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Who's Afraid of Sovereign Wealth Funds?

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Long-standing features of the global financial architecture, Sovereign Wealth Funds (SWFs) leapt into the West's political consciousness last year with a string of investments into troubled banks. These injections of liquidity propped up several major financial institutions at the height of the sub-prime crisis, and widespread gratitude was expressed for the timely interventions. Yet political concerns linger on both sides of the Atlantic about SWFs' sheer size - they are collectively estimated to hold US $ 2-3trn - and whether their opaque nature masks ulterior - non-financial - aims. This paper argues that a closer examination of SWF's nature and track-records suggests little reason for concern, and that while a constructive dialogue between SWFs and investee countries should be encouraged, political scaremongering in the West is short-sighted and intellectually inconsistent.

Mutatis Mutandis

The vagaries of each financial cycle are at once unique and familiar. The current crisis over sub-prime mortgages - which were bundled into complex debt instruments and dispersed throughout the global financial system - is merely the latest manifestation of the bundling of financial risk and speculative lending to borrowers of questionable credit-worthiness. History is replete with similar examples, from the markets developed by Lloyds during Britain's maritime expansion through the Dutch tulip mania in the 17th century. What differentiates financial crises is the rapidity which with the broader economy is able to return to business as usual, reflecting the relative importance of the financial sector to the real economy at the time. A crucial factor in the successful short-term recoveries – notably absent in the immediate aftermath of the Great Crash in 1929 and the Japanese downturn of the early 1990s – is the return of liquidity into the broader economy. Liquidity – the implicit availability of cash derived from the convertibility of a given asset – is ultimately a factor of market confidence, because for each seller of an asset, there must be a buyer.

The current crisis – aptly named the credit crunch - is predicated on financial institutions' lingering inability to fully assess their and their counterparties' exposure to bad debt. Predictably, and despite the best efforts of central banks to ply wholesale lenders with cheap credit, they are opting to hold on to their capital to meet potential deficits. De-leveraging on a massive scale continues, and several financial institutions and investment funds have already fallen, most notably Northern Rock and Bear Stearns. But none have been allowed to default by governments cognisant that the outright collapse of a major counterparty could, in the intricately entangled world of modern finance, lead to a prolonged economic malaise.

A crucial factor in propping up the international banking system during the early phases of the crisis was the massive injection of liquidity by sovereign wealth funds (SWFs).[1] Four major banks received over US $40bn in equity capital from these government-owned investment funds, allowing them to recapitalise their balance sheets after early sub-prime write-downs. Considerable gratitude was expressed by policymakers for this timely injection of liquidity. Yet concerns remain in political circles. The recent controversies over Gazprom's interest in Centrica and other European utilities, the bid by CNOOC, the Chinese national oil firm, for UNOCAL, a US oil company, Dubai Ports World attempted acquisition for P&O, and the Qatari Government's proposed takeover of supermarket chain J Sainsbury has seen a broader re-politicisation of foreign investment. In this environment, the distinction between SWFs and state-owned enterprises, like Gazprom, are inevitably misunderstood. Some commentators, and this report, argue that SWFs long-term investment approach constitutes a force for global economic interdependence. Others maintain that these funds may have ulterior motives, and that the uncertainty this creates, combined with their limited transparency, remains a source of political concern.

[1] For the purposes of this research note, SWFs are being broadly defined and at times encompass Sovereign Pension Funds (SPFs). There remains no official definition of an SWF. The IMF included an annex of 'selected definitions' of SWFs, which outlines eight similar but not identical views, in a recent paper: *Sovereign Wealth Funds – A Work Agenda,* International Monetary Fund, 29/02/08 (www.imf.org/external/np/pp/eng/2008/022908.pdf) For a longer discussion on the definition of SWFs, see 'The Definition of a Sovereign Wealth Fund' by Stephen Jen - Morgan Stanley, 26/10/07 (www.morganstanley.com/views/gef/archive/2007/20071029-Mon.html)

The purpose of this research note is therefore threefold. Firstly to explain the emergence and purpose of SWFs for developing (and some developed) nations. Secondly to outline their recent activity during the early stages of the credit crunch. And lastly to encourage policy-makers to look beyond simplistic comparisons between SWFs and the traditional M&A activities of SOEs, and concerns about the magnitude of these funds, in order to better understand SWF's objectives, incentives and interests.

A Brief History of SWFs

The origins of sovereign fund investment lie in the recent past. Within five years of Kuwait's first export shipments of oil in 1946, oil sales constituted 94% of government revenue and provided the Kuwaiti government with a 69% budget surplus.[2] The prescient decision in 1953 to invest this fiscal surplus through the newly-established Kuwait Investment Authority (KIA) – the world's first SWF - has allowed Kuwait to stabilise its government revenues despite the volatility of the global oil price. Figure 1 (below) demonstrates the importance of this mechanism, as oil prices have fluctuated between nearly US $10 per barrel in July 1999 and to a peak of US $114 per barrel in April 2008.

