ETHICAL DEFICIT

How requiring transparency from borrowers can make the Norwegian Government Pension Fund Global a more responsible lender

SLETT U-LANDSGJELDA | 2012 | LEON DU TOIT

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SLUG is an umbrella organization with more than 40 affiliated organizations. Our work consists of raising awareness, campaigning and political lobbying on debt cancellation and responsible lending. Read more about our work, our demands and our principles at www.slettgjelda.no.

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Abbreviations

CRA – Credit Ratings Agencies.

ESG – Environmental, Social and Governance. This is the foundation for NBIM's Responsible Investor policy and involves an evaluation of various risk factors such as energy and pollution, human rights and company structures.

EURODAD – European Network on Debt and Development.

GPFG – Government Pension Fund Global.

IAS – International Accounting Standards.

IBP – International Budget Partnership.

IFAC – International Federation of Accountants.

IMF – The International Monetary Fund

IPSAS – International Public Sector Accounting Standards.

NBIM – Norges Bank Investment Management.

OBI – Open Budget Index.

OECD – Organization for Economic Co-operation and Development.

PRI – Principles of Responsible Investment (UN).

RI policy – Responsible Investment policy which in the case of NBIM is based on the UN Global Compact, the OECD Guidelines on Corporate Governance and the OECD Guidelines for Multinational Enterprises.

ROSC – Report on Observance of Standards and Codes (IMF).

SRI – Social and Responsible Investment.

UNCTAD – UN Conference on Trade and Development.

UN-PRI – UN Principles for Responsible Investments.

Key terms

Accountability – When the public holds the government responsible.

Debt audit – An audit of debt or loans, depending on if the country carrying out the audit is a debtor or a creditor. Norway's debt audit is a "creditor's debt audit" since it involves auditing debt to Norway.

Democratic deficit – When an institution should have oversight but has none.

Ethical barometer – An index that measures the ethical nature of behavior.

Fiscal policy – government policy about public expenditure and revenue.

Good governance –Catch-all term for government best practices.

Government bonds – Debt instruments issued by governments.

Illegitimate debt – Debt that has not benefitted the population in the debtor country because of conditions the lender knew about or should have known about.

To Issue – To issue a government bond means to sell a government bond. By doing this the government increases the financial resources available for the Treasury to spend today (but the resources will have to be paid back in the future).

Portfolio – A collection of financial assets.

Responsible finance – A term describing ethical behaviour by investors.

Overlapping consensus – Broad political consensus between different parties.

Tax haven – A country with financial secrecy and inconsistent tax policy.

Transparency – When an institution is open about decision making.

Photo: SLUG

When Erik Solheim cancelled illegitimate debt in 2006 this was historic. Since then Norway has promoted reponsible lending internationally

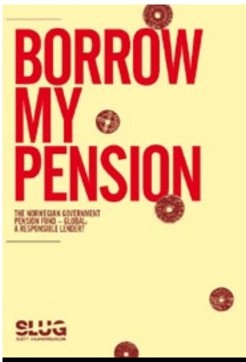
Foreword by SLUG

Norway pioneers debt justice

The Norwegian government deserves praise for spearheading work on promoting responsible lending and creditor co-responsibility. In 2006, the Norway's Minister of International Development Erik Solheim announced that Norway would unilaterally and unconditionally cancel debt because of creditor co-responsibility. The reasoning behind the cancellation was that the claims derived from a failed development project – the Ship Export Campaign of the late 70's. This was the first time a creditor and an OECD-country admitted responsibility for irresponsible or bad lending and took action. The move broke with the silent consensus and practice in the Paris Club that all debt is the responsibility of the borrower and that debt cancellation could only be granted on the basis of debt sustainability. It represented a crucial and significant step pointing towards creditor responsibility and more equality in the creditor/debtor relationship.[1]

Progressive debt policies were formulated in the Government Platform in 2009, which set the goals of working for "mechanisms to abolish international debts and deal with illegitimate debts, a binding international set of regulations for responsible lending and by applying a Norwegian debt revision scheme"[2]. In August 2009 the government turned words into action by announcing that they would finally carry out an audit of developing countries' bilateral debt to Norway. No creditor government has ever done this before.[3]

It is important to note, however, that while the debt covered by the Norwegian audit is around 1.3 billion NOK, Norway also has outstanding loans held by the Norwegian Government Pension Fund Global (GPFG, or the Oil Fund) worth 600 billion NOK, spread across 44 different countries. The debt owed to the Norwegian Oil Fund is in the form of government bonds, which makes up about 17% of the Fund's portfolio. The rest is invested in companies and businesses, based on comprehensive ethical guidelines that ensure the Oil Fund a first place on the Truman Scoreboard for Sovereign Wealth Funds year after year. The Truman Scoreboard ranks Sovereign Wealth Funds' management and governance, considering structure, governance, accountability, transparency and behavioral rules.[4] Less well known is it that investments in government bonds, which is practically lending to another country, are not covered by these guidelines, or any form of rules for responsible investment or responsible lending. The only guideline for these investments is that the Fund cannot purchase bonds from countries that are subject to international



Before SLUG launched the report Borrow My Pension in 2009, the Oil Fund as a lender had not been debated in Norway before.

sanctions that Norway support.[5] To this date, this only applies to Burma.

The financial crisis of 2008 and the ongoing debt crisis in Europe have illustrated that irresponsible lending and borrowing does not only affect poor countries. Up until now, the international market for lending and borrowing has largely been excluded from international regulation. This does not, however, legitimize that the Norwegian Oil Fund's lending is exempt from guidelines for responsible lending. On the contrary, in order for Norway to live up to its goal of being a responsible creditor, the government should take the lead as a responsible lender and ensure that accountability criteria are applied to all investments in government bonds made by the Oil Fund. This would be a logical extension of the government's efforts to promote responsible lending and creditor co-responsibility.

If the Norwegian government intends to keep spearheading responsible lending internationally, it needs to pick up the pace. The Danish government has already stated that it will work for increased accountability in Danish investments in government bonds, meanwhile the Swedish consulting firm Ethix already provides investors with so-called "ethical screening" of government bonds. Thus, it is possible to establish guidelines for such investments. It does, however, require political will.

A new approach

In 2009, SLUG launched the report "Borrow My Pension – The Norwegian Government Pension Fund – Global: A responsible lender?".[6] The report triggered great interest both nationally and internationally, because it was the first to publicly criticize the Oil Fund's role as an investor in government bonds. The report was based on the ethical guidelines for investments in businesses and corporations, and asked why there were no similar guidelines for investment in government debt. The author of the report, Øygunn Brynildsen, argued that applying ethical guidelines to investments in government bonds would not necessarily undermine the government's intention to manage the Fund apolitically. Brynildsen argued that it is imperative for guidelines to be put in place in order to ensure that the Norwegian people do not profit from investments in illegitimate debt.

This report builds on the principles in Brynildsen's report from 2009, but it goes further in identifying how the Fund can ensure that it is lending responsibly. The author of this report, economist Leon du Toit, brings a new approach to the debate. du Toit explores the possibility of conditioning government bond investments on a certain degree of transparency in the bond-issuing country, and suggests various existing guidelines that could be used to assess relevant aspects of transparency. The argument is that the criteria should be based on transparency in government finances as well as the possibilities populations have to influence bond sales through parliamentary participation and civil society input. Conditioning bond investments on transparency and political participation will contribute to preventing the Fund from financing human rights violations. In turn, such guidelines will be less political than setting up a "blacklist" of countries that grossly violate human rights.

Issuing government bonds can be an important source of financing for developing countries, as such loans are not tied to conditionalities that may undermine governments' sovereignty. Therefore, it must be emphasized that SLUG does not want to contribute to blacklisting countries that do not qualify for investments, and we encourage increased investments in developing countries. However, in order to invest responsibly, the people, who ultimately repay the debt, have to have an opportunity to provide input to what the government spends its money on. If this is not the case, we cannot be sure that Norwegian oil money will not contribute to the build-up of illegitimate debts.[7]

Brynildsen's report from 2009 generated an important debate about the lack of guidelines for investments in government bonds, but unfortunately the discussions did not lead to political change. This time around, we are exploring a somewhat different question: Can conditioning investments in government bonds on measures of transparency in bond-issuing countries ensure more responsible investments by the Government Pension Fund Global?

The Norwegian Government in front of the government building in Oslo, 30. March 2012.

1. Introduction

The point of departure of this policy report is that the current ethical oversight system of the Norges Bank Investment Managements (NBIM) Government Pension Fund Global portfolio is problematic. It is problematic because the current regulatory framework does not give guidance on responsible government bond investment. This stands in stark contrast to the ethical regulation of equity and corporate bond investment and the Norwegian government's commitment to responsible lending.

The explanation for this problem is the will to manage the Fund in a non-political way. This means that the Fund's investments and Norwegian foreign policy remain distinct. A brief look into the formal regulatory arrangements that allow the Ministry of Finance to exclude certain countries' bonds from the investment universe, will clarify this. The Government Pension Fund Act[8] states that "The Fund's capital shall not be invested in fixed income instruments issued by governments or government-linked issuers in exceptional cases where the Ministry has barred such investments based on large-scale international initiatives that Norway supports and that are aimed at specific countries."

More recently in a report to the Norwegian Storting in 2010[9] it was said that:

"The current framework for the management of the Fund, […] gives the Ministry the option of barring investments in Burmese government bonds. […] Exclusion of government bonds issued by certain countries should only be decided where comprehensive UN sanctions have been adopted, or where Norway has supported other large-scale international initiatives aimed at a specific country"

This echoes the 2009 findings and recommendations of the government appointed Graver Committee, which adds that "such decisions have to reflect broad political agreement in line with the principle of 'overlapping consensus' as defined by the Graver Committee.[10]

Two key points emerge. Firstly, the current regulatory framework requires a broad political consensus to justify the exclusion of a country's bonds from the portfolio. Secondly, as previously mentioned, there is a strong will to manage the fund in an apolitical way. Both of these points tie in with a desire to keep the management of the Fund separate from Norwegian foreign policy.

