



PURPOSE, FORMATION AND MANAGEMENT OF WEALTH FUNDS

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Abstract. In the face of the current economic crisis, some countries made use of their advantage of having state reserves or national wealth funds, which helped them to buffer the economic recession. Finance from the funds has been allocated for the stabilization of the financial situation, rescue of banks, or solving acute social problems. The article shows that such funds and reserves have been available not only in economically powerful countries, but also in EU newcomers, the best example being Estonia. Regrettably, Lithuania, in the period of rapid economic growth, was not building up such reserves and directed the high income received—mainly from privatization and the development of export—towards solving current (often populist) problems. Thus, the article analyzes the purpose of such funds, the peculiarity of their formation and management issues.

Keywords: fund, reserves, wealth, investment.

Reikšminiai žodžiai: fondas, rezervas, turtas, investavimas.

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Introduction.

In the face of the current economic crisis, countries are making efforts to stabilize their economies by providing cash injections, as a rule, from national reserve funds. Such funds have been built up by many countries having strong economies or rich in natural resources. Professional managers and administrators manage foreign currency reserves; they control the wealth that could help mitigate economic recessions or be allocated to satisfy other unforeseen national needs. Countries having large currency reserves have established national wealth funds—sovereign wealth funds or sovereign wealth enterprises.

The first national wealth fund was founded in the United States of America (the U.S.) in the middle of the twentieth century; it was meant for the investment of excess foreign currency within and outside the country. From 2000, the number of national wealth funds increased to 40, the amount of wealth owned by such funds—to USD 3.9 trillion [9]. A further increase in the wealth of the funds was forecasted; their wealth was expected to reach as much as USD 10–12 trillion in 2015. However, these forecasts may be corrected by the current economic crisis.

A wealth fund should meet the following five criteria: 1) be independent; 2) have large foreign currency reserves; 3) have no obligations (liabilities); 4) tolerate risk; 5) have broad geography of investment [5]. A wealth fund may be defined as a state-owned fund investing state assets irrespective of official reserves and usually having a specific purpose (mission) in stabilizing the national economy in case of a crisis or ensuring social welfare in future. Wealth funds may also be defined as state-owned investment instruments, with the help of which portfolios of two types of assets—accumulated national and international financial—may be managed.

A large part of investment from national wealth funds is allocated for the economies of the countries financing the funds. Moreover, national wealth funds help the international financial system to remain stable as they are characterized by a longer-term strategic perspective. In recent years, when, due to the outbreak of crisis, there was a decrease in liquidity in credit markets, the benefit of national wealth funds for stabilizing the financial situation became obvious. The complicated situation was handled with the help of national wealth funds as financial institutions used investment from such funds to increase their capital. Thus, the world system of banks gained

strength, and the international financial system regained trust.

In the face of a considerable economic recession, Lithuania was also confronted with the lack of funds for maintaining the viability of its economy and funding social obligations.

2. Structure and Limitations of Wealth Funds

The purpose and structure of wealth funds is probably best reflected by the concepts and definitions developed by different organizations or authors, presented in brief in the table below.

Table 1. Variety of definitions of wealth funds and their characteristics

Author or organization	Definition
Christopher Balding, California University	A <i>sovereign wealth fund</i> is a pool of capital controlled by a government or government-related entity that invests in assets seeking returns above the risk-free rate.
	<i>Sovereign wealth funds</i> are a pool of domestic and international assets owned and managed by governments to achieve a variety of economic and financial objectives, including the accumulation and management of reserve assets, the stabilisation of macroeconomic effects and the transfer of wealth across generations.
	<i>Commodity stabilization funds</i> are national investment funds the main purpose of which is to offset revenue declines due to falling commodity prices or production levels.
Fotak and Megginson	<i>Sovereign wealth funds</i> are special investment funds created or owned by governments to hold foreign assets for long-term purposes.
	<i>Stabilization funds</i> are set up by countries rich in natural resources to insulate the budget and economy from volatile commodity prices (usually oil). The funds build up assets during the years of ample fiscal revenues to prepare for leaner years.
	<i>Savings funds</i> are intended to share wealth across generations. For countries rich in natural resources, savings funds transfer non-renewable assets into a diversified portfolio of international financial assets to provide for future generations, or other long-term objectives.
	<i>Reserve investment corporations</i> are funds established as a separate entity either to reduce the negative cost-of-carry of holding reserves or to pursue investment policies with higher returns.
	<i>Development funds</i> allocate resources for funding priority socioeconomic projects, such as infrastructure.
International Monetary Fund	<i>Pension reserve funds</i> have identified pension and/or contingent-type liabilities on a government's balance sheet.
Blundell-Wignall, Hu and Yermo	<i>Sovereign wealth funds</i> are pools of assets owned and managed directly or indirectly by governments to achieve national objectives.
	<i>Sovereign wealth funds</i> diversify investment portfolios comprised of property, real estate, permanent income, bank deposits, and alternative investment, such as risk capital funds and private capital.
McKinsey Global Institute	

