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SOVEREIGN WEALTH FUNDS

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Sovereign Wealth Funds (SWFs) are generally defined as state-controlled investment instruments funded by foreign-exchange assets. Traditionally, SWFs were the preserve of major commodity exporters, particularly oil-rich countries like Kuwait, Norway or Saudi Arabia. SWFs have existed since the early 1950s but they become an important issue in the last years as their total size has increased seriously to reach around $3 trillion. Today, more than 30 countries have SWFs, although some of them have relatively small funds compared to the funds of the countries such as UAE, Norway.

The distinguishing feature of SWFs from other categories of investment instruments, such as pension funds, investment funds and trusts, hedge or private equity funds, is that they are state-owned. In general, SWFs are funded from accumulated foreign-exchange reserves in origin countries, but are governed autonomously from the official reserves. As SWFs are foreign state-owned investment instruments, they may raise concerns for the recipient state. The most often raised concern is the worry that SWFs investments may be driven by considerations other than maximization of profits. For instance, investment goals may illustrate a desire to get technology and know-how for national strategic interests, rather than being driven by commercial interests. More generally, business and investment decisions could be affected by the political interests of the SWF-owner States.

SWFs have been with us for more than fifty years since the first fund was established by the Kuwait Investment Office in 1953. During the oil price rises of the 1970s and 1980s, major funds were set up by the oil producers. It is only in the last 10 to 15 years that a significant increase was seen in the number of SWFs all over the world.

The major motive for the growth of SWFs comes mainly from high oil prices, financial globalization, and ongoing imbalances in the global financial system that has resulted in the rapid accumulation of foreign assets in some countries.

As a result, since the beginning of the millennium about 20 new SWFs have been set up including Russia's Oil Stabilization Fund and Korea's Investment Corporation. Established last year, The China Investment Corporation, manages $200 billion worth of assets. In the future more SWFs are expected to be created, especially by Brazil, Japan and India. The IMF estimates that SWFs may increase from $2-3 trillion to about $6-10 trillion within five years.

These are extremely large numbers and there is no question that SWFs have become important and influential players in many financial markets, with pension funds, insurance funds and other private investors.

The current size of SWFs is estimated at $2–2½ trillion as of mid-2007. This amount is equivalent to 50% of foreign exchange reserves managed by world's central banks and it is larger than the hedge fund industry. 75% of these assets are in the hands of the first five countries, namely Kuwait, Norway, Russia, Singapore and United Arab Emirates.

The SWF assets growing very rapidly, however it is very difficult to estimate the future size because of the uncertainties in the commodity prices, pace of foreign exchange reserves accumulation, and also allocation of the increase in reserves between SWFs and official reserves. Some private sector institutions make an estimation of $12 trillion by 2015. Further, it is argued that SWFs will surpass foreign exchange reserves by 2011.

Two Different Approaches to SWFs: the EU and the USA

The EU and the USA have parallel concerns about these funds; however there is a considerable difference between their regulations.

The efforts of the EU in this field aim at a non-mandatory regulation. The regulation proposal is aiming only at the SWFs and excluding other kinds of state-owned funds. According to the European approach, SWFs are different in character from other foreign government instrumentalities. They are generally less transparent. So reinforcing transparency is a strong antidote to economic and security concerns.

At the end of February 2008, The European Commission adopted a communication proposing an EU approach on SWFs. This position was endorsed by the European Council at the Spring Summit on 13-14 March.

One of the EU Principles for a common approach to SWFs is the commitment to an open investment environment. In line with the Lisbon strategy for growth and jobs, the EU reaffirms its commitment to open markets for foreign capital and to an investor-friendly investment climate. On the other hand, the EU supports a multilateral work, namely the work currently underway in the IMF on a code of conduct for SWFs and the OECD's work in identifying best practice guidelines for recipient countries. According to the proposal, Member States can continue to use the existing instruments for challenges raised by cross-border investments, including SWFs.

