# Egil Matsen: Government Pension Fund Global - experiences and organisation

Speech by Mr Egil Matsen, Deputy Governor of Norges Bank (Central Bank of Norway), Oslo, 27 October 2017.

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*Accompanying slides*

## Introduction

At a press conference in February 2017, Prime Minister Erna Solberg summarised Norway's management of its oil and gas revenues as follows: "We have been fortunate, but we have also managed our resources well."[1] Many will probably agree with the Prime Minister's assessment.

In 1990, the Storting (Norwegian parliament) passed the Act relating to the Government Petroleum Fund, an important milestone for the management of Norway's petroleum revenues. The Act draws a distinction between current oil and gas revenues and the spending of these revenues over the central government budget. This distinction has allowed the accumulation of the savings in what is now called the Government Pension Fund Global (GPFG). Under the Act, all of the government petroleum revenues are to be placed in the GPFG, which can only be used via the central government budget. Under the fiscal rule, the transfers are to follow the long-term expected annual real return of the GPFG.

*Chart: A large fund – NOK 8 000 billion*

The first deposit in the fund was NOK 2 billion and was made in May 1996 by Sigbjørn Johnsen, the Minister of Finance at the time. Today, the value of the GPFG is around NOK 8 000 billon, or almost three times annual mainland GDP. The transfers to the central government budget are expected to finance 15 percent of central government expenditure in 2018.[2] The GPFG has become important to the Norwegian economy.

Norges Bank has been tasked with managing the fund since its establishment in 1996. Already then, objections were raised, both inside and outside the Bank, to the Bank's role as manager of the fund. Could a bureaucratic institution like Norges Bank be suited to reaching the objective of earning the highest possible return? Would the Bank succeed in recruiting employees with the necessary expertise? What about safeguarding the central bank's reputation? Would this weaken executive management's focus on the Bank's core tasks? It is interesting to note that more than 20 years later, the Central Bank Law Commission[3] addresses some of the same issues.

Despite the scepticism, the management of the fund was assigned to the Bank. In the history of Norges Bank, the authors write: "Even though the challenges posed by investment management at Norges Bank were obvious, neither the civil servants at the Ministry of Finance nor the executive management of Norges Bank appeared to be in any doubt that the fund should be placed in the central bank."[4] The historians cite the need to keep investment management under control and fears of lower returns if investment management were divided among several institutions among the reasons behind the choice of Norges Bank as manager. We should also remember that it was uncertain how large the fund could grow and how long it would last. It was therefore natural that an existing institution with systems and expertise for managing the country's foreign exchange reserves was chosen to perform this task. It may be said that the fund was thought of as a savings account that the government opened at Norges Bank, alongside the government's ordinary sight deposit account.

*Chart: A large fund*

The return on this savings account has so far been good. Since the beginning of 1998, the fund has achieved an average annual return of 6 percent. In NOK terms, the total return came to more than NOK 3 800 billion at the end of September 2017. The return has been around ¼ percentage point higher than the return on the fund's benchmark index. The annual real return has been 4 percent. Management costs have been low. Over time, they have fallen as percentage of assets under management down to 0.06 percent annually at present.

## Governance model and governance principles

The Central Bank Law Commission has considered alternatives for the future organisation of the GPFG. Before I comment on the Commission's conclusions, I would like to speak briefly about the current governance model and the interaction between the Storting, the Ministry and Norges Bank.

*Chart: Governance structure*

The legislative basis is decided by the Storting, while the Ministry of Finance lays down a management mandate that is issued to Norges Bank. Moreover, the Ministry has established a practice whereby decisive changes are submitted to the Storting for approval. Pursuant to the Ministry's mandate, the Bank's Executive Board prepares a job description and investment mandate for the CEO of Norges Bank's investment management unit, NBIM.

The current governance model is in line with the Santiago Principles, which have been developed for the governance of sovereign wealth funds. The Principles stress that the policy purpose of such a fund should be clearly defined. The Government Pension Fund Act contains an explicit objective that the fund shall support government saving and support long-term considerations in the use of petroleum revenues. In the mandate from the Ministry, this has been specified by providing that Norges Bank shall seek to achieve the highest possible long-term real return with moderate risk.

The Santiago Principles also emphasise the importance of a clear division of roles and responsibilities and of avoiding micromanagement of investment activities. This is provided for with regard to the relationship between the Ministry of Finance and Norges Bank as the Ministry does not issue instructions in matters relating to the exercise of ownership rights or individual investments.

The Santiago Principles are derived from more general principles of corporate governance. An important purpose of these principles is to mitigate what is called the "principal-agent problem". This problem arises when a principal delegates a task to an agent who has more information and who may have interests other than those of the principal. Delegated investment management is an often-used example of a situation where the principal-agent problem can arise.

