Developing Iraq's Infrastructure Through a Sovereign Wealth Fund

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INTRODUCTION

Sovereign wealth funds (SWFs) are not the magic solution to resource rich countries if the necessary ingredients for success are absent. They are saving mechanisms that represent an innovative attempt to leverage a country's resources, not a replacement for spending through the budget allocation process, rather a complement to facilitating growth and development in a domestic context. They are not mechanisms to circumvent weak governance and poor institutions at the local level. If the necessary institutional framework is absent or lacking, the resulting sovereign wealth fund will fail and as a result, Iraq will fall to "resource curse"[1].

In short, the creation of a SWF will not, on its own, improve fiscal and monetary outcomes. These funds are not a replacement for broader institutional development and poverty abatement. SWF are simply mechanisms for fiscal surplus management.

Although there has been an evolution of the structure and definitions of SWFs around the world, Iraq does not need to follow that same process of establishing a conventional SWF through a stabilization or savings fund as prerequisites for a domestic development fund that would contribute to the local economy through development of its infrastructure. We don't want a "blueprint template" of a SWF for Iraq. We need to look at local conditions and the institutional and economic policymaking climate, and use local inputs to model a fund most suitable to Iraq's current circumstances.

Iraq requires domestic investments as the catalyst for local economic growth. Without investments locally, the country will not grow and this highlights the crucial need for a development fund in Iraq. Hence, establishing a development fund with a co-investment SWF framework would address a number of these issues by allowing private and foreign investors to add to the transparency of the process and ultimately the likely success of the initiative.

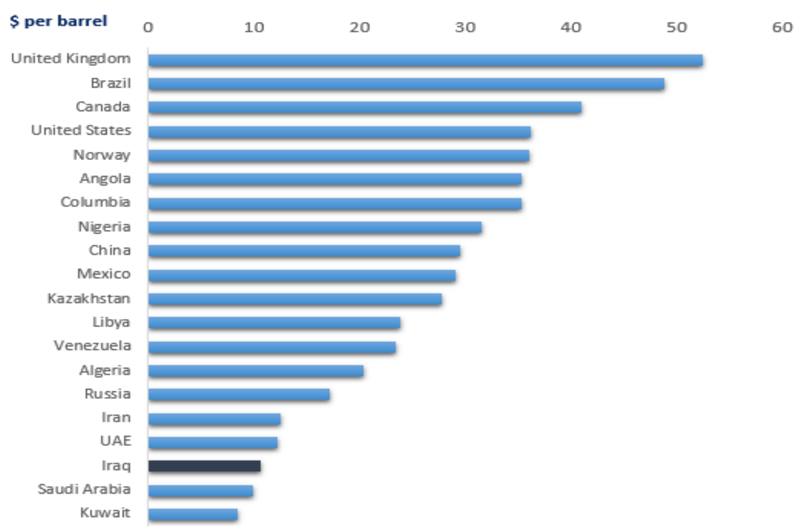
[1] Resource Curse, also known as the "paradox of plenty", refers to the paradox that countries with an abundance of natural resources, specifically non-renewable resources like minerals and fuels, tend to have less economic growth, less democracy, and worse development outcomes than countries with fewer natural resources.

BACKROUND & CONTEXT

Oil Dependence: high and rising

The oil sector contributes 90% of Iraq State income. Iraq will continue to depend on oil as a significant source of revenue for years to come, given Iraq's low marginal cost of oil extraction and large proven reserves. As of end of 2015, Iraq has 143 billion barrels of proved crude oil reserves[2], representing 18% of proved reserves in the Middle East and almost 9% of global reserves, ranking fifth in the world.

Figure 1: Total Cost to Extract One Barrel of Crude Oil[3]



As witnessed with the recent significant deficits facing the Iraqi government on the back of a crash in oil prices and government discretionary spending patterns, oil revenues alone will not be sufficient to meet spending needs in the short term, and Iraq requires funding alternatives for the long run. This highlights the strong need for diversification of government revenue, especially in the face of a rising need for infrastructure investment and development.

