

Role of Central Banks in Managing a Country's Natural Resource Revenues: Investment and Institutional Considerations

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Key questions to ponder during this session

- What role(s) should CBs play in managing a country's SWF assets?
- What are key advantages for CBs to manage sovereign assets?
- What are the main shortcomings and how to overcome them?
- What are relevant lessons from different institutional arrangements?
- What are the key implications for each of your institutions?

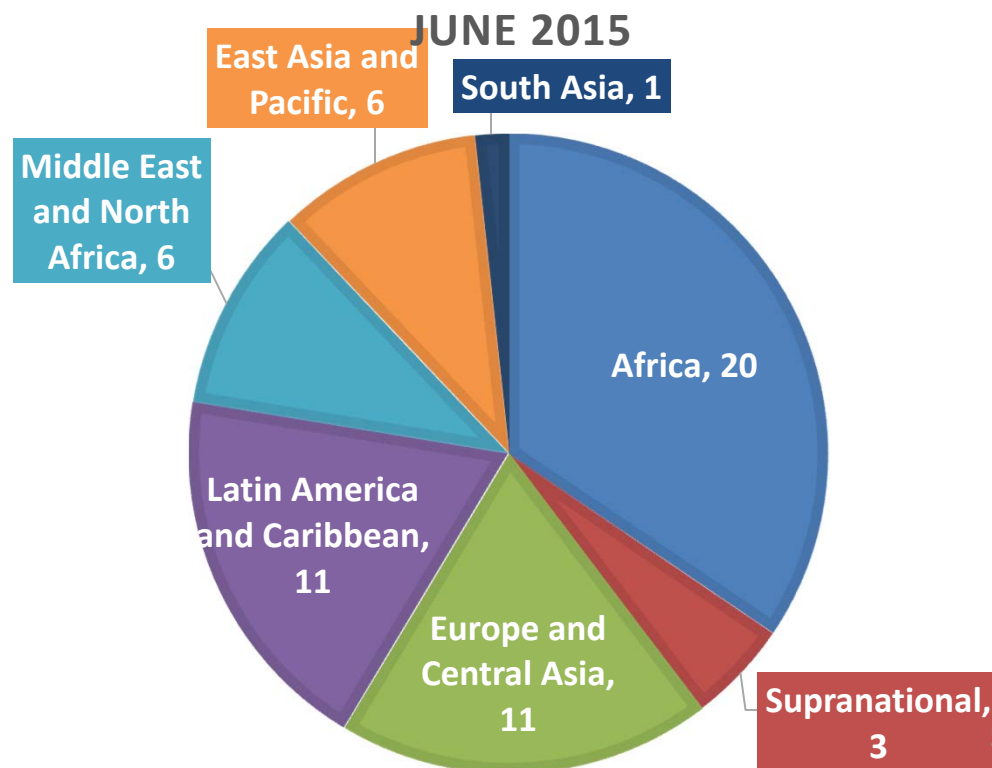
- World Bank Treasury and its engagements with Central Banks (CBs) and Sovereign Wealth Funds (SWFs)
- International best practice principles in a SWF institutional set-up and role of CBs
- Select country examples of SWF institutional set-ups
- Key takeaways

World Bank Treasury and its engagements with Central Banks
(CBs) and Sovereign Wealth Funds (SWFs)

Reserves Advisory and Management Program TREASURY THE WORLD BANK

- RAMP assist official sector institutions in upgrading internal capacity to manage the foreign currency reserves effectively and efficiently
- As of June 2015 total of 58 RAMP members:
 - Central Banks with foreign currency reserves from \$800 million to > \$400 billion
 - Sovereign Wealth Funds
 - Public Pension Funds
 - Multilateral Organizations

NUMBER OF RAMP CLIENTS BY REGION

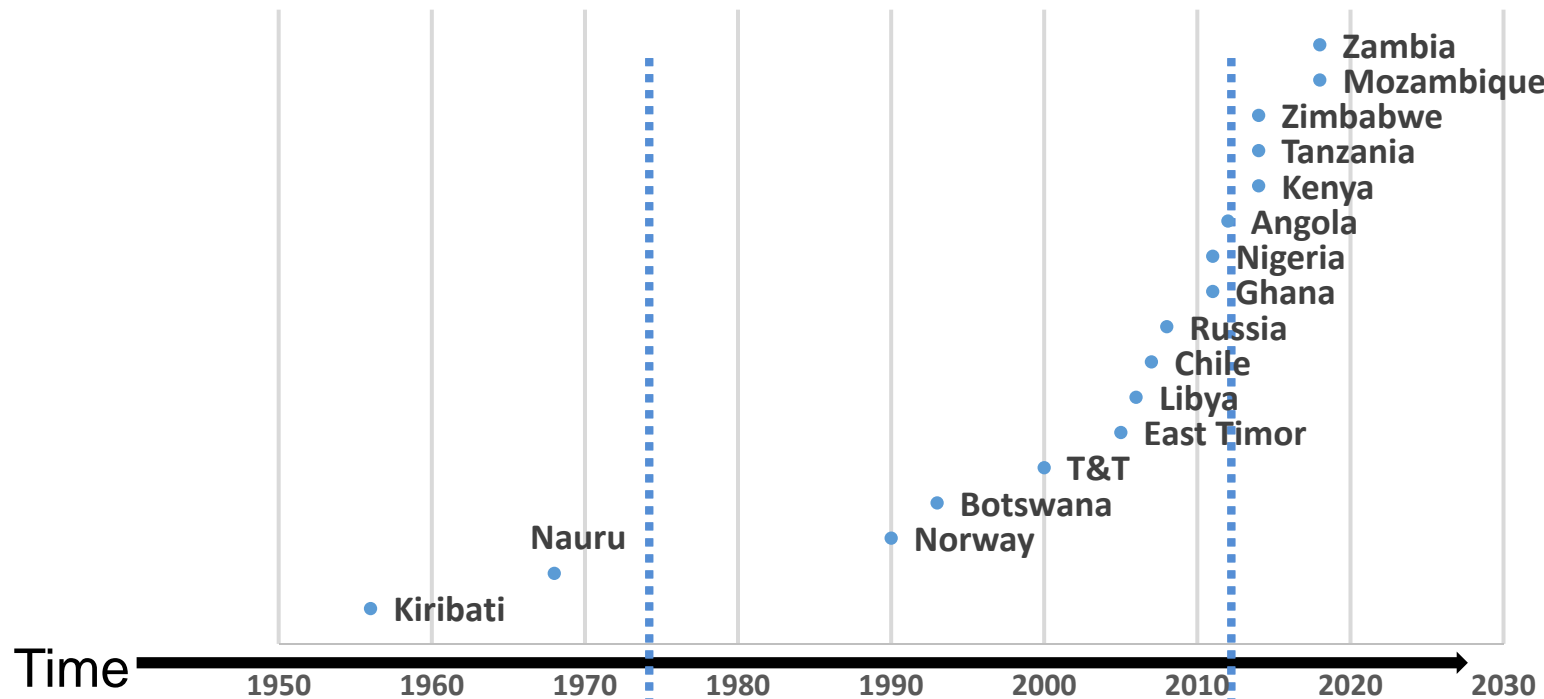


RAMP engagements with CBs and SWFs

- RAMP has been involved in developing capacity and improving investment management operations since 2001
- Long-term engagements with public institutional from the most senior level to the technical level on issues ranging from governance to investment operations
- African CBs are the largest RAMP constituency
- Growing involvement with SWFs across all regions at different stages of SWF institutional development: from conceptual stage to implementation of institutional design blueprints to assisting in expanding existing operations for well established institutions
- Practitioner approach founded on practice and lessons from well run institutions with focus for long-term sustainability and impact