Edwin Truman, Institute for International Economics	<i>Government investment corporations</i> invest directly into domestic and foreign corporate assets, shunning the portfolio investment approach and operate like private equity funds that actively buy and manage companies, either alone or with consortia of other investors.
	The broadest definition of a <i>sovereign wealth fund</i> is the whole set of assets controlled or owned by the state. <i>Sovereign wealth funds (SWFs)</i> are pools of assets owned and managed directly or indirectly by governments to achieve national objectives. They may be funded by: foreign exchange reserves; the sale of scarce resources such as oil; from general tax and other revenue. There are a number of potential objectives of SWFs, which are not always easy to attribute to a particular fund. <i>Social security reserve funds</i> are set up as part of the overall social security system, where the inflows are mainly surpluses of employee and/or employer contributions over current payouts. <i>Sovereign pension reserve funds</i> refers to those funds which are established directly by the government (completely separated from the social security system), and whose financial inflows are mainly from direct fiscal transfers from the government. They have been set up by governments to meet future deficits of the social security system.
Organization for Economic Cooperation and Development	

Source: Compiled with reference to Balding (2008), Jen (2007), Johnson (2009).

Thus, national wealth funds are, first of all, perceived as capital funds, accumulating assets obtained from natural resources (e.g. oil in Norway, United Arab Emirates, Saudi Arabia), long-term budget surplus (Singapore, South Korea, China), or cover pension reserve funds (Ireland, France, New Zealand).

With the increase in the influence of national wealth funds in the international financial system, more and more discussions take place between the owners of the funds and countries receiving investment. The main topic of such discussions is fair competition between national wealth funds and private investors. Countries make efforts in order to tackle the issue: how to ensure strong motivation behind investment solutions of national wealth funds by economic purposes (market development, introduction of new goods and services, increasing transparency). Attention is focused on investment objectives and strategies, determining the composition of the portfolio, standards for the provision of information on the value of owned assets, internal control, and risk management systems. In November 2007, the International Monetary Fund (IMF) organized a conference, where assiduous attention was devoted to the issues of the transparency of national wealth funds. Together with the owners of the funds, the IMF undertook to prepare a code of conduct for national wealth funds, where it is attempted to establish the following: management and institutional struc-

ture, transparency and disclosure of information, risk management, and accountability.

In November 2008, the International Working Group of Sovereign Wealth Funds presented 24 Generally Agreed Principles and Practices (GAPP), the so-called Santiago Principles, covering obligations relating to financial objectives and guidelines for greater clarity and disclosure of relations with the government. The principles were approved by the IMF's International Monetary and Financial Committee. These principles, along with a common agreement between countries having national wealth funds to stick to them, boost the confidence in national wealth funds as in investors.

3. National Wealth Funds in the European Union

The EU is one of the key participants in solving the problems of national wealth funds and already has considerable experience in the field of ensuring their transparency and fair practice. Currently EU Member States apply a manifold regulatory regime (legislation) aimed at controlling the entrenchment and activity of foreign investors in the European Community (EC). Such national, social and economic legislation should be followed by national wealth funds, just as by any other type of foreign investors. The World Trade Organization (WTO) and the Organisation for Economic Co-operation and Development (OECD), in turn, have established certain international obligations, aimed at defining EU actions. The legal system of the EU has been developed in such a way that national wealth funds are applied the same rules and are controlled in the same way as any other domestic or foreign investment scheme. The free movement of capital in the EC is not absolute; it may be regulated (e.g. the EC may, by qualified majority voting, adopt measures related to the direct movement of foreign capital from the third countries).

