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Sovereign Wealth Funds and Political Risk: New Challenges in the Regulation of Foreign Investment*

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1. Introduction

Sovereign wealth funds (SWFs) are key actors in the global financial landscape of the twenty-first century. According to the OECD, at the peak of the global financial crisis in 2009, government-driven international M&A reached US$120 billion, or 20% of the total international M&A. This dropped significantly in 2010 to US$70 billion, or 10% of the total, but still well above the average of 3% between 2000 and 2007. The bulk of this government-driven international investment originated either in China or from SWFs in the Middle East and North Africa (MENA) region and Asia.[1]

This trend is indicative of a profound shift in the importance of the state in the global economy. Oil- and gas-exporting nations in the Middle East, and those in Asia that have benefitted from

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[1] *OECD Investment News*, May 2011, Issue 15.

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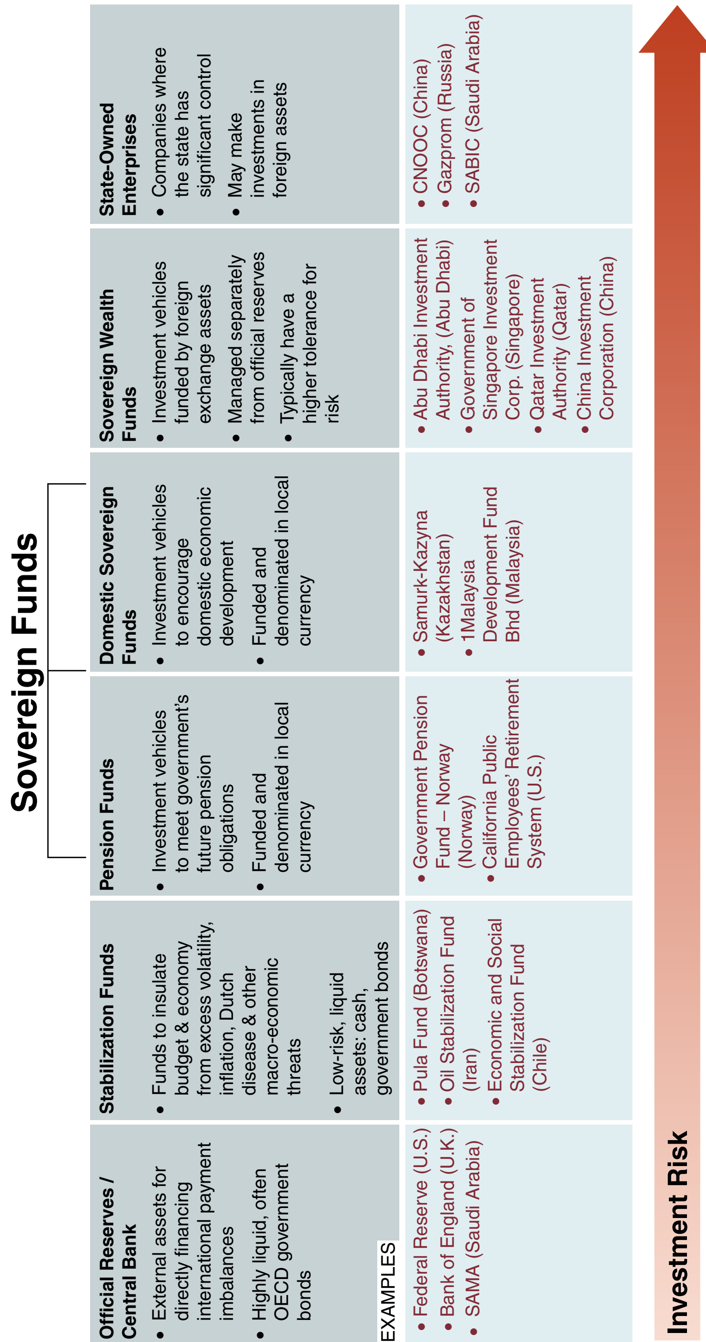

Fig 1. The sovereign wealth investment continuum

low-cost manufacturing to serve Western markets have generated large surpluses, which they have sought to invest outside their home markets to ease inflation, diversify their reserves, prevent Dutch disease and save for future generations. However, this has created a new global paradigm in which large pools of capital are held by undemocratic or authoritarian governments with poor records on human rights and the freedoms that people in much of the developed world take for granted.

The first time that the West took note of this trend was in 2006 when state-owned Dubai Ports World acquired several American ports through its purchase of P&O's assets. SWFs were immediately characterized as the new "barbarians at the gate," ready to launch hostile bids to take over strategic companies of developed economies. SWFs were then turned into the "White Knights of Wall Street" when the financial crisis started to hit hard. They invested just shy of $63 billion in the American and European banking industries on the verge of default, becoming lenders of last resort and relieving a distressed financial system, profoundly changing the balance of global economic power toward the developing world. The events of "Arab Spring,"the outbreak of war in Libya in 2011 and the subsequent freezing of Libyan state-owned assets, including those of the Libyan Investment Authority, have once again raised the question of the nature of the sovereign government owners of SWFs and their legitimacy, and whether the proceeds from their investments could be used to oppress their citizens.

Public debate has refocused on assessing the intentions and uses, structure and governance, impact and performance of SWFs and whether investments by SWFs with undemocratic government owners are nefarious, with the intention of pursuing an anti-democratic agenda both at home and abroad. There is, however, no evidence to suggest that they act as anything other than financial entities, pursuing economically driven strategies. Yet, as clearly stated in the "Beijing Communiqué" from the International Forum of Sovereign Wealth Funds, the state-owned funds that formulated and have applied the Santiago Principles, SWF investment continues to cause some to suspect political motivations.

That said, although SWF investment does not appear to be overly distorted by the political agenda of governments, this does not mean these investments are dissociated from their countries' political risk. Particularly in the Middle East, but also in China, conditions are arising that increase the risk of political and social unrest and upheaval.

We claim that this new environment is changing the perception of political risk associated with SWF investments. More particularly, a Western target acquired by a SWF with an undemocratic government owner should, in principle, demand a political risk premium on returns. However, our preliminary results suggest that political risk factors may contribute to the observed negative market performance of listed SWF target companies. If this was consistently replicated, a widespread increase in political risk in the MENA region, which may eventually move eastwards, could have systemic consequences, adversely affecting capital movements, financial integration and ultimately limiting the ability of SWFs to absorb global imbalances, as they have done thus far. This concern provides a rationale for a regulatory framework for SWF investment that addresses these global externalities. The question here is that which system of rules and incentives best mitigates these risks.

The aim of this chapter is to describe the key features of SWFs, their most recent behavior, and the economic implications of political risk-related SWF investment for host countries and firms. After pointing out how the market fails to take account of the political risk of SWF investments, we set forth some tentative recommendations at the national and multilateral levels that by regulating SWF investment aim to preserve free capital flows while fostering social progress in resource-rich, non-democratic countries.