International best practice principles in a SWF
institutional set-up and role of CBs

SWFs: paradigm shift over time



Pioneers:

- Natural resources exhausted
- Kiribati's financial assets are about 400% of GDP; no CB in the country
- Nauru's financial assets fully depleted

"Classical" SWF design:

- Focus predominantly on foreign financial assets
- MOFs retain ownership
- CBs manage SWFs assets
- Growing sophistication of investment management operations

Future:

- Increasing focus on domestic investment
- Expectations of lower international market returns and higher risks going forward
- High level of volatility in commodity prices

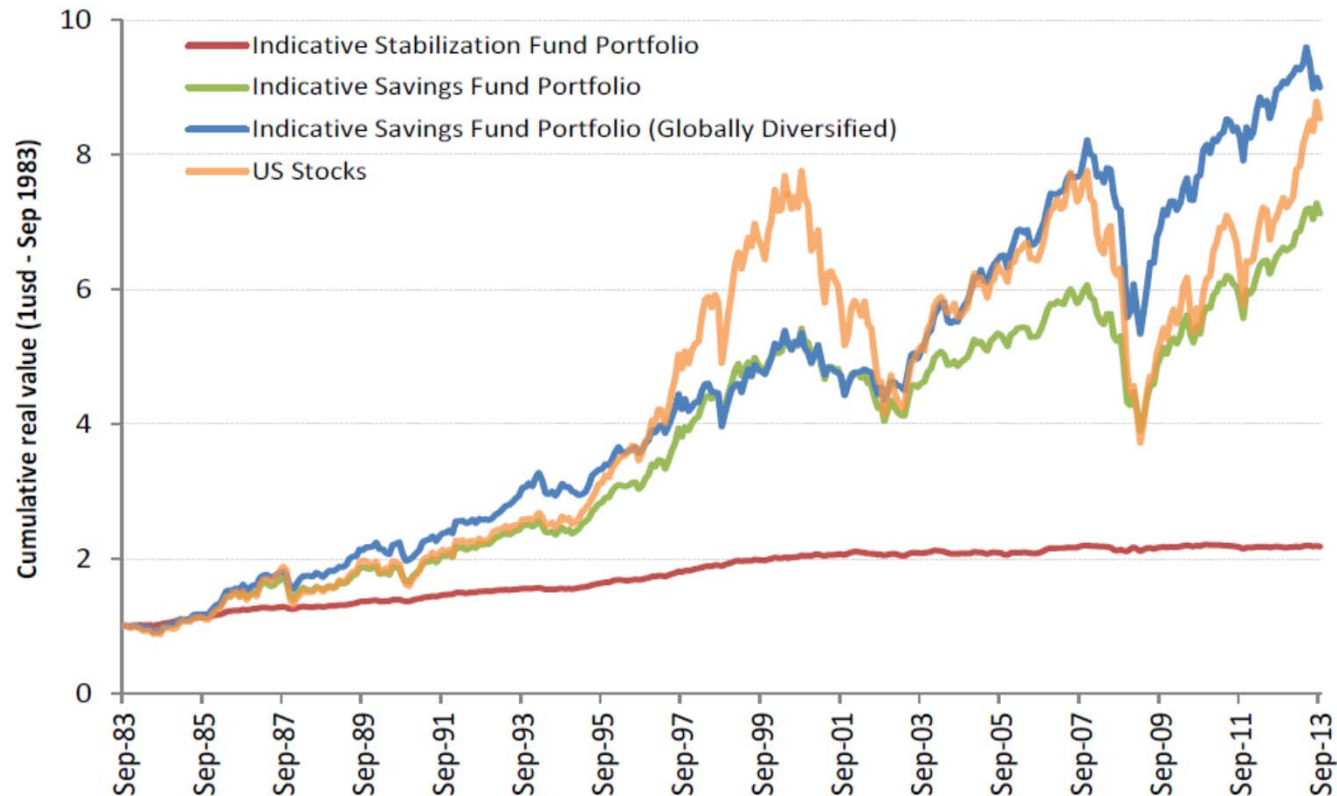
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- The governance arrangements to manage SWFs cover a wide spectrum of possibilities, with varying degrees of independence from government, in order to balance two competing demands:
 - informed policy making and ownership of the risk/return profile of the portfolio to meet its strategic objectives at the highest level of sponsorship; and,
 - delegation of authority and accountability for implementation to an specialized financial management entity
 - The lack of an appropriate framework to segregate policy decisions from implementation can lead to imposing inefficient constraints on investments that are inconsistent with the investment horizon and risk tolerance of the SWF

The strategic objectives of a fund are key to defining its investment habitat

	CB Core Reserves & Stabilization Funds	Future & Endowment Funds	Domestic Development Funds
Objective	Cover unexpected Balance of Payments outflows or budget shortfalls	Preserve capital in real terms for future generations or to generate alternative sources of revenue	Economic development and growth creation
Investment horizon	Short term	Long term	Medium to long term
Return Target	Prevailing nominal returns	Long term real return target	Total returns with economic and social focus
Risk Tolerance	No negative nominal returns over the investment horizon	Not meeting the real return target over time	Not achieving expected economic impact

