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Investigating the Possibility of a Sovereign Wealth Fund for Nepal

Policy Brief

Prepared by Enzo Rovira Diaz

Contributions by Kamakshi Shah

Supervised by Dr. Bijan Bhattarai and Dr. Biswas Gauchan

Institute for Integrated Development Studies

Background

Sovereign Wealth Funds have taken the world by storm in the last century these institutions serving as national private equity firms competing in the global market and investing foreign exchange surpluses from resource and government revenue streams to achieve better returns than foreign bonds. Nepal currently has a surplus of almost \$5 billion U.S Dollars that are invested in low-yield bonds, this amount of money could generate greater returns if invested in national projects, international companies, and Nepali entrepreneurs. In 1854, the State of Texas in the United States of America established the Permanent School Fund to fund the development of the state's education. Ever since the inception of the first SWFs in the United States of America the rest of the global community has adopted the concept to utilize funds raised from a variety of revenue streams to raise more funding for national objectives. Some of the most notable sovereign wealth funds today are the likes of Norway's Norwegian Bank Investment Management (NBIM) which manages the Government Pension Fund of Norway (GPNF) with a portfolio of almost U.S \$1.6 trillion, China's China Investment Corporation (CIC) which commands a portfolio of U.S \$1.3 trillion, and Singapore's Temasek Holdings which manages a portfolio of U.S \$287 billion just to name a few. While most of the funds are funded from natural resource revenues, it is not a requirement. Modern funds use surplus revenues from different sectors ranging from petroleum to finance, and even donations to maintain capital. Sovereign Wealth Funds around the world command a cumulative total of \$11 trillion through all their portfolios. The concept has proven successful over the last two centuries helping fund large infrastructure projects, pushing national financial objectives, and maintaining a source of financial security for future generations.

