

Non-renewable resource funds: Best practice in transparency

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Norges Bank

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Why is transparency important?

- For the Fund to achieve its objectives and be viable over time, its rationale and mechanisms must be understood and accepted by the decision-makers themselves, by the markets and by the public at large.
- This can only be achieved through a high degree of transparency and public debate.

The questions that need to be answered:

- What is the objective of the Fund – why is it there?
- What are the rules for accumulation of capital in the Fund?
- What are the rules for spending resources from the Fund?
- What are the rules guiding the investment and management of the Fund:
 - The investment strategy
 - The considerations regarding risk-return trade-off
 - Actual results, risks and costs
 - Remuneration principles, internal ethical guidelines
 - Ethical investment guidelines – corporate governance

The questions that need to be answered (cont.):

- Who makes all these decisions – what is the governance structure of the Fund and the division of responsibility between the various bodies?

And – last but not least:

- How can we check that the principles and rules are adhered to and that the decision-makers and managers are doing a good job?

The Norwegian Pension Fund

- Objectives
 - Savings fund – vehicle for transforming natural wealth into financial wealth to benefit future generations as well
 - Protect the non-oil (mainland) economy from volatile oil prices and extraction rates.
- Rules of accumulation:
 - By law, all government cash flows, as well as the return on the Fund's capital and the net results of financial transactions associated with petroleum activities, shall accrue to the Fund (specified in detail in the Pension Fund Act)

Definition of inflow to the Fund

Section 3 Income of the Government Pension Fund – Global consists of the cash flow from petroleum activities, which is transferred from the central government budget, the return on the Fund's capital, and the net results of financial transactions associated with petroleum activities.

The cash flow is the sum of

- total tax revenues and royalty deriving from petroleum activities collected pursuant to Petroleum Taxation Act (no. 35 of 13 June 1975) and the Petroleum Activities Act (no. 72 of 29 November 1996),
- revenues deriving from tax on CO₂ emissions due to petroleum activities on the continental shelf,
- revenues deriving from the State's Direct Financial Interest in petroleum activities, defined as operating income and other income less operating expenses and other direct expenses,
- central government revenues from net surplus agreements associated with certain production licences,
- dividends from Statoil ASA,
- transfers from the Petroleum Insurance Fund,
- central government revenues deriving from the removal or alternative use of installations on the continental shelf
- any government sale of stakes representing the State's Direct Financial Interest in petroleum activities,

- less
- central government direct investments in petroleum activities,
- central government expenses in connection with the Petroleum Insurance Fund,
- central government expenses in connection with the removal or alternative use of installations on the continental shelf
- any government purchase of stakes as part of the State's Direct Financial Interest in petroleum activities.

Net financial transactions associated with petroleum activities are the sum of:

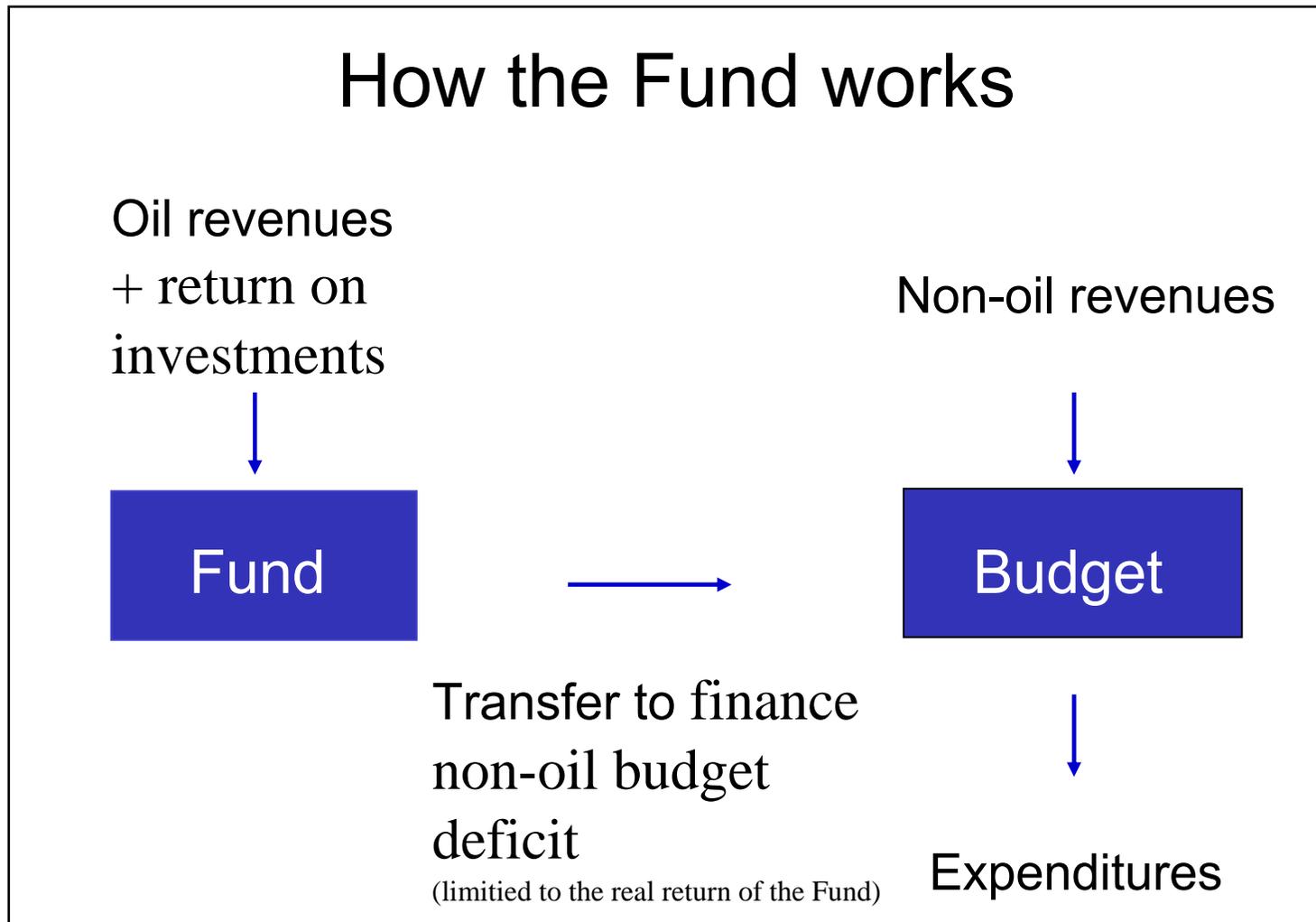
- gross revenues from government sale of shares in Statoil ASA,

less

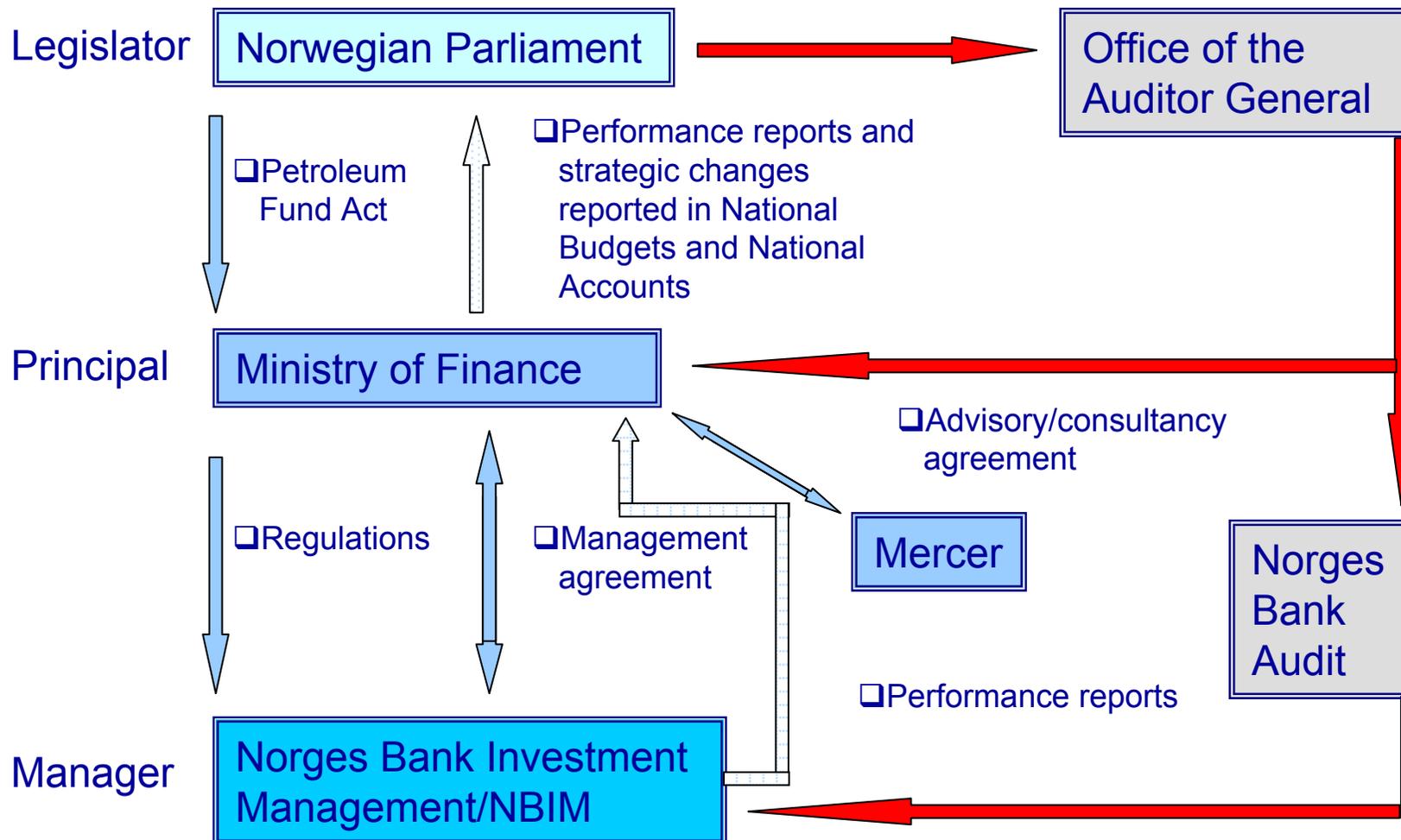
- government capital contributions to Statoil ASA and companies attending to government interests in petroleum activities.