Increasing tolerance for short term risk and decreasing need for liquidity

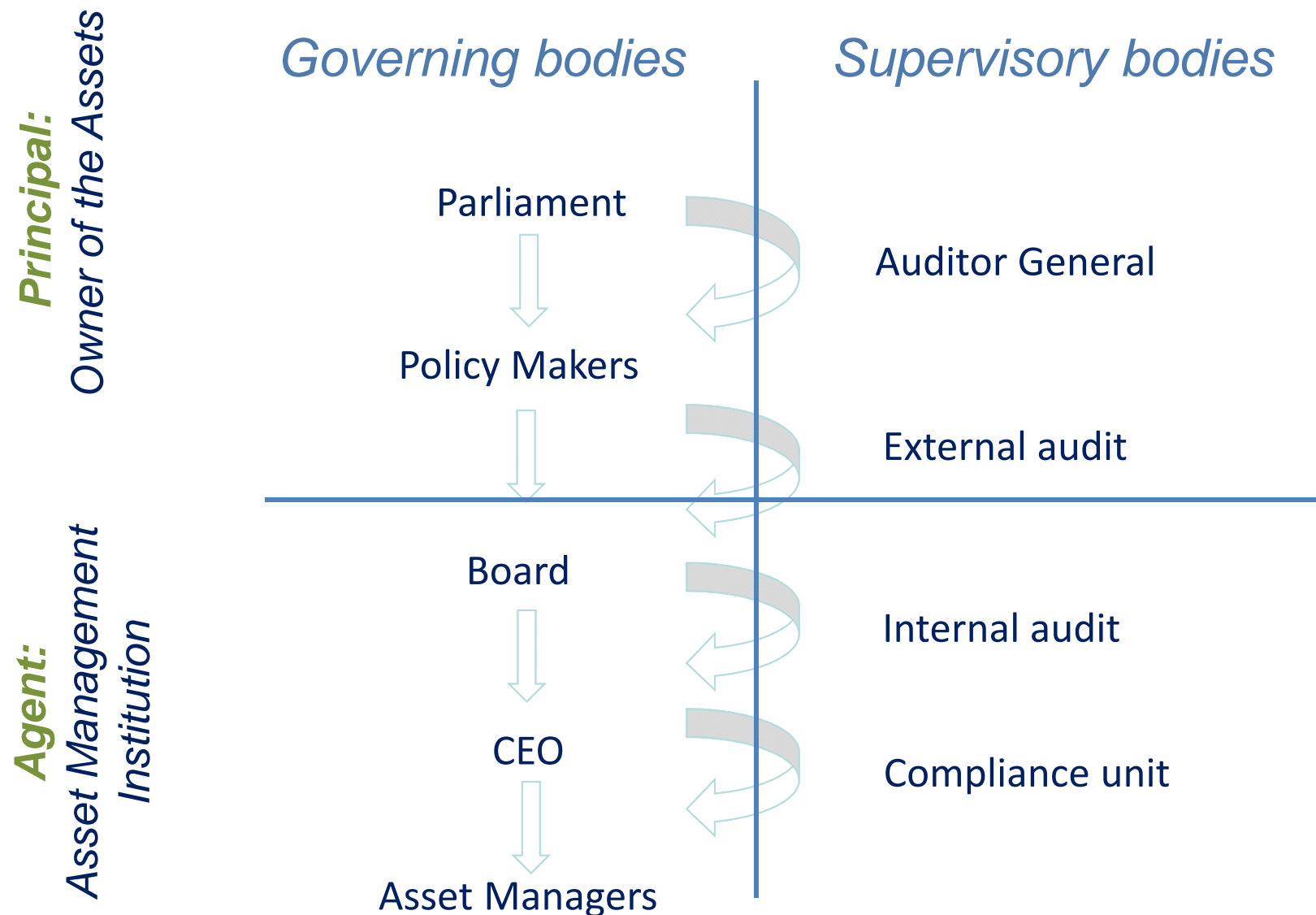
The strategic objectives of a fund are key determinants of wealth over the long run



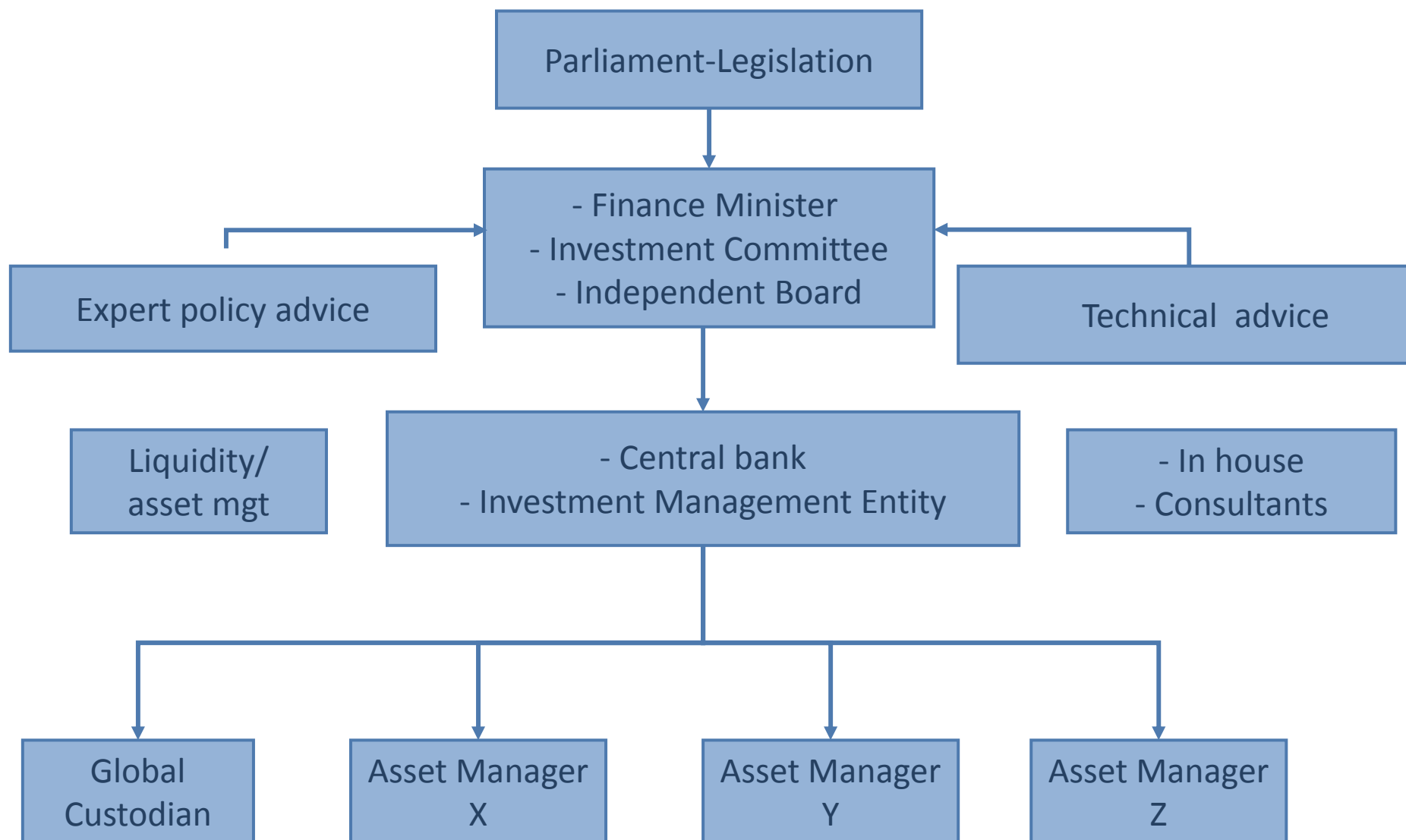
- Indicative stabilization portfolio is represented by 90% short duration US Treasuries and 10% US Stocks
- Indicative savings portfolio is represented by 60% US Stocks, 20% US Treasuries and 20% US Corporate bonds
- Globally diversified savings portfolio is represented by 40% Developed Market Stocks, 10% Emerging Market Debt, 5% Commodities, 20% US Treasuries and 20% US Corporate bonds

- Clarity of institutional objectives formulated in the legal mandate
- Informed policy making and ownership of the risk/return profile of the portfolio at the highest level of sponsorship
- Clear delegation of authority and accountability for implementation to an specialized asset management entity
- Effective controls and oversight supported by well recognized standards of prudential care
- Transparency and communication

