IDEAS
Institute for Democracy and Economic Affairs

Mar 2015

POLICY IDEAS No.19

The New Face of KWAN: Proposals to improve Malaysia's Natural Resource Fund

By Sri Murniati

The Natural Resource Governance Index places KWAN in the "Weak Governance" category, scoring it 46 out of 100. General rules for deposit and withdrawal, weak legislative oversight and limited publicly accessible information are cited as the reasons for this decision.

Abstract

This paper discusses the Kumpulan Wang Amanah Negara (KWAN), Malaysia's natural resource fund. Using good governance frameworks from research on Natural Resource Funds by the Natural Resource Governance Institute (NRGI) and Columbia Center for Sustainable Investment (CCSI), the paper evaluates the strengths and weaknesses of KWAN and suggests several improvements. Among them are revising the deposit and withdrawal rules to encourage saving and accountability, improving the oversight mechanism and public disclosure.

Introduction

Establishing a Special Petroleum Fund, in which all or part of Malaysia's petroleum revenue will be kept, seems to be seen by the Government and opposition parties as a way to make the Malaysian Government more fiscally prudent and less reliant on unsustainable petroleum revenues.[1] The New Economic Model document, drafted by the Government, envisions that petroleum revenue will be set aside in a special fund or account and withdrawn at a "sustainable rate." The document creates a target that when Malaysia implements the 11th Malaysia Plan, "the funds from this account should not be used to finance current expenditure." (NEAC, 2010)

1 Unless new discoveries are made, the current Reserve/Production Ratio (R/P Ration) for both oil and gas is about 15 years (2014 BP Statistical Review of World Energy), which means Malaysia can only rely on its petroleum resources for another 15 years.

In the 2015 shadow budget, Pakatan Rakyat pledged to introduce a Private Members' Bill in the Dewan Rakyat in 2015, to amend the current provisions of the Petroleum Development Act 1974. This includes a provision requiring the government to save a portion of PETRONAS profits in a special fund that may only be used for purposes approved by Parliament, such as education, human resource development and technology. (Pakatan Rakyat, 2014)

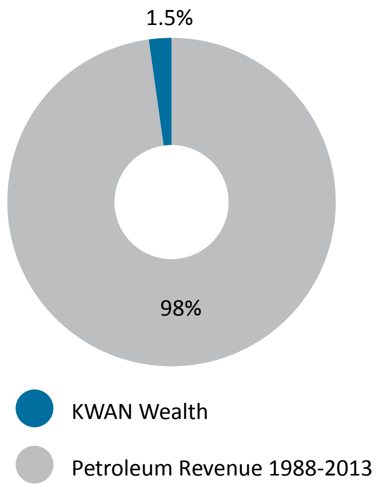
Special Petroleum Funds, referred to as the Natural Resource Funds in governance of extractive industries literature, due to it having been financed from depleted natural resources, can be used to "improve public spending efficiency and encourage the government to spend thoughtfully." (Bauer, 2014) However, without good governance mechanisms in place, Natural Resource Funds may be mismanaged, abused for political patronage and nepotism and become a source for corruption. A study by the Natural Resource Governance Institute (NRGI) and the Columbia Center for Sustainable Institute (CCSI) on Natural Resource Funds around the world, found that half of the 58 Natural Resource Funds identified are not managed transparently and only a handful are achieving their objectives. (Bauer, 2014)

Malaysia has one Natural Resource Fund which was established in 1988 and is known as Kumpulan Wang Amanah Negara (KWAN). Twenty six years old, the fund has accumulated approximately RM 9 billion. (Panel Kumpulan Wang Amanah Negara, 2014) This represents only 1.5 percent of the total petroleum revenue gained over the last 26 years, approximately RM 600 billion.

CHART 1: KWAN WEALTH COMPARED TO TOTAL OIL REVENUE FROM 1988-2013

Petroleum Revenue 1988-2013[1]	RM 621,130,000,000
KWAN Wealth	RM 9,512,800,000

The KWAN Act established some beneficial rules. Considering that the Malaysian government has already amassed so many funds[3], this paper argues that the best course of action is to maintain the KWAN as Malaysia's petroleum fund, without establishing a new mechanism. The current fund has the potential to encourage the Government to be more fiscally prudent and disciplined. However, to be effective, KWAN's governance standards must be improved. This paper will identify the strengths and weaknesses of KWAN and recommend potential strategies for improvement.



The paper will commence with an exploration of good governance standards for Natural Resource Funds and apply these standards to evaluate KWAN and suggest improvements.

2 Please note that the amount listed here only accounts for revenue received from the following sources: Petroleum Income Tax (PITA), Petroleum Royalty and PETRONAS Dividend. There are other sources of federal government revenue that can be classified as Petroleum Revenue. They are petroleum export duty and petrol sales tax. Details of these two sources are not found in the Federal Government Revenue Sheet provided in the Treasury website.

3 Government Trust Funds (Kumpulan Wang AmanahKerajaan) are funds that are established under Section 10 of the 1957 Financial Procedures Act (Act 61) to allocate money from the Consolidated Fund for specific purposes. Apart from Government Trust Funds, the Government has another type of funds called Public Trust Funds (Kumpulan Wang AmanahAwam) which are established under Section 9 of the 1957 Financial Procedures Act. The Public Trust Funds, while being managed by the Government, does not receive allocations from the Consolidated Fund.

The Second Schedule of The Financial Procedures Act lists 48 different Federal Government Trust Funds. However, according to the 2013 Financial Statement of the Federal Government (PenyataKewanganKerajaan Persekutuan tahun 2013), the Government manages approximately 165 Government Trust Funds accounts. The Statement lists 50 Government Trust Funds, some of which are not listed in the Second Schedule.

The types of funds under this category vary; the Development Fund was set up to receive and disburse allocation for development expenditures, the Housing Loan Fund which was set up to provide "housing loan facilities to employees in the civil service, local authorities and members of administration, legislature and judiciary are part of Government Trust Funds. Clearance Accounts, Trading Account, Loan Accounts and Contingencies Funds are also under the umbrella of Government Trust Funds. Other than these categories, there are also other funds that government categorises as "Miscellaneous Funds". The Kumpulan Wang Amanah Negara is under this category. See *PenyataKewanganKerajaan Persekutuan tahun 2013* and Financial Procedures Act 1957.

Good Governance: the main factor in establishing a successful petroleum fund

The Norwegian Government Global Pension Fund is probably the most frequently mentioned example of a successful Natural Resource Fund. In just 24 years, the fund was established in 1990 and the first net transfer only took place in 1996, it has successfully accumulated over USD 850 billion.

The fund is not only famous for its wealth. It is among the most transparently managed Natural Resource Funds in the world. The Natural Resource Governance Index, an international instrument that measures the quality of governance in the oil, gas and mining industries, awarded it with a full score of 100. The fund also scores excellently in two other international standards for Sovereign Fund's Governance. The Santiago Compliance Index scored it with 94 out of 100 and the Truman Sovereign Wealth Fund Scoreboard marked it 98 out of 100. (Bauer, 2014)

There are at least two other success stories that are worth mentioning here. These are the Petroleum Fund of Timor Leste and the Economic Stabilisation and Social Stabilisation Fund and the Pension Reserve Fund of Chile. Established in 2005, the Petroleum Fund of Timor Leste was introduced to tap into the potential for a large inflow of petroleum revenue. The fund has two functions, firstly, it helps to smooth government's expenditure, buffering Timor Leste's budget from fluctuation of revenue, secondly, it contributes to the mitigation of "Dutch Disease."[4] It does this through "fiscal sterilisation", in which "foreign currency is drawn out of the economy and placed in foreign assets to prevent inflation or exchange rate appreciation."[5] The current market value of the fund is USD 15.7 billion. The Chilean funds were established in 2006, with a combined market value of USD 23.5 billion. The fund has helped the Chilean government to stabilise the national budget in a period of low copper prices.

Similarly to the Norwegian Pension Fund Global, the Timor Leste and Chilean funds have been managed transparently. Information about the status of the funds, including their size and geographic locations, external independent audits, return of investments, amount of deposits and withdrawals and detailed asset allocations are all made publically available.

