

Autoridade Bancária e de Pagamentos de Timor-Leste

Banking and Payments Authority of Timor-Leste

Av.º Bispo Medeiros, PO Box 59, Díli, Timor-Leste
Tel. Nº (670) 3 313 718, Fax. Nº (670) 3 313 716

Gabinete do Director Geral

Data: 11 de Julho de 2011
Ref.: GM/2011/111/VA

Excelentíssimo Senhor

Dr. Cecílio Caminha Freitas
Presidente da Comissão, em Exercício
do Parlamento Nacional
da República Democrática de Timor-Leste

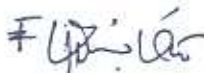
Assunto: Submissão dos comentários da ABP a Proposta de Alteração da Lei do
Fundo Petrolífero.

Excelentíssimo Senhor Presidente;

Na sequência do convite endereçado no passado dia 29 de Junho de 2011 a esta Autoridade, com a referência-n. 1045/4^ª/II-Com C, enviamos em anexo versão Portuguesa e Inglesa dos comentários à Proposta de Alteração a Lei do Fundo Petrolífero.

Sem outro assunto de momento, subscrevo-me com a mais elevada consideração.

O Director Geral,



Abraão de Vasconcelos

Autoridade Bancária e de Pagamentos de Timor-Leste

Banking and Payments Authority of Timor-Leste

Av^a Bispo Medeiros, PO Box 59, Dili, Timor-Leste
Tel. Nº (670) 3 313 718, Fax. Nº (670) 3 313 716

**SUBMISSION ON PROPOSED AMENDMENTS TO
THE PETROLEUM FUND LAW**

1. Introduction

The Government has proposed amendments to the Petroleum Fund law that were presented to Parliament on 28 June 2011.

The BPA wishes to preface its submission by noting that the proposed amendments are intended to be in place for the long term. Accordingly, the BPA's submission is made with long-term considerations and best public policy in mind, and are not intended to be interpreted as reflections on the current persons occupying various positions of authority within the governance structure of the Petroleum Fund.

The BPA notes that the proposed amendments to the law have the potential to significantly increase the influence and authority of the Ministry of Finance over the management of the Petroleum Fund at the expense of the institutional checks and balances built into the existing law. In particular, the Minister of Finance will have the power to determine (with the approval of parliament) who the operational manager shall be. Furthermore, the proposed amendments transfer significant responsibilities from the Investment Advisory Board to the Minister of Finance, while at the same time disenfranchising the Central Bank and Treasurer from their ex officio positions on the Investment Advisory Board, potentially separating the investment and management of the Petroleum Fund from the nation's fiscal and monetary functions.

The current Petroleum Fund law devolves the management and investment of the Petroleum Fund across three organs (Minister of Finance, Investment Advisory Board, and Central Bank) underpinned by a carefully constructed system of institutional checks and balances designed to minimise the potential for mismanagement and to optimise the transparency of the management process. The overall effect of the proposed amendments is to concentrate the power and authority over the Petroleum Fund in the Ministry of Finance.

In 2004/5 BPA officials actively worked with the Ministry of Finance throughout the legal drafting of the Petroleum Fund law as it stands today. However during the 2010/11 review, the Ministry of Finance has not involved the Banking and Payments Authority in the development of the proposed amendments, except to the extent of giving the BPA an opportunity to make a written submission on an earlier draft of the amendments during a brief period of public consultation in late October 2010, at which time the Minister gave the BPA an even shorter period (which was subsequently extended) than was given to the general public to make submissions. Several of the BPA's recommendations, primarily of a technical nature, have been adopted. The reference on page 3 of the Exposição de Motivos to the BPA's involvement should be read in this context.

2. Recommendations

This section summarises the BPA's recommendations concerning the draft law. The issues and reasons for the BPA's opinions are discussed in more detail in the annexes to this submission.

2.1. Articles 2, 14 and 16: Investment Policy and Risk Profile

The present governance framework of the Petroleum Fund recognises three distinct functions: setting the investment policy and benchmarks, implementing the operational management, and undertaking overall management of the Petroleum Fund. The three functions are assigned to independent but coordinated entities in order to implement a strong system of institutional checks and balances.

Because some confusion has arisen regarding the relative roles of the Minister of Finance and the Investment Advisory Board, the BPA submits that additional clarity of the respective roles be added to the law.

- The **Minister of Finance** (in addition to having the role of overall manager) is responsible for setting the Investment Strategy, reflecting the manner in which the government wishes to invest the Petroleum Fund, including the general investment principles based on the government's risk and return objectives, the classes of assets in which the Fund may be invested, and proportion of assets to be allocated to each asset classes (strategic asset allocation).

The Minister, as the elected representative of the Timorese citizens, has the responsibility to develop an Investment Strategy that balances the natural desire for high financial returns from the Petroleum Fund with the nation's tolerance for taking financial risk.

- The **Investment Advisory Board** is responsible for developing the Investment Policy, namely the framework through which the Investment Strategy will be implemented. The Investment Policy involves developing and recommending the particular assets within each asset class that the Petroleum Fund may invest in (i.e. the investment universe), the management style (e.g. active, passive), the limits on the level of risk appropriate to each investment mandate, the investment instructions (mandates), and the performance benchmarks. The Investment Policy may also from time to time include tactical asset allocations through which short-term variations from the Investment Strategy are incorporated.

The Board, having at least two members with significant experience in investment management supported by the two officials responsible for developing and implementing Timor-Leste's fiscal and monetary policies – the Treasurer and the Central Bank Governor respectively – has the role of developing an Investment Policy for the Petroleum Fund that fully integrates the investment of the Petroleum Fund with the requirements of the state budget and the management of the nation's other financial reserves.

- The **Operational Manager** is responsible for implementing the Investment Policy at an operational level, namely by either managing a mandate internally or selecting and overseeing external managers (subject to certain checks and balances) and to report to the Minister of Finance and the IAB about the performance of the various managers (including itself) against the performance benchmarks.

The Operational Manager's implementation of the investment of the Petroleum Fund should be guided by international best practice and standards. The Operational Manager needs statutory autonomy from the political process in order to select and manage the best and most qualified team of asset managers and other supporting parties. This approach minimises the significant financial and operational risks faced by the Petroleum Fund when investing in global financial markets that provide surprisingly little regulatory protection for institutional investors in the event that things go wrong.

