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CONTROL MECHANISMS FOR SOVEREIGN WEALTH FUNDS IN SELECTED COUNTRIES

STEFFEN KERN*

Introduction

Sovereign wealth funds (SWFs) have attracted great attention lately and busied financial dealmakers, policymakers, economists and the academic community. Starting at the latest in mid-2007 when the scale of the SWFs' business and their potential influence in conjunction with the emergence of new players, mainly in emerging markets, were fully realised by the wider public, an intense policy debate commenced on whether and how SWF transactions should be controlled.

Only one year later, two important advances have been made, the results of which can be expected to deliver instructive empirical evidence from the perspective of institutional economics. On the one hand, SWFs have – under the aegis of the IMF – committed to a set of principles of good conduct in an attempt to appease concerns in many recipient countries. On the other hand, recipient countries, facilitated by the OECD, are working towards a more coordinated approach towards rules inward foreign investments. As international agreements, both initiatives are non-binding, and their effectiveness will critically depend on the willingness and ability of national governments to apply and enforce the internationally agreed guidelines.

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This article discusses the two initiatives with a view to their institutional properties, based on a review of the underlying economic forces and political rationale for their realisation.

Cross-border investments – on the verge of a global diffusion of corporate ownership?

The political issues discussed over the past months were sparked off by the recently accelerated rise of SWFs, i.e., government-owned investment funds which are commonly funded by the transfer of foreign exchange assets and set up to serve the objectives of a stabilisation fund, a savings fund for future generations, a reserve investment corporation, a development fund or a contingent pension reserve fund by investing the funds on a long-term basis, often overseas.

This class of institutional investors – comprised of 64 SWFs – today disposes of a total of USD 3.6 trillion, and is developing forcefully, driven by continually high incomes from commodity sales and reserves accumulation for existing funds, as well as the establishment of new entities. The assets are concentrated in the top funds, 10 of which manage more than USD 100 billion each. Thus, the top 10 SWFs administer 85 percent of all sovereign assets.



Figure 1

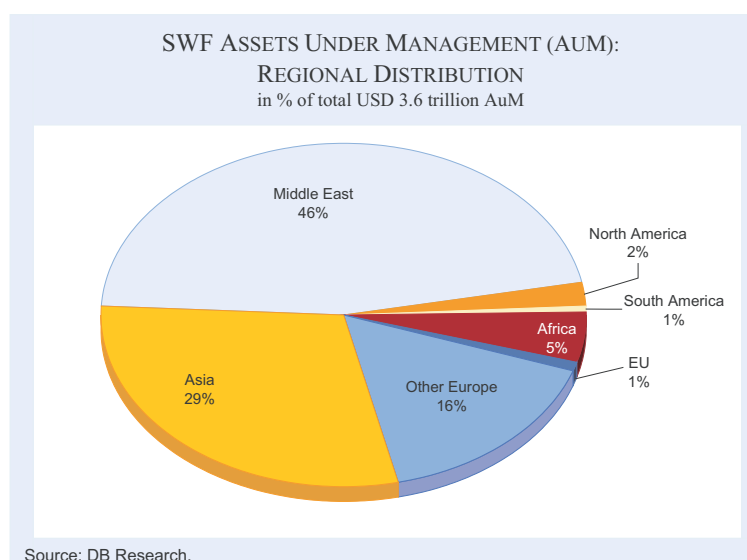
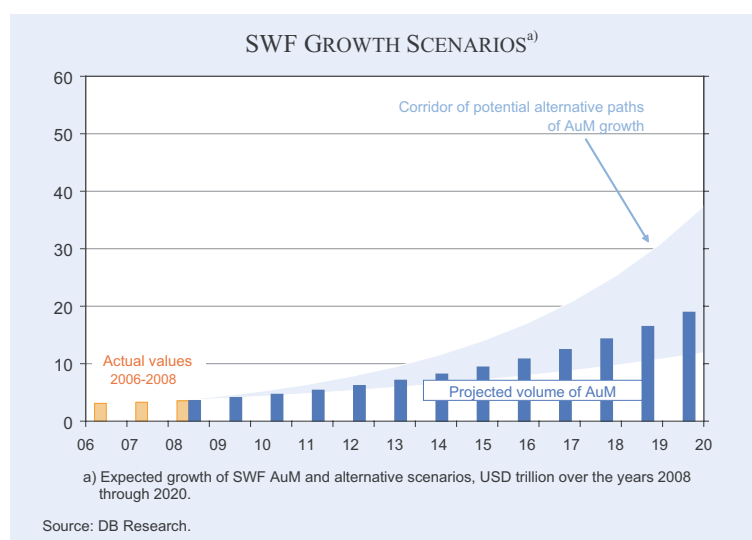