A study of natural resource funds, conducted by the National Resource Governance Institute and the Columbia Center on Sustainable Investment, found that there are six elements of good governance in a Natural Resource Fund. This paper will now explore these elements, employing examples from the three natural resources funds discussed above.

4 Dutch Disease is a situation where a sudden large increase in country's income especially that comes from natural resource sector makes the non-oil sectors more expensive and therefore less competitive.

5 The author would like to thank Andrew Baeur for explaining fiscal sterilisation in this paper. The sentence in apostrophes is his.

1. CLEAR OBJECTIVES

A good natural resource fund has clear objectives which should be stated in government documents, including legislation, regulations and policy documents. The objectives can be singular or multiple, but must be well defined. For example, objectives could be to save for future generations, to stabilise the budget or to ring fence the resource revenue from corruption or mismanagement. Other objectives can be determined by individual countries.

The Natural Resource Funds of Norway, Timor Leste and Chile were established as saving accounts and stabilisers for the national budget. Timor Leste stated the fund's objectives in the country's legislation, whereas Norway and Chile included them in their annual reports of the fund. In Norway and Timor Leste, one natural resource fund serves two objectives, to act as a savings accounts and budget stabilisation tool. Meanwhile, in Chile, these objectives are served by two separate funds. The Chilean Pension Reserve Fund is set up to finance pensions and social welfare programmes for the elderly and disabled, while the Economic and Social Stabilisation Fund functions to stabilise the national budget and pay public debt, if necessary.

2. CLEAR, APPROPRIATE AND WELL-ENFORCED FISCAL RULES

A fiscal rule is "a multiyear constraint on overall government finances defined by a numerical target." (Bauer, 2014) It limits the government on decisions concerning public finances. Constraints can be applied to debt, expenditure or growth, the use of certain revenues or to ensure the budget is balanced. Fiscal rules can be imposed by legislation, but also by political agreements or government pledges. However, the latter should be binding for at least three years. (Kinda et.al, 2013)

In the context of natural resource funds, the fiscal rule is important because it determines how much money should be deposited or withdrawn from the fund. For example, Norway rules that its annual budget deficit should not exceed 4%, which is the annual expected return. Petroleum revenue should be placed into the fund and withdrawals are only made to meet the non-oil deficit.

3. CLEAR, APPROPRIATE AND WELL-ENFORCED INVESTMENT RULES

Natural Resource Funds are usually established as extra-budgetary entities that can invest part or all of their money into different kinds of assets. It is very important therefore to have clear investment rules to prevent excessive risk taking, unnecessary investment, corruption and ensure the investment results in profitable returns.

The three natural resources funds have certain allocations for what kind of investments they can make, whether in equities, bonds or real estate assets. For example, the Norway Pension Fund invests in 40% fixed income, 60% equities and less real estate, while the Chilean Pension Reserve Fund only allow 15% investment in equities. Interestingly, all three funds do not allow investment domestically to prevent inundating the domestic market with foreign currencies that may cause inflation and exchange rates appreciation. Additionally to investment allocations, the three funds have rules on investment strategies, objectives and ethical guidelines.

BOX 1: INVESTMENT LAWS, RULES AND POLICIES OF THE NORWAY PENSION FUND

Investment Authority

The Ministry of Finance is responsible for establishing the fund's investment rules.

Investment Objectives

"Management of the Fund's capital shall be based on the goal of achieving the highest possible return . . . dependent upon sustainable development in economic, environmental and social terms as well as well-functioning, legitimate and effective markets."

Investment Allocation

- Investments are allocated and diversified by asset class and geography.
- Allocation by asset class:
  - 40% fixed income, 60% equities, less real estate.
  - Fixed income: 70% government bonds, 30% corporate bonds.
  - Equities: Benchmark based on the FTSE Global All Cap Index.
  - Real Estate: Up to 5% of the fund's capital.

Investment Strategy

- External investment managers may be used. Selection procedures are regulated by the Norges Bank and the list of external managers is made public.
- The main characteristics of the fund's investment strategy are:
  - Long-term investment horizon
  - Wide diversification of investments across asset classes and geography
  - Ethical investment guidelines
  - Limit 10 percent ownership in any single company
  - Strict risk-taking guidelines and strong oversight of investment managers

Ethical Investment Guidelines

- Exercise ownership rights to promote long-term financial returns based on UN Global Compact and OECD Guidelines for Corporate Governance.
- Negative screening of companies that produce weapons, which "through normal use may violate humanitarian principles."
- Exclusion of investments that risk systematic human rights violations, individuals' rights, severe environmental damages and gross corruption.

Policy on In-State Investments

Fund assets may not be invested in Norway.

Source: Natural Resource Governance Institute

4. CLEAR DIVISION OF RESPONSIBILITIES BETWEEN THE ULTIMATE AUTHORITY OF THE FUND, THE FUND MANAGER AND THE DAY-TO DAY OPERATIONAL MANAGER

The management of the fund may involve different entities in the government from parliament to the ministry of finance and the national bank. It may also involve non-government entities or individuals who are appointed to provide advice on the management of the fund. The roles of these different entities should be clearly established in regulations and policies. There should be rules of conduct, governing their relations, including advice on potential conflicts of interest that may arise.

5. THE AVAILABILITY OF REGULAR AND EXTENSIVE DISCLOSURES OF KEY INFORMATION AND AUDITS TO THE PUBLIC

Public disclosure is a crucial element of ensuring a natural resource fund is well-governed. Primarily, it encourages those involved in managing and overseeing the fund to comply with the established rules and regulations. Information concerning the Chilean, Norwegian and Timor Leste funds are available for public access. The manager of the fund discloses information to the public regarding deposit and withdrawal amounts, investment location and type, including information about the countries and currencies of the investment and the names of the people who are directly in charge of the fund's operations.

