

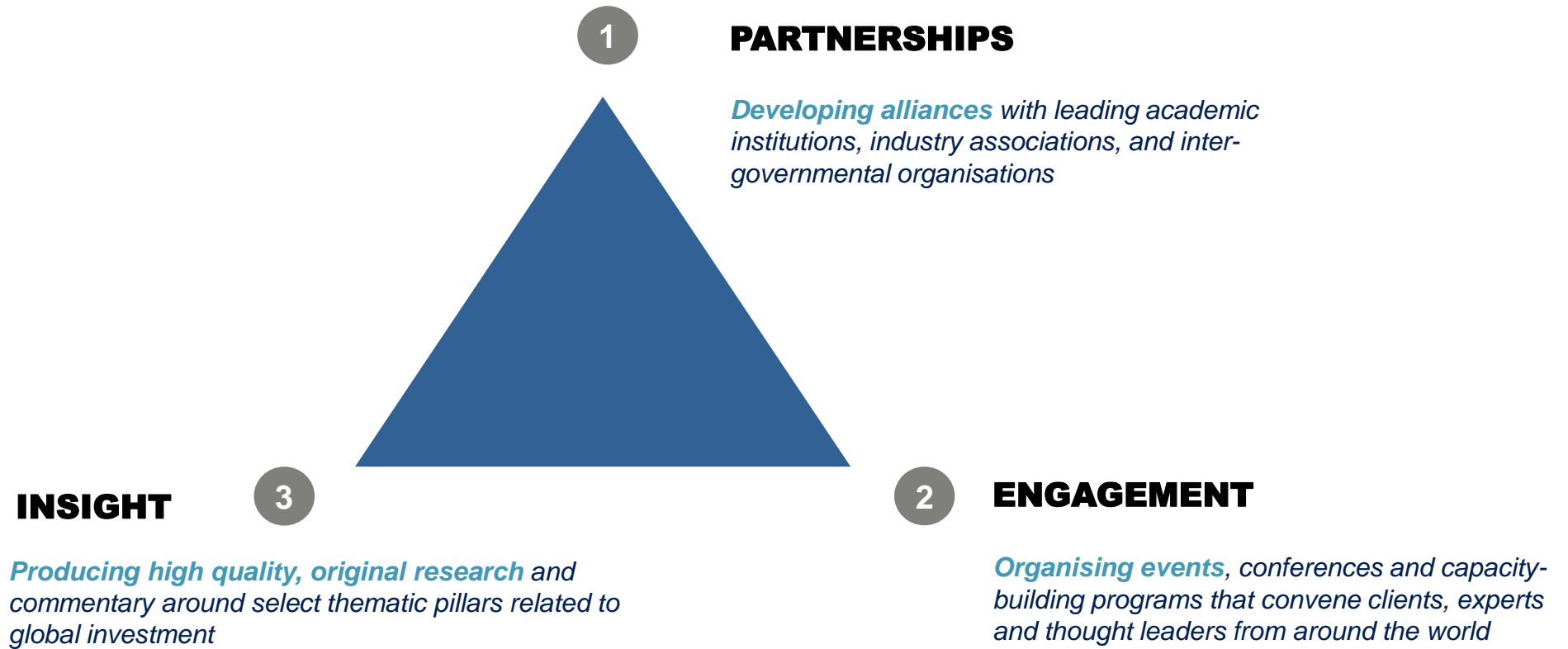
INVESTMENT INSTITUTE



The case for SWFs in Africa

MEFMI Region
Central Bank Governors' Forum
27 June 2015 Basel

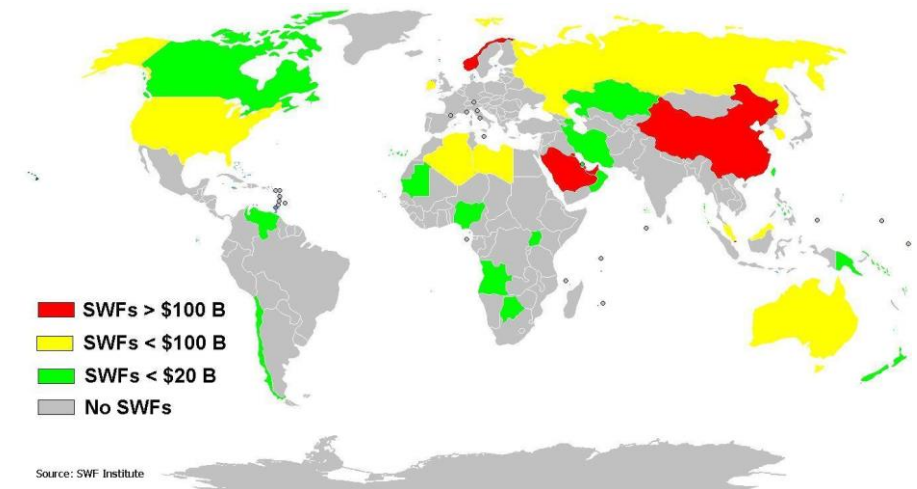
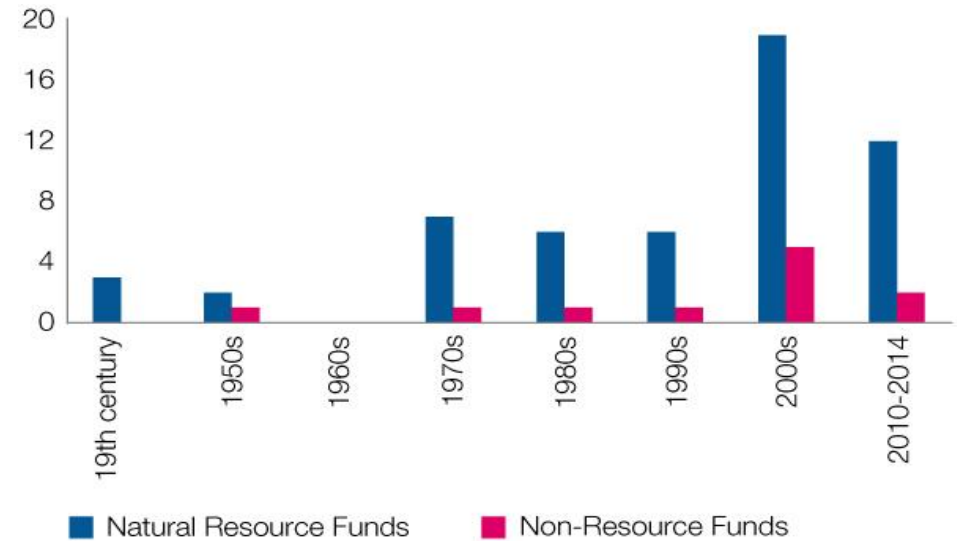
Introducing the Investec Investment Institute