Stylized general SWF governance structure



How different SWFs have managed their governance and institutional arrangements



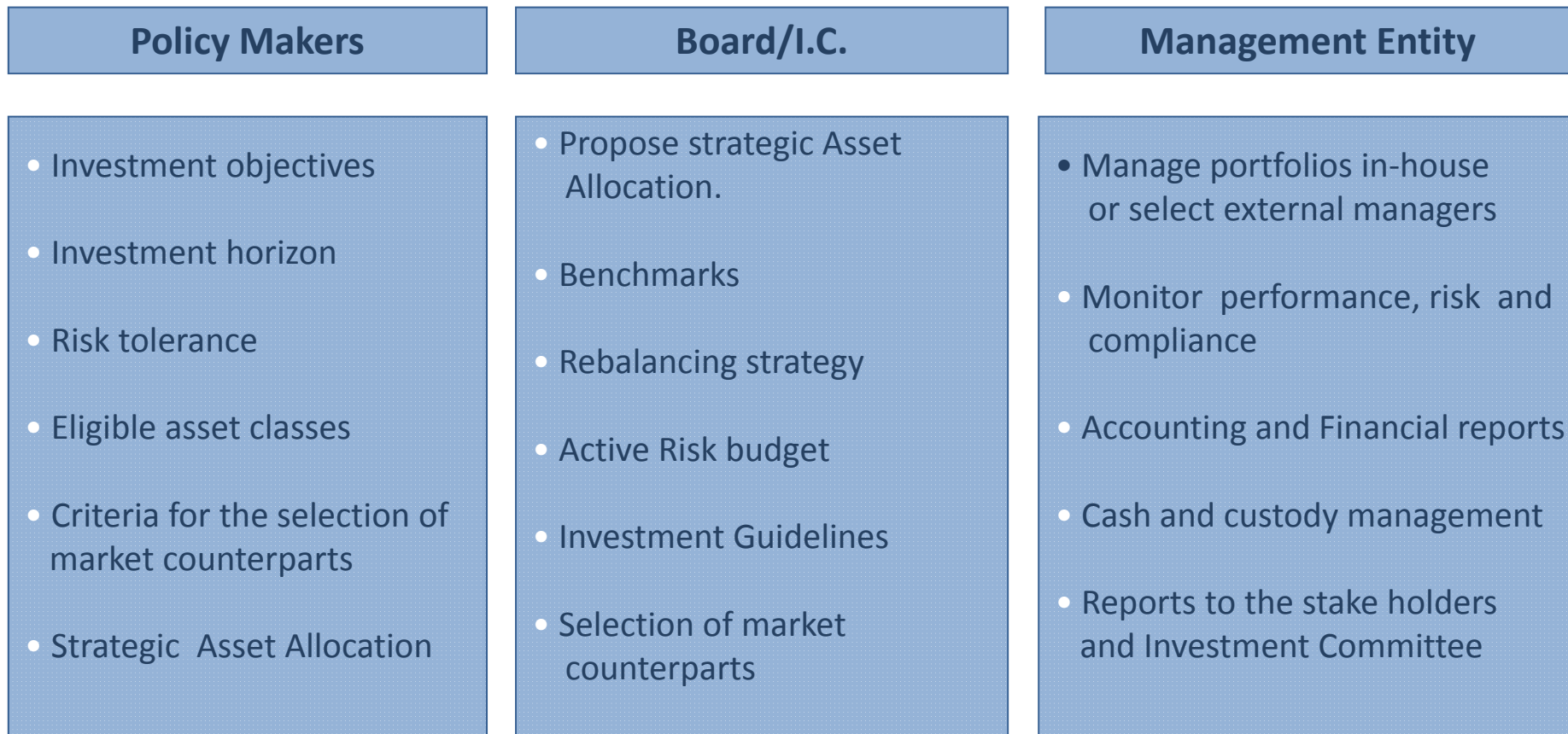
Governance: who makes which decision?



Illustration of segregation of responsibilities between policy making and implementation

Policy setting

Implementation



Considerations for investment management entity to manage SWF's assets

- **Institutional mandate:**
 - One objective-one instrument, multiple objectives-one instrument or multiple objectives-multiple instruments?
- **Institutional autonomy:**
 - Independence from political interference
 - Budgetary arrangements and procurement procedures focused on enhancing the investment management process
- **Legitimacy and operational capacity:**
 - Creating the necessary conditions for the entity to develop over time supported by best practice asset management processes and investment infrastructure
- **Ability to attract and retain qualified staff:**
 - HR policies and competitive compensation schemes to attract and retain financial specialists to foster a performance based management culture
- **Legal issues:**
 - Impact of institutional set-up on sovereign immunity and the risk of attachment
 - Impact of international and domestic regulations
 - Impact on market counterparties' abilities to enter into and enforce the contracts with the entity

Central Banks as a delegated asset manager for SWF assets

- Institutional autonomy:
 - CBs tend to be most independent technical institutions from the government
- Legitimacy and operational capacity:
 - By managing the country's FX reserves, CBs have established:
 - institutional history and track record
 - investment processes and infrastructure
 - market access, market counterparties and relationships
 - Need to expand existing technical capacity from reserves/liquidity management to more advanced asset management
- Ability to attract and retain qualified staff:
 - In developing countries CBs tend to be the centers of financial management expertise in the country
 - In countries with weak financial sector, CBs tend to hire the most qualified staff in the country
 - Public sector regulations and HR policies are seen as a significant constraint to retaining talent or attracting advanced asset management skills
- Legal issues:
 - CBs offer the strongest immunity for assets due to its internationally recognized mandate
 - Market counterparties have existing legal contracts/relationships with CBs

Independent entity as an asset management company for SWF assets

- **Institutional autonomy:**
 - Critical to ensure *de facto* and *de-jure* independence from political interference through appropriate governance mechanisms
 - Will need to develop budgetary arrangements and procurement procedures focused on enhancing the investment management process
- **Legitimacy and operational capacity:**
 - New institution with no legacy relationships will offer an opportunity to implement the current best industry practices
 - On the other hand, they will need to establish credibility and operations with the market and international community
- **Ability to attract and retain qualified staff:**
 - Specialized asset management entity may enable access to required skills that are typically scarce in the public sector
 - HR policies are not constrained by public sector rules and regulations
- **Legal issues:**
 - Legal matters related to immunity, taxation and entering into contracts with counterparties need to be assessed carefully as an independent entity would be subject to international and domestic regulation

