Sovereign Wealth Funds: Practical Experience and Lessons from Trinidad and Tobago

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Summary

A. Background
- The number and sizes of Sovereign Wealth Funds have risen.
- SWFs have diverse objectives.
- They should be founded on the principles of transparency, accountability and good governance.

B. Trinidad & Tobago’s Heritage & Stabilization Fund
- Born of boom/bust period in 1970s/80s.
- Precursor was 2000 Interim Revenue Stabilization Fund.
- HSF formalized in 2007 legislation.
- Strategic Asset Allocation framework guides investment.
- Market conditions affect investment actions.
- Central Bank uses external managers to carry out investment.

C. Trinidad and Tobago’s Experience
- HSF Fund size grew consistently; mandate largely met and the Fund is an important macroeconomic buffer.
- Issues included ‘borrowing to save’ and dealing with investment in volatile capital markets.
- Consideration being given to splitting Fund into savings and stabilization components.

D. Lessons for setting up a SWF
- Make a start.
- No need to reinvent the wheel.
- Sound governance is key.
- Establishing public trust is important.
- Public may be wary of ceding too much control to governments.
- Some flexibility should be reserved.
- Central Banks well placed to manage but technical expertise must be strengthened.
Sovereign Wealth Funds (SWFs) have become an integral part of fiscal frameworks across the world. Figure 1: SWFs have been established by both resource and non-resource rich countries/states. Source: Sovereign Wealth Fund Institute. For illustrative purposes only, not meant to be comprehensive.

Figure 2: Number of SWFs by Region, as at 2018. Source: Sovereign Wealth Fund Institute.
SWFs have grown in size and number over the years.

**Figure 3:** Assets Under Management, Global SWFs

**Figure 4:** The number of Funds increased significantly following the last energy price boom

**Figure 5:** Number of SWFs: IFSWF Members vs Non-IFSWF Members, as at end 2018

Source: Statista.

Source: Sovereign Wealth Fund Institute.

Sources: Sovereign Wealth Fund Institute, International Forum of SWF (IFSWF).
The diversity among SWFs reflects the different needs of their owners

- The objectives typically dictate the type of Fund.
- Many SWFs have multiple objectives, e.g. Angola, Bahrain, Norway, Timor Leste, T&T, etc. (AlHassan et. al. 2013).
- It is important that the objectives of the SWF are aligned with the macroeconomic objectives of the country (Das et. al. 2009).

IMF Identifies 5 Types of SWFs

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- Objectives
  - Intergenerational Equity/Savings
    - Fiscal Savings Funds
    - Development Funds
    - Pension Funds
  - Stabilization
    - Fiscal Stabilization
  - Return Generation
    - Reserve Investment Corporations

See Das et. al. 2009.
Transparency, accountability and good governance are the foundations of a well-managed SWF

- The Santiago Principles, delivered in 2008 by the International Working Group of SWFs and the IMF, are considered industry best practice with respect to SWFs.
- They refer to 24 generally accepted principles and practices (GAPP).
- The International Forum for SWFs (IFSWF) comprises 31 members from across the globe, and supports members through knowledge sharing and representation to the wider financial community.

See IWG Sovereign Wealth Funds Generally Accepted Principles and Practices, ‘Santiago Principles’. 
Although SWFs are not homogenous, there are some common features.

**Objectives**
- Savings
- Stabilization
- Returns

**Governance**
- Legislative Framework and Fiscal Rules
- Institutional Framework
- Board of Directors and Oversight
- Guided by the Fund’s objectives
- Strategic Asset Allocation (SAA)
- External Manager Selection

**Investment Policy**
- Accountability to the owners of the Fund
- Routine publication of reports
- Investment Performance Analysis

**Reporting**
- See AlHassan et. al, 2013.
B. CHARACTERISTICS OF T&T’S HERITAGE AND STABILIZATION FUND (HSF)

Experiences from the 1970s/80s informed Trinidad and Tobago’s decision to establish its SWF

- Trinidad and Tobago (T&T) is a small, open, energy exporter. Main exports include natural gas, petrochemicals and crude oil.

