The legitimacy and governance of Norway's sovereign wealth fund: the ethics of global investment

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Abstract. The Norwegian Government Pension Fund-Global is one of the world's largest sovereign wealth funds and is one of the most transparent institutions of its kind. It also has an explicit mission aimed at integrating long-term investment with a two-sided ethical commitment: to corporate engagement according to accepted global principles of best-practice corporate governance, and to ensuring that the fund is not associated with companies that pose a risk to global social and environmental justice. As such, the Norwegian fund has an ethical mandate—something remarkable when compared to other sovereign wealth funds. In this paper, we argue that this mission is best understood in terms of procedural rather than substantive justice. Our argument is sustained by reference to recent work on the nature of state authority and legitimacy in democratic societies, the logic of institutional governance, and the functional integration of decision-making. The paper focuses on the nature and significance of the recommendations from the advisory Council of Ethics and the exercise of powers related to standards of corporate governance. Implications are drawn for understanding the functional performance of the fund in the context of changing global financial markets.

Keywords. Norway, democracy, ethics, investment, sovereign wealth fund

JEL Codes. G23, G24, L12

Introduction

A recurrent theme in commentary about sovereign wealth funds (SWFs) is the global power associated with their vast financial resources and the fear that SWFs may be the strategic instruments of their sovereign sponsor's geopolitical interests (Aizenman and Glick 2008; Monk 2009). When a SWF announces the acquisition or intended acquisition of a country's infrastructure assets, one response is to suppose that behind the assessment of risk and return is an interest in acquiring a strategic foothold that will pay political dividends for the national sponsor in the future. A second, related, theme is about the effective independence of SWFs from national political interests. There is a fear that SWFs may be subject to the latest fad or fancy of their political masters. Best-practice investment management has it that clarity of mandate and the formal division of authority and responsibility are essential in driving performance over the long-term (Clark and Urwin 2008).

The Norwegian Government Pension Fund-Global (GPF-G) is not a 'pension fund' in the sense that pension funds normally have designated beneficiaries, are ruled by the principle of fiduciary duty, and have well-defined time horizons over which they must realise their commitments (Clark 2000). In fact, the GPF-G is a deposit account with the Norwegian Central Bank: its assets are managed by Norges Bank Investment Management (NBIM) which is, in the first instance, responsible to the Bank's Governor and Board and ultimately to the Minister of Finance. It has neither an independent board of trustees nor does it hire its CEO and CIO; those employed in the NBIM are employees of the Bank and are subject to the Bank's employment policies and practices. Further, NBIM investment is subject to Ministry policies including quantitative rules regarding the allocation of assets as well as mission-led policies regarding ethical investment that derive from the national Parliament. Since the fund is required to invest its assets outside of Norway, its ethical investment policies seek to give global effect to national values and commitments.

Given the huge size of the fund (approximately $US400 billion in 2010) and the ethics policy whereby the Fund may be required to exclude certain companies from its investment portfolio, the process of ‘naming and shaming’ can make headlines around the world. For some commentators, notably Backer (2009), the GPF-G challenges conventional boundaries between ‘private’ investment and ‘public’ responsibility for global social and environmental standards. As such, it is both an instrument of long-term national welfare and an expression of Norway’s commitment to global justice. In contrast to other similar funds found in the west, the Norwegian GPF-G is also enmeshed in the machinery of government and is subject to the play of democratic debate over investment in companies around the world that are deemed to violate widely-held national standards. Unlike other similar funds, the GPF-G is not ‘protected’ from parliament and public opinion through statutory powers invested in its trustees (see Clark 2010 on the design and structure of the Australian Future Fund).

We accept that governments may have a legitimate interest in affecting the nature and scope of the investment of public assets. We also accept that governments may wish to give affect to the values of their citizens through the investment policies of responsible agencies and instrumentalities. These propositions form the background to the paper: our focus is on the legitimacy and governance of the GPF-G through the system of agencies and institutions that in sum amount to the ‘pension fund’. In doing so, we are most concerned with the process of decision-making rather than the fund’s financial performance. This is because we believe that the apparent bipartisan political support for the GPF-G and its ethical policies relies upon the representation of public interests in investment decision-making and the accountability of the fund to the responsible minister. In this sense, its legitimacy is reliant upon the political process more so than its functionality if measured in terms of the risk-adjusted rate of return. In the next section of the paper, we suggest that the governance of the fund reflects a public commitment to procedural democracy and, in particular, what Estlund (2008, 6-7) referred to as "epistemic proceduralism": the notion that institutional legitimacy is a product of the procedures whereby decisions are made <u>and</u> the "correctness" of those decisions.

As Norwegian society came to grips with the discovery of North Sea oil and gas reserves in the late 1960s, the government recognised that this wealth would profoundly distort the Norwegian economy and society. The capitalisation of resource earnings in the Government Petroleum Fund, which was latter renamed GPF-G, sought to impose discipline on budget planning in a manner consistent with intergenerational equity. If a 'rational' solution to the costs of short-termism, it is apparent that the application of ethical criteria to investment management transgresses conventional boundaries between professional management and political interest in deliberately integrating global social and environmental standards into the investment process. We seek to show, however, that there is a tension embedded in this policy. Notwithstanding a recent review sponsored by the Ministry of Finance (2008), there are two separate policies under the banner of ethical or socially responsible global investment. One is focused on corporate governance that seeks to affect the market performance of companies which are managed in ways inconsistent with long-term value, and the other is focused on foreign-listed companies deemed to act in ways inconsistent with widely shared Norwegian expectations of proper behaviour.