In the current governance model, it is natural to think of the Ministry of Finance as the principal and Norges Bank as the agent. For the Ministry, the formulation of the management mandate, reporting and supervision will be important tools for ensuring that investments are managed in line with objectives. It is my view that the interests of the Ministry and the Bank largely coincide. All employees of the Bank are highly conscious of the Bank's social mission. But there is no escaping the fact that the Bank has much more information about the investments and their management at its disposal than the Ministry.

The Ministry has given Norges Bank a relatively detailed mandate for the management of the fund. The investment strategy is largely determined by this mandate. The mandate sets the benchmark index and tracking error limits. In addition, the mandate imposes constraints on the fund's investment universe. The permitted deviations between the actual portfolio and the benchmark portfolio are subject to defined limits, also known as index-tracking, which means that the GPFG's return and investment risk are for the most part determined by the benchmark index.

*Chart: Return on the GPFG and the benchmark index*

The role of the Bank and the Executive Board in formulating and elaborating the management mandate is to advise the Ministry of Finance. This is an important job. Beyond this, the Bank has limited responsibility and room for determining the overriding investment strategy, especially in comparison with other large public investment funds.

An example is the Singapore Government Investment Corporation (GIC), where the country's finance ministry also formulates a mandate with a benchmark portfolio and investment limits, but the board of the GIC has greater responsibility for actual asset allocation than Norges Bank's Executive Board. Another example is the Canada Pension Plan Investment Board. The governance structure of this fund differs even more from our own in that the board itself draws up the investment strategy pursuant to a statutory objective.

*Chart: Asset allocation in the GPFG, GIC and CPPIB.*

At the same time, there are considerable differences between the asset allocation in the GPFG and that in the Canadian and Singaporean funds. This probably reflects the differences in governance structure as governance structure and organisation set a framework for the investment strategy to be pursued. In the consultation response to the Central Bank Law Commission's recommendations, we place emphasis on the relationship between governance, organisation and strategy. I shall return to this shortly.

First, however, remember that in addition to defining the investment strategy, the mandate from the Ministry of Finance contains specific reporting requirements. Thanks to its extensive reporting, the GPFG enjoys a reputation of being one of the world's most transparent sovereign wealth funds. For a fund with the entire population as actual owners, transparency is vital for ensuring democratic control and confidence in investment management.

Both the fund's investment strategy and investment management have tolerated substantial return volatility over the past 20 years, partly owing to transparency about the consequences of strategic choices and performance. Regardless of how the GPFG is organised in the future, it is essential to maintain the established confidence in and legitimacy of the fund. Transparency about investment management will continue to be important in this regard.

## The investment strategy and organisation have evolved in parallel

The investment strategy for the fund has evolved gradually since the beginning in 1996, with decisive changes along the way. The initial capital in the fund was invested exclusively in government bonds. Already in 1997, it became clear that the fund would grow larger than assumed and the saving horizon longer. It was therefore decided that 40 percent should be invested in equities to attain a higher long-term real return. From 1998, the fund therefore went from being a lender to just a handful of countries to becoming part owner of a wide range of private companies.

*Chart: Evolution of strategy and governance structure over time*

From 2002, fixed income investments were expanded to include bonds issued by corporates and international organisations. Important new steps were taken in 2007, when it was decided to increase the equity allocation and invest in new markets. The fund could thereby become a larger shareholder in more companies and in more countries. By increasing the equity allocation from 40 to 60 percent during the financial crisis, the fund doubled its average stake in the world's publicly traded companies to around 1 percent.[5]

Since 2011, Norges Bank has also invested in real estate. And most recently, earlier this year it was decided to increase the equity allocation in the GPFG to 70 percent. In the course of 20 years, the fund has changed from being a small lender to a handful of countries to becoming the world's largest sovereign wealth fund. The GPFG is invested in thousands of companies worldwide and now owns the equivalent of close to 1.5 percent of all large listed companies in the world.

Such a large ownership stake entails rights and obligations. As the fund has grown, there have been increasing expectations and demands concerning what the GPFG *should not own* and the type of owner it should be. As the manager of the GPFG, Norges Bank is to act as a responsible investor and exercise the fund's shareholder rights in line with the Ministry's management objectives.

In parallel with the growth of the GPFG and the broadening of the management mandate, Norges Bank's organisation and governance structure have evolved in response to growing responsibilities and complexities.

The most important change came as early as 1998, which was to organise NBIM as a dedicated investment management unit, with responsibility for the investments in the fund. NBIM now has a staff of around 600, with about half working outside Norway, while Norges Bank Central Banking Operations has a staff of 340.