1. T&T did not save sufficiently during the oil price boom of the 1970s.

2. The decline in oil prices in the 1980s led to a deterioration in the fiscal position, prompting the country into a SBA with the IMF in 1989.

3. The Interim Revenue Stabilization Fund (IRSF) was created in 2000.

4. The Heritage and Stabilization Fund (HSF) was formalized in 2007, subsuming the assets of the IRSF.

5. The country was better able to withstand the 2014 energy price shock.
An Interim Revenue Stabilization Fund (IRSF) was set up in 2000 as a precursor to the HSF

- The IRSF was first announced to the public in the fiscal year 1999/2000 national budget speech by the then Minister of Finance.

- As the name suggests, the initial intention was to save surplus energy revenues in order to cushion against future energy price shocks. It was in essence a ‘rainy day’ fund.

- At that point in time, there was no specific legislative framework to govern the operations of the Fund….but it was a start.
Plans for our HSF were fleshed out about 5 years later

- In 2004 the Government announced the decision to formalize T&T’s SWF into law.
- To do so, the Government engaged in widespread consultation and sought perspectives from international experts and countries with SWFs.
- International bodies such as the World Bank (including its Reserve Advisory and Management Program) and the IMF provided advice on international best practices, such as on governance, transparency and investment.
- Internal consultation was also key, with the proposed legislative framework and Fund objectives being discussed and debated in T&T’s Parliament.
- In 2007, Parliament passed the Heritage and Stabilization Fund Act formalizing the Fund into law and establishing its objectives, governance structure and deposit/withdrawals rules.
The HSF Act of 2007 established the Fund into law and sets its parameters

- The HSF has dual objectives of savings (heritage) and fiscal support (stabilization).

- The Parliament (elected) sets the legal basis for the Fund, provides oversight and is ultimately accountable to the citizenry.

- The Minister of Finance (MOF) appoints the Board, makes deposits and withdrawals according to the Act, and reports to the Parliament annually.

- The Board is responsible for the investment policy, including the SAA, performance reviews and reports to the MOF.

Source: Central Bank of Trinidad and Tobago.
The HSF’s flow of funds: deposits, investments, withdrawals in a fiscal context

**HSF** Assets under management of US$6.0 bn as at Sept. 2018 (25% of T&T’s GDP)

**Central Government Budget**

**Energy Sector** Monetizes T&T’s hydrocarbon assets and pays taxes

**Public Expenditure**

**Deposit and Withdrawal rules set forth in the HSF Act (2007)**

**Deposit Rules:**
- Where quarterly actual revenues exceed budgeted (surplus) petroleum revenues by 10%, the equivalent must be deposited into the HSF following the end of the quarter.
- In addition to the above, a minimum of 60% of surplus petroleum revenue to be deposited into the HSF in a fiscal year.

**Withdrawal Rules:**
- If actual revenues are at least 10% less than budgeted revenues.
- Withdrawals cannot exceed 25% of the Fund in a given fiscal year.
- There is a capital floor of US$1 billion, at which no further withdrawals are allowed.

**Investment Returns**
(The HSF has earned 5.6% per annum since inception to 2017)

**Invests in External Assets according to its Strategic Asset Allocation**

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Investment management is at the heart of the Fund’s operations

- There are several dimensions to consider when formulating the investment strategy:

  **Investment Decision Making**

  Where and how to invest?
  
  Guided by the Fund's objectives and risk tolerance limits.
  
  Informs the universe of assets: foreign vs domestic, financial vs non-financial, liquid vs illiquid, etc.
  
  Build SAA based on appropriate asset classes and risk-return optimization models.
  
