ANALYSIS OF THE NAURU INTERGENERATIONAL TRUST FUND

A. Background and rationale

1. The government of Nauru has pursued the establishment of a trust fund since 2009. The ADB has supported this effort through the provision of technical assistance to design and establish the fund.[1] The Nauru National Sustainable Development Strategy 2005-25: Partnerships for Quality of Life (as revised in October 2009) identified the establishment of a trust fund as one of the seven strategies to stabilize the macroeconomic environment conducive to private investment. The aim was to have a trust fund provide supplementary funds to the budget as of 2030, mainly to replace dwindling phosphate revenues. A prospectus was forwarded to potential donors in 2009 and parliament passed the Nauru Trust Fund Act in 2012.

2. The economy and government finances have changed significantly since that time with the arrival of large windfall revenues associated with the reopening of the Regional Processing Center for asylum seekers and associated refugee resettlement program operating in cooperation with the Australian Government from mid-2012. Revenue from fishing license fees has also increased significantly in recent years. Both of these revenue streams face considerable uncertainty around both short-term revenues and overall longevity. The government's response has thus focused on the need to save a sizeable portion of these windfalls for future generations and specifically to meet future budget financing needs.

3. Nauru has a troubled history with the operation of trust funds. In particular the Nauru Phosphate Royalties Trust (NPRT) was poorly managed in a variety of ways which resulted in large financial losses and the fund's eventual liquidation. Poor governance, lack of transparency, weak management, and broader fiscal mismanagement all played a role in the funds collapse. The scale and nature of Nauru's financial crisis dealt significant and long-lasting damage to Nauru's financial reputation, both domestically and abroad. This experience has had an important bearing on the design of the new trust fund.

B. Overview of the fund

4. The Intergenerational Trust Fund for the people of the Republic of Nauru (hereafter the NTF) was established in late 2015 through the signing of bilateral Memorandum of Understanding (MOU) agreements between the government and the other original contributing partners which included the Australian Government (signed November 2015) and the Government of Taipei,China (pending signature). The NTF is governed by a Committee comprising representatives from each of the original contributing partners.

5. The purpose of the NTF is to build-up a sufficient principal value that can provide a future stream of public revenue to support investments in education, health, environment and public infrastructure. The intention is for there to be a build-up phase, prospectively to FY2033 but potentially shorter, which is used to grow the value of the fund before it enters a distribution phase whereby annual distributions will be made to the government whilst seeking to preserve the real value of the fund in perpetuity. The Committee will decide when to begin the distribution phase based on actual fund performance. The targeted principal value at the time of establishment is A$400 million but is subject to Committee discretion.

[1] ADB. 2013. *TA-8565 REG: Pacific Economic Management (Phase 2).* Manila

6. The fund is expected to receive its initial contributions during the first quarter of 2016 including A$2.5 million from the Australian Government, US$2 million from the government of Taipei,China, and A$20.4 million (or more) from the Nauruan government. In addition the proposed ADB policy grant will also be paid into the NTF. This brings the total initial resources of the NTF to an expected A$30.9 million. Each of the original contributing members is expected to make regular annual contributions to the fund. Additional contributing members can also join the NTF at a future date through the signing of similar MOUs with the government.

C. Contribution framework

7. The NTF will receive regular financial contributions from the government and other contributing partners. Government contributions will be guided by a set of targeted contribution ranges based on domestic revenues in any given year (Table 1). The framework is adopted with the intention of the government having flexibility to at least contribute at the bottom of each range and, depending on competing expenditure priorities, contribute additional funds if possible. Allowance is made for there to be no government contribution in years where domestic revenues are below A$24 million. There is also an allowance under rare and extenuating circumstances (such as a natural disaster, civil unrest or other events out of the government's control), whereby the government may delay, reduce or forgo a contribution to the NTF, as approved by the Committee. The Australian Government has committed to an initial contribution of A$5 million (inclusive of A$2.5 million co-financing of the proposed policy grant) and intends to contribute up to A$2.5 million annually thereafter. Taipei,China intends to contribute A$2 million per year for the first four years and will review its contribution at that point.

Table 1: Targeted Trust Fund Contribution Ranges

Scenario	Domestic Revenue*	Contribution
High	**≥ A$90 million**	**8% to 12%**
Band 1	A$90-$100 million	8%-10%
Band 2	≥ 100 million	10.1%-12%
Medium	**A$50-A$89 million**	**4% to 7.9%**
Band 1	A$50-$69.9 million	4% to 6%
Band 2	A$70-$89 million	6.1%- 7.9%
Low	**A$24-A$49 million**	**2%-3.9%**
Band 1	A$24-A$36.5 million	2%-2.9%
Band 2	A$36.6-A$49 million	3%-3.9%
No Contribution	**> A$24 million**	**0**

*****Amounts to be adjusted for inflation based on an agreed rate

8. Given significant uncertainty around future domestic revenues, the contribution ranges were determined based on an assessment of various revenue scenarios. The 'high' scenario corresponds to the levels of revenue collected in recent years as Nauru benefited from significant windfall revenues. The 'low' scenario corresponds to the average situation prior to the arrival of windfall revenues. The 'medium' scenario represents a blend of the two.

