JOINT ECONOMIC COMMITTEE

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SOVEREIGN WEALTH FUNDS

Since 2000, sovereign wealth funds (SWFs) in emerging countries have become major investors in the United States and other developed countries that are members of the Organization for Economic Cooperation and Development (OECD). Since September 2007, SWFs invested at least $62 billion in OECD-country banks and other financial firms, whose capital had been diminished by losses related to the subprime mortgage loan crisis.

While recent SWF investments may have forestalled involuntary loan retrenchments at these banks and other financial firms, these funds raise a number of questions for U.S. policymakers. This research report responds to these questions.

What are sovereign wealth funds? Governments invest through four major vehicles:

- **International reserves** are liquid, low-risk assets – usually U.S. Treasuries, U.S. Agencies, or highly rated government debt securities of other OECD countries – held by central banks or finance ministries that are readily available for intervening in foreign exchange markets.
- **Pension funds** are typically funded through payroll taxes. Pension funds accumulate debt and equity securities to pay promised retirement, disability, or healthcare benefits in the future. Since pension fund liabilities are in the domestic currency, a majority of fund assets are usually domestic.
- **State-owned enterprises** (SOEs) are domestic firms over which governments exercise significant control through majority or significant minority stock ownership.
- **Sovereign wealth funds** (SWFs) are usually funded by (1) taxes on the private extraction of non-renewable resources and the profits of SOEs engaged in such extraction, (2) international reserves that exceed liquidity needs, or (3) sustained budget surpluses. SWFs invest in a wide variety of assets and accept significant risk in their portfolios to seek higher returns. Unlike pension funds, SWFs are not encumbered by specific future liabilities and tend to invest most of their funds abroad.

The management of SWFs varies. Some funds are actively managed by members of a royal family or former senior policymakers (e.g. Abu Dhabi Investment Authority (ADIA), Government of Singapore Investment Corporation (GIC)). Others are managed by the central bank or finance ministry (e.g., Stabilization Fund of the Russian Federation, Alberta Heritage Savings Trust Fund). Still other funds outsource their management to professional fund managers (e.g., Kuwait Investment Authority, Temasek Holdings, Alaska Permanent Reserve Fund). In addition to SWFs that clearly fall under this definition, some central banks both manage international reserves and make other diverse long-term investments like SWFs (e.g., Saudi Arabia Monetary Agency, Hong Kong Monetary Authority).

Currently, SWFs and central banks with a large SWF function manage an estimated $3.2 trillion of assets (see Table 1). In 2006 by comparison, global stock market capitalization was $42 trillion, while the market value of private debt securities was $23 billion.

The importance of SWFs in global capital markets is expected to grow. Mainly because of high oil prices and persistent current account surpluses in China and certain other Asian countries, Morgan Stanley projects SWFs may manage $12 trillion by 2015.

SWFs serve different **policy objectives**:

- **Stabilization**. Governments with economies dependent on commodity production or non-renewable resource extraction use SWFs to moderate changes in foreign exchange inflows and government revenue due to commodity price fluctuations (e.g., Stabilization Fund of the Russian Federation). Stabilization funds tend to invest conservatively in debt securities.

- **Intergenerational savings**. Governments with economies dependent on the extraction of nonrenewable resources use SWFs to save a portion of current revenue and invest in assets that will generate income for future generations (e.g., Abu Dhabi Investment Authority).

- **Higher returns on excess international reserves**. Governments with international reserves in excess of their liquidity needs use SWFs to earn higher returns by investing in a broad range of assets – marketable equity and debt securities, non-marketable equity interests, loans, real estate, hedge funds, commodities, and financial derivatives (e.g., Temasek Holdings, China Investment Corporation).

Moreover, SWFs have different **investment approaches**:

- **Conventional**. Under this approach, the sole investment objective is wealth maximization. Investments are highly diversified. Conventional SWFs do not seek to influence the management of firms in which such SWF invest (e.g., Alaska Permanent Fund).

- **Strategic**. Under this approach, wealth maximization is not the sole investment objective. Investments may be concentrated in certain countries or sectors. Strategic SWFs may seek to influence the management of firms in which such SWFs invest (e.g., Malaysia's Khazanah Nasional invests primarily in Malaysian firms to promote industrial development and to increase the international competitiveness of the Malaysian economy. However, Khazanah Nasional is rapidly expanding its foreign investments).