CBs vs. independent institution: key considerations

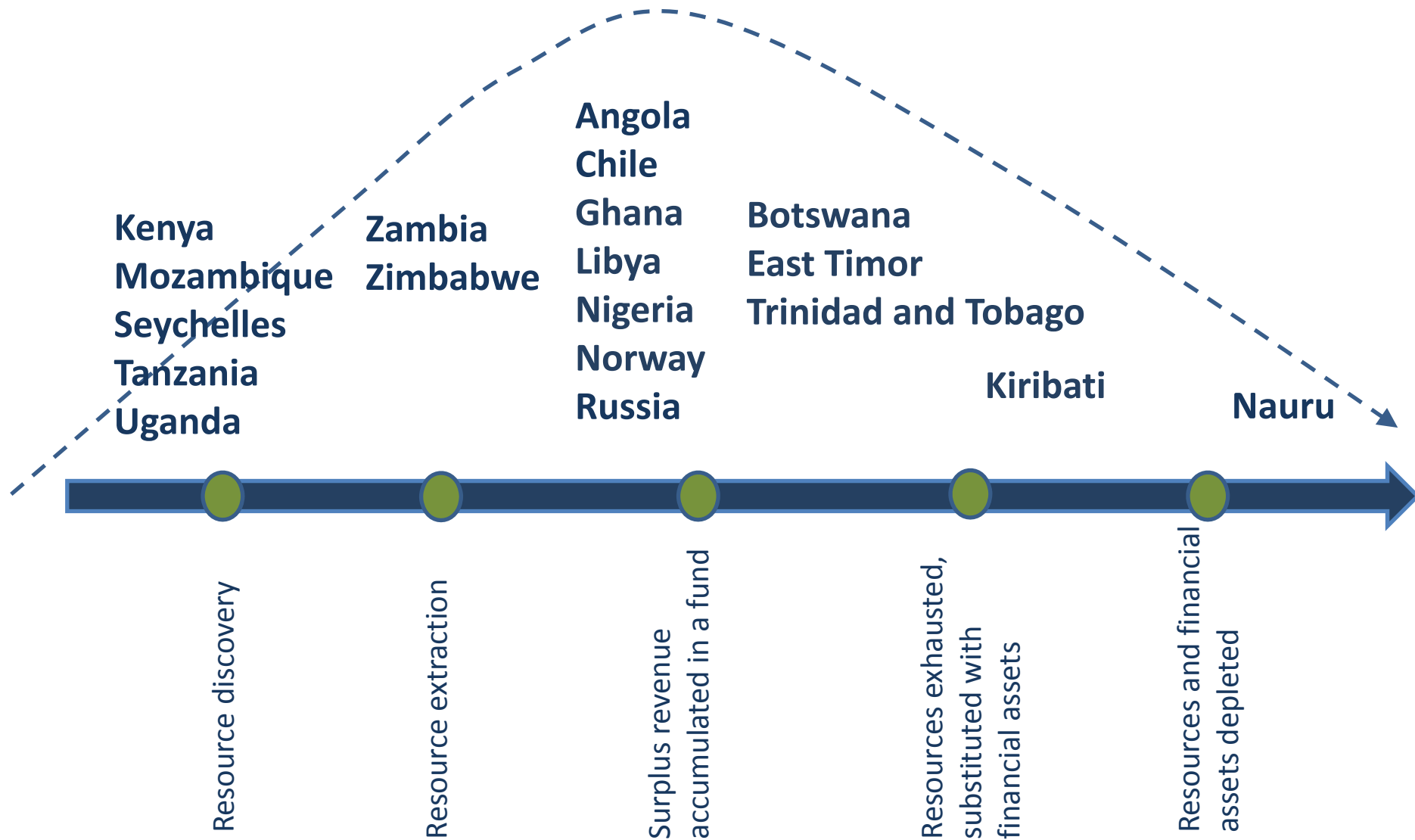
	Central Banks	Independent Entity
Institutional autonomy	Track record of financial independence	Mixed record and examples of institutional failures
Legitimacy and operational capacity	Leveraging of existing governance and operational infrastructure	Need to build and enable institutional development consistent with best practice
Legal issues	Strongest immunity protection	Requires careful examination
Investment management capacity	Not the core mandate; typically constrained to liquidity management	Potential to develop advanced investment management capacity
HR and personnel	Limited by public sector rules and regulations	Not constrained by public sector rules and regulation

Use of country's institutions: country examples

- Central Banks as the sole asset managers for SWF assets:
 - Predominant model in SWFs institutional design until recently: Chile, Ghana, Norway, Russia, Trinidad and Tobago, etc.
 - Different treatment within CBs:
 - Commingled with FX reserves: Botswana, Romania, Russia
 - Segregated government accounts with CBs: Congo, Ghana
 - Separate dedicated departments to manage SWF assets: Norway, TnT
- Delegation of implementation to a specialized independent entity:
 - Separate Agency managed at arms-length from government : Australia, New Zealand, Singapore, South Korea
 - Typically in countries with relatively developed financial sector
 - Recently established funds: Angola
 - In countries with no CBs: Panama
- Other institutional variations are based on countries' specific circumstances:
 - Multiple institutions within the country based on funds' distinct objectives
 - MoF in Kiribati (and other pacific islands) is responsible for policy and its implementation as the country has no CB and no financial industry

Select country examples of SWF institutional set-ups

Stylized life cycle of resource funded SWFs: select examples



Ghana: design of petroleum funds

- Timeline:
 - June 2007- oil discovery
 - Q1 2010-first oil production
 - 2011-funds start flowing to the fund

GHANA STABILISATION FUND

Objective

- To sustain public expenditure capacity during periods of unanticipated revenue shortfall

Source of Funds

- 70% (Petroleum revenues in excess of ABFA)

Investment horizon

- Short term

GHANA HERITAGE FUND

Objective

- To provide an endowment to support development for future generations

Source of Funds

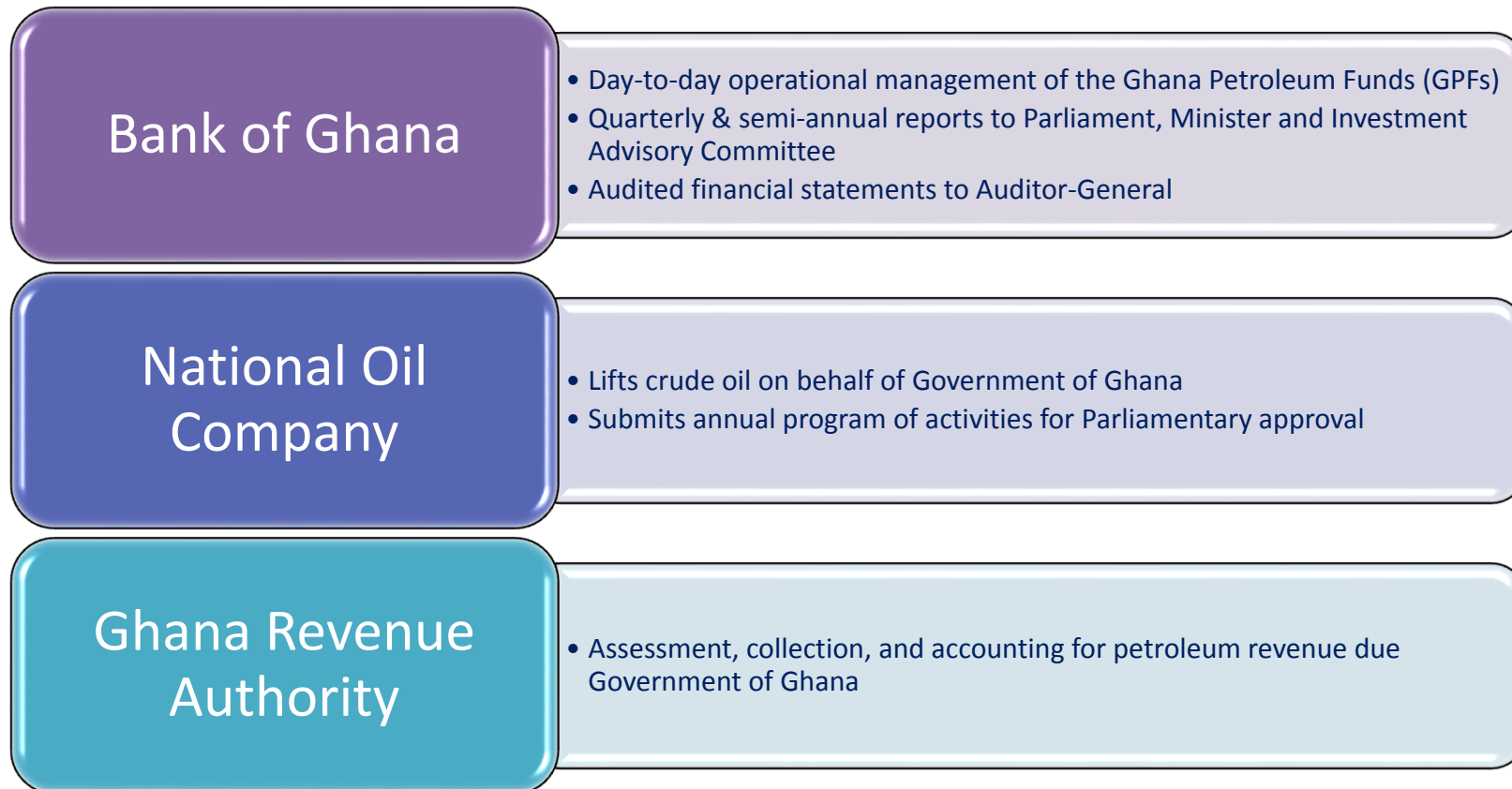
- 30%(Petroleum revenues in excess of ABFA)