In their national legislation, EU Member States have established certain national measures for controlling and supervising the investment of national wealth funds and other types of investment. Should new, special needs arise, the countries may introduce new measures. In such case, these measures should be harmonized with the Treaty Establishing the European Community (hereinafter referred to as the Treaty), may not be in breach of international regulations, should be proportional and non-discriminatory. The range of the competence of EU Member States in imposing prohibitions upon national wealth funds is regulated by the European Court of Justice, which has prepared guidelines for

using national measures for such regulation without a breach of the Treaty.

The OECD has established the principles of investment activity, which are to be followed not only by national wealth funds but also by other financial entities. The countries have to stick to these principles in implementing investment policy and create a more favourable investment climate. The investment principles cover the following: non-discrimination of foreign investors, transparency in limiting investment, liberalization of restrictions on the movement of capital, preventive measures for new restrictions.

Countries financing national wealth funds have to adhere to strict governance and transparency principles [3]:

1. Governance. An essential condition for the elimination of uncertainty about political and non-commercial activity of national wealth funds is clarity: to what extent the fund may be influenced politically. According to OECD guidelines, the following good governance principles may be distinguished:

- Clearly defined, several liability in the internal structure of a national wealth fund;
- Development and disclosure of a policy establishing general investment objectives of a national wealth fund;
- Autonomy of the fund's performance, allowing the achievement of set objectives;
- Publicly available information about the fundamental principles;
- Disclosure of the general principles of internal governance ensuring the integrity of the fund's performance;
- Development and disclosure of a risk management policy.

2. Transparency is another essential condition, valid for the open investment environment, ensuring confidence in the funds. It allows the parties concerned to monitor and supervise the performance of the funds: whether they do not deviate from the declared objectives. Thus market discipline is enforced, and the government's desire to intervene is reduced. The following transparency principles may be distinguished:

- Disclosure of the positions of investment, especially those managed directly;
- Exercise of property rights;
- Disclosure of the composition of a currency basket;
- Provision of information about the use of the leverage effect;
- Provision of information about the amount and sources of reserves;
- Provision of information about regulation and supervision.

4. World's Largest Wealth Funds

In recent years, closer attention has been devoted to the growth in the reserves of central banks, especially in Asia. However, even more attention has been paid to a new player in the financial sector—national wealth funds, which are neither traditional pension funds nor reserves maintaining the stability of national currency, but a mix of the two. Nevertheless, the difference between national wealth funds and the reserves of central banks has been gradually vanishing. The assets often flow into such funds from one main product produced in a country and are accumulated throughout many years owing to harmonized macroeconomic, trade and fiscal policies, together with long-term budget planning and limitation of expenditure. Such funds are established for one of the following purposes: to protect the budget and economy from large fluctuations, to help reduce excess liquidity, to build up reserves for future generations, or to use the accumulated assets for urgent economic and social needs.

Some funds, although completely new, have already accumulated large assets. There are, however, funds which have already been operating for many years. Experts usually call them oil or natural resource funds as the absolute majority of such funds were established using surplus assets received from trading in oil, gas, diamonds, copper, etc. However, there are funds which have no direct relation to natural resources (e.g. Singapore funds). The first example of a national wealth fund to come to mind for most Europeans would probably be the Norway's wealth fund, which invests assets received from trading in oil and accumulates them for future generations, who will live in the days when oil reserves will have been exhausted. However, there are more of such funds, and the Norway's wealth fund is not the biggest one. Table 2 presents a list of ten largest wealth funds.

Table 2. Largest national wealth funds

Country	Name of the fund	Owned assets, USD billion	Year of foundation	Source of assets
UAE, Abu Dhabi	Abu Dhabi Investment Council	\$875	1976	Oil
Norway	Government Pension Fund – Global	\$396.5	1990	Oil
Singapore	Government of Singapore Investment Corporation	\$330	1981	Not goods
China	SAFE Investment Company	\$311.6		Not goods
Saudi Arabia	SAMA Foreign Holdings	\$300	n/a	Oil

Kuwait	Kuwait Investment Authority	\$250	1953	Oil
China	China Investment Corporation	\$200	2007	Not goods
China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	\$163	1998	Not goods
Russia	National Welfare Fund	\$162.5	2008	Oil
Singapore	Temasek Holdings	\$159	1974	Not goods

Source: Compiled with reference to the data of the Sovereign Wealth Fund Institute [8].