  Contract external fund managers to execute the SAA. Involves manager selection and assessments.
Portfolio management is dictated by the Fund’s Strategic Asset Allocation

### HSF’s Strategic Asset Allocation

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Weight (Per cent)</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Short Duration Fixed Income</td>
<td>25.0</td>
<td>Bank of America Merrill Lynch 1-5 Year Treasury Index</td>
</tr>
<tr>
<td>US Core Fixed Income</td>
<td>40.0</td>
<td>Barclay US Bond Aggregate Index</td>
</tr>
<tr>
<td>US Core Domestic Equities</td>
<td>17.5</td>
<td>Russell 3000 Index excluding Energy</td>
</tr>
<tr>
<td>Non-US Equities</td>
<td>17.5</td>
<td>MSCI EAFE Index excluding Energy</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Central Bank of Trinidad and Tobago.

### Investment Considerations

- The Fund cannot be used to finance Government capital expenditure or used as collateral for borrowing.
- The Fund should be invested mostly in medium- to long-term foreign assets.
- The Fund should be invested in assets not directly related to oil and gas (avoid correlation with economic developments).
The HSF’s SAA was approved in 2007 and was to be achieved by 2010.

It basically involved moving towards a portfolio that was higher earning, longer term and included equities.

In the wake of the global financial crisis, some flexibility was needed.

Hence the transition to the new SAA was delayed, and achieved at the end of 2011 instead.

The timing was fortuitous as it prevented possible large losses due to the initial turbulence in equity markets.
The Central Bank carries out the investments using external managers

- The legislation designated the Central Bank of T&T (CBTT) as the Fund Manager.
- The CBTT is responsible for operationalizing the investment strategy of the Fund.
- The Bank is paid a management fee (3 basis points of Fund size), and in turn selects a global custodian for the Fund and contracts external managers to execute the Fund’s SAA.
- The Bank is responsible for ensuring that external investment managers invest according to the SAA, and provides them with the Fund’s objectives, benchmarks and risk tolerance limits.
- The Bank closely monitors and reviews the performances of the external managers.
- This arrangement has worked well so far. The same team in the Bank is responsible for investing the international reserves, but uses a different SAA.
- The Bank assures that its technical team is adequately trained and experienced to do the job.
Accountability and transparency: The HSF Act details the accounting and reporting structure

**Parliament**

**Minister of Finance (MOF)**
Presents audited financial statements no later than four months following the end of the fiscal year

**Auditor General**
The law requires annual HSF audits; Must be submitted to the MOF immediately after completion.

**HSF Board of Directors**
Submits: quarterly, annually and ad hoc reports as requested to the MOF

**Central Bank**
Submits quarterly reports on the holdings and investment performance, no later than one month after the end of the quarter to the Board;
Submits annual audited financials and investment report, no later than two months after the end of the fiscal year to the Board.
C. TRINIDAD AND TOBAGO: EXPERIENCE WITH THE SWF

The Fund size has grown consistently over the years

The Fund was accessed in fiscal years (FY) 2016 and 2017 for budgetary support, but the withdrawals were “financed” largely by portfolio returns, ensuring that capital was preserved.