This report agrees with the principle of overlapping consensus as a basis for ethical oversight of the Fund, and recognizes the importance of maintaining a consistent management of the Fund. However, the potential political tension that would be created by introducing ethical oversight of government bond investment is an unavoidable cost of doing what should be done. Given that potential tension, the challenge is to generate an overlapping consensus about the regulations that should apply to government bond. The current benchmark of UN sanctions or equivalent is not good enough. It simply does not give Norwegian citizens any mechanism to hold the Fund accountable for the ethical nature of its government bond investments. Adding the fact that there is consensus at the Norwegian Storting to have the NBIM following ethical guidelines for investments, the lack of such guidelines for investments in government bonds represents a democratic deficit.

In fact, many asset managers (the NBIM is itself an asset manager) already implement ethical guidelines for government bond investments. A leading player in this field is Ethix; a Swedish advisory firm that implements Social and Responsible Lending as a service to asset managers. Ethix uses a method called norm-based screening, similar to the method employed by the Ethical Council that currently advises the NBIM on company investments.[11] The difference is that Ethix, and all the clients that subscribe to this service, apply norm-based screening to government bonds too. In this respect they are way ahead of the NBIM in the practice of Social and Responsible Investment (SRI).

The main part of this report will explain the concept of responsible lending in the arena of government bond investment, and develop evidence-based suggestions for ethical investment criteria. Like the Graver Committee, it will make recommendations on how to implement these criteria in practice and suggest mechanisms on how to increase responsible investments. Thereafter, these recommendations are applied to the cases of South Africa and China, to show how the recommendations can generate a transparency score for countries – to show that it can be done.

The content of these recommendations is open for discussion by the Norwegian Storting. It is ultimately their responsibility to take these issues into account and seek overlapping consensus on which guidelines to adopt and how to implement them.

2. The current framework needs to be reformed

This report agrees with the Graver Committee and the Ministry of Finance that "normal foreign policy channels are a far more important instrument for influencing the authorities of other countries in the desired direction" and that "to avoid creating uncertainty about the purpose of the investments in the Fund, such decisions should reflect broad political agreement"[12]. Furthermore, the Ministry of Finance rightly said that the money given to states through government bond purchases is not earmarked for certain expenditures unless of course the bond is tied to a specific investment project[13]. Even the NBIM has recognized the need to act as a responsible investor: there is an explicit NBIM Responsible Investor (RI) policy[14]. This is based on the UN Global Compact, the OECD Guidelines on Corporate Governance and the OECD Guidelines for Multinational Enterprises.

The NBIM's RI policy is based on assessment of Environmental Social Governance (ESG) Risk Factors. These typically entail energy and pollution assessments, human rights practice assessment and analysis of corporate structures. The distinguishing feature to notice, once more, is that these ESG Risk Factors are applied only to companies. So the current RI policy has nothing to say about responsible investments in government bonds. The motivation for ESG risk assessment is a concern with human welfare. This report argues that concern should be addressed in government bond investments too.

There is undeniable evidence that improper debt management negatively affects the welfare of a country's people. Greece is a stark example of this. The current ethical framework should, therefore, be changed so that it gives guidance on which countries apply improper debt management. In short, the ethical framework should be changed so that irresponsible loans are prevented. The core question is how to assess a country's debt management in a systematic way. A fruitful approach is to investigate the extent of transparency in government and state affairs – those dimensions that are relevant to the bond market.

Transparency in a country's debt management matters for both the lender (the buyer of the bond) and for the borrower (the issuer of the bond). It matters to the buyer since the nature and extent of transparency in the issuing country will influence the quality of the investment and the ethical composition of the portfolio (from the perspective of responsible lending). It matters for the issuer because it determines the quality of debt management: A better assessment of the debt helps avoiding the buildup of unsustainable debts. Thus, it will have a significant effect on the country's economic well being.

BOX A: Overview of the GPFG bond portfolio

Government bonds represent 15 – 20% of the total value of the Oil Fund. More than half of the bonds owned by the Fund are government bonds. As of December 2011, the NBIM's annual report lists a total of 44 different countries in the group of government bond investments. As the map below shows, the majority of the bond investments are channeled to developed countries in North America and Europe – the US, UK, France, Japan and Germany alone account for 77% of all government bonds (a total value of 5,500 million NOK). But the map also shows that significant investments are made in emerging markets like Mexico, Brazil, India, China, South Africa and developing countries like Egypt and Turkey. For a full list of countries in the portfolio see the Appendix.

Several developing countries have recently begun to issue government bonds. An example is Zambia, which in 2011 was upgraded by the World Bank from low-to middle-income countries, and issued its first government bond in 2012. According to the credit rating agency Moody's, it is likely that Rwanda, Uganda, Kenya, Tanzania, Mozambique and Angola soon will issue its first bonds[15]. With new issuers in the international market, the issue of accountability becomes more relevant than ever. As previously stated, SLUG considers the issuance of government bonds to be a useful way for developing countries to receive finance. The purpose of compulsory guidelines is not to keep developing countries outside the bond market. The purpose is rather to ensure that the investments made in developing countries (and developed countries) government bonds are responsible.

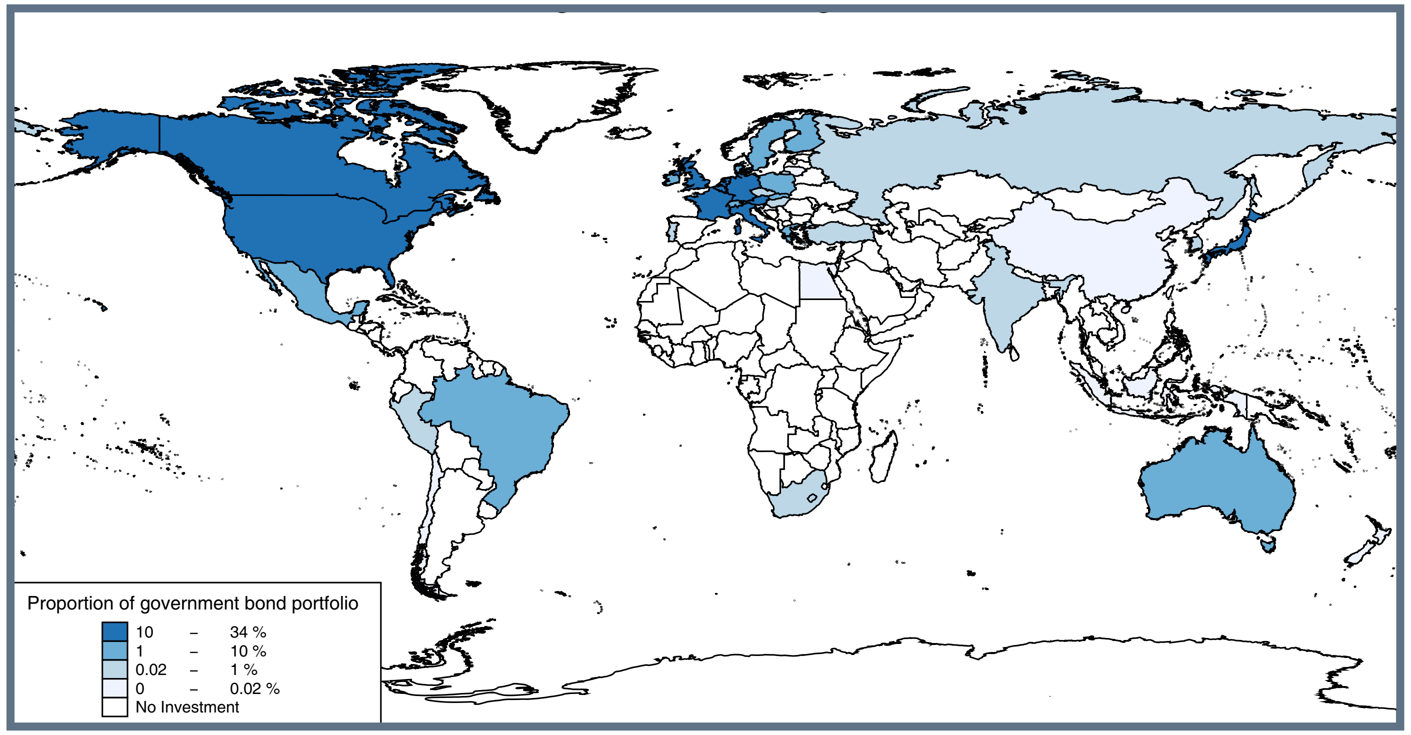


Fig. D1: Value Distribution – Norwegian Oil Fund's government bond investments

Lack of transparency is a welfare concern

The lack of transparency in international market for lending and borrowing is a systemic and global welfare concern, demonstrated by the financial crises that began in late 2008. Reckless lending, poor regulation and lack of transparency have been at the core of the financial crisis of 2008, the ongoing Euro crisis and past debt crises. Instead of reacting to the current crisis by assuming that "this time is different" and that crises will not reoccur, systematic steps towards better regulation of lending and borrowing and increased transparency, need to be taken. As owners of the world's biggest sovereign wealth fund, a better regulated financial market is in our interest.

Furthermore, it is in our interest that the Oil Fund does not invest in debt-ridden countries at the brink of default. Had there been stricter rules to ensure transparency, it would have been more difficult for Greece to get away with hiding most of its public debt. Had Greece not gotten away with this, there would have been less of a lending spree to the country, and in the end, Greek bond investors would not have had to take such a big haircut in the bailout deal for Greece. Finally, it is in the interest of the people of the debtor country that transparency measures are enforced, so that the government is held accountable to the people. This report argues that transparency matters for government bond investment, and should therefore be the foundation of ethical guidelines regulating the GPFG's bond portfolio.

2.1 Illegitimate investments in government bonds

In all legal and social systems, there are certain debts which are not expected to be repaid either because the debt itself is improper, or because of the hardship that would be caused by repaying the debts. "Illegitimate debt" has no existing definition in law, and the term seems almost never to have been used in legislation or court judgments. Dictionary definitions of "illegitimate" include "not authorized by law", "not legal or fair" and "against the law; illegal". In everyday language it is associated with something that is illegal, unjust, immoral and unacceptable. International debt cancellation organizations have used the term to describe situations where lenders knowingly have provided loans to regimes that have not ensured the interests of the population. A report made by the Norwegian Church Aid[17], concludes that "illegitimate debt" is debt which satisfies one of the following conditions:

- Is against the law or not sanctioned by law,
- Is unfair, improper or objectionable, or
- Infringes some public policy

SLUG believes that debt is illegitimate if the borrowed money is used for purposes that do not benefit the population. Another case of illegitimate debt is if the money went to failed projects that caused environmental or social damage, and where the lender should have known that these projects were likely to fail. These criteria describe the debt of many debtors today.

