8

The Future for Sovereign Wealth Funds

Sovereign wealth funds are a permanent, prominent feature of the international financial landscape. As countries become wealthier, and governments expand their responsibilities for the long-term welfare of their citizens, it is highly likely that those citizens will look to their governments to help manage their countries' financial wealth, including wealth associated with natural resources, for themselves and for future generations.

These trends are not set in stone. Responsibility could devolve back onto the citizens themselves, but that is less likely. Moreover, as societies become wealthier, the scale of government involvement in managing their wealth will increase, even if, contrary to recent trends, it does so less than proportionately.

Despite the potential setback to international financial integration as a consequence of the global economic and financial crisis of 2007–09, the financial case for globalizing the allocation of all forms of financial investment via diversification remains overwhelming. Thus, three trends interact to suggest that SWFs are here to stay: the expanding wealth of all societies, growing involvement of governments in managing that wealth, and increasing recognition of the benefits of international portfolio diversification. At the same time, SWFs are instruments of "big money," and big money is distrusted whether in the hands of governments, banks, hedge funds, or other private investment vehicles.

SWFs are not the only mechanisms through which governments actively manage the wealth of their countries on behalf of their citizens. Government pension funds are essentially the same as SWFs except where they are invested solely in government paper or the beneficiaries make the investment choices. However, governments have other mechanisms at their disposal. They generally manage their international reserves more conservatively, and manage other government-owned or -controlled financial or nonfinancial institutions with greater attention to return and less attention to risk, than in the case of SWFs. However, such generalizations can be deceiving because distinctions between these three broad types of governmental financial activity are blurred. Specifics depend on the country and its culture, history, political structure, and economic and financial circumstances. The potential for institutional or regulatory arbitrage is a significant concern in the future. For some countries, a standard such as the Santiago Principles increases the incentive to establish government-controlled investment pools that fall outside the definition of SWFs used by the IFSWF.

Setting aside those complications, and concentrating for the moment on SWFs themselves, distrust of these funds has been substantially defused since they burst into the global consciousness five years ago. The general public and its political representatives know more about what SWFs are and what they are not.

The growth of SWFs slowed with the diminished external surpluses that feed some of the funds, the reduced rate of accumulation of reserves by most countries, and the financial losses that many SWFs suffered during the global economic and financial crisis. This has helped to temper, but again not to eliminate, some of the exaggerated fears promulgated under the heading of state capitalism operating through the channel of SWFs. On the other hand, the philosophical, political, and economic contest between the traditional model of mature industrial economies, with their reliance on markets, and state capitalism, with its appeal to power and nationalism, is far from settled in many emerging-market economies in particular.

The economic and financial threats to both SWF home and host countries that some observers saw in their activities also have not generally materialized. Chapter 3 summarized those concerns under five headings: (1) mismanagement of SWF investments; (2) pursuit of political or economic power objectives; (3) exacerbation of financial protectionism; (4) contribution to financial market turmoil and uncertainty; and (5) conflicts of interest, in particular between home and host countries. Nevertheless, as with much about the complex world today, it is impossible to remove these potential concerns from the economic, financial, and political landscape.

One important contribution to clarifying the role and responsibilities of SWFs and institutionalizing their participation in the international financial system has been the promulgation of the Santiago Principles for such funds. As shown in chapter 6, the Santiago Principles conform broadly to the structure of the SWF scoreboard presented in chapter 5. Moreover, over the past several years the ratings on that scoreboard have significantly improved for a number of SWFs. Nevertheless, the Santiago Principles should be made more comprehensive and robust, and the record of compliance with them by the major SWFs must continue to improve.

The SWF scoreboard and the Santiago Principles are built on the concept of accountability and transparency both to citizens of the home country as well as to citizens and governments of host countries. This approach reduces the risk of mismanagement of SWF investments. The structure of most SWFs, along with their transparency, if practiced, also reduces the possibility that a country will use the funds as a mechanism to pursue economic power objectives. On the other side, with less of a perceived threat, host countries should be less inclined to resort to financial protectionism to guard against such risks. Similarly, financial market participants should be reassured if SWFs adhere to a high degree of accountability and transparency regarding their activities and business practices. All of this should build trust and reduce the scope for conflicts of interest for each SWF and between the home and host country of those funds' investments.