Today, NBIM and Central Banking Operations are two virtually independent operational areas at Norges Bank. The Governor is the chair of the Executive Board and at the same time general manager of Central Banking Operations. Under a resolution of the Executive Board, NBIM is to have its own chief executive officer with a specific job description, mandate and separate lines of reporting to the Executive Board.

The Executive Board's total board time and the number of items for consideration have increased considerably in recent years. This pertains especially, but not exclusively, to investment management matters. In 2015, the Executive Board appointed two new committees, an Ownership Committee and a Risk and Investment Committee. This has strengthened the Executive Board's work on responsible investment and investment strategy, risk limits and large real estate investments. As you know, in January 2016, the government also appointed a new Deputy Governor, with special responsibility for investment management matters.

The supervisory and control structure has been strengthened, among other things by establishing an internal audit function for the Bank and an Audit Committee solely comprising external members of the Executive Board. Moreover, since 2010 Norges Bank's Supervisory Council has reported supervisory results directly to the Storting, and in addition an external auditor was appointed for the Bank.

### Investment strategy, governance and organisation must continue to evolve in tandem

The sceptics who 20 years ago doubted the decision to give Norges Bank task of managing the oil fund have not been proven right so far. In the National Budget for 2018, the Ministry of Finance states that the Bank has managed and continues to manage the fund in a sound manner.

Norges Bank believes that the Bank is well positioned to manage the GPFG and perform central banking tasks in a sound manner also in the future. If the fund remains under the aegis of the Bank, Norges Bank recognises that there are arguments for establishing a separate committee for monetary policy and financial stability. Such a committee will substantially unburden the board of central banking matters, and the composition of the board can then be tailored more closely to specific tasks relating to investment management. In this case, the Executive Board favours a model that is based on the current governance structure.

Norges Bank also recognises that there are aspects of the current organisation and governance that could be reconsidered. The organisation, governance structure and supervision must be considered in the light of new challenges for the management of the fund and for central banking.

In recent years, changes in the Ministry's mandate have given the Bank greater responsibility for formulating parts of the GPFG's investment strategy. The Executive Board and the organisation have had to devote greater resources to investment management, partly owing to the addition of unlisted real estate to the GPFG's investment universe. Since the beginning of 2017, the Bank has been responsible for deciding the allocation to unlisted real estate subject to an upper limit. In addition, the Executive Board now decides whether individual companies will be placed under observation or excluded from the GPFG's investment universe on the basis of advice from the Council on Ethics. From the turn of the year, the Executive Board shall also decide which government bond issuers are eligible for inclusion in the fund.

The Bank has managed these tasks by adapting its organisation and governance structure. An example of this is the establishment in 2014 of a separate organisation within NBIM to manage real estate investments. Nevertheless, developments in recent years show that the future organisation and home of the GPFG should be considered in the light of the continued evolution of the investment strategy.

As you may know, the Central Bank Law Commission proposes to separate management of the GPFG from Norges Bank and establish a statutory entity to manage the fund. The Commission does not discuss the actual management mandate, but its assessment of governance models for the Bank and the GPFG takes into account that it may be changed.

The Commission itself points out that the Ministry may hand over more decision-making responsibility regarding investment strategy and asset composition to the manager, as is the case with many other sovereign wealth funds. It is also possible that the investment strategy may be broadened to include more unlisted asset classes, such as infrastructure and private equity. These sorts of investments will place heavier demands on executive management and the governance structure and require a larger and more complex organisation. Moreover, demands and expectations concerning the fund's exercise of ownership rights may increase further. The Commission raises the question of placing the Council on Ethics within the management organisation. This would mean that the organisation given the responsibility of managing the fund will also be given greater responsibility for making ethical assessments.

If there are prospects that investment management evolves as I have indicated above, it may be appropriate to organise the management of the fund outside the central bank.

## The fund must not be compromised

The chair of the Central Bank Law Commission has underscored that "the fund must not be compromised" in the event of a new governance model. This was also a concern echoed in the public debate, reflecting fears that changes in the organisation of the fund may give special interests influence over investment management. I would like to highlight four areas that could have serious pitfalls: the primary objective of investment management, the division of responsibility in the governance model, board composition and cost-effectiveness.

*Chart: Important considerations for the future*

The purpose of investment management as defined by the political authorities sets a clear aim for the long-term return. To illustrate this point, I have chosen again to look to Canada, more specifically to the province of Alberta. Alberta has earned considerable oil and gas revenues since the 1970s. In 1976, the provincial government established the Alberta Heritage Savings

Trust Fund (AHSTF), where these revenues were invested.

