Background note: Norway's position in relation to the international debate on Sovereign Wealth Funds

1. Background

Government investment vehicles, so-called Sovereign Wealth Funds (SWF), are not a new phenomenon. The Kuwait General Reserve fund was established in 1953, and The Abu Dhabi Investment Authority, created in 1976, has investments estimated at USD 875bn, making it the largest SWF in the world (see figure 1).

The attention directed at SWF recently reflects in part their rapidly growing size and influence in international financial markets, in addition to the opaque and secretive nature of some of the funds. Norway's Government Pension Fund – Global (PFG) is in this regard often cited as an example of a very transparent fund. The recent decisions by China and Russia to create large state controlled investment vehicles have intensified the international debate about such funds. Mechanisms for protecting domestic financial markets against investments by SWF are being called for in several western countries.

Country	Fund Name	Assets (Mlns US$s)	Inception year	Source of funds
Total		**2,939,456**		
UAE	ADIA 1/	875,000	1976	Oil
Norway	Government Pension Fund - Global	341,200	1996	Oil
Singapore	GIC 1/	330,000	1981	Other
Saudi Arabia	Saudi Arabian funds of various types 1/	300,000	N/A	Oil
Kuwait	Reserve Fund for Future Generation	250,000	1953	Oil
China	State FX Investment Corp. + Hueijing Co. 2/	200,000	2007	Other
Singapore	Temasek Holdings 1/	159,210	1974	Other
Russia	Stabilisation Fund 3/	133,000	2003	Oil
Libya	Oil Reserve Fund	50,000	2005	Oil
Algeria	Fond de régulation des recettes	42,600	2000	Oil
Qatar	Qatar Investment Authority	40,000	N/A	Oil, gas
US (Alaska)	Permanent Reserve Fund	38,000	1976	Oil
Brunei	Brunei Investment Authority	30,000	1983	Oil
Malaysia	Khazanah Nasional BHD	25,700	1993	Other
Korea	KIC (Korea Investment Corporation)	20,000	2006	Other
Chile	A new SWF based on the Copper Fund 4/	17,820	1985	Copper
Kazakhstan	National Fund	17,600	2000	Oil, gas
ROC (Taiwan)	National Stabilisation Fund *	15,000	N/A	Other
Canada	Alberta Heritage TF	15,500	1976	Oil
Iran	Oil Stabilisation Fund	15,000	1999	Oil
Nigeria	Excess Crude Account	11,000	2003	Oil
Botswana	Pula Fund	6,800	1966	Diamonds
Oman	State General RF	2,000	1980	Oil, gas
Azerbaijan	State Oil Fund	1,500	1999	Oil
Venezuela	FIEM	756	1998	Oil
Canada	Fond des générations (Québec)	560	2006	Electricity
Trinidad & Tob.	Revenue SF	460	2000	Oil
Kiribati	Revenue Equliz. Fund	400	1956	Phosphates
Uganda	Poverty Action Fund	350	1998	Aid
	Oil & gas-related funds	2,163,616		
	Non-oil related funds	775,840		

1/ My guesstimates as of September 2007.
2/ Not yet finalised. Will be launched in September 2007.
3/ Will be launched in February 2008.
4/ The Pension Reserve Fund, FRP, and the ESSF and FEES.

Figure 1 *Source: Stephen Jen, Morgan Stanley Research*[1]

[1] Morgan Stanley Research, "How Big Could Sovereign Wealth Funds Be by 2015?", May 3, 2007

The accumulation of wealth channelled into SWFs can be distinguished by its origin:

- *Commodity:* Accumulation of foreign exchange from large exports of petroleum and other non-renewable resources (e.g. Norway, Russia, Middle-East)
- *Non-commodity:* Accumulation of foreign exchange reserves owing to large current account surpluses and exchange rate policy (e.g. China, Singapore)

