

ABAC 2008, SECOND MEETING, MOSCOW, 12/14TH MAY

FACILITATION WORKING GROUP

SOVERIEGN WEALTH FUNDS (SWF)

Background

SWF are government-owned investment funds, set up for a variety of purposes, including stabilization, intergenerational equity, portfolio diversification; they are commonly funded by the transfer of foreign exchange that are invested long-term overseas.

Apart from providing key issues and responses, this note also outlines developments in SWFs, reviews proposals being discussed in the IMF and the OECD, other relevant international developments – and a recent agreement between the US, Singapore and Abu Dhabi.

There are around 30 funds internationally and in APEC there are SWFs in Russia, Brunei, USA (Alaska) Canada, Malaysia, Singapore China, Australia, Korea, Chinese Taipei and Chile.

Key Issues

- SWF have been around for a long-time but rising energy and commodity prices are leading to strong growth. At around US\$ 2 to 3 trillion they are relatively small in terms of total global financial assets of around US\$190 trillion, but growing rapidly
- SWF activities can be important in terms of their impact on global financial stability
- in the main, funds are a force for good and the various purposes for their establishment soundly based
- however, transparency about their operations and purposes is often obscure and there is uncertainty about accountability; most recently there have been public concerns about some fund investment activities which are seen by some to be of a “strategic” rather than of a commercial nature.

International responses

- the IMF, the World Bank and the OECD are reviewing existing codes and while these in the main are highly relevant to the safeguarding of good investment regimes as they apply to SWFs and their activities, more work is needed toward

best practices for the activities of SWFs – in both the originating country (the home country) and in host countries, recipients of SWF investments

- the broadly agreed central purpose of this work is to ameliorate public concerns about the activities of SWFs and to help bring them into the mainstream of approaches on international investment flows – where they clearly ought to be
- more work is also needed and is being undertaken on data collection by the IMF through its various surveillance modes
- there is valuable cooperation between international agencies and SWFs themselves in arriving at best practice codes and this work should help ameliorate concerns about SWFs
- the private sector through the Financial Stability Forum is involved with the IMF and other agencies in developing best practices
- the US, Singapore and Abu Dhabi have recently agreed a set of principles – see attachment – aimed at ensuring that SWFs base their investments in a host country on commercial rather than strategic grounds, conform with investment laws, improve disclosure and compete fairly with the private sector; host countries should ensure non-discriminatory treatment of SWFs investments, should not erect protectionist barriers, ensure predictable investment frameworks, avoid intrusive policies toward SWFs and ensure any restrictions on national security grounds are proportional to risk raised by a transaction.

Developments relating to Sovereign Wealth Funds

In recent IMF papers and speeches, the Fund has noted the following aspects of SWFs:

- are becoming increasingly important in international monetary and financial systems; they are government owned investment funds, set up for a variety of purposes and commonly funded by the transfer of foreign exchange assets that are invested long term overseas
- some Middle East oil funds have been long-established, and the rise in oil and commodity prices have resulted in the rapid accumulation of funds
- some 30 countries have SWFs, including UAE, Norway, Saudi Arabia, Libya and in APEC - Russia, USA (Alaska) Brunei, Malaysia, Canada, Singapore, China, Korea, Chinese Taipei, Australia and Chile
- benefits to home countries include the facilitation of savings and intergenerational transfer of proceeds from non-renewable resources – they help reduce boom/bust cycles; portfolio diversification and focus on return than is traditionally the case with Central

bank reserves; can represent sound asset management and enhance general market liquidity at times of global financial stress

- estimates of *foreign assets* held by sovereigns (governments) are about US\$7 trillion in international reserves (including gold) and an additional \$US 2 to 3 trillion in SWF assets (this compares with hedge funds of around \$US 1.7 trillion and global financial assets of US\$190 trillion (stock market capitalization 50.9 trln., public and private debt securities 68.7 trln., and bank assets, 70.0 trln.)

