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Sovereign wealth funds: Spending now and in the future

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Sovereign wealth funds: Spending now and in the future[1]

Abstract

Governments around the world are increasingly setting aside money to meet future financial commitments, such as infrastructure investments or pension obligations. Sovereign wealth funds, including those known as "Future Funds", have been established by national and sub-national governments around the world using a variety of structures, investment strategies, legislative frameworks and investment timeframes.

In a period of strong economic growth and government budget surpluses, investing for the future is a policy direction that is difficult to argue against, and it is the political attractiveness of sovereign wealth funds that increasingly see them introduced into the fiscal debate. To use a household budget analogy, it is similar to investing in superannuation to fund future retirement plans.

In times of public sector debt and budget deficits, however, is investing in a sovereign wealth fund akin to leaving money in an online savings account while carrying a credit card debt at a much higher interest rate?

This paper considers the emergence of sovereign wealth funds around the world in different historical, geographical and political contexts, including successful sovereign wealth funds such as those in Norway and Australia. It studies the different purposes, structures and investment outcomes of existing sovereign wealth funds, including how and when funds are distributed, and the level of transparency in reporting.

Of interest to academics, policy makers and practitioners, this paper identifies good practice and successful models to inform responses to future economic booms.

Key words

Sovereign wealth funds; future funds; wealth transfer, natural resource wealth

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Introduction

Governments around the world are increasingly setting aside money to meet future financial commitments, such as infrastructure investments or pension obligations. Sovereign wealth funds, including those known as "Future Funds", have been established by national and sub-national governments around the world using a variety of structures, investment strategies, legislative frameworks and investment timeframes.

In a period of strong economic growth and government budget surpluses, investing for the future is a policy direction that is difficult to argue against, and it is the political attractiveness of sovereign wealth funds that increasingly see them introduced into the fiscal debate. To use a household budget analogy, it is similar to investing in superannuation to fund future retirement plans.

In times of public sector debt and budget deficits, however, is investing in a sovereign wealth fund akin to leaving money in an online savings account while carrying a credit card debt at a much higher interest rate?

This paper considers the emergence of sovereign wealth funds around the world in different historical, geographical and political contexts, and both at the national and sub-national levels of government. It studies the different purposes, structures and investment outcomes of existing sovereign wealth funds, including how and when funds are distributed, and the level of transparency in reporting.

This paper comprises three main sections. Firstly, the reasons to establish a sovereign wealth fund are examined, along with the principles guiding good practice. Secondly, several case studies of national and sub-national sovereign wealth funds from around the world are presented. Finally, policy considerations are summarised, which may be of assistance to a government considering if and how to establish a new sovereign wealth fund.

Definition and establishment of sovereign wealth funds

There is no single definition of a sovereign wealth fund. As noted by Rozanov (2011), sovereign wealth funds differ in size, structure, objectives, risk profile, timeframes and categories of assets in which funds are invested. Capape and Guerrero (2013)

consider more than 30 definitions of sovereign wealth funds, with only the requirement for a sovereign wealth fund to be a government-owned investment fund a consistent factor in the definitions. (See also Rozanov 2011, Fini 2011, Alhashel 2015)

One commonly quoted definition is from the International Working Group of Sovereign Wealth Funds: "SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports" (2008 p.27).

Why establish a sovereign wealth fund?

Existing research has identified several main reasons governments choose to establish sovereign wealth funds. Firstly, it recognises that natural resources are a finite resource, and that unless revenues are set aside for future generations to also enjoy, additional government spending creates generational inequity (Meng 2015).

Secondly, increased exports can lead to exchange rate appreciation, which tends to negatively impact on other sectors of the economy such as non-mining related manufacturing. This can be referred to as the resource curse, or Dutch disease (Baena et al 2012). Investment in foreign markets and different currencies can mitigate this impact by stabilising foreign exchanges (Meng 2016, Sandbu 2006).

Also, investments in sovereign wealth funds are sometimes described as adding discipline to government expenditure, with open and transparent reporting, and publicly known spending rules to guide eventual flows out of the fund (Schubert and Barenbaum 2011). As the case study examples will show, this is achieved to varying success.

Santiago Principles

Given the increasing number of sovereign wealth funds, and the variety of sizes, structures and investment strategies, it has been recognised that identification and

application of best practices would benefit both investors and beneficiaries. At the conclusion of three meetings of the 26 member countries of the International Working Group of Sovereign Wealth Funds in 2008, a set of generally accepted principles and practices regarding investment objectives and practices was agreed, commonly referred to as the Santiago Principles (International Working Group of Sovereign Wealth Funds 2008).

There are 24 Santiago Principles, addressing legal frameworks, relationship to macroeconomic policies, institutional, investment and risk management frameworks, and governance structures. Selected examples include:

“GAPP 1. The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).