SWFs also vary in **transparency**. Transparent SWFs have clearly stated objectives and investment policies; publish regular financial statements with detailed information on specific investments; and are audited by independent accountants (e.g., Alberta Heritage Savings Trust Fund). Other SWFs are opaque (e.g., Kuwait Investment Authority).

National security. Some policymakers fear that SWFs may threaten U.S. national security by obtaining access to sensitive information or technologies through their ownership of U.S. corporations. Foreign acquisitions of U.S. assets that may threaten national security are regulated under the Exon-Florio provision of the *National Defense Production Act* as amended by the *Foreign Investment and National Security Act of 2007*.

In summary, the amended Exon-Florio provision authorizes the President to modify or block any foreign acquisition of "persons engaged in interstate commerce in the United States" that threatens national security, including homeland security, critical infrastructure, and critical technology.

Under this provision, the Committee on Foreign Investment in the United States (CFIUS), which is composed of the Secretary of the Treasury (who serves as its chair), six other members, two ex-officio members, and others designated by the President must decide within 30 days of formal notification of a proposed acquisition whether to launch an investigation. An investigation is mandatory if the acquirer is a foreign government or an SOE. If an investigation is launched, CFIUS must examine the proposed acquisition in light of 12 statutory factors and make recommendations to the President within 45 days after launching its investigation. The President has 15 days after receiving CFIUS recommendations to make a decision and report it to Congress.

Any information submitted under the Exon-Florio provision is confidential. As a practical matter, foreign firms usually make informal inquiries to the administration before announcing a proposed acquisition that could run afoul of the Exon-Florio provision. This allows foreign acquirers to cancel or modify acquisitions that are likely to be prohibited. Since 1998, CFIUS received more than 1,500 notifications and initiated 25 investigations. Twelve transactions were withdrawn, and thirteen transactions were sent to the President, one of which was prohibited.

Transparency. Private individuals and businesses invest abroad to maximize their wealth. With rare exceptions, their investment decisions are not clouded by other motives. However, government policymakers often have multiple motives for making decisions. In the absence of laws, regulations, and clearly stated investment policies, a government agency may make investment decisions based on political rather than economic criteria. Thus, it is reasonable to assume that at least some SWFs may have investment motives other than wealth maximization.

Other investment motives are not necessarily threatening. For example, strategic SWFs may invest some of their funds in domestic infrastructure projects with lower expected returns to improve the delivery of basic services to poor residents. However, strategic SWFs with large investments in a corporation could potentially use their financial clout to influence the economic decisions of its management (e.g., locating new facilities in home countries of SWFs), or to press its management to advocate domestic policy changes favorable to the home countries of such SWFs.

In a recent Standard Chartered report, Oxford Analytica rated SWFs based on two characteristics: level of transparency and investment approach (see Chart 1).[1] Policymakers should have no concerns about SWFs in the lower right-hand quadrant that are highly transparent and follow conventional investment strategies. However, SWFs in the upper left-hand quadrant that are opaque and follow strategic investment strategies may raise concerns.

SWFs can alleviate anxiety about their intentions among U.S. policymakers through increased transparency. SWFs that disclose their organization, source of funds, investment strategy, and policies; that publish regular financial statements with detailed information on specific investments; and that are audited by independent accountants are far less likely to raise suspicions than SWFs that are opaque. Over time, transparency builds confidence about the intentions and behavior of SWFs.

Likewise, SWFs also can reduce apprehensions by pursuing a conventional investment approach, or by widely publicizing and adhering to their policies when pursuing a strategic investment approach. A large concentration of SWF investments in a single industry, firm, or location without explanation may raise concerns. Strategic SWFs can reduce these concerns by agreeing to be passive investors (i.e., by not seeking to gain seats on a corporation's board of directors, replace its executives, or change its policies) or by stating in advance the conditions under which strategic SWFs might seek an active role in management.

The leaders of a number of large SWFs have come to realize that a lack of transparency increases uncertainty and may ignite a political backlash against their investments. On October 20, 2007, Secretary of the Treasury Henry Paulson hosted a dinner for G-7 finance ministers and the managers of large SWFs to propose the development of a SWF "best practices" code. On behalf of several large SWFs, Tony Tan, the Deputy Chairman of the Government of Singapore Investment Corporation (GIC), is currently working with U.S. officials through the International Monetary Fund (IMF) to devise a SWF "best practices" code. The results of these discussions will be presented at the IMF spring meetings on April 12-13, 2008.