The goal of the Investment Institute is to provide unique partnerships, insight and engagement that support investment decision-making across geographies and asset classes

The growth of new SWFs

- A number of very established, large funds
 - Proliferation of new funds since 2000
- Aggregate AUM of \$4-6 trillion
- Massive economic diversity amongst countries with SWFs
 - Richest countries: Norway, Canada, US
 - Poorest countries: East Timor, Papua New Guinea
- Africa is the new growth area for SWFs



Source: Investment Institute, Investec Asset Management

Project background: who, what and how

Who

- Investec Investment Institute and Harvard's Kennedy School of Government
- Center for International Development: **Prof. Ricardo Hausmann**
- Belfer Center: **Dr. Khalid Alsweilem** (former Director-General for Investments at Saudi Arabian Monetary Agency)



What

- Defining and classifying “sovereign investor models”
- Macroeconomic policies: spending, stabilisation and savings public (particularly resource) revenues
- Governance and implementation



How

- Macro model: developed with Harvard team for resource-based SWFs
- Case studies of governance of 12 leading sovereign funds
- Interviews and peer reviews with 15 global SWF experts and practitioners

Case studies

Profiles of 15 leading sovereign investors

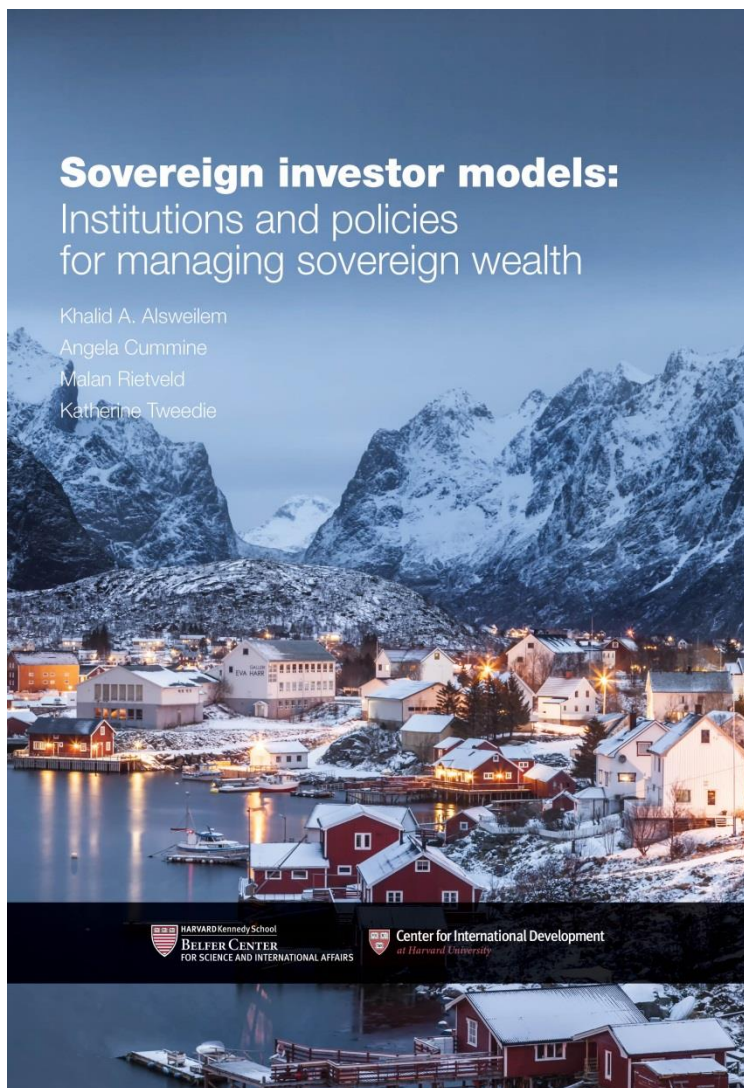
- Economic and political context
- Official mandate(s)
- Source of funding (savings rule)
- Liabilities (spending rule)
- Governance structure
- Investment style

Funds studied

- Norway
- Chile (stabilisation and saving funds)
- Abu Dhabi
- Kuwait
- Kazakhstan
- Botswana
- South Africa
- South Korea
- Hong Kong
- China (CIC & SAFE)
- Singapore (GIC & Temasek)
- Saudi Arabia



Sovereign investor models



Defining sovereign investor universe

- Classic SWFs: stabilisation, savings and income (and sovereign development) funds
- Central banks
- Public-pension reserve funds
- Development banks and funds

Savings rules for resource-based SWFs

- Rule of thumb measure: suboptimal
- Better to have an integrated, rule-based framework

Model

- Rule-based framework for savings, spending and stabilisation decisions (see Ghana application)

Governance and implementation

- Rules for resource-based SWFs
- The role and structure of the board
- Institutional positioning: arm's length independence, the central bank model, etc.

