ICGN members are together estimated to manage assets exceeding USD 10 trillion. The network addresses key topics related to owner participation and corporate governance by arranging global and regional meetings and organising the work of various expert committees. The ICGN engages with national and supranational authorities, accounting standard-setters and other leading market players. NBIM took part in the ICGN's annual conference in July 2007 and presented its work, including its priority area of child labour and children's rights, in the ICGN's yearbook published in connection with the conference. NBIM has also been involved in the preparations for a European ICGN meeting in Sweden in March 2008.

In 2007, NBIM took part in the Council of Institutional Investors (CII), a forum for the promotion of shareholder rights in the US. In addition to facilitating dialogue with authorities and other standard-setters, the network seeks to improve market practices by various means, one of which is to draw up a list of companies whose governance systems and practices are regarded as unsatisfactory.

NBIM was also involved in more informal networking with large, globally diversified investors in 2007. NBIM collaborated with the large Dutch pension funds ABP and PGGM and Hermes in the UK on joint statements to the US Securities and Exchange Commission (SEC) concerning the opportunities available to investors to influence the election and replacement of board members at US companies. The funds have also written to the European Commission, with a view to ensuring that a natural level of communication and collaboration between investors of our type on influencing companies is not unintentionally affected by the group provisions of the securities regulations in European countries. In both cases, these approaches were positively received, and work on these issues will continue for NBIM's part in 2008, even though the investor initiative in the US suffered a temporary setback when the SEC decided in November 2007 not to make changes in the current regulations for the time being. (See also below.)

As part of a group of investors, NBIM also participated in discussions on proposed legislation governing communication between investors and companies in Germany.

In October, NBIM was the joint organiser of an international roundtable meeting for large funds and management organisations held at the Centre for Corporate Governance at the Tuck School of Business in New Hampshire in the US.

NBIM is a signatory to, and helped to draw up, the UN's Principles for Responsible Investment (PRI). The principles are based on an understanding that environmental, social and governance issues can affect the performance of investment portfolios. By signing the six principles, investors undertake to analyse these issues, collaborate on the implementation of the principles, be active owners, demand adequate reporting by companies, and report on their own activities. NBIM has presented and discussed the principles at several meetings with large institutional investors, and uses them as a basis for its ownership practices and collaboration with other investors.

The international Extractive Industries Transparency Initiative (EITI) aims to combat corruption and increase transparency in countries rich in natural resources. NBIM has endorsed the Investors' Statement on Transparency in the Extractives Sector. The initiative argues that it is in the interests of portfolio companies themselves to operate in a business environment characterised by stability, transparency and respect for the law.

4.1.2 More about the priority areas

In its corporate governance strategy, Norges Bank has chosen to focus on six priority areas spanning both ownership rights and social and environmental sustainability. Key criteria for the selection of these areas included: importance for long-term returns; the likelihood of an investor like NBIM being able to contribute to real change; the possibility of identifying relevant companies, sectors and jurisdictions; and the potential for working together with other investors in order to increase the chances of success. The priority areas in the strategic plan for 2007-10 were discussed in a separate feature article ("Priority areas of corporate governance: ownership rights, children and the environment") in the 2006 Annual Report. A more detailed account of aspects of the social and environmental priority areas can be found in a separate feature article in the present Annual Report.

NBIM continuously evaluates its work on these priority areas. This is done to ensure that satisfactory results are achieved, as well as to provide a basis for an assessment of whether any priority areas should be added or removed.

Ownership rights

Four of the priority areas concern topics generally related to ownership rights:

- the right to vote
- the right to nominate and elect board members
- the right to trade shares freely
- the right to open and timely information

These rights are, to varying degrees, impeded or poorly developed in many markets, including in Europe and the US. At the same time, they are crucial for achieving real influence and dialogue with companies. They are also an essential basis for work on social and environmental issues. Against this background, it is unnatural to view these four priority areas and the social and environmental issues separately from each other.

In the four priority areas concerning ownership rights, NBIM engaged in dialogue with around 15 companies in 2007 in Denmark, France, Japan, Holland, Sweden, and the United States.

The right to vote

The right to vote at general meetings puts shareholders in a position to influence the management of the company they own, either directly or indirectly through their elected representatives on the board of directors. By exercising their voting rights, shareholders elect the company's board and make other decisions which are potentially of great importance to the company.

NBIM's voting is largely by proxy – in other words, through a representative who attends the general meeting and is authorised to vote on behalf of NBIM. The majority of institutional investors make use of proxy voting, especially across national borders. Between 30 and 80 per cent of shares in listed companies in European countries are typically owned by non-nationals, but there has been little adjustment of national legislation on general meetings and voting to reflect this. There are no common standards to regulate voting practices. Requirements may even vary within one and the same market. In many countries, voting rules which may have been well-founded historically have not been adapted to international proxy voting.

Voting across national borders can therefore be resource-intensive and, in many cases, difficult to do. NBIM continued a research procject that started at the end of 2006, with the Tuck School of Business at Dartmouth College in the US. The project is mapping players, market practices and regulations of relevance to voting in the most important markets in which NBIM has investments, with the aim of identifying better methods and practices for efficient global voting. This mapping process is an important starting point for NBIM's work on ensuring that voting across national borders becomes easier and less resource-intensive, and the results of the surveys also have considerable relevance for other investors.

NBIM has participated in the European Commission's consultation process on shareholder rights as part of the work on updating company law in the EU. Issues covered by NBIM's contribution included requirements for large companies to translate general meeting documentation, clearer regulation of the role of intermediaries in voting, and the need for closer analysis of the relationship between equity lending and voting. Together with a number of other institutional investors, NBIM also took part in an initiative vis-à-vis the Swedish Industry and Commerce Stock Exchange Committee concerning unequal treatment of shares with different voting rights in connection with corporate acquisitions. This group of investors believes that the committee should change the regulations so that shares with different voting rights are not treated differently in terms of price if they have the same claims to the underlying assets of the company.

It is a commonly held view that shareholders' voting rights should be proportional to the capital they are risking in a company. Through our principles, voting, contact with individual companies and regulatory authorities, and other ownership practices, NBIM is promoting the principle of "one share, one vote". In the US, most listed companies adhere to this principle. However, this is not the case in much of Europe. A study carried out by the European Commission shows that more than 40 per cent of listed companies in the EU have one or more "control-enhancing mechanisms" and therefore depart from the "one share, one vote" principle.[1] In 2007, NBIM endeavoured, both through its voting and through direct contact with companies, to reduce companies' use of structures which restrict voting rights. Large numbers of companies in France, Sweden and the Netherlands have multiple share classes with different voting rights, which distorts the balance between financial ownership and voting power. NBIM raised this practice specifically with a number of French and Dutch companies in 2007, both by supporting shareholder proposals to remove these practices and by writing letters and holding meetings with companies. In addition, NBIM contacted the French companies in the portfolio which still have a ceiling on voting rights – in other words, shareholders are unable to cast more than a certain number of votes no matter how many shares they hold. A ceiling of this kind can be found at 10 per cent of European listed companies.

The right to nominate and elect board members

Directors are there to represent shareholders' interests, and so it is natural for shareholders to be able to approve who sits on the board. Shareholders can best safeguard their interests by having a real influence over who represents them on the board. However, this is not always the case; the US and Canada are examples of this. In these countries, shareholders have little say in practice on who represents them on the board, as directors are elected largely through plurality voting, combined with hindrances against the proposal of alternative candidates. Under this system, a director is elected if he or she receives more votes than any other candidate. A director can therefore be elected without the support of the majority of shareholders. In practice, it is enough to get just a single vote if there is no other candidate (as is generally the case). For several years, NBIM has supported shareholder proposals to introduce majority voting, where candidates must win a majority of the votes cast at

[1] *Report on the Propertionality Principle in the European Union*, ISS Europe / European Corporate Governance Institute / Shearman & Sterling, May 2007.

the general meeting. This type of proposal has gradually come to win considerable support, and many companies have made changes: more than two-thirds of the companies in the S&P 500 index have now reformed their election procedures.

The most important corporate governance case in the US in 2007 concerned whether shareholders should be allowed to nominate their own board candidates. In principle, shareholders can already nominate candidates, but the costs associated with this – both financial and practical – are so high that it is not a realistic option for most shareholders. This is because shareholders' candidates are not included on the agenda (proxy statement) sent out by the company, which means that the shareholders themselves have to ensure that information is distributed to other shareholders. In 2007, NBIM teamed up with other large European investors to engage in dialogue – in the form of both meetings and letters – with the chairman and commissioners of the Securities and Exchange Commission (SEC) on the importance of regulations to ensure that shareholders have real influence over director elections at US companies. It was underlined that the absence of this fundamental shareholder right undermines the confidence that NBIM and many other international investors have in the US capital market. NBIM, together with a number of other large institutional funds, has defended this stance in public. NBIM believes that the results to date are not satisfactory.

Many shareholder proposals aim to strengthen the board's independence and make it more accountable to shareholders. At many American and Asian companies, NBIM and a large proportion of other shareholders have expressed their concern, through their voting, about the absence of independent directors on companies' boards and on board committees where it is particularly important that the members are independent, namely nomination, remuneration (compensation) and audit committees.

Another important element in the work to make the board of directors more accountable is the removal of anti-takeover mechanisms. One such mechanism is the staggered board, where not all directors come up for re-election each year, which would prevent a new owner from actually controlling the company. NBIM has therefore voted against proposals preventing the annual re-election of all directors, and we have supported shareholder proposals calling for annual re-election of all directors.

The right to trade shares freely

The right to trade shares freely includes, among other things, the right to sell shares in connection with a bid for the company or gradual acquisition of controlling shareholdings. This right is important if the shareholder is to be able to realise the maximum possible value. A bid for a company or a large shareholding will often cause the share price to rise as a result of a "control premium" being priced in. For the market, corporate acquisitions are a source of regeneration and flows of capital into the best possible applications. This is often known as the "market for corporate control".

Attempts to take over companies can be made for various reasons. Most often, the party wishing to acquire the company sees potential to increase the value of the company's assets by changing its strategies, merging its operations with others, or reorganising the business. Acquisitions can entail major changes and losses of positions for the management of the target company, and are therefore often contested. Thus, in many markets, it is common for there to be various forms of protection against takeovers. In the US, various forms of "poison pills" – a procedure by which the board is given unrestricted authority to issue shares in the event of a takeover bid – combined with weak shareholder rights in terms of director elections constitute a major problem for minority investors. In some European countries, takeovers are made more difficult through ownership structures, often combined with weaknesses in corporate governance.

As the market for corporate control can be a driver for value creation, NBIM will, as a rule, be critical of explicit and implicit anti-takeover mechanisms. As a minimum, such schemes should be approved by shareholders. The costs represented by control mechanisms are not immediately apparent. The main cost is associated with the absence of takeover bids which would have been made in a market with fewer obstacles. Anti-takeover mechanisms can also mean that the board's motives fall out of alignment with their value creation mandate from shareholders.

NBIM's desire for a functional market for corporate control means that it should be the individual shareholder who decides whether a takeover would be beneficial. In a takeover scenario, NBIM considers the specific bid and takes account of the fact that not all acquisitions turn out to create value for the companies involved.

When companies propose to introduce schemes which act as anti-takeover mechanisms, NBIM will, as a rule, vote against them, unless it is demonstrated that the scheme in the case in question is in the interest of shareholders. As a rule, NBIM has voted against proposals to retain existing anti-takeover mechanisms, whether explicit (in the form of poison pills) or more implicit. In its direct dialogue with companies, NBIM has also raised matters related to the companies' governance systems which either individually or collectively make acquisitions difficult or impossible. Long or partially overlapping terms of office for directors (staggered/entrenched boards), differences in voting rights, differences in the practicability of exercising voting rights, dominant shareholders, board composition and a lack of transparency are aspects of a governance structure which may together limit the chances of a successful takeover attempt.

The right to open and timely information

Shareholders depend on good information about portfolio companies' operations if they are to be able to exercise their ownership rights. Not least, it is important that all shareholders receive adequate and timely information ahead of general meetings so that they can reach a position on the matters to be raised, and companies' periodic performance reporting must be of a high standard.

NBIM encourages companies to give shareholders adequate information which clearly communicates which strategies the company is pursuing, and what consequences these strategies can be expected to have. The company must also provide relevant information on how its operations impact on social and environmental factors, and what effect these kinds of issues have on the company. In addition, shareholders should have an opportunity to communicate with directors, who are their representatives at the company. Companies should have procedures for how shareholders can present their views to the board.

In 2007, NBIM supported more than 60 shareholder proposals related to open and timely information. As a rule, NBIM will vote against proposals from a company if the information provided by the company is clearly inadequate and we therefore do not have enough information to reach a position on the proposal.

An example was where NBIM voted against a proposal for a long-term executive compensation plan at the general meeting of a large technology company due to lack of information about the goals and criteria underlying the calculation of this compensation. The proposal was not passed, and we subsequently entered into a dialogue with the company. NBIM and other shareholders received more information about the details of the plan, and a number of adjustments were made to the plan itself, so that it could finally be approved at an extraordinary general meeting. NBIM and the company have continued their dialogue on the evaluation and further development of the company's compensation plan.

NBIM supported more than 30 proposals concerning reporting on sustainability, corporate social responsibility and companies' support for political and charitable causes. NBIM attaches particular importance to a company disclosing information on its business operations, its strategy for relevant social and environmental issues, any actions taken and results achieved, how the company handles relations with employees and others directly affected by its operations, and the company's systems for risk management and compliance with laws and regulations. (More detailed information on NBIM's voting can be found later in this chapter.)

Beyond this, the requirement for open and readily available information is a key part of most company dialogues on social issues. We encourage companies to publish their principles, discuss the particular challenges they face, report on the resources they are allocating, and disclose the control mechanisms and other measures introduced, along with the results achieved through their use.

Social and environmental issues

Through voting and communication of its Principles for Corporate Governance, NBIM addresses many topics each year spanning a wide range of social and environmental issues which can be assumed to be relevant to long-term financial returns. NBIM has also chosen to look at a number of areas in particular depth. Two such priority areas have been chosen to date, as set out in the strategic plan for 2007-10.

Both of these areas are presented in a separate feature article in this Annual Report where we look at aspects of this work in more detail.

On three occasions in 2007, NBIM's management and corporate governance group held information meetings with some of the Norwegian NGOs which have shown the greatest interest in NBIM's work, especially in the social and environmental area. NBIM provided information on its work in these priority areas and gained valuable input for its future work.

Child labour and children's rights

As a particular priority area when it comes to the social impact of companies' operations, Norges Bank has chosen children's rights in the value chain of multinational companies, including the fight against child labour. This choice was the result of both NBIM's long-term perspective as an investor and the international standards on which its exercise of ownership rights is based.

In line with its goals from 2006, NBIM carried out a number of analyses in 2007 paving the way for future work on this issue, and initiated extensive and concrete engagement processes. The focus has been on building up the expertise, knowledge and methods needed to make a real difference, and on communicating our expectations and requirements to individual companies. NBIM is continuing to develop measurement tools so that it can manage and measure the work on each company process.

One important part of this work is the analysis of markets and companies. More than 200 companies have been analysed, with the initial emphasis on multinationals with operations in specific countries in Asia, Latin America and Africa. New computer systems have been developed to systematise company information, which will facilitate future analysis work in this and other areas. The bulk of this analysis was performed by NBIM's corporate governance group, but external consultant assistance was obtained for an overview of examples of best practices in this area, for the development of the document *NBIM Investor Expectations on Children's Rights* (see separate box), and for some other company analyses.

The overriding objective for ownership work in this area is to safeguard the fund's long-term financial interests by encouraging companies in the fund's portfolio to comply with the principles of the UN Global Compact and the OECD's Guidelines for Multinational Companies, as well as other relevant documents and standards. The reputational risk – together with the perpetuation of poverty, poor education, substandard working conditions and bad health – associated with the abuse of children's rights makes it natural for a financial investor to base its dialogue on the long-term financial interests involved. At the same time, this is an important moral issue per se, as established through international standards and conventions.

Against this background, it is in the companies' own interest to show their investors and the outside world that they are capable of properly addressing this type of issue.

Our main means of influence is direct dialogue with companies. By the end of 2007, NBIM had initiated or continued dialogue with close to 60 companies on social issues, with the emphasis on child labour and children's rights. The target group for this work comprises portfolio companies in risk sectors in countries where child labour is common. NBIM has chosen primarily to engage in dialogue in cases where there is a complete or partial lack of relevant and necessary information from the company on how it is complying with international conventions on human rights in general and children's rights in particular.

In 2007, NBIM entered into more in-depth processes with companies which are leaders in two sectors – agriculture and metals – and face significant challenges in avoiding complicity in serious and hazardous forms of child labour and associated violations of children's rights. This dialogue with a total of eight companies in these sectors is continuing in 2008. All have acknowledged the importance of NBIM raising these issues, and all have committed themselves to continued dialogue. Several of the companies are working on concrete improvements which could, in a best-case scenario, benefit the whole of the sector in question, and which could also have positive consequences for these companies' operations in other countries. Several of the companies have announced that they will be able to present concrete improvements in the way they address these issues in their reporting for 2007. NBIM will be closely monitoring this reporting.

To clarify NBIM's position and expectations in the field of child labour and children's rights, NBIM has developed the document *NBIM Investor Expectations on Children's Rights*. The document is based on the UN Convention on the Rights of the Child and the ILO's child labour conventions; these are also incorporated into the OECD Guidelines for Multinational Companies and the UN Global Compact, which are defined as a basis for NBIM's exercise of ownership rights. Several external experts were consulted during the work on *NBIM Investor Expectations on Children's Rights.* The document has already been taken into use and has been presented to around 30 relevant companies. NBIM is also in talks with UN bodies such as UNICEF and the UN Principles for Responsible Investment (PRI) initiative with a view to further cooperation on raising awareness of the document.

NBIM Investor Expectations on Children's Rights also addresses the importance of transparency and openness. NBIM wishes to encourage companies in its portfolio to report more clearly on

NBIM Investor Expectations on Children´s Rights

At the same time as this Annual Report, NBIM is publishing a document which sets out NBIM's fundamental expectations, as an investor, of companies operating in areas or sectors where there is a considerable risk of violations of children's rights. The full text of this document, *NBIM Investor Expectations on Children's Rights,* is available on NBIM's website (www.nbim.no).

The document has been designed in such a way that it can also be used by other investors who are interested in this issue, or who are engaged in dialogue with companies in the danger zone in terms of violations of children's rights.

NBIM Investor Expectations on Children's Rights was developed in conjunction with specialists on issues related to child labour and other abuses of children's rights. The document will assist companies wanting to know exactly what NBIM and like-minded investors expect of them in this important area.

The document has two main parts:

The first sets out the reasons why NBIM as an investor has this issue high up on its agenda, and why this is an important issue for long-term financial investors in general. It notes that both the functionality and the moral legitimacy of the market depend on its players helping to combat abuses of society's weakest members – children. It is stressed that the purpose of the document is not to rank or blacklist companies but to set out very clearly the expectations which an investor can reasonably have of companies which, through their own operations and/or through their value chain (subsidiaries, suppliers etc), are in danger of violating children's rights.

The second part consists of four sets of criteria which companies are expected to meet. Companies are expected to have: (1) strategies and systems to prevent the worst forms of child labour, such as hazardous labour, forced labour and the splitting up of families; (2) strategies and systems to prevent breaches of the ILO convention on minimum working age, which is normally 15; (3) strategies and systems to promote child welfare, for example by ensuring access to medicines and clean water; and (4) governance structures which facilitate effective strategies and systems to prevent violations of children's rights.

The expectations in this document tie in with international norms and conventions on the protection of children's rights, including ILO Conventions 138 and 182 and the UN Convention on the Rights of the Child, as well as fundamental principles for good corporate governance.

The document has already been taken into use in actual company dialogues, and it has been presented to other investors. Where necessary, the document will be revised and adapted as NBIM gains further experience through its dialogue with companies.

their performance in this and similar areas. In particular, NBIM asks companies to be clearer about their risk analyses, problems and actions in the supply chain, and the inspection and auditing of their work on child labour and children's rights. The document is being published on NBIM's website at the same time as this Annual Report, and it is also discussed in a separate box and in the feature article in this Annual Report on the social and environmental priority areas.

NBIM also exercises its ownership rights and influence by using its voting rights. During the year, NBIM voted on around 60 proposals that were put forward within the category of social issues. In most cases, these dealt with calls for improved reporting and increased transparency from the company on its social responsibilities and the protection of basic human rights. Towards the end of the year and early in 2008, individual companies were selected for special follow-up ahead of their next general meeting. In 2007, ten companies were selected for direct dialogue to follow up concrete matters from their general meetings.

In light of the deteriorating situation in Burma/Myanmar during the fall of 2007, NBIM chose to ask 10 companies in its portfolio about their activities in the country. The tense situation entails a significant reputational and, consequently, financial risk for companies with activities there. Companies believed to be planning or implementing large infrastructure projects are already being followed up by the Council on Ethics, which has interpreted the Ethical Guidelines as meaning that these activities qualify companies for exclusion from the portfolio. (See statement from the Council on Ethics dated October 2007, www.etikkradet.no.) However, companies which either have less extensive activities in Burma or are following up previous investments and projects may also run the risk of complicity in breaches of human rights or expose themselves to other types of risk. This includes negative effects on children's development and child labour. NBIM has therefore engaged in dialogue with these companies to ensure that we have the best possible information on the situation and can urge them to improve their actions and reporting, where necessary.

NBIM also collaborates with other investors. As part of the so-called Iron & Steel initiative, NBIM and a dozen other international investors engaged in dialogue with 15 companies with links through their supply chain to charcoal and pig iron production in Latin America, concerning slave-like conditions at some facilities there. Child labour can also be a real risk in some of these cases.

In 2007, NBIM worked on mapping and systematising best practices in companies' handling of child labour and children's rights. This material will be used systematically in future dialogue with companies.

NBIM held meetings with various NGOs in 2007. NBIM also held meetings with a group of specialists in child labour and children's rights drawn from both NGOs and academia, and also began cooperating with UNICEF, the UN Global Compact and other UN bodies to ensure good follow-up of – and good networks around – these initiatives.

Lobbying and the environment

As described in the 2006 Annual Report, NBIM has singled out companies' lobbying of national and supranational authorities on questions related to long-term environmental change as one of its priority areas. The emphasis in 2007 was on climate issues.

The background to NBIM's involvement can be found in our position as a global investor with a long time horizon. NBIM's portfolio is exposed to global trends, including environmental ones. The Government Pension Fund – Global's long-term earnings are therefore dependent on sustainable development, a point also emphasised by the Ethical Guidelines for the fund. The potential costs of serious climate change could lead to substantial costs for the portfolio. There is a growing consensus in academic circles that measures to limit climate change today will be far more cost-effective than attempts to repair the damage once it has been done. NBIM's analysis is also based on a growing consensus in many sectors and industries that there is a need for greater certainty about the future legislative and regulatory framework.

In 2007, NBIM closely monitored the ongoing global debate on climate change, including the discussion of post-Kyoto regulation, the legislative process in the US, the further development of the emission allowance system in the EU, and the latest research – including the fourth UN report on climate change from the IPCC (the UN's international climate change panel). NBIM held regular meetings with leading researchers in the field.

To begin with, NBIM analysed more than 100 companies in the portfolio to identify the companies which are most active in lobbying on climate issues, and it has initiated contact with 24 companies to date. These companies have been chosen because they will be affected by future climate legislation, and because their stance will influence the design of this legislation. NBIM's key message to these companies is that their lobbying should naturally reflect broad and long-term investor interest in effective climate legislation. The companies are mainly in the energy and transport sectors.

The dialogues with these companies have given NBIM a better understanding of their strategy and their view on both current and future climate legislation. The discussions have centred around the risks and opportunities for these companies presented by various forms of legislation and technological advance. NBIM believes that lobbying per se is wholly legitimate in a democratic society. However, more in-depth dialogue between investors and the top-level managemnet of companies will help to ensure that companies listen to their owners when they seek, often very effectively, to shape new legislation.

We are very pleased with these dialogues and the response from of these companies' management teams to date. Our impressions from before the dialogues began have been confirmed. Both in Europe and the US, the infrastructure for the supply of energy is dominated by fossil fuels, and the respective industries play an active role in shaping legislative processes. Financial considerations related to earnings in the short to medium term regularly clash with more long-term financial considerations. We can also see that the climate debate in many countries, not least the US, is closely intertwined with a debate about the strategic national energy supply.