Investment horizon

- Long term

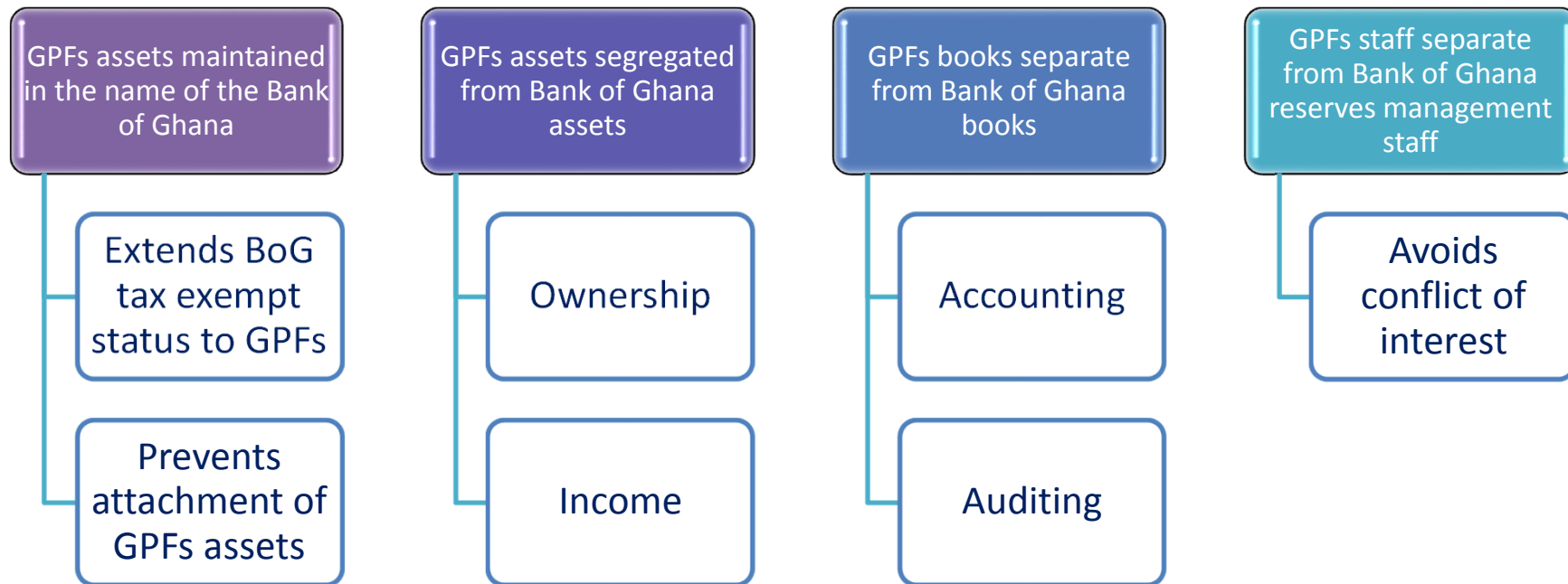
Ghana: governance arrangements

- Roles and allocation of responsibilities



Source: Nana Aba Ashun, Head of GPFs Secretariat, Bank of Ghana

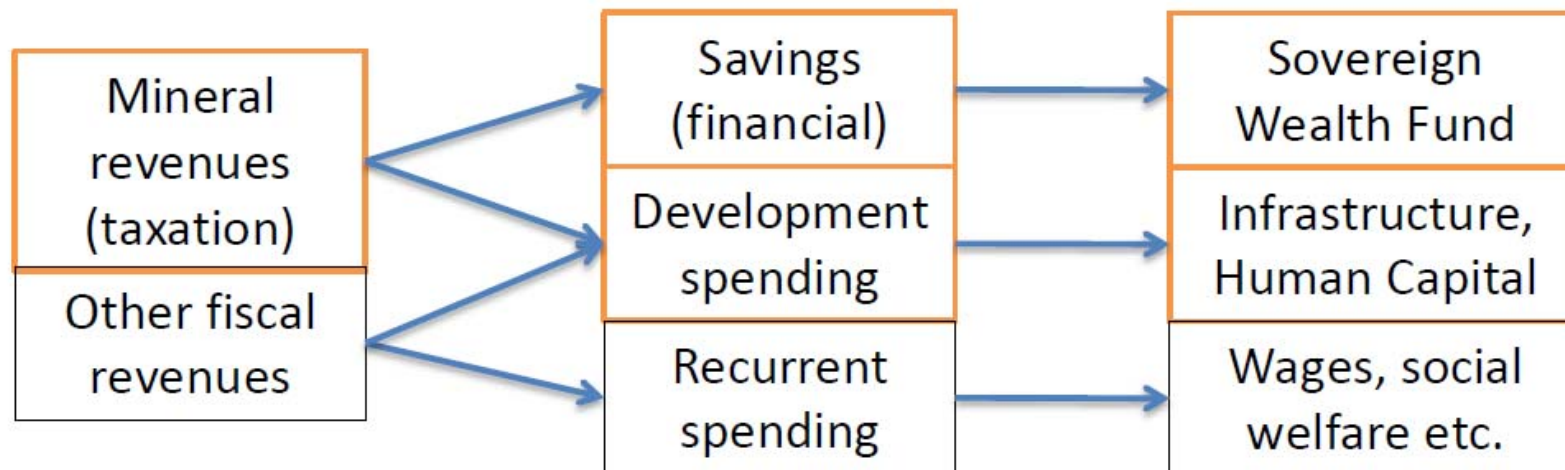
Ghana: operational management principles



