Sovereign Wealth Funds: A Model for Citizenship by Investment Programmes in the ECCU (Summary)

EASTERN CARIBBEAN CENTRAL BANK

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Key Recommendations[1]

1.0 Establishing a regional Sovereign Wealth Fund is a proactive step towards a sustainable long term economic strategy.

2.0 The excess flows from the citizenship by investment programmes can be used to create a SWF which will become useful in insulating the economy when the inflows from the CBI are not forthcoming.

3.0 The establishment of an appropriate body, with responsibility for compliance, to monitor the activities of the SWF to ensure that the managers adhere to the regulations.

4.0 The development of appropriate legislation by Parliament to ensure that the SWF's financial statements are published and that the assets' size and portfolios are known.

[1] The full paper can be accessed on the ECCB's website – http://www.eccb-centralbank.org

1.0 Introduction

Subsequent to an increase in corporate sector investments over the last decade, sovereign wealth funds have been a popular subject in the debate on international investments. Sovereign wealth funds (SWF) are state-owned investment funds developed with the purpose of investing surpluses or excess reserves. The growing interest in sovereign wealth funds emanated from the steady increase in the value of their total assets since the beginning of the recent global economic and financial crisis. Sovereign wealth funds' assets were estimated at US$5.4 trillion at the end of 2013, recording growth of $750b over the level in 2012. This improved performance is attributed to an increase in both the volume and value of these funds world-wide. These investments therefore yield substantial returns, which the governments may utilize for various purposes, including imminent liability.

The Eastern Caribbean Currency Union (ECCU) comprises of eight countries in a common financial arrangement governed by a Monetary Council. Recently there has been much discussion on the issue of economic citizenship programmes or citizenship by investment (CBI) programmes that have been undertaken by a few of the countries within the ECCU. Currently, there are programmes in Antigua and Barbuda, Dominica, Grenada and St. Kitts and Nevis. The legislation for a CBI programme in Saint Lucia was passed in the House of Parliament and the programme was officially launched in January 2016. Available data indicate that the programme in St Kitts and Nevis is the most popular, as it provides visa-free access to at least 100 countries worldwide. Additionally, these investment programmes constitute a significant proportion of non-tax revenue in three of the ECCU countries.

Cognizant of the significance of the OECS economic union and the importance of the CBI programme to majority of the territories in the ECCU, how useful or efficient would the framework of sovereign wealth funds be to these countries or to the ECCU on a whole? Will the establishment of a sovereign wealth fund assist in the effective management of the inflows from the CBI programmes? The rest of the note is as follows;

Section 2.0 provides an analysis of the strengths and weaknesses of sovereign wealth funds, Section 3.0 examines what a CBI funded SWF should look like, Section 4.0 looks at the source and use of SWF funds and finally Section 5.0 concludes the note.

2.0 Strengths and Weaknesses of a Sovereign Wealth Fund

There are tremendous benefits to be had from creating SWFs and as (Dedu & Nitescu, 2014) pointed out these include protecting the national wealth and economic diversification especially for economies that depend on limited raw material exports. A sovereign wealth fund also contributes to a sustainable long term economic strategy and can aid central banks in sterilizing the surplus of liquidity, countering macroeconomic cycles and assist in sustaining key infrastructural projects.

In comparison to other forms of asset management, SWFs are not only highly liquid, but attract long term investors who are less sensitive to market conditions and have a high risk appetite (Dedu & Nitescu, 2014). Additionally, SWFs are highly diversified in locating higher yields and attract little to no debt. If the fund is incorporated, its cost of capital is determined using the weighted average of the cost of debt and the cost of equity, and therefore with little or no cost of debt or cost of equity, SWFs may be able to accept lower returns on investments than listed companies – private or public. Considering that SWFs are not liable to any individual or institutions per se, they do not have to worry about paying returns or dividends to investors, who may threaten to withdraw, and as a consequence SWFs have more leverage in adopting longer term investment strategies (Jory et al, 2010).