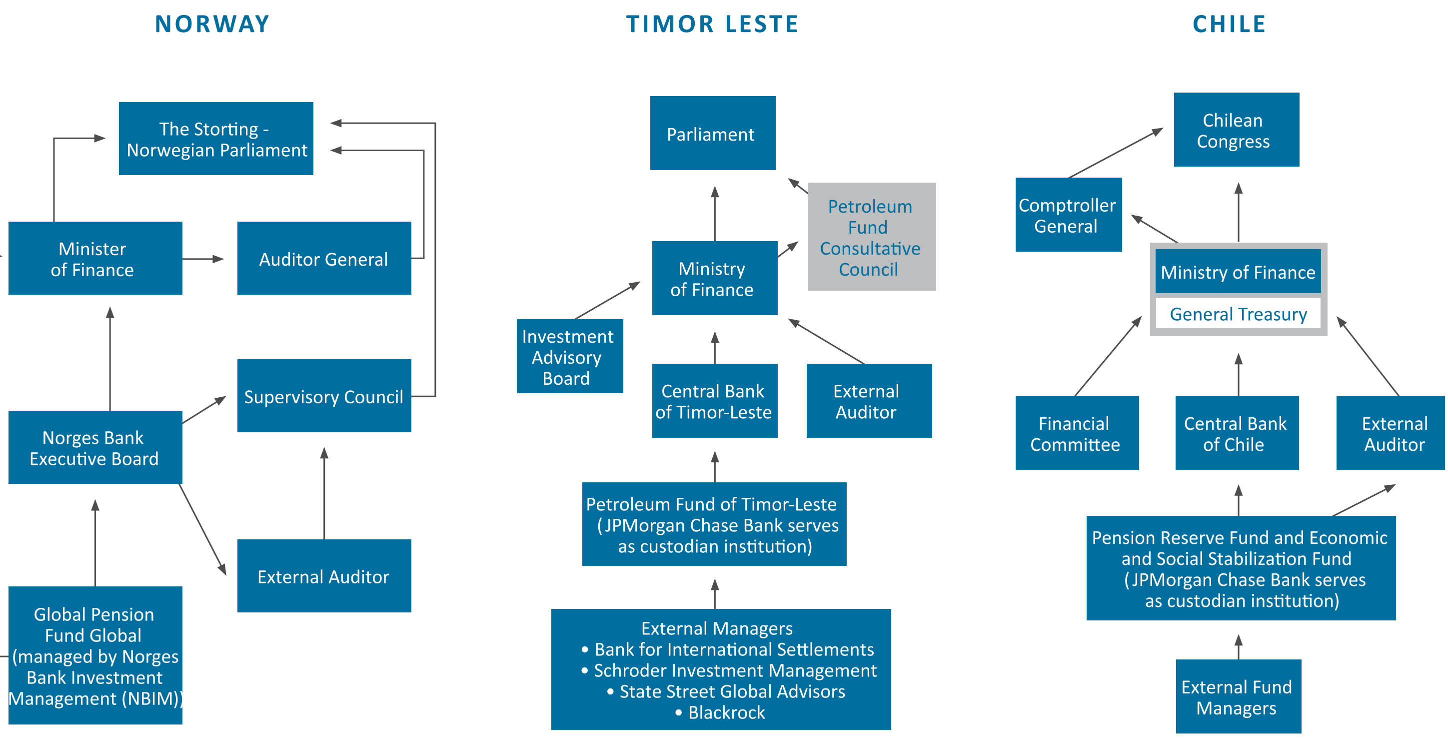
6. INDEPENDENT OVERSIGHT BODIES TO MONITOR FUND BEHAVIOUR AND ENFORCE RULES

Effectively governed natural resources need clear rules and regulations and systems to ensure they are followed and implemented. In this context, oversight mechanisms and bodies play fundamentally important roles. Responsibility for oversight can be granted to various bodies, both internally and externally to the government. Parliament may be the ultimate oversight body, charged with receiving the fund's report annually. Other institutions, such as the auditor general, an external auditor or special supervisory body can be part of oversight mechanisms.

Natural resource funds in Norway, Timor Leste and Chile are audited by external auditors, who submit their reports to the respective Ministries of Finances. The reports are then incorporated into the Ministry of Finance's Report to be audited by the Comptroller General in Chile or the Auditor General in Norway and submitted to Parliament. In Timor Leste, the Petroleum Consultative Council, consisting of representatives from civil society, private sector and former government officials, monitors the management of the fund by the Ministry of Finance and reports to Parliament. In Norway, additionally to an auditor general, a supervisory council monitors the compliance of the fund manager the Norges Bank to the fund rules and in turn reports to Parliament.

Public disclosure is a crucial element of ensuring a natural resource fund is well-governed.

CHART 2: THE MANAGEMENT AND ACCOUNTABILITY STRUCTURE OF THE NATURAL RESOURCE FUNDS OF NORWAY, TIMOR LESTE AND CHILE



Source: Natural Resource Governance Institute

Evaluating the performance of The Kumpulan Wang Amanah Negara (KWAN)

The Kumpulan Wang Amanah Negara (KWAN-National Trust Fund) is one of many Malaysian government owned funds[6] that fits the definition of a Natural Resource Fund, as introduced in this paper. Established on the 18 February 1988, under the National Trust Fund Act 1988 (Act 339), KWAN is a special purpose investment vehicle. It receives funding from revenue derived from depleting resources and contribution from entities, who are involved in any business, research and development activities related to depleting resources.

As of 2013, the KWAN Annual Report stated the total amount accumulated in the fund was RM9.513 billion.[7] Of this amount, RM6 billion was from PETRONAS contributions. The remaining was derived from investments by the fund in domestic and foreign bonds, local equities, gold and fixed deposits in local and foreign currencies.[8] The only withdrawal, amounting to RM42 million, was made to finance the construction of Malaysia Wetland Sanctuary Project in Ulu Langat. (Panel Kumpulan Wang Amanah Negara, 2014)[9]

6 The Second Schedule of the 1957 Financial Procedures Act lists 48 Government Trust Funds, but the Federal Government's Annual Financial Statement says that the government is managing about 165 Government Trust Funds. See also footnote no. 3 for further information.

7 The total amount mentioned in the report is different from the total amount reported in the PenyataKewanganKerajaan Persekutuan (The 2013 Financial Statement of the Federal Government). Reports that there was about RM 7 billion in the fund (the exact amount is RM7040478437), increased from RM5.6 billion in 2012 (JANM, 2015, p. 47).

8 The 2013 Petronas Annual Report states they will contribute another RM2billion which makes the total contribution of the national oil company to the fund is RM8 billion. (PETRONAS, 2014)

9 The author is still not clear whether the Wetland Sanctuary Project mentioned in the KWAN is the Paya Indah Wetland in Kuala Langat that was started to be developed in 1997. http://library.perdana.org.my/Digital_Content/Prominent_Leaders/Mahathir/News_1968-2004/1996-1998/1998aj/approveplan%20for%20.pdf, http://news.google.com/newspapers?nid=1309&dat=19971203&id=Hv1OAAAAIBAJ&sjid=_RQEAAAAIBAJ&pg=5001,6392265,

TABLE 1: KWAN'S WEALTH IN COMPARISON WITH THE NRFS OF NORWAY, CHILE AND TIMOR LESTE

	KWAN	Norway's Global Pension Fund	Chile's Pension Reserve Fund	Chile's Economic and Social Stabilisation Fund	Timor Leste's Petroleum Fund
Year established	1988	1990	2006	2006	2005
Total Wealth	USD 3.1 Billion (December 2013)	USD 670 Billion (July 2013)	USD 7.01 Billion (August 2013)	USD 15.21 Billion (August 2013)	USD 13.5 billion (August 2013)
Natural Resource Governance Index (NRGI) Score	46	100	87	87	83

Information about KWAN is available through the National Trust Fund Act, the KWAN Annual Report and Annual Financial Statement of the Federal Government. However, while the Act is easily accessible to public, the KWAN Annual Report is not so easily found. The report is submitted to Parliament and is available in the Parliamentary library or directly from Parliamentarians. The Bank Negara Malaysia (The Central Bank of Malaysia), the party appointed by the Act as the fund operational manager, does not have any information regarding the fund on its website, let alone reports on the size and investments of the fund.

The Natural Resource Governance Index places KWAN in the "Weak Governance" category, scoring it 46 out of 100.[10] General rules for deposit and withdrawal, weak legislative oversight and limited publically accessible information are cited as the reasons for this decision. In the next section, the strengths and weaknesses of the fund's governance standards will be highlighted.

10 http://www.resourcegovernance.org/countries/asia-pacific/malaysia/overview

1. OBJECTIVE IS CLEAR, BUT NOT PUBLISHED IN PUBLICLY ACCESSIBLE DOCUMENT

The objective of the fund is not stated clearly in the Act. However, examining the types of deposits and expenditures of the fund, it can be ascertained that KWAN was established to ensure Malaysia has savings from its depleting natural resources. These savings can be used as an alternative source of income, especially for development expenditures, for both the Federal and State Governments. The KWAN Annual Report stated the objective of the fund clearly. However, as mentioned above, it is not easily accessible to the general public.[11]

11 The author obtained the Report from an MP's office.

2. GENERAL DEPOSIT AND WITHDRAWAL RULES

The deposit and withdrawal rules of the Fund are mainly regulated by the National Trust Fund Act. They are stipulated in Section 5 and 6 of the Act respectively. The deposit rules are very general. The Act mentioned the list of sources from which the fund derives its revenues as follows:

a. appropriation from Consolidated Fund
b. direct contribution from PETRONAS
c. contributions from states that obtain royalties from oil and gas or other depleting resources
d. all revenues gained from investments of the Fund's moneys
e. all donations, contributions and gifts given for the benefit of the Fund;
f. all contributions given by any persons or authority whose business involves research or development in the area of depleting resources.

The Act does not regulate the percentage or timing of contributions. For example, there is no provision governing the amount of contributions Petronas should make annually or what percentage of royalty the state should contribute to the fund. This general rule, governing deposits, contributes to the relatively low amount placed into the fund.

