



Lebanese Oil & Gas Initiative
المبادرة اللبنانية للنفط والغاز

Report on Lebanese Sovereign Wealth Fund Proposal

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Report on Lebanese Sovereign Wealth Fund Proposal

Commissioned by:
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Norwegian People's Aid
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1. INTRODUCTION TO EXTRA-BUDGETARY FUNDS INCLUDING SOVEREIGN WEALTH FUNDS

1

Extra-budgetary funds are defined by the IMF as “general government transactions, often with separate banking and institutional arrangements, which are not included in the annual state (national) budget law and the budgets of subnational levels of government.”

2

<http://www.ifswf.org/>

Many countries use extra-budgetary funds to manage their natural resource revenues.¹ In fact, all but a handful of large oil producers have established a natural resource-financed special fund. Together, these funds manage trillions of dollars in resource revenues annually.

In some cases, these funds are merely accounts within the state treasury, created for political purposes to demonstrate a commitment to financing a certain expenditure item (e.g. education) or for accounting purposes. For example, Mongolia’s petroleum- and mineral-financed General Local Development Fund, which allocates money to subnational governments, is simply a government account. In other cases, they are institutions that are subject to different rules than the rest of the government’s financial transactions, such as in the case of the Libyan Investment Authority. They may even have their own staff and legal standing.

Sovereign wealth funds (SWFs) are but one type of extra-budgetary fund. The International Forum on Sovereign Wealth Funds defines them as government-owned entities, established for a macroeconomic purpose, which do not have liabilities and invest at least partly in foreign assets.² As of 2017, there were approximately 60 SWFs financed by oil, gas or mineral revenues or by fiscal surpluses in countries dependent on natural resources. Eight of the 10 largest natural resource-financed funds are held by governments in the MENA region.

There are several legitimate reasons why a government might establish an extra-budgetary fund. First, traditional budgets are set on an annual basis, whereas funds can serve as multi-year funds. Timor-Leste Infrastructure Fund is essentially a multi-year earmarked budget. Parliament must approve the fund’s budget and spending must be channeled through normal budget processes, however the fund retains any unspent funds at the end of the year.

Second, funds can be used to earmark revenues for a specific purpose. For example, the oil- and land sales-financed Texas Permanent University Fund in the U.S. earmarks interest earned to the public university system in the state. Similarly, Alabama’s (U.S.) Forever Wild Trust Fund, financed by between 3-5 percent of the state’s oil and gas revenues, allocates money to environmental protection.

Third, funds can protect a specific stock of fiscal revenues from political interference. Most government pension funds are established as extra-budgetary entities in order to safeguard this pool from appropriation for other purposes. This enhances senior citizens' confidence that they will receive their full pension benefits many years in the future. The Canada Pension Plan and France's Fonds de réserve pour les retraites are good examples of such funds. They both have clear objectives, legal structures, investment strategies and codes of conduct for staff and managers, and publish comprehensive annual and quarterly reports. They also have strong independent audits that are published online and compliance mechanisms to ensure that the funds are managed in the best interest of their ultimate beneficiaries, retired citizens.³

Fourth, the budget process sometimes does not function well, especially in low-capacity environments. Extra-budgetary funds can be subject to more stringent transparency, oversight and governance standards than the budget, and be allocated more qualified staff, in order to create islands of good governance inside the government. While this may be true in theory, real world examples of these "islands of good governance" are rare.

As commonly as they are established to address a justified economic or political need, governments create extra-budgetary funds to avoid public scrutiny or finance pet projects. As the Overseas Development Institute writes, "transactions outside the budget are unlikely to be subject to the same kind of financial discipline as are budget operations (for example, state-owned enterprises may have their own financial regulations and appoint their own auditors), partly because they are financially independent and partly because they are not explicitly compared with other public expenditures. This may result in an increased level of fraud, irregularity, or the use of such funds for unauthorized purposes. In addition, the use of extra-budgetary funds means the reported level of government expenditure may be understated. It also is more difficult to compare the finances of two governments if they have different levels of extra-budgetary funds."⁴

For each case of a well-run extra-budgetary fund, there is a case where the fund is a problematic source of corruption and patronage. Of course, there are also cases where a fund is simultaneously a macroeconomic tool and serves the personal interests of the political elite. And there are cases where funds are simply mismanaged or take excessive risks and are therefore ineffective.