Defining sovereign investor universe

SOVEREIGN INVESTOR TYPE	MAIN SOURCES OF CAPITAL	MAIN FUNCTIONS	TYPICAL INVESTMENT MODELS
Sovereign wealth funds	Resource revenues Excess foreign exchange reserves	Investing national wealth (surpluses and savings), typically through by an independent entity Promoting macroeconomic and fiscal stability	Savings funds: diversified portfolios with long-term horizons Stabilisation funds: highly liquid, fixed-income denominated portfolios
Central banks	Foreign exchange reserves	Held predominantly for exchange-rate management and intervention purposes	Highly liquid, fixed-income denominated portfolios Limited diversification into liquid equities, equity indexes and alternatives
Public pension reserve funds	Earmarked fiscal provisions and/or surplus contributions	Dedicated asset pools without short-term liabilities, promoting long-term solvency of national pension and social security systems (anticipation of rising entitlements)	Diversified portfolios with long-term horizons and ability to hold illiquid assets
Sovereign development funds, banks and agencies	Government transfers, debt- and equity-financing using own balance sheet	Investing in projects and sectors with high expected social and economic returns, particularly in context of financing gaps (commercial versus developmental orientation differs)	Large variation in assets and portfolios, with assets that may include debt, public and private equity, infrastructure and public-private partnerships

Simple saving rules

TYPE OF RULE	OPERATION	ADVANTAGES	DISADVANTAGES	REAL-WORLD EXAMPLES
Fixed percentage	A fixed percentage of annual resource revenue is transferred to the SWF – for example 10% or 20% of oil revenues	Easy to communicate and monitor (if data for total resource revenues is available, accurate and public)	Rule is mechanistic and does not respond to cyclical state of the economy or commodity prices/revenue – government still has to transfer a portion of revenues in a low-revenue year ⁸	Kuwait Investment Authority Alaskan and Wyoming Permanent Funds
Deviation from moving average	Revenues are transferred to (and potentially from) the SWF when revenues are above (or below) their multi-period moving averages. Policymakers need to decide if rule is symmetrical or asymmetrical ⁹	A more dynamic, counter-cyclical rule than the fixed-percentage transfer rule. Does not require transfers to the SWF in periods of low revenues	Difficult to communicate and monitor, and therefore open to abuse. Can generate volatile transfers to (and from) the SWF, complicating the fund's investment process	Ghana Heritage Fund Mongolia Fiscal Stabilisation Fund
Non-resource deficit financing	The government commits to running a non-resource fiscal deficit that can be sustainably funded by income from the SWF	If prudently applied, combats fiscal dependence on resources and ensures sustainable consumption of resource revenues (incentivises the generation of non-resource revenues)	Requires strong commitment from government to run sufficiently small non-resource fiscal deficit. Cannot be implemented in countries that are already fiscally dependent on resources (but can help prevent a new producer from becoming dependent)	Norwegian Pension Fund Global East Timor Petroleum Fund
Reference-price	Revenue transfers are based on deviations from a pre-determined reference price for the underlying commodity	Can provide strong counter-cyclical force. Also allows government to better plan multi-year public spending programmes, as unanticipated surpluses are saved rather than spent	Rule is constantly open for manipulation in the absence of a binding commitment or institutional arrangement to set prudent (low) reference price. Transfers to the SWF can be very lumpy	Nigerian Sovereign Investment Authority/Excess Crude Account (non-binding) State Oil Fund of Azerbaijan

Model for resource-based SWFs

Based on Ricardo Hausmann's work for resource-rich governments

- Kazakhstan, Albania and Colombia

Model quantifies critical policy choices around the use volatile and finite resource revenues

- Finding a balance between spending, stabilization and saving
- Essentially, it's a fiscal rule

Model is very flexible to different contexts and country needs

- Different revenue scenarios, assumptions and shocks
- Different assumed SWF returns and volatilities
- Spending rates
- Dynamics: spending now versus the future

Intuitive overview

Assume that spending is not based on (volatile) annual resource revenues

- Spending and revenue are “decoupled”

Rather, spending is anchored on:

- a fixed percentage of previous year,
- transfers from Stabilization
- Income from the Saving/Income Fund

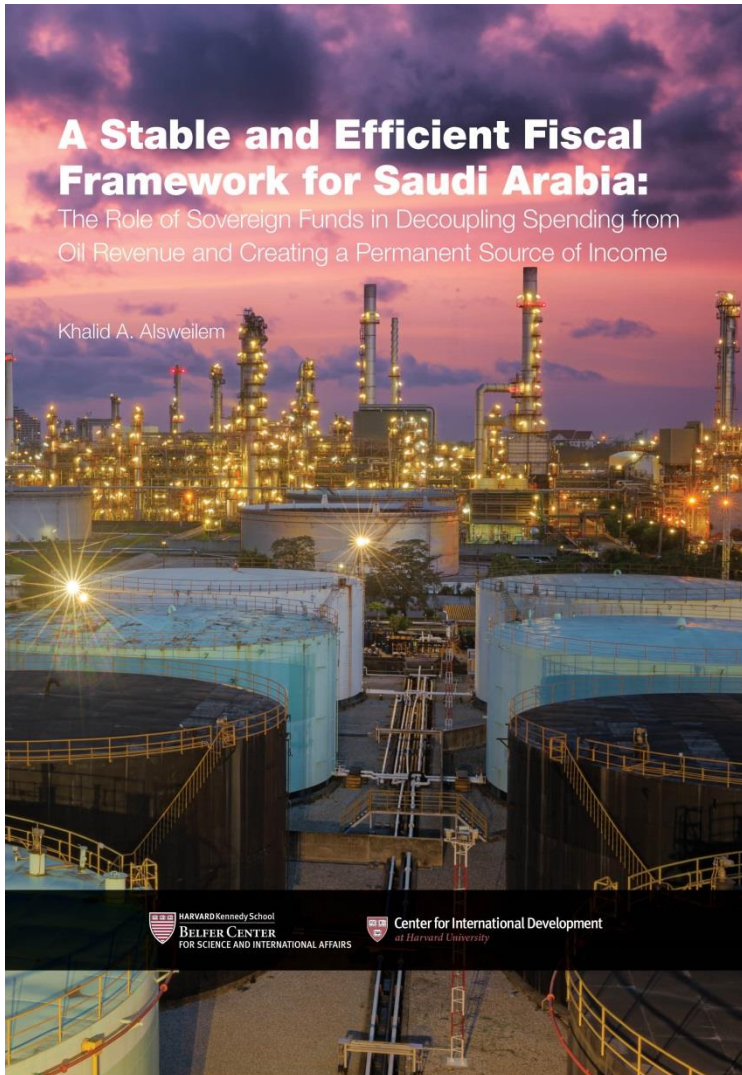
This can be captured in a simple spending rule:

$$T_t = \alpha TS_{t-1} + \beta S_{t-1} + \delta E_{t-1}$$

Flexibility with respect to different assumptions and policy needs

- Different revenue scenarios, assumptions and shocks
- Different assumed SWF returns and volatilities
- Dynamics: spending now versus the future (via parameter choices)

A Stable and Efficient Fiscal Framework for Saudi Arabia



Background

- World's largest oil producer
- Decades of (cheaply to extract) oil reserves
- \$850bn in reserves

What on earth could go wrong?