The Ministry of Finance oversees these policies through an unusual model of investment management. If there are costs associated with the Norwegian governance model, we suggest that the functionality of the investment management process is more likely associated with political legitimacy rather than the efficacy of financial decision-making. Presumably, any 'costs' associated with this governance system are costs willingly borne by the public given the significance associated with accountability and the pursuit of shared values in the global arena. In conclusion, the paper suggests that the opportunity costs of the Norwegian model may be growing as the structure and performance of global financial markets change in ways unanticipated by those that rely upon an historical approach to the issues.

Political Legitimacy

The idea that sovereign wealth funds are the geopolitical instruments of their national sponsors, and the idea that SWFs may be subject to the arbitrary influence of organised domestic interests, are ideas often-times supplemented with another argument: investment management is an exacting discipline and should be protected from the public because of their lack of knowledge and expertise. In part, this is an argument about the costs of ignorance. It is also an argument familiar to many political theorists: some aspects of modern life are so complex and so significant for public welfare it is far better if informed experts perform these tasks (see, for example, Sunstein 2005, pp. 85-87). In its broadest form, this argument maintains public authority and responsibility while recognising those matters best delegated to others to manage. At the limit, expert management of the economy and financial markets could be thought essential for effective public participation in the daily life of culture and society. A good example of this argument realised in practice is the current independence of many western countries' monetary policy committees.

This argument does not always find favour with democrats (see Cohen 2009, pp. 80-82). Liberal political theorists believe that modern states owe their legitimacy to public participation in the process of decision-making whether it be about economic, financial or social matters. If sometimes caste in populist terms, these types of arguments carry, more often than not, exacting expectations of the public good including social justice (Cohen 1986).

Even so, it is apparent that financial markets are especially demanding environments for public decision-making given the prevailing risks and uncertainties that characterise domestic and international markets (Allen and Gale 2007). Periods of market stability may, nonetheless, encourage broadening of responsibility for decision-making only to be disturbed in unpredictable ways by episodes of market volatility, instability and crisis. Lessons learnt in one period about the theory and practice of investment management may not translate to subsequent periods when both the nature and probability of global financial crises change in unpredictable ways (see Barro 2006 and the lessons drawn for financial governance by Clark and Urwin 2010). Whereas democratic societies may value participation in, or at least public representation on, the institutions responsible for financial management, there may be significant costs associated with policies that favour participation over the timely application of expertise.

Elsewhere, it has been shown that the skills of untrained but representative UK pension fund trustees were little better than the skills of neophytes (Clark et al. 2007). One implication to be drawn is that the balance between ‘representation’ and ‘expertise’ may have to be re-caste if pension funds are to be effective institutions in the context of market uncertainty. This argument goes against the policies of the previous Labour government that placed a premium on representation over expertise supposing that commonsense is sufficient to adjudicate between differing expert opinions. More recently, it has been shown that funds that sought through innovation to enhance their performance in the context of the global financial crisis have done so in part by mimicking best-practice in corporate governance where the selection, compensation, and allocation of responsibilities to board members reflects their expertise and their domain-specific skills (Clark and Urwin 2010). Here, the question of public participation and representation could be ‘resolved’ by discriminating between those *eligible* to represent the public interest according to their qualifications.

In a similar vein, Estlund (2008) has argued that the principle that western democracies owe their legitimacy to the willing participation of the public in collective decision-making is confounded by reality on two counts. Most democracies are complex entities necessarily reliant upon representation rather than direct participation, and; in any event, participation is hardly an unalloyed ‘good’ given the possibility of poor decision-making in circumstances that are subject to partisan control of the purpose and prospects of public institutions. He might have also noted that many issues are so difficult to understand and require the skills and expertise associated with domain-specific knowledge that commonsense or a common commitment to the public good are not adequate bases for collective decision-making. In this respect, it may be the case that the value attributed to commonsense in deliberative democracies may overwhelm the best interests of those that stand to benefit (or otherwise) from the collective decision-making process (compare Cohen 2009 with Sunstein 2005).

In any event, few of us have the opportunity to act in a manner consistent with the tenets of deliberative democracy; one conclusion to be drawn is that implied 'consent' rather than the public participation in collective decision-making is the most common metric of legitimacy (as suggested by nineteenth century political philosophers). Therefore, states may owe their legitimacy to the process of representation and the extent to which the resulting actions of governmental institutions have some validity beyond the obvious interests of those involved and the various options considered. For Estlund, validity hinges on the existence of an acceptable moral template for decision-making that has widespread support if not universal acclaim. While he is properly concerned about the possible tyranny of well-entrenched minorities, his procedural model of democracy combines a commitment to an open or transparent process of decision-making with a *test* of the value of the decision-making process.

It is important to stress, however, that tests of value may be quite broad (in a sense, society must also decide). Nor need tests of value be based on outcomes per se. So, for example, in the Norwegian case it is apparent that the value attributed to ethical standards in the investment mandate of the GPF-G is, on one side of the equation, a moral value not a financial issue. That is, the chosen ethical standards flag-up areas of investment that the public would not accept as part of the GPF-G investment universe. As such, these standards are not subject to a profit and loss statement. It is also apparent that there is a premium on the transparency and accountability of the process whereby ethical issues are evaluated. In fact, we would argue that the process is more important than any outcome in these circumstances. Put slightly differently, the degree to which the public trusts the process of evaluation determines the degree to which the public takes-up the opportunity to dispute resulting ministerial decision-making. If after the process of assessment and consultation it is recommended to not to exclude a company from the GPF-G mandate, the integrity of the process should be such that even those against the decision may be willing to accede to the decision.

