Norges Bank Investment Management

Annual Report 2006

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

NBIM
Norges Bank Investment Management

Report

Feature articles

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

Government Pension Fund – Global. Key figures 2006

Market value in NOK at 31.12.2006

Total portfolio	1783.7 billion
Equity portfolio	725.9 billion
Fixed Income portfolio	1057.8 billion

Transfers from the Ministry of Finance in 2006 (in NOK)

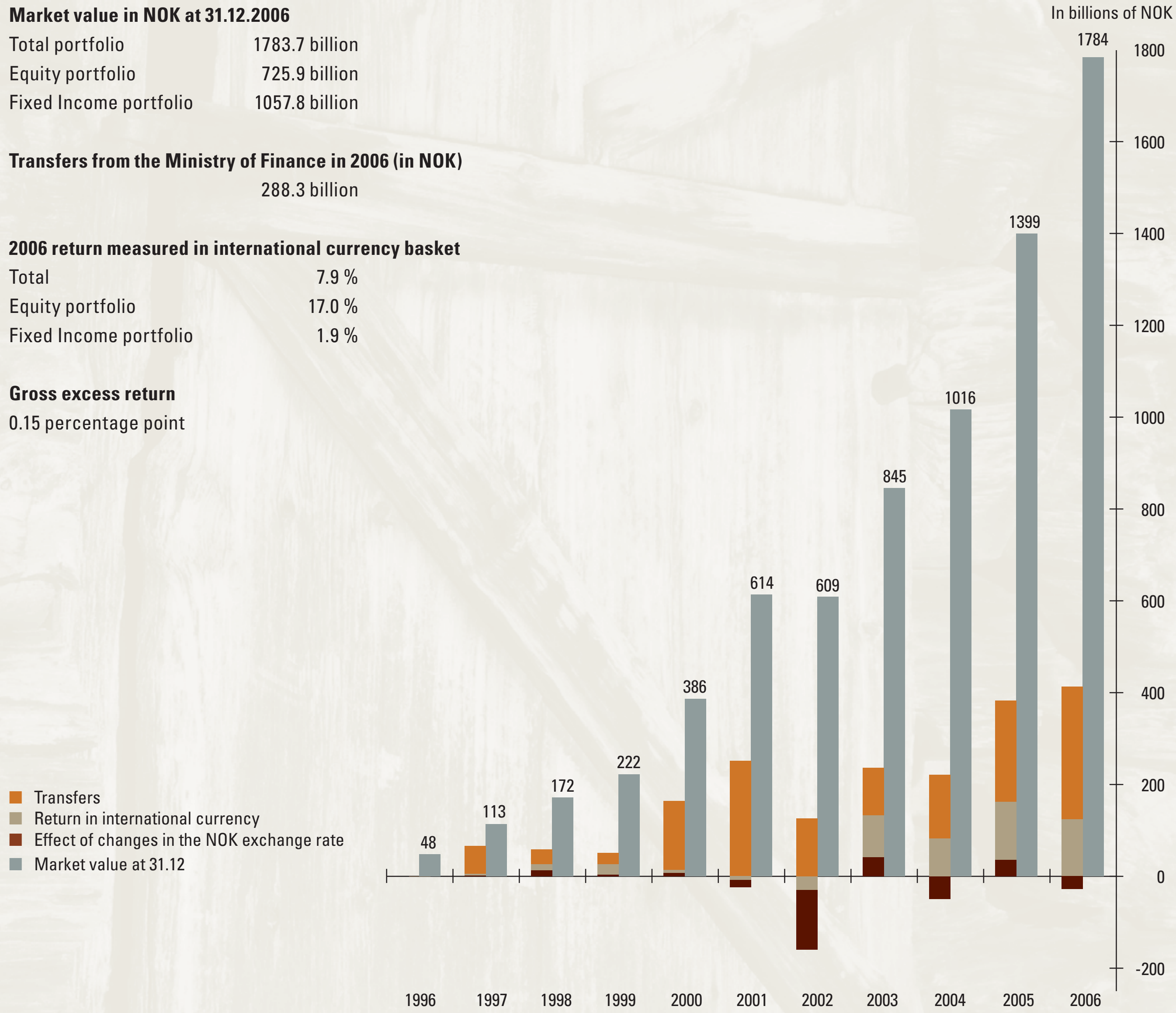
288.3 billion

2006 return measured in international currency basket

Total	7.9 %
Equity portfolio	17.0 %
Fixed Income portfolio	1.9 %

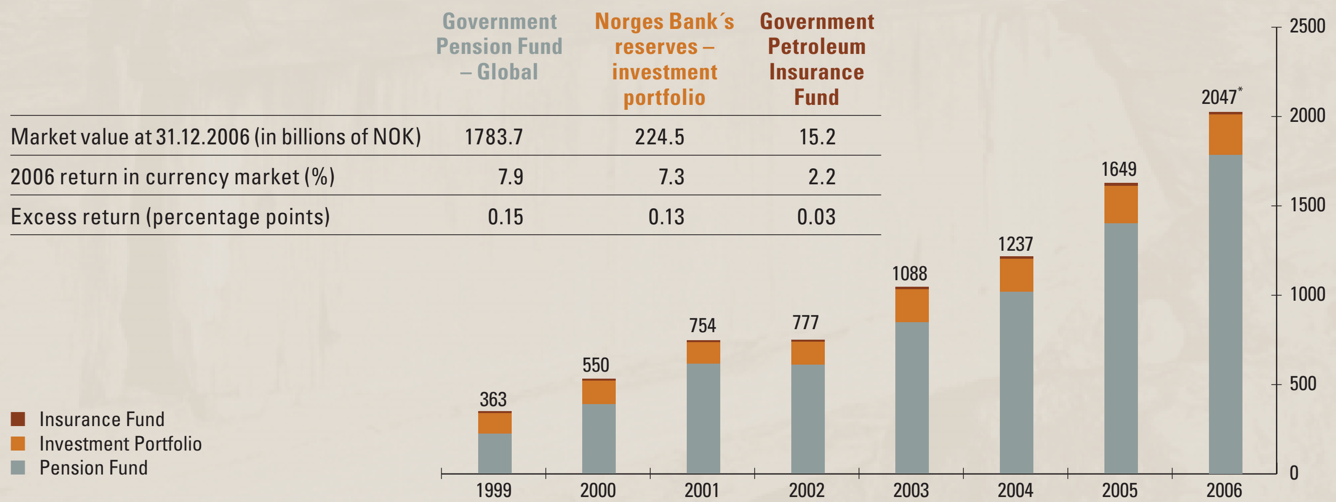
Gross excess return

0.15 percentage point



Total assets under management. Key figures 2006

	Government Pension Fund – Global	Norges Bank´s reserves – investment portfolio	Government Petroleum Insurance Fund
Market value at 31.12.2006 (in billions of NOK)	1783.7	224.5	15.2
2006 return in currency market (%)	7.9	7.3	2.2
Excess return (percentage points)	0.15	0.13	0.03



* Including the foreign exchange reserves buffer portfolio, with a market value of NOK 23,7 billion at 31.12.2006.

The first 10 years

In May 1996, the Ministry of Finance made the first transfer to what was then called the Government Petroleum Fund. Starting with a capital of close to NOK 2 billion, the Fund has now increased to NOK 1 784 billion. At the beginning of 2006, the Fund was renamed the Government Pension Fund – Global, albeit with the same overriding function and investment strategy.

Ten years is a short period to assess the long-term strategy for the management of the Government Pension Fund – Global. The average nominal annual return for the years 1997 to 2006 was 6.5 per cent and the real return after management costs was close to 4.6 per cent. Since 1998, around 40 per cent of the portfolio has consisted of international equities, while 60 per cent has been invested in fixed income instruments. Even though the decline in global equity markets from 2000 into 2003 was the sharpest since the interwar years, equities have accounted for the largest contribution to the return. In 2006, Norges Bank recommended that the Ministry of Finance should increase the allocation to equities in the strategic benchmark portfolio.

When the Government Pension Fund – Global starting investing in equities in 1998, Norges Bank established a new operational area called Norges Bank Investment Management (NBIM). In addition to the operational management of the Fund for the Ministry of Finance, NBIM also manages the bulk of the Bank's foreign exchange reserves, and the Government Petroleum Insurance Fund for the Ministry of Petroleum and Energy. In this Annual Report, we present the results of all the funds under NBIM management for the first time. At the end of 2006, total assets under management amounted to NOK 2 047 billion.

In 2006, asset management generated solid returns on the Government Pension Fund – Global and the Bank's foreign exchange reserves, reflecting strong gains in international stock markets. International equity prices rose by double-digit figures for the fourth consecutive year, and around 17 per cent over the past year. Bond markets exhibited sluggish developments with market returns close to 2 per cent.

The Ministry of Finance has defined a benchmark portfolio for the Government Pension Fund – Global, against which Norges Bank's asset management is measured. The benchmark portfolio consists of a large number of international equities and bonds. In constructing the benchmark portfolio, the Ministry of Finance also determines the bulk of the expected return and risk in management.

NBIM has increased the average annual return on the Pension Fund by 0.48 percentage point in excess of the benchmark return. This is equivalent to a total of NOK 28.9 billion. Active management has not increased the Fund's absolute market risk. The Fund has outperformed the benchmark in each of the nine years. In 2006, the excess return was 0.15 basis points.

After the Ministry of Finance defined new ethical guidelines for the management of the Pension Fund in 2004, Norges Bank has intensified the work on promoting corporate governance in the companies and markets in which the Fund invests. A separate Section and two feature articles provide further details about the activities in 2006 and plans and priorities for future work.

Investment management has become a key component of Norges Bank's activities. In 2006, the Executive Board revised the strategy for the further development of NBIM. The ambition is to be among the world's leading asset managers. The objective is to generate considerable values through active management of the portfolios. The transfer of new capital and day-to-day management shall be cost-effective and sound. By exercising ownership rights, NBIM protects financial assets and seeks to promote a high level of corporate ethical standards. NBIM will continue to devote substantial resources to developing the organisation, its capabilities and efficient information systems.

Confidence is of particular importance in the management of such substantial values for future generations. Norges Bank places considerable emphasis on a high degree of integrity and adequate cost control in its management. As in all earlier years, there were no significant breaches of the guidelines that have been established for the management of the portfolio in 2006.

Transparent and comprehensive information is one of the preconditions for a high degree of confidence. By means of this Annual Report, submitted by Norges Bank's Executive Board, we wish to present material that provides a good basis for assessing Norges Bank's work in the field of international investment management.

Svein Gjedrem
Central Bank Governor

Knut N. Kjær
Executive Director, Norges Bank Investment Management

1 – Key figures 2006

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 secure the government savings necessary to meet the rapid rise in public pension expenditures in the coming years, and to support a long-term management of petroleum revenues. The Ministry of Finance has delegated the operational management of the Fund to Norges Bank. Norges Bank Investment Management (NBIM), which is an area of operation at Norges Bank, is responsible for the operational management.

Key figures 2006

In 2006, the *return* on the Government Pension Fund – Global was 7.9 per cent measured in international currency.[1)] The return on the equity portfolio was 17.0 per cent and the return on the fixed income portfolio was 1.9 per cent. Measured in NOK, the return on the Fund was 5.9 per cent in 2006. The difference between the return measured in international currency and the return measured 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.

Norges Bank achieved an *excess return* of 0.15 percentage point compared with the benchmark portfolio defined by the Ministry of Finance. The excess return is largely attributable to internal equity and fixed income management. External equity management made a negative contribution to the results in 2006. This was the ninth consecutive year with an excess return.

The *market value* of the Fund at the end of 2006 was NOK 1 784 billion, an increase of NOK 384 billion since the beginning of the year. The Ministry of Finance transferred NOK 288 billion in new capital and the return measured in the international currency basket increased the market value by NOK 124 billion. The Norwegian krone appreciated against the international currency basket, reducing the NOK value of the Fund by 28 billion.

Return 1997 - 2006

Table 1 shows the return on the Government Pension Fund – Global. Since 1997, the average nominal annual return has been 6.49 per cent, measured in international currency. The return has been positive in eight of these years and negative in two. In 1997, the Fund was invested only in government securities. Since 1998, the portfolio has consisted of both equities and fixed income instruments. The average nominal annual returns on the equity and fixed income portfolios for the years 1998 - 2006 have been 5.37 and 7.02 per cent respectively.

Since 1997, the real return on the Fund, i.e. the nominal return adjusted for inflation, has been 4.67 per cent. Average

[1)] All fund returns are measured in an international currency basket, which is equivalent to the Funds´ benchmark portfolio, and also in NOK.

Table 1-1: Nominal and real annual return measured in terms of the Fund's currency basket. 1997 -2006. Per cent

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	1997–2006
Nominal return											
Equity portfolio	–	12.85	34.81	–5.82	–14.58	–24.39	22.84	13.00	22.49	17.04	7.02*
Fixed income portfolio	9.07	9.31	–0.99	8.41	5.04	9.90	5.26	6.10	3.82	1.93	5.37*
Total portfolio	**9.07**	**9.26**	**12.44**	**2.49**	**–2.47**	**–4.74**	**12.59**	**8.94**	**11.09**	**7.92**	**6.49**
Price inflation**	1.75	0.92	1.28	2.02	1.17	1.91	1.57	2.37	2.33	2.14	1.75
Real return	**7.19**	**8.26**	**11.02**	**0.46**	**–3.59**	**–6.53**	**10.85**	**6.41**	**8.57**	**5.65**	**4.67**
Management costs***	0.04	0.06	0.09	0.11	0.07	0.09	0.10	0.11	0.11	0.10	0.09
Net real return	**7.15**	**8.20**	**10.93**	**0.35**	**–3.66**	**–6.62**	**10.75**	**6.30**	**8.46**	**5.55**	**4.58**

* 1998–2006.
** Weighted average of consumer price inflation in the countries included in the Fund's benchmark portfolio during the year in question.
*** Costs include fees to external managers for excess return achieved.

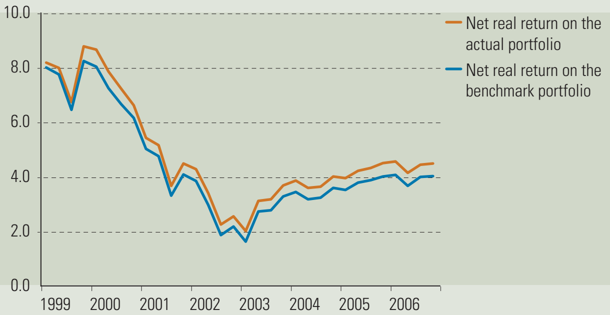


Chart 1-1: Average net real annual return since 1997

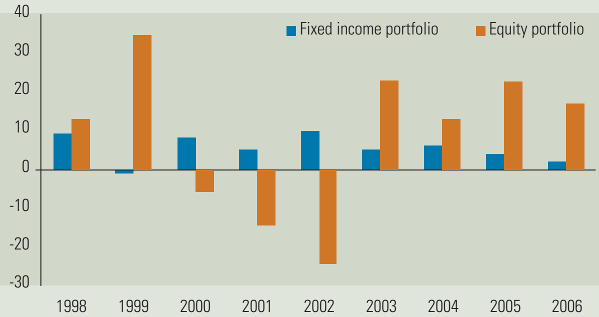


Chart 1-2: Annual return on the equity and fixed income portfolios, measured in terms of the Fund's currency basket. 1998 - 2006. Per cent

management costs have amounted to 0.09 per cent of assets under management. Since 1997, the net real annual return less management costs has been 4.58 per cent.

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

Chart 1-2 illustrates the annual percentage return on the equity and fixed income portfolios since 1998, measured in terms of the Fund's international currency basket. A positive return on the equity portfolio was recorded for six of these nine years, and a positive return on the fixed income portfolio for all years except 1999.

The Fund's cumulative return in the period 1 January 1998 to end-2006 amounted to NOK 336 billion. This is shown by the shaded area in Chart 1-3. NOK 222 billion or 66 per cent of the cumulative return came from equity investments, which have accounted for approximately 40 per cent of the portfolio. The red line in the chart shows the cumulative return on the equity portfolio. Between August 2001 and November 2004, the cumulative return on the equity portfolio was negative. The past four years' strong advances in equity markets have contributed to this return. The market value of the equity portfolio at the end of 2006 was 32 per cent higher than the average purchase price.

The blue line in the chart shows that there has been a far more stable development in the return on the fixed income portfolio. The cumulative return on the fixed income portfolio was NOK 114 billion at the end of 2006.

Chart 1-4 shows the excess return for each quarter since the beginning of 1998. Norges Bank has achieved an excess return in 26 of the 36 quarters since the Fund first invested in equities. Since 1998, the cumulative return on the benchmark portfolio has been 65.1 per cent, whereas the actual return has been 72.0 per cent (see Chart 1-4). The cumulative gross excess return has been 6.9 percentage points, which corresponds to NOK 28.9 billion. The average annual excess return since 1998 has been 0.48 per cent.

Norges Bank's foreign exchange reserves

The foreign exchange reserves shall be available for interventions 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. In Norges Bank the investment portfolio and the buffer portfolio are managed by Norges Bank Investment Management (NBIM), while the money market portfolio of approximately NOK 6.5 billion is managed by Norges Bank Monetary Policy.

Key figures 2006

In 2006, the *return* on the investment portfolio was 7.3 per cent measured in international currency. The return on the equity portfolio was 17.0 per cent and the return on the fixed income portfolio was 1.8 per cent. Measured in NOK, the return on the total portfolio was 5.2 per cent. The difference between the return measured in international currency and the return measured 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.

NBIM achieved an *excess return* of 0.13 percentage point compared with the benchmark portfolio defined by Norges Bank's Executive Board. The excess return is largely attributable to the internal fixed income management. Equity management made a negative contribution in 2006.

The *market value* of the portfolio at the end of 2006 was NOK 225 billion, an increase of NOK 13 billion since the beginning of the year. New capital of NOK 2 billion was transferred to the portfolio and the return on the investments increased the market value by NOK 15.5 billion, while a stronger krone reduced the portfolio's market value by NOK 4.5 billion.

Return in the period 1998 - 2006

Table 1-2 shows the percentage return on the investment portfolio since 1998. Until the end of 2000, the entire portfolio was invested in fixed income securities. Since 2001, the portfolio has included equities and in 2006, the equity portion was increased from 30 to 40 per cent. Since 2002, the portfolio has also included non-government-guaranteed bonds. Since 1998, the average nominal annual return on the portfolio has been

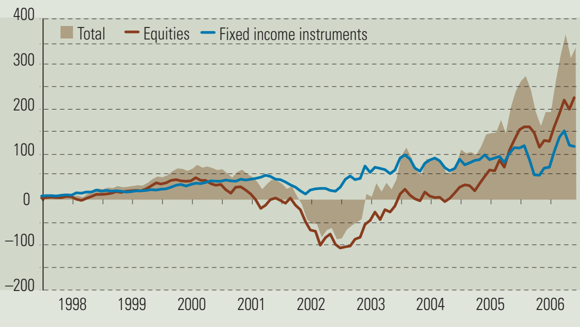


Chart 1-3: Cumulative return on the Pension Fund 1998-2006. In billions of NOK

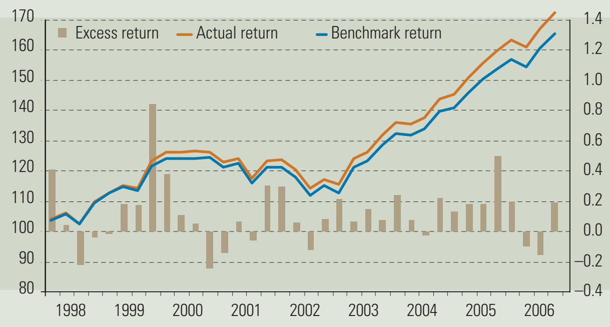


Chart 1-4: Pension Fund. Index for cumulative actual return and benchmark return (left-hand scale) and quarterly excess return in percentage points (right-hand scale). 1998-2006

Table 1-2: Nominal and real annual return measured in terms of the investment portfolio's currency basket. 1998 -2006. Per cent

	1998	1999	2000	2001	2002	2003	2004	2005	2006	Average 1998-2005
Nominal return										
Equity portfolio	NA	NA	NA	–14.80	–26.36	20.48	11.85	20.53	17.02	2.98*
Fixed income portfolio	9.78	–1.14	8.49	5.11	10.14	4.51	6.15	4.12	1.83	5.31*
Total portfolio	**9.78**	**–1.14**	**8.49**	**2.44**	**2.17**	**8.28**	**7.75**	**9.08**	**7.30**	**5.95**
Price inflation**	0.94	1.35	2.11	1.33	2.03	1.51	2.41	2.37	1.99	1.78
Gross real return	8.76	–2.45	6.24	1.10	0.15	6.67	5.22	6.55	5.21	4.10
Management costs***	0.06	0.06	0.07	0.07	0.07	0.06	0.06	0.06	0.06	0.06
Net real return	**8.70**	**–2.52**	**6.18**	**1.03**	**0.08**	**6.60**	**5.16**	**6.49**	**5.15**	**4.04**

* 2001–2006.
** Weighted average of consumer price inflation in the countries included in the benchmark portfolio during the year in question.
*** Costs include fees to external managers for excess return achieved.

5.95 per cent measured in international currency. In the six years of equity investment, the average annual return on the equity portfolio has been 2.98 per cent. During the same period, the average annual return on the fixed income portfolio has been 5.31 per cent.

The gross real annual return since 1998 has been 4.10 per cent. Average management costs have amounted to 0.06 per cent of assets under management. The net real annual return since 1998 has been 4.04 per cent.

The Fund's cumulative return in the period 1 January 1998 to end-2006 amounted to NOK 73 billion. This is shown by the shaded area in Chart 1-5. NOK 23 billion or 32 per cent of the cumulative return came from equity investments. The red line in the chart shows the cumulative return on the equity portfolio. From January 2001 to April 2005, there was a cumulative negative return on equity investments.

The blue line in the chart shows that there has been a far more stable development in the return on the fixed income portfolio. The cumulative return on the fixed income portfolio came to NOK 50 billion at the end of 2006, which was the equivalent of 68 per cent of the cumulative return in the period.

Since 1998, the investment portfolio's gross excess return has been positive in 27 of 36 quarters (see Chart 1-6). Since 1998, the cumulative return on the benchmark portfolio has been 65.5 per cent, whereas the actual return has been 68.3 per cent. The cumulative gross excess return measured in terms of the currency basket has been 2.8 percentage points, which corresponds to NOK 2.1 billion.

The 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 by means of foreign exchange transfers to Norges Bank from the State's Direct Financial Interest in petroleum activities (SDFI) and by Norges Bank's foreign exchange purchases in the market to meet the foreign exchange requirements of the Government Pension Fund – Global. A benchmark portfolio has not been defined for the buffer portfolio. With the exception of December, capital is normally transferred to the Fund each month. In 2006, the return on the buffer portfolio was 1.9 per cent measured in NOK. The market value of the portfolio was NOK 23 688 billion at year-end.

Government Petroleum Insurance Fund

The Government Petroleum Insurance Fund's purpose is to provide a reserve to cover damages and liabilities which affect the State's Direct Financial Interest in petroleum activities (SDFI). Pursuant to the Act relating to the Government Petroleum Insurance Fund, Norges Bank is responsible for the operational management of the fund. The management mandate is stipulated in a regulation and

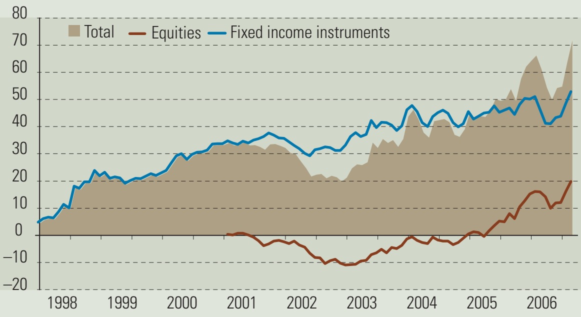


Chart 1-5: Cumulative return on the investment portfolio 1998-2006. In billions of NOK

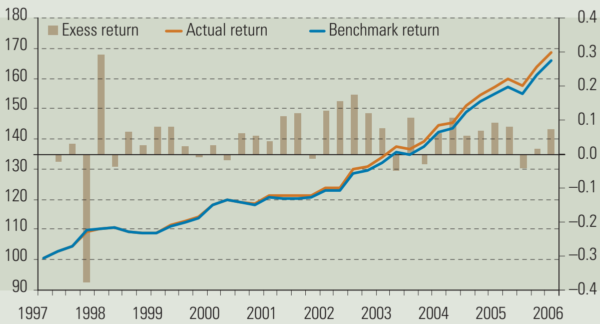


Chart 1-6: Investment portfolio. Index for cumulative actual return and benchmark return (31.12..1997=100, left-hand scale) and quarterly gross excess return in percentage points (right-hand scale). 1998-2006

written guidelines issued by the Ministry of Petroleum and Energy. A management agreement, which further regulates the relationship between the Ministry of Petroleum and Energy as delegating authority and Norges Bank as operational manager, has also been drawn up. The guidelines and management agreement are available on Norges Bank's website.

Key figures 2006

In 2006, the *return* on the Government Petroleum Insurance Fund was 2.2 per cent measured in international currency. Measured in NOK, the return on the portfolio was 1.3 per cent. The difference between the return measured in international currency and the return measured 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.

Norges Bank achieved an *excess return* of 0.03 percentage point compared with the benchmark portfolio defined by the Ministry of Petroleum and Energy. The Fund's assets are only invested in fixed income instruments and the entire Fund is managed internally by an indexing strategy.

The *market value* of the Fund at end-2006 was NOK 15.2 billion, an increase of NOK 1 billion since the beginning of the year. Insurance premiums from the Government amounted to NOK 1.2 billion and claims payments amounted to NOK 462 million.

Table 1-3: Return measured in NOK and risk as at 31.12.2006. Annualised

	2006	2004–2006	2002–2006	1998–2006
Return/excess return*				
Pension Fund	5.89	7.94	4.07	5.92
Benchmark portfolio	5.74	7.36	3.57	5.44
Excess return	0.15	0.58	0.50	0.48
Investment portfolio	5.18	6.62	4.33	5.69
Benchmark portfolio	5.05	6.43	4.04	5.49
Excess return	0.13	0.19	0.29	0.20
Insurance Fund	1.34	2.59	4.34	3.45
Benchmark portfolio	1.31	2.47	4.21	3.37
Excess return	0.03	0.13	0.13	0.08
Standard deviation**				
Pension Fund	8.95	8.37	9.29	8.52
Investment portfolio	8.98	8.07	8.06	7.15
Insurance Fund	8.15	7.31	7.23	6.52
Tracking error***				
Pension Fund	0.37	0.34	0.31	0.38
Investment portfolio	0.14	0.15	0.17	0.23
Insurance Fund	0.04	0.06	0.07	0.15
Information ratio (IR)****				
Pension Fund	0.39	1.60	1.58	1.22
Investment portfolio	0.85	1.15	1.65	0.82
Insurance Fund	0.64	1.98	1.79	0.50

* 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 3.1.7

**** The IR is a measure of risk-adjusted return and is an indicator of skills 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 is achieved for each unit of risk.

Total excess return of NOK 2.8 billion in 2006

NBIM's management is measured against a benchmark portfolio defined by the Ministry of Finance. One important goal of asset management is to generate a somewhat higher return over time on the actual portfolios than on the benchmark portfolios. In 2006, the Government Pension Fund – Global, the investment portfolio and the Government Petroleum Insurance Fund generated excess return. The aggregate excess return amounted to NOK 2.8 billion.

Chart 1-7 shows the cumulative excess return since the establishment of NBIM in January 1998. The combined contribution in the period is NOK 31.1 billion. This breaks down into NOK 28.9 billion on the Government Pension Fund – Global, NOK 2.1 billion on the investment portfolio, and NOK 0.1 billion on the Government Petroleum Insurance Fund.

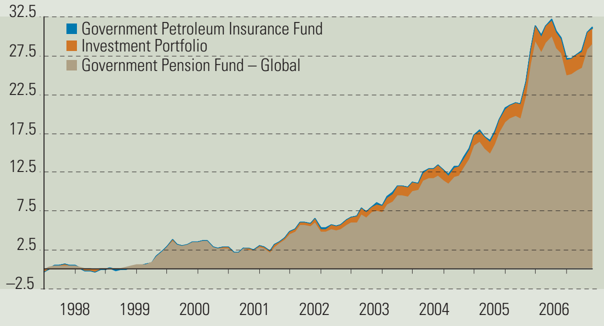


Chart 1-7: Cumulative gross excess return from 1 January 1998 to 31 December 2006. In billions of NOK

2 – Market developments in 2006

2.1 Macroeconomic developments

Global economic growth remained high in 2006, although towards the end of the year there were signs that the expansion of the past three years was slowing. The rate of growth in the US economy declined, while the activity level in Japan, and particularly in the euro area, gathered pace. Thus, growth disparities across major regions were reduced. The current expansion has been the strongest for several decades, with increasing output and falling unemployment in most industrialised countries. Capacity utilisation has increased, which normally tends to push up prices and wages. Most industrialised countries operate various inflation targeting regimes in the conduct of monetary policy. The central banks of the largest economies raised their policy rates in 2006. The US, which has been a primary engine behind the cyclical upturn, ended the monetary policy tightening cycle in mid-2006, while other major countries continued tightening through the year. There are many indications that short-term interest rates are peaking at a lower level than in previous cyclical upturns.

A special feature of this expansion is that inflation has remained relatively low. This may be partly attributable to a high degree of confidence in central bank policy and low inflation expectations, but increasing globalisation has also been of importance. Increased imports from low-cost countries have contributed to curbing domestic inflation, and wage growth has been restrained by the risk that jobs may be outsourced to countries with lower cost levels. These factors have contributed to curbing wage growth. However, prices have risen substantially in some sectors of the economy, particular sectors relating to commodities, property and transport services.

Following several years of strong economic expansion, there were signals of slowing growth in the US in 2006. Slower growth particularly reflected the slowdown in the housing market after the upswing of recent years. Housing starts and turnover fell markedly and the rise in prices levelled off.

The decline in the housing market has been partly offset by increased investment and higher employment in the business sector. Rising share prices and lower energy prices towards the end of the year led to an increase in household wealth and real disposable income. Private consumption, which has been the most important growth factor in the US economy in recent years, has been stimulated by lower oil prices and a decline in long-term interest rates. The lower interest rate level has enabled households to withdraw mortgage equity by refinancing housing loans.

After raising its policy rate in 17 increments since June 2004, the Federal Reserve Bank has kept its policy rate unchanged at 5.25 per cent since June 2006. In the reasoning behind its monetary policy decisions, the Federal Reserve has gradually signalled that growth is beginning to slow, with an easing of inflation pressures.

Economic growth in the euro area gathered pace in 2006, and the expansion was the strongest since 2000. Exports of goods and services have been the most important driving force, but private investment and private consumption have also contributed. In Germany, VAT was raised from 16 per cent to 19 per cent on 1 January 2007, which may have contributed to the growth in consumption towards the end of 2006. Solid corporate profitability and low interest rates were conducive to investment growth. Employment has increased and unemployment has fallen to the lowest level recorded since 2001. Wage growth has been moderate, and with falling energy prices inflation fell to below 2 per cent towards the end of the year. The ECB raised its key rate on five occasions in the course of the year, to 3.50 per cent at end-2006.

Growth in industrial production remained buoyant in the UK, while there were signs of somewhat weaker growth in retail trade in the past few months of the year. House prices continued to rise, while turnover in the housing market levelled off somewhat. There has been considerable inward labour migration to the UK from the new EU countries, which has helped to curb wage growth. The inflation rate has hovered at just over 2 per cent, and the Bank of England raised the key rate to 5 per cent in the course of the year.

