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In Brief

Sovereign Wealth Funds: Threat or Salvation?

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Sovereign wealth funds (SWFs)—large pools of government-owned or -controlled funds that are invested in whole or in part outside their home countries—have existed for nearly five decades but began to attract international attention only a few years ago. Their explosive growth up until 2007 fanned widespread anxieties about shifts of global economic wealth and the role of governments in managing that wealth. In 2003, assets under management of SWFs were about $0.5 trillion, but by 2007, they had increased six times to $3 trillion and were projected optimistically to reach $12 trillion by 2015. This rapid growth was seen as a threat in many countries receiving SWF investments. On the other hand, SWF investments assisted some major Western financial institutions that were under financial stress weather the recent global financial crisis.

The rapid expansion of SWFs was fueled by high and rising prices of natural resources and other commodities and by policies that led to massive accumulations of foreign exchange and financial resources in government coffers. To a significant degree, this wealth was accumulating under the control of countries that did not entirely share in the history, culture, and forms of government of the United States and of Western European countries. Excluding pension funds, seven countries have SWFs with international assets of more than $100 billion: United Arab Emirates, Norway, Singapore, Russia, Kuwait, Hong Kong, and China. Saudi Arabia's international investment holdings often are placed in the same category. Only one country, Norway, is a member of the Organization for Economic Cooperation and Development (OECD), the traditional grouping of wealthy nations.

Sovereign wealth funds are symbolic of two major, recent trends in the global political economy: (1) a redistribution of wealth and economic and financial power from the United States, Europe, and other mature industrial economies to countries perceived to be less firmly grounded in similar economic, financial, and political mores; and (2) an increasing role of governments in managing wealth and economic power in today's world.

A government's decisions about its international investments, including decisions by an SWF under its control, affect the interests of four key groups: the government of the country with the SWF, the citizens of those countries, financial market participants at home and abroad, and governments and citizens in other countries.

Given such wide potential impacts, SWFs raise concerns in five broad areas: (1) mismanagement of investments by SWFs to the economic and financial detriment of the country with the fund; (2) pursuit of political or economic power objectives (or both) via SWFs; (3) exacerbation of financial protectionism that may be inspired by actual or imagined threats from SWFs; (4) the potential for financial market turmoil and uncertainty associated with SWF activities; and (5) conflicts between countries with SWFs and countries in which they invest, for example, with respect to behavior and regulatory treatment.

As is appropriate and desirable when international controversies emerge, responsible policymakers have sought multilateral solutions to address these concerns and, to that end, the involvement of multilateral institutions—the International Monetary Fund, World Bank, and OECD. Outside observers, including the author of this book, Edwin M. Truman, suggested the development of a set of standards for SWFs. Truman, one of the pioneers of independent, policy-oriented research on SWFs, advocated in 2007 a voluntary set of international best practices in accountability and transparency for the SWFs and developed a prototype in the form of an SWF "scoreboard." His SWF scoreboard helped to inspire the Generally Accepted Principles and Practices of SWFs (known as the Santiago Principles or the GAPP), which were agreed by the International Working Group (IWG) on SWFs and released in October 2008, setting out the first international agreement on these institutions and their practices. The International Forum of Sovereign Wealth Funds (IFSWF) is the successor body of the IWG working on implementation of the Santiago Principles.

Table 1 Sovereign wealth fund scoreboard and the Santiago Principles

Country[a]	Fund[a]	SWF scoreboard	Santiago Principles
Norway	*Government Pension Fund-Global*	97	96
United States	California Public Employees' Retirement System	95	96
New Zealand	*Superannuation Fund*	94	98
Canada	Canada Pension Plan	92	96
United States	*Alaska Permanent Fund*	92	96
	Wyoming Permanent Mineral Trust Fund	91	96
Canada	Caisse de dépôt et placement du Québec	89	98
France	Fonds de reserve pour les retraites	89	92
Ireland	*National Pensions Reserve Fund*	86	94
Netherlands	Stichting Pensioenfonds ABP	85	84
Timor-Leste	*Petroleum Fund*	85	80
Japan	Government Pension Investment Fund	84	89
Canada	Ontario Teachers' Pension Plan	83	86
Trinidad and Tobago	*Heritage and Stabilization Fund*	83	82
Australia	*Future Fund*	80	90
United States	New Mexico Severance Tax Permanent Fund	80	80
Thailand	Government Pension Fund	78	81
Azerbaijan	*State Oil Fund*	76	76
Canada	*Alberta Heritage Savings Trust Fund*	74	80
Singapore	*Temasek Holdings*	73	82
Chile	*Economic and Social Stabilization Fund*	71	70
China	National Social Security Fund	70	74
Hong Kong	Exchange Fund	70	74
Chile	*Pension Reserve Fund*	68	68
United States	Alabama Trust Fund	68	76
Kazakhstan	National Fund	65	67
Singapore	*Government of Singapore Investment Corporation*	65	78
Kuwait	*Kuwait Investment Authority*	63	71
Korea	*Korea Investment Corporation*	60	67
United Arab Emirates	Mubadala Development Company	59	66
China	*China Investement Corporation*	57	60
Botswana	*Pula Fund*	56	62
United Arab Emirates	Dubai International Capital	55	62
Russia	*Reserve Fund and National Wealth Fund*	50	52
São Tomé and Príncipe	National Oil Account	48	58
Malaysia	Khazanah Nasional	44	48
Mexico	*Oil Income Stabilization Fund*	44	42
Kiribati	Revenue Equalization Reserve Fund	35	44
Vietnam	State Capital Investment Corporation	35	42

