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"Sovereign Wealth Funds" Towards a Structural Shift in World Financial Order

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On October 11, the International Working Group of Sovereign Wealth Funds (IWG) released the Generally Accepted Principles and Practices (GAPP) that would guide the governance and accountability framework of sovereign wealth funds.

The IWG was set up in May 2008