*Chart: Alberta Heritage Savings Trust Fund*

At the outset, the AHSTF had a number of objectives. In addition to saving for the long term, the AHSTF was also tasked with strengthening and diversifying the economy of Alberta and improving the quality of life of Albertans. Individually, these are admirable aims, but as an overall objective for investment management, they are more demanding. Retrospectively, it is difficult to measure the fund's contribution to a more diversified economy or to an improved quality of life of residents. Such purposes may also conflict with a desire to save for the future. Alberta has chosen to adjust course along the way. The management objective of the fund is now to maximise long-term returns at a prudent level of risk.

*Chart: Important considerations for the future*

The Central Bank Law Commission advises against multiple objectives for the management of the GPFG. The Commission underscores that a change of manager for the GPFG should not occur if this entails that other considerations overshadow the aim of maximising long-term returns. Norges Bank concurs with this view. Using the fund to attain policy objectives such as environmental, foreign, regional or industrial policy goals may easily come at the expense of high, long-term returns.

The other area I would like to address is the division of responsibilities in the governance model. It must be explicit, with a clear division of roles and responsibilities. The current governance model for the GPFG is based on a delegation of responsibilities and powers from one level to another. A control and supervisory line runs in parallel from the manager upward to the Storting. Regardless of whether the fund remains under the aegis of the Bank or is organised in a separate entity, its governing bodies and management must be held to account. This also requires that the parties at the various levels in the governance hierarchy respect the powers and delegated authority actually conferred on them. A lack of clarity in decision-making responsibility may adversely affect investment management in the long term.

The third potential pitfall concerns the composition of the board of a new management entity. The Central Bank Law Commission emphasises that such a board must have expertise in finance and investment management, but also expertise beyond the purely financial. In Norges Bank's experience, a sound understanding of the GPFG's role in the Norwegian economy and in economic policy is important for the board in discharging its tasks, and not least important in filling the role of key adviser to the Ministry on matters concerning the mandate and investment strategy. The board must also be conscious that it is the owner's representative – its loyalty must lie with the principal. If this emphasis is misplaced, it can damage the position of the fund in the public consciousness.

Finally, I would like to underscore the importance of preserving cost-effective investment management. In the course of 20 years, Norges Bank has built up a competent investment management organisation. Considerable economies of scale have been realised – investment management costs are low. The level of management costs over time is particularly important for the owner's net return. We must keep the GPFG's management costs at a low level, regardless of whether the fund remains within the Bank or is organised outside the Bank. Norges Bank concurs with Central Bank Law Commission in that neither the fund nor its management tasks should be divided among several entities. This will raise management costs. Any gains, however, would be difficult to come by.

## Conclusion

Norway has managed its petroleum resources well. We have set aside wealth for the future and have created a stable institutional framework for the management of the country's savings. In the quotation I began with, the Prime Minister points out that Norway has also been somewhat lucky. Oil and gas prices were high during a period where production was also substantial.

Luck is hardly a permanent condition. Oil prices are now far below the levels prevailing just a few years ago. Looking ahead, volatility in global capital markets may have a pronounced impact on the value of the GPFG, to both the upside and the downside. Good institutions can enable us to use favourable periods to create long-term value. The same institutions can also help us through less favourable periods without permanent damage. And, unlike either good or bad luck, institutions, as a rule, are more permanent.

The future management model for the GPFG is ultimately a matter of institutions that are supposed to be long-lasting. Norges Bank's societal and constitutional role has provided a stable framework for the fund. Should the framework that the Bank can provide still be the decisive factor, or has the fund now become so large and investment management so extensive, that the assets can be best preserved and grown in a separate organisation?

The Commission's recommendation and the ensuing debate show that there is a wide range of views. The discussion reflects both the evolution towards an increasingly complex fund and the fund's key role in Norwegian politics and Norway's economy. But once the decision is made, the issue of the fund's future organisation must be regarded as settled. Regardless of the outcome, we must be prepared to live with the chosen governance model for many years to come. Broad political consensus is an effective guarantee in this context.

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1 Regjeringen.no: Pressemelding 16.02.2017 Økt aksjeandel i pensjonsfondet og justert anslag for fondsavkastningen"

2 The non-oil deficit as a percentage of total general government expenditure.

3 Official Norwegian Reports NOU 2017:13 New central bank act. Organisation of Norges Bank and the Government Pension Fund Global (Summary in English).

4 Lie, E., J. T. Kobberrød, E. Thomassen and G. F. Rongved (2016): *Norges Bank 1816–2016*. Fagbokforlaget (in Norwegian only).

5 Between 31 December 2007 and 31 December 2009, the average stake in listed companies worldwide doubled.