Does the Oil Fund invest in illegitimate debt?

As there are no ethical guidelines that determine which regimes the Oil Fund can invest in, there is always the risk that Norwegian oil money is invested in illegitimate debt. As the issuing of government bonds seldom are earmarked to certain areas of investments, countries are free to spend the money on what they consider important. On one hand, this does indeed strengthen country ownership over their finances. On the other hand, the history has shown several examples where governments issue bonds before investing in costly projects such as war. One example is when the Oil Fund increased its investments in American government bonds in 2003 at the time when the US started their

In 2009 Kristin Halvorsen did not want the Oil Fund to withdraw from Israeli bonds, even though Norway was against Israel's war waged in Gaza.

war against Iraq. This highlight a political challenge as the Norwegian government officially took a stand against the war, while indirectly funding it through the purchase of US bonds[18]. A more recent example is the Oil Fund investments in the government bonds of Tunisia, Egypt and Bahrain right before the Arab Spring. Norwegian authorities have no guarantee that these resources were not used to suppress the population in these countries.

Another example that shows the double standard and gray area of the Oil Funds history is the investment in Israeli state bonds before the war with Gaza in 2009[19]. At this point, the Oil Fund pulled out of Israeli companies. Although there were not international sanctions against Israel in place at that time, the Minister of Finance, Kristin Halvorsen, did not allow the Fund to sell Israel's government bonds that it had invested in. Halvorsen expressed that this would be to let the management of the Fund become too political.

Read more about the illegitimate debt that Egypt, Tunisia and Bahrain owe the Norwegian Oil Fund in the report "The Arab Spring and International Debt: Tunisia, Egypt and Bahrain's debt to Norway" by Ingrid Westgaard Stolpestad[20].

BOX B: Regulatory structure

The governance model of the Fund is based on a delegation of responsibilities to different institutions. The framework for the Fund is laid out by the Norwegian Storting in the Government Pension Fund Act[16]. The Act states that the Ministry of Finance manages the Fund, which is split into two separate investment arms: The Pension Fund Global and the Norwegian Pension Fund. This report is concerned with the Pension Fund Global, which invests outside of Norway. This arm of the Fund is deposited in an account at the Norges Bank. The Ministry of Finance is responsible for the management mandate and ethical guidelines. Norges Bank carries the Executive Board principles and investment mandate and specifies the NBIM chief executive officers (CEO) job description. The CEO, while being advised by committees and complying with risk management and other rules, is responsible for delegating the investment mandate and job descriptions to the employees at NBIM. At the more operational level, the NBIM leader group sets guidelines, work tasks and investment mandates.

Regulation and authority is, therefore, delegated from Parliament to the NBIM through these channels, whereas reporting from actual investment activities follows the reverse channel. The Ministry of Finance's Ethics Council provides evaluations of companies, based on ethical guidelines, to the Ministry, which then decides on exclusion. The NBIM then carries out the tasks set forth by the decision. The guidelines proposed by this report argue that both the regulatory and the reporting parts of the investment process need to be changed.

2.2 The role of credit rating agencies

A credit rating agency (CRA) is a company that assigns credit ratings to issuers of debt instruments and to the debt instruments themselves[21]. Although the CRAs' ratings are widely used by investors, they neither take the bond issuing country's degree of transparency into account, nor any measure of ethics. Instead, the agencies provide investors with ratings that summarize the extent and type of risk accompanying country-specific bonds. These measures represent an assessment of a host of factors that summarize various forms of risk. A typical classification of risk types faced by investors is as follows: interest rate, yield curve, liquidity, exchange rate, inflation, volatility, event, sovereign, call and repayment, reinvestment and credit risk (default, credit spread, and downgrade risk). All of these risks change over time when economic and political conditions in bond issuing countries change. They do, however, not take into account the transparency and accountability of the government issuing the bond.

The three largest credit rating agencies are Standard & Poor's, Moody's, and Fitch. These agencies evaluate a wide variety of organizations[22]. These include companies, national, and local governments, and government and semi-government entities. Each agency applies its own methodology in measuring creditworthiness and uses a specific rating scale to publish its ratings opinions.

Typically, ratings are expressed as letter grades that range, for example, from "AAA" to "D" to communicate the agency's opinion of relative level of risk. In theory, an entity with very strong finances will be given the highest rating, while the least creditworthy will receive the lowest rating, which applies to debt that is already in arrears. But what happens in practice is less certain. Issuers rely on credit ratings as an independent verification of their own credit-worthiness and the resultant value of the instruments they issue. In most cases, a significant bond issuance must have at least one rating from a respected CRA for the issuance to be successful (without such a rating the price will rarely be high enough for the issuer's purposes).

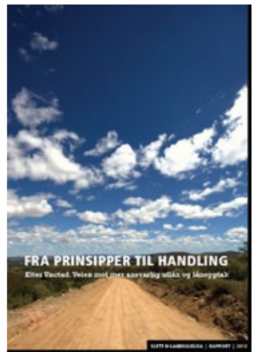
NBIM, as other investors, also uses credit rating agencies when deciding which government bonds to invest in[23]. These investments are based on assessments of risk and expected return, drawing largely on ratings made by the credit rating agency, Barclays. Applying these ratings is intended to avoid undesirable risk in parts of the markets that do not fit with the Oil Fund's size, long-term outlook and objective. No ethical evaluation of the investment is made.

What is the problem with the CRAs?

Apart from the fact that the CRA's do not take any measure of transparency or ethics into account, many flaws in their methodologies have been uncovered in recent years. The UN has raised concerns regarding credit rating agencies' strong influence in the international private financial flows and pledged to "strengthen modalities [...] to enhance and improve the level and objectivity of information regarding a country's economic situation and outlook"[24].

In the wake of the current economic crisis and the downgrading of American and European debt instruments, credit rating agencies have come under increased scrutiny. Worryingly, according to the 2012 report from the US Securities and Exchange Commission (SEC), many of the agencies fail to disclose their rating methodologies or follow policies to timely downgrade securities[25].

Additionally, the SEC report from 2008 identifies "serious shortcomings" in the rating of securities related to subprime mortgages, the products that triggered the financial crisis[26]. The CRA's also came under fire for problems in structured finance products that they have rated, particularly in assigning AAA ratings to structured debt, which in a large number of cases has subsequently been downgraded or defaulted.



Read more about the UNCTAD Principles and how they can be implemented in SLUG's report from September 2012

BOX C: Bond fundamentals – markets and types

Government bonds, often referred to as sovereign bonds, come in different flavors, each having distinct characteristics. This section explains some of the major differences typically found in sovereign bond markets around the world.

The major bond sectors are classified into the following categories: Firstly, there are internal and external bond markets; secondly, within the internal market there are domestic and international bonds. Governments can issue bonds in their own domestic markets or the foreign markets of other countries. In addition, they can also issue bonds in the external/international market. This market is distinct from domestic bond markets. While governments usually issue bonds denominated in their own currencies, sovereign bonds can theoretically be denominated in any currency.

The primary market is where new government bonds are first distributed to buyers. There are four general methods for doing so. Firstly, the regular auction cycle/multiple-price method. In this method winning bidders are allocated securities (bonds) at the yield price they bid. In the second distribution method, the so-called regular auction/single-price method, bidders are awarded bonds at the highest bid-price (this method is currently used by the US). A third method is the ad hoc auction, where governments announce sale when market conditions appear favorable (the Bank of England uses this method). Lastly, there is the tap method, where additional bonds of a previously outstanding bond issue are auctioned (this has been used in the US, UK and the Netherlands).

The secondary bond market allows bondholders to trade their investments with other parties. This makes the bond market more liquid, thereby driving down overall risk. There are different ways to trade bonds: it can be done in either an electronic or in a dealer-to-customer fashion. Once a government has sold a bond on the primary market it can be traded on the secondary market until it reaches maturity, and the government must repay the value of the bond.

A fundamental difference between different bonds is their maturity. When a bond is issued a contract called the indenture specifies all the borrower obligations and duties. In this contract the time to maturity (the time at which the principal amount will be paid back to the creditor) is specified. Numerous other features of bonds are specified in the indenture, but this report focuses on maturity, given its centrality. Governments typically issue bonds with maturities up to 30 years. Common maturities are: 12 months, 5-, 10- and 20-years. Bonds with different maturities are fundamentally different because each one carries a different type and extent of risk. Investors typically choose between buying bonds at different maturities from different issuers, mainly according to the type and extent of risk that holding the bonds exposes them to.

2.3 Responsible financing and ethical guidelines

It is the intention of ethical investment guidelines to establish the investor as a responsible market participant. For the Oil Fund, this has been defined for investment in equities and corporate bonds but not yet for investment in government bonds. Since investment in government bonds is the same as lending to governments, this report develops a metric for quantifying responsible lenders, thus giving substance to the idea of an ethical or responsible lender.

But what does it mean to be a responsible lender? To answer this question we draw insights from firstly the UNCTAD[27] "Consolidated principles on promoting responsible sovereign lending and borrowing" and secondly the European Network on Debt and Development's (Eurodad) "Charter on responsible financing"[28]. The Norwegian government has stated clearly that it is determined to apply the UNCTAD Principles in its current lending practices. Thus, these Principles form a natural starting point for developing ethical guidelines for lending through the Norwegian Oil Fund.

The UNCTAD Principles

The UNCTAD Principles aim to establish a set of best practices for both lenders and borrowers. In the Fund's case we consider best practices of the bond investor and issuer. It is important to note that responsible lending depends on the actions of investors and bond issuers. In the case of investors, they need to make adjustments to their investment policies and management procedures. Bond issuers, however, need to address debt management practices.

The UNCTAD Principles put forward four aspects of responsible borrowing that are relevant to responsible bond-issuer behavior: agency, transparency, disclosure or publication and monitoring or management of debt. The Agency aspect suggests that governments should recognize their accountability to citizens for responsible debt management, because it is citizens who ultimately finance the debt. This implies the need for responsible debt management and the avoidance of corruption. Transparency is required in the debt issuing and management process. Transparency has many facets though – legal, economic, political and institutional – all of which will be explored in the rest of this report. As the UNCTAD Principles note, effective transparency rests on proper disclosure and publication, and that furthermore, relevant stakeholders must also have an understanding of their government's finances in order to hold it accountable. Lastly, the UNCTAD principles assert that there should be suitable debt management and monitoring (for a more detailed discussion see appendix A2).

