

# Chicago Fed Letter

## Raising capital: The role of sovereign wealth funds

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This article describes what sovereign wealth funds do, where their funding comes from, and what drives their investment strategies. It also highlights some of the policy issues that their activities raise.

Sovereign wealth funds are investment funds controlled by governments.

In their efforts to weather the subprime crisis and shore up balance sheets, many commercial and investment banks have been raising new capital. One important source of new capital has come from sovereign wealth funds (SWFs). For example, Morgan Stanley received \$5 billion from the Chinese SWF China Investment Corporation. The United Arab Emirates' SWF Abu Dhabi Investment Authority purchased a 4.9% equity share in Citibank, and Merrill Lynch received \$5 billion from Singapore's Temasek Holdings.

While there is no generally agreed upon definition of an SWF, the U.S. Department of the Treasury defines SWFs as government investment vehicles funded by foreign exchange assets that are managed separately from official reserves.<sup>1</sup> More colloquially, SWFs are investment funds controlled by governments. One example is the Norwegian Government Pension Fund; much of its funding comes from oil revenues. Other SWFs such as the Government of Singapore Investment Corporation are funded through foreign exchange reserves.

In addition to their recent investments in global financial institutions, SWFs are of interest because of their size and their potential to grow even larger. Figure 1 lists the ten largest funds, their sponsoring countries, their estimated value in U.S. dollars, their source of funds, and the year when each fund was established, according to a recent study.<sup>2</sup> The largest

funds are quite large. For example, Abu Dhabi's fund manages \$875 billion in assets, and Norway's fund has \$380 billion assets under management. There are approximately 40 SWFs in total, and collectively they are estimated to manage \$3.6 trillion dollars. Assets under management are projected to reach \$10 trillion by 2012 if recent trends continue.<sup>3</sup> To put this in perspective, approximately \$1.4 trillion is managed worldwide by hedge funds, \$15 trillion by pension funds, \$16 trillion by insurance companies, and \$21 trillion by investment companies.<sup>4</sup>

### Why would a country start an SWF?

First of all, the country typically has substantial funds to invest. One prominent source of funds is commodities. Many oil-exporting countries started commodity stabilization funds in the 1970s and 1980s as a way to reduce the impact of changes in oil prices on government budgets. Over time, especially when oil prices increased, the balances in the commodity stabilization funds grew beyond what was needed for commodity stabilization. Other countries generated substantial foreign exchange reserves from large net exports. Given these funds, the countries that control them have decided to create SWFs that use global financial markets to help them meet their investment goals.

For the sponsoring countries, SWFs can perform several useful functions. A recent International Monetary Fund (IMF)

report<sup>5</sup> lists five potentially overlapping functions of SWFs:

- Stabilization funds established by commodity-rich countries to insulate federal spending from commodity price fluctuations;
- Savings funds that share wealth across generations by investing the proceeds from nonrenewable assets (often oil) into a variety of assets to fund long-term objectives and future generations;
- Reserve investment corporations that are designed to increase the net returns to holding foreign exchange reserves;
- Development funds that are designed to fund infrastructure and other socioeconomic projects; and
- Pension reserve funds that invest to fund the government's pension-like liabilities.

Like other investors, SWFs hope to achieve these goals by using financial markets to diversify risk, to transfer funds through time, and to maximize returns.

### SWF investments in financial firms

One reason that SWFs have received a lot of attention in the popular press is because of their recent high-profile investments in developed countries' financial institutions. Some of the most prominent investments are highlighted in figure 2. This figure lists the firm that received the investment, the SWF that made the investment, the date of the investment, the size of the investment, the percentage of the firm's equity that the SWF acquired, the percentage change in the firm's share price since the investment, and the percentage change in the Standard and Poor's (S&P) Financial Index over the same time period. These investments have helped a number of systemically important financial institutions raise critical new capital. They have also heightened the scrutiny of SWFs and raised concerns about the desirability of these investments.