Figure 2



Almost half of all sovereign assets are held by funds in the Middle East. At USD 1.6 trillion in assets or 46 percent of the total, the region represents the highest concentration of SWF assets worldwide. The volume and share of the Middle East is, in fact, likely to be even substantially higher, as no robust data are available on the size of SWFs for a number of states in that region. With around USD 1 trillion in volume, or 29 percent of the total, Asia is the second largest region with SWF assets, followed by non-EU Europe – mainly Russia and Norway – with USD 0.6 trillion or 16 percent of assets and Africa with USD 0.2 trillion or 5 percent. The EU – home to only one SWF-type vehicle, the Irish National Pensions Reserve Fund – and South America, with a share of below 1 percent each, play no significant role in a global comparison (Figure 1).

The rise in assets over the past year amounts to an estimated USD 450 billion, up 14 percent from the estimated volume of assets in mid-2007, keeping in mind the vagueness of the underlying data. The development reflects an increase in the size of a majority of the existing funds fuelled by the continued inflow from government revenues or excess reserves, as well as the establishment of new entities (Figure 2).

The size of the state-owned funds and their growth has greatly influenced public debates, in which SWFs are occasionally characterised as state funds of monstrous size, able to buy up, for example, all the stocks traded on the London Stock Exchange at once. Reality, to be sure, speaks a different language, and it becomes clear that SWFs are – albeit

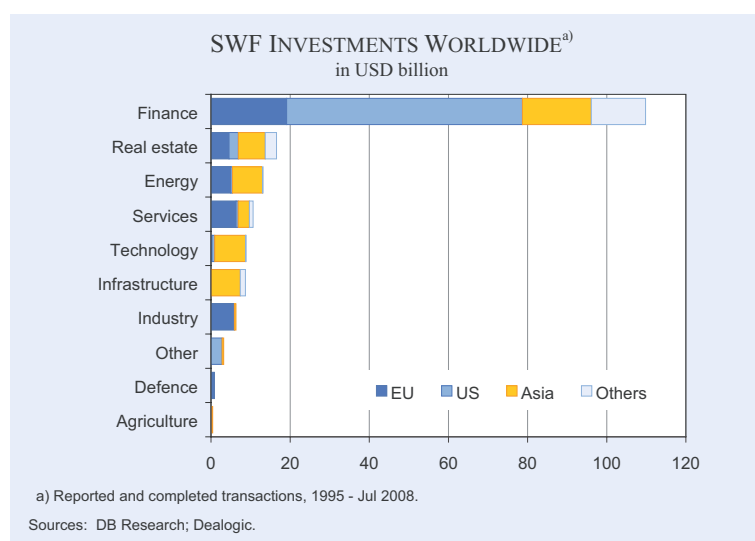
large and growing – a relatively small group of institutional investors, whose total assets under management amount to merely one-seventh of the investment-fund industry, and to less than 5 percent of bank assets worldwide.

This point is also illustrated by the investments SWFs have effectively undertaken. Measured against the reported and completed direct equity investments by SWFs between 1995 and mid-2008, North American and European companies have been the targets of choice for state

investors. 37 percent of the total transaction volume was related to North American enterprises and 32 percent to Europe-based firms. To some extent, this large share reflects that traditional European and American capital markets offer the widest selection of investments and a high level of liquidity, and are thus able to absorb the large volumes institutional investors typically seek to allocate. Other considerations, including expected returns at the time the investments were made or diversification may have contributed to this outcome. Asia is not only home to the most active state investors, but is also among the most preferred regions of investment, absorbing 28 percent of the volumes reported. Investments in Asia are predominantly intra-regional, i.e., they originate to a large part – 83 percent by volume – from Asian SWFs. Intra-regional transactions in the Middle East are, in contrast, much less frequently reported.