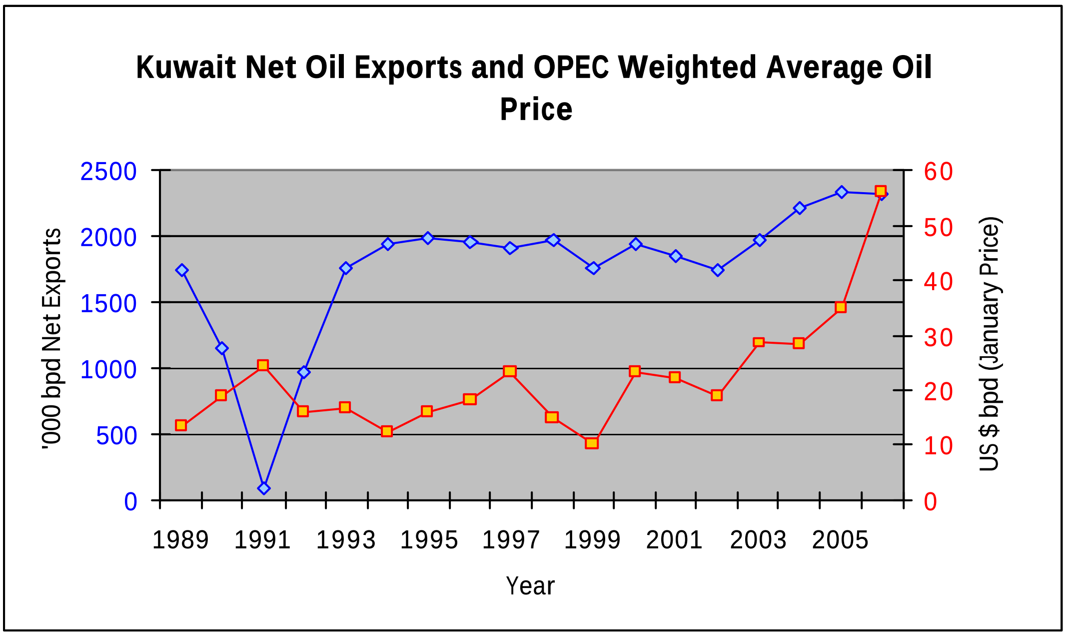

Figure 1. Source: EIA

When oil prices slumped in 1986, revenue from Kuwait's investment funds actually exceeded total oil export receipts and following the Gulf War in 1990-1, these funds were used to finance the rapid reconstruction of the kingdom's economy and infrastructure.[3] In 2007, fifty four years after exports began, oil shipments from Kuwait still provided 95% of the kingdom's export revenues and around 80% of total government revenues.[4]

Many oil-rich Gulf Cooperation Council (GCC) countries now operate SWFs, along with several other commodity-dependent countries. Research by Deutsche Bank reveals (see Figure 2, below) that over half of the world's twenty largest SWFs are funded by commodity exports.[5]

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[2] 'Supreme Petroleum Council, Ministry of Energy and Kuwait Petroleum Corporation: Issues of a trilateral organisation' by Prof. Imad M. Al-Atiqi – Joint Chatham House – CEPMLP Project, 21-23/09/05

[3] 'About KIO', Kuwait Investment Authority website (www.kia.gov.kw)

[4] 'Background Note: Kuwait', US Department of State, Bureau of Near Eastern Affairs, June 2007.

[5] 'Sovereign Wealth Funds – State Investments on the Rise', Deutsche Bank, 10/09/07 (www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD0000000000215270.pdf)

Nation	SWF	US $	Inception	Source
UAE	Abu Dhabi Investment Authority (ADIA)	875bn	1976	Oil
Singapore	Government of Singapore Investment Corporation (GIC)	330bn	1981	Non-commodity
Norway	Government Pension Fund - Global (GPFG)	322bn	1990	Oil
Saudi Arabia	Various funds	300bn	NA	Oil
Kuwait	Kuwait Investment Authority (KIA)	250bn	1953	Oil
China	China Investment Company Ltd	200bn	2007	Non-commodity
Hong Kong	Hong Kong Monetary Authority Investment Portfolio	140bn	1998	Non-commodity
Russia	Stabilization Fund of the Russian Federation (SFRF)	127bn	2003	Oil
China	Central Hujin Investment Corp.	100bn	2003	Non-commodity
Singapore	Temasek Holdings	108bn	1974	Non-commodity
Australia	Australian Government Future Fund (AGFF)	50bn	2004	Non-commodity
Libya	Reserve Fund	50bn	NA	Oil
Qatar	Qatar Investment Authority (QIA)	40bn	2000	Oil
USA	Alaska Permanent Reserve Fund Corporation (APRF)	40bn	1976	Oil
Brunei	Brunei Investment Agency (BIA)	35bn	1983	Oil
Ireland	National Pensions Reserve Fund (NPRF)	29bn	2001	Non-commodity
Algeria	Reserve Fund	25bn	NA	Oil
South Korea	Korea Investment Corporation (KIC)	20bn	2006	Non-commodity
Malaysia	Khazanah Nasional BHD (KNB)	18bn	1993	Non-commodity
Kazakhstan	Kazakhstan National Fund (KNF)	18bn	2000	Oil, Gas & Metal