It is in the interests of NBIM's portfolio for the worst-case scenarios for climate change to be avoided, and this is an important premise for all of our dialogues with companies in this field. It is also NBIM's interests that the authorities in each individual country, nationally and through international co-operation, choose the most cost-effective solutions which serve our portfolio's earnings and sustainability in the longer term.

In its further work in this area, NBIM will seek better dialogue between investors, companies, legislators and academics. Technological development is particularly crucial. A good dialogue, where investors too play a role based on their long-term financial interests, can help to bring about more rapid progress and support for the necessary solutions.

Going forward, NBIM's dialogue will be based on the assumption that the period 2008-10 will bring continued moves internationally towards large-scale climate solutions, as well as see a conclusion to the legislative process in the US. In such a process, it is important that an investor like NBIM with long-term financial interests and a global portfolio assists companies with the financial arguments to support robust solutions.

4.1.3 Voting in 2007 in more detail

NBIM's voting guidelines are based on the Principles for Corporate Governance laid down by the Executive Board of Norges Bank. The overriding objective is to safeguard the long-term financial interests of the portfolio. In keeping with these principles, NBIM supported proposals promoting the following in 2007:

- that the company has a clearly defined business strategy endorsed by the board of directors
- that the company discloses adequate information about its financial position and other relevant factors
- that internal management and control systems tailored to the business have been established
- that the company's board of directors takes account of the interests of all shareholders
- that the board of directors has a sufficient number of members with relevant and adequate qualifications, and a majority of its members are independent
- that the board of directors can be held to account for its decisions
- that the company openly reports on its policy and actions in relation to human rights and the company's impact on the environment and the local community

Voting disclosure

NBIM is publishing its voting at individual companies in 2007 at the same time as this Annual Report. This is the first time this is being done, and there are still many pension funds and similar funds which do not do so. NBIM will follow the same procedure each year, publishing its voting during the previous year in connection with the launch of its Annual Report. The data will be available on the Internet at www.nbim.no.

In some jurisdictions, including the US, some proposals are put forward by shareholders directly. Most of these come from pressure groups, voluntary organisations and trade union organisations. It is worth noting that there are instances where NBIM supports many of the intentions behind a shareholder proposal but still does not lend its support, because the proposal is redundant or outdated, or formulated in a way which does not serve NBIM's interests in the company or market in question.

NBIM uses a number of sources to obtain information on companies as a basis for voting. We devote the most resources to the 500 largest companies in the portfolio, as their actions will normally have the greatest impact and influence in the market and for our portfolio. We also look at issues related to our priority areas, and we try to analyse all proposals related to social and environmental issues before voting.

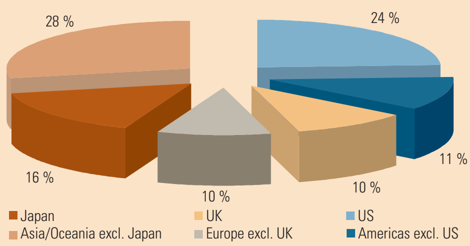


Chart 4-1: Voting in 2007 – by region

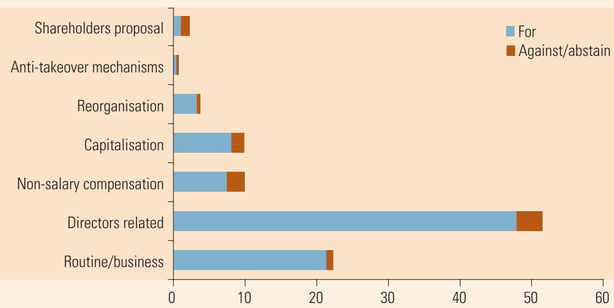


Chart 4-2: Voting 2007 – by category. Per cent

Table 4-1: Voting in 2007 – number of meetings

		2007		2006	2005
Region	**Number**	**Voted**	**Voted %**	**Voted %**	**Voted %**
Americas	1 547	1 489	96 %	94 %	92 %
Europe	1 257	852	68 %	50 %	50 %
Asia/Oceania	1 927	1 861	97 %	86 %	85 %
Total	**4 731**	**4 202**	**89 %**	**79 %**	**78 %**

"Number" is the number of meetings held over the year by companies included in the portfolio. "Voted" denotes the number of meetings where the right to vote was exercised.

Table 4-2: Voting 2007 – against management's recommendation

	Total number of proposals	Against management	
Routine/operational	8 627	358	4 %
Director-related	19 992	1 410	7 %
Non-salary compensation	3 842	949	25 %
Capitalisation	3 822	693	18 %
Reorganisation	1 418	163	11 %
Anti-takeover mechanisms	300	122	41 %
Total	**38 001**	**3 695**	**10 %**

A closer account of NBIM's voting in 2007 is presented below and shows how the voting can be broken down according to the main types of issues. Among other things, we look at instances where NBIM supported shareholder proposals and opposed management's own recommendations. The usual procedure is to support management's recommendations, as management has to be assumed to know the business and the company best. Sometimes, however, management may have different interests to owners, or management may for other reasons be acting in ways which are out of alignment with the views and interests of owners.

Number of meetings

An overview of the number of meetings where NBIM exercised its voting rights in 2007 is presented in Table 4-1.

I 2007, NBIM voted at 4 202 general meetings, or 89 per cent of the meetings held. The percentage of meetings at which NBIM voted was lower in Europe than in the other regions, but was still far higher than in 2006 and 2005. In many European markets, it has been standard practice to block the sale of shares for which votes have been cast until the general meeting takes place. This share-blocking reduces the individual portfolio manager's freedom to trade shares, and so it is only in special circumstances that NBIM votes at the general meetings of companies which practise share-blocking. More and more markets and companies have abandoned the practice of blocking shares, and we therefore voted at far more European companies in 2007 than before.

As shown in Chart 4-1, 24 per cent of the meetings at which NBIM voted were held by companies in the US, 20 per cent by European companies and 16 per cent by Japanese companies.

Number of proposals

At the more than 4 200 general meetings where NBIM used its voting rights, NBIM voted on 38 862 proposals. Shareholders can vote for, vote against or abstain on each proposal. Shareholders must vote on all items on the agenda. Proposals are mostly submitted by management, but shareholders can also submit proposals. Just over 2 per cent of the proposals on which we voted were shareholder proposals. Shareholder proposals are very common in the US, but we also saw a growing number of these proposals in some European countries and Japan in 2007. NBIM voted against 10 per cent of management proposals and in favour of almost 50 per cent of shareholder proposals.

The various proposals to be voted on at the general meetings can be divided into six categories as shown in Chart 4-2.

More than 50 per cent of the proposals were in the Director-related category and concerned the election of board members and the structure of the board. Just over 20 per cent of proposals were more-routine matters and have been categorised as Routine/operational. This category includes proposals concerning changes in

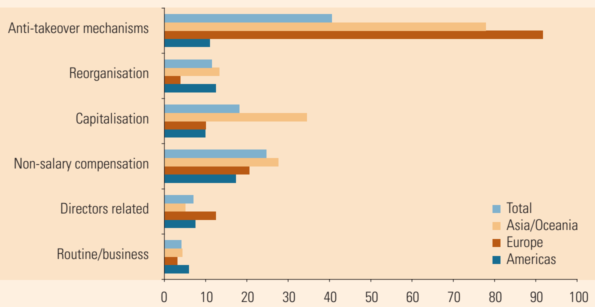


Chart 4-3: Voting 2007 – against management by region. Per cent

the articles of association, approval of the accounts, the annual report and dividends, and approval of auditors and their fees. 9 per cent of the proposals were related to bonuses and share-based payments and have been categorised as Non-salary compensation. 10 per cent of the proposals come under Capitalisation, while 4 per cent have been categorised as Reorganisation, which includes proposals for general meeting approval of mergers and acquisitions. 2 per cent were Shareholder proposals and, finally, less than 1 per cent were in the category Anti-takeover mechanisms, which are the various steps a company can take to make it harder for another company to take it over.

Voting against management proposals

NBIM voted against management on 3 695 proposals. NBIM supported 90 per cent of management proposals, which is natural, because in most cases NBIM has confidence in the way a company is being managed. More than half of the cases where we voted against management were at companies in Asia and Oceania, 24 per cent in the Americas and 23 per cent in Europe. Almost 40 per cent of the cases where NBIM voted against management proposals were in the director-related category, while a quarter were related to non-salary compensation.

Chart 4-3 shows to what extent NBIM voted against management by region and category of proposal. We voted against 8 per cent of management proposals in the Americas, 9 per cent in Europe and 11 per cent in Asia and Oceania. In the Americas, NBIM voted against management in between 7 and 17 per cent of cases in all of the categories. In Europe and in Asia and Oceania, NBIM's opposition to management proposals was highest on proposals related to anti-takeover mechanisms. On proposals related to non-salary compensation, we voted against management in 25 per cent of cases.

NBIM voted against management proposals in the following categories:

Routine/operational

NBIM voted against management's recommendation in 4 per cent of proposals of a more routine nature. NBIM voted against proposed auditors due to strong conflicts of interest and a lack of independence; this applies particularly to Japan and South Korea. NBIM did not support the approval of annual reporting due to a lack of information and because the proposed dividend was considered too low in light of the company's strong results over several years. In many cases, NBIM did not support proposed changes in a company's articles of association due to a lack of information and because the changes would transfer more power to the board as some decisions would no longer be considered by the general meeting.

Director-related

NBIM voted against management's recommendation in 7 per cent of proposals on director-related matters. At a number of US and Asian companies, NBIM abstained or voted against the election of candidates proposed by management because independent directors were not in the majority, or because directors who were not independent of the company were appointed to important board committees (nomination, compensation and audit committees). At a number of European companies, we voted against director elections on account of inadequate information about the candidates, and as a result of candidates being elected for a longer period than is standard practice for companies in the market in question.

NBIM voted against the re-election of the chairman of the board in many US companies because this individual was also the company's CEO. NBIM voted against the election of directors who had been members of compensation committees at companies where the CEO was awarded a very large pay increase even though the company's performance had been poor for a long period. We also voted against the re-election of directors who, without justification, had not participated sufficiently in the board's work, and in some cases also against directors who sit on large numbers of boards. In some cases, NBIM voted against the re-election of directors in the US who had disregarded shareholder proposals which had been supported by a majority of the general meeting for several years in a row.

Non-salary compensation

NBIM voted against management's recommendation in 25 per cent of proposals on non-salary compensation. NBIM did not support the approval of compensation plans which were not performance-based, permitted option repricing, resulted in relatively strong dilution of existing shareholders' ownership interests, were awarded at a price well below market value, or involved over-generous pension schemes and pension bonuses for directors and auditors. NBIM also voted against a number of plans due to inadequate information.

Capitalisation

NBIM voted against management's recommendation in 18 per cent of proposals related to capital structure. NBIM voted against proposals to issue shares which would greatly dilute existing shareholders' ownership interests, or would take place at a substantial discount to market value. At the general meetings of many Hong Kong companies, NBIM voted against share issues where the offer was made to a small group of shareholders at a very favourable price. In France, we voted against plans for buying back shares where these buybacks can continue even after a takeover bid for the company's shares has been received.

NBIM voted against share issues which would exacerbate departures from the "one share, one vote" principle. In Japan, NBIM voted against proposals to pay dividends which were considered to be too low in relation to earnings. NBIM also voted against share issues where shareholders were not given sufficient information.

Reorganisation

NBIM voted against management's recommendation in 11 per cent of proposals related to reorganisation. NBIM voted against proposed acquisitions because the offer was considered financially unsatisfactory or the strategy proposed for the merged company was not considered credible, because a better offer was available, or because there was a lack of information on the proposed changes. At many Japanese companies, NBIM voted against proposed changes in the articles of association which would transfer more authority to the board to decide whether the company should start up activities in new areas or sell parts of the business, and a number of other changes which would give the board increased discretionary powers.

Anti-takeover mechanisms

NBIM voted against management's recommendation in 41 per cent of proposals concerning anti-takeover mechanisms. NBIM voted against proposals to give the board unrestricted authority to issue shares in the event of a takeover bid ("poison pills"), which make it less attractive to buy a company. NBIM voted against proposals to change the articles of association so as to depart from annual re-election of all directors and instead have longer election periods for board directors, and proposals to increase the majority required to pass a resolution to replace a director. We did not support proposed changes to the articles of association which would increase the board's authority and thereby potentially increase its powers to resist mergers.

Shareholder proposals

Shareholder proposals are not normally supported by management, and a vote in favour of such a proposal is often a vote against management. Shareholder proposals accounted for 2 per cent of the proposals on which NBIM voted in 2007. NBIM supported 46 per cent of shareholder proposals at the general meetings at which we voted. In 2006, NBIM supported 52 per cent of shareholder proposals.

Shareholder proposals are most common in the US, but there were also a growing number of these proposals in some European countries and Japan in 2007. Almost 700 shareholder proposals were put to the vote at general meetings of US companies. The level of support attracted by shareholder proposals has increased in recent years, especially for proposals which make the board more accountable. Support for shareholder proposals on issues of a more social and environmental nature has also increased in recent years. Besides calls for better disclosure, the number of proposals asking companies to introduce guidelines on corporate social responsibility and sustainability is rising. More than 110 of the shareholder proposals in the US were supported by a majority of shareholders. At the same time, there are a growing number of proposals which are withdrawn after they have been submitted. This often occurs because the companies in question enter into dialogue with the shareholders submitting the proposal and commit to change. Almost 30 per cent of the submitted shareholder proposals in the US in 2007 were withdrawn.
Most of the shareholder proposals submitted at companies in Europe and Asia concerned director elections, although proposals related to social and environmental issues were also filed. For example, there were proposals at some European and Canadian companies for better reporting on these companies' activities in countries with a poor human rights record, and at some European companies there were proposals for better reporting on these companies' impact on the environment and the wider community.

Shareholder proposals are a very mixed bag and are submitted both by large, influential pension funds and other institutional funds and by individuals who represent special interests and own a small proportion of a company's shares. The proposals are primarily about the protection of shareholder rights, the work and structure of the board, and executive pay, but proposals on social and environmental issues are also submitted. The subjects of these proposals are often very relevant, but in many cases NBIM does not vote in favour because of the form of the proposal or because of the demands made of the company.

In 2007, for example, NBIM voted against proposals demanding reporting and/or guidelines on human rights or sustainable development because the proposals were either too detailed and wide-ranging and so did not represent responsible use of the company's resources, or because we believed that the company already had adequate systems and reporting in place. We also voted against proposals for disclosure of support for party political organisations because the existing reporting was good enough. In other cases, a company's management may already have dealt with the issue in a more appropriate manner, or shareholders may not be served by the proposal on account of its form, credibility, feasibility or financial consequences. This means that, even though NBIM votes against some such proposals, we are not necessarily against promoting the issues involved, and in many cases we will be able to promote such issues more effectively through other ownership activities and by publicising our principles.

NBIM experienced in 2007 a somewhat positive development as regards company responsiveness to shareholder concerns, especially when it comes to the extent and quality of reporting.

A shareholder proposal will normally come from investors who do not have the opportunities or resources to engage in dialogue with the company's senior management, or who wish to draw particular attention to specific issues. For large institutional investors like NBIM, it is usual to view shareholder proposals first and foremost as a last resort for when conventional dialogue proves unsuccessful. A shareholder proposal will normally be interpreted by the company as a hostile act, albeit not necessarily a "declaration of war", by the shareholder filing it. Although NBIM supports many shareholder proposals once they have been filed, NBIM therefore considers submitting its own proposals to be a last resort when dialogue breaks down completely or proves inappropriate. NBIM has yet to find itself in such a situation, but we nevertheless explored the legal background for filing shareholder proposals in various jurisdictions in 2007.

See also the separate box on trends in 2007.

Trends and shareholder influence

USA
More than 1 100 shareholder proposals were submitted for general meetings of US companies in 2007. These proposals dealt with both governance and social and environmental issues. More than 300 were withdrawn, often as a result of the company and the shareholders in question entering into dialogue and agreeing on changes on the company's part. More than half of the more than 120 proposals that directors should be elected by majority voting were withdrawn. Almost half of the proposals calling for increased disclosure of companies' social and environmental performance were also withdrawn. Much of the reason why companies are showing greater willingness to enter into dialogue with shareholders and make changes can be put down to shareholder proposals having won increasingly strong support at general meetings in recent years. Of the almost 700 proposals that were actually voted on in 2007, more than 100 won a majority.

Proxy access – shareholders' right to have their board candidates included on the agenda (proxy statement) for general meetings distributed by the company – was the most hotly debated governance issue in the US in 2007. The US Securities and Exchange Commission (SEC) reviewed its rules on shareholders' right to nominate directors during the course of 2007 and sent two competing proposals for new rules out for consultation in July. One proposal entailed completely eliminating shareholders' right to have their own candidates included on the proxy statement, while the other permitted this subject to a number of more extensive – and to an investor such as NBIM unsatisfactory – requirements concerning the size of the shareholder's holding and how long it has been held. The SEC concluded in November that no changes should be made for the time being, but also said that it would return to the issue once companies had held their general meetings in 2008. NBIM's letter of commentary, co-written with fellow investors ABP, PGGM and Hermes, can be found on SEC's Internet site.

Recent years have brought a growing number of shareholder proposals in the US calling for greater transparency about levels of management compensation and the levels of performance required to trigger payments, and for compensation plans to be put before the general meeting each year for an advisory vote. These proposals have won increasing support, and many companies have introduced changes. In April, the House of Representatives considered a bill requiring the general meeting to have an advisory vote on executive compensation plans. The bill was passed, but has yet to go through the Senate. Proposals on such votes won a majority at the general meetings of several companies in 2007. A working party consisting of both investors and companies has also been set up to look at the consequences – in other words, the costs and benefits – of implementing votes of this kind. This type of vote is mandatory in the UK, Australia, Sweden and the Netherlands.

2007 was the first year when US companies had to comply with the new rules on the disclosure of executive pay in connection with their annual reporting. Among other things, they must now describe in detail the basis for compensation plans and their implementation.
The year also saw many shareholder proposals calling for directors to be elected by majority voting – in other words, they need to obtain a majority of the votes cast in order to be elected. At many US companies, directors are still elected by plurality voting, and shareholders can only vote in favour of a candidate or abstain, which makes it possible to be elected with just one vote in favour. As a result of shareholders filing proposals for directors to be elected by majority voting in recent years, more and more companies have introduced electoral systems of that kind.

Europe
Shareholder proposals are less common at European companies, but there have been a growing number in recent years. These have largely concerned director elections, but there have also been proposals on social and environmental issues.

In 2007, the European Commission adopted a directive on how various obstacles to voting across national borders can be reduced. The directive aims to make it possible for shareholders to participate and vote at general meetings electronically without physically attending. It also sets out minimum requirements for shareholders' rights to ask questions, and the company's duty to answer them. In addition, the results of votes at general meetings will have to be published on companies' websites. The directive is binding on member states, but not on individual companies. Member states must implement the directive in national law by 3 August 2009, and some countries started making adjustments in 2007.

In May, the European Commission published its report on a study of "control-enhancing mechanisms" – in other words, mechanisms which mean that an investor's rights are not proportional to the investor's economic risk in the company. The study looked at almost 500 companies listed on exchanges in 16 EU countries, and included equivalent information from Australia, Japan and the US. The study concluded that this type of mechanism is widespread among European companies, particularly in certain countries. The study also contained a review of the academic literature in the field which concluded that, based on current literature, there is no clear indication that these mechanisms undermine value. The last part of the study presented the results of a survey of investors asked how they viewed this type of mechanism. The results showed that 80 per cent of investors expect a discount on the price of shares in a company with this type of mechanism relative to companies which do not. The discount will vary depending on the type of mechanism and the degree to which shareholders' rights are otherwise protected in the legislation of the country in question.

In several European markets, there has been growing concern about hedge funds, government-controlled foreign investment funds and other types of "activist" investors acquiring controlling holdings in large, strategically important companies:

- In the Netherlands, the government proposed lowering the notification threshold (the limit on how large a holding a shareholder or co-ordinated group of shareholders can build up before having to disclose their intentions) from 5 to 3 per cent. This proposal was probably strongly influenced by the Dutch bank ABN Amro being strongly criticised by some investors, a case that ended with the bank being acquired and split up. The regulatory authorities in Switzerland also recommended lowering the notification threshold and demanding increased reporting on the use of derivatives to obtain control.

- After the investment fund of the authorities in Dubai and a government-controlled Russian bank both acquired substantial stakes in EADS, a listed Franco-German aviation and weapons group which produces, among other things, Airbus aircraft, strong concern was expressed by the authorities in France and the Netherlands and at EU level. Proposals were put forward for the issue of shares with special rights, known as "golden shares", to the authorities in order to safeguard strategic industries and national/European ownership. This may go against the European Court of Justice's 2002 ruling based on the EU's takeover rules that the right of governments to create shares with special rights in strategic industries must be restricted.

Japan

More shareholder proposals were filed than in previous years in Japan, and there was a general tendency towards increased activism on the part of both Japanese and international investors. This increased activism probably contributed to more and more companies introducing mechanisms to block takeover bids. Following recent changes in Japanese company law, companies can now be acquired with payment in shares. Foreign acquisitions of Japanese companies have not been common in the past because payment had to be made in cash, but the new legislation has resulted in an increase in takeovers by foreign companies. This has led to companies wanting to introduce "poison pills". More than 200 companies put forward proposals to introduce these anti-takeover mechanisms. At more companies than before, this type of proposal did not achieve the level of support needed to be passed. This was particularly the case at companies with a high level of international institutional ownership.

4.2 Exclusion of companies

The Ministry of Finance's Ethical Guidelines are to be implemented through the use of three instruments – see discussion in the box in Section 4.1. One of these instruments is the exercise of ownership rights, which is the responsibility of Norges Bank and is discussed in the previous section and a separate feature article. The other two instruments are the responsibility of the Ministry of Finance and comprise negative screening of companies involved in the production of certain types of weapons, and ad hoc exclusion of individual companies which contravene fundamental ethical norms – for example, through involvement in serious environmental degradation or serious violations of human rights.

The government has appointed a Council on Ethics to advise the Ministry of Finance on negative screening and company exclusions. The Ministry takes the final decision on the exclusion of companies and instructs Norges Bank accordingly. Norges Bank has decided that the companies which the Ministry of Finance has chosen to exclude from the investment universe for the Government Pension Fund – Global are also to be excluded from the investment universe for Norges Bank's foreign exchange reserves.

Table 4-3: Companies excluded from the investment universe by the Ministry of Finance*

Reason	Date	Company
Anti-personnel landmines	26 April 2002	Singapore Technologies Engineering Ltd, Singapore
Cluster munitions	31 August 2005	Alliant Techsystems Inc, USA General Dynamics Corporation, US L-3 Communications Holdings Inc, US Lockheed Martin Corporation, US Raytheon Company, US Thales SA, France
	30 November 2006	Poongsan Corporation, South Korea
	31 December 2007	Hanwha Corporation, South Korea
Nuclear weapons	31 December 2005	BAE Systems plc, UK Boeing Company, US Finmeccanica SpA, Italy Honeywell International Inc, US Northrop Grumman Corp, US Safran SA, France United Technologies Corp, US
	10 May 2006	EADS Co, Netherlands**
	31 December 2007	GenCorp Inc, US Serco Group plc, UK
Breaches of human rights	31 May 2006	Wal-Mart Stores Inc, US Wal-Mart de Mexico SA, Mexico
Environmental damage	31 May 2006	Freeport McMoRan Copper and Gold Inc, US
	31 March 2007	DRDGOLD Ltd, South Africa
Environmental damage and breaches of human rights	31 October 2007	Vedanta Resources plc, UK Sterlite Industries Ltd, India Madras Aluminium Company, India

* The company Kerr-McGee Corporation was excluded on 31 May 2005 because the company was active in Western Sahara. These activities ceased in spring 2006, and the company (subsequently merged with Anadarko Petroleum) was included again from 30 June 2006.

** EADS was originally excluded on 31 August 2005 because the company was involved in the production of cluster munitions. EADS no longer produces cluster munitions. However, EADS is involved in the production of nuclear weapons, and the Ministry of Finance therefore renewed its exclusion on 10 May 2006.