Concerning withdrawal, the Fund can only be used for development purposes or loans to the Federal and State Governments. If the Federal Government finds the annual budget is insufficient to bear the cost of future development projects, the National Trust Fund can be used to ensure these development projects continue. However, like the deposit rule, the Act does not determine what percentage of the Fund can be withdrawn for such purposes.

3. DETAILED INVESTMENT RULES

Section 7 stipulates the investment rules. Unlike the sections on deposit and withdrawal, the Act covers investment rules more clearly. It determines what kinds of investments the fund is permitted to make and the years of maturity investments should have. Furthermore, in the KWAN Report, the Panel issued more detailed guidelines and policies to implement the Act's regulations.

The money from the Fund can be invested as deposits in Malaysian or international banks in any currency, investment instruments, allowed by the Trustee Act 1949, securities at a fixed or variable interest rate, currencies issued by Malaysia and countries in the Organisation for Economic Cooperation and Development (OECD), international financial institutions, money market instruments, loans to federal or state government and corporations, advances for exploration and marketing, mineral resources and precious metals.

The Act stated that investments in loans to government corporations and advances to the mineral sector should be less than 20% of the total amount of the fund. Loans to the federal and state governments should be no more than 5% of the total disposable assets.

In the annual report, the KWAN Panel suggested the re-examination of current rules on investment to broaden their scope and encourage higher returns on investments.

FIGURE 1: FLOW OF KWAN'S FUND

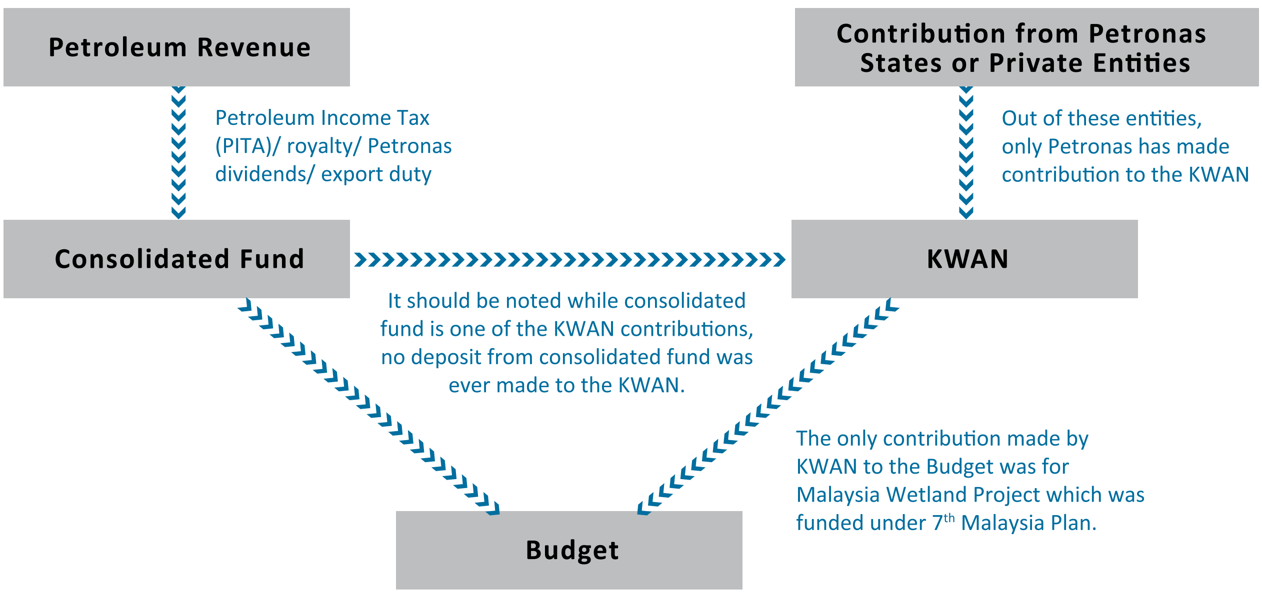


TABLE 2: INVESTMENT RULES FOR THE KWAN AS STIPULATED BY THE KWAN ACT

No	Type of investment	Conditions
1	Bank deposits (in or outside Malaysia, in any currency including Ringgit)	
2	Investments as authorised by the Trustee Act 1949 (Act 208) or the Trustee Investment Act 1965 *Act 36 of 1965)	
3	Securities with fixed or variable rates of interests in Ringgit	
4	Securities with fixed or variable rates of interests in foreign currencies	Maturity period should not be more than ten years
5	Money market instruments such as treasury bills, bankers' acceptances and certificates of deposit in any currency including ringgit	Maturity period should not exceed one year
6	Loans to the Federal Government or State Governments	Terms should be remunerative to the Fund. Total investment for this purpose should not exceed 5% of the disposable assets of the Fund
7	Loans to any public authority or corporations in which the Federal Government has an interests	Terms should be remunerative to the Fund. Total investment for this purpose should not exceed 20% of the disposable assets of the Fund
8	Loans/advances to any authority formed under any written law in the Federation and any cooperative society engaged in mining, farming, agriculture, horticulture, or fishing operations	Only for assisting the exploration and development of minerals, and the growing, processing or marketing of any primary produce
9	Precious metals including gold, silver, platinum, and palladium	
10	Any investment authorised by Finance Minister	

4. CLEAR ROLE AND RESPONSIBILITIES

Bank Negara Malaysia, the Central Bank of Malaysia, is the operational manager of the fund. Section 3 of Act 339, states it is "responsible for the day to day administration and management of the affairs of the fund." The fund is administered under the Investment Operations and Financial Market department of the bank.

The fund manager is the National Trust Fund Panel, whose members are appointed by the Minister of Finance. For withdrawal of funds, the panel should seek approval from the Minister of Finance as the ultimate authority of the fund. However, they can make decisions on how to invest the money providing it is in compliance with the stated conditions.

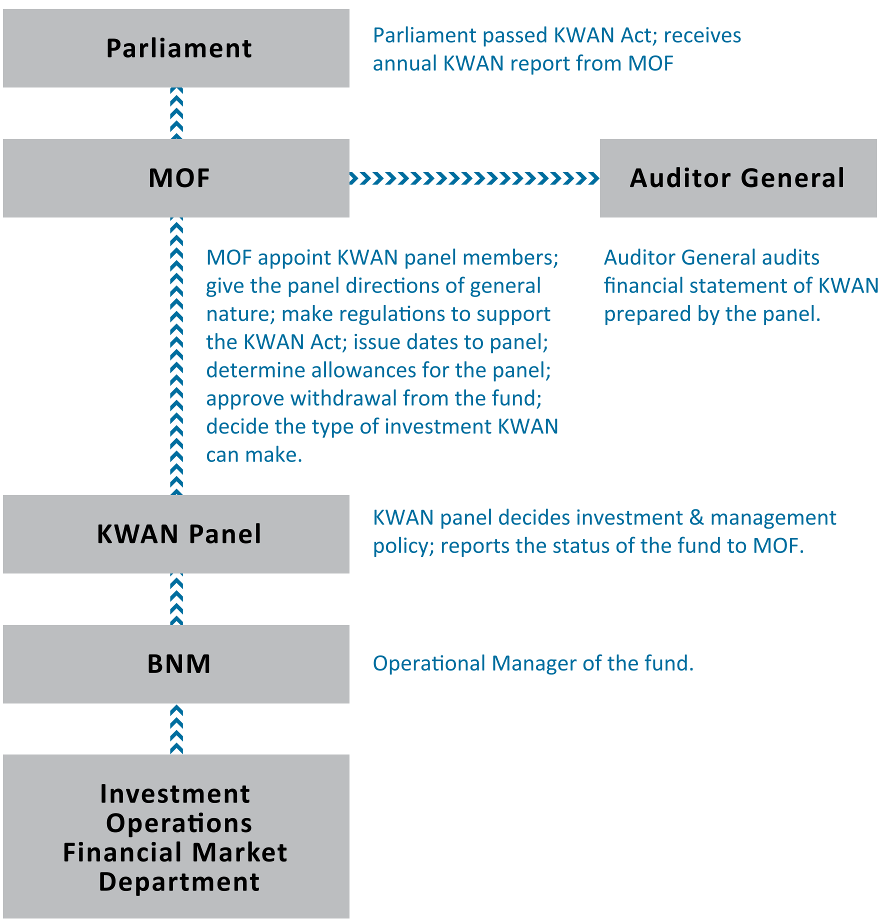
As of 2013, Tan Sri Dato' Shamsul Azhar Abbas, President and Chief Executive Officer of PETRONAS[12] is the Chairman and Dato' Mat Noor Nawi, Deputy Treasury of Ministry of Finance, is Deputy Chairman of the National Trust Fund Panel.[13]

The Panel answers to the Minister of Finance who, in addition to appointing members, may give the panel "directions of a general nature", make regulations for carrying out of the provisions of the act, issue any duties to the panel, determine allowances for the panel, approve any withdrawal from the fund and direct the type of investment that the fund can make. This provides the minister with broad power over the Fund and its operations.