Figure 2. Source: Deutsche Bank

These commodity-funded SWFs, such as the Abu Dhabi Investment Authority (ADIA) and Norway's Government Pension Fund[6], primarily function as fiscal 'stabilisation funds', according to IMF criteria, but may also serve as 'savings funds', 'pension reserve funds' or 'development funds' to finance infrastructure development. In some instances, most notably Saudi Arabia, foreign reserves are invested directly by the central banks, not via an independent SWF. Similarly, non-commodity funds such as Singapore's Government Investment Corporation (GIC) and the Chinese Investment Corporation (CIC) which are 'reserve investment corporations' set up 'to reduce the negative cost-of-carry of holding reserves or to pursue investment policies with higher returns' have both short and long-term objectives.[7]

The oldest non-commodity funds – GIC and Temasek – were set up in Singapore, which needed to insulate its small, open economy from the distorting effects of massive capital inflows as it became a major trading hub. As China has emerged as the world's workshop over the last decade, its government has faced a similar predicament. China now holds around a quarter of global foreign reserves and is the single largest contributor to historic global imbalances (see

[6] Formerly known as the Petroleum Fund, it was renamed the Government Pension Fund in 2006 as recognition of the fund's growing role in 'facilitating government savings necessary to meet the rapid rise in public pension expenditures', even though the fund's returns are not hypothecated.

[7] 'Annex 1.2 Sovereign Wealth Funds', *Global Financial Stability Report 2007,* International Monetary Fund, October 2007 (www.imf.org/External/Pubs/FT/GFSR/2007/02/index.htm)

Figure 3, below) as high consumption rates in (predominantly) Western countries have funded high savings rates in producer nations such as China.[8]

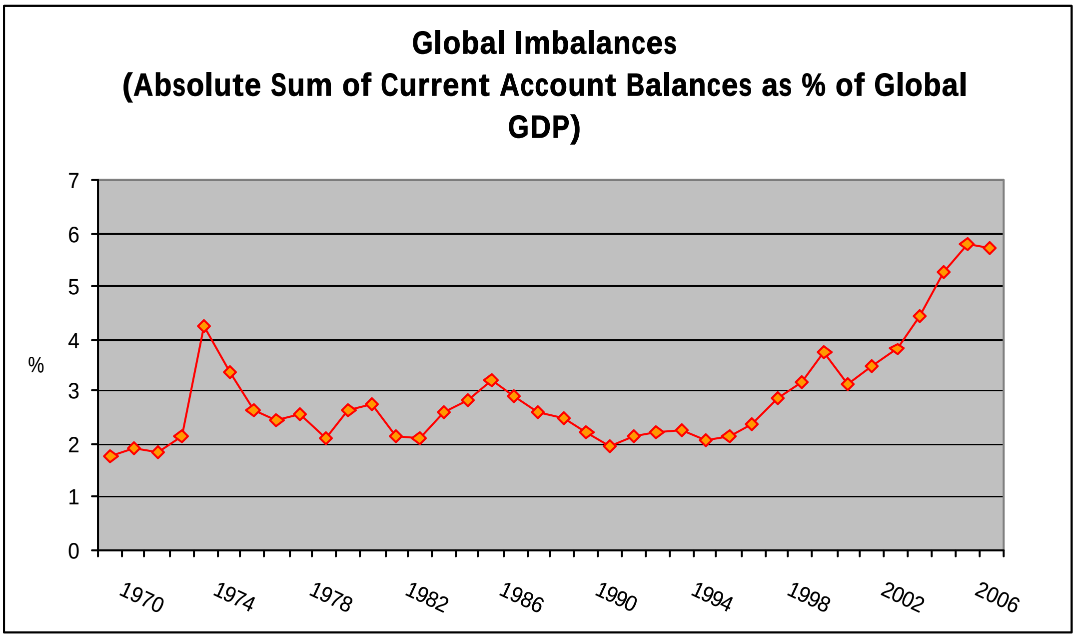

Figure 3. Source: WEO 2007, IMF

These massive capital inflows have allowed producer nations to amass considerable foreign capital reserves. As Figure 4 (below) shows China's foreign exchange reserves grew from US $150bn in 1999 to over US $1.5trn in 2007 - roughly 25% of total global foreign reserves - while its total trade surplus concurrently increased from US $29bn to US $262bn.[9]