Others have been concerned that this additional scrutiny combined with the poor performance of these recent investments (see the sixth column of figure 2) will lead SWFs to scale back their willingness

## 1. Large sovereign wealth funds

|    | Sponsoring country               | Name of fund                                      | Estimated assets (\$ billions) | Source of funds | Year started |
|----|----------------------------------|---|--------------------------------|-----------------|--------------|
| 1  | Abu Dhabi (United Arab Emirates) | Abu Dhabi Investment Authority                    | 875                            | Oil             | 1976         |
| 2  | Norway                           | Government Pension Fund–Global                    | 380                            | Oil             | 1990         |
| 3  | Singapore                        | Government of Singapore Investment Corporation    | 330                            | Noncommodity    | 1981         |
| 4  | Saudi Arabia                     | Saudi Arabian Monetary Agency                     | 300                            | Oil             | n.a.         |
| 5  | Kuwait                           | Kuwait Investment Authority                       | 250                            | Oil             | 1953         |
| 6  | China                            | China Investment Corporation                      | 200                            | Noncommodity    | 2007         |
| 7  | China (Hong Kong)                | Hong Kong Monetary Authority Investment Portfolio | 163                            | Noncommodity    | 1993         |
| 8  | Singapore                        | Temasek Holdings                                  | 159                            | Noncommodity    | 1974         |
| 9  | Australia                        | Australian Future Fund                            | 61                             | Noncommodity    | 2004         |
| 10 | Qatar                            | Qatar Investment Authority                        | 60                             | Oil             | 2003         |

NOTES: n.a. means not applicable. For Saudi Arabia, this represents some of the funds that are managed by the country's central bank.

SOURCES: Chhaochharia and Laeven (2008); and Sovereign Wealth Fund Institute, [www.swfinstitute.org](http://www.swfinstitute.org).

to invest in financial firms at a time when many need to raise new capital. Figure 2 shows that the stock prices of the firms that have received SWF investments (with the exception of Credit Suisse's) are performing somewhat worse than the financial sector as a whole (see the last column of figure 2), perhaps reflecting the tendency of SWFs to invest in companies that are in financial distress.

### Concerns about SWFs

Because SWFs are controlled by governments, critics have been concerned that their investment strategies may be politically motivated and potentially conflict with the national interests of the countries in which they invest. These concerns have increased with the size of the SWF sector and with the establishment of SWFs by strategically important countries, such as China and Russia.<sup>6</sup> Sponsoring countries argue that SWFs are motivated by a desire to maximize investment returns, not political ones.

Because many SWFs do not publicly reveal their investments, the evaluation of these claims has proven difficult. Anecdotal evidence suggests there may be some cause for concern. For example, in a deal that was meant to be secret, China agreed to buy \$300 million Costa Rican bonds

as an incentive for Costa Rica to drop its diplomatic recognition of Taiwan in favor of China instead.<sup>7</sup> Other SWF transactions that have generated controversy include Temasek Holdings' (Singapore) purchase of the telecom businesses of then Thai Prime Minister Thaksin Shinawatra.<sup>8</sup> Less political, but still potentially at odds with maximizing risk-adjusted returns, Norway's SWF has a policy against investment in certain arms manufacturers, and in 2005, that fund sold its stake in Wal-Mart, citing human rights concerns.<sup>9</sup>

Other anecdotes suggest that SWFs go to great lengths to ensure that they will be seen as passive investors. For example, after acquiring a \$3 billion stake in the Blackstone Group (a major global alternative asset manager and provider of financial advisory services) in 2007, the China Investment Corporation refused a seat on its board.<sup>10</sup> Similarly, the Government of Singapore Investment Corporation refused a seat on the board of UBS after acquiring a substantial stake in the global financial services company.<sup>11</sup> A recent Monitor Group study of 420 publicly reported equity investments by SWFs since 2000 found that half involved the purchase of majority stakes.<sup>12</sup> This study suggests that the recent SWF investments in financial institutions, which

## 2. Performance of selected SWF investments in financial firms

| Firm                    | Sovereign wealth fund(s)   | Date of investment | Investment (\$ billions) | Equity stake (%) | % change in share price | % change in S&P Financial Index |
|-------------------------|--|--------------------|--------------------------|------------------|-------------------------|---------------------------------|
| Credit Suisse           | Qatar Investment Authority   | 2/18/2008          | 0.5                      | 2.0              | -34.16                  | -43.84                          |
| Barclays                | Qatar Investment Authority   | 6/25/2008          | 3.5                      | 8.9              | -44.61                  | -31.30                          |
| Citigroup (round 1)     | Abu Dhabi Investment Authority   | 11/26/2007         | 7.5                      | 4.9              | -61.28                  | -46.59                          |
| Citigroup (round 2)     | Government of Singapore Investment Corporation and Kuwait Investment Authority | 1/14/2008          | 7.9                      | 5.2              | -60.36                  | -46.14                          |
| UBS                     | Government of Singapore Investment Corporation                                 | 12/10/2007         | 9.7                      | 9.0              | -71.91                  | -52.71                          |
| Morgan Stanley          | China Investment Corporation   | 12/19/2007         | 5.0                      | 9.9              | -69.27                  | -48.23                          |
| Merrill Lynch (round 1) | Temasek Holdings   | 12/19/2007         | 5.0                      | 9.9              | -70.35                  | -48.23                          |
| Merrill Lynch (round 2) | Kuwait Investment Authority and Korea Investment Corporation                   | 1/15/2008          | 8.9                      | 5.4              | -69.38                  | -44.07                          |