A SWF should be considered in the context of an overall sovereign balance sheet, as it aids in the mitigation of risks associated with exchange rates, monetary policy and fiscal policy (Al-Hassan, et al., 2013). SWFs assist in reducing the pro-cyclicality of fiscal policy, as withdrawal rates are clearly stipulated and remain consistent with the purpose of the fund. Also, since SWFs do not borrow money and have the backing of central governments, it is not necessary to account for any default risk in their cost of capital

(Jory et al, 2010). Consequently, SWFs have the ability to successfully compete with other funds by accepting lower rates of return on investments, which results in more valuable investments than those financed through debt or equity.

In times of crisis it is more likely that much needed funding will come from SWFs. During the most recent global economic and financial crisis, on the onset of the crisis, SWFs invested almost US$40 billion in the US financial sector; indicating that SWFs help cushion the negative impact of a crisis (Jory et al, 2000). Finally, SWFs are efficient in the redistribution of capital and credit from wealthy nations to needy underdeveloped countries and so a number of developing countries stand to benefit from the financial resources of sovereign funds for much needed infrastructural development.

Given the sheer size of sovereign wealth funds, these investment vehicles can and have become systemically important in global financial sector development. Jory et al (2010) warns that while SWFs have grown significantly over the years on an international level, concerns about their political risks have remained elevated, due largely to issues with transparency and disclosure. In this light, limitations associated with SWFs include not only a lack of transparency, but also political interference. It is difficult and perhaps near impossible to totally eliminate political involvement in SWFs given that they are owned by governments, both democratic and non-democratic. A fund may be influenced by the political mandate through representatives on its board or management committee. This influence may inevitably lead to corruption in the form of nepotism, which can hinder the recruiting and retaining of scarce, highly demanded, skilled managers, who are paramount to the sustainability of any fund.

While institutions may be set up to own and manage SWFs, the policy framework generally reflects the objectives set by the state and may be biased towards identified priorities, which could compromise the achievement of optimal returns. Also, the nature and structure of these funds may promote a level of protectionism, where countries are likely to carefully select investors, who may not be the best candidates, for particular investments (Johnson, 2007).

3.0 What should a CBI - SWF in the ECCU look like?

Taking into consideration the positive impacts of SWFs on a country's economy and given that the actuarial reports for a number of social security systems in the ECCU highlight the challenges that demography is likely to pose on the existence of these pension schemes, a SWF for the ECCU may be a useful and viable undertaking. In this light, it becomes necessary to develop a framework for a SWF, which uses CBI flows as its source of funding for investments. Furthermore, it is important to create a roadmap for the establishment of a SWF and an asset allocation framework for its successful operation.

3.1 Governance and Associated legislation

The Working Group of Sovereign Wealth Funds (IWG) was set up to give support and guidance to SWFs, given their relevance in recent difficult financial times in the international economy. To encourage best practice, the organization designed the generally accepted principles and practices (GAPP) based on intense research into the governance structures of existing funds and surveys of these institutions. As a result, it is important to take on board the recommendations of the IWG for the proper set-up of SWFs and sound investment decisions. The three main pillars of any SWF are the legal framework on which it is built or developed, its institutional framework and the framework of its investment portfolio and management of risk. Following the enactment of the appropriate legislation, identifying the main objectives and ensuring that they harmonize with the main macro-economic policies, proper governance is imperative.

Since the ECCU consists of eight territories, the governance structure will have to include representatives from each country. The main function of Parliament in each territory will be to approve the legislation, hence ensuring that the basis for existence and operation is legal. While the ultimate beneficiaries of the fund will be the governments, an investment company should be incorporated to act as owner and manager of the SWF. The Executive board, at the top of the management hierarchy, will be responsible for the internal guidelines of the organization and will appoint the CEO. The CEO will oversee all the managers, giving them guidance and instruction on the goals set by the Executive Board.

