KEY MESSAGES

- Natural resource funds (a subset of sovereign wealth funds) can help governments respond to some of the macro-economic challenges of natural resource wealth by setting aside or investing some or all of natural resource revenues in foreign or other assets.

- To be effective, funds must have clear objectives, and their deposit, withdrawal and investment rules must be aligned with those objectives. Potential objectives can include smoothing expenditures, savings, mitigating Dutch disease, earmarking for public investment, ring fencing and political leverage.

- Stabilization funds can help smooth budget expenditures and savings funds can set aside revenues until they can be spent more efficiently or create an endowment for future generations.

- Fiscal rules for natural resource funds dictate how much a government deposits into and withdraws from the fund each year. Which fiscal rules a government applies should take into account the overall fund objective and the amount of savings or expenditures necessary to meet that objective in the country context.

- Natural resource funds are most effective when they are subject to independent external oversight and publish regular reports on investments, activities and managers.

WHAT ARE NATURAL RESOURCE FUNDS?

Natural resource funds (NRFs) are a revenue management tool used by many governments as a way of investing or putting aside revenues derived from oil, gas or mineral extraction. As of July 2014, there were approximately 58 funds in more than 40 countries holding about $4 trillion in assets. Funds are created for many different reasons and used in many different ways. Some countries created funds to cover budget deficits when revenues decline, save for future generations, earmark for national development projects, or mitigate Dutch disease. In other countries, however, funds have been created or used to avoid the public scrutiny of the regular budget process.

Effective management of natural resource funds requires clear objectives, fiscal rules, investment rules, division of responsibility between actors, public disclosures, and oversight opportunities.
FUND OBJECTIVES

The objective of a fund is a clear statement about why the government is putting some money into a different account instead of directly into the budget. Governments create NRFs for a variety of reasons, including:

- **Smoothing expenditures.** The volatility of resource revenues can lead some governments to create a *stabilization fund* that will receive deposits when prices are high and supplement the budget when prices are low. See figure 1.

- **Saving.** Where the exhaustibility of resource revenues is a primary concern, governments may direct a portion of these revenues to a *savings fund*. The investment returns on these funds can then be used to finance government expenditures once oil or minerals are depleted.

- **Mitigating Dutch disease.** Saving a portion of resource revenues in foreign assets can mitigate inflation and exchange rate appreciation that often comes from a large influx of resource revenues. This tactic is called *fiscal sterilization*.

- **Earmarking for public investment.** Some countries find that using a fund to earmark resources for particular development goals can guarantee financing for chronically underfunded expenditure items, such as environmental protection, water systems or education programs.

- **Ring fencing.** By subjecting natural resource revenues to a high degree of transparency and public scrutiny, natural resource funds can be used to protect resource revenues from corruption or mismanagement.

- **Political leverage and autonomy.** Having large savings can protect a government from needing to borrow from private banks or international financial institutions during economic downturns, both of which can impose burdens on the government. Subnational governments with NRFs find that they may become less dependent on the national government, both financially and politically. Unfortunately, natural resource funds have also been used by some governments to avoid public scrutiny and pursue their own objectives, either by releasing scant information on their activities or using them as a parallel and less accountable budget.

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*Sovereign wealth funds*

Sovereign wealth funds are state-owned entities with macroeconomic objectives that invest at least partly in foreign financial assets. A natural resource fund is a type of sovereign wealth fund.

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*Figure 1. Volatile revenues*

(Source: Bauer, Andrew, Subnational Oil, Gas and Mineral Revenue Management (NRGI, 2013), 12)
NRGI strongly urges governments establishing funds to clarify their objectives so that the fiscal and investment rules they select are appropriate. Some countries create multiple funds with different fiscal rules to meet different needs. Other countries, such as Timor-Leste, create one fund with multiple objectives.

**FISCAL RULES**

_Fiscal rules_ for natural resource funds dictate how much a government deposits into and withdraws from the fund each year. Which fiscal rules a government applies should take into account the overall fund objective and the amount of savings or expenditures necessary to meet that objective in the country context. For example, if a country needs financing for development projects and has the _absorptive capacity_ to implement projects, then the government may wish to spend more and save less. However, the government may also wish to save a significant fraction of resource revenues to create a buffer in case of economic downturn. The rules also need to take into account which revenue streams (bonuses, royalties, fines, sale of profit oil, etc.) are deposited into the fund. Withdrawal rules specify how often withdrawals can be made, where they must go and whether they need to be approved by parliament.