GAPP 2. The policy purpose of the SWF should be clearly defined and publicly disclosed.

GAPP 4. Principle There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF’s general approach to funding, withdrawal, and spending operations.

GAPP 10. The accountability framework for the SWF’s operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.

GAPP 11. Principle An annual report and accompanying financial statements on the SWF’s operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.

GAPP 19. The SWF’s investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.”

(International Working Group of Sovereign Wealth Funds 2008, p.8).

Case studies

The following case studies present a selected sample of national and sub-national sovereign wealth funds of varying sizes and structures, and briefly considers whether or not they are consistent with the voluntary Santiago Principles.

Norway – Government Pension Fund Global

Established in 1990 as the Petroleum Fund, this fund was established to set aside net cash flow from the extraction of petroleum. The first deposits into the fund did not occur until 1996, with 1.98 billion kroner (US$314 million) in May and 40 billion kroner (US$6.15 billion) in December of that year. Initial investments were in low risk foreign currency government bonds. As the value of the fund grew, the central bank's capacity to manage the fund was stretched. A separate entity was established in 1998, and the fund is now managed by the Norges Bank Investment Management (Cleary 2016, p.134-6). As at the end of 2016, the fund value was 7.51 trillion kroner, approximately double the size of gross domestic product.

Part of the success of the fund has been attributed to the investment of the fund in foreign currencies, to the exclusion of the Norwegian krone, thereby hedging against declines in oil prices (Cleary 2016, p107).

The annual average return of the fund was 5.8 per cent over the period from 1998 to the end of the first quarter in 2017, with a total return of 6.9 per cent in 2016. After allowing for average management costs of 0.04 per cent of assets under management, and inflation, the average return was 3.9 per cent for the same 10 year period (Norges Bank Investment Management n.d).

The fund currently invests primarily in shares (62.5 per cent) and fixed income (34.3 per cent) and the remaining 3.2 per cent in real estate. Almost 9,000 companies are held, representing 1.3 per cent of all listed companies worldwide, and 2.3 per cent of European shares (Norges Bank Investment Management n.d.). The target for equities investment is currently under consideration, and may be lifted from 60 per cent to 70-75 per cent in order to increase investment returns. Along with other publicly available regarding investment of the fund, the Norges Bank Investment Management publicly discloses industries which it considers unethical and therefore will not invest in,

including nuclear weapons, tobacco and coal. (Norges Bank Investment Management n.d.).

In 2001, a ‘spending rule’ was introduced, which intended to limit spending on the annual national budget at the level of the estimated real return of the fund i.e. to maintain the capital invested (Cleary 2016, p.144). With lower commodity process contributing to the first net withdrawal from the fund in 2016, attention is being given to proposals to lower government spending from the fund to 3 per cent.

Despite the change of name in 2006, the fund is a general savings instrument, and is not earmarked for pensions or other specific purposes. As a result, spending from the fund is approved by parliament in accordance with the usual general government budget process (Cleary 2016, p.107). The actual government expenditure is increasingly focussed on education, research, infrastructure and reductions in taxation.

Timor-Leste – Petroleum Fund

A former colony of Portugal and then Indonesia, Timor-Leste gained independence in 2002. With petroleum and gas exports beginning in 2004, the new nation sought advice from multilateral development agencies on the best way to manage the natural resource revenues. The International Monetary Fund recommended establishing a petroleum fund based on the Norway model to manage the expected revenue.

The Petroleum Fund Law was passed in 2005, and the fund was established with an initial contribution of US$370 million. The initial investment approach was relatively simple, with revenues received by the Central Bank. With US dollars being the currency used in Timor-Leste, the Central Bank then invested exclusively in US government bonds until 2009. Following the disruption and volatility of the global financial crisis, investment options have expanded. The Central Bank continues to invest in US government bonds, but also invests offshore through external investment managers.

As at December 2015, the balance of the fund was US$16.2 billion, more than 11 times gross domestic product of US$1.4 billion in the same year. Half of the funds were invested in US government bonds, 40 per cent in developed market equities, and the balance in other government bonds. The cost of managing the fund in 2015 was US$15.7 million, or 0.1 per cent of the fund’s value (Timor-Leste Ministry of Finance n.d.).

The annual investment return from 2005 to 2015 was 3.8 per cent, higher than the targeted return of 3 per cent. This target is equivalent to the Estimated Sustainable Income (ESI) level of the fund, which is intended to limit the amount of transfers from the fund to general government spending to ensure the long-term sustainability of the fund.

Increasingly, the ESI has not been adhered to, with parliament able to approve transfers higher than ESI, and has done so primarily to fund spending on infrastructure. In 2015, compliance with the ESI would have limited transfers from the fund to US$629 million. Actual transfers were US$1.28 billion. This trend continues, with the 2017 budget showing intended transfers of $1.1 billion, which would fund 78 per cent of the government's spending in that year.