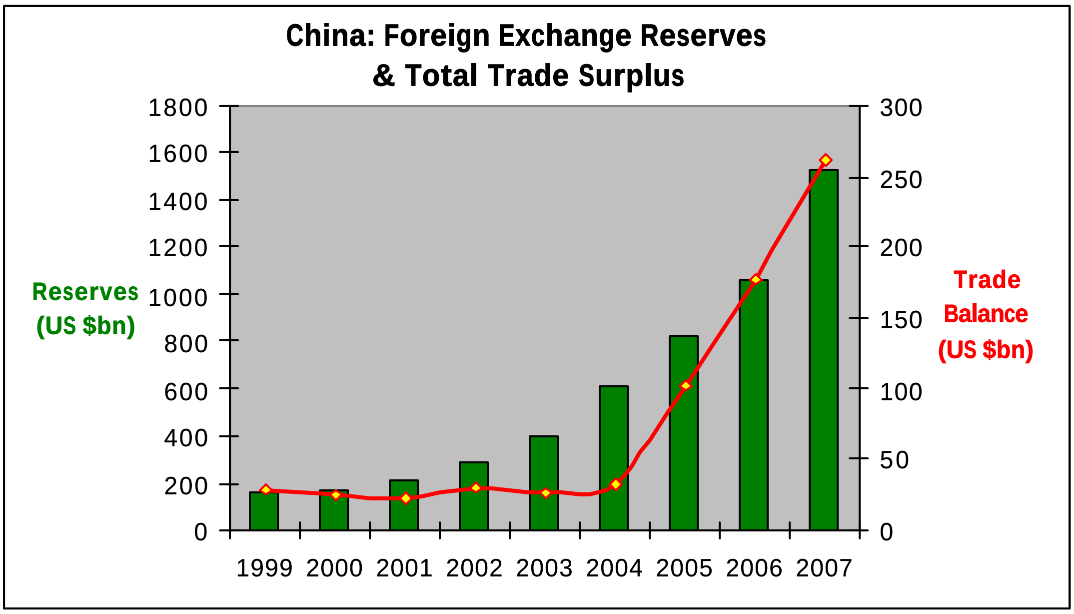

Figure 4. Source: PBOC/ US China Business Council

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[8] For these purposes, global imbalances are the net asymmetry between all countries' budget deficits and surpluses. If all countries had equal savings (monies retained internally) and investment (monies invested or spent aboard, then no imbalance would exist. The other major contributory factor to global imbalances has been the rising oil price over the last four years which has fuelled a similar dynamic between oil consumer and oil producer nations – the previous peak, unsurprisingly, occurring in 1974 at the height of the oil crisis, when oil-producing nations garnered huge windfalls from record prices.

[9] People's Bank of China website, statistics (www.pbc.gov.cn/english), and US China Business Council (www.uschina.org/statistics/tradetable.html)

However, China's reserves grew at this rate in large part because of its complex capital controls, under which all business and banks are required to exchange their foreign currency earnings for Renminbi with the People's Bank of China (PBOC).[10] The growth of these foreign exchange reserves prompted China to become the latest country to create its own SWF in order to attract higher returns when it allocated an estimated $200bn of its foreign reserves to the newly created China Investment Corporation (CIC), which officially began trading on September 29, 2007.

The Credit Crunch

Several months prior to this, in May 2007, CIC had burst onto the world's headlines by announcing that they would be taking a $3bn stake in the IPO of Blackstone, a US private equity firm. The investment was lauded as imaginative and politically savvy - in part because CIC waived their shareholder voting rights to ameliorate political concerns about their intent – but less than a month later, global credit markets ground to a halt amidst growing concern about financial institutions' exposure to sub-prime mortgage liabilities. The scale of banks' losses remains unclear, and media estimates of the final bill range from US $150 - 460bn, but several major banks have already announced massive losses. Citi announced a 2007 Q4 net loss of US $9.83bn, caused by sub-prime write-downs totalling US $18.1bn, while Merrill Lynch recorded a loss of US $7.8bn for 2007 after writing-down US $14.1bn in high-risk mortgage losses. In Europe, Swiss bank UBS posted a 2007 Q4 loss of US $11.3bn after taking a US $13.7bn hit in the sub-prime market.[11] British banks performance is harder to assess because only HSBC – at US $11.7bn - has published a realistic figure for their aggregate sub-prime write-downs.

Prior to the credit crunch, major western banks had received only limited investment from SWFs and foreign state-owned banks, and often for specific strategic projects. For example, Barclays sought additional capital from Temasek and China Development Bank, a Chinese SOE, during its bid for ABN Amro in 2006-7. But during late 2007 and early 2008, four major banks received over US $40bn in additional capital from SWF (see Figure 5, below).