When investors take part in secondary or primary bond markets, the debt instruments they buy and sell have a material effect on the welfare of the citizens in bond issuing states. This is the main impetus behind establishing ethical guidelines for investment in government bonds: To compel investors to take ethical considerations into account and thus prevent them from making harmful investments. Harmful investments could be investments that likely to harm the citizens, such as money that are used for repression (like in the case of the Oil Fund's investments before the Arab Spring), or investments that impose too high a debt burden on the populace. In order to avoid this, investors must assess the extent to which bond issuers implement responsible debt management practices. This means that the ethical guidelines for investors must be rooted in an assessment of the prevailing conditions in debt issuing countries. Responsible risk assessments need to be implemented through compulsory guidelines. By doing so, investors

Photo: Steen Brogaard

Can Minister of Finance, Sigbjørn Johnsen accept being any worse than Danish Ole Sohn?

will recognize the agency of the state and make responsible risk assessments.

To implement these broad principles requires turning them into specifying measures that can be applied in practice. The rest of the report will develop and suggest measurable criteria that can form part of the investment decision-making process.

Social and Responsible Investment in practice

The introductory part of this report explained the NBIMs current approach to responsible investment – based on the ESG Risk Factors. There is, however, a similar approach in the investment world, though with important differences. Many investors already apply a principle-based exclusion of government bonds. The Danish Minister of Commerce and Growth, Ole Sohn, recently announced government support for a drive towards responsible government bond investments. The following section will provide a brief introduction to this practice.

Responsible investment practice, as embodied in the NBIM's commitment to ethical investments in companies, is already an established practice in the world of government bond investments too. Ethix SRI Advisors is an example of a company that practices screening of government bonds, based on a norm-based approach. Norm-based screening aims to be more "all-encompassing" than the common ESG approach. Instead of comparing companies in the same sector (best-in-class), a norm-based approach establishes minimum ESG norms. Ethix applies norm-based screening to countries as well as companies. Ethix practices this in partnership with the United Nations Principles for Responsible Investments, and several organizations with a substantial interest in socially responsible investment such as Eurosif, Finsif, Swesif and Dansif. They serve public and private institutional investors with estimated assets totaling 2,200 billion NOK.

Bank Invest, a Danish asset manager with operation in the Nordic countries, provides a pertinent example of their services. On the recommendation of norm-based screening they excluded Russia and Venezuela from their fixed income portfolio. This exclusion was, therefore, the result of an application of investment protocols.

In the case of Ethix, their norm-based screening of sovereign bonds (government bonds) involves a weighted assessment using the following criteria: human rights, international humanitarian law, labor rights, environmental impact and anti-corruption. This is a much richer and more comprehensive set of criteria than explored in this report. It is an important example showing that investment practitioners and other investment professionals are already undertaking serious measures to be responsible in their sovereign bond investments. Norwegian policymakers cannot ignore these developments in ethical investment practice without losing their star as a responsible investor.

The Danish drive to responsible investment in government bonds is instructive. The Minister of Commerce and Growth has agreed with commentators in that government bond investments should meet the general standards for responsible investments, such as the UN's principles for responsible investment. There are several initiatives that have been proposed to reach the goal of responsible investments. First, Danish institutional investors (investors with institutions for clients) will work with the UN PRI's special working group for government bonds which will present its findings before the end of 2012. Second, institutional investors will disclose their policies and practices and their approach to responsible investment. Third, the Minister will ask the Council for Corporate Responsibility to be responsible for further development of ethical investment criteria. This last process will be open and involve relevant third parties.

The Danish example shows clear and directed initiative towards instituting responsible investment in government bonds for all Danish institutional investors. This report suggests similar institutional changes and commitments for the NBIM and suggests specific ethical investment criteria that will allow it to improve its investment practices and keep up with its neighbors.

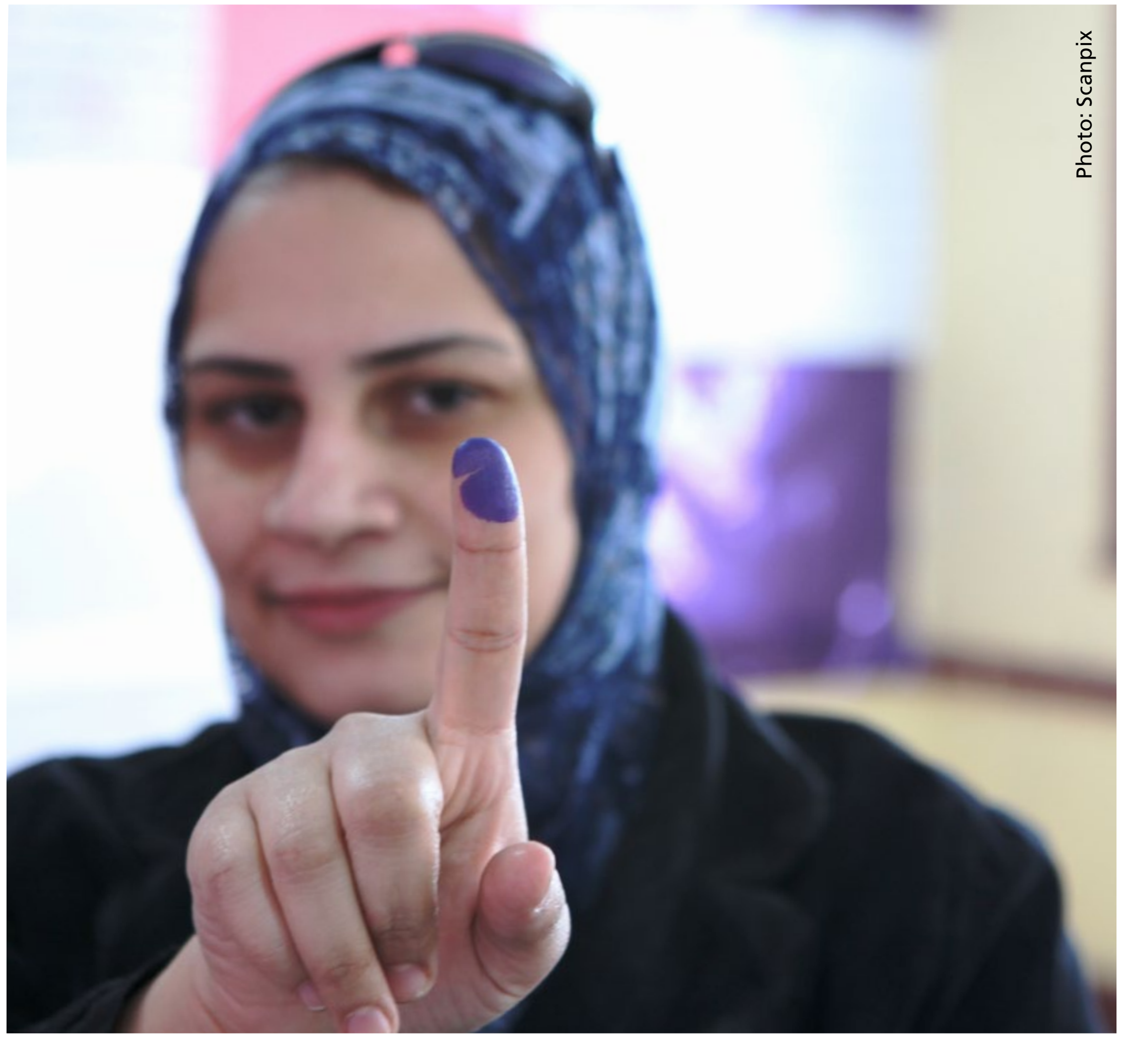


Photo: Scanpix

A woman after voting in Egypt

3. Developing transparency criteria

This section presents arguments supporting the development of transparency criteria for ethical investment in government bonds. The arguments are developed into operational recommendations. An example will clarify what to expect: Check whether the national budget is accompanied by a long-term economic forecast, because it supports consistent long-term economic planning.

It is important to make the distinction between transparency and disclosure at the outset. The point is that transparency needs to be effectively combined with a communication strategy so that market participants and citizens can use information. Only then can market discipline be enforced. Throughout this section the availability and the quality of information will, therefore, be considered.

In this report an institution is considered transparent if parties that are affected by its operation can freely obtain knowledge of the decision making process in the institution. For example, a central bank is transparent if it announces the reasons for interest rate decisions to the market and explains its operational methodology. Similarly, the government debt process is more transparent if the amount of debt and its management is publicly known. Given this information-based understanding of transparency, this report will develop criteria to measure its extent in bond issuing countries.

Measuring the extent of transparency matters for the Fund because, apart from affecting the quality of the investment, it is necessary to fulfill any commitments to responsible investment. Let's explore the relevant dimensions of transparency.

3.1 Economic transparency

The economic dimension of transparency, as interpreted in this report, is the main dimension from which ethical guidelines derive. Even within the economic dimension there are many facets of transparency. We will focus on fiscal and budgetary aspects of economic systems.

Transparency in fiscal matters is central to being a responsible borrower. Also, for bond investors, credit ratings and other bond market participants, fiscal measures are key inputs to the investment process. It is standard practice for investors to estimate the expected return and risk of the bond investment. A good investment, therefore, necessitates reliable budget estimates from bond issuers.

Governments report on the fiscal position of the country in national accounts. The national accounts record a number of fiscal indicators which are meant to reflect, for instance, the size of the current debt burden and the health of the budget. The budget may either be in a deficit, in which case expenditure outweighs revenue, or in a surplus. The reliability of these fiscal indicators is, however, under threat from non-transparent accounting practices and standards: fiscal indicators can be artificially manipulated so that budget deficit and debt measures seem better than they really are. Governments have many incentives to cook their books: to reach targets after or during times of crisis; to get better credit ratings for their debt; or to achieve political goals in elections, to name but a few. The consequence for the investor is that unreliable fiscal measures in the issuing country will lead to unreliable risk calculations. In other words: a non-transparent investment is a bad investment.