- Oil dependence: high and rising
- Oil-related volatility in revenue, debt and capital spending
- Reserves at risk as breakeven oil price rises
- Uncertain long-term oil-revenue trends
- Rising long-term spending pressure

Assets were accumulated on an *ad hoc* basis

- Spending and saving decisions not anchored by a rule-based framework

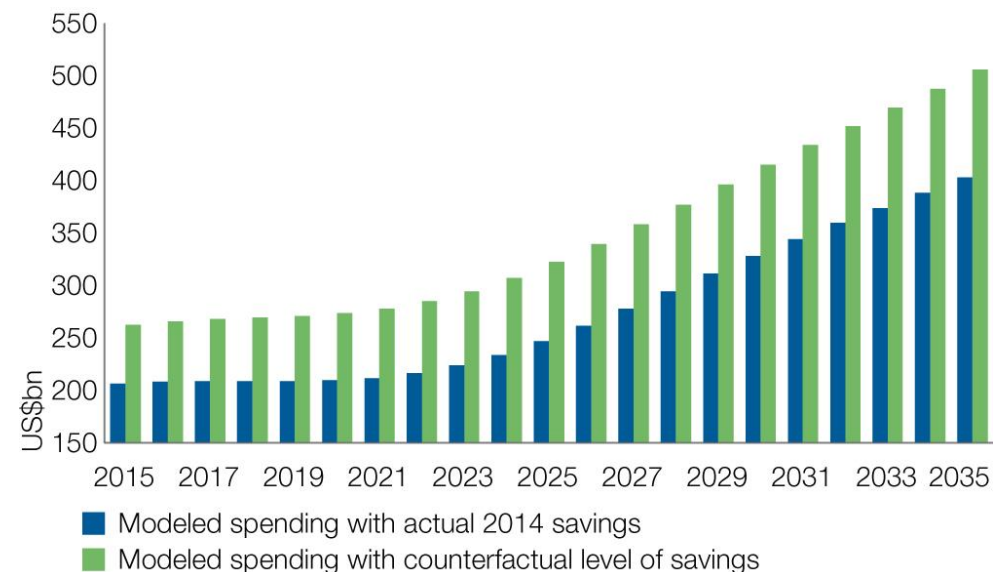
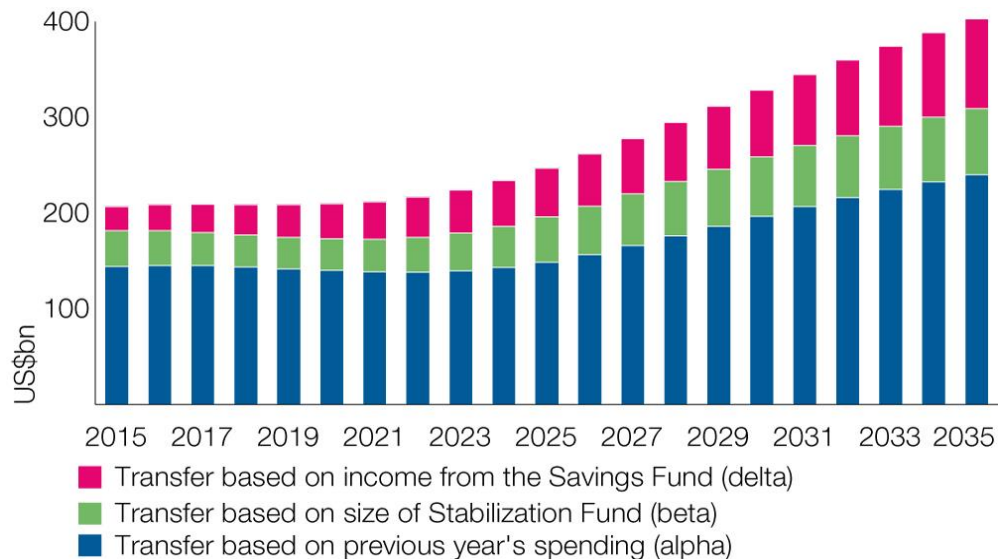
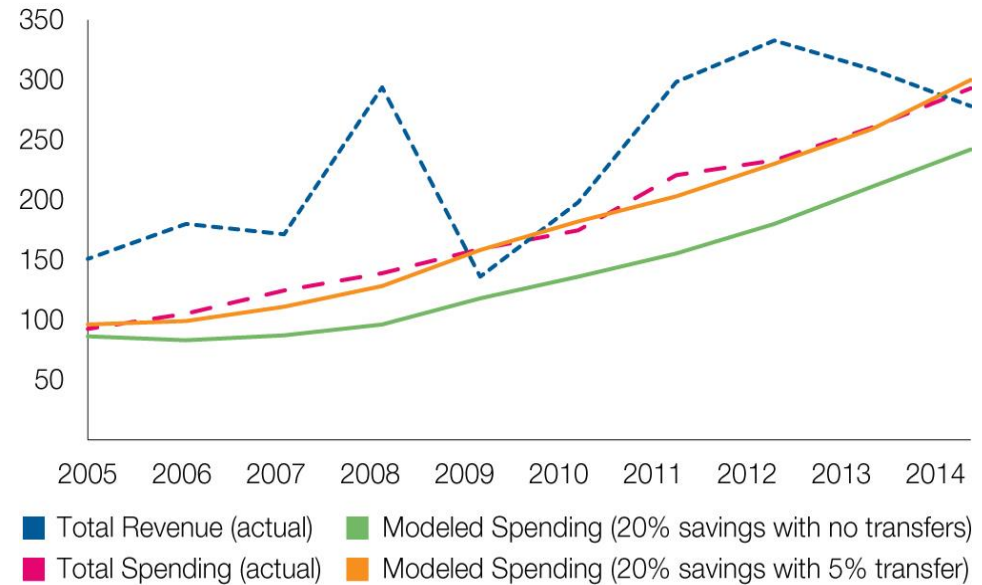
Application: Saudi Arabia

Modelling various scenarios

- Counterfactual based on earlier reforms
- Implementing reforms in 2015
- The cost of delayed reforms

Unsurprisingly...