Five biggest national wealth funds own about 75% of assets accumulated in all of such funds. Although the total amount of assets owned by the funds is still lower than the amount of reserves owned by central banks or assets owned by pension funds, it attracts attention owing to its rapid growth. There are at least three reasons for such attention. First, the larger the increase in the amount and significance of assets owned by the funds, the faster the growth in their influence on various markets. Second, national wealth funds—before they become as uniform as central banks or pension funds—attract attention with their distinctive features. And finally, the third reason is the desire to answer the question: what is the difference between the manager of such a fund and that of central bank reserves now, and what will it be in future? It is considered that, traditionally, such funds are long-term investors, i.e. their investment strategy will remain unchanged in future.

5. Experience, Mistakes of and Lessons Learnt by Lithuania

The property (assets) of the Republic of Lithuania is mainly managed by three funds: State Property Fund, Privatization Fund, and Stabilization Fund [7]. The functions of the State Property Fund are as follows: preparation of a draft list of privatization objects and submission of the list for the approval of the Government; establishment of the method and terms and conditions of privatization of a specific object; formation of a commission for assessing the value of a privatization object (shareholding in a company) and for setting the initial selling price; where necessary, restructuring of a state-controlled enterprise; approval or non-approval of transactions to be entered by state-controlled enterprises; search for investors for a privatization object.

The Privatization Fund, founded in 1997, manages the assets received in the course of privatization and distributes them according to priorities set by law. The fund was founded after the privatization

procedure and the use of assets had been established by law; the assets that enter the fund are all the assets received as a result of transfer of property to private persons.

The Law on the Privatization of State-Owned and Municipal Property of the Republic of Lithuania (of 4 November 1997) allows the following modes of using assets: for the restoration of savings of the population and covering related expenses, as well as for the formation of the Reserve Fund (up to 2/3 of funds received from privatization); for the implementation of national programmes approved by the Government (up to 1/3 of funds received from privatization); for the Guarantee Fund under a separate programme; for the remuneration of experts for their services.

The third level of management of state-owned assets is the Reserve Fund, which gets 2/3 of assets received by the Privatization Fund. As may be seen from the foregoing, all three funds are closely inter-related and, without going deeper into details of bureaucratic governance, may be treated as a single public welfare fund, or Reserve Fund, as the assets contained in the fund directly determine our welfare. According to the Law on State Reserves (of 31 August 2000), state reserves are monetary assets (in national and foreign currency) and material resources purchased from state funds, as well as compulsory material resources for mobilization needs, satisfaction of the economic and civil security system performance needs under the circumstances of mobilization, emergency situation, economic threat, or other cases provided for in this law [5]. The assets from the Reserve Fund by a government resolution may be allocated for funding in the following fields: reform of the pension system; accumulation of monetary assets, meant for maintaining stability and functioning of the economy, in the state reserves; expenditure on the management of the fund; exercise of state property liabilities related with the state debt under a recoverability principle.

During its lifetime, the Privatization Fund collected almost LTL 4 billion worth of income. The Law on the Restoration of Savings of the Population of the Republic of Lithuania establishes that at least 2/3 of the income of the Privatization Fund should be allocated for the restoration of the savings of the population and formation of the Reserve Fund. According to the law, up to 1/3 of the income of the Privatization Fund may be allocated for the implementation of various national programmes approved by the Government.

The Reserve Fund was established when Lithuania assumed obligations to the IMF, and an agreement was signed, where, among other recommendations, a position on the restoration of savings was presented. Back then, the IMF recommended to

stop the legally established restoration of savings and allocate all income received as a result of privatization for the formation of a Reserve Fund. At that point, an opinion was expressed that the assets received in the course of selling state-owned property should be used for covering state debts and reforming the pension system, i.e. for the transition to a partly private pension accumulation scheme.