The Ministry of Finance decided in 2007 to exclude a total of seven companies from the investment universe. These decisions were based on recommendations from the Council on Ethics. The background to the exclusions is discussed in greater detail in press releases from the Ministry of Finance. The recommendations from the Council on Ethics can be found at www.etikkradet.no.

The combined value of the investments in companies excluded in 2007 at the time of the decision to exclude them was approximately NOK 530 million.

Since 2002, 27 companies with a combined value in the portfolio of NOK 10.9 billion have been excluded. Norges Bank has estimated the total transaction costs associated with exclusion at NOK 59.5 million. This is believed to be only a small part of the potential financial losses resulting from exclusion. However, there is little point in estimating potential losses of return over periods of only a few years. Table 4-3 provides an overview of the companies excluded as of 31 December 2007.

5 – Organisation

5.1 Management model and organisation

Norges Bank Investment Management (NBIM), a division of Norges Bank, is responsible for the management of the Government Pension Fund – Global. NBIM also manages the Government Petroleum Insurance Fund on behalf of the Ministry of Petroleum and Energy and the bulk of Norges Bank's foreign exchange reserves. At the end of 2007, assets under management amounted to NOK 2 261 billion.

The Executive Board has overriding responsibility for Norges Bank's operations. The Executive Board consists of seven members, all appointed by the King. The Governor and Deputy Governor of Norges Bank are its chairman and vice-chairman respectively. The Supervisory Council, which consists of fifteen members appointed by the Storting (Norwegian parliament), is the Bank's supervisory body and approves the Bank's budget.

The Supervisory Council organises the auditing of Norges Bank pursuant to the Norges Bank Act. Central Bank Audit is to submit an audit report to the Supervisory Council on the Bank's annual financial statements. With effect from 2007, the Supervisory Council has entered into an agreement with the auditing firm Deloitte AS on co-operation with Central Bank Audit on the financial auditing of investment management. Deloitte and Central Bank Audit are to submit a separate audit statement to the Supervisory Council on the annual financial statements for the Government Pension Fund – Global. The management agreement for the fund also requires Central Bank Audit to submit statements to the Ministry of Finance concerning NBIM's Quarterly and Annual Reports on the management of the fund.

The Office of the Auditor General is responsible for the final audit of the Government Pension Fund – Global and bases its work partly on material from Central Bank Audit. The Government Petroleum Insurance Fund is managed by Norges Bank, and its accounts are kept by the Bank, but the fund is not included in the Bank's annual financial statements. The fund is audited by the Office of the Auditor General. Central Bank Audit carries out audit procedures related to the annual financial statements in accordance with an agreement with the Office of the Auditor General.

The Executive Board establishes the framework for NBIM's operations through strategy plans. The strategy plan covers a three-year period and is revised every other year. A new strategy plan for the development of investment management in the period to 2010 was adopted by the Executive Board at the beginning of 2007. During the period covered by the plan, assets under the management of Norges Bank may increase substantially. Investments may also be made in new asset classes such as real estate and private equity. The principal objectives of the plan are to generate substantial added value through active management of the government's and Norges Bank's foreign financial assets, to foster the owners' long-term financial interests through active corporate governance, and to implement the owners' management strategy in a cost-effective, prudent and confidence-inspiring manner. Underlying the operational objectives is an acknowledgement of the fact that Norges Bank manages substantial assets for Norwegian society. This is also evident from NBIM's mission, vision, objectives and values (see discussion in NBIM's Annual Report for 2006).

In 2006, the Executive Board set up an Advisory Board to support its work on investment management. The background to this is the challenges faced by the Executive Board in developing and monitoring investment management. The Advisory Board consists of four internationally recognised experts with extensive experience from large investment management institutions. The Advisory Board had two meetings with the Executive Board in 2007.

NBIM attaches great importance to managing and controlling operational risk in its activities. In 2006, a formal framework was established for the management of operational risk. This has been approved by the Executive Board and is discussed in more detail in Section 5.2. In 2007, the international accounting firm Ernst & Young conducted a review of investment management at Norges Bank on behalf of the Ministry of Finance. The final report from Ernst & Young concerns internationally recognised principles for the various aspects of risk and return measurement.

In 2007, NBIM was organised into separate business lines for equity and fixed income management respectively. In addition, NBIM had departments which were organisationally independent of these two business lines and reported directly to the Executive Director of NBIM. These departments were responsible for the exercise of ownership rights, measurement of risk and return, compliance with investment guidelines, and shared administrative functions. An organisation chart for NBIM can be found on its website (www.nbim.no).

NBIM has its head office in Oslo. In 2007, the Chinese authorities gave Norges Bank permission to open an office in Shanghai, and the office was formally inaugurated in November. The office in New York was transferred from downtown Manhattan to a more central location in midtown Manhattan during the year. NBIM also has an office in London.

5.2 Operational risk

NBIM defines operational risk as the risk of financial losses or loss of reputation for the organisation or for the funds under management caused by weaknesses or errors in internal processes and systems, as well as errors due to human factors or external events.

In recent years, NBIM has attached considerable importance to work on managing and controlling operational risk in order to be able to achieve the goal of high returns with low operational risk.

In 2006, NBIM established a framework based on the COSO principles[1] for the management of operational risk. These guidelines have been approved by the Executive Board and were implemented in all business lines and departments in 2007. The guidelines cover roles and responsibilities, and principles and procedures for identifying, evaluating, monitoring, controlling, reducing and reporting operational risks in the organisation.

Identifying, managing and controlling operational risks is a clear and integral part of management responsibility at all levels of NBIM. Each individual line manager has direct responsibility for operational risk within his or her business line or department, and for those parts of the organisation's activities which are outsourced.

Shared frameworks and methods helped NBIM to establish a comprehensive system for the management and monitoring of operational risk in 2007. Important instruments in monitoring the risk situation include the use of risk indicators which provide early warning of undesirable changes in risk levels or efficiency. Risk indicators are being developed for all material risks.

Before NBIM embarks on a new activity, such as investment in a new market, product or asset class, NBIM is to assess the operational risk factors associated with this activity to make sure that these are identified, measurable and controllable. Corresponding risk assessments are also carried out when choosing suppliers, carrying out reorganisations and changing IT solutions, and following loss events etc.

One key instrument in the management of operational risk is good emergency and contingency planning. NBIM strives for continuous improvement in this area.

Operational risk is less quantifiable than other types of risk, but NBIM aims to increase quantification in order to improve risk management and create a dynamic development picture. Setting targets and tolerance limits is a key element of this work so as to give management an effective overview of performance.

5.3 NBIM's employees

At the end of 2007, NBIM had a total of 178 permanent employees, 14 full-time temporary employees and 14 trainees. In addition to Norwegian nationals, NBIM had 48 employees from 19 other countries. During the year, 59 permanent employees joined the organisation and 13 left. Women account for 26.4 per cent of permanent employees. At the end of 2007, the average age was 37.5 and the average length of service with NBIM was six years. Sickness absence was 2.1 per cent.

Most employees are based in Oslo, but NBIM also has offices in New York (20 employees), London (19 employees) and, since autumn 2007, Shanghai (six employees). At the end of 2007, a total of 45 of NBIM's permanent employees were based at its offices outside Norway. Most of these employees are engaged in active management of the equity and fixed income portfolios.

5.4 Salary and incentive system

The Executive Board acknowledges that the task of managing the Government Pension Fund – Global requires active use of pay incentives and human resource policy measures. The quality of the Bank's investment management depends heavily on the capacity to attract, develop and retain employees with pre-eminent and specialised expertise. Norges Bank complies with the provisions of the Accounting Act on the disclosure of remuneration, pension benefits and other benefits accruing to the Bank's executive management and management group. This information is provided in Norges Bank's Annual Report.

NBIM recruits internationally. A number of Norwegians have been recruited from foreign companies and remained resident in London or New York. Both within and outside Norway, the remuneration of investment management employees normally consists of two main components: fixed pay and a variable component which depends on performance. For those who make investment decisions and are assessed on the basis of these results, the performance-based component will often be larger than the fixed component.

Performance-based pay is a means of retaining employees who succeed in adding value through their investment decisions. The system of performance-based pay also serves another function. It is to help ensure that those with investment authority actually take active market risk. NBIM's goal of adding value through active management requires there to be individuals who take this risk, within the constraints of applicable limits and procedures. An incentive system

[1] In 1992, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) established an internal control framework which has now become the most widely recognised international framework in this area. COSO is sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, Financial Executives International, the Institute of Internal Auditors and the Institute of Management Accountants.

which rewards high performance increases the willingness to engage in such active management.

The Executive Board defines pay and personnel policy as a means for NBIM to achieve its strategic goals. The Annual Report for 2006 contained a detailed presentation of the principles for pay and incentive systems.

Remuneration in 2007

The excess return on the funds managed by NBIM is discussed in previous sections. Since the Government Pension Fund – Global is by far the largest fund, its results will have the greatest impact on overall pay figures.

The return in 2007 was well below the target of 25 basis points value added. This was due primarily to weak results from fixed income management. Equity management, on the other hand, had a very good year. Performance-based pay reflects differences in individual performance, which varied greatly in 2007.

Total performance-based pay for NBIM's front-office departments came to NOK 67.7 million in 2007. This is equivalent to 42 per cent of the upper limit. In the Equities Department, 59 per cent of the limit was paid; in the Fixed Income Department, 13 per cent.

Chart 5-1 shows employees in the front-office departments grouped according to the percentage of the individual's performance-based pay limit actually disbursed. The chart shows, for example, that 46 per cent of front-office employees were paid less than 25 per cent of their performance-based pay limit.

The system and scale for the remuneration of NBIM's Executive Director is determined by the Executive Board. The actual remuneration is decided by the Governor of Norges Bank according to specific criteria. These criteria include NBIM's financial performance over the past few years and various measures for the quality of management, compliance with guidelines and fostering of confidence in NBIM, development and operation of the organisation, and implementation of action plans. The Executive Director of NBIM was paid a salary of NOK 3 218 630 in 2007. He also received other benefits with a combined value of NOK 12 864. The Executive Director of NBIM is a member of Norges Bank's pension scheme, which is described in Norges Bank's Annual Report.

Remuneration at NBIM

Front-office departments:

Number of employees with performance-based pay	86
Percentage of these in internal management	93 per cent
Total fixed pay, all front-office employees	NOK 70.2 million
Total performance-based pay, all front-office employees	NOK 67.7 million
Upper limit for performance-based pay, all front-office employees	NOK 159.3 million
Performance-based pay as a percentage of limit, all	42 per cent
Performance-based pay as a percentage of limit, equities	59 per cent
Performance-based pay as a percentage of limit, fixed income	13 per cent

Other departments:*

Number of employees	91
Total fixed pay	NOK 52.4 million
Number of employees with performance-based pay	67
Total performance-based pay	NOK 8.8 million

* Excludes remuneration of the Executive Director of NBIM.

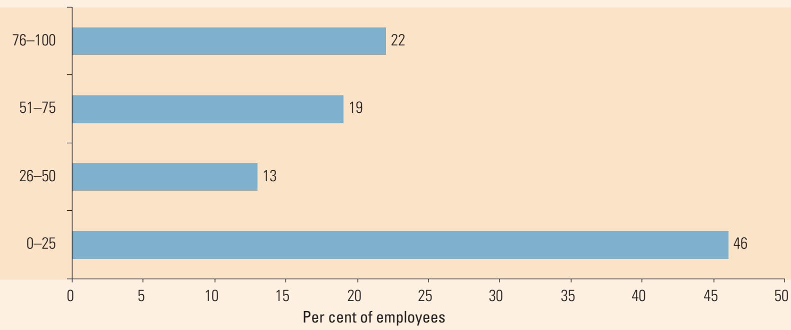


Chart 5-1: Performance-based pay relative to upper limit in front-office departments

6 – Financial reporting

Accounting information for the portfolios managed by Norges Bank Investment Management is presented below. The financial reporting for the Government Pension Fund – Global and Norges Bank's foreign exchange reserves form part of, and are excerpts from, Norges Bank's own audited annual financial statements, as approved by Norges Bank's Supervisory Council on 28 February 2008. A separate audit statement for the Government Pension Fund – Global has been submitted and can be found below. The Government Petroleum Insurance Fund's accounts are kept by Norges Bank, but the fund is not included in the Bank's annual financial statements. For a full presentation of the financial statements, see Norges Bank's Annual Report and the separate reporting for the Government Petroleum Insurance Fund.

6.1 Government Pension Fund – Global

Profit and loss account

Figurea in millions of NOK	Note	2007	2006
Profit and loss on financial assets excl. exchange rate adjustments			
Interest income, deposits in foreign banks		431	137
Interest income, lending associated with reverse repurchase agreements		33 564	25 717
Net income/expenses and gains/losses from:			
- Equities and units	2	41 627	104 667
- Bonds and other fixed income instruments	2	19 750	11 710
- Financial derivatives		5 265	-85
Interest expenses, borrowing associated with repurchase agreements		-32 509	-21 613
Other interest expenses		-118	-60
Other expenses		-179	-6
Profit before exchange rate adjustments and management costs	**1**	**67 831**	**120 468**
Exchange rate adjustments		-146 412	-24 232
Loss / profit before management costs		**-78 581**	**96 236**
Accrued management fee	3	-1 783	-1 531
Net profit and loss for the year		**-80 364**	**94 705**

Balance sheet

Figurea in millions of NOK	Note	2007	2006
ASSETS **FINANCIAL ASSETS**			
Deposits in foreign banks		23 905	13 154
Lending associated with reverse repurchase agreements		669 607	619 746
Shares and units	4	945 113	720 195
Bonds and other fixed income instruments	4	1 120 540	1 166 911
Financial derivatives	5	2 094	0
Other assets	6	5 229	328
Total financial assets	**10,11**	**2 766 488**	**2 520 334**
LIABILITIES AND CAPITAL **FINANCIAL LIABILITIES**			
Short-term borrowing	7	187	57
Borrowing associated with repurchase agreements	8	710 898	728 357
Unsettled trades		33 480	5 123
Financial derivatives		0	1 777
Other liabilities	6	3 185	1 355
Management fee due		1 783	1 526
Total financial liabilities	**10,11**	**749 533**	**738 195**
Capital	9	2 016 955	1 782 139
Total liabilities and capital		**2 766 488**	**2 520 334**

The Government Pension Fund – Global is presented as follows in Norges Bank's balance sheet:

Assets (Figures in millions of NOK)		
Investments for Government Pension Fund – Global	**2 016 955**	**1 782 139**

Liabilities (Figures in millions of NOK)		
Deposits in krone account Government Pension Fund – Global	**2 016 955**	**1 782 139**

ACCOUNTING POLICIES AND NOTES TO THE FINANCIAL REPORTING

Accounting policies

The accounting policies for Norges Bank were approved by the Supervisory Council on 13 December 2007. It has been agreed with the Ministry of Finance that the accounting policies for Norges Bank are also to be applied to the Government Pension Fund – Global.

1 General

Basis for preparing the annual financial statements

Norges Bank is subject to the Act of 24 May 1985 relating to Norges Bank and the Monetary System etc and is not required to comply with Norwegian accounting legislation. Nevertheless, the accounts have, with some exceptions, been prepared in accordance with the Accounting Act of 1998, supplementary regulations and generally accepted accounting principles in Norway. The departures are due principally to the special conditions applying to a central bank.

The principal departures from the Accounting Act are in the following areas:

- The profit and loss account and balance sheet are presented in a manner appropriate to the Bank's activities
- A cash flow analysis has not been prepared
- Financial derivatives, unsettled trades and accrued interest are reported net on the balance sheet
- Re-invested cash collateral from securities lending is not recorded
- The foreign exchange element linked to realised and unrealised changes in the value of financial instruments is removed and entered on a separate line
- Some of the information in the notes differs

Presentation of the Government Pension Fund – Global

The Government Pension Fund – Global is managed by Norges Bank on behalf of the Ministry of Finance and in accordance with management guidelines. The portfolio under management corresponds to the balance at any given time in the Government Pension Fund – Global's krone account at Norges Bank. The entire return on the portfolio is transferred to the krone account. Norges Bank bears no economic risk in connection with changes in the value of the fund. Therefore, the performance of the Government Pension Fund – Global does not affect Norges Bank's profit or Norges Bank's capital. The Government Pension Fund – Global's net investments are recorded as an asset on a separate line. The fund's krone account is recorded as a liability in the same amount to the Ministry of Finance.

2 Use of estimates when preparing the annual financial statements

The preparation of the financial statements for Norges Bank involves the use of estimates and judgements which can affect assets, liabilities, income and expenses. Estimates and judgements are evaluated regularly and are based on historical experience and expectations of future events which are considered probable at the time the financial statements are presented. The estimates are based on best judgement, but may differ from the final outcome.

3 Currency translation

Transactions in foreign currency are recorded in the financial statements at the exchange rate prevailing at the transaction date.

Assets and liabilities in foreign currency are translated into NOK at the exchange rate prevailing at the balance sheet date.

In the profit and loss account, the foreign exchange element linked to realised and unrealised changes in the value of financial instruments is removed and entered on a separate line. Foreign exchange adjustments are calculated monthly on the basis of fair value in foreign currency at the end of the month.

4 Financial instruments

4.1 Recording and exclusions

Financial assets and liabilities are recorded on the balance sheet when Norges Bank becomes a party to the contractual terms of the instrument. The transactions are entered at the trade date.

Financial assets are excluded from the balance sheet when the contractual rights to the cash flows expire or when the financial asset and the bulk of the risks and returns relating to ownership of the asset are transferred.

Financial obligations are excluded from the balance sheet when the obligation ceases to apply.

4.2 Valuation

First entry

A financial asset or liability is recorded at purchase price including direct transaction costs.

Subsequent valuation

Financial assets and liabilities are recorded at fair value at the balance sheet date. Fair value is the realisable value of an asset or the cost of settling a liability in an arm's length transaction between independent parties.

The price quoted by a stock exchange, price provider or broker is used for securities that are traded in an active market.

Valuation methods are used to establish fair value for securities that are not traded in an active market. Valuation methods include the use of recent arm's length market transactions between independent parties, if such information is available, reference to current fair value of another instrument that is essentially the same, discounted cash flow calculations, and option pricing models. If there is a valuation method that is commonly used by market participants to price the instrument, and this technique has provided reliable estimates of prices achieved in actual market transactions, this technique is used. Market information is used in the valuation methods to the extent possible.

Changes in fair value are recorded in the profit and loss account.

4.3 Securities lending (lending programmes)

Securities lending is where securities are transferred from Norges Bank to a borrower against collateral in the form of cash or securities. When the loan is terminated, identical securities are to be returned. The borrower is obligated to compensate the lender for various events relating to the securities, such as subscription rights, dividends etc. Securities that are lent out are not removed from Norges Bank's balance sheet. Lending fees are recorded daily as interest income on lending.

The borrower has the voting rights attached to the securities during the lending period.

Collateral received is not recorded in the balance sheet. This applies whether the collateral is re-invested or not. Unrealised gains and losses on re-investments are recorded in the profit and loss account at market value.

4.4 Repurchase/reverse repurchase agreements

Repurchase agreements do not meet the criteria for excluding the security from the financial statements. Therefore, the security is not excluded from the balance sheet when a transactiohn is agreed. During the contract period, the security will be recorded in the financial statements in accordance with the ordinary accounting rules for securities. Collateral received is recorded gross during the contract period as both a financial asset and a short-term financial liability at amortised cost.

Reverse repurchase agreements are recorded on the balance sheet at amortised cost as a financial asset with cover from bank deposits during the contract period. The underlying security is not recorded on the balance sheet.

4.5 Interest earned and accrued

Interest earned and accrued is recorded on the balance sheet on the same line as the appurtenant financial asset or liability.

5 Taxation

Norges Bank's operations are not subject to tax in Norway.

Withholding tax on dividends and coupons in foreign markets is entered as a reduction in the income item. If withholding tax can be reclaimed, it will be shown as a receivable until it has been refunded.

Notes

Note 1. Profit before foreign exchange adjustments 2007

Figures in millions of NOK	Interest	Dividends	Realised gains/losses	Unrealised gains/losses	Total
Interest income, deposits in foreign banks	431	0	0	0	431
Interest income, lending associated with repurchase agreements	33 564	0	0	0	33 564
Net income/expenses and gains/losses from:					
- Equities and units	938	18 823	61 925	-40 058	41 627
- Bonds and other fixed income instruments	51 993	0	-15 215	-17 028	19 750
- Financial derivatives	3 142	0	-1 416	3 539	5 265
Interest expenses, borrowing associated with repurchase agreements	-32 509	0	0	0	-32 509
Other interest expenses	-118	0	0	0	-118
Other expenses	-179	0	0	0	-179
Profit before exchange rate adjustments and management fee	**57 262**	**18 823**	**45 294**	**-53 547**	**67 831**

Note 2. Securities lending

Interest income of NOK 938 million from lending out equities has been recorded under “Net income/expenses and gains/losses from equities and units”. Interest income of NOK 647 million from lending out bonds and other fixed income instruments has been recognised under “Net income/expenses and gains/losses from bonds and other fixed income instruments”. As a result of negative market performance, an associated unrealised loss of NOK 3 088 million on re-invested cash collateral has been recorded under “Net income/expenses and gains/losses from bonds and other fixed income instruments”. See Note 11 for further information. This means that securities lending generated a net loss of NOK 1 503 million in 2007. Lending and collateral levels are presented at fair value in the table below:

Fair value in millions of NOK	
Loans of securities	
Loans of equities	181 929
Loans of bonds and other fixed income instruments	334 424
Total loans of securities against collateral	**516 352**
Off balance sheet	
Collateral in the form of cash	298 012
Collateral in the form of equities	127 637
Collateral in the form of bonds and other fixed income instruments	110 049
Total collateral	**535 698**
Collateral in the form of cash which is reinvested	**294 493**
Of which:	
Lending associated with repurchase agreements	201 227
Asset-backed securities	45 720
Structured investment vehicles	10 791
Other fixed income instruments	36 755

Norges Bank has entered into lending agreements with JP Morgan Chase Bank, State Street Bank & Trust and Dresdner Bank AG. All these agreements contain provisions which protect Norges Bank's interests if the party borrowing the securities is unable to return them or if the collateral provided for the loan is not sufficient to cover losses.

Norges Bank accepts cash, equities (industrialised countries) and bonds and other fixed income instruments of high credit quality as collateral for securities lending.

Security in the form of cash is re-invested in repurchase agreements or diversified bond funds with short maturities and the highest possible credit rating (Aaa from Moody's). Norges Bank has entered into agreements with State Street Bank & Trust and Dresdner Bank AG as managers of these funds.

Note 3. Management costs

	2007		2006	
	NOK 1 000	Basis points	NOK 1 000	Basis points
Internal costs, equity management	315 751		223 889	
Custody and settlement costs	110 400		95 689	
Total costs, internal equity management	**426 151**	**7.7**	**319 578**	**8.1**
Internal costs, fixed income management	290 616		184 178	
Custody and settlement costs	115 088		79 858	
Total costs, internal fixed income management	**405 704**	**4.1**	**264 036**	**3.2**
Minimum fees to external managers	513 442		431 829	
Performance-based fees to external managers	268 546		387 816	
Custody, settlement and monitoring costs	169 433		122 340	
Total costs, external management	**951 421**	**25.1**	**941 985**	**28.3**
Total management costs	**1 783 275**	**9.3**	**1 525 600**	**9.8**
Total management costs, excluding performance-based fees	**1 514 729**	**7.9**	**1 137 784**	**7.3**

Note 4. Equities and units and bonds and other fixed income instruments 2007

Figures in millions of NOK				
	Cost	Market value of securities	Dividends earned	Market value
Equities and units				
Listed equities and units	912 736	942 210	1 110	943 320
Units in unlisted fixed income and equity funds	1 855	1 793		1 793
Total equities and units	**914 591**	**944 003**	**1 110**	**945 113**
Bonds and other fixed income instruments	Cost	Market value of securities	Accrued interest	Total market value
Government and government-related bonds	294 372	276 443	8 655	285 098
Inflation-linked bonds	98 512	94 753	562	95 315
Corporate bonds	323 181	285 590	5 465	291 055
Securitised debt	465 056	438 035	6 675	444 709
Short-term certificates	4 404	4 362	0	4 362
Total bonds and other fixed income instruments	**1 185 526**	**1 099 184**	**21 356**	**1 120 540**

"Securitised debt" comprises covered bonds with a market value of NOK 289 billion and asset/mortgage-backed securities with a market value of NOK 156 billion. Of the latter, approximately NOK 99 billion are securities issued by US Federal agencies, such as Fannie Mae, Freddy Mac and Ginnie Mae (see Note 11).