2. Background

The shifting discourse surrounding SWFs is largely the consequence of poor understanding of the motives and investment behavior of SWFs. There is a massive variety of sovereign investment vehicles, to which the label "sovereign wealth fund" is

frequently applied for convenience. The rationale for the existence of sovereign investment vehicles is different in each country, so they are immensely diverse and this over-generalization masks important distinctions in purpose, strategy, and asset allocation, and does not aid analysis of their investment behavior.

These state-owned funds act as long-term, institutional investors, investing to fulfil the needs of their shareholders. However, because their owners are governments, their objectives may also be extra-financial, involving pursuit of a "double bottom line." For example, a SWF may choose to increase its allocation to commodities and the companies that produce and trade in them. This is important from a strategic asset allocation perspective as commodities have recently performed strongly, have little correlation with mainstream assets such as stocks and bonds, and act as a hedge against inflation. However, a SWF may also require access to commodities such as metals, oil and gas for economic development purposes. This is a legitimate aim and underlines the fact that the investment behavior of a SWF cannot be isolated from the broader economic and fiscal policy tools of the nation from which it comes and thus the fund inherits some of the political risks associated with the government owner.

As shown below, sovereign investment vehicles can be loosely grouped into six categories along a spectrum of financial risk Ranging from central banks as the most liquid and low-risk, to state-owned enterprises, which have many fixed assets and operate higher-risk strategies. Each type of vehicle has a specific purpose within the economic and fiscal policy of the state.

- **Central bank and foreign exchange funds** are used for currency stabilization and to control inflation and are thus highly liquid. For example, the Saudi Arabian Monetary Agency (SAMA) has assets of US$472.5 billion, 70% of which are foreign exchange reserves held in low-risk foreign securities.[2]

[2]As of March 31, 2011, Saudi Arabian Monetary Authority, 1st Quarter 2011, Quarterly Statistical Bulletin, Table 8a. Available at http://www.sama.gov.sa/sites/samaen/ReportsStatistics/ReportsStatisticsLib/5600_S_Quarterly_Bulletin_Bo.pdf

- **Stabilization funds**, like Chile's Economic and Social Stabilization Fund, are established to be drawn on at short notice to stabilize a country's currency at times of severe macroeconomic stress. Like central banks, therefore, these funds must be invested in a manner that gives the government owner "instant access," rather than for maximum return. Consequently, portfolios are liquid and low-risk, consisting of sovereign debt, cash and gold, and potentially high-quality commercial debt, such as that of large diversified banks. Chile's ESSF has an investment policy to hold its portfolio "exclusively as international fixed-income instruments."[3]
- **Pension and social security funds** have on-going liabilities of the pensions of those covered by the fund when they reach retirement age. Their asset allocation must ensure that there is sufficient liquidity to pay current pension liabilities, and that the risk profile is managed to ensure that it can continuously meet its future obligations. Some pension funds, particularly those from North America, such as the Canada Pension Plan Investment Board, have balanced their liability and risks to enable them to invest in illiquid assets such as infrastructure and private equity.
- **Domestic development funds** are prevalent around the world. Some of these funds, like the French Caisse des Dépôts et Consignations or Cassa Depositi e Prestiti in Italy, are old institutions with historic mandates, while others, like 1 Malaysia Development Bhd. and Samruk Kazyna in Kazakhstan, have been formed to accelerate development in emerging economies. These funds create new government-linked companies and joint ventures at home to facilitate economic development, help domestic companies, and manage government holdings in existing GLCs. Like Temasek Holdings, these funds may eventually transition into SWFs as they exit portfolio companies and invest the proceeds abroad.
- **State-owned enterprises** are wholly, or majority, owned by the state. They invest in assets and undertake operations in specific economic sectors. The highest-profile in recent years

[3] Economic and Social Stabilization Fund, Third Quarter Report 2009.

> have been national oil companies from emerging markets, such as Saudi Aramco, Russia's Gazprom, CNPC of China, Brazil's Petrobras, and Petronas of Malaysia, which have been dubbed the "new seven sisters," and dominate world oil production.[4]

Amongst these various vehicles, a "sovereign wealth fund" is thus a specific form of investment vehicle that is owned directly by a sovereign government. It is managed independently of other state financial institutions and does not have predominant explicit pension obligations. It invests in a diverse set of financial asset classes in pursuit of commercial returns and has made a significant proportion of its publicly reported investments internationally.[5]

Currently, 30 funds from 22 nations meet these criteria. The UAE is represented by six funds, while China, Singapore, and Oman each have two. There are 12 funds from the Middle East and North Africa (MENA) and 12 from Asia-Pacific. Three are from non-Pacific Asia, two — Norway and Ireland — are European, while only one from sub-Saharan Africa (São Tomé and Príncipe) conforms to our definition. According to the most recent estimates, global SWFs manage assets worth US$2,753.2 billion (see Table 1).

As the geographical spread described in Table 1 suggests, 71% of SWF assets under management (AUM) are controlled by authoritarian governments or hybrid regimes, with only 27% of the total being controlled by funds in democracies (see Figure 2). Of the SWF total assets, a third is controlled by autocratic regimes in the Middle East and 20% by China.

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[4]See Hoyos (2007).

[5]In some cases, such as that of the United Arab Emirates, funds attached to sub-national governments have decision rights comparable to those of a sovereign authority. However, we do not believe that sub-national governments in North America possess these decision rights, so funds such as those in Alaska and Alberta have been excluded.

Table 1. Global sovereign wealth funds, 2011[6]

Country/ Sub-National Affiliation	Fund Name	Assets Under Management (USD bn)	Founding date	Regime Type
Australia	Future Fund	80.6	2006	Full Democracy
Azerbaijan	State Oil Fund of Azerbaijan (SOFAZ)	30.4	1999	Authoritarian
Bahrain	Mumtalakat Holding Company	13.7	2006	Authoritarian
Brunei	Brunei Investment Agency	39.3	1983	Authoritarian
China	China Investment Corporation (CIC)	409.6	2007	Authoritarian
China	National Social Security Fund (NSSF)	132	2000	Authoritarian
Republic of Ireland	National Pension Reserve Fund (NPRF)	30.2	2001	Full Democracy
Kazakhstan	Kazakhstan National Fund	48.7	2000	Authoritarian
Kiribati	Revenue Equalization Reserve Fund	0.4	1956	N/A
Kuwait	Kuwait Investment Authority (KIA)	296	1953	Authoritarian
Libya	Libyan Investment Authority (LIA)	64.2	2006	Authoritarian
Malaysia	Khazanah Nasional Bhd	36.5	1993	Flawed Democracy
New Zealand	New Zealand Superannuation Fund	15.8	2001	Full Democracy
Norway	Government Pension Fund — Global (GPFG)	578.5	1990	Full Democracy
Oman	State General Reserve Fund	8.2	1980	Authoritarian
Oman	Oman Investment Fund	Unknown	2006	Authoritarian
Qatar	Qatar Investment Authority (QIA)	100	2005	Authoritarian

(*Continued*)

[6] Economist Intelligence Unit Democracy Index 2010.