Date	Bank	SWF / *SOE*	$ Stake	Size of Stake
23/07/07	*Barclays*	*China Development Bank*	*$3bn*	*3.1%*
23/07/07	Barclays	Temasek	$2bn	2.1%
22/10/07	*Bear Stearns*	*Citic Securities (China)*	*$1bn*	*6.0%*
26/11/07	Citi	ADIA	$7.5bn	4.9%
10/12/07	UBS	GIC	$9.75bn	9.0%
19/12/07	Morgan Stanley	CIC	$5bn	9.9%
21/12/07	Merrill Lynch	Temasek	$ 4.4	(Conv.) 9.4%
15/01/08	Citi	KIA	$3bn	(Est.) 2.3%
15/01/08	Merrill Lynch	KIA	$2bn	(Conv.) 3.3%
15/01/08	Citi	GIC	$6.88bn	(Conv.) 4.0%
15/01/08	Merrill Lynch	Korean Investment Corp. (KIC)	$2bn	(Conv.) 3.3%
18/02/08	Credit Suisse	QIA	$500m	(Est.) 1-2%

Figure 5. Source: Media Reports

[10] According to James Fallows, a journalist, the People's Bank of China receives over $1bn per day in exchanged currency. See 'The $1.4 Trillion Question', *Atlantic Monthly*, January/February 2008. This policy allows to the Chinese Government to both mitigate the inflationary pressures of rapid growth and, more controversially, control the value of Renminbi against other major currencies.

[11] UBS subsequently announced a further write-down of US $ 19bn in early April 2008, taking their total sub-prime-related losses to over US $37bn, according to the *Financial Times.*: 'April 1 predicament is no joke for UBS', *Financial Times,* 02/04/08. Merrill Lynch's write-down now total over $24bn according to Reuters: 'Merrill Lynch targeted by earnings downgrades', Reuters, 25/03/08.

As Figure 6 (below) demonstrates, the four banks suffering the largest sub-prime write-downs were able to largely recapitalise their balance sheets through SWF investment.

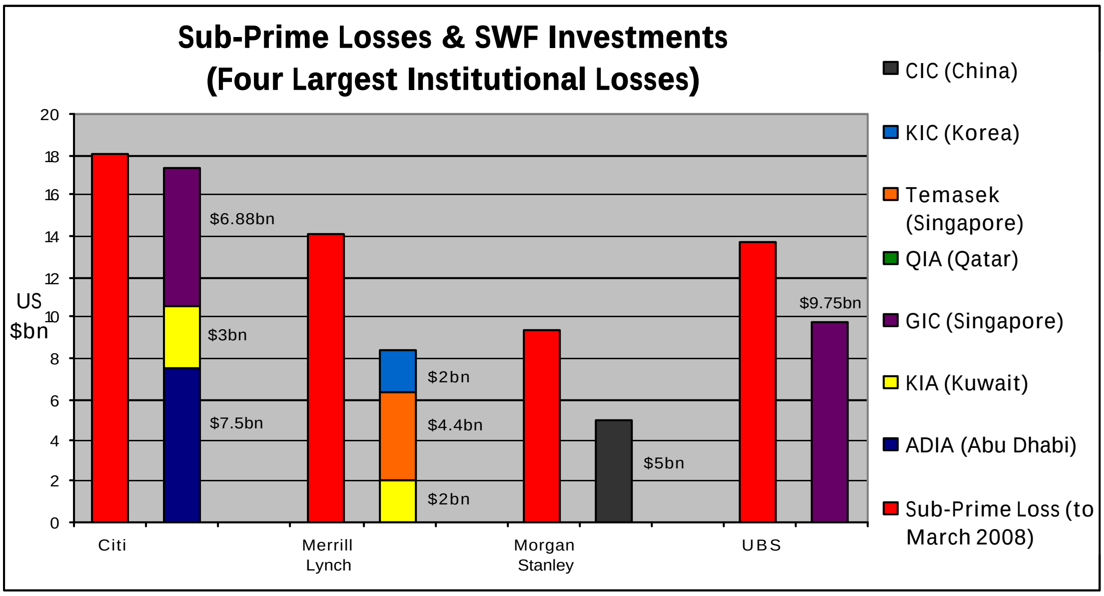

Figure 6. Source: Company Reports

The SWFs drove hard bargains for these crucial injections of liquidity. The deal announced on 27th November 2007 between Citi and ADIA - the first major recapitalisation of a Western bank by a SWF during the credit crunch - provided Citi with US $7.9bn in new capital in return for an 11% annual coupon to ADIA until 2010-11, when the loan converts into a 4.9% equity stake.[12] Tellingly, 11% is nearly twice the interest rate at which Citi managed to sell only US $4bn worth of 10-year bonds on the open market only two weeks earlier.