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**Case study: Ghana**

When news came of large gas discoveries in Ghana, the government decided to establish multiple resource funds to meet various objectives. Though the rules are somewhat complex, they show how a government can meet different objectives with different operational rules. All petroleum revenues are deposited into the Petroleum Holding Fund. The Petroleum Holding Fund then disperses money to the Ghana National Petroleum Company (up to 55 percent of carried interest), the Annual Budget Funding (not more than 70 percent of a seven-year average of potential revenues, which must be approved by parliament), the Ghana Heritage Fund (minimum 30 percent of the remaining amount), and the Ghana Stabilization Fund (remainder). The clear goals of the Heritage Fund and the Stabilization Fund also dictate different investment rules to help them reach these objectives.

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**Figure 2. Flow of petroleum funds in Ghana**

_Source: Ghana profile in Bauer, Andrew (ed.), Managing the public trust: How to make natural resource funds work for citizens (NRGI and Vale Columbia Center, 2013)._
INVESTMENT RULES

Once a country decides to deposit revenues, it must make decisions about how, where and when to invest them. As with any investment, the decisions about where to invest the funds depend on the appetite for risk and desired return. A fund’s objectives should inform its financial return target and act as an implicit statement of the fund’s risk appetite. For example, a stabilization fund, which may be needed to fill budget gaps in the short term, must hold liquid assets that are more readily available. Assets could be allocated in a range of choices, such as:

- **Cash**: Highly liquid and low-risk, low-return, such as short-term government bonds and bank deposits
- **Fixed income/bonds**: Debt instruments with more risks and return, such as corporate bonds
- **Equities**: Stocks in companies with varying degrees of risk and return
- **Alternative assets**: More volatile and complex assets with higher long-run expected returns, such as real estate and infrastructure

Usually, fund managers select a breakdown of these different types of assets based on the fund’s overall risk. Sometimes the actual investment decisions are made by government or central bank officials, called *internal portfolio managers*. In other cases, the government or central bank hires a firm to make the actual investment decisions for them within a clear set of instructions.

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“As with any investment, the decisions about where to invest the funds depend on the appetite for risk and desired return.”

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Figure 3. The risk-return profile of major asset classes


Risk: The possibility that returns won’t be positive in the short term
FUND STRUCTURE

The structure of the fund lays out who inside and outside of the government makes decisions about the fund. Key roles required in a fund include the ultimate authority, fund manager, advisory body and operational manager. These roles are listed in figure 4. Generally the roles can be divided into three levels.

- **Ultimate authority:** Usually held with the legislature, executive branch or central bank board of governors, the ultimate authority approves deposits and withdrawals, approves fund manager decisions and chooses and dismisses the fund manager.
- **Fund manager:** Usually held by the executive branch (often the minister of finance), central bank or special agency, the fund manager sets investment guidelines and deposits and withdraws money from the fund.
- **Operational manager:** Usually held by someone in the ministry of finance, central bank or a separate entity, the operational manager is responsible for day-to-day trading, advises on investment guidelines, selects and oversees external managers, and reports on fund activities.

Countries vary greatly in how they have allocated these different roles within their existing structure. That said, researchers find funds most effective when the day-to-day management of the fund is done by politically independent, skilled actors with strong internal controls. The choice of where to house this day-to-day operational manager—whether as a unit within the central bank, a unit in the ministry of finance or as a separate entity—is context-specific. However, no matter how they are designed, effective management and organizational structures are key determinants of good fund governance of NRFs. In addition, strong codes of conduct and monitoring systems can help prevent misconduct by the fund’s executive and staff.