The Norwegian Pension Fund

- Spending of resources from the Fund's:
 - Withdrawals from the Fund may only be used to cover government budget deficits – no subversive second budget.
 - A fiscal rule limits the withdrawals to the expected real return on the Fund (stipulated at four per cent).



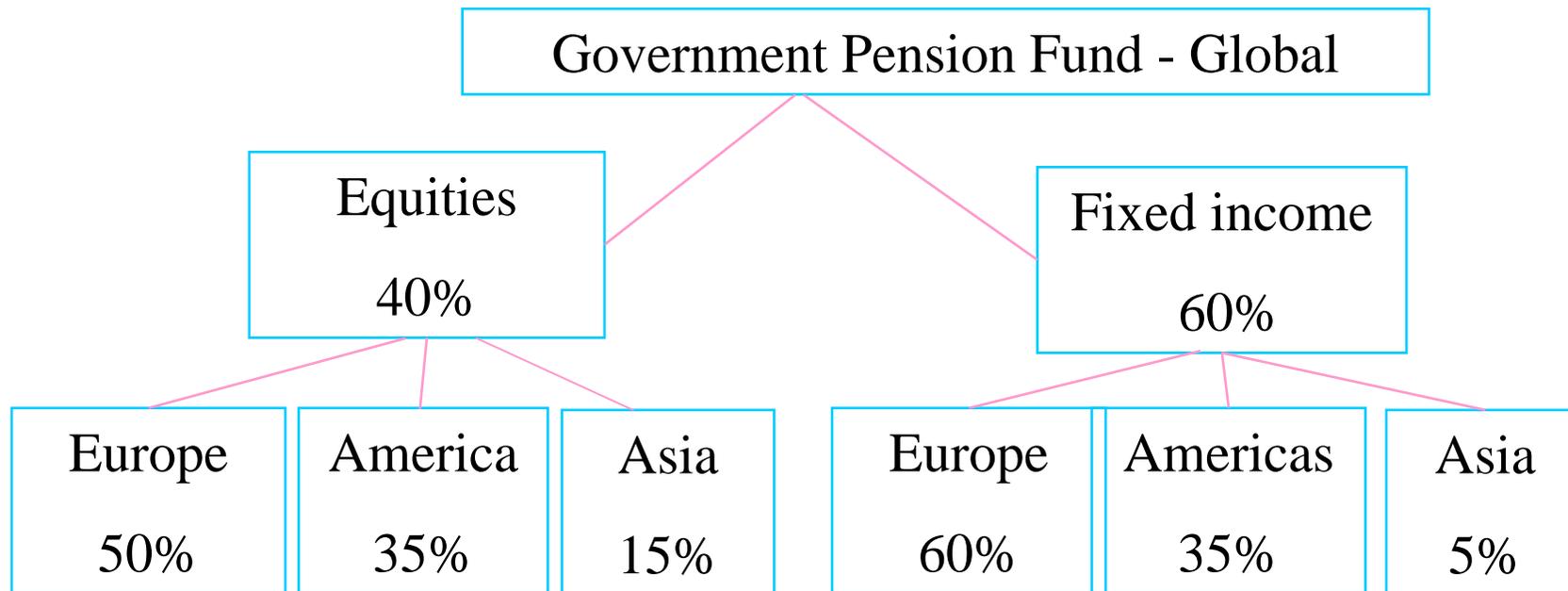
Pension Fund Governance Structure



Division of responsibilities

- Ministry of Finance
 - decides on the general investment strategy as defined by the benchmark portfolio
 - sets limit for deviations from the benchmark portfolio (scope for active management)
 - defines the ethical investment guidelines, decides on exclusion of companies
 - reports to the Norwegian parliament
- Norges Bank
 - cost-effective transitions and market exposure
 - active management to achieve excess return
 - risk control and reporting
 - provides professional advice on investment strategy
 - corporate governance/exercise of ownerships rights

The Norwegian Pension Fund: Current strategic asset allocation



FTSE all-world country indices in 27 countries

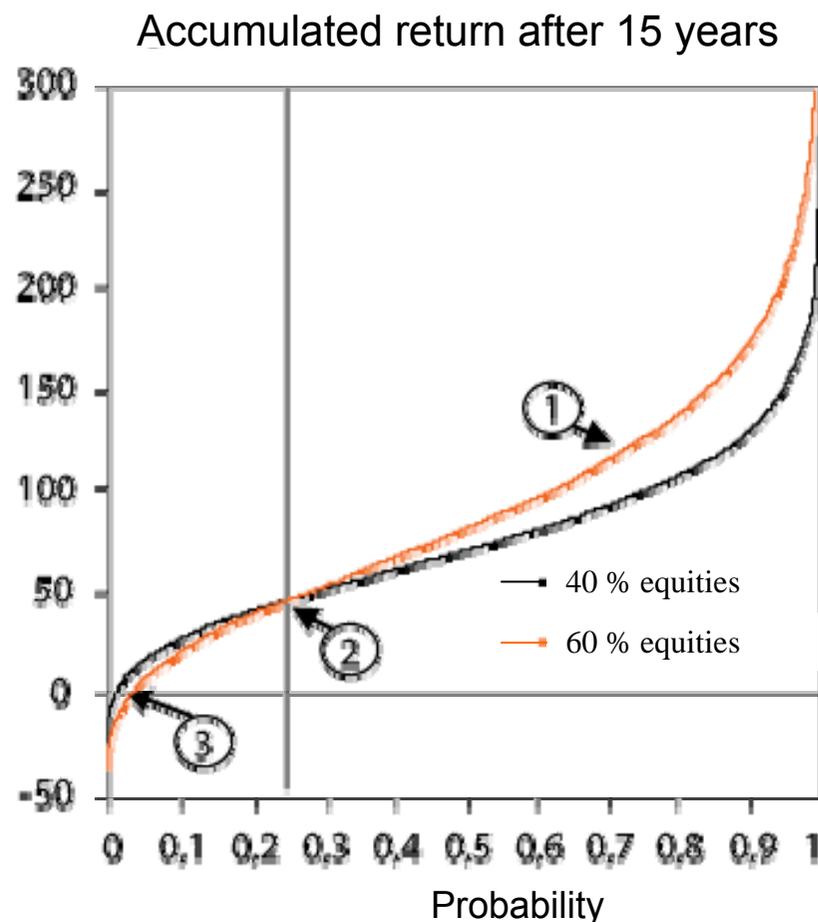
Lehman Global Aggregate broad fixed income index in 18 European and North American countries and LGA Treasury indices in 4 Asian countries

Proposal to change strategic asset allocation

Risk return trade-off illustration

Model computations of real return and risks, with assumptions based on the risks associated with equities and bonds since 1900. Percent

Equity portion	Average annual return (geometric) over 15-years periods	Standard deviation of annual return	Standard deviation of annual return Over 15 years	Probability of negative accumulated return after 15 years
40	4.2	9.7	2.5	4.6
60	4.6	11.9	3.1	6.3



Investment operations

Extensive reporting:

Return and risk

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-

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.