The definition of "Investment Policy" in the proposed Article 2.1(q) merges the development of the Investment Strategy and the Investment Policy under a single heading, and has the effect of transferring the current role of the Investment Advisory Board in setting the Investment Policy, including the performance benchmarks to the Minister of Finance.

Accordingly, the BPA makes the following recommendations:

- 1). The BPA believes that the institutional checks and balances that reflect an appropriate division of duties between the Minister and the Investment Advisory Board be retained as in the present law.

The BPA **recommends** replacing the proposed definition (Política de Inversión) at Article 2.1(q) with the following two definitions:

"Investment Strategy means the general principles governing the investment of the Petroleum Fund, including the risk and return objectives, the classes of assets in which the Fund may be invested, and the broad allocation of funds to the eligible asset classes."

"Investment Policy means the manner in which the Investment Strategy is to be implemented, including the definition of eligible investments within each asset class, the management styles through which the assets are managed, the risk tolerances, the investment instructions, the performance benchmarks, and short-term tactical positions."

- 2). As a result of introducing these two definitions, a number of consequential changes are proposed in other Articles of the law:

- a). Article 14.1

The proposed amendment reads,

"The Minister shall establish the Investment Policy for the Petroleum Fund that shall apply the principles of diversification ..."

The BPA **recommends** that the wording of this proposed clause be made consistent with the definitions above, namely,

*"The Minister shall establish the Investment **Strategy** for the Petroleum Fund that shall apply the principles of diversification ...[as existing proposed text]"*

- b). Article 14.2

The proposed amendment reads,

“The Investment Policy must provide sufficient liquidity...”

The BPA **recommends** that the wording of the proposed clause be made consistent with the definitions above, namely,

*“The Investment **Strategy** must provide sufficient liquidity... [as existing proposed text]”*

c). Article 14.3

The proposed amendment reads,

“The Minister and the Operational Manager shall develop and maintain policies, systems and procedures to ensure that the risks associated with the implementation of the Investment Strategy are identified, monitored and managed.”

The BPA **recommends** that the wording of the proposed clause be made consistent with the above definitions, namely,

*“The Minister and the Operational Manager shall develop and maintain policies, systems and procedures to ensure that the risks associated with the implementation of the Investment Strategy **and Investment Policy** are identified, monitored and managed.”*

d). Article 14.5

The proposed amendment reads, “The Minister shall present a summary of the proposed Investment Policy of the Petroleum Fund to the Parliament ...”

The BPA **recommends** that the wording of the proposed clause be made consistent with the above definitions, namely,

*“The Minister shall present a summary of the proposed Investment **Strategy** of the Petroleum Fund to the Parliament ... [as existing proposed text].”*

e). Article 24.1(c)

The proposed amendment reads,

“(c) A report on the Investment Policy in accordance with Article 14.5.”

The BPA **recommends** that the wording of the proposed clause be made consistent with the above definitions, namely,

*“(c) A report on the Investment **Strategy** in accordance with Article 14.5.”*

2.2 Article 9: Transfers/Withdrawal Rules

The BPA recognises the considerable social and developmental challenges facing the government, but believes that drawings from the Fund in excess of ESI be exceptions rather than the norm, because the Fund will not otherwise be sustainable over the longer term. The BPA therefore proposes that all drawings in excess of ESI be justified by reference to particular projects or other initiatives that have a demonstrable rate of social or financial return.

The current Article 9(d) reads,

“(d) a detailed explanation of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the Estimated Sustainable Income.”

The proposed Article 9(d) reads,

“(d) a justification of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the Estimated Sustainable Income.”

The BPA **recommends** that Article 9(d) read:

“(d) Details of the social or financial investments to be financed by the excess withdrawal, supported by an analysis of the related costs and benefits, and a justification of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the Estimated Sustainable Income.”

2.3 Articles 2, 11, 12, 13 and others: Operational Management

As unanimously recognized by all observers, the current governance arrangements have been working well, and the BPA sees neither need nor advantage in introducing “flexibility” into the law.

The Santiago principles¹ identify three basic models for the governance structure of sovereign wealth funds. The BPA **strongly recommends** that the National Parliament adopt only one of the available models, rather than passing a law that enables flexibility to implement any (or a mixture of all) of the three governance models without making consequential changes to the Petroleum Fund law. Different governance structures require different provisions in the founding law, because each model has differing legal and governance issues that need to be addressed. For example, the “central bank” model adopted in the present law relies on provisions regarding institutional independence, statutory obligations regarding the management of public funds, and so on which are contained in the central bank law and so do not need to be repeated in the Petroleum Fund law. In the Santiago Principles, GAPP 9 states that the operational management of the SWF should implement the SWF’s strategies in an independent manner. A change in the governance model for the Petroleum Fund therefore requires a proper review of all the legal implications, and changes to the governance provisions in the law that go far beyond simply adding “or another public entity” to the definition of Operational Manager.

The BPA believes that a well-defined governance structure should clearly leave no doubt about which public institutions are involved and their roles in managing the Petroleum Fund. Without such clarity, the proposed flexibility risks leading to ongoing politicisation of the Petroleum Fund governance process. In particular, the ability of the Ministry of Finance to change operational managers at almost any time (subject to obtaining parliamentary consent) is not consistent with the normal relations that should exist between a Ministry of Finance and a central bank. In particular it seriously threatens the independence of the central bank.

Further, the goal of increasing the long-term return of the fund — with which the BPA

¹ The “Generally Accepted Principles and Practices (GAPP) for Sovereign Wealth Funds” (known as the “Santiago Principles”) were developed by the International Working Group of Sovereign Wealth Funds, of which Timor-Leste is a founding member. The Santiago Principles reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by Sovereign Wealth Funds on a prudent and sound basis. The GAPP is a voluntary set of practices and principles that the members of the IWG support and intend to implement.

totally agrees — only marginally depends on the operational manager since returns are primarily a function of the investment policy which is not defined by the operational manager.

The BPA notes with some concern various reports that Ministry of Finance officials are actively working on establishing an alternative operational manager, suggesting that the “flexibility” in the law intends to be used in the immediate future.