The role of the legislative body in KWAN's operations is minimal. While Parliament passed the Act governing the fund and receives KWAN Report annually, they are not involved in approving or directing the fund's purposes or reviewing the withdrawals.

Another agency that is involved in KWAN's governance is the National Audit Department. The agency is mandated by the Act to audit KWAN's financial statement annually.

FIGURE 2: MANAGEMENT STRUCTURE OF THE KWAN



12 Wan Zulkiflee Wan Ariffin took over Tan Sri ShamsulAzhar's position in February 2015. It is not clear whether this change will impact the composition of the KWAN Panel.

13 The members of the panel are: (1) Dato' Muhammad Ibrahim, Deputy Governor of Malaysian Central Bank, (2) Tan Sri Amirsham A Aziz, Chairman of Malaysian Investment Development Agency and former Maybank CEO, (3) Datuk Dr RahamatBiviYusoff, Director of Economic Planning Unit at Prime Minister's Department, (4) Nuraini Ismail, Vice President of Treasury at PETRONAS. (KWAN Panel, April 2014)

5. THE OVERSIGHT MECHANISM IS GOOD BUT CAN BE IMPROVED

The Act mandates the Panel to submit the fund's statement of accounts to the Auditor General. The result of the audit is not featured in the Auditor General Report which is issued annually. However, the Auditor General does issue a Certificate which is featured in the KWAN Annual Report. The Act also mandates the panel to submit a report to the Minister of Finance containing the investments and policies made by the panel for the fund, a statement of account and the Auditor General's observations on the statement.

The report is then tabled by the Minister to the Parliament annually. The last report submitted to Parliament was in 2014, detailing the activities completed in 2013. Legislative oversight therefore only takes place during the tabling of the report. The body is not consulted for any expenditure or withdrawals from the fund.

6. MINIMUM DISCLOSURE TO THE PUBLIC

As mentioned above, while the KWAN Panel submits a report to Parliament annually, information about the fund is not easily accessible to the public. The report provides comprehensive information on the size of the funds, withdrawal and deposit amounts, return on investments, types of investment instruments and return rates.

For example, in 2013, the fund's investments generated RM 416 Million returns, RM 255 million from coupons, interests and dividends, RM 38.4 million from investments in foreign exchanges, gold and security and RM 122.6 million from investment managed by external managers. The total amount of KWAN assets can be found in the annual Financial Statement of the Federal Government.

Current discussion on the Petroleum Fund

Interest to establish a petroleum fund comes from the current Government and opposition parties. Individual politicians from the Opposition such as YB Lim Kit Siang[14] and YB NurulIzzah Anwar[15] have commented on this issue. It seems that all sides recognise the need to set up a fund to encourage the Government to be more fiscally disciplined and effective in using the resources at its disposal.

However, no-one has related the discussions on the fund to KWAN. Additionally, commentators vary in their visions of the petroleum fund. Points of dispute are what percentage of petroleum revenue should go into the fund, what kind of legal instruments should be used to set it up and for what purpose its money should be spent.

The National Economic Action Council (NEAC) stated the fund should be a separate account reserved for petroleum revenues. Should the annual budget require additional funds, withdrawal could be made from the fund. (NEAC, 2010) The Pakatan Rakyat's Shadow Budget envisioned the fund to be mainly financed by a portion of PETRONAS profits and used exclusively for purposes approved by Parliament, for example, funding for education, human resource development and technology. (Pakatan Rakyat, 2015) Contrastingly, Lim Kit Siang proposes that the "50% of windfall from oil and gas" should be invested in human capital, research and development, but not typical educational and training programmes. (Kit Siang, 2007) NurulIzzah Anwar sees the Norway Pension Fund as the ideal model to be replicated in Malaysia. Therefore, all petroleum revenue should go into the fund and may only be used only in difficult times. NurulIzzah (2014) recommends that only 4% of the total amount the fund can be used to finance the budget.

A recent idea for a petroleum-related fund was proposed by Rafizi Ramli, a member of Parliament from the Keadilan Party, after Malaysia implemented the floating mechanism to determine the retail price of petrol and diesel. He recommended the use of the Fuel Price Balancing Fund to capture revenue collected from the difference between retail price and market price and to stabilise fuel prices.

Commencing discussions on what the petroleum fund should look like is a good start. Research on the Natural Resource Funds showed that the rules for the fund should be generated through political consensus with the involvement of key stakeholders and the general public. This encourages the monitoring of the fund and ensures it is administered according to set rules.

14 Member of Parliament, Democratic Action Party (DAP)

15 Member of Parliament, Parti Keadilan Rakyat (PKR)

TABLE 2: VARIOUS PROPOSALS FOR MALAYSIA'S NATURAL RESOURCE FUND

Proposals of	Deposit	Withdrawal
NEAC	All Petroleum Revenue	
Pakatan Shadow Budget	Portion of Petronas Profit	Education, Human Resource Development, and Technology
Lim Kit Siang	50% and any of unused windfalls from oil and gas	Investment in human capital as well as research & development
NurulIzzah Anwar	All Petroleum Revenue	"Rainy days" in the future, only 4% of the fund can be used annually to finance the budget
RafiziRamli	Revenue collected from the difference between fuel retail price and market price	To stabilise fuel price

Suggestions for improving the KWAN

The exploration of KWAN's legal regulation suggests that while there are positive features in the current system, certain improvements are needed to ensure effectiveness, most importantly the deposit and withdrawal rules, structure and oversight mechanisms. The following section will explain in detail the suggestions for improvement.

1. OBJECTIVES OF THE FUND

Malaysia's budget has been in deficit since at least 1998. The revenue, including that from the petroleum sector, which accounts for about 30%, covers only the operating expenditures of the Government. Development expenditures are largely funded by loans that mostly originate from domestic sources.

Recently, concerns have been raised over the debt level which has reached the 55% self-imposed debt limit. If it continues to rely on highly volatile revenue sources such as petroleum and wants to maintain its current operating expenditures pattern, the Government will either need to increase the debt limit or reduce development expenditures. In response to these concerns, the Government planned to implement the Goods and Service Tax (GST) in April 2015, with a fiscal deficit target of 3% in 2015. However, in January 2015, this was revised to 3.2% to address decreasing global oil prices.

In the first two years of its implementation, the GST may increase non-petroleum revenue. However, it will not boost revenue, let alone replace the petroleum sector as the major contributor.

If this is the case, Malaysia will continue to face a budget deficit and may resort to borrowing from other sources. There is a need for the Government to create additional fiscal rules to further curb spending, which is elaborated upon in the next section. However, most importantly, Malaysia requires a fund in which future fiscal deficits for certain purposes will not be solely fulfilled by loans but instead by withdrawal from the fund. An effective KWAN should function well for that purpose.

Additionally, while it is true that the implementation of GST may not change the revenue patterns in the next five years long-term it may become one of the major contributors to the revenue. This may reduce the Government's dependence on petroleum revenues. If this happens, Malaysia may have a surplus from petroleum revenue which should be saved to fund development projects or decrease public debts. Again, an effective KWAN can function as this saving account.

