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NIGERIAN SOVEREIGN WEALTH FUND (SWF): LESSONS FROM EXISTING SWF[21]

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INTRODUCTION

Sovereign wealth fund (SWF) is a state owned investment fund composed of financial assets such as stocks, bonds, property, precious metals or other financial instruments and invested globally. When a country, by running a current account surplus, accumulates more reserves than it feels it needs for immediate purposes, it can create a sovereign fund to manage those "extra" resources.

Sovereign funds have existed since the 1950s, but their total size worldwide has increased dramatically over the past 1015 years (Johnson 2007). Kunzel, et al (2010) defined SWF as special investment fund created or owned by governments to hold foreign assets for long-term purposes. In recent years, SWF has witnessed remarkable rise to prominence in the international financial landscape. The largest holders of SWF include, Abu Dhabi Investment Authority, Norway's Government Pension Fund-Global, Kuwait Investment Authority, and China Investment Corporation. Collectively, SWFs managed assets are in excess of US$5.0 trillion. Although many suffered losses during the 2008 global financial and economic crises, SWFs managers have become important players in worldwide portfolio investment, especially in the wake of the crisis when they took stakes in companies as prominent as UBS, Citigroup, Morgan Stanley, Merrill Lynch, Barclays, Blackstone, Standard Chartered, and the Carlyle Group (Afyonoglu et.al 2010).

It is generally agreed that although SWF is not a new phenomenon, it has attracted much public debate in recent years owing to its increasing role in the global financial markets. The growth of these funds is part of the larger accumulation of foreign exchange assets by developing countries. Decades ago, funds were established by governments as commodity price stabilization funds as insurance against instability in price volatility especially in crude oil. With sustained increase in oil prices in recent years, these funds have changed from 'Stabilization Funds' to 'Sovereign Wealth Fund'. The main endeavor of SWF in all countries is to smoothen the short and medium-term fluctuations, and promote domestic economic stability. The Funds are set aside to maximize returns on investment and long-term goal of creating a pool of wealth for future generation. Currently, over half of global sovereign wealth funds are in the hands of oil exporting countries which include Saudi Arabia, Algeria, Libya and Kuwait.

In this regard, the initiative by Nigeria towards the establishment of a SWF with the aim of safeguarding the country's resources for future generations and building a robust institutional framework for strong fiscal policy and management of excess crude earnings, is a welcome idea. Since the discovery of crude oil deposits in the late 1950s, Nigeria had made several attempts to put aside surplus receipts arising from crude oil price increase. The most recent being the excess crude account (ECA) which was created in 2004 to enable the country save for the future and also stabilize fiscal operations, particularly deficit that could result from adverse oil price shocks. Although the present SWF is similar to the ECA, the initiative accords it legitimacy rather than being a product of political and economic expediency. The fund has a seed capital of US$1.0 billion. Currently, Nigeria is the only member of the Organization of Petroleum Exporting Countries (OPEC) without a SWF.

This paper would examine the merits and demerits of some existing SWFs with the view of drawing some lessons of experience for Nigeria to establish its own SWF. To do that, following this introduction, the paper in section two would outline the objective of SWF, section three discusses the merits and demerits of SWF, while section four examines countries experiences and section five dwells on the institutional framework for the fund and section six provides policy recommendation.

[21]*The views expressed in the paper are those of the author and do not in any way represent the official position or thinking of the Central Bank of Nigeria. The author acknowledges the comments and criticisms of anonymous reviewer.*

2.0 Objectives of Sovereign Wealth Fund (SWF)

The prime objectives of creating SWF are economic and strategic in nature. It is created when governments have budgetary surpluses and have little or no external debt. It is not always possible or desirable to channel excess liquidity or surpluses into immediate consumption. Therefore, SWF is created as store of wealth for future generations so that they can benefit from the resources after their depletion. The fund is also a mechanism designed to reduce the impact of volatile fiscal revenues and/or foreign exchange receipts, linked to the pro-cyclical pattern of export prices or volumes.

Generally, there are two types of SWF: saving funds and stabilization funds. Stabilization SWFs are created to reduce the volatility of government revenues, to counter the boom-bust cycles' adverse effect on government spending and the national economy. It is believed that SWF in resource rich countries can help avoid resource curse. Generally, sovereign wealth funds are held solely by central banks, which accumulate the funds in the course of their fiscal management of a nation's banking system and are usually of major economic and fiscal importance. Other sovereign wealth funds are simply the state savings which are invested by various entities for the purposes of return on investment which may not have significant role in fiscal management. Generally, when states institute SWF, they also put in place well defined rules for investment and withdrawals from the Fund as it matures from the initial stabilization objectives. Countries with high levels of foreign reserves are no longer contented with low returns offered by international banks. For example, the Singaporean SWF declared its desire to "achieve good long term returns" on "Singapore's foreign reserves". China diverted its foreign currency reserves from the Central Bank to provide the China Investment Corporation (CIC) with $200 billion to start its sovereign wealth fund. Nowadays, states use their sovereign wealth fund as a means to diversify their economies and improve their human capital.