The total assets of SWF are estimated to be between USD 2 trillion and USD 3 trillion. (No accurate figures are available due to limited disclosure of information on SWF fund performance, investment strategy and size of investment assets.) This comes in addition to official foreign exchange reserves amounting to USD 5.6 trillion. The potential growth of SWF is significant, with some estimates of their aggregate size reaching USD 12 trillion by 2015. Such estimates assume that many of the Asian exporting countries that have accumulated large foreign exchange reserves will choose to convert these into investment vehicles seeking higher returns, thus boosting the size of SWF. However, the estimated size of foreign assets held by sovereigns is dwarfed by existing assets under management of mature market institutional investors (USD 53 trillion).

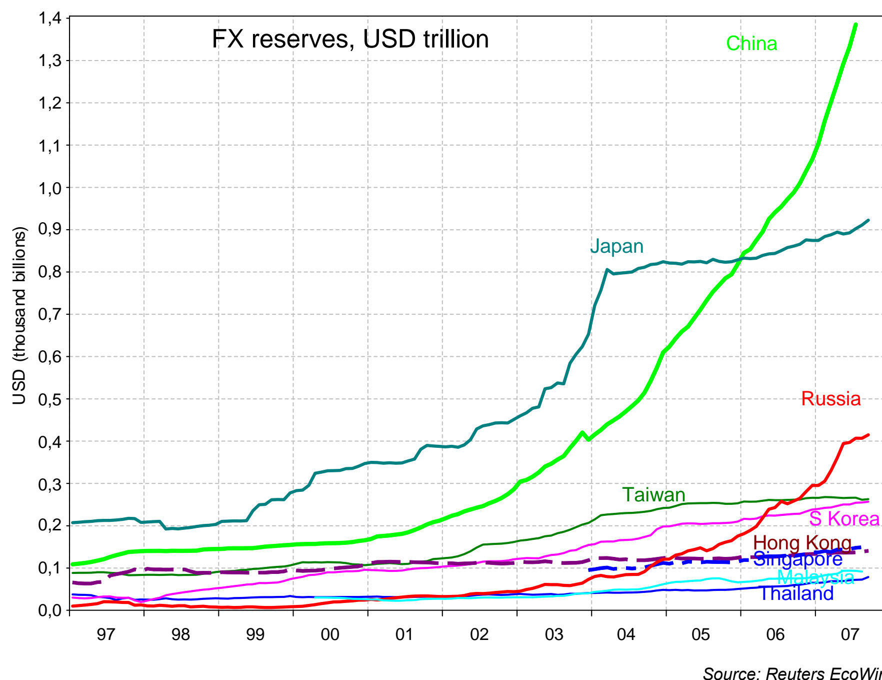

Figure 2 *Source: Reuters EcoWin*

Figure 2 demonstrates the rapid development in foreign exchange reserves in several countries in recent years, especially in China, Japan and Russia. Traditionally, foreign exchange reserves of countries such as China have to a great extent been placed in passive and low-yielding investments such as US Treasury bonds. A desire to earn higher returns on central banks' large and escalating foreign reserves have prompted a more active approach to investing through state investment funds. These funds have a higher tolerance for risk than that of traditional official reserves management. The PFG's decision to increase its exposure to equities to 60 % can also be seen as an example of SWF willingness to take on more risk in their portfolio management.

2. SWF growing role – important aspects

The main concerns in the debate on SWF are the lack of transparency and uncertainty surrounding the purpose of the investment activity. Reluctance to disclose comprehensive information is to a large extent making recipient countries sceptical as to SWF investment strategies and underlying motives. This aspect is recently witnessed in Germany's concern with respect to Russia's buying of energy infrastructure in Europe. Worries that political motives, rather than financial and economic considerations, are guiding SWF investments are currently causing some governments to call for the OECD and IMF to establish voluntary "codes of conduct" for these investment vehicles, for example building on the existing IMF Guidelines for Foreign Exchange Reserve Management. The lack of transparency in many SWF has also raised questions as to whether corruption might be a risk, particularly in the absence of clear guidelines with respect to the funds' behaviour and difficulty in monitoring their activities. However, it is believed that increased transparency and accountability will to a large extent mitigate the main concerns pertaining to the activities of state investment funds in international financial markets.

