

# Keeping Markets Open for Investment from Sovereign Wealth Funds

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Since the beginning of 2007, Sovereign Wealth Funds (SWFs) from emerging economies have invested more than US\$60 billion into sub-prime crisis-stricken financial sector institutions in the United States and Europe. Despite the funds' important contribution to financial market stability, many feel unease about their rapidly growing role as foreign investors. The concerns about SWFs fuel debates about how open our economies should be to investment from abroad, in particular when it is government sponsored. As a result, some countries are already applying tighter scrutiny to incoming investment. If others follow suit, this could inhibit foreign investment and deprive our economies of associated tangible benefits. The Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF) are playing a key role in developing policy guidance and best practices that help to keep our markets open for foreign investment, while simultaneously addressing legitimate concerns about SWFs and other state-sponsored investors.

## SWFs – what are they?

SWFs are government-owned investment funds. They are predominantly based on government revenues from oil and gas, earnings from foreign exchange transactions and fiscal budget surpluses. Governments have set up SWFs to pursue a variety of macroeconomic objectives. Some funds are there to help to mitigate the impact that volatility of important commodity markets may have on the home country. Some are tasked to manage wealth for future generations, and some are there to mobilize otherwise idle foreign exchange reserves. SWFs may pursue different strategies to achieve their objectives. What they typically have in common is that they are rather long-term oriented and relatively cautious investors with diversified portfolios. While most SWFs originate from emerging Asian economies that are strong industrial exporters, or from countries in the Middle East and Africa that are rich in oil and gas, some industrialised economies (Australia, Canada, Norway, Korea, and United States) are also home to SWFs.

## SWFs' strong growth...

SWFs have been around for decades. However, in recent years they mushroomed with assets under management and foreign investment increasing rapidly. Today, there are over 30 SWFs, 20 of which have been set up in the past eight years. Many are quite small, though the largest funds manage sizable assets. Abu Dhabi is the biggest with assets estimated to amount to US\$800 billion, followed by Norway (US\$390 billion), Singapore's Government Investment Corporation (US\$330 billion), Kuwait (US\$250 billion) and China (US\$200 billion).

Total assets under SWF management grew within a decade from several hundred billions of US\$ to an estimated US\$2-3 trillion. Today, SWF assets already exceed those of the global hedge funds but are still small in comparison with global financial assets (estimated at US\$190 trillion according to the IMF), pension funds, mutual funds and insurance assets. As SWFs have grown they have also become internationally more active. By some estimates, SWFs carried out over 120 cross-border deals in the past two years that were worth about US\$140 billion. 37 of these deals involved more than US\$1 billion.

## ... reflects global imbalances

Looking ahead, SWFs will likely rise further as their growth is driven by global macroeconomic imbalances. Over the past decade, the United States has been running current account deficits of 5% of GDP pa while a number of industrial goods and commodity exporting emerging economies have been accumulating considerable surpluses. As current account deficits must be financed by capital inflows and current account surpluses are matched by capital outflows, we have seen net capital outflows from emerging economies rising sharply. Between 2001 and 2007, they increased from zero to an estimated US\$740 billion says a recent Goldman Sachs report. With oil prices likely to remain high and exchange rates in

many emerging countries pegged to the dollar, many experts expect large global current account imbalances to persist. This situation will provide for further accumulation of foreign exchange that governments in emerging economies can transfer to their SWFs. According to the IMF, global SWF assets will surge to US\$6-10 trillion by 2013.

## SWFs bring benefits...

The countries that are home to the SWFs, as well as those that receive their investment stand to benefit from projected growth of the funds. At home, the SWFs perform useful functions through which they help to improve the risk-return profile for government assets. For countries that receive the SWFs' investment, significant opportunities emerge from the additional capital that our businesses need in order to thrive, boost investment and create jobs. Not only sub-prime crisis-stricken financial sector institutions have benefited greatly from capital injections by SWFs: a number of companies have had positive experiences with sovereign funds that have proven themselves to be reliable and long-term investors.

## ... but concerns have arisen

Despite the tangible benefits that SWFs offer to our economies, their rapid growth and cross-border activity has aroused unease. While some of the issues raised need to be addressed by appropriate policy frameworks in recipient countries as well as by the funds themselves, other concerns appear exaggerated or simply unjustified.

One often heard concern is that SWFs may destabilize financial markets. However, experience to date, as well as analyses by the IMF, OECD and others, suggests the contrary. While the bigger SWFs, like any other large institutional investors, may cause market disturbance particularly in shallower markets, it appears that up until now SWFs have actually acted as stabilizing forces. In the current financial situation, their significant capital injections have helped to stabilize the banking system and restore confidence in the global financial markets. Even beyond the current economic situation, it is hard to see why SWFs should pose any particular problem to financial stability. They are relatively cautious and long-term investors and they diversify their portfolios across countries and asset categories.

Another concern about SWFs is that they may acquire stakes in companies in order to influence business decisions that would serve the interests of their home country government. If this was the case, SWF investment in the defence and other sensitive sectors may even represent a risk to the recipient country's national security. While it is conceivable that an SWF may be tasked by its home government to pursue non-commercial objectives, history does not suggest that this has ever actually been the case. The European Commission, for example, says that in five decades of SWF activity in the internal market, the funds have never created any problems. Moreover, SWFs are acutely aware of the need for professional management and clear focus on commercial objectives, as these are critical for optimizing the risk-return profile for their respective governments' assets. It should also be added that the potential impact of SWFs on the decisions of companies is usually quite limited as the funds mostly invest in non-controlling minority stakes.