Technically, the type of accounting trick that is used is related to the accounting standard that is implemented to calculate the measure. All cases involve a trade-off between current and future revenue/expenditure. There are five cases in the taxonomy and this report will treat them one-by-one along with real world examples. Information Box D summarizes the different types of accounting tricks while the text explains each one in turn.

Responsible investment strategy

Before spelling out fiscal transparency recommendations, it is worth noting that promoting transparency with a responsible investment strategy will contribute to systemic financial stability. Given the crucial role that non-transparent accounting practices and unreliable risk assessments played in the global financial crises that started in late 2008, this will strengthen the global financial system. The next section will develop a set of indicators to measure transparency in government budget reporting.

To accomplish that, one needs to ask how distortion from such accounting devices can be detected. One possibility is to look at alternative statistics for the same fiscal measures. Another is to track the size of official revisions of statistical data. In general, there is a stronger incentive to cheat on measures that form part of official targets, so it is wise to pay special attention to those measures.

Improving fiscal transparency

It is more difficult to hide these accounting tricks when the budget is part of a long-term forecast. This is because the future revenue and expenditure changes cannot be hidden from view. Publishing long-term forecasts would, therefore, greatly improve fiscal transparency. Of course this can only become useful to the public and other third parties if the results are intelligible. The quality of communication, therefore, is also important in this context. Lastly, the presence of so-called watchdogs (like a free press and/or independent fiscal committees) is likely to improve the quality of budget information since it will act as an accountability mechanism between officials and the public.

There are a number of existing guidelines set by prominent international organizations that specify how to improve fiscal transparency. Much information can be drawn, for instance, from the IMF. Three

BOX D: Fiscal accounting tricks

Hidden borrowing

One accounting device is to increase revenue now at the expense of increasing spending in the future; this is called hidden borrowing. An example is a government taking over the pension schemes of private or public entities. Since future pension payments are not recorded as current liabilities, the trade will generate revenue without a detectable cost. This was done in Portugal in 2010/2011 and also by Austria, Belgium, Denmark, France and Sweden[29]. A currency swap, as used by Greece from 2001 until 2007, has the same effect.

Disinvestment

A second strategy is to increase revenue now and decrease revenue later, this is known as “disinvestment”. Disinvestment involves using the proceeds raised from privatization, for instance, to create current revenue, while simultaneously decreasing future revenue. Similar outcomes are attainable through the securitization and sale of future government revenues. Greece, for instance, did this with the lottery, air-traffic control fees and EU grants. Although there is nothing wrong with such measures per se, they can hide the true health of the fiscal position. Health here refers to the size of the deficit and overall debt levels.

Deferred spending

Thirdly, a government can use accounting tricks to seemingly reduce spending now, only to increase it later; this is known as deferred spending. A prime example here is to defer military and Medicare payments by one day so that the expenditure will reflect in a different budget period. While this is not an extreme distortion, the real saving from shifting the payment into the future is not equivalent to the deficit reduction, making it a non-transparent accounting practice.

Public-private partnership

Fourthly, an accounting practice called foregone investment can induce an artificial decrease in current spending and decreased revenue in the future. This can be accomplished by entering into a public-private partnership (PPP) to build public infrastructure. This way, the debt is registered in the private company’s budget, and does not appear as public debt. This makes the country’s debt burden appear smaller than it really is.

Disappearing government

Fifth, and last on this list of accounting devices, there is the case of “disappearing government” where spending is spun off government books into peripheral non-state organizations. The general trend of passing government spending to non-government entities can be seen as “disappearing government”. In Eurostat’s audit of Greece in 2010[30] they found that accounting for bus, railway and other government-funded companies increased the debt burden by 7.8% of GDP.

Distortion and deficit measures

An empirical investigation undertaken by the International Monetary Fund (IMF), suggests that fiscal accounting devices can significantly alter a country’s fiscal picture[31]. The size of distortion in deficit measures caused by accounting devices in Europe, for the period 1994 to 2000, are estimated to be 2.5% of GDP at maximum. Distortions of this size, hidden behind non-transparent accounting practices, are a real concern for investors and country constituents alike. In developing and emerging nations with even looser accounting standards, and less third-party oversight, the extent of the problem may well be larger. A hidden fiscal picture makes the country’s economy appear healthier than it really is, which may allow for more investments and loans than the economy can carry.

In the current international market, the largest amount of yet unrecognized liabilities are those created by the global financial crisis that started in 2008, and the current European debt crisis. Governments have acquired massive debt by nationalizing banks and other deposit-taking institutions, but these are not reflected on current estimates of budget deficits and debt.

This is a prime example showing how fiscal transparency matters, both economically and ethically: The extent of transparency in national accounting and statistics has a significant impact on an investor’s assessment of a bond-issuer’s ability and willingness to pay. Therefore a more transparent fiscal regime allows better quality risk assessments. This is why fiscal transparency matters to the investor. But investing in countries with transparent fiscal regimes is not only profitable, it is also a part of being a responsible lender: the transparency of a country’s fiscal position matters for the welfare of its citizens.

documents are notable: the IMF code of good practices on Fiscal Transparency[32], the IMF Public sector debt statistics: Guide for Compilers and Users, and sets of questions that authorities can ask about their fiscal institutions and management of natural resource revenue. The IMF itself conducts and compiles Reports on Observance of Standards and Codes (ROSC). Undertaking a ROSC is a collaborative process that involves country authorities, the relevant IMF area department, and the IMF Fiscal Affairs Department (FAD).

Upon completing the ROSC, a country investigates its own transparency set up, following aspects of fiscal transparency in cooperation with the IMF: government structure and relationships (central bank, financial corporations, and public non-financial corporations), the budget (preparation and approval, executing and reporting), accounting and oversight mechanisms and lastly tax law, policy and administration. The process includes an external audit and involves completing questions about the transparency of each of these dimensions. The process is designed to gather basic information about fiscal institutions and management. This then forms the basis of the 'code of good practices' document. The information contained in the ROSC reports is, therefore, a valuable source for assessing fiscal transparency in a country.

Best practices

Other sources of information about fiscal transparency (budgetary and accounting practices) can be drawn from the OECD, the International Budget Partnership, the International Federation of Accountants (IFAC – lays down IPSAS), and from credit ratings agencies.

The OECD's best practices for budgetary transparency[33] recognize that the budgetary transparency – openness about policy intentions, formulation and implementation – is a key element of good governance. Its recommendations are classified into three areas: budget reports and their general content, specific disclosures, and practices to ensure quality and integrity. The recommendations on specific disclosures are aimed at improving the transparency of fiscal accounting. They provide, therefore, a useful and well-tested list of checks when investigating a country's budget reports.

The International Federation of Accountants (IFAC) has laid down their own set of accounting principles for the public sector (IPSAS). These principles are an adaptation of the International Accounting Standards (IAS) for companies for the public sector. Although, like many accounting standards, they do not have legally binding force, they serve as a useful source of information about the necessary quality that public accounting should fulfill. Since the IMF and the World Bank backed the promotion and elaboration of these standards, they are widely recognized as internationally accepted benchmarks. An assessment of a country's fiscal accounting, can therefore benefit from a comparison between actual accounting practices and those recommended by IPSAS.

Lastly, another invaluable resource for comparative analysis of budgetary transparency is contained in the International Budget Partnership's Open Budget Survey[34]. The IBP is a collaborative effort between 94 research organizations and civil society bodies. Their survey is the only independent and comparative measure of government budget practices. The survey is based on the Open Budget Index (OBI); an assessment of the availability and comprehensiveness of eight key budget documents. The index also evaluates the extent of effective oversight provided by legislatures and supreme audit institutions as well as the opportunities for public participation in the budgetary process. Countries are then scored and ranked according to how open their budgets are.

Operational recommendations to measure of economic transparency:

The following list of criteria makes up factors that will go into a score. A responsible borrower, even a determined ethical one, will have difficulty fulfilling this list in its entirety. Thus, a country does not need 100% fulfillment to be considered a responsible borrower. Pay attention to fiscal targets and track statistical revisions

- Check whether alternative deficit and debt measures exist and check their consistency
- Check for a richer set of statistical accounts on key measures
- Check the availability, length and quality of long-term budget forecasts
- Check whether the bond-issuing countries attempt to make supplementary information intelligible. Evaluate the quality of communication.
- Check whether there are independent oversight bodies like fiscal committees or institutions like Congressional Budget Office (US) and Office for Budget Responsibility (UK)
- Use IMF ROSC reports to gather evidence about fiscal transparency
- In accordance with the OECD best practices check for the following elements in a country's budget reports:
    - Statement of economic assumptions and disclosure of tax expenditures (this is the cost to tax revenue due to preferential treatment for specific activities)
    - Financial assets and liabilities and non-financial assets
    - Employee pension obligations
    - Contingent liabilities
- Check if a summary of accounting policies and methods accompanies all records
- Check whether records are audited
- Check whether the Ministry of Finance actively promotes an understanding of the budget
- Check whether accounts comply with the IPSAS
- Use the OBI score and survey information to assess budgetary transparency


Photo: s_falkow/Flickr

3.2 Legal transparency

Legal institutions that have clearly defined procedures, responsibilities and accountability are a core component of practical transparency. In particular, there should be proper approval and oversight of official borrowing and similar forms of finance. If, for example, there are constitutional limits to the extent of borrowing a government may incur, then the constitutional court should have the independence to enforce such limits. A country that commits to the principles of transparency without embodying them in law is obviously less credible. The stronger the legal support for responsible borrowing practices, the better the case will be for responsible debt management. A responsible lender has to consider the existence and quality of the legal framework in the borrowing country.

Operational recommendations to measures of legal transparency:

- Check whether there is any legal specification of the responsibilities of different state actors regarding the debt management process
- Check whether the roles are consistent with the UNCTAD and EURODAD debt management principles

3.3 Political transparency

Political transparency is made up of a countless number of elements. The scope of this report, however, is limited to three dimensions of political transparency: parliamentary participation in public debt matters; the information flows between different branches of government; and the public and good governance practices by government.

It is usually the job of the National Treasury to issue government bonds. In this sense the government is not directly involved in issuing public debt. It is, however, the government's responsibility to be actively involved in debt matters, since they are the representative interface between the taxpayers and the state. To score highly on political transparency facet of responsible borrowing, a country must be a regular communication between state departments and government officials. This includes regular reporting on the amount and type of debt issued by the government. For a borrower to act responsibly to its taxpayers there must be a legal basis whereby parliament can oversee debt related activities. For example, parliament has to be notified about the decision to issue more bonds before the fact, and check whether this is consistent with prevailing fiscal targets or other regulations.