Table 1. (*Continued*)

Country/ Sub-National Affiliation	Fund Name	Assets Under Management (USD bn)	Founding date	Regime Type
Republic of Korea	Korea Investment Corporation (KIC)	37.6	2006	Full Democracy
Russia	National Wealth Fund	28.3	2008	Hybrid Regime
São Tomé and Príncipe	National Oil Account	0.009	2004	N/A
Singapore	Government of Singapore Investment Corporation (GIC)	220	1981	Hybrid Regime
Singapore	Temasek Holdings	133	1974	Hybrid Regime
Timor-Leste	Petroleum Fund	8.3	2005	Flawed Democracy
U.A.E	Emirates Investment Authority	10	2007	Authoritarian
U.A.E/Abu Dhabi	Abu Dhabi Investment Authority (ADIA)	342	1976	Authoritarian
U.A.E/Abu Dhabi	Abu Dhabi Investment Council	10	2006	Authoritarian
U.A.E/Abu Dhabi	International Petroleum Investment Company (IPIC)	49.7	1984	Authoritarian
U.A.E/Abu Dhabi	Mubadala Development Company	27.6	2002	Authoritarian
U.A.E/Ras Al Khaimah	RAK Investment Authority (RAKIA)	2.0	2005	Authoritarian
Vietnam	State Capital Investment Corporation	0.6	2006	Authoritarian
Total		2,753.2		

Source: 2011 Preqin Sovereign Wealth Fund Review; Government Pension Fund — Second Quarter 2011; International Institute of Finance, *The Arab World in Transition: Assessing the Economic Impact: Regional Overview*, May 2, 2011; CIC Annual Report 2010; Kholaif and Fiona MacDonald, "Kuwait's Net Assets Increase to $296 Billion, Lawmaker Says," Bloomberg, June 7, 2011; US State Department, Bureau of Economic, Energy and Business Affairs, *2011 Investment Climate Statement — Singapore; Temasek Review 2010; "China's Social Security Fund to Expand Overseas Investment," People's Daily,* March 24, 2011*;* Russian Ministry of Finance Website, Future Fund Portfolio update, June 31, 2011; *Libyan Investment Authority Management Information Report; Asa Fitch, "IPIC Profits Down as Assets Hit $50bn," The National, May 17, 2011;* Kazakh Ministry of Finance Website; *Shifting to the Next Stage*, KIC Annual Report 2010; Khazanah Sixth Annual Review 2011; National Pensions Reserve Fund, *Quarterly Performance and Portfolio Update at June 30, 2011; Mubadala Development Company PJSC 2010 Full Year Results March 24, 2010*; Azeri Ministry of Finance Website; New Zealand Superannuation Fund, Performance and Portfolio Update to June 30, 2011; Bahrain Mumtalakat Holding Company Consolidated statement of Financial Position 2010; Petroleum Fund of Timor-Leste Quarterly Report, June 2011; State Capital Investment Corporation website.

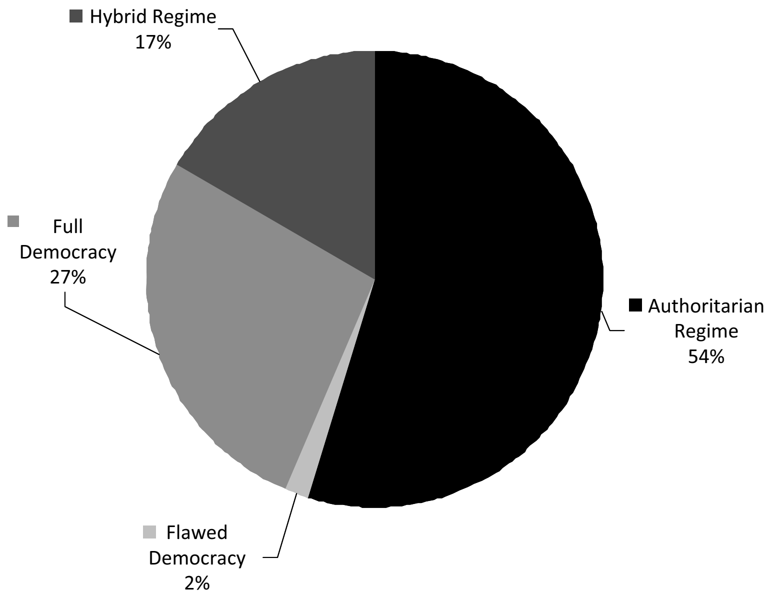

Fig 2. Share of SWF assets under management by type of political regime, 2010
Source: Sovereign Investment Lab, 2010 EIU Democracv Index.

Non-democratic SWFs have also dominated the investment flows since the start of the pre-crisis boom of 2006. Whereas the funds from Singapore [a "hybrid regime," according to the Economist Intelligence Unit (EIU)] dominated SWF investment until the mid-2000s — accounting for nearly 90% of total SWF investment in 2000 — by 2006, authoritarian funds accounted for nearly half of all investment value, and in 2007 more than three-quarters of all investments (see Figure 3).

Those investment flows do not take account of Norway's GPFG as noted elsewhere (Bortolotti and Miracky, 2010), we struggle to track the investments of the GPFG because they are usually undertaken through open market purchases that rarely rise above regulatory reporting limits, or through asset managers. As a result, the flow figures are slightly skewed, but are instructive as an indicator of just how much authoritarian governments' SWFs have risen in importance in recent years.

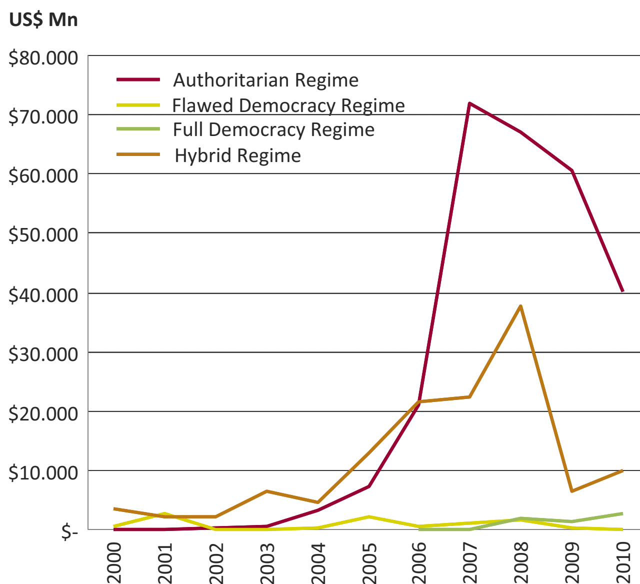

Fig 3. SWF investment flows by political regime, 2000–2010

Source: Sovereign Investment Lab.

This point is also underlined by the fact that authoritarian countries' international reserves have increased rapidly since the mid-2000s, both absolutely and as a proportion of global foreign exchange reserves. They now account for a larger proportion of reserves than any other political regime (35% of total global reserves in June 2010, up from 12.9% in January 2000). This growth has been driven by rising oil and gas prices, the reserves of which are concentrated in the authoritarian regimes of the Middle East, and the rising trade surpluses of China and Singapore (see Figure 4).