There are several categories of risks related to extra-budgetary funds. Among them are the following:

- Undermining public financial management systems and accountability:** Many extra-budgetary funds are designed to circumvent normal budgetary processes. These can range from parliamentary approval to procurement systems to reporting requirements. While in some cases these measures to bypass the public financial management system can help improve government decision-making, in most cases they slow down improvements to the system and create parallel budgets that are difficult to manage. In the most extreme cases, they lead to states-within-states or competing power structures within the government. For example, land sales in China by subnational governments generally go into extra-budgetary funds, which provides less money for budgetary allocations to health and education.⁵ The Azerbaijani and Iranian sovereign wealth funds are also cases in point.

3

Allie E. Bagnall and Edwin M. Truman (2013) *Progress on Sovereign Wealth Fund Transparency and Accountability: An Updated SWF Scoreboard*. Peterson Institute for International Economics. Online: <https://piie.com/publications/pb/pb13-19.pdf>.

4

ODI (2010) *Guide to Transparency of Public Finances: Looking Beyond the Core Budget*. Online: <https://www.internationalbudget.org/wp-content/uploads/Looking-Beyond-the-Budget.pdf>

5

Yinqiu Liu and Tao Sun (2013) *Local Government Financing Platforms in China: A Fortune or Misfortune?* IMF Working Paper 13/243.

6

Andrew Bauer (ed.) (2014) *Managing the Public Trust: How to make natural resource funds work for citizens*. NRCI-CCSI.

7

Ibid.

8

NRGI-UNDP (2016) *Natural Resource Revenue Sharing*. Online: <https://resourcegovernance.org/analysis-tools/publications/natural-resource-revenue-sharing>.

- **Do not achieve macroeconomic or policy objectives:** Some extra-budgetary funds are created to address a macroeconomic problem, such as excessive expenditure volatility, mismatching time horizons or to generate an endowment to finance a certain expenditure. Yet many funds do not achieve those objectives since they do not have inflow, outflow or investment rules necessary to achieving their objectives. In some cases this is due to poor fund design; in others it is because the actual objectives are different from the stated objectives. For example, the Alberta Heritage Savings Trust Fund (Canada) was established as a savings fund in 1976, though deposits were halted in 1987. As a result of this lack of a deposit rule, the fund saved less than \$4 billion in oil revenues over 25 years, despite hundreds of billions of dollars in oil revenues entering government coffers over the same period. In 2013, the Alberta government finally instituted a set of fiscal rules with long-term savings and fiscal stabilization objectives in mind.⁶
- **Excessive risk-taking / lack of due diligence in investments:** Many funds invest in complex or risky assets without the fund managers' being fully aware of the risks involved. In some cases, this is a result of lack of due diligence; fund managers do not adequately research their investments or inadequate information is provided by external managers or asset owners. In other cases, fund managers simply take excessive risk without fully understanding the consequences of their actions. For example, prior to 2012, the Libyan Investment Authority (LIA) invested in opaque hedge funds run by friends of the regime, including a \$300 million investment in Palladyne International Asset Management, a previously unheard-of fund with links to the former chairman of Libya's National Oil Corporation. Despite investing only slightly more than half of these funds, Palladyne recorded more than \$50 million in losses from 2008 to mid-2010. The LIA also invested billions of dollars in risky assets, racking up billions in losses. For example, it lost \$1.18 billion out of a \$1.2 billion Goldman Sachs-managed derivatives investment in 2010. In another egregious example, the LIA paid \$27 million in fees on a \$300 million investment with Permal, a fund manager, only to lose \$120 million on the deal.⁷
- **High management fees:** Some funds have been found to pay excessive management fees given the services provided. Passive investment managers generally charge approximately 0.05% of the value of assets annually. While more complex investment strategies and more services, such as accounting and reporting, justify higher fees, in some cases fees paid have far exceeded market rates. Furthermore, performance incentives for investment managers, while common, often lead to high fund costs that are not justified by earnings. The Albertan (Canada) and Libyan funds provide good examples.
- **Patronage and corruption:** Some funds have become outright sources of patronage or corruption through their asset purchases. Fund managers can invest directly in companies where they are beneficial owners, can invest in companies in exchange for a kick-back, or can use fund money to invest to serve their political interests. The mineral-financed Regional Development Funds in Kyrgyzstan, which are designed to fund local infrastructure, socio-economic programs and small loans but which are operated by local officials virtually without oversight, are but one example.⁸ Angola's sovereign wealth fund and Malaysia's 1MDB are others.