In contradistinction to Lithuania, Estonia, from 1997, started building up a Stabilization Reserve Fund; the amount of assets in the fund stood at about EEK 700 million. For several years, the Estonian Government had a marked budget surplus, and, through transferring surplus assets to the reserve fund, accumulated substantial financial reserves. Thus, the Estonian Stabilization Reserve Fund is financed from the budget surplus and is managed by the Government. The use of assets from and the management of the fund are regulated by the Law on State Property of the Republic of Estonia. At present, Estonian stabilization reserves contain more than EEK 7 billion. As announced by the Ministry of Finance of the Republic of Estonia, the Estonian Stabilization Reserve Fund uses a conservative investment strategy, which means that it invests in low-risk bonds issued by the governments of EU Member States and bonds of state-owned enterprises. Estonia has built up not only stabilization but also health care, job-loss insurance and other reserves; therefore, in the face of deterioration in the global economic situation, it did not have to immediately start using assets from the reserve fund, and, first, could use the assets from the abovementioned special-purpose funds. The IMF stressed that Estonia, making use of the assets from reserve funds, will not be faced with the necessity to apply for financial support to international organizations for about two or three more years.

6. National Wealth Funds in the Time of Crisis

With the outbreak of financial crisis, national wealth funds became important participants in the global financial market as they invested a large amount of assets in key world financial institutions. In some countries, on government request, such funds invested in national financial institutions and national stock market, thus saving the domestic market. National wealth funds are expected to act as stabilizers in the global financial market.

Many analysts state that national wealth funds, as long-term investors, will manage to wait out the period of crisis and will not suffer as huge financial losses as other investors because they do not have direct obligations. Moreover, national wealth funds, as long-term investors, increase the diversity of in-

vestment in world markets, reduce instability in and contribute to the extension of markets.

Investment horizons of national wealth funds make them unique in comparison with traditional institutional investors, such as, for example, pension funds, which owe obligations to future pensioners. In recent years, national wealth funds considerably enlarged owing to the increase in natural resource prices and permanent trade surplus of countries.

At the beginning of 2008, based on the data of the 2009 World Economic Forum, the assets of sovereign wealth funds, together with the reserves of central banks and sovereign pension funds, amounted to USD 13 trillion, which made up about 8% of global bond and stock market capitalization [9].

the increased significance of national wealth funds worldwide.

Conclusions

1. Countries rich in natural resources as well as those which had built up large foreign currency reserves, established national wealth funds, which—in the face of the current economic crisis—help to mitigate the economic recession or are allocated for meeting other unforeseen national needs. Such funds or reserves are available not only in wealthy countries but also in some EU newcomers, e.g. Estonia.

2. In recent years, when, due to the outbreak of crisis, there was a decrease in liquidity in credit markets, the benefit of national wealth funds for stabilizing the financial situation became obvious. Financial

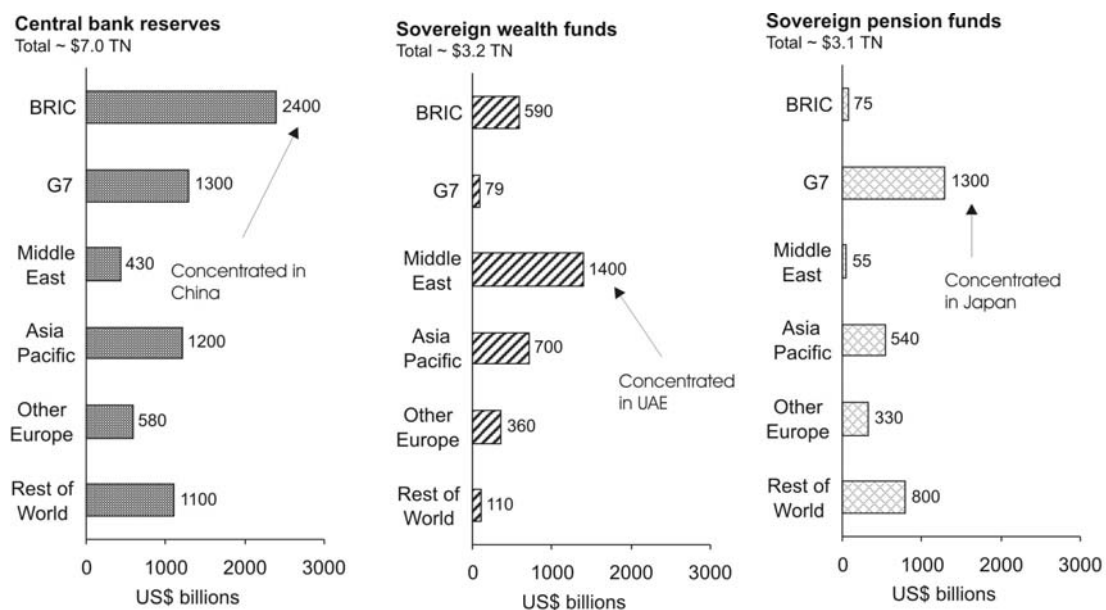


Figure 1. The assets of sovereign wealth funds

Source: SWF institute.