“The Fundamental Law of Active Management”

- Information Ratio = Return / Risk

$$IR = IC \cdot \sqrt{BR}$$

Information Coefficient (IC) = $\text{corr}[\alpha, \theta]$

α = expected (ex ante) return

θ = actual (ex post) return

$\text{corr}[\alpha, \theta]$ = correlation between α and θ

BReadth (BR) = number of independent positions

- The Challenge:
 - Improve IC (hit ratio) and/or
 - Increase breadth by taking many independent positions and trading often

Management guidelines – risk exposure limits

NBIM NORGES BANK INVESTMENT MANAGEMENT

ANNUAL REPORT 2006

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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)

Salary and incentive system

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

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

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

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

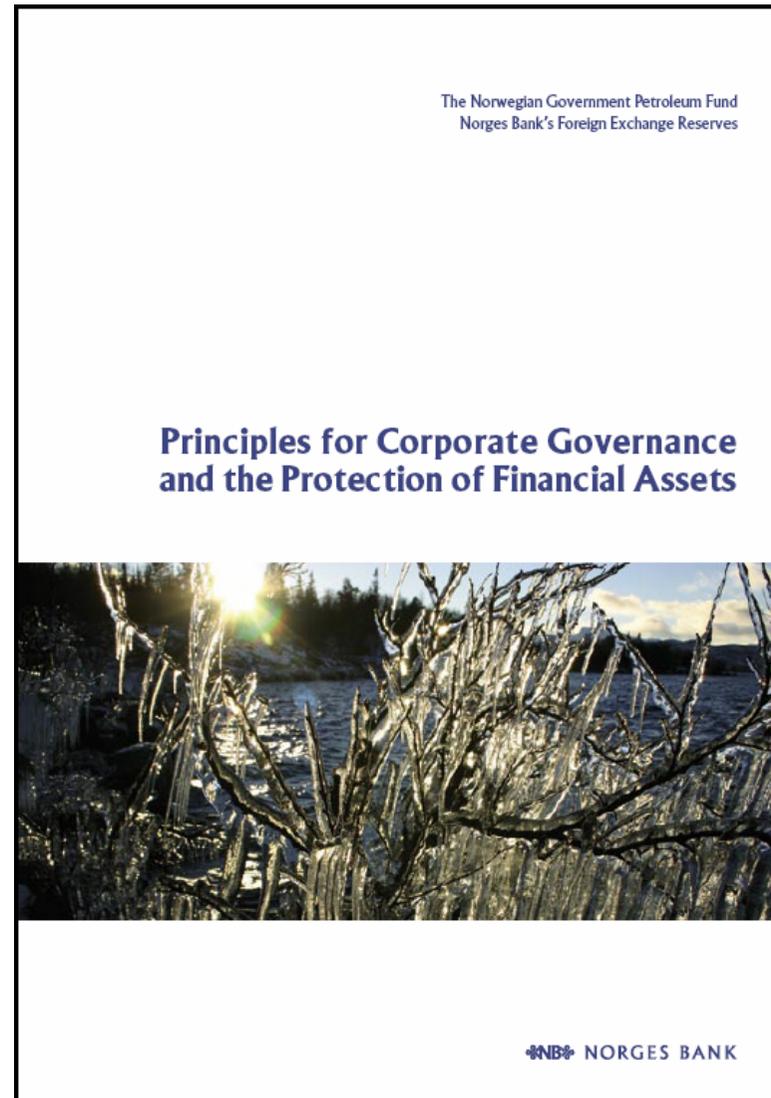
Investment positions

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Government Pension Fund – Global Holding of equities at 31 December 2006

