



Office Memorandum

To: Mr. Ekeli

From: Paulus Dijkstra

Subject: **Timor-Leste – MFD Suggestions on Draft Law on Petroleum Fund**

Please find below MFD's comments on the draft law on the Petroleum Fund (PF) of Timor-Leste, revised to reflect our phone conversation of March 10, so that they can be published and shared with the Petroleum Fund Steering Group.

Investment guidelines

In principle, we would argue that specific wording on the investment guidelines should generally not be incorporated in law, as it inhibits necessary adjustments in the allocation of the investment portfolio over time. Moreover, the investment guidance as included in the draft law is too conservative for a fund with a longer-term orientation. It entails paying a premium for liquidity that is not needed and too little scope is available for diversified exposure to an appropriate level of investment risk and return.

However, we do understand that in early stages the PF should have a relatively low level of investment exposure as the capacity in investment management needs to be build up and the risk of adverse policy reactions to negative investment outcomes shortly after the inception of the Fund. We also understand that the current guidelines are intended to be of a temporary nature and that the intention is to broaden the investment universe once sufficient strategic asset allocation skills have been developed and a proper understanding of risk-return trade-offs over the relevant investment horizon is gained by the decision-making bodies.

Against this background, we fully support the idea to move the guidelines to the Transitional Provisions of the law to emphasize their temporary nature. We also strongly suggest to:

- Reflect in the Transitional Provisions that the motivation for the investment guidelines is to ensure a cautious investment risk profile at the outset of the PF, which is appropriate in the near term given the current high-risk aversion of the authorities in light of the prevailing circumstances in Timor-Leste, but that this entails potentially significant opportunity costs over the longer term.
- Clearly state that the intention is to broaden the investment universe at the time of a future review of the guidelines and to remove too specific wording on investment guidelines from the law, contingent on the existence of sufficient investment management expertise in the relevant institutions at that time.

Decision-making framework regarding Strategic Asset Allocation

Currently, the draft law envisages that the Minister takes decisions on strategic asset allocation (SAA), based on advice of the Investment Advisory Board (IAB). In principle, we would favor enhancing the role of the IAB by having it decide on the SAA instead of the Minister. The MoFP should then have a controlling seat in the IAB and have the power to dissolve it in case of clearly inappropriate decisions. That way, the Minister would retain effective strategic control over the investments of the PF, while at the same time being shielded against direct criticism. The current model risks exposing the Minister to direct criticism on the short-term performance of the Petroleum Fund and is therefore not very conducive of effectively adopting a longer-term investment horizon. However, we understand that there is currently little political support for strengthening the decision-making power of the IAB. As a necessary prerequisite for the current model to work, we would emphasize the importance of publishing the strategic asset allocation advice of the IAB, perhaps with a certain time lag, as we understand is being currently considered. This way, the Minister will have a strong incentive to follow the advice of the IAB, and they can focus on a longer investment horizon.

Cc. Mr. Das, Mr. Mulder, Mr. Nyawata