- \$1 trillion makes a big difference



Policy recommendations: Saudi Arabia

Establishment of savings and spending rule

- Under the jurisdiction of the Supreme Economic Council
- Modelled the impact of specific fiscal rules on Saudi government finances
 - **Key message:** don't delay further...

Proposed the formalisation of two sovereign funds

- Stabilisation Fund: with \$250bn in initial capital
- Saudi Future Generations Fund: with \$500bn in initial capital


Suggested governance arrangements for both funds

- Stabilisation to remain with SAMA (central bank), reporting to MoF
- Future Generations Fund to be managed by new entity, with:
 - Governing Council: Supreme Economic Council
 - Board of Directors: independent, fixed-term appointments
 - Management authority: led by Senior Executive

Policy recommendations: Saudi Arabia

BODY	KEY FUNCTIONS	WHO
Governing Council	<p>Create the mandate of the Savings Fund, ensuring it is realistic and promotes the achievement of the fiscal rule.</p> <p>Ensure that the operational independence of the Savings Fund and its management authority is preserved at all times.</p> <p>Oversee the appointment, competence and independence of the Board of Directors.</p>	Selected members from the Council of Economic & Development Affairs and the Council for Political & Security Affairs.
Board of Directors	<p>Establish the fund's fundamental risk-return profile as an articulation of the mandate received from the Governing Council.</p> <p>Determine the fund's Strategic Asset Allocation, risk-factor allocation and benchmarks to promote the achievement of the long-term real return target in the fiscal rule.</p> <p>Establish Board-level governance committees to develop strategies and oversee management: Investment Committee, a Risk Committee and operational committees.</p>	Independent technocrats, appointed by the Governing Council on the basis of investment expertise. Board members would serve fixed (renewable) terms and potentially include international experts.
Senior Executive Team	<p>Implementing the policies and strategies handed down by the Board of Directors.</p> <p>Administering the investment of the fund's assets.</p> <p>Attempting to outperform the benchmarks established by the Board (i.e. "generating alpha").</p> <p>Overseeing external fund managers and other service providers (investment consultants, IT services, etc.).</p>	Chief executive officer, chief investment officer, chief risk officer, chief operational officer. Senior executive team appointed by the Board of Directors.

The rise of African SWFs



From **NEWS** 22 December 2012

Rise of the African sovereign wealth fund

Africa Has Strongest Growth in Sovereign Funds, JPMorgan Says

By Klaus Wille Jun 10, 2013 2:54 AM GMT+0200 [1 Comment](#) [Email](#) [Print](#)

Africa is experiencing the strongest growth in new sovereign wealth funds in the world as the continent's nations are amassing commodity revenues and foreign-exchange reserves, according to JPMorgan Asset Management Inc.

During the past two years, 15 state funds have been set up or are being considered in Africa, Patrick Thomson, the global head of sovereigns at JPMorgan Asset said. The region will see more starting in the coming years, he added.

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December 15, 2013 11:20 pm

Sovereign funds expand in Africa

By Javier Blas



Land of opportunity: Statoil and ExxonMobil have made a large discovery of natural gas off the coast of Tanzania, which is expected to set up a sovereign wealth fund

Africa may not be home to the world's largest sovereign wealth funds (SWFs) – those are in the Middle East and Asia – but the continent is becoming an important place for

top 10 funds.com

INVESTMENT STRATEGIES FOR THE WORLD'S LARGEST INSTITUTIONAL INVESTORS

ANALYSIS

African countries come to the sovereign wealth fund party

Revisiting the case for African SWFs

Commodity-price declines raise prospect of new global pricing regime

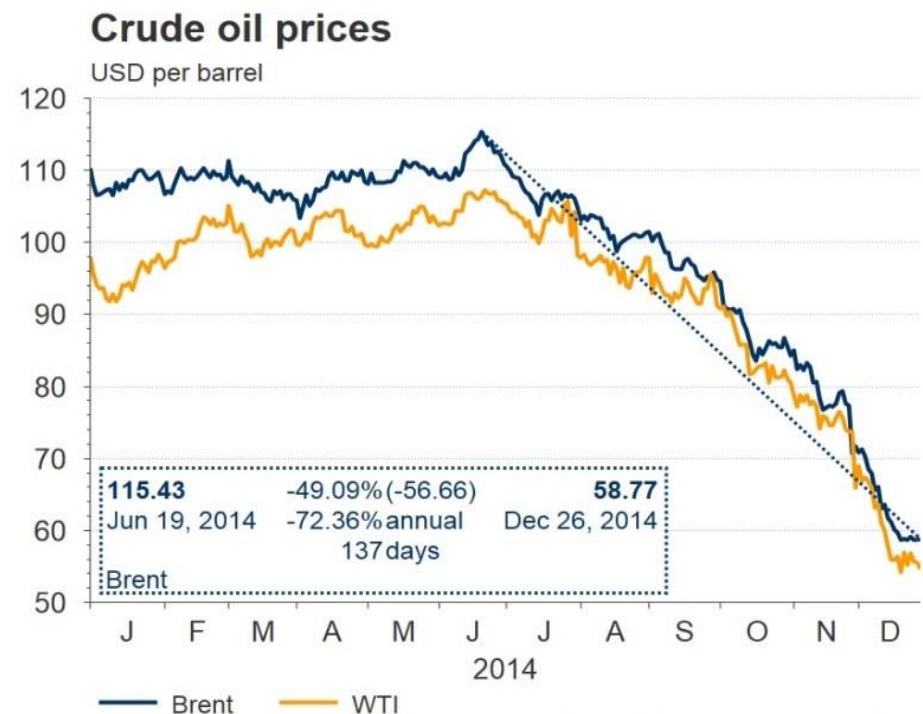
- Potential for sustained growth in global supply, particularly in oil