On the side of the host countries, their collective and individual actions over the past several years have been less than impressive. Collectively, the members of the OECD have agreed that a separate regime for SWF investments in their economies is not required. Instead, existing codes and standards governing government investments should be sufficient. Unfortunately, the OECD members did not take advantage of their review of policies in this area to strengthen their openness to government investments. Perhaps, this was inevitable given the increased involvement of the governments of many countries that are not members of the OECD in international investment activities. It is a point of tension that these nonmember countries have not participated in writing the rules of the OECD, which until its recent expansion was an exclusive group of mature industrial countries. This change in the landscape also helps to explain, if not to excuse, the tendency of many individual OECD countries to establish, clarify, or otherwise tighten their policies on foreign direct investment, particularly when that investment involves governmental entities, including but not even primarily SWFs.

On the one hand, SWFs are more trusted than five years ago; on the other, concerns about investment by SWFs and other governmental entities, while somewhat reduced, have not been eliminated. These concerns have been reinforced by the tendency of SWFs to partner with other investors, thus perhaps disguising their intentions. Such partnering by SWFs is of greater concern when it takes the form of co-investment with another state-owned enterprise and involves sensitive sectors such as natural resources or strategic sectors such as electronics.

Thus, policymakers in countries that are home to SWFs should not declare victory. What is required to build on the progress that has been made? I recommend action in four areas: an upgrade of the Santiago Principles and compliance with them; greater reciprocal responsibility by host countries to SWF investments; improvements in related data collection and disclosure; and pursuit of a comprehensive framework governing all forms of government investment as the ultimate goal.

Upgrading the Santiago Principles

Using the framework of the IFSWF, countries with SWFs must be diligent in promoting adherence to the Santiago Principles, upgrading the ratings of their funds on those principles, and enhancing the principles so that they conform more closely to the SWF scoreboard. Unless sustained progress in this area is achieved, observers in countries receiving SWF investments will be justified in their cynicism about the process that led to the promulgation of the Santiago Principles. I expect continued progress, but I am prepared to be disappointed.

The IFSWF should be diligent in encouraging all countries with large SWFs to join the IFSWF and adhere to the Santiago Principles. Economies with estimated total assets of more than $25 billion in their SWF that are not members of the IFSWF are Hong Kong, Algeria, Brunei Darussalam, Kazakhstan, and Malaysia—in order of the size of their funds listed in table 2.1. In addition, Saudi Arabia has a large investment portfolio that is often viewed as similar to an SWF. Saudi Arabia, which was an observer in the IWG that produced the Santiago Principles, should clarify the management of its portfolio of foreign assets and conform their management to international norms of disclosure. Finally, major SWF countries with multiple funds, including the United States and the United Arab Emirates, should ensure that each of their funds complies with the Santiago Principles.

Going forward, as part of the IFSWF's peer review processes that body must actively consider improvements in the Santiago Principles, which are only a good first start toward meeting the standards outlined in the SWF scoreboard presented in chapter 5. As noted in chapter 6, for only 17 of the 25 principles where there is an overlap with the elements in the SWF scoreboard do the Santiago Principles explicitly require public disclosure of compliance with the principle. Given that many of the funds of member countries of the IFSWF already publicly disclose how they implement the eight other principles, there is no reason why the Santiago Principles should not recommend public disclosure of how an SWF complies with a principle that has already been established.

The most important of the principles where public disclosure should be recommended is the release of the SWF's annual report. This is the easiest path to increased accountability and transparency. The vast majority of funds do so already.

The next most important elements for which public disclosure should be made explicit are those covering independent audits of the funds. The

Santiago Principles endorse the principle of independent audits, but they are silent about public disclosure, one of the eight elements of the SWF scoreboard not included in the principles.