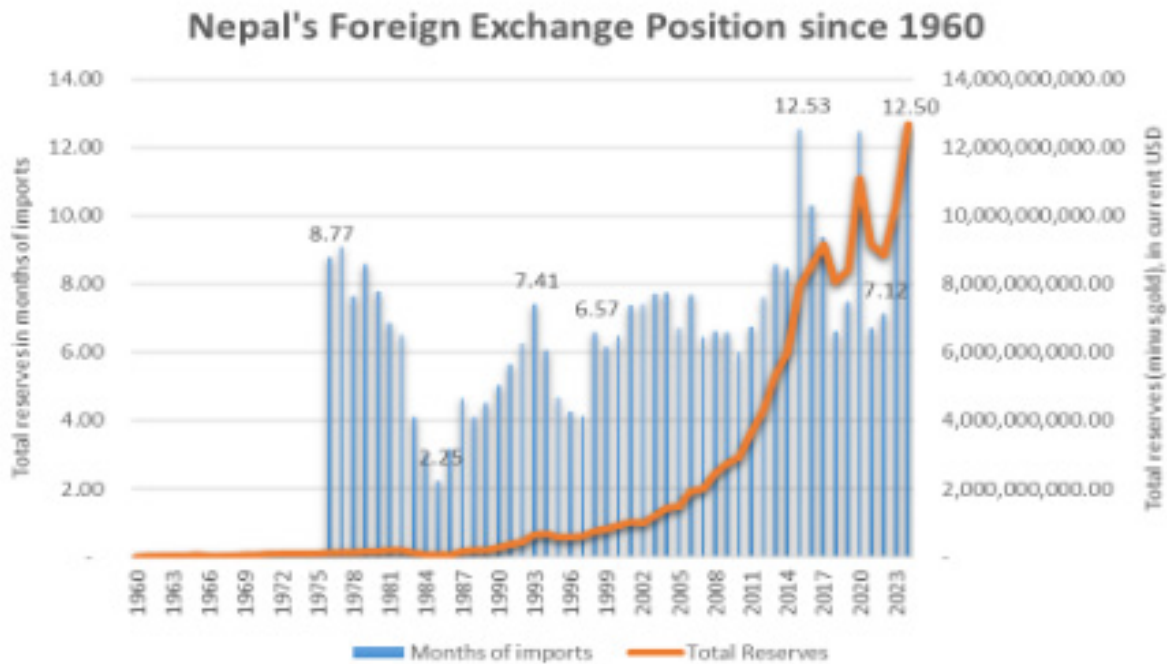
A Case for Nepal A Proven Method

Most of the SWFs around the world finance their funds through the use of their FOREX surpluses, be it from trade, natural resources, or other sources of income such as donations. Nepal finds itself in a position where it has recently accumulated a surplus of foreign currencies in its reserves. The status quo commands that the money be invested in foreign financial instruments such as bonds from the United States and India, however, these provide relatively low returns compared to the returns seen by SWFs through domestic and foreign investments. Through the establishment of a sovereign wealth fund, Nepal could efficiently utilize its reserves all the while helping prosper its nascent industries through domestic investments made by the sovereign wealth fund. Establishing a national investment fund would also provide a means for entrepreneurs and firms to receive capital for their projects that they would have to have found in foreign investors abroad. A firm would provide the opportunity for a new generation of entrepreneurs to establish themselves and grow their startups in Nepal rather than taking the project abroad to places like Dubai, Silicon Valley, and Shanghai.

A Tool for Economic Stability

The establishment of a SWF may also attract foreign investment by presenting the SWF as a partner in the projects being invested in. Countries such as the UK are establishing national wealth funds with the objective of bringing in about £3 in foreign investment for every £1 spent by a British Sovereign Wealth Fund. The very same idea and objective would apply to a Nepali fund, to attract an amount in foreign capital for every dollar spent from the foreign reserves in domestic investments. An aspect to be noted of SWFs is their impact on the macroeconomic conditions of a country, most funds abroad such as Mumtalakat of Bahrain, The Heritage & Stabilization fund of Trinidad and Tobago, and Norway's Norges Bank Investment Management invest mixed portfolios or wholly international portfolios. Investing internationally can mitigate negative impacts on the domestic economy which have arisen as a result of "Dutch Disease" when a sector grows so dominant over the national economy that it hurts national productivity. Dutch Disease has arisen in Nepal as a result of large foreign currency inflows from remittances. Over 70% of households in Nepal depend on currencies for daily expenses, this proves that Nepal could for the foreseeable future depend on remittances as its source of FOREX as one could look at how other countries depend on natural resource revenues to fund their SWFs. Another issue however concerning the fact that 70% of households depend on remittances is that national productivity is incredibly low, and this is further backed by the fact that Nepal has been running a large trade deficit for years and imports have been hitting historical highs with the peak being only 3 years ago in 2078/2079. The situation draws parallels to that of Sri Lanka, however the same crisis as Sri Lanka can be avoided if the Nepalese government commits investment to raise national productivity, and this could be achieved through the establishment of a Sovereign Wealth Fund. Sovereign Wealth Funds have been used as "cures" to Dutch Disease all around the world from the Gulf States to Europe to small countries such as Timor L'Este thus it has been a proven solution to the issues raised by over-dependence on one sector. A portfolio that may find a 60/40, 60% domestic investment and 40% international (Following the 60/40 stocks-bond model) investment would allow for a fund to provide conditions to grow local industries through investments and hedge from potential crises that may hurt the value of the fund's portfolio. A Nepali SWF who also invests internationally may also allow Nepal to pose itself as a global-facing economy as well as using its shares in foreign investments to allow for greater technology and knowledge sharing opportunities with smaller Nepali companies in parallel industries as the investments. Another benefit of a Nepali SWF with a partially international portfolio would be currency sanitation, as mentioned earlier a firm that wholly invests locally could pose a risk to the exchange rates of the local currency but investing the money abroad allows for the funds to maintain their value, providing more foreign currency streams and avoiding situations like that of Sri Lanka. However, investments into large endeavors in Nepal such as hydroelectricity projects and transmission lines feeding electricity to India could provide returns to the fund greater than international investments, and while the portfolio should not be compromised exclusively of national pride projects and local investments, they should certainly be the priority.