Uncertainty affects African resource outlook

- Unclear whether it will be a temporary or permanent setback

Underlines the importance of SWF functions

- Stabilisation and Savings/Income
- Domestic investment/infrastructure remains a priority



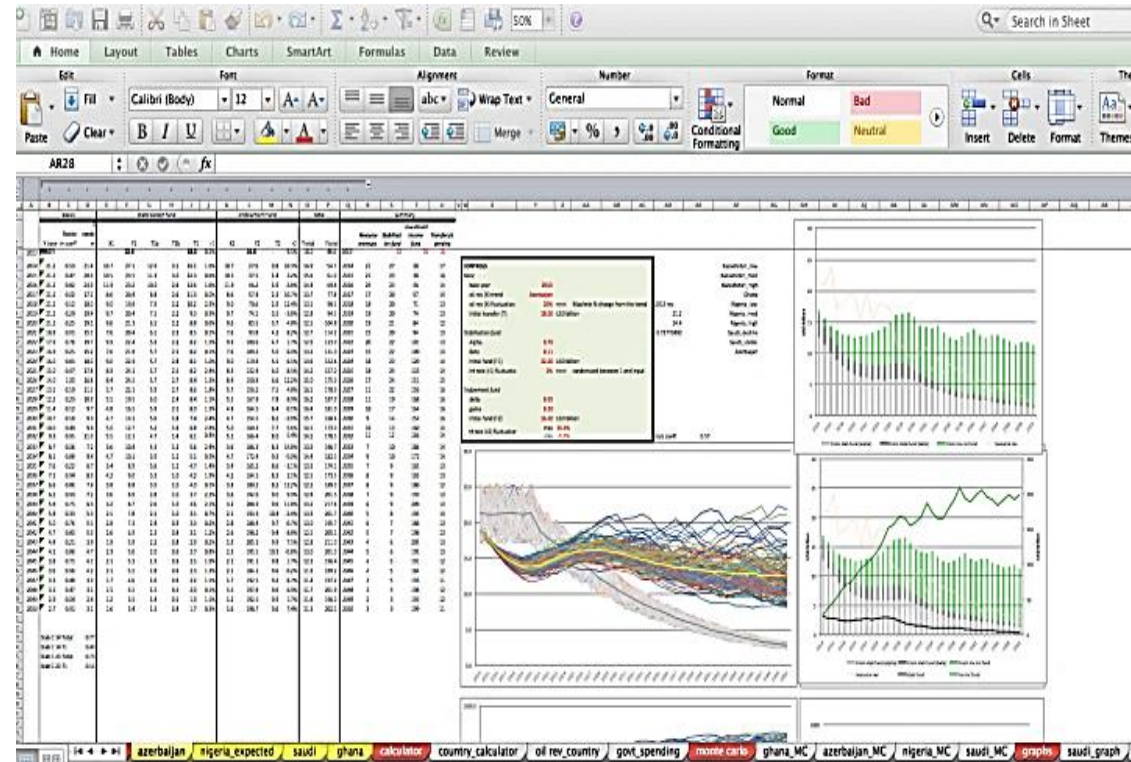
Application: spending Ghana's oil revenue

Think of parameters α and β as technical choices

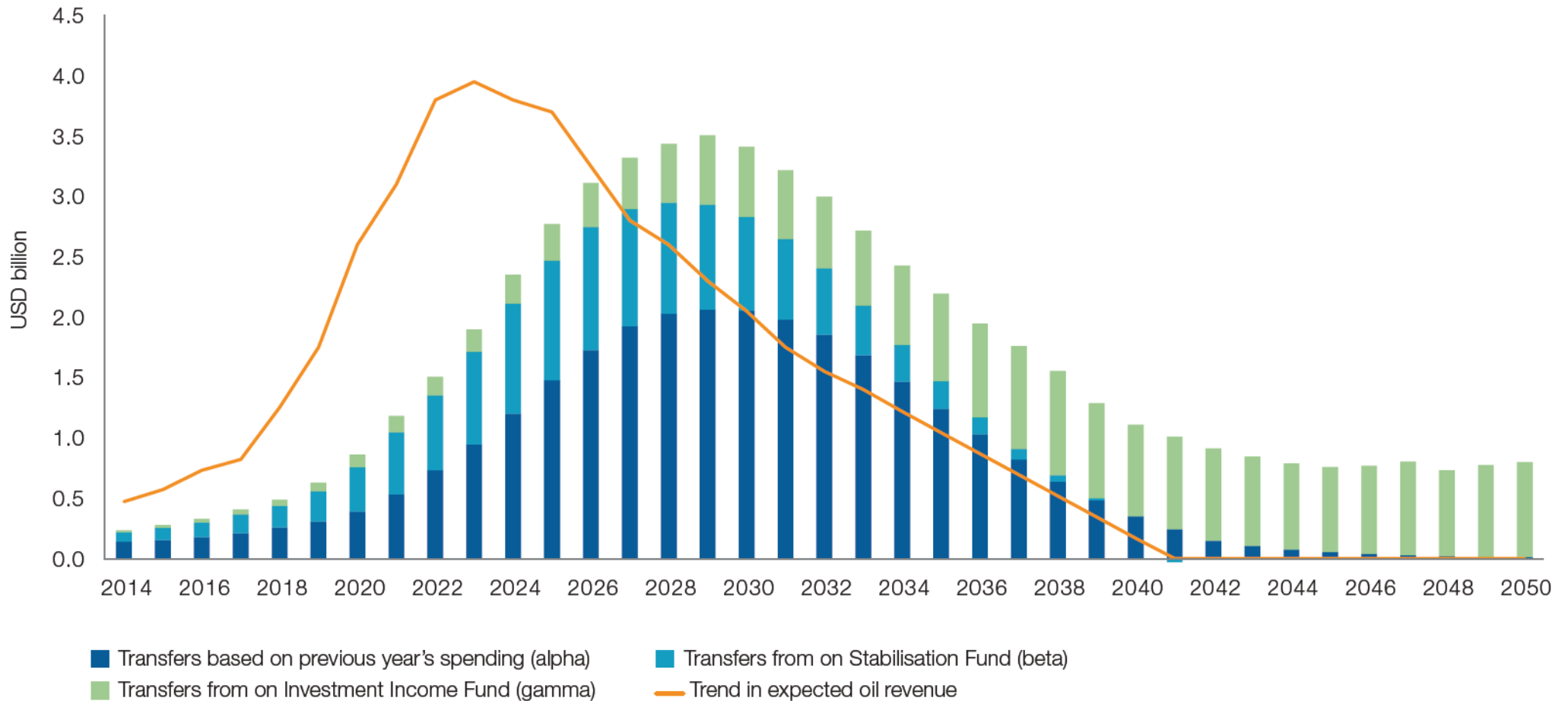
- How to achieve stability in spending growth
- Based on assumptions, given existing assets, spending and revenue expectations