<table>
<thead>
<tr>
<th>Financial Year Ended</th>
<th>Net Asset Value (Period End, US$ mn)</th>
<th>FY Contributions (US$ mn)</th>
<th>FY Withdrawals (US$ mn)</th>
<th>FY Total Comprehensive Income (US$ mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-Mar-07*</td>
<td>1,402.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sep-07</td>
<td>1,766.2</td>
<td>321.7</td>
<td>-</td>
<td>42.0</td>
</tr>
<tr>
<td>Sep-08</td>
<td>2,888.4</td>
<td>1,054.2</td>
<td>-</td>
<td>68.4</td>
</tr>
<tr>
<td>Sep-09</td>
<td>2,964.7</td>
<td>-</td>
<td>-</td>
<td>76.3</td>
</tr>
<tr>
<td>Sep-10</td>
<td>3,622.0</td>
<td>477.3</td>
<td>-</td>
<td>177.6</td>
</tr>
<tr>
<td>Sep-11</td>
<td>4,084.0</td>
<td>451.4</td>
<td>-</td>
<td>9.7</td>
</tr>
<tr>
<td>Sep-12</td>
<td>4,712.4</td>
<td>207.6</td>
<td>-</td>
<td>420.7</td>
</tr>
<tr>
<td>Sep-13</td>
<td>5,154.0</td>
<td>42.4</td>
<td>-</td>
<td>399.0</td>
</tr>
<tr>
<td>Sep-14</td>
<td>5,533.4</td>
<td>-</td>
<td>-</td>
<td>379.2</td>
</tr>
<tr>
<td>Sep-15</td>
<td>5,655.1</td>
<td>-</td>
<td>-</td>
<td>120.6</td>
</tr>
<tr>
<td>Sep-16</td>
<td>5,584.2</td>
<td>-</td>
<td>(375.1)</td>
<td>305.5</td>
</tr>
<tr>
<td>Sep-17</td>
<td>5,762.5</td>
<td>-</td>
<td>(252.5)</td>
<td>429.5</td>
</tr>
<tr>
<td>Sep-18</td>
<td>5,965.8</td>
<td>-</td>
<td>-</td>
<td>203.7</td>
</tr>
<tr>
<td>Total Flows</td>
<td>2,554.6</td>
<td>(627.6)</td>
<td></td>
<td>2,632.2</td>
</tr>
</tbody>
</table>

*Inception of the HSF.
The HSF provides both economic and psychological security.

The Fund enjoys widespread public support and citizens pay close attention to developments related to the Fund, including earnings, deposits and withdrawals.

The governance structure and reporting frameworks have worked well.

The size of the Fund represents an important macroeconomic buffer. As at September 2018, it was equivalent to about 7 months of imports cover.

Figure 8: Trends in HSF and Gross Official Reserves
There have been instances where the overall fiscal balance has been in deficit, but deposits were made to the Fund due to its rules—‘borrowing to save’.

The low international interest rate environment combined with periods of volatility have been challenging for investment management.
Considerations going forward include splitting the Fund into savings and stabilization components.

- Discussions are on-going on whether the HSF should remain a dual purpose Fund, or whether it should be spilt between the savings and stabilization components.

- Separation of the Fund can sharpen the investment focus, leading to better risk-return optimization, but there are some key questions:
  - How should we allocate between separate Funds?
  - What are the deposit and withdrawal rules for the separate Funds?
  - What are the costs implications of separating the Fund?

- A review of the Fund is ongoing and many ideas have been put forward by different parties, including:
  - Investing in domestic infrastructure;
  - Investing in domestic financial instruments;
  - Using for capital expenditure;
  - Changing deposit rules.
1. **Make a start**, with a simple deposit of a portion of energy revenues into a special account. The details will come.…

2. **There’s no need to reinvent the wheel.** Considerable expertise in the area of SWF management has been built over the last decade or so, learn from the experiences of others (World Bank, IMF, other countries).

3. **Sound governance is key.** The Fund should be established by law, with legislation providing the basis for its governance structure, reporting framework, rules and objectives. The Santiago Principles can be used to provide a broad framework.

4. **Establishing public trust is important.** Good communication is necessary to explain the trade-offs between intergenerational equity versus current needs and why there may be short-term volatility in fund earnings.
ADVICE (Continued)…

5. The holistic sovereign asset liability management (SALM) framework which integrates the Fund into the country’s economic and fiscal policies is useful, but the public may be wary of ceding too much control to governments for fear that the electoral cycle may dominate decision making on the use of the Fund to the detriment of saving for future generations.

6. Some flexibility should be preserved. The future is uncertain, the Fund and its rules may need to be reviewed periodically and adjusted if necessary to meet evolving societal needs, the investment climate and the macroeconomic situation.

7. The Central Bank is generally well placed to manage the Sovereign Wealth Fund. The agency function should be specified precisely and transparently, and the Bank would need to strengthen its technical expertise in investing and in dealing with external managers.
Thank you.
REFERENCES