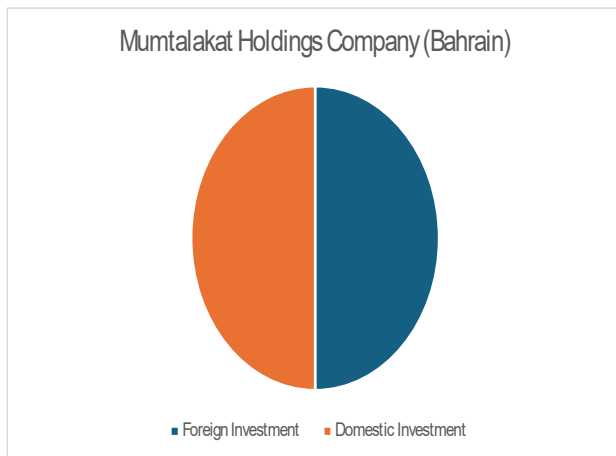
All Sovereign Wealth Funds have an objective that they try to fulfill using the revenues from their investments, some save money for future generations and others fund development of all types. A Nepali SWF would allow for the revenues to go towards developing projects that would otherwise not be as profitable such as irrigation projects, highways, and other large projects that while may not turn a profit do impact millions of Nepalis. This would be a potential objective of the fund, to fund development projects and maintain them.



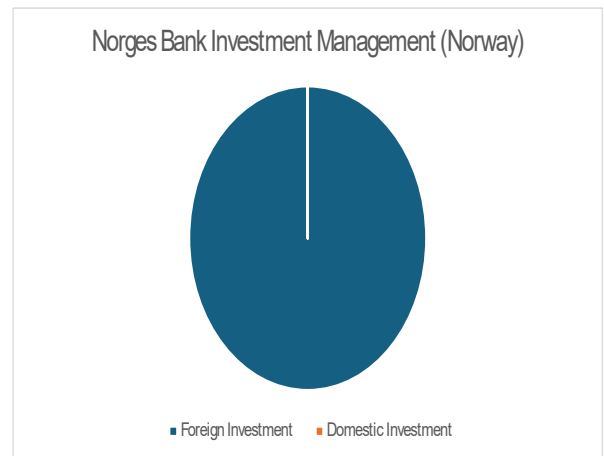
Source: The World Bank, Nepal Rastra Bank.

The graph above showcases the state of Nepal's foreign currency reserves. As the graph shows the state of the reserves as it stands is enough for 12.50 months worth of imports the opportunity presents itself when taking into account the fact that the Nepalese Rastra bank only maintains about 6-7 months worth of imports (about half of the current reserve) on hand, and the rest is invested into financial instruments such as US Treasury bonds or Indian bonds. As of the last report by Rastra bank the reserves stand at a figure of 14.5 billion USD, meaning that close to \$5 billion is being invested into relatively low-yield investments. The size of the surplus in FOREX reserves that Nepal would allow for the creation of a strong wealth fund with sufficient funding with even just a fraction of the surplus. Funds like Mumtalakat and the Heritage & Stabilization fund started with initial allocations of 2.6 billion USD and 1.4 billion respectively, and have actively contributed to the fund since. These countries while petroleum exporters do hold GDPs on par with Nepal's, with the only difference being that Nepal's fund would be funded by FOREX surpluses from remittances rather than natural resource revenues. Some funds such as the Agaciro Development Fund in Rwanda started with initial allocations as small as 26,000,000 USD due to the nature of the fund's contribution