Discretion/policy variable is “how much to save”

- Trade-off between current and future spending
- The rate at which you transform a natural asset into a (permanent) financial asset

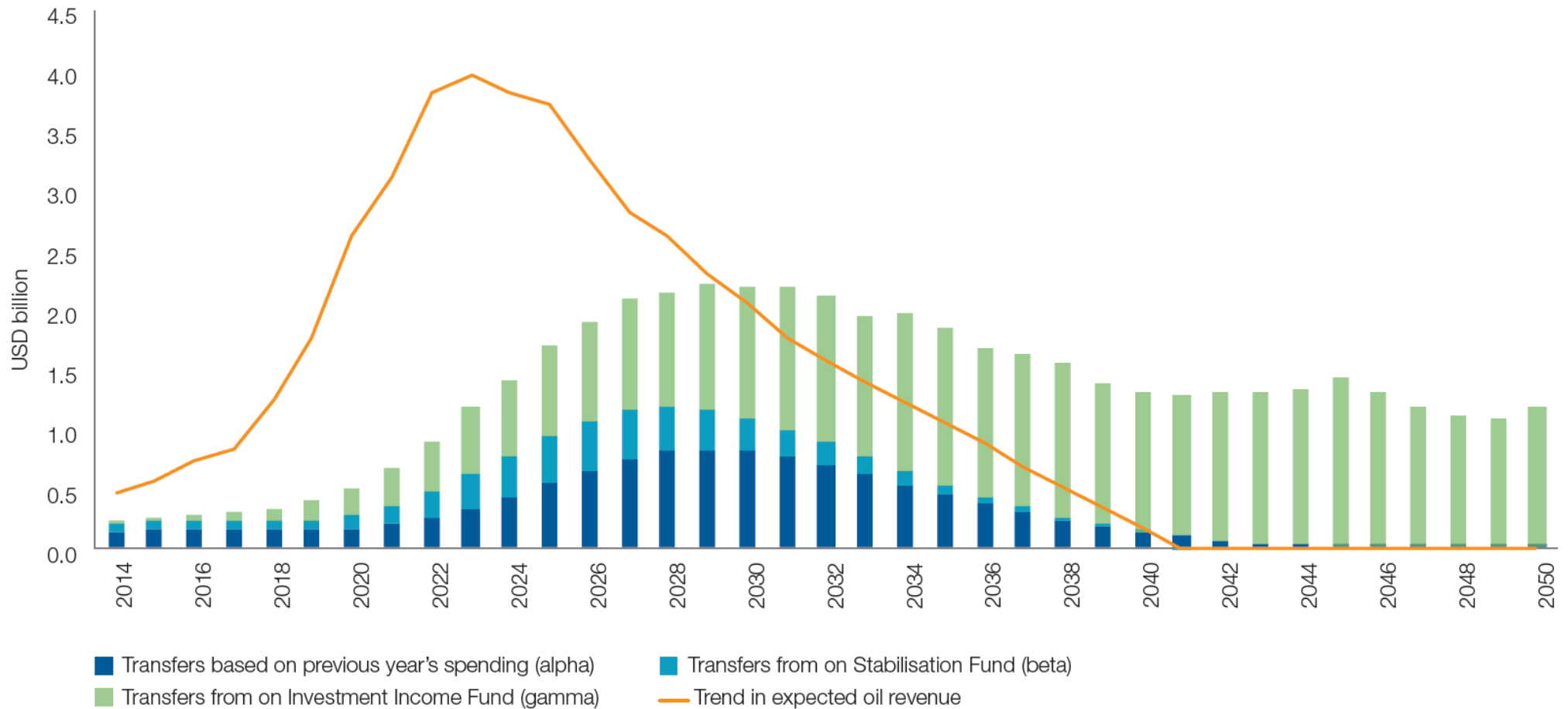


Application: spending Ghana's oil revenue



Source: Investment Institute, Investec Asset Management

Application: spending Ghana's oil revenue



Source: Investment Institute, Investec Asset Management

The case for saving: “oil to equities”