The Japanese economy showed favourable developments in 2006. GDP growth was solid, and unemployment was falling. The economy began to show signs of pressures. There was a greater shortage of qualified labour, and scattered signs of wage and price inflation. House prices started to rise again, after falling for more than ten years. After a

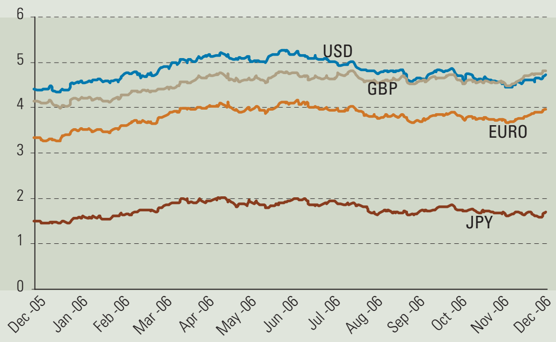


Chart 2-1: Developments in the most important fixed income markets in 2006. Yields on 10-year government securities. Annual percentage figures
Source: Morgan Markets

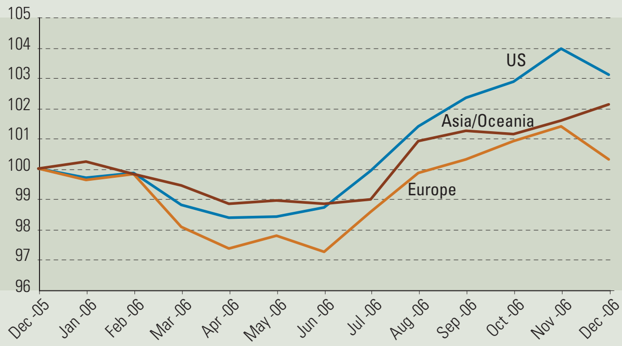


Chart 2-2: Movements in Lehman Global Aggregate's government securities indices in the main markets in 2006 (31.12.05 = 100)
Source: Lehman Brothers

long period of close to zero interest rates, the Bank of Japan raised its policy rate to 0.25 per cent in July.

The most important force driving economic growth in Japan has traditionally been exports, primarily to neighbouring Asian countries. China, for example, accounts for 15 per cent of Japan's exports, twice the level 5 years ago. Many firms in Japan are operating at close to full capacity.

China's global economic importance is rising steadily each year, and in 2006 GDP growth was over 10 per cent. The most important factors behind the upturn are a continued rise in investment and an increase in net exports. The most important force driving China's growth in recent years has nevertheless been its entry into the global economy, which has laid the foundation for the country's further industrialisation. In order to curb the risk of overheating, the authorities tightened policy in a number of areas. Restrictions have been placed on access to land in some areas, the equity required for investment projects has increased, and the policy rate and primary reserve requirements have been raised.

Growth is also high in India. This is primarily due to growth in the service sector, which accounts for just over 50 per cent of output. Developments in the agricultural sector, which employs more than half the labour force, have been far more moderate. There are signs of a tighter labour market for qualified labour in service production, which may dampen growth in the short term.

Table 2-1: Performance of the FTSE All-World Equity Index in 2006, measured in USD, NOK and in terms of an international currency basket. Per cent

	USD	NOK	Currency basket*
Oil and gas	21.51	11.74	13.87
- of which recovery and refining of oil and gas	22.60	12.74	14.90
Commodities	32.54	21.88	24.21
General industrials	20.58	10.88	13.00
Consumer goods	23.09	13.18	15.35
Health services	10.75	1.83	3.78
- of which pharmaceuticals and biotechnology	12.96	3.87	5.85
Consumer services	16.64	7.25	9.31
- of which retail trade	7.11	–1.51	0.37
- of which media	25.40	15.31	17.52
Telecommunications	35.09	24.22	26.60
- of which "fixed line" telecommunications	36.34	25.37	27.77
Utilities	37.85	26.76	29.18
Financial services	25.46	15.37	17.57
- of which banks	25.39	15.30	17.51
- of which insurance	18.48	8.95	11.04
- of which other financial services	23.07	13.17	15.33
Information technology	11.89	2.88	4.85
- of which software and computer services	14.13	4.95	6.96
- of which hardware and IT equipment	10.70	1.79	3.74
Total**	22.06	12.24	14.39

* The currency basket reflects the benchmark portfolio of the Government Pension Fund – Global.
** The composition of the Pension Fund's benchmark portfolio is different from the FTSE World Index, and hence the return will be different.

2.2 Fixed income market development

In 2006, yields on 10-year government bonds rose by between 0.6 and 0.7 percentage point in the euro area and the UK, by 0.3 percentage point in the US and 0.2 percentage point in Japan. Chart 2-1 shows that the level of 10-year yields was rising in the first half of the year and falling in the second half of 2006. The decline in interest rates in the second half of the year was related to reduced inflation expectations and an end to the monetary policy tightening cycle in the US. As a result of lower 10-year yields in the US, the yield curve became steeper as the yield spread between short-term and long-term yields widened.

Chart 2-2 presents changes in the value of Lehman Global Aggregate

Chart 2-3: The difference between yields on corporate bonds* and Treasuries (credit spread) in the US in the past four years. Basis points
* Companies with AAA credit rating from Standard&Poor's.
Source: Lehman Brothers

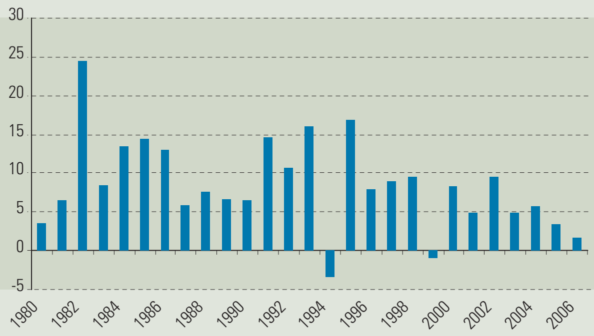


Chart 2-4: Return in fixed income markets 1980-2006 measured in terms of an international currency basket. Per cent and annual figures

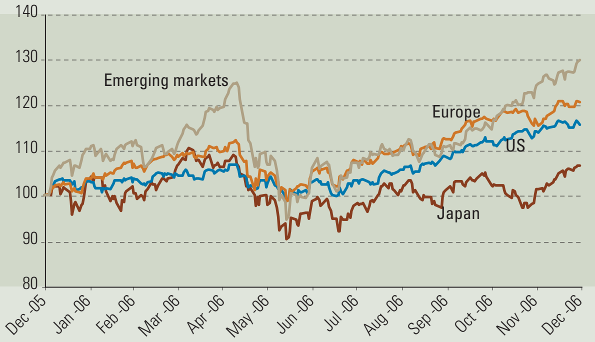


Chart 2-5: Movements in the FTSE equity indices in the main markets in 2006 (31.12.2005=100)
Source: FTSE

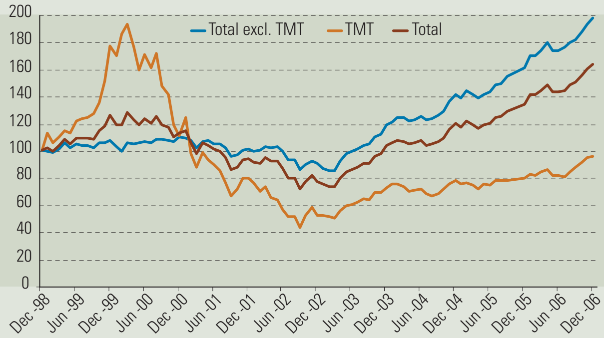


Chart 2-6: The FTSE All-World Equity Index 1998-2006: Total and for the technology, media and telecommunications (TMT) sector (31.12.1998 = 100)
Source: FTSE

government bond indices in 2006. In 2006, the total return was 3.1 per cent in the US, 0.3 per cent in Europe and 2.1 per cent in Asia.

The yield spread between corporate bonds and government bonds did not change substantially in 2006 as a whole. The spread widened in connection with the equity market decline in May and June. In the second half of the year, the yield spread gradually narrowed to a level somewhat lower than at the beginning of the year. Over the past three years, the yield spread has varied between 80 and 100 basis points, which historically is very low (see Chart 2-3).

Chart 2-4 shows returns in fixed income markets each year since 1980. During this period, the average annual return was 8.5 per cent. The return in 2006 was 1.7 per cent and it has only been lower in 1994 and 1999.

In the early 1980s, inflation rates and interest rates were unusually high. Both inflation and interest rates have been low in recent years, which explains why nominal returns on fixed income instruments have been lower in recent years than they were early in the period.

2.3 Equity market developments

The rise in global equity markets, which began in the spring of 2003, continued through 2006. The return on an equity portfolio with the same composition as the benchmark portfolio of the Government Pension Fund – Global was 17.1 per cent in 2006, compared with 20.3 per cent in 2005. The rise was particularly strong in Europe and the US, where prices rose by 20.5 and 15.7 per cent, respectively. The price rise in Japan was 6.6 per cent. An index consisting of 24 emerging equity markets rose by 29.9 per cent in 2006. Price developments were particularly strong in the second half of the year in most markets, following the fall in May/June (see Chart 2-5).

Table 2-1 shows that developments were positive in all main sectors in 2006. Gains were strongest in utilities, telecommunications and commodities, and weaker in health services and IT.

Chart 2-6 illustrates the significance of the technology, media and telecommunications (TMT) sectors for the equity indices over the past seven years. Equity prices in the TMT sectors rose sharply from 1999 up to the early summer of 2000 and then fell more sharply. Developments in equity prices in the TMT sectors have been somewhat weaker than in the other sectors in the FTSE All-World Equity Index in the past three years.

Chart 2-7 shows annual returns in the equity market since 1980. During this period, the average annual return was 14.6 per cent. The return in 2006, 17.1 per cent, was thus above average.

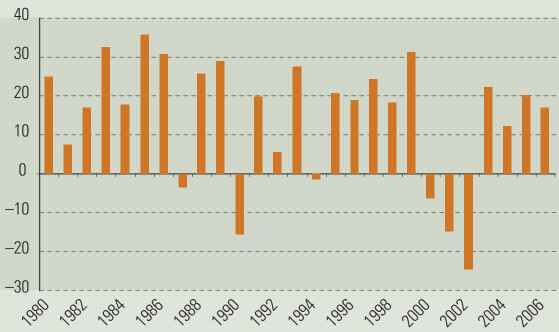


Chart 2-7: The return on the Fund's equity benchmark, 1980-2006. Measured in terms of an international currency basket.* Per cent

* The currency basket reflects the benchmark portfolio of the Government Pension Fund – Global

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 in 1990. The first capital transfer of NOK 2 billion was made in 1996. The name was changed as from 1 January 2006. At the same time, the Ministry of Finance revised the guidelines for the management of the Fund. The most important changes were that the maximum ownership stake in companies was raised to 5 per cent (previously 3 per cent), the requirement of a minimum credit rating for corporate bonds was removed (previously a minimum of BBB investment grade), and investments may now be made in commodity-based contracts and in funds.

In the Revised National Budget for 2006, the Ministry of Finance published its decision to change the regional weights for the Fund's investments. The composition of the benchmark portfolio for equities was changed to 15 per cent in Asia and Oceania, 50 per cent in Europe and 35 per cent in the Americas and

The Fund's investments

(countries and currencies in the benchmark portfolio at 31.12.2006 are in italics):

Equities listed in a regulated market in the following countries:

Europe: *Austria, Belgium,* Cyprus, Czech Republic, *Denmark, Finland, France, Germany, Greece,* Hungary, Iceland, *Ireland, Italy,* Luxemburg, *the Netherlands,* Poland, *Portugal, Spain, Sweden, Switzerland,* Turkey and *the UK*

Americas: *Brazil, Canada,* Chile, *Mexico* and *the US*

Asia and Oceania: *Australia,* China, *Hong Kong,* India, Indonesia, Israel, *Japan,* Malaysia, *New Zealand,* the Philippines, *Singapore, South Korea, Taiwan* and Thailand

Africa: *South- Africa.*

Fixed income investments issued in the currency of the following countries:

Europe: *Austria, Belgium,* Cyprus, Czech Republic, *Denmark, Finland, France, Germany, Greece,* Hungary, Iceland, *Ireland, Italy,* Luxemburg, *the Netherlands,* Poland, *Portugal, Spain, Sweden, Switzerland* and *the UK*

Americas: *Canada,* Mexico and *the US*

Asia and Oceania: *Australia,* Hong Kong, *Japan, New Zealand, Singapore* and South Korea

Africa: South Africa.

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. The indices include individual stocks and bonds to reflect movements in the stock market and fixed income market 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 large and medium-sized companies in 27 countries and of Lehman Global Aggregate fixed income indices in the currencies of 21 countries (see box with actual benchmark portfolio). Equities account for 40 per cent of the Fund's strategic benchmark portfolio while fixed income instruments account for 60 per cent. The equity portion of the benchmark consists of equities listed on exchanges in Europe (50 per cent), Asia/Oceania (15 per cent) and the Americas/Africa (35 per cent). The regional distribution in the fixed income benchmark is 60 per cent Europe, 35 per cent the Americas and 5 per cent Asia/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. This kind of rebalancing did not occur in 2006.

Documentation on the Internet

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

Table 3-1: Benchmark portfolio at 31.12.2006. 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	40.6	60.0	59.4
Belgium		0.8		
Finland		0.9		
France		8.2		
Greece		0.5		
Ireland		0.6		
Italy		3.3		
Netherlands		2.7		
Portugal		0.3		
Spain		3.4		
Germany		5.6		
Austria		0.4		
Euro area		*26.5*		*48.1*
UK		16.8		9.8
Denmark		0.6		0.9
Switzerland		4.9		0.5
Sweden		2.0		1.1
Total Europe	50.0	50.8	60.0	60.5
US		30.4		32.6
Brazil		0.7		
Canada		1.9		2.0
Mexico		0.5		
South Africa		0.6		
Total Americas / Africa	35.0	34.1	35.0	34.6
Australia		2.3		0.2
Hong Kong		1.3		
Japan		8.7		4.4
New Zealand		0.1		0.1
Singapore		0.4		0.2
South Korea		1.4		
Taiwan		1.1		
Total Asia / Oceania	15.0	15.1	5.0	4.9

Africa. The composition of the fixed income benchmark portfolio was changed to 5 per cent Asia and Oceania, 60 per cent Europe and 35 per cent the Americas and Africa. The change was phased in gradually and was completed in the third quarter of 2006.

In November 2004, the Ministry of Finance approved ethical guidelines for the Fund's investments. These guidelines require that ethical issues be addressed through three mechanisms: *corporate governance* 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 corporate governance, in accordance with the guidelines issued by the Ministry of Finance. Norges Bank's Executive Board has approved principles of corporate governance. Section 4.1 contains an account of corporate governance activities in 2006. The government has appointed an Advisory Council on Ethics to advise the Ministry of Finance on negative screening and exclusion of companies. The Ministry makes the final decision on the exclusion of companies and instructs Norges Bank accordingly. Section 4.2 provides an overview of the companies that were excluded from the investment universe at end-2006.

The Ministry of Finance has delegated the operational management of the Government Pension Fund – Global to Norges Bank, with a mandate set out in a regulation and written guidelines issued by the Ministry. A management agreement, which further regulates the relationship between the Ministry of Finance as delegating authority and Norges Bank as operational manager, has also been drawn up. According to the regulation, Norges Bank shall seek to achieve the highest possible return within the limits set out in the regulation. The Bank's strategy for achieving an excess return has been presented in earlier annual reports (for further details, see the 1999 and 2003 reports). Norges Bank reports to the Ministry of Finance on the management of the Fund, quarterly and annually. The reports are also made public.

The Ministry of Finance has specified countries and currencies that are to be included in the Fund's benchmark portfolio. The benchmark portfolio consists of specific equities and fixed income

Table 3-2: Market value of the Fund in 2006. In millions of NOK

	31.12.2005	31.03.2006	30.06.2006	30.09.2006	31.12.2006
Equity portfolio	582 304	606 890	609 879	687 887	725 922
Fixed income portfolio	816 746	877 019	895 143	1 024 385	1 057 761
Total portfolio	**1 399 050**	**1 483 909**	**1 505 022**	**1 712 272**	**1 783 683**

instruments and reflects the delegating authority's investment strategy for the Pension Fund. The benchmark portfolio provides the basis for managing risk in the operational management and for evaluating NBIM's management performance. The composition of the benchmark portfolio and how it is changed are described in a separate box.

Table 3-1 shows the weights in the actual benchmark at 31 December 2006. The weights in the fixed income benchmark apply to the currency in which the securities are issued. Therefore, the weight for each country in the euro area is not listed.

Table 3-3: Transfers to the Government Pension Fund – Global in 2006. In billions of NOK

	To the equity portfolio	To the fixed income portfolio	Total to the Fund
January		31.1	31.1
February		31.1	31.1
March		20.2	20.2
April		21.4	21.4
May	24.2		24.2
June	8.7	15.3	23.9
July	12.7	11.4	24.1
August		24.0	24.0
September	4.0	27.3	31.4
October		30.3	30.3
November	2.9	23.7	26.6
December			
Total 2006	**52.5**	**235.8**	**288.3**

3.2.2 Return in 2006

At end-2006, the market value of the Government Pension Fund – Global was NOK 1 783.7 billion, an increase of NOK 384.6 billion since the beginning of the year. The Ministry of Finance transferred NOK 288.3 billion in new capital and the return measured in the international currency basket increased the market value by NOK 124.1 billion. The value of the currencies in which the Fund is invested fell in relation to NOK, thereby reducing the Fund by NOK 27.8 billion. Changes in the krone exchange rate have no effect on the Fund's international purchasing power, however. Table 3-2 shows the size of the equity and fixed income portfolios at the end of each quarter in 2006.

In the course of the year, the Ministry of Finance transferred NOK 288.3 billion to the Fund's krone account, and the equivalent of this capital was transferred simultaneously to the Fund's portfolio of international securities. The transfers are distributed between the two sub-portfolios so as to maintain the Fund's equity and fixed income shares at 40 and 60 per cent respectively (see discussion of the rebalancing regime in Section 3.1.1). As a result, the Fund normally buys more of the asset class that has had the least favourable return. Table 3-3 shows that over 80 per cent of the capital transferred in 2006 was invested in fixed income markets, but a considerable amount was also invested in equity markets.

In 2006, the return on the Fund was 7.9 per cent measured in terms of the currency basket which corresponds to the country weights in the benchmark

Table 3-4: Return on the Fund by quarter and for 2006 as a whole. Per cent

	Return measured in terms of the portfolio's currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	2.24	2.04	0.25	0.06	0.20
Q2	–1.55	–1.45	–3.30	–3.20	–0.10
Q3	3.94	4.09	8.30	8.46	-0.16
October	1.49	1.47	2.56	2.54	0.02
November	0.93	0.79	–2.89	–3.02	0.14
December	0.70	0.66	1.27	1.23	0.03
Q4	3.15	2.95	0.86	0.66	0.20
2006	**7.92**	**7.76**	**5.89**	**5.74**	**0.15**

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 each year and capital equivalent to the projected surplus for the 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 by correcting for the discrepancy between the amount transferred during the year and the final allocation to the Fund. The allocation in the central government accounts has varied between NOK 26 billion in 1999 and more than NOK 257 billion in 2001. Actual transfers in 2006 totalled NOK 288 billion, which is the highest annual amount transferred to the Fund. A total of NOK 1 443 billion has been transferred to the Fund for the years 1995-2006.

The right-hand column of the table also shows the share of the central government's net cash flow from petroleum activities that has remained 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 2/3 of the cash flow. In 2005, and 2006 this share increased to 80 per cent.

Accounting year	Actual transfers during the year*	Final allocation in the central government accounts	Share of government petroleum income 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		81**
Total 1995–2006	1 442 674		

* Less management remuneration to NBIM
** Preliminary figures based on new balanced central government budget for 2006

portfolio. In absolute figures, the return measured in terms of the currency basket was NOK 124.1 billion. With the exception of the second quarter, when there was a sharp fall in global equity prices, the return was positive in all quarters in 2006 (see Table 3-4). The return on the Fund was high in the second half of 2006 in particular. The last column of Table 3-4 shows the difference between the actual return and the benchmark return. The excess return was negative in the second and third quarters, but positive in the first and fourth quarters. The excess return for the year as a whole was 0.15 percentage point, equivalent to approximately 2.5 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 return for the past three years. At end-2006, the annualised excess return, based on figures from the past three years, was 0.58 percentage point.

The excess return in 2006 was largely attributable to internal equity management. External equity management had a weak year in comparison with 2005. As a result, the overall return on equity investments was somewhat lower than the return on the benchmark. Both the internal and especially the external fixed income management contributed positively to the excess return in 2006 (cf. Table 3-5). Overall, the excess return achieved through internal management was higher in 2006 than in 2005.

Chart 3-2 shows the contribution in NOK of each internally managed and

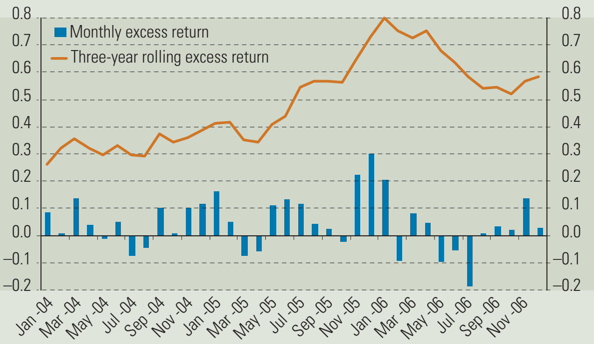


Chart 3-1: Monthly return (right-hand scale) and 3-year rolling return (left-hand scale). Per cent

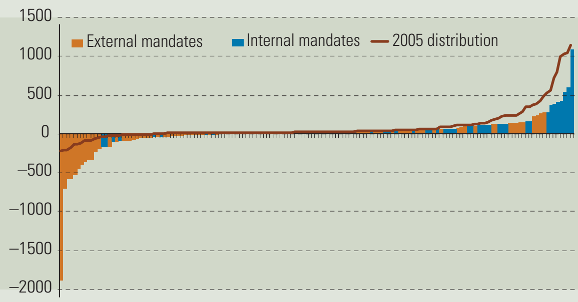


Chart 3-2: The contribution of individual mandates to the excess return in 2006

Table 3-5: Contributions to gross excess return in 2006. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity management	−0.32	0.31	−0.01	−0.05
Fixed income management	0.03	0.13	0.16	0.24
Total	**– 0.29**	**0.44**	**0.15**	

Table 3-6: Contributions to gross excess return after operating costs in 2006. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity management	−0.37	0.29	−0.08	−0.20
Fixed income management	0.02	0.11	0.13	0.22
Total	**−0.35**	**0.40**	**0.05**	

Table 3-7: Annualised contributions to gross excess return. 2004-2006. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity management	0.18	0.20	0.38	0.95
Fixed income management	0.04	0.16	0.20	0.32
Total	**0.22**	**0.36**	**0.58**	

Table 3-8: Contributions to gross excess return after operating costs. 2004-2006. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity management	0.13	0.18	0.31	0.78
Fixed income management	0.03	0.14	0.17	0.28
Total	**0.16**	**0.32**	**0.48**	

Table 3-9: Information ratio. 2004-2006

	External management	Internal management	Total
Equity management	0.48	1.44	1.08
Fixed income management	1.69	2.58	2.77
Total	**0.61**	**2.55**	**1.60**

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, NBIM has, since the beginning of 2005, used a model that calculates direct and indirect transaction costs individually (cf. feature article published in connection with the annual report for 2004). Indirect transaction costs comprise three main components: liquidity costs, market impact and opportunity costs. NBIM's model calculates transaction costs in the fixed income portfolio using the full bid-ask spread. Indirect transaction costs in the equity portfolio are estimated using StockFactsPro®. Market impact in the fixed income market is a function 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.

each externally managed mandate to the excess return in 2006. The orange bars show externally managed mandates, while the blue bars show internally managed. A large preponderance of externally managed mandates contributed negatively to the excess return in 2006. The line in the chart shows the distribution of the contributions of individual mandates to the excess return in 2005. In 2005, the distribution was clearly more favourable, with a larger share of mandates with a high excess return and a smaller share with a negative contribution.

Table 3-6 shows the contributions to the excess return after operating costs for 2006. Total operating costs for management of the Fund amounted to NOK 1 526 million or 9.8 basis points of the average assets under management in 2006 (see more detailed information in Section 3.1.7). The excess return after accrued operating costs is approximately NOK 1.0 billion.

The annualised excess return for the past three years came to 0.58 per cent (cf. Table 3-7). Internal and external equity management combined contributed approximately 66 per cent to the excess return. Internal equity and fixed income management contributed appreciably more than external management.

Table 3-8 shows contributions to excess return after accrued operating costs for the three-year period 2004-2006. Total operating costs for management of the Fund amounted to NOK 3 748 million or 10.3 basis points of the average assets under management during the period.

The information ratio is the ratio of excess return to market risk. It shows the excess return in relation to the risk taken.

Table 3-10: Estimated net value added by active management. Percentage points

Gross excess return	**0.15**
+ Transaction costs associated with indexing	0.04
+ Other transaction costs	0.04
- Extra costs of active management	0.07
- Lending income associated with index management	0.04
= Value added by active management	**0.12**

Table 3-9 shows the information ratio, or the risk-adjusted excess return, for the various profit centres in the period 2004-2006.

The gross excess return is comparable to the excess return reported by other managers. However, it does not provide a measure of NBIM's net contribution to performance. The Fund could have been managed passively, with a portfolio that was very similar to the benchmark at all times. Instead, NBIM has chosen to engage in active management. Costs are higher, but expected returns are also higher.

The value added by active management is an estimate of the net contribution from this strategy to the Fund's return in 2006. Table 3-10 presents the estimated net value added through active management. The starting point is the Fund's gross excess return. With passive indexing, transaction costs accrue when the benchmark portfolio's composition is changed. The normal annual transaction costs of maintaining index management amount to about 0.04 per cent of the total portfolio.

When estimating gross excess return, costs relating to phasing new capital into the markets, adjusting the actual portfolio when the Ministry of Finance excludes companies from the investment universe, and other changes in the benchmark portfolio are not taken into account. The methodology for calculating such costs is described in a separate article published on Norges Bank's website in 2005 and in a box in this section of the *Annual Report.*

For 2006, NBIM has estimated the cost of phasing in new capital at approximately NOK 497 million. This was 0.17 per cent of the amount transferred (NOK 288 billion) and 0.03 per cent of the Fund's market value.

NBIM has estimated the cost of disposals in connection with the exclusion of companies at roughly NOK 10 million in 2006 or 0.001 per cent of the Fund's market value. These estimates assume that disposals will be made over a 60-day period, which is in accordance with the procedures established by the Ministry of Finance for company exclusions.

In April 2006, the Ministry of Finance decided to change the regional weights in the benchmark portfolio for both equity and fixed income management. NBIM has estimated the costs of adjusting the portfolios at NOK 121 million: NOK 69 million for equity management and NOK 52 million for fixed income management.

If passive indexing had been employed, the Fund's operating costs in connection with asset management would have been low. The Fund's normal management costs for indexing are estimated at 0.03 per cent of the total portfolio. In 2006, total management costs amounted to 0.10 per cent, i.e. the costs associated with active management are estimated at 0.07 per cent.

On the other hand, passive management would also have generated some income from securities lending. Income from securities lending in 2006 amounted to 0.07 per cent of the total portfolio. An estimated return of approximately 0.04 per cent would have been achieved by using a more passive management style.

These estimates indicate that the net value added by active management was 0.12 percentage point in 2006 (cf. Table 3-10). This is equivalent to about NOK 1.7 billion.

NBIM's average net contribution to the excess return over the period

Securities lending

Norges Bank has entered into securities lending agreements. This is a part of normal portfolio management. The purpose of these agreements is to achieve an excess return on securities that are deposited in Norges Bank's custodian institutions. Securities are lent out against a fee to international banks and brokers/dealers. Norges Bank receives cash or securities as collateral for such loans. Collateral in the form of cash is reinvested in instruments with low credit risk in accordance with agreed guidelines.

Norges Bank has a lending agreement for equities and fixed income instruments with J.P. Morgan Chase Bank and lending agreements for fixed income instruments with State Street Bank & Trust and Dresdner Bank AG. All these agreements contain provisions that 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.

Table 3-11: NBIM's contribution to the return on the Fund 1998-2006. Percentage points

Total	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**1998–2006**
Excess return	0.20	1.25	0.28	0.15	0.25	0.59	0.53	1.10	0.15	0.48
Value added by active management	**0.19**	**1.18**	**0.20**	**0.11**	**0.21**	**0.54**	**0.49**	**1.05**	**0.12**	**0.45**

Operational tasks in the management of the Fund

Operational tasks can be divided into four main categories:

- *Investment of new capital in the market.* In 2006, NOK 288.3 billion in new capital was invested in international capital markets. This is the largest annual amount transferred so far. NBIM places considerable emphasis on keeping transaction costs associated with these investments as low as possible, and uses considerable resources to achieve this.
- *Continuous indexing of the portfolio.* A major portion of the Fund is indexed. The index portfolio mirrors the benchmark defined by the Ministry of Finance, which is based on recognised equity and fixed income indices. These indices change constantly as companies and fixed income instruments are added and removed. In order to maintain the index portfolio, most of these changes must also be made in the actual portfolio. In view of the size of the Fund's portfolio, it is very important to keep the costs of indexing as low as possible. The indices are not followed exactly. There is some active management designed to take advantage of special pricing situations. This is called enhanced indexing, and involves somewhat higher operating costs than passive indexing but, so far, also higher returns.
- *Transfer of capital to new managers or takeover of capital on the termination of mandates.* Portfolios for external managers are constructed internally by NBIM to keep transaction costs to a minimum and permit measurement of the return on the portfolio from day one. NBIM also takes over portfolios from external managers as soon as their mandates have been terminated and restructures them for the next external or internal manager.
- *Portfolio administration including corporate governance activities.*

1998-2006 was 0.45 percentage point (see Table 3-11). This is equivalent to NOK 26.3 billion.

Table 3-12 presents the Fund's return measured in various currencies. The return measured in terms of the currency basket was 7.9 per cent, whereas measured in NOK it was 5.9 per cent. The difference is due to an approximately 1.9 per cent appreciation of the krone in relation to the currency basket in 2006. Changes in the krone's international value have no effect on the Fund's international purchasing power. Calculated in EUR, the return was 3.0 per cent, whereas in USD it was a full 15.2 per cent. This is because the dollar depreciated against most other currencies, the euro in particular, in 2006.

Table 3-12: Total return in 2006 measured against various benchmark currencies. Per cent

Return measured in terms of:	Total portfolio
Benchmark portfolio's currency basket	7,92
Import-weighted currency basket	4,25
USD	15,16
EUR	3,01
NOK	5,89

3.1.3 The size of the Fund from an international perspective

Measured by capital under management, the Government Pension Fund – Global is large compared with the largest international pension funds. In Chart 3-3, 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 end-2006, the Fund was somewhat larger than both the largest European pension fund (ABP in the Netherlands) and the largest US pension fund (CalPERS in California).

The Pension Fund is far from being among the largest asset managers in the world, however. At end-2006, the largest international asset manager (UBS in Switzerland) had more than USD 2 016 billion in total assets. The world's largest pension fund is the Japanese Government Pension Investment Fund. This fund invests a large portion of its assets in

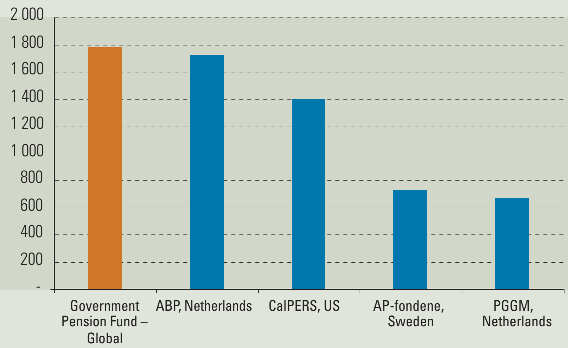


Chart 3-3: Capital in large international funds in 2006. In billions of NOK
Source: Fund´s web pages

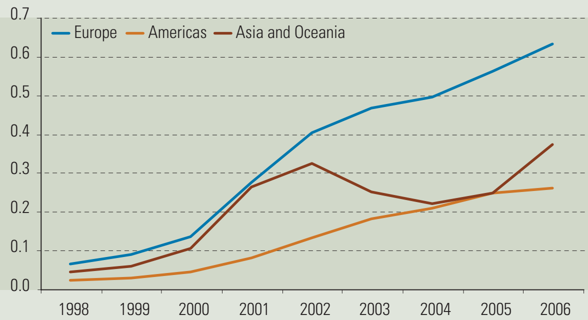


Chart 3-4: The Fund's ownership interests in equity markets at year-ends 1998-2006 as a percentage of market capitalisation in the FTSE indices
Source: FTSE and Norges Bank

Methodology for calculating returns[1)]

The return calculations are based on internationally recognised standards.