Note 5. Financial derivatives

	Exposure		Fair value		
Figures in millions of NOK	Purchased	Sold	Asset	Liability	Value
Foreign exchange contracts	**61 402**		**278**	**430**	**(152)**
Listed futures	**119 875**	**147 379**	**539**	**785**	**(246)**
Interest rate swaps	813 119	747 671	20 856	18 980	1 876
Total return swaps	24 140	18 497	404	447	(43)
Credit default swaps	166 715	50 889	1 838	1 328	510
Equity swaps	30 473	15 775	2 605	3 199	(593)
Total swaps			**25 703**	**23 953**	**1 749**
Listed options	46 907	28 926	92	29	64
Other options	146 951	78 694	3 720	3 040	680
Total options			**3 812**	**3 069**	**743**

Total derivatives	**30 331**	**28 237**	**2 094**

Foreign exchange contracts

This item consists of foreign exchange contracts with normal settlement for future delivery. Exposure is the sum of the nominal value of the contracts entered into.

Listed futures

Exposure is the market value of the underlying instruments.

Interest rate swaps

This item includes both straight interest rate swaps and combined interest and exchange rate swaps.

Exposure expresses whether Norges Bank receives (contracts purchased) or pays (contracts sold) a fixed rate of interest.

Total return swaps

With a total return swap (TRS), the protection purchaser transfers the total return on an underlying credit to the protection seller in return for a fixed or floating rate of interest. Total return denotes the sum of coupon payments and any change in value. The underlying assets for the TRSs in which the fund invests are commercial mortgage-backed security (CMBS) and mortgage-backed security (MBS) indices.

Exposure shows whether Norges Bank receives (contracts purchased) or pays (contracts sold) the index return.

Credit default swaps

With a credit default swap, the protection seller receives a periodic premium or lump sum from the protection purchaser as compensation for assuming the credit risk. The protection purchaser receives payment from the seller only if the credit protection of the underlying credit is triggered (credit event). A credit event might include default on the underlying credit. A credit default swap is very much like a traditional guarantee. The protection normally expires after the first credit event.

The underlying assets for credit default swaps are corporate bonds, securities issued by nation states, corporate bond indices, asset-backed security (ABS) indices and commercial mortgage-backed security (CMBS) indices.

Exposure expresses whether Norges Bank has purchased or sold protection for all or part of the credit risk associated with the various types of underlying asset.

Equity swaps

Equity swaps are unlisted agreements between two counterparties to swap cash flows based on changes in the underlying security. In addition, they receive payments in the event of dividends and corporate events. The underlying security can be an equity, a group of equities or an index.

Exposure corresponds to the market value of the underlying equities or indices.

Options

Exposure expresses the market value of the underlying assets. Options written by the fund are reported under “Sold”. Options where Norges Bank pays a premium are reported under “Purchased”.

Note 6. Other assets/liabilities

Figures in millions of NOK	2007	2006
Withholding tax	293	237
Outstanding accounts with other portfolios under management	4 766	0
Accrued interest, securities lending	171	91
Total other assets	**5 229**	**328**

Figures in millions of NOK	2007	2006
Outstanding accounts with other portfolios under management	0	1 355
Adjustment of re-investments in lending programme	3 088	0
Foreign tax liability	97	0
Total other liabilities	**3 185**	**1 355**

“Outstanding accounts with other portfolios under management” comprises the net value of deposits, loans, repurchase agreements and reverse repurchase agreements vis-à-vis other portfolios managed by Norges Bank.

The tax liability for 2007 is estimated at NOK 97 million. The equivalent figure for 2006 was approximately NOK 40 million. This was included in the fund's equity holdings in 2006.

Note 7. Short-term borrowing

Short-term borrowing is used in the liquidity management of the portfolio and has a maturity of between one and ten days.

Note 8. Borrowing associated with repurchase agreements

Figures in millions of NOK	2007	2006
Borrowing, repurchase agreements	708 163	728 357
Borrowing, securities lending collateral	2 735	0
Total borrowing associated with repurchase agreements	**710 898**	**728 357**

Note 9. Capital

Figures in millions of NOK	2007	2006
Deposits in krone account on 1 January	1 782 139	1 397 896
Transfers during the year	315 179	289 537
Management remuneration to Norges Bank	-1 783	-1 530
Return transferred to/from krone account	-78 580	96 236
Capital – deposits in krone account on 31 December	**2 016 955**	**1 782 139**

Note 10. Currency distribution 2007

Figures in millions of NOK BALANCE SHEET	USD	CAD	EUR	GBP	JPY	Other	Total
FINANCIAL ASSETS							
Deposits in foreign banks	11 124	2 724	6 961	(864)	436	3 524	**23 905**
Lending associated with reverse repurchase agreements	330 304	20 261	157 438	128 661	10 416	22 528	**669 607**
Shares and units	305 194	17 621	257 892	137 023	73 735	153 648	**945 113**
Bonds and other fixed income instruments	311 303	15 321	650 721	56 596	55 944	30 655	**1 120 540**
Financial derivatives	876	(142)	2 425	(294)	(353)	(418)	**2 094**
Unsettled trades	-	-	-	-	-	-	**-**
Other assets	(2)	804	(727)	3 253	1 402	499	**5 229**
TOTAL FINANCIAL ASSETS	**958 799**	**56 588**	**1 074 710**	**324 376**	**141 580**	**210 435**	**2 766 488**
FINANCIAL LIABILITIES							
Short-term borrowing	-	-	24	11	1	151	**187**
Borrowing associated with repurchase agreements	263 995	10 998	306 782	84 249	21 169	23 705	**710 898**
Financial derivatives	-	-	-	-	-	-	**-**
Trades awaiting settlement	31 658	949	1 181	(394)	37	49	**33 480**
Other liabilities	3 088	-	0	-	-	97	**3 185**
Management remuneration due	-	-	-	-	-	1 783	**1 783**
TOTAL FINANCIAL LIABILITIES	**298 741**	**11 947**	**307 987**	**83 865**	**21 206**	**25 785**	**749 533**

Note 11. Risk

Investments in global securities markets entail market risk and a relatively high probability of wide variations in annual performance. For the Government Pension Fund – Global, the level of market risk is determined primarily by the benchmark portfolio defined by the Ministry of Finance. The most important elements of market risk are the allocation to equities in the portfolio, fluctuations in equity prices, exchange rates and general interest rate levels, as well as changes in the fixed income portfolio's credit risk.

In addition to the absolute level of market risk, which is determined by the investment strategy expressed through the benchmark portfolio, Norges Bank tries to achieve an excess return through active management.

Market risk must be seen in relation to expected returns, and an increase in market risk means higher expected returns.

All investments are made in foreign currency without any currency hedging, and so the market value of the portfolio in NOK will move with fluctuations in exchange rates. See Note 10 for information on the currency distribution.

Market risk

Most of the fund's market risk is determined by the benchmark portfolio's market risk. Norges Bank also takes on some risk through its active management. Norges Bank measures both absolute and relative market risk in the fund. Absolute risk is estimated on the basis of the actual portfolio, while relative risk is estimated as the standard deviation of the difference between the return on the actual portfolio and the return on the benchmark portfolio.

At the end of 2007, the portfolio's annualised market risk, measured in NOK terms, was 8.6 per cent, which was higher than at the beginning of the year. At the end of the year, the value of the portfolio was NOK 2 017 billion.

The level of risk in the portfolio fell during the first half of the year, but increased markedly in the second. The reason for the increase in risk was the financial turbulence in the market in 2007. Besides increased volatility in both the fixed income and equity markets, the risk at fund level will depend on the correlation between the two markets. This correlation has been at relatively high levels in recent years, but there was a significant reduction in 2007. Thus, part of the increase in the markets' volatility in 2007 did not materialise in the fund's risk, because the diversification effect (as a result of investments being spread across both fixed income and equity instruments) increased.

Credit risk

Credit risk arises in the fund's fixed income portfolio, partly as a result of the Ministry of Finance's choice of investment strategy, and partly as a result of Norges Bank's active management (credit portfolio risk). In both the equity and the fixed income portfolios, Norges Bank is exposed to risk vis-à-vis counterparties in the execution of transactions, vis-à-vis custodian institutions with which securities are deposited, and vis-à-vis international settlement and custody systems (counterparty risk).

All fixed income instruments in the fund's benchmark index have a rating from one of the major credit rating agencies: Standard & Poor's, Moody's and Fitch.

All three agencies classify the issuers of fixed income instruments on the basis of their creditworthiness. A credit rating scale from AAA to D is used for long-term bonds. The highest rating is AAA from S&P and Fitch, and Aaa from Moody's. The lowest investment grade ratings are BBB from S&P and Fitch and Baa from Moody's. Lower ratings are known as speculative grade. All bonds in the fund's benchmark portfolio have an investment grade rating. There is no requirement for a credit rating from the rating agencies for the fund's portfolio of fixed income instruments.

Credit risk based on credit ratings 2007

	Market value (in millions of NOK)								
Credit risk based on ratings from Moody´s	**Aaa**	**Aa**	**A**	**Baa**	**Ba**	**Lower**	**P-1**	**None**	**TOTAL**
Inflation-linked bonds	40 369	8 210	30 791					18 928	98 298
Securitised debt	382 811	13 810	2 558	1 268	389	839		43 033	444 708
Corporate bonds	21 058	87 150	89 743	70 435	5 306	2 023		15 342	291 057
Short-term certificates							4 198	165	4 363
Government and government-related bonds	114 568	98 381	32 126	8 039	1 272	752		26 976	282 114
Total bonds and other fixed income instruments	**558 806**	**207 551**	**155 218**	**79 742**	**6 967**	**3 614**	**4 198**	**104 444**	**1 120 540**

	Market value (in millions of NOK)								
Credit risk based on ratings from Standard & Poor´s	**AAA**	**AA**	**A**	**BBB**	**BB**	**Lower**	**A-1**	**None**	**TOTAL**
Inflation-linked bonds	39 606	23 317	9 751					25 624	98 298
Securitised debt	330 893	4 981	2 841	1 694	464	1 019		102 816	444 708
Corporate bonds	19 631	56 654	109 043	80 745	5 493	2 232		17 259	291 057
Short-term certificates							4 198	165	4 363
Government and government-related bonds	95 528	80 249	64 091	10 224	2 000	37		29 985	282 114
Total bonds and other fixed income instruments	**485 658**	**165 201**	**185 726**	**92 663**	**7 957**	**3 288**	**4 198**	**175 849**	**1 120 540**

	Market value (in millions of NOK)								
Credit risk based on ratings from Fitch	**AAA**	**AA**	**A**	**BBB**	**BB**	**Lower**	**F-1**	**None**	**TOTAL**
Inflation-linked bonds	32 685	20 611	1 541					43 461	98 298
Securitised debt	293 175	5 351	2 575	1 110	190	945		141 362	444 708
Corporate bonds	4 675	74 762	95 436	55 724	2 907	582		56 971	291 057
Short-term certificates							2 246	2 117	4 363
Government and government-related bonds	108 304	75 021	27 433	9 017	1 889			60 450	282 114
Total bonds and other fixed income instruments	**438 839**	**175 745**	**126 985**	**65 851**	**4 986**	**1 527**	**2 246**	**304 361**	**1 120 540**

The equity and fixed income portfolios also include investments in unsecured bank deposits and unlisted derivatives. The Ministry of Finance has decided that no counterparties involved in such transactions may have a credit rating lower than A-, A3 or A- from Fitch, Moody's or S&P respectively. Credit risk limits are determined by the credit rating of the counterparty, where a higher rating results in a higher limit.

Uncertainty in the valuation of securities

For all securities priced on the basis of sources other than observable market prices, there is some uncertainty as to whether the price used reflects a best estimate of fair value. This uncertainty is normally very limited for the bulk of the securities in which the fund invests.

In the third and fourth quarters of 2007, valuation was particularly demanding and uncertain in the sector for securitised debt, in particular investments in structured products consisting of asset-backed securities, including mortgage-backed securities and structured investment vehicles. What began as concern about sub-prime mortgages in the US developed during the year into a more general and deeper credit and liquidity crisis. At the end of the fourth quarter of 2007, the market for some structured credit instruments therefore featured very limited liquidity and corresponding uncertainty about the valuation of these instruments. Following a number of analyses and discussions with various players in the market (price providers, brokers and external managers), valuation methods have therefore been developed to take account of this uncertainty. These methods mean that the value of some types of instrument has been revised downwards by means of a liquidity deduction from the value reported from the ordinary price sources. The size of this liquidity deduction depends on the estimated uncertainty about the price from the price source.

The following presents the estimation of market value for asset-backed securities and structured investment vehicles.

Asset-backed securities (ABS)

At the end of the fourth quarter, the fund had exposure to various types of ABS both as part of its ongoing management of the portfolio and as part of the re-investment of cash collateral in its securities lending programmes. To be included in the re-investment programme for securities lending, such investments must have the highest possible credit rating (AAA/Aaa), but there is no requirement for a credit rating from the credit rating agencies for the fund's investment portfolio. Total exposure to ABS (including MBS) considered to have limited liquidity amounted to NOK 92.5 billion. Given the limited liquidity and corresponding price uncertainty for ABS Norges Bank has established a method for taking account of this price uncertainty. A liquidity deduction has been made only for ABS other than those issued by the US Federal agencies, such as Fannie Mae, Freddy Mac and Ginnie Mae. The credit ratings from Moody's, S&P and Fitch are the key factor for the size of the deduction. A total unrealised loss on ABS of NOK 2 463 million has been recorded in the profit and loss account under "Net income/expenses and gains/losses from bonds and other fixed income instruments." Of this, NOK 1 359 million is related to the method described in this section, while NOK 1 104 million is based on ordinary price sources. Of the total unrealised loss of NOK 2 463 million, a total of NOK 1 214 million relates to unrealised losses on re-invested cash collateral.

Structured investment vehicles (SIV)

SIVs are a type of ABS which suffered particularly from a shortage of liquidity at the end of the fourth quarter. Through its securities lending programmes, including the re-investment of cash collateral (see Note 2), the fund was exposed to the senior securities of 13 different SIVs with a combined value of NOK 10.8 billion. In order to be included in the re-investment programme, such investments must have the highest possible credit rating (AAA/Aaa). The average maturity for these SIVs was September 2008, with most of the securities maturing during the course of 2008, while the security with the longest maturity matures in November 2009. At the end of 2007, one of the SIVs to which the fund was exposed was being wound down (in enforcement mode).

Given very low liquidity and correspondingly high price uncertainty, Norges Bank has developed a method for classifying SIVs according to risk. In this context, importance is attached to gearing, liquidity gap, asset mix, and the degree to which the SIV is subject to restructuring initiatives. Following this risk classification, a total unrealised loss on SIVs of NOK 1 874 million has been recorded in the profit and loss account under "Net income/expenses and gains/losses from bonds and other fixed income instruments." Of this, NOK 775 million is related to the risk classification method, while NOK 1 099 million is based on ordinary price sources.

Central Bank Audit and Deloitte AS have submitted the following joint audit report to the Supervisory Council on the financial reporting of the Government Pension Fund – Global as presented in the notes to Norges Bank's annual financial statements for 2007.

Translation from the original Norwegian version.

Auditor's report to the Supervisory Council of Norges Bank

AUDITOR'S REPORT ON THE FINANCIAL REPORTING OF THE GOVERNMENT PENSION FUND – GLOBAL FOR 2007

We have audited the financial reporting of the Government Pension Fund – Global for 2007 included in Norges Bank's annual financial statements for 2007. The financial reporting, showing a net loss for the year of NOK 80 364 million, comprises a profit and loss account, a balance sheet and notes. The financial reporting of the Government Pension Fund – Global has been prepared in accordance with the provisions of the Norwegian Accounting Act and generally accepted accounting practices in Norway with the departures set out in the accounting policies in the notes to the financial statements. The financial reporting is the responsibility of the Executive Board of Norges Bank. Our responsibility is to form an opinion on the financial reporting.

We have conducted our audit in accordance with the Norwegian Accounting Act on Auditing and Auditors and generally accepted auditing practices in Norway, including auditing standards adopted by Den norske revisorforening, and issue our auditor's report in accordance with International Standard on Auditing 800 "The auditor's report on special-purpose audit engagements". These auditing standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial reporting is free of material misstatement. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial reporting. An audit also includes assessing the accounting principles and significant accounting estimates applied, as well as evaluating the overall financial reporting. To the extent required by generally accepted auditing practice, our audit also comprises a review of Norges Bank's financial affairs and its accounting and internal control systems that are relevant to the Government Pension Fund – Global. We believe that our audit provides a reasonable basis for our opinion.

In our opinion

- the financial reporting gives a true and fair view of the Government Pension Fund – Global's financial position as at 31 December 2007 and the return for the financial year in accordance with the Accounting Act and generally accepted accounting principles in Norway with the departures set out in the accounting policies in the notes to the financial statements
- the management has fulfilled its duty to ensure proper and well arranged recording and documentation of accounting information.

Oslo, 20 February 2008

Central Bank Audit	**Deloitte AS**
Svenn Erik Forsstrøm (signed)	Aase Aa. Lundgaard (signed)
State Authorised Public Accountant	State Authorised Public Accountant

6.2 Investment portfolio

For a presentation of the accounting policies applied, see Section 6.1. Otherwise, reference is made to the more detailed information in Norges Bank's annual financial statements.

Profit and loss on the investment portfolio

Figures in millions of NOK	31.12.06	31.03.07	30.06.07	30.09.07	31.12.07
Interest income	6 695	1 479	3 448	5 365	7 238
Dividends	2 017	491	1 749	2 247	2 621
Exchange rate adjustments	-4 298	-3 159	-8 220	-19 270	-16 678
Unrealised gains/losses on securities	1 265	-2 249	-3 215	-6 177	-10 116
Realised gains/losses on securities	4 626	2 671	4 253	5 973	6 570
Brokers´ commissions	-5	-1	-3	-32	-36
Gains/losses on derivatives	718	520	1 474	482	-109
Other operating expenses	-64	-18	-36	-58	-81
Profit and loss	**10 954**	**-266**	**-550**	**-11 470**	**-10 591**

Investment portfolio by instrument

Figures in millions of NOK	31.12.06	31.03.07	30.06.07	30.09.07	31.12.07
Short-term assets/debt incl. deposits in foreign banks	-9 593	-11 559	-28 141	-11 837	-8 737
Money market investments in foreign financial institutions against collateral in the form of securities	77 501	86 658	106 137	75 203	61 849
Borrowing from foreign financial institutions against collateral in the form of securities	-99 350	-104 123	-94 048	-94 112	-85 202
Foreign fixed income securities	163 757	162 660	140 659	152 903	158 030
Foreign equities	92 300	90 068	97 993	90 627	88 498
Adjustment of derivates *Note 1*	-100	561	1 401	320	-436
Total portfolio	**224 515**	**224 265**	**224 001**	**213 104**	**214 002**

Note 1

Derivatives exposure	31.12.07
Derivatives sold	160 306
Derivatives purchased	162 363

6.3 Buffer portfolio

Profit and loss on the buffer portfolio

Figures in millions of NOK	31.12.06	31.03.07	30.06.07	30.09.07	31.12.07
Interest income	580	266	407	530	632
Exchange rate adjustments	-1 414	-544	-1 058	-1 468	-1 119
Other operating expenses	-1	-1	-1	-1	-1
Net return	**-835**	**-279**	**-652**	**-939**	**-488**

Buffer portfolio by instrument					
Figures in millions of NOK	**31.12.06**	**31.03.07**	**30.06.07**	**30.09.07**	**31.12.07**
Short-term assets/debt incl. deposits in foreign banks	12 447	1 858	18 361	1 085	2 280
Money market investments in foreign financial institutions against collateral in the form of securities	8 510	23 394	3 051	15 856	10 121
Adjustment of derivatives	0	9	-21	-21	0
Amounts payable to Government Pension Fund – Global, transfers awaiting settlement	0	-24 985	-20 276	-17 458	0
Total portfolio as per financial statements	**20 957**	**276**	**1 115**	**-538**	**12 401**
Unsettled cash transfers	2 731	2 929	2 386	3 395	1 651
Total portfolio	**23 688**	**3 205**	**3 501**	**2 857**	**14 052**

6.4 Government Petroleum Insurance Fund

Profit and loss on the Government Petroleum Insurance Fund					
Figures in thousands of NOK	**31.12.06**	**31.03.07**	**30.06.07**	**30.09.07**	**31.12.07**
Interest income	663 863	176 266	353 967	539 932	726 441
Exchange rate adjustments	-96 302	-221 108	-548 697	-1 391 488	-1 221 042
Unrealised gains/losses on securities	-277 159	-8 373	-240 937	-24 511	108 950
Realised gains/losses on securities	-37 234	-45 526	-67 493	-75 489	-73 716
Gains/losses on derivatives	-2 399	-1 971	-6 354	-2 170	-2 598
Other operating expenses	5	0	0	0	0
Book return on investments	**250 775**	**-100 711**	**-509 514**	**-953 725**	**-461 965**
Accrued management remuneration	-8 741	-2 273	-4 514	-6 841	-9 192
Profit and loss	**242 034**	**-102 985**	**-514 028**	**-960 566**	**-471 157**

Government Petroleum Insurance Fund by instrument					
Figures in thousands of NOK	**31.12.06**	**31.03.07**	**30.06.07**	**30.09.07**	**31.12.07**
Short-term assets/debt and deposits in foreign banks	-61 495	-210 567	-601 952	-151 480	-37 346
Money market investments in foreign financial institutions against collateral in the form of securities	2 768 751	3 230 844	3 025 780	3 083 649	3 122 679
Borrowing from foreign financial institutions against collateral in the form of securities	0	0	0	0	-88 270
Foreign fixed income securities	12 611 428	12 070 404	12 165 403	11 511 764	11 828 173
Adjustment of forward contracts and derivatives *Note 1*	-3 381	-5 352	-9 736	-5 552	-5 979
Total portfolio before management remuneration	**15 315 302**	**15 085 328**	**14 579 495**	**14 438 381**	**14 819 257**
Management remuneration due	-8 741	-2 273	-4 514	-6 841	-9 192
Total portfolio	**15 306 561**	**15 083 055**	**14 574 981**	**14 431 541**	**14 810 066**

Note 1

Derivatives exposure	**31.12.07**
Derivatives sold	983 628
Derivatives purchased	983 628

Norges Bank Investment Management's Annual Report for 2007 was approved by Norges Bank's Executive Board on 20 February 2008.


AI

Ten years of NBIM

It is ten years since Norges Bank set up NBIM to manage the Norwegian government's financial wealth abroad. An international investment management organisation working on commercial lines has been built up within the central bank. 178 employees from almost 20 countries operate from offices in Oslo, New York, London and Shanghai. The first equity trades were made on 20 January 1998, and NBIM has since invested new capital from the government of NOK 1 756 billion in global capital markets. Assets under management have grown from NOK 113 billion in January 1998 to NOK 2 261 billion at the end of 2007. This article outlines the most important experience and results from NBIM's first decade.

In the spring of 1997, the Ministry of Finance decided that the Government Pension Fund – Global (then the Government Petroleum Fund) should be managed by Norges Bank. At the same time, the Ministry submitted a proposal to the Storting (Norwegian parliament) that parts of the portfolio be invested in equities. Just six months later, Norges Bank was ready to embark on one of the largest injections of capital into global equity markets of its time. During the course of a few hectic months in the first half of 1998, the Bank converted around 40 per cent of the bond portfolio into equities, a total of NOK 44 billion.

The mandate to manage the Government Pension Fund – Global was a vote of confidence in Norges Bank. But the mandate also presented considerable challenges. An internal working party at the Bank advised the Governor not to accept the mandate. The reasons for this were fear of a loss of reputation in the event of poor results, and the fact that this kind of activity fell outside the traditional role of the central bank.