Domestic investment remains a priority

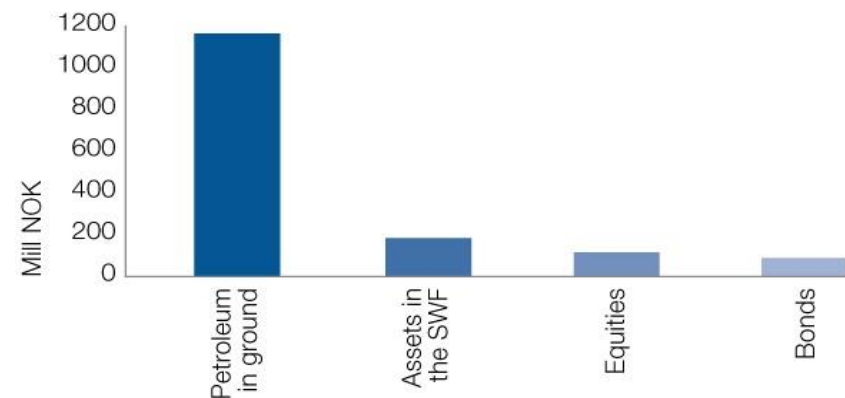
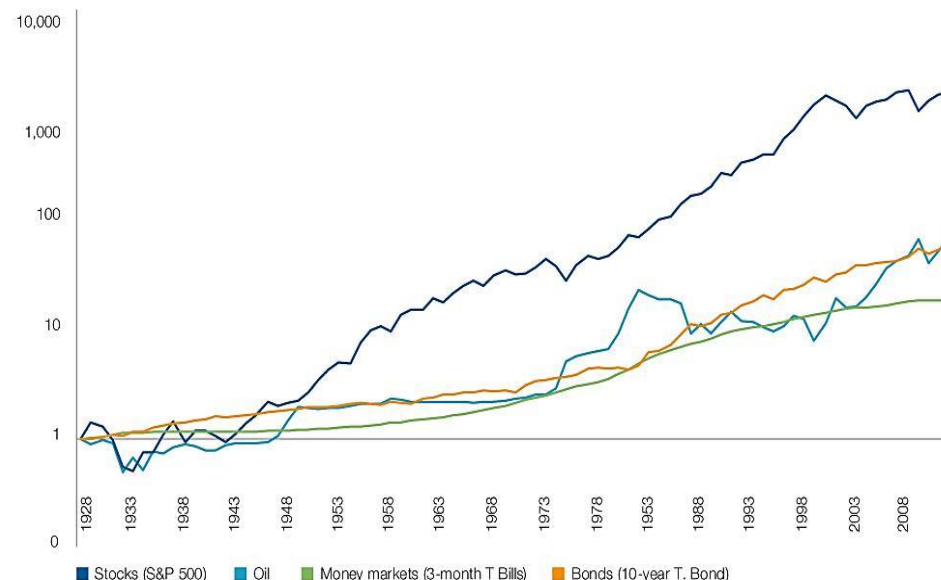
- But medium- to long-term fiscal stability and sustainability are important

Economic and institutional capacity constraints

- Complicate attempts to rapidly scale up domestic investment
- Dutch disease
- Bottlenecks
- Political economy

Transforming resource wealth and rents into financial capital and income

- Has (historically) been rewarded



Source: Investment Institute, Investec Asset Management

No one-size-fits all model

SWF models adapt over time

- Rome wasn't built in a day

Established funds are looking to do better and meet shifting targets

- Kazakhstan, Abu Dhabi and Saudi Arabia

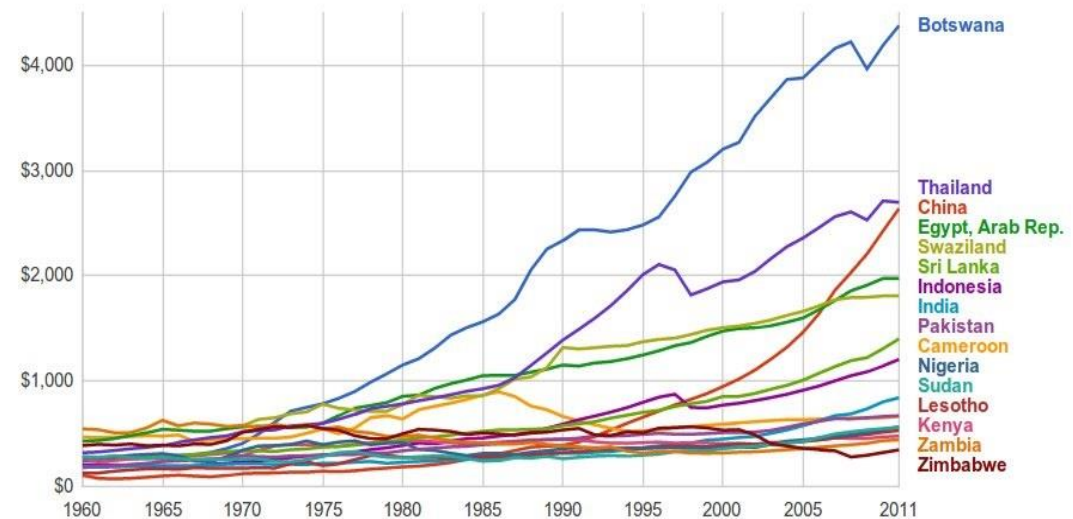
Seeking independent evaluation

- Norway and Chile

Botswana is a great model

- Pula Fund: keep it simple
- Always framed in terms of a medium-term fiscal framework
- The investment model and mandate is clear
- Pragmatic use of the Bank of Botswana's skills and expertise

GDP per capita (constant 2000 US\$)



Source: Investment Institute, Investec Asset Management

Key messages

SWFs are about creating stability and sustainability in the management of resource revenues

- Commodities (and revenues) are uncertain, volatile and unpredictable
- The absence of appropriate rules leads to procyclicality and short-termism
- Planning for the future should continue despite current commodity prices

The African model is likely to be a hybrid:

- Stabilisation
- Savings/Income generation
- Domestic investment

However, domestic investment should be subject to stability and sustainability constraints

- Rule-based fiscal framework is a – if not *the* – key part of story

Oil-to-equities logic part of the case for savings and alternative source of wealth and income

Source: Investment Institute, Investec Asset Management

Biography



Malan Rietveld is the Director of the Investment Institute. His focus is on policies towards investment around the extractive industries, including resource-related infrastructure, foreign direct investment and the management of resource revenues. Previously, he worked in the Emerging Market Debt team at Investec Asset Management and was involved in the firm's advisory work with central banks and sovereign wealth funds. Prior to that he worked at Central Banking Publications and the Official Monetary and Financial Institutions Forum in London. He is the editor of three books on sovereign wealth funds: *Sovereign Wealth Management* (with Jennifer Johnson-Calari), *New Perspectives on Sovereign Asset Management* and *Sovereign Risk Management*.

Malan holds an M.Sc in Economics from the University of Leuven and an M.Sc in Economic History from the London School of Economics. He is currently completing his PhD in Economics from the University of Stellenbosch on the topic of sovereign wealth funds. Malan is a Fellow at the Center for International Development at Harvard Kennedy School and a Fellow of the Columbia Center for Sustainable Investment at Columbia University.

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