Ewart S Williams: The Heritage and Stabilization Fund of Trinidad and Tobago

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Heritage and Stabilization Fund Forum, Port-of-Spain, 2 May 2007.

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Why the Forum?

The HSF is a most important national asset. It is a sizable sum which, in principle, could become a very significant sum of money over time. These sums are to be held in trust for future generations. Accordingly, it requires constant oversight of all stakeholders, starting with the Parliament but including civil society, business and all those who have an interest in the country's economic development.

Viewed from this perspective, the main objectives of this public information programme are:

1. to create a better understanding of the workings of the Fund and ensure transparency of the process;
2. to foster compliance with the new laws, procedures and policies;
3. to create social ownership; and
4. to avoid misinformation and to create realistic expectations.

What are the objectives of the Fund?

The Fund has two primary objectives.

Firstly, to insulate fiscal policy and the economy from swings in international oil and gas prices (let's call this the Stabilization objective).

Secondly, to accumulate savings from the country's exhaustible assets of oil and gas for future generations. The future generation will not benefit from these savings through annual cheques as was done by Alaska but through Government's ability to maintain expenditures over the long term when oil and gas revenues are gone.

While not a specific objective, the Fund, by holding resources abroad, could provide a cushion to monetary policy in the face of volatile external flows.

Why should the Fund cover stabilization?

As you know, we ended up with a hybrid fund to cover stabilization and savings for future generations.

The simple answer is because of our heavy dependence on the energy sector. While the sector accounts for a mere 3 per cent of total employment, as is shown in the slide, the sector accounts for 45 per cent of GDP; 91 per cent of merchandise exports and 62 per cent of fiscal revenues. Specifically, in respect of the budget, 43 per cent of every dollar of expenditure is financed by energy sector revenues. Thus, let's say oil and gas revenues decline by one-half, in the **absence of a stabilization fund**, expenditures would need to be reduced by 21 per cent. Sudden sharp reductions in government expenditures (of this magnitude) could have serious adverse effects on government programmes.(Particularly, in view of the lumpiness of government investment projects).

This is what happened in the 1980s when oil prices declined from US$36 to US$15 per barrel, forcing government expenditures to be cut by 40 per cent, even after the Government had recourse to foreign borrowing of about US$1 billion.

Many commentators have raised a very valid concern that, in the event of a secular decline in oil and gas prices, **drawdowns for stabilization could consume the entire Fund** over time. To deal with this, the law sets a floor of US$1 billion beyond which no drawings can be made for stabilization purposes. A five-year review built into the legislation also allows this floor to be raised as the Fund grows.

Inter-generational savings

The major objective of the Fund is top generate inter-generational transfers (savings for the future).

This could be justified by the fact that Government revenue from the exploitation of non-renewable resources differs from other tax revenue in that it partly represents a depletion of wealth, and that some of this wealth needs to be saved for fiscal sustainability and for inter-generational equity.

Essentially, what the HSF does is to convert depleting resources into a permanent source of income.

By saving some of the oil revenues and investing it wisely, we may be able to:

- • preserve the capital (somewhat like having the oil and gas remain in the ground); and
- • live off the interest.

Thus, when the oil resources are depleted, the income from the Fund would flow into the budget to preserve government expenditures. [The idea is that the earnings from the Fund would replace the energy taxes as oil and gas resources are depleted].

Of course this requires a critical mass of savings (built up over a period) to generate sufficiently large income flows.

The question is sometimes raised: Why not spend all the oil revenues on infrastructure to broaden productive capacity to serve future generations – **in our case there is the argument of our limited implementation capacity which is already stretched**. More broadly, tying public expenditure to available revenue invariably leads to some poor quality projects.

So that's the basic rationale behind the Fund.

How is the HSF supposed to work?

As Minister Enill noted, 60 per cent of any excess revenues will be credited to the Fund which will be invested in foreign assets and with a long-term focus.

Conversely, the Government will be able to draw from the Fund when actual revenues are more than 10 per cent below budgeted revenues. They could draw 60 per cent of the shortfall subject to a maximum.

In order to avoid the excess or shortfall from being manipulated, the law specifically defines the basis on which "budget revenues" are to be projected, i.e. using an eleven-year projected price of oil and gas to be obtained from a defined independent source such as the IMF or other independent sources.

Also there is the valid argument that a sustained decline in oil prices would trigger a depletion of the Fund to sustain expenditures. The legislation seeks to deal with this eventuality by imposing a capital of US$1billion beyond which no drawings could be made. The intention is to adjust this capital over time.

Minister Enill also spoke about the governance structure of the Fund which is specified in law. This structure provides for four main actors:

- Parliament;
- the Minister of Finance;
- the Board of the HSF; and
- the Central Bank.

Roles and responsibilities

1. Parliament

- Has passed the enabling legislation that would continue to have oversight of the Fund exercised through review of annual reports and audited financial statements.

2. Minister of Finance

- Advises the President on the appointment of the Board in accordance with the legislation;
- Makes deposits to HSF according to formula prescribed in the legislation;
- Makes withdrawals from the HSF in accordance with the legislation.
- Annual reporting to the Parliament.