2. DEPOSIT TO THE FUND SHOULD ONLY BE MADE FROM CONSOLIDATED FUND

As discussed, deposits to the fund can be made by entities other than federal governments. While intentions may be positive, expecting contributions from non-government entities is potentially problematic. To remedy this problem, there could be incentives, such as tax exemptions when an entity contributes. However, this would mean that contributions to the fund would reduce the total revenue collected elsewhere.

This paper suggests that deposits to the fund should only be made by the federal consolidated fund. State governments should be allowed to set up their own natural resource funds. Conversation about the need for the state to set up its own natural resource funds came up at the roundtable on natural resource governance that IDEAS organised in Sarawak in November 2014. Other entities, including PETRONAS, should not be allowed to contribute directly to the fund.

3. ESTABLISH ADDITIONAL FISCAL RULES, ENCOURAGING SAVING AND ACCOUNTABILITY AND DEVISE COMPLIANT DEPOSIT RULES

The only party that has deposited funds to KWAN since its formation has been PETRONAS. The Government, both at the federal and state level, have not deposited petroleum revenues to the fund. This lack of interest can be partly explained by the general nature of the deposit rule. It is also due to the use of the petroleum revenues, received by both federal and state governments, to pay their respective expenditures.

In such a situation, it is difficult to save petroleum revenues. For example, if one saved 50% of Petronas Dividend in 2014, RM 29000, the total revenue would not cover basic operating expenditures, consequently increasing the annual debt. Nevertheless, saving is not impossible, but requires the Federal Government to limit their spending. In other words, the Government has to impose stricter fiscal rules.

Malaysia has implemented the "Golden Fiscal Rule" which only allows the Government to employ loans for investment purposes. The Loan (Local) Act 1959 and the Government Funding Act 1983 limits borrowing for development and capital spending purposes and caps the federal government domestic debt at 55 percent of GDP. This is complemented by other legal rules, such as the RM 35 billion limit on external debt and restriction of Treasury bills issued to RM 10 billion.

Additionally to the Golden Rule, in 2013, the Government established an objective to set the overall fiscal deficit at around 3 percent of GDP by 2015. To an extent, the debt rule and the deficit target have encouraged the Government to reduce fiscal deficit and limit borrowings. However, since the deficit target is not as strict as the Golden Rule, this target was revised in early January 2015 to 3.2%, due to the decrease in oil prices. Additionally, incentives were not provided for the Government to set aside some of the petroleum revenue and may actually encourage the government to spend.

The current financial position of KWAN testifies to this situation. It may be a good time for the Government to consider implementing "Expenditure Rule" to further restrict spending and ensure the surplus will be placed into KWAN.

Expenditure Rule is a type of fiscal rule that limits spending growth. Academic analysis of public finance suggests that the most successful fiscal consolidations heavily rely upon imposing expenditures rules. According to the study, expenditure rules "seem to have not only reinforced spending control but also to have increased the effectiveness of budget balance rules." Malaysia's expenditure growth has not always been consistent. In 2010, expenditure was lower than in 2009. However in 2008, the budget was 20% higher than in 2007. On average, our operating expenditure from 2001 to 2012 grew about 11% annually.

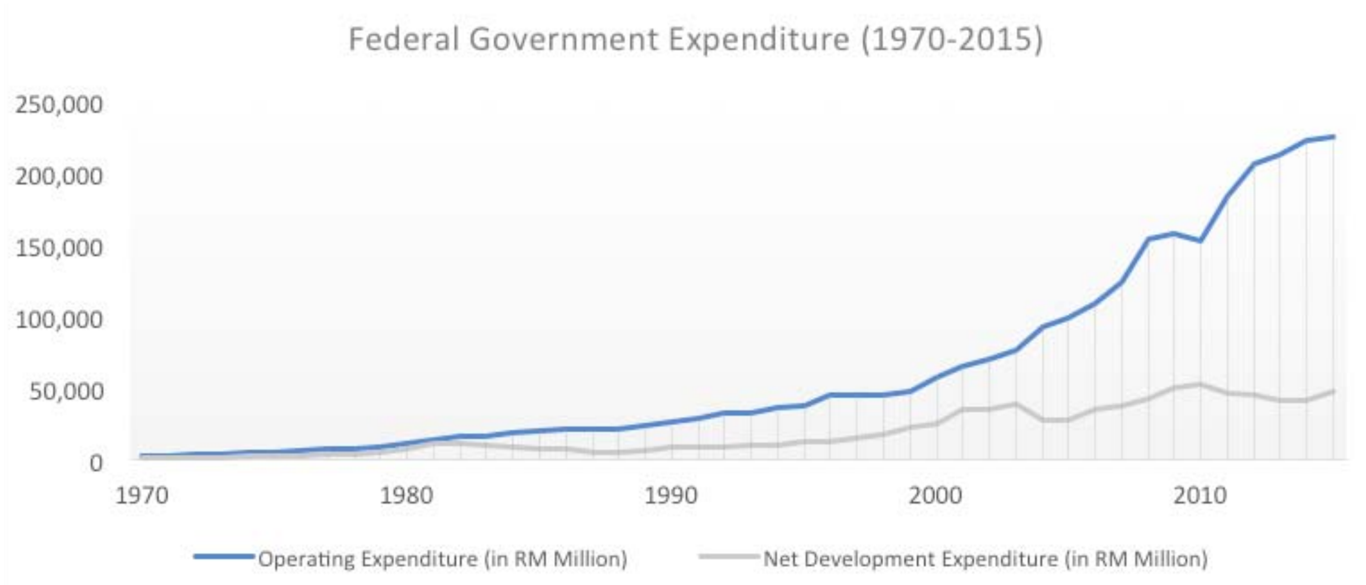
In a sustainable fiscal situation, where public debt grows at the same rate or slower than GDP growth, operating expenditure should increase at a rate less than the GDP growth.

Assuming Malaysia's fiscal situation is sustainable, which it is not because the public debt increases at a higher rate than the GDP growth, the operating expenditures should grow approximately 5-6% annually. The growth rate of operating expenditures from 2001-2012 is clearly below this sustainable rate. If Malaysia is serious about improving the fiscal situation and considering the implementation of expenditure rules, the growth of its operating expenditures should be kept below 3%.

The 3% Fiscal Deficit target as set by the 2015 Budget has encouraged the Government to maintain the increase in operating expenditures to 1.1%. This trend should be kept. If the Government can function with a 1% percent increase in operating expenditure, capping the operating expenditures to less than 3% annually should not be problematic.

Once the fiscal rule is in place, the deposit rule to the fund is more easily determined. If the above proposed fiscal rule is to be implemented, the deposit rule of KWAN can become surplus and should be deposited into the fund annually.

FIGURE 3: GROWTH RATE OF FEDERAL GOVERNMENT OPERATING AND DEVELOPMENT EXPENDITURE

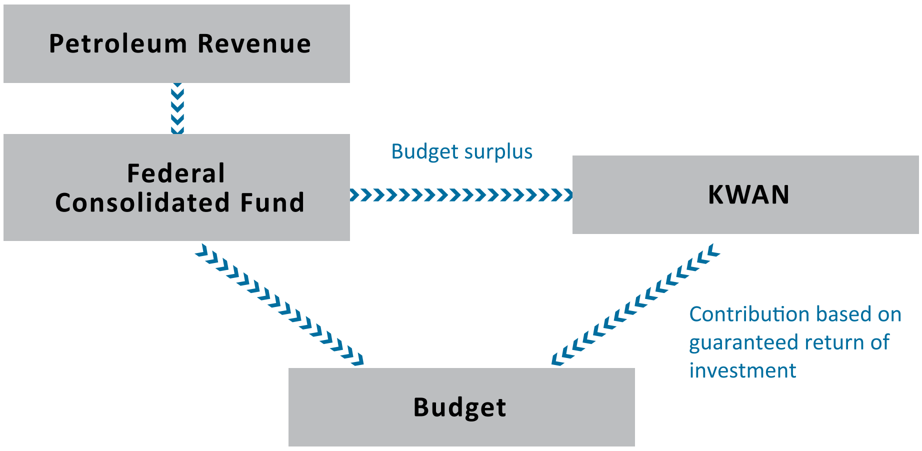


4. REVISE WITHDRAWAL RULE TO ENSURE THE SUSTAINABILITY OF THE FUND

The current withdrawal rule has specified the expenditures that can be financed by the fund. However, it does not address the rate of withdrawal. For the fund to be sustainable, this paper proposes that the amount of annual withdrawal to stabilise the budget should not exceed the average returns of given investments. The rule should also explicitly state that withdrawal should only be made once a year, after the budget has been passed and the amount of withdrawal-based rule has been approved by the parliament.

