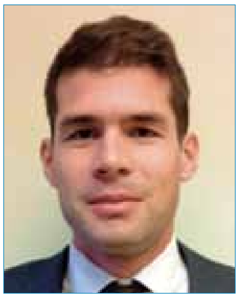
# Putting money aside: The Norwegian example



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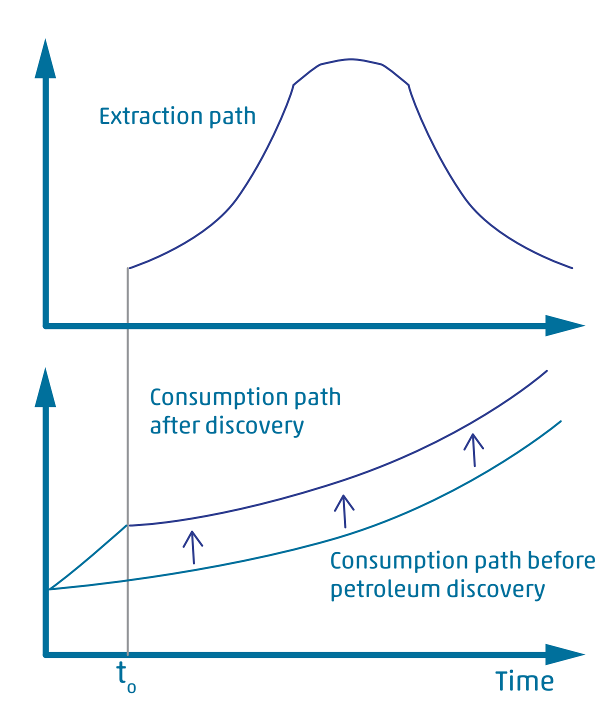
The history of modern Norway was altered by the discovery of oil during Christmas 1969. Norway had been a relative laggard in Western Europe in terms of industrialisation, and the economy was largely influenced by a geography favouring hydro-electric power, fisheries and shipping. The oil discovery roughly coincided with end of the post-war reconstruction period and the establishment of the welfare state. It was realised early on that the one-off monetisation of the nation's resource wealth should also benefit future generations. Figure 1 illustrates the challenge faced by resource-rich countries in their management of resource windfalls: how to transform fluctuating and perishable revenues into a permanent increase in consumption? A financially motivated fund is one answer to this. By investing the fund solely in foreign assets, the threat of overheating the domestic economy can also be reduced.

The Government Pension Fund Global (GPFG) was established in 1990 as a fiscal policy tool to support a long-term management of the petroleum revenues. Due to the macroeconomic situation, the first transfer to the Fund happened six years later. The Fund has an important role in facilitating government savings to meet the rapid rise in future public pension expenditure (Figure 2). The Fund is, however, not earmarked for pension expenditures. The Fund's objective is to maximise long-term international purchasing power. The Fund's size at year end 2010 was some US$525bn, and it owns around one per cent of the world's listed equities.

Figure 1: The natural resource extraction path does not provide for a smooth consumption path




## The Fund's structure and governance

The Fund's income consists of all state petroleum revenues, net financial transactions related to petroleum activities, as well as the return on the Fund's investments. The Fund's expenditure is the sum needed to cover the non-oil budget deficit. Transfers can only be made following a vote in the Norwegian parliament. Net allocations to the Fund reflect the total budget surplus (including petroleum revenues). The Fund cannot be earmarked for specific purposes and cannot be invested in Norway (and thus is not a secondary budget). Consequently, the allocation of fund liquidity forms part of an integrated budgetary process, and renders the State's use of petroleum revenues visible. Fiscal policy is anchored in the guideline that over time the structural, non-oil budget deficit shall correspond to the real return on the Fund, estimated at 4 per cent. Whilst this is not a legal requirement, it enjoys broad political support. It is a transparent and simple rule, which should ensure that the Fund remains a permanent fund.

In the Government Pension Fund Act, the Norwegian Parliament made the Ministry of Finance responsible for the management of the GPFG. Key changes to investment guidelines are presented to Parliament before implemented. There is a clear division of roles and responsibilities between the the Ministry of Finance, and the operational management, which is carried out by Norges Bank (the Central Bank) based on a mandate given by the Ministry (see figure 3). In the mandate, the Ministry sets guidelines, including benchmark, provisions on responsible investment and risk limits. The Ministry reports yearly to Parliament on the management of the fund.