In terms of the sector distribution of SWF investments, financial institutions have been the main beneficiaries of SWF funds. This goes back to the transactions related to Wall Street and some European banks with investment volumes unseen to that point. Given that these investments can be regarded as part of a recent, singular phase of investment activity, other sectors deserve attention in view of long-term investment trends. Real estate and construction with USD 17 billion worth of investments, commodities and energy with USD 13 billion, services and retail with USD 11 billion, technology with USD 9 billion, infrastructure and transportation with USD 9 billion, and industry with USD 6 billion are further important targets of SWF investment activity.

Figure 3



Regarding commodities and energy, technology, and infrastructure and transport, Asian enterprises have been the most preferred targets of state investments, mainly reflecting intra-regional diversification. In real estate and construction as well as services, the distribution has been more balanced across the regions. Regarding industrial companies, the EU with its strong and competitive industrial base has been the most interesting investment location. Foreign state investments in defence-related companies – one of the most critical issues in political debates in the US and the EU – have played an insignificant role. The records show only one transaction (Figure 3).

In aggregate, the reported and completed direct equity investments by SWFs worldwide amount to USD 178 billion between 1995 and mid-2008, of which USD 72 billion were invested in 2007 alone. These figures are dwarfed by private capital flows, e.g. the USD 899 billion of private capital that was invested in the emerging markets in the same year. In addition, SWF investments are only one part of a broader trend in the course of which foreign direct investments from the emerging markets – whether from public or private sources – have accelerated substantially in the past decade. With USD 151 billion and USD 44 billion of foreign investments from Asia and the Middle East, respectively, emerging markets have multiplied their participation in global corporate ownership in the past. But, again, it is useful to keep in mind that this compares with a total of USD 2 trillion foreign direct investments globally, more than half of which originate in the EU.

While the size of SWFs is often overrated, public debates also mistakenly focus on this group of investors when it comes to the question whether foreign sovereign investments could harm national security and public order in the recipient country. In fact, states have a number of means and institutions at their disposal through which investments can be pursued. These include public pension funds, development banks, state-owned enterprises and other public entities. Of these institutions, SWFs are the least suspicious in terms of political investment

objectives, as they are known to be long-term oriented financial investors and mainly seeking small minority stakes, many of which have proven and long-standing track records for being reliable partners of their invested companies.

SWFs as foreign investors in the US and the EU – the policy issues

SWFs, no doubt, should be considered important investors, but in terms of volumes they are anything but dominant players in the global marketplace. Nevertheless, their recent growth and investment activities have given rise to substantial concerns in recipient countries, especially the US and the EU, which can be summarised as follows:

- *Financial market stability*

The SWF industry represents a systemically relevant part of the global financial industry. Given the volume of individual funds as well as of single investments held by these entities, this may also apply to individual funds in the industry. It cannot be excluded that an individual transaction undertaken by one SWF may lead to herding behaviour by other market participants, resulting in excessive capital movement and price and rate changes for the security concerned as well as – if contagion effects occur – for correlated assets. In extremis, such herding behaviour can destabilise regional or segmental parts of the financial industry or even financial markets at a global scale. The probability of herding behaviour and contagion is aggravated

by the fact that SWFs have been comparatively opaque entities so far.

- *State funding*

Drawing on budgetary revenues or official reserves, SWFs are state-funded investment vehicles, open to the charge that their activities stand in contrast to the concept of a free market economy with minimum state intervention and distort market activities as their funds are not refinanced at market conditions or do not originate from market activity. With state support to the financial sector in industrialised economies made in response to the financial crisis and its critical importance for restoring well-functioning markets, this argument has surely receded to the background in the current debate.

- *Sale of strategic assets and know-how*

Although SWFs repeatedly emphasised their commercial objectives, much of the public debate in recipient countries has centred around the concern that foreign investors could seek control of companies and assets with non-financial motivations. This, in turn, it was conjectured could pose a threat to national security and public order, especially with a view to the control over and know-how in the defence industry, public and private infrastructure, high technology, and financial markets, but also with respect to accessing natural resources worldwide.

