Ewart S Williams: Understanding the Heritage and Stabilisation Fund

Feature address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, to The South Trinidad Chamber of Commerce Annual General Meeting, Port-of-Spain, 20 September 2007.

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Let me thank the South Chamber for inviting me to speak at your Annual General Meeting.

As the Chairman indicated, my theme is the **Heritage and Stabilization Fund** and what I would like to do is not only discuss the underpinnings and the specifics of the Fund …. in addition I see this as the launch of a **communication initiative** geared to convince the stakeholders, like you and the public at large, that this is their Fund over which they should show the same interest and vigilance that they exercise over their pensions or their personal savings.

The public must have an interest in how much money is placed in the Fund: how it is invested and what returns are being generated. The HSF is a reserve for the people of Trinidad and Tobago, their children and hopefully their children's children.

In the economic literature, funds like our Heritage and Stabilization Fund are called **Sovereign Wealth Funds** and their distinguishing characteristic is that these are national savings that are invested actively with the purpose of earning **high returns** – returns that would provide an important source of revenue to the Government later. These sovereign funds are different in nature and in purpose from the **country's official reserves**.

Every country holds official reserves that are managed by the Central Bank. However, invariably rate of return is not the primary objective for holding reserves. Central Banks hold reserves for **prudential purposes**, for example, for meeting government external debt payments; to finance payments for imports and to be available for intervention in the foreign exchange market, as needed. Countries like ours, that are heavily dependent on primary products, also hold reserves for precautionary purposes – so that we could avoid any disruption to international trade if there is a sudden fall in oil and gas prices.

Given these objectives, **liquidity** is perhaps the most important consideration in the foreign reserve management policy of Central Banks. Consequently, central bank reserves are invested in short to medium term low risk financial assets.

Sovereign wealth funds have assumed heightened popularity in the last few years, as many emerging countries have seen a **phenomenal increase in their international reserve holdings**. Most of these funds belong to commodity exporting countries that have benefited from the increase in the international prices of oil and gas (as in the case of **Norway** and the oil producing Arab countries) but you also have **Chile** (where the **commodity export** is copper) and **Botswana** (where the commodity export is diamonds).

There are a few countries that are not commodity exporters **that also have sovereign wealth funds.** These countries have accumulated significant foreign exchange reserves from trade surpluses. The most notable of these are **Singapore,** China, Hong Kong, South Korea and Malaysia.

As you know, **Trinidad and Tobago** is a commodity exporter, with heavy dependence on oil and gas. The energy sector accounts for **about 40 percent of GDP**; about **90 per cent of total exports and close to one-half of total government revenue**.

All of you would, no doubt, recall the first oil shock in the late 1970's and early 1980's when there was a significant increase in Government revenues consequent of the rise in oil prices.

Some of this windfall went to finance the **start-up of the petrochemical platform**, from which we are now benefiting. However, the increase in government spending also contributed to a rise in the **non-energy deficit,** from less that 10 percent of non-energy GDP to over 40 percent by early 1980s.

When oil prices collapsed, the end of the oil boom brought about the need for **a sharp fiscal adjustment** and **total expenditure had to be reduced from an average of 56 percent of non-energy GDP in 1980 – 1985 to 36 percent in the nineties**. Output per capita declined by about 33 percent between 1981 and 1992, and unemployment rose from 10 percent to 22 percent from 1987 – 1989.

Having learnt our lesson, when oil prices started to rise in the late 1990's, the Government established an **Interim Revenue Stabilization Fund**. Annual contributions were made to the Fund since 2000, but **it became** a **formal legal entity**, only in March 2007, with Parliament's approval of the **Heritage and Stabilization Fund**.

For the record, we now have **official reserves of about US$6 billion** and by the end of this month **assets in the Heritage and Stabilization Fund are expected to be close to US$2 billion**.

The Heritage and Stabilization Fund – is a joint account, firstly, to help deal with boom-bust cycles, and secondly to generate savings for future generations.