A sound governance structure is necessary for successful strategy implementation; it must ensure that important decisions relating to fund management risk have the support of the Fund's owners, the Norwegian people as represented by the Parliament. There must also, however, be sufficient delegation of authority to allow day-to-day decisions in the operational management to be made close to the markets. Efforts are made to achieve this balance by submitting decisions of material significance to the Fund's risk level to the Storting before their implementation, while the mandate issued by the Ministry to Norges Bank is based, insofar as possible, on principles and frameworks. In this way, a necessary and high degree of delegation is combined with the "owner" having a good understanding of, and ultimate responsibility for, all major strategy decisions. Such a balance can only be achieved through a clear division of roles and responsibilities between all governance levels involved in the management. One needs to make every level of management resposible for the decisions delegated to them, and have good control and supervisory bodies in place.

Over time, there should be interaction between the governance system and the Fund's investment strategy. The investment strategy must take into account the distinctive institutional features of the Fund. The need to secure the support of political bodies for important aspects of management means, for example, that it is difficult to design investment strategies based on taking quick, time-critical decisions. On the other hand, the strategy must also be able to exploit the Fund's distinctive characteristics, in order to improve the trade-off between return and risk.

## Investment strategy

The Ministry receives advice on the investment guidelines from Norges Bank, the Ministry's advisory council on investment strategy and external consultants. The Ministry uses external consultants for controlling performance measurement and peer group benchmarking.

Investment strategy must be based on a combination of how the markets in which the Fund invests work, and what distinctive characteristics the Fund has as an investor. The most important characteristic of the Fund as a whole is probably its long horizon, size, state ownership and very diversfied portfolio.

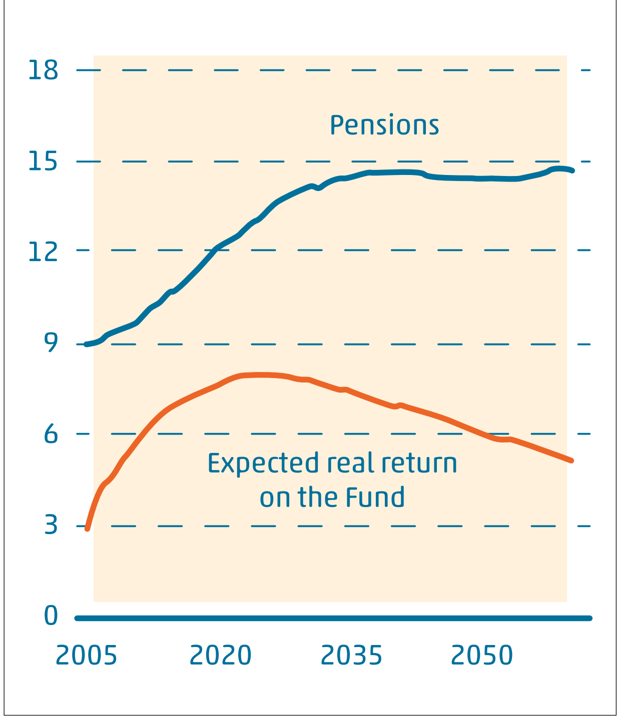
Avoiding risk is not an objective for the management of the Fund. On the contrary, risk-taking contributes to returns over time. The GPFG has considerable ability to bear fluctuations in the Fund's returns from year to year. The investment strategy is therefore not aimed at minimising short-term value fluctuations.

Diversification is a powerful mechanism which allows one to realise better risk-adjusted returns. The power of diversification underlies the entire investment strategy, and also the motive behind the Fund; to reinvest the windfall gain from a perishable resource into a diversified portfolio of foreign assets which will provide a more stable and secure, income stream. Developments in the investment strategy has meant the fund has become more diversified over time. A portfolio of property investments is currently being built up.