Rapid depletion of reserves

Absent institutional reforms and meaningful fiscal policies, the rise in the fiscal break-even price for oil in recent years has created significant budget deficits and the depletion of any substantial foreign reserves in Iraq. Drawing on existing reserves has led Iraq to avoid painful spending cuts in the short-

[2] US Energy Information Agency, Iraq Analysis Brief:
https://www.eia.gov/beta/international/analysis_includes/countries_long/Iraq/iraq.pdf

[3] Rystad Energy Figures

term, at the expense of placing the country on a long-term disciplined fiscal path. As a result, policy makers are now less resilient to fluctuations in oil prices and oil revenue shocks.
At its peak, the Central Bank of Iraq (CBI) held reserves of USD 77bn[4] as of year-end 2013. This surplus declined to USD 66bn year-end 2014 and USD 59bn as of late-2015. As the country continues to draw down on its accumulated assets, it highlights the dangers associated with a discretionary fiscal policy.

In a memo addressed to the IMF in January 2016, the Iraqi government laid out plans to finance its balance of payments deficit in 2016 by drawing its financial reserves down to USD 43bn by year end 2016[5]. This represents a 45% decline in reserves in the short space of three years and will most likely decline even more if actual government spending continues to exceed budgeted spending as it has in the recent past.

Continuing to draw down on financial reserves in an ad hoc manner will place the country on the dangerous road of bankruptcy and before too long, Iraq will lose its entire fiscal cushion during a period of lower oil prices and State revenue.

Beyond the short-term horizon, Iraq needs to address the risk of rapidly depleting reserves if oil revenues are lower than expected in the coming years. It is now more than ever that the Government needs to map out a fiscal framework for managing oil revenues and implement a fiscal discipline that will help rebuild financial buffers and implement spending cuts in the public sector.

Only through strong fiscal discipline will Iraq be able to develop the confidence and good governance required for encouraging foreign investment and private participation in the local economy.

[4] Central Bank of Iraq, http://www.cbi.iq/

[5] Reuters Article, "Iraq sees foreign reserves dropping to USD43bn in 2016- IMF memo", January 2016: http://www.reuters.com/article/iraq-imf-idUSL8N14W4Z920160112

INTRODUCTION TO SOVEREIGN WEALTH FUNDS

While Sovereign wealth funds (SWFs) are a varied group of investors with multiple objectives and diverse legal, institutional and governance structures, in the most basic definition, SWFs are pools of assets owned and managed directly or indirectly by governments to achieve national objectives. These funds have existed for decades now with the first fund, the Kuwait Investment Authority, established in 1953. Global SWF assets under management reached USD 6.51 trillion as of March 2016[6] and are expected to reach USD 8.9 trillion by 2020[7].

As defined by the IMF and the Santiago Principles[8] there are five main types of SWFs: fiscal stabilization funds, savings funds, development funds, reserve investment corporations, and pension reserve funds without explicit pension liabilities.

However, for the focus of this policy brief and in an Iraqi context, the first three types of SWFs are currently the most relevant i.e. stabilization, savings and development funds.

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[6] The 2016 Preqin Sovereign Wealth Fund Review

[7] PwC, "Sovereign Investors 2020: A growing force", May 2016

[8] The Santiago principles are a set of 24 voluntary principles that assign best practices for the operations of SWFs and were proposed in 2008 by the International Working Group of Sovereign Wealth Funds, currently known as the International Forum of SWFs (IFSWF). Details to the guidelines: http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf

Table 1: The three main categories of SWFs based on macroeconomic objectives[9]