NOTES: The numbered rounds indicate rounds of investment by sovereign wealth funds (SWFs). The sixth column shows the change in share prices between the date of investment and November 5, 2008; the seventh column shows the change in the Standard and Poor's (S&P) Financial Index over the same period.

SOURCES: Steffen Kern, 2008, "SWFs and foreign investment policies—An update," Current Issues, Deutsche Bank Research, October 22; and author's calculations based on Bloomberg quotes and Standard and Poor's Financial Index.

generally involved purchase of stakes of less than 10%, were not typical.

### Regulation and transparency

In addition to the steps that SWFs themselves take to avoid controversy, their investments may be scrutinized through various laws and regulations. For example, the U.S. Department of the Treasury's Committee on Foreign Investment in the United States reviews foreign investments to ensure that they do not compromise national security. In the summer of 2007, the U.S. Congress enacted new legislation, aimed at SWFs, that requires additional scrutiny and higher-level clearances for transactions involving foreign government control.<sup>13</sup>

Investments in U.S. banks and bank holding companies are potentially subject to additional review. Investments in U.S. banks and bank holding companies by SWFs that meet certain criteria—including having substantial control of voting shares or the board of directors—trigger regulatory review under the Bank Holding Company Act and the Change in Bank Control Act.<sup>14</sup> To date, SWF investments

in U.S. banks have been structured to avoid these triggers.

In addition to political questions, there is also a concern that SWFs, which are controlled by governments, may not allocate capital as efficiently as private firms. A recent study of SWF behavior suggests that this is a real issue. Chhaochharia and Laeven (2008) find that SWFs diversify risk by investing in industries that are underrepresented in the sponsoring country but that they also tend to invest in countries that share religious outlooks with their own. This suggests that profit maximization is not the only objective of some SWFs.

More generally, the fact that some SWFs do not disclose their investment strategies—i.e., precisely how much money they manage or how it has been invested—makes it very difficult to systematically evaluate whether SWF investment strategies are influenced by political concerns or are otherwise inefficient. This lack of transparency is exacerbated by SWF investments in other opaque entities, such as hedge funds and private equity funds.

A recent study by Kotter and Lel<sup>15</sup> suggests that SWFs pay a price for their lack of transparency. They find that the announcement of an SWF investment is typically associated with a positive stock price response. However, they also show that the increase in stock prices is larger when the SWF doing the investment is more transparent.

### Policy responses

In response to concerns about lack of transparency and the potential for politically motivated investments, international efforts have been initiated to develop best practices and voluntary codes of conduct for both SWFs and the countries that receive SWF investments. Efforts sponsored by the International Monetary Fund have led to the establishment of a set of 24 principles that SWFs that participated in the IMF talks have voluntarily agreed to follow.<sup>16</sup> These principles include a commitment to financial objectives and guidelines for better transparency and disclosure of SWF relationships with the sponsoring government. The Organization for Economic Cooperation and Development (OECD) is working to develop a set of standards for countries that receive SWF investments to ensure that they are evaluated on an equal basis as other investments and to make sure that recipient countries' policies

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do not create barriers to efficient flows of capital across borders.<sup>17</sup>

## Conclusion

Over the longer term, both the sponsors of SWFs and the countries they invest in

are likely to profit from policies that carefully balance strategic interests with the benefits of allowing for the efficient flow of capital across borders. Increased transparency on the part of SWFs with regard to investment strategies, holdings,

and performance appears to benefit SWFs in the form of higher investment returns, and this increased transparency will also boost confidence that SWFs' investment strategies are driven by financial rather than political factors.

<sup>1</sup> U.S. Department of the Treasury, Office of International Affairs, 2007, "Appendix III: Sovereign wealth funds," in *Semiannual Report on International Economic and Exchange Rate Policies*, June, available at [www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007\\_Appendix-3.pdf](http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_Appendix-3.pdf).

<sup>2</sup> Vidhi Chhaochharia and Luc Laeven, 2008, "Sovereign wealth funds: Their investment strategies and performance," University of Miami and International Monetary Fund, working paper, August 31, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1262383](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262383).