Being a geographically small nation with finite natural resources, and with production having peaked and now declining, there are concerns for the long-term sustainability of the fund. One argument suggests that the ESI, based on Norway's spending rule, is too low for a developing nation with significant infrastructure needs. Conversely, there are limits to the capacity of the economy to absorb additional government spending, potentially leading to inflation or inefficient and ineffective spending.

Australia – Future Fund

The Australian Future Fund was established by the *Future Fund Act 2006* in May 2006 with the explicit aim of reducing the burden on future generations. Specifically, the Future Fund aims to fund the cost of liabilities relating to unfunded superannuation liabilities of Australian federal public servants and military personnel. These liabilities were estimated to total A$140 billion by 2040, and these defined benefits pension schemes were closed to new members in 2006.

It is noted that the Santiago Principles exclude government employee pensions funds from the general definition of a sovereign wealth fund (International Working Group of Sovereign Wealth Funds 2008).

Initial funding from the Australian Government of A$18 billion was transferred to the Future Fund on 5 May 2006, with additional investments continuing until 21 November 2008. This included transfer of part of the 2005-06 budget surplus and several transfers

of Telstra shares, the privatised telecommunications company. Total contributions from the Australian Government were A$60.5 billion (Department of Finance 2017).

The Future Fund has since more than doubled in size, with a balance of A$129.6 billion as at 31 March 2017. This reflects a one year return of 10.5 per cent and an annualised annual return of 7.7 per cent (Department of Finance 2017). This exceeds the targeted ten-year annualised average return of 6.9 per cent.

The Future Fund Management Agency was established to oversee investment of the Future Fund, and engages commercial fund managers. In 2015-16, total management costs were A$246 million, representing approximately 0.2 per cent of the funds under management (Future Fund Board of Guardians 2016).

Quarterly updates on the performance and asset allocation are published by the Future Fund Management Agency on it's website, and details of individual fund managers and investments are available in annual reports. As at 31 March 2017, the Future Fund's assets were invested in:

- Australian equities 6.5 per cent
- Global market equities 15.2 per cent
- Emerging market equities 7.3 per cent
- Private equity 10.6 per cent
- Property 6.0 per cent
- Infrastructure and timberland 7.6 per cent
- Debt securities 11.3 per cent
- Alternative assets 15.1 per cent
- Cash 20.4 per cent

The Future Fund Management Agency also manages four other funds for the Australian Government: the Medical Research Future Fund (A$4.6 billion), the DisabilityCare Australia Fund (A$6.2 billion), the Building Australia Fund (A$3.8 billion) and the Education Investment Fund (A$3.8 billion) (Future Fund Management Agency 2017). To date, only the latter two funds have reported disbursement of funds.

Changes to the Future Fund were announced as part of the 2017-18 federal budget, including the commencement of drawdowns from the Medical Research Future Fund

in 2016-17 (Australian Government 2017 p.116) and the delay of drawdowns from the Future Fund until at least 2027 (Costello 2017).

On 15 May 2017, the *Future Fund Investment Mandate Direction 2017* (Cth) amended the investment target from CPI plus 4.5 per cent to CPI plus 4-5 per cent. This legislative instrument also explicitly states that the Future Fund may only invest in financial assets.

Western Australia – Future Fund

In the 2011-12 budget, the State Government of Western Australia forecast an operating surplus of A$784 million in 2010-11 and A$442 million in 2011-12 (Department of Treasury 2011). With the recognition that much of the State's revenue was generated from finite natural resources such as iron ore, a sub-national sovereign wealth fund was established to ensure future generations also benefitted from the resources boom occurring at the time.

Initial funding was sourced from the State's Royalties for Regions fund. This was established by the *Royalties for Regions Act 2009* to receive an equivalent of 25 per cent of annual mining and petroleum royalties.

The Future Fund was established under the *Western Australian Future Fund Act 2012.* Initial contributions over the period from 2012-13 to 2015-16, along with interest receipts, were expected to total $1 billion. This target was met, with the balance of the Future Fund being A$1.044 billion as at 30 June 2016, and $1.1 billion as at 31 March 2017 (Department of Treasury 2016, 2017).

From 2016-17 onwards, the future Fund will receive additional contributions of 1 per cent of annual estimated royalties revenue, estimated at A$38 million in the first year. Interest earning are estimated at A$35 million in 2016-17.

The W*estern Australian Future Fund Act 2012 re*quires that the earnings are reinvested for 20 years, and the balance at 30 June 2032 is estimated to be A$3.8 billion. From this time, only the new interest earned may be spent. Interest must be on public works and other economic and social infrastructure, and cannot be used for government service delivery. The purpose and metropolitan / regional split of expenditure must be agreed by the Treasurer and Minister for Regional Development.