Once deposits are made to the fund, if it is managed prudently, the total value will gradually increase. For this reason, another withdrawal rule should be in place to govern the remaining balance. The fund should be earmarked for special purposes and the circumstances for such withdrawal should be strict. For example, it can be only be drawn for certain development expenditures, such as improving educational services or developing human resource and technology, as proposed by Pakatan Rakyat. It can also be used for underfunded development expenditures. Additionally, there should be a limit for such withdrawals and Parliament's role in approving withdrawals should be made mandatory.

FIGURE 4: PROPOSED FLOW OF FUND



5. IMPROVE ACCOUNTABILITY BY IMPROVING OVERSIGHT AND REVISING THE STRUCTURE

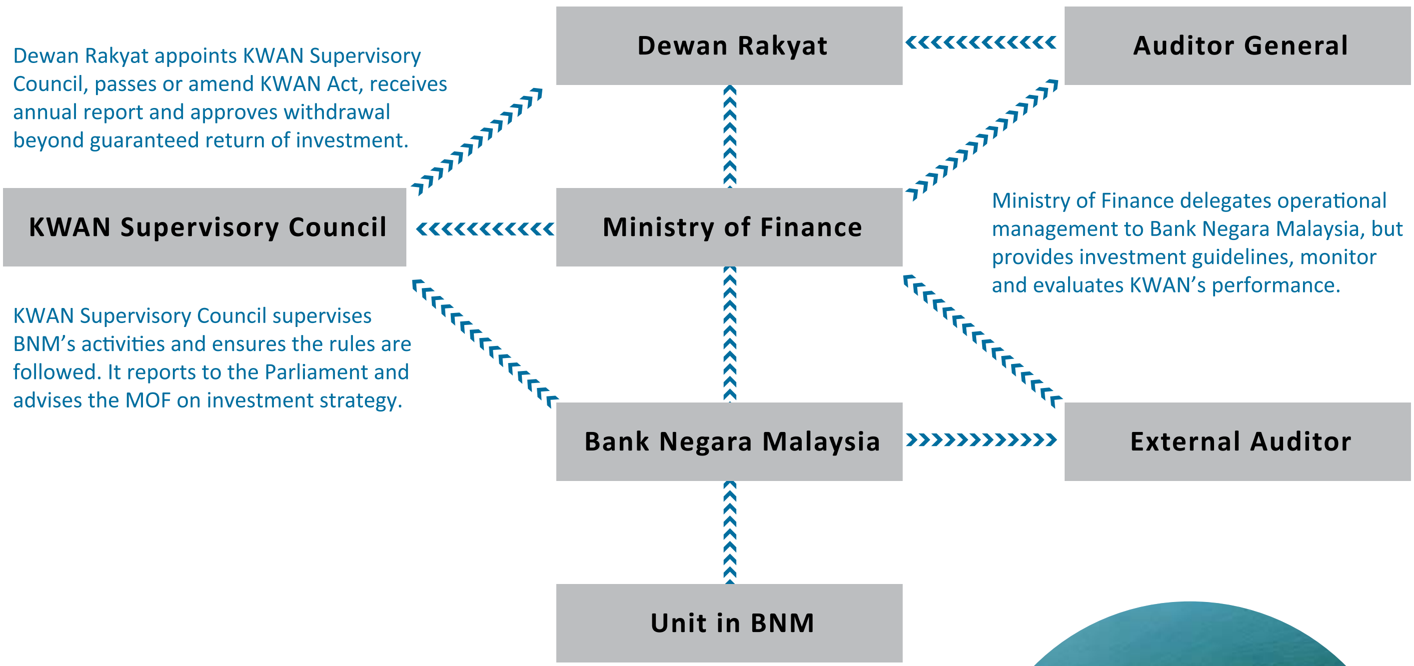
It is clear from the previous sections that if the new fiscal rule is implemented and KWAN is part of the budgetary process, the Parliament will be more involved in overseeing its operation. Parliament currently oversees the KWAN through an annual report submitted by the panel, a function which should continue. However, the parliament will be involved in approving withdrawal to the remaining balance and they will know the amount of withdrawal from the fund to stabilise the budget earlier than what it is now.

The KWAN Panel may remain to be the manager of the fund. However, as the KWAN withdrawal and deposit is part of the budgetary process, it is better for the current panel to be positioned as advisory or supervisory council for the fund since the KWAN will be part of budgetary process and the managerial function can be exercised by the Ministry of Finance. The council can act like the Supervisory council of Norway Pension Fund or Consultative Council of Timor Leste Petroleum Fund in which they supervise and advise both the manager and the operational manager of the conduct of the fund, especially in any investment that the fund makes. This council reports and is responsible directly to the parliament.

The manager of the fund will then be the Ministry of Finance while the operational manager will remain Bank Negara Malaysia. It is very important however for the public to know which section within the Bank Negara Malaysia is tasked to operationalise the fund.

The Auditor will continue to audit the fund report that will be submitted by the Ministry of Finance to the Parliament and table its audit report to the parliament, preferably together with his audit of the financial statement of the federal government. Additionally, an external auditor can be invited to audit the fund and submit their reports to the Ministry of Finance as the owner and manager of the fund.

FIGURE 5: POTENTIAL NEW STRUCTURE OF THE KWAN



6. IMPROVE PUBLIC DISCLOSURE

The amount of information currently available on KWAN can be improved. The first step is to make the KWAN Report available for download either in parliament website or the website of Bank Negara. Bank Negara, as the operational manager of the fund, should establish a website dedicated to current information on KWAN. The Norges Bank, the operational manager for the Norway Pension Fund, has a website providing thorough, in-depth information to the public on the profile of the fund, their investment strategy and policy, the organisation structures and the people who manage the fund. This is an example of good practice which Malaysia should follow.

However, as Malaysia's petroleum resources are limited and the Government has relied excessively on petroleum revenues to fund its expenditure, it is time for KWAN's structure and regulations to be revised.

Conclusion

The Kumpulan Wang Amanah Negara is envisioned as a tool for the Government to save some of the wealth obtained from petroleum resources for future generations. The current structures and rules have allowed the Government to gain contributions from petroleum related entities. These contributions have been invested and saved. However, as Malaysia's petroleum resources are limited and the Government has relied excessively on petroleum revenues to fund its expenditure, it is time for KWAN's structure and regulations to be revised. The paper has explored the proposals for revisions that can be considered by the Government. They are:

1. State the objectives of saving for future generations, stabilising the budget and financing development expenditures clearly in policy documents, preferably in the KWAN Act.
2. Deposits to KWAN should only be made from consolidated funds. Other entities that are currently allowed to make contributions to KWAN should no longer be allowed to contribute. Private entities contribute indirectly to the KWAN by paying taxes. Additionally, state governments should be allowed to establish their own natural resource funds, as they deem necessary.
3. Implement expenditure rules for saving and accountability. The expenditure rule that can be applied is a limit of 2% to the growth operating expenditures.
4. Revisions to withdrawal rule:
    a. Withdrawal can be made from KWAN to help the budget. However, the amount of withdrawal must not exceed the guaranteed return of the KWAN's investments. This withdrawal should be part of the budgetary process.
    b. Withdrawal of the remaining balance of the fund must be approved by parliament and used for earmarked purposes as agreed by various stakeholders.
5. Revise the oversight mechanism and the management structure of the fund.
    a. The MOF will be the owner and the manager of the fund, but the day-to-day operations will remain the responsibility of the BNM.
    b. As a result, the KWAN Panel should no longer be the manager of the fund. Instead, they should act as a supervisory or advisory council to the manager of the fund (the MOF) and report directly to Parliament. Membership of the KWAN Panel should be revised. Private sectors can be invited to the panel and the elements from the MOF should no longer be there.
    c. External audit can be invited to audit the management of the fund by the BNM.
6. Improve public disclosure by:
    a. Making the KWAN Report downloadable in the MOF, BNM and Parliament websites.
    b. Having a dedicated website managed by BNM as the operational manager of the fund. The website should feature key information about KWAN.