The rationale for **setting aside funds for stabilization is as follows**: (notwithstanding the prolonged increase in oil prices since the turn of the current decade), oil and gas prices are inherently volatile and even the most optimistic projections suggest that at some time oil prices will revert to a more normal long term equilibrium level. Given our economy's heavy dependence on oil and gas, a sharp fall in prices will affect government revenue and could require a drastic cutback in government spending. By putting aside some resources for stabilization, the Government would have the ability to cushion the impact on its spending and consequently on the level of economic activity.

The rationale for setting up a savings fund is a bit more complex and incorporates both economic and ethical considerations. It says that natural resources are an exhaustible sovereign asset, the benefits of which should be spread over generations. And therefore what a **savings fund** does is to transform the assets under the ground (in our case oil and gas) into a diversified portfolio of financial assets, **which are managed so as to yield a high rate of return, which will flow back into the budget as revenue** – not now—but when the oil resources have dwindled or have run out.

Thus, future generations will be benefiting from the oil resources (not in cash transfers), but by **not having to face expenditure** cutbacks because the oil and gas resources would have been depleted. Future generations will thus be enjoying the benefits of oil and gas resources even when the oil and gas resources are gone.

The flow of investment income from a commodity fund can go on for a very long time after the oil resources are gone, **if you have built up sufficient assets and if the country's fiscal position is sustainable over the long term**.

A recent study done by the IMF suggests that, given the expected trend in oil prices over the next two decades, the HSF could possibly build up assets of up to **US$40 billion by 2020, if we could move to a non-energy fiscal deficit of 10 per cent of GDP** (we are currently at 15 per cent of GDP). And this is a fairly conservative scenario since it assumes a rate of return on investment of 4 percent in real terms – which is considered average for sovereign funds.

The HSF Act approved by Parliament in March of this year, is very much consistent with best practice legislation for Sovereign Wealth Funds. The legislation provides for **clear deposit and withdrawal rules; a governance structure that incorporates checks and balances and a number of provisions to ensure adequate transparency and accountability**.

In terms of the basic deposit and withdrawal rules, the Act provides:

- **That on the deposit side**, a minimum of 60 per cent of the excess between actual and budgeted revenues must be credited to the Fund (where actual revenues are based on long term projected prices).
- **The withdrawal rule** allows the Government to tap into the Fund to cover 60 per cent of revenue shortfalls, provided that the shortfall is **at least 10 per cent** of budget revenues. This **is a maximum entitlement and the Government could elect to cover the entire shortfall through reductions in expenditure**. As indicated earlier, there is a cap on the amount of the Fund that could be used for stabilization.

There are some **other significant provisions** in the law or in the principles underlying the Fund. Thus, for example:

- HSF deposits are to be invested in **foreign assets** with a medium to long term focus.
- The Fund cannot be used to directly finance capital expenditure or as collateral for government borrowing.
- In principle, the Fund should be invested in assets not directly related to oil and gas (so as to avoid contagion).
- The Act comes up for review every five years.

An appropriate **governance structure** is critical for the smooth and optimal functioning of the Fund. Best practices require that the structure provides **a clear division of responsibilities** and an **effective system of checks and balances** with investment decisions based on professionalism in a clear line structure.

The HSF meets these criteria by defining clear roles for the major players – **Minister of Finance**, **the Board of the HSF**, **the Central Bank**, and the **Parliament**, which represents the people, as the ultimate authority.

The Minister of Finance is responsible for approving the deposits and withdrawal from the Fund.

The HSF Board decides on the investment objectives of the Fund and approves the Strategic Asset Allocation – which in effect is the **definition of the overall risk-return profile of the portfolio**. In the final analysis the Board is answerable for the overall performance of the Fund but it delegates this function to **the Central Bank, which is given responsibility for the day to day management of the Fund**. To fulfill its function the Bank will make extensive use of external fund managers which it will help to select and oversee. The Bank is also available to give technical advice to the Board as required.

The Parliament, as representative of the people has the ultimate oversight role of the Fund, exercised through review of the annual reports and the audited financial statements.

The credibility of the HSF depends importantly on the **degree of transparency and information disclosure** that is practiced. The legislation provides for:

- Quarterly Reporting by the Central Bank to the Board;
- Quarterly and Annual Reporting by the Board to the Minister of Finance;
- Annual Reporting by the Minister of Finance to the Parliament;
- Annual auditing by the Auditor General.