- while relatively small, SWFs they are growing quickly and it is estimated they could reach US\$6 – 10 trillion by 2013 and US\$ 13.4 trillion over the next decade

- SWFs serve various purposes: stabilization funds; savings funds for future generations; Reserve investment corporations; development funds; contingent pension funds; sometimes there are overlapping functions

Characteristics of SWFs investments

- while some information is available, there is no uniform disclosure of the assets, strategies, and governance of SWFs and a few funds reveal little information

- the information that is available suggests SWFs have been largely conservative investors and while some larger funds behave as portfolio investors, investing relative to a market index and holding only small stakes in individual companies; newer funds rely mostly on external fund managers and in contrast to hedge funds, leverage is generally thought to be low

- SWF assets are more diversified than reserve holdings and some have considerable stakes in equities and wide geographic spread

- they can have a stabilizing influence on markets in time of financial turmoil;

- there is no clear evidence that investments have been motivated by narrow political objectives

Issues/Concerns – noted by the IMF

- ensuring a SWF's actions are consistent with national monetary and fiscal policy goals and that they contribute to rather than detract from better public-sector balance sheets

- for countries with SWFs, ensuring funds contribute to external stability both in the current account and capital account,

- for smaller economies receiving SWF inflows, large inflows may impact on prices and external stability

- activities could cause volatility in capital markets as SWFs grow in size
- asset prices can be affected by shifts from reserve assets to SWFs and they could impact on global imbalances; diversification out of mature capital markets into higher risk assets may affect interest rates and equity prices
- for the above reasons, SWFs carry important implications for multilateral surveillance and financial stability analysis

Emerging international responses

- for domestic stakeholders the need for good corporate governance of SWFs to ensure funds are run efficiently and are consistent with national economic and financial policies; this requires the application of general principles of governance for example the rights of shareholders, disclosure and transparency; that good risk management practices are in place
- for recipients of SWF investment, there are some concerns that some funds may invest with political or non-commercial objectives or may target perceived strategic interests
- many observers have called for general rules or standards relating to SWF activities to allay concerns; these could include upper limits on ownership and or voting rights of SWFs in a foreign company; that SWF publish a voting list on a regular basis or the issue of negative lists of strategic and sensitive areas in which a SWF may not invest
- a general call for capturing more information about SWFs in public financial statistics and in balance of payments statistics and in a country's international investment position
- the IMF is developing a more systematic approach to its surveillance role in respect of SWFs under its Article IV consultations with members; through multilateral surveillance, for example in the Global Financial Stability Report and the World Economic Outlook, through technical assistance and in improving data collection
- the Fund will encourage improved better transparency on SWFs and is proposing to develop and coordinate with other agencies a set of best practices that SWFs could adopt on a voluntary basis – best practices to improve accountability and transparency would foster better public understanding of the role of SWFs, would provide benchmarks for countries with SWFs and would help ease concerns about SWF investment policies and contribute to an open global financial system
- the IMF already has in place relevant guidelines established in its various codes, as does the OECD and the World Bank but there are compelling arguments to develop best practices on a cooperative basis with SWFs and for treating SWFs separately from other state owned funds, such as pension funds and hedge funds.

- separate work is going on in the Finance Stability Forum to improve the transparency of highly leveraged institutions in which the IMF is involved

- at the request of G7 ministers, the OECD's Investment Committee has recently issued a report on SWF, noting that these funds bring benefits to home and host countries and that existing OECD investment instruments are well suited to guide countries receiving investment from SWFs; the OECD instruments (the Code of Liberalisation of Capital Movements (1961); the Declaration on International investment and Multinational Enterprises (1976 and revised in 2000), include the following principles:

- non-discrimination; foreign investors to be treated no less favourably than domestic investors (practice shows that where OECD members apply this principle to investments from non-member countries)

- transparency: information on restrictions of foreign investment should be Comprehensive and accessible

- progressive liberalisation and standstill (commit to not introducing new restrictions)

- unilateral liberalisation

- the OECD supports the work underway in the IMF on best practices for SWF and calls attention to the OECD's voluntary standards on good governance and good business conduct and will continue to address the SWF issue as part of the "Freedom of Investment" project it is currently undertaking (refer to separate ABAC briefing Note on national interest matters) to assist governments in maintaining their long-standing commitment to open international investment policies while protecting essential security interests.

- the United States, Singapore and Abu Dhabi recently agreed principles on SWF and agreed to work with the IMF and the OECD to develop voluntary best practices for SWFs and inward investment regimes for government-controlled investment in recipient countries respectively: key principles agreed include:

for SWFs:

- investment decisions should be based solely on commercial grounds rather to advance directly or indirectly the geopolitical goals of the controlling Government

- greater information disclosure by SWFs; purpose and objectives of SWF and Institutional arrangements

- have a strong place in government structures

- compete fairly with the private sector
- respect host country rules

for receiving countries

- do not erect protectionist barriers to portfolio or FDI
- ensure predictable investment frameworks
- non-discrimination among investors
- respect investor decisions by being as unintrusive as possible, rather than seeking to direct SWF investment
- any restrictions imposed for national security reasons should be proportional to genuine risks raised by the transaction