Sri Murniati is Manager of Political Economy and Governance Unit at the Institute for Democracy and Economic Affairs (IDEAS). She obtained her M.A in Political Science from Ohio University, USA, and participated in number of trainings related to the governance of oil and gas sector organised by the Natural Resource Governance Institute. She thanks Andrew Bauer, Senior Economic Analyst at the Natural Resource Governance Institute for reviewing the paper and providing insightful comments to the content.

Bibliography

Andrew Bauer (ed.). 2014. *Managing the public trust: How to make natural resource funds work for citizens*. New York: Natural Resource Governance Institute and Columbia Center on Sustainable Investment. Online: http://www.resourcegovernance.org/sites/default/files/NRF_Complete_Report_EN.pdf

Pakatan Rakyat. 2014. *Belanjawan Malaysia 2015*. https://www.pakatanrakyat.my/doc/Pakatan_Rakyat_Belanjawan_2015-ENG.pdf, accessed on 1 December 2014.

Lim Kit Siang. *Reliance on Oil and Gas*. http://blog.limkitsiang.com/2007/09/12/reliance-on-oil-gas/

Malaysia to set up oil fund following Norway Model. *The Nordic Times*, 22 February 2014. http://www.nurulizzah.com/site/2014/02/24/malaysia-to-set-up-oil-fund-following-norway-model/

Joaquim AyusoiCasal. 2012. *National Expenditures Rules: Why, Now and When. Economic Papers 473. December 2014*. Brussels: European Commission Directorate General for Economic and Financial Affairs. http://ec.europa.eu/economy_finance/publications/economic_paper/2012/pdf/ecp473_en.pdf

TidianeKinda et.al. 2013. *Fiscal Rules at Glance*. International Monetary Fund. http://www.imf.org/external/datamapper/fiscalrules/Fiscal%20Rules%20at%20a%20Glance%20-%20Background%20Paper.pdf

Panel Kumpulan Wang Amanah Negara. 2014. LaporanTahunan 2013.

National Economic Advisory Council. 2010. New Economic Model for Malaysia: Concluding Part Strategic Policy Measures. https://www.pmo.gov.my/dokumenattached/NEM_Concluding_Part.pdf

Ministry of Finance. Fiscal and Economic Data. http://www.treasury.gov.my/index.php?option=com_content&view=article&id=2702&Itemid=2481&lang=en

RafiziRamli. 2015. Complete Overhaul Of Fuel Retail Industry: Change To Consignment Stock To Avoid Excessive Hidden Fuel Tax. http://rafiziramli.com/2015/01/complete-overhaul-of-fuel-retail-industry-change-to-consignment-stock-to-avoid-excessive-hidden-fuel-tax/

IDEAS
Institute for Democracy and Economic Affairs

IDEAS is inspired by the vision of Tunku Abdul Rahman Putra al-Haj, the first Prime Minister of Malaysia. As a cross-partisan think tank, we work across the political spectrum to improve the level of understanding and acceptance of public policies based on the principles of rule of law, limited government, free markets and free individuals. On 17 January 2013, IDEAS was announced as the 5th best new think tank in the world (up from 13th in 2011) in a survey of 6,603 think tanks from 182 countries.

Please support us by making a donation. You can make a contribution by cheque payable to “IDEAS Berhad” or by transfer to our account CIMB 8001367104. We can only survive with your support.

Institute for Democracy and Economic Affairs (IDEAS)
F4 Taman Tunku, Bukit Tunku, 50480 Kuala Lumpur
www.ideas.org.my
Reg no: 940689-W

DONATION FORM

( ) I enclose a cheque made payable to “IDEAS Berhad”

( ) I have transferred my donation to IDEAS (CIMB account no: 8001367104)

Amount

( ) RM500 ( ) RM5000

( ) RM1000 ( ) RM10,000

( ) RM2500 ( ) other amount: ____________________

The information below is optional. But please supply full details if you need a receipt.

Name (with titles): ____________________

Address: ____________________

City / State: ____________________ *Postcode:* __________

Email: __________ *Tel:* __________ *Fax:* __________

( ) *For donations above RM5000, please tick here if you agree to being listed as a donor on our website and literature.*

Please send this form with your donation to:

Institute for Democracy and Economic Affairs (IDEAS)
F4 Taman Tunku, Bukit Tunku
50480 Kuala Lumpur, Malaysia.

IDEAS' Publications

Public procurement in FTAs: The challenges for Malaysia by David Seth Jones, Policy IDEAS No.16 (December 4, 2014)

Key failings in the Malaysian public procurement system and how they can be addressed by greater transparency by David Seth Jones, Policy IDEAS No.7 (October 1, 2013)

The hardware and the software to overcome a middle-income trap by Wolfgang Kasper, Policy IDEAS No.8 (November 5, 2013)

Morality and the Rule of Law: Inspirations from Raja Aziz Addruse by Tunku Zain Al-'Abidin ibni Tuanku Muhriz (October 17, 2014)

School choice and school vouchers programmes: Why do they succeed and why do they fail? Lessons for Malaysia by Jenny Gryzelius, Policy IDEAS No.15 (November 17, 2014)

Dropping out of school in Malaysia: What we know and what needs to be done by Tamanna Patel, Policy IDEAS No.14 (August 4, 2014)

Transparency in European public procurement: benefits and lessons for Malaysia Dr Francesco Stolfi and Sri Murniati, Policy IDEAS No.10 (January 15, 2014)

Generating best value for taxpayers' money: How to improve transparency and accountability in Malaysia's public contracting system by Sri Murniati, Policy IDEAS No.13 (July 2, 2014)

Setting up special needs centres: A focus on early intervention centres for the underprivileged by Tamanna Patel, Policy IDEAS No.17 (December 9, 2014)

ICT in Classroom Learning: Exploring the Discrepancies between Ideal Conditions and Current Malaysian Policy by Jenny Gryzelius, Policy IDEAS No.18 (27 February 2015)

Market solutions to the education crisis by Myron Lieberman, Tamanna Patel and Wan Saiful Wan Jan, Policy IDEAS No.9 (December 10, 2013)

The Malaysian Trust School Model: It's good but is it sustainable?* by Dr Arran Hamilton, Policy IDEAS No.11 (February 13, 2014)

Malaysian education: what do the poor really want? A look at education needs and aspirations of the bottom 40 percent of households in Malaysia by Tamanna Patel, Policy IDEAS No.12 (April 15, 2014)

Private education for the poor? The case of India and lessons for Malaysia by Joanna Lim and Wan Saiful Wan Jan, Policy IDEAS No.5 (July 4, 2013)

After GE13: Strengthening Democracy in Malaysia by Dato' Muthiah Alagappa, Policy IDEAS No.6 (August 1, 2013)

Fake medicines in Asia Philip by Stevens & Dr. Helmy Haja Mydin (February 13, 2013)

Giving Voice to the Poor by Wan Saiful Wan Jan, Policy IDEAS No.4 (February 5, 2013)

IDEAS
Institute for Democracy and Economic Affairs

Policy IDEAS are IDEAS' regular publications that introduce and propose ideas for policy reforms based on analysis of existing policies or best practices.

Institute for Democracy and Economic Affairs (IDEAS), F4 Taman Tunku, Bukit Tunku, 50480 Kuala Lumpur
Tel: +603 6201 8896/8897 Fax: +603 6201 2001
www.ideas.org.my