Unlike many other sovereign wealth funds, no separate entity was created. Instead, the transactions are managed by the Western Australian Treasury Corporation on behalf of the Department of Treasury, resulting in relatively low costs.

Publicly available investment information is relatively high level, and describes only categories of expenditure. As at 31 March 2017, the Future Fund contained:

- Cash or cash investments A$322,000
- Corporate bonds A$206.7 million
- Floating rate notes A$131.1 million
- Western Australian Treasury Corporation bonds A$199.3 million
- Other semi-government bonds A$579.2 million

(Department of Treasury 2017).

Although the quarterly updates do not list individual investments, the W*estern Australian Future Fund Act 2012* requires that the Future Fund is invested in line with the Public Bank Account, and also allows for investment in physical gold. The Public Bank Account invests in cash and high credit debt instruments, and quarterly reports of investments by credit counterparty are published and available at the Department of Treasury's website (n.d.).

The Future Fund's investment target is to exceed to cost of funds on average, and has achieved this in all periods since inception, though returns do not necessarily exceed the rate of inflation. Therefore, the real return can be negative e.g. actual return of 0.4 per cent above the cost of funds in 2013-14.

Noting a change in economic conditions since 2012, a review of the Future Fund's investment strategy has recently been conducted and some changes have been implemented. These include allowing increased holdings of corporate bonds and a move towards one to five year floating rates (Department of Treasury n.d.).

Alaska Permanent Fund

Unlike other sovereign wealth funds established by legislation, the Alaska Permanent Funds was established in 1976 by constitutional amendment. Managed by the Alaska Permanent Fund Corporation, it received at least 25 per cent of annual resource royalties. As at March 2017, the balance of the fund was US$57.8 billion, comprising

US$46.1 billion of principal from royalties and $11.7 billion in earnings revenue (Alaska Permanent Fund Corporation n.d.).

The fund invests in income producing assets, including shares, bonds, cash and real estate. It is currently achieving an 8.98 per cent year to date return, and an annual average return of 7.7 per cent over five years.

A significant difference of the Alaska Permanent Fund is that it is not designed to fund general government expenditure, or specific purposes such as pension liabilities. Instead, a cash dividend is paid annually to all residents of the state, defined as those living in Alaska for at least 12 months, and including children (Baena et al 2012). It is the only sovereign wealth fund to make this type of direct distribution to citizens (Cummine 2011).

The dividend is calculated using a five year average of 52.5 per cent of the fund's earning, less expenses, divided by eligible recipients. This ensures the value of the fund increases over time. In recent years, the cash dividend has been approximately US$2,000 per person – 2014 was US$1,884, 2015 was US$2,072, and 2016 was calculated at US$2,052. The actual payment in 2016 was approximately half at US$1,066, after the full payment was vetoed by the Governor.

The cash dividends as considered income for taxation purposes, and are likely to be a contributing factor in the relative wealth of Alaskan households. Based on 2015 census data, Alaska has the 5th lowest poverty rate in the United States, and the 4th highest household income. It will be interesting to consider whether the reduced cash dividend in 2016 will impact these statistics, especially if future years also have lower payments than calculated.

Consistency with selected Santiago Principles

The five brief examples of sovereign wealth funds include three national and two sub-national funds. All appear to comply with the Santiago Principle of having a sound legal framework to support its operation and achievement of objectives, though variations exist e.g. legislation versus constitutional amendment. And each fund publicly discloses its policy purpose, as per generally accepted principle two.

Other Santiago Principles appear to have been applied less consistently. For example, clear and publicly disclosed information about the way in which the fund will be invested, operated and withdrawn from are not available to the same extent for all funds. In particular, the level of detail regarding individual investments varies.

Annual and other regular financial reporting occurs, but a separate, audited set of financial statements is not always publicly available. Finally, considerable differences exist regarding the approach to maximising financial returns, with conservation of capital sometimes appearing to be of more concern to governments.

Policy considerations and conclusions

These examples of sovereign wealth funds, along with consideration of the Santiago Principles, have identified key policy considerations that should inform future government decisions to establish a new sovereign wealth fund.

Clearly, the policy purpose of the fund will inform the appropriate operational, governance and transparency structures. The intended use of funds, expenditure timeframes and retention of capital requirements will also help define appropriate structures. The investment approach and asset classes will depend on the risk and return profile of the government.

Impacts on other parts of the domestic economy must be taken into account, including the capacity of the economy to absorb additional expenditure, and potential inflationary impacts. Once funds start to flow out of the sovereign wealth fund and spending does occur, clear spending rules should ensure efficiency and effectiveness of expenditure.

Governments should also consider the opportunity to involve citizens in financial decision making, whether through participatory budgeting approaches, or direct cash dividends to allow direct benefit from the state’s natural resource wealth.

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