The second important political dimension of transparency concerns the flow of information between government and the public. There are two main aspects to consider here: firstly, the communication from government to the public, and secondly, the feedback from the public to the government. This communication should involve debt matters directly and also include other important fiscal policy dimensions.

Regarding the first aspect, it is not enough to merely require transparency as the availability of information. Government needs to have an active communication strategy whereby the public is informed about debt. For example, when new bonds are issued to finance public expenditure this has to be announced to the public in the right forum. Transparency has to be coupled with disclosure. Public records need to be available in all the official languages, for example.

The second requirement of this communication interface is that there has to be an effective mechanism for public feedback to parliament. The effectiveness of this interface depends, of course, on party-politics and civil society. While it is not possible to prescribe the precise format of the communication process, it is important that the conditions for communication are present. This means freedom of political association (with whatever party the citizen wants) and freedom for civil society organizations to lobby for their causes. Only if these conditions are present can the public give meaningful feedback about the debt issuance and management process.

The final aspect when assessing transparency is the extent of corruption in a country. This is a crucial part of responsible borrowing since it has a direct bearing on the responsible application of fiscal policy and public money.

The study of corruption is itself a deeply challenging field that demands expert attention. As it is an issue that is hard to define and how to measure, there is a vast amount of information to draw on when assessing a country's corruption. The independent global movement against corruption, Transparency International, is a world leader in providing corruption related information. They classify this information by country and per topic. Per country information includes: the corruption perceptions index, the OECD bribery convention, an assessment of judicial independence and rule of law, the bribe payers index, an assessment of voice and accountability, the global corruption monitor and information about the control of corruption.

Additionally, Transparency International provides public opinion surveys about corruption with institutional breakdowns which are readily available per country. Important dimensions of corruption are covered in depth by topic too. The following topics being especially relevant to developing ethical guidelines based on transparency: politics and government, intergovernmental bodies, access to information and whistle blowing. Even more information at the country level can be obtained from reports sponsored and produced by the World Bank Public Sector Governance and Anti-corruption initiative.

Another important source of information about transparency relates to government censorship. Google publishes a Transparency Report[35] where they detail requests from government to remove content from their services. The reasons for these requests often provide clear evidence of censorship and, therefore, limits to freedom of speech and expression; both of which are necessary conditions for holding government accountable to manage public debt responsibly.

Each of these dimensions has an important bearing on the way that governments act responsibly relative to citizens. When public funds, including those raised from issuing bonds, are used in a non-transparent way, a country will not obtain a high score as a responsible borrower. The consequence is that financing such a government through bonds would not constitute responsible investment.

For the investor, political transparency matters in a more traditional way too: Political risk adds to the overall risk of the investment. And the stability of political policy at the macro-economic level is much less secure when a country is corrupt and when there is limited freedom of speech to fight against such corruption. If this is the case, the country has a higher risk of pursuing damaging fiscal policy, for example. This, in turn, could hurt the credit rating of the country and lead to a higher debt burden. It is therefore a natural aspect of a country to investigate when making a government bond investment.

The recommendations based on these considerations are as follows:

- Operational recommendations to measures of political transparency
- Check whether there is suitable political representation of taxpayers
- Assess extent of representation and accountability of officials to the public
- Assess the difficulty of access to correct and appropriate information
- Check whether records are available in all official languages
- Assess the online presence of government and public debt records
- Check what kind of corruption problems the government faces
- Investigate Transparency International's information sources; per country and by topic
- Specific focus: debt issuance and management: Check whether there is regular reporting to parliament about debt, whether this information is publicly available and whether this information is in the appropriate format.

Photo: Jonathan Rashad

3.4 Financial transparency

This section considers three aspects of the financial system: Transparency of tax policy, transparency in the bank sector and transparency in the broader non-bank financial sector. These aspects are important for responsible borrowing, and hence responsible investment. The recent and on-going global financial and European debt crisis has shown that the cost of general financial mismanagement is ultimately carried by society at large; whether it is in the form of direct government bailouts, or a general economic recession that results from such mismanagement. When a government issues bonds and increases the amount of public debt in the economy, the quality of tax policy and the well being of the domestic financial sector become even more important since they are the institutional requirements for repaying bond debt.

Leveraged economies, with much debt, are more vulnerable to negative shocks and, therefore, need a healthy financial system to support the debt. If the financial system is not able to support debt repayment, citizens will bear an extra cost over and above debt repayment. If the tax system, bank sector and non-bank financial sector are not transparent, citizens are much more vulnerable to such potentially negative consequences.

The Norwegian government has long been aware of the potentially negative developmental consequences of investing in tax havens, locations with high degrees of financial secrecy. The Commission on Capital Flight, a report prepared for the Norwegian government, explicitly recommended reducing investment of public funds in tax havens[36]. This is a tension that the Fund cannot shy away from forever: a review of leading tax-haven classification and ranking indexes[37] shows that about 15 to 23 of the 45 governments that are present in the Oil Fund's portfolio are identified as having tax haven-like qualities. The Capital Flight report's overall recommendation was that continued investment in such tax havens is not a favorable developmental policy.

Regarding the financial stability of the bank sector a country assessment can rely on the requirement set out in Basel III - international regulatory framework for banks. Such banking stability is a necessary condition for responsible borrowing because if the bank sector does not comply with international standards there is a higher chance that it will crash. In that event it will be impossible to repay bond debt and the economic well being of the country will be even worse.

Operational recommendations to measures of financial transparency:

- Consider financial secrecy and taxation practices as inputs into ethical assessments (e.g. use the Financial Secrecy Index)
- Check if the country is on a prominent tax haven ranking
- Conduct a country by country assessment of the level of financial secrecy and case-based assessment of taxation practices
- Check the implementation of Basel III in the country's bank system

3.5 Institutional transparency

The section on fiscal transparency highlighted the role of independent fiscal bodies such as the Congressional Budget Office (in the US) in providing oversight of state activities. Such bodies give credibility to official results and act as an accountability mechanism in addition to the normal channels of representative democracy. In the same way that these specialized bodies create more transparency, having a free press that can investigate government activities enhances the extent of transparency in general. Reporters Without Borders, an international organization based in France, is dedicated to defending free press all over the world. They publish the Press Freedom Index, Internet Enemies and hold relevant records about limitations of press freedom in country files. Each of these sources provides a way to rank countries in terms of their press freedom.

The existence of civil society groups that hold governments accountable for debt management is clearly a useful indicator of transparency. This will improve the feedback between the public and the government. While it is not the job of bond issuers to create such organizations it is important that such organizations are allowed to operate and, once they operate, not hindered from doing their work independently. Freedom of association is, therefore, an important condition for transparency.

Operational recommendations to measures of institutional transparency:

- Consider press freedom as an indicator of transparency in government
- Employ Reporters Without Borders' Press Freedom Index
- Consider the harshness with which whistle-blowers are dealt with – this is a specific measure of press freedom
- Consider other forms of censorship (the Google Transparency Report for example)

3.6 Summary

This section presents how, why and what specific dimensions of transparency in bond issuing countries should be assessed. Each aspect has been grouped under a different part of society. The economic dimension is mainly concerned with fiscal and budgetary transparency and it is argued that a responsible borrower has to carry out responsible fiscal policy and have a transparent budget process. The legal section stresses the need for legal clarity about the roles of different state bodies in the budgetary and debt management process.

The political dimension of transparency relates to the importance of the interactions between the government and the public. The stress here is on reporting, oversight, budgetary approval, communication and feedback. For transparency to be effective there has to be active disclosure. The Financial transparency section emphasizes the need to assess tax policy, and to consider the transparency and stability of the bank and financial sector. A stable and transparent financial sector is necessary to repay bond debt, and to keep financial risk in check.

In each of these subsections concrete suggestions are made about what to do to develop and measure these aspects of transparency. The goal is to establish operational ethical guidelines that help distinguish responsible from irresponsible borrowers. Investing in responsible borrowers would constitute responsible investment. In addition, it would remove a troubling democratic deficit from Norwegian society and establishing policy consistency. Furthermore, this report argues that the adoption and application of ethical guidelines for government investments are consistent with proper risk management. In fact, the implementation of guidelines would reinforce existing risk management measures. In sum, there is no inconsistency between the long-term objectives of increasing the wealth of the Fund and making ethical investments. The next section gives examples of how these suggestions can be operationalized through a concise case study, before the report concludes with suggestions for institutional reform.

Hu Jintau shakes Jacob Zumas hand.

4. China and South Africa – a screening exercise

This section applies the recommendations developed in section 1 by conducting a short screening exercise on China and South Africa (note that Hong Kong is not included in this analysis). The recommendations of each section have been summarized into a set of operational questions (for a full list see the case study notes in the appendix). Each of the transparency criteria has their own questions and is presented in tables along the way.

A note on the method is appropriate at this stage. There are two types of questions in the list: firstly, those that are answered with "bad, OK, or good" and secondly, those that are answered with a "yes, to some extent, or no". To quantify qualitative assessments and to rank countries in a consistent order based on the criteria, answers have been scored in the following way:

Bad, No = 0

OK, To some extent = 1

Good, Yes = 2

When all the questions have been scored, the totals are calculated, divided by the potential maximum and multiplied by 100. This converts an actual score into percentage terms. Of course, the quantification scheme used here rests on several assumptions. Most importantly it assumes that each of the questions is equally important in their assessment of transparency. It also assumes a linear increase in transparency from a "bad" to "OK" to "good", each time one additional point is added, for example. Transparency in these areas makes for a better assessment of a country's debt management, and hence a better decision-making base for responsible investment in government bonds. Even though these are huge simplifications it provides a useful starting point for further refinement. The main goal, after all, is to apply the recommendations and show how they can generate a transparency score for countries – to show that it can be done. Basically, to show how transparency criteria, and principles can be operationalized into a usable quantifiable measure that can give a country a score.

The analysis begins with the economic dimension and lists the relevant questions and country scores in table 3.1 below.

4.1 Economic Transparency

The economic transparency criteria focus mostly on the national budget. The first few questions establish whether the fiscal accounting is transparent and reliable while the remaining questions focus explicitly on the openness of the budget as a whole. The analysis in this section draws heavily on the work done by the International Budget Partnership (IBP) – an independent group of organizations working for budget openness[38].