The **Norwegian Petroleum Fund** is recognized as the benchmark for transparency and disclosure of information. **The Norwegian Ministry of Finance reports to Parliament on all important matters relating to the Fund such as the size of petroleum revenues**; the outlook for fiscal sustainability, any planned changes in investment strategy and the Fund's performance, risks and costs. **The HSF Board and the Ministry of Finance will need to work out the scope of our information and disclosure policy**.

I would like to dwell a bit more on the concept of the **strategic asset allocation** and its importance in meeting the objectives of the Fund.

Let's recall that unlike the official reserves administered by the Central Bank, a main objective of the HSF is to maximize the **risk/return equation** or put another way, to maximize long-term returns at an acceptable level of risk. In the case of our official reserves, where the main objectives are safety and liquidity, the **Strategic Asset Allocation emphasizes money market instruments** (including deposits), short to medium term government securities of G-7 countries and other investment grade securities.

I am not in a position to say what the Strategic Asset Allocation for the HSF will look like. That's a decision for the Board. What I can say is that typically, sovereign wealth funds choose from a wider range of diversified asset classes which could include equities, commodities, emerging market stocks and bonds, real estate, and private equity. In practice, most funds focus on longer term fixed income securities and equities. In fact, the proportion of assets invested in equities is usually considered the main parameter in determining the risk assumed by the Fund.

Norway, which is unquestionably, one of the most successful of sovereign funds, **for a long time had a strategic asset allocation of 60 per cent fixed income securities and 40 per cent equities**, before increasing the share of equities to 60 per cent. There is an abundance of evidence to suggest that over the long term an appropriately diversified portfolio, comprising bonds and equities, could yield significantly higher real returns than one of purely fixed income assets.

Since the HSF Act was approved, much has been done to prepare for its active implementation.

Pending the appointment of the HSF Board and its instructions with respect to the investment of the portfolio, the **Ministry of Finance authorized the maintenance of the Fund "in accordance with the Investment Guidelines and Procedures used in respect of the Interim Stabilization Fund**". This meant maintaining the Fund in US dollar short term deposits, in institutions with high credit ratings.

You would have seen on yesterday's newspapers that the HSF Board is now in place.

The Bank is currently making arrangements for the longer-term management of the Fund. We are working with the World Bank **to develop the alternative scenarios, as a basis for recommending a Strategic Asset Allocation (SAA)** to the Board.

After the SAA is approved, the **next step will be to select External Managers**. Preparation for this latter stage has already begun with identification of a broad group of potential External Managers. The process of engaging external managers can be relatively long, largely because of the contract negotiation phase. We are hoping that this could be done in six to nine months.

Due to the length of time that could elapse between the approval of the SAA and the selection and engagement of the external asset managers, the Bank will develop an interim investment policy for recommendation to the Board of the HSF.

Work is well advanced in the **preparation of the Instrument of Delegation** which is a legal contract that details the duties and responsibilities of the Bank as it pertains to the management of the HSF.

A public education programme is also being developed to inform and prepare the public for the Fund.

Let me end with a few words about the critical importance of a public education and communication programme, for the success and credibility of the HSF. As I said earlier, it is important that the public understands what is involved in the HSF in order to get buy-in. For example some people need to be convinced of the need to put aside savings for future generations rather than to pursue expenditures to meet current needs.

It is important that we counter mis-information and misperceptions by, for example, **explaining the rationale behind the transfers to the Fund** and withdrawals from the Fund, when they become necessary. It is important that we explain the procedures behind the selection of external managers so as to underscore transparency and avoid the perception of special deals.

We need to manage expectations in line with market realities, since there are going to be questions about whether we are taking too little of too much risk, or the Fund is earning enough. A successful long term investment strategy is not incompatible with one or two years of low returns. In such circumstances, open communication could serve to maintain support for the Fund and its objectives.

Let me repeat that this is neither the Government's Fund nor the Central Bank's Fund; it is the **country's Fund** – for you and for your children and perhaps for your children's children. In addition to ensuring that the purpose and the operations of the Fund are well understood, **it is important that the public feels social ownership for the Fund as this will foster vigilance and ensure accountability, transparency and compliance**. In the final analysis, this is a precondition for the Fund's success.