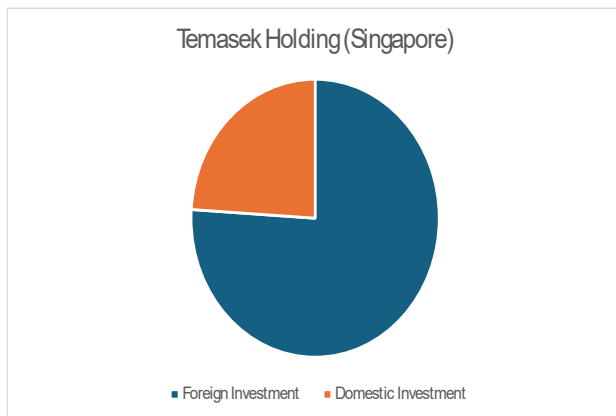
Global Fund Investment Allocations & Performance



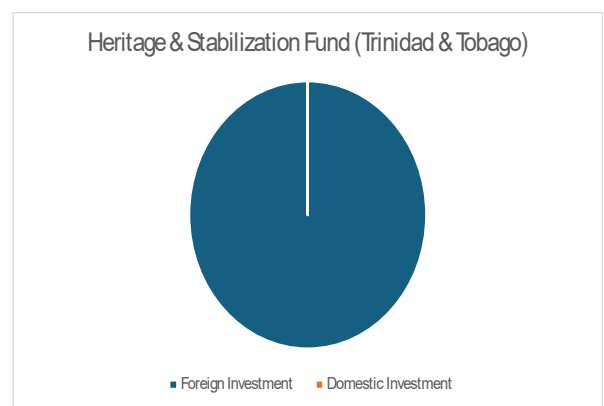
Source: MEED, Mumtalakat Holding



Source: Norges Bank Investment Management



Source: Channel News Asia, Temasek Holdings



Source: Heritage & Stabilization Fund



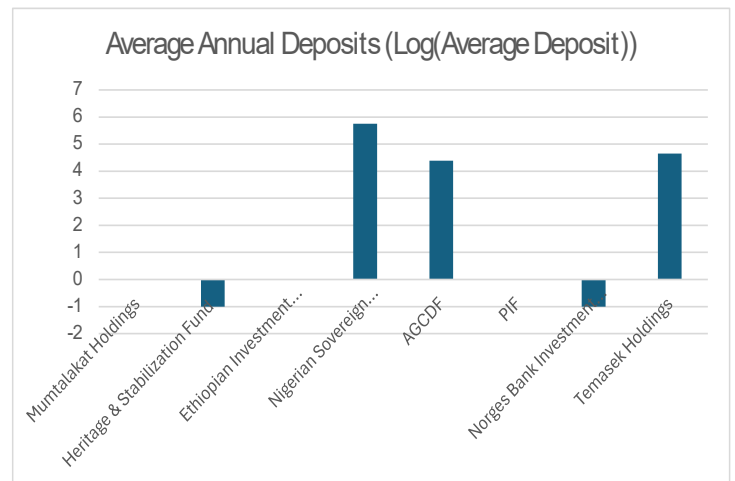
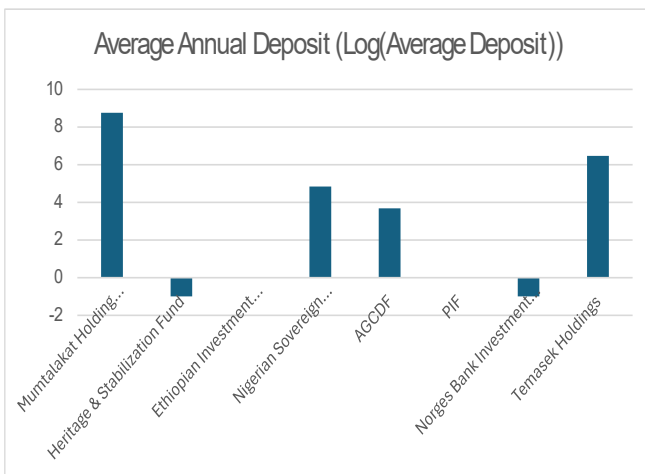
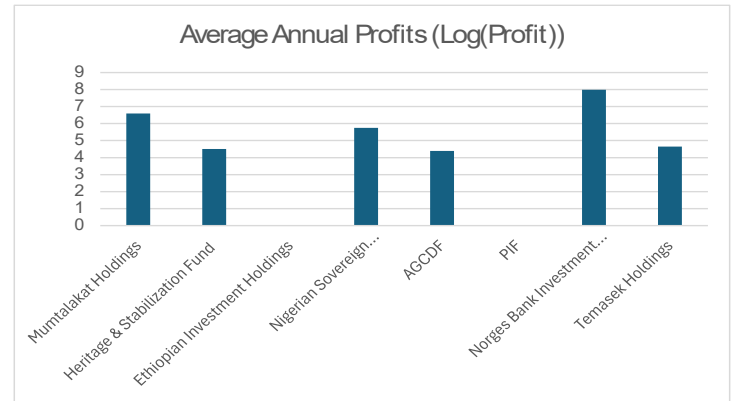
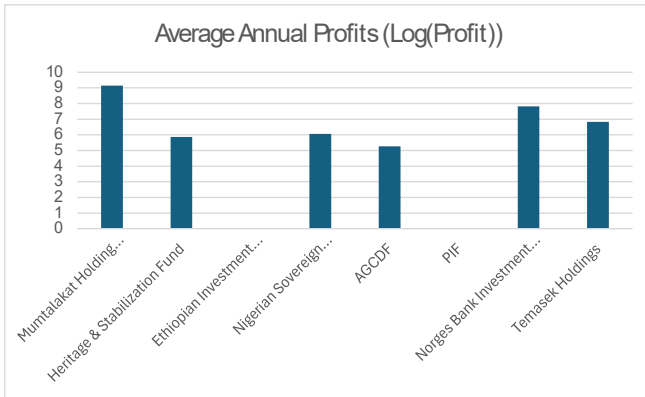
Source: Ethiopian Investment Holdings