3. SWF Investment and Political Risk

Since SWF investment first came to the public notice during the mid-2000s, fears have been raised in developed countries that the autocratic government owners of SWFs would seek to use them as

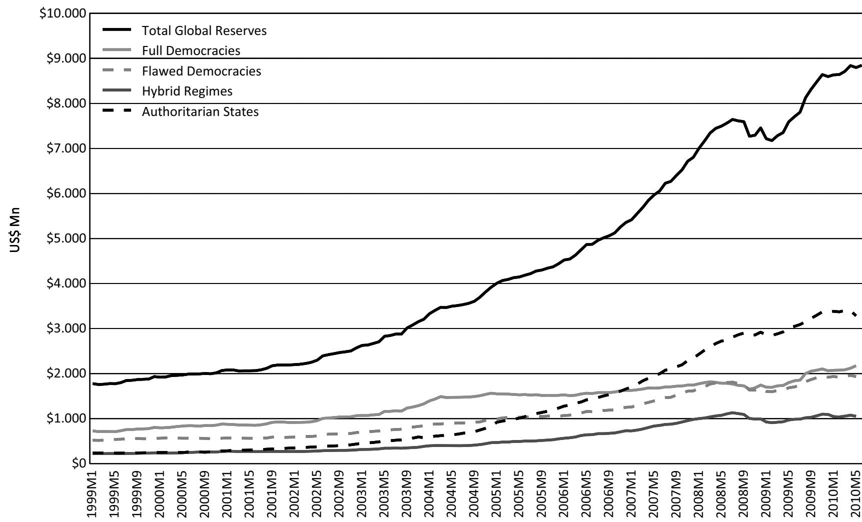

Fig 4. Global international reserves by political regime, 2000–2010

Source: International Monetary Fund, International Finance Statistics Database, EIU Democracy Index 2010.

a political tool, purchasing strategically important assets to undermine the economies of the West. However, there is little evidence to support the suspicion that SWF investment is driven by non-commercial or strategic objectives. Indeed, our data suggest that authoritarian governments actually shy away from investing abroad in politically sensitive sectors.

As shown in Figure 5, of all the foreign investments by SWFs with authoritarian government owners only 2% occurred in sectors that might be considered to have strictly national security implications — telecoms, aerospace and defence. If we take a broader view and include economically strategic sectors such as national resources and utilities, we end up with a total share of 22%.

One might claim that this conclusion is drawn from a partial picture based on limited knowledge of SWF activity, and that a significant part of relevant deals might be executed out of the public eye by asset managers, under the radar screens of the financial media and international research community. However, with a few notable

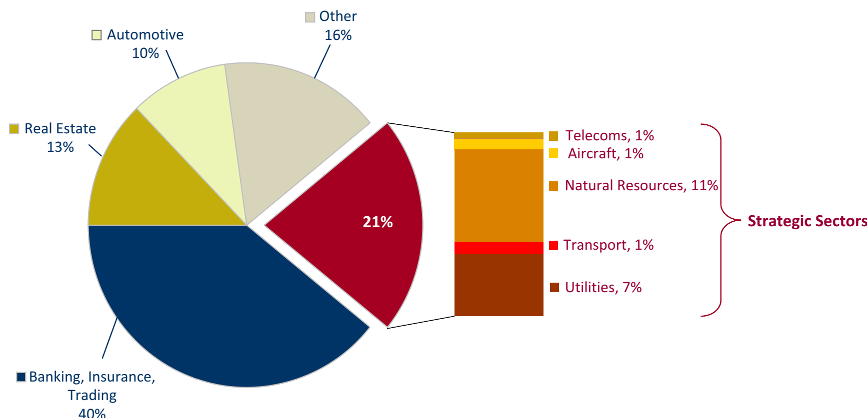

Fig 5. SWF foreign investment from authoritarian regimes by sector, 1985–2010

Source: Sovereign Investment Lab.

exceptions, international investments made by SWFs over the last decade have not been severely questioned, but rather welcomed by recipient countries. This suggests that the protection of strategic interests is not a fundamental problem raised by SWF investment.

These data provide a quite reassuring picture for Western politicians. SWF seem to pursue commercial objectives when they invest abroad. Nevertheless, what are the economic implications of SWF investment for target firms?

Several competing arguments can be made to explain why an SWF acquisition could influence the performance of the investee company. First, SWFs tend to be large investors with significant ownership positions that enable them to play an active monitoring role in management, reducing agency costs and managerial slack. Second, as liquidity providers of last resort, SWFs may alleviate financial constraints in distressed companies. Third, as the ultimate owner of the SWF, the government can provide business opportunities for the investee company in their country, such as contracts, licenses, market access, etc. Fourth, the SWF could also operate with non-commercial objectives against the investee company by channelling corporate resources and technologies for the benefit of its home country. Given

the presence of several competing explanations, the issue can only be settled empirically by looking at the performance patterns of targets around the dates of SWF investment.

Bortolotti *et al*. (2010) conducted an event study based on 802 transactions executed in the May 1985 — November 2009 period by 18 of the largest and internationally active SWFs. They conclude that the long-term performance of target firms during the three years after the acquisition is, on average, negative. The results are obtained by using the abnormal stock returns and accounting metrics such as return on equity (ROE) with respect to a control sample of listed firms from the same country and sector and comparable in size. The estimated post-acquisition performance is indeed poor: over a three-year period, the stock price of targets of SWF lost on average 11% against a control sample of similar targets and similar results were obtained using ROE (see Figure 6).

Caution is always needed when interpreting results from empirical tests. As we pointed out in Section 2, SWFs are heterogeneous in terms of structure, behavior and strategies so we cannot

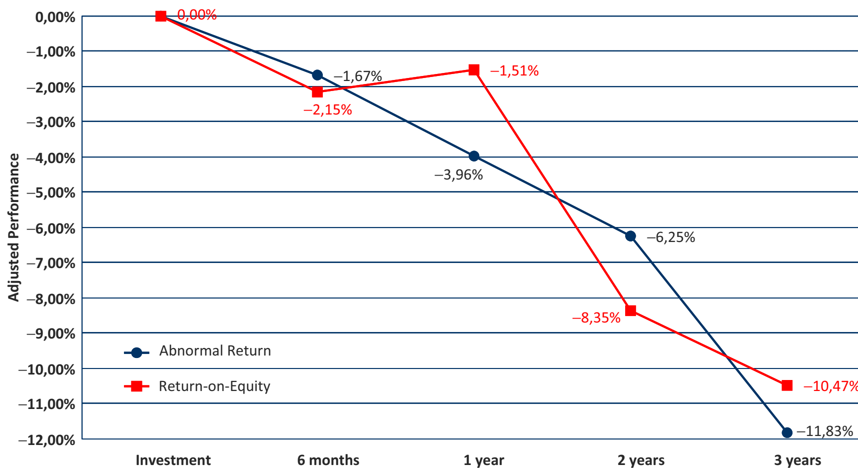

Fig 6. The financial performance of SWF targets

Source: Bortolotti *et al*. (2010).

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conclude that all SWF investments are "bad news" for a target firm. However, the fact that average performance worsens over time warrants explanations and questions the empirical validity of most of the theoretical arguments that suggest SWF investment should have a positive effect on performance.