We examine the governance of the GPF-G, beginning with its formation as what was then known as the Government Petroleum Fund. We focus on the governance process including its constituent institutions and the mechanisms of accountability precisely because the process is a constitutive element of the legitimacy of the whole edifice. As such, the GFP-G's claims to be heard on matters relating to ethical standards in the rest-of-the-world is based, in part, on the legitimacy (at home) of the process used to evaluate the ethical standing of identified companies from other jurisdictions. Such is the transparency and accountability of the governance process that the fund scores highly in independent tests of governance quality. We would contend, however, that the impetus for such transparency is more about domestic political legitimacy than it is about the performance of investment management.

Establishment of the Petroleum Fund

In 1990, an act of the national parliament (Storting) established the Norwegian Government Petroleum Fund (GPF) (see Backer 2009). The reasons for its establishment are, in retrospect, widely appreciated. One reason references the potential costs of long-term resource wealth for the structural configuration of any economy that has to absorb such riches. Eriksen (2006) from the Norwegian Ministry of Finance rehearsed the argument made by many to the effect that resource wealth may distort the economy, discounting the value of agriculture and industry as well as the benefits of education for long-term individual human capital and social development. Although not mentioned directly, Eriksen effectively explained the establishment of the GPF as a policy designed to ameliorate the 'curse' of resource wealth. As Skancke (2000, 326) noted, the 'Dutch disease' can result in the "weakening of international exposed industries" and "substantial restructuring costs and unemployment".[1]

A second reason for establishing the fund was the potential short-term costs of fluctuating revenues for macroeconomic stability. For such a small economy, the volume and volatility of resource earnings posed a threat to domestic economic stability. This point has been made in a number of other smaller, developed countries such as Australia and Singapore. So, for example, the Australian Future Fund was established, in part, to dampen the flow-on effects of booming resource prices on an already capacity-constrained economy (Clark 2010). For Norway, the issue of macroeconomic stability was particularly acute because of the significant and sustained increase in public spending based on resource earnings over the late 1970s through the 1980s. The increasing reliance of the public *fisc* on resource earnings for social welfare threatened to amplify the volatility of international resource prices

[1]/. Much has been written about the 'Dutch disease' and the 'curse of resource wealth'. See, for example, Corden (1984) and Corden and Neary (1982) on the implications of resource wealth for countries' economic structure and Gylfason (2001) for an exposition linked to The Netherlands. The relevance of these issues for Scandinavia and Norway is to be found in Karl (1997), Notermans (2000), and Auty and Kiiski 2001).

through the Norwegian domestic economy. Given the fixed nature of public spending when channelled through multi-year commitments, unpredictable foreign earnings can result in accumulated public indebtedness as unfunded government spending seeks to dampen the effects of price volatility.

At the time of the establishment of the GPF, two political 'rules' were applied to manage the public budget and the flow of earnings to the fund. In the first instance, to constrain the future reliance of government spending on oil and gas revenues a notional long-term 'share' of resource wealth was set. In the second instance, to impose discipline on the year-to-year budget process the flow of earnings to the fund was made dependent upon year-to-year budget surplus. That is, only in budget surplus would financial assets be allocated to the fund. For Skancke (2000, 320), these two rules and the fund itself could be "seen as a fiscal management tool to ensure transparency in the use of petroleum revenues." He contended that policy makers believed that the fund should be closely aligned with the budget process and noted that "a budget surplus is the only way a government can accumulate financial assets on a net basis." Fiscal discipline in the face of resource wealth was sustained through a comprehensive financial management process rather than sequestering 'windfall' assets into a self-governing independent fund.[2]

Because of the global recession in late 1989 through the early years of the 1990s, the Norwegian government budget did not return to surplus until 1995 when the first allocation was made to the GPF. Thereafter, reserves grew dramatically. In Figure 1,

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[2]/. Rule-based constraints on short-term government spending can be thought of as an implicit contract between political elites on behalf of the national best-interest. Its robustness depends upon a deliberate though often-times unstated denial of the advantages of mobilising vocal minority interests for immediate political gain. Coleman and Ferejohn (1986) discuss the virtue of these devices in terms of social contract theory but doubt the stability of such non-binding agreements in democracies.

the combination of earnings inflows and returns on investment are depicted showing that the fund grew from NOK48 billion in 1996 to just over NOK1000 billion in 2004 and then doubled in value through the on-set of the global financial bubble through to 2008 only to loose asset value in the consequent downturn. In the first instance, assets were invested in Central Bank currency reserves. In 1998, the government allowed investment in foreign equities with an initial allocation of between 30-50 per cent (and the equity portion of the benchmark portfolio was 40 per cent) of assets. It is notable that the fund is required to invest in traded foreign securities subject to the interplay between strategic asset allocation and actual market performance. We return to this issue in later sections, especially as regards the implications of such holdings for meeting ethical commitments.

[INSERT FIGURE 1 ABOUT HERE]

In 2006, the GPF was renamed the Government Pension Fund-Global (GPF-G). The renaming of the fund reflected strategic issues as regards the long-term economic and financial prospects of the country. Eriksen (2006) observed that by 2005 the petroleum sector accounted for 25 per cent of the Norwegian GDP and that the net cash flow of oil and gas revenue accounted for 33 per cent of the government's revenue. At the same time, Eriksen noted that both crude oil and gas production were close to achieving their likely peaks in production and that there were some uncertainties over the future scope and size of reserves (depending on the rate of exploration and exploitation). Forecasts of future production by the Ministry of Petroleum and Energy cited by Eriksen suggested that the volume of oil production would likely decrease by as much as 66 per cent through to 2030 and the volume of gas production would likely decrease through to 2030 by about 25 per cent. Inevitably, net earnings would follow production and the global prices for these resources. By this account, the rate of growth in Norway's accumulation of wealth would likely decline as well.