As the graphs suggest, there are a variety of approaches that can be taken to the investment strategies of a sovereign wealth fund. However from the data collected it can be calculated that funds that the best performers on average are ones that undertake mixed portfolios such as Bahrain's Mumtalakat's Holdings and Temasek Holdings and who maintain investments at home and abroad.

Global Performance of SWFs

2015-2019

2020-2024



Before the COVID pandemic the best performing funds had been Temasek Holdings and Mumtalakat Holdings which managed to outpace the Norges Bank Investment Management with its large portfolio. However, these two firms also had the highest amount of contributions relative to their portfolios. It's important that the funds have a constant flow of liquidity allowing for new investments as can be seen above. Following the COVID pandemic a majority of funds liquidated assets to fund emergency responses to the disaster, hence there was a slow-down in profits and contributions. A notable case however is that the Heritage & Stabilization foundation and Norges Bank Investment Management have been withdrawing funds even pre-COVID, and still managed to maintain positive growth in their portfolios. The graphs above are all logged for two reasons, one being that NBIM is an outlier, and two it allows the data to be put in perspective of their portfolios. The different funds also have different approaches to their investments, some funds like Mumtalakat are actively involved in the decision-making of the firms they're invested in whereas a fund like the Heritage & Stabilization Fund are not actively involved and give liberty to the other shareholders and executives of the firms they are invested in. These aspects are important to take into account when looking at the performances of the firms.

Governance Framework for a Nepali SWF

Governance Structures

Throughout the dozens of Sovereign Wealth Funds around the world there is a variety of governance structure styles that are tailored to different political systems around the world. Singapore's Temasek Holding company acts as a private entity completely detached from Singapore's Monetary Authority (Central Bank) while others such as Trinidad & Tobago's Heritage Fund is managed by a board of representatives from the Ministry of Finance. Nepal has already taken one step forward and denoted that a Sovereign Wealth Fund would be an independent Special Purpose Vehicle (SPV) which would give it complete autonomy over how it spends the money and would be allowed to do so without the bureaucratic constraints of having decision-making run through different institutions. It would be beneficial if the fund maintained a decision-making board and a separate advisory board. A decision-making board would be comprised of experts hired by the firm or delegated by the Ministry of Finance and Rastra Bank as well as a chairman who could be a delegated expert from Rastra Bank. Separate from the governing board would be a detached advisory board of Nepali and international experts and industry leaders would allow for insights into the global markets, provide guidance to the decision-making board. The Advisory Board would not make any decisions but rather help provide markinsights to the governing board as well as provide needed guidance and allow for a greater sense of oversight to prevent mismanagement of funds. Ultimately there should also be a team of experts for day to day management of the fund that report on a scheduled basis (monthly or quarterly) to the governing board of the fund to monitor investments and research investment horizons.