Political risk is one possible explanation for this poor performance, which is seldom taken into account in the academic literature and in the wider debate. As we have seen, the overwhelming majority of SWFs originate from undemocratic countries and authoritarian regimes. With the exception of Norway, the countries endowed with large SWFs are characterized by the lack of political legitimacy of their regimes and the weakness of institutions granting an orderly succession of power. More importantly, the socio-economic indicators of most countries alert us to mounting tensions and likelihood of conflict that could ignite turmoil and rebellion against the incumbent rulers and regimes.

This trend is clearly visible in the data. Table 2 reports the value of the EIU Index of Political Instability, an attempt to predict where trouble across the world is most likely to arise by applying a subjective weighting to factors such as the length of time the leader had been in power, per capita GDP, the extent of democracy, adult literacy rate and internet penetration. We have constructed the index for the countries with an operating SWF for 2010. Countries with an SWF display a considerable likelihood of unrest, even if the variability is quite high. The index, which ranges from 0 to 10, takes the value 2.3 for Norway (one of the soundest democracies around the world) to 8.06 in the case of Libya, actually torn by civil war. According to our data, Oman, Bahrain and, interestingly, China display high likelihood of unrest.

We believe that the political risk in most SWF countries could affect the risk and return properties of the investee company through two main channels: upheaval risk, transforming the country's wealth management; and geopolitical risk triggered by targeted sanctions.

As to upheaval risk, in the event of incipient political unrest, sovereign owners of SWFs may choose to divert their surplus away from saving for future generations, toward meeting the welfare

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Table 2. The EIU index of political instability 2009–2010

	% of Population Under 25		Gov't Years in Power		Corruption Index		Democracy Index		Censorship Index		GDP per Capita ppp		Illiteracy Rates		Internet Penetration Rate		
Country	%	share	yrs	share	indexval	share	indexval	share	indexval	share	value	share	%	share	%	share	Tot.
Norway	31,90	0,81	n/a	—	6,80	0,09	—	—	—	—	52.013	0,18	—	—	94,80	1,25	2,33
Singapore	29,80	0,76	6,00	0,18	—	—	51,90	0,65	79,50	1,00	56.522	0,17	5,60	0,45	77,80	1,03	4,24
Malaysia	47,80	1,23	n/a	—	38,30	0,48	44,90	0,56	73,40	0,91	14.670	0,64	8,10	0,65	64,60	0,85	5,32
China	36,80	0,94	7,00	0,21	53,40	0,66	86,00	1,08	94,20	1,17	7.519	1,25	6,70	0,54	34,40	0,45	6,30
Korea	29,80	0,76	n/a	—	26,70	0,34	12,70	0,16	34,90	0,44	29.836	0,31	—	—	81,10	1,07	3,08
Bahrain	35,00	0,89	12,00	0,36	32,80	0,41	77,20	0,96	79,60	1,00	26.852	0,35	11,20	0,90	88,80	1,17	6,04
Libya	49,00	1,25	42,00	1,25	100,00	1,25	100,00	1,25	100,00	1,25	13.805	0,68	13,20	1,06	5,50	0,07	8,06
Oman	49,00	1,25	41,00	1,20	28,00	0,35	90,50	1,13	79,60	1,00	25.439	0,37	15,60	1,25	41,70	0,55	7,10
Qatar	28,00	0,71	16,00	0,48	13,00	0,16	86,00	1,00	76,00	0,95	88.559	0,11	6,90	0,56	60,90	0,79	4,76
Kuwait	37,00	0,94	5,00	0,15	37,00	0,46	72,10	0,90	60,00	0,75	37.849	0,25	5,50	0,48	39,40	0,52	4,45
UAE	34,00	0,87	7,00	0,21	19,00	0,24	93,60	1,17	79,60	1,00	56.580	0,17	10,00	0,80	75,90	1,00	5,46

needs of the population and "buying" peace and social cohesion. As documented by Waki (2011), several countries in the MENA region are now launching large spending plans including unemployment benefits, affordable family housing, and other forms of support to lower income-earners. Saudi Arabia alone unveiled benefits worth US$130 billion, and UAE, Kuwait, Bahrain, and Oman are implementing fiscal packages totalling US$8 billion. Such a shift in wealth management will obviously affect the management and strategies of SWF, focusing their new investments on the domestic economy, or even divesting their holdings abroad if the fiscal condition of the country deteriorates.

We have already seen this happen in Kuwait during the financial crisis. As the price of oil plummeted in the second half of 2008, the Kuwait Stock Exchange lost nearly 50% of its value as foreign capital took flight, unemployment rose and there was popular dissatisfaction with the government and Kuwait's SWF, the Kuwait Investment Authority, which was hemorrhaging losses on its US$5 billion investments in Citigroup and Merrill Lynch. In an unprecedented move, the Kuwaiti parliament turned to KIA to shore up the economy, particularly the overleveraged financial sector. Rather than reviving the economy by delivering government funds directly to citizens, or by increasing infrastructure spending, the government obliged KIA to withdraw US$3.6 billion from its foreign portfolio to establish a fund to invest in the struggling local bourse. This crisis also shifted KIA's focus; whereas previously it had diverted its cash abroad, since 2008, the fund has looked to support the local economy through direct investments in Kuwaiti companies and the healthcare system. Symbolically, it also divested its controversial stake in Citigroup at a small profit at the end of December 2009.

If such a trend was to be replicated across the MENA region, we might observe an aggregate reduction in SWF demand for global shares, and at the company level an increase in divestitures, causing a reduction in share prices and stock overhang.

As to geopolitical risk, if the tensions revealed by the index reached a critical level igniting revolts, rebellions and civil war as happened in Libya, Yemen and Syria, concerns that SWFs' financial

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resources could be used by the challenged authoritarian regimes to suppress the political opposition may motivate the use of targeted sanctions involving for example, the freeze of SWF assets.

Again, Libya is a case in point. On March 17, 2011, in resolution 1973, the Security Council of United Nations imposed *inter alia* an asset freeze on assets owned by the Libyan authorities. The Council of the European Union officially endorsed the resolution, and it was implemented by most member states. The asset freeze caused tensions in listed companies in the LIA's portfolio, including bellwether stocks such as Unicredit, a large Italian bank, Pearson, the owner of the *Financial Times*, and Finmeccanica, the Italian aerospace and defence company.

Companies in the portfolio of a SWF originating from an undemocratic country are thus exposed to this upheaval and geopolitical risk, and this could increase volatility, causing higher expected returns and generally a higher cost of capital in the investee company. Obviously, the degree of exposure will depend on the size of the stake. While portfolio diversification is often a stated objective in SWF strategies, it is widely documented that SWFs tend to acquire large direct ownership positions in listed companies. The average and median direct stake acquired in foreign SWF deals is 19.9%, and 4.9%, respectively. According to our calculations based on the reported deals from 1985 to 2010, the total value of stakes taken by SWF from undemocratic countries in foreign listed firms is US$295 billion in real terms. This certainly underestimates the actual value of assets under management, but provides an illustrative picture of the economic relevance of the assets exposed to the political risk described above.