As noted in many studies of the spending patterns of western governments, the ageing of the baby boom generation and the increasing longevity of each cohort as they age through retirement implies a growing liability against a likely absolute decline in most European countries' total population (Tanzi and Schuknecht 2000). Norway will be similarly affected by these trends, leading to a twofold growing liability: making good on the costs associated with the retirement of expanding public sector employment and making good on the costs of increasing longevity for those that stand to benefit from these promised benefits. In the context of declining (in relative terms) expected resource revenues and increasing commitments to the retired population, the Norwegian government, like a number of governments, has sought to invest for the future. Skancke (2000) argued that an important purpose of the GPF is to insure the payment of those long-term obligations and hence protect the welfare of future generations of Norwegian citizens.

Structure, Control, and Accountability

The Parliament established the status and powers of the Norwegian Government Pension Fund. Therein, a distinction is made between the GPF-Global, which holds the flow of net receipts from Norway's petroleum reserves and the GPF-Norway, which holds the assets and liabilities of the government's National Insurance Scheme (NIS). Together, the purpose of the fund is "to support government savings to finance the pension expenditure of the NIS and long-term considerations in the spending of government petroleum revenues" (Ministry of Finance 2009, 11). Further, the Ministry is charged with the responsibility for the management of the fund including its investment strategy, the regulation of investment, and its ethical guidelines. Operationally, the GPF-G is managed by the Norges Bank through Norges Bank Investment Management (NBIM) and is accountable to the Minister through the Bank's Governor and Board. Figure 2 maps the various institutions involved in the governance of the fund including the hierarchical status attributed to the NBIM (manager), the Ministry (principal), and Parliament (legislator).

[INSERT FIGURE 2 ABOUT HERE]

The Ministry has a secretariat dedicated to the management and regulation of the fund staffed by permanent civil servants. There are advisors to the Ministry on matters pertaining to the management of the fund including the Council on Ethics (and until this past August the Council of Investment Strategy). Both Councils have 'members' appointed by the Minister for fixed terms with mandates to advise the government on important policy issues (see below). So, for example, the Ethics council is comprised of 5 appointed members, a staff of 8 government employees, and an annual budget of NOK9 million. Appointees to the Ethics council are expected to be independent experts, with appropriate knowledge of ethics in theory and practice and Norway's international commitments as evident in treaties and conventions as well as OECD and UN agreements and guidelines. The current Council has three professors, two of which have significant expertise in international law. In summary, "the Council on Ethics provides evaluation (to the Ministry) of whether potential investments in financial instruments issued by specific issuers are inconsistent with the ethical guidelines” (Ministry of Finance 2009, 12).

Unlike some SWFs where government delegates the framing and execution of investment strategy to the designated responsible board, in Norway the Ministry has a detailed set of ‘Provisions’ that effectively regulate the management and operation of the Fund. To illustrate, Section 1 of ‘Regulations’ (found in Provisions) states that the “Norges Bank manages the Government Pension Fund-Global … on behalf of the Ministry of Finance. The Bank may use other managers.” Regulation requires investment in instruments denominated in foreign currencies subject to an asset allocation formula with various elements: first, assets are to be allocated to fixed income instruments between 30-70 per cent and equity instruments 30-70 per cent. The Ministry also sets the geographical spread of assets such that fixed income and equity assets are to “be invested in accordance with the following currency and regional distribution”: in 2009, respectively Europe 50-70 per cent and 40-60 per cent, the Americas and Africa 25-45 per cent, and Asia and Oceania 0-15 per cent and 5-25 per cent. In short, the Ministry determines the asset classes and allocations that are permissible.

The Ministry regulates the benchmarking of investment portfolios, the rebalancing of the fund, the limitation of tracking errors, and the valuation, measurement and control of investment risk. The Ministry also sets expectations as regards proper investment behaviour: on tracking errors, its Guidelines state that the Bank shall “employ conservative estimates and methods making it more likely that expected tracking error will be overestimated than underestimated” and “an important objective for the risk system is that risk attending financial instruments should be calculated in such a way as to ensure that, over time, estimated risk in the Fund deviates as little as possible from actual risk." On investment in countries not previously included in the Bank's portfolio, the guidelines require "a thorough process" of review and risk assessment; on valuation and performance measurement, the guidelines require compliance with "international recognised standards and methods". On the valuation and measurement of returns, the guidelines require monthly valuation reports; and on risk management, there are detailed and extensive requirements on assessment, measurement, and reporting (see Sections 4.2 and 4.3 of the 'Guidelines').

Section 5 of the "Guidelines for the Management" of the fund provides instructions as regards the "ethics". In Sec 5.1 the Ministry sets out two statements of principle: first, "the Fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations and "financial wealth must be managed with a view to generating a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense" and; second, "the Fund shall not make investments that entail an unacceptable risk that the Fund is contributing to unethical acts or omissions" including violations of humanitarian principles, human rights, gross corruption, and severe environmental damage. In the following Section, the Ministry identified three ways in which ethical considerations were to be given effect: through the exercise of ownership rights based on international conventions, negative screening of companies that produce weapons whose use violates fundamental humanitarian principles, and the exclusion of companies from the fund's portfolio that are deemed to constitute a "considerable risk" of corruption, environmental degradation, and the violation of human rights.

The Ministry's Council on Ethics advises on the first two matters (negative screening and exclusion) while exercise of ownership is managed exclusively by the NBIM; though final authority for any related decision rests with the Minister.

Should a decision be made to exclude a company from the Fund's portfolio, the decision is transmitted to the Bank and is implemented by the NBIM. As to the exercise of ownership rights, Sec 5.3 states that the "exercise of ownership rights shall be based on a long time horizon and broad diversification of assets across markets informed by the appropriate international and national guidelines on corporate governance." Elsewhere, this policy is described in terms of the circumstances (and responsibilities) that face what Hawley and Williams (2005) term as 'universal owners'—institutional investors that, by reason of their size, hold such significant stakes in the market for traded securities that portfolio diversification is not an adequate means of risk management (see also Gjessing and Syse 2007). The NBIM, as the entity charged with exercising ownership rights, holds the equity of nearly 8000 companies. In doing so, the Bank is required to report on an annual basis the nature and scope of these activities including the voting of proxies, corporate engagement and the initiation and participation in campaigns designed to encourage or enhance standards of corporate governance and its regulation around the world.