Oversight Structures

An important aspect that must be considered when establishing an institution of the likes of this that would command large sums of money and responsibility is oversight. It is of extreme importance that the proper preparations are made to prevent graft or mismanagement of funds from the SWF. Most SWFs around the world publish annual reports, one internally prepared and another audited by a trusted 3rd party, the responsibility of auditing is often delegated to Ernest & Young and PricewaterhouseCoopers by firms such as the Trinidad & Tobago Heritage Fund, Bahrain's Mumtalakat, and Norway's Norge's Bank Investment Management just to name a few. As an institution managing public funds, one of the foremost priorities for leadership should be transparency. Hence quarterly and annual reports detailing any transactions made by the firm and payments to its leadership should be made as well as updates on the size of its portfolio, debts, and cashflows no matter how small or large. A would-be Nepali SWF must adhere to the Santiago Principles put in place for SWFs worldwide, and its performance should be tracked using several indicators from third-party sources such as the GSR (Governance, Sustainability, Resilience) Scoreboard developed by GlobalSWF and the Edwin-Truman Index for transparency. By utilizing these tools and adhering to international standards the would-be

Final Recommendations

As the window of opportunity for Nepal to open a sovereign wealth fund closes with every passing day, it is of utmost urgency that the fund is made as soon as possible to take advantage of the surplus that the country currently maintains. The Government of Nepal should seize the opportunity and leverage it to achieve the goal of having Nepal become a upper-middle income by 2100 and a SWF is a pivotal tool that can spring the country to the designation. As a result of this study some of the final recommendations to the Nepalese government are as following.

- As the concept of a SWF has been already introduced into the FY 2081/2081 budget the next step forward would be a parliamentary act to establish the structure of a SWF with the recommended governance structures.
- The Nepalese government should seek to make a sovereign wealth fund governed by a governing board of experts headed by a delegate of Rastra Bank and maintain voting with representation all relevant governmental institutions.
- The Government of Nepal should also establish a seperate non-governing advisory board made up of Nepali and International industry leaders and experts to provide insights, industry knowledge, and guidance to the management of the fund.
- The Nepalese government should seek to establish an oversight committee made up of experts independent to the fund that seeks to monitor the fund for mismanagement of funds and graft. The Sovereign Wealth Fund must also publish annual reports and be annually audited by a trust third-party auditor adhering to international standards such as the Santiago Principles.
- The Nepalese government should outline withdrawal rules that would allow only to make withdrawals for the development and maintenance of infrastructure projects such as high-ways, irrigation, and such projects that increase the welfare of Nepalis but may not be profitable in its own. The fund would use its profits to finance such.
- Once a parliamentary act is passed establishing the institution itself through the means of a SPV (Special Purpose Vehicle) the funding for the fund should be allocated through the next year's fiscal budget, ideally an initial funding of 20%-50% of the surplus, and 20% of the surplus per annum following the initial funding.

- The Nepalese SWF should maintain a team of experts for day-to-day operations as well as maintain itself actively involved in the decision-making processes of the firms and projects it's invested in with the respective experts the SWF maintains.
- Following the establishment, initial funding, and beginning of operations of the SWF the Nepalese government should maintain a steady flow of deposits while a FOREX surplus is maintained to ensure the growth of the firm and a base of capital for investment.

Finally, it is of upmost urgency to establish this fund and seize this opportunity. This study concludes that a sovereign wealth fund is not only feasible but necessary for the growth of the Nepali economy and to reach objectives such as the 2100 campaign.

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