As a matter of fact, the EU's search of transparency, accountability and multilateralism reflects its economy's fragile structure towards the external challenges, especially from the emerging countries such as China and Russia. Joaquin Almunia, Commissioner for Economic and Monetary Policy, says *"the recent rapid growth in Sovereign Wealth Funds reflects **large and persistent global imbalances** which are a continuing threat to the stability of the world financial system and the global economy. Over the past decade, **emerging markets economies - in particular China and oil producing countries – have been running progressively larger current account surpluses that reached an estimated $685 billion dollars last year.** According to the IMF, the combined current account surplus of China and oil-exporting countries will be around $800 billion over the next three years."*

On the other hand, the American regulation is mandatory but not specifically targeted at SWFs. According to the American approach, there is no distinction between SWFs and other governmental financial actions.

Since the Exon-Floria Amendment, a law enacted in 1988, already authorizes President to block any foreign acquisition of a US business that would threaten to weaken the national security, American State is not in search of a new regulation specifically for SWFs and hence Exon-Floria Amendment has no provisions specific to SWFs. An interagency group named the Committee on Foreign Investment in the US (CFIUS) is authorized to examine any foreign acquisition of a US business where such an acquisition might weaken the national security. If the foreign acquirer is a private entity, the buyer and seller in the transaction **MAY** notify CFIUS of the proposed acquisition and subject the transaction to CFIUS review. However if the foreign acquirer is a governmental entity, such as a SWF, any transaction that implicates the national security **MUST** be submitted to CFIUS. Although the fundamental concept of "national security" is not defined in the Exon-Florio Amendment, it encompasses not only the US defense sector but also the energy, infrastructure, technology, telecommunications, and transportation sectors.

International Monetary Fund's Approach:

IMF's ministerial body, the International Monetary and Financial Committee (IMFC) — called on the Fund last October to engage in a dialogue with countries to arrive at a ***voluntary set of best practices*** in the management of SWFs.

IMF's approach has progressed on a number of fronts. By conducting a deepening analysis, IMF is organizing a survey of SWFs to help identify their investment objectives and risk management practices; as well as institutional frameworks, such as governance structures and accountability arrangements. On the other hand, IMF is trying to facilitate communication between all the related parties. For this purpose, IMF organized a Roundtable of Sovereign Asset and Reserve Managers in November 2007, which included a preliminary discussion with important SWFs. The IMF is following up further contacts with SWFs as part of a collaborative process to reach at an agreed view on best practices. Lastly, as an extension of a search for multilateralism, IMF is coordinating with other international institutions such as Organization for Economic Cooperation and Development (OECD), the European Commission, the World Bank.

Norway Case:

Norway holds one of the world's largest SWFs. The IMF statistics suggests that Norwegian SWFs have surpassed $300 trillion in 2007. Norway is the only democratic country with large amounts of SWFs and the country has a strict policy to invest the money in ethical ways. The fund management excludes all arm manufacturers, corporations that have bad records in terms of human rights violations, environmental crimes, child working etc. Because of its transparency and ethical approach, Norwegian model is considered to be a model for "best practices" in the SWFs world.

The Norwegian SWF, which is known as "Government Pension Fund" in Norway, is within the responsibility of the Ministry of Finance while the operational management of the Fund is delegated to Norges Bank. In other words, there is a clear separation of roles between "owner" and the "operational manager".

Being the “owner” of the funds, Ministry of Finance has overall responsibility on, among others, strategic asset allocation, monitoring and evaluating operational management, ethical guidelines and the preparation of reports to Parliament (legislative body).

As the “manager” of the funds, Central Bank is responsible for the implementation of investments strategy, active management to achieve excess return, risk control and reporting, exercise the Fund’s ownership rights and to provide professional advice on investment strategy.

The capital of the Norvegian SWF is invested in non-Norwegian financial instruments (bonds, equities, money market instruments and derivatives), and in 42 developed and emerging equity markets and 31 currencies for fixed income investments. NBIM manages the Fund partly internally and partly by engaging external managers. Due to the good management, the Norvegian SWF is always expressed as a model for other SWFs by the EU officials and international financial institutions such as IMF and OECD.