Before the outbreak of the financial crisis, serious doubts were expressed about actions and intentions of national wealth funds, and critics encouraged a prompt development of a common legal basis for ensuring performance and governance transparency of such funds, thus reducing distrust of these national investors. From the beginning of the crisis, national wealth funds made considerable direct investment in problematic financial institutions, which contributed to the formation of a new image of such funds—of responsible players in the global economic arena. Unfortunately, this investment was not very profitable for the funds themselves. Nevertheless, despite losses suffered by the funds during the crisis, they are constantly observed by alternative enterprises (such as large banks), which again proves

institutions of some countries used investment from such funds to increase their capital, and thus the international financial system regained trust.

3. In Lithuania, the modes of using assets received from the privatization of state and municipal property—restoration of the savings of the population and formation of the Reserve Fund—had been established by law. However, later, a decision was made to use part of the assets for the reform of the pension system.

4. At present, the Reserve Fund does not function as expected and does not fulfil one of the currently most important functions—assistance in solving economic problems in the face of the recession. In contradistinction to Lithuania, Estonia, which for several years has had a budget surplus, from 1997, started building up a Stabilization Reserve Fund.

Today this fund helps the country in solving urgent financial stabilization and social problems.

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TURTO FONDUŲ PASKIRTIS, FORMAVIMAS IR VALDYMAS

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Santrauka. Straipsnyje nagrinėjama nacionalinių turto fondų (NTF) problematika. NTF dažnai vadinami naftos arba gamtos išteklių fondais, nes jie sukurti naudojant perteklines lėšas, gautas iš prekybos nafta, dujomis, deimantais, variu ir kt. Jų formavimo tikslai yra apsaugoti biudžetą ir ekonomiką nuo didelių svyravimų, padėti mažinti nepageidaujamą likvidumą, sukaupti atsargas ateities kartoms ar panaudoti sukauptas lėšas neatidėliotinoms ekonominėms bei socialinėms reikmėms. Turto fondas dažniausiai turi atitikti penkis kriterijus: 1) būti nepriklausomas, 2) turėti dideles užsienio valiutos atsargas, 3) neturėti įsipareigojimų, 4) toleruoti riziką; 5) turėti plačią investavimo geografiją.

Nacionalinius turto fondus finansuojančios šalys laikosi griežtų valdymo ir skaidrumo principų. OECD pasiūlė gero valdymo principus. Svarbiausi jų yra tiksli vidinė fondo atsakomybė, investavimo tikslų numatymas ir paskelbimas, fondų veiklos autonomiškumas ir viešai apie juos prieinama informacija. Skaidrumas taip pat yra svarbiausia pasitikėjimą užtikrinanti sąlyga, nes taip suinteresuotos šalys gali stebėti ir prižiūrėti fondų veiklą, ar ji nenukrypsta nuo savo deklaruojamų tikslų, išsaugoma rinkos drausmė ir yra mažinamas noras įsikišti vyriausybei.

Lietuvos valstybės turtą valdo trys fondai – Valstybės turto fondas, Privatizavimo fondas ir Stabilizavimo fondas. Pagrindinis pajamų šaltinis buvo valstybės ir savivaldybių turto privatizavimas. Nors įstatymu buvo numatyta lėšas panaudoti gyventojų santaupoms atkurti ir rezerviniam fondui sudaryti, vėliau didelė lėšų dalis buvo skirta pensijų sistemai reformuoti. Tuo tarpu geras pavyzdys yra Estija. Ji, turėdama biudžeto perteklių, suformavo Stabilizavimo fondą ir dabartiniu metu naudodama jo lėšas gali sėkmingiau spręsti nuosmukio sukeltas problemas.

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