Accountability to the cabinet, parliament and the public are all essential for overcoming some of the risks mentioned earlier in this paper. In practice, this means setting up an institutional structure whereby all decisions are being overseen by at least two organizations, one internal and one external. Internal organizations can refer to managers, internal auditors, supervisory councils or elected officials. External organizations can refer to parliament-appointed supervisory councils, independent external auditors, the media, civil society organizations, or the judiciary. While the details are context specific, there are proven strategies to ensuring that managerial structures and oversight are effective.

Inflow and outflow rules for SWFs also ought to be context specific and serve the objectives of the fund. That said, certain rules are more effective than others in achieving those objectives. For example, Kazakhstan's National Fund was created as a stabilization fund to reduce the negative impacts of volatile oil prices on the economy, and as a future generations savings fund to save a portion of oil revenues for future generations.

Investment rules also ought to be a function of the fund's objectives. For instance, a stabilization fund which needs to be drawn upon in case of low fiscal revenues must be invested in much more liquid assets than a long-terms savings fund which can invest in higher-risk and less liquid assets. Similarly, a fund that is designed to sterilize capital inflows should not be allowed to invest in the domestic economy since that undermines the sterilization objective.

The Alberta (Canada), Chile, Norway and Timor-Leste SWFs have each codified comprehensive investment rules that limit the risks fund managers can take and, in Norway's case, impose ethical investment guidelines on fund investments. The rules and guidelines vary, but commonalities include prohibiting domestic investments as well as the purchase of assets that are in non-convertible currencies or are highly-risky, such as real estate in locations with weak property rights. The rules and guidelines also specify the remunerations scheme for external managers, limiting fees and risk-taking.⁹

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Andrew Bauer (ed.)
(2014) *Managing the
Public Trust: How to
make natural resource
funds work for
citizens.* NRGI-CCSI.



2. THE LEBANESE OIL AND GAS CONTEXT

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Nicholas Newman (2013) "Levant Basin Holds Massive Energy Potential" *E&P Magazine*. 5 November 2013. Online: <https://www.epmag.com/levant-basin-holds-massive-energy-potential-706926#p=1>.

According to preliminary geological surveys, the Levant Basin contain more than 3.5 trillion cubic meters of gas and 1.7 billion barrels of oil spread along multiple jurisdictions in the Mediterranean. This is on par with North Sea reserves. Approximately 25 percent of the gas and 40 percent of the oil is in Lebanese territory, according to the Lebanese government. However the commercial viability of these reserves and the transport routes remain unclear.¹⁰

In December 2017, after much delay, the Lebanese cabinet awarded Exploration and Production Licenses for two offshore blocks to a consortium made up of TOTAL, ENI and Novatek. The exploration period is expected to last 3 years. The first wells will be drilled in 2019.¹¹



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Marc Ayoub (2017) "Lebanon Finally Books its Place on the East-Med O&G Map" *Lebanon Oil and Gas*. 19 December 2017. Online: <http://www.lebanongasandoil.com/index.php/news-details/155>.

3. BROAD ASSESSMENT OF THE PROPOSED SWF BILL

There are several proposed SWF bills before the Lebanese parliament. This assessment is based on a preliminary draft of the “Lebanese Sovereign Wealth Fund (SWF) Bill”. The bill establishes a SWF with two sub-funds: A Savings Portfolio and a Development Portfolio. The Savings Portfolio is meant to invest petroleum revenues for the benefit of future generations while the Development Portfolio is designed to reduce the public debt level. Returns on state equity (and perhaps royalties, though this unclear) are deposited into the Savings Portfolio. A portion of the interest earned may be used to finance the government expenditures. Tax revenue from petroleum companies is deposited into the Development Portfolio and may be used to pay down the public debt until the debt level reaches 20 percent of GNP. In terms of asset allocation, these funds cannot invest in financial derivatives, except in certain circumstances. The bill does not contain any other concrete prohibitions on asset allocation.