All financial instruments are valued at market price and the index suppliers' prices are generally used for securities in the benchmark indices.[2)] Bloomberg's prices are used for equities and fixed income securities that are not in the benchmark index. In addition, prices from Reech are used for some fixed income derivatives, and prices taken directly from local stock exchanges are used for some equity markets.

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

Transfers to the Fund and between the equity and fixed income portfolios are made on the last business day of each month. The return for each month can then be calculated by looking at monthly changes in market value adjusted for incoming and outgoing payments. The geometrical return is used for longer periods, such as quarterly and annual return and return so far this year. This means that the return indices for each sub-period are multiplied. This return is thus a time-weighted return on the returns for 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.[3)]

The return in local currency is obtained by calculating the geometric 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 return differential emerges as an arithmetic 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 models and market values in the accounts are primarily due to different valuation principles for money market investments. Allocations are also made in the accounts to cover remuneration to NBIM.

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1) An article available on Norges Bank's website provides more details about the calculation of returns. See "Performance measurement methodology" published in 2000.
2) Lehman Global Aggregate (LGA) and FTSE for fixed income instruments and equity instruments, respectively.
3) WM/Reuter Closing Spot Rates, fixed at 4 pm London time.

Japanese bonds (primarily government bonds). At end-March 2006, this fund had total assets of USD 874 billion. A number of central banks also invest substantial assets in international capital markets through their foreign exchange reserves. At end-2006, the Chinese central bank's foreign exchange reserves totalled USD 1 066 billion.

Chart 3-4 shows the Fund's average ownership interests in listed companies in three geographic regions, calculated as a share of the market value of the companies in the FTSE index for the countries in which the Fund is invested. At end-2006, the average ownership interest in European companies was 0.63 per cent, in US companies 0.26 per cent, and in Asian/Oceanian companies 0.37 per cent.

Chart 3-5 shows the Fund's ownership interests in the various fixed income markets in each of the three geographic regions,[1)] calculated in relation to the securities in the Lehman Global Aggregate index in the currencies in which the Fund has been invested. The ownership interest is highest in Europe, where the Fund owned 1.07 per cent of all outstanding securities at end-2006. The ownership interests in the Americas and Asia/Oceania were 0.59 per cent and 0.27 per cent respectively.

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1) Up to and including 2001, the benchmark portfolio consisted solely of government bonds. In 2002, the benchmark portfolio was expanded to include non-government-guaranteed sub-indices. This resulted in a sharp fall in ownership interests in relation to the new benchmark portfolio in 2002. With the increase in the fixed income portfolio, NBIM's ownership interests have increased in subsequent years.

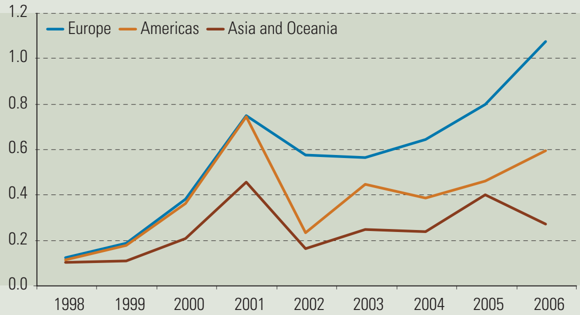


Chart 3-5: The Fund's ownership interests in fixed income markets at 31 December at year-ends 1998-2006 as a percentage of market capitalisation in the Lehman indices
Source: Lehman Brothers

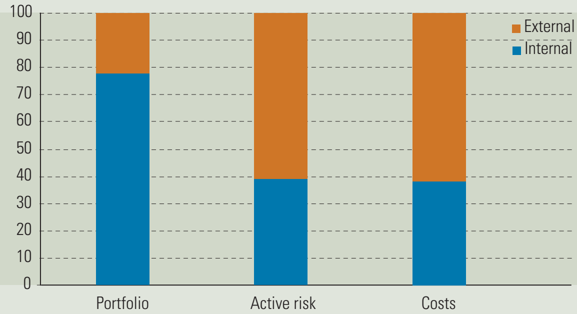


Chart 3-6: Distribution of portfolios, management costs and active risk between internal and external management. Per cent

Table 3-13: Fixed income return for each quarter and for the year 2006. Per cent					
	Measured in terms of the portfolio's currency basket		Measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	–1.13	–1.23	–3.05	–3.15	0.10
Q2	–0.39	–0.43	–2.16	–2.20	0.04
Q3	3.13	3.09	7.45	7.41	0.04
Q4	0.35	0.30	–1.88	–1.93	0.05
2006	1.93	1.68	0.01	–0.23	0.24

3.1.4 Internal and external management

NBIM's management of the Fund's assets is based on an investment philosophy where excess returns are achieved by means of a large number of individual decisions that are independent of one another. The investment philosophy is described in more detail in articles published on Norges Bank's website in 2000 and 2004. 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 over half of the overall active risk-taking, while NBIM, through internal management, seeks to take advantage of the economies of scale inherent in the Fund's size as well as to engage in active management in selected areas.

On average, about 78 per cent of the Fund was managed internally in NBIM in 2006. Internal management costs accounted for about 38 per cent of total management costs.

External management is more expensive than internal management. In 2006, external and internal management costs represented 0.28 per cent and 0.05 per cent, respectively, of the assets under management. Internal managers were responsible for about 39 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 in chart 3-6 is based on a summation of the value at risk (VaR) of each mandate, irrespective of correlation between mandates.

Chart 3-7 shows that the number of external managers and external mandates in the Government Pension Fund – Global, increased in 2006. At end-2006, 50 external managers had a total of 80 mandates.

3.1.5 Fixed income management

The market value of the Fund's fixed income portfolio rose by NOK 241 billion to NOK 1 058 billion in 2006. NOK 239 billion[2)] of new capital was transferred to the portfolio during the year. Positive returns on the fixed income portfolio contributed NOK 19 billion, while a stronger krone in relation to the investment currencies reduced the portfolio's market value in NOK by 17 billion.

The return on the fixed income portfolio in 2006 was 1.93 per cent measured in terms of the currency basket (cf. Table 3-13). The return was negative in the first two quarters of the year, but positive in the final two quarters. The third quarter return was particularly high.

The managers contributed to outperforming the benchmark in every quarter of 2006. The total return on the fixed income portfolio was 0.24 percentage point higher than the return on the benchmark portfolio. About 20 per cent of the excess return was attributable to external management, while approximately 80 per cent was attributable to NBIM's internal management. The total

[2)] As a result of different excess returns in the two asset classes, there were net transfers of capital from the equity to the fixed income portfolio during the year. The net transfer to the fixed income portfolio during the year was therefore higher than transfers from the Ministry of Finance shown in Table 3-3.

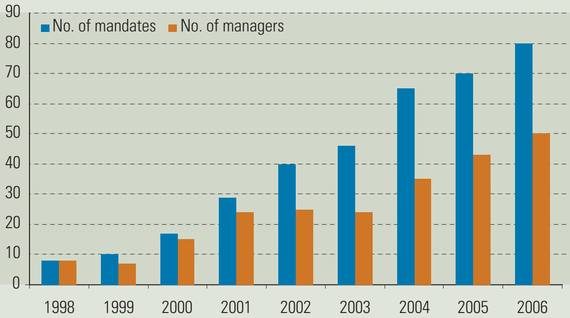


Chart 3-7: Number of external managers and external management mandates

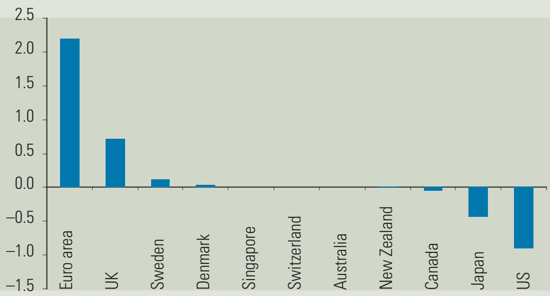


Chart 3-8: Individual countries' contributions to fixed income return in 2006, measured in terms of the currency basket. Per cent

contribution was roughly NOK 2 500 million in 2006.

Chart 3-8 shows how contributions to the fixed income return measured in terms of the currency basket are distributed among the currencies in which the Fund is invested. By far the largest positive contribution came from investments in euro area countries and the UK. Contributions from the other currency areas were small. Investments in Japan and the US made the largest negative contributions. The weak contribution from the US is attributable to the depreciation of USD against the other investment currencies in the course of the year.

Since 1999, aggregate gross excess return on the fixed income portfolio has amounted to approximately NOK 11.5 billion. Of this, 22 per cent, or NOK 2.5 billion, represents the contribution of external managers. Until end-2006, 80 per cent of the specialist units (external mandates and internal groups) made a positive contribution to performance since start-up.

The return figure includes income from securities lending, which is equivalent to 0.04 per cent of the average fixed income portfolio. The figure has not been adjusted for transaction costs in connection with indexing and costs in connection with the investment of new capital in markets.

At the end of 2006, about 89 per cent of the fixed income portfolio was managed internally by NBIM. However, the share of total risk associated with fixed income management that was attributable to internal management was lower. This is because the majority of the external fixed income mandates are managed actively and have a high risk profile.

There are two main types of management. One is indexing and active management that is directly related to the indexing task. The objective of this enhanced indexing is to adjust the portfolio so that it remains relatively close to the benchmark, while taking advantage of special pricing situations to achieve an excess return. Three sub-portfolios are indexed: government-guaranteed bonds, corporate bonds and securitised bonds. The three sub-portfolios are indexed internally, with the exception of securitised bonds in the US, which are managed externally.

The other main area is active management based on an investment philosophy of specialisation and delegation of decisions. This type of management is carried out by both internal and external managers. A group structure has been established to achieve the objective of specialisation. Each group is assigned a mandate with a limited investment universe. The groups are specialised to achieve effective utilisation of risk (through diversification gains). In practice, this is not sufficient to ensure profitability because both quality (information ratio) and scaling possibilities vary between groups. Profitable management thus requires effective diversification, dynamic risk allocation between groups (in relation to information advantages) and critical review of possible scaling obstacles.

In active management, the main distinctions are between micro- and macro-positions and the degree of credit risk. This is reflected in the fixed income management group structure, both internally and externally. As in previous years, the highest excess return generated by fixed income management has been achieved via micro-strategies and active indexing strategies. Elements of credit risk have also been important for value added. The most important reason for not increasing the risk-taking in these strategies is a lack of profitability at group level (within a reasonable horizon). At the same time, increased breadth and specialisation imply a constant need to expand the investment universe at instrument level. This is a challenge in purely operational terms, and requires a dynamic organisational structure and expertise.

Each manager in a group is given a risk limit. There is very little overall coordination of positions, and there is no overriding market view that restricts the positions in the portfolio. All positions may be attributed to one owner.

External fixed income managers at 31.12.006
(including funds)

At the end of the year, 22 external fixed income managers with 35 mandates managed total assets of NOK 126 billion.

- Advantus Capital Mangement Inc
- Aspect Capital Ltd.
- Babson Capital Management LLC
- Barclays Global Investors N.A.
- Bridgewater Associates Inc
- Daiwa SB Investments (UK) Ltd.
- Delaware Investment Advisers
- Ellington Management Group, LLC
- European Credit Management Ltd.
- Hyperion Capital Management Inc
- Insight Investment Management (Global) Ltd.
- Lehman Brothers Asset Management LLC
- Morgan Stanley Investment Management
- Nomura Asset Management U.K. Ltd.
- PanAgora Asset Management Inc
- Pareto Partners
- Putnam Advisory Company LLC
- Smith Breeden Associates Inc
- State Street Global Advisors
- TCW Asset Management Company
- Greylock Capital Management LLC (fond)
- Smith Breeden Credit Partners LLC (fund manager)

Table 3-14: The return on the equity portfolio for each quarter and for 2006 as a whole. Per cent

	Return measured in terms of the portfolio's currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	7.17	6.86	5.08	4.79	0.29
Q2	–3.31	–3.00	–5.02	–4.72	–0.30
Q3	5.14	5.57	9.54	9.99	–0.45
Q4	7.43	7.00	5.04	4.62	0.41
2006	**17.04**	**17.09**	**14.84**	**14.89**	**–0.05**

In 2006, the hit ratio was generally very high at the group, mandate and personal level. This more than outweighed the relatively conservative risk-taking through the year and is consistent with previous experience marked by high quality and moderate risk-taking. Even with a substantial improvement in results measured in NOK, this was not sufficient to make up for the portfolio growth, so that results measured in basis points were somewhat lower than in the two previous years.

An important element of the investment strategy is to diversify among many independent positions. NBIM achieves this diversification by selecting independent specialists, both internally and externally. At the end of 2006, there were 45 specialist mandates within fixed income management, ten of which were internal. Eleven new external mandates were allocated in 2006.

NBIM considers the choice of external managers to be an investment decision, where different mandates receive capital allocations or are terminated on the basis of liquidity analyses and expected future excess returns. At the end of 2006, NBIM had 35 different externally managed mandates. The majority of these are regional specialist mandates.

3.1.6 Equity management

The market value of the equity portfolio increased from NOK 582 billion to NOK 726 billion in 2006. NOK 50 billion[3)] in new capital was transferred to the portfolio during the year. Gains in equity markets were high and market returns increased the value of the portfolio by NOK 106 billion. A stronger krone in relation to the investment currencies reduced the portfolio's market value by about NOK 12 billion.

Table 3-14 shows that the return on the equity portfolio measured in terms of the Fund's currency basket was 17.04 per cent in 2006. The return was positive for all quarters of the year except the second.

Chart 3-9 shows the various markets' contributions to the return on the Fund's equity portfolio in 2006 measured in terms of the currency basket. The euro countries, the UK and the US made the largest positive contributions.

The actual return on the equity portfolio was 0.05 percentage point lower than the benchmark return. In the second quarter, the whole excess return of the first quarter was reversed, while the substantial negative excess return in the third quarter was almost cancelled out in the fourth quarter. The months May to July were particularly negative for the portfolio. In these figures, account is not taken of the transaction costs associated with excluding individual companies, or the costs of phasing in new capital into the Fund's equity portfolio. Nor is account taken of the costs associated with changing the share of the portfolio invested in Asia. These costs accounted for 0.5, 3.2 and 1.3 basis points of the results.

In 2006, the return on the externally managed portfolios was far weaker than expected. The external managers lost a total of NOK 6.1 billion compared with their benchmark portfolios. 2006 is the

[3)] There were net transfers of capital from the equity to the fixed income portfolio during the year. Net transfers to the equity portfolio during the year were therefore lower than the transfers from the Ministry of Finance shown in Table 3-3.

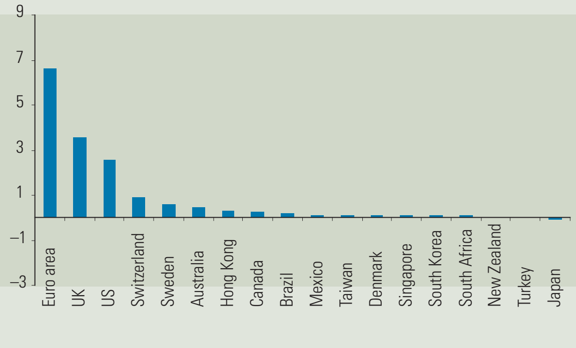


Chart 3-9: The individual countries' contributions to equity returns measured in terms of the currency basket in 2006. Per cent

first year since the inception of the Fund that the externally managed portfolios underperformed the benchmark portfolio. Almost half of the negative excess returns is attributable to the mandates in Japan. Both regional and sector mandates contributed negatively as groups. The weak results in 2006 must be considered in relation to exceptional performance in 2005. The negative contributions from both the European and Asian regional mandates, and from the sector mandates, were far smaller than the positive excess return contributed by the same groups in 2005. It is normal to evaluate manager performance based on a long-term assessment horizon, and losses of this order have to be expected in occasional unfavourable years.

At end-2006, NBIM had 45 different externally managed equity mandates distributed among 27 fund managers. Of these mandates, 30 represented regional and country-specific mandates and 15 represented various industry sectors. At year-end, the share of the equity portfolio under external management was unchanged at 37.7 per cent. The market value of the aggregate externally managed portfolio increased by 24 per cent, from NOK 217 billion to NOK 271 billion.

The share of the external portfolio allocated as specialist mandates in industry sectors rose somewhat in 2006, to 29 per cent. There were unusually extensive changes in these mandates, owing to the termination of many of the smaller sector mandates in connection with a major portfolio reorganisation, and not to performance. In 2006, new specialist mandates were awarded for countries like Canada and China, and NBIM also allocated three global mandates.

The internal management strategies delivered an excess return of NOK 5.6 billion. Thus, the underperformance of the external mandates was nearly offset by the excess return of the internal mandates. At the end of the year, 62.3 per cent of the equity portfolio was managed in an internal indexing portfolio. The remainder of the internal active management has been built up gradually over the past few years and currently comprises 24 portfolio managers who use fundamental analysis of companies in the industry sectors finance, telecommunications, energy, and consumer services globally, as well as relative value and strategy mandates. Of all the mandates within these three strategies, plus the active indexing mandates, which were managed throughout the year, 88 per cent were on the plus side. This is higher than in 2005, but somewhat lower than in 2004, and far higher than can be expected over time.

At the beginning of the year, the internal portfolios accounted for approximately 30 per cent of the total risk in the equity portfolio, a share that was unchanged at the end of the year. This share will increase somewhat in the year ahead. Experiences of internal equity management and the results of the past five years are described in more detail in a separate feature article.

Equity management underwent sub-

External equity managers at 31.12.06

At the end of the year, 28 external equity managers with 45 mandates managed assets equivalent to NOK 271 billion.

Regional mandates:

- Aberdeen Asset Management
- Alliance Bernstein LP
- Altrinsic Global Advisors, GLB
- APS Asset Management Pte Ltd.
- Atlantis Fund Management Ltd.
- BlackRock International Ltd.
- Capital International Ltd.
- Dalton Capital (Guernsey) Ltd. (FunNex)
- Fidelity Pensions Management
- Gartmore Investment Management PLC
- GLG Partners
- Intrinsic Value Investors LLP
- Legg Mason Capital Management Inc
- Massachussetts Financial Services Company
- 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 PLC

Sector mandates:

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

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

stantial changes in the course of 2006. The most important of these were a further reduction in transaction costs, both direct (taxes, excise duties and commissions) and indirect (market impact and opportunity costs). Considerable emphasis was placed on increasing the share of transactions made directly in relation to stock exchanges. Algorithm trading was implemented, and new methods of borrowing and lending equities were introduced. Changes were also made in the IT-system architecture, and outsourcing of a large part of system operations commenced.

3.1.7 Risk

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

Investments in international securities markets entail considerable market risk and a relatively high probability of wide variations in annual financial 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 share of equities in the portfolio, fluctuations in equity prices, exchange rates and the general interest rate level, 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 only led to 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.

NBIM also faces a number of operational risk factors. There is the risk of financial losses or an impaired reputation as a result of a failure in internal procedures, human error or system error, or other losses that are due to external factors that are not a consequence of the market risk in the portfolio.

Market risk

Market risk of the Fund is largely determined by the market risk of the benchmark portfolio. NBIM also takes on some risk through its active management. NBIM measures the Fund's absolute and relative market risk. The standard deviation of the return on the actual portfolio is used to measure absolute risk, and the standard deviation of the difference between the returns on the actual portfolio and the benchmark portfolio is used to measure relative risk. Standard deviation is a statistical concept that provides some indication of the variations in return that may be expected in normal periods. It is one of the most common measures of portfolio risk.

Chart 3-10 shows developments in the Fund's absolute market risk during the past four years, measured as expected tracking error. The level fluctuates with market volatility, but the actual portfolio risk and the benchmark risk differs only slightly through the entire period. At the end of 2006, the actual portfolio had an absolute market risk, measured in NOK, of 7.5 per cent, which is somewhat higher than at the beginning of the year.

At year-end, the value of the actual portfolio was NOK 1 784 billion. Historical return figures provide grounds for expecting an annual return on the Fund of 6.5 per cent. Given the estimated absolute tracking error at the end of the year, the return in two of three years may be expected to be 7.5 percentage points higher or 7.5 percentage points lower than the expected market value. Translated into NOK, assuming no transfers of new capital, and including expected historical return, this means that with a 68 per cent probability, the value of the Fund in any one year will be between NOK 1 757 billion and NOK 2 042 billion.

Absolute market risk is largely determined by the Fund's benchmark portfolio. The Ministry of Finance has also set a limit for expected tracking error in management which limits how much the Fund's portfolio can differ from the benchmark portfolio.

This expected tracking error shall always be less than 1.5 percentage points (150 basis points) (see box). The Fund's tracking error was relatively stable until summer 2006, when it increased appreciably as a result of the higher absolute

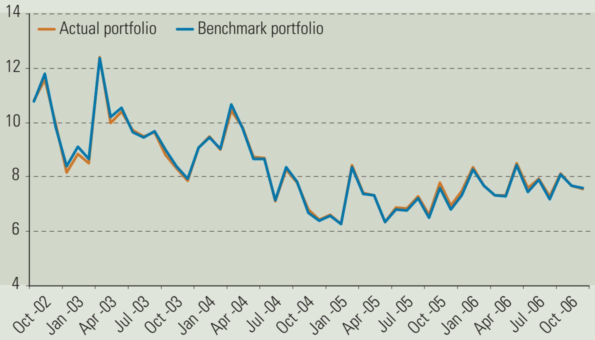


Chart 3-10: Absolute market risk in the Government Pension Fund—Global. Month-end. Per cent

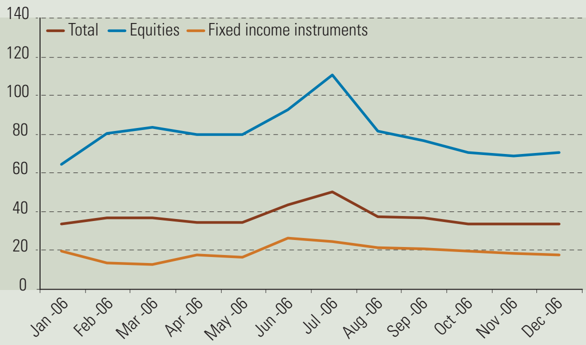


Chart 3-11: Expected tracking error at each month-end in 2006. Basis points

Expected tracking error

The Ministry of Finance has set the limit for relative market risk in the management of the Petroleum 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 returns on the actual portfolio and 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.

volatility of the equity portfolio (see Chart 3-11). In the second half of the year, the relative risk of the equity portfolio fell, and as a result the Fund's risk also fell back to the level at the start of the year. At the end of 2006, it was 0.28 per cent for the total portfolio.

Chart 3-12 shows developments in tracking error between the actual portfolio and the benchmark portfolio since 1999. Two different measures of risk are used in the chart. Expected tracking error is calculated in advance on the basis of market volatility during the past few years. This risk measure shows relatively small variations over time and during the entire period has been well below 1.5 percentage points, which is the upper limit set by the Ministry of Finance for NBIM's risk-taking in connection with the management of the Fund. Actual tracking error is calculated retrospectively on the basis of the variation in the actual return differential in the past 12-month period. The two measures show very different levels of risk-taking in 2000 when there were unusually large fluctuations in stock prices for companies with similar risk properties. During the past six years the two measures show roughly the same level of risk-taking.

NBIM is testing whether 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 3-13. The points in the chart show the realised monthly excess return since October 2002 (diamonds) and the confidence interval measured by the standard deviation. The model indicates that in approximately 67 per cent of the cases, the actual return should be within the interval formed by the green lines. The model further indicates that in 95 and 99 per cent of the cases, the actual return should be within the intervals defined by the orange and red lines respectively. The chart indicates that the actual return is in line with what might be expected on the basis of the risk model used. Analyses of longer time series provide similar results.

Credit risk

Credit risk arises in the Fund's fixed income portfolio, partly as a result of the Ministry of Finance's 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 counterparty risk, risk vis-à-vis custodian institutions, and risk vis-à-vis international settlement and payment systems (counterparty risk).

The regulation on the management of the Fund stipulates the countries and/or currencies in which the Fund's portfolio of fixed income instruments may be invested. Special rules apply to bonds issued by the government sector in other countries, but in a currency used by one of the countries or areas specified in the regulation. Up to 0.5 per cent of the market value of the fixed income portfolio may be invested in bonds issued by the government sector with ratings of BB, Ba, BB as their highest long-term credit rating from at least one of the three international credit rating agencies Fitch, Moody's and Standard & Poor's (S&P) respectively. There are no credit rating requirements for bonds issued by others than the government sector. Table 3-15 shows the Fund's fixed income portfolio by credit rating.

The equity and fixed income portfolios include investments in unsecured bank deposits and unlisted derivatives. The Ministry of Finance has decided that no counterparties involved in such

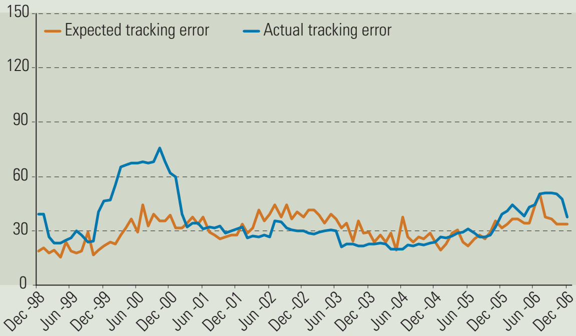


Chart 3-12: Expected and actual tracking error at the end of each month. 1999-2006. Basis points

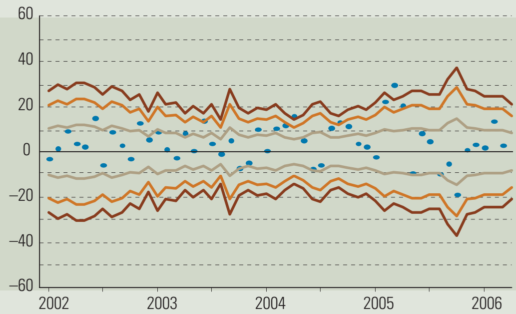


Chart 3-13: Confidence interval for risk and realised excess return. Basis points

transactions may have a credit rating lower than A-, A3 or A- from Fitch, Moody's or S&P respectively.

Operational risk

Market risk and credit portfolio risk are important factors in connection with the establishment of an investment strategy and in active management. The objective is to achieve the highest possible risk-adjusted return and not necessarily the lowest possible risk. On the other hand, operational risk is an intrinsic risk, and there is not necessarily a payback for taking higher risk. At the same time, it is often necessary to take somewhat higher operational risk in order to achieve the objectives set. The objective is low operational risk in the execution of the assignment in order to achieve the highest possible return. NBIM uses recognised standards and current market practice to identify and monitor operational risk. It is more difficult to quantify operational risk than market risk and credit portfolio risk.

Operational risk cannot be isolated from market and credit portfolio risk, but it is more comprehensive and affects the entire organisation. NBIM has defined operational risk as the risk of financial loss or loss of reputation as a result of a failure in internal procedures, human error or system error, or other losses that are due to external factors that are not a consequence of market risk in the portfolio. Examples of risk categories are errors in transaction settlements, in our ability to recruit and retain employees with the right expertise, down-time in IT systems or failure to deliver by external suppliers.

Norges Bank has decided that Kredittilsynet's (Financial Supervisory Authority) regulation on internal control in financial institutions shall be complied with. It has been adapted to the Bank's management system. In 2006, NBIM established a new framework for managing operational risk based on COSO[4] and the Bank's own internal control guidelines. The framework is used by all parts of the organisation, and clear lines of responsibility have been established for the management of operational risk. A risk analysis is to be performed annually, or in connection with major changes in, for example, organisation or infrastructure. The analysis consists of an established procedure inluding description of work processes, identification of main risks, ranking of risks according to a set of criteria, identification of risk indicators and corrective action and measurement of the effect of the corrective action. The risk picture is updated through the year, and the risk indicators are measured regularly.

Credit rating agencies

All fixed income instruments in the Fund's benchmark index have a rating from one of the two large rating agencies S&P and Moody's. The Ministry of Finance has also decided that the Fund may also invest in companies with a rating from 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 from S&P and Fitch is AAA, and from Moody's, Aaa. The lowest investment grade ratings are BBB from S&P and Fitch and Baa from Moody's. Lower ratings are termed speculative grade. All bonds in the Fund's benchmark portfolio have a rating of investment grade.

The issuers pay these agencies to provide credit ratings. The agencies consider the issuer's ability to repay debt and the general security for investors that is 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 only rate 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 may be issued without a credit rating from one or more of the agencies.

Table 3-15: The fixed income portfolio at 31.12.06. By credit rating. Per cent of market value

Moody's		Standard & Poor's	
Rating	Percentage of total	Rating	Percentage of total
Aaa	56.84	AAA	54.73
Aa	15.75	AA	10.18
A	14.88	A	18.50
Baa	7.57	BBB	8.40
Ba	0.46	BB	0.56
Lower	0.16	Lower	0.16
No rating	4.34	No rating	7.47

Fund management guidelines

The Ministry of Finance has issued a number of guidelines for the management of the Government Pension Fund

[4] In 1992, COSO (the Committee of Sponsoring Organisations of the Treadway Commission) established an internal control framework that 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.

Table 3-16: The regulation's risk exposure limits

	Risk	Limits	Actual				
			31.12.05	**31.03.06**	**30.06.06**	**30.09.06**	**31.12.06**
§ 5	Market risk	Maximum tracking error 1.5 percentage point	0.33	0.34	0.50	0.33	0.28
§ 4	Asset mix	Fixed income instruments 50-70 %	58.4	59.1	59.8	59.8	59.3
		Equity instruments 30-50 %	41.6	40.9	40.5	40.2	40.7
§ 4	Market distribution, equities*	Europe 40–60 %	47.3	48.5	49.0	49.1	50.1
		Americas and Africa 25–45 %			36.1	35.5	34.4
		Asia and Oceania 5–25 %			14.9	15.4	15.5
		Americas, Africa, Asia and Oceania 40-60 %	52.7	51.5			
	Currency distribution fixed income instruments*	Europe 50–70 %	55.1	55.5	60.8	59.8	60.4
		Americas and Africa 25–45 %	34.8	34.2	32.6	34.7	34.3
		Asia and Oceania 0–15 %	10.1	10.4	6.6	5.5	5.3
§ 6	Ownership interest	Maximum 5% of a company	2.7	3.9	4.7	4.5	4.5

* The Ministry of Finance changed the regional weights in 2006 (cf. section 3.11.1)

– Global. Table 3-16 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.

There was one minor breach of the guidelines during the year when an external manager bought equities in an unlisted company. The breach was rapidly discovered, and the manager unwound the position immediately.

3.1.8 Costs

Table 3-17 shows the costs of managing the Fund in 2006. 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 shared 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 are calculated in accordance with the guidelines that 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 2006, remuneration shall 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 perfermance-based

Table 3-17: Management costs in 2006. In thousands of NOK and basis points of the average portfolio

	2006		2005	
	NOK 1 000	Basis points	NOK 1 000	Basis points
Internal costs. equity management	223 889		169 438	
Costs of equity custodians and fund administration	95 689		54 629	
Total costs, internal equity management	**319 578**	**8.1**	**224 067**	**7.8**
Internal costs, fixed income management	184 178		165 243	
Costs of fixed income custodians and fund administration	79 858		57 729	
Total costs, internal fixed income management	**264 036**	**3.2**	**222 973**	**3.6**
Minimum fees to external managers	431 829		360 509	
Performance-based fees to external managers	387 816		320 182	
Other costs, external management	122 340		110 951	
Total costs, external management	**941 985**	**28.3**	**791 642**	**31.1**
Total all management costs	**1 525 599**	**9.8**	**1 238 681**	**10.6**
Total management costs, excluding performance-based fees	**1 137 784**	**7.3**	**918 499**	**7.8**

fees paid to external fund managers. Norges Bank has entered into agreements concerning performance-based fees with the majority of external active managers, in accordance with principles approved by the Ministry of Finance.

Management costs in 2006 totalled NOK 1 525.6 million. There was a decline from 10.6 basis points in 2005 to 9.8 basis points in 2006 in relation to the average portfolio under management. Excluding performance-based fees to external managers, Norges Bank's management costs came to NOK 1 137.8 million in 2006, a 24 per cent increase on 2005. The average size of the Fund increased by 33 per cent, so that costs in relation to the average portfolio fell from 7.8 basis points in 2005 to 7.3 basis points in 2006.