<sup>3</sup> Simon Johnson, 2007, "The rise of sovereign wealth funds," *Finance and Development*, Vol. 44, No. 3, September, available at [www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm](http://www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm).

<sup>4</sup> These figures come from Scott G. Alvarez, 2008, "Sovereign wealth funds," testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC, April 24, available at [www.federalreserve.gov/newsevents/testimony/alvarez20080424a.htm](http://www.federalreserve.gov/newsevents/testimony/alvarez20080424a.htm). (Alvarez is general counsel for the Board of Governors of the Federal Reserve System.) The figures for assets managed by pension funds, insurance companies, and investment companies are for Organization for Economic Cooperation and Development (OECD) countries only.

<sup>5</sup> International Monetary Fund, 2008, "Sovereign wealth funds—A work agenda," report, Washington, DC, February 28, available at [www.imf.org/external/np/pp/eng/2008/022908.pdf](http://www.imf.org/external/np/pp/eng/2008/022908.pdf).

<sup>6</sup> See, e.g., Shachar Bar-On (producer), 2008, "China investment an open book?," *60 Minutes*, April 6, available at [www.cbsnews.com/stories/2008/04/04/60minutes/printable3993933.shtml](http://www.cbsnews.com/stories/2008/04/04/60minutes/printable3993933.shtml).

<sup>7</sup> Graham Bowley, 2008, "Cash helped China win Costa Rica's recognition," *New York Times*, September 12, p. A8, available at [www.nytimes.com/2008/09/13/world/asia/13costa.html](http://www.nytimes.com/2008/09/13/world/asia/13costa.html).

<sup>8</sup> Jean Chua, 2007, "Temasek gains fall 29%, without asset sales," *International Herald Tribune*, August 2, available at [www.iht.com/articles/2007/08/02/business/sxtem.php](http://www.iht.com/articles/2007/08/02/business/sxtem.php).

<sup>9</sup> Andrew Leonard, 2008, "The socially responsible sovereign wealth fund," *Salon*, January 16, available at [www.salon.com/tech/htww/2008/01/16/socially\\_responsible\\_norway/print.html](http://www.salon.com/tech/htww/2008/01/16/socially_responsible_norway/print.html).

<sup>10</sup> Christopher C. L. Anderson, 2008, "Sovereign wealth: It could be good for you," *Registered Rep.*, March 1, available at [http://registeredrep.com/mag/finance\\_sovereign\\_wealth\\_good/](http://registeredrep.com/mag/finance_sovereign_wealth_good/).

<sup>11</sup> Kevin Lim, 2008, "Singapore GIC says turned down UBS board seat offer," Reuters, January 27, available at [www.reuters.com/article/etfNews/idUSSIN9630520080128](http://www.reuters.com/article/etfNews/idUSSIN9630520080128).

<sup>12</sup> William Miracky, Davis Dyer, Drosten Fisher, Tony Goldner, Loic Lagarde, and Vicente Piedrahita, 2008, *Assessing the Risks: Behaviors of Sovereign Wealth Funds in the Global Economy*, Monitor Group, report, June, available at [www.monitor.com/Portals/0/MonitorContent/documents/Monitor\\_SWF\\_report\\_final.pdf](http://www.monitor.com/Portals/0/MonitorContent/documents/Monitor_SWF_report_final.pdf).

<sup>13</sup> Lee Hudson Teslik, 2008, "Sovereign wealth funds," Council on Foreign Relations, backgrounder, January 18, available at [www.cfr.org/publication/15251/](http://www.cfr.org/publication/15251/).

<sup>14</sup> Investments that meet these criteria are subject to the same review regardless of whether the investor is an SWF, a domestic investor, or a foreign investor. For additional details, see Alvarez (2008).

<sup>15</sup> Jason Kotter and Ugur Lel, 2008, "Friends or foes? The stock price impact of sovereign wealth fund investments and the price of keeping secrets," International Finance Discussion Papers, Board of Governors of the Federal Reserve System, working paper, No. 940, August, available at [www.federalreserve.gov/pubs/ifdp/2008/940/ifdp940.pdf](http://www.federalreserve.gov/pubs/ifdp/2008/940/ifdp940.pdf).

<sup>16</sup> The 24 principles are available at [www.iwg-swf.org/pubs/gapplist.htm](http://www.iwg-swf.org/pubs/gapplist.htm).

<sup>17</sup> More details on the OECD effort can be found at [www.oecd.org/dataoecd/34/9/40408735.pdf](http://www.oecd.org/dataoecd/34/9/40408735.pdf).