Citi agreed to these exacting terms because its large sub-prime write-down had undermined its capital adequacy ratios. Under domestic US legislation, derived from the Basle I & II international banking agreements, banks with retail depositors (like Citi) must maintain a level of capital adequacy – defined as the proportion of shareholder equity (the most reliable and liquid form of equity, called Tier 1) to the bank's total risk-weighted assets. Typically, financial regulators set a minimum requirement (4% in the UK and US), and banks set their own internal targets – Citi's, for example, is 7.5%. Prior to the ADIA investment, Citi's ratio had dropped to 7.3% - an unacceptably low figure which prompted the share issuances.[13] Following the cash infusions from ADIA, KIA and GIC, Citi estimated that their Tier 1 ratio would return to around 8.2%.[14] These investments, at the crucial early stages of the credit crunch, propped up key financial institutions and arguably prevented a far greater calamity than we are now facing.

Lingering Concerns

Yet concerns remain about the sheer size of SWFs, and their presumed intent to buy up swathes of the West's critical infrastructure. Angela Merkel's comments last summer crystallised these misgivings. "How do we actually deal with funds in state hands? This is a phenomenon which until now has not existed on such a scale… One can question whether these funds are solely concerned with attaining a high return on capital. State-owned funds can also have politico-strategic aims in mind that could be problematic in sensitive areas."[15]

[12] 'Citigroup to Raise $7.5 billion from Abu Dhabi State', Bloomberg,, 27/11/07
[13] Ibid.
[14] 'Citigroup, Merrill tap foreign-aid lifelines; damage tops $90 billion', *The Wall Street Journal*, 17/01/08
[15] 'Concern about 'sovereign wealth funds' spreads to Washington', *International Herald Tribune*, 20/08/07 & 'Merkel Plays Protector', *Forbes.com*, 20/07/07.

An examination of SWFs track record suggests such fears are overdone. The IMF admits in a recent report that 'there is no clear evidence that SWF investments have been motivated by narrow political objectives'[16], and deals such as ADIA's investment in Citi demonstrate what a hard commercial bargains SWFs can drive, though like CIC, ADIA forwent seats on the board. On the rare occasions when SWFs have bought companies outright - for example Istithmar, a Dubai SWF, purchasing Barney's, a New York fashion retailer, or the Qatar Investment Authority's attempted purchase of J Sainsbury last summer - their interest has focussed explicitly on non-sensitive economic sectors. Moreover, they will logically remain intolerant of investing on a loss-leading basis, for example to under-cut prices and grow market share, for any period of time. Indeed, Mrs Merkel's comment, made in the midst of the German debate over Gazprom, and in a political milieu prone to periodic tantrums about foreign investors, intentionally conflates two different types of investors.

The political difference between Gazprom-like SOEs and SWFs is that while the former's words and actions have all too often had a destabilising influence on markets, SWFs have constituted an all too rare source of stability during the recent credit crunch. Gazprom's stated intention to vertically integrate energy supply lines from gas-field to domestic consumer would likely create considerable economic inefficiencies, reduce competition in the sector and increase consumer prices. The United States, UK and most other European nations have robust competition authorities and such issues, arising from either a SOE or SWF investment would be examined accordingly at a national or EU level. There are no examples of SWFs seeking to integrate existing and prospective investments to monopolise or cartelise strategic – or indeed, any – markets in Western countries. As Peter Mandelson, EU Commissioner for Trade, recently put it, 'both kinds of asset sales can in certain circumstances raise issues. But treating them the same ignores the difference between a state acting like a business and a state acting like an investor.'[17] Sovereign Wealth Funds are much more analogous to large institutional investors like CalPERS than Gazprom.

The other source of political concern about SWFs is their sheer size. Numerous column inches have been devoted to ever-greater estimates – ranging from US $2trn at present to US $13.4trn in 2018 - about their scale.[18] But to conflate size with power presumes that SWFs operate as a bloc, or even that each SWF pursues a uniform investment strategy.[19] The former notion is nonsensical, as these funds are *de facto* direct competitors, and the latter proposition is being undermined by growing evidence that SWFs are fragmenting their capital base and utilising independent fund managers to diversify their risk. ADIA, the largest SWF, for example, recently revealed that it 'uses a combination of in-house capabilities as well as outside portfolio managers and fund advisors....in fact, 80% of ADIA's funds are managed by outside firms.'[20] Increasing numbers of SWFs are seeking to invest via fiduciary vehicles such as private equity firms, which allow them to garner the enhanced rewards of business transformation without directly taking an equity stake. GIC has revealed that it has invested in around 50 hedge funds.[21] Large investors will always seek to diversify their risk across a range of assets and managers – all of whom compete with each other for greater allocations. A SWF's total resources are therefore less important than the nature of their deployment. CIC, for example, which holds roughly US $200bn

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[16] 'Sovereign Wealth Funds – A Work Agenda', International Monetary Fund, 29/02/08

[17] *Putting Sovereign Wealth Funds in Perspective,* Speech to the OECD, Paris 28/03/08

[18] Simon Johnson, Chief Economist at the IMF, estimates that SWF capital is between US $ 2-3trn and Standard Chartered have proposed US $13.4trn by 2018. Other banks' estimates fill out this range. By way of comparison, IFSL Research estimates that Pension Funds managed US $28.5trn in 2006, and the IMF calculates the global value of traded assets in global capital markets in 2006 to total US $190trn.