Costs can be distributed between internal and external management by using a cost distribution key for internal and custodian costs. Approximately 62 per cent of the costs were related to external management, while about 21 per cent of the Fund's assets are under external management. Unit costs for internal management were roughly 0.05 percentage point, compared with 0.28 percentage point for external management. This is partly attributable to the fact that index management is largely internal.

Recorded performance-based fees to external managers increased by 21 per cent from 2005 to NOK 320.2 million in 2006. The accounts show the costs actually accrued in 2006. Most performance-based fees to external managers are based on the average excess return achieved over a period of several years, so that there is no direct relationship between recorded costs and excess return achieved in a single year. Although external managers contributed negatively to the excess return in 2006, a higher performance-based fee was paid in 2006 than in 2005. This is largely because of the favourable results achieved by external managers in 2005 and earlier years. Total costs for external management amounted to 28.3 basis points of the average assets under external management.

Cost comparisons with other funds

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

The latest analysis the Ministry of Finance received from CEM concerned management in 2005. 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 -2005 (Basis points)

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

3.2 Norges Bank's foreign exchange reserves

3.2.1 Mandate

The foreign exchange reserves shall be available for interventions in the foreign exchange market in connection with the implementation of monetary policy and 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. In November 2005, the Executive Board decided to increase the equity portion of the investment portfolio from 30 per cent to 40 per cent. The phase-in to increase the equity portion was completed on 30 April 2006. With effect from 1 January 2006, the Executive Board decided that the maximum ownership interest in any one company shall be 5 per cent, compared with 3 per cent earlier. If the combined holdings in the foreign exchange reserves and the Government Pension Fund – Global exceed 5 per cent, a separate report must be submitted to the Executive Board.

The Executive Board has laid down joint guidelines for corporate governance of the two Funds, and has also ruled that companies which the Ministry of Finance

Table 3-18: Benchmark portfolio on 31.12.06. 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**	**41.1**	**60.0**	**58.9**
Belgium		0.8		
Finland		0.9		
France		8.4		
Greece		0.5		
Ireland		0.6		
Italy		3.4		
Netherlands		2.7		
Portugal		0.3		
Spain		3.5		
Germany		5.8		
Austria		0.4		
Euro area		*27.3*		*47.2*
UK		17.3		9.6
Denmark		0.6		0.9
Switzerland		5.1		0.6
Sweden		2.1		1.1
Total Europe	**50.0**	**52.3**	**58.0**	**59.3**
US		29.9		32.4
Brazil		0.7		
Canada		1.9		3.6
Mexico		0.4		
South Africa		0.6		
Total Americas and Africa	**35.0**	**33.5**	**37.0**	**36.0**
Australia		2.2		0.2
Hong Kong		1.2		
Japan		8.1		4.5
New Zealand		0.1		
Singapore		0.4		
South Korea		1.3		
Taiwan		1.0		
Total Asia and Oceania	**15.0**	**14.2**	**5.0**	**4.7**

Table 3-19: Market value of the investment portfolio in 2006. In millions of NOK

	31.12.2005	31.03.2006	30.06.2006	30.09.2006	31.12.2006
Equity portfolio	70 669	83 495	79 754	87 672	92 143
Fixed income portfolio	140 817	129 174	125 934	135 407	132 374
Total portfolio	**211 486**	**212 670**	**205 688**	**223 079**	**224 517**

has decided to exclude from the Pension Fund shall also be excluded from the foreign exchange reserves. Section 4.1 provides an overview of corporate governance in 2006, and Section 4.2 provides an overview of the companies that have been excluded from the investment universe.

The strategic benchmark portfolio for the investment portfolio is composed of FTSE equity indices for large and medium-sized companies in 27 countries and of Lehman Global Aggregate fixed income indices in the currencies of 18 countries. Equities account for 40 per cent of the Fund's strategic benchmark portfolio, while fixed income instruments account for 60 per cent. 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 58 per cent in Europe, 37 per cent in the Americas and 5 per cent in Asia/Oceania.

Table 3-18 shows the weights in the actual benchmark at 31 December 2006. The weights in the fixed income benchmark apply to the currency in which the securities are issued. Therefore, the weight for each country in the euro area is not listed.

3.2.2 Return in 2006

The investment portfolio's market value was NOK 224.5 billion at the end of 2006, an increase of NOK 13.0 billion since the beginning of the year. During the year, a total of NOK 2.0 billion was transferred from the money market portfolio of the foreign exchange reserves to the investment portfolio. The return on investments totalled NOK 15.5 billion in 2006, while a stronger krone in relation to the investment currencies led to a reduction of NOK 4.5 billion in the portfolio's market value. The negative contribution from a stronger krone has no effect on the international purchasing power of the foreign exchange reserves. Table 3-19 shows the size of the equity and fixed income portfolios at the end of each quarter in 2006.

Chart 3-14 shows developments in the portfolio's market value since 1998, measured in NOK.

The return on the investment portfolio in 2006 was 7.30 per cent measured in terms of the benchmark portfolio's currency basket and 5.2 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, resulting in a depreciation of the portfolio's currency basket in relation to the krone.

Table 3-20 presents the return figures.

Table 3-20: Return on the investment portfolio by quarter and for 2006 as a whole. Per cent

	Return measured in terms of the portfolio's currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Excess return
Q1	1.62	1.54	−0.37	−0.45	0.08
Q2	−1.53	−1.48	−3.28	−3.24	−0.04
Q3	4.10	4.09	8.46	8.44	0.01
October	1.47	1.44	2.52	2.50	0.03
November	0.79	0.78	−3.07	−3.07	0.00
December	0.72	0.67	1.27	1.23	0.04
Q4	3.00	2.92	0.64	0.57	0.08
2006	**7.30**	**7.17**	**5.18**	**5.05**	**0.13**

Table 3-21: Contributions to gross excess return in 2006. Percentage points

	External management	Internal management	Total	Excess return in each asset class
Equity portfolio	–	−0.08	−0.08	−0.23
Fixed income portfolio	0.02	0.19	0.21	0.33
Total investment portfolio	**0.02**	**0.11**	**0.13**	

Table 3-22: Estimated net value added by active management. Percentage points

Gross excess return	**0.13**
+ Transaction costs associated with indexing	0.04
+ Other transaction costs	0.02
- Extra costs of active management	0.03
- Lending revenues associated with passive management	0.04
= Value added by active management	**0.11**

The actual return in 2006 was 0.13 percentage point higher than the benchmark return and amounted to NOK 271 million.

Table 3-21 shows that internal fixed income management in particular contributed positively to the overall excess return of the portfolio.

Chart 3-15 shows the return on the investment portfolio since 1998 measured in international currency. The return has been positive in 29 of 36 quarters.

The gross excess return of 0.13 percentage point for the portfolio as a whole is comparable to the excess return reported by other managers. However, it does not provide an expression of NBIM's net contribution to management performance. The investment portfolio could have been managed passively and could have been kept very close to the benchmark at all times. Instead, NBIM has chosen to engage in active management, which involves higher costs but also higher expected returns. The value added by active management, which is estimated in Table 3-22, is a measure of the net contribution of this strategy to the portfolio's return in 2006.

The starting point is the portfolio's gross excess return. If passive indexing is employed, transaction costs will accrue when the composition of the benchmark is changed. Normal transaction costs associated with indexing are estimated at about 0.04 percentage point of the total portfolio.

When estimating gross excess return, the costs of phasing in new capital into the markets, adjusting the actual portfolio when companies are excluded from the investment universe and other changes in the benchmark portfolio are not taken into account. For 2006, NBIM has estimated the costs of phasing in new capital at NOK 9 million, the costs of disposal in connection with the exclusion of companies at NOK 1 million, and the costs associated with adjustments in the benchmark at NOK 26 million. The combined transaction costs amount to just under 0.02 per cent of the portfolio's market value.

Passive indexing of the portfolio would also involve some operating costs associated with portfolio management.

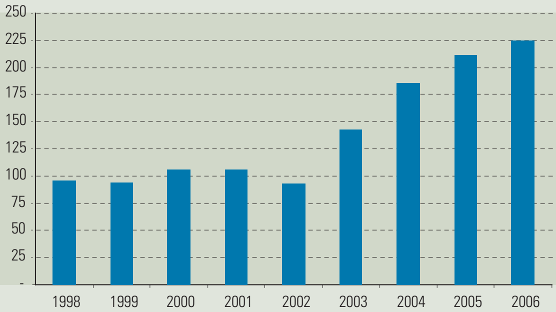


Chart 3-14: Market value of the investment portfolio 1998-2006. In billions of NOK

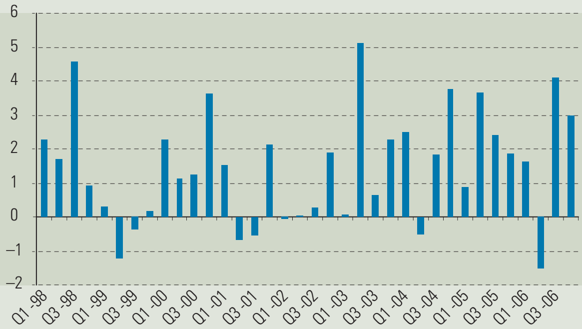


Chart 3-15: Quarterly return measured in international currency. 1998-2006. Per cent

Table 3-23: Excess return on the investment portfolio each year in the period 1998 -2006 and the average for the period. Percentage points

	1998	1999	2000	2001	2002	2003	2004	2005	2006	Average 1998-2006
Gross excess return	–0.03	0.13	0.12	0.15	0.32	0.58	0.08	0.35	0.13	0.20
Value added through active management*	–0.03	0.10	0.10	0.13	0.29	0.55	0.09	0.31	0.11	0.18

* Gross excess return less active management costs and securities lending revenues. but including estimated transaction costs due to ordinary indexing and the phasing in of new capital.

For the investment portfolio, the normal management costs associated with indexing may be estimated at 0.03 percentage point of the total portfolio. In 2006, total management costs amounted to 0.06 percentage point, i.e. the extra costs associated with active management are estimated at 0.03 percentage point. On the other hand, with passive management there would also have been some revenues from securities lending, which are estimated at 0.04 percentage point in 2006.

With these items, the net value added by active management in 2006 is estimated at 0.12 percentage point or about NOK 250 billion.

The first line of Table 3-23 shows that the gross excess return was 0.13 percentage point in 2006 and that the annual average since 1998 is 0.20 percentage point. This is equivalent to NOK 2.1 billion for the period as a whole.

Line 2 of the table shows net value added through active management. The method used to calculate this is described above. The average net contribution to the excess return for the period 1998-2006 was 0.18 percentage point.

When evaluating the quality of active management, it is also important to consider the market risk involved in achieving the excess return. The Executive Board's guidelines for the investment portfolio stipulate that market risk, defined as the deviation from the benchmark portfolio, shall not exceed an expected tracking error of 1.5 percentage point.

Chart 3-16 shows developments in the market risk of the actual portfolio relative to the market risk of the benchmark portfolio since 1999.

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

This risk measure shows relatively small variations over time, and expected tracking error has been well below the upper limit set by the Executive Board for risk-taking in connection with the management of the portfolio during the entire period. The actual tracking error (ex post) is calculated retrospectively on the basis of the variation in the actual return differential in the past 12-month period.

The information ratio is one indicator of skills in investment management. It is calculated as the ratio of the annual excess return to the excess risk taken in relation to the benchmark (measured by tracking error). In other words, the information ratio shows how much excess return is achieved for each unit of risk. During the period from June 1998 (when responsibility for management was transferred to NBIM) until the end of 2006, the average information ratio for the investment portfolio was 0.82. See also Table 1-3 in Part I for an overview of the return on and risk associated with the portfolio in recent years.

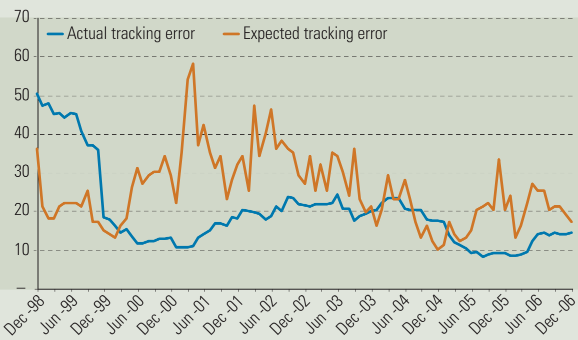


Chart 3-16: Expected and actual tracking error at the end of each month. 1999-2006. Basis points

Fixed income management

The market value of the fixed income portfolio fell by NOK 8.4 billion to NOK 132.4 billion in the course of the year. The value of the portfolio fell by NOK 7.8 billion when the equity share of the investment portfolio was increased from 30 to 40 per cent during the year. A stronger krone in relation to the investment currencies reduced the portfolio's market value by NOK 2.6 billion. A positive return on investments increased

External fixed income managers at 31.12.06

At the end of the year, 11 external fixed income managers with 17 mandates managed total assets of NOK 24 billion.

- Barclays Global Investors N.A.
- Bridgewater Associates Inc
- Hyperion Capital Management Inc
- Lehman Brothers Asset Management LLC
- Morgan Stanley Investment Management
- PanAgora Asset Management Inc
- Pareto Partners
- Putnam Advisory Company LLC
- Smith Breeden Associates Inc
- State Street Global Advisors
- TCW Asset Management Company

Table 3-24: Fixed income return for each quarter and for the year 2006. Per cent

	Return measured in terms of the portfolio's currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Return differential
Q1	–1.13	–1.29	–3.07	–3.22	0.15
Q2	–0.47	–0.50	–2.25	–2.27	0.02
Q3	3.20	3.12	7.52	7.44	0.08
Q4	0.27	0.19	–2.03	–2.10	0.07
2006	**1.83**	**1.49**	**–0.18**	**–0.51**	**0.33**

Table 3-25: Return on the equity portion of the investment portfolio in 2006. Per cent

	Return measured in terms of the portfolio's currency basket		Return measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Return differential
Q1	6.81	6.87	4.72	4.77	–0.05
Q2	–3.14	–2.99	–4.87	–4.72	–0.15
Q3	5.51	5.60	9.93	10.02	–0.09
Q4	7.21	7.11	4.76	4.66	0.09
2006	**17.03**	**17.26**	**14.72**	**14.95**	**–0.23**

Table 3-26: Bond portfolio at 31.12.06 by credit rating. Percentage of market value

Moody's		Standard & Poor's	
Rating	Percentage of total	Rating	Percentage of total
Aaa	55.88	AAA	54.05
Aa	20.00	AA	10.63
A	11.59	A	16.39
Baa	5.98	BBB	6.81
Ba	1.66	BB	2.16
Lower rating	0.97	Lower rating	0.68
No rating	3.92	No rating	9.28

the value by NOK 2.0 billion.

At the end of the year, about 84 per cent of the portfolio was managed internally in Norges Bank. The management strategies used include enhanced indexing, where the primary objective is to achieve a market exposure that is in line with the benchmark, and active strategies that are designed to outperform the benchmark. Approximately 16 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 bonds in the US have also been assigned to external managers.

Table 3-24 shows the return on the fixed income portfolio in 2006. The return was 1.83 per cent measured in international currency. The gross excess return was 0.33 percentage point. Internal fixed income management in particular made a positive contribution to the return, although the external managers also made a positive contribution.

Equity management

At the end of 2006, the market value of the equity portfolio was NOK 92.1 billion, an increase of NOK 21.5 billion in the course of the year. High equity market returns contributed NOK 13.5 billion to the increase. A total of NOK 9.8 billion was transferred to the portfolio. NOK 2.0 billion was transferred from the money market portfolio and NOK 7.8 billion was transferred from the fixed income portfolio in connection with the increase in the equity portion. A stronger krone in relation to the investment currencies reduced the portfolio's market value by NOK 1.8 billion.

The whole equity portion of the investment portfolio is managed internally, largely by means of active indexing and relative value strategies. However, the portfolio has also been adjusted to reflect parts of the risk profile in the external mandates. This had a negative effect in 2006.

Table 3-25 shows the return on the equity portfolio in 2006. The return was 17.0 per cent measured in international currency, or 0.23 percentage point below the benchmark portfolio. Account is not taken in these figures of transaction costs associated with the exclusion of individual companies. Nor is account taken of the costs of increasing the equity portion of the investment portfolio from 30 to 40 per cent. These costs accounted for 0.2 and 4.1 basis points of the results.

3.2.3 Risk

The Executive Board's guidelines define a limit for the market risk associated with the actual portfolio compared with the benchmark portfolio. This relative market risk shall always be less than 1.5 percentage points expected tracking error. Chart 3-17 shows that relative market risk remained well within this limit throughout 2006. At the end of the year, expected tracking error was 0.17 percentage point.

Table 3-26 shows the composition of the bond portfolio (fixed income portfolio excluding cash) based on Moody's and Standard and Poor's (S&P) credit ratings. In the table, government bonds and government-guaranteed bonds without credit ratings have been assigned the credit rating of the issuer country.

Table 3-27 provides an overview of risk and market exposure in the investment portfolio in 2006. The table shows

Table 3-27 Key figures for risk and exposure

Risk		Actual				
		31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Market risk (percentage points)	Tracking error	0.31	0.16	0.25	0.21	0.17
Asset mix	Fixed income	66.58	60.74	61.23	60.70	58.96
	Equities	33.42	39.26	38.77	39.30	41.04
Market distribution equities	Europe	48.56	50.00	50.91	51.18	52.40
	Americas	39.79	36.58	35.58	35.51	34.61
	Asia and Oceania	11.65	13.42	13.51	13.31	12.99
Market distribution fixed income	Europe	52.79	56.43	61.34	58.42	59.70
	Americas	39.28	37.38	32.44	35.70	35.01
	Asia and Oceania	7.93	6.19	6.22	5.88	5.29
Ownership stake (per cent)	Largest ownership stake 5 %	0.97	0.68	0.82	0.95	1.23

that at the end of each quarter portfolio management has complied with the limits for market risk and ownership interest laid down in the Executive Board's guidelines. There was a minor breach of the Executive Board's guidelines in the third quarter. The fixed income benchmark was incorrectly weighted for Canadian fixed income instruments. The weighting was corrected and did not cause a loss for the Fund.

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 the Government Petroleum Insurance Fund as well as the foreign exchange reserves' investment portfolio and buffer portfolio. The fees of 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 that apply to business operations at Norges Bank.

The costs of managing the investment portfolio amounted to NOK 130 million in 2006. This included performance-based fees to external managers. The costs were equivalent to 0.06 percentage point of the average portfolio under management.

3.2.4 The buffer portfolio

Table 3-28 provides an overview of transfers of capital to the buffer portfolio and transfers from the buffer portfolio to the Government Pension Fund – Global in 2006. NOK 166.5 billion was transferred to the portfolio from the State's Direct Financial Investment in petroleum activities (SDFI) in the course of the year. In addition, foreign exchange for a total of NOK 121.9 billion that was purchased by Norges Bank in the market was added to the portfolio.

A total of NOK 288.3 billion was transferred to the Government Pension Fund – Global in 2006.

At the end of 2006, the market value of the buffer portfolio was NOK 23.7 billion, compared with NOK 24.1 billion on 31 December 2005. The fourth quarter return on the buffer portfolio was -1.2 per cent measured in NOK. This is equivalent to NOK 418 million. The negative return was due to a stronger krone exchange rate. In 2006, the return on the buffer portfolio was 1.90 per cent.

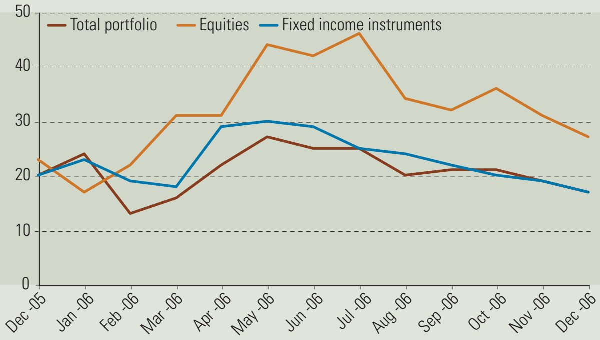


Chart 3-17: Expected tracking error at each month-end in 2006. Basis points

Table 3-28: Transfers to and from the buffer portfolio in 2006. In millions of NOK				
Period	Capital from SDFI	Foreign exchange purchased in the market	Transferred to Government Pension Fund – Global	Market value at end-quarter/month-end
Q1	46 115	16 175	82 366	4 322
Q2	40 660	28 321	69 550	3 497
Q3	40 645	37 768	79 467	2 700
October	11 030	19 574	30 348	2 758
November	12 814	20 013	26 567	8 374
December	15 288	–	–	23 688
Q4	39 132	39 587	56 915	–
2006	166 552	121 852	288 298	–

3.3 Government Petroleum Insurance Fund

3.3.1 Mandate

Pursuant to the Act relating to the Government Petroleum Insurance Fund, 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, which regulates the relationship between the Ministry of Finance as delegating authority and Norges Bank as operational manager, has also been drawn up. The guidelines and management agreement are available on Norges Bank's website.

Table 3-29: Benchmark portfolio at 31.12.06		
Currency	Strategic benchmark portfolio	Actual benchmark portfolio
EUR	50.0	50.0
GBP	15.0	15.4
USD	35.0	34.6
Total	**100.0**	**100.0**

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 Lehman Global Aggregate Treasury (government bond indices) for the three currencies and a money market deposit to weight the interest rate risk, measured by modified duration in each currency, to 4. During the year, the currency weights fluctuate with market developments. However, at the beginning of July each year, the weights are readjusted to the strategic currency weights.

Table 3-29 shows the currency weights in the Fund's strategic and actual benchmark at 31 December 2006.

The Ministry of Petroleum and Energy has decided that market risk, defined as deviation from the benchmark portfolio, must never exceed an expected tracking error of 0.75 percentage point.

Modified duration

The Ministry of Petroleum and Energy uses modified duration to measure interest rate risk associated with the management of the Petroleum Insurance Fund. The duration of a bond is the average time it takes for all cash flows (interest 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.

The Ministry has also decided that the interest rate risk, measured by the modified duration of the total portfolio of fixed income instruments and related derivatives, shall not exceed 5.

Table 3-30: Market value of the Petroleum Insurance Fund at the end of each quarter. In millions of NOK					
	31.12.2005	31.03.2006	30.06.2006	30.09.2006	31.12.2006
EUR	7 038	6 906	7 389	7 696	7 596
GBP	2 120	2 073	2 220	2 349	2 343
USD	5 039	4 835	5 092	5 492	5 248
Total market value	14 197	13 814	14 700	15 535	15 187

3.3.2 Return in 2006

At end-2006, the market value of the Government Petroleum Insurance Fund was NOK 15.2 billion, an increase of NOK 1.0 billion since the beginning of the year. The insurance premium from the Ministry of Petroleum and Energy for 2006 was NOK 1.2 billion. NOK 462.2 million in claims was paid during the year.

The market value of the Petroleum Insurance Fund's foreign exchange portfolio at the end of each quarter in 2006 is shown in Table 3-30. The portfolio is managed internally by Norges Bank and has always been kept very close to the benchmark.

The portfolio is primarily invested in government bonds and other bonds included in the LGA Government-related sub-sector. In addition, the portfolio may be invested in German bonds that have been 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.

In 2006, the return on the Government Petroleum Insurance Fund was 2.17 per cent measured in terms of the currency basket corresponding to the composition of the benchmark portfolio (see Table 3-31). Measured in NOK, the return was 1.34 per cent. The difference is due to the appreciation of the krone against the currencies in the benchmark in 2006, so that the Fund's currency basket depreciated in relation to the krone. The actual return was 0.03 percentage point higher than the benchmark return. This is equivalent to approximately NOK 3.0 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 portfolio value per year. On the other hand, the actual return includes income from lending of fixed income instruments, while the benchmark return does not. Norges Bank and some of the external custodian institutions conduct lending operations. In 2006, income from this type of activity totalled NOK 10.6 million, which is equivalent to an annual rate of 0.07 per cent, calculated as a share of the Fund's average market value.

Table 3-32 shows the return and excess return on the Government Petroleum Insurance Fund each year since 1998. The annual average excess return in the period of 0.08 percentage point is equivalent to NOK 78.8 million.

Table 3-31: The return on the Government Petroleum Insurance Fund. Per cent

	Measured in terms of the benchmark currency basket		Measured in NOK		
	Actual portfolio	Benchmark portfolio	Actual portfolio	Benchmark portfolio	Return differential
Q1	–0,71	–0,72	–2,38	–2,39	0,00
Q2	–0,07	–0,08	–1,63	–1,64	0,01
Q3	2,52	2,50	7,06	7,04	0,01
October	0,39	0,41	1,43	1,45	–0,02
November	0,60	0,58	–3,01	–3,04	0,02
December	–0,55	–0,54	0,20	0,21	–0,01
Q4	0,44	0,44	–1,42	–1,42	0,00
2006	**2,17**	**2,14**	**1,34**	**1,31**	**0,03**

Table 3-32: Return on the Government Petroleum Insurance Fund in the period 1998-2006

	1998	1999	2000	2001	2002	2003	2004	2005	2006	Average 1998–2006
Actual return	3,27	–1,06	6,92	5,68	7,90	3,56	5,64	4,28	2,17	4,23
Benchmark return	3,38	–0,85	6,78	5,48	7,74	3,46	5,42	4,15	2,14	4,16
Excess return	–0,11	–0,21	0,15	0,19	0,16	0,10	0,22	0,14	0,03	0,08

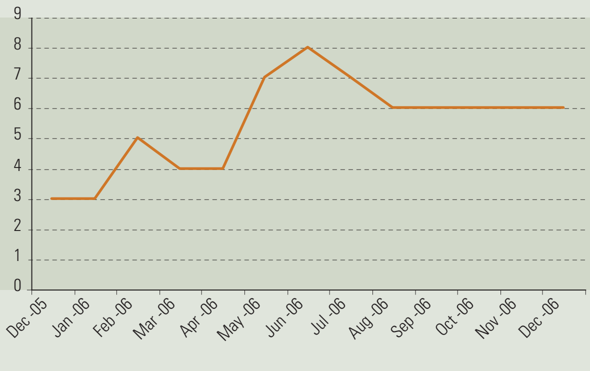


Chart 3-18: Expected tracking error in the past 12 months. Basis points

3.3.3 Risk

Market risk

The guidelines from the Ministry of Petroleum and Energy establish a limit for market risk associated with the actual portfolio compared with the benchmark portfolio. This relative market risk shall always be less than a tracking error of 0.75 percentage point. Relative market risk has remained well within this limit throughout 2006 (see Chart 3-18).

According to the guidelines of the Ministry of Petroleum and Energy, the average modified duration of each currency shall be 4 in the benchmark portfolio and no higher than 5 in the actual portfolio overall. Table 3-33 shows the modified duration of the portfolio at 31 December 2006.

Credit risk

Table 3-34 shows the composition of the bond portfolio based on credit ratings from Moody's and S&P. In the table, the agencies' detailed subdivisions have been grouped together into main rating classifications – 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. The portion of the portfolio that Moody's assigned to the highest credit rating class is larger than the portion Standard & Poor's assigned to the highest credit rating class.

Compliance with the regulation

Table 3-35 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 the quarter.

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 2006, a remuneration rate of 0.06 per cent of the average market value of the portfolio was stipulated. Total remuneration in 2006 was NOK 8 741 086.

Table 3-33: The portfolio's modified duration by currency at 31 December 2006

Currency	Actual portfolio	Benchmark portfolio
EUR	3.88	3.96
GBP	3.86	4.10
USD	4.13	4.05
Total	**3.97**	**4.01**

Table 3-34: The bond portfolio on 31 December 2006, by credit rating. Per cent

Moody's		Standard & Poor's	
Rating	Per cent of total	Rating	Per cent of total
Aaa	65.74	AAA	59.20
Aa	29.24	AA	16.01
A	3.41	A	23.20
No rating	1.61	No rating	1.59

Table 3-35: Risk exposure limits stipulated in the regulation and the guidelines

Risk	Limits	Actual				
		31.12.05	**31.03.06**	**30.06.06**	**30.09.06**	**31.12.06**
Market risk	Maximum tracking error 0.75 percentage point	0.03	0.04	0.08	0.06	0.06
Interest rate risk	Modified duration max. 5	3.93	3.92	3.98	3.98	3.97

4 – Corporate governance and ethics

4.1 Corporate governance

NBIM invests in equities in more than 3 500 companies. Corporate governance reflects how we exercise our ownership rights in these companies and hence influence the companies and markets in which NBIM invests.

According to the ethical guidelines for the Government Pension Fund – Global, as laid down by the Ministry of Finance, the overriding objective of NBIM's exercise of ownership rights is to protect its financial assets. Corporate governance is based on a long investment horizon and a broadly diversified portfolio in the markets included in the investment universe. It should primarily be based on the UN's Global Compact and the OECD's principles of corporate governance and guidelines for multinational companies. The guidelines issued by the Ministry of Finance stipulate that NBIM's internal guidelines for the exercise of ownership rights should reflect how the principles in the documents mentioned are integrated into corporate governance. Norges Bank has provided for this in *"Principles for Corporate Governance and the Protection of Financial Assets",* which was adopted by Norges Bank's Executive Board in December 2004. Norges Bank's Executive Board has approved the application of the same principles to the Bank's foreign exchange reserves.

The principles stipulate that the companies in NBIM's portfolio shall act in accordance with the internationally recognised principles mentioned above. A number of criteria apply to the companies regarding their objectives, strategy and transparency. Moreover, criteria have been formulated as to companies' management and structure, as well as long-term sustainability in that companies must take account of the impact of their activities on the environment and the wider society. The principles also include a discussion of instruments of corporate governance and NBIM's reporting on its corporate governance

activities. Norges Bank's Executive Board has defined its priority areas of corporate governance in its Strategic Plan for NBIM (cf. Section 5.1). In a separate feature article, the priority areas of corporate governance for the coming years are discussed in further detail. Another feature article sheds light on how and why voting is an important instrument for securing sound management of financial assets.

4.1.1 Activities 2006

Since 2003, NBIM has been gradually building up capacity and competence in corporate governance. Previously, external managers exercised voting rights for the assets under their management on behalf of NBIM. As from 1 January 2005, all voting in the equity portfolio was transferred to NBIM in order to achieve more concise and consistent voting in accordance with NBIM's principles. In 2003 and 2004, NBIM voted in a limited

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 similar rules shall apply to the Bank's foreign exchange reserves. The ethical guidelines are based on two fundamental principles:

- The Fund is a means of assuring coming generations a reasonable share of Norway's petroleum wealth. This financial wealth must be managed in such a way that it yields a solid return in the long term, which depends on sustainable development in an economic, environmental and social sense. The Fund's financial interests shall be strengthened through the employment of its ownership positions to promote such sustainable development.
- The Petroleum Fund shall not make investments that constitute an unacceptable risk of the Fund contributing to unethical actions 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 shall be promoted by means of the following three mechanisms:

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

Corporate governance is Norges Bank's responsibility. Norges Bank's Executive Board has approved principles of corporate governance. Decisions regarding negative screening and company exclusions are taken by the Ministry of Finance, not Norges Bank. The Government has appointed a separate Advisory Council on Ethics, which advises the Ministry of Finance. The Ministry issues instructions regarding exclusions to Norges Bank. This section and the following provide an account of corporate governance and an overview of the companies that had been excluded from the investment universe at the end of 2006.

number of companies in the internally managed portfolios, but as from 2005 NBIM has covered most of the companies in the portfolio, and has focused more attention and resources on controversial issues, i.e. complex issues that require deeper analysis. Internal systems and databases containing information on matters to be discussed at companies' general meetings have been developed.

NBIM established a separate corporate governance group in the latter half of 2005, and the governance activities have since been intensified. Over the year, NBIM has been engaged in a wide range of matters, particularly in connection with voting. In addition, analysis and research have been conducted to select priority areas that NBIM considers particularly important to ensure long-term returns and sustainability. The importance of establishing cooperation with other investors with mutual interests and prospective mutual benefits is reflected in the work NBIM has invested in building up networks and cooperation with other international pension funds.

In 2006, the group was able to draw on resources equivalent to 6 person-years. The group should comprise around ten employees by the end of 2007, with a budget of NOK 10 million allocated for execution of proxy voting, the development and purchase of IT systems, external analysis, and communications and external consultancy services related to specific areas.