Governing Ethics

As one of the world's largest SWFs, the GPF-G is widely recognised as a remarkably transparent and well-governed financial institution. By Truman's (2007) assessment, based on publicly available information, the GPF-G scored 92 out of a possible 100 in terms of its adherence to best-practice. In doing so, it came second only to the Alaska

Permanent Fund (which scored 94). By contrast, the average score across 34 non-pension funds was 46—the Alberta Heritage Fund scored just 77 against Truman's criteria. The GPF-G has also led the development of the Santiago Principles arguing for the importance of agreed principles and practices consistent with global best-practice. Indeed, international conventions loom large for the GPF-G: shared principles and practices are referenced time and again in official statements that justify investment decision-making with an explicit ethical component. If these statements have a rhetorical element, there is little doubt that they are underpinned by broad bipartisan political support (see Runciman 2008 on rhetoric as a substantive commitment).

By Ministry edict, the GPF-G is required to keep any individual equity holding to less than 10 per cent of outstanding shares. As such, the GPF-G is always in a minority position, and for the vast majority of holdings its claim on outstanding shares is less than 1 per cent. Nonetheless, in some cases to hold 5-10 per cent of a company may provide the GPF-G considerable power over management especially if combined with the holdings of other large institutional investors. It is not surprising that "there are concerns reflecting the view that the growing size of SWFs matters and that sovereign fund management may be motivated by non-economic considerations, deviating from conventional wealth maximization" (Aizenman and Glick 2008, 23). On the ethics issue, however, it is arguable that the principles and practices followed by the Council on Ethics and the Ministry of Finance are such that negative screening and exclusion have the virtues of deliberation and transparency. That is, it is arguable that the process of review, recommendation, and Ministry decision-making is such that the application of ethical principles to GPF-G investment can claim both virtue and integrity.

In large part, the government established the Council to deal with a controversial issue: investment in Total, the French energy company with significant investment in Myanmar (Burma), and the ensuing claims that it was complicit in the military regime's suppression of human rights (see also Chesterman 2008). At the time, there was considerable political pressure on the Minister to personally direct NBIM to exclude Total from the GPF-G portfolio. The formation of the Council, its mandate, and the appointment of members with acknowledged expertise in ethics and international law provided the Ministry with an opportunity to postpone any decision and deflect claims made on the Minister. However, it is apparent that the formation of the Council meant that the government could hardly reject out-of-hand any recommendation. This is recognised by the major political parties, and has been acknowledged as government has changed hands between the parties.

From this issue, the Council developed a multi-stage process of review and assessment designed to identify the crucial issues and apply a series of decision-rules that provide for robust and defensible recommendations. The Minister may ask the Council to consider a specific case, and the Council may identify an issue and company that it considers significant (given the limits of time, expertise, and institutional capacity). The Council maintains a regular 'scanning' process conceived to keep members abreast of the issues on a worldwide basis. Given the various issues and companies identified by the 'scanning' process, the Council undertakes research to better understand the significance of the identified issues drawing upon the enormous flow of information available on the web and from NGOs. As 'targets' for assessment and evaluation are identified, the Council limits disclosure of their interest so as to dampen speculation and political manoeuvring. Having decided there is a case to be considered given the terms of the Council's mandate, a factual case is developed focused, in part, on the extent to which the company is directly involved in the ethical violation. The last stage in the process normally involves contacting the target company with a view to eliciting a response. Thereafter, the case is formally presented at the Council, and the members make their determination as to whether a recommendation for exclusion should go forward to the Minister.

Over the period 2005 to 2009, the Council recommended that a number of companies be excluded. In Table 1, the companies, the issue that was the basis of a Council recommendation for exclusion and the date of exclusion are summarised. In almost all instances, the Minister accepted the Council's recommendation. Note that the companies excluded come from a variety of jurisdictions although the largest single group are US corporations (reflecting, perhaps, the significance of US corporations in the weapons industry and their market capitalisation).

[INSERT TABLE 1 ABOUT HERE]

Here, it is useful to emphasize three aspects of the Council's business. The Council has limited time, expertise and institutional capacity. Inevitably, it has had to choose amongst a large number of possible issues and cases. As noted elsewhere, large companies with recognised names are attractive targets given their public visibility (Clark et al. 2008). The Council is also concerned to distinguish between ‘association’ and ‘causality’: that is, their case is believed strengthened when it can be shown that the target company has a direct connection with the circumstances giving rise to the ethical assessment. Most importantly, the Council sees its recommendations as an expression of the public interest in "proper" behaviour, according to the criteria set out in the ethical guidelines. As such, the Council is not concerned to affect corporate behaviour except in the sense that ‘naming and shaming’ may prompt companies to reconsider their alliances and management performance (Braithwaite 1989).

