Sovereign Wealth Funds and Long-Term Development Finance: Risks and Opportunities

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**SWFs: Large and Growing**

- SWF holdings total about $6.35 trillion
  - Over 3 times Africa’s GDP
  - $3.8t from oil, gas, $2.5t from other
  - Major funds include China/HK ($1.7t), UAE ($1t)r, Norway, Saudi, Singapore, Kuwait, Russia, Qatar...

- Growing rapidly with high commodity prices plus China surpluses
  - Only $500 billion in 1990: 20% annual growth
Many countries are establishing new funds, including new resource exporters

- Examples include Nigerian Sovereign Investment Authority, Fundo Soberano de Angola, Colombia, Morocco, Tanzania, Uganda, Mozambique, Sierra Leone...

- These may not be the largest funds but they open up new possibilities for investments in Africa, and also raise some new questions.
Traditional: maximize returns subject to risk limits
Invest in liquid high-quality financial assets
Composition will depend on exact purpose of SWF

* Shift to wider range of investments: emerging markets
  * Infrastructure investment by SWFs:
    56 percent of funds invest in infrastructure (Prequin, 2012).
    Mostly non-domestic brownfield, low-risk, high-return, Europe, Asia

* Motivation for investments: commercial.
  * Portfolio optimization strategies like private funds
  * Yet are public investors: can be subject to pressures
At least 14 existing SWFs include domestic development objectives:

- several established since 2005, mostly resource-based:
  - Abu Dhabi, Angola, Bahrain, Kazakhstan, Malaysia, Nigeria, Russia, United Arab Emirates

- Planned by several other resource-rich countries:
  - Tanzania, Uganda, Zambia, Colombia, Sierra Leone, Republic of Congo
Abu Dhabi Investment Council (est. 2007):

➢ “To increasingly participate in and support the sustainable growth of the Abu Dhabi economy”.

Kazakhstan, Samruk Kazynah (est. 2008):

➢ “To develop and ensure implementation of regional, national, and international investment projects”.
➢ “To support regional development and implementation of social projects”.

Nigeria Infrastructure Fund (est. 2011):

➢ “To invest in projects that contribute to the development of essential infrastructure in Nigeria”.

Development objectives complement traditional goals: macro stabilization and saving abroad
SWFs and Infrastructure

* Role 1: traditional investor:
  * No reason to see SWFs as different to other investors with long investment horizons
  * Portfolio optimization: risk and return appropriate to fund purpose

* Role 2: domestic investor
  * Motivated by infrastructure gap, limited financing
  * Basic conflict of interest: fund owner is also investment promoter
Fiscal Rules for Resource Exporters

* Traditional” approach: some version PIH
  * Non-resource fiscal deficit = permanent return on resource wealth \( D = r \times W \)
  * \( W = \) accumulated savings + discounted future rents

* However, challenges to PIH
  * How to treat domestic infrastructure investments?
  * If high domestic return, boost \( r \) and open more fiscal space

* This approach breaks fiscal rule, leaving only absorptive capacity to constrain spending
Macro-fiscal risks

- Procyclical investments may exacerbate macro volatility
- Risk of inflating asset bubbles

Potential duplication national budget

- Relationship of SWF to the national budget process and procurement systems of sector ministries
- Could be used to bypass parliamentary scrutiny of spending
- May undermine quality of public investment and wealth objectives of the SWF
“Zero cost of capital”, no direct accountability outside government

- Funded by resource revenues, does not need to raise funds in financial markets
- Unlike pension funds, not accountable to contributors
- Not funded by tax revenue, not directly accountable to taxpayers
- Vulnerable to political interference and elite capture
- Risk of low-productivity, “white elephant” projects
Why Invest Domestically through a SWF?

* If able to operate as an expert investor can maintain a Wealth focus on investments

* Some argue: should never invest at home

* But its happening anyway........

* And other strategies are not risk-free either
  * Savings funds can be raided,
  * Budget spending might have little oversight
As an expert investor

- Sharing of risk with private investors
- May crowd in private investment to projects that would otherwise not be bankable but have an important development impact

Innovative PPP arrangements

- May accept a somewhat lower return on marginally commercial projects with large social benefits, thereby making the projects attractive for the private sector

Bring in external specialized capacity

- Where necessary may boost its capacity by involving foreign majority investors to strengthen investment discipline
Competitive investments

- Domestic allocations should compete with return on foreign assets, rather than fixed portfolio share for domestic investment.
- Possible limited mark-down from benchmark rate for investments that have a development impact.

Pooled Investments

- With private investors, other SWFs, IFIs.
- To bring additional expertise and integrity.
- Only minority stakes by domestic SWF.

Strong corporate governance

- Independent board, professional staff, transparent reporting, independent audit.
How to trade off financial vs. economic returns?

- Investing domestically on purely commercial basis:
  - New Zealand’s Superannuation Fund (currently 17% of portfolio),
  - Singapore’s Temasek (currently 25% of portfolio)
- But only if there are well-developed domestic equity markets
- Greenfield infrastructure investments are risky, frequently not bankable on purely commercial terms

Management risk:

- With a dual objective, SWF management can no longer be assessed purely on financial return
- Wider economic returns (externalities) are difficult to measure
- For Wealth focus only limited concessions on financial returns otherwise SWF unaccountable
Implications

* Only a narrow range of infrastructure appropriate for SWF investors
  * Need acceptable financial return in addition to economic return
  * Other investments through budget

Need:

➢ Transparent process for benchmarking financial returns and trading off financial against wider economic objectives
➢ Crowd in, rather than crowd out, private investors
➢ Invest only as a minority partner, to limit effects of political pressure
➢ Due diligence to ensure that the balance between risk and return does not unduly favor the private partners
Determining “home bias”, or mark-down from benchmark rate:
- Examples from development banks:
  - Return that exceeds inflation
  - Return that exceeds government long-term borrowing costs
- Specific target return
- IFC: Sustainability Program Quality Framework

Current proposal to address home bias:
- Target return for SWF overall portfolio, combined with a threshold minimum rate of return for all investments (further research)

SWF governance arrangements
- Global survey of SWFs that invest domestically
Thank You!