Taming Leviathan

Towards a Regulatory Framework for Sovereign Wealth Funds*

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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, government-driven international acquisitions reached US$120 billion, or 20% of the global M&A market. The bulk of this government-driven international investment originated in the Middle East and North Africa region (MENA) and Asia. Global SWFs today manage assets worth US$2,679 billion.

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 low-cost manufacturing to serve Western markets have generated large surpluses, which they have sought to invest outside their home markets to ease inflation, 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 taking over strategic companies of developed economies. SWFs were then quickly turned into the "White Knights of Wall Street" when the financial crisis started to hit hard; they invested just shy of US$63 billion in the American and European banking industries on the verge of default for the benefit of Western governments and the global financial system.

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The "Arab Spring" of 2011, the outbreak of war in Libya, and the subsequent freeze of Libyan state-owned assets, including those of Libya's SWF, the Libyan Investment Authority, has once more raised the question of the nature and legitimacy of government ownership of SWFs, given that the proceeds from their investments could be used to oppress their citizens. Public debate has once more focused on assessing the intentions and uses of SWFs and whether investments by SWFs with undemocratic government owners are beneficial or nefarious for hosting countries.

There is, however, no evidence to suggest that they have any intention of pursuing a political agenda abroad. Yet, it does not mean that they 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. And this may change the economics of SWFs.

THE DOUBLE BOTTOMLINE

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 strategies.

According to an established definition, a "sovereign wealth fund" is a specific form of investment vehicle that is owned directly by a sovereign government; is managed independently of other state financial institutions; does not have predominant explicit pension obligations; 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.

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 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 this definition.

According to the most recent estimates global SWF manage assets worth US$2,679. Using the Economist Intelligence Unit Democracy Index classification, the 72% of SWF AUM are controlled by authoritarian governments or hybrid regimes, with only 28% of the total being controlled by funds in democracies; a third are controlled by autocratic regimes in the Middle East and 17% by China.

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 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.

These state-owned funds act as many long-term, institutional investors, investing to fulfill 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 policy tools of the nation from which it comes. For the same reason, the fund inherits the political risks associated with the sovereign owner.

THE METAMORPHOSIS OF SOVEREIGN WEALTH FUNDS

It is not only the fact that the overwhelming majority of SWFs originate from undemocratic countries that is alarming. More importantly, the socio-economic indicators of most of these countries alert us about mounting tensions and likelihood of conflict which could ignite turmoil and rebellion against the incumbent rulers.

Enhanced 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 "encouraging" peace and social cohesion through handouts or meeting the welfare needs of the population. Indeed, 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 totaling 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.

This happened 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 popular dissatisfaction mounted against 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 all 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 were to be replicated across the MENA region, one might observe a slight aggregate reduction in the 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 reached a critical level igniting revolts, rebellions and civil war as happened in Libya, Yemen and Syria, concerns that SWFs' financial 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 SWFs' assets.

Again Libya is a case in point. On March 17, 2011 the Security Council of United Nations imposed *inter alia* an asset freeze on assets owned by the Libyan authorities in resolution 1973. 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 primary Italian bank, Siemens AG, the German largest conglomerate, and Pearson, the owner of the *Financial Times*.

The portfolio companies of the SWF originating from a politically unstable 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.

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 sovereign owners. Autocratic leaders 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 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. With contagion of political demonstration increasing across MENA, this political risk for undemocratic SWF-owning nations thus becomes greater.

In broader terms, the mounting social and political instability in MENA (which could spread eastwards), is contributing to a change in the fundamental nature and behavior of SWFs. This metamorphosis involves the partial loss of SWFs' status as patient, long-term investors, providing capital and liquidity across business cycles, and turning them into financial players with shorter-term horizons and unpredictable liquidity needs. This trend has already surfaced in 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 towards "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.

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

PECUNIA NON OLET? MARKET FAILURES 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 SWF? Are there market failure considerations at stake suggesting the desirability of some form of policy action, or can we expect that the markets will spontaneously adjust to the new risk environment and converge to a better equilibrium?

If companies and recipient countries realize that SWFs carry political risk that negatively affects performance, they may decide to thwart SWFs if they 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 lower pace.

On the other side, SWFs' government owners may understand that a lack of representative government and underlying socio-political tensions contributes to raising barriers to international capital flows, and could seek to improve their political legitimacy at home to assuage protestors, financial markets and the international political community. In such a perfect world of rational investors and far-sighted governments, democracy and global financial integration will go hand in hand and flourish in the long run.

In reality, the transition to this equilibrium can be 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 implications for their economic development.

At a more fundamental level, social and political stability and democratic transition in emerging and less-developed countries is a global public good which is unlikely to be provided by a decentralized market-based system alone. At the investee company level, the financial benefit from improved political risk in terms of cost of capital is limited by the equity stake the company acquired by the SWF and obviously smaller than the overall social and economic benefit the country would garner. The management, while evaluating an acquisition of the company's stock by an undemocratic SWF, will tend to disregard this larger benefit, and to choose rationally to close the deal with the SWF in spite of the marginal increase in the cost of capital induced by political risk. As a consequence, "market sanctioning" from targets will hardly reach the socially optimal level that would trigger a genuine democratic transition abroad.

In a decentralized system, too many foreign acquisitions with SWF managed by authoritarian 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.

A "SMART" REGULATION FOR SWFS

There might be scope to create a regulatory framework for SWF investment on the basis of 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 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 international legislation 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. 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 towards 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 international capital flows.

However, creating a policy framework in this space clearly requires SWFs to understand that investment by some of their number 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 realization 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 preventive mechanism along the lines of the Committee on Foreign Investment in the United States, 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 more lax 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 from undemocratic countries amongst the shareholders of the firm. Disclosure of this information could become a best practice of corporate reporting in annual reports and prospectuses.

It may also be appropriate that this issue be recognized within existing self-regulatory frameworks, such as the Santiago Principles established by 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 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") covering 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.

An addition to these principles could provide non-binding, non-coercive norms of conduct qualifying as a self-regulatory framework for political risk. A GAPP 25 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. Being the adherence to the principle only voluntary, widespread free riding would limit the practical effectiveness these rules.

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 non-binding principles could be overcome by charging a recognized international organization to set common rules and enforce them at the multilateral level. A number of international organizations such as the United Nations, the World Bank, the WTO, the OECD, the Gulf Cooperation Council, as well as the International Forum for Sovereign Wealth Funds itself and regional development banks. The organization could establish a Sovereign Investment Office, 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 a 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.

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 we expect that some sovereign investment will still take place away from the public gaze, 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.