Function	Fund Objectives	Strategic Asset Allocation	International Examples
Fiscal Stabilization	Insulate the budget and economy from commodity price volatility and external shocks	*Capital preservation*- short to medium term highly liquid investments that usually have an inverse correlation with resource revenues or source of risk being mitigated by the fund. Funds typically managed by central banks with assets usually held overseas to minimize currency appreciation.	Chile Economic and Social Stabilization Fund, Russia Reserve Fund, Timor Leste Petroleum Fund, Mexico Oil Income Stabilization Fund. Azerbaijan SOFAZ
Savings	Create inter-generational equity, national endowment, meeting particular long-term liabilities	*Capital Maximization*- long term investment horizon, diversification with moderate to high risk tolerance, and low liquidity requirement in short-medium run. Funds operate independently as institutional investment arms of government.	Abu Dhabi Investment Authority, Australia Future Fund, Kuwait Investment Authority, Qatar Investment Authority, New Zealand Superannuation Fund, China Investment Corporation, Korea Investment Corporation, Russia National Wealth Fund
Domestic Development	Invest locally to diversify economy and increase long-term rate of national productivity	*Domestic economic development*- investments in local infrastructure and domestic industrial diversification. Funds operate like a private equity fund, relatively independent from government budgetary processes. They sometimes take the form of SWF co-investment vehicles (RDIF, CDC, CDP Equity) or alliances with portfolio companies (Mubadala, Temasek, Samruk-Kazyna)	Abu Dhabi Mubadala, Bahrain Mumtalakat, Russia Direct Investment Fund, Nigeria Infrastructure Fund, Singapore Temasek, Italian CDP Equity, France CDC, Kazakhstan Samruk-Kazyna

[9] IMF, "Sovereign Wealth Funds: Aspects of Governance Structures and Investment Management", Author

WHAT TYPE OF SWF SHOULD IRAQ ESTABLISH?

Arguments Against the "Conventional" SWF Model

While the specific local macroeconomic circumstances dictate the type(s) of fund established and the resulting time horizon, historically most SWFs around the world, specifically in low-income developing countries, were established as stabilization funds to escape the natural resource curse and manage the high volatility of commodity revenues. In most conventional cases, a stabilization or savings fund are a prerequisite to having a domestic development fund and funds are established using a typical "SWF cascade" model.

Figure 2: SWF Cascade Model

Fiscal Rule:
- Fixed rule to allocating revenues to SWFs
Percentage of revenues (e.g. 10% of revenue allocated as in Kuwait)
Excess over benchmark prices is allocated to fund (e.g. Nigeria NSIA)
- Fixed rules with regards to allocating budgetary surpluses (e.g.70% of surplus allocated to ADIA and 30% surplus allocated to ADIC in Abu Dhabi)
- Ad hoc, sporadic allocation to fund (e.g. Saudi PIF)

The idea behind a SWF cascade model is based on the premise that a country's resource wealth must be channeled through a fiscal spending rule with wealth funneled into the government budget in addition to different types of investment funds on an interval basis.

Evolutions and success stories in the space of SWFs prove that it is not necessarily the case. The recent challenges facing these global funds (collapse of oil prices for oil-based funds, the foreign reserve challenge facing Singapore and the slowing economic growth in China), has placed these funds on the frontline of supporting domestic economies and sustaining government budgets. The question now being asked is whether or not these funds must prioritize domestic investment to reduce economic dependence on resources in the coming era of potentially lower oil prices[10], and hence, evolve into a more domestic development role.

While a globally diversified savings fund to manage intergenerational wealth may befit developed Norway or Singapore, it is seemingly unsuitable for an infrastructure and capital starved, developing economy such as Iraq.

[10] Morgan Stanley, "Outlook for Oil: Lower Prices for Longer", February 2016

SWF SUCCESS STORIES

Numerous success stories from around the world, specifically from developing countries, show how such investment vehicles can contribute to achieve policy objectives regarding diversification and economic development. Different countries structure their SWFs based on their State objectives. Recently there has been a surge of domestic development funds establishing co-investment vehicles to promote domestic investments with foreign partners, pioneered by the Russian Direct Investment Fund (RDIF).