## The value of transparency

The Fund is subject to a high degree of transparency and much public interest. The management of the petroleum revenues in general and the Fund in particular is characterised by a high level of disclosure. The Ministry of Finance emphasises transparency and public access to information. We see transparency as crucial to building trust and confidence in the management of the Fund – both domestically and internationally. Internationally, there has been considerable attention paid to the fact that some sovereign wealth funds (SWFs) have little transparency about their activities and to the possibility →

Figure 2: Pension expenditure and expected Fund real return as a share of mainland (excluding oil and shipping) GDP



that they may have non-financial objectives for their investments. Domestically, transparency is a preconditon to secure public support for sound management of Norway's petroleum wealth. Anchoring the strategy, and explaining the various sources of risk, has been a particular focus in public documentation.

The Ministry reports to Parliament on all important matters relating to the Fund, such as the size of petroleum revenues and the Fund; the outlook for fiscal sustainability; changes to the investment strategy; the Fund's performance, risk and costs. The Ministry publishes advice and reports received from Norges Bank and external consultants. Norges Bank publishes quarterly reports on the management of the Fund, as well as an annual report, an annual listing of all investments and annual voting records. The reports include performance, risk and costs and is published on the website. In addition the asset manager publishes live simulated total assets under management on its website.

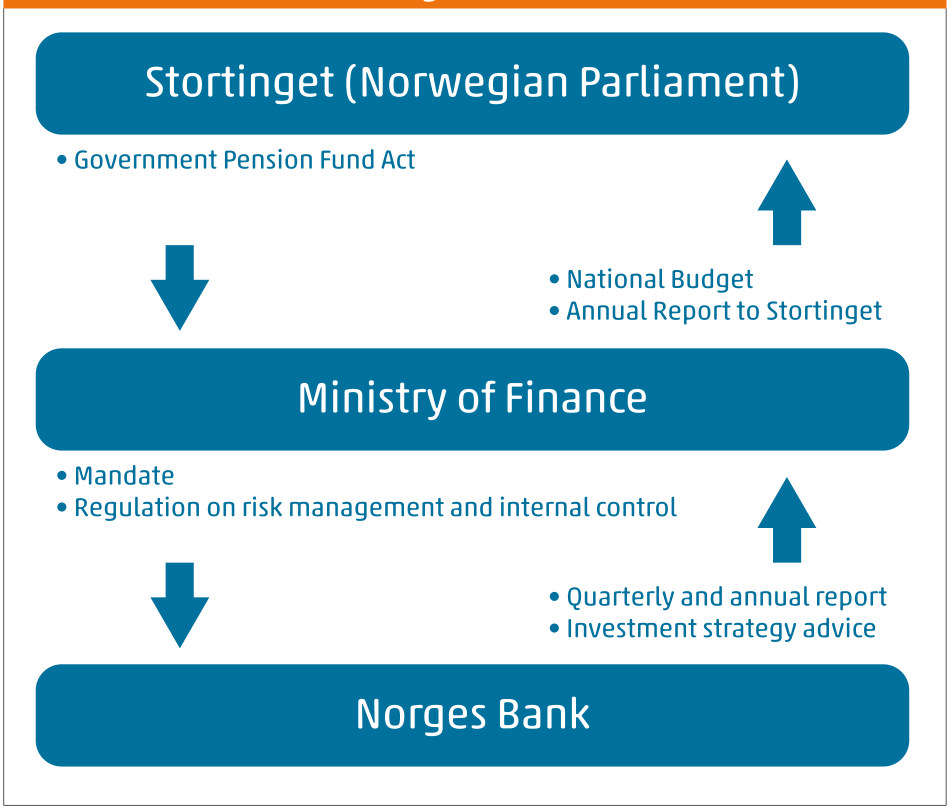
Whilst transparency is fundamental, there is probably also such a thing as "too much transparency". On the strategic level this can lead to an execessively short-term focus or under-utilisation of financial risk limits. It can also threaten the efficiency of the GPFG's ownership efforts, as it might reduce the topics NBIM, the fund managers, could engage in dialogues with companies, external managers and other stakeholders. Finally, specifically when it comes to regimes for rebalancing or transfers to the fund, too much transparency might lead to harmful "front-running," where advance knowledge of transactions can lead to market share abuse.

## External assessments

The Generally Accepted Principles and Practices (GAPP), or Santiago principles, for SWFs establish a set of sensible principles for the organisation and management that can build trust with recipient countries and in financial markets. The Ministry of Finance view the principles as a minimum standard which all SWFs should adhere to where applicable. The Ministry has published a self-assessment of the GPFG's adherence to the principles.