Most countries explicitly or implicitly state as an objective, investment of their SWF in the domestic or regional economy. States may use their SWF to make much needed infrastructure investments while others use theirs to restructure their economies to specialize in a particular area. For example, states such as Abu Dhabi and Qatar with large per capita sovereign wealth restructured their cities into large financial service centers importing specialized financial talent from and around the world. Others focus more on the diversification of their economy away from a commodity dependent economy. Sovereign wealth funds have also been increasingly professionalized, importing world class talent to improve the quality of financial management and domestic human capital. These days, countries are no longer contented to park financial capital in assets that earn a negative real return in foreign markets.

According to the Sovereign Wealth Fund Institute (2009), countries that have created SWF globally include United Arab Emirates (US$ 627 billion), Algeria (US$56.7 billion),Libya (US$70 billion),Kuwait (US$202.8 billion),Venezuela(US$0.8 billion, Saudi Arabia (US$439.1 billion), Iran (US$23 billion) and recently Angola (N/A). Other countries that have substantial investment through SWF are Norway (US$512 billion) and China has three corporations where its fund is invested. These corporations are the State Administration of Foreign Exchange (SAFE) Investment Company established 1997 with (US$347.1 billion), the National Social Security Fund established in 2000 with (US$ 146.5 billion) and the China Investment Corporation established in 2007 with (US$ 332.4 billion). The three corporations' cumulative fund stood at (US$826.0). The Chinese SWF has its origins from non-commodity exports and invested in a variety of asset classes in developed and emerging markets. Significant investments have been made in the UK equity market with top holdings in Royal Dutch Shell, Rio Tinto, BG Group, Tesco, BHP Billiton, and Barclays. Other areas of Chinese investment through its SWF include hedge funds, futures, sovereign debt, corporate debt and real estate.

3.0 Merits and Demerits of SWF

3.1 Merits of SWF

From economic perspective, countries that promote SWF have a valuable tool for achieving certain public policy and macroeconomic goals including infrastructural development. The movement of capital around the world with unregulated ease can contribute to rapid productivity growth and a global boom. Significantly, SWFs are established for four principal reasons. Firstly, they are created as an inter-generational fund transfer mechanisms, whereby future revenues are guaranteed by today's earnings. When a country's natural resources are exhausted, future generations can continue to live prosperously using the earnings of their forefathers. Next, most sovereign wealth funds are created to diversify a country's income so that it can respond to shocks to the country's comparative advantages. When a country is faced with a competitiveness crisis, it can call on its sovereign wealth fund assets to reinvest in new sectors of the economy that can revive the country's competitive advantages. Thirdly, countries establish sovereign wealth funds to increase the return on assets held in their central bank reserves. By investing in other sectors than U.S. or European sovereign bonds, they can raise returns above the 3-5 per cent annual returns acquired by most foreign reserve holdings. The rapid rise of SWFs has undoubtedly brought a number of benefits including as a source of capital against the backdrop of the current financial crisis to number of financial institutions.

As argued by Curto (2010), in the next decade, SWFs would have the potential to boost global wealth by helping recycle large savings in budget surplus countries toward more productive investments, particularly in the developing countries. Over the medium term, many developing countries will continue to depend on external savings to finance critical investment. On the supply side, major fiscal stimulus packages in advanced economies are likely to result in a general re-pricing of sovereign debt risk and the associated cost of borrowing; and in more limited access to and a crowding-out of credit for developing-country borrowers, forcing some of them into fiscal austerity if they do not find alternative resources. In this context, SWFs could bridge the gap between the growing investment needs and the reduced supply of external resources, thereby sustaining growth, accelerating progress towards the Millennium Development Goals, increasing economic integration, and helping build the foundations for a multi-polar world. Africa, in particular, may benefit most from SWFs' resources, given its relatively weak starting point in trade, regional integration, infrastructure, and private sector development.

In particular, SWFs rapid development reflects the significant shift of emerging economies from world's debtors to world's creditors. Indeed as from 1999, the emerging world as a whole began to run a current account surplus and export capital to the rest of the world as well as accumulating foreign assets. When the level of such assets outstripped the level of reserves needed for stabilization purposes, it became reasonable to try to increase returns on investment by diversifying investments from traditional government debt securities. SWFs are being accumulated rapidly and being invested more actively, buying stakes in western companies with the aim of reducing the impact of volatile oil and other commodity prices on government revenues, balance of payments and savings for future generations.