By contrast, the NBIM’s commitment to global standards of corporate governance seeks to affect the structure and performance of the companies that are targets of actions and campaigns. This can be justified on efficiency grounds, as well as ethics. It is widely accepted that well-governed firms are more likely to enhance shareholder value (Bebchuk 2005). Equally, it is widely accepted that some governance regimes are more likely to protect the interests of minority shareholders than others such that reform of the regulation of corporate governance in favour of global best-practice is consistent with the long term efficiency of global capital markets and the interests of large institutional investors (Gordon 2004). In this context, the actions of the NBIM in exercising the GPF-G’s ownership rights through proxy voting, sponsoring and supporting shareholder resolutions, and corporate engagement have the virtue of promoting the GPF-G’s financial interests as well as acting consistently with respect to collective welfare. [3]

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[3]/. In these matters, the NBIM is an active investor—the 2008 Annual Report of the GPF-G noted that the fund voted on more than 68,000 items at more than 7500 annual meetings around the world. This role is shared by a number of other, very large institutional investors from the UK, USA, Canada and Australia. The most active institutional investors tend to be pension funds rather than sovereign wealth funds and are motivated, in part, by the fact that their investment performance is dependent

In practice, the NBIM has relied upon international standards of corporate governance to motivate its campaigns for best-practice corporate governance. In part, this is because recognised international standards allow for coalition-building amongst large institutional investors that have a global mandate. In part, these standards allow for third-party validation of campaigns, especially as events prompt shareholder response to apparent instances of malpractice. So, for example, the expectation that the Chairman and CEO of major corporations be held by separate people with distinct roles and responsibilities has been an important reference point in motivating shareholder actions. Given limited time, expertise, and institutional capacity the NBIM office tends to focus its voting activities upon the world's 500 largest companies, representing approximately 80 per cent of the market value of the total equity portfolio of the GPF-G. Moreover, the NBIM has sought to influence not only individual companies but also whole industries, especially those with distinctive characteristics (eg. seed producers). The goal is to safeguard the GPF-G's financial assets, and add value over the long term recognising that investment strategies that rely upon the performance of whole markets typically depend upon regulation and investor vigilance.

Recently, the NBIM strategy of active ownership has been revised (by the Executive Board) and broadened. Most specifically, the NBIM focuses upon 6 areas: the first set of 3 relate to capital market performance and the second set of 3 relate to three substantive issues, which represent for the fund areas of significant risk as regards safeguarding the long-term value of the portfolio. The first three are equal treatment

upon the efficient functioning of home and global financial markets. See Clark and Hebb (2005) and Hawley and Williams (2000) for accounts of this development.

of shareholders, shareholder influence and Board accountability, and well-functioning, legitimate and efficient markets. The second three issues are children's rights, climate change, and water management. So, for example, protecting children's rights could involve major corporations that have extensive supply networks through to the developing world. Based upon ILO conventions, the NBIM has sought information on sectors' child labour practices, the extent of company monitoring of this issue, and disclosure on existing practices and intended policies. As noted elsewhere, these issues can have significant implications for sectors of the economy where 'value' is a product of corporate reputation and consumer tastes. In this respect, reputation can be a significant albeit intangible asset (Clark and Hebb 2005).

The NBIM agenda is about protecting and creating long-term value. If relevant in this respect, ethical commitment has more to do with the long-term consequences of corporate engagement than the virtues of acting in a manner consistent with social values. In this respect, the NBIM is consequential in intention whereas the Council is deontological in intention. This distinction goes to the heart of differences in intended effects between the two arms of Ministry policy. Even so, in the external assessment of Articles 3 and 4 of the Ethical Guidelines, the independent Review Panel (Ministry of Finance 2008) recommended the allocation of resources to better manage coordination. Whether these efforts will result in effective cooperation will depend upon reconciling very different professional expectations as regards the logic of global financial markets, and the mechanisms used to integrate shareholder activism into the disciplines of active and passive investment—issues that quite problematic (see the independent assessment of NBIM investment strategy; Ang et al. 2009).

Implications and Conclusions

One way of justifying public institutions is to 'test' their legitimacy against independent norms, including functionality. When coupled with unambiguous goals and objectives, the test of functionality allows observers (even voters) to discriminate between competing institutional forms and attribute to those that are found 'superior' appropriate support. If this logic depends upon the existence and routine application of a public ethic of perfectionism, it has broad support across the social sciences including financial theorists (Merton and Bodie 2005). Few public institutions begin life in such a manner, and it is arguable that over time public institutions become increasingly encumbered with various amendments to their mandates such that their functional effectiveness is increasingly constrained. At one level, this is a *realist* observation about the life of institutions in western democracies. At another level, it draws on theories of institutional formation and interest-group representation that are arguably essential in understanding the nature of public regulation (Roe 2006).

In this paper, we have sought to analyse the legitimacy of the Norwegian SWF from a rather different standpoint arguing that public support for its existence depends upon the <u>process</u> whereby the public interest in its decision-making is governed. It was shown that there is a premium on public accountability, represented by the Minister of Finance and the accountability of the Minister to government and ultimately Parliament. This process-based claim of institutional legitimacy has been quite successful; witness the bipartisan support for the institution, its commitment to intergenerational equity, and to global justice. As such, the Ministry of Finance is at the centre of a web of governmental entities all of which have a role in either implementing or overseeing the GPF-G's activities. It was also argued that this institutional framework is representative of what Estlund (2008) and others have termed *epistemic proceduralism*: a means of legitimating institutions by virtue of the processes used to represent the public interest in realising the public good rather than the functionality of those institutions against measured performance criteria.

There is a paradox embedded in the governance of the GPF-G. On one side of the equation, it is clear that the procedures developed to give effect to the public interest in ethics and global justice have been very important in representing shared commitments to Norway's international obligations. The recommendations of the Council on Ethics on GPF-G investment are taken very seriously by the Ministry and serve as a vital element in screening and excluding companies from the GPF-G's investment portfolio. Even so, it is apparent that naming and shaming hardly ever moves markets, unless enormous financial assets are used against those firms over the long-term (Clark and Hebb 2005). Further, there is no evidence that naming and shaming increases the long-term cost-of-capital for the affected companies unless accompanied by the systematic destruction of shareholder value. Nonetheless, naming and shaming is an essential ingredient in their process-model of institutional legitimacy: the Council's recommendations mean to *represent* public values. Whether or not these recommendations exact a penalty on the targeted companies is much less important.