[19] Peter Mandelson recently exemplified the politicians' quandaries about this issue when he argued that '[SWFs] do not have a single brain or governing mind. We are in fact dealing with forty funds...and they are all making independent investment decisions – no more likely to act in unison than pension or hedge funds. Still – it is a large pool of money. Should we be worried about these things? My politician's answer is yes and no.' *Putting Sovereign Wealth Funds in Perspective,* Speech to the OECD, Paris 28/03/08

[20] Letter to Hank Paulson from Yousef Al Otaiba, Director of International Affairs, Government of Abu Dhabi, 12/03/08

[21] 'Singapore's GIC to invest more in high-risk assets', Reuters, 11/07/06

in operating capital, recently announced that it was planning to deploy US $80bn – only 40% of its capital - overseas.[22]

The IMF and OECD's ongoing work on voluntary codes of conduct for both SWFs and recipient countries has highlighted the dual issues of transparency and strategic intent as areas of concern. On the latter point, there is an emerging but fragile political consensus that, cognisant of the current political environment in the US and Europe, SWFs accept that certain sectors, such as defence and energy firms, are off limits to foreign investors for all but tiny, passive stakes. Most Western politicians would regard this as an acceptable outcome, but it is important to recognise that protectionist scepticism in the West carries an opportunity cost. Politically-marginal investments that may once have been pursued by Middle Eastern SWFs, for example, are now likely to be ignored for opportunities in Asia.

Saudi Arabia is reluctant to set up an official SWF for fear of a political backlash in the United States, so their foreign reserves continue to be invested by their central bank, the Saudi Arabian Monetary Authority (SAMA). "People are assuming that sovereign wealth funds are guilty until proven innocent", Mohammad al-Jasser, vice governor of SAMA, recently argued.[23] Indeed, even Norway's fund, regarded as the best-practice model by many in the West, is feeling the political backlash. "They don't like us, but they want our money" said Norwegian Finance Minister Kristen Halvorsen at Davos this year.

Yet neither should policy-makers under-estimate the growing pressures of transparency and accountability on SWFs from their own people. According to the *New York Times*, the drop of nearly US $1.4bn in the value of CIC's stake in Blackstone was the subject of considerable ire on the Chinese blogosphere. 'Chinese bloggers, and even some financial media, have not taken the hammering lying down. They are assiduously tracking the dwindling value of the government stake, and some bloggers and postings in Internet chat rooms are bitterly questioning Beijing's stock judgment — often in particularly Chinese terms. "O senior officials of the Chinese Government please do not be fooled by sweet-talking wolves dressed in human skin," said one of seven scathing Internet postings compiled by an anonymous blogger on Sina.com, a Chinese Web site. "The foreign reserves are the product of the sweat and blood of the people of China, please invest them with more care!" [24] Cyber-scrutiny of this kind by the citizenry of investor nations, easily conducted on publicly traded stakes, may come to constitute a powerful political check on SWFs. Unused to such public criticism, Chinese officials are understood to have intervened to prevent the China Development Bank – which was already carrying a trading loss on its US $3bn stake in Barclays – from investing a further US $2bn in Citi last November, fearing greater public opprobrium given the likelihood of short-term losses.[25] Similar ructions in Singapore prompted GIC to promise greater transparency in future. This impetus for transparency and accountability carries greater legitimacy than exhortations by recipient countries, all of whom already have their own corporate disclosure laws.[26] Indeed, some commentators have argued that these alone should suffice to keep SWFs transparent.[27]

Mimicking the array of national and international initiatives to encourage SWF transparency, SWFs are responding to these concerns in a variety of ways. Russia's SWFs – the Reserve Fund and the National Wellbeing Fund – have issued a list of the foreign sovereign bonds into which they intend to invest, including Fannie Mae and Freddie Mac, the US debt agencies, and a segmented breakdown of their investment portfolio. Following a letter sent by ADIA to Hank Paulson, the US Treasury Secretary in early March, which outlined ADIA's investment strategy and principles, ADIA and GIC subsequently agreed with the US Treasury a set of principles for

[22] 'CIC chief brands sovereign wealth attacks unfair', *Private Equity News*, 02/04/08
[23] 'Sovereign Wealth Funds defend themselves against calls for regulation', *The Guardian,* 24/01/08
[24] 'Feeling the Heat, not breathing the fire', *New York Times*, 03/08/07
[25] 'Watching Sovereign Wealth', *Wall Street Journal Europe*, 28/02/08
[26] In the UK, for example, any investor owning more than a 3% stake in a company must declare that fact publicly.
[27] 'Watching Sovereign Wealth', *Wall Street Journal Europe*, 28/02/08

SWFs and countries receiving SWF investment, outlining their mutual and reciprocal responsibilities. In Britain, the British Venture Capital Association, a trade body, is in discussion with an as-yet unnamed SWF about compliance with their code of practice and the Walker guidelines, which deals with disclosure issues from companies taken private by investor buy-outs.