Norges Bank's management decided to establish a new investment management organisation, which was able to build its operations on existing expertise and systems at the Bank, in particular the Market Operations Department. The new investment management organisation was also given resources and opportunities to recruit from the Norwegian and global employment markets. A dedicated project was launched on 7 May 1997 to prepare for the first equity investments and serve as a forerunner for the new investment organisation. On 1 January 1998, NBIM was established as an operational investment manager.

This article takes a brief look at key milestones in the first ten years of NBIM. There is also a review of the results achieved for NBIM's five core products: phasing in new capital, implementing the strategy set by the Ministry of Finance, creating value through active management, exercising ownership rights, and advising the Ministry of Finance on overall strategy. The article then presents some of the key choices made along the way which have led to the distinctive structure and culture which characterise NBIM as it is today.

One aspect of NBIM is perhaps more striking than any other. It is a publicly owned organisation within a central bank, but is, in every respect, run on commercial lines like a private-sector operator – indeed, perhaps even more closely guided by bottom-line performance than many private-sector operators. It is not often that this kind of culture is encountered in the public sector. So how did this come about?

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The first ten years

Chart 1 shows movements in the number of employees and assets under management since 1998. At the end of the first year, NBIM had 41 employees managing a total of NOK 279 billion in three portfolios: the Government Pension Fund – Global, the investment portfolio in Norges Bank's foreign exchange reserves, and the Government Petroleum Insurance Fund. Employee numbers grew sharply in 1999 when NBIM took over functions previously part of the Market Operations Department: securities settlement, IT and measurement of return.

Chart 2 shows the fund's assets down between the four main types of management: external and internal, equities and fixed income. In the first year, external managers accounted for all equity management, and everything was invested in index strategies. Only in the latter part of 1998 were external mandates for active equity management awarded. In the summer of 1999, NBIM started up an internal equity management operation. At first, active management was given priority internally. Starting in 2000, however, index management was transferred from external to internal management. Since 2001, more than half of the capital in the portfolio has been managed internally. However, external managers have accounted for more than half of the risk taken in active management.

When it comes to bonds, Norges Bank itself handled all management itself to begin with. During the first few months, this was done by the Market Operations Department so that NBIM could concentrate on building up its equity management operation. From 2000, external managers were used to a certain extent. At first, this was solely for active management, but external index management was subsequently also included. This concerned the management of US mortgage-backed bonds, which were included in the management strategy with effect from 2002. In 2007, NBIM built up its own expertise in this field. External fixed income managers have invested around 10 per cent of the capital in the bond portfolio and have accounted for around 20 per cent of active fixed income management.

The current strategy plan for NBIM, approved by the Executive Board in January 2007, divides NBIM's operations into five core products and sets specific targets for each of these. When looking back at the results achieved by NBIM during its first decade, it is natural to use this same subdivision into five core products:

- phasing new capital into the markets (transition)
- implementing the strategy adopted by the owners (beta management)
- excess return through active management (alpha management)
- exercise of ownership rights to safeguard the portfolios' long-term financial interests
- advising the owners on investment management strategy

Back in 1997 Norges Bank was considered as one of several potential operational managers for the Government Pension Fund – Global. However, the Government Petroleum Fund Act of 1990 stated that the fund's capital was to be invested in the same way as the government's other assets, which pointed towards Norges Bank, it being the government's bank.

At this time, the future size of the fund was uncertain. This, in itself, spoke against building up a separate institution. Norges Bank already had an expert environment for the management of its foreign exchange reserves in global bond markets and well-functioning systems for supporting and monitoring these investments. The Executive Board's special professional responsibilities and independence are laid down in law and reinforced through practice. At the same time, investment management could prove a demanding role which could also affect the Bank's reputation positively or negatively depending on how it was played. This role demanded the development of a clear commercial culture within an institution which is also to perform the traditional functions of a central bank.

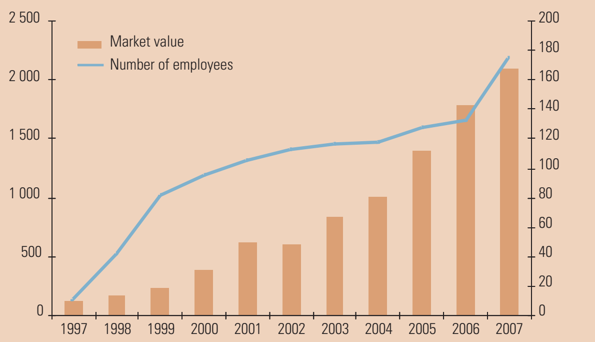


Chart 1:
Developments in the number of employees (right-hand scale) and assets under management (left-hand scale, in billions of NOK)

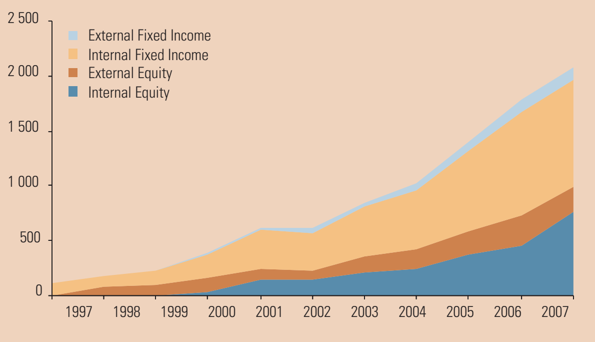


Chart 2:
Government Pension Fund – Global broken down by asset class and between external and internal management. In billions of NOK

FEATURE ARTICLE 1

7 May 1997	Investment Management Project launched at Norges Bank under the leadership of Knut N. Kjær.
May-December 1997	Prospective suppliers evaluated, contracts entered into with global custodian and index managers for equities, systems established for risk measurement etc, recruitment and planning for future organisation.
1 January 1998	Norges Bank Investment Management started up as a separate division of Norges Bank.
20 January 1998	First equities purchased, the equity portfolio then gradually being built up to 40 per cent by selling parts of the bond portfolio.
June 1998	Transition from bonds to equities completed.
8 June 1998	Press conference and presentation of first Quarterly Report.
Second half of 1998	Tenders invited for external active equity management, and first managers selected.
First half of 1999	Internal active equity management introduced, and tenders invited for active fixed income management and tactical asset allocation.
15 March 1999	First Annual Report (for 1998) published.
September 1999	First contract entered into on outsourcing settlement services for equity management.
23 November 1999	Executive Board approves first strategy plan for NBIM.
August 2000	NBIM opens office in London.
2002 and 2003	Bond portfolio extended to include non-government bonds as well as government bonds.
28 March 2003	NBIM votes at a company's general meeting for the first time.
December 2004	Executive Board adopts Principles for Corporate Governance and the Protection of Financial Assets.
Autumn 2005	Contract entered into on outsourcing settlement services for fixed income management.
2007	IT infrastructure services and operation/development of applications outsourced.
2007	Increase in Government Pension Fund – Global's equity allocation to 60 per cent and inclusion of small-cap sector in benchmark portfolio approved by Storting.
November 2007	NBIM opens office in Shanghai.
1 January 2008	Yngve Slyngstad succeeds Knut N. Kjær as Executive Director of NBIM.

Phasing in new capital (transition)

Through the Government Pension Fund – Global, the government transfers its petroleum wealth into portfolios of global securities. Transaction costs play a significant role in the long-term net real return on the fund. From the outset, NBIM gave priority to developing its own expertise and systems to make trading in securities as efficient as possible. This section focuses on equity trading, which is generally far more expensive than trading in liquid bond markets.

In principle, trading is the final step in the investment process. Trading costs consist of commission, taxes, charges, market impact (bid-ask spread, price movements due to trading) and opportunity costs. Together, these costs can eat significantly into management results and make investment decisions potentially unprofitable.

There are four main types of equity trading at NBIM:

- Inflows of new capital. In 2007, these inflows averaged more than USD 300 million per trading day. The benchmark portfolio against which NBIM is measured has no trading costs.
- Maintaining the market portfolio (see following section on beta management). Once cash has been converted into equities, the portfolio needs to be maintained to reflect the return on the benchmark portfolio. Equities move in and out of the benchmark index for many reasons, and dividends need to be reinvested in equities. As with trading related to inflows of new capital, the cost of maintaining the market portfolio is not included in the benchmark for NBIM.
- Active internal management. As mentioned above, trading is normally the final step in the investment process. Investment ideas and decisions need to be executed in the market, and this is done by trading. NBIM's equity team manages a substantial proportion of its assets internally, and this demands a fairly large number of transactions every year. In 2007, for example, internal trading for active strategies accounted for more than 60 per cent of total internal trading, or USD 250 billion.
- Active external management. Around 25 per cent of the equity portfolio is managed by external active managers. NBIM handles purchases of equities when establishing portfolios for external managers and when mandates are wound up (funding and defunding). Otherwise, the managers trade themselves. As with internal active management, the cost of trading in and out of the externally managed portfolios is potentially quite high.

Chart 3 shows developments in quarterly equity trading volumes broken down into the main types of trade.

Even if NBIM confined itself to index management, the trading costs associated with cash flows and indexing would be considerable. These costs are difficult to gauge, but we believe 25 basis points to be a fair estimate.

Since 1998, the equity team has consisted of two groups: one specialising in transition trading (cash flows and external manager funding and defunding), the other specialising in trading for internal index and active strategies (known as the single-stock group). Each group trades in all types of instrument (equities, futures, currency derivatives), and the two work together closely to build up systems and procedures to reduce total trading

FEATURE ARTICLE 1

costs. Besides traders, the equity team has specialised operations groups whose role is to develop and maintain the necessary trading systems. NBIM's equity department has systems, development, settlement and data groups which ensure the provision of systems which can support trading from start (initiation of a trade by a portfolio manager) to finish (settlement and safekeeping by the global custodian). An advanced trading infrastructure has been developed in order to interact with the marketplace (both trading and settlement).

Recent years have seen extensive changes in the structure for global equity trading. Two major changes which have impacted on the way in which NBIM organises equity trading are the growth in electronic trading and the availability of data.

Direct electronic trading on stock exchanges has exploded in the last five years – to the point where it is beginning to account for a substantial proportion of total trading for most trading operations on the buy side. Electronic trading has many potential benefits, such as speed, lower trading costs and anonymity. However, to be able to trade electronically efficiently and reap all these rewards, there is a need for traders with specialist expertise and for specialised and advanced systems. NBIM's equity team began to look at electronic trading around the turn of the millennium and began building up systems early in 2003. Since then, electronic trading has come to account for a significant share of our trading and has contributed directly to reducing trading costs.

Chart 4 shows development in NBIM's use of electronic trading for single stocks. Between 60 and 70 per cent are now traded directly on the stock exchanges.

The proliferation and availability of trading data due to advances in systems and architecture have given the equity team access to information and data which are critical to an understanding of the trading process and allow a reduction in total trading costs. What was difficult to calculate and analyse a decade ago is now available thanks to today's systems. The large quantities of information and data available, on top of the number and size of trading transactions, provide constant opportunities to further develop trading systems and methods which can bring down total trading costs.

In the early years, NBIM's equity trading was based in Oslo. NBIM has also had traders at its office in New York for the last four years, and in Shanghai since autumn 2007.

Chart 5 shows development in average equity trading costs at NBIM from 2003 to 2007. There is a clear downward trend, which can be put down to both electronic trading and other changes in NBIM's ways of executing trades. Falling volatility in the markets is another important factor.

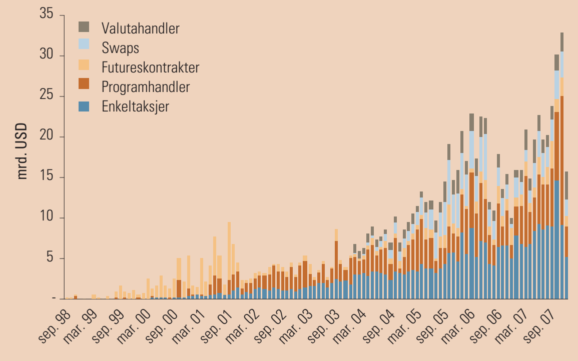


Chart 3:
Development in quarterly equity trading volumes by main types of trade

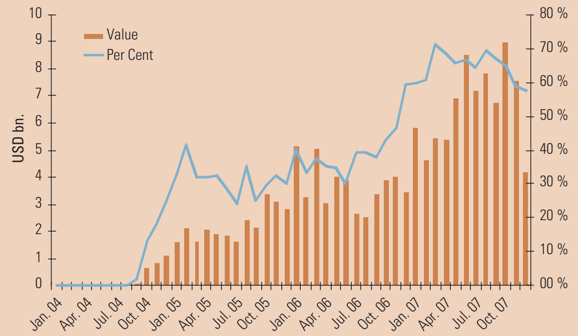


Chart 4:
Development in NBIM's use of electronic trading for single stocks

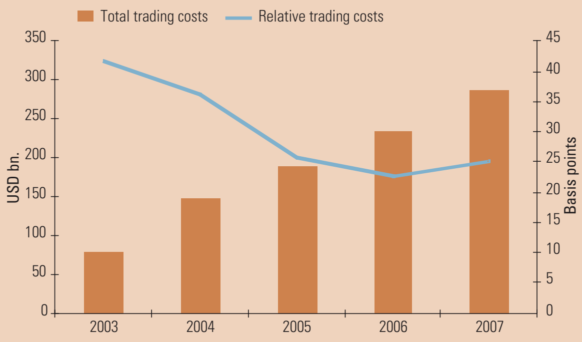
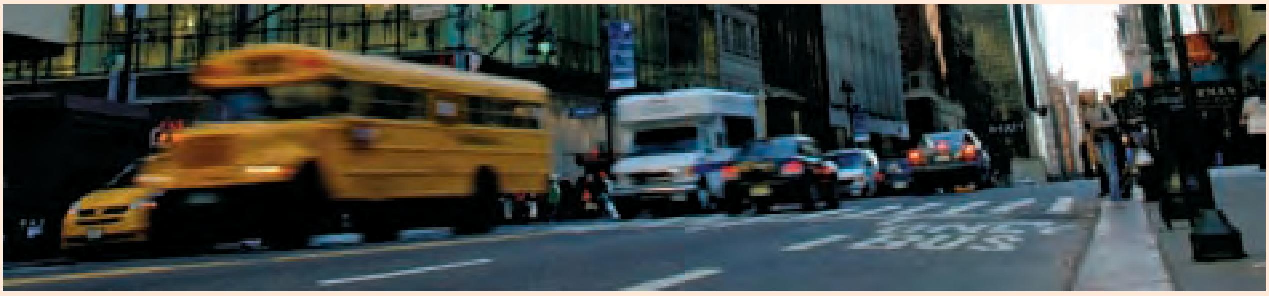


Chart 5:
Development in NBIM's equity trading costs



FEATURE ARTICLE 1

Market exposure (beta)

For large funds, expected risks and returns are determined largely by the overall choice of investment management strategy. Particularly important is the allocation between equities and bonds. In the case of the Government Pension Fund – Global, these choices are made by the Ministry of Finance after seeking the advice of Norges Bank and gaining approval from the Storting. The strategy is crystallised into a benchmark portfolio of equities and bonds.

One point of departure for NBIM's investment management is investing all new capital in line with the benchmark portfolio. This kind of investment management is often known as index management. Another name is beta management. This name reflects how the aim of management is to achieve the exposure to systematic market risk determined by the client as its long-term strategy. The market risk priced in the capital market is often known in financial theory as beta. Excess returns beyond those resulting from diversified exposure to the market are known as alpha.

At NBIM, beta and alpha management are kept separate. There are several reasons for this. They are two entirely different types of management with different requirements in terms of expertise and systems. In both equity and fixed income management, separate groups have been built up specialising in beta management. This provides scope to realise economies of scale and focus on portfolio management and special techniques for identifying opportunities to generate slightly higher returns. Financial theory also provides grounds to separate beta and alpha in the operational implementation of investment management.

Beta management can be performed at very low cost. As demonstrated in a feature article published in 2002 pure index management of the Government Pension Fund – Global would not generate as high a return as the benchmark portfolio due to various types of transaction and management costs.

Beta management at NBIM has undergone major changes since 1998. This is due partly to the substantial growth in the size of the portfolios, and partly to changes in the strategies issued by the Ministry of Finance (and, in the case of the foreign exchange reserves, the Executive Board of Norges Bank). Chart 6 shows how these strategies have evolved over the last decade. By far the most important changes in the benchmark portfolio have been the inclusion of a 40 per cent allocation to equities in 1998 and the increase in this allocation to 60 per cent from 2007.

Chart 7 presents, as an example, developments in the Government Pension Fund – Global's bond portfolio. It illustrates both the growth in volume and changes in its composition. To begin with, the portfolio was invested exclusively in government bonds. Bonds with credit risk were added from 2002, and it took around 18 months to complete the transition to the new benchmark portfolio. Inflation-linked bonds have also been added, and the allocation to US mortgage-backed bonds was increased from 2007. Until 2007, NBIM outsourced all index management of US mortgage-backed bonds to external managers due to the particular complexity associated with the option elements. As larger volumes increased, NBIM deemed it appropriate to build up its own expertise in index-managing these bonds.

New countries have been included in the equity portfolio, regional weightings have been adjusted, and, in the last year, small- and mid-cap companies have been explicitly included in the benchmark portfolio.

Index management is often referred to as passive management. However, there are constant changes to which the portfolio managers must adjust over and above the aforementioned changes in management strategy. New equities or bonds join the indices, while others leave. There are also events associated with individual stocks, such as the payment of dividends and the issue of their reinvestment, and changes in the weights of countries and regions (rebalancing). In NBIM's index management, these changes and other openings are used in active strategies to try to achieve a slightly higher return than would result from pure index management. One important condition for this activity is very high-quality and up-to-date data, good IT systems, and portfolio managers capable of focusing on the detail.

In the early years, NBIM did not have sufficient equity management expertise in-house and so purchased index management services from external managers with specialist expertise. From 2000-2001, NBIM took over all such management. One reason for this was that NBIM wanted to use the index portfolio more actively in managing and implementing alpha management. In our equity management, much of the active management in the different subportfolios is broken down by sector and country or region. By keeping beta management in-house, it became possible to fine-tune the allocation of external and internal portfolios. For example, we could then choose to index-manage in specific sectors where we did not see the same potential for active management as in other sectors.

In recent years, internal active equity man-

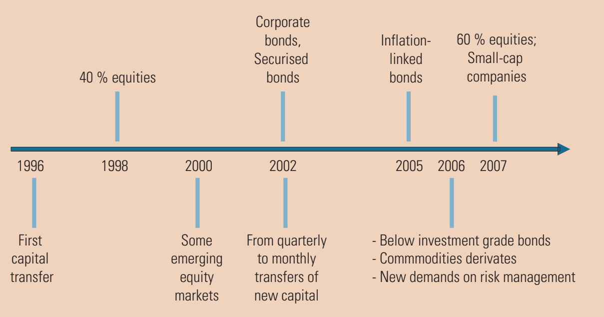


Chart 6:
Most important changes in the benchmark portfolio and investment universe

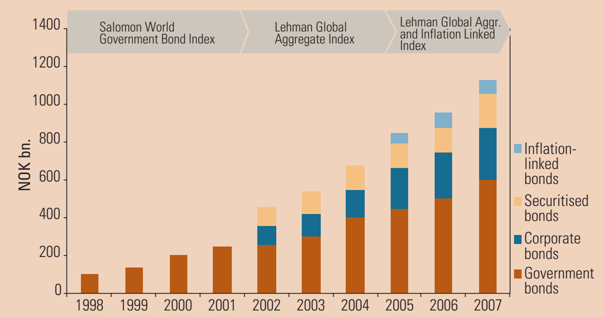
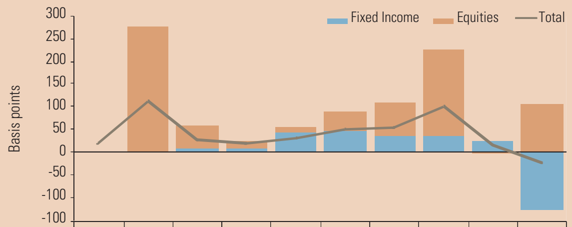


Chart 7:
Developments in fixed income management

FEATURE ARTICLE 1



	Average 1998	Average 1999	Average 2000	Average 2001	Average 2002	Average 2003	Average 2004	Average 2005	Average 2006	Average 2007
Equities		274.27	51.68	14.94	8.87	41.96	74.49	189.34	-2.36	105.81
Fixed Income		1.68	6.70	14.94	44.41	46.69	34.81	34.92	23.75	-127.10
Total	17.33	112.44	25.52	16.95	30.12	50.20	51.17	99.29	14.23	-24.87

Chart 8:
Accumulated annual excess return 1998-2007

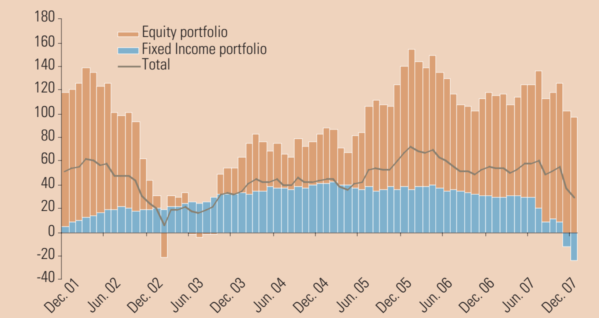


Chart 9:
Three-year rolling excess return. Basis points

agement has been converted to a "long-short" system. Equities are borrowed from the beta portfolio, resulting in lower funding costs than from borrowing in the market. Internal beta management has become an important factor in being able to perform internal active management in the most efficient way possible.

The benchmark portfolio for bonds contains 9 750 securities. It would not be appropriate or cost-effective to buy all of these securities. NBIM's beta portfolio contains around 4 000 securities. When picking securities, we attempt to reproduce the risk characteristics of the benchmark portfolio as efficiently as possible and to choose an overweight of bonds which can generate a slightly higher return. The risk limit for this type of active selection is far lower than for NBIM's active management.

Table 1:
Excess return and statistical properties[1]

Statistics (1998-2007)	Total	Fixed income	Equities
Mean	39.24	9.35	74.16
Standard deviation	42.05	34.47	88.81
t-value	2.69	0.78	2.43
Information ratio	0.93	0.27	0.83
Max monthly	42.92	36.30	102.56
Min monthly	-41.34	-57.01	-58.66
Skewness	-0.30	-2.54	0.53
t-value (s)	-1.35	-11.34	2.36
Excess kurtosis	3.39	14.10	2.29
t-value (k)	7.58	31.52	5.10
Jarque-Bera test	53.05	1032.15	28.26
Critical value, Jarque-Bera	7.98	7.98	7.98
Lilliefors test	0.11	0.21	0.08
Critical value, Lilliefors	0.09	0.09	0.09
Ljung-Box test	22.52	11.89	25.28
Critical value, Ljung-Box	39.36	39.36	39.36

Meravkastning (alpha)

The return on the Government Pension Fund – Global is measured against the return on a benchmark portfolio and is calculated as the difference between the return on the fund and the return on the benchmark portfolio, and is a measure of how well the manager has executed the management mandate. This section looks at the results for the ten years from 1998 to 2007.[1]

Chart 8 and 9 shows the excess return on the fund. The chart shows the annual and three-year rolling excess return[2] on the fund as a whole and on the fixed income and equity portfolios separately.

During NBIM's first decade, the average annual excess return on the Government Pension Fund – Global was 0.39 percentage points (39.2 basis points). The target in the strategy plans for NBIM has been an average annual excess return of more than 25 basis points over rolling three-year periods[3]. Chart 9 shows that the results have exceeded this by a good margin other than during a few months in late 2002 and early 2003. At the end of 2007, the average for the last three-year period was 29.6 basis points. During the last couple of months of this period, equity management accounted for the whole of the excess return generated, while fixed income management produced a negative average excess return for the first time.

1) The data and methodology upon which this article is based, are the same as those presented in the feature article published in 2006 where eight years of data were reviewed. The performance data are the same as those published in the annual report, but due to different calculation methodology there are some minor differences on an annualised basis.

2) Based on the monthly arithmetical average.

3) As discussed in Section 3.1.2 of the Annual Report, the target is more accurately for net value-added from active management. The chart shows only the gross excess return.