Lack of transparency has also raised concern that maximizing the value of the shareholdings will not be the only objective of governments as shareholders. Possible alternative motives may involve privileged access to home markets, aspirations to achieve political influence, gain access to technology and expertise and provide support for other national companies. Risk of hidden political objectives, rather than seeking the highest risk-adjusted return on investment, may encourage financial protectionism in host countries. Additionally, the pursuit of non-financial objectives may be problematic in itself, as it may disrupt the proper functioning of markets in which these large state-controlled funds invest. In particular, when it comes to investments in industries deemed to be of importance to national security or other strategic interests, the role of SWF is often eyed with suspicion. However, it is important to identify those concerns that truly reflect issues of national security, and not allow this to be a cover for protectionism. The statement from the G8-summit on 7 June 2007 addressed this issue: *"…we remain committed to minimize any national restrictions on foreign investment. Such restrictions should apply to very limited cases which primarily concern national security."*

Another concern often advanced in the international debate on SWF is the sheer size and potential growth of these funds, which give rise to a potential influence on international financial market prices and the risk of market instability in face of abrupt changes in investment positions. On the other hand, it would not seem to be in their self-interest for large investment funds to undermine the return on their investments - assuming they pursue financial objectives. IMF has highlighted the importance of the political perspective in investment decisions carried out by governments: *"In some cases, assets may be shifted for political strategic reasons rather than economic and financial reasons"* [2] In connection with market rumours of such imminent changes in investment positions, the opaque nature of the majority of these large funds may exacerbate investors' uncertainty and lead to higher market volatility.

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[2] http://www.ft.com/cms/s/0/60246632-0a5f-11dc-93ae-000b5df10621.html

The growing importance of SWF and their evolution towards more active investment strategies with increased levels of market risk are likely to affect the structure of international financial markets. The increased tolerance for risk in such funds is believed to positively influence the price of risky assets in general, such as equities, real estate and private equity. Although countries with an extensive part of their large foreign exchange reserves placed in US government bonds, or other large liquid developed bond markets, are unlikely to risk damaging the value of their investments through extensive sales of such fixed income assets, a greater share of new reserve accumulation is likely to flow into more risky assets, and perhaps especially in emerging markets. The impact on the relatively small financial markets in emerging economies may be substantial – increasing their size and liquidity. Indications are that asset allocations by the newly founded SWF in China will be gradual and timed to minimize their impact on markets, to avoid undue upward pressure on smaller neighbours' exchange rates and equity markets. A change in China's reserve allocations is, on the other hand, not considered to have a profound impact on developed world equity markets.[3]

Boosting equity exposure at the expense of government bonds might have an effect on the level of long-term interest rates and the valuation of global equity markets. The accumulation of large foreign exchange reserves in recent years, mainly invested in high-quality fixed income instruments, has put downward pressure on long-term interest rates. Shifts in investment strategies towards riskier assets may result in higher bond yields (and thus weaker bond prices). The entry of SWFs in international financial markets may in this regard have an impact on the pricing of certain asset classes.

Notwithstanding apparent challenges, SWF may represent a positive stabilizing element in international financial markets by enhancing market liquidity and financial resource allocation. Large SWF often use a mix of well-trained in-house expertise and well-regarded international external managers. Typical characteristics of SWF are long time-horizons, no leverage and absence of claims for the imminent withdrawal of funds. Hence, SWF have a strong risk-bearing capacity and an ability to accommodate short-term volatility. They may therefore act as a stabilizing factor in financial markets by dampening asset price volatility and lowering liquidity risk premia, compared with a situation in which these assets were to be managed with shorter duration.