Nigeria Sovereign Investment Authority

An interesting case that lends lessons learnt to Iraq is the case of Nigeria's evolution of establishing an SWF. Nigeria can be classified as a classic rentier. Oil revenue contributes to 80% of government income and similar to the case in Iraq, have been poorly managed given the country's weak infrastructure. In 2003 a conservative oil benchmark price was introduced to set up the Excess Crude Account (ECA). The Parliament established a fiscal rule that allocates oil proceeds to the budget based on oil production volumes. Any oil revenues exceeding the threshold price were transferred into the ECA. As oil prices surged in the commodity super-cycle, the ECA managed to accumulate USD 20bn by year end 2008.

The ECA was off to a good start as it initially repaid Nigeria's external debt. Subsequently however, the fund was regularly raided by policymakers and the fund lost close to USD 17bn in ad hoc political spending. There are strong lessons learnt for Iraq from the failed ECA case. First and foremost, the ECA was not established as a separate legal entity with full capacity to act. It lacked the governance guidelines and operational frameworks to establish autonomy from bureaucratic and political interference.

Following the failed case of the ECA, the Nigerian government established the Nigeria Sovereign Investment Authority (NSIA) in May 2011 funding it with USD1 billion drawn from the country's USD6 billion Excess Crude Account (ECA).

The fund overlooks three separate funds: the Future Generations Fund, the Nigeria Infrastructure Fund and the Stabilization Fund. Each fund serves a different national objective and is subject to certain restrictions, rules and authorities.

Nigeria Infrastructure Fund (NIF) was established solely to invest locally. The NIF represents 40 percent of the NSIA's USD1 billion capital, the rest of the capital being held at the future generations fund and the stabilization fund. The NIF launched a five year plan[11] to invest in domestic sectors considered important including power, transport, agriculture and health care, and relies heavily on international partnerships and co-investors. To date, the NIF has signed memorandums of understanding with the Africa Finance Corporation and the International Finance Corporation to work together on transactions. For power sector investment, there is an agreement with General Electric, and another one being discussed with Power China.

The lessons learnt for Iraq will be that with a small amount of seed capital, domestic infrastructure can still be developed with international partners co-investing in specific projects and assets, provided that the correct legal and governance frameworks are in place.

Russian Direct Investment Fund

The Russian Direct Investment Fund (RDIF) was established in 2011 with an initial start-up capital of USD 10bn. Initially, before investing its capital, the RDIF[12] secures a co-investment agreement with partners that must match or exceed its own capital commitment.

To date, the fund has invested USD 1bn in Russian infrastructure projects and secured more than USD 11bn from co-investment partners, namely international SWFs. RDIF has signed agreements and raised capital from the Kuwait Investment Authority, Mubadala, Qatar Investment Authority, Public Investment Fund of Saudi and China Investment Corporation.

RDIF has three levels of governance within the fund. Most notably, the International Advisory Board has members from other SWFs and global asset managers such as the president of China Investment Corporation, the managing director of the Kuwait Investment Authority, the CEO of Mubadala, Chairman and CEO of Blackstone. Managing partner of TPG, COO of Walburg Pincus and the chairman and CEO of Apollo, amongst other notable and experienced investment professionals. This provides RDIF with a wide range of management and investment expertise from experienced global investors.
The Iraq Development Fund learn much from the structure and governance established by the RDIF which is responsible for encouraging co-investment partnerships to promote investment in the local infrastructure.

[11] Nigeria Infrastructure Fund details: http://nsia.com.ng/nigeria-infrastructure-fund/

[12] RDIF Website: http://www.rdif.ru/Eng_Management/

POLICY RECOMMENDATIONS

The process for creating a sovereign wealth fund is unique to every country. Depending on a number of functions, SWFs can fall on a spectrum ranging from internally managed departments at central banks to independent, legally separate financial institutions to strategic investors that drive a country's economic and social agenda.

SWFs can vary in structure depending on three main variables: i) ownership- which represents degree of control by the government; ii) objective and investment mandate- capital preservation, maximization or domestic economic development; iii) source of funding- commodity or non-commodity funded and likely size of the fund.

The last thing Iraq needs is a "blueprint template" of a SWF that does not consider local conditions and the institutional and economic policymaking climate, and use local inputs to model a fund most suitable to Iraq's current circumstances. To grow the local economy, Iraq must invest in it. The priority for Iraq should be to consider an economic development mandate, regardless of the existence of a fiscal stabilization objective.