The transparent nature of Norway's SWF decision-making and its apparent accountability to the democratic process are widely cited and score highly in comparative studies of SWF governance (witness the Truman 2007 scores). At another level, however, there are reasons to doubt the functionality of the process of accountability and transparency for timely and resource-efficient long-term investment. Whereas the GPF-G may score highly on accountability, it is not as clear that it would score as highly on functionality (see Clark and Monk 2010). Given the premium attributed to epistemic proceduralism, this may be entirely appropriate and a cost willingly borne by the public. But in a resource-constrained environment with the consequences of the global financial crisis evident in the flow of resource-income to the Norwegian government, can the costs of epistemic proceduralism be borne indefinitely without the fracturing of the political consensus that has made the complex system of governance so desirable?

A distinction might be also drawn between the high premium on timeliness and decision-making effectiveness in short-term investment management and the ethos of long-term investment that is meant to take a strategic perspective on short-term volatility. We note that the NBIM's asset allocation formula is based on the finding made popular by Dimson et al. (2002) that over the past 100 years equities have out-performed bonds and that trading for short-term advantage incurs both high direct costs and high opportunity costs relative to holding stocks over the long-term. In basing the fund's investment strategy on this argument, the NBIM has been able to 'buy' the time needed to negotiate with its various 'stakeholders' the formulation and implementation of investment strategy. However, there is considerable debate over the degree to which the past 100 years are an adequate recipe for the next 100 years (witness Borio 2006). The relevance of Dimson et al.'s findings hinge on the moment in which we may find our ourselves in the past 100 years, and the degree to which globalisation may have accelerated the integration of global capital markets such that financial crises will be more common and more rapidly propagated through global markets. It may be the case that the costs of Norway's epistemic proceduralism have been relatively low over the past decade because of the particular circumstances dominating global financial markets but these costs may not be nearly as low in the future as investors come to rely upon markets at the margins of the developed economies of the world (see Barro 2006 in relation to Ang et al. 2009, p. 26). If so, the claimed basis of GPF-G legitimacy may be self-defeating. As such, the political legitimacy of the GPF-G may so threaten the fund's functional performance that its very existence is imperilled. If so, another way may have to be found for Norwegians to give affect to their ethical commitment to international justice.

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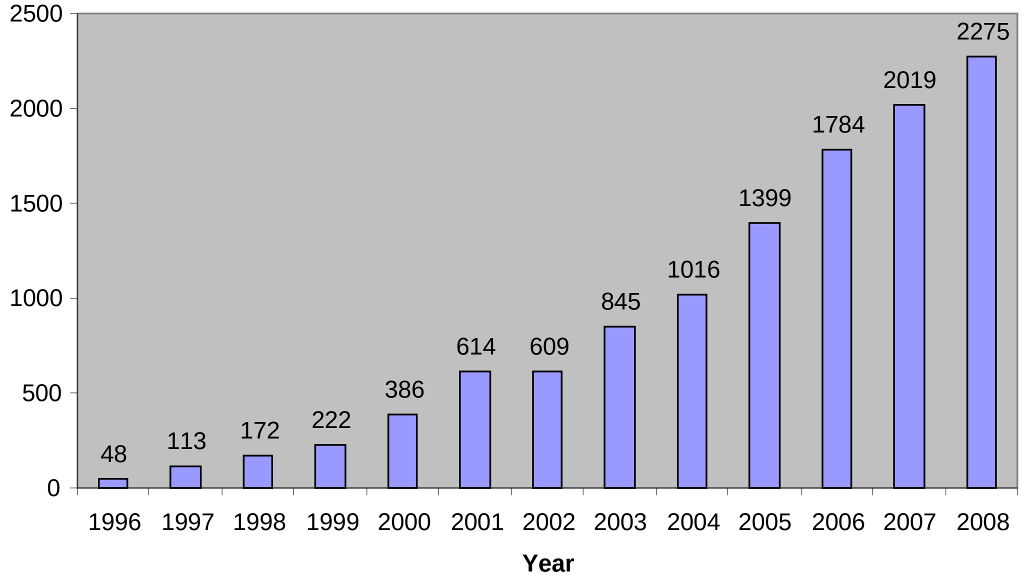
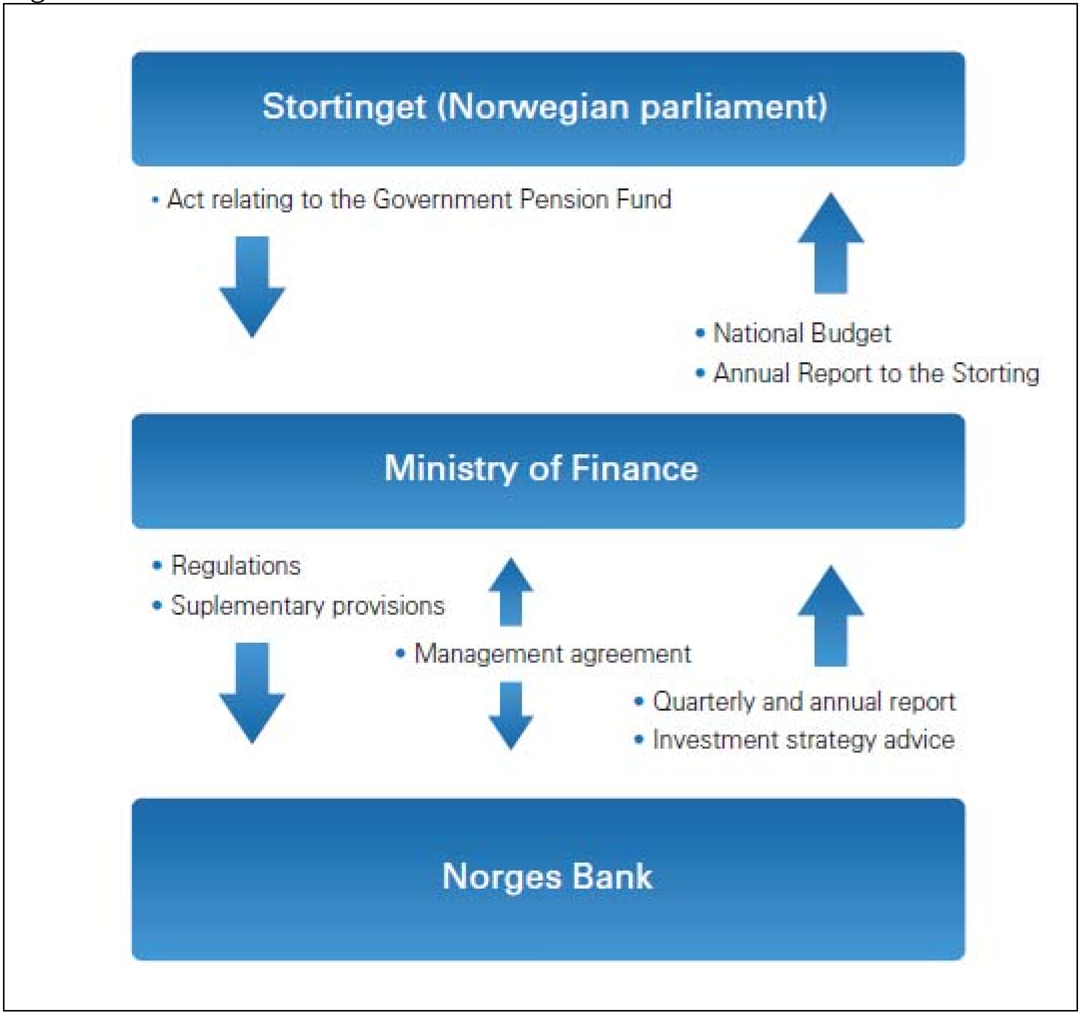
Figure 1. Market value of the Government Pension Fund-Global at December of each year (NOK Billion)