Statistical analysis of returns

This section considers whether it is likely that the Government Pension Fund – Global's excess return during the first ten years was due to chance or can more reasonably be attributed to management skill. Key properties of the excess return are analysed, such as the risk associated with active management, whether extremely high or extremely low excess returns have been more common, whether excess returns have had fatter tails than the normal distribution, and whether there has been any relationship between excess returns from one month to the next. The analysis links largely to Table 1, which presents the statistical properties of the excess return on the fund as a whole and the two asset classes: fixed income and equities.

The monthly excess returns on which the analysis is based are shown in Chart 10.

One of the limits set for the management of the fund is a ceiling of 1.5 per cent (150 basis points) for tracking error (relative risk, cf. Section 3.1.7 of the Annual Report), defined as the annualised standard deviation of the difference between the returns on the actual portfolio and the benchmark portfolio. This is a measure of the variation in the fund's excess return. As can be seen from Table 1, the average standard deviation of the excess return (or tracking error) in the period 1998-2007 is estimated at 42 basis points.

The purpose of taking greater risks is to obtain higher expected returns. The information ratio (IR) is defined as the relationship between excess return and tracking error. The IR before costs for the period 1998-2007 is estimated at around 0.93. This is a relatively high IR, which

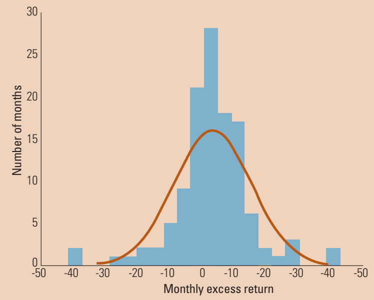


Chart 10:
Histogram of monthly excess returns on the Government Pension Fund – Global 1998-2007

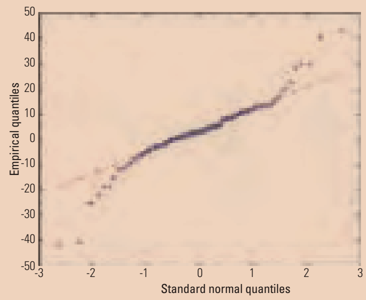


Chart 11:
Normal distribution plot of the Fund's excess return (QQ plot) 1998-2007

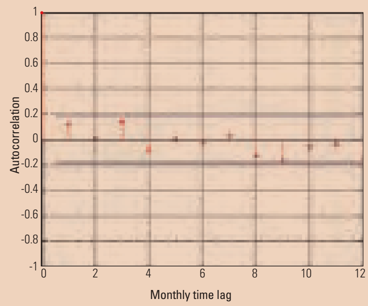


Chart 12:
Autocorrelation coefficients with a time lag of 1-12 months

indicates that NBIM has contributed high levels of value-added per unit of active risk[4]. Statistical analysis makes it possible to assess whether this is due to management skill or chance. There are a total of 120 monthly observations, which provides a basis for calculating a test statistic (t-value) which, with given assumptions, follows a particular probability distribution. In this case, the t-value is an estimated 2.7. The probability of observing a t-value this high purely by chance is virtually zero, and we can therefore reject the hypothesis of the good results being down to chance.

Skewness

The empirical distribution of historical excess returns on the Government Pension Fund – Global does not show any significant skewness (see Table 1). However, closer analysis of equity and fixed income management individually reveals that the latter is significantly skewed to the left. This means that there are more low than high excess returns.

Fat tails

As illustrated in Chart 10, there are indications of fat tails in the empirical distribution. Fat tails mean that the probability of observing either high or low returns is greater than might be expected given normally distributed returns. This applies both to the fund as a whole and to equity and fixed income management individually (see Table 1). Whether excess returns are normally distributed or not can also be illustrated in a normal distribution plot (QQ plot). Chart 11 shows that there are more extremely high and extremely low excess returns than would be expected for normally distributed returns. This means that, when considering the fund's relative risk, we must be careful about basing probability assessments on the normal distribution. It may be the case that the probability of observing both high and low excess returns is greater than the normal distribution would suggest.

Autocorrelation

It is an express aim of NBIM's investment strategy to take a large number of investment decisions which are independent of one another both at a given point in time and over time. This investment philosophy has been presented in feature articles published in connection with previous Annual Reports. The philosophy is based on the Fundamental Law of Active Management (FLAM). When we analyse the fund's return, it is therefore important to consider whether the return in one month is (linearly) independent of the return in the preceding month. The analyses show that it is not the case that an above-average excess return in one month is followed by an above-average return in the following months. Nor has any negative correlation between excess returns over time been identified. This independence over time in excess returns is consistent with NBIM's investment philosophy.

The autocorrelation coefficients are shown in Chart 12. This correlation, which has been calculated for a time lag of 1-12 months, shows the relationship between the return in a given month and the return 1-12 months earlier. The solid blue lines on the chart indicate the 95 per cent confidence interval for the coefficients. None of the correlations fall outside this interval and are therefore significantly different from zero. The hypothesis of autocorrelation is also rejected by other tests (see Table 1).

Active management and the fund's total risk

This section considers whether active management has impacted on the fund's total risk, whether the fund's excess return has been inde-

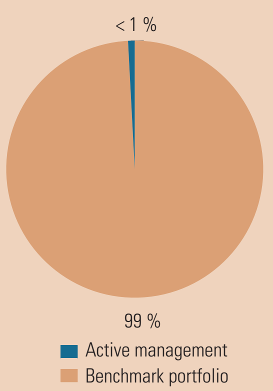


Chart 13:
The fund's absolute risk and the contribution from active management

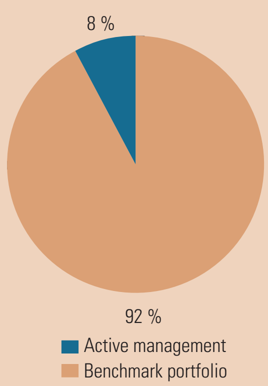


Chart 14:
The fund's total return and the contribution from active management

4) The information ratio provides an indication of the quality of active management has produced, adjusted for the risk taken. However, one must be careful to use the ratio only as a guide to active management performance. There is no official standard in the financial sector for what constitutes a good/high information ratio. Nevertheless, information ratios above 0.5 are often referred to as very good.

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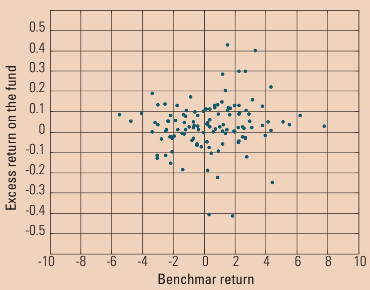

Chart 15: Monthly excess returns and returns on the benchmark portfolio

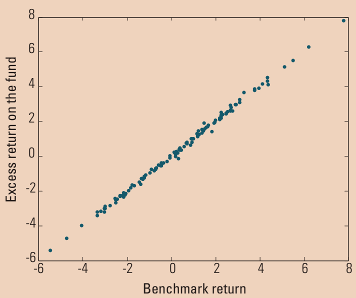

Chart 16:
Monthly returns on the actual and benchmark portfolios

Regression model

The aim of the regression is to estimate a (linear) relationship between the return on the fund and the return on the benchmark portfolio. This is achieved by calculating the slope and intersection with the Y-axis for a straight line which minimises the vertical distance between the points in Chart 16 and the line.

$$R_{pf,t} = \alpha + \beta R_{BM,t} + \varepsilon_t$$

$R_{pf,1}$ the return on the fund in month *t*
$R_{BM,t}$ the return on the benchmark in month *t*
ε_t non-systematic variation in the return on the fund
β the fund´s systematic risk relative to the benchmark
α the risk-adusted excess return on the fund

Alpha (α, the intersection with the Y-axis) is a measure of the return adjusted for the portfolio's market exposure (beta). If alpha is greater than zero, this means that the excess return adjusted for the portfolio's market exposure is positive. This in turn means that the manager has added value beyond that which can be achieved by adjusting the portfolio's market risk relative to the benchmark portfolio's market risk. When alpha is less than zero, the "risk-adjusted" excess return is negative.

Beta (β, the slope of the straight line) is a measure of whether the return on the actual portfolio is more or less sensitive than the return on the benchmark portfolio. If beta is greater than zero, this means that a return on the benchmark portfolio of, for example, 10 per cent will, on average, be accompanied by a return on the actual portfolio which is greater than 10 per cent. If beta is less than 1, the return on the actual portfolio will, on average, be less than 10 per cent.

R-squared explains how much of the variation in the return on the actual portfolio can be explained by the variation in the return on the benchmark portfolio. The higher the R-squared, the better the actual portfolio tracks the benchmark portfolio. One could say that the actual portfolio is a good "hedge" for the benchmark portfolio. The latter also assumes a beta of approximately 1 for the actual portfolio relative to the benchmark portfolio.

pendent of the return on the benchmark portfolio, and whether parts of this excess return can be attributed to the fund having had greater market exposure than the benchmark portfolio.

Chart 13 shows that active management had a limited impact on the fund's absolute risk in the period 1998-2007. The contribution to risk from active management is less than 1 per cent of the fund's total risk.

Chart 14 shows that active management increased the fund's return considerably more than its risk. The excess return associated with active management is around 8 per cent of the fund's total return.

Chart 15 shows that there has been no significant relationship between excess return and the return on the benchmark portfolio. Therefore, the fund's total volatility has not been affected particularly by active management. For all practical purposes, there is no difference between the standard deviations for the return on the fund and the return on the benchmark portfolio.

Both the fund's low relative risk and the fact that the fund's total risk has not been affected to any great extent by active management are a result of the management style. There is little relationship between excess returns on the equity and fixed income portfolios, and there is also little relationship between the excess returns on the individual mandates within the equity and fixed income portfolios.

Portfolio return, market return and excess return

It would appear from Chart 16 that the points plot along a straight line with a slope of 1. The relationship between the return on the benchmark portfolio and the return on the actual portfolio can be analysed using a regression model (see box).

The results of the regressions are summarised in Table 2. The fund's beta relative to the benchmark portfolio is an estimated 1.0059. This is not significantly different from 1.00, which means that the fund has had approximately the same market exposure as the benchmark portfolio. In other words, NBIM has not chosen to operate with a level of systematic risk which departs notably from that of the benchmark portfolio. Table 2 shows an R-squared of 0.9975, which means, for all practical purposes, that all of the variation in the return on the actual portfolio can be explained by variations in the benchmark portfolio.

The return on the benchmark portfolio explains "all" of the return on the actual portfolio. The same applies to risk. As can be seen from Table 3, more than 99% of the total risk is associated with the benchmark portfolio. The reason why security-specific risk is slightly lower than the contribution to risk from active management in Chart 13 is that beta has, in practice, deviated from 1 (slightly higher).

Management skill can be assessed by calculating how large the return on the portfolio should have been given the level of market exposure accepted, and then calculating the difference between the actual return and this "risk-adjusted" return. There are different approaches to what can be considered a relevant risk to adjust for when calculating risk-adjusted returns. One is to start from the classical capital asset pricing model (CAPM). The use of the CAPM requires extensive use of assumptions and does not give an entirely accurate picture.

There are other models (such as multifactor models) which capture more of the real risk factors in a portfolio than the CAPM. However, the CAPM is often preferred due to its simplicity. Note that the term "risk-adjusted" is used in this section for a single-factor model in line with the classical CAPM. The risk adjusted return in this context implies to calculate how large the return on the portfolio should have been given the market exposure accepted. We use the same regression analysis as presented in Table 2 to analyse these relationships. If the return on the portfolio is greater than the "risk-adjusted" return, the manager has generated a "risk-adjusted" excess return and so "outperformed the market". The opposite is the case if the "risk-adjusted" excess return is negative.

As can be seen from Table 2, the average annual excess return on the fund is an estimated 39.2 basis points. The "risk-adjusted" excess return (alpha) is an estimated 36.4 basis points, which is 2.8 basis points lower than the unadjusted excess return and significantly greater than zero (t-value of 2.7).

The fund's alpha is 2.8 basis points lower than the average excess return. This can be attributed to the combination of a beta in excess of 1.00 and a positive average return on the benchmark portfolio during the period. The actual portfolio has featured marginally higher systematic risk than the benchmark portfolio, which is allowed for in the calculation of the fund's alpha. These results are consistent with the conclusions drawn in the feature articles published in 2004 ("Results of six years of active management") and in 2006. ("Analysis of Norges Bank's results").

As shown earlier, the beta deviations have had little impact on the excess return on the portfolios. Table 4 shows that these deviations have not affected the portfolios' relative risk to any great extent either. For the fund as a whole, the risk associated with beta deviation is less than 1 per cent of the total relative risk. This corresponds to around 0.2 basis point, while the security-specific risk is estimated at 41.8 basis points. The fund's total relative risk is therefore 42 basis points. For the fixed income portfolio, beta deviation accounts for around 0.4 per cent of the total relative risk, corresponding to 0.1 basis point out of a total of 34.5 basis points. In the equity portfolio, beta deviation accounts for 2.3 per cent of the total relative risk, corresponding to 2.0 basis points out of a total of 88.8 basis points.

Table 2:
Regression analysis 1998 - 2007

Regression	Fund	Fixed income	Equities
Estimated alpha	36.44	11.58	67.43
t-value for alpha	2.71	1.05	2.41
Estimated beta	1.0059	0.9946	1.0113
t-value for beta	1.27	-1.23	2.17
R-squared	0.9975	0.9977	0.9969
Standard deviation of residuals	41.94	34.40	87.45
Distribution of excess return	**Fund**	**Fixed income**	**Equities**
Average excess return (bp)	39.24	9.35	74.16
Average alpha (bp)	36.44	11.58	67.43
Average beta (bp)	2.80	-2.22	6.72

Table 3:
Distribution of absolute risk 1998 - 2007

	Fund	Fixed income	Equities
Total risk (bp)	42.0	34.5	88.8
Beta risk (bp)	0.2	0.1	2.0
Security-specific risk (bp)	41.8	34.3	86.8
Total risk (%)	100.0	100.0	100.0
Beta risk (%)	0.5	0.4	2.3
Security-specific risk (%)	99.5	99.6	97.7

Table 4:
Distribution of systematic and non-systematic risk – excess return 1998 - 2007

	Fund	Fixed income	Equities
Total risk (bp)	834.9	712.0	1570.1
Beta risk (bp)	832.8	710.3	1565.2
Security-specific risk (bp)	2.1	1.7	4.9
Total risk (%)	100.0	100.0	100.0
Beta risk (%)	99.7	99.8	99.7
Security-specific risk (%)	0.3	0.2	0.3

Defined using a simplified model universe, more specifically the capital asset pricing model (CAPM), the regression analysis performed indicates that active management has resulted in a significant risk-adjusted excess return during the period. However, it is important to note that this single-factor model (CAPM) does not capture all relevant risk factors, and that it is very difficult to calculate in practice how much of the contribution from active management can be attributed to management skill, and how much to individual exposure to priced risk.

Summary

The analysis presented above indicates that NBIM's active management of the Government Pension Fund – Global has made a statistically significant positive contribution to returns. A significant excess return has been generated in both equity and fixed income management. This excess return has been achieved despite limited risk exposure in active management. A positive excess return has been produced in both bull and bear markets, and can be put down to a large number of individual positions.

The Ethical Guidelines issued by the Ministry of Finance in November 2004 made the exercise

FEATURE ARTICLE 1

Exercise of ownership rights

of ownership rights one of NBIM's most important tasks. As an active owner with holdings in more than 7 000 companies, NBIM is to safeguard and build financial assets for future generations by promoting good corporate governance and high ethical, social and environmental standards at companies.

The Norwegian debate about ethical guidelines started up in spring 1997. When the Storting first discussed the proposals from Norges Bank and the Ministry of Finance for the inclusion of equities, ethical criteria were among the topics covered. Since then, separate ethical guidelines have been part of the work on the design of investment management. Norges Bank conducted studies of the consequences of various forms of ethical criteria in 1998 and 1999. From 2001 until 2004, NBIM managed a separate sub-portfolio based on defined environmental criteria. The Ministry of Finance gave the Bank a separate benchmark portfolio for this environmental fund.

Norges Bank participated in the committee which performed a detailed review of ethics in investment management in 2002 and 2003, and endorsed the committee's main conclusions. The new Ethical Guidelines in 2004 gave the Bank increased responsibility for the active exercise of ownership rights. This mandate, how NBIM has implemented it to date, and plans for the future are discussed in detail in Section 4.1 of the Annual Report and in the other feature article.

When equity management started up in 1998, NBIM delegated the role of voting on behalf of Norges Bank to external managers. In 2003, NBIM began to vote for shares managed internally. In 2005, it took over all voting for externally managed portfolios as well. However, voting at general meetings is just one of many instruments used by NBIM to achieve its active ownership ambitions. It is increasingly engaging in direct dialogue with companies' boards and management, and teaming up with other investors to increase its influence.

The Ethical Guidelines require Norges Bank's exercise of ownership rights to take account of the extremely long time horizon for the Government Pension Fund – Global's investments and their high degree of diversification. This obligates the Bank to promote the markets' long-term sustainability.

Under the terms of the Management Agreement between the Ministry of

Strategy

Finance and Norges Bank for the Government Pension Fund – Global, the Bank is to advise on the overall future strategy for investment management. The Bank also contributed actively as an adviser in the original establishment of how investment management should be organised. Among the key recommendations was drawing a clear distinction between political responsibility for setting risk appetite and overall strategy on the one hand, and operational management on the other. The first recommendation to invest in global equity markets was issued in April 1997.

Recommendations from Norges Bank are issued in formal letters from the Executive Board, all of which are made public. NBIM has participated actively in work on formulating these recommendations, but until 2007 it was a separate staff function outside NBIM which had the main responsibility for contributing to the formulation of the recommendations. Responsibility for the Bank's recommendations on investment strategy was transferred to NBIM with effect from 1 January 2007.

The Bank's recommendations on investment strategy have covered both the fundamentals, such as the choice of asset classes and their weights, and other areas, such as the exercise of ownership rights and guidelines for ethical investment management, risk limits, choice of benchmark indices, and rebalancing regime. From time to time, the Bank has also issued recommendations of a more technical nature and interpretations of the Ministry's guidelines.
The box below presents some of the recommendations made by Norges Bank to the Ministry of

Finance over the years.

13 March 1996	Norges Bank presents proposals for guidelines for investment management during a start-up phase where it is assumed that the value of the fund could go down as well as up. Norges Bank recommends investing in government securities issued in European currencies.
2 May 1996	Norges Bank presents revised proposals for guidelines which also deal with the question of investing in equities.
10 April 1997	Norges Bank points out that the management of the fund must be based on clear delegation of duties between the client (Ministry of Finance) and operational manager (Norges Bank), and recommends that at least 30 per cent of the fund be invested in equities, that there be a broad spread of investments, and that the Ministry should set a limit for active market risk for the fund's investments.
22 August 1997	Norges Bank presents more detail on the proposals from April 1997, including a ceiling for relative market risk (tracking error of 1.5 per cent).
22 April 1998	Alternative models for introducing ethical guidelines for the fund's management are discussed.
16 March1999	The consequences of introducing environmental guidelines for the fund's investments are discussed.
16 March and 26 August 1999, and 30 August 2000	Norges Bank presents its assessment of the inclusion of emerging market equities in the fund's investment universe, and discusses the criteria which should be met before new countries are included, the limits for these investments, and concrete suggestions for countries to be included in the benchmark portfolio.
29 March 2000	Norges Bank presents proposals for guidelines for an environmental fund which the Ministry of Finance has decided to set up.
25 April 2000	Norges Bank recommends increasing the maximum ownership stake in individual companies from 1 to 3 per cent.
5 September 2000	Norges Bank presents its assessment of the choice between internal and external management.
15 March 2001	Norges Bank proposes extending the benchmark portfolio for fixed income investments to include corporate bonds, securitised debt and other bonds issued by the public sector (local authorities, public corporations, etc.) as well as government bonds.
22 August 2001	Norges Bank proposes a change from quarterly to monthly inflows of new capital.
12 February 2003	Norges Bank reviews the Bank's exercise of ownership rights and recommends more active ownership practices to safeguard the fund's financial interests.
19 December 2003	Norges Bank gives its opinion on the proposals from the Graver Committee for the introduction of ethical guidelines for the management of the fund.
5 February and 26 February 2004	Norges Bank assesses the management of the environmental fund and recommends that it be wound up once the new ethical guidelines are adopted.
11 March 2005	Norges Bank recommends a number of changes in the operational management of the fund, including an increase in the maximum ownership stake from 3 to 10 per cent, allowing the use of commodities contracts, removing the country and currency restrictions from the investment universe, removing the 5 per cent limit for emerging equity markets, and removing its own limits for credit risk in the fixed income portfolio, as well as introducing separate requirements for counterparty risk.
10 February 2006	Norges Bank proposes increasing the allocation to equities from 40 to 50 or 60 per cent.
20 October 2006	Norges Bank recommends allowing investment in real estate and infrastructure (up to 10 per cent of the fund) and private equity (up to 5 per cent) and the inclusion of small-cap companies in the equity benchmark portfolio.

Competence and trust

During its first ten years, NBIM has delivered results right across its five core products. Opinions will differ on how good these results are, and on which are the most important products. One important aspect in this assessment is the degree of confidence in NBIM and its investment management. The first decade has brought many examples of the outside world showing considerable confidence in NBIM's operations. In particular, there is the confidence shown by the political authorities. But there are also signs to suggest that NBIM has been accepted as a manager by the Government Pension Fund – Global's owners, namely the Norwegian public, and that it has won a high degree of recognition in global financial circles.

From the outset, high levels of credibility have been among NBIM's key goals. However, it is difficult to measure this. Nor is it easy to separate credibility as a target from the target of excess returns. The two are related: without good financial results, it will be difficult to build credibility; and even with good financial results, it will be difficult to build credibility if there are shortcomings in controls and integrity.

Another result of NBIM's first decade is the accumulation of extensive specialist expertise in the management of government capital in global financial markets. Through Norges Bank, the government owns an organisation which is capable of managing a revenue stream which currently amounts (in a normal year) to 4 - 6 per cent of Norwegian GDP and has the potential to grow over the next decade to as much as 8 - 10 per cent of GDP – bigger than all other industrial sectors except for petroleum. This organisation has the skills to handle all strategic changes and major inflows of new capital, and has the expertise and culture to ensure that no money is wasted on unnecessary transaction or external management costs.

Investment management expertise and confidence in the way in which the nation's capital is managed are important in ensuring that Norway can meet the far more fundamental challenge of continuing to set aside the lion's share of new petroleum revenues for future generations

FEATURE ARTICLE 1

Key choices that were made

Over the past decade, NBIM has developed some distinct character traits as an investment management organisation. These may possibly explain many of the results achieved and help to shed light on the differences between NBIM and other international funds and fund managers. This section looks in more detail at these traits and at some of the specific choices which have been important in the development of NBIM.

These key choices have included the vision for the organisation, the strategy for its operations, the principles for the management and development of the organisation, and a set of core values.

Vision

In May 1997, the Investment Management Project presented its business plan to the Bank's management. This formulated the following vision for what was to become Norges Bank Investment Management:

> "NBIM is to build up expertise of the highest international standard in the management of investments in global markets and generate an excess return relative to the specified benchmark by making the best possible use of risk limits. Considerable importance is to be attached to risk management, control and reporting. NBIM as a department – and the individual employees at NBIM – are to inspire confidence in the outside world."

This vision stated that NBIM was to meet the highest international standards. The reason for this was straightforward: the Government Petroleum Fund would be one of the world's largest capital bases. The quality of investment management would be of considerable importance to the Norwegian economy over time. The expertise of the manager therefore needed to be right up there with the best internationally.

However, the first sentence of the vision also set out a more concrete ambition for the future organisation: adding value through active management. This by no means went without saying. It would be pointless investing extra resources in trying to "beat" the markets given prevailing financial theory which assumed efficient markets – and which also largely confirmed the likelihood of such efficiency in the most liquid markets. The best approach would be to manage highly diversified market portfolios as cheaply as possible (index management). This was supported by overwhelming empirical research – only a few investment managers have managed to add value consistently over time. The economists at Norges Bank and the Ministry of Finance were well aware of this research.

Nevertheless, the Investment Management Project was explicit about its aspiration to be among the few managers to succeed with active management. Several reasons for this were presented to the Bank's Executive Board and Supervisory Council during the rest of 1997. One was that there was no point having ambitions to achieve the highest international standards without the organisation having a concrete target to work towards. The target of excess returns was very concrete, it was ambitious, and whether or not it was achieved could be seen from measurable results over time.