Strategic plan for corporate governance

In its corporate governance strategy, NBIM has chosen to focus on six priority areas, related to both ownership rights and social and environmental sustainability. Key criteria for the selection of these areas included: the importance for long-term returns, the probability of an investor like NBIM being able to bring about actual changes, the possibility of identifying relevant companies, industries and jurisdictions, and the potential for cooperation with other investors that would increase the likelihood of success.

The priority areas are discussed in more detail in a separate feature article ("Priority areas for the exercise of ownership rights: corporate governance, children and the environment") and include four areas 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, timely information

These are central rights that are necessary to achieve real influence and dialogue with companies. They are also a necessary basis for working on social and environmental issues. At the same time, these rights are to a varying degree restricted or are poorly developed in a number of markets, including in Europe and the US.

Priority will also be given to the following two areas for future social and environmental sustainability:

- Children's rights within the value chains of multinational companies, particularly related to limiting child labour and measures to protect children's health;
- Companies' response to national and supranational authorities on issues related to long-term environmental change – including the risk of a pronounced climate change, the destruction of ecosystems and biodiversity, the extensive and long-term depletion of water resources and declining access to clean water.

Both of these topics harmonise well with NBIM's long-term perspective as investor and are dealt with in the international standards mentioned earlier on which NBIM's principles of corporate governance are based.

Communicating NBIM's principles of corporate governance

In 2006 NBIM continued to work on communicating NBIM's principles for corporate governance, among portfolio companies as well as other investors. The most important forms of written communication, apart from direct contact with companies, were the Annual Report for 2005 and its feature articles, articles published in periodicals, newspaper articles, lectures, and papers presented at seminars and conferences. NBIM staff members have given lectures and participated on a number of panels for leading investors and active corporate governance practitioners at international conferences. NBIM's corporate governance activities have also been featured in the international press.

NBIMs principles of corporate governance are available on NBIM's website and in a paper edition. These principles will be revised and updated in 2007.

It is also important to NBIM to communicate with interested communities in Norway on the subject of corporate governance and its underlying principles. NBIM therefore contributed with a number of public lectures in 2006 about NBIM's activities and strategy for corporate governance and ethics.

Voting and contact with portfolio companies

Voting at companies' general meetings is an important instrument of corporate governance and provides a platform for all further contact with the company. Voting is conducted in accordance with the corporate governance guidelines. This ensures concise, focused and global voting. In 2006, NBIM covered most of the companies in the portfolio, and focused more attention and resources on controversial issues, i.e. complex issues that require deeper analysis. Voting in 2006 is presented in more detail below.

Voting is by proxy, i.e. via 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, particularly when voting is conducted across national borders. Between 30 and 80 per cent of shares in listed companies in European countries are owned by non-nationals, but national legislation on general meetings and voting has not been adjusted accordingly. There are no common standards to regulate voting practices. Requirements may vary even within one and the same market. In many countries, voting rules that historically may have been well founded, have not been adapted to proxy voting.

Voting across national borders can therefore be resource-intensive, costly and in many cases difficult to conduct. As part of the process to operationalise the strategy area *The right to vote at general meetings,* NBIM started a comprehensive project in 2006 to identify participants, market practices and regulations relevant for voting in the Fund's most important markets with the aim of promoting effective global voting. This project is an important basis for NBIM's work to simplify cross-border voting and limit the use of resources.

Through its corporate governance activities, NBIM seeks to ensure that shareholder interests are sufficiently protected by a company's governing bodies. In its contact with a company, NBIM will therefore mainly communicate with the company's board of directors, primarily the chairman. As an owner, NBIM always seeks to act in a well-prepared and predictable manner. This is important to ensure that NBIM's portfolio companies and other investors have confidence in its corporate governance activities. Contact with companies is in principle always confidential. However, NBIM seeks to be as transparent as possible about the areas and the type of issues that are in focus, and the principles underlying its activities.

In 2006, NBIM also included direct contact with companies in its corporate governance activities, in addition to voting, network-building, maintaining contact with the authorities and working on (and publishing) its main principles. In this context, considerable weight was given to basic company and sector analyses and engagement activities which will be fully implemented in 2007, particularly related to our priority areas. We also approached companies directly in 2006. In a number of matters where NBIM chose to withold its support for the board in the voting at a general meeting, NBIM contacted the company to explain NBIM's views, and in some cases to request further communication on the issues. Contact with these companies was related to matters involving both ownership rights issues and social and environmental issues. In 2006, NBIM approached 11 companies as part of its work related to the priority areas and as a follow-up of voting.

Active contact between owner and company will occur over time and take many forms. Exactly how this will take place will depend on the matter at hand, developments that have occurred, how the company responds and not least to what extent other owners or interest groups also become involved.

In some controversial matters related to issues of control, for example where a large shareholder wishes to replace some members of the board because it is felt that the board's strategy is not in the best interest of the company, NBIM has communicated with the various stakeholders prior to the vote in order to establish a more solid basis for the final vote. In several cases where NBIM supported a shareholder's proposal that won the majority vote but where the board was not obliged to implement the proposal and in fact did not do so, NBIM subsequently contacted the company to follow up the matter.

NBIM contacted some companies that had included matters related to human rights on their agenda at the general meeting in 2006, in particular those focusing on working conditions for subcontractors. NBIM encouraged one company, for example, to publish its guidelines for foreign suppliers. In other cases, NBIM requested the companies to provide more information on how they would follow up and report to the shareholders on measures related to labour rights and human rights in connection with the company's activities abroad.

NBIM also contacted a group of companies in the energy sector which conduct activities in areas where there was a risk of serious human rights violations as a direct result of these activities. As well as expressing its views, NBIM requested the company to provide concrete answers as to the consequences of the company's activities for the local population in the relevant areas, and whether the companies themselves had instigated measures to prevent human rights violations.

With another group of investors, NBIM contacted the board members of a large European energy company in connection with a proposed merger. The group of investors expressed concern that the exchange ratio for the shares did not reflect the company's real value and that the largest shareholder in the merged company would have full control without paying the minority shareholders a control premium.

In a number of cases, the contact established, as in the examples above, will be followed up in 2007 with a view to initiating further processes. NBIM will also approach a number of other companies in connection with the preparations for portfolio companies' general meetings in spring 2007.

Contact with regulatory authorities

In 2006, NBIM provided input to consultative rounds etc to help ensure that government agencies, stock exchanges and other regulatory authorities develop and monitor regulations that enhance the protection of ownership rights in accordance with NBIM's principles. NBIM participated in the round of consultation conducted by the IASB (International Accounting Standards Board), which formulates international accounting standards, about which information that is important to the company's position, beyond the purely financial, should be included in the CEO's report in annual reports.

NBIM has also been in contact, by letter and dialogue, with the US Securities and Exchange Commission (SEC) in connection with proposed changes to executive pay disclosure rules for US companies, and in connection with the ongoing discussion about the possibilities open to shareholders to elect and replace board members in US companies. As part of the priority area *The right to nominate and elect board members,* NBIM participated in the debate on the interpretation of the SEC's role in the approval of shareholder proposals submitted to US companies' general meetings. In this connection, meetings with the chairman and commissioners of the SEC were prepared in the last quarter of 2006 and held in Washington in January 2007.

Contact and collaboration with other investors

Owner activity to influence companies and market standards is resource-intensive. The costs will be borne by the investors conducting the activities while the results achieved will benefit all the shareholders. Owners will be able to strengthen their influence by coordinating their activities. NBIM therefore recognises the strategic importance of participating in informal and more formalised networks.

Broad global and regional networks are platforms for establishing contact, exchanging views, spreading information and formulating representative views vis-a-vis regulatory authorities and other standard-setters in the markets.

NBIM is a member of the International Corporate Governance Network (ICGN), a world-wide network for investors and suppliers of services in the field of ownership rights and corporate governance. ICGN members are estimated to manage assets exceeding USD 10 000 million. The network arranges global and regional meetings to discuss central topics related to owner participation and corporate governance and organises the work of various expert committees. ICGN engages with national and supranational authorities, accounting standard-setters and other leading market participants.

In 2006, NBIM took part in the Council of Institutional Investors (CII), a forum for the promotion of corporate governance comprised of institutional shareowners 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 is engaged in informal network-building among larger, globally diversified investors. These networks are considered useful for handling ad-hoc matters, particularly in relation to individual companies, and for improving investor coordination in the longer term.

In autumn 2006, NBIM collaborated with the large Dutch pension funds ABP and PGGM and British Hermes on a joint statement to the SEC concerning the opportunities available to investors to influence the election and replacement of board members in US companies (see above).

NBIM took part in the formulation of the UN "Principles for Responsible Investment" (PRI) in 2005-2006 and when the principles were launched in April 2006. The Principles are based on the understanding that the environment, social conditions and corporate governance can influence funds' returns. Traditionally, investors and managers have focused little attention on these factors. In signing the six principles, investors undertake to analyse these factors, collaborate in their implementation, be active owners, require adequate reporting from companies and report on their own activities. NBIM presented and discussed the principles at meetings with large institutional investors in Japan in October, and at a UN conference in Africa in November.

The international initiative EITI ("Extractive Industries Transparency Initiative") aims to combat corruption and increase transparency in countries rich in natural resources. NBIM has endorsed the section of the EITI entitled "Investors' Statement on Transparency in the Extractives Sector". According to the initiative, it is in the interest of the portfolio companies themselves to operate in a business environment characterised by stability, transparency and respect for the law. The investors therefore support principles regarding disclosure by private and public stakeholders of all payments and agreements related to the extraction of raw materials and natural resources. On the basis of this initiative, NBIM requires transparency from the companies in extractive industries in which it invests, particularly those operating in countries with poor regulatory frameworks and widespread corruption.

4.1.2 Voting in 2006

NBIM's voting guidelines are based on the Principles of Corporate Governance. The fundamental objective is to protect the long-term financial interests of the portfolio. In accordance with the Principles of Corporate Governance, NBIM has supported issues that promote the following:

- that the company has a clearly defined business strategy that is endorsed by the board of directors
- that the company must present accurate, adequate and timely information concerning its financial position and other relevant information
- that internal management and control systems adapted to activities have been established
- that the company's board of directors protects the interests of all shareholders
- that the board of directors consists of a sufficient number of members with relevant and adequate qualifications and that more than the majority of its members are independent
- that the board of directors shall be accountable for its decisions
- that the company openly reports its policy and actions related to human rights and the company's impact on the environment and the local community

A closer account of NBIM's voting in 2006 is presented below and shows how voting was distributed by main types of issue. Issues where NBIM supported shareholder proposals and opposed the management's own recommendations are described in particular detail. NBIM has started work to promote even greater detail in reporting. Such publication will take place as from 2007, in connection with the annual reporting on corporate governance.

Table 4-1: Voting in 2006 / Number of meetings

Meetings/region	Number	Voted	Voted per cent
Americas	1227	1156	94
Europe	1017	505	50
Asia and Oceania	1475	126	86
Total	**3797**	**2928**	**79**

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

Number of meetings

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

I 2006, NBIM voted at 2 928 general meetings, or 79 per cent of the meetings held. NBIM's voting percentage was lower in European markets than in the other regions. This is primarily due to the practice of share-blocking, which prevents investors from selling shares in the period between voting and the general meeting. Share-blocking restricts portfolio managers' ability to trade shares, and NBIM therefore only votes in special cases at general meetings of companies that practise share blocking. An increasing number of markets and companies are moving away from the practice of blocking shares, and NBIM therefore expects to vote at more meetings in this region in the future.

As shown in Chart 4-1, 26 per cent of the meetings where NBIM has voted have been in companies in the US, 17 per cent in European companies and 22 per cent in Japanese companies.

Number of items

In the close to 3 000 general meetings NBIM voted on 26 826 agenda items. For each proposal, shareholders can vote for, vote against or abstain. Shareholders must vote on all items on the agenda. Proposals are generally submitted by the management, but shareholders can also submit proposals. Close to 3 per cent of the proposals NBIM voted on were shareholder proposals. Shareholder proposals are very common in the US, relatively common in Japan but more unusual in Europe. NBIM voted against 8 per cent of management proposals and for 52 per cent of shareholder proposals.

The various issues to be voted on at the general meetings may be divided into seven categories as shown in Chart 4-2.

Close to 55 per cent of the proposals were in the category *Director related,* including those concerning the election of board members and other proposals related to the board's structure. 20 per cent of proposals were more routine matters and are categorised under *Routine/business.* The category *Routine/business* includes proposals related to changes in the articles of association, approval of the accounts, the annual report and dividends, as well as approval of auditors and their fees. 10 per cent of proposals were related to bonuses and pay schemes in the form of equity instruments, and these are categorised under *Non-salary compensation.* 8 per cent of the proposals were included in *Capitaliation*, while 4 per cent were categorised under *Reorganisation,* which includes proposals for general meeting approval of acquisitions and mergers. 3 per cent were shareholder proposals and, finally, less than 1 per cent were included in the category *Anti-takeover mechanisms,* which are matters related to different mechanisms that may be employed to resist a takeover bid.

Voting against management proposals

NBIM voted against the management in 2 164 matters. NBIM supported 92 per cent of management proposals, which is natural since in most cases NBIM has confidence in the way the company is being managed. More than half of the cases where NBIM voted against the management were companies in the Asia/Oceania region, a third in the Americas region and about a tenth were companies in Europe. More than 40 per cent of the cases where NBIM voted against management proposals were in the *Director related* category, while a quarter were related to pay.

Table 4-2 shows to what extent NBIM voted against the management by region and category of proposal. In the Americas, NBIM voted against 8 per cent of management proposals, in Europe the figure was 4 per cent and in Asia/Oceania 10 per cent. In the Americas, NBIM voted against the management on 5-15 per cent of in all the categories. In Europe, NBIM's opposition to management was greatest in matters related to remunera-

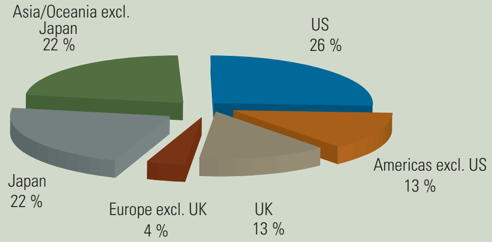


Chart 4-1: Voting in 2006/Regional distribution 2006

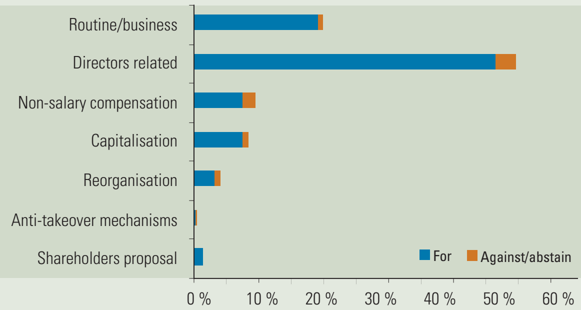


Chart 4-2: Voting 2006/voting issues

Table 4-2: Voting 2006 / Against management´s recommendation

	Total no. of proposals	Against management	
Routine/business	5426	194	4 %
Director related	14 683	887	6 %
Non-salary compensation	2588	566	22 %
Capitalisation	2270	268	12 %
Reorganisation	1084	213	20 %
Anti-takeover mechanisms	113	36	32 %
Total	**26 164**	**2164**	**8 %**

tion. In Asia/Oceania, NBIM did not support management proposals in more than 60 per cent of matters related to anti-takeover mechanisms, and voted against the management in close to a third of matters related to remuneration, capital structure and acquisitions.

NBIM voted against management proposals in the following categories:

Routine/business
NBIM voted against the management's recommendation in 4 per cent of matters of a more routine nature. NBIM voted against the proposed auditor due to strong conflicts of interest and a lack of independence; this particularly applied to Japan. NBIM did not support the approval of an annual report due to 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 company articles of association due to a lack of information and because the changes would transfer more authority to the board as some decisions would no longer be deliberated at the general meeting.

Director related matters
NBIM voted against the management's recommendation in 6 per cent of board-related matters. In a number of US and Asian companies, NBIM voted blank or against the board members proposed by the management because independent board members were not in the majority, or because board members that were not independent of the board were members of important board committees (nomination, executive remuneration and audit committees). In US companies, shareholders can either support the candidate proposed by the management or abstain. This means that a candidate may be elected on the strength of only one vote and that the shareholders have little real influence on the choice of board members.

NBIM abstained in the re-election of the chairman of the board in many US companies because this individual was also the company's CEO. NBIM abstained in the election of board members that had been members of board remuneration committees in companies where the CEO was awarded an enormous pay increase although the company's short-term and long-term performance had been poor. NBIM also abstained in the re-election of board members who had not participated sufficiently in the board's work without good reason. In some cases, NBIM abstained in the re-election of board members in US companies who had disregarded shareholder proposals that had been supported by a majority of the general meeting for several years in a row.

Non-salary compensation
NBIM voted against the management's recommendation in 22 per cent of proposals related to remuneration. NBIM voted against the approval of compensation schemes that were not performance-based, that permitted option repricing, that resulted in a relatively considerable dilution of existing shareholders' ownership interests and that involved over-generous pension schemes and pension bonuses for board members and auditors. NBIM also voted against a number of compensation schemes due to inadequate information.

Capitalisation
NBIM voted against the management's recommendation in 12 per cent of proposals related to capital structure, including proposals for new share issues that would significantly dilute existing shareholders' ownership interests, or where these shares would be priced considerably below the market price. 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. NBIM also voted against share issues that would contribute to a further deviation from the principle of "one share – one vote". In Japanese companies, NBIM voted against proposals to pay dividends that were considered to be too low in relation to earnings and against share issues where shareholders did not receive adequate information.

Reorganisation
NBIM voted against the management's recommendation in 20 per cent of proposals related to reorganisation.

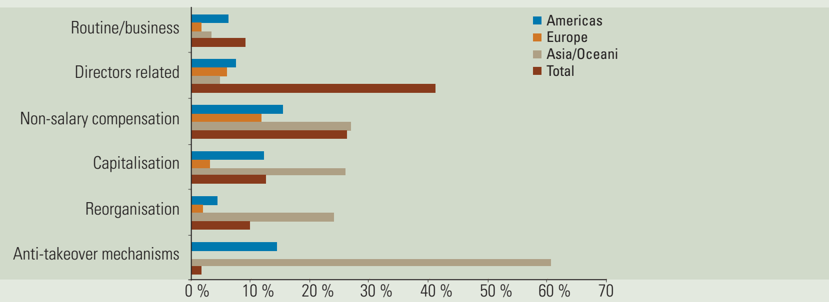


Chart 4-3: Voting 2006/Against the management in the different regions

NBIM voted against proposed mergers because the offer was considered financially unsatisfactory and the strategy proposed for the merged company was not considered viable, or because a better offer was available. In many Japanese companies, NBIM voted against proposed changes in articles of association that would transfer more authority to boards to decide on dividends and share buy-backs, decide whether the company should start up activities in new areas and a number of other changes that would provide greater scope for board discretion.

Anti-takeover mechanisms
NBIM voted against the management's recommendation in 32 per cent of proposals related to anti-takeover mechanisms. NBIM voted against proposals to give the board unrestricted authority to issue shares in the event of a takeover bid, so-called 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 elections of all board members, and proposals to increase the majority required to support a proposal to replace a board member for the decision to be approved. Proposed changes to articles of association that would increase boards' authority and thereby increase their potential power to resist mergers were not supported.

Shareholder proposals
Shareholder proposals are not normally supported by the management, and a vote in favour of such a proposal is often a vote against the management. Shareholder proposals accounted for close to 3 per cent of the proposals that received NBIM's support in the vote. Shareholder proposals are most common in the US, are somewhat less frequent in Japan and even less so in Europe. At general meetings where NBIM voted, it supported 52 per cent of shareholder proposals. In 2005, NBIM supported 41 per cent of shareholder proposals.

Shareholder proposals have seen an

Shareholder influence

In 2006, a number of changes were made to national rules and guidelines relating to corporate governance, which entailed adaptations to the changes on the part of individual companies. Pressure from shareholders like NBIM, both through voting and other activities, has probably made an important contribution to the changes.

Regulatory changes
In 2006, a series of national corporate governance recommendations were revised, new rules relating to corporate governance and control procedures were introduced and several governance themes were incorporated into various countries' stock exchange regulations. Many of these changes relate to board independence and shareholder voting rights at general meetings.

In many markets, there has been mounting shareholder pressure to increase transparency of executive compensation. In the US, shareholder proposals to enhance transparency surrounding both the level of compensation and the performance requirements for executives to be awarded the benefits in their contracts have increased in number in recent years. These shareholder proposals have received growing support. Many companies have introduced changes and in the US the SEC has introduced new reporting requirements for executive pay, including requirements for more detailed reporting. Canada is also considering revising reporting requirements relating to executive pay.

In January, the EU Commission presented a final draft directive aimed at reducing obstacles to cross-border voting. Many points are still unclear and it will still take some time before the directive is ratified. Input from pension funds and other institutional investors has been important in the draft process and it is important that these types of institutions continue to influence the process up to ratification and member states' implementation of the directive.

Changes to French company law in 2006 provide for the use of poison pills by companies, in contrast to the US where such actions must be approved by the general meeting before they can be applied. Many companies have introduced these types of devices in 2006, and in many cases they met with strong opposition from institutional investors.

Board elections
In the US, there has been an ongoing debate on shareholders' role in board elections. Board candidates are elected using the plurality method. i.e. the candidate who receives the most votes is elected (even though there may be only one vote for the candidate and the rest are abstentions) and shareholders may not propose candidates to be included on the ballot sent out by the company. If a shareholder desires to propose a candidate, he or she must do so at own cost, and the cost is considerable. Under pressure from shareholders through shareholder proposals and contact with the companies, more than 180 companies have changed their board election guidelines in 2006 so that a board candidate who does not receive at least 50 per cent of the votes is not elected.

Shareholders have also supported proposals for annual elections of all board members and for simple majority voting. Many companies have changed their practice in these areas.

Executive compensation
In the US, executive pay was clearly the most important issue at the general meetings in 2006. Pension funds and other activist shareholders have long been critical of corporate executive pay policies, in particular with regard to compensation schemes that are not performance-based and backdating when

awarding options. In many cases, it has been difficult to understand and assess compensation schemes in the absence of comprehensive and detailed reporting of, for example, option plans, pension agreements and compensation in the event of takeover. This criticism has been expressed in many shareholder proposals relating to compensation and has also been reflected in shareholder voting against management proposals on this issue and against the re-election of board members who have sat on board committees that deal with pay issues. Criticism relating to executive pay has also been directed at regulators, which contributed to the SEC's approval of new reporting rules relating to executive compensation, as referred to above.

In 2006, it became known that a large number of US companies had practiced backdating of options. More than 125 companies are now under investigation. As the scandal erupted, shareholders responded by contacting the companies with demands for corrective action. At the general meetings, there was strong opposition to re-electing certain board members who had been responsible for awarding the options.

Shareholder proposals to introduce annual voting to approve compensation packages received substantial support. This is mandatory in countries such as the UK, Australia, Sweden and the Netherlands.

Shareholder proposals

Shareholder proposals are far more common in the US than in most other markets. In 2006, the general meetings of US companies voted on almost 700 shareholder proposals. More than 100 of the proposals received a majority vote. The proposals primarily related to the removal of supermajority voting, i.e. that a simple majority is not sufficient for approving the proposal, annual election of all board members, shareholder approval of golden parachutes and mechanisms to resist takeovers.

Support for shareholder proposals pertaining to social and environmental issues has also gained ground in recent years, for example requesting more detailed reporting requirements regarding guidelines for equal rights for employees, the company's impact on the economy, society and the environment (sustainability). The number of proposals withdrawn after submission has also increased. This frequently occurs because companies where shareholder proposals are filed often enter into dialogue with the shareholders concerned and promise to make changes.

In other regions of the world, shareholder proposals are the exception rather than the rule. Most shareholder proposals submitted in companies in Europe and Asia have involved board elections, but proposals have also included social and environmental matters. For example, certain European and Canadian companies have put forward proposals to improve reporting on the companies' activities in countries with a poor human rights record and in some European companies there have been proposals to enhance reporting on companies' impact on the environment and the wider society.

The *Annual Report* includes a feature article that sheds light on why and how voting is an important instrument for securing sound management of the Fund. The article presents a series of examples of the types of shareholder proposals that were endorsed by NBIM in 2006.

increase in the US in recent years, and in particular proposals related to social and environmental issues. Most of the shareholder proposals submitted at companies in Europe and Asia have been related to board elections, although proposals related to social and environmental issues have also been filed.

Shareholder proposals constitute a heterogeneous group and are submitted both by large, influential pension funds and other institutional funds and by individuals who represent special interests and who own a small number of a company's shares. The proposals are primarily related to protecting shareholder rights, to board work and structure and to management remuneration, but proposals related to 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 on the company. The company's management may already have dealt with the subject in a more appropriate manner or the shareholders may not benefit from approving such proposals due to their form, seriousness, feasibility and financial consequences. This means that even though NBIM votes against some of the 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 corporate governance activities.

NBIM voted in favour of shareholder proposals that demanded:

- equal voting rights for all shares
- that the CEO cannot be the chairman of the board
- that shareholders may propose board candidates under certain conditions
- that options must be expensed
- that the general meeting must approve any anti-takeover mechanisms and over generous pension schemes and bonuses
- that the granting of options and other remuneration in the form of equity instruments must be performance-based

- that board members must be elected by a majority vote
- that the majority of the board members must be independent
- annual re-election of all board members
- that a simple majority is sufficient for approval of all types of resolutions
- that reports on remuneration must be submitted to the general meeting in the form of a proposal to which shareholders are asked to give their support (advisory vote)
- that executive pay is disclosed in the annual report
- that the company must have guidelines specifying how bonuses and other forms of remuneration are to be dealt with in the event of changes in reported financial results (claw-backs)
- that companies draw up ethical guidelines related to human rights and report on their compliance with these guidelines, particularly for operations in countries where human rights have traditionally not been respected
- that companies report on sustainability and on the company's economic, social and environmental impact (triple-bottom-line accounting)
- that companies report on their guidelines for equal rights for all employees and on the steps taken by the company to safeguard equal treatment
- that companies in the petroleum sector report on the impact of their operations for the ecosystem in specific geographical areas
- that companies in the petroleum sector report on how they will prepare for and adapt to regulatory changes related to climate change, and the effect this might have on their competitive situation
- that companies disclose their support for political parties
- that companies publish or introduce guidelines based on internationally recognised standards concerning foreign suppliers working conditions, and that audits of these conditions are carried out and reports submitted.

A feature article included in this annual report provides further detail on why and in what way voting is an important instrument for ensuring sound Fund management. See also the box on shareholder influence.

4.2 Exclusion of companies

Norges Bank is responsible for corporate governance in accordance with the guidelines issued by the Ministry of Finance. Norges Bank's Executive Board has adopted principles of corporate governance. Norges Bank's corporate governance activities in 2006 are discussed in Section 4.1 and presented in more detail in two feature articles in this Report. The government has appointed an Advisory Council on Ethics, which will advise the Ministry of Finance on negative screening and company exclusions. The Ministry makes the final decision on the exclusion of companies and instructs Norges Bank accordingly.

Since 2002, 20 companies with a combined value in the portfolio of NOK 14.2 billion have been excluded. The excluded companies correspond to 1.8 per cent of the Pension Fund's benchmark portfolio for equities. Norges Bank has estimated the total transaction costs associated with exclusion to NOK 47.7 million. This is expected to be only a small portion of the potential financial losses resulting from exclusion. However, it is of little relevance to estimate potential return losses over periods of only a few years.

The Ministry of Finance decided in 2006 to exclude four companies from the Fund's investment universe. The decisions were based on recommendations from the Advisory Council on Ethics. The background for the exclusions is discussed in greater detail in press releases from the Ministry of Finance. The Council's recommendations are available on the Ministry of Finance´s website. Table 4-3 provides an overview of the companies that have been excluded. The total value of the investments at the time the exclusion decision was made was NOK 3.2 billion.

Table 4-3: Companies that the Ministry of Finance has excluded from the investment universe

Date	Reason	Company
26 April 2002	Production of anti-personnel landmines	Singapore Technologies, Singapore
31 May 2005	Oil exploration in West Sahara	Kerr-McGee, US*
31 August 2005	Manufacture of key components for cluster bombs	Alliant Techsystems, US EADS (Airbus), Netherlands** General Dynamics, US L-3 Communications, US Lockheed, US Raytheon, US Thales, France
31 December 2005	Involved in the production of nuclear weapons	BAE Systems, UK Boeing, US Finmeccanica, Italy Honeywell, US Northrop Grumman, US Safran, France United Technologies, US
31 May 2006	Breaches of human and labour rights (1) Degradation of the environment (2)	Wal-Mart Stores Inc, US (1) Wal-Mart de Mexico S.A. (1) Freeport McMoRan, US (2)
30 November 2006	Manufacture of cluster munitions	Poongsan Corporation, South Korea

* KerrMcGee (now merged with Anadarko Petroleum) was included again from 30 June 2006.
** EADS has announced that the company is no longer involved in the manufacture of cluster munitions. However, EADS is involved in the production of nuclear weapons, and in consequence the Ministry of Finance maintained its exclusion on 10 May 2006.

5.1 Management model and organisation

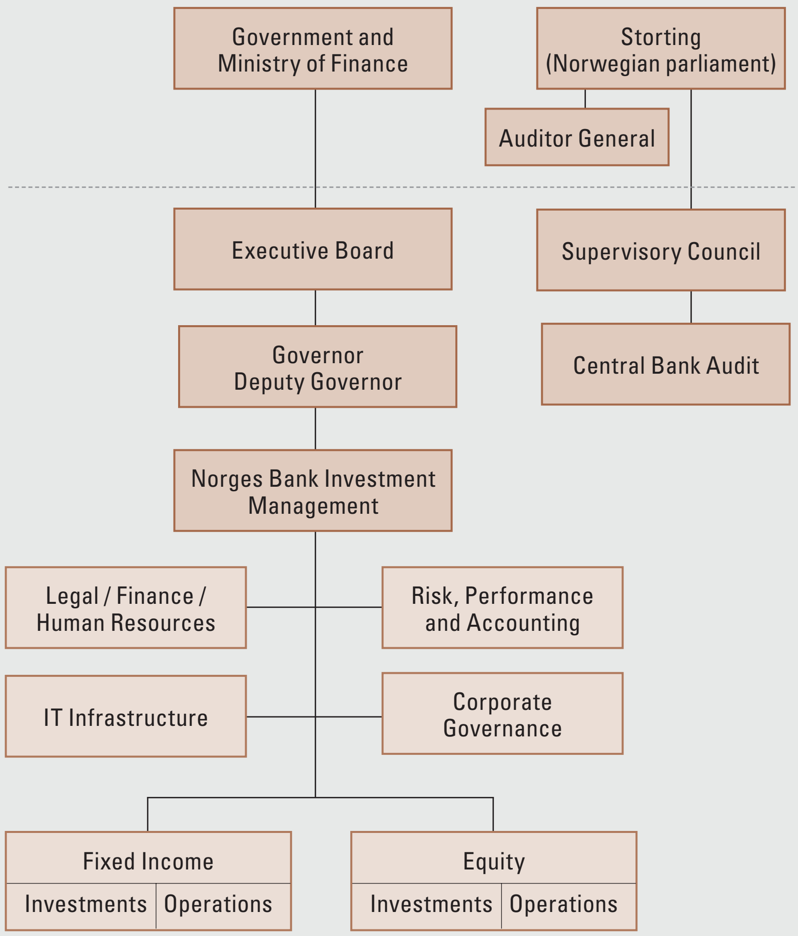
Norges Bank Investment Management (NBIM), which is an area of Norges Bank, is responsible for the management of the Government Pension Fund – Global. NBIM also manages the Government Petroleum Insurance Fund on behalf of the Ministry of Petroleum and Energy and the bulk of Norges Bank's foreign exchange reserves. At the end of 2006, assets under management amounted to NOK 2 047 billion.

The Executive Board has overriding responsibility for Norges Bank's operations. The Executive Board consists of seven members, appointed by the King. The Supervisory Council, which consists of fifteen members appointed by the Storting, is the Bank's supervisory body and approves the Bank's budget. Norges Bank's audit department, Central Bank Audit, reports to the Supervisory Council and is responsible for operational auditing of investment management operations. Norges Bank's foreign exchange reserves and the Government Pension Fund – Global are included in Norges Bank's annual accounts, which are audited by Central Bank Audit.

The Office of the Auditor General is responsible for the final audit of the Government Pension Fund and bases its work partly on material from Central Bank Audit. The Government Petroleum Insurance Fund is managed and its accounts kept by Norges Bank. The Office of the Auditor General bases its audit of the Fund on work carried out by Central Bank Audit.