On the supervisory side, the internal audit, although accountable to the Executive Board, will assist the board in overseeing the fund's management to ensure that it operates in line with all regulations and procedures. External audits will ensure that the fund is adequately supervised and that the control mechanisms are efficiently executed. In most of the ECCU countries, the Public Accounts Committee (PAC) is charged with the responsibilities of examining public audits and questioning policy makers – ministers, permanent secretaries and other ministry officials. These audits may be conducted, reviewed or commissioned by the Auditor General. Therefore, the Auditor General is well poised to commission, conduct or review audits of the SWFs; present these to the PAC when necessary and ensure that reports on the activities of the fund submitted to Parliament are accurate and timely.

Table 1: Roadmap to Establishment of ECCU Sovereign Wealth Fund

Activity	Responsibility	Time Frame
Legislation – SWF Regulation	Attorney(s) General, ECCB LSD, OECS Must be passed by Parliament in all countries	12-24 months
Determination of Model – Manger Model or Investment Company Model	Parliament, Ministers of Finance (Monetary Council), other stakeholders including Central Bank and OECS	9 – 18 months
Establishment of Governance Structure	Parliament, Ministries of Finance, Central Bank, OECS, other	6 - 9 months
Appointment of Executive Board	Cabinets with guidance from OECS and Central Bank	3 - 6 months
CEO	Recruitment Agency appointed and monitored by Executive Board	3-6 months
Managers	Recruitment Agency with input from CEO	3-6 months
Establishment of Compliance Unit – with requisite operational autonomy and manned by adequately qualified and trained personnel	CEO and Managers with assistance and guidance from Executive Board	4-5 months
Appointment of Auditors	Management Team with input from OECS and ECCB	3-5 months

Source: Authors' Estimates

4.0 Source and use of SWF funds

To develop a SWF in the ECCU, member governments actively involved in economic citizenship programmes can provide a percentage of excess revenue to the fund on a quarterly/annual basis. For example, the Federation of St Kitts and Nevis received $414.7m in non-tax revenue for 2014 of which $296.1m was attributed to the CBI. The budgeted amount for the CBI in 2014 was estimated at $100.0m. Presumably, the government of St Kitts and Nevis can allocate a portion of the excess $196.1m to a SWF for investment purposes. A conservative allocation of 15.0 to 20.0 per cent can provide $29.4m to $39.2m to the fund.

The Government of Saint Lucia projects average collections of approximately $70m per annum from its Citizenship by Investment Programme. An allocation of 15 to 20 per cent will contribute approximately $10.5m annually to a SWF. The Government of Antigua and Barbuda and Grenada have seen annual inflows of over $100m from the economic citizenship programme, while the government of Dominica budgeted on average $75m per fiscal year for the last 2 years. The conservative 15 to 20 per cent allocation towards an ECCU wide SWF could range from about $15m to $38m per annum on average from each country with a CBI programme.

Another strategy that could be adopted is one used by the SWF in Ireland, which is supported by the Government, through an allocation of 1.0 per cent of GNP per annum. The ECCU can decide to combine the allocations from the CBI, with a 1.0 per cent (or a percentage agreed on) of GDP from the countries without the CBI so that they too could be included in the SWF. Anguilla, Montserrat and St Vincent and the Grenadines will together contribute approximately $20m yearly. These funds can yield favourable returns if invested using a 50/30/20 split in fixed income, equity and cash respectively.

The returns associated with SWFs are used for a variety of purposes and often reflect the initial purpose for which the fund was constructed. SWFs are designed to provide an additional cash flow stream to governments when it is absolutely necessary. Often these flows are used as fiscal balancing tools and may offset budget deficits or increase transfers and subsidies to specific social groups or productive sectors. Evidence of these or similar activities was noted with the SIDF in St Kitts and Nevis. The SIDF has been used to provide grant funding to entrepreneurs in the country, as well as to develop infrastructure.