9. The framework has a number of desirable features. The contribution ranges reflect intergenerational equity (with the contribution percentage rising with higher levels of windfall revenue) and also a need for precautionary saving (with small contributions expected to continue even in relatively low revenue years). It is relatively straight forward compared to

alternative frameworks that rely on more complex indicators. It also allows a degree of flexibility and thus helps limit fiscal rigidity (particularly given the need to respond to adverse shocks).

D. Investment framework

10. The investment strategy of the fund will be determined by the Committee based on the professional advice of its investment advisor/s. An Investment Policy Statement will set out aspects such as the asset allocation classes, allocation target ranges for asset classes, risk level of the portfolio and industry-standard benchmarks for the fund.

11. The investment portfolio is expected to evolve over the course of the life of the NTF. At design it was anticipated that the fund may initially take a conservative approach as the fund accumulates initial contributions before shifting to growth-oriented investment strategy to generate higher returns. The fund would then shift back towards a more conservative strategy as the fund approaches the distribution phase in order to protect the value of the fund and its ability to make sustainable distribution payments to government.

12. The investment strategy of the NTF is bound by certain restrictions and principles to protect the financial integrity of the fund. Investments are restricted to “qualified instruments” defined as including stocks, bonds, and other securities issued or recognized in any major stock exchange agreed to by the Committee, or other instruments approved by the Committee in accordance with the investment policy. The investment strategy must also ensure that the NTF complies with requirements to maintain all income as tax exempt in Australia. The NTF will not issue negotiable or transferable instruments evidencing indebtedness for any contributions received. Further, the principal cannot be encumbered in any way.

E. Distribution framework

13. Once the NTF reaches a principal value deemed sufficient by the Committee the fund will enter the distribution phase. During this time the distribution amount will be made available within six months of the end of each fiscal year. The size of the transfer will follow a 3-year Moving Average Distribution Approach. Under this approach the Committee will determine the amount to be transferred each year up to a maximum level set by a specified ‘distribution percentage of the moving average of the principal value in the preceding three fiscal years. The distribution percentage will be determined by the Committee based on the estimated real long-term annual rate of return less any investment fees and administrative expenses and include a predefined “sustainability gap” to be determined by the Committee. The Committee will agree to the various parameters for this calculation based on the recommendations of the NTF investment advisor and accountant (and potentially third-party sources) and will review the distribution percentage at least every three years. The Committee will retain the right to distribute less than the distribution percentage.

14. Distributions are to be made based on the submission by the government of a program and budget setting out how the distributed funds will be used. This is to be accompanied by a monitoring and evaluation framework. The Committee can refuse to accept a program and budget if it is not in accordance with the purposes stated in the trust fund MOU or is likely to require distributions in excess of the amount available under the distribution policy. The Committee will also determine fiscal procedures which will apply to the use of the distribution amount, including remedies should these not be adhered to.

15. The distribution policy is designed to balance the need for stable budget financing with the desire to safeguard the real value of the fund for future generations. Basing distributions on a 3-year moving average of the principal value is intended to smooth the size of the distribution from year to year, improve predictability, and provide for potential distributions even where the NTF earns low or negative investment returns. Preservation of the real value of the fund is intended to be achieved through the inclusion of the sustainability gap as a precaution against the risk of significant and persistent weak returns due to uncertain market developments. The ability of the Committee to distribute less than the distribution percentage provides an additional flexible mechanism for balancing stability and sustainability concerns.

E. Governance and management

16. The NTF is governed by the terms of the MOU agreements signed between the original contributing partners. This establishes the Committee as the governing body for the fund with representatives drawn from each of the original contributing partners and any subsequent contributors as agreed by the Committee. The Committee is responsible for the operation, supervision and management of the NTF; the investment and distribution of NTF resources; and concluding agreements and arrangements with subsequent contributors and other organizations. Committee decisions are to be taken on a consensus basis. Disputes are to be settled exclusively amongst the Committee members. If a member chooses to withdraw from the NTF they will receive the present value of their contributions.

17. The Committee is to be supported by several core service providers including custodian bank, investment advisor/s, fund manager/s, accountant, and executive administrator. Other service providers will also be contracted as required. The investment advisor/s will play a critical role in providing advice to the Committee particularly regarding the investment policy for the trust fund and determining the distribution percentage. The executive administrator will serve as secretariat to the Committee, coordinate the work of the other service providers, and otherwise support the Committee in all NTF activities.