It was also suggested that successful active management could result in considerable additional returns – in other words, that this was an important end in itself. Another argument was that risk management and control would be better if some active management was allowed than if the goal from the outset was only to replicate the benchmark return. There was an apparent paradox in that slightly more market risk through a risk limit for active management would reduce the overall investment management risk. The explanation was that concrete targets for creating value laid down as expectations for managers, departments and individual employees would result in each and every one of them having to be involved in the quality of the fundamental inputs into investment management: risk measurement, return measurement, efficiency in securities trading, data quality, settlement and so on.

The final part of the first sentence of the vision connected with the strategy for the organisation: excess returns were to be generated by making the best possible use of risk limits. We will return to this below.

The second and third sentences of the vision were also key to an operation charged with managing a nation's financial wealth: high standards of risk management, control, reporting and integrity. In the subsequent operationalisation process where this vision was translated into concrete targets, these requirements became the foundation for NBIM's operations: any excess return is of no value if operations are not founded on good control and management systems and implemented with absolute requirements for integrity for both the organisation as a whole and the individual employee.

The conclusion from the first ten years is that active management at NBIM has proved profitable, and that this ambition was important in building up professionalism and expertise. Maybe the scepticism of economists at Norges Bank and the Ministry of Finance in the early years was just what was needed to spur a structured and judicious investment strategy.

Strategy

The Investment Management Project's business plan set out a strategy for the development of the organisation during its first few years. Since 1999, new strategy plans have been adopted every two years. These have been the Executive Board's most important instrument in the governance of NBIM.

During the early years, the key strategic issues were how to get the best possible results from active management, and what kind of structure for investments would maximise the chances of achieving excess returns consistently over time.

As mentioned above, the focus from the very beginning was on making the best possible use of risk limits. A feature article published in 2000 examined this in more detail and presented the Fundamental Law of Active Management (FLAM).[5] The essence of this theory is that the expected information ratio can be maximised by spreading active management across as many independent positions as possible. Put another way, rather than large top-down positions, there should be many more decisions each accounting for less of the overall risk limit, and investment management should be organised in such a way that these decisions are as independent of one another as possible.

Several factors played a role in the choice of FLAM as the starting point for NBIM's active management. NBIM's core expertise provided a good seedbed for applying financial theory and approaching strategy in a structured, near-scientific manner. This was partially an "inheritance" from the investment management environment at Norges Bank and was cemented through the recruitment of key personnel in the early years. Academic background and skills were given greater priority at NBIM than in many other Norwegian and international investment management environments.

FLAM was also a natural choice given the unique situation faced by NBIM in 1998 with the high degree of scepticism about active management in the world around it. If the first few years produced negative results, this could result in an about-turn not only in the development of the investment management strategy but also in the principles for building and operating the organisation. In FLAM, NBIM found a sound basis for not allowing individual decisions to have a major effect on the overall management outcome.

The choice of FLAM was confirmed in each of the four strategy plans for NBIM approved by the Executive Board between 2000 and 2007. In a feature article published in 2004 the strategy was presented once again. The principles and priorities were the same as in the article from four years earlier referred to above, but updated in the light of a few years of experience.

This strategy has been pursued in both equity and fixed income management. Priority has been given to active management based on fundamental analyses and relative value strategies. This has also been reflected in the choice of external managers. Originally, NBIM had three investment management departments: Equities, Fixed Income and Tactical Asset Allocation. With the last of these, risk exposure was naturally concentrated in a small number of positions. The results were not satisfactory, and the department was closed after three years.

FLAM also provided extremely important guidance on how NBIM should be managed and organised. Investment strategy and organisational principles became two sides of the same coin. To ensure the greatest possible level of independence between active decisions, the following principles were adopted:

- there was to be the greatest possible degree of delegation of investment decisions to groups and individuals
- there was to be no overall investment stance or top-down management of investments
- there were to be no committee decisions
- both external and internal managers were to be used
- when choosing external managers, managers with fundamental strategies were preferred
- in internal management, the individual portfolio manager was to be given the resources and opportunities to build up specialist expertise

Outsourcing is another important strategic choice made by NBIM. From the very first strategy plan approved by the Executive Board, one guiding principle for NBIM has been to outsource as much as possible outside its core business. The reason for this is partly to focus limited management resources on tasks which it would not be possible to outsource, and partly to promote higher quality and more rapid development. The reason is not to cut costs. It was acknowledged from the very outset – and has been confirmed along the way – that outsourcing can result in slightly higher operating costs than in-house production. The profitability of choosing to outsource stems from better quality and better management of the remaining business.

Leadership

Even when it was first established, it was realised that NBIM would face continuous change over many years. Rapid growth in assets under management would also mean growth in the organisation and constant redevelopment of systems and investment management. It was also expected that the Ministry of Finance and the Storting would make changes in the overall investment management strategy.

These unique challenges were naturally associated with requirements for NBIM's leadership to be change-oriented and flexible. No manager could count on retaining his or her position and responsibilities indefinitely: managerial duties were defined as a relay where, sooner or later, it would be time to pass on the batten. Management evaluations were performed and external help brought in to train both the senior management team at NBIM and individual managers.

From the beginning, NBIM was a small organisation with no need for numerous management tiers and with small formal differences between management and other employees. As with modern knowledge companies, management was based more on natural authority than formal authority. Technical expertise was, in practice, put on an equal footing with managerial competence. Together with the constant growth in duties and the associated increase in interesting career opportunities, this has made it easier to alter the management and structure of NBIM than at many other types of organisation.

The informal management style and cautious use of formal authority have persisted even as NBIM has grown in size and complexity. NBIM is not only a knowledge organisation – it is also dependent on recruiting, developing and retaining special talents. Experience from the

5) FLAM was launched a few years earlier by Grinold and Kahn in their book "Active Portfolio Management", Irwin Professional Publishing, 1995.

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first decade – and in the global investment management industry as a whole – is that only organisations with particularly skilled and talented people are able to add value for their clients. This makes unique requirements of management.

Perhaps the most important has been allowing people to do their jobs their own way without unnecessary intervention. Strong individuals need room to manoeuvre. But passive acceptance of this is not enough – employees need to be encouraged to take responsibility and to take control of how they will achieve the targets set. Talented key personnel also ask a lot of their surroundings – they want to have the best possible access to resources and systems, and cannot accept less being asked of others in the organisation than is asked of them themselves.

In a feature article on experience of the use of external equity managers published in 2004 this was summarised as follows: "One lesson that we have learned is that some individuals have a very substantial impact on results. Of course, very few individuals perform well in an organisational vacuum. Organisations perform best when a skilled portfolio manager is faced with a challenging investment environment."

At NBIM, these management principles have coincided with and supported the strategy for investment management. To achieve the greatest possible level of independence for decisions on active investments, these must be delegated to many different groups and individuals. This delegation must be real, without intervention from superiors, provided that the individual employee stays within the agreed structure and risk limits. To ensure the best possible outcome for each individual investment decision, each individual employee must have an opportunity to develop his or her specialist expertise. The sense of ownership which derives from responsibility and an absence of intervention from superiors is an important motivation and driving force for the development of this expertise.

Structure ad systems

From the outset, NBIM has adhered to the principles of line management. For every krone in the portfolios, which are spread across more than 40 000 positions,[6] there is an employee at NBIM who is its "owner". This also applies to portfolios managed by external managers. The individuals at NBIM responsible for choosing external managers are also responsible for the results they achieve. There are no committees along the line between the individual position in the portfolios and the Executive Director of NBIM. There has been a conscious decision to avoid line responsibility in investment decisions being muddied by group or committee decision-making.

The pay system has played an important role in clarifying responsibilities and encouraging employees to focus on the targets which management decides are important. Variable pay based on performance has been an important part of the system and has contributed to NBIM having succeeded to a great extent in retaining its most talented employees. (Section 5 of the Annual Report looks at NBIM's pay system in more detail.)

A simple description of NBIM's structure might be as follows:

- Roles and objectives are defined by the clients.

6) A position is a manager's investment in a security. If, for example, three managers all invest in the same security, this counts as three positions.

- Strategy plans approved by the Executive Board provide further detail and guidance.
- NBIM's senior management expands on this with annual targets and action plans.
- This ends up in targets and plans for each individual employee.
- A wide range of management and control systems serve as resources in work on achieving the targets and contribute to independent control and follow-up.
- For the individual employee, performance relative to these targets has consequences in terms of career opportunities, risk limits and remuneration.

Culture and values

The vision was very ambitious, and NBIM's culture was soon characterised by a businesslike approach and a focus on tangible results. But the environment was also relatively academic and detail-oriented. One illustration of this is how, from the very outset, NBIM performed daily measurements of relative market risk across the portfolio. Resources were channelled into this ahead of the development of investment management, although hindsight has shown that daily measurements at an aggregate level are of rather limited value.

This example also illustrates another of NBIM's character traits: the very great importance attached to management and controls. Activities are not launched until all conceivable checks have been carried out. In this respect, the organisation clearly shows its kinship with the central bank. The same applies to the importance attached to requirements for personal integrity and honesty. But there is less evidence of this kinship in the emphasis on a commercial approach and line management and on personal responsibility for measurable results.

NBIM has extensive contact with private investment managers and other large private and public institutional investors. This contact serves as a source of inspiration for the further development of NBIM's organisation, but also as a good starting point for comparisons. One impression is that NBIM goes further in terms of line management, delegation and prioritising personal responsibility than even many private managers. Perhaps this has to do with our origins in a central bank. It was very clear right from the outset that the central bank and NBIM needed to have very difficult cultures to reflect the differences in their roles.[7]

As NBIM grew, a need gradually also emerged to formulate and follow up a number of core values to support the objectives for its operations and its culture. These were developed in 2004 after an extensive process involving all employees. The four core values – Excellence, Innovation, Integrity and Team Spirit – are discussed in more detail in Section XX of the Annual Report.

At NBIM, there is a clear connection between investment strategy (FLAM), line management with a high degree of delegation, and the emphasis on developing values and culture. Delegation is essential for implementing the investment strategy. But this high level of delegation can be achieved only when we can be sure that employees share our underlying values. NBIM follows up its core values in regular group exercises, in employee appraisals, and in the recruitment of new employees.

7) Here is a stylised example. When it comes to monetary policy, a central bank takes only a few rate-setting decisions each year, which have significant consequences. Each decision must be subjected to extensive quality assurance. In an investment organisation like NBIM, thousands of decisions are taken each year, many of which will necessarily be incorrect. An investor is successful if just over half of his decisions are correct (given symmetry in terms of gains and losses). One of the biggest mistakes that can be made is not to be prepared to take risks when there is actually an opportunity to build an organisation with sufficient expertise.

Continuous changes

The markets in which NBIM operates are constantly evolving. What might have been a good way of managing investments for some years may be unsuitable in subsequent years. The capacity for change is therefore an important success factor.

NBIM's first decade can be seen as a process of continuous change. The growth in assets under management and changes in the owners' investment management strategy have also provided important impulses for change. The structure of the organisation has evolved constantly, with consequences for many managers and other employees. In most cases, these changes have resulted in new career opportunities and been welcomed.

A major test faced by NBIM in the coming decade is maintaining its ability to add value through active management at the same time as assets under management may grow very rapidly. Significantly more assets under management are not a problem per se, provided that they are invested in large and liquid markets. NBIM has the expertise and apparatus to handle further large inflows of new capital and invest them efficiently with broad exposure to the markets.

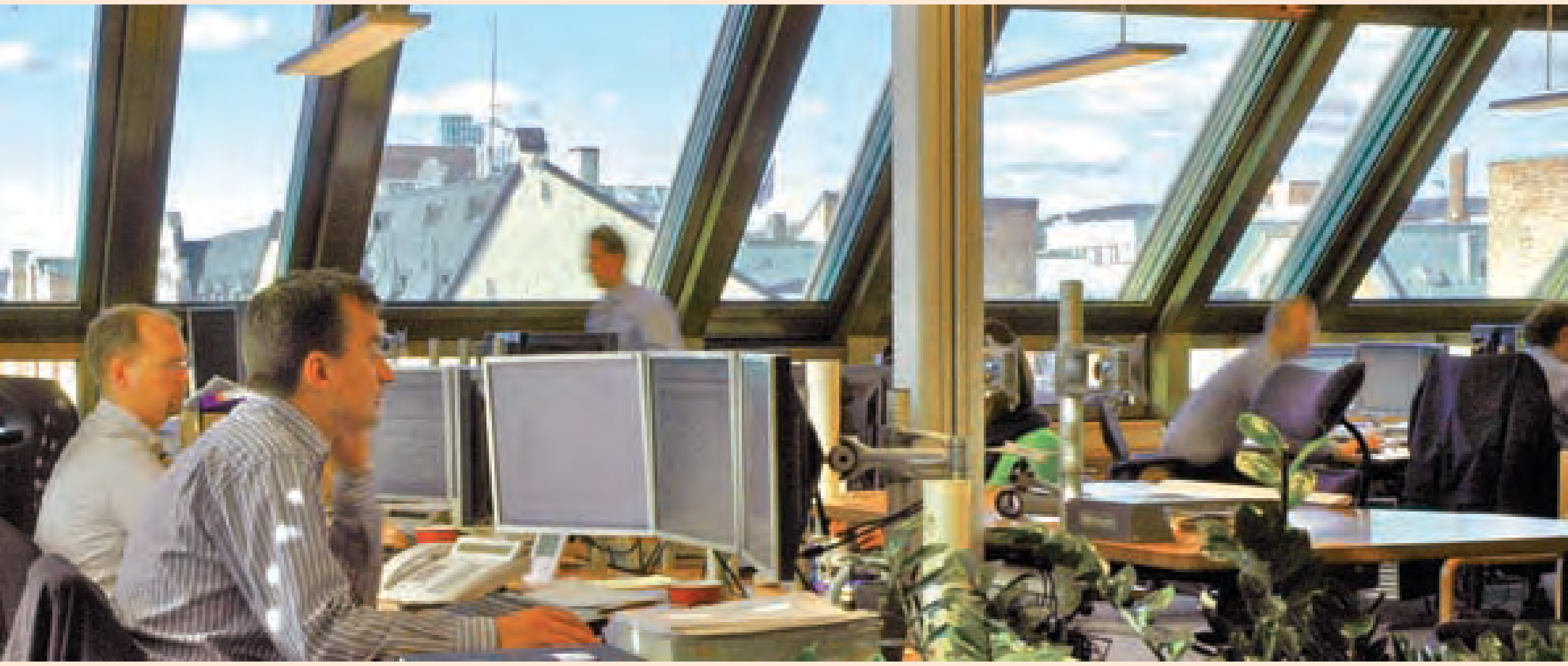
The challenges lie partly in implementing active management and partly in investing substantial sums in less liquid markets. Some parts of active management cannot be scaled up as assets under management grow (see the feature article on investment strategy published in 2004). One approach would be to have larger individual positions, but this could also result in a slightly lower return for the active risk taken.

All comparable large funds are far more diversified across asset classes than the Government Pension Fund – Global. Common to the asset classes in which the fund is not yet invested – such as real estate, infrastructure and private equity – is that they are far less liquid than today's equity and fixed income investments. Investments in these markets will bring new demands for specialist expertise and require extensive resources.

With more assets under management, new types of active investment strategy, and maybe also new asset classes, NBIM faces continuous challenges in recruitment, skills development and leadership. The ability and willingness to handle change will probably be as important in the second decade as in the first. Much of the growth in the organisation will probably need to be outside Norway, and NBIM will increasingly become an international investment management organisation.

More assets under management will give NBIM greater influence as an active owner. In implementing the Ethical Guidelines, it will be a particular challenge to ensure that NBIM remains an investment operation and is not charged with playing a purely political role. Whatever the size of the Government Pension Fund – Global, active ownership will only be effective for as long as companies and other investors view NBIM as a professional investor. At the same time, the fund's long time horizon means that NBIM must engage companies on issues beyond just short-term earnings. Account needs to be taken of the sustainability of marketplaces and of external impacts, including ethical and social considerations. However, the approach to active ownership will be based on the instruments of an investor and not on political means.

FEATURE ARTICLE 2



Social issues, the environment and financial returns

Norges Bank's corporate governance strategy for 2007-2010 specifies six priority areas for the work in this field. Four of these concern fundamental ownership rights, while the other two concern social and environmental sustainability: child labour and children's rights in the value chains of multinational companies, and companies' lobbying of national and supranational authorities on questions related to long-term environmental change. These priority areas and the strategy as a whole were described in a feature article in the 2006 Annual Report. This article looks in greater detail at the ideas behind the work on the two social and environmental priority areas, how we have approached this work, and how we plan to proceed.

The Ministry of Finance's Ethical Guidelines for the Government Pension Fund – Global state that the overriding objective for Norges Bank's exercise of ownership rights is to safeguard the fund's financial interests. The exercise of ownership rights must also reflect the fund's long time horizon and broad diversification, and therefore questions related to corporate finances and social and environmental issues are all to be included in this work.

A proper focus on the first four priority areas in the strategy, which encompass the protection of fundamental ownership rights (specifically, the right to vote, the right to nominate and elect directors, the right to trade shares freely, and the right to transparent information) are key to this work. If the rights we have as shareholders are not sufficient, or if they are not adequately protected, we cannot exercise the influence that an owner must have. This is an important reason why much of NBIM's active ownership work has to do with corporate governance in the conventional sense, namely the systems through which companies are controlled and the associated rules and regulations on the exercise of ownership rights. If our rights as shareholders are not upheld in the areas which Norges Bank has singled out as particularly important, our other active ownership efforts will be of little value.

In its strategy for NBIM's work on corporate governance, the Executive Board of Norges Bank has included work on other factors which may be financially significant in the longer term but cannot be identified in the financial accounts as easily in the short term and are therefore often referred to as "extra-financial". This broad approach is supported by the fund's Ethical Guidelines and is in keeping with a way of exercising ownership rights which is becoming increasingly common among large, diversified investors.

A commonly used collective term in this context is ESG (environmental, social and governance) issues. When Norges Bank addresses these issues, it is not as part of a political agenda or because investment management has been made subject to requirements which contradict or override return targets and risk limits. The reason why addressing ESG issues is increasingly being defined as the investor's role is the relationship that exists between well-regulated and

FEATURE ARTICLE **2**

morally legitimate markets and companies on the one hand, and long-term returns for diversified investors on the other. Many of these issues are ethically important per se, but when an *investor* works on them, this will be first and foremost for financial reasons.

Both of the social and environmental issues singled out by Norges Bank fall well within this way of thinking. A highly diversified portfolio with returns decades into the future as its principal objective is vulnerable to the kind of societal problems of which the exploitation of children and a more general failure to safeguard the rights of future generations are an expression. Clearer demands of companies in the portfolio concerning their treatment of children, both directly and indirectly, are therefore a natural issue for NBIM to address: it is a long-term issue; it is morally important per se; in many countries, domestic legislation and compliance concerning child labour and the protection of children's rights are limited, which makes the actions of companies (and especially multinational companies) particularly important; the issue has been addressed by investors only to a limited extent in the past; and the reputational and financial risk of *not* ensuring better behaviour in this area may be significant.

In keeping with the Ethical Guidelines for the Government Pension Fund – Global, it is also natural to single out environmental sustainability – threatened in our time not least by potentially serious climate change – as important to a long-term global investor. In order to contribute to this process, Norges Bank has chosen, taking the investor's tools and interests as our point of departure, to focus on companies' lobbying of the authorities in relation to long-term environmental change.

The following looks at these two priority areas.

Priority areas for NBIM's corporate governance work

In the corporate governance strategy adopted by the Executive Board in 2006, Norges Bank singled out priority areas covering both ownership rights and social and environmental sustainability. The key criteria for the selection of these priority areas included:

- importance for long-term returns
- the likelihood of an investor like NBIM being able to contribute to real change
- the possibility of identifying relevant companies, sectors and jurisdictions
- the possibility of attracting the support of other investors in order to increase the chances of success.

There are currently six priority areas. These are evaluated continuously, adjustments to the strategy may be considered, and new areas may be added. However, it is important for NBIM to build up active ownership expertise, and its efforts must not be spread so thinly that they become superficial or make it difficult to follow them up with the necessary thoroughness. For this reason, it is important to concentrate on a limited number of areas with which the bank can be engaged for some time.

The first four areas generally concern ownership rights:

- the right to vote
- the right to nominate and elect directors
- the right to trade shares freely
- the right to open and timely information

These rights are necessary if an investor is to wield real influence over a company. They are also essential for the work on social and environmental issues. At the same time, these rights are to some extent hindered or poorly developed in some markets, including otherwise well-developed markets such as Europe and the US. In 2007, NBIM took part in a major research project to map the most important obstacles to shareholders exercising the right to vote – their most clear-cut and obvious right – in companies outside their home country. Continuous improvement in international shareholders' opportunities to exercise their ownership rights in full will remain a priority for NBIM in the future.

The other two priority areas concern social and environmental sustainability:

- children's rights in the value chains of multinational companies, in particular limiting child labour and protecting children's health
- companies' lobbying of national and supranational authorities on questions related to long-term environmental change

These areas have been chosen because they tie in well with NBIM's long-term perspective as an investor. They cover issues which are clearly ethically and socially important per se but are also important for the future functionality, legitimacy and profitability of global markets.

FEATURE ARTICLE 2

Child labour and children's rights

Norges Bank has chosen as a priority area children's rights in portfolio companies' value chains and operations, particularly in terms of the fight against child labour, but also in terms of measures to safeguard children's rights and health in a broader sense. This work is being carried out in line with NBIM's long-term perspective as an investor and the international standards on which its active ownership work is based. NBIM's goal in this work, derived from the overriding objective of safeguarding long-term returns, is to bring about a lasting improvement in the life of affected children. This, in turn, has been translated into targets tailored to each individual company dialogue entered into by NBIM.

It is important to note that, in this context, the term "portfolio company" also includes a company's subsidiaries and supply chain to the extent that these can reasonably be controlled or influenced by the companies in which NBIM is a direct shareholder. Increased transparency and better reporting in line with international standards, with realistic risk analyses and strategies for solving the problems, will normally be an important part of NBIM's demands.

Although child labour globally has been reduced in recent years, there are still, according to ILO's 2006 estimates, 218 million children who can reasonably be considered child labourers by ILO's definition. Of these, 126 million are engaged in hazardous work.

Financial risk

Given NBIM's role as a long-term investor, it is particularly important to consider human rights issues, including children's rights, from a financial risk perspective. Ethically, there can be few issues more important than upholding children's rights, including efforts to promote children's health and combat child labour. However, safeguarding children's rights is also important to an investor financially: poor educational opportunities and health standards make for a weak and unsustainable basis for future production and employment, and this also erodes social stability in the markets concerned. This could have a negative impact on values for an investor at both company and portfolio level. Commercial activities which harm children's rights and health also harm the market system by challenging its legitimacy. How a company's board of directors and management tackle issues relating to child labour and children's rights also provides a good indication of the company's ability to manage risk, its internal procedures and its willingness to shoulder its social responsibilities. It is the clear responsibility of the board of directors to evaluate – and, as needed, report on – the financial effects which social issues, including those to do with children's rights, have on the company's activities and profitability.

Company dialogue

The main means of influencing companies is direct dialogue. By the end of 2007, NBIM had carried on or initiated engagement processes with close to 60 different companies in its portfolio on social issues, with the emphasis on child labour and children's rights. Starting from analyses of high-risk sectors and regions, NBIM has decided to engage with companies in cases where they do not provide relevant and necessary information about how they comply with international conventions on human rights, including child labour, and information on how they manage risks related to social issues. Engagement is also initiated on the basis of specific corporate events. The dialogue takes the form of e-mail or postal correspondence, telephone contact, and face-to-face meetings.