The Chinese Ministry of Finance provides the official source of historical information about central government debt and the deficit – the National Bureau of Statistics of China gathers statistics. The same is true for South Africa. To begin with, of the 10 budget documents that IBP uses to compile a country analyses, only 4 were available for China. For South Africa all 10 were present.

According to the IBP it is "virtually impossible" for the Chinese public to hold the authorities accountable for how public money is being administered during the budget year. This is due to the limited extent of information available. There are a number of reasons for this. The accounting process is not seen as transparent by the IBP since no independent or legislative oversight is given. The executive budget and supporting documents do not specify data on national debt or interest payments on debt. For these reasons, China scores "To some extent" on the availability of debt and deficit statistics and "No" on transparency in accounting. South Africa on the other hand, has an excellent track record on the provision of national accounting data about debt and the deficit. Data about government debt and interest payment on debt are available in the budget. In addition to that multi-year estimates of expenditure and revenue are given.

China scores quite poorly on the forecasts side of economic transparency too: although it provides a forecast, it is generally uninformative[28]. It does not give multi-year estimates of expenditure/revenue items, lacks detail in additional information, does not include scenario analysis, and lastly, does not explicitly analyze how policies may affect future expenditure/revenues. Although this information may exist for internal policy-making purposes it is not available to the public. Once again, South Africa scores "Yes" on both accounts: a detailed forecast and analysis is provided with the budget, making for useful assessments.

We have already mentioned that China does not have independent oversight of its fiscal accounting and fiscal policy. That is why it scores "No" on this question. In South Africa, however, the Financial and Fiscal Commission (FFC) – a constitutionally defined, independent and impartial advisory body – is responsible for fiscal policy and budget oversight. The body has a well-defined work cycle and reporting mechanisms to the public via parliament. Their work is freely available to the public in the form of research, technical and annual reports. South Africa, therefore, scores "Yes".

The IBP compiles a composite measure of a country's budget openness by looking at the availability and quality of eight key budget documents. It also assesses the extent and quality of oversight provided by Supreme Audit Institutions. On this ranking China scores 13% and South Africa scores 92% – hence China scores "Bad" and South Africa "Good" (Anything below 33% was considered "Bad", while anything above 67% was judged as "Good", with the space in between 33% and 67% being reserved for "OK"). Furthermore, while there is no public participation in the budget in China, there is also room for improvement in that area in South Africa.

Table 3.1: Economic Transparency

Questions	China	SA
Are statistical accounts for debt and deficit available?	To some extent	Yes
Is the national accounting transparent?	No	Yes
Is the budget accompanied by a long-term economic forecast?	Yes	Yes
How good is the quality of the forecast?	Bad	Good
Do independent fiscal committees oversee fiscal results?	No	Yes
How does the country rank on the OBI score?	Bad	Good
Is there opportunity for public participation in the budget?	No	To some extent
Do ministries communicate about the budget to parliament and public?	No	Yes

A more comprehensive review of their debt management and resolution mechanisms would be a fruitful extension of the current analysis, but is outside the scope of this report.

4.2 Legal Transparency

Section 2 of the report argues that clear legal definitions of the roles and responsibilities of various state actors are important to ensure responsible borrowing. Both China and South Africa have formal legal procedures in place, so both score "Yes" here. However, are these definitions consistent with the proposed UNCTAD principles?

An important legal aspect discussed in the UNCTAD principles relates to dispute settlements. For example, if reckless macroeconomic policies followed by the borrower (the bond issuer) lead to an inability to pay interest on debt, then the legal mechanisms for resolving this conflict have to be in place. Neither China nor South Africa would be active participants in the international bond market if such mechanisms did not exist in part. Because they only exist in part, both, therefore, score "To some extent".

Table 3.2: Legal Transparency

Questions	China	SA
Are roles of state and government in debt formally defined?	Yes	Yes
Are these definitions consistent with the UNCTAD principles?	To some extent	To some extent

4.3. Political Transparency

While China is an authoritarian regime, South Africa is a consolidated constitutional democracy. This means that taxpayers have formal mechanisms to keep government accountable for public debt management in South Africa, but not in China. Even if Chinese citizens wanted more transparency in debt matters the government would be under no obligation to grant their collective wishes. For these reasons South Africa is considered more politically transparent, which equates to a higher score than China.

Since there is no parliament in China it is impossible for the debt issuing authority to report to it. This is not a redundant fact since such reporting gives the public access to oversight through representation. In South Africa, however, such reporting does exist. The economic transparency section investigates the availability of information and notes that debt information is more freely available in South Africa than in China. This must, however, be seen through a political lens too since it is the government's to make such information available. Where the information is available it is still very difficult to understand, even in the South African case. Only someone with a very high level of financial and economic literacy would be able to understand the meaning of the debt figures. Not enough is being done to make the information understandable to the common citizen. Both countries, therefore, score "To some extent" here.

China does better than South Africa in providing what little information it actually does in the official language; Mandarin. South Africa, however, does not come even close to providing budgetary information in all of its 11 official languages. This may impede proper understanding of the meaning of debt. However, it must be noted that multiple official languages should not be weighed as heavily as it appears in this evaluation. This is rather to illustrate the importance of communication between the government and the public. While both countries have an online presence it can be improved greatly in both cases.

For an assessment of corruption this report relies on the work of Transparency International; an impartial global organization providing corruption research[39]. The Corruption Perceptions Index (CPI) is a composite index that reflects the perception of corruption in a country. It takes inputs from many independent businesses and organizations. China scores 3.6 and South Africa 4.4 (0 is "highly corrupt" and 10 is "very clean"). Both, therefore, do poorly on this metric. It must, however, be noted that this index is only used as an example on how to collect date on corruption. Because corruption is deliberately hidden, it is impossible to measure it directly, thus various analyses and indexes are extensively scrutinized. The CPI is no exception, and the data should therefore be treated with caution.

Table 3.3: Political Transparency

Questions	China	SA
Is the regime a formal democracy?	No	Yes
Is the democracy consolidated?	No	Yes
Does the government bond issuing authority report to parliament about debt?	No	Yes
Is information about debt publically available?	To some extent	Yes
If available, is it easy to understand?	To some extent	To some extent
Is it available in all official languages?	Yes	No
Does government have an online presence?	To some extent	To some extent
What is the extent of corruption in the country?	Bad	Bad

4.4 Financial Transparency

The Tax Justice Network (TJN) compiles a Financial Secrecy Index, a tool to enable the understanding of international financial secrecy, corruption and illicit financial flows. The primary aim of the index is to identify "secrecy jurisdictions". A secrecy jurisdiction provides facilities that enable people or entities to escape or undermine the laws, rules and regulations of other jurisdictions, using secrecy as a prime tool[40].

There are two rounds to investigating such secrecy jurisdictions. Firstly, narrowing the scope of countries included in the list, then secondly, ranking those that remain. To identify potential countries TJN checked how many times the particular country appeared on other tax haven lists during the last 20 years. China appeared in nine of the eleven studies checked, while South Africa only appeared twice. Having excluded South Africa from the TJN Financial Secrecy Index, China is ranked 4th worst out of 71 countries.

Both China and South Africa have implemented Basel II requirements in their domestic banking systems and are making headway with Basel III[41]. The transitional so-called Basel 2.5 has been implemented in force in China and in South Africa. Basel III reforms are in draft form in China, while they are not yet in draft regulation form in South Africa. China, therefore, scores "Good" while South Africa scores "Bad" on this account.

Table 3.5 summarizes the institutional transparency assessment. Two basic areas are identified as important: free press and freedom of association.

Table 3.4: Financial Transparency

Questions	China	SA
How does the country rank on tax haven indices?	Bad	OK
Is there active implementation of Basel III reforms?	Good	Bad

4.5 Institutional Transparency

To judge the extent of press freedom, we refer to Reporters Without Borders' Press Freedom Index, which "reflects the degree of freedom that journalists, news media and citizens enjoy in each country, and the efforts made by the authorities to respect and ensure respect for this freedom"[42]. China ranked 174th out of 179 countries, while the Hong Kong region ranked 54th. South Africa ranked 42nd. Therefore, according to the index, Chinese media freedom is not meaningful at all. South Africa's press freedom has recently been under scrutiny, which has led to the possible introduction of the so-called "Secrecy Bill", but this has yet to materialize. For the moment then China scores "Bad" and South Africa scores "OK".

In their "Freedom in the World" report, Freedom House states that the "Communist Party efforts to restrict public discussion of political, legal, and human rights issues, including through the systematic disappearance of dozens of leading social-media activists and lawyers and growing online censorship among domestic social-networking services"[43]. They classify China as "Not free" with very limited civil liberties and political rights. South Africa is classified as "Free" and scores well on civil liberties and political rights.

A summary of the screening questions and the scores they give is shown in table 3.6 below. Adding the questions within that category scores each dimension of transparency. These scores are then added together to get a total. This total is divided by the maximum amount of points that a country could get and multiplied by 100 to express the score in percentage terms Countries can then be ranked according to this percentage.

Table 3.5: Institutional Transparency

Questions	China	SA
How free is the press?	Bad	OK
Is freedom of association constitutionally guaranteed?	Bad	OK
Is it and allowed de facto?	No	Yes

4.6 Summary

On the whole, South Africa scores much better than China on transparency: 77% versus 30%. The same scoring can be done for all the countries in the portfolio and also for a country that is being considered as a potential bond investment. This transparency score is itself transparent and supported by explicit arguments and a replicable method. While this exercise is not the final analysis of transparency in these countries, it has illustrated that principles of transparency can indeed be operationalized into ethical investment decision criteria.

Table 3.6: Total Transparency Scores

Dimension	China	SA	Maximum
Economic	3	15	15
Legal	3	3	4
Political	5	10	16
Financial	2	1	4
Institutional	0	5	6
Total	13	34	46
Percentage total	30%	77%	100%

Although this exercise does illustrate that screening on the basis of transparency criteria is possible, this model has several faults. For example, the threshold for how transparent is transparent enough would need to be determined should the Oil Fund implement such guidelines. Furthermore, the various measures would have to be given different weights, as not all measures of transparency are equally important in order to ensure responsible debt management. Although it is beyond the scope of this report to develop a complete model for responsible investment in government bonds, we hope that the report will encourage policy makers to advocate the development and implementation of guidelines based on transparency.