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 established by the Executive Board at the beginning of 2007. During the plan period, capital under management in Norges Bank may increase substantially. At the same time, it may be determined to invest in new assets classes such as real estate and private equity. The principal objectives of the plan are to generate substantial added

Organisation chart as of 01.01.07



Advisory Board for investment management

In 2006 the Executive Board established an advisory board as reinforcement for their work on investment management. The background to this is the challenges faced by the Executive Board in developing and monitoring investment management. The capital in the Government Pension Fund – Global is expected to increase rapidly, and at the same time the Fund's capital may be invested in less liquid asset classes such as real estate. The Council consists of four internationally recognised experts with extensive experience from large investment management institutions. The Advisory Board will meet the Executive Board two or three times a year.

The four members are: Alan Hodson, former Global Head of Equities in UBS Investment Bank, Jean Frijns, former CEO of ABP Investments, Kenneth G. Lay, Vice President and Treasurer of the World Bank, and Tony Watson, former CEO of Hermes Asset Management.

Mission, vision, objectives and core values

Norges Bank manages considerable assets for Norwegian society. The strategic plan sets specific objectives and establishes important premises for asset management. Underlying the operational objectives is a recognition of the significance of the task as expressed in the organisation's **mission:**

NBIM shall safeguard and grow financial wealth for future generations through highly professional management coupled with strict integrity.

This business idea is underpinned by the **vision** that

Norges Bank Investment Management shall be the world's leading and most respected manager of individually owned funds.

NBIM's **primary objective** is to

create extensive added value through active management of the government's and Norges Bank's foreign financial assets, foster the owners' long-term financial interests through active corporate governance and implement the owners' management strategy in a cost-effective, prudent and confidence-inspiring manner.

This fundamental objective is embodied in the following goals for NBIM's main products, and an aim for confidence in the management assignment:

Transfers	Transfer of new capital to the market shall take place cost-effectively and pursuant to the guidelines issued by the Ministry of Finance.
Beta management	Cost-effective exposure to the benchmark portfolio
Alpha management	Achieve 25 basis points' annual net added value over rolling 3-year periods through active management of the Government Pension Fund – Global and the investment portfolio in Norges Bank's foreign exchange reserves.
Corporate governance	Safeguard and generate financial wealth for future generations by contributing to sound corporate governance and by promoting high ethical, social and environmental norms in the companies.
Advice on strategy	Develop a strategy function that contributes to the portfolios under management generating the highest possible long-term return, given the owners' risk preferences. NBIM shall foster innovation in the most important strategic choices, and help to ensure that our strategy is in line with best international practice.
High level of confidence	NBIM shall work actively to ensure a high level of confidence among its clients and the general public. Confidence may follow from attainment of the other main objectives, but must also be underpinned by open, honest information, and by a strong ethical awareness within the organisation.

NBIM has developed a set of core values to underpin the realisation of its goals. These values set the direction for our operations and culture, and adherence to these values is followed up in part through the evaluation of managers and other staff. The core values are expressed under the headings: Excellence, Innovation, Integrity and Team spirit.

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 recognition 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 box).

NBIM follows a clearly defined investment philosophy to achieve the objectives of excess return. According to NBIM's investment philosophy, excess returns shall be achieved by means of a large number of individual, mutually independent decisions rather than by means of large strategic decisions. Responsibility

External service providers

Norges Bank purchases a number of services from external service providers. All contracts with external service providers have undergone thorough negotiations and are subject to legal quality assurance before they are signed. The main service providers are:

External managers
The use of external managers is an important element of the investment strategy. Section 3.1.4 contains an overview of the external fixed income managers and Section 3.1.5 provides an overview of the external equity managers.

Custody and clearing of securities
Norges Bank uses two global custodian institutions for international payments and securities custody and clearing:
- JP Morgan Chase Bank (New York, US – London branch) for all equity portfolios and externally managed fixed income portfolios
- Citibank (New York, US – London branch) for fixed income portfolios under internal management

Transaction settlement with counterparties
Norges Bank purchases fund administration services from Investors Bank and Trust (Boston, Massachusetts, US) for the internally managed equity and fixed income portfolios.

Performance measurement
The return on the equity and fixed income portfolios is calculated using the performance model Statpro Performance and Attribution from Statpro Group (London, UK).

Accounting
JP Morgan Chase and Citibank are responsible for the financial accounting of investments.

Benchmark portfolios
The Fund's benchmark portfolios are provided by:
- FTSE Group (London, UK) - equity portfolio
- Lehman Brothers (New York, US) – fixed income portfolio

Voting
Norges Bank makes its own voting decisions. Logistics for the execution of voting are purchased from Institutional Shareholder Services (Washington, US). Information about items on the agenda of limited companies' annual general meetings are purchased from ISS and from other companies providing analytical services.

Market risk
The market risk in the portfolios is measured using the risk model RiskManager provided by RiskMetrics Group (New York, US).

Credit ratings
The credit ratings of the fixed income portfolio and unsecured counterparty exposures are based on deliveries from:
- Fitch Ratings (London, UK / New York, US)
- Moody's Corporation (New York, US)
- Standard & Poor's (New York, US)

Compliance with investment guidelines
A system provided by LatentZero (London, UK) is used to verify that asset management complies with the guidelines established by the funds' owners.

IT operations
Operational services (round-the-clock services all days) for IT infrastructure for all NBIM offices (Oslo, London and New York) are provided by Computer Sciences Corporation (US).

for decision-making has been delegated to individuals in the form of specific investment mandates and to external asset management organisations. The external management mandates also have clearly defined objectives and limits. The investment philosophy is described in more detail in articles published on Norges Bank's website in 2000 and 2004.

Management shall be conducted in a prudent manner with considerable emphasis on good internal control procedures and without substantial infringements of the guidelines issued by the delegating authorities. The organisation shall be run in a cost-effective and profitable manner. Management resources will be focused on core activities and outsourcing will be considered in connection with all other activities. A separate box in this section provides an overview of outsourcing.

NBIM has business areas for equity and fixed income management. The heads of these areas are responsible for all portfolio investment and performance, strategic planning and cost management within their respective area. Each business area has a chief operating officer who is responsible for support and analytical functions, transactions and IT systems. The chief operating officers report both to their respective business lines and to the executive director of NBIM. In addition, NBIM has departments that are organisationally independent of the two business areas and report directly to NBIM's executive director. These departments are responsible for corporate governance, risk measurement, performance measurement, accounting, compliance with investment guidelines, negotiation of legal agreements, human resources, IT policy, IT infrastructure and shared administrative services.

5.2. NBIM employees

At end-2006, NBIM had a total of 132 permanent employees, 14 full-time temporary employees and five trainees. In addition to Norwegian nationals, NBIM numbered 32 employees of 15 different nationalities. During the year, 17 permanent employees joined the organisation and 15 left. Of the permanent employees, 28 per cent are women, and in 2006 women accounted for 41 per cent of new recruits. 111 employees are university graduates. At the beginning of 2007, the average age was 39 and the average number of years of employment with NBIM was 5. Sickness absence was 1.5 per cent. Most employees are located in Oslo, but NBIM also has offices in New York and London. At end-2006, 34 of NBIM's employees worked at one of the offices outside Norway. Most of these employees are engaged in active management of the equity and fixed income portfolios.

5.3 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 management depends strongly on the capacity to attract, develop and retain employees with preeminent and specialised expertise. The following is a more detailed account of the principles applied by Norges Bank in the remuneration of NBIM employees, and key performance figures for 2006. Norges Bank complies with the provisions of the Accounting Act relating to reporting on remuneration, pension benefits and other benefits to the Bank's executive management and management group. An account is provided in Norges Bank's Annual Report.

NBIM recruits from an international labour market. A number of Norwegians have been recruited from foreign companies and remained resident in London or New York. In the foreign as in the Norwegian market for investment management employees, pay normally consists of two components – a fixed salary and a performance-based component. For persons who make investment decisions and who are assessed on the basis of these results, the performance-based pay component will often be larger than the fixed component.

It is notably within investment activities (the front office) that the pay level may be high compared with the average pay in the financial sector. At the same time there are large variations between employees, which reflect different contributions to performance.

Performance-based pay is a means of retaining employees who succeed in generating excess return through their investment decisions. The system of performance-based pay also has another function. It is intended to encourage persons with investment authority to take active market risk. NBIM's ambition of adding value through active management implies that there are individuals who take this risk within the framework and follow-up routines that are set for them. An incentive system that rewards high performance increases the willingness to engage in such active management.

NBIM's pay and personnel policy

The Executive Board defines pay and personnel policy as a means for NBIM to achieve its strategic goals. See Section 5.1 for a more detailed description of the strategic goals the Executive Board has set for NBIM.

NBIM shall compete for the most skilled personnel with the required specialist knowledge. Competitiveness is promoted through interaction between many factors. The pay level and remuneration system is very important, but there are also other elements. Benefits are determined on the basis of market pay in the international and Norwegian labour markets for the different types of personnel.

Norges Bank does not aim to be a wage-leader. NBIM has a number of advantages in the competition for labour which it employs actively – and which mean that we are not obliged to offer the highest pay. However, the Executive Board does not want the difference in relation to those who receive the highest pay to be so wide that it leads to an undesirably high outflow of persons with key expertise. Therefore staff recruitment and outflow are carefully considered in relation to general developments in pay conditions in the markets. The alternative to competitive conditions in NBIM is to outsource far more management to external managers. This may entail substantially higher costs.

Part of the basis for determining pay levels is independent analyses of market pay for the various skills categories. These reveal relatively large differences between the labour markets in Oslo, London and New York. Market pay in international markets is appreciably higher than in Oslo. The differences are also reflected in the pay conditions in our organisation. However, the pay level in Oslo remains the reference for Norwegians on temporary postings to our offices in London and New York. NBIM pays for housing and schooling for the children of these employees at the rates used by the Norwegian Ministry of Foreign Affairs.

A particular edge that NBIM uses in competing for the best human resources is that the size of the capital under management, and NBIM's position in the international capital market, offer very favourable opportunities for professional development. One important consideration in the management of NBIM and in the development of the organisation's structure is to create a stimulating environment for talented persons and specialists. NBIM's approach is based on extensive delegation of investment decisions to individuals, allowing them to design the strategy and method they wish to use. This takes place within a framework of clearly defined investment mandates and ongoing monitoring of both results and compliance with the guidelines. Emphasis is also placed on making good information systems available to the managers.

Important functions in NBIM other than the front office departments are: Continuous measurement of performance and risk, trading and settlement of securities, accounting, legal quality assurance of agreements and decisions, and IT-based analysis and decision-support systems. The quality of these functions, which account for about 48 per cent of NBIM employees, cannot be measured as concretely as the management function. However, it is of great importance to NBIM's ability to provide effective management of high integrity. The pay of some employees outside the front office departments also has a variable portion which is performance-based. However the share is far lower than for front office employees.

The design of the system

In the front office departments, 70-90 per cent of the variable pay is typically dependent on measurable financial results. Common to all measurement is that it is based on the portion of value added that can be related to the individual, and to some extent also to the group of which that person forms a part. For the most central managers of the front-office departments, it is the department's overall performance that counts, but there are also some incentives associated with NBIM's overall excess return. For each employee, the criteria for disbursement and the upper limit are agreed the previous year.

Since the agreements are related to excess return, we avoid a situation where employees are rewarded for general market trends. Managers are rewarded for achieving better results than would be achieved by following the markets. In accordance with NBIM's strategy for achieving excess return through taking many maximally independent active management positions (cf. Section 5.1), active management decisions are delegated extensively to groups and individuals.

The incentive system is based on this 'bottom-up' strategy, by placing greatest emphasis on the results of the individual. However, it may mean that there is not a direct relationship between NBIM's overall result and how much performance-based pay is disbursed. This will particularly be the case in years when there are large differences between the results of external and internal management, as there are far fewer employees with responsibility for external managers than there are internal management employees.

Performance-based pay is linked largely to the previous year's developments. Performance over a number of years may form the basis for some employees. Typically, some of the payment for particularly high performance one year may be transferred to later periods. This may also lead to differences between overall performance and the disbursements in the individual period.

The qualitative criteria for performance-based pay tend to be related to how the individual employee has contributed to the work and results of the rest of the group, the performance of tasks and projects according to plan, and compliance with NBIM's four core values (see Section 5.1).

Remuneration in NBIM

Front-office departments:	
Number of front-office employees with performance-based pay:	65 employees
Share of this number in internal management	94 per cent
Total fixed pay, all front-office employees	NOK 58 million
Total performance-based pay, all front-office employees	NOK 69.5 million
Upper limit for performance-based pay, all front-office employees	NOK 118 million
Performance-based pay as a percentage of performance-based pay limit, all:	59 per cent
Performance-based pay as a percentage of performance-based pay limit, equities:	59 per cent
Performance-based pay as a percentage of performance-based pay limit, fixed income	60 per cent
Other departments:*	
Number of employees:	66
Total fixed pay: NOK	31 million
Number with variable pay:	35
Total variable pay:	NOK 4.5 million

* Does not include the salary for NBIM's executive director

The scope of performance-based pay in NBIM's activities outside the front-office departments is distinctly smaller. Maximum variable pay tends to amount to between 10 and 30 per cent of the fixed salary. The variable pay of all employees who work on measuring performance and risk and keeping accounts, or in some other manner have tasks that are important for ensuring the integrity of management, is not linked to NBIM's excess return. The measurement criteria are based on the quality of the work viewed in relation to action plans and compliance with NBIM's core values.

Remuneration in 2006

On balance, excess return was achieved in 2006, which forms the basis for disbursing performance-based pay. Transfers based on the previous year's results for some employees have little impact on the total figures. The excess return on the funds that are 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 strongest impact on overall pay figures.

NBIM's excess return in 2006 was clearly lower than the value added target of 25 basis points. In isolation, this implies relatively low performance-based pay in the front-office departments. However, performance in internal and external management differed. Performance was very good in internal management, where more than 90 per cent of NBIM front-office employees work. Only 6 per cent of NBIM's front-office employees are engaged in monitoring external managers and receive a performance-based pay component.

Total performance-based pay for NBIM's front-office departments came to NOK 69.5 million in 2006. This is equivalent to 59 per cent of the limit. In the Equities Department, 59 per cent of the limit was paid, and in the Fixed Income Department 60 per cent.

Chart 5-1 shows employees in the front-office departments grouped according to how large a share of the individual's performance-based pay limit was disbursed. The chart shows, for example, that 21 per cent of the front-office employees were paid less than 25 per cent of their performance-based pay limit.

The remuneration policy of NBIM's executive director is determined by the Executive Board. His actual remuneration is decided by the Governor of Norges Bank according to specific criteria. The criteria include NBIM's financial performance over the past few years and various measures of the quality of management, compliance with guidelines and fostering of confidence in NBIM, building up and operation of the organisation and execution according to action plans. The salary of the Executive Director of NBIM was NOK 2 784 462 in 2006. In addition he received other benefits with a total value of NOK 15 424. The Executive Director of NBIM is a member of Norges Bank's pension scheme, which is described in Norges Bank's Annual Report.

5.4 Accounts reporting

An excerpt from Norges Bank's annual accounts and an excerpt from the accounts of the Government Petroleum Insurance Fund are presented below. For a full picture, please see Norges Bank's *Annual Report* and the separate reporting for the Government Petroleum Insurance Fund.

5.4.1 Government Pension Fund – Global

At end-2006, the balance in the Government Pension Fund's NOK account was NOK 1 782 139 million. The accounting return and accrued management remuneration for 2006 has been taken into account. Table 5-1 shows the Fund's international portfolio distributed by instrument.

Pursuant to the Regulation on the management of the Government Pension Fund – Global, Norges Bank's net book return on the Fund's international portfolio shall be transferred to the Fund's NOK account. The return in 2006 consists of the components presented in Table 5-2.

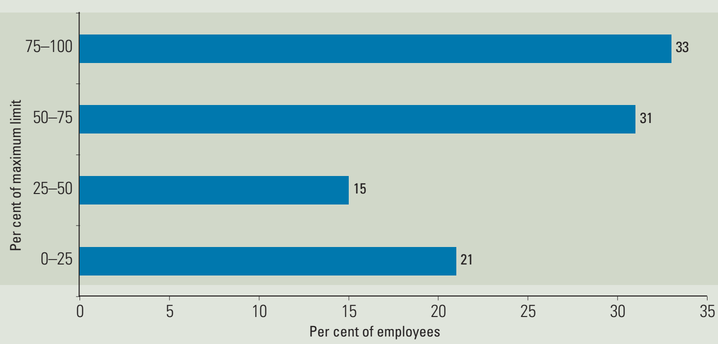


Chart 5-1: Actual performance-related pay compared with maximum limit for front-office departments

Table 5-1: Government Pension Fund – Global. Portfolio at 31 December 2006. In millions of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Short-term assets/debt, incl. deposits in foreign banks	23 784	–3 436	–2 885	–14 981	6 918
Money market investments in foreign financial institutions against collateral in the form of securities	558 979	556 186	689 872	664 740	619 746
Borrowing from foreign financial institutions against collateral in the form of securities	–438 717	–456 642	–529 545	–623 527	–728 414
Foreign fixed income securities	682 024	785 047	746 861	1 005 701	1 166 941
Foreign equities	576 683	603 624	600 826	682 149	720 256
Adjustment of forward contracts and derivatives	–3 618	–775	17	–1 712	–1 777
Total portfolio before remuneration for management	**1 399 135**	**1 484 004**	**1 505 146**	**1 712 370**	**1 783 670**
Management remuneration due	–1 239	–386	–726	–1 108	–1 526
Consulting services	0	0	0	0	–5
Net portfolio	**1 397 896**	**1 483 618**	**1 504 420**	**1 711 262**	**1 782 139**
Off-balance sheet items (in 1 000s)	**31.12.05**	**31.03.06**	**30.06.06**	**30.09.06**	**31.12.06**
Liabilities					
Derivatives and forward contracts sold	798 223	933 480	1 134 791	1 144 587	1 228 557
Derivatives and forward contracts purchased	785 681	892 746	1 133 381	1 160 268	1 241 246
Rights					
Options sold	5 273	7 657	84 172	26 480	24 154
Options purchased	8 578	36 675	50 687	118 184	131 203

Table 5-2: Return on the Government Pension Fund – Global's international portfolio at 31 December 2006. In millions of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Interest income	27 815	8 010	18 325	30 195	43 014
Dividends	10 309	3 024	8 909	11 832	14 232
Exchange rate adjustments	33 610	–27 447	–49 146	13 536	–24 232
Unrealised gain/loss on securities	36 521	–8 444	–55 504	–11 364	13 592
Realised gain/loss on securities	49 908	23 224	29 629	36 261	47 482
Brokers' commissions	–19	–17	–25	–37	–6
Gains/losses futures	1 250	369	–3 142	–3 358	–3 329
Gains/losses options	0	56	77	55	126
Gains/losses equity swaps	1 239	758	1 402	1 794	2 174
Gains/losses interest rate swaps	1 756	2 970	3 570	2 938	3 183
Book return on investments	**162 389**	**2 503**	**–45 905**	**81 852**	**96 236**
Accrued management remuneration	–1 239	–386	–726	–1 108	–1 526
Consulting services	0	0	0	0	–5
Net return	**161 150**	**2 117**	**–46 631**	**80 744**	**94 705**

5.4.2 The investment portfolio

Table 5-3: The investment portfolio at 31 December 2006 by instrument. In millions of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Short-term assets/debt, incl. deposits in foreign banks	–9 159	–4 353	–941	–12 070	–9 593
Money market investments in foreign financial institutions against collateral in the form of securities	66 211	69 274	104 289	96 907	77 501
Borrowing from foreign financial institutions against collateral in the form of securities	–61 002	–67 157	–90 622	–98 978	–99 350
Foreign fixed income securities	146 676	134 460	120 212	148 834	163 757
Foreign equities	70 615	84 461	80 536	88 699	92 300
Adjustment of forward contracts and derivatives	–377	175	378	–303	–100
Total portfolio	**212 964**	**216 860**	**213 852**	**223 089**	**224 515**
Off-balance sheet items	**31.12.05**	**31.03.06**	**30.06.06**	**30.09.06**	**31.12.06**
Liabilities					
Derivatives and forward contracts sold	137 043	179 303	196 015	201 036	200 684
Derivatives and forward contracts purchased	136 662	157 815	191 100	207 393	202 861
Rights					
Options sold	759	4 973	10 835	11 664	8 851
Options purchased	1 448	7 901	6 568	16 452	21 656

Table 5-4: Return on the investment portfolio to 31 December 2006. In millions of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Interest income	5 067	1 431	3 087	5 094	6 695
Dividends	1 467	424	1 233	1 664	2 017
Exchange rate adjustments	5 570	–3 970	–7 608	651	–4 298
Unrealised gain/loss on securities	5 318	–1 186	–8 888	–2 308	1 265
Realised gain/loss on securities	5 390	1 762	3 357	4 126	4 626
Brokers' commissions	–3	–1	–2	–4	–5
Gains/losses futures	–145	91	144	82	114
Gains/losses options	–3	8	10	–5	26
Gains/losses equity swaps	–13	8	91	53	130
Gains/losses interest rate swaps	440	619	784	240	448
Other operating expenses	–44	–14	–33	–51	–64
Net return	**23 044**	**–828**	**–7 825**	**9 542**	**10 954**

5.4.3 The buffer portfolio

Table 5-5: The buffer portfolio at 31 December 2006 by instrument. In millions of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Short-term assets/debt, incl. deposits in foreign banks	13	37	2 452	13 305	12 447
Money market investments in foreign financial institutions against collateral in the form of securities	20 301	18 298	14 560	16 945	8 510
Adjustment of forward contracts and derivatives	0	–8	24	–9	0
Debt to the Government Pension Fund – Global, unsettled transfers	0	–20 181	–23 907	–31 409	0
Total portfolio according to accounts	**20 314**	**–1 854**	**–6 871**	**–1 168**	**20 957**
Unrecorded unsettled contracts	3 828	6 186	10 368	3 868	2 731
Foreign exchange for management	**24 142**	**4 332**	**3 497**	**2 700**	**23 688**
Off-balance-sheet items	**31.12.05**	**31.03.06**	**30.06.06**	**30.09.06**	**31.12.06**
Liabilities					
Derivatives and forward contracts sold	0	1 689	1 860	3 959	0
Derivatives and forward contracts purchased	0	1 689	1 860	3 959	0

Table 5-6: Return on the buffer portfolio at 31 December 2006. In millions of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Interest income	360	172	301	436	580
Dividends	0	0	0	0	0
Exchange rate adjustments	753	–206	–692	–643	–1414
Other operating expenses	0	0	–1	–1	–1
Net return	**1 113**	**–34**	**–392**	**–208**	**–835**

5.4.4 Government Petroleum Insurance Fund

Table 5-7: The Petroleum Insurance Fund's international portfolio, by instrument, at 31 December 2006. In thousands of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Short-term assets/debt, incl. deposits in foreign banks	32 040	–292 689	–990 679	206 958	–61 495
Money market investments in foreign financial institutions against collateral in the form of securities	2 854 221	2 888 074	2 104 500	2 546 411	2 768 751
Borrowing from foreign financial institutions against collateral in the form of securities	0	0	–14 156	0	0
Foreign fixed income securities	11 312 548	11 265 328	12 491 997	12 987 634	12 611 428
Adjustment of forward contracts and derivatives	–983	–1 215	–1 664	–1 827	–3 381
Total portfolio before management remuneration	**14 197 825**	**13 859 498**	**13 589 999**	**15 739 177**	**15 315 302**
Management remuneration due	–8 222	–2 141	–4 156	–6 389	–8 741
Total portfolio for management	**14 189 603**	**13 857 357**	**13 585 843**	**15 732 788**	**15 306 561**
	31.12.05	**31.03.06**	**30.06.06**	**30.09.06**	**31.12.06**
Derivatives and forward contracts sold	1 149 753	804 257	921 630	854 741	1 025 453
Derivatives and forward contracts purchased	1 148 770	803 043	919 964	852 879	1 022 070

Table 5-8: Return on the Government Petroleum Insurance Fund at 31 December 2006. In thousands of NOK

	31.12.05	31.03.06	30.06.06	30.09.06	31.12.06
Interest income	559 657	150 514	299 431	484 399	663 863
Exchange rate adjustments	325 078	–238 604	–455 986	192 946	–96 302
Unrealised gain/loss on securities	–18 437	–247 371	–371 032	–178 343	–279 557
Realised gain/loss on securities	16 017	–2 778	–36 248	–24 976	–37 234
Other operating expenses	–6	5	5	5	5
Net return	**882 309**	**–338 235**	**–563 830**	**474 032**	**250 775**
Accrued management remuneration	–8 222	–2 141	–4 156	–6 389	–8 741
Net return	**874 087**	**–340 376**	**–567 986**	**467 643**	**242 034**

Accounting principles

Norges Bank's accounting policies (cf. note in Norges Bank's Annual Report), which are based on the Norwegian Accounting Act and on generally accepted accounting principles in Norway, are used when preparing the financial statements. Securities transactions are recorded on the transaction date and income and costs are accrued in accordance with the accounting principle.

Securities are regarded as financial current assets and are carried at fair value as at 31 December 2006. Fair value is based on market values provided by recognised international index suppliers. Accrued interest is included in the securities holdings. Unrealised gains are taken to income.

Assets and liabilities in foreign currency are translated into NOK at market rates quoted on WM Reuters London at 4 pm. 29.12.2006. Income and expenses in foreign currency are translated into NOK at the exchange rate prevailing on the transaction date.

In securities management, the securities are sometimes used as underliers for financial instruments, for example in the sale of securities with an agreement for repurchase at a later date. The repurchase agreements are presented as borrowing against collateral in securities.

Off-balance sheet financial instruments are contracts concerning future delivery of foreign exchange or securities at a pre-determined price. These comprise forward exchange contracts, financial futures, interest rate swaps and options. Forward contracts are recorded at forward rates. Forward premia/discounts, futures contracts, interest rate swaps, equity swaps and options are carried at fair value at 31 December 2006. Fair value is based on market values provided by internationally recognised index suppliers.

[1)] Adjustment of exchange rates for accounting purposes is based on the actual composition of the portfolios. Income and expenses are translated at the exchange rate prevailing on the transaction date, and assets and liabilities are translated at the market rate prevailing at the end of the month. This variable will differ from the estimated exchange rate effect in the performance measurement presented elsewhere in the report. In measuring returns, the exchange rate effect is calculated on the basis of the benchmark's currency composition at the beginning of each month and appurtenant exchange rate adjustments.

Norges Bank Investment Management Annual Report 2006 was approved by Norges Bank´s Executive Board on 7 February 2007.

Statement to the Supervisory Council of Norges Bank

NORGES BANK INVESTMENT MANAGEMENT – ANNUAL REPORT 2006

We have audited the financial statements in Section 5.4 in Norges Bank Investment Management – Annual Report 2006 for the Government Pension Fund – Global, Norges Bank's investment portfolio and Norges Bank's buffer portfolio, which on 31 December 2006 had portfolio values of NOK 1 782 139, 224 515 and 23 688 billion respectively. We have also audited compliance with quantitative provisions for management and risk exposure according to the regulation concerning management of the Government Pension Fund – Global and the Executive Board's guidelines for management of the Bank's foreign exchange reserves. The Annual Report is submitted by Norges Bank's Executive Board. Our responsibility is to form an opinion on the financial statements and compliance with the aforementioned relevant guidelines.

The basis for the audit of the annual report is our audit of Norges Bank's annual accounts, including the portfolios mentioned above. Our audit report on the Bank's financial statements for 2006 was submitted on 8 February 2007. Our statement does not include the Government Petroleum Insurance Fund, which is not included in the Bank's annual accounts (see Section 5.1 in the Annual Report for a more detailed description of the organisation of accounting and audit).

We have conducted our audit in accordance with instructions issued by Norges Bank's Supervisory Council and with good auditing practice in Norway, including auditing standards adopted by Den norske Revisorforening (Norwegian Institute of Public Accountants), and submit our statement in accordance with auditing standard RS 800 "Auditors' report on special purpose audit assignments". These auditing standards require that we plan and perform the audit so as to obtain reasonable assurance that the financial statements are free of material misstatements and that management is carried out according to the relevant guidelines. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. We have verified that the reporting of accounts is consistent with Norges Bank's financial statements for 2006. Our audit also includes examining, on a test basis, the information supporting compliance with relevant guidelines. We believe that our audit provides a reasonable basis for our opinion.

In our opinion,
- the report on the accounts provides a true and fair presentation of the portfolio values as of 31 December 2006 and of the return for the accounting year in accordance with the annual financial statements of Norges Bank
- the portfolios are managed in compliance with quantitative provisions according to regulations and guidelines

For a complete accounts presentation of investment management at Norges Bank and a description of the scope of the audit, the Annual Report should be read in the context of the Bank's financial statements and the audit report for 2006.

Oslo, 8 February 2007

Svenn Erik Forsstrøm
Central Bank Auditor
State Authorised Public Accountant (Norway)

Internal equity management

This article summarises our experience of internal equity management for the Government Pension Fund – Global over the last five years, with emphasis on active global sector management. Norges Bank has had favourable experience of its internal management strategies, and they have made a major contribution to the Fund's excess return. As can be seen from the article, internal equity management as a whole has produced an information ratio (risk-adjusted excess return) of 1.2 based on the actual risk in the portfolios. The total excess return generated by these mandates is in excess of NOK 7.3 billion.

History

Three main tasks

Norges Bank has three main tasks in the management of the Government Pension Fund's equity investments. The first is acquiring the market exposure in equities that the Ministry of Finance decides that the Pension Fund should have. This task involves both phasing in new capital and rebalancing, and was discussed in an article published in connection with the 2002 Annual Report. The Fund began investing in the equity market in January 1998. In the first year, a 40 per cent allocation to equities was phased in, while management was outsourced to external managers in the form of index mandates. Internal management was limited during this first year to rebalancing and phasing in through trading in index futures contracts.

The second main task is to manage the equity exposure decided on by the Ministry. This implies investing in a portfolio close to the client's wishes as expressed in the specified benchmark index. For the Pension Fund, this indexing task means purchasing an equal ownership stake in all of the companies included in the Ministry of Finance's benchmark index. The task includes exercising ownership rights. Norges Bank Investment Management (NBIM) decided in 1999 to manage the index portfolios itself, and the last external index mandates were phased out in 2001. The implementation of this transfer, and the reasons for managing these mandates internally, were discussed in an article published in connection with the 2001 Annual Report. At the end of 2006, Norges Bank managed a total of NOK 441 billion in index portfolios for the Pension Fund. Corporate governance has been given greater attention over the last two years, as the Ministry of Finance revised the primary objective for the exercise of ownership rights in November 2004. Two articles on this topic can be found in the present Annual Report.

FEATURE ARTICLE 1

The third main task is generating excess return for the client over and above the return that would come from holding an equal ownership stake in all of the companies in the client's benchmark portfolio. The first active external equity mandates were allocated funds in December 1998. The size of the externally managed portfolio almost doubled each year until 2003, and has since grown in line with the Fund by around 25 per cent a year. Our experience with these external active equity mandates was discussed in an article published in connection with the 2003 Annual Report. Internal management has been built up at an equivalent pace, but three years after external management. The importance of the internal active investment strategies has grown substantially in recent years, and this article discusses the investment strategy and experience to date.

Investment strategy, organisation and risk

Investment strategy

The investment strategy behind our internal active equity management is based on NBIM's overarching investment philosophy, as discussed in an article published in connection with the 1999 Annual Report. One important element in this strategy is *diversification* across numerous independent investments. This is achieved both through different types of investment strategies in different investment units (and mandates) and through a large number of different individual investments. Another element is *specialisation.* The idea is for specialist expertise to provide the competitive edge needed in a near efficient market.[1)]

[1)] Note: Underlying the strategy is what is often referred to as the Fundamental Law of Active Management – that the risk-adjusted return (information ratio) increases proportionally with skill (information coefficient) and with the square root of the number of positions.

Different investment strategies

Our internal equity management employs three main groups of strategies. Firstly, NBIM has built up an investment strategy based on analysis of the financial statements and corporate strategies of individual companies *(global sector strategy).* The aim for this investment strategy is to look for information on company-specific factors rather than broad analyses of the market. This management area has been built up around independent investment teams which invest globally in their respective industry sectors.