The BPA therefore **recommends** that in light of the recent passing of the Central Bank law which will shortly come into force, the proposed Article 2.1(i) read:

“(i) Operational Manager means the Central Bank.”

2.4 Article 17: Investment Advisory Board

2.4.1 Membership of the Investment Advisory Board

Considering past experience, the BPA believes that the IAB has been functioning effectively as currently constituted and recommends that the composition and appointment processes of the Investment Advisory Board remain as in the current law.

The IAB has developed and published a statement of investment beliefs that describes how the Investment Policy is developed as evidence of its commitment to making its activities as transparent as possible.

Whether or not an alternative governance regime for the operational management is adopted, the BPA believes that the Central Bank must be represented on the Investment Advisory Board because the IAB’s Investment Policy needs to take account of how Timor-Leste’s foreign reserves are being invested at a global level, and conversely, the Central Bank needs to have an intimate knowledge of how the national reserves in the Petroleum Fund is being invested.

Following similar logic, the most appropriate way for the investment of the Petroleum Fund to be fully integrated with the fiscal requirements of the state budget is to have the Treasurer as an ex officio member of the Board with full voting powers.

The BPA regards the inclusion of the Treasurer and Central Bank Governor on the Investment Advisory Board as evidence that the Petroleum Fund is complying with Santiago Principle GAPP 3, which requires an SWF’s activities to be closely coordinated with the domestic fiscal and monetary authorities. On the other hand, the proposed disenfranchisement of the Central Bank and Treasury from any role other than observer of the management of the Petroleum Fund would put the Petroleum Fund in breach of this principle.

The BPA therefore **recommends** that the wording of Article 17 in the existing law be retained.

2.4.2 Role of the Investment Advisory Board

The proposed Article 16.1(a) reduces the role of the Investment Advisory Board from “developing” (desenvolver) the Investment Policy including benchmarks to “preparing” (elaborar) the benchmarks. The proposed change of wording appears to be consistent with the Ministry of Finance’s apparent desire to make a significant transfer of responsibility from the IAB to the Minister in the definition at Article 1.2(q).

The existing Article 16.1(a) reads, “(a) developing for the Minister performance

benchmarks of desired returns from, and appropriate risks of, the investments of the Petroleum Fund.”

The proposed Article 16.1(a) reads, “(a) preparing for the Minister benchmarks in order to evaluate the performance and returns on investments of the Petroleum Fund, and the adequacy of the risks.”

The BPA **recommends** that Article 16.1(a) be amended to read:

“(a) developing for the Minister the Investment Policy including performance benchmarks in order to evaluate the performance and returns on investments of the Petroleum Fund, and the adequacy of the risks.”

The proposed amendment to Article 16.1(d) gives the IAB the duty to advise the Minister on the need for changes in the Investment Strategy (as in the present law) but removes the power of the IAB to recommend appropriate changes (as at present). The BPA sees no good reason for disenfranchising the IAB of this power.

The BPA **recommends** that the present wording of Article 16.1(d) be retained, namely,

“(d) Advising the Minister on the need for changes in the overall Investment Strategy or management of the Petroleum Fund, including the making of recommendations as to such changes.”

2.5 Article 12.3: Appointment of Timorese External Managers

The BPA wishes to state at the outset that as a general principle it supports the concept of developing national capacity wherever possible and appropriate in order to encourage economic and social development.

However Timor-Leste has no operating financial markets, minimal financial system infrastructure, and few human resources with any knowledge of asset management. There are other far more pressing priorities in the development of Timor-Leste’s financial system than developing a domestic asset management sector solely dependent on earning management fees from the Petroleum Fund.

The proposed amendment to exempt Timorese asset managers from two of the three basic safeguards in the law means that external managers would be given mandates to manage hundreds of millions of dollars but would not be selected on merit but based on non-financial considerations.

The proposal would require the Operational Manager to ignore the reputation and financial record when recommending national candidates to the Council of Ministers. Far from building a sustainable national financial sector, such a provision would send a strong signal that Timor-Leste encourages the type of financial services companies that would not be welcome in other jurisdictions.

By way of example, asset managers are known to be aggressive marketers and not averse to using any means, including political influence, with the sole objective of increasing their own financial returns. It would be possible for a foreign asset manager of dubious quality to establish a token legal presence in Timor and then leverage the proposed clause to insist on being appointed as an external manager, claiming that any evidence of the candidate’s poor record of operational and financial management, or bad reputation, is required by law to be ignored.

The BPA can envisage significant practical difficulties in incorporating the provisions of the proposed clause into what is already a complex procurement process, because domestic and foreign candidate external managers would need to be evaluated and

selected according to substantially different standards. Furthermore, the provision would likely discourage large and reputable international asset managers from investing considerable sums of money in preparing bids.

Finally, if the Operational Manager were obliged to respect the terms of the proposed clause, the BPA believes there would be a very real possibility that Petroleum Fund assets would end up being sub-optimally managed at best or, at worst, completely mismanaged.

The BPA therefore **recommends** that all external managers be selected according to the same minimum criteria, and that the proposed clause 12.3 on the appointment of national investment managers be deleted.

2.6 Additional Recommendations

2.6.1 Article 2.1(h): Definition of Investment Manager

Investment Manager to be defined as the Operational Manager and the **External Investment Managers**, as in the current law.

2.6.2 Article 6.1: Requirement to publish details of all operational cash accounts

The present law (article 5.4) requires that the details of the earmarked receipts account be published in the operational management agreement. The purpose of doing this is to enable persons making payment of taxes, royalties, and other contributions to the Petroleum Fund to be sure that they are directing funds owed to the State into the proper bank account.

The Fund's financial transactions, on the other hand, take place through a large number of cash and securities accounts held at the Fund's global custodian. At present investment income is received into more than 25 bank accounts in various places and currencies. The number of cash accounts will rapidly increase to hundreds when new external managers are appointed to invest in the new investment guidelines.

The BPA's earlier submission recommended an amendment to Articles 5 and 33 of the Petroleum Fund law to remove the requirement to deposit investment receipts into the earmarked receipts account, a USD denominated account at the Federal Reserve Bank of New York. It is not only impossible to use the earmarked receipts account for receipts in currencies other than US dollars, but even if it were possible, the process would mingle the assets and income of the various managers that is currently managed by keeping each portfolio of managed assets completely separate.