Source: Nana Aba Ashun, Head of GPFs Secretariat, Bank of Ghana

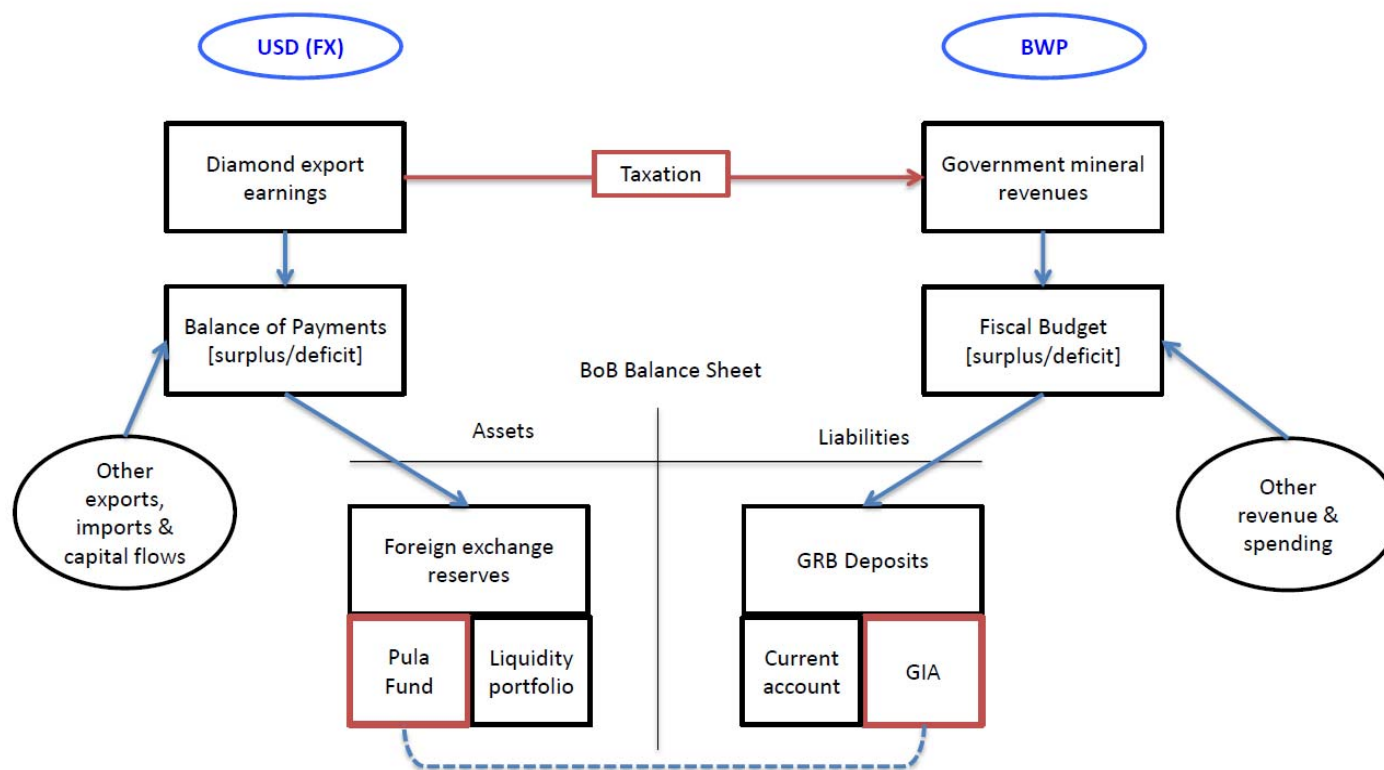
Botswana: management of revenue flows

- Mineral revenues very large relative to total government revenue and GDP, although well below peak
- Key management principles:
 - Investment of mineral revenue in accumulation of assets: financial, economic, human and social
 - Ensure accumulation of financial assets
 - Counter-cyclical fiscal policy
 - Respect absorptive capacity constraints
 - Public investment project must be subject to appraisal and funds only made available to projects with identified commercial returns



Botswana: operational arrangements

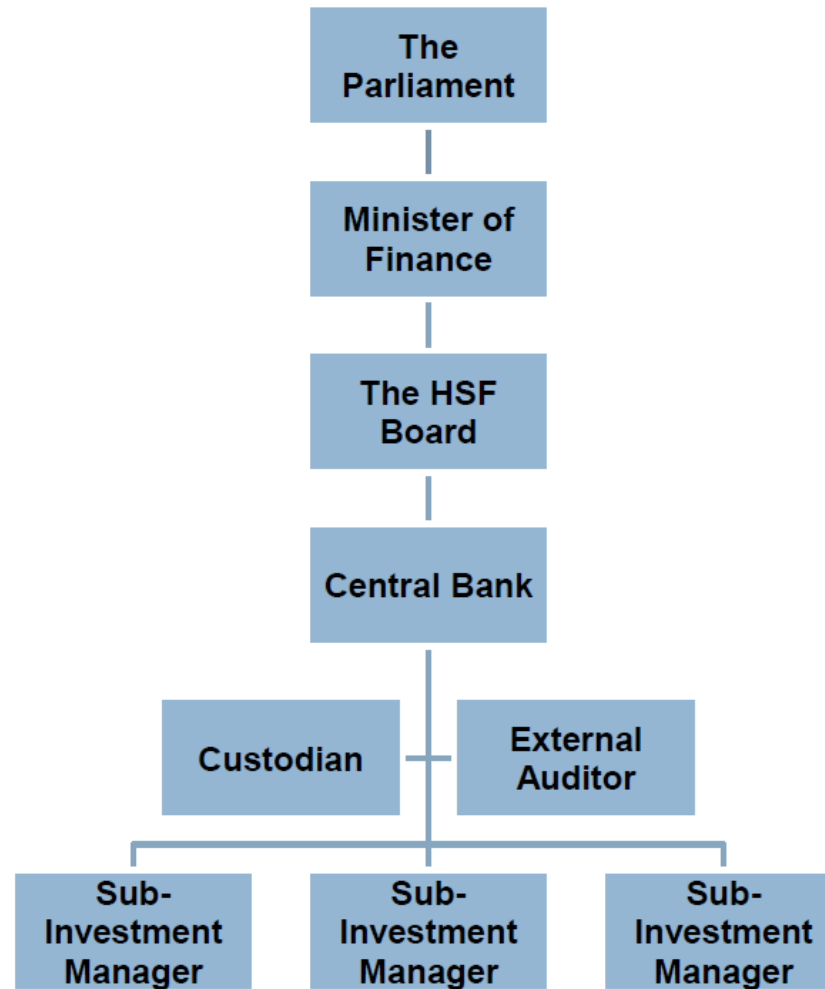
- Surplus financial assets are held in account with the central bank
 - Not a legally separate SWF; a sub-division of central bank balance sheet
- Assets invested in foreign assets, commingled with FX reserves
- Invested in global bonds and public equities with long investment horizon
- Both in-house managers and contracted external asset managers



- HSF Act was approved by Parliament in 2007
- The HSF is both a stabilization and a savings fund. The rationale behind this dual purpose Fund is to:
 - Insulate fiscal policy and the economy from adverse swings in international oil and gas prices (the stabilization objective)
 - Accumulate savings from the country's exhaustible assets of oil and gas for future generations (the heritage element)
- HSF Act defines, inter alia:
 - a savings Rule
 - a withdrawal Rule
 - a clearly defined governance and disclosure or reporting regime
- The Central Bank is appointed as Fund Manager, but outsources the function to external fund managers
- Quarterly reporting by the Board to the Minister of Finance, who in turn provides an annual report to the Parliament
- Annual audit of the Fund by the Auditor General's Office