18. The MOUs governing the NTF require that the trust fund be based in Australia and conducts its operations within the jurisdiction of the Australian Government. All service providers are to be registered in Australia and meet relevant Australian regulatory requirements. These restrictions ensure that the service providers meet international professional standards, remain effectively regulated, and that the NTF is able to benefit from access to Australia’s sophisticated financial services industry.

19. The chosen governance structure seeks to support effective decision-making and encourage donor contributions. Consensus decision-making is intended to promote dialogue and discussion, encourage negotiated compromise, and strengthen ownership of decisions by all members. Importantly this means each Committee member can veto any proposal and thus protect their respective interests in the fund. By helping ensure each member’s contribution is managed and used as intended this can encourage greater donor contributions. There are some drawbacks however including risks of slow decision-making (which may risk the timely availability of budget financing) and reduced policy flexibility open to the government. However these concerns must be weighed against the benefits for attracting donor contributions of the chosen arrangement. The small size of the Committee, clear guidelines around the purpose of the fund, and the close relationship between the government and its development partners is expected to be conductive to effective consensus-based decision-making.

F. Accountability and reporting

20. The NTF is required to follow Australian accounting and audit standards. Annual reports are to be prepared by the Committee and include financial reporting, fund performance, key management decisions, and an assessment of the effectiveness of the NTF to fulfill its purpose. The fund's accounts will be subject to annual audit by an independent auditor. An independent evaluation of the fund is also required at least every eight years. This is to provide a comprehensive evaluation of investment strategy and performance, governance, management, costs, and achievement of the fund's purpose. The evaluation report is to be made public.

F. Assessment

21. The NTF has been designed to fit Nauru's unique circumstances and history. The presence of windfall revenues, questionable scope for sustained economic growth, and heavy donor dependence suggest a trust fund arrangement has the potential to play an important role in achieving a sustainable economic future.[2] This is similar to a number of other Pacific microstates where trust funds play a major role in the economy and fiscal management.

22. Many aspects of the NTF have been designed to address concerns that arise from Nauru's own history with trust funds. Learning from this experience, extensive provisions have been made to ensure that the NTF is well-managed, benefits from the advice of qualified service providers and its performance is actively monitored and evaluated. Consensus-based governance provides a strong mechanism for ensuring effective management and decision-making that is aligned with the purpose of the fund. It also helps commit the government to good fiscal management which should encourage donor contributions. Provisions are also made to prevent other historical mistakes and abuses, including restrictions on the type of investments that can be made and the prohibition of any borrowing against the assets of the NTF.

23. The design of the NTF generally follows international lessons and good practices with regard to national trust funds and sovereign wealth funds more generally.[3] However experience also suggests that such funds operate best when accompanied by broader fiscal reforms.[4] This is an area where ongoing complementary work is needed.

24. Given the relative magnitude of both the NTF and Nauru's revenue windfalls, the NTF needs to be effectively integrated into a broader fiscal framework. During the build-up phase, this should focus on ensuring recurrent expenditure is generally sustainable, adequate fiscal buffers are maintained to weather adverse shocks, and sufficient public investment is made through a balance of transfers to the NTF and investment in infrastructure and human capital.[5] During the distribution phase it will continue to be important that NTF distributions are integrated into a fiscal framework matching Nauru's economic circumstances at that time (particularly as there is limited scope to for the NTF to provide buffer financing). The Committee should also

[2] ADB 2005 B. Graham. *Trust Funds in the Pacific: Their Role and Future*. *Pacific Studies Series*. Manila.

[3] The key issues relating to various aspects of the NTF are discussed in the preceding sections. Lessons from the Pacific are reviewed in Graham (2005; see footnote 4) and Le Borgne and Medas (2007; see footnote 6). Broader lessons for sovereign wealth funds are encapsulated in the *Santiago Principles* prepared by the International Working Group of Sovereign Wealth Funds. One shortcoming in the design is mandatory public disclosure of key financial information such as the annual report and audited financial statements. This could be considered by the Committee.

[4] IMF 2007 E. Le Borgne and P. Medas. *Soveriegn Wealth Funds in the Pacific Island Countries: Macro-Fiscal Linkages*.

[5] A strong fiscal framework (potentially with legal foundations) would also help the government to more effectively for meeting its targeted contributions and encourage greater donor contributions to the NTF.

ensure that the program and budget for the use of NTF distributions is integrated with the Nauru budget process and does not operate off-budget. Other fiscal reforms are also important. Weaknesses in revenue generation, budget formulation, medium-term budgeting, expenditure control, and cash management all have implications for the size and timeliness of transfers to the NTF and the eventual effective use of NTF distributions.