The Santiago Principles should also embrace the public disclosure of mandates given to outside managers rather than just calling for a description of the extent and nature of such mandates. This is important to limit opportunities for corruption and conflicts of interest.

The Santiago Principles should incorporate the public disclosure of how the operation of the funds is integrated with the fiscal and monetary policies of the government. This is crucial to the goal of not undermining macroeconomic stability of the home country.

In addition to calling for funds to have policies on leverage and the use of leverage, those policies should be made public. This is an important part of good risk management practices.

Finally, it is not enough that a fund declares that it has internal ethical standards as recommended by the Santiago Principles. The fund should also make those standards public.

With respect to the elements in the SWF scoreboard that were omitted from the Santiago Principles, the two most important of these, after the publication of independent audits, are disclosure of the size of the fund at least annually and establishment of a public policy on the speed of adjustment of the fund's portfolio. The first is widely practiced now and enhances the credibility of each fund's overall disclosure policy. The second would help provide greater confidence that the fund as a good public citizen is dedicated to minimizing market turmoil.

Augmented Reciprocal Responsibility

My second recommendation is that countries receiving SWF investments should develop a mechanism, for example within the OECD Investment Committee, for deeper peer reviews of the adherence by OECD members to its codes and practices. These peer reviews should routinely involve nonmembers of the OECD, including representatives of the largest SWFs or their governments. They should also cover cases where investments have been disallowed because of exceptions to the principle of national treatment based on national security or broader economic or social criteria.

While sovereign governments must make their own decisions, consistent with their own laws and regulations, they should be held responsible to the broader community of governments as well as to official and private investors for justifying and defending their actions. Reciprocal responsibility on the part of host and home countries to SWF investments requires greater accountability and transparency by both groups of countries. The Santiago Principles are a step in this direction by the home countries, and the host countries should more fully reciprocate.

Improving Data Collection and Related Disclosures

My third area of recommendations focuses on the principal reason why SWFs attract so much political attention: they are instruments of cross-border governmental investment activity. Government investors by their nature are faced with a different set of incentives than private investors. In addition, their actions are interpreted as being politically motivated even when they are not. Moreover, to the extent that one vehicle of cross-border investment, such as SWFs, comes under closer examination, governments have an incentive to shift to the use of other vehicles.

It is well known that the managers of the international reserves in a growing number of countries follow investment strategies similar to those of many SWFs. For example, the investments of China's State Administration of Foreign Exchange (SAFE) include those via the SAFE Investment Company said to have about $350 billion in assets under management. The SAFE Investment Company is sometimes classified as an SWF. The Data Template on International Reserves and Foreign Currency Liquidity (IMF 2000), the international disclosure standard that covers some countries' international reserves, is less detailed and comprehensive than the Santiago Principles, and China in particular is not a participant. The Reserves Template, as the international standard is known, was designed to encourage countries to be more transparent and disciplined about their release of information about international reserves and to provide more confidence that those reserves were readily available to meet the country's international obligations. It was not designed to inform the public about investment strategies. For example, the Reserves Template does not distinguish between reserves held in securities in the form of bonds or equities, to say nothing of equity stakes that are significant and might be controlling.

A decade after the Reserves Template was agreed upon, its content should be updated to include more information on the nature of countries' reserve holdings, in particular when those holdings may be indistinguishable from the holdings of any country's or the same country's SWF. At the same time, countries that have large SWFs should be encouraged to adhere to the revised Reserves Template, starting with the United Arab Emirates, China, Kuwait, Libya, Qatar, and Algeria.[1] In addition, as recommended above, Saudi Arabia should become a full participant in the IFSWF as well as adhere to the Reserves Template. Adherence to the IMF's Special Data Dissemination Standard, which is voluntary, requires adherence to the Reserves Template, but not vice versa. One objective of this recommendation is to limit the scope for institutional or regulatory arbitrage as is already readily apparent in China.