The proposed amendment requires a formal amendment to the Operational Management Agreement every time a new bank account is opened. This would impose significant operational constraints on the BPA, its global custodian, its external managers, and their brokers and agents, particularly should a new cash account be needed at a day's notice to enable settlement of a market transaction.

The BPA believes that the legislated audit requirements provide sufficient control over the cash accounts maintained by the Fund, and that publishing the full details of potentially hundreds of internal cash accounts (an average equities manager uses about 20 cash accounts) would neither provide additional levels of control nor be of any public benefit. Furthermore, the publication of all the details of the Fund's internal cash accounts would not only be an extremely unusual requirement, but would present significant operational security risks.

The BPA **recommends** that Article 5 should be amended to refer to the publication of the details of the earmarked receipts account only, in the following manner:

5.5 The accounts of the Petroleum Fund referred to in clause 2 of the present Article include an earmarked receipts account into which all Petroleum Fund receipts set out in Article 6, with the exception of the investment receipts referred to in Article 6.1(c), are credited.

5.6 The details concerning the earmarked receipts account referred to in clause 5 of the present Article and the State budget account referred to in Article 7.1 are made public through the publication of the operational management agreement to which Article 11.3 refers.

2.6.3 Article 20: Encumbrances on the Petroleum Fund

The BPA notes the significant changes to this Article and notes that there are benefits from being able to encumber the Fund, including access to international loans and the possibility of paying a lower interest rate.

The BPA also acknowledges that such encumbrances be limited to 10% of the value of the Fund at the time of the encumbrance being placed on the Fund. There appears to be no form of sanction or disincentive to encumbering the Fund above the 10% limit.

The existing Article 20 renders all contracts and agreements that encumber the Fund to be null and void, and it would seem sensible to maintain this concept for the portion of the Fund that Parliament wishes to remain unencumbered.

The BPA **recommends** that a provision, closely modelled on the present Article 20.2, be included in the new Article 20, but only applicable to the remaining 90% of the value of the Fund, as follows:

20.3 Any contract, agreement or arrangement, to the extent that it purports to encumber the assets of the Petroleum Fund beyond the 10% of the value of the Fund referred to in clause 2 of the present Article, whether by way of guarantee, security, mortgage or any other form of encumbrance, is null and void.

2.6.4 Article 23.1: Publication of Annual Report

The current law provides for the Annual Report of the Petroleum Fund, which contains a range of information aside from the annual financial statements, to be published within 15 days of its presentation to Parliament.

In practice, the presentation of the Annual Report has taken place towards the end of the subsequent financial year, when the government's annual financial statements are presented with the Budget. On this time scale, some of the information in the Petroleum Fund's annual report can be nearly two years old.

It is general practice for annual reports containing financial statements to be published in a timely manner. In particular, the Central Bank of Timor-Leste is required to publish its annual financial statements within four months of its annual balance date, and its Quarterly Reports are required to be submitted within 20 days of the end of each quarter.

The first draft of the Petroleum Fund's annual financial statements is contractually required to be produced within one month of balance date, following which the external audit takes place. There is no operational reason why the Annual Report of the Petroleum Fund cannot be published within four months of the annual balance date.

For consistency, it is noted that Article 23.1 refers to fiscal years, whereas the relevant definition in Article 1 has been changed to financial years.

The BPA **recommends** that the Annual Report of the Petroleum Fund be submitted within four months of the end of each financial year, by amending Article 23.1 in the following manner:

23.1 The government shall submit an Annual Report for the Petroleum Fund to Parliament within four months of the end of each financial year.

Investment Policy

Introduction

Santiago Principle GAPP7 calls for the owner to set the objectives of the SWF, appoint the members of its governing body(ies), and exercise oversight over the SWF's operations. The BPA sees this as the primary role of the Minister of Finance, as overall manager of the Petroleum Fund.

The Petroleum Fund law establishes a governance framework that enables the effective implementation of the complex process of managing huge financial resources of undisputed importance to Timor-Leste's future.

The principle underlying the division of duties in the present Petroleum Fund law is that:

- The Minister implements overall management of these processes by appointing IAB members, exercising oversight over the Petroleum Fund's operations and governance framework, setting the investment objectives, and making the necessary decisions.
- The Investment Advisory Board sets the investment policy, including performance benchmarks.
- The Central Bank implements the operational management, i.e. the investment activities

The BPA makes its submission in terms of this basic architecture, which was developed through extensive public consultation and approved unanimously in the National Parliament.

The roles of the three institutions responsible for determining how the Petroleum Fund is invested

The BPA understands that the current law was drawn up to construct a framework in which the overarching intention was to create a system of institutional checks and balances to minimise the potential impact of institutional weakness or mismanagement in any of the three entities primarily involved in the day-to-day management of the Petroleum Fund.

- The **Minister of Finance** (in addition to having the role of overall manager) is responsible for setting the Investment Strategy, reflecting the manner in which the government wishes to invest the Petroleum Fund, including the general investment principles based on the government's risk and return objectives, the classes of assets in which the Fund may be invested, and proportion of assets to be allocated to each asset classes (strategic asset allocation).

The Minister, as the elected representative of the Timorese citizens, has the responsibility to develop an Investment Strategy that balances the natural desire for high financial returns from the Petroleum Fund with the nation's tolerance for taking financial risk.

The Minister's decisions in this area will take account of the government's views on risk and return, and will seek to balance differing political views on how the Petroleum Fund should be invested. The Minister's Investment Strategy is subject

to transparency by being required to be published in the Annual Report of the Petroleum Fund.

The broad objective of the Investment Strategy is to state what the overall investment objectives are.

- The **Investment Advisory Board** is responsible for developing the Investment Policy, namely the framework through which the Investment Strategy will be implemented. The Investment Policy involves developing and recommending the particular assets within each asset class that the Petroleum Fund may invest in (i.e. the investment universe), the management style (e.g. active, passive), the limits on the level of risk appropriate to each investment mandate, the investment instructions (mandates), and the performance benchmarks. The Investment Policy may also from time to time include tactical asset allocations through which short-term variations from the Investment Strategy are incorporated.