Source: Ewart Williams, Former Governor, Central Bank of TnT

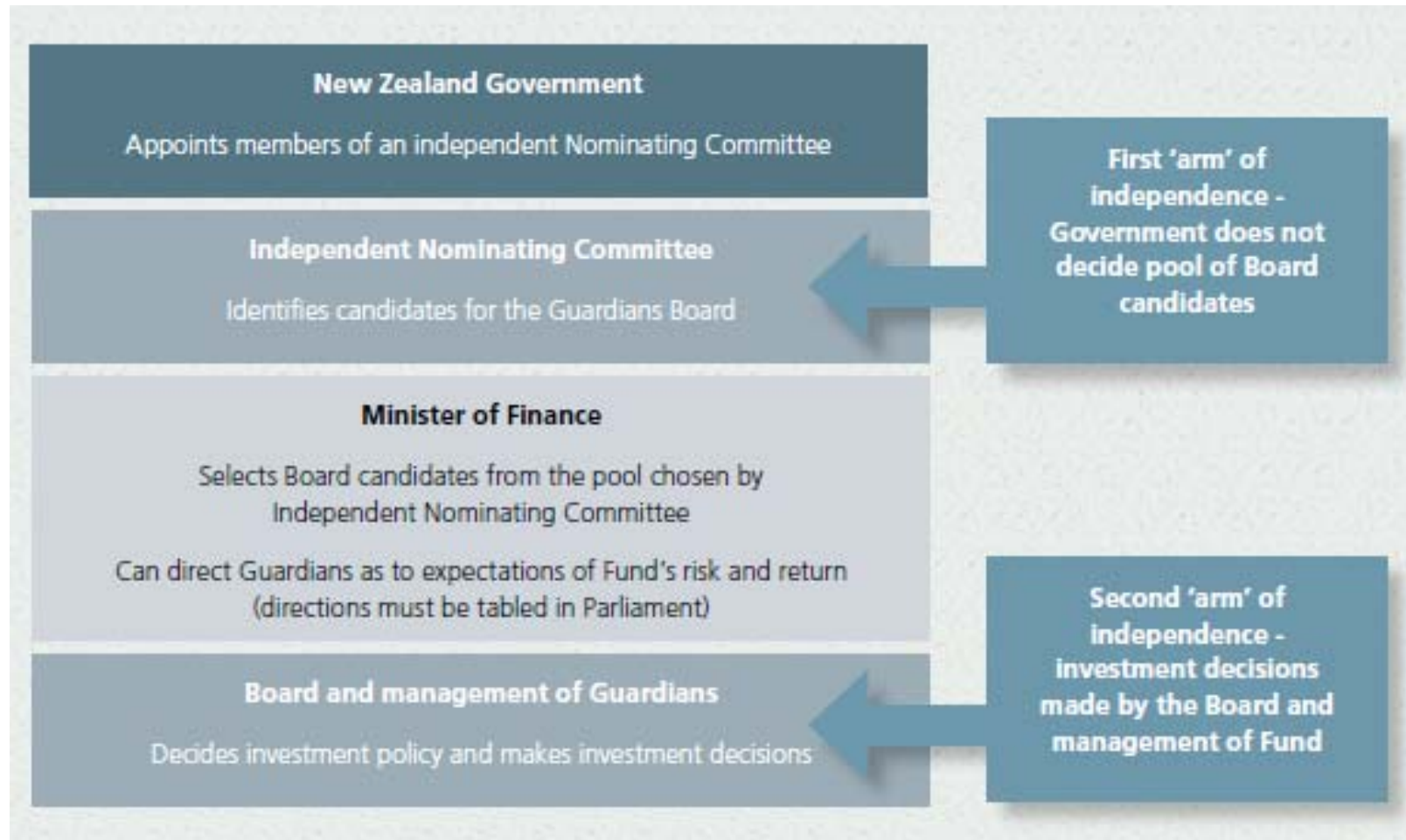
TnT: institutional arrangements



Source: Ewart Williams, Former Governor, Central Bank of TnT

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- **Sovereign status:** the fund is a pool of financial assets wholly owned by the Government and the Fund obtains sovereign tax status:
 - Beneficial taxation treatment
 - Regarded favorably by counterparts and it can position the Fund well as a potential co-investor of choice within New Zealand
 - **Independent investment responsibility:** the legislation created the fund and established investment independence from the Government
 - The fund to be invested on a purely commercial basis
 - The Government may only express their expectations of the Fund's overall risk and return
 - **Certain liquidity profile:** the cash into and out of the Fund is governed by a public funding formula
 - **Long investment horizon:** investment structure is designed to exist for many decades
 - More tolerance to market volatility
 - Additional flexibility to invest in assets with longer-term return characteristics

New Zealand: “double-arm” length autonomy in organizational structure



Source: Tim Mitchell, Head, New Zealand Superannuation fund

New Zealand: key lessons from establishing a specialized entity

- **Governance matters**
 - Long horizon investing will struggle in the absence of sound, aligned, governance
 - Governance arrangements must be strong enough to avoid prematurely stopping out of positions
 - Clarity around roles and responsibilities between Board and management is critical
- **A clearly articulated risk appetite is essential**
 - Ideally by sponsor but at least by Board
- **Incentives matter**
 - Alignment of staff to Fund objectives is critical
 - Avoid over-paying external managers for risk premia you can obtain very cheaply

New Zealand: key lessons from establishing a specialized entity, cont.

- **Ongoing education is critical**
 - Investment programs can be complex
 - Staff live them everyday; board members perhaps a dozen times a year
- **Transparency helps**
 - Proactive communication supports stakeholder alignment
 - Transparency imposes a discipline for clearly articulated strategy
- **Strong peer relationships help**
 - No need to reinvent the wheel
 - Peers generally happy to knowledge share
- **Growth is evolutionary**
 - Avoid jumping to a complex solution
 - Start simple and allow the investment program complexity to evolve with organizational (and governance) capacity

Key takeaways



There is no single right model for the institutional set-ups to manage a country's SWF and the country specific context matters

- The guiding principles include:
 - Institutional mandate and the fund(s) objectives
 - Institutional autonomy and independence from political interference
 - Legitimacy and operational capacity
 - Legal and sovereign immunity issues
 - Ability to attract and retain qualified staff
- Possible institutional arrangements
 - CB and various asset management arrangements within
 - Independent specialized entity
 - Combination of multiple institutions targeting specific mandates and fund objectives

Regardless of specific institutional arrangements

- The governance arrangements to manage SWFs cover a wide spectrum of possibilities and should balance two competing demands that should be clearly segregated:



Informed policy making:

- The stakeholders should clearly articulate and disclose to the public, the broad strategic criteria governing the management of the funds



Delegation of authority and accountability for implementation:

- The institutional arrangements for managing the funds should be dedicated, specialized and shielded from political interference to facilitate a stable stewardship over the management of the funds

Regardless of the institutional arrangements (continued):

- ➔ • **Transparency, communications and public education** are key to consolidate the purpose and objectives of the SWF, as well as manage political expectations
- ➔ • **Independent, knowledgeable and effective oversight mechanisms** should be in place to review the activities of the SWF following prudential standards of care

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