Since 2001, NBIM has built up investment teams in the financial services, telecommunications, energy (oil & gas and utilities) and consumer services sectors. From 2005, the energy team was expanded to include analysis and investment in the basic materials industry (paper, chemicals, steel and mining), and the consumer services team to include consumer goods. Each team is free to develop its own investment strategy, process and systems. There is also considerable freedom within each team for the individual to further develop his or her own investment style, methodology and tools. The different managers in each team may have independent or overlapping investment universes, and they may on occasion invest in the same companies at different times, or with opposing positions.

Another investment unit specialises in *relative value strategies*. These are based on special situations in the markets and do not attempt to analyse individual companies' fundamentals. These strategies include enhanced indexing strategies (discussed in an article published in connection with the 2001 Annual Report) and various quantitative strategies. The strategies used may relate to mergers and acquisitions, share issuance, index inclusion, listing on additional exchanges, and so on. These situations may affect the supply and demand for a share disregarding changes in future earnings or other aspects of the companies' finances.

A third group of strategies look at broad groups of shares in the market *(equity strategy).* The fundamental analysis of companies in the global sector strategies and the situation-dependent analysis of company-specific factors in the relative value strategies both focus on the analysis of individual companies. The strategies in this third group are based on the analysis of shares with a common denominator or the analysis of entire segments of the market, such as all shares in a particular industry sector or country.

Specialisation

The majority of our internal active management is made up of global sector mandates. This investment activity is built around industry teams but with independent investment mandates for the different managers within each team. The individual portfolio manager can invest in any country in our investment universe, but is restricted to a specific industry sector. We believe in the value of giving managers the opportunity to invest globally, but aim to retain the focus and accumulation of specialist expertise that go with each individual manager concentrating on a single industry sector.

Relative value management is also highly specialised. Typically each manager will monitor only a few of the different types of special situation that may arise. A manager who regularly takes positions in takeover situations will have a good understanding of the particular issues in these.

The internal investment mandates are generally specialist mandates awarded to individuals for small parts of the investment universe. NBIM has been careful about building up investment strategies covering broad parts or aspects of the market. It is difficult to build up specialist expertise in the third type of strategy mentioned above, and the risk taken in these strategies has been limited. Nevertheless, the results have been far better than anticipated.

Large number of independent positions

The more numerous and the more independent the investments in the overall portfolio, the better the balance between risk and return. This is the key difference between individual investments and portfolio management. NBIM has attached importance to building up a highly diversified portfolio of relatively independent investments.

An investment strategy based on the analysis of individual companies will result in more independent positions in each individual portfolio than a strategy where stock-picking is based on a small number of factors affecting the entire market. A portfolio with many different shares will not necessarily provide any real diversification if the investments are based on a single theme or factors that could impact on all of the investments, such as macroeconomic developments, raw material prices, or interest rate and credit conditions.

The focus on individual investments, and to build up specialist expertise in them, implies that we do not want the individual manager to invest in too many different companies. However, a mandate structure based on a subdivided investment universe – such as a structure of global mandates in different industry sectors – will, in most cases, result in more independent positions than broad overlapping mandates. Thus we obtain a large number of positions by having many different specialist mandates rather than having a large number of investments per manager. By having the managers invest in different industry sectors, their portfolios will overlap only to a limited extent, provided that they are not based on the same assessments of factors affecting the whole market.

Thus we are looking for an investment strategy based on the analysis of individual companies, with a small number of investments per manager, divided into a variety of specialist mandates, in different segments of the market. This is the same strategy as underlies the structure of our external management mandates.

Organisation

The investment strategy has shaped the organisation. Investments are based on teams which are given freedom to develop their investment process in order to ensure real independence between strategies. There is not a desire to establish a common investment process for the entire organisation.. Nor have we attempted to cover all industries, focusing instead on building up a cluster of expertise in selected industries.

NBIM's investment organisation does not divide the role between analysts and portfolio managers. We want the people who know the companies best to take the actual investment decisions. The majority of the managers have previous experience as analysts, rather than as portfolio managers. The focus has been on individual investments, and we have established few organisational structures to obtain broad market information. Contact with corporate management has been given great emphasis. A performance orientation means full delegation of investment decisions to individuals and remuneration based largely on individual results.

Risk profile

Number of positions

At the end of 2006, internal management was divided into 15 global sector mandates, five relative value mandates and four equity strategy mandates. In addition, NBIM had four managers responsible for the internal index portfolios.

At the end of 2006, the 24 internal managers working on NBIM's active strategies had invested a total of NOK 62.1 billion in around 1 200 positions (and sold a corresponding number). The average position was therefore relatively modest in relation to the overall size of the fund at just over NOK 50 million. The average position in the global sector mandates was NOK 126 million, and that for the relative value strategies was NOK 60 million. The portfolio managers in the global sector teams each had an average of 17 long positions (and 19 shorts), of which the five largest accounted for an average of 61 per cent of risk exposure. A total of 45 out of 234 stocks (and 50 out of 265 shorts) were held by more than one manager. The relative value and equity strategy managers had far more positions, as can be seen from Table 1.

Overall risk

The risk (measured using the standard deviation of weekly returns) in the overall internally managed portfolio was NOK 1 861 million at the end of 2006. Statistically, it can be expected that at least this amount will be either lost or gained in one out of three years. However, the sum of the risk in each of the individual mandates was NOK 5 274 million. In other words, the overall risk was around 35 per cent of that for all of the mandates added together.

The reduction of risk through diversification is achieved with a mandate structure of independent mandates with different investment strategies and positions. In the overall portfolio of external mandates, NBIM has found that around 55 per cent of the risk in each individual mandate is reduced through diversification. This is slightly less than with the internal mandates, even though at the end of 2006 there were 45 external mandates and only 24 internal mandates.

Table 1: Number of positions in internal management at the end of 2006.

Year-end 2006	Consumer	Telecom	Energy	Finance	Strategy	Rel. value	Total
No. of managers	5	3	5	2	4	5	24
No. of long/short positions	52/59	35/14	52/84	50/58	821/867	225/209	1 196/1241
Position. average (NOKm)	104.1	163.8	156.3	128.3	27.3	59.9	52.0
Exposure per manager. average (NOKm)	1 082.8	1 911.0	1 625.4	3 207.5	5 605.3	2 696.8	2 589.0

Table 2: Risk profile for internal management at the end of 2006.

Year-end 2006	Consumer	Telecom	Energy	Finance	Strategy	Rel. value	Total
Sum of realised risk (NOKm)	468.6	597.4	1 670.5	521.9	1 375.8	640.0	5 274.2
Overall estimated risk (NOKm)	268.0	441.0	757.0	348.0	1 074.0	418.0	1 679.7
Diversification, estimated risk	55 %	80 %	56 %	84 %	64 %	53 %	35 %
Mandate correlation, average	0.21	0.44	0.25	0.005	0.46	(0.02)	0.24

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There was also considerable diversification within each of the internal strategies. The model-estimated risk for each group together was, as can be seen from Table 2, between 53 and 84 per cent of the sum of the risk in the mandates. The diversification was even greater in the realised return figures for all of the investment teams in 2006: between 35 and 67 per cent.

None of the 20 individual mandates within the global sector and relative value strategies accounted for more than 16 per cent of the overall risk for of these two management strategies. The five mandates with the greatest risk exposure within these strategies accounted for 49 per cent of overall risk exposure at the end of 2006.

Diversification

There is always a risk of managers in the same investment organisation being influenced by one another's views, and of investments becoming too similar in the sense that they will outperform or underperform the market at the same time. The average correlation between the internal mandates was 0.24 in 2006.

Recent years' results have shown a slightly higher correlation between the results for internal management than between those for the external mandates. Over the last five years, the correlation between the internal mandates has been 0.23. In the three groups of regional external mandates (Americas, Europe and Asia), the correlation has been 0.18, 0.15 and 0.15 respectively, and the correlation between external sector mandates has been 0.12.

The internal mandates have also had very limited factor risk. This is the risk associated with exposure to equities with similarities in valuation, momentum and so on. While around a quarter of the external mandates' risk can be attributed to this type of risk, the figure for the internal mandates has been less than 10 per cent. This suggests that the risks taken in internal management relate to company-specific factors rather than factors that move many different shares in the market.

Table 3: Risk profile for internal management 2002-06.

	2002	2003	2004	2005	2006	Total
Sum of realised risk (NOKm)	801.1	848.5	1 434.7	3 474.4	5 274.2	3 480.8
Overall realised risk (NOKm)*	485.0	446.8	733.9	2 327.0	1 860.8	1 116.0
Diversification	61 %	53 %	51 %	67 %	35 %	32 %
Mandate correlation, average	0.37	0.33	0.28	0.38	0.24	0.23
Information ratio	0.29	1.62	1.28	1.00	1.79	1.20

* After diversification

Experience 2002-06

Developments in risk exposure

Internal management has been expanded considerably in recent years. Since the end of 2002, overall risk exposure has risen from NOK 485 million to NOK 1 861 million, while the sum of the risks in individual mandates has risen from NOK 801 million to NOK 5 274 million. This is a trend that we expect to continue in the years ahead.

Diversification gains have risen over time from a 39 per cent reduction of risk in 2002 to 65 per cent in 2006 in line with the increase in the number of managers. During the period 2002-06, the correlation between the internal mandates fell gradually, from 0.4 to almost 0.2.

At the end of 2006, these mandates had an average exposure of NOK 2.6 billion, but with relatively large variations. The largest mandate was NOK 13.2 billion and the smallest NOK 200 million. These variations are due partly to the assessment of the individual managers' experience and ability to generate excess return, but also to the risk profile of the particular portfolio and the overall market capitalisation of its investment universe.

Results of strategies and mandates 2002-06

On the whole, the internal mandates have performed very well from the outset, with an excess return for all of the investment strategies every single year. They have generated an excess return of almost NOK 12 billion, a very high figure relative to the level of risk.

The global sector mandates have made the greatest contribution, with a total excess return of NOK 5 095 million, while the relative value mandates have contributed NOK 1 305 million. The excess return from the equity strategy mandates of NOK 3 748 million includes positions taken by selling shares other than those in the benchmark index in connection with the allocation to external mandates. This excess return of

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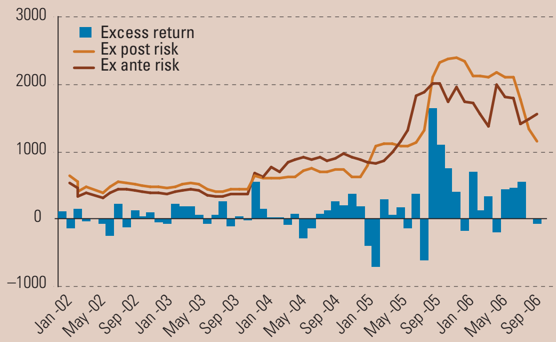

Chart 1: Results for internal management 2002-06. NOK million.

NOK 2 815 million is allocated to the external mandates in the Annual Report, although it is not a result of investment decisions made in these mandates. Net of this, the excess return from the equity strategy mandates is NOK 933 million.

The results have also been consistent across the strategies, with approximately the same excess return for each of the strategy types when taking into account the number of managers. The 20 mandates under the global sector and relative value strategies have contributed NOK 6 400 million, which is just over NOK 320 million per manager or NOK 8.4 million for each month in which each manager has held a mandate. We are pleased with this performance given the gradual build-up of risk exposure. The equity strategy mandates had few managers prior to 2006.

Excluding the return from allocation positions in the equity strategy mandates and the internal enhanced indexing strategies, the overall excess return from internal management was NOK 7 333 million.

Evaluation of results

It is customary to evaluate portfolio returns relative to risk. The most widely used measure is the information ratio – the excess return during a period divided by the standard deviation of the return series during that period.

All of the strategies in NBIM's internal equity management have generated an information ratio in excess of 1. Global sector management has produced an information ratio of 1.2 based on actual variations in returns, and 1.4 based on model-estimated risk. The relative value strategies have generated a higher information ratio of 1.8. This is due largely to the difference in the types of position taken.

The target for the individual internal mandates is an information ratio (risk-adjusted excess return) of 0.25 after costs. However, the cost of the internal mandates is so low that the net information ratio is not materially affected by costs. To date, NBIM has had a higher risk-adjusted excess return than expected from almost all of the individual mandates. The average information ratio for the managers has trended upwards over the last five years, as can be seen from Table 5. The risk in each individual mandate has risen gradually, while the excess return has grown at a more rapid rate. We do not expect this to continue. The information ratio will fall with higher risk exposure in NOK terms, as the positions will either be taken in larger companies or face higher liquidity costs.

Table 4: Excess return from the different internal management strategies 2002-06. NOK million

	2002	2003	2004	2005	2006	Total
Global sector	29.6	566.5	543.0	1 494.3	2 461.3	5 094.5
Relative value	113.5	163.7	402.8	252.4	372.9	1 305.2
Equity strategy	248.4	428.6	333.2	1 046.1	1 691.3	3 747.6
Indexing	–	–	184.6	526.9	1 066.0	1 777.5
Total	391.4	1 158.7	1 463.6	3 319.7	5 591.5	11 924.9

Table 5: Results for individual mandates in internal management 2002-06.

	2002	2003	2004	2005	2006	Total
No. of managers	10	13	20	22	24	
Managers with positive return	50 %	62 %	75 %	82 %	88 %	88 %
Manager-months w. pos. return	53 %	57 %	59 %	58 %	62 %	58 %
Realised risk, average (NOKm)	79.6	62.7	100.0	143.4	132.2	139.2
Excess return, average (NOKm)	14.3	55.8	45.6	91.4	107.5	285.6
Information ratio, avg. manager	0.14	0.43	0.65	0.71	0.91	0.24

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Future strategy

Choice between internal and external management

NBIM has had good results from both the internally managed mandates and those outsourced to other management organisations. One obvious question is how we choose between internal and external management. However, the way that management is organised means that no such decision is necessary. This is because internal active management is not allocated any part of the portfolio for management, but takes positions by borrowing shares which are sold in the market in order to finance purchases of other equities. These loans of equities will normally be made from the internal index portfolio. If there is no such holding, the internal managers will borrow from the externally managed portfolios or, where necessary, from other investors in the market.

NBIM will continue to outsource to external managers whenever we expect such managers to produce a better return after management fees than would be generated by index management. The positions taken in internal active management do not affect the proportion of the portfolio allocated to external management mandates. Even if the portfolio were outsourced to external managers in its entirety, the level of internal investment activity would be as today.

Further expansion of internal management

In recent years, the internal mandates have accounted for around 20 per cent of the overall risk in the Pension Fund's equity portfolio. During the second half of 2005, however, this risk exposure increased substantially, and the internal equity mandates accounted for around 30 per cent of risk at the end of the year. The internal mandates accounted for 26 per cent of the sum of the risk in all internal and external mandates at the end of 2006. However, the marginal contribution – the increase in risk with or without the internal mandates – has only been around 20 per cent. At the end of 2006, for example, the Pension Fund would have had a risk of 60 bp from a combination of external mandates and internal index management, and this rose by only 12 bp or NOK 870 million as a result of the internal active mandates. A combination of internal and external mandates therefore offers good diversification. It is worth noting that the internal mandates in NOK terms have made a greater contribution to excess return than the external mandates, both over the last five years and from the outset, given the relatively lower percentage of risk for which they have accounted.

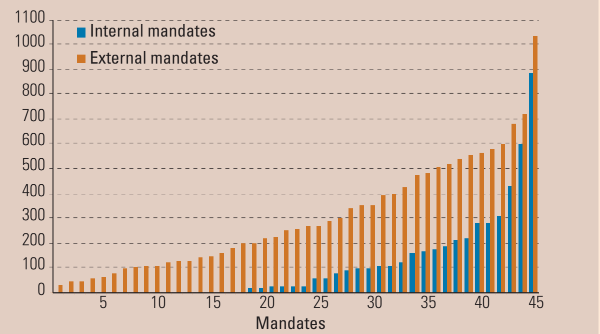

Chart 2: Distribution of risk between internal and external mandates. NOK million.

In the coming years, NBIM will be increasing the number of internal mandates and the risk in each of these mandates so as to bring the risk profile of internal and external management more closely into line. This means almost twice as many internal mandates as today, and more than doubling the risk in each mandate. See Chart 2.

However the external mandates fare in the future, the importance of the internal active investment strategies will grow in the years ahead. NBIM will be intensifying its work in this area.

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Priority areas of corporate governance: ownership rights, children and the environment

This article presents the plans for Norges Bank's corporate governance work in the coming years. This work will concentrate on six priority areas. Four concern fundamental ownership rights: the right to vote, the right to nominate and elect board members, the right to trade shares freely, and the right to open and timely information. The other two concern social and environmental sustainability: children's rights in the value chains of multinationals, and companies' interaction with national and supranational authorities in questions related to long-term environmental changes and liabilities.

Introduction

To move mountains, you need high ambitions. Norges Bank indeed has high ambitions for its corporate governance work and aims to become known as one of the world's most prominent and professional active shareholders over the coming four-year period. The results may in many cases be difficult to gauge, not least because it will often take time for them to become apparent. Nevertheless, Norges Bank's goal is to contribute to – and be able to point to – concrete changes both in its portfolio companies and in the markets as a result of its work.

The Ministry of Finance's Ethical Guidelines for the Government Pension Fund – Global state that the primary objective for Norges Bank's exercise of ownership rights is to safeguard the Fund's financial interests. The exercise of ownership rights is to be based on a long time horizon for the Fund's investments, and broad investment diversification in the markets that are included in the investment universe. Financial, social and environmental issues must therefore all be taken into account in the exercise of ownership rights. This clearly necessitates an ambitious and wide-ranging agenda. However, for several reasons, active involvement in all potentially important issues at every one of the 3 500 or so companies in the equity portfolio would not be a reasonable goal.

Firstly, it is not possible for a single investment manager to pay full attention to all of its portfolio companies at one and the same time. External consultants, agencies and news services can contribute information, and NBIM does make active use of such information, for example in its voting (see separate article). But to go into depth and put resources into all of the matters that arise – and on which we might have an opinion – is simply not possible given the natural constraints on the time and resourc-

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es available to NBIM (or any other investment manager for that matter).

Secondly, there is the delegation of duties and responsibilities between Norges Bank and the Ministry of Finance. The Ministry, acting on the advice of the Advisory Council on Ethics for the Government Pension Fund, determines which companies are to be excluded from the portfolio on the basis of the Ethical Guidelines (see section 4.1 of the 2006 Annual Report for a report on these guidelines, or see www.etikkradet.no). Norges Bank for its part follows up these same guidelines through active ownership of its portfolio companies. This means that the most serious types of breaches of human rights and fundamental ethical principles will normally be dealt with by the Council on Ethics. This does not mean that Norges Bank never addresses such issues, but it is natural for the Bank to look mainly at long-term and persistent ethical problems which do not come under the auspices of the Council on Ethics, as well as the promotion of good governance systems at companies and the safeguarding of shareholder rights.

Thirdly, Norges Bank's reputation as an active shareholder could be tarnished if its actions are viewed as arbitrary, unconsidered or politically motivated. If NBIM becomes known as a player with multiple agendas and bees in our bonnet without any common direction and prioritisation, we will lose influence and credibility as an investor.

Finally, even though the Government Pension Fund – Global is large, its holdings in each individual company are small. We cannot expect to be heard on the grounds of size or financial importance alone. The quality of our message and the credibility of our communication will also be crucial, not least if we are to secure the support of other investors.

For all these reasons, Norges Bank has decided to concentrate its corporate governance work on a small number of priority areas which are of particularly great importance for its portfolios – and so also for all of the people who stand to benefit from its returns in future generations. This does not rule out the possibility of involvement in other areas too, or of new priority areas being added as our resources and experience grow. The point is that our corporate governance work needs direction and focus, and this is something that we are hoping to achieve through the priority areas that we have chosen.

The choice of priority areas for Norges Bank's corporate governance work was based on the following criteria: they must be relevant to investors in general and our portfolio in particular; they must be suited to dialogue with companies and/or regulators and provide scope for us to make a real difference; and they must be justifiable financially, as we are acting in the capacity of an investor, not of a political player or NGO. This latter factor means that we must identify issues where ethics and long-term financial returns go hand in hand, as it is in these areas that an investor can be expected to make an impact.

Global ownership interests

Norges Bank's assets under management are among the largest of their kind in the world at around NOK 2 050 billion, of which NOK 818 billion is invested in global equities. The investment strategy means that the equity portfolio is spread across all significant regional and national markets. Norges Bank's portfolios therefore stand to benefit from – and are exposed to – value creation in all regions and in the global economy.

This "universal" ownership means that long-term returns are determined not just by how each individual company or sector performs, but at least as much by the overall capacity to create value in all parts of the world. Large investors with such diversified portfolios effectively interface with a cross-section of the global economy. This can give rise to influence in the markets *even where each individual holding is small*. It is therefore natural that Norges Bank's ownership activities aim to influence both the governance of companies and market standards. Other factors that can help or hinder value creation potential may also be relevant targets for active ownership work. This applies not least to the contributions of companies to serious negative externalities, i.e., their effects on business, the environment and society outside the company.

Norges Bank's corporate governance work therefore covers more areas than investors have traditionally become involved in. General economic considerations or social and environmental issues may therefore be emphasised when engaging with the individual company, and also in dealings with the regulatory authorities.

To follow up this broad approach, NBIM has embarked on ownership activities relating to:

- making boards of directors accountable to shareholders, partly through increased direct shareholder influence over director elections, the removal of mechanisms which give some shares fewer voting rights than others, a reduction in inappropriate barriers to takeovers, and a decrease in other restrictions on value-increasing measures at companies;
- increasing transparency, partly through improved requirements for how companies report on operations that could pose ethical or legal dilemmas;
- better coordination between institutional investors in order to follow up the governance of companies more effectively, as few investors can afford to follow up a large number of companies alone;
- expressing expectations that companies comply with accepted international norms for the treatment of the workforce and the local environment (as set out, for example, in the UN Global Compact) in order to strengthen both the basis for the company's business and the legitimacy of open markets, globalisation and multinational enterprise; and
- identifying particular priority areas both within traditional corporate governance and within social and environmental areas.

NBIM's corporate governance work involves voting, direct contact with companies and authorities, networking with other investors, and contributing to broad public debate about corporate governance and active share ownership. An overview of these activities in 2006 can be found in the annual corporate governance report in the 2006 Annual Report, and a discussion of voting practices can be found in a separate thematic article. The present article concentrates on the areas chosen to ensure that NBIM has the right priorities and shoulders its responsibilities as a "universal owner" – a shareholder exposed to a cross-section of the challenges and trends in global markets.

Strategic priority areas

All of Norges Bank's priority areas of corporate governance, presented in more detail below, deal with owners' key interests – in other words, they relate to long-term returns and the mitigation of risk, and they concern key principles of good corporate governance, ethics or environmental protection. They can be divided into three main categories.

First, there is good corporate governance – good and legitimate management of the companies in which we have ownership interests, and of the markets of which these companies are part. Here, our most important role is to ensure that the rights of minority shareholders are protected, and that companies are governed in a way that ensures good long-term returns while observing recognised norms and laws. This area is subdivided into four parts, each of which is discussed below. Good corporate governance is essential for overall investor influence.

Second, we have ethical and social issues, not least the observance of core human rights. As an investment manager with a long-term horizon and a special interest in the potential of future generations to participate in the economy and in society, Norges Bank has decided in this context to focus on children and their welfare, particularly in relation to combating child labour and protecting child health. Children's rights in the value chain of multinationals will be especially important, as it is here that our work as an investor can be expected to have the greatest impact.

Thirdly, we have the type of long-term environmental problems that could affect the Fund's sustainability. The most high-profile of these is climate change, but there are also other problems that need to be monitored carefully and that we will increasingly be taking up with relevant portfolio companies. Norges Bank will be working particularly on the actions of portfolio companies in relation to national and supranational authorities in questions related to long-term environmental changes – including the risk of serious climate change, the destruction of ecosystems and biodiversity, and large-scale and long-term destruction of water and other natural resources. In these areas, Norges Bank will promote greater transparency and accountability when it comes to the lobbying activities of companies, so that this lobbying runs counter to Norges Bank's interests to the least possible extent.

On top of all this, NBIM also monitors other issues at company and portfolio level, including corruption, executive pay, workers' rights and companies' position in terms of violations of human rights. Matters of this kind will regularly be brought up at general meetings or be part of international campaigns which NBIM may support, together with other investors and investor networks.

Good corporate governance: director elections, voting rights, transparency and anti-takeover mechanisms

One of the single most important elements of Norges Bank's corporate governance work is holding the companies' boards of directors to account. NBIM's engagement with respect to broad ownership issues, including ethics and the environment, is therefore directed to the boards of companies. As NBIM increasingly instigates engagement processes with individual companies (which will be a key part of our activities throughout the four-year strategy period from 2007 to 2010), the chairman and key board representatives will be the most important points of contact. The board is responsible for a company's long-term strategy and is to make management accountable for its actions and communicate shareholders' views.

As part of the work to make directors more accountable, NBIM has made the nomination and election of directors one of its priority areas. This is currently a hot topic in the US, where the rights of investors to nominate candidates or vote against the candidates put forward by the company itself are strictly limited. Given that the chairman and chief executive officer are one and the same person at many listed companies in the US, it is clear that we face a governance problem. However, changes are afoot, both at individual companies and in the regulatory framework (at the Securities and Exchange Commission, for example). NBIM has been pushing for change and will work together with other investors to ensure that boards have as broad and favourable a composition as pos-

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sible, with representatives who are willing to listen to their investors.

A closely related priority area is the right to vote at companies' general meetings. In many jurisdictions, especially in Europe, shares may confer limited voting rights in practice, partly because some shares carry more votes than others, and partly because trading in shares around the time of general meetings can be subject to complex restrictions which make it difficult for many funds to exercise their voting rights. NBIM is campaigning for the rules on voting rights to be made as predictable and clear as possible in all markets, and for minority shareholders to be able to have their say and exercise their voting rights at the companies of which they are the co-owners.

For voting rights to really count, and for other forms of engagement with a company to be meaningful, the information that investors receive – both ahead of general meetings and in the exercise of their ownership rights in other respects – needs to be accurate and readily available. This is far from the case at many companies. Simple things such as receiving the agenda for a general meeting in time, or having it made available in languages other than that of the country in question, can be difficult in practice at some portfolio companies. It may also be complicated and time-consuming getting answers to questions or finding out whom to approach. Not least in some Asian jurisdictions, investors struggle with this. Work on ensuring transparent reporting and information from companies is therefore a dedicated priority area for NBIM.

Another key feature of a well-functioning equity market is the ability of shareholders to sell their shares when they want to. However, the sitting management and boards of many companies place obstacles in the path of this, especially if they resist a takeover by new owners. In some cases, such obstacles may be legitimate, such as protection against takeover attempts which may in reality be a form of corruption or in some other way may not be in the interests of shareholders or the company as a whole. However, NBIM insists that such obstacles to the sale of shares and takeovers be presented openly to shareholders, and that the consent of the latter be required for both the introduction and the retention of such measures. Normally, NBIM is of the view that a free market for the buying and selling of shares with no anti-takeover mechanisms will best safeguard the interests of shareholders and the legitimacy and health of the markets. Against this background, the right to trade shares freely and the right to approve anti-takeover mechanisms has been selected as our fourth priority area.

These four priority areas are directly related to actual corporate governance: (1) board accountability and director elections, (2) the right to vote, (3) the right to good information and reporting, and (4) the right to sell and trade shares. Together, they are key prerequisites if an investor such as Norges Bank is to be able to protect its interests as an investor and exercise its ownership rights.

It is important to add that following up on these areas is not just about engaging with individual companies but also about engaging with the regulatory authorities. International organisations such as the International Corporate Governance Network play a key role here. Information from and participation in such networks are therefore important for NBIM.

Child labour and children's rights

Few topics are of such great importance ethically as the protection of children's rights. Children are normally the weakest link in conflicts and disputes, including in industry. As they cannot protect themselves, they can come to considerable harm as a result of the actions of adults. It has been established beyond doubt that some companies and sectors in our portfolios do contribute to such harm and could do more to protect children's legitimate interests and rights. The most serious breaches of children's rights will come under the auspices of the Council on Ethics and, if verified as gross breaches of human rights, lead to a recommendation on the exclusion of the relevant companies from the investment universe. In some cases, however, it may be beneficial first – before reaching a final decision on exclusion – to use Norges Bank's influence as a shareholder to enter into a dialogue with the companies in question and make sure that the companies understand the severity of the situation. There are also companies that could take action in children's interests, yet are not behaving in such a way as to qualify for exclusion. In this case, it is a matter for Norges Bank rather than the Council on Ethics.

For three important reasons, efforts to safeguard children's rights are also of *financial* importance and hence a natural area for an investor such as Norges Bank to take on.

Firstly, a generation lacking education and health provides a poor basis for future employment. The number of people aged 15-40 is set to grow sharply in many of the world's countries in the coming decades, because the number of women of child-bearing age is now higher than ever before (both in absolute terms and relative to the overall population), and because birth rates are still high in most developing nations. If large parts of the coming generation reach working age without skills and with their childhood wrecked by physical exploitation or inadequate social conditions, this could clearly lead to social unrest and instability, on top of the personal tragedy for the individual. On the other hand, a well-educated younger generation surrounded by stable social frameworks could be a unique resource for building a more sustainable society. Focusing on child welfare in the value chains and spheres of influence of our portfolio companies, including combating the most serious forms of child labour, is therefore a natural priority area for an investor with an investment horizon stretching forward many decades.

Secondly, corporate behaviour that harms children's health and rights distorts the market in a way that threatens the legitimacy of both individual companies and entire markets. NBIM is dependent on the credibility and legitimacy of the markets in which we operate – which, in practice, are markets all around the world, as many portfolio companies also have activities in countries where we do not have any direct investments. Serious ethical problems in the market could serve to undermine confidence not only in individual companies and sectors but in the whole of the global market economy in which NBIM participates. Measures to increase the legitimacy and morality of the market system, in the form of both general regulations and company-specific initiatives, will therefore be important for NBIM's long-term position as a global investor. In this respect, few things are as important as steps to increase the protection of children's rights within companies' spheres of responsibility.

Finally, it is natural for NBIM to assume that an unwillingness to address and combat the exploitation of children and safeguard children's rights may be indicative of a generally weak strategy at the company in question for dealing with its externalities. Working with selected portfolio companies on improving the handling of children's rights in their value chain is therefore a useful way of strengthening the ability of these companies to build a sustainable strategy for their externalities in general.

NBIM's overriding aim in this priority area is to improve the situation of children employed in, or directly affected by, the value chains of companies in NBIM's portfolio. These companies are to be encouraged to comply with the requirements of the UN Global Compact and other relevant documents on human and children's rights. They must also, where realistic, be encouraged to exceed these minimum standards in order to ensure good health and education for children within their sphere of activity and influence.

However, it should be noted that the abolition of all forms of child labour is currently unrealistic and, indeed, undesirable, given the social and familial structures that would collapse in many countries were children not able to contribute labour and income. Several international aid organisations, including Save the Children, have reached the same conclusion, even though the long-term goal is the abolition of all child labour.

Norges Bank's overriding aim of improving the situation of children is subdivided into a series of concrete objectives, all of which are in line with the UN Global Compact and the ILO Worst Forms of Child Labour Convention. These objectives require NBIM to work with relevant portfolio companies to ensure that those children who do work are not too young, and that work for the very youngest is abolished altogether; that the work that children do is not physically dangerous; that their working hours are limited; that the children are under competent adult supervision; that the children are not forcibly removed from their families; and that their work is combined with education and adequate health care. (Note that the use of the term "portfolio companies" here also includes subsidiaries and important suppliers in the supply chain, over which the companies have an influence. However, whether it is NBIM's portfolio company or companies further down the value chain which have the main responsibility for implementing these measures will vary.)

For example, large new development projects – greenfield projects – often affect whole families and local environments in ways that expose children to considerable danger and often involve child labour. NBIM will encourage companies involved in such projects to provide full reports on steps taken in line with the overriding aim and subsidiary objectives above *before* the projects start up. This should be developed into an international reporting standard.

To ensure that NBIM always concentrates on the most important issues, sectors and companies in this area, NBIM works with its own groups of experts who help identify the greatest problems at any one time and hold up good role models, so that the overriding aim and subsidiary objectives are implemented as realistically as possible. NBIM will also gradually involve other investors in its work on this priority area, so as to ensure the greatest possible impact, and use public communication to raise awareness of these issues. In parallel with this, NBIM has already embarked on concrete engagement processes with individual companies.