Although we are focusing here on the political risk for those companies and nations receiving SWF investment, it is important to make a case for political risk on the other side of the equation. The potential for the imposition of sanctions and other restrictions on SWF investments has implications for their government owners. Leaders from autocratic countries often (but not always) take the opposite point of view from many recipient countries in the West on the necessity for improving the political representation of

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the people. There is, therefore, a risk that if a fate similar to that of Libya or Syria befalls their country and sanctions are imposed, they will not have the ability to call on the financial assets that they require to reassert their authority. Consequently, when they make an investment, SWFs should consider the political position of the recipient country, its tolerance for what could be considered "repressive action" or "human rights abuses," and the likelihood that it might impose unilateral sanctions on a regime for acting in that manner. As the potential for the Arab Spring spreading increases, this political risk for undemocratic SWF-owning nations thus becomes greater.

In broader terms, the mounting social and political instability in the Arab world, is contributing to a change in the fundamental nature and behavior of global SWF. This metamorphosis involves the partial loss of SWFs' status as patient, long-term investors, providing capital and liquidity across business cycles, turning them into financial players with shorter-term horizons, unpredictable liquidity needs, and carrying political risk. We have begun to see this trend in some cases like China where the China Investment Corporation has reportedly been advised to improve its short-term returns. This seems to have an effect on the funds' investment strategies, with CIC looking toward "a major change to its investment practices" to focus on private equity, real estate and other alternatives, while the State Oil Fund of the Republic of Azerbaijan has recently announced that it is focusing on medium-term investments and wants to start investing in overseas property.

To test the hypothesis that the political risk associated with an SWF investment negatively affects financial performance of investee companies, we have conducted a preliminary analysis on the possible effect of political risk on the financial performance of SWF targets after the acquisition. We measure performance using the conventional buy-and-hold abnormal return over different time horizons (6 months, 1, 2 and 3 years) and regress it against the EIU index of unrest described above, controlling for a several other possible factors. Results are presented in Table 3. As expected, political

Table 3. Explaining stock returns of SWF targets: The role of political risk

Variable: Buy and Hold Adjusted Returns	1 Year from Investment	2 Years from Investment
Political Unrest Index	–0.31309864	–0.32604307
	0.0284	0.0747
Govt Involvement	0.05410613	–1.4061047
	0.9327	0.3018
SWF passivity	–0.19614493	–0.50469912
	0.2138	0.1473
Strategic Target Dummy	0.020129	0.04296757
	0.7333	0.7322
SWF Age	–0.01018229	–0.07029254
	0.6413	0.1436
Capital Infusion	–0.62466721	1.9326637
	0.7566	0.4157
SWF Stake	0.21320963	–0.8246279
	0.8604	0.1488
Forign Target Dummy	–0.62759119	–1.1820403
	0.0000	0.0000
Target Market Value	–3.622e-06	–0.00001155
	0.3285	0.0173
Target Leverage	0.10698612	–0.23162654
	0.4606	0.2909
Target Liquidity	0.01115337	–0.00152727
	0.2823	0.9656
SWF in the board	0.13625312	0.04482498
	0.2150	0.7342
Buy and Hold Returns (previous year)	–0.05082958	–0.05358762
	0.0090	0.0104
Constant	19.691.506	4.4301511
	0.0237	0.0119
Number of Obs R2	293	144
	0.04359465	0.22252844

This table reports the results of OLS regressions where the dependent variable is the local market index-adjusted abnormal return over the one and two year periods after the acquisition by a SWF, respectively. *t*-values are reported below the estimated coefficients.

risk is negatively associated with financial performance, and this relation is particularly strong and statistically significant over the 1 and 2 year period post-acquisition. This evidence is broadly consistent with our story: rational investors tend to discount country risk in the pricing of securities acquired by SWFs.

Mounting social and political tensions in emerging countries spill over in global financial markets, and a crucial disturbing factor is the metamorphosis of SWF.

4. Pecunia Non Olet? Market Failure Considerations

Now we beg a fundamental question: should the international financial and political community be concerned about the economic consequences of this potential shift in nature and behavior of SWFs? Are there market failure considerations at stake suggesting the desirability of some form of policy action? Can we expect that the markets will spontaneously adjust to the new risk environment and converge to a better equilibrium?

In a perfect world of rational investors and governments, companies and recipient countries would realize that SWFs carry political risk that can negatively affect performance and may decide to oppose SWFs if the directors perceive the costs of this investment exceed the benefits. Financially distressed companies or firms with high growth opportunities, but lacking capital may opt for having SWF as major shareholder at their own risk, so that in equilibrium there will be some SWF investment, even at a slower pace.

On the other side, SWFs' government owners may realize that the lack of representative government and underlying socio-political tensions contributes to raising barriers to international capital flows, and will seek to improve their political legitimacy at home to assuage protestors, financial markets and the international political community. If this were the case, democracy and global financial integration would go hand in hand and flourish in the long run.

But in reality, the transition to this equilibrium is littered with stumbling blocks. A democratic transition triggered by this "boycott" by Western democracies of SWF investment may be a long process, and during the transition, social turmoil may escalate to disruptive revolts and civil wars, with high economic and humanitarian costs. Furthermore, declining SWF investment abroad may substantially limit investment opportunities in the recipient countries, so that large capital projects would not be undertaken despite a high net present value. At the aggregate level, the contraction of SWF activity would entail a lack of diversification and an excessive accumulation of foreign reserves in surplus countries, causing inflationary and exchange rate pressures, which may have major implications for their economic development.

At a more fundamental level, social and political stability and the advancement of democracy in emerging and less-developed countries is a global public good, which is unlikely to be provided by the market system alone. In our context, at the company level, the immediate benefit of the cash injection from an SWF with an autocratic owner will outweigh any potential risk that they might bring — after all SWFs usually take a minority position. Consequently, there will not be enough "market sanctioning" from targets to trigger a genuine democratic transition abroad. In a decentralized system, too many foreign acquisitions with SWFs managed by authoritarian, undemocratic regimes will be cleared and executed, causing an overall increase in the international cost of capital due to higher political risk, with mounting tensions and upheavals a defining and persistent feature of the political climate of emerging countries, as vividly illustrated by recent events in the MENA region.

The classical coordination failure in the provision of public goods may thus provide a rationale for a specific regulatory framework of SWF investment. Before setting forth some proposals, it is important to review the international regulatory framework for overseas investment, with special reference to SWFs.

5. The Current Regulatory Setting on Foreign Sovereign Investment: A Sketch From a US and European Perspective

After a long wave of liberalization of international financial flows and global financial integration, in the mid-2000s, major Western economies with the higher share of incoming FDI started to pass legislation to restrict foreign investment or to grant powers to national governments that require foreign investment to be authorized to protect national security and strategic sectors. This coincided with a period of high political tension around the surge in sovereign investment by state-sponsored entities, including SWFs, from autocratic developing countries, which many politicians feared would be used to undermine Western economies. This is a possible reason why UNCTAD recorded the highest number of restrictive measures on FDI in 2006 (Quadrio Curzio and Miceli, 2010).