Using the experiences from countries outside the region and what currently obtains in the ECCU countries with a CBI programme, an ECCU SWF can be a useful tool for developing important sectors within the region, proportionate to a country's contribution to the SWF. Further, the fund may be utilized as a fiscal tool, under specific guidelines, in times of economic malaise. Since a SWF is countercyclical in nature, the fund may be used to off-set macroeconomic volatility in the fiscal balances of a country. Countries may draw from the funds to offset fiscal deficits and reduce the impact of an external shock. The region is susceptible to natural disasters, particularly with the adverse impacts of global warming. A buffer immediately following an unfortunate weather occurrence augurs well for impact mitigation and recovery.

It is important to note that seventy-five per cent of the ECCU territories consistently register fiscal balance deficits and more than fifty per cent record annual external deficits. Consequently, saving and investing funds have become a challenge for these countries. Since SWFs are mainly funded by surpluses, it may be prudent to implement a SWF for the ECCU on a phased level. It would begin with St Kitts and Nevis, since the Federation has been realizing surpluses and its CBI programme is very successful. The second phase would gradually incorporate the remaining countries with the CBI programmes, as their fiscal situations turn around. In the final stage, the non-CBI countries will be taken on board. Also, the fund could start with short term investments to satisfy government liquidity needs and gradually develop into a full-fledged SWF for long term purposes.

5.0 Conclusions and Recommendations

Based on the foregoing analyses, some very useful deductions can be postulated. Foremost is that there are a number of benefits to be derived from establishing a SWF for the ECCU. Given the region's vulnerability to natural disasters and other external shocks, which ultimately impact fiscal operations and growth objectives, a SWF would serve as a significant buffer in these critical times. A key platform for the implementation of a sovereign wealth fund framework is the work currently being conducted in the Commonwealth of Dominica on a resilience fund using the inflows from the CBI. Further, the history of the region has shown that annually, at least one of the territories is adversely affected by an exogenous shock, with consequent fiscal and growth setbacks. The region's policy makers need to be a bit more proactive and put additional measures in place, which allow for immediate response and also to mitigate the negative impact of these occurrences. A sovereign wealth fund, according to the literature, has proven to be a very appropriate medium for this level of fiscal consolidation.

Since SWFs vary based mainly on their stated objectives, management and investment strategy, it is therefore important that those are clearly defined from the onset. The important issues have to be addressed prior to the establishment of a fund. What is the purpose of the fund? Who will manage it and how will the investment strategy be determined? Additionally, it is imperative that the management framework for the SWF be enshrined and clearly stated in the legislation. Hence, before the establishment of a SWF, the proper legislation must be developed and passed by Parliament to ensure that the financial statements are published and that the assets' size and portfolios are known. An appropriate body, responsible for compliance should be appointed to monitor the funds' activities to ensure that the managers of these SWFs adhere to the regulations.

Making the relevant information on a SWF available to the public is likely to reduce the level of resistance towards that fund and combat the current challenge of non-disclosure.

The main stakeholders should be involved in the discussions about the SWF so that best practice can be used in the setting up, management and continuous monitoring of these funds. Due to their nature, political interference may not be eliminated but governments should avoid using these funds as a tool for geopolitical advancement. The International Working Group of SWFs advocates the use of the generally accepted principles and practices (GAPP) of SWFs in understanding the objectives, general management and operative functions of a SWF. Although adopting the GAPP principles is voluntary, careful consideration should be given to their implementation when operationalizing a SWF.

SWFs have a track record of being used for fiscal consolidation and stability, which can augur well for the state of the region at this juncture. The regional focus continues to be on, inter alia; fiscal reform programmes that are expected to translate into more effective debt management and contribute to overall economic growth. A SWF fuelled largely by the excess flows from the citizenship by investment programmes, may be extremely useful in insulating the economy when the inflows from the CBI are not forthcoming. As the region has been warned by experts, there will come a time when due to competition, changes in the global economy or otherwise, the CBI programmes may not be able to yield the anticipated flows for budgetary support. The region needs to prepare and not be caught unaware as serious fiscal imbalances are likely. Establishing a regional SWF is a very proactive step towards a sustainable long term economic strategy.

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