3.2 Demerits of SWF

The first major criticisms of SWFs deal with their effectiveness. As shown by a 2007 IMF study on sovereign wealth funds in natural resource-exporting countries, there is little evidence to show that sovereign wealth funds have achieved the goal of "smoothing out" liquidity, government expenditures, and pension obligations between times of strong and weak natural resource prices. Furthermore, the IMF reported that countries possessing SWFs found it difficult to coordinate fund operations with fiscal policy, where investments by companies held by SWFs did not occur in concert with government programs. Very few SWFs have ever been asked to draw down their holdings for the greater, "national" well being, and, in general, the IMF found that SWFs acted as independent bodies, disconnected from their governments. The IMF in the study found an interesting paradox in the relation between SWFs and their home countries that, the more reliant a country is on one commodity, the less effective its SWF is in achieving its goals. Secondly, another major criticism of sovereign wealth funds as discussed by Balin (2008), is that their goal of building a financial base that can be used to respond to shocks in comparative advantages is misguided. He argued that, it makes much more sense to invest now to diversify a country's economy and protect against possible comparative advantage shocks than to create an "endowment" to rebuild an economy once a shock occurs.

4.0 Countries Experiences

Norway

The Norwegian SWF provides an excellent opportunity to systematically evaluate the performance of one of the largest Sovereign Wealth Funds. Norges Bank Investment Management (NBIM) was formed in 1998 as a separate agency within the Norwegian central bank (Norges Bank) responsible for investing its SWF assets. It evolved from the Petroleum Fund that was established in 1990, now the Government Pension Fund-Global. Fundamental purpose of the Norwegian fund is to allow Norwegians to smoothen their pattern of spending relative to the volatile pattern of the nation's oil revenue. The goal of its fund is maximum income subject to a level of risk and portfolio specified by the Ministry of Finance. The Norwegian government has acknowledged the transitory nature of oil with its production declining steadily since 2001 and prices have been erratic. The Fund was first authorized to invest in equities in 1998, and the allowable equity share was increased from 40 to 60 per cent in 2007. The Fund was authorized to hold nongovernment bonds in 2002 and real estate and private equity by April 2008. Accountability is insured by requiring that the Fund's actual portfolio remains close to a benchmark specified by the Finance Ministry. Fund Management regularly meets and compares the performance of portfolio managers with the benchmark to ensure that fund managers are not taking excessive risk on investments.

To achieve transparency, the NBIM publishes quarterly and annual reports. The NBIM hires both external and internal portfolio managers and detailed management expenses are reported regularly. External managers are identified by firm and responsibility (equities, fixed income, region, industry) and they are compensated on the basis of performance. Employees are not exclusively Norwegian nationals, and the Fund has offices in London, New York and Oslo. The actual performance of the Fund is as result of decisions of many individual portfolio managers operating within general guidelines set by the government.

United Arab Emirates (UAE)

The UAE has one of the largest Sovereign Wealth Fund (SWF) in the world with over US$620 billion under management of the Abu Dhabi Investment Authority (ADIA). Founded in 1976, the source of the fund is primarily from the oil wealth of the Emirate of Abu Dhabi. According to ADIA's 2009 Review, ADIA's sole mission is "to invest funds on behalf of the Government of the Emirate of Abu Dhabi to make available the necessary financial resources to secure and maintain the future welfare of the Emirate". A robust and discerning investment powerhouse, highly sought after in fund investor portfolios, ADIA is a truly global operation with only 30.0 per cent of its 1,200 staff from the UAE, 36 per cent from Asia and 12 per cent from Europe. ADIA does not invest in the UAE or Gulf region. With a substantial SWF and a gross national income (GNI) per capital of $11,906, Emirate of Abu Dhabi can afford not to invest in their region. UAE's investment of its SWF had helped build its capital, Abu Dhabi, which is the second largest city in the emirates. The city is currently counted as one of the most progressive ones in the entire world. Until the mid 20th century, the economy of Abu Dhabi was maintained by camel herding and production of dates and vegetables. Fishing and pearl diving were also engaged during summer time. However, things changed completely after the city struck oil, in the year 1958 and gained independence in 1971.

Kuwait

Kuwait's SWF is probably the oldest sovereign fund in the world with the objective of transferring non-recurring oil revenue into a diversified portfolio to create a social stability in the country. In 1953 the Kuwait Investment Authority (KIA) established the Kuwait Investment Office in London in order to invest oil revenues and reduce Kuwait's reliance on oil. In Kuwait 10.0 per cent of all state revenues are transferred annually to the Future Generations Fund, including 10 percent of the income generated by the General Reserve Fund. By 1986, government revenue from investments exceeded oil revenue. The KIA is a government-owned corporation responsible for managing the sovereign wealth fund of Kuwait created in 1953 to create a fund for future use and lessen the country's dependence on its oil reserves. The source of the money for the sovereign wealth fund is derived primarily from the excess proceeds from Kuwait's oil reserves. The fund is divided into General Reserve Fund and the Future Generations Fund. According to the Sovereign Wealth Fund Institute, the Kuwait Investment Authority controls the seventh-largest sovereign wealth fund in the world, with approximately $202.8 billion in assets under management. Kuwait Investment Authority was instrumental in rebuilding the Kuwaiti economy in the aftermath of the Iraqi invasion of the country which sparked the 1990 Gulf War. The combination of increased stability, increased returns, and greater economic power through the concentration of its finances makes the creation of an SWF an appealing policy for such powers.