At the same time, the United States and other developed economies are working through the OECD to devise a "best practices" code for countries receiving SWF investments. This code will draw upon the OECD's *Guidelines for Corporate Governance of State-Owned Enterprises*.

Investment reciprocity. Another issue for U.S. policymakers to consider is investment reciprocity. Some of the countries that sponsor SWFs have severe restrictions on inward foreign investment by individuals and firms in the United States and other OECD countries (e.g., the People's Republic of China, Russia). The desire of SWFs to invest a large portion of their assets in the United States and other OECD members creates an opportunity to press restrictive home countries to open their economies to inward foreign investment by U.S. and other OECD individuals and firms.

Conclusion. The importance of SWFs in global capital markets will increase in the future.

[1] Gerald Lyons, "State Capitalism: The Rise of Sovereign Wealth Funds" in *Thought Leadership* (London: Standard Chartered Bank, 15 October 2007).

On balance, U.S. policymakers should welcome inward foreign investment from SWFs.

The Exon-Florio provision as amended in 2007 fully addresses any legitimate concerns about national security regarding SWFs. However, two other major concerns remain. SWFs differ widely with respect to their transparency. The lack of transparency in many SWFs feeds apprehensions about their intentions. Fortunately, many SWFs have recently acknowledged this problem and are currently working with the United States to devise a SWF best practices code that would improve transparency.

Another issue is the lack of investment reciprocity in some countries that sponsor SWFs. U.S. policymakers should press these countries to open their economies to inward foreign investment.

Chart 1 – Investment Approach and Level of Transparency in Sovereign Wealth Funds