From a financial optimization point of view, if the domestic risk adjusted rate of return on investment is higher than that on foreign assets, the optimal strategy would be to target domestic investment rather than accumulating long-term lower yielding, foreign assets.

Many opponents to the SWF case for Iraq, argue the need for excess reserves to accumulate before Iraq should consider such models. My response to such argument is: i) Looking at one of the most successful cases of SWFs around the world, the Norway's Norges Bank Investment Management (NBIM), the first transfer took place *six* years after the fund was initially established as most of the income from petroleum resources was reinvested for the development of the oil and gas fields in Norway ii) establishing a development fund with a co-investment SWF framework would probably address a number of issues by raising additional funds for critical infrastructure projects and allowing private and foreign investors to add to the transparency of the process and ultimately the likely success of the proposed development fund.

POLICY ACTIONS

Operational Independence & Institutional Positioning of the Fund

For a domestic development fund in Iraq to succeed in facilitating growth in the local economy, it must be established as a separate legal entity insulated from partisan politics. It must be managed by professional investment managers based on meritocratic nomination who complement direct investments through the State budget allocation process and seek commercially viable investments locally. Numerous operational examples include Singapore's Temasek, Bahrain's Mumtalakat, Kazakhstan's Samruk-Kazyna, Malaysia's Khazana, and Abu Dhabi's Mubadala. These funds have the autonomy to seek commercially viable investment opportunities independent of government and operate much like private equity houses and as such, have a better chance at picking successful investments, instead of the white elephants that would most likely result through a politicized budget allocation process.

In addition, if domestic development funds establish co-investment vehicles with international parties they will help introduce more transparency to the local investment climate, mitigate risk and be a source of support and discipline for local companies.

SWF Development Fund Requirements for Success

1. Ownership Alignment & Separation:

   This refers to alignment of interest between a fund and its owner, the government or the Ministry of Finance more specifically, and sponsor i.e. Parliament. Central to the success of any proposed fund is the clear separation of responsibilities and authority. The fund must have a structure with well-defined levels that differentiate the sponsor, owner, board, oversight committee and operational manager of the fund. This is a necessary condition for accountability and legal credence.

   If the owner interferes with the investment decision-making process of the fund for specific politically motivated outcomes and redirects the assets of the fund, then the likelihood of failure of the fund is greater. The assets within the fund must be protected from political and bureaucratic interference.

   A clearly defined structure ensures a decision-making hierarchy that limits the possibility of interference and risks by protecting the integrity and authority over management and at the same time, ensures that there are no gaps and overlaps in roles and responsibilities.

2. Legislation & Legal Structure:

The owner of the fund is the central government (Ministry of Finance) and the Parliament approves the laws that establish the legal structure of the SWF and thus, the legal basis for its operations. Within an Iraqi context, it is advised that there be an independent professional committee that advises parliament on the appropriate risk levels of the fund and high-level investment mandates and return targets.

The initial step in establishing the governance structure of the fund must be recognizing that the managers of the fund assets are trustees on behalf of the Iraqi people. Therefore, this requires a structure that will derive the legitimacy of the fund's operations and guarantees that the decisions taken by management reflect the best interests of the Iraqi people. This in turn requires a solid legal foundation for the fund and the introduction of accountability at every level of the hierarchy from the legislature down to the individual managers of the investment portfolio.

There is a wide variety of legal frameworks for SWFs. Generally, the different types of legal structures for establishing SWFs include i) separate legal entities under law with the complete scope to act ii) state-owned corporations also with distinct legal identity and iii) pool of assets owned by the state or the central bank, with no separate legal identity.

For Iraq, establishing a separate legal entity for the development fund is a key requirement for its operational success in order to limit political access to the fund and encourage international parties to co-invest and have faith in the independence and autonomy of the fund.