The Fund has been assessed by external bodies which address many of the same issues as the GAPP. The GPFG has consistently scored well in these assessments. Whilst not directly comparable to the recently published self-assessment, these correspond well with the conclusion that the Fund adheres satisfactorily to the GAPP. The transparency of the petroleum revenues before they reach the Fund has also been assessed externally by the Extractive Industries Transparency Initiative (EITI), of which Norway is a member.

Figure 3: Division of roles and responsibilities in the management of the GPFG



The work of the International Forum for Sovereign Wealth Funds (IFSWF) and the continued implementation of the GAPP are important. At the same time, it is clear that the members of the forum are a very heterogenous group, and so the application of the principles will legitimately and necessarily differ from SWF to SWF – an obvious example is that some of the IFSWF member do not invest in equities, making equities related principles largely irrelevant. It is also clear that some of the issues that concern us as an investor, for example good corporate governance or other factors leading to well-functioning markets are not addressed through the principles.

## Responsible investing and active ownership

The Pension Fund is managed on behalf of the Norwegian people. Shared ethical values therefore form the basis for the responsible management of the Fund. Generating good long-term returns is a fundamental obligation, and may depend on a sustainable development in economic, environmental and social terms, and on well-functioning financial markets. The Fund is a long-term owner with assets spread across a large number of companies in many industries and countries. In this way, the Fund indirectly owns a share of the world's production capacity, it is what has been referred to as a "universal owner". The Fund therefore has a comprehensive RI strategy which includes both exclusion (as a measure of last resort) and observation of companies, financially motivated mandates specifically targeting environmental investments, research and international collaboration. Perhaps the main and most appropriate RI tool for a diversified and long-term investor is active ownership. The overall purpose of active ownership is to safeguard the Fund's financial values by contributing to good corporate governance and by striving to achieve higher ethical, social and environmental standards in the companies. Good corporate governance is important for the Fund's returns over time and to ensure the owners real influence and dialogue with the companies in the portfolio.

Norges Bank has chosen to concentrate its ownership activities in certain key areas of significance to the portfolio. With relatively small individual holdings, such a strategy provides a better opportunity for making an impact. The manager has made it a priority that the areas should be relevant for investors generally and the Fund's portfolio in particular. They should also be suitable for dialogue with companies and/or regulatory authorities, provide an opportunity for making a real impact and be justifiable financially, since the manager acts in the capacity of investor. The focus areas include the equal treatment of shareholders, shareholder influence and board accountability, well-functioning, legitimate and efficient markets, climate change, water management and children's rights.

The NBIM has developed publicly available principles for voting, and aims to vote at all annual general meetings, currently around 10,000 a year. The manager votes on all issues, including those that fall outside the focus areas. The voting records are made public.

## Conclusion

Large petroleum revenues have resulted in substantial financial assets in the GPFG, to the point where it is now amongst the largest SWFs in the world. In the more than 15 years that have elapsed since the first transfer to the former Government Petroleum Fund, there have been major changes to the Fund's strategy. This seems likely to continue.

The Norwegian experience is rather unique. Norway has realised its resource wealth from an already enviable position, as a small, stable, democratic and economically developed country. This, and previous examples of economies over-heating and succombing to so-called dutch disease, has enabled the country to choose what is hopefully a more sustainable and long-term management of the country's resource wealth. For this reason, while the Norwegian model has been well received in internationally, and to some extents inspired developments elsewhere, it is inappropriate to use any one country's experience and set-up as a blue print for developments elsewhere. The general principle probably holds for most countries, however; if you find yourself with substantial and perishable source of income, it might make both current economic and inter-generational sense not to spend it all at once.

The Fund is already a major owner in the global equity market. On average, the GPFG owns around one per cent of all listed equity in the world. In many companies it numbers amongst the largest individual owners. Projections for the Fund for the period to 2020 show that the Fund's ownership shares will continue to grow. This, however, does not alter the Fund's role as a financial investor. But it does strengthen the need for the exercise of ownership as a necessary effort to protect the Fund's economic interests. The Fund's management cannot be built on the assumption that this important work will be adequately taken care of by other owners. ■