“Researchers find funds most effective when the day-to-day management of the fund is done by politically independent, skilled actors with strong internal controls.”
Figure 4. Model natural resource fund organizational structure

Ultimate Authority

Options
- Legislature
- Executive (e.g., President)
- Central bank board of governors

Responsibilities
- Approves deposits and withdrawals
- Approves fund manager decisions
- Chooses and dismisses the fund manager

Advisory Body

Responsibilities
- Provide research and recommendations on investment strategies
- In some cases, approve and control withdrawals from the natural resource fund

Fund Manager

Options
- Executive (e.g., Ministry of Finance)
- Central bank
- Special body (e.g., Supervisory Board)

Responsibilities
- Sets investment guidelines
- Deposits or withdraws money

Operational Manager

Options
- Ministry of finance
- Central bank
- Separate entity

Responsibilities
- Day-to-day trading
- Advise on investment guidelines
- Selection and oversight of external managers
- Reporting

Governing or Supervisory Board

Responsibilities
- Approves the fund’s budget and strategic plans
- Approves changes to risk management and reporting processes
- Advise or approve changes to asset allocation or eligible assets

Executive Committee or Managing Director

Responsibilities
- Oversee all aspects of the investment process
- Allocating internal operational budget
- Staffing (human resources management, compensation, recruitment and training)
- Strategic and organizational planning
- Managing the internal audit

Front Office (Investments)

Responsibilities
- Market research and trading
- Managing the external managers
- Preparing investment reports for internal and external stakeholders

Middle Office (Risk Management)

Responsibilities
- Measure, monitor and manage all operational, credit, counterparty and market risk
- Establish, recommend and maintain benchmarks
- Propose appropriate asset allocation

Back Office (Settlements)

Responsibilities
- Financial reporting and accounting
- Conducting internal audits and interacting with external auditors

Ultimate Authority

Source: Bauer, Andrew and Rietveld Malan, Institutional Structure of Natural Resource Funds (NRGI and Yale Columbia Center, 2013), 3.
NRF TRANSPARENCY

NRF transparency is necessary to promote efficiency, prevent fiscal crisis, improve policy coherence and allow for oversight actors to do their job effectively. To be considered transparent, a NRF must have clear roles and responsibilities for managers and policy makers, publicly available information, open decision-making processes, reporting and assurances of accurate information.

- **Defining of clear roles and responsibilities:** The roles and responsibilities of the key actors and institutions should be clearly defined well in advance.

- **Publicly available information:** Freedom to easily access information on managerial activities, financial flows in and out of funds, specific assets and returns on investments are key elements of natural resource fund transparency.

- **Open decision-making processes and reporting:** The government needs to give assurances to the general public that resource revenues are being used effectively to meet social and economic policy goals.

- **Assurances of integrity:** Data should meet accepted criteria of quality, and there should be oversight mechanisms in place.

INDEPENDENT OVERSIGHT

Independent oversight is the supervision of government behavior. Such oversight is only possible when there is sufficient transparency for someone outside the fund’s operations to analyze the work of the fund. For NRFs, oversight bodies can encourage a government to follow its own rules, meet its own objectives and manage funds in the public interest. Who provides oversight varies from country to country but can include the legislature, the judiciary, regulatory agencies, external auditors, the media, civil society organizations or citizens. Oversight tends to be most effective when the oversight body has expertise in the topic under investigation, possesses the power or capacity to investigate, has access to information, holds enforcement power, and is integrated with the institutional environment.

The risks of poor oversight are drastic. In Libya, for example, the ex-dictator’s son, Saif al-Islam Gadhafi, had nearly full discretion to manage much of the fund’s approximately $65 billion. The fund showed very disappointing results. Reports by government officials reviewing the fund’s management written after the fall of the regime found that in addition to investing with companies run by those close to the regime, the fund took very large investment risks and paid unnecessarily high transaction fees. The type of oversight provided by these reports during a new government could be provided during the investment process when there is a properly empowered independent oversight actor.
QUESTIONS TO ASK

- Does my country use a natural resource fund?
- What are the objectives of my country’s natural resource fund? If my country does not have a fund, what objectives do I think would be most important to use a fund for?
- How is the fund in my country structured?
- What are the fiscal rules for withdrawal and deposits in my country?
- Where are the assets in our fund invested, and what are the rules for making decisions about investments?
- Can I readily access information about the roles of different people involved in the fund, the fund’s assets and investments, and the fund’s strategy? Do I trust this information?
- Does anyone provide oversight to the fund? If not, who do I think would be the optimal oversight actor?

ADDITIONAL RESOURCES