The environment and lobbying

NBIM's portfolio is global and long-term and is therefore exposed to large-scale environmental changes and environmental destruction. NBIM is therefore working to make both itself and other investors aware of the environmental factors that could impact most on the markets' long-term sustainability, and then include these in corporate governance work.

The Stern Review for the UK government published in autumn 2006 confirmed that climate change also poses a particularly serious economic threat. Unless something is done about the risk of serious climate change, there could be a decrease in global economic activity equivalent to a permanent reduction of 5-20 per cent – or more – in annual global GDP, with effects which will be noticed in the next decade. The necessary action to combat the most serious forms of climate change will themselves cost around 1 per cent of annual global GDP, according to the Stern Review. Against this background, the risk of climate change – which a clear majority of international scientists believes to be partly due to human activity and can also be combated through human activity – is a good example of the type of environmental threat that NBIM must bear in mind as an active shareholder.

However, it is important to remember that an investor's influence in this field is limited. Each individual portfolio company's emissions of carbon dioxide and other greenhouse gases are generally neither illegal nor immoral per se. It is the aggregate amount that is the problem. It is also unrealistic for companies that produce carbon dioxide and other greenhouse gases to cut their emissions without statutory requirements in this area which apply both to them and to their competitors. Companies may be able to reduce greenhouse gas

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emissions on their own initiative for economic reasons, in order to improve their profile and credibility, or to be better equipped to meet the more stringent statutory requirements of tomorrow. In many cases, NBIM will support initiatives to strengthen such incentives, together with the growing body of international investors expressing concern about climate change. However, it is political initiatives and market regulations, both national and international, that will be the key factor in the fight against serious climate change. This includes international solutions after the Kyoto Protocol expires in 2012 (such as more clearly expressed – and binding – targets for the total amount of greenhouse gases in the atmosphere), and national and regional tax regimes to encourage reduced emissions of greenhouse gases and increased use of alternative energy sources.

Does an investor have any influence over this at all? Can such initiatives be promoted through active share ownership? In spite of everything, we believe the answer to be yes. Some of NBIM's portfolio companies devote considerable resources to influencing national and international authorities through lobbying, both directly and through trade organisations. Lobbying per se is a legitimate and necessary part of the interaction between industry and regulators. However, it is a problem if companies actively pursue lobbying *contrary to the interests of their investors.* In many countries, including the US, companies (in the energy sector, for example) have employed considerable means to fight climate initiatives which would benefit NBIM and other "universal" investors, and which could also benefit the companies and sectors in question if these measures are implemented with the necessary degree of consistency and predictability. NBIM will therefore be working both with individual companies and with trade organisations to promote increased openness about the lobbying activities of companies in the environmental field, with a view to aligning investor interests on the one hand and the aims of companies in their lobbying activities on the other. NBIM wishes to highlight responsible and transparent lobbying as an area where investors can contribute to responsible environmental initiatives, in a way which serves both the long-term return on the portfolio and our interests as a financial investor in the individual company.

This same approach – openness and responsibility in lobbying the authorities on environmental initiatives – could also be significant for other environmental issues. Problem areas relevant to the portfolios include reductions in biodiversity with long-term effects on entire ecosystems, unsafe management of nuclear waste, and long-term destruction of drinking water sources and similar industrial and natural resources.

Conclusion

Norges Bank's ambition is to be a prominent and respected active shareholder that manages to combine ethical and financial considerations in a way that wins the support of other investors, companies and regulators alike. To begin with, during the four-year period from 2007 to 2010, NBIM aims to build up a solid reputation based on concrete results and changes in the market. These results may often be difficult to gauge, not least because it will often take time for them to become apparent. Nevertheless, our goal is to be able to point to increased awareness and concrete changes at portfolio companies – and in the markets – in all of our priority areas within this four-year period. Concrete information about individual companies will often have to remain confidential on account of the processes in which we are involved, but we will endeavour to report as openly as possible on the principles and priorities underlying our ownership processes, the types of resources that have been used, and the results that have been achieved. Norges Bank has also begun work on making it possible to report in even more detail on voting at company level. The publication of this material will take place with effect from the 2007 annual general meeting season in connection with the annual corporate governance report.

NBIM will also continue to promote and support good principles of corporate governance and ethics in fields outside our priority areas, through voting, participation in the public debate, publication of our ownership principles, and support for other investors' initiatives.

In this way, Norges Bank will emerge as a serious and comprehensive player with ambitious yet realistic goals.

Voting – why and how?

This article explains why Norges Bank attaches importance to voting in its portfolio companies, and why voting is a key means of safeguarding our ownership rights. Continued participation in companies' AGMs, increased efforts to ensure judicious voting, and work to promote the provision of sufficient, timely and accurate information by companies will be key elements in Norges Bank's corporate governance work in the years ahead.

Introduction

Voting is very important for safeguarding our fundamental ownership rights. Voting also helps Norges Bank to satisfy the two sets of obligations in the Ethical Guidelines for the Government Pension Fund – Global. First, the Bank has an ethical obligation to safeguard the financial interests of the Fund. Second, the Bank is to promote good corporate governance and social and environmental sustainability, as these factors are expected to have an influence on long-term returns.

Voting helps, not least, to make the board and management of a company accountable. Norges Bank is a minority shareholder, and voting at a company's general meetings is a way for minority shareholders to avoid being expropriated by management or controlling shareholders and to protect their financial interests. Voting is also a means of addressing social and environmental issues, which are increasingly being put forward as shareholder proposals at companies' general meetings. It is the general meeting that appoints and removes the company's directors. Who is elected onto the board, and their ability and willingness to take on board this type of issues, will obviously impact on a company's strategy. A large and growing proportion of the world's shares are held by pension funds and other investors with largely the same objectives as Norges Bank. In this context, it may be worth noting the following statistics. In 2005, pension funds in the OECD countries had estimated assets under management of more than USD 17 900 billion.[1)] The economic importance of pension funds varies from country to country, but in large markets like the UK and the US, the assets managed by funds of this type were equivalent to two-thirds and 100 per cent of GDP respectively. In the US, pension funds hold more than 60 per cent of listed equities. Pension funds in large European countries like the Netherlands and the UK have an average direct allocation to equities of more than 50 per cent, and in the US the figure is around 40 per cent.[2)] The Government Pension Fund –

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Global's equity allocation is currently 40 per cent.

Voting is an important platform for other elements of Norges Bank's corporate governance work, because engaging with companies outside the general meetings is more credible if it builds on judicious voting. Furthermore, our work on voting gives us an insight into the individual company and its operations which is fundamental to other contact with the company in a corporate governance context.

[1] Source: OECD Pension Markets in Focus, October 2006, Issue 3.

[2] US pension funds also invest more than 20 per cent of their capital in mutual funds, which invest primarily in equities.

Voting at general meetings

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. By exercising their voting rights, shareholders elect the company's board and decide on other matters that may be of great importance to the company.

However, it is not always the case that all shareholders agree on fundamental decisions for the company. In such situations, voting at general meetings is a mechanism for settling disagreements. In principle, all shareholders are to be treated equally. Participation in general meetingss helps to ensure that this principle is upheld, and so to protect minority shareholders from being expropriated. In some markets – and probably increasingly so in the years ahead – the general meeting is also a key arena for raising social and environmental issues. Of course, the idea is not for shareholders to use general meetings to micromanage the company, but active participation in voting helps to ensure influence over the company's overall strategy. Norges Bank holds shares in several thousand companies, and it would be impossible in practice for NBIM to physically attend the general meetings of all of them. However, most companies now offer shareholders an alternative to voting in person, in the form of proxy voting. The way this system normally works, investors name a representative who attends the meeting and votes on their behalf. The proxy has the same rights as a shareholder to speak and vote at the meeting.

NBIM gets help from a number of sources with obtaining information and analyses of matters to be dealt with at general meetings. However, it is important for NBIM to perform independent analysis of issues of particular importance in terms of corporate governance. This applies particularly to proposals concerning areas covered by the Ethical Guidelines for the Government Pension Fund – Global.

In 2006, NBIM voted at a total of 2 928 general meetings, corresponding to 79 per cent of meetings held. A more detailed report on voting in 2006 is provided in section 4.1 of the Annual Report.

Shareholder proposals

Most matters at general meetings are raised by the company's management, but it is also possible for shareholders to introduce proposals.

There are generally restrictions on who can file shareholder proposals, and on the types of proposal that can be filed. In most countries, the backing of shareholders representing a certain percentage of the share capital is required before a matter has to be considered at a general meeting. In the US, shareholder proposals are generally only advisory, and a company may exclude a shareholder proposal from the general meeting if it concerns the company's "ordinary business" or activities that do not make up a significant part of the company's business.

Shareholder proposals are far more common in the US than in most other markets, partly because ownership is less concentrated. In the US, nearly 700 shareholder proposals were voted on at general meetings in 2006. There has been an increase in the number of shareholder proposals in the US in recent years, particularly those concerning social and environmental issues. In markets with more concentrated ownership, it is easier for management to have a dialogue with shareholders outside AGMs. Nevertheless, the use of shareholder proposals is growing in Europe and Asia. Most such proposals have concerned the election of directors, but proposals have also been introduced dealing with social and environmental issues. For example, various European and Canadian companies have seen proposals filed for better reporting on their operations in countries where human rights have traditionally been neglected, and some European companies have seen proposals for better reporting on their impact on the environment and society in general.

In a few cases, management supports the shareholder proposal, but often the proposal conflicts with the company's recommendation. As many shareholders normally follow the recommendations of the company's management, it is difficult for a shareholder proposal to win a majority. Another reason why shareholder proposals often attract little support is that they take a form, or entail a type of demand on the company, that may not be well suited to achieving the aim of the proposal. For example, NBIM will sometimes vote against proposals raising important social and environmental issues because it believes that other engaged ownership activities would be more effective, or because the proposal is formulated in such a way that it could prove counterproductive. However, there is a trend for a growing number of shareholder proposals, including those on social and environmental topics, to win broad support, in some cases even a majority.

Although relatively few shareholder proposals actually gain a majority at general meetings, this does not mean that these proposals have no impact. For one thing, high levels of support for a proposal send an important signal to management even if it is not passed, and will often trigger action from management, not least to avoid the proposal being re-introduced.

Paradoxically, shareholder proposals also have an impact when they are withdrawn. If it is likely that a shareholder proposal will garner high levels of support, companies will often enter into a dialogue with the proponent to come up with a mutually satisfactory solution. Almost 30 per cent of shareholder proposals filed in the US in 2006 were withdrawn ahead of the general meeting. Several of these contributed to significant changes in the companies' guidelines.

NBIM has actively considered shareholder proposals for several years now, supporting them where this has been in line with the Executive Board's Principles for Corporate Governance and international norms supported by Norges Bank. NBIM is now increasingly also contacting companies both before and after general meetings to inform them that we support shareholder proposals that management does not appear willing to follow up.

So will NBIM file shareholder proposals itself in the years ahead? This is likely, especially in the US market, where the use of these proposals is most common. However, such proposals will come only after we have made our views known to the company and attempted to find out whether there is any support for them in the company – and whether they can be accommodated without having to resort to a proposal at the general meeting. A shareholder proposal has the greatest impact if the company realises that it is part of a broader ownership strategy and not just a freestanding declaration. In this case, there is also a greater chance of the company granting our wishes ahead of the general meeting, precisely to avoid a public dispute.

It is particularly in areas prioritised by Norges Bank for its corporate governance work (see separate article on the Bank's priority areas) that we may see concrete shareholder proposals from NBIM in the years ahead. But efforts to bring about important changes will rarely be served by starting out with a shareholder proposal, or by filing a shareholder proposal without the company seeing the bigger picture of which the investor's proposal is part.

Participation in voting

There are major variations in the level of participation in voting from company to company and from market to market. In the US, participation is generally far higher than in Europe and most Asian countries. Voting participation averages around 80 per cent in the US, almost 60 per cent in the UK, and between 30 and 50 per cent in countries like Italy, the Netherlands, France and Germany. One reason for the lower turnout in many European (and indeed Asian) countries is that these markets have a high proportion of international investors, and international investors face various practical barriers to exercising their voting rights. Another reason is that companies in these markets often have a group of controlling shareholders, which reduces the other shareholders' chances of wielding any influence through their voting. Nevertheless, the trend is towards increased voting participation in these markets too.

It is interesting to draw an analogy between voting in political elections and voting at general meetings. In both cases, a low turnout is a potential problem. In national democracies, three main reasons are often cited for why a high turnout is important: it lends greater legitimacy to the elections being held, it increases the likelihood of the majority in the vote actually representing the majority of the electorate, and it makes elected representatives more accountable to voters.

Similar considerations apply to voting at AGMs. It is important for management to document that they have shareholders behind them. It is particularly important for management to have the legitimacy lent by broad support from shareholders when companies have plans to undertake major changes. The casting of a vote sends a signal even in situations where it is in a minority. Voting against management's proposals or withholding support is a clear sign of discontent which will be noted by management.

If investors holding a substantial proportion of a company's shares fail to vote, there is a risk of decisions taken by the general meeting not representing the real interests and financial risk that shareholders have in the company. This is a particular danger if the various shareholders have different interests in some areas and if the shareholders who do exercise their voting rights are not representative. Institutional investors, especially pension funds investing outside their domestic market, have traditionally been less likely to exercise their voting rights than larger shareholders, with the result that their interests have not been as well represented. However, this picture has changed significantly in recent years, and shareholders of this type are increasingly exercising their voting rights.

Participation in AGMs (or voting through a proxy) means that shareholders are increasingly becoming engaged in the issues being raised. High voting participation will therefore typically mean that shareholders are better able to control and hold management to account.

Again we must stress that the role of the general meeting is not to micro-manage the company. Rather, the general meeting enables the principals (shareholders) to assure themselves that their agents (board and management) are not using their power in a way that conflicts with the principals' legitimate interests and rights.

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Costs and free riders

The Government Pension Fund – Global is one of the world's largest single-owner funds, and Norges Bank has shares in around 3 500 companies. Because we have invested in so many companies, we hold, despite our size, an average of only around 0.5 per cent of the votes in each company. This diversification of the portfolio means that our vote will rarely be decisive in the outcome of a ballot. It is therefore natural to wonder why a minority shareholder with holdings this small should vote at general meetings at all.

This issue is exacerbated by the fact that voting is not inexpensive. First, there are the administrative costs relating to the actual voting process. The use of proxy voting, voting using Web-based solutions developed by service providers, and the green light for electronic voting in a number of countries have reduced these costs, but they are still significant. For a large manager like NBIM, these costs can be justified, but they may be too great for smaller investors. NBIM is actively promoting the simplification of the voting system and the introduction of electronic voting in more markets so that as many shareholders as possible can participate in AGMs.

Other significant costs relate to analysing all the items to be voted on at AGMs. The approximately 3 500 companies in which Norges Bank holds shares will together have tens of thousands of items on the agenda at AGMs during the year. Obtaining relevant information on the items to be considered at these meetings is costly in itself. Undertaking independent analysis of all of these items would demand huge resources. Although NBIM concentrates on issues of fundamental importance and companies in which we have large investments, analysing the issues and obtaining relevant information are still associated with substantial costs.

One last type of cost concerns restrictions on the right to sell shares. In a number of markets, mainly in Europe, investors who wish to vote will have their shares blocked. This means that investors are not entitled to sell their shares in the company for a specific period until the general meeting is over. In practice, this means that investors must choose between exercising their voting rights and retaining the freedom to sell their shares without restrictions.

As mentioned above, there is also much to be gained from being an active owner, such as increased board accountability, greater control and a reduced risk of expropriation. However, these gains benefit not only the investor putting resources into voting but also all other shareholders with the same interests. A situation where the cost of an activity falls to one player but the benefits also fall to others will often result in the problem of "free riders" – in this case, shareholders who prefer other shareholders to invest resources in active ownership and are unwilling to bear the cost themselves.

The free rider problem has meant that institutional investors have traditionally been passive owners who have made little use of their ownership rights to influence the companies they own. The result is a market where the owners of companies with a broad ownership structure have had little chance of influencing how these companies behave. This has contributed in turn to numerous corporate scandals and inappropriate use of corporate resources.

Pension funds and other institutional investors have increasingly realised that they need to exercise their right to vote at general meetings, because the right to disinvest cannot sufficiently protect minority shareholders from being exploited by management or controlling shareholders. It is also important to remember that many such funds are invested very broadly in line with specific indices, which reduces the scope for completely disinvesting from companies or rapidly changing a portfolio's composition. Investors of this type are increasingly working together on active ownership practices, and this collaboration is helping to reduce the free rider problem and compensate for the small size of each individual player's holdings.

Although our stake in each company is small, Norges Bank's management of the Government Pension Fund – Global and its own foreign exchange reserves makes it one of the world's largest investors. With this comes an obligation, as we see it, to be an active owner and help to ensure that the systems for exercising ownership rights function as best possible. It is not sustainable for large investors to be free riders.

Social and environmental issues

As mentioned above, the Ethical Guidelines for the Government Pension Fund – Global require Norges Bank to include in its corporate governance work social and environmental issues that can be expected to impact on long-term returns. Voting is important in this context too.

As a long-term investor with a broad range of investments in the equity markets, NBIM is keen to see the individual portfolio companies adopting a not overly short-term approach and taking account of those who are affected by their activities. A company's board must also ensure that the company reports openly on these areas, so that its shareholders are able to assess the board's decisions and actions. The company must therefore publish information about its policies on ethical and environmental issues, the actions taken and results achieved, how it deals with employee and other stakeholder issues, its assessment of the risks associated with social, ethical and environmental issues, and any systems for managing these risks and complying with laws and regulations in these areas.

Perhaps the most important demand that shareholders can make of a company's management is that it should improve its reporting. Better reporting can be a powerful tool in addressing problems such as breaches of labour rights, corruption and environmental destruction. A high proportion of the negative effects that listed companies have on their surroundings, either directly or through their suppliers, are only able to take place because of a lack of information on what is happening. For example, few listed companies will accept gross breaches of labour rights by their suppliers if this is widely known and can be verified.

Unfortunately, it is probably the case that some companies in which Norges Bank is a shareholder are complicit in breaches of labour and human rights. This is a something which we consider to be unacceptable, and which other stakeholders (both shareholders and the company's customers) are not normally willing to accept. A lack of good information is an important reason why management is not being forced to do something about this type of problem. If reliable information is obtained, both shareholders and other stakeholders will increasingly be able to put pressure on management to act. Better information on companies' impact on the economy, society and the environment will therefore make a key contribution to solving important social problems. For this reason, NBIM regularly supports shareholder proposals calling for better and clearer reporting by companies. Some of these proposals are also withdrawn ahead of the general meeting after management and proponent reach agreement on various changes.

A number of shareholder proposals on environmental issues were filed in 2006. Several of these were motivated by concern about the effects that the companies are having on global climate problems. For example, proposals on reporting greenhouse gas emissions and measures to improve energy efficiency attracted considerable support. One proposal on energy efficiency supported by NBIM was at the general meeting of a large US retailer. The proposal attracted almost 30 per cent support, which is considered high for this type of proposal. NBIM also supported a proposal on greenhouse gas emissions at the general meeting of a US energy company, which also attracted relatively strong support. Many shareholder proposals raised local environmental issues, such as the release of chemicals and the effect of oil production on sensitive natural environments. One proposal in this area supported by NBIM was filed at the general meeting of one of the world's largest oil companies and won 26 per cent of the vote. In Japan, several proposals were filed concerning the safety of nuclear power stations, an area of great importance to long-term investors on account of the potential consequences of poor nuclear safety and, not least, nuclear waste.

Other shareholder proposals in 2006 concerned labour and human rights, and this type of proposal won greater support on average than in previous years. Several such proposals asked companies to improve their re-

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porting and monitoring of labour standards in their foreign operations. Companies with activities in countries where human rights have traditionally not been respected, and companies that have historically not published adequate details of their policy on human rights, were asked to produce ethical guidelines on labour and human rights and to report on compliance with these guidelines. NBIM supported a proposal at the general meeting of a large US automotive component producer on improving its surveillance of fundamental labour rights, both at the company itself and at its suppliers, and the proposal won about half of the vote. Proposals to do with non-discrimination on grounds of gender and sexual orientation were also filed, and these attracted relatively broad support at some companies – for example, one at the general meeting of one of the largest US oil companies won almost 35 per cent support. Many such proposals were also withdrawn as a result of companies entering into dialogue with the proponents.

Political donations have been the target of many shareholder proposals, especially in the US. At the heart of these proposals has been a call for companies to disclose all such donations made and their guidelines for making them. NBIM supported one such proposal at the general meeting of a large biotechnology company, which won around 75 per cent of the vote after management itself gave its backing to the proposal.

In the above, we have given examples of the types of issue that shareholders raise through their participation in AGMs, and that NBIM considers and, in many cases, supports. In its future work on voting, NBIM will concentrate particularly on issues that are part of Norges Bank's focus areas (see separate article), and on how voting and the associated analysis can be combined with other active ownership practices in these areas. However, we will actively consider shareholder proposals in other areas too.

Protecting shareholder rights

Since the general meeting is the fundamental channel of influence in a number of important areas, it is crucial that the voting system actually works. This is especially important for minority shareholders who have few other opportunities to influence decisions made at the companies they own. In the absence of good corporate governance systems, minority shareholders can be exploited by those who are in a position to shape or decide the company's behaviour, such as senior executives, directors and large shareholders. Many shareholder proposals at general meetings therefore seek to increase shareholders' influence and ensure a board which is independent of management and is accountable to shareholders. A number of such cases are presented below, some of which are closely related to NBIM's priority areas.

Majority voting

The directors are there to represent shareholders' interests, and so it is natural for shareholders to have an opportunity to approve who sits on the board. However, at most companies in the US and Canada, shareholders have little say in practice in who represents them on the board, as the directors are elected through plurality voting. Under this system, a director is elected if he or she gets more votes than any other candidate. A director can therefore be elected without having 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). Of course, shareholders can, in principle, nominate their own candidates, but the costs associated with this, both financial and bureaucratic, are so high that it is not a realistic option for most shareholders. This is because shareholder nominees are not included in the agenda for the meeting (proxy statement) distributed by the company, which means that the nominating shareholders themselves have to get this information sent out to the other shareholders, which is difficult and costly in practice.

One important topic at many AGMs in the US and Canada has therefore been shareholder proposals on the introduction of majority voting, so that directors have to win a majority of the votes cast to be elected. NBIM has actively supported this. More than 150 shareholder proposals calling for majority voting were filed in the US in 2006, and 36 of these were passed by an absolute majority. Furthermore, a large number were withdrawn when the companies concerned voluntarily introduced guidelines asking directors who do not win the backing of a majority of shareholders to step down. In Canada, half of the 60 biggest companies decided to introduce guidelines of this kind. Work is also now under way on making it easier to put forward alternative nominees.

One important development in shareholders' influence over director elections in the US came in September 2006, when a state court ruled in favour of pension fund AFSCME that shareholders have a right to file proposals for the amendment of corporate bylaws to allow shareholder-nominated candidates to be included in the agenda (proxy statement) sent to shareholders by the company. It is uncertain whether the Securities and Exchange Commission (SEC) will revise its interpretation of shareholder rights in this respect; if so, this could be very significant for shareholders' rights in the context of director elections.

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An independent and accountable board

Many shareholder proposals aim to increase the board's independence and make it more accountable to shareholders. This is also an important issue for NBIM, as shareholders can best safeguard their interests by having a real influence over who represents them on the board. A high proportion of shareholders at some American and Asian companies are concerned about board independence, because independent directors are not in the majority, and because directors who are not independent of management sit on board committees where it is particularly important for them to be independent, such as nomination, remuneration and audit committees. One expression of this concern is the way that many shareholders in companies without a majority of independent directors are unwilling to support candidates nominated by management.

Another factor which can undermine board independence is where the chairman of the board is also the company's chief executive officer. In such cases, shareholders are increasingly voting against the reelection of the chairman. In the US, Canada, Europe and Australia, we have seen dissatisfaction with executive pay resulting in shareholders withdrawing their support for directors, or even voting against them. After the CEO of one of the largest home improvement retail companies in the US had received USD 200 million over five years despite the company's earnings falling significantly during the period, ten of the company's 11 directors received between 30 and 36 per cent withhold votes – a very clear sign of dissatisfaction from NBIM and other shareholders. NBIM also supported the election of shareholder-nominated candidates at a large US food producer, because we believed that change on the board would be good for the company's long-term strategy and value. The shareholder-nominated candidates won considerable support, and a majority of them were elected to the board.

An accountable board should listen to advisory shareholder proposals that attract high levels of support. If directors ignore shareholder proposals that win a majority, this provides grounds for voting against their reelection. This has, for example, been the case at a number of US companies where directors have for several years ignored shareholder proposals to remove poison pills (see next paragraph) or introduce annual reelection of all directors even though these proposals have been backed by a majority at AGMs.

Another important element in the work to make directors more accountable is removing anti-takeover mechanisms. One such mechanism is the staggered board, where not all directors come up for reelection each year, which would prevent a new owner from actually controlling the company. Many shareholders are therefore voting against proposals preventing the annual re-election of all directors, and supporting shareholder proposals calling for annual re-election of all directors. The average level of support for the more than 40 shareholder proposals of this kind that were put to the vote in 2006 was almost 70 per cent. NBIM lent its support to these proposals. Another anti-takeover mechanism is the poison pill, which gives management carte blanche to issue shares in the event of a takeover bid, so making it less attractive to acquire the company. In some cases, the sitting management or board may have a legitimate reason to protect itself from a takeover in this way. However, according to the principles to which NBIM works, these mechanisms must be openly put before and approved by shareholders before being introduced, and must not be renewed without being put before them once again. Proposals to give management the right to introduce or extend poison pills without shareholders' approval have therefore met with considerable opposition. Shareholder proposals requesting that such proposals be approved by the general meeting before being adopted won more than 55 per cent support on average.

Management remuneration

The remuneration of executives and directors has been a hot topic in both the national and international debate in recent times. There has been particularly strong dissatisfaction in the American market with the disclosure and design of executive pay packages. NBIM has voted against management on this type of issue on several occasions.

One key concern has been that management remuneration has not been linked closely enough with a company's results. In particular, many shareholders have been critical of management at poorly-performing companies receiving excessive remuneration. Many shareholders have also reacted to the high level of and rapid growth in executive pay. These concerns are also due to reporting on the design of executive pay packages (including information on option agreements and pension schemes) often having been insufficient and unclear. Close media scrutiny of companies where management is suspected of having manipulated the design of option agreements has heightened these concerns.

In the US, Canada, Europe and Australia, this dissatisfaction has led to shareholders withholding support for directors or voting against them. Shareholder proposals on the design of management remuneration systems have increasingly been filed. A number of pay-for-performance proposals have attracted high levels of support at general meetings. NBIM has supported many such proposals, including one at one of the world's largest investment banks, which was supported by more than half of the votes cast. Proposals requiring shareholders to approve the introduction of golden parachutes have also won considerable support, several being passed by absolute majorities. Shareholders have also asked for better information about management remuneration.

Regulators in several markets have introduced new rules to improve the disclosure of information to shareholders. In countries such as Australia, the UK and Sweden, shareholders must now be given a chance to vote on remuneration reports in an advisory ballot, and in the Netherlands these votes are binding on the company. Several shareholder proposals in this area were filed in the US in 2006, and more are anticipated in 2007. In July 2006, the SEC approved new rules on the disclosure of executive pay, and there is considerable interest in how companies will implement these rules in 2007.

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The one-share-one-vote principle

It is a commonly held view that shareholders' voting rights should be proportional to the capital that they are risking in the company. Most listed companies in the US observe the one-share-one-vote principle, but this is not the case in large parts of Europe, where various departures are made from this principle. One is where some shares carry multiple voting rights. Very many companies in France, Sweden and the Netherlands have this type of share, and this creates an imbalance between financial ownership and voting power. Another departure is special/golden shares, which give their holders special rights irrespective of the size of their shareholding. Shares of this type are most common at Dutch companies. A third departure from the one-share-one-vote principle is voting ceilings. Ten per cent of European companies – mainly in Spain, Switzerland, Italy and Germany – have upper limits on the number of votes a shareholder can exercise, however many shares he may hold. A fourth departure is where some shareholders have no voting rights at all. These shares may or may not be preference shares with special rights to dividends.

Through its principles, voting and other corporate governance work, NBIM is promoting the principle of one-share-one-vote with no upper limits on the exercise of voting rights. As part of the updating of company law in the EU, the European Commission has tabled proposals for a directive on shareholder rights and invited tenders for an independent study of issues relating to the one-share-one-vote principle in Europe.

Conclusion

Pension funds represent the economic interests of much of the population, and hold an increasingly large proportion of the world's shares. In the US, pension funds and similar funds already hold more than 60 per cent of listed equities. Because these funds have a long-term investment horizon and typically a diversified portfolio, it is in their interests to promote both good governance systems and socially and environmentally sustainable development.

Despite their size, pension funds have, with a few important exceptions, been largely passive owners and have not used their ownership rights to influence the companies in which they are shareholders. One important reason for this is the restrictions that shareholders often face when exercising their ownership rights, especially when operating outside their domestic market. Even if a majority of shareholders would like a company's activities to take greater account of shareholders' preferences, it may therefore still be difficult to bring about changes. One key goal for Norges Bank's corporate governance work is therefore to help adjust the voting system so that companies' boards better reflect the interests and values of the majority of shareholders, but without shareholders ending up micro-managing the company or taking away the board's responsibilities and room for manoeuvre.

The combination of increased voting participation and changes in the voting system will increase the influence that pension funds and similar funds wield over developments at listed companies. As pension funds are typically broadly invested and have a long investment horizon, this will make an important contribution to the creation of a business world which better protects shareholders' long-term interests. It will also result in companies managing their impact on the outside world in a sustainable manner. This is in the interests of both shareholders and society as a whole.

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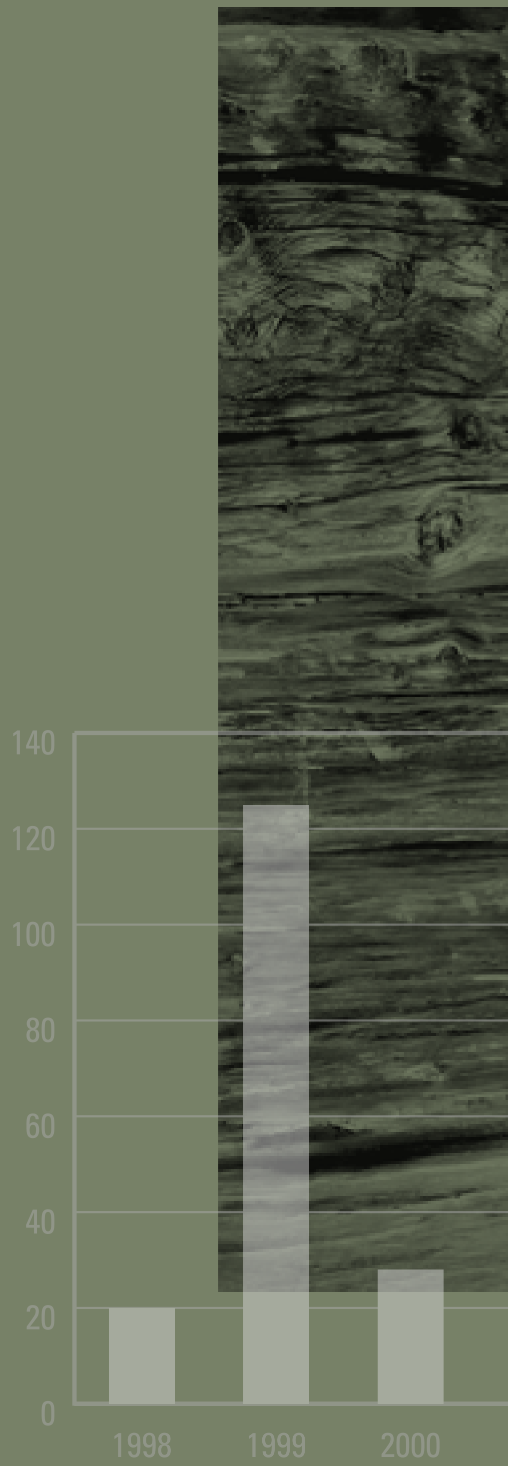

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