



Event Summary

Roundtable on the Governance of Natural Resource Funds Hosted by Brookings Institution, April 9th 2014

The Revenue Watch Institute-Natural Resource Charter (RWI-NRC) and the Vale Columbia Center on Sustainable International Investment (VCC) organized a roundtable discussion on the governance of natural resource funds (NRFs) on May 9th. The event was hosted by the Brookings Institution in Washington, D.C. and brought together stakeholders from the international financial institutions, think tanks, the private sector and non-governmental organizations.

The roundtable started with a brief overview of findings and recommendations of a joint study of NRF governance by RWI-VCC, before the floor was opened for a discussion of the research and emerging trends and challenges in the management of these funds. The RWI-VCC study surveyed 22 natural resource funds, covering 18 national and subnational jurisdictions. Profiles of these funds were produced following the in-depth study of the laws, regulations and policies governing one or a set of funds in a given country or subnational jurisdiction. Primary sources were used when available and all profiles were peer-reviewed by sovereign wealth fund experts. Lessons from these case studies are crystalized into five *Policy Briefs* and a six-step policy process to enhance the governance of NRFs. Details can be found at www.revenuwatch.org/nrf.

Salient themes from the discussion

The goal of the meeting was to help build consensus amongst of variety of stakeholders around the role of NRFs and what constitutes good governance of these increasingly important institutions. This note covers several themes from discussion that sharpen the focus on some of the leading governance and policy challenges around NRFs.

NRF governance in the context of overall institutional quality

The discussion raised a number of questions around the interaction between the specific governance structures of NRFs and the more general institutional quality of the countries and sub-national territories in which they are found. Two specific questions that warrant further analysis and research are: whether sound governance arrangements for NRFs can be, and indeed have been, established in jurisdictions characterized by weak institutions at the more general level; and whether detailed governance structures around NRFs are required in countries and territories that have strong institutions at the more general level and a track record of prudent economic policymaking and respect for the rule of law.

With regards to the latter question, several participants cited historical examples of problems with NRFs in countries and territories with otherwise strong institutions. A prime example is the NRF of Alberta, which has largely stagnated due to a dearth of steady deposits of capital funded by resource revenues, despite the quality of institutions and policymaking in the province and the country more generally. A more robust governance structure, particularly the specification of a clear fiscal (savings) rule, would have resulted in a more steady accumulation of assets managed by the fund. This would have aided its stated objective: managing part of today's resource revenues for future generations. It was also observed that even in the cases of Norway, Chile and several U.S. states (North Dakota and Wyoming), which today possess widely lauded NRFs, the current governance and institutional structure around these funds only emerged in response to previous failures and problems – including irregular withdrawals and deposits, the mismanagement of finances and investment, and a lack of transparency and accountability.

It is more difficult to find examples of NRFs with sound governance structures and a *sustained* track-record of success in a country with otherwise poor institutions. There may be qualified successes (Saudi Arabia and Trinidad & Tobago) and promising starts (Ghana, Timor-Leste and Papua New Guinea) – but several participants questioned whether these positive developments will be sustained in the absence of more generalized institutional and governance reforms. Of particular interest for future research is whether different institutional and political contexts require a differentiated approach to the *governance* of NRFs (naturally, the policies and mandates of NRFs do, and should, differ depending on the social, economic and political context in which they are found).

Constraint versus discretion: different institutional structures in different contexts?

A critical dimension of the preceding question is the extent to which the governance structure of NRFs should attempt to impose iron-clad constraints on discretionary power, rather than permitting some flexibility to exercise “constrained discretion” by the NRF's board and/or senior management. An example of a tight constraint is the establishment of an NRF's asset allocation, investment targets and risk limits *in law*. In contrast, merely specifying an institutional mandate and objectives in law, and then permitting the board/management to interpret and reflect these through their own *Investment Policy* statement is an example of an institutional arrangement that permits greater flexibility and discretion.