3. The Board

- Is basically responsible for the arrangement of the Fund but has delegated some of the functions to the Central Bank;
- Within this context it will decide on the Investment Objectives and Strategic Asset Allocation;
- Reviews the performance of the HSF;
- Reports quarterly and annually to the Minister of Finance (who in turn will report to the Parliament).

4. Central Bank

- Responsible for day-to-day management of the Fund (to meet Investment Objectives of the Board);
- Reports quarterly and annually to the Board.

The Public also a role to play in the oversight of the Fund. Before expanding a bit on the nature of these responsibilities, let me clarify that currently the Central Bank has responsibility for the management of the country's foreign exchange reserves. Excluding the HSF, these reserves currently amount to US$5.4 billion.

But, there is a difference in the management philosophy underlying of the Central Bank reserves (official reserves) and the management of oil funds, like the HSF. The objective of Central Bank reserve management is **capital preservation** and thus the investment strategy involves **middle to low-risk tolerance**.

In the case of oil funds like the HSF – the rate of return assumes greater importance and thus risk tolerance tends to be moderate to high. The objective is to maximize expected investment returns while meeting a set of risk constraints.

Responsibilities of the Board

The main task of the Board is to define the risk tolerance of the Fund and consequently to set a target for portfolio returns. The target rate of returns comes out of a complex modeling exercise that takes into consideration several factors including: information on oil and gas production and reserves; projected oil and gas prices; possible drawdowns from the Fund; and the projected government spending path. These factors will yield a profile of the size of the Fund while the investment strategy will influence the flow of returns.

Having determined the target portfolio returns, the Board will decide on the mix of assets that could meet the target portfolio returns. This mix is called the Strategic Asset Allocation.

Perhaps I could provide an example of the Strategic Asset Allocation for the official reserves.

The Bank manages the country's foreign exchange reserves in three tranches:

- A Working Capital Tranche – largely in money market instruments;
- A Liquidity Tranche – in fixed income securities and money market instruments; and
- An Investment Tranche with a higher percentage of fixed income securities but at longer maturities. This tranche is managed partly by external managers and partly by the Bank staff.

The Strategic Asset Allocation for the official reserves is consistent with low- to medium-risk tolerance and is heavily concentrated on bonds and money market instruments.

To earn higher returns and with greater risk tolerance for the HSF, consideration will need to be given to a more aggressive investment strategy. For example, empirical evidence suggests that although equities are considered riskier in the short term, a portfolio combining equities and fixed income assets could give a higher rate of return over the long run horizon relevant for the HSF.

Central Bank's responsibilities

Currently, the Central Bank manages the official reserves partly through in-house management and partly through external investment managers.

In the case of the HSF, with emphasis on higher returns and consequently greater risk tolerance, the idea will be to focus more on external investment managers with a record of achievement in the chosen asset classes. The selection of these external managers will be done with technical support from the World Bank Treasury and consistent with best practice procurement standards.

The selection process is likely to involve: (i) the issuance of RFP's to selected international investment management firms; (ii) an evaluation of their investment philosophies and performance records as well as risk management and operational capabilities of these firms; (iii) paying visits to a shortlist of these managers to get a better insight into their investment processes and models.

After negotiating contracts with the selected managers, the process involves the negotiation of a Custodian who provides safe keeping for the financial assets and trade settlement services to the international investment manager.

The legislation requires that close attention be paid to disclosure and accountability. Specifically, it calls for quarterly reports by the Central Bank to the Board, and an annual report from the Minister of Finance to the Parliament. In addition, the Annual audited accounts of the Fund are to be laid in Parliament. Best practices require that some or all of these reports are made public. The Norwegian Fund is cited as an example of best practice in disclosure and transparency. As a practical matter, we will have to build the capacity and infrastructure to deliver this level of transparency over time.

What are the next steps?

- With the passage of the HSF legislation, the HSF account has been formally established. For the time being, the funds will continue to be invested by the Central Bank, in line with the Bank's current Strategic Asset Allocation.
- An important next step is the appointment of the HSF Board which has the responsibility for defining the Strategic Asset Allocation and benchmarking.
- Preparation of the delegation agreement between the Board and the Central Bank as envisaged in the legislation.
- With the technical assistance from the World Bank, work will begin soon on the Strategic Asset Allocation to be recommended to the Board. The arrangements with the World Bank provide for continuing training of Central Bank staff in sovereign asset management. When the work on the Strategic Asset Allocation is sufficiently advanced, work will need to start on the selection of External Managers.
- A public information and disclosure strategy will need to be developed.

This is a demanding timetable and we will work to have everything in place by year end.

As regards public information we would hope to have more of these sessions on specific aspects of the HSF operations and on our role in the process.

Thank you for accepting our invitation to this launch.

[There was considerable discussion as to whether there should be two separate funds – one for stabilization and the other, a heritage fund – the former invested in short-term instruments and the heritage fund invested with a longer term focus.

The main argument against two funds was that the division would imply unnecessary operational rigidity and compromise the objective of maximizing returns. While this is true, it must be recognized that having one Fund serving both stabilization and savings purposes will provide its own challenges in terms of defining an appropriate liquidity and **maturity** distribution of the portfolio.]