As drafted, the bill leaves significant discretion to fund managers and runs the risk of becoming a new vehicle for corruption and patronage. Specific concerns include:

- **Fund role in macroeconomic management:** The net result of Articles 11 and 12 is likely to be no savings and a small amount of money earmarked for debt servicing and/or repayment. The same goal could be achieved without risk of mismanagement or bureaucratic costs by simply enacting a fiscal rule that limits expenditure growth or creates a public debt ceiling. Furthermore, Article 12 does not clarify that “withdrawals” refers to withdrawals to the state treasury, leaving open the possibility that money would be withdrawn into some other account.
- **Governance structure:** The fund’s governance structure is unclear and possibly contradictory. The Board of Directors is made up of experts appointed by the Council of Ministers, however the fund is meant to be supervised by the Minister of Finance. In most funds, the Minister of Finance is a member of the Board or appoints some Board members. Furthermore, the Board does not have independent members, as is sometimes the case, and the roles of Board members and their qualifications are unclear, leaving open the possibility of unqualified appointments. Also, the 35-year threshold for Board member experience disqualifies many competent candidates.
- **Fund management:** The Ministry of Finance sits simultaneously below and above the Board, a practice not found in any other fund globally. There is also no mention of using a custodian bank or where the funds will be physically held and who is responsible for bookkeeping. Also, the bill names fund committees but not their roles or responsibilities, which is unusual for SWF bills.

- **Investment rules:** The lack of investment rules or prohibitions on specific types of asset purchases (e.g., real estate; below investment-grade shares) is alarming. So is the absence of any detail on maximum management fees, oversight of external managers or selection of external managers. The 20 percent domestic investment target also leaves the fund open to channeling money to Lebanese companies linked to investment managers. Finally, there ought to be strict conflict of interest standards and penalties for misconduct in the law. Given these rules, or lack thereof, there is a high probability that the fund could be used for patronage or corruption.
- **External oversight:** There is no requirement to make full independent external audits public, only an edited annual report, implying that any potential misconduct might not be revealed publicly or to parliament. It is also unclear whether the Audit Court report is sufficient to ensure that the public and parliament receive adequate information on behavior and decisions of fund managers.
- **Transparency:** The legislation should clarify that the fund publish a list of assets it holds along with asset managers.

4. FEEDBACK FROM WORKSHOP ON SWF GOVERNANCE IN LEBANON AND RECOMMENDATIONS

On December 9, 2017, LOGI organized a workshop of civil society and political representatives to discuss the development of a SWF in Lebanon. The workshop covered the definition and history of SWFs and other extra-budgetary funds; management of natural resource revenues; international experience of fund governance; and considerations for fund governance in Lebanon. Participants spent the afternoon discussing objectives, management and oversight of any future Lebanese fund.

There was some disagreement over the objectives of the fund. Law 132 requires that all petroleum income be directed to a SWF and that the fund serve as a tool to save for future generations, however participants differed on the operational objectives. Some felt that the interest earned should be earmarked for specific infrastructure projects rather than paying down the Lebanese debt (since debt repayment may benefit special interests in Lebanon), while others felt that a debt reduction mandate was appropriate. Yet there was full consensus among the group that a fiscal rule that controls all government finances should be a prerequisite to passing any SWF bill. The fiscal rule could limit expenditure growth, cap the public debt level or require a structural balanced budget. Any of these would help ensure that the fund does not pay down public debt on the one hand while the government borrows on the other.

The group agreed that several principles should guide fund management, namely independence, neutrality, and control of public funds. Parliament and the Council of Ministers should be ultimately responsible for the fund with the Ministry of Finance acting as a trustee only. Board members should include the Central Bank, the Economic and Social Council and foreign financial or governance experts, with the Chairman of the Board appointed by the Council of Ministers, similar to the LPA. An advisory council of professional and independent financial advisors should feed into board and managerial decisions. The Audit Court should supervise the fund. The fund should submit an annual report should be submitted to the Minister of Finance who then submits it in whole to the Council of Ministers. Once approved, it is to be released publicly.

The fund should also be subject to a high degree of external oversight and transparency. An independent auditor and the Central Bank should oversee the fund's activities. The Advisory Board may also have a role in assessing and monitoring fund activities. Civil society groups could sit on the Advisory Council.

As it stands, the SWF bill before parliament needs much work if it is to meet international standards. As drafted, in the best case scenario it will earmark petroleum revenues to debt reduction. In the worst case scenario it will become a new source of patronage and corruption. It is therefore crucial that the law be revised immediately or delayed until proper amendments can be made.



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