However, the history of strategic interests being legally protected from potential compromise by foreign investment dates back to the 1950 US Defence Production Act at the start the Korean War in June 1950. The law prefigured the establishment of the Committee of Foreign Investment in the United States (CFIUS), which started to operate in 1975 with the mission to assess the impact of foreign investment on national security. In 1988, with the Exon-Florio amendment, Congress granted the President the power to veto acquisitions affecting the national security. After the controversial attempted acquisitions of Unocal, a large US oil company, by the Chinese National Offshore Oil Corporation, and of P&O management of several American ports by Dubai Ports World, in 2007 the US passed the Foreign Investment and National Security Act, substituting the Exon-Florio amendment and extending CFIUS' powers and competencies. The CFIUS can start a review process in case of a foreign merger, acquisition, or takeover involving a change in control jeopardizing national security. Interestingly, formal clearance by CFIUS is mandatory in case of a state-sponsored entity, such as a SWF. Between 2008 and 2010, CFIUS received 313 notifications, issued more than 20 mitigation or

"national security" undertakings, but never recommended the President block any deal.

Free movement of capital is one of the cornerstones of the single market enshrined in the Treaty of Rome establishing the EU. Some articles allow for exceptions both at the EU level and at the member-state level for reasons of protection of national economic security and strategic interests and several countries have enacted restrictive measures, in most cases sanctioned by the European Court of Justice, more favorable to a restrictive interpretation of the principle of free movement of capital.

Yet there are still legal barriers to foreign investment in most European countries. For example, in 2005, the French government issued a decree establishing a process of authorization for foreign investors (even from the EU) seeking to undertake acquisitions in 11 strategic sectors, which is under scrutiny by the EU. Importantly, in November 2008, the French government established its own state-owned development fund, the Fond d'Investissement Stratégique, with an initial capital of €20 billion, with the aim of investing in SMEs and in French national champions to protect strategic firms from foreign hostile takeovers. In 2008, the Federal Government of Germany passed legislation establishing that every investment in German companies involving the acquisition of 25% of capital by a non-EU investor would be subject to investigation by the Ministry of the Economy. The German development institution, KfW, which was established in 1948, is historically a strategic investor in the largest German companies.

Thanks to the openness of its financial markets and a *laissez faire* attitude, the UK has historically attracted a substantial flow of foreign investment and qualified as one of the major global financial hubs. Indeed, a favorable regulatory environment has attracted capital, while protection of strategic interested has been warranted by the 2002 Enterprise Act, granting the government the right to block foreign acquisitions against the public interest and national security. Another important institutional mechanism put in place for this purpose is the "golden share," initially proposed by the Thatcher government 1988 and then adopted by

governments around the world. This practice issues a special share with nominal value of £1, granting special rights to the government including the power to veto acquisitions on strategic interest. Curiously, the "golden share" was set up right after a controversial acquisition by a SWF. By early 1988, the Kuwait Investment Office (the British branch of the Kuwait Investment Authority) began building a stake in BP that in a few months amounted to 21.7% of the company's share capital. The possibility that a foreign shareholder might gain control of the company raised alarms in the British establishment. After an investigation by the Monopolies and Mergers Commission, the government endorsed its findings that KIO could operate against the public interest. The KIO was then required to reduce its stake to no more than 9.9%. In 1989, BP purchased (at three times the price) and then cancelled KIO's shares.

Italy's approach toward foreign investors, even if a golden share mechanism is in place for the largest privatised companies such as Eni, Enel, Finmeccanica, Telecom Italia, and Alitalia, has been questioned. In 2001, the government passed a legislative decree freezing the voting rights of foreign shareholders in the aftermath of a wave of foreign acquisitions in the energy sector. In 2004, the European Court of Justice condemned Italy for violating principles of the Treaty with this law.

This is a cursory glance at the international regulation on FDI; yet even this shows that there are no specific regulations concerning SWFs in many major markets. At the EU level, the existing laws have been considered a suitable tool to maintain free movement of capital while preserving legitimate national interests and public security.

However, in an attempt to avoid adopting multiple and uncoordinated regulations that could interfere with the functioning of the internal market and hinder SWF investment, the European Commission issued a memorandum entitled "A common European approach to Sovereign Wealth Funds" in February 2008. The document invites European governments to maintain an open environment and avoid protectionist backlash and

recommends SWFs implement good principles of governance and transparency.

This effort was complemented by the OECD's Committee of Foreign Investment, which, in April 2008, issued "Sovereign Wealth Funds and Recipient Countries Policies." The premise of the report is that SWFs can make a constructive contribution to the economic development of home and host countries, and acknowledging that, to date, they have been reliable, long-term, commercially driven investors and a force for global financial stability. However, the report recognizes that if SWF investments were motivated by political rather than commercial objectives, they could be a source of concern, and that legitimate national security concerns could arise. Against this background of benefits and risks, the OECD's statements welcome international discussions involving SWFs, their governments and recipient governments helping to avoid protectionist responses that could undermine economic growth and development.

The OECD report invites recipient countries to resist protectionism and discrimination against foreign investors. That said, whenever national security concerns arise, recipient countries should impose accountable, transparent and predictable safeguards that are proportional to the risk identified. However, these guidelines are purely voluntary, and only applicable to OECD members.

That said, it is not just recipient governments that are concerned with maintaining the free flow of capital, it is also in the interest of SWFs themselves. Many SWFs have the mandate to diversify their funds out of the home country and thus require an environment with minimal restrictions or other limitations that would distort investment regimes and affect free flow of capital across borders. Indeed, this issue is the focus of the International Forum of Sovereign Wealth Funds, which comprises representatives of 23 governments, the OECD, the World Bank, and the European Commission as permanent observers. The International Forum was established in 2008 as the International Working Group of Sovereign Wealth Funds with the aim of drawing up a

non-binding code of conduct for SWFs, which was finally approved in Santiago on October 2008 in the form of 24 principles (Generally Accepted Principles and Practices, or the "Santiago Principles").

According to the official statements, the purpose of the Santiago Principles is "to identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis." The Principles cover some key areas, including the legal framework, coordination with macro policies, governance, the distribution of roles and duties with government, reporting, investment strategies and risk management. The overarching objective is the quest for transparency on mission and operations. It is important to remark that the Santiago Principles, undersigned by the largest global SWFs, are purely voluntary and do not entail any legal obligation, even if they represent the most significant effort to draft collectively voluntarily Principles. By providing such guidelines, the SWF community sought to allay fears to political interference in SWF investments, and to facilitate the wider community's understanding of the nature of SWFs. The hoped for corollary was that markets would remain open to SWF investment, and the uninhibited international flow of capital maintained.

Neither the OECD guidelines nor the Santiago Principles are enforced by any powers or sanctions; consequently, doubt arises that such a multilateral framework based on goodwill will not work effectively. More importantly from our perspective, the existing regulatory framework is almost targeted on the protection of strategic interests in recipient countries, with a strong quest for increased transparency by SWFs. In this respect, it fails entirely to address concerns related to political risks underpinning market failure considerations or the fact that it is in SWFs' own interests to help recipient countries understand and mitigate these issues to avoid misrepresentation or hindrance to the free flow of capital. In the next section, we will try to advance some tentative suggestions to tackle the issue.