- *Corporate governance*

Finally, critics of foreign state fund investments have argued that SWFs – especially if domiciled in emerging economies – may not be able to live up to corporate governance requirements to the extent established in many industrialised economies. In particular, it has been questioned whether SWFs would be able to meet standards of capital market law and the responsibilities associated with seats on governing or supervisory boards.

National policy responses – the danger of protectionist reflexes

As these concerns were increasingly articulated, governments in many countries have been quick to review their domestic rules governing incoming investments. In the end, legislative or regulatory initiatives leading to concrete changes in market entry conditions have occurred only in four major

economies over the past year, namely the US, Australia, Russia and Germany. The outcomes vary considerably between the establishment or refinement of reasonable review mechanisms for inward investments to the establishment or heightening of outright protectionist barriers to entry of foreign capital.

- *United States*

Since 1988, the United States have operated a review process for foreign investments, undertaken by the Committee on Foreign Investments in the United States (CFIUS), on the basis of which the US president can prohibit incoming investments. Existing rules were sharpened in the course of 2007 and 2008, including the extension of the range of transactions open to CFIUS review and a broadened definition of the review criterion of national security so as to include transactions involving critical infrastructure, energy assets and critical technologies. Further implementing regulations currently under negotiation are likely to substantially lower the trigger value for setting off the CFIUS process and increase the reporting requirements for the companies involved. The so-called FINSA reform clearly sharpens CFIUS as a policy instrument, raising the complexity of the review and making it one of the most demanding foreign investment processes among the industrialised economies – not least for sovereign investors.

- *Australia*

Australia has maintained a foreign investment screening process since 1975, as introduced by the Foreign Acquisitions and Takeovers Act. It is designed to ensure that foreign investment in Australia is consistent with the national interest. The process requires that significant foreign investment proposals be notified to the government and examined by the Foreign Investment Review Board (FIRB), which advises the Treasurer, who can reject proposals deemed contrary to the national interest or impose conditions. The FIRB examines whether foreign investments may have adverse implications for national security, economic development or government policies. In 2008, the government issued additional principles applicable to foreign state investors, including the operational independence of investors from the government, clear commercial objectives, the adherence to adequate and transparent regulation and supervision, and the economic

impact of foreign state investments on Australian business. Even though none of these principles establishes qualitatively new criteria the intervention clearly set the tone for investment policies at a time when the Australian public was, and still is, particularly concerned about the entry of foreign state investors in the areas of natural resources, commodities, ownership and exploration rights as well as processing. Unlike the policy measures in the US and Germany, the Australian approach explicitly includes broader economic and societal interests in its review criteria and does not confine itself to questions of national security.

- *Russia*

In 2008, Russia introduced a Federal Law on Foreign Investments in Companies Having Strategic Importance for State Security and Defence, establishing a process of approval of foreign investments in strategic sectors in Russia. The process features the specification of 42 strategic sectors in which foreign investments are outlawed or can be prohibited by government. Furthermore, it sets threshold values for foreign shares in Russian companies triggering the review process and establishes notification requirements and sanctions. The new law marks a substantial tightening of conditions for foreign investments in the Russian Federation, especially in the strategic sectors identified by the new rules. In addition, it has to be recalled that investments in areas outside the realm of the strategic sectors ringfenced by the new laws are regulated by a number of existing general or sectoral rules, which are tight by international standards. As a result, the Russian investment framework belongs to the most restrictive regimes worldwide, as reflected in the OECD's measures for market openness in which Russia – already prior to the additional restrictions in the new law – ranked third last.

- *Germany*

Germany's proposals for responding to foreign state investments belong to the most widely noted developments in this policy area; nonetheless, the proposed law that emerged from this debate is certainly one of the most overrated political measures of the past months, as it is not nearly as restrictive as argued by some. The proposed law envisages the establishment of a review process under the auspices of the Federal Ministry of Economics for foreign investments originating

outside the EU or EFTA and leading to a stake in a listed or unlisted German company of more than 25 percent. The Federal Government can prohibit or approve with conditions a transaction found to be in violation with the country's security or public order. The draft law can best be characterised as a lightweight version of America's CFIUS review process. With its high trigger value, a generally lean review process and its clear structure, the proposed investment measure is certainly one of the least restrictive in an international comparison.