Once Bitten, Twice Shy

Months on, almost all of the SWF investments in financial institutions during the credit crunch constitute large potential losses. Temasek's stake in Barclays, purchased at £7.20, is down to £4.10 per share as of early May 2008. Similarly, KIC and KIA's investments in Merrill Lynch will see both SWFs pay $52.40 for those shares in 2010, which at a current trading price of US $48 constitutes a current loss of around US $150m each, though they will garner US $375m on the bond yield over the two year period. Worst hit is GIC, whose US $9.75bn stake in UBS has plummeted in value. The agreement will see GIC purchase UBS shares at minimum of CHF 51.48 in 2010. Those shares traded in early May 2008 at CHF 32.

Yet SWFs remain sanguine, arguing that these investments are inherently long-term because they are predicated on financial institutions' reputations and ability to recover their market positions.[28] *The Independent* recently quoted a 'leading Emirate financier, who runs one of the biggest funds in the Gulf' stating that he was investing "with a 25 year view in mind".[29] But actions speak louder than words. Following the initial flurry last winter, there have been no further major investments by SWFs into Western financial institutions. Rumours are currently circulating that the Korea Investment Corporation (KIC) may seek to take a stake in Barclays bank, which needs to increase its core Tier 1 equity ratio of 5.6%, but as a rule, SWFs stepping back from the crisis to assess their strategies amidst concern about how their advance may be received by recipient countries in the West.

Chancellor Alistair Darling stated late last year that "sovereign wealth funds need to play by the rules. We believe in liberal trade. Britain gets tremendous benefits from liberal trade. The reason London is the world's number one financial centre is because we have a very open economy. I am vehemently opposed to moves to re-establish protectionism from wherever it arises. It would be a hugely backward step. We welcome inward investment from sovereign wealth funds but it has to be a two-way street. They have to operate on a commercial basis and no other basis."[30] This would seem to suggest that, unlike in Germany, there is no intention to create an American style Committee for Foreign Investment into the United States (CFIUS) – an inter-departmental panel that examines large foreign direct investments from a national security perspective, and has become a tool for protectionist lobbyists. Ministers would do well to recognise the dangers of taking a precautionary approach to regulating financial inflows given that foreign investment has constituted one of the greatest forces for peace and stability in recent times. The entangling economic interdependence between China and the United States, for example, will go some way to mitigating the periodic susceptibility of both sides to nationalist and protectionist impulses.[31]

Instead, the British Government should actively engage with SWFs to encourage them to participate in the international dialogue about SWF transparency, while pushing their host governments to lift their own barriers to inward capital investment. Similarly, HM Treasury should engage with the BVCA to add official weight to their efforts to sign-up potential SWF investors to their guidelines, while offering assurances of their intention to maintain the UK's

[28] There is precedent for this kind of intervention. In 1991 during the US economic down-turn – and at the urging of senior US Administration officials - Prince Waleed bin Talal of Saudi Arabia took a US $ 590m stake in Citicorp. He has pledged never to sell the stake, which is now worth US $ 6bn.
[29] 'Sovereign Wealth Funds shrug off losses and pledge to ramp up their investments', *The Independent,* 23/03/08
[30] 'Chancellor backs G7 moves to get tough on Sovereign Wealth Funds', *Guardian*, 20/10/07
[31] CIC's intention to invest heavily in Japan is also encouraging in this regard. 'China wealth fund to invest $ 33bn in Japan', *Private Equity News,* 22/02/08

status as a desirable location for foreign investment. Just as QIA agreed to sign up to the voluntary Walker guidelines had their attempted purchase of J Sainsbury been successful, national governments should recognize that, presented with a consistent, non-discriminatory investment framework, SWFs are strongly inclined to play by the rules.

Ultimately, the political reaction to SWFs in the West reveals a deeper lack of unwillingness to acknowledge our own complicity in current global macroeconomic conditions. As Warren Buffett recently argued, Western economies – and politicians - must recognise that SWFs are the logical consequence of their own policy decisions and lifestyle choices. Our increasing consumption of oil and desire for consumer goods has provided much of the funding that has found its way into SWFs. As the Sage of Omaha put it, "this is our doing, not some nefarious plot by foreign governments. Our trade equation guarantees massive foreign investment in the US. When we force-feed US $2 billion daily to the rest of the world, they must invest in something here. Why should we complain when they choose stocks over bonds?"[32]

Sacha Kumaria is writing in a personal capacity.

[32] Buffett defends sovereign funds', BBC Online, 02/03/08