While the RWI-VCC project identified the clear and unambiguous specification of investment risk limits as an example of good governance, it was noted that current best practices amongst public investors is for the government or public owner of assets to allow an independent Board of Directors to articulate and quantify risk limits, asset allocation and target returns as a reflection of the mandate and objectives it receives from the former. This allows the independent Board to make qualified assessments of the risks and opportunities in the financial markets, which are dynamic and therefore require annual or bi-annual reviews. However, in exceptional circumstances, characterized by concerns that even such limited discretionary powers may be abused (for example, due to a lack of expertise and independence of the NRF's Board or Policy Committee), it may be desirable to "hardwire" the critical investment parameters into law. The usefulness of such second-best institutional solutions need to be assessed across a range of NRF governance arrangements (including whether a new bureaucracy is established for the operational management of the NRF, and whether it is accountable to new or existing supervisory authorities).

NRFs in the context of severe capacity and human capital constraints

The discussion also focused on how NRF governance structures and policies – and indeed the decision to establish an NRF in the first place – need to reflect the availability of human capital, investment expertise and institutional capacity to manage such funds. A number of the participants agreed that the decision to establish an NRF may in many ways largely reflect the realization that the country lacks the requisite capacity to manage a large windfall of resource-related revenue in a short space of time through spending and investment in the domestic economy. Several participants agreed that, particularly if the investment model and strategies of the NRF is relatively simple (for example, passive investments into global indexes of public assets), the management of such a fund can be considerably less skills- and capacity-intensive than the management of large-scale public investments funded by volatile resource revenues. In addition, private sector fund managers and the International Financial Institutions can assist in the management of NRF assets in the absence of "in-house" investment expertise and capacity.

Building public support for the NRF

The discussion touched on the extent of public support for NRFs amongst domestic stakeholders, and ways in which this may be enhanced in the future. It was noted that successful NRFs, such as those in Norway, Chile, Botswana, and Timor-Leste are popular institutions that enjoy a high degree of broad-based public support; although it may take some time to build such support. A striking observation is that governments have typically done remarkably little public education and consultation prior to the establishment of their NRFs. This certainly is an important dimension to explore, not only from an ethical and accountability perspective, but also to ensure that citizens and other stakeholders are fully informed of the purpose and objectives of the NRF and to put pressure on governments to comply with their own legislation governing NRFs.

Another concrete step that governments can take in order to generate public "buy-in" for a NRF is to be explicit about the fund's liabilities. In particular, tying the assets of intergenerational or savings-type NRFs to

future liabilities – for example pension, healthcare or education benefits – in a transparent way, can help build public support and demands for accountability on the part of government and the management of the fund. Similarly, a fund that generates a steady stream of investment income provides an alternative and supplementary form of fiscal revenue, which can be explicitly tied to particular recurrent budget expenditure items, such as the maintenance of schools, hospitals or infrastructure. The overarching message is that linking an NRF's assets and income to liabilities in a transparent and accountable manner, improves public support and buy in for the fund (in addition to being an ethical practice of government).

Compliance with governance rules

Several participants noted the lack of compliance with fiscal rules and good governance standards, despite widespread acceptance of the *Santiago Principles*. This provoked a wide ranging discussion around how NRF governance can be improved, particularly in the low-capacity environments in which they are proliferating. Two points were stressed. First, appropriate rules that find the right balance between constraining policymakers yet remaining flexible enough to adjust to changing circumstances are crucial. This includes deposit rules, withdrawal rules, investment risk constraints and rules about fund institutional structure. Second, there needs to be strong independent oversight by parliament, the judiciary, media and the public to pressure the government to comply with its own rules. Examples of strong oversight came from Chad (*College de Controle et de Surveillance des Revenus Petroliers*), the Ghanaian Public Interest and Accountability Committee, and the Timor-Leste judiciary.

The biggest current challenge: balancing domestic and foreign investment

A pervasive theme during the discussion was the need to strike an appropriate balance between domestic and foreign investment of resource revenue – particularly in the context of resource-rich developing countries that have significant infrastructure investment needs. Many unresolved issues remain around the role of NRFs in striking this balance, but the discussion touched on two key policy issues:

- **How much to save:** this remains one of the biggest policy challenges for developing countries in particular, with the answer depending on the expected size and of revenue windfall, the type of resource (with different degrees of volatility and unpredictability), the administrative ability and absorptive capacity to channel revenue windfalls into productive domestic projects, etc. What is clear, however, is that the so-called “Norwegian model” of saving *all* resource revenues (and only using investment income of the NRF to finance the non-oil budget deficit) is most likely too conservative for most resource-rich developing countries, who should use some part of their current revenue windfalls to finance domestic capital investment needs. That said, volatility and absorptive capacity constraints mean that even capital-scarce developing countries may wish to save *unanticipated* and/or *unsustainable* revenue windfalls – for example, by transferring all resource revenues that accrue above a conservatively estimate “hurdle price” (for example, \$79 per barrel for oil), to a savings fund (to preserve part of the windfall for future generations) or a stabilization fund (to provide a source of financing for when prices or production drop unexpectedly).

- **Should the NRF make domestic investments:** this is rapidly becoming the biggest policy debate around NRFs. A domestic mandate could be justified in reference to:
 - Domestic investment needs, particularly in infrastructure where a large financing gap remains a stumbling block;
 - Higher expected returns on domestic investment vis-à-vis foreign investments;
 - The need to diversify the structure of the economy and revenue sources away from a dependence on volatile and finite natural resources and extractive industries;
 - The fact that a NRF should in theory have a longer investment horizon than that of the annual budget, which is more aligned with the investment profile of, for example, physical infrastructure projects.

However, the case *against* a domestic investment mandate is also compelling:

- The NRF should not be a substitute for a rigorous and consultative budget process – the risk being that an NRF becomes an unaccountable mechanism through which to direct public resources and bypass the budget.
- Once a domestic investment mandate is added to NRF, the fund’s governance arrangements necessarily become much more complicated, as the fund needs to establish and employ a robust framework for selecting and approving projects (that insulates its domestic investment decisions from undue political pressure).
- It is not clear what type of investor in the domestic economy a NRF would be: would the NRF simply provide the initial capital to finance domestic projects; would it remain involved and liable for recurrent expenditure and financing (for example maintenance of physical infrastructure, or the salaries of education and health care workers in the schools and hospitals it financed); would the NRF become of a project-manager or developer of large-scale infrastructure projects and schemes, or assume positions on the board of such undertakings?

The RWI-VCC study made the argument that an NRF should not make *direct* investments in the local economy and should at all times remain subject to parliamentary approval through the budget process. This recommendation stems from the fact that a NRF should never become a “quick fix” for deep-rooted governance and capacity problems around the budget process. The danger is not only that a NRF would then delay and disincentivise the need for difficult fiscal reforms, but also that the bypassing of standard, consultative budget-approval processes is a step backwards in terms of transparency and accountability in resource-revenue management. The other strong recommendation of the RWI-VCC study is that purpose, selection and performance criteria for any domestic investments should be made explicit: there is no *a priori* assumption that domestic investment *have to be* return-maximizing, but for the sake of transparency, accountability and good governance of natural resource revenues, NRFs should declare whether their domestic investments are made in order to maximize returns or achieve broader economic objectives (such as infrastructure development, diversification and employment).

Conclusion

Natural resource funds are an increasingly popular institutional innovation through which to manage resource revenues: 30 of the 54 funds currently active were established since 2000, with authorities in more than a dozen more countries considering or planning new funds. While a trend toward legislated governance rules and greater transparency leaves much to be optimistic about, the RWI-VCC project and the roundtable discussion at the Brookings Institution underlined what is perhaps the single most important over-arching policy implication: NRFs may be seen as part of the solution to the prudent, accountable and sustainable management of natural resource revenues in countries with large and unsustainable oil, gas or mineral revenue windfalls, but they are not a panacea that negates the need for deep-rooted reform and capacity development in many resource-rich countries.

The over-arching challenge for many resource rich countries is to establish a robust fiscal and budgetary framework, which includes sound taxation and revenue collection policies. Natural resource funds are merely a part of such a fiscal framework. Several participants emphasized the dangers of assuming that the establishment of a NRF is a panacea or one-stop solution to the resource curse – a belief that is arguably taking root amongst the many enthusiastic adopters of new NRFs. Participants agreed that there is a real danger that NRFs are sold as a “quick fix”, which delays more fundamental reforms and capacity building to ensure that resource revenues are managed in a sustainable and growth-enhancing manner.