Source: http://www.norges-bank.no/templates/article____42086.aspx

Figure 2:



Source: http://www.norges-bank.no/upload/73979/nbim_annualreport08_rev.pdf

Table 1. Companies excluded from the investment universe by the Ministry of Finance upon recommendation by the Council of Ethics *

Reason	Date	Company
Anti-personnel landmines	26 April 2002**	Singapore Technologies Engineering Ltd, Singapore
Companies supplying arms or military equipment to Burma	28 February 2009	Dongfeng Motor Group Co. Ltd, China
Cluster munitions	31 August 2005	Alliant Techsystems Inc, USA
		General Dynamics Corporation, US
		L-3 Communications Holdings Inc, US
		Lockheed Martin Corporation, US
		Raytheon Company, US
		Thales SA, France
	30 November 2006	Poongsan Corporation, South Korea
	31 December 2007	Hanwha Corporation, South Korea
	31 December 2008	Textron Inc, US
Nuclear weapons	31 December 2005	BAE Systems plc, UK
		Boeing Company, US
		Finmeccanica SpA, Italy
		Honeywell International Inc, US
		Northrop Grumman Corp, US
		Safran SA, France
		United Technologies Corp, US
	10 May 2006	EADS Co, Netherlands***
	31 December 2007	GenCorp Inc, US
		Serco Group plc, UK
Breaches of human rights	31 May 2006	Wal-Mart Stores Inc, US
		Wal-Mart de Mexico SA, Mexico
Environmental damage	31 May 2006	Freeport McMoRan Copper and Gold Inc, US
	31 March 2007	DRDGOLD Ltd, South Africa
	30 June 2008	Rio Tinto plc, UK / Rio Tinto Ltd, Australia
	30 November 2008	Barrick Gold Corporation, Canada
Environmental damage and breaches of human rights	31 October 2007	Vedanta Resources plc, UK
		Sterlite Industries Ltd, India
		Madras Aluminium Company, India

Notes: * The company Kerr-McGee Corporation was excluded on 31 May 2005 because the company was active in Western Sahara. These activities ceased in spring 2006, and the company (subsequently merged with Anadarko Petroleum) was included again from 30 June 2006. ** Exclusion of Singapore Technologies Engineering Ltd was recommended by the Advisory Commission on International Law. On 30 November 2001 the Government appointed a special advisory Commission on International Law for the Petroleum Fund. The Commission should, at the request of the Ministry of Finance provide an evaluation of whether specific investments are in conflict with Norway's commitments under international law. When the Ministry of Finance issued ethical guidelines for the Government Petroleum Fund in autumn 2004, the exclusionary mechanism was extended and the Advisory Commission on International Law was replaced by the new advisory Council on Ethics. *** EADS was originally excluded on 31 August 2005 because the company was involved in the production of cluster munitions. EADS no longer produces cluster munitions. However, EADS is involved in the production of nuclear weapons, and the Ministry of Finance therefore renewed its exclusion on 10 May 2006.

Sources: Norges Bank Investment Management, Government Pension Fund - Global, Annual Report 2008; Council on Ethics for the Government Pension Fund - Global, Annual Report 2008, p. 12; Website Ministry of Finance, Norway:
http://www.regjeringen.no/en/dep/fin/Selected-topics/The-Government-Pension-Fund/Ethical-Guidelines-for-the-Government-Pension-Fund---Global-/History.html?id=434896