Investors' expectations

Matters relating to child labour and children's rights are difficult for companies to handle because the causal relationships are normally complex and because companies often have little awareness of the ways in which they are infringing on children's rights. It is therefore important for NBIM to formulate clear expectations to which companies can adhere. These expectations have resulted in a separate document which NBIM uses with portfolio companies: *NBIM Investor Expectations on Children's Rights*. This document has been developed in dialogue with specialists in the field from organisations such as UNICEF, Save the Children and the ILO, and the document will be further disseminated through cooperation with UNICEF, the UN Global Compact and the UN Principles for Responsible Investment (UN-PRI) initiative. It has already been used in dealings with around 30 portfolio companies. The document sets out expectations towards companies concerning the most hazardous forms of child labour, compliance with standard requirements for the minimum age of workers, measures to safeguard children's health and development, and the company's management system and its suitability for addressing these issues. These expectations are based on the UN Convention on the Rights of the Child and ILO's conventions on child labour. (The latter are also integrated into the OECD Guidelines for Multinational Enterprises and the UN Global Compact, on which NBIM bases its active ownership work.)

The primary target group for the document is portfolio companies operating in areas and sectors where there is a particular risk of child labour and other infringements of children's rights. Another target group is investors who share NBIM's goal of safeguarding children's rights as part of their ownership work. NBIM hopes, with the help of *NBIM Investor Expectations on Children's Rights*, to move the issue of child labour and children's rights higher up on the international agenda both in industry and among investors.

Critical markets and sectors

It is not possible to analyse continuously all of the 3,500 or so companies which NBIM has had in its equity portfolio to date, and even more difficult now that the number of portfolio companies is greatly increasing. Based on a risk perspective, the most critical markets and sectors are therefore selected for more detailed attention. More than 200 companies active in these markets and sectors have been subjected to analysis, including companies with activities in Asia, Latin America and parts of Africa.

To ensure a consistent and complete approach to these companies, NBIM's corporate governance group has built up systems to provide an overview of analyses of and contact with companies. We gather information and reports on countries, sectors and individual companies from external sources and systematise them for our own use. In addition, we have developed a database containing information on voting and our own analysis of the issues, as well as information on holdings in each individual company, sector classification and so on. Internal tools of this kind are important both for NBIM's reporting and as a basis for analysis of the portfolio and selection of companies for dialogue. They are used in all of the priority areas for corporate governance.

When it comes to engaging with companies, work during the opening phase has con-

centrated on portfolio companies with operations in Asia and Latin America, hereunder companies with operations in India and Brazil. Contact with companies is being stepped up continuously, both in these markets and in the other markets analysed. Company and market analyses are based on local market insight obtained from researchers, charitable and idealistic organisations, and our own investigations.

In India, it is primarily the textile industry and parts of agriculture which have been identified as sectors where child labour is widespread and remains a considerable and potentially growing challenge, despite greater public concern about child labour in India in recent years, and a stated government commitment to reducing child labour. Much of the problem, not least in agriculture, is to be found on small farms and in remote areas, making it difficult to gain a full overview of the situation. Even for a company with real ambitions to help solve this problem, bringing about rapid change is complex. Here, NBIM is demanding more extensive controls, better follow-up measures for children and clearer reporting to the outside world. This work has required both gathering information directly in India and engaging in dialogue with portfolio companies through their head offices. (See also separate box on the agricultural sector.)

Brazil is an example of a country where child labour, as defined in the ILO conventions, is prohibited by federal legislation (the legislation here is more stringent than in India). The authorities in the various states are trying to ensure that the law is not broken. Child labour has been in decline for several years but is still a real problem in some sectors and regions, including the mining industry and the supply chains for the iron and steel industry. NBIM has entered into dialogue with several companies to discuss how the risk of child labour is being managed in their supply chains and production. NBIM has presented its expectations regarding codes of conduct and reporting and has followed these up in dialogue with the companies. In several cases, the companies are showing a willingness to step up their work and contribute better reporting. (See also separate box about the the mining and steel industries.)

To date, this dialogue has yielded results in the form of the boards of directors and management of several of the companies in question committing to better controls and reporting. NBIM plans to monitor these companies' results as reported to us in 2008. Good practices and results will, in turn, be used in dialogue with other companies.

The way ahead

There are two needs which NBIM has so far identified as particularly important when it comes to monitoring child labour and children's rights:

1. collaboration between companies in the same sector and region on codes of conduct, monitoring and auditing
2. assuring the *quality* of external monitoring and auditing

This will require more follow-up from both the individual company and the companies together.

NBIM will use the knowledge it has built up through analysis and dialogue to work for more exchange of experiences between companies. NBIM does this kind of work primarily through dialogue with the companies' boards of directors. It is worth remembering that it is not NBIM's role as an investor to micro-manage each individual company. NBIM's role is to make sure that the long-term investor is heard, and that companies have the necessary strategy and reporting to get the job done.

Other geographical regions also represent challenges. In sub-Saharan Africa, child labour is a growing problem, partly as a result of the AIDS pandemic and the large number of adults of working age who are dying. At the same time, there are several sectors, such as the cocoa industry, which are organised in such a way that multinationals have limited control over the actual cultivation of crops.

Work on children's rights at NBIM is a matter of being "patiently impatient". On the one hand, NBIM demands improvements which are visible in the short term and can be seen in companies' results from year to year. At the same time, NBIM and other players need to be aware that improvements often take time. The infrastructure is complex; in many places, child labour is an integral part of the economy; overly rapid change could actually make things worse for the children; and it can take time for changes to have an effect. It helps here that NBIM has a long-term investment horizon. We signal to companies that we, as shareholders, plan to work on this issue for many years to come, and that we wish to contribute to lasting solutions, not short-term publicity campaigns.

NBIM will also continue to focus on these issues when exercising its voting rights. Even today, companies are being followed up after their general meetings with a view to ensuring that they are listening to shareholders' advice on social issues.

FEATURE ARTICLE 2

Other stakeholders

Many different parties are involved in and affected by companies' activities and impacts on their surroundings.

When it comes to social issues relating to companies' activities, we find natural stakeholders among their employees, those working in their supply chains, investors, the local population where the companies operate, purchasers of the companies' products and services, NGOs, politicians, experts and specialists. These stakeholders can often have different priorities, views and approaches, but often their interests coincide, and sharing knowledge and experience can be useful either way.

NBIM makes active use of the knowledge which other stakeholders can provide in order to strengthen its work to combat child labour in the operations and supply chains of portfolio companies. (The same applies to work on lobbying and climate change.) Exchanging information with others plays an important role when mapping problems in different regions. Global and local NGOs which fight child labour and organisations which inspect the suppliers of multinationals to check on labour conditions are a source of expertise from which NBIM can benefit.

In 2006, NBIM invited a number of Norwegian organisations and individuals with expertise in children's rights and child labour to provide input for NBIM's work in this field. The group included representatives of UNICEF, Save the Children and Childwatch. In 2007, the group gave its reactions to problems and priorities raised by NBIM within this priority area. The participants in the group also commented on the document *NBIM Investor Expectations on Children's Rights*. NBIM also asked international organisations and initiatives, other investors and portfolio companies for comments while drawing up the document.

One of NBIM's goals is for other professional investors to be engaged in issues concerning child labour and children's rights. Among other things, NBIM will therefore be using the platform provided by the UN's Principles for Responsible Investment (PRI) to encourage other investors to use *NBIM Investor Expectations on Children's Rights* in their dialogue with companies. NBIM also cooperates with other investors on engaging with companies in specific cases. In 2007, for example, we were involved in an initiative related to iron and steel production. (See also separate box on the mining and steel industries.)

From time to time, NBIM contacts other investors who are behind shareholder proposals at general meetings. In the US, where shareholder proposals are most widespread, it is often the case that the company and the shareholder in question enter into a dialogue either before the proposal comes to a vote (with the shareholder sometimes withdrawing the proposal) or after the general meeting if the proposal attracts a given level of support. Such shareholders may be an important source for finding out about how the company is handling the matter.

Another side of the work in this priority area is mapping best practice, based on experience from companies and relevant organisations. The accumulation of better and more readily available information on best practice will increasingly be used by NBIM as a tool in its dialogue with companies in connection with their work on developing guidelines, control systems and reporting in relation to child labour and protecting children's rights.

Child labour in the agricultural sector

The agricultural sector accounts for no less than 70 per cent of child labour worldwide. According to the ILO, 130 million children aged 5-14 are employed on farms and plantations, many of them working long hours and exposed to harmful chemicals, rather than going to school.

NBIM has in 2007 initiated company dialogues in Asia related to child labour and children's rights. Within the textile and agricultural sectors several multinational companies in NBIM's portfolio have activities which carry a risk of serious violations of children's rights, with accompanying financial and reputational risk for the companies and sectors.

In 2007, NBIM has, *inter alia,* visited organisations in India working on children's rights and gathered information about the activities of multinational companies in relation to child labour there. This resulted in, among other things, extensive dialogue with a select group of companies which have production in the Indian agricultural sector. Child labour in agriculture is not against the law in India. The production units – farms – supplying the companies are often small and scattered across large parts of rural India.

External reports show that companies which have introduced guidelines and built up control systems to prevent child labour can point to a decrease in the incidence of child labour in their production, even where the control systems are not yet functioning optimally and significant challenges remain. The incidence of child labour in agriculture is lowest where NGOs and multinationals have worked together the longest on raising awareness and introducing controls. According to reports, it is multinational companies, not domestic companies, which have come furthest in combating child labour.

In its dialogue with companies, NBIM has attached importance to urging companies to further improve their guidelines, control systems and public disclosures concerning child labour, both in their production chain in general and in India in particular. Importance has also been attached to the opportunity for multinational companies to influence their national partners and local authorities. This dialogue is being developed and extended.

Laws and standards are essential in the fight against child labour. However, it is difficult for producers to have to comply with different rules depending on who they are supplying. As mentioned earlier, India has no prohibition against child labour as such in the agricultural sector. At present, it is also the case that companies to some extent build up their own control systems independently of one another. In light of this, NBIM wishes to contribute to better coordination, with the aim of more uniform guidelines and, in time, a more coordinated control system. This will strengthen the fight against child labour and increase the likelihood of market practices which also extend to domestic companies in the industry. Most NGOs and researchers are agreed that the multinationals have a real opportunity to influence market practices and, to an even greater extent than is the case today, lead the way in safeguarding social rights.

FEATURE ARTICLE **2**

Hazardous child labour in the mining and steel industries

The number of children employed in mining is estimated at around a million worldwide and is rising in some parts of the world. Due to the health risks associated with this work, it comes under the ILO's definition of the worst forms of child labour.

Against this background, NBIM has focused on selected companies in Latin America. Brazil is one of the countries where child labour is to be found despite it having legislation banning child labour and an increasingly extensive infrastructure to ensure compliance with the law. (Brazil has experienced a significant decline in the total number of child labourers over recent years; ILO's reports indicate that between 1992 and 2004 there was an approximately 35% reduction in the number of children between 10 and 17 engaged in labour.)

It is, *inter alia,* in the mining industry and the steel industry that child labour remains a problem, partly because production takes place in remote areas. In spring 2007, NBIM's corporate governance group therefore conducted an analysis of companies in the portfolio which can be linked to child labour either in their own operations or through suppliers. The principal criterion was whether the company had a policy on child labour at all – in other words, whether the company's board of directors had taken a clear decision to forbid child labour in the company's operations. In such cases, a company will normally refer to its supporting or having signed up to one of the relevant international standards, such as the UN Global Compact or the ILO child labour conventions. Another criterion for the analysis was whether the company had a strategy to ensure that its suppliers complied with its policy on child labour.

After an initial review of the portfolio, the companies which had published neither a policy nor a strategy were contacted by NBIM. Readily available information on a company's policy and strategy is needed by NBIM to assess the risk that it faces as an investor, and is therefore important to ask for. Of the companies contacted, NBIM decided to follow up on five which responded that they did not have a policy or strategy. These companies were contacted at board chairman level with a request for a meeting.

Meetings were held with the five companies in October 2007. In all cases, NBIM was put in touch with the target people at the companies for these specific questions, and in several cases also the CEO or representatives of the board. NBIM presented its requirements and expectations in relation to its financial interest in good risk management and legitimate systems in this area. By the end of the year, one of the five companies had decided to sign up to the UN Global Compact, and another was considering it. All five companies will be followed up in 2008, partly with requirements for reporting and auditing.

It should be added here that NBIM has also taken part in an initiative taken by a British fund manager, through the secretariat of the UN Principles of Responsible Investment (UN-PRI). This so-called Iron and Steel Initiative has consisted in coordinated company contact through which relevant companies have been asked about their knowledge about and measures against slave labour, including possible child labour, within the Latin American coal industry. The coal in question is being used in the production of pig iron, which is subsequently sold to steel producers who, in turn, sell to multinational companies with well-known brands. NBIM signed letters to 15 companies in its portfolio, along with more than 10 other investors. By the end of the year, most of these companies had responded, and some had taken part in direct talks with the investors, in several cases with NBIM among the participants. On the basis of the dialogue established, the initiative will be followed up in 2008 with a view to obtaining clearer responses from the companies where necessary and further assessing the efficacy of the steps being taken by the companies or their supply chains.

FEATURE ARTICLE 2

The environment and lobbying

An investor with a global portfolio will be exposed to factors which affect the market's general functionality and profitability. A factor which NBIM as an investor must assume will have relevance for the portfolio's value is climate change that could lead to major changes in the world's ecosystems, large-scale migration, natural disasters, and the potential for increased social unrest or poor access to resources for large parts of the world's population.

At the same time, the Government Pension Fund – Global is not intended as an instrument of environmental policy. As manager of the fund, NBIM must find ways of raising environmental issues which naturally promote investors' interests and contribute to long-term value creation. It is against this background that Norges Bank has chosen to make companies' lobbying of the authorities on environmental issues a priority area.

Climate change

There has been growing consensus in recent decades that climate change due to concentrations of greenhouse gases such as carbon dioxide (CO_2) in the atmosphere may have significant consequences for society and the environment in large parts of the world. However, there has been disagreement over how high the CO_2 concentrations could actually become, how much of this is man-made, the temperature effects of different CO_2 levels, the workings of the climate system, and how dramatic the consequences might be. As time has passed, this disagreement has abated. The scientific consensus – as expressed, for example, in the reports of the UN-sponsored Intergovernmental Panel on Climate Change (IPCC) – is sufficiently strong, and the potential consequences have been found to be so serious, that there is also growing agreement on the need to act quickly. In practice, this means that concentrations of CO_2 in the atmosphere need to be stabilised, and that emissions of CO_2 and other greenhouse gases need to be reduced. According to the IPCC and others, these reductions need to be substantial and swift.

In its 2006 Annual Report, NBIM noted that an investor's contribution to long-term sustainable financial returns could include a focus on climate change. This is because serious climate change could have a significant negative effect on NBIM's global portfolio. It is natural here to refer to, *inter alia,* the reports of the IPCC and the Stern Review[1], which suggest that proactive implementation of measures to reduce greenhouse gases will result in a substantially lower cost to global society than the likely cost of inaction.

It has been important for NBIM to concentrate its efforts in this area in a way that can produce tangible results. In this light, an investor urging individual companies to make voluntary reductions in emissions is of limited value. It is the overall level of emissions which must come down, and this requires legislation and international agreements. The necessary technological advances will also, in all probability, depend on legislation which helps to make this technology profitable.

It is the political authorities locally and globally which together hold the key to effective regulation regimes with a global impact. The investor does not have environmental policy as such as part of its toolbox and must leave it to the political authorities to set the limits for companies' activities, including their emissions. However, investors can encourage companies to introduce long-term strategies to meet these environmental threats and, at the same time, prepare for future legislation. Perhaps the most important thing companies can do to help prevent dramatic environmental change globally is to contribute to – or, at least, not fight – the necessary political initiatives. We know that large companies play key roles in the design of environmental policy in some countries through their lobbying. In itself, it is both natural and legitimate for companies to seek to influence the authorities on such issues. But an investor can reasonably expect that this influence coincides with the interest of investors in putting into place effective legislation which can reduce the risk of serious negative economic consequences of climate change.

Against this background, NBIM has engaged in dialogue with a selection of its largest portfolio companies in relevant sectors, including some of the world's biggest emitters of greenhouse gases, concerning how they seek to influence future climate legislation through their strategy and lobbying activities. This is an area which is often controlled from the company's central management and board of directors. In most cases, therefore, this dialogue has brought us into direct contact with the most important individuals in the companies in question.

Analysis and dialogue

In 2007, NBIM conducted analyses of the portfolio to identify companies which are particularly active in lobbying the authorities on climate issues. Legislative processes were also analysed. The emphasis has been on the US, because most researchers and observers assume that future legislation in the US will be of particular importance for both overall reductions in emissions and the path that other countries will take. Against this background, NBIM's corporate governance group has been in close contact with researchers and other experts in both climate policy and lobbying.

Based on analyses of more than 100 companies, NBIM has held meetings with around 20 companies in its portfolio during the year. These are companies in the oil, coal, gas, electricity and transport sectors. All are major contributors to greenhouse gas emissions and have been identified as key lobbyists. The dialogue has been mainly with the companies' boards of directors and senior management. In this dialogue, NBIM has attached importance to technological development and alignment with new emission and taxation regimes, as well as companies' position on lobbying. NBIM has stressed its interest as an investor in having effective legislation put into place within a reasonable time span. This dialogue has continued into 2008 with most of the companies.

The signals coming back from these companies show that NBIM's message and position are being taken seriously, and that our emphasis on lobbying is attracting attention. In several cases, the companies themselves have raised difficult issues for further consideration.

The way forward

In 2008, NBIM will continue the dialogue described above. In the US in particular, but also in several other jurisdictions, potentially

1) *The Stern Review* was commissioned by the UK government and published its report in October 2006. The work was led by economist Sir Nicholas Stern. Some calculations and conclusions in the report have met with criticism. However, there seems to be broad agreement with the report's more general conclusion that effective action to combat climate change today will cost less than the future price of more dramatic forms of climate change.

crucial debates on key climate measures are due to take place in 2008 and into 2009. The portfolio companies with which we have engaged in dialogue are – and will remain – among the key players in this work. Our dialogue with these companies is ongoing, the aim being to continue to emphasise the interests of long-term and diversified investors in this issue, and to discuss the technological and strategic alignment of these companies with the demands of tomorrow. NBIM plans to carry out this work both alone and in co-operation with other investors.

It is probably more difficult to measure results in this area than in the other priority areas. Our work is partly about raising awareness and partly about the long-term strategy of individual companies. When the results do begin to show, it will therefore not always be clear what is a direct result of NBIM's input. Nevertheless, work in this priority area has a clear goal: investor-friendly and robust strategies in each individual company and sector to meet the challenges of climate change. This is to be reflected in the way in which companies work with the authorities as the latter attempt to put into place regulation which lead to substantial reductions in emissions of greenhouse gases.

In 2007, a number of companies in NBIM's portfolio altered their public stance on climate issues. Many of them have made changes to the way in which they lobby national authorities, and we are also seeing changes in the way in which they are preparing for new technology. NBIM believes that it has contributed to this process. It will be decicive for future legislation what kind of position companies take on climate proposals coming up for consideration in individual countries, as well as the international processes leading up to, for instance, the international Copenhagen summit in 2009, which will follow up on the 2007 Bali meeting. As a financial investor, NBIM will encourage relevant companies in the portfolio, with an emphasis on the energy and energy-intensive sectors, to introduce strategies which ensure a good return for their investors and also support a sustainable development.

FEATURE ARTICLE **2**

Challenges in NBIM's dialogue with companies

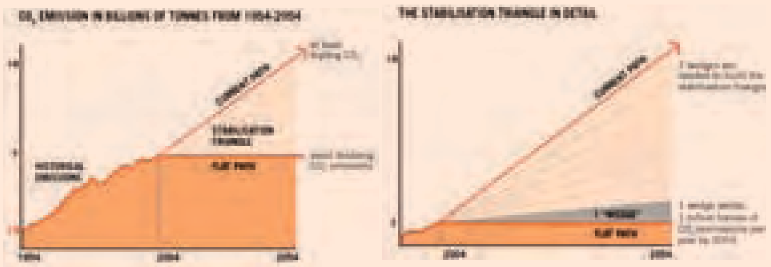
Companies in the energy sector currently find themselves caught in a crossfire: on the one hand, they need to meet the growing need for energy in both the developing world and the industrialised world; and on the other, they need to adjust in a reasonable and pragmatic way to possible climate change and give their contribution to limiting such change and its effects.

This formed the backdrop to many of the meetings which NBIM held with leading energy companies on climate issues and lobbying in 2007. The point of departure for the discussion was management's own view of this crossfire. Where are the opportunities and constraints in terms of technology, new energy sources and different business strategies? What does this mean for the individual company or sector? How can the knowledge we have today be translated into a specific business strategy? And how should companies relate – and contribute – to new legislation?

Among other things, NBIM has engaged in dialogue with a number of companies in the US. The US is the single largest country in NBIM's portfolio, and many of the companies there will be affected by future climate measures. The US also plays an important part in forming the premises for future environmental policy worldwide. There are still several contentious issues when it comes to future climate legislation in the US, and many of the companies in NBIM's portfolio are concerned about these issues, which include: Should there be a price ceiling for emission allowances – so-called "safety valves" – and if so, what kind of ceiling, to avoid individual companies and sectors being hit particularly hard by a quota trading system? Are the reductions in emissions in the most relevant proposals sufficient? Will the administration of possible quota trading schemes be and remain effective? For NBIM, it is important to understand the consequences that any legislation would have for companies in our portfolio, and to understand how these companies relate to this legislation in their lobbying activities. As an investor, NBIM is not a political player with its own view of how domestic legislation in the US or other countries should be formulated. However, NBIM represents a type of investor with a real financial interest in seeing effective climate legislation within a reasonable timeframe. The signals that NBIM sends to relevant companies in its portfolio, and the dialogue that we have concerning future strategies and technology, are therefore important as a contribution to achieving the environmental sustainability on which NBIM's portfolio will depend in the longer term.

The International Energy Agency (IEA), an organisation set up by the OECD in the wake of the oil crisis in 1973, estimates in its *World Energy Outlook 2007* that if global energy consumption continues on its current path, demand for energy will be 50 per cent higher in 2030 than today due to population growth and increased needs. Around 85 per cent of the world's energy supply is fossil-based at present, and the world is set to remain dependent on fossil fuels despite a projected increase in energy production from renewable sources. The increase in the consumption of fossil fuels between now and 2030 could be as high as 55 per cent.

These figures stand in stark contrast to the recommendations in the fourth report of the International Panel on Climate Change (IPCC), also published in 2007, which forecasts a need for significant reductions in emissions compared to "business as usual" if the worst consequences of climate change are to be avoided.



The gap between the current IEA "business as usual" scenario (see, for instance, *World Energy Outlook 2007*) and the necessary decline in CO_2 release recommended by the IPCC is apparent. The two Princeton researchers Stephen Pacala and Robert Socolow have introduced the idea of splitting that gap into several parts. Each part ("wedge") representes a promising, already existing solution, for instance, solar energy or hybrid technology in cars. (See, *inter alia*, Stabilization Wedges: Solving the Climate Problem for the Next 50 Years with Current Technologies, *Science*, August 13, 2004.)

The discussions which NBIM has had against this background with relevant companies in its portfolio have been constructive and had a positive tone. It is important to remember in these discussions that the infrastructure for generating and transporting energy generally represents a very long-term investment. A power station can be in operation for more than 50 years, sometimes as many as 70. The conflict between the long-term satisfaction of demand, new investment and climate factors has become increasingly clear, not least when it comes to coal-based energy. Many planned coal-fired power stations in the US have been put on hold.

In addition, new technologies such as integrated gasification combined cycle (IGCC) power stations, which turn coal into gas, have yet to be tested on a large scale and have proved uncertain due to very high development and testing costs. Nevertheless, many researchers believe that gasification offers a better and more energy-efficient way of capturing CO_2 than traditional methods. Carbon capture and storage (CCS), which involves storing CO_2 underground, presents significant technical challenges, whatever the method, and considerable time and expense will probably be needed before the technology can be used on a large scale.

There are also new opportunities in renewable energy, but these are mainly relatively small projects which can serve only limited areas, at least to begin with. There also remain challenges in the storage of renewable energy, such as the storage of solar and wind energy for when the weather is overcast or still. In 2007, there was also a lively debate about ethanol and other biological fuels, but here too there are as yet no quick and easy energy-efficient solutions capable of meeting real needs.

All of these issues have been part of the discussions which NBIM has had with companies. By stressing the long-term investor's expectations for – and dependence on – robust legislative solutions, combined with in-depth discussion of the technological possibilities, we are trying to make companies more aware, especially when it comes to their lobbying of legislators.

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