In the debate on SWF it is vital to recognize that well functioning financial markets are to everyone's advantage. Well functioning financial markets allow capital exporters to decouple consumption and current revenues as well as earning a higher return on savings. Additionally it allows capital importers to fund profitable investments without reducing current spending. A sensible management of oil-producing countries' petroleum wealth in well functioning financial markets is in everyone's interest. This should be the point of departure of any discussion on SWFs. It has also been pointed out that there is a substantial opportunity cost for investors of tying up capital in large foreign exchange reserves.[4]

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[3] Henderson Global Investors, "China's New Sovereign Wealth Fund: Implications For Global Asset Markets", July 2007

[4] Ft.com, Tassel & Chung; "How sovereign wealth funds are muscling in on global markets", 24.5.07

A likely precondition for SWF to contribute to stable international financial markets is a fair degree of transparency in their operations. As mentioned earlier, lack of transparency may make SWF less predictable and may lead to higher market volatility in some situations. Transparency in areas such as investment strategy, asset holdings and fund performance is necessary to build trust, both domestically and internationally. Transparency domestically is essential to achieve public support and legitimacy for managing sovereign wealth in a democracy. Furthermore, transparency provides a disciplinary effect on fund management. As fund performance is subjected to public scrutiny managers of sovereign wealth are met with pressures to deliver sound financial returns.

3. The Norwegian Government Pension Fund – Global (PFG)

The PFG is one of the largest SWFs in the world (see figure 1), with total assets under management at approximately USD 328 billion as of 30.06.2007. In the operations and financial activities of PFG emphasis is placed on professionalism and transparency. The management of petroleum revenues in general and the Fund in particular is characterized by a high degree of transparency and disclosure of information. This helps build public and political support and trust in the management of Norway's sovereign wealth. Additionally, transparency reduces the risk of bad governance. The Ministry of Finance, representing the owner of the fund, reports regularly on the governance framework, the fund's goals, investment strategy and results. Also, the operational manager of the fund, Norges Bank, publishes quarterly and annual reports on the management of the Fund, including Fund performance as well as an annual listing of all investments.

The PFG acts as a fiscal policy tool to support a long-term management of the petroleum revenues, and is fully integrated with the state budget. The Fund is only invested abroad in financial assets, which ensures risk diversification and good financial returns, and also helps to shield the non-oil economy from transitory and volatile revenues stemming from the petroleum sector.

Governance of the PFG is marked by a clear division of responsibilities between the Ministry of Finance, which is responsible for the management of the Fund, and Norges Bank, which carries out the operational management in accordance with guidelines issued by the Ministry. The investment strategy is to achieve a high financial return subject to moderate risk. Moreover, the Fund is a financial investor, with a diverse portfolio of non-strategic holdings in a large range of companies. Maximum ownership stake in an individual company is limited to 5 pct, while the average ownership stake is approximately 0.5 pct. The Fund takes no large or "strategic" ownership stakes.

The investment strategy of PFG has developed gradually over time. Equities were included in the benchmark in 1998, with an allocation of 40 pct. The Ministry of Finance decided to increase the Fund's exposure to equities to 60 pct. in 2007. Including real estate in the benchmark is currently under consideration.

The Ministry of Finance laid down Ethical Guidelines for the PFG in 2004, based on a broad political consensus. The Ethical Guidelines' paramount objectives are sound financial returns, along with the obligation to respect fundamental rights of those who are affected by the companies in which the Fund invests. Two policy instruments - the exercise of

ownership rights and exclusion of companies - are prescribed as tools to promote the ethical commitments of the Fund. It is emphasized that ownership interests in the companies in which the Fund invests is exercised with a view to promoting good and responsible conduct, showing respect for human rights and the environment. Furthermore, the Fund avoids investments in companies whose practices constitute an unacceptable risk that the Fund is or will be complicit in grossly unethical activities.