3. Governance:

   a. Internal Governance: Includes the internal institutional arrangements and processes such as the structure and functioning of the board of directors and the fund's executive management and individual asset manager's process for decision-making, funding, recruitment and accountability.

   b. *External Governance:* Relationship between the SWF and its sponsor (Parliament) and owner (central government). Each governing body has roles and responsibilities including electing, appointing, and removing board members; and obtaining information on the performance of the SWF, its board and its management.

   c. *Supervisory Bodies:* This includes the auditor general who will be appointed by the sponsor (Parliament) to oversee the activities and governance guidelines of the owner (central government or Ministry of Finance). The external auditor is appointed by the owner of the fund to account for the SWF management and perform control activities. The internal auditor is appointed by the board of directors and reports to the board and assists in the supervision of management activities and processes.

The compliance department is appointed by the CEO and ensures that all operations and activities from the lower chain levels are occurring according to the rules and regulations governing the fund's operations.

OPERATIONAL ROADMAP FOR A DOMESTIC DEVELOPMENT FUND IN IRAQ

Phases for project- Generally speaking, there are four broad phases which encompass the establishment of the proposed fund in Iraq:

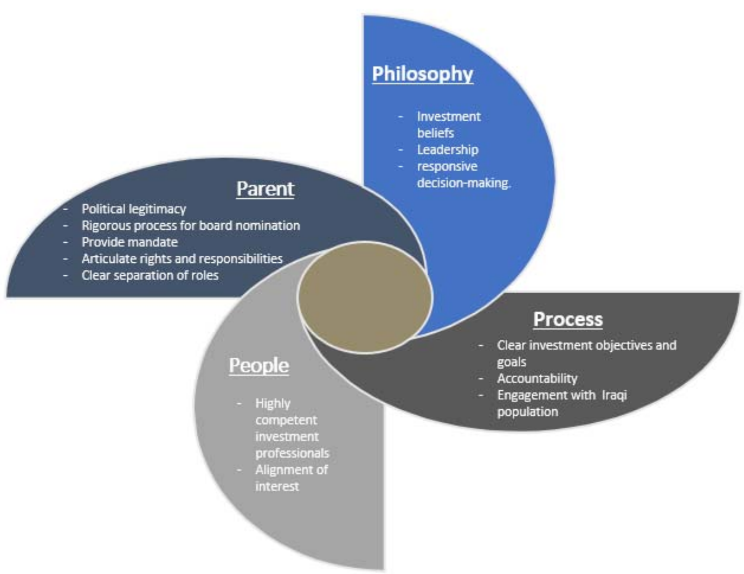
Phase 1: Includes the initial decision for establishing the fund. In this phase, the sponsors announce the intention to establish a domestic development fund and the initial fund seed capital is approved. The owner or central government is then given the green light to design feasibility study based on the sponsor guidelines.

Phase 2: Design of legislation and stakeholder management agreements. The owner proposes to the sponsors the recommended organizational and operations governance models and instills within the fund article of incorporation a strategy for advocating co-investor models.

Phase 3: Designing the strategic architecture of the fund, identifying vision, mission and purpose of fund, proposing the investment framework and co-investment platforms and agreements

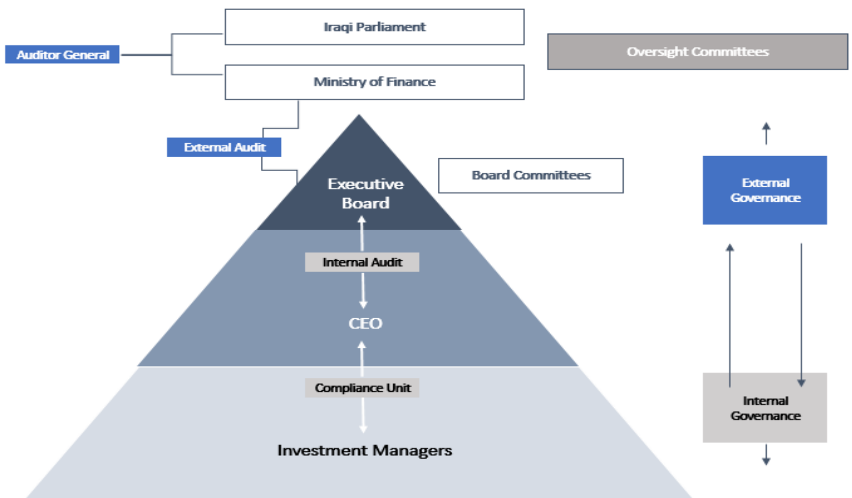
Phase 4: Implementation

Iraq Domestic Development Governance Checklist- The Four P's:



Operational Model & Governance

The governance structure must be consistent with the objectives and risks of the investment strategy. There must be a distinction between governing and supervisory bodies and committees and those bodies that are external and internal to the organization. These are key requirements for an Iraqi development fund to safeguard against political interference and mismanagement of funds.



A Robust Investment Process

Co investment Vehicles Utilized by the Iraq Development Fund and Project Financing Considerations

The Iraq Development Fund must seek co-investment partnerships through establishing the structures and vehicles with the supporting governance to encourage foreign strategic investors to join forces in developing Iraq's infrastructure.
Infrastructure projects are mostly project financed and are highly leveraged which leave no capacity for deviation from project outcomes. A stable and certain legal framework is thus a prerequisite for infrastructure investment. This includes legislation around concessions around ways for private investors to invest alongside the government and SOEs, and hence, may pave a way for decreasing the infrastructure burden on the government's shoulder through partnerships.

If Iraq develops the correct investment governance and frameworks around the fund, and establishes the political climate supporting domestic infrastructure, it would create a compelling case for investment in Iraq's infrastructure for a number of reasons:

1. Post-2008 financial crisis, SWFs and asset managers around the world have been increasing allocations to alternative investments including infrastructure projects as fixed income and equity markets yield lower returns to their portfolios[13]

2. This has created a strong competition for infrastructure assets around the world as investors allocate more of their portfolios

3. SWFs are well suited to infrastructure investments given the large investment ticket sizes required for these projects and the long-term investment horizon

4. Many SWFs have developed in-house infrastructure teams to support the fund's diversification agenda in this space. Teaming up with such investors would provide the Iraq Development Fund with strong technical support and know-how for deriving returns and managing these complex investment projects

5. There has been a surge in the amount of co-investment models across SWFs as this approach to direct investment has proved successful.

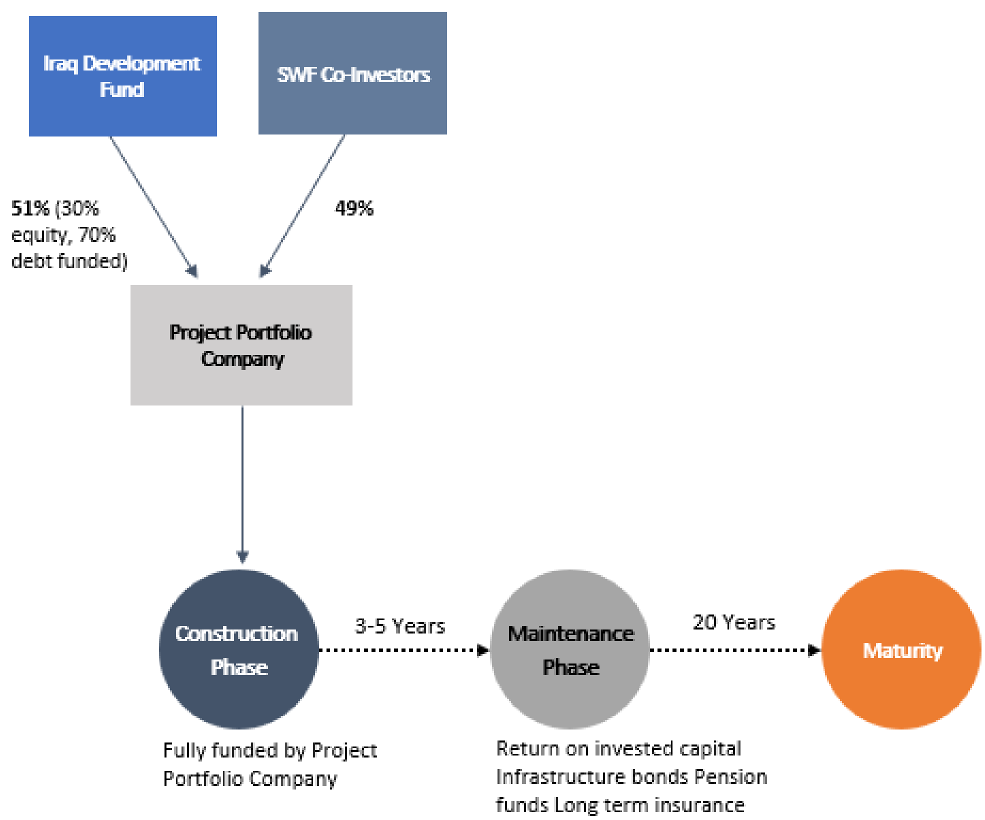
The benefits of this model are numerous as, in addition to fundraising and mitigation of risk, the Iraq Development Fund will have access to external expertise and evaluation, added transparency, increased efficiency in the investment selection and execution process and establish a culture that mirrors that of a private equity fund. And this would in turn, provide more discipline for local private firms and hopefully with time, decrease the burden on the public sector.