The overall design of the draft review process represents an appropriate policy response to the challenges as perceived by public policymakers. However, this cannot belie the fact that the draft currently contains a number of shortcomings that should be rectified in the course of parliamentary deliberations before its adoption. This includes comparatively long maximum duration of the policy process and the lack of confidentiality ensured by the law.

In the final analysis, the quality of the new law can only be judged by the way it is applied in practice. Optimally, the process would and should be invoked in as few cases as possible, and certainly only in circumstances where a material threat to public order or security can be detected.

The international dimension – ensuring open markets in a fragmented regulatory environment

The above measures reflect the fact that rules for foreign investments have remained a national prerogative. In practice, economies worldwide are separated from each other in terms of foreign investments by substantial regulatory barriers in the form of direct and indirect hurdles. This discourages important investments, or – if they are nevertheless undertaken – substantially raises the cost, especially considering that the barriers differ widely from country to country and no general patterns exist.

From an international perspective, there are no agreements that provide national governments with guidelines, let alone binding rules, which encourage the liberalisation of investment regimes or at least their standardisation. In addition, there is a growing number of international and bilateral agreements which – while useful per se for facilitating cross-bor-

der capital flows – further fragment the operational environment for international investments. As of end-2006, there were almost 5,500 international investment agreements (IIAs), including more than 2,500 bilateral investment treaties, more than 2,600 double taxation treaties and almost 250 free trade agreements.

The severity of investment barriers has been measured across various categories of direct and indirect hurdles as well as sectors. The EU and its member states are, on average, the most open and liberal economies in the world, with Latvia, Belgium, Germany, the UK, Italy, the Netherlands, Ireland, Lithuania and France leading the field. Japan, the US and other industrial and emerging economies follow. Russia, India and China are the most restrictive countries. Paradoxically, a comparison of the degree of restrictiveness on foreign direct investments versus the volumes of sovereign assets at issue suggests that it is particularly countries with extensive state-owned funds at their disposal which currently maintain the strictest regimes when it comes to preventing foreign investment from entering their domestic markets.

With protectionist reflexes against foreign state investors in potential recipient countries looming, the finance ministers of the G7 have asked the OECD to examine possibilities to provide principles for foreign investment policies. In response to this mandate, the OECD recently issued its Declaration on Sovereign Wealth Funds and Recipient Country Policies, calling for

- No protectionist barriers to foreign investment in recipient countries;
- No discrimination among investors in like circumstances;
- Investment restrictions only to address legitimate national security concerns, and subject to the principles of transparency, predictability, proportionality to clearly-identified national security risks and accountability;
- Adherence to OECD General Investment Policy Principles, including, in addition to the above, progressive liberalisation, commitment to not introducing new restrictions and unilateral liberalisation.

These principles and the detailed guidance the OECD provides are important yardsticks for national investment policies. To what extent this will lead to

success in terms of more open and harmonised investment regimes is a different question which critically hinges on four factors.

First, on the political climate. Following the benign international conditions in the 1990s, further market opening has faced increasing opposition in recent years and months. General concerns over the impact of globalisation and concrete national and sectoral protectionist interests in many economies have considerably weakened the political momentum for further liberalisation of capital movements.

Second, on the application. The OECD guidelines are no more than guidelines, effectively leaving political application to national governments, so that the degrees of commitment and the ways of implementation and enforcement are likely to vary. On the one hand, it has to be recognised that the OECD will be using its peer review process to promote adherence to the standards. But the recent dramatic rise in the economic importance and volumes of foreign investments warrants a much stronger commitment by national governments that should result in binding rules along the lines of trade agreements under the WTO.

Third, on the symmetry of market access. Cross-border investments not only suffer from high regulatory barriers per se, but also from the asymmetric way in which many economies pursue foreign investments and benefit from open markets elsewhere while maintaining restrictive rules on inward investment. This is counterproductive, and policymakers should work towards reducing these asymmetries.

Finally, on their scope. OECD guidelines have only a limited geographical reach and primarily address the traditional industrialised countries. It is encouraging that the OECD has made special efforts in its SWF-related work to include some 20 non-OECD countries in its discussions and is intended to maintain and enhance this dialogue going forward.