The Ethical Guidelines of the PFG do not represent political interference with the Fund. The Guidelines are transparent and predictable, and based on internationally accepted principles such as the UN Global Compact and the OECD Guidelines of Corporate Governance and for Multinational Enterprises.

For further information on the Government Pension Fund, see the attached appendix and Report No. 24 (2006-2007) to the Storting, available at www.government.no/gpf.

4. Speaking notes

- In relation to the current debate on SWF Norway’s Government Pension Fund - Global is often cited as an example to be followed. Key factors include: a high degree of transparency in all aspects of its purpose and operation, the fund’s role as a financial investor with non-strategic holdings, an aim to maximise financial returns, and clear lines of responsibility between political authorities and the operational management.
- The management of the fund aims for international best practice, and the exercise of ownership rights is based on internationally accepted principles such as the UN Global Compact and the OECD Guidelines of Corporate Governance and for Multinational Enterprises.
- Transparency is emphasized as a key tool in building trust, both domestically and internationally. It is only by being open about the management that the government can expect the population to support putting aside 15 percent of GDP a year, in a fund that is now 100 percent of GDP and growing, in order to meet rising spending needs in the future (driven partly by pension expenditures).
- Openness about the fund management can also contribute to stable international financial markets. Other market participants will then be familiar with our investment strategy and circumstances, facilitating well-functioning financial markets.
- Furthermore, transparency provides a disciplinary effect on the fund management. As fund performance is subjected to public scrutiny, managers of sovereign wealth are met with pressures to deliver sound financial returns.
- Norway’s PFG is a tool to manage our petroleum wealth wisely and avoid the “resource curse”. A sensible management of oil-producing countries’ petroleum wealth in well-functioning financial markets is in everyone’s interest.
- Well-functioning international financial markets are beneficial to all parties. They give borrowers the opportunity to finance productive investments (without reducing consumption), and lenders the chance to smooth consumption over time and achieve better returns. Any discussion about SWF must bear this in mind.
- Typical characteristics of SWF are a long time-horizon, no leverage and no claims for the imminent withdrawal of funds to meet short-term liquidity needs. Hence,

SWF have a strong risk-bearing capacity and an ability to accommodate short-term volatility. They may therefore act as a stabilizing factor in financial markets by dampening asset price volatility and lowering liquidity risk premia.
- Apart from restrictions applying to very limited cases concerning national security, we must respect freedom of investment and equal treatment of shareholders as a fundamental principle.
- The declaration from the G8-summit on 7 June 2007 expressed what would seem to be a sound principle: *"…we remain committed to minimize any national restrictions on foreign investment. Such restrictions should apply to very limited cases which primarily concern national security."*
- We support the ongoing work in the IMF and the OECD in studying the effects of SWF.
- Any work on developing a voluntary set of best practices for SWF should be carried out by the IMF, with the collaboration of relevant partners.
- However, we see no cause for regulations that would restrict the present investment activities of our Fund, or any regulation imposing restrictions on SWF over and above those applying to non-SWF investors.

APPENDIX 1: Useful links

The Ministry of Finance's homepage for the Government Pension Fund:
www.government.no/gpf

Norges Bank Investment Management's home page :
www.norgesbank.no/nbim

IMF Guide on Resource Revenue Transparency:
www.imf.org/external/np/pp/2007/eng/051507g.pdf

IMF Guidelines for Foreign Exchange Reserve Management:
www.imf.org/external/np/mae/ferm/eng/index.htm

APPENDIX 2: Fact-sheet on the Government Pension Fund – Global

(Formerly known as the Government Petroleum Fund)

History

1969: Petroleum discovered in the North Sea (Ekofisk), production start in 1971.
1990: Parliament passed the Government Petroleum Fund law.
1996: First net transfer to the Fund. Invested like Central Bank currency reserves.
1998: Investment in equities introduced in the benchmark (40% allocation).
2000: Five emerging market countries added to the equity benchmark.
2002: Non-government bonds added to the fixed income benchmark.
2004: New ethical guidelines.
2006: The Government Petroleum Fund renamed the Government Pension Fund – Global.
2007: Strategic equity allocation increased to 60%, small-cap stocks included in benchmark.