The Board, having at least two members with significant experience in investment management supported by the two officials responsible for developing and implementing Timor-Leste's fiscal and monetary policies – the Treasurer and the Central Bank Governor respectively – has the role of developing an Investment Policy for the Petroleum Fund that fully integrates the investment of the Petroleum Fund with the requirements of the state budget and the management of the nation's other financial reserves.

The Board has responded to its obligations by publishing a Statement of Investment Beliefs that sets out the framework within which the Board intends to convert the Investment Strategy into investible mandates.

An illustration of the difference between the Investment Strategy and the Investment Policy may be helpful. For example, the proposed amendments to the law indicate a major change in investment strategy. Suppose (for illustrative purposes) the Minister decides to adopt an Investment Strategy in which 40% of the Fund will be invested in equities, to be implemented over a period of two years. Based on the size of the Petroleum Fund (\$8 billion), this would require the Investment Advisory Board to respond with an Investment Policy that includes the management of the many risks (including opportunity risk, market impact risk, and so on) associated with a global transition of about \$3 billion of fixed interest investments into equities, as well as determining appropriate individual investment mandates and benchmarks within each asset class.

The broad objective of the Investment Policy is to determine how the Investment Strategy will be implemented.

- The **Operational Manager** is responsible for implementing the Investment Policy at an operational level, namely by either managing a mandate internally or selecting and overseeing external managers (subject to certain checks and balances) and to report to the Minister of Finance and the IAB about the performance of the various managers (including itself) against the performance benchmarks.

The Operational Manager's implementation of the investment of the Petroleum Fund should be guided by international best practice and standards. The Operational Manager needs statutory autonomy from the political process in order to select and manage the best and most qualified team of asset managers and other supporting parties. This approach minimises the significant financial and operational risks faced by the Petroleum Fund when investing in global financial

markets that provide surprisingly little regulatory protection for institutional investors in the event that things go wrong.

The primary duty of the Operational Manager is to implement the Investment Policy. Just as important is the duty of the Operational Manager to manage the operational risks associated with the management of the Fund on an ongoing basis.

To illustrate the complexity of managing operational risks, the BPA points to its recent review of operational controls to manage the Petroleum Fund and other reserve assets. The review drew on best practices used by central banks for reserve management, as well as criteria drawn from internationally recognised investment management standards and guidelines, including those issued by the International Auditing and Assurance Standards Board, the CFA Institute in the USA, the European Fund and Asset Management Association, the UK Investment Management Association, and several others. As a result of the review, the BPA identified nearly 100 major control objectives to ensure the Petroleum Fund is being properly managed. More than 500 individual policies and procedures are in place (or planned) to form the framework necessary to provide assurance that the operational control objectives are being achieved.

Rationale for retaining the current system of institutional checks and balances

One of the strengths of the above structure is that it avoids as far as possible the possibility that the investment policy will be subject to political considerations and that the oversight/investment policy/operational aspects can be kept separate to maximize the effectiveness of the institutional checks and balances built into the current law.

As reported in the Petroleum Fund's 2009 Annual Report, the checks and balances in the governance structure of the Fund proved to be effective against an attempted fraud and illustrates the benefit of maintaining and strengthening clear divisions between the roles and responsibilities of the three parties.

The BPA believes that strengthening, not diluting, the institutional segregation of duties and maintaining an operational manager with constitutional independence (but still subject to close oversight by MOF and IAB) will optimise the long-term success of the Petroleum Fund. This view is supported by a comment in a recent publication² of the Petersen Institute which expresses concern about the possibility of SWF assets in countries with a low level of development through corruption or mismanagement.

The combination of the proposed Article 2.1(q) and the proposed Article 14 moves a substantial portion of the responsibility for developing investment policy from the Investment Advisory Board to the Minister. While such a move may be intended to reflect the Minister's role as the representative of the owner of the Petroleum Fund, the BPA is concerned that the change of focus also introduces the possibility that political considerations could be introduced into the investment policy, a possibility that is far less likely if the Minister sets the overall investment objectives and constraints, and the IAB develops the technical investment solutions. On the other hand, it is entirely appropriate that political considerations should be fully taken into account when setting the Investment Strategy, including the long-term investment objectives, the global level of risk that the Petroleum Fund will be exposed to, and the broad range of assets in which the Fund will be invested.

² "Sovereign Wealth Funds – Is Asia Different?", Petersen Institute for International Economics, June 2011. Page 8

The IAB's development of the Investment Policy will be informed only by technical considerations, primarily the return from the investment portfolio. That said, the IAB needs to be aware that the Investment Policy is consistent with the nation's fiscal and monetary requirements.

The present Article 16.1 requires the Investment Advisory Board to develop performance benchmarks of desired returns from, and appropriate risks of, the investments of the Petroleum Fund. The performance benchmarks are in effect the key performance indicators for the Petroleum Fund. Although the Minister may or may not choose to accept the Board's performance benchmarks, Article 24.1(f) makes it clear that the Board's benchmarks are those against which the performance of the Fund must be measured and reported.

The benchmark setting process involves a number of activities, including evaluating implementation options, determining the range of assets within defined asset classes that meet the Minister's constraints, identifying the style of investment management to be implemented, and specific risk measures and tolerances. The IAB may also see merit from time to time in making tactical moves away from the strategic asset allocation. As a final step, these matters are brought together in investment mandates containing the investment benchmarks, such as MSCI World or the Merrill Lynch 0-5 year Government Bond Index, which can then be given (via the Minister) to the operational manager for implementation.

This whole process of determining what is called the Investment Policy is undertaken by the Investment Advisory Board including "persons with significant experience in investment management" (Article 17.1(c)) rather than by the Minister of the day who may or may not have an in-depth knowledge of investment markets, theory, and processes. Under the proposed amendments, the statutory role of the Investment Advisory Board would be significantly reduced and the responsibility of the Minister commensurately increased.

The proposed Article 14 follows the advice given to the Minister by the Investment Advisory Board itself. Nonetheless the BPA sees merit in further clarifying the respective roles of the Minister of Finance and the Investment Advisory Board, because the proposed amendments (primarily the definition of Investment Policy in Article 1.2(q)) consolidate a wide range of functions in the Ministry of Finance.