China

China provides another classic example of SWF. For many years, China's rapid export growth has caused it to accumulate an ever-growing reserve that reached US$1.5 trillion by 2007. As a consequence of the rapid increase within the last decade, the government established its sovereign wealth fund, the China Investment Corporation (CIC) on September 29, 2007 with US$200 billion in initial capital. The CIC is one of the largest sovereign wealth funds (SWFs) in the world. The investments by the CIC are commercial based, seeking to maximize return on investment. Since its creation, the CIC and its subsidiaries have made several investments, including the purchase of 9.9 per cent of the U.S. financial firm, Morgan Stanley in 2007. The CIC was created to improve the rate of return on China's $1.5 trillion in foreign exchange reserves and to soak up some of the nation's excess financial liquidity. China's economy is rapidly growing and coupled with its foreign exchange reserve and the large SWF, China saves today to consume even more in the future. Its high savings rate reflects what economists call "precautionary saving" against a downturn. The CIC is a semi-independent, quasi-governmental investment firm established by the Chinese government to invest a portion of the nation's foreign exchange reserves. The CIC reports directly to China's State Council, conferring it with the equivalent standing of a ministry.

5.0 Institutional Framework and Governance Structure of SWF

Based on generally accepted principle and practice (GAPP) - the Santiago Principal document (2008), the institutional and governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF. Regardless of the specific governance framework, the SWF's operational management should be conducted on an independent basis to ensure its investment decisions and its operations are based on economic and financial considerations consistent with its investment policy and objectives as well as free from political influence or interference. The governance structure should be set out with legal framework through relevant legislation, charter or other constitutive documents. It should ensure appropriate and effective division of oversight, decision making, and operational responsibilities. However, a number of SWFs are established as separate legal entities with clear governance structure while others are established as pools of assets without separate legal personality. The owner may exercise the functions of the governing body through one or more of its organizational units (e.g., a ministry, a parliamentary committee, etc.). In such case, it is important that there should be a clear distinction between the owner/governing body and the agency responsible for the operational management of the SWF. For example, the operational management of the SWF could be delegated to an independent entity or a separate statutory agency.

6.0 Conclusion and Policy Recommendation

Generally, SWFs are established as inter-generational fund transfer mechanisms to diversify a country's income and to increase return on assets held in central bank reserves. Based on survey of some countries experiences such as in Norway, UAE, Kuwait and China, SWF provides an excellent investment opportunity. For example, the Norwegian Norges Bank Investment Management (NBIM) was formed in 1998 with the responsibility of investing Norwegian SWF assets. The fundamental purpose of the Norwegian fund is to allow Norwegians to smoothen their pattern of spending relative to the volatile pattern of the nation's oil revenue. The goal of its fund is maximum income, subject to a level of risk and portfolio specified by the Ministry of Finance. Similarly, UAE has one of the largest SWF in the world with over US$620 billion under management of the Abu Dhabi Investment Authority (ADIA) founded in 1976. UAE's investment of its SWF has helped build its capital Abu Dhabi which is the second largest city in the emirates. The city is currently counted as one of the most progressive in the entire world. Until the mid 20th century, the economy of Abu Dhabi was maintained by camel herding and production of dates and vegetables. Kuwait is another country whose SWF is probably the oldest in the world founded in 1953. In Kuwait 10.0 per cent of all state revenues are transferred annually to the SWF, including 10.0 percent of the income generated by the General Reserve Fund. By 1986, government revenue from investments in the SWF exceeded oil revenue. Kuwait SWF was instrumental in rebuilding the Kuwaiti economy in the aftermath of the Iraqi invasion during the 1990 Gulf War owing to increased stability, increased returns, and greater economic power.

Surely, the current initiative by Nigeria to establish a SWF is a welcome idea and a valuable tool for achieving certain public policy and macroeconomic goals. With the current economic downturn, establishment of SWF is an elegant idea but we need to know a lot before we rush to embrace its establishment. There is the need to have strong institutional arrangements with rules and regulations on how the fund would be utilized, borrowed and where to invest. There has to be a well structured regulatory and oversight structures in place and transparency. Any disbursement, withdrawal or appropriation of the fund should be in strict compliance with the provisions of the bill governing its establishment. Appointment to the fund management should be based on technical expertise not on the basis of political, ethnic, or other partisan considerations.

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