The third category of concerns about SWFs reflects doubts as to whether the funds apply sufficiently high standards of corporate governance that ensure a level playing field with private investors. Relevant issues include whether or not SWFs are separate from national regulators; have access to privileged information; are exempted from regulatory compliance; and whether there are checks and balances that ensure that the funds are run efficiently and in accordance with the stated objectives. The OECD looked at these key issues in a recent study in which it analysed the corporate governance arrangements of a number of large SWFs. The study shows that

several SWFs actually possess advanced corporate governance systems. Many are fully incorporated entities subject to corporate law with professional managements, corporate boards (including external directors), and independent auditing. However, the study also notes that some SWFs need to raise their game and become more transparent about their objectives, strategies and operations.

### **Policy responses in recipient countries**

Unease about foreign investment from SWFs and other state-controlled investors has contributed to governments' reassessments about their approaches towards investment from abroad. As a result, several countries tightened screening, notification and authorization procedures for incoming investment. The United States, for example, stepped up its inter-agency screening process (CFIUS process) that potentially covers all security related foreign investment. The increased interest of state-sponsored investors in US companies is an important factor that triggered the changes. Similarly, the Australian government has announced that it will apply more scrutiny specifically towards foreign government-controlled investment, and Canada is planning a national security investment review process. Meanwhile, the German government, driven by concern about SWFs and other state-controlled foreign investment, plans to expand the so-far very limited scope of its foreign investment screening procedures to cover all sectors of the economy. Other countries have also become more restrictive in their approaches towards foreign investment while some are still in a reflection mode.

### **Important roles for OECD and IMF**

Last year, the G7 finance ministers asked the OECD and the IMF to conduct evidence-based analysis and develop guidance for policies that ensure that our economies can continue to benefit from SWF investment. The OECD's focus is on the receiving end of investment. As part of its broader policy initiative aimed at ensuring freedom of international investment, the Paris-based intergovernmental organisation is developing policy guidance as to how to keep markets open for all types of investors without jeopardizing national security. The OECD Ministerial Declaration on SWFs and Recipient Countries Policies issued in June is a remarkable first achievement towards this goal. The ministers from all 30 member countries endorsed the principles not to erect protectionist barriers and not to discriminate between SWFs and other foreign investors. The ministers also announced to limit any additional investment restrictions to cases where there are legitimate national security concerns and, where such concerns arise, to only apply measures that are transparent, predictable, proportional and accountable in their application. As follow-up to its political Declaration, the OECD will issue more detailed technical guidance by spring 2009 as to how countries should put the endorsed investment policy principles into real life practice.

While the OECD is addressing investment policies in the recipient countries, the IMF is focusing on the other side of the equation. Before its next board meetings in autumn, the IMF wants to develop, in co-operation with SWFs and their home governments, best practices guidance for transparency and accountability to be applied by SWFs.

### **BIAC perspective**

The Business and Industry Advisory Committee to the OECD (BIAC) and its members, the major industry associations in the 30 OECD countries, are seriously concerned over the tightening of foreign investment vetting processes that we have witnessed. If more countries continue this trend towards enhancing their scrutiny vis-à-vis foreign investors, we may face the real risk of putting the brakes on global investment and depriving ourselves of the significant benefits that it brings to our economies.

Governments must address relevant questions about state-sponsored investors, but legitimate, concerns about national security must not be misused as cover for protectionism. In order to fully reap the benefits from globalization, we must keep our economies as open as possible and treat all incoming investment fairly and in a non-discriminatory way. Remedies to any potential challenges should primarily be sought within the context of appropriate policy frameworks such as security regulation, corporate governance, financial sector regulation, and anti-monopoly and take-over regulation. Restricting investment when it crosses the border should be a measure of last resort. If, after careful consideration of alternatives approaches, enhanced scrutiny applied to foreign investment is deemed necessary to achieve narrowly-defined national security objectives, governments must ensure that the vetting procedures be used with restraint and applied in ways that ensure fairness, efficiency and integrity.

BIAC is providing strong business input to the development of the emerging OECD policy guidance for recipient countries. We feel encouraged that ministers followed our request to endorse in the OECD Ministerial Declaration key principles towards keeping markets open for investment. It is now critical that governments live up to their commitments. To make this happen, the OECD needs to translate the general principles enshrined in the declaration into more practical "how to do" guidance for member government's investment policy experts. Even more importantly, the OECD must effectively monitor member countries' implementation of the agreed principles. Rigorous monitoring will foster peer pressure among governments which should help prevent countries from setting up protectionist investment barriers.

Looking at the investor side of the equation, SWFs must apply the same high standards of governance and transparency as any investor. The better a funds' performance is in these areas, the easier it is for any host government to welcome it with open arms. SWFs that operate below the best practices that the IMF is identifying will in future likely have to make an extra effort to dispense any perception that they have something to hide or even present a security risk.

In sum, so long as they are properly developed and implemented, the emerging OECD policy guidance and the IMF's best practices for SWF transparency and governance may foster an international investment environment where SWFs enjoy fair treatment in recipient country markets and the recipient countries can confidently resist pressures for protectionist responses.