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Table 1 Sovereign wealth fund scoreboard and the Santiago Principles *(continued)*

Country[a]	Fund[a]	SWF scoreboard	Santiago Principles
Bahrain	*Mumtalakat Holding Company*	30	32
Algeria	Revenue Regulation Fund	29	32
Iran	*Oil Stabilization Fund*	29	32
Nigeria	Excess Crude Account	29	34
Venezuela	Macroeconomic Stabilization Fund	27	28
	National Development Fund	27	25
United Arab Emirates	International Petroleum Investment Company	26	26
Oman	State General Reserve Fund	23	26
Brunei Darussalam	Brunei Investment Agency	21	28
United Arab Emirates	Investment Corporation of Dubai	21	22
Sudan	Oil Revenue Stabilization Account	18	16
Qatar	*Qatar Investment Authority*	15	15
United Arab Emirates	Istithmar World	15	16
	Abu Dhabi Investment Authority	11	12
Total:			
IFSWF funds		63	67
IFSWF countries		64	67
Pension SWFs		84	88
Nonpension SWFs		50	54
All SWFs		59	62

a. Countries and their funds that are members of the International Forum of Sovereign Wealth Funds (IFSWF) are shown in italics.

Notes: The SWF scoreboard includes 33 elements on a scale of 100. The Santiago Principles include 25 of these elements also on a scale of 100.

This book is the culmination of a three-year research program at the Peterson Institute for International Economics on this topic. Truman reviews the origins of SWFs, the potential for their future growth, the policy issues that they raise, and various proposals for the regulation of SWFs. He concludes that the best approach is a robust set of best practices for SWFs and a high degree of compliance with that standard. To this end, he updates the SWF scoreboard and extends it to 53 pension and nonpension funds in 37 countries. He reports on the considerable progress since 2007 in compliance by some funds with the 33 elements in the scoreboard.

The elements are grouped in four categories: (1) structure of the fund, including its objectives, links to the government's fiscal policy, and whether the fund is independent from the countries' international reserves; (2) governance of the fund, including the roles of the government, the board of the fund and its managers, and whether the fund follows guidelines for corporate responsibility; (3) accountability and transparency of the fund in its investment strategy, investment activities, reporting, and audits; and (4) behavior of the fund in managing its portfolio and its risk management policies, including the use of leverage and derivatives.

Based on the scores as of the end of 2009, the 53 SWFs fall into three broad groups: 14 funds score above 80 percent, 14 funds score at or below 30 percent, and 25 funds are in a middle group. The top group includes funds of two developing countries, Timor-Leste and Trinidad and Tobago, as well as nine pension and three nonpension SWFs from industrial countries. The middle group includes funds of nonindustrial countries as diverse as Russia, Mexico, Kuwait, and Singapore as well as Australia's Future Fund and the SWF of the province of Alberta, Canada. The bottom group includes four funds from the United Arab Emirates, two from Dubai and two from Abu Dhabi, one of which was the Abu Dhabi Investment Authority (ADIA) as of the end of 2009. However, in March 2010, the ADIA released its first annual report and raised its score to the average for all SWFs.

Truman provides a positive assessment of the Santiago Principles as a first step toward high quality best practices for SWFs. Table 1 presents a summary of the scores of the 53 funds on the 33 elements in the scoreboard and 25 elements in the Santiago Principles that overlap with those in the scoreboard. Full compliance of an SWF with the Santiago Principles alone would receive a score of only 76 on the scoreboard.

As a result of the Santiago Principles and other parallel efforts at education, such as the SWF scoreboard that Truman has featured in his research, a substantial amount of distrust surrounding SWFs has been defused. Unfortunately, reciprocal actions by host countries to SWF investments have been less than impressive in recent years with respect to their openness to foreign direct investment. OECD members agreed that no special regime for SWF investments is required because those investments are (rightly) seen as not inherently different from other government-owned or -controlled investment vehicles. But these countries did not address how to strengthen their current codes, procedures, and practices to reinforce their openness to foreign investments, including by governments and their SWFs. Instead, and partly as a consequence of the rise of SWFs, there recently has been a tangible increase in financial protectionism in OECD countries via a tightening of laws, standards, and procedures. The United States, in its Foreign Investment and National Security Act passed in 2007, updated the legislation governing the Committee on Foreign Investment in the United States, to tighten that framework, which had the effect of raising the costs of investing in the United States by governments and their SWFs.

Truman concludes with four broad recommendations: First, countries with SWFs should promote adherence to and implementation of the Santiago Principles and the progressive improvement of the quality and content of those principles to the level of his SWF scoreboard. Second, recipient countries should take reciprocal steps to monitor more closely incipient financial protectionism put in place in recent years with a view to rolling it back, for example, by narrowing exemptions from national treatment and opening up decisions to ex post review. Third, to prevent regulatory and institutional arbitrage by diverting funding to other state-controlled entities such as banks and nonfinancial institutions, governments should step up their collaborative efforts in order to improve other accountability and transparency standards, such as those on the management of foreign exchange reserves, and to collect more comprehensive data on all cross-border government investments. Fourth, the long-term goal should be a comprehensive, internationally agreed-upon framework governing all types of cross-border investments by governments.

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