There is a broad political consensus that the Pension Fund should be managed with a view to achieving the maximum possible return within a moderate level of risk. The Ministry of Finance has formulated a long-term investment strategy ensuring that the capital is invested in a broadly based portfolio comprising securities from many countries. The long investment horizon of the Fund means that the portions invested in various asset classes and geographical regions can be determined on the basis of assessments of expected long-term returns and risks.

The investment strategy chosen by the Ministry of Finance has decisive influence on the Pension Fund’s expected return and risk, and reflects a trade-off between these two characteristics. The Pension Fund shall act as a financial investor, and not as a tool for exercising strategic ownership in individual companies. The Fund is characterised by good diversification of risk, as a result of it being invested in securities issued by many different states and by companies in many different countries. There is no requirement to the effect that the capital of the Pension Fund shall at all times correspond to a certain share of the pension liabilities of the State under the National Insurance Scheme. This makes the Pension Fund less vulnerable to short-term return fluctuations than many other funds.

Priority is accorded to achieving broad political agreement as to the investment strategy of the Fund, and a high degree of openness as far as the management of its capital is concerned. This strengthens the credibility of, and confidence in, the Fund. The investment strategy of the Government Pension Fund is defined by the general investment limits and the benchmark portfolios of the Government Pension Fund – Global and the Government Pension Fund – Norway, respectively. The benchmark portfolios of the Government Pension Fund comprise equity and bond indices from different countries, cf. Chart below. The indices include representative security samples, and developments in such indices reflect, in large part, market developments in the relevant countries. The return on the Government Pension Fund will, to a large extent, mirror market developments for the securities included in the benchmark portfolios.

The Ministry of Finance has defined the benchmark portfolio of the Government Pension Fund – Global. It has been decided to increase the equity portion to 60 pct., and the equity portion is now being gradually increased. As from 1 January 2008 it is intended that the investment limits of the Government Pension Fund – Norway will also be determined by the Ministry of Finance, in the form of a benchmark portfolio with limits on permitted deviations.

The Government Pension Fund is mainly invested in listed equities and bonds of high credit quality. Equity investments represent ownership interests in the production of goods and services, and the value of such investments will therefore reflect, inter alia, expectations as to the future profits of businesses. Bond investments involve the granting of a loan to the issuer, to be repaid to the bondholder together with a predetermined interest payment.

As shown in the Chart above, the Government Pension Fund – Global holds all its investments abroad, and its return in international currency is the relevant measure of developments in the Fund's international purchasing power. The Government Pension Fund – Norway is primarily invested domestically, and its return is measured in Norwegian kroner. Norges Bank and Folketrygdfondet (also known as the National Insurance Scheme Fund) both seek to achieve a higher return than dictated by the benchmark portfolios of the Government Pension Fund – Global and the Government Pension Fund – Norway, respectively, within the defined risk limits.

Annex: The list of major SWFs

Major Sovereign Wealth Funds			
Country	**Fund name**	**Assets**	**Source**
UAE	Abu Dhabi Investment Authority (ADIA) / Abu Dhabi Investment Council (ADIC)	$ 250 billion to $ 875 billion	Oil
Norway	Government Pension Fund - Global	$ 308 billion	Oil
S. Arabia	No designated name	$ 250 + billion	Oil
Kuwait	Kuwait Investment Authority (KIA) General Reserv Fund (GRF) and Future Generations Fund (FGF)	$ 160 billion to $250 billion	Oil
Singapore	Government Investment Corporation (GIC) Temasek Holdings	$ 100 + billion $ 100 + billion	Other Other
China	State Foreign Exchange Investment Corporation	$ 200 billion	Other
Russia	Oil Stabilization Fund	$ 127 billion	Oil
Australia	Australian Future Fund	$ 42 billion	Other
USA-Alaska	Alaska Permanent Reserve Fund	$ 35 billion	Other
Brunei	Brunei Investment Authority General Reserve Fund	$ 30 billion	Oil
Korea	Korea Investment Corporation	$ 20 billion	Other
Canada	Alberta Heritage Savings Trust Fund	$ 15 billion	Oil
Chile	Economic and Stabilization Fund Pension Reserve Fund	$ 9.83 billion $ 1.37 billion	Copper Copper
Botswana	Pula Fund	$ 5+ billion	Diamonds

Source: IMF