1. Each of these countries, with the exception of Algeria, is already a member of the IFSWF.

In the same spirit, countries should agree to a broader effort to record and track all forms of international investment by governments and government-owned or -controlled financial or nonfinancial institutions. The *Sixth Balance of Payments and International Investment Position Manual* (BPM6) (IMF 2009a) recognizes that some governments may create "special purpose government funds, usually called sovereign wealth funds." The BPM6 focuses on whether the assets in such funds can be classified as reserve assets and suggests the application of the test of whether they are readily available to the monetary authorities and whether there is a liquid claim of a resident entity on a nonresident that is denominated in foreign currency. The BPM6 goes on to state with respect to such funds: "Some of these assets may be included in reserve assets or possibly in other functional categories. Where the funds are significant, the special purpose government fund's foreign assets not included in reserve assets *can* be shown separately as a supplementary item" (IMF 2009a, 130; emphasis added). One would hope that the international assets of SWFs would be included somewhere in a country's international investment position. The quoted passage is less prescriptive than is desirable. In any case, the guidance does not indicate that SWF assets should be separately identified.

The approach of the BPM6 to the suggested treatment or nontreatment of SWF assets also is recommended for all international assets of governments with the exception of reserves. Those other assets are to be included in the category for the particular type of asset (securities, direct investment, etc.) rather than being shown separately, or in a supplemental item, as government assets. Where the amounts are significant, foreign-government-owned assets and liabilities to foreign governments should be separately recorded and reported.

US statistical treatment of government assets and liabilities to foreign governments is somewhat more informative than is recommended by the BPM6. All US government assets are reported either as reserve assets or other US government assets. However, this treatment applies only to federal government assets and not to the general government category, which includes state and local governments. As reported in chapter 2, US state and local pension funds and SWFs hold substantial international assets—more than $400 billion. On the liability side, the United States reports foreign official holdings by category of asset, such as US treasury securities, under the heading "foreign official assets in the United States." The subcategory of "other foreign official assets" has grown quite rapidly recently and includes SWF holdings of assets other than US government securities or other liabilities reported by banks, as reported in chapter 2. Again, this category generally does not include subnational government entities such as pension funds or nonpension SWFs. Thus, Australia's Future Fund is included, but the holdings of assets in the United States by the Canada Pension Plan or Alberta Heritage Savings Trust Fund are not. One exception involves the United Arab Emirates, where eight of the nine

UAE entities listed in table 2.1 are included in the US Treasury's instructions for what is an official entity.[2]

In light of the increased attention and concern about the international economic and financial role of governments, whether benign or as a manifestation of state capitalism with potential malign overtones, it would be appropriate for the home and host countries to have more comprehensive data on the international assets of governments on both the asset and liability side. This would help to further build trust in SWFs as well as in government investments in other forms, such as direct investment, in particular via mechanisms of institutional or regulatory arbitrage that seek to avoid the inconvenience of SWF reporting standards under the Santiago Principles.

A Comprehensive Investment Framework as the Ultimate Goal

The recommendation on improved data and disclosure leads to my final recommendation: the development of a comprehensive framework governing all forms of government investment in other countries.

Perceptions of SWFs have been adversely affected by the international investment activities of other governmental entities, ranging from institutions managing international reserves to government-owned banks and nonfinancial institutions. If SWFs are to have a safe future, home and host governments should comprehensively approach the broader issues associated with capital flows and international investments by governments.

Preferably this activity would lead to an international investment treaty or at least a more comprehensive approach to governmental investment flows than today is the case. That broader approach should encompass the revision of the IMF's Articles of Agreement to square them with the positive and negative realities of international capital flows—in other words, revival of the capital account amendment proposal that was abandoned in 1997. The broader approach should also encompass standards governing both the behavior and treatment of government investments. The standards could be developed under the aegis of the OECD as long as nonmembers were included in the process. If these standards were to be enforced, the WTO would be a logical place to lodge them because that organization has a proven track record on enforcing international agreements.

2. The exception is the Emirates Investment Authority.