Europe						
	Market value (NOK 1000)	Ownership stake (per cent)	Voting (per cent)	Market value (NOK 1000)	Ownership stake (per cent)	Voting (per cent)
AUSTRIA						
Bank Austria Creditanstalt AG	432 786	0,287	0,299	Arkema	97 380	0,504
Erste Bank der Oesterreichischen Sparkassen AG	753 121	0,510	0,511	Assurances Generales de 531 898	0,287	0,287
EVN AG	118 795	0,398	0,398	Atos Origin SA	115 379	0,454
Immoeast AG	115 104	0,237	0,237	AXA SA	3 970 336	0,754
IMMOFINANZ Immobilien Anlagen AG	189 286	0,477	0,477	BioMerieux	2 629	0,016
OMV AG	293 810	0,280	0,280	BNP Paribas	6 906 137	1,094
Raiffeisen International Bank Holding AG	200 186	0,148	0,148	Bourbon SA	72 962	0,426
Semperit AG Holding	41 558	0,843	0,843	Bouygues	764 491	0,573
Telekom Austria AG	351 768	0,422	0,422	Cap Gemini SA	241 633	0,430
Verbund - Oesterreichische Elektrizitaetswirtschafts AG	105 507	0,103	0,211	Carrefour SA	1 706 474	0,642
Voestalpine AG	224 096	0,403	0,403	Casino Guichard Perrachon SA	42 173	0,067
Wiener Staedtische Versicherung AG	65 074	0,142	0,142	Christian Dior SA	975 952	0,810
Wienerberger AG	138 768	0,506	0,506	Cie de Saint-Gobain	1 050 696	0,573
				Cie Generale dOptique Essilor International SA	515 056	0,744
BELGIUM				Ciments Francais SA	68 818	0,150
Ackermans & Van Haaren	158 383	0,914	0,914	CNP Assurances	350 643	0,364
AGFA-Gevaert NV	142 784	0,697	0,697	Compagnie Generale de Geophysique SA	119 985	0,508
Almancora Comm Va	358 218	0,722	0,722	Compagnie Generale des Etablissements Michelin	279 867	0,328
Banque Nationale de Belgique	10 109	0,086	0,086	Credit Agricole SA	569 210	0,145
Belgacom SA	311 210	0,314	0,314	Dassault Systemes SA	88 510	0,233
				Eiffage SA	204 954	0,372

Principles for Corporate Governance



How can we check?

- Reporting requirements
- Extensive auditing

How can we check?

Reporting requirements

4.3 Reporting

Annual reports prepared by Norges Bank under section 1 of the regulations shall contain:

- Norges Bank's strategic plan and the investment strategy for the Fund
- A list of all significant external service providers, including a complete list of external managers
- An account of the standards employed by Norges Bank for the purpose of valuation (accounts), measurement of return, along with management, measurement and control of identified risk factors (market risk, counterparty risk and operational risk)
- A report on the Fund's return, including absolute and relative return measured in Norwegian kroner and the Fund's currency basket, real return, decomposition of return on asset class and internal/external management
- A report on costs related to the phasing in of new capital, exclusion of companies and other changes resulting from any decision by the Ministry of Finance to change the Fund's benchmark portfolio
- A report on the Fund's absolute and relative market risk (volatility), monthly figures – in the aggregate and distributed on asset classes
- The composition of the fixed income portfolio by main categories of credit rating grade
- An overview of new countries, currencies and instruments in which the portfolio has been invested

- An overview of the Fund's investments in relation to the regulations' quantitative provisions
- An account of the exercise of ownership rights in accordance with the ministry's Ethical Guidelines, see 5.3.2
- A list of companies that are excluded from the investment universe
- A report on the accounts in accordance with Norges Bank's accounting principles
- A complete list of equities and bonds as of 31 December
- An account of the organisation and operating expenses of Norges Bank Investment Management

Quarterly reports prepared by Norges Bank shall contain:

- A report on the Fund's return, including absolute and relative return in Norwegian kroner and the Fund's currency basket, real return, and a description of important contributions to relative return
- A report on the Fund's absolute and relative market risk (volatility), monthly figures – in the aggregate and distributed on asset classes
- The composition of the fixed income portfolio by main categories of credit rating grade
- An overview of the Fund's investments in relation to the regulations' quantitative provisions
- A list of companies that are excluded from the investment universe
- A report on the accounts in accordance with Norges Bank's accounting principles

Any breach of the regulations' cap on maximum holdings that is reversed within 10 trading days does not constitute a formal breach of the regulations and shall not be reported to the ministry.

The questions – are they adequately answered in the Norwegian set-up?

- ✓ Objective
- ✓ Accumulation
- ✓ Spending
- ✓ Management of the Fund
- ✓ Governance structure
- ✓ Verification

For further information:

Norges Bank:

<http://www.norges-bank.no>

Ministry of Finance:

<http://www.regjeringen.no/nb/dep/fin.html?id=216>