6. Toward a "Smart" Regulatory Framework for SWF Investment

Our previous arguments suggest that there is scope to create a regulatory framework for SWF investment on the basis of the political risk they may transfer to the investee company and the negative spillovers this may generate in global financial markets. However, any policymaking effort in this space faces a fundamental problem of effectiveness and legitimacy: on the one hand, it should aim to protect firms from perilous investment but on the other, it should encourage the SWF originating country to implement political reforms and to foster economic and social progress. We thus face a problem of global governance with deep economic, financial, and political implications, to be addressed in a context where national policies interact with international legislation. Given the intrinsic complexity of the issue, the approaches we suggest are intended to open a discussion rather than provide definite recommendations and should be judged as such.

To the best of our knowledge, the only type of regulation currently in place is the regime of targeted sanctions which are executed by international organizations such as the United Nations against the political élite of a country involved in illegitimate activities at home by freezing the assets of SWFs or other sovereign investment vehicles, as is currently the case for Libya. However, these measures are retrospective as they are only implemented after acquisitions have been completed and only in extreme circumstances, such as when a political crisis degenerates into rebellion, repression and civil war. As such, sanctions are not particularly effective in preventing and mitigating *ex ante* the political risks, which are the focus of this analysis.

We thus provide a tentative series of measures at the national and international level to complement the existing regime toward a more effective protection of legitimate interests in recipient countries while creating incentives for political and social progress abroad.

A central tenet of creating any policy framework for SWF investment must be to obtain the agreement of both recipient

governments and SWFs. Imposing rules on SWFs from the outside without their involvement can only lead to an ill-fitting set of regulations based on imperfect information that may exacerbate the problem it seeks to address and create resentment amongst a significant group of institutional investors. In contrast, by collaborating in the creation of such a framework, it can be perceived to be beneficial to both investors and recipients by improving and strengthening relationships between them to allay fears and lubricate the international flow of capital.

However, creating a policy framework in this space clearly requires SWFs to understand that investment by some of them does indeed carry political risk to other nations, which requires those regimes to make a sanguine assessment of their political position and a recognition of the need (economic or otherwise) to consider implementing political reform. On the recipient side, there needs to be an acceptance of the political realities surrounding authoritarian governments, and a realisation that any change in position will be evolutionary.

We do not believe that it is either necessary or desirable for recipient countries with significant potential inflows of SWF investment to adopt a restrictive approach to face political risk. A CFIUS-style preventive mechanism, requiring a mandatory clearance of SWF acquisitions of the basis of a case-by-case review of countries' political outlook would create a significant barrier to SWF activity and restrict international capital flows. It would also provide incentives to regulatory arbitrage in favor of countries with a friendlier regulatory framework. In the absence of any coordination mechanism, the most likely outcome is a race to the bottom by recipient countries without any significant improvements in investing countries.

A more appealing alternative may be the self-regulation of political risk at the national level by amending the code of conduct of stock exchanges, requiring listed companies themselves to disclose as a specific risk factor the presence of SWF or other state-owned investor among the shareholders of the firm. Disclosure of

this information could become a best practice of corporate reporting in annual reports and prospectuses.[7]

It may also be appropriate that this issue be recognized within existing frameworks, such as the Santiago Principles. An addition to these could provide non-binding, non-coercive norms of conduct qualifying as a self-regulatory framework for political risk. A GAPP 25 could be added to existing Santiago Principles and could read as follows:

> While members consider being in the mutual interests of recipient countries and sovereign investors to maintain free movement of capital, they also realize that social inequality and political instability in the investing country represent critical risk factors in the international allocation of capital. Upon these considerations, members agree that sovereign investment abroad will be associated with commitments to foster economic prosperity, social progress and political reforms in the investing country.

While the letter of the statement could vary according to the concrete actions that could be negotiated and agreed upon, the main consequence from this solution would be a public recognition of the problem at stake, and reputation loss whenever major upheavals take place in a SWF country. However, as the adherence to the principle is only voluntary and not associated with any formal enforcement mechanism, potential widespread "free riding" would limit the practical effectiveness these rules — i.e., funds may claim to adhere to the rules without actually doing so.

The fundamental drawback of national regulation of SWF investment (creating multiple and uncoordinated regulations that impede the flow of capital) and the lack of effectiveness of

[7] In a similar vein, prospectuses of public offerings by state-owned firms often report detailed information about ownership and control rights retained by governments as possible risk factors in that significant government ownership may affect corporate decision-making.

non-binding principles could be overcome by charging a recognised international organization to set common rules and enforce them at the multilateral level. There are a number of candidate institutions, many of which would meet firm opposition from some stakeholders. However, an organization that has a role to foster monetary and financial stability and international cooperation, like the Bank for International Settlements, may be a potential candidate. Whichever institution is appointed, it would be supported by other institutions such as the IMF, the WTO, the OECD as well as the International Forum for Sovereign Wealth Funds itself. A Sovereign Investment Office could be established, with the mandate to impartially evaluate and monitor the political risk profiles of countries endowed with SWFs or other sovereign investment vehicles, with assistance of qualified research institutions and NGOs. On the basis of the reported assessments, the Office could publish a list of "politically risk-neutral" SWFs with a blanket authorization to operate in global financial markets, or establish conditionality on investments based on case-by-case undertakings in the space of human rights, political freedom, constitutional reform and democratic transition. This organization could then provide guidance to recipient governments and companies as to the opportunities and risks certain investment vehicles carry and the issues they must consider when partnering with them or accepting their investment. On the other side, it could provide guidance to SWFs on the rules and help them comply.

In closing, we would like to stress that the main advantage of the suggested system is to provide a significant financial incentive for resource-rich countries to advance democracy at home, while keeping international financial markets open and competitive. While some sovereign investment will still take place undercover, an agreement to implement a SWF regulatory framework should be self-enforcing, given the significant benefits it could provide to advanced and emerging economies and its contribution to international security and peace.

7. Conclusions

It is clear that the current political environment in the MENA region has brought into sharp relief the importance of factoring in political risk into investment decisions surrounding SWFs and other state-owned investors from undemocratic countries. We do not believe, however, that this is an intractable problem or that it should be a reason not to accept investment from these countries. Rather, it is important for all sides to enter agreement with their eyes wide open and fully cognizant of the risks and opportunities that each investment engenders.

In an ideal world, SWFs and recipient countries would work together to create a single international framework through an impartial multilateral institution, which would facilitate understanding between investors and investees. That said, we understand that this solution is unlikely to be established in the near future. Yet, this is an issue that must be thought through today, as it has the potential to have damaging effects on the world economy particularly at a time when the economic future is uncertain. We thus urge recipient governments and countries to create strong relationships with SWF countries, to understand the opportunities and risks related to sovereign foreign investment and to factor these into their decision-making processes for the benefit of the global economy.

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