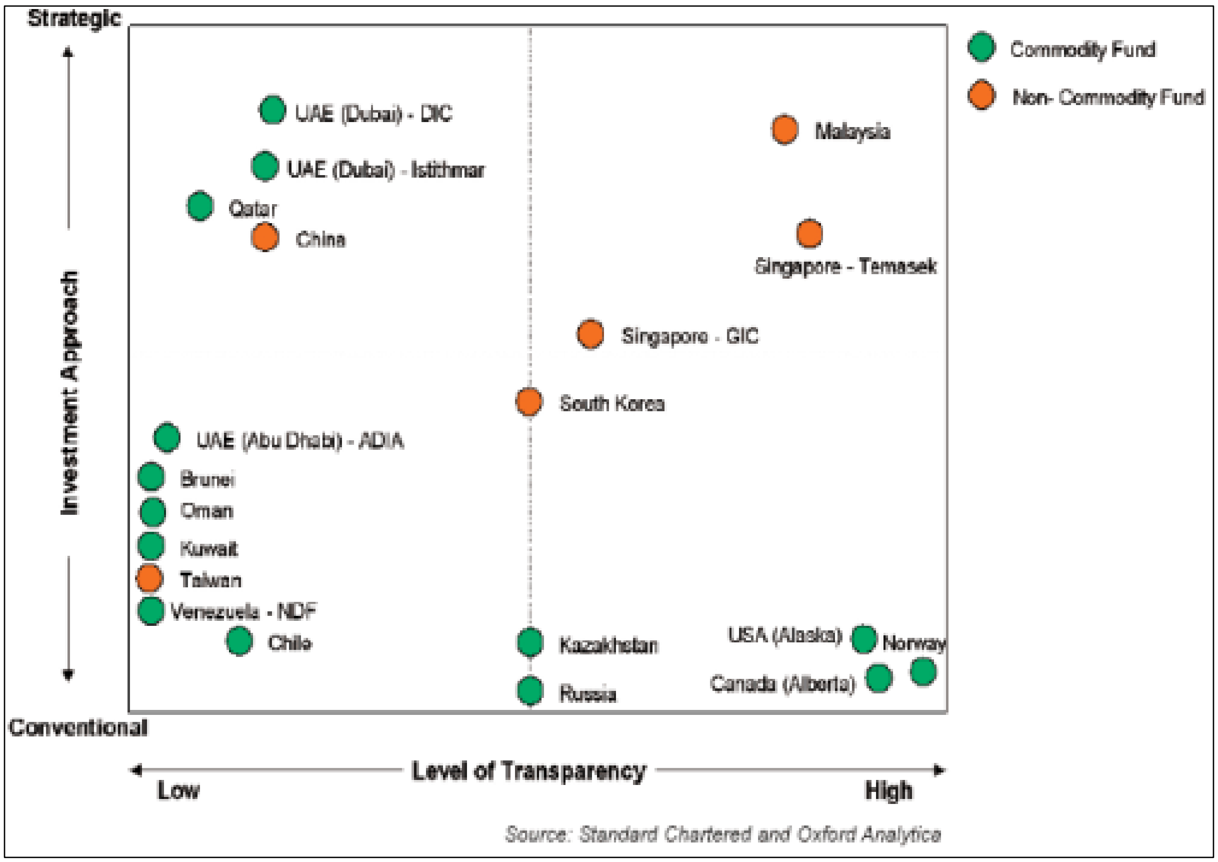

Table 1 – Sovereign Wealth Funds & Monetary Authorities Performing SWF Functions with Estimated Assets of $1 Billion or More				
Name	**Home Country**	**Founded**	**Source of Funds**	**Assets (in billions U.S. $)**
Abu Dhabi Investment Authority and Corporation (ADIA)	UAE (Abu Dhabi)	1976	Oil	875
Government of Singapore Investment Corporation (GIC)	Singapore	1981	Excess reserves	330
Government Pension Fund-Global	Norway	1990	Oil	322
Saudi Arabia Monetary Agency	Saudi Arabia	n/a	Oil	300
Kuwait Investment Authority	Kuwait	1960	Oil	250
China Investment Corporation	PRC	2007	Excess reserves	200
Hong Kong Monetary Authority Investment Portfolio	Hong Kong SAR, PRC	1998	Excess reserves	140
Stabilization Fund of the Russian Federation	Russia	2004	Oil	127
Temasek Holding	Singapore	1974	Excess reserves	108
Central Hujin Investment Corp.	PRC	2003	Other	100
Reserve Fund	Libya	n/a	Oil	50
Australian Government Future Fund (AGFF)	Australia	2006	Budget surpluses, sale of Telstra	50
Qatar Investment Authority	Qatar	2005	Oil	40
Alaska Permanent Fund	U.S.	1976	Oil	40
Brunei Investment Authority	Brunei	1983	Oil	35
National Pensions Reserve Fund	Ireland	2001	Other	29
Revenue Regulation Fund	Algeria	2000	Oil	25
Korea Investment Corporation	South Korea	2005	Excess reserves	20
National Oil Fund	Kazakhstan	2000	Oil, gas	18
Khazanah Nasional	Malaysia	1993	Debt	18
National Development Fund	*Venezuela*	*2005*	*Oil, excess reserves*	*18*
Alberta Heritage Savings Trust Fund	Canada	1976	Oil	17
Taiwan National Stabilization Fund	Taiwan	2000	Postal savings, loans from domestic banks	15
New Mexico State Investment Office Trust Funds	United States	1958	Other	15
Foreign Exchange Reserve Fund	Iran	2000	Oil	15
Excess Crude Account	Nigeria	2004	Oil	11
Government Pension Fund	*Thailand*	*1997*	*Budget surpluses, payroll taxes*	*11*
Superannuation Fund	New Zealand	2003	Other	10
State General Stabilization Fund (SGSF)	Oman	1980	Oil, gas	8.2
Isithmar	*UAE (Dubai)*	*2003*	*Oil*	*8*
Pension Guarantee Fund	*Chile*	*2007*	*Budget surpluses*	*6.8*
Dubai International Capital	*UAE (Dubai)*	*2004*	*Oil*	*6*
Economic and Social Stabilization Fund	Chile	2006	Copper	6
Pula Fund	Botswana	1993	Diamonds	4.7
Permanent Wyoming Mineral Trust Fund	United States	1974	Minerals	3.2
Government Petroleum Insurance Fund	Norway	1986	Oil	2.6
State Oil Fund	Azerbaijan	1999	Oil	1.5
Heritage and Stabilization Fund	*Trinidad and Tobago*	*2006*	*Oil*	*1.4*
Timor-Lease Petroleum Fund	East Timor	2005	Oil	1.2

Total	**3,239**
Source: Steffen Kern, *Sovereign Wealth Funds – State Investments on the Rise*, Deutsche Bank Research, Sept. 10, 2007, and Lyons, Oct. 15, 2007. Amounts from Kerns, unless in italics then from Lyons.	