Good conduct by SWFs – key to greater acceptance in recipient countries

The second crucial political development in response to the rise of SWFs has been the call for rules for the good conduct of these funds, resulting in the G7 mandating the IMF to explore ways of reaching international standards in this regard. In October

2008, the International Working Group of Sovereign Wealth Funds (IWG) issued the results of this process, presenting a set of 24 Generally Accepted Principles and Practices (GAPP), also known as the Santiago Principles.

The GAPP are designed as a voluntary framework which is subject to home country laws, regulations, requirements and obligations. They provide guidance for appropriate governance and accountability arrangements, as well as for appropriate investment practices on the part of SWFs. With the GAPP, the IWG aims to further develop the level of transparency and quality of governance of SWFs worldwide, including a commitment to financial and non-political objectives. In terms of transparency, the principles seek to improve knowledge of investment strategies, including details on the intended use of voting rights, risk management and the use of financial leverage. Regarding governance, the GAPP aim at better information about organisational structures and processes, most importantly featuring a commitment to a separation of fund management and government.

Despite the breadth of the GAPP and their voluntary nature, their adoption no doubt marks a remarkable achievement on the part of the IMF and the members of the IWG, not least considering the political challenges on the way. The success of their implementation will depend on three critical questions:

- Fulfilling expectations of key stakeholders: Can the GAPP satisfy the expectations of the various stakeholders, including policymakers in SWF home countries and in recipient economies, as well as market participants and the wider public? If the GAPP fail to address the key concerns of the main parties to future investment transactions, there is a risk that they will become ineffective and SWFs will continue to face difficulties finding access to certain economies and being accepted as reliable institutional investors.
- Securing broad support and adherence: Will SWFs and the states that run them – whether they participate in the IWG process or not – subscribe and adhere to these principles in practice? If an SWF decides not to embrace the GAPP, will it be subjected to heightened political scrutiny or even resistance in the recipient economies compared to those SWFs participating in voluntary self-regulation as stipulated by the GAPP? In other words, subscribing to the GAPP could become a

cachet among SWFs signalling to recipient economies that the entity is committed to financially-motivated investments and fulfils minimum standards in terms of transparency and governance.

- Ensuring oversight and implementation: Will the IWG and the IMF be able to succeed in overseeing and ensuring their implementation or is there a risk that these voluntary commitments may remain unobserved in the countries to which they are particularly addressed? If committing to the GAPP were to develop into a seal of quality, SWFs would need to back up their commitment with action. They should adhere to financial objectives and implement and apply transparency and governance standards in a way that can actually be monitored by all stakeholders. Establishing a standing group of sovereign wealth funds with a view to carrying forward the work relating to the GAPP and to facilitating dialogue with official institutions and recipient countries on developments that impact SWF operations can be an important measure in this regard.

Conclusion – the global perspective

To conclude this discussion on SWFs and investment policies, it is worthwhile to put the debate into a global perspective. SWFs and their investments are one facet of a new phase of globalisation, which is about ownership of assets globally and a new quality in terms of the participation of emerging markets in the global economy. As many emerging markets have made tremendous economic progress in recent years and are becoming wealthier, private individuals and public institutions in these economies are increasingly engaging in international investments. This has boosted capital flows from the emerging economies to the traditional industrialised economies and resulted in greater and more active participation in global capital markets.

Both are positive and highly welcome developments, considering that – owing to the economic realities in earlier phases of globalisation – capital traditionally flowed from the industrialised countries into the emerging markets. The growing international investments of emerging markets are likely to help them achieve a more established role in world finance, which is more commensurate with their importance in the global economy.

Foreseeable economic developments of this kind call for early and coordinated policy approaches. The IMF's coordinating strategy on SWF transparency and governance is a very positive example of how a swift and targeted policy response brought emerging markets to the negotiating table, actually making them the drivers of the process.

If SWFs can be regarded as harbingers of the growing international involvement of emerging markets in global economics and finance, their case illustrates that an intensification of the dialogue increases the chances of achieving mutually acceptable policy outcomes. Ultimately, there will be a need for stronger participation of the emerging markets in international economic and financial policymaking and diplomacy. Their participation will be an important precondition for reaching joint rules in globalised capital markets.

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