5. Areas for reform

The screening exercise has illustrated how investors can assess a country's legal, political, financial and institutional transparency, based on existing data. The subsequent policy recommendations are linked to three areas for reform of the NBIM's government bond investment practice: Regulation and ethical oversight of NBIM investment in government bonds, reporting from the NBIM and independent oversight from relevant third parties. Taken together, reforms in each of these areas will bring the NBIM's government bond investment practice in line with leading ethical practices in the investment industry.

This report develops transparency based ethical guidelines for government bond investments. The aim of these operational screening principles is to distinguish between countries that are responsible borrowers and those that are not. Investing in the bonds of a responsible borrower is, in general, making a responsible investment. How can these principles be implemented, given the current institutional and operational framework of the NBIM?

Before answering how, it is useful to revisit the why. Why is it necessary to implement these principles? At the outset the report highlighted the fact that Norwegian citizens – the ultimate trustees of the Fund – have no mechanism for overseeing the ethical nature of government bond investments. This is a major democratic deficit: Public money is being invested without public oversight. The issue should, therefore, be submitted to parliamentary discussion. It is the responsibility of parliament to ensure that the Ministry of Finance and its ethical committee provide ethical oversight for government bond investments, just like they currently do for investment in equities and corporate bonds. In doing so, the NBIM will be able to catch up with other countries in ethical investments in government bonds.

This means that there should be a change in regulation that defines the roles and responsibilities of the Ministry of Finance and the ethical committee in implementing and delegating ethical investment decisions. The ethical committee could, for example, launch an independent investigation into possible ethical guidelines similar to those outlined in this report, as is being done in Denmark. This report suggests starting by looking at transparency, responsible borrowing and responsible investment. The previous section showed that this framework produces clear questions and can be combined into a composite transparency score. This report suggests that something similar could be used for potential ethical guidelines for investments in government bonds. The method itself is transparent. Even though transparency is a necessary criterion for ethical investment it is most certainly not the only one. The ethical committee can look to Ethix's norm-based screening and the Danish example for guidance on how to extend the framework. It is of vital importance that once the ethical guidelines are decided upon, they are made public, and that the process that goes into each judgment also is transparent.

The NBIM can also make useful changes to its public reporting. Along with quarterly and annual reports, which are freely available, the NBIM should include accounts of their government bond investment decision process where they explain how ethical considerations are taken into account. In this way the public, the Ministry of Finance and Parliament can hold them accountable for how they are investing public money. The NBIM must explain exactly how the adopted ethical guidelines steer their investment decision process.

Lastly, third parties should increase their external monitoring of the government bond portfolio. If there is public will to have ethical investments, then there should be a clear effort to institute ethical guidelines. This report is one example of this will, but it is only a small part of what can be done. The core problem is a lack of information and awareness among the public. In order to increase awareness, information about the NBIM's government bond investment has to reach the public in the right form. An effective way to communicate this would be to create an ethical barometer that monitors the government bond portfolio and plots the ethical score of these investments over time. A method similar to that used in this report could generate such an ethical score. Communicating this periodically through various media would create much needed awareness and spread the relevant information to both the Norwegian Storting and the public.

Screenshot of oljefondet.no, a site tracking the size of the fund.

6. Conclusion

The Norges Bank Investment Management's government bond portfolio (as part of the government pension fund) includes many countries that have questionable civil rights and political liberties practices. Many regimes in which the Fund invests are not transparent about how they manage their public debt. Knowingly investing in countries that have oppressive regimes or are irresponsible with their public debt is inconsistent with the Norwegian Government's goal of being a responsible lender. Furthermore, not having any ethical guidelines for ethical investments in government bonds means that both Norway and the NBIM is out of touch with leading ethical investment practice.

The Norwegian government has expressed a deep understanding of the importance of responsible lending and borrowing in many international fora. This is important, as reckless lending, poor regulation and lack of transparency have been at the core of recent crises. The Norwegian government's decision cancel debt on the basis of creditor co-responsibility, as well as to fund UNCTAD's work to promote responsible lending and borrowing, illustrates that Norwegian government officials indeed take irresponsible lending and borrowing seriously.

It is important to address this lack of ethical oversight as soon as possible for three reasons. Firstly, it will stop the risk of Norway's money being used for ill purposes and the harm that causes. Today we have no way of ensuring that the Oil Fund is not contributing to the buildup of illegitimate debt and profiting from political suppression. Secondly, it will solve a glaring democratic deficit by giving the public a mechanism to hold the NBIM accountable for the way they invest public money. Finally, stricter rules are a necessary first step on the way to building a healthier financial system. Reforming Norway's largest lending arm is a logical and necessary next step in the Government's work towards increased creditor responsibility.

This report reviews the status quo in ethical investment in government bonds in Norway and takes examples from Sweden and Denmark. The report focuses on developing operational principles that can be used to screen countries based on how transparent they are. A short screening case study illustrates how these transparency-based ethical criteria can be used to rank countries according to how transparent they are. These scores can be used for measuring the ethical nature of Norwegian investments over time, and can therefore be used for developing actual guidelines. The UNCTAD Principles for promoting responsible lending and borrowing and Eurodad's Principles for responsible financing are good starting points for further discussion and eventual institutional change. Hopefully, this report will inspire policy-makers to take the lack of regulation of lending through the Oil Fund seriously. While this report has demonstrated that implementing guidelines for investment in government bonds is possible, political will is necessary.

A1. Country shares in the government bond portfolio

These countries are sorted according to their share of the Norwegian Oil Fund's government bond portfolio.

Rank	Country	% Share all countries	% Share all bonds
1	USA	34.89	18.6
2	United Kingdom	15.38	8.2
3	France	11.18	5.9
4	Japan	9.39	5.1
5	Germany	7.19	3.8
6	Italy	4.61	2.4
7	Netherlands	2.83	1.5
8	Austria	2.18	1.1
9	Belgium	2.07	1.1
10	Canada	1.69	0.9
11	Sweden	1.50	0.8
12	Denmark	1.40	0.7
13	Finland	0.99	0.53
14	Australia	0.58	0.3
15	Switzerland	0.55	0.29
16	Ireland	0.53	0.28
17	Brazil	0.44	0.23
18	Mexico	0.39	0.2
19	Poland	0.36	0.19
20	Greece	0.21	0.11
21	Slovakia	0.17	0.09
22	South Korea	0.17	0.08
23	Russia	0.15	0.08
24	Slovenia	0.13	0.07
25	South Africa	0.12	0.06
26	Portugal	0.10	0.05
27	Turkey	0.10	0.05
28	Hungary	0.09	0.04
29	India	0.08	0.04
30	Qatar	0.07	0.03
31	Peru	0.06	0.03
32	Czech Republic	0.06	0.02
33	Indonesia	0.05	0.02
34	Lithuania	0.04	0.02
35	Luxemburg	0.04	0.019
36	Chile	0.04	0.018
37	Cyprus	0.03	0.017
38	Israel	0.03	0.014
39	China	0.03	0.013
40	New Zealand	0.03	0.013
41	Egypt	0.02	0.012
42	Croatia	0.02	0.012
43	Hong Kong	0.01	0.004
44	Singapore	0.01	0.003
45	Bahrain	0.00	0.002

A2. UNCTAD Principles relevant to transparency-based guidelines

Agency:

For Lenders: they should recognize that government officials involved in sovereign lending and borrowing transactions are responsible for protecting public interest (to the State and its citizens for which they are acting as agents). For borrowers: Governments are agents of the State and, as such, when they contract debt obligations, they have a responsibility to protect the interests of their citizens. Where applicable, borrowers should also consider the responsibility of lenders' agents toward their organizations.

Transparency:

The process for obtaining financing and assuming sovereign debt obligations and liabilities should be transparent. Governments have a responsibility to put in place and implement a comprehensive legal framework that clearly defines procedures, responsibilities and accountabilities. They should particularly put in place arrangements to ensure the proper approval and oversight of official borrowings and other forms of financing, including guarantees made by State-related entities.

Disclosure and publication:

Relevant terms and conditions of a financing agreement should be disclosed by the sovereign borrower, be universally available, and be freely accessible in a timely manner through online means to all stakeholders, including citizens. Sovereign debtors have a responsibility to disclose complete and accurate information on their economic and financial situation that conforms to standard reporting requirements and is relevant to their debt situation. Governments should respond openly to requests for related information from relevant parties. Legal restrictions to disclosing information should be based on evident public interest and to be used reasonably.

Monitoring and management:

Debtors should design and implement a debt sustainability and management strategy and to ensure that their debt management is adequate. Debtor countries have a responsibility to put in place effective monitoring systems, including at the sub-national level, that also capture contingent liabilities. An audit institution should conduct independent, objective, professional, timely and periodic audits of their debt portfolios to assess quantitatively and qualitatively the recently incurred obligations. The findings of such audits should be publicized to ensure transparency and accountability in debt management. Audits should also be undertaken at sub-national levels.

A3. Full List of Questions

Economic

- Are alternative sources of statistical accounts for debt and deficit available?
- Is the national accounting transparent?
- Is the budget accompanied by a long-term economic forecast?
- How good is the quality of the forecast?
- Do independent fiscal committees oversee fiscal results?
- How does the country rank on the OBI score?
- Is there opportunity for public participation in the budget?
- Do ministries communicate about the budget to parliament and public?

Legal

- Are the roles of state and government in debt issuance and management formally defined?
- Are these definitions consistent with the UNCTAD principles?

Political

- Is the regime a formal democracy?
- Is the democracy consolidated?
- Does the government bond issuing authority report to parliament about debt?
- Is information about debt publically available?
- If available, is it easy to understand?
- Is it available in all official languages?
- Does government have an online presence?
- What is the extent of corruption in the country?

Financial

- How does the country rank on tax haven indices?
- Is there active implementation of Basel II reforms?

Institutional

- How free is the press?
- Is freedom of association constitutionally guaranteed?
- Is it and allowed de facto?

End notes

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The Norwegian Coalition for Debt Cancellation (SLUG) is an umbrella organization with over 40 affiliated Norwegian organisations. Working with our domestic and global partners, we gather information on debt related problems as well as the mechanisms that cause them. We work to illuminate these issues, place them on the political agenda and exert pressure on decision makers to address them.

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