[13] State Street, "A Glance at SWF Asset Allocation", December 2015

Project Financing Considerations

The Iraq Development Fund alongside its co-investors would act as facilitators of infrastructure financing with the target of a return on invested capital after the construction period. The finance model could work as follows: The construction phase is fully financed by the Iraq Development Fund and co-investors. The project company, a legal entity founded for the special purpose of constructing the infrastructure project, has 49 percent equity held by co-investors and 51 percent held by the Iraq Development Fund. 70% of the Iraq Development Fund's investment can be debt financed. Within the maintenance phase, the Iraq Development Fund debt will be in full or partly converted into private debt by issuance of infrastructure bonds. The bonds could be collateralized by infrastructure fee income, which reduces the investor's credit risk and enhances the bond's rating. Hence, the project company could refinance its debt with low interest rates in international capital markets. Besides a bond issuance, it is likely that at this stage of the project, long-term insurance companies and pension funds will also be willing to lend to the SPV.

Done in this way, after 3-5 years once the infrastructure project enters the maintenance phase, the Iraq Development Fund gets its invested money back and could reinvest it in the next infrastructure project. Hence, co-investment cycles of 3-5 years depending on the length of the construction phase. It could follow a structure in a similar fashion to below:



CONCLUSION

Establishing a sovereign wealth fund with sound financial management and strong fiscal discipline will be a tool to support Iraq's macro fiscal framework, however, it should not be seen as a substitute for fiscal reforms.

With the ever-expanding government budget and falling oil prices without sufficient increases in oil production, Iraq is in dire financial straits and needs to make the necessary changes to ensure long-term fiscal sustainability. Until the fiscal framework is restructured in a way that allows Iraq to invest the oil revenue prudently and live within its means, Iraq must pursue the establishment of a domestic development fund to invest in the country's capital starved infrastructure.

The real challenge for Iraq in the context of any SWF discussions is not the current lack of surpluses for the establishment of an SWF, but rather designing and managing a SWF that can realistically achieve the objectives set out for it by the government.

The success of a sovereign wealth fund in Iraq is ultimately more than setting money aside or raising money from international donors, it is

1. a function of good governance, both internal and external
2. clear distinction between ownership and management of the fund, and
3. a robust investment process with clear investable mandates.

Establishing a development fund with a co-investment SWF framework would address a number of these issues by:

- allowing the fund to raise additional sources of capital
- mitigating risk
- adding transparency to the process
- providing external expertise that would support local private firms and allow for more discipline
- increasing efficiency in the investment selection and execution process
- establishing a culture that mirrors that of a private equity fund which would in turn provide more discipline for local private firms and hopefully with time, decrease the burden on the public sector.

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