Purpose

The Petroleum Fund was established in 1990 as a fiscal policy tool to support a long-term management of the petroleum revenues. Renaming the Fund to the Pension Fund - Global in 2006 was part of a broader pension reform, highlighting also the Fund's role in facilitating government savings necessary to meet the rapid rise in public pension expenditures in the coming years. The Fund is not earmarked for pension expenditures.

"The Norwegian petroleum fund model" in a nutshell

- The Fund is fully integrated into the state budget. It functions as a tool to strengthen the budget process and builds on existing institutions.
- The Fund is only invested abroad in financial assets. This ensures risk diversification and good financial returns, and helps to protect the non-oil economy.
- There is a high degree of transparency and disclosure of information. This helps build public support for a wise management of petroleum revenues, and reduces the risk of bad governance.

Key Design Features

- The Fund's inflow consists of all state petroleum revenues, net financial transactions related to petroleum activities, as well as the return on the Fund's investments.
- The outflow from the Fund is the sum needed to cover the non-oil budget deficit.

This means that the Fund is fully integrated into the state budget and that net allocations to the Fund reflect the total budget surplus (including petroleum revenues). Fiscal policy, which regulates the outflow from the Fund, 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%.

Governance

- The Ministry of Finance is responsible for the management of the Fund.
- The operational management is carried out by Norges Bank (the Central Bank), which invests the Fund in accordance with guidelines issued by the Ministry.
- Key changes to investment guidelines are presented to Parliament before implemented.
- 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 independent performance measurement and benchmarking of performance and costs.

Investment Guidelines

- The investment strategy is to achieve high financial returns subject to moderate risk.
- The Fund is only invested abroad in financial instruments. The fund is a financial investor with a diversified portfolio of non-strategic holdings in a range of companies.
- The Fund's financial results are primarily assessed in international currency terms, in order to gauge the development in the Fund's international purchasing power.
- Equities account for 60% of the Fund's strategic benchmark portfolio, consisting of equities listed on exchanges in Europe (50%), America/Africa (35%) and Asia/Oceania (15%).
- Fixed income instruments account for 40% of the strategic benchmark portfolio, consisting of fixed income instruments issued in currencies from Europe (60%), America/Africa (35%) and Asia/Oceania (5%).

Ethical Guidelines

The ethical guidelines for the Fund are based on the recommendations of the Graver Commission (NOU 2003:22). The guidelines have two main elements:

- The Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations, and it is an ethical obligation for present generations to manage it so as to generate a sound return.
- The Fund should not make investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages.

To implement the ethical guidelines, the following mechanisms are employed:

- Manage the Fund well so as to achieve high returns subject to moderate risk.
- Exercise the ownership rights associated with the equity holdings (done by Norges Bank).
- Exclude some companies from the Fund's investment universe (decided by the Ministry based on advice from a Council on Ethics). Exclude some government bonds from the investment universe (decided by the Ministry).

Transparency

The management of petroleum revenues in general and the Fund in particular is characterised by a high degree of transparency and disclosure of information.

- 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, the Strategy Council and external consultants.
- Norges Bank publishes quarterly reports on the management of the Fund, as well as an annual report and an annual listing of all investments.

More information is available at the websites of the Ministry of Finance at www.government.no/gpf and Norges Bank at www.norgesbank.no/nbim.

Key numbers

	2004	2005	2006	1997-2006
Size in NOK bn	1 016	1 399	1 784	
Size in USD bn	168	207	285	
Total return in % (in FX basket)	8.9	11.1	7.9	6.2
…of which manager excess return	0.5	1.1	0.2	0.5
Net real return in %	6.3	8.5	5.6	4.6