The definition of "Investment Policy" in the proposed Article 2.1(q) merges the development of the Investment Strategy and the Investment Policy under a single heading, and has the effect of transferring the current role of the Investment Advisory Board in setting the Investment Policy, including the performance benchmarks to the Minister of Finance.

Recommendations

Accordingly, the BPA makes the following recommendations:

1. The BPA believes that the institutional checks and balances that reflect an appropriate division of duties between the Minister and the Investment Advisory Board be retained as in the present law.

The BPA **recommends** replacing the proposed definition (Política de Inversión) at Article 2.1(q) with the following two definitions:

"Investment Strategy means the general principles governing the investment of the Petroleum Fund, including the risk and return objectives, the classes of assets in

which the Fund may be invested, and the broad allocation of funds to the eligible asset classes.”

“*Investment Policy* means the manner in which the Investment Strategy is to be implemented, including the definition of eligible investments within each asset class, the management styles through which the assets are managed, the risk tolerances, the investment instructions, the performance benchmarks, and short-term tactical positions.”

The rationale for this recommendation has been set out at length in the preceding notes.

2. As a result of introducing these two definitions, a number of consequential changes are proposed in other Articles of the law:

- a). Article 14.1

The proposed amendment reads, “The Minister shall establish the Investment Policy for the Petroleum Fund that shall apply the principles of diversification ...”

The BPA **recommends** that the wording of this proposed clause be made consistent with the definitions above, namely,

“The Minister shall establish the Investment **Strategy** for the Petroleum Fund that shall apply the principles of diversification ...[as existing proposed text]”

The rationale for this recommendation is that the Minister should establish the Investment Strategy, whereas the Investment Advisory Board should develop the Investment Policy.

- b). Article 14.2

The proposed amendment reads, “The Investment Policy must provide sufficient liquidity...”

The BPA **recommends** that the wording of the proposed clause be made consistent with the definitions above, namely,

“The Investment **Strategy** must provide sufficient liquidity... [as existing proposed text]”

The rationale for this recommendation is that the Minister should establish the Investment Strategy, whereas the Investment Advisory Board should develop the Investment Policy.

- c). Article 14.3

The proposed amendment reads, “The Minister and the Operational Manager shall develop and maintain policies, systems and procedures to ensure that the risks associated with the implementation of the Investment Strategy are identified, monitored and managed.”

The BPA **recommends** that the wording of the proposed clause be made consistent with the above definitions, namely,

“The Minister and the Operational Manager shall develop and maintain policies, systems and procedures to ensure that the risks associated with the implementation of the Investment Strategy **and Investment Policy** are identified, monitored and managed.”

The rationale for this recommendation is that the systems and procedures needs to reflect the overall investment framework set by the Minister (the Investment Strategy) as well the Investment Policy developed by the Investment Advisory Board describing how the Strategy will be implemented.

d). Article 14.5

The proposed amendment reads, “The Minister shall present a summary of the proposed Investment Policy of the Petroleum Fund to the Parliament ...”

The BPA **recommends** that the wording of the proposed clause be made consistent with the above definitions, namely,

“The Minister shall present a summary of the proposed Investment **Strategy** of the Petroleum Fund to the Parliament ... [as existing proposed text].

The rationale for this recommendation is that the Minister should establish the Investment Strategy, whereas the Investment Advisory Board should develop the Investment Policy.

e). Article 24.1(c)

The proposed amendment reads, “(c) A report on the Investment Policy in accordance with Article 14.5.”

The BPA **recommends** that the wording of the proposed clause be made consistent with the above definitions, namely,

“(c) A report on the Investment **Strategy** in accordance with Article 14.5.”

The rationale for this recommendation is that the Minister should establish the Investment Strategy, whereas the Investment Advisory Board should develop the Investment Policy. The Report on the Minister’s Investment Strategy should appear in the Annual Report. The quarterly performance reports prepared by the Operational Manager provide the related information on the Investment Policy for the Petroleum Fund, including the performance benchmarks, developed by the Investment Advisory Board.

Introduction

The BPA wishes to preface its comments to this section by acknowledging that the National Parliament may at its absolute discretion decide that an entity other than the Central Bank of Timor-Leste should be the Operational Manager of the Petroleum Fund.

Nor is it the BPA's intention to discuss the merits of alternative models for the management of Timor-Leste's sovereign wealth fund, although it notes that these issues were discussed at length in 2004/5 when the Petroleum Fund law was being developed, and that the governance model chosen following those deliberations was adopted unanimously by the National Parliament.

Background

The draft law proposes to change the Operational Manager of the Petroleum Fund from the central bank to "the central bank or any other public entity established by the National Parliament to manage and operate the Petroleum Fund".

The manner in which the BPA has fulfilled its role to date as the operational manager does not suggest that there is a need to change the model. From a financial perspective the BPA has consistently managed the great majority of the Fund internally over the past five years with an average deviation from the benchmark of about three basis points (0.03%) a year, a performance standard that commercial managers would find almost impossible to beat.

At an operational level we remember with pride that the BPA was unique amongst Timorese government organizations in remaining open to manage the Fund throughout the 2006 crisis. The BPA has successfully built the foundations for the future management of the Fund, including completion of major procurement processes to appoint the Fund's global custodian and two external managers. In December 2009 the BPA's operational processes were reviewed by Towers Watson who wrote, "*We were very impressed by the investment operations of the BPA and the management of the existing US Government bond portfolio. The overall process appears to be of a high quality and the historically close to the benchmark of the nominal portfolio reflects this.*"

The BPA has also been singled out in a 2006 Transparency International report as the leading government organization in Timor-Leste for its commitment to accountability and transparency. In 2009 an UNMIT advisor to the government included in his advice, "*Rather than look to foreign models of transparency and accountability it will be important to include in the list of role models those Timorese institutions which successfully model these practices, of which the Banking & Payments Authority is a particularly good example.*"

The BPA asks what might happen if the proposed "flexibility" had been in place, and an apparently reputable but crooked international financier convinces the Government to be appointed as the overall manager of the Petroleum Fund, promising greatly enhanced returns in complex financial products apparently with no additional risk. Up against such competition, the BPA would have almost certainly present the weaker case for continuing as the operational manager and the nation's wealth would run the risk of being lost.

The BPA can therefore see no rationale for introducing the proposed "flexibility" into the Petroleum Fund law, particularly because the present system is working well.

More importantly than these considerations, the BPA believes that the public interest would be best served by the National Parliament retaining the existing governance framework, and only making a change to the operational manager when all the implications of changing to an alternative model for the operational management of the Fund have been fully evaluated.

The BPA makes this recommendation based on the following considerations.

Sovereign Wealth Fund governance models

The Generally Accepted Principles and Practices for Sovereign Wealth Funds, developed by the International Working Group of Sovereign Wealth Funds (of which Timor-Leste is a founding member) known as the “Santiago Principles” identifies three basic approaches to managing a sovereign wealth fund.

The first type of SWFs is established as a **separate legal entity with full capacity to act** and governed by a specific constitutive law. Such SWFs are legal identities under public law.

The second category of SWFs takes the form of a **state-owned corporation**. These corporations are typically governed by general company law, although other SWF specific laws may also apply.

The third category of SWFs is constituted by a **pool of assets without a separate legal identity**, with the pool being owned by the state or the central bank.

The Santiago principles state, “Provided that the legal framework is sound, each of these structures can be employed to meet the requirements laid down”.

The BPA believes that the National Parliament should legislate for a single governance model and not for two or more alternatives from which the Government of the day can choose. Legislation that is ambiguous about which entity should be the operational manager cannot be defined as good legislation. Should a different governance model be deemed more appropriate, that would be the time to make appropriate amendments to the Petroleum Fund law. The BPA cautions against enacting a “one size fits all” law that would enable the implementation of any one of three categories of governance structures for the management of the nation’s sovereign wealth without taking into account the specific circumstances at the time, the attributes of each model, and the need for the law to reflect these differences.

Independence of Operational Manager

The present Petroleum Fund Law was drawn up using the “pool of assets managed by the central bank” model, and the BPA notes that the present law does not contain the necessary measures to adequately protect the Fund should an alternative governance model be implemented. For example, the Santiago principles (GAPP6) require that *“regardless of the specific governance framework, the SWF’s operational management should be conducted on an independent basis to ensure its investment decisions and operations are based on financial considerations...”*.

The Exposition of Reasons supporting the proposed amendments states that should another public entity be established to manage the Petroleum Fund, it would be independent. **However, this essential safeguard has not been proposed for inclusion in the law.**

The reason why it is not needed in the existing law is because Article 143 of the

Constitution of Timor-Leste, the BPA's founding legislation, and the recently-passed Central Bank law guarantee the independence of the central bank, so that there is no need to include an independence provision for the operational manager in the Petroleum Fund law. Another management entity, particularly a state-owned and controlled entity without independence, could be set up under the proposed amendments.

As noted above, the Petroleum Fund is currently a pool of assets owned by the state and managed by the central bank. Should one of the other two Santiago governance models be adopted, there are other issues and safeguards that would need to be considered.

The BPA recommends that the requirements underpinning an alternative governance structure should be effected by specific amendments to the Petroleum Fund law.

On the basis of these examples, quite apart from the pros and cons of the three governance models (which is a substantial subject in its own right), the simplistic addition of the words, "or any other public entity established by the National Parliament to manage and operate the Petroleum Fund" falls far short of addressing the substantive legal issues that need to be addressed in the Petroleum Fund law in the event that another model of operational management were appointed.

The BPA recommends that a change of governance model for the operational management of the Petroleum Fund should only result from extensive analysis and study including extensive public consultation, and will necessarily result in amendments to the Petroleum Fund law that take into account the specific needs of the new model.

The current model, based on the central bank as the independent operational manager, has served the nation well and there is no apparent reason for changing it.

Moreover, it seems that the proposal to change the present model of operational management seems to have as an assumption that such a change is needed to get a better return from the Fund's investments. This is not true since the return of the Fund is primarily a function of the options on the investment strategy and policy which are determined by institutions other than the operational manager, whose main role is to abide by the benchmarks defined by others.

The BPA notes with some concern that officials at the Ministry of Finance are said to be actively working on the establishment of an alternative external manager in the form of a state-owned entity and that should proposed amendment be incorporated, it would be interpreted as a mandate for the Ministry continuing its work on developing an alternative Operational Manager.

Given the pressing needs of Timor-Leste to develop many aspects of its national infrastructure and continue the necessary work to strengthen most of its government institutions, the BPA cannot understand why it is contemplated to including the "flexibility" to dismantle one of the country's most widely respected achievements (the BPA's operational management of the Petroleum Fund) and replace it with an as-yet unidentified state institution apparently established to achieve exactly the same objectives. Re-establishing the operational management of the Petroleum Fund under a new institution would not only set back the development of the Fund many years, but would restrict the Fund's ability to invest in more diverse assets during the period the institution was being established. The planning and implementation process would occupy the significant amounts of time and resources of Ministers and government officials that would achieve far greater benefits for Timor-Leste if applied to other areas of government activity.

Impact on the Central Bank

The inclusion of an alternative Operational Manager in the draft law sends a strong signal to the BPA and the public that it is the present government's intention to change the governance model, and to all intents and purposes appears to establish the BPA as little more than a transitional operational manager. Meantime, the so-called "flexibility" has created considerable uncertainty about the future within the BPA about the role of the Central Bank in the management of the Petroleum Fund, which represents the vast majority of Timor-Leste's foreign financial reserves.

Without the Ministry having such an intention — and it is possible despite rumours to the contrary that it isn't — the proposed "flexibility" would appear to serve no useful public policy purpose, and indeed has considerable potential to harm the day-to-day management of the Petroleum Fund and the close relationship that has been built between the Ministry of Finance and the BPA. Meantime, the proposed amendment hangs like the "Sword of Damocles" over the BPA.

Rumoured plans that the Ministry intends to transfer the necessary staff from the BPA to the new institution appear to be simplistic. The BPA's management of the Petroleum Fund is completely integrated into its procedures for managing its own and other state assets, and transferring the staff would seriously deplete the BPA's ability to carry out some of its other roles. Not transferring the staff, on the other hand, would mean that the Petroleum Fund runs the risk of being managed by an under-resourced entity.

While the BPA has every intention to maintain its efforts to manage the Petroleum Fund to the highest professional standards, so long as it has the mandate to do so, the potential downsides to the government's perceived intention in the proposed changes in the law:

1. The BPA's commitment to the long-term training and development of its Petroleum Fund Department and support staff in the specialist skills necessary to manage the Fund is likely to be diminished if its responsibilities for the Petroleum Fund are seen as temporary. The long-term interests of the Fund will be harmed if these necessary skills are not acquired by Timorese nationals.
2. The management of the Petroleum Fund requires ongoing cooperation and trust between the BPA and the Ministry of Finance. If the BPA perceives that Ministry officials or others are gathering detailed information about the operational management (for example, when the BPA is asked for details of its specific operating procedures) for the purpose of advancing a covert agenda to establish another operational management organization, the relationship between the two institutions will continue to be strained.
3. It seems that the justification for the amendment is that the appointment of a new operational manager would not require a change to the Petroleum Fund law, but would be enacted by an organic law of some kind. It would be far better public policy if a fundamental change to the governance structure of the Petroleum Fund were effected by specific changes to the Petroleum Fund law rather than enacting the change through another piece of legislation.
4. The preamble to the draft amendments states that the intention is to "provide flexibility regarding the entity responsible for Operational Management". The Santiago principles and good public policy call for a sovereign wealth management law that provides a clear picture of the governance structure of the nation's sovereign wealth fund, rather than permitting a menu of governance options to the government of the day.
5. While on the basis of the above arguments the BPA recommends that the central

bank be the only operational manager defined by statute until such time as parliament decides otherwise, it is possible that the government may wish to change the operational manager because it is dissatisfied with the manner in which the central bank is managing the Petroleum Fund. That would be a more appropriate time to consider making the required change to the Petroleum Fund law because the issues that gave rise to the problems, the nature of the successor manager, and which of the other two Santiago governance models would be adopted, would all be known factors that could be properly addressed in legislation.

In the meantime, the current governance arrangements of the Petroleum Fund are receiving consistent positive recognition from such monitors of international sovereign wealth funds as the Petersen Institute.

Transfer/Withdrawal Rules (Article 9)

Article 9(d): Justification for Drawings in Excess of ESI

The current law requires a government wishing to make a transfer in excess of ESI to present parliament with a “detailed explanation” to justify its request. The proposed amendment will reduce the standard to a simple “justification” and is despite the

The BPA is aware that the requirement for a “detailed explanation” has been subjected to juridical interpretation, and that this may be the motivation for weakening the criterion. Nonetheless, the proposal is not good practice in public policy.

The BPA is aware of the considerable social and developmental challenges that the government faces in the short term, and which it is addressing. Nonetheless, the BPA wishes to note from the longer-term perspective of the Petroleum Fund as an intergenerational store of the nation’s wealth (being the objective of the Petroleum Fund law unanimously approved by the Parliament) that:

- a) The drawing of funds in excess of the ESI should be on an exceptional basis, and not become the rule. The Ministry has models that demonstrate that regular drawings above the ESI will cause the Fund to be depleted.
- b) Drawings above ESI should be “earmarked” for specific investments for which a minimum rate of return (social or financial) can be clearly demonstrated.
- c) From an economic perspective, having a potentially unlimited supply of funds that can be obtained for budgetary purposes with only a limited justification tends to encourage demand, in the form of budget provisions without measurable benefits, excessive tendering prices for government contracts, and so on. This results in an environment of irrational expectations about prices and opens the door not so much to actual productive activities but to simple commercial arbitrage opportunities, both of which have the potential to fuel domestic inflation.
- d) A large percentage (a figure of 70% has been quoted) of government budget expenditure is reported to end up offshore, to pay for imports, or in the form of non-domestic investments. For this reason it would seem appropriate for the justification of excess ESI withdrawals to identify the extent to which the target projects have domestic content and/or import substitution potential.

Article 17.1: Investment Advisory Board

The existing provisions define a five-member Board comprising two ex officio members (from the Treasury and Central Bank), two experts in investment management, and one other person.

The proposal changes the composition to comprise five or more persons including three experts in investment management. Rights of participation without voting are proposed to be given to the Director of Treasury and a representative of the Operational Manager. The Board, currently appointed by the Minister, would be appointed by the Prime Minister.

The BPA reiterates the argument in its comments on Article 2.1(q) above, and notes that the apparent strengthening of the Investment Advisory Board by the inclusion of an additional expert in financial management and elevating the appointments to be made by the Prime Minister, appears to provide the Board with additional expertise and authority, while at the same time the proposed amendments would devolving some of the Board's key responsibilities for the investment policy to the Ministry of Finance.

In regard to the proposed composition of the Board, in the event that another Operational Manager were to be appointed, the central bank would have no part to play, even as a non-voting member of the Advisory Board, in the management of the nation's sovereign wealth fund which hold and manage almost the entirety of the nation's financial reserves. The central bank would thus have no right of access to economic information and planning other than that available to the general public.

The disenfranchisement of the Central Bank Governor and the Treasurer as members of the Investment Advisory Board (both of whom are proposed to have observer rights only) means that the close association in law between the investment of the Petroleum Fund and Timor-Leste's fiscal and monetary authorities would be significantly reduced.

The BPA notes that the Investment Advisory Board has operated effectively since its formation and has facilitated the diversification of the Fund across two major asset classes (international bond and global equities) within the limits of the present law. The Board has also made important progress by publishing its beliefs and principles, demonstrating its commitment to conducting its role in a transparent and prudent manner.

The Exposition of Reasons states, "The Director of Treasury and the director of the Operational Manager shall be ex-officio members of the Board". The BPA agrees that this should be the case, as at present. However, under the proposed amendment they are not members of the Board, but non-voting participants in the Board's meetings.

Furthermore, the BPA is not convinced that having the Board members appointed by the Prime Minister on the advice of the Minister will materially improve the manner in which the Board operates. Of more importance is the simultaneous disenfranchisement of the Treasurer and the Head of the central bank, which takes the two key players responsible for the nation's fiscal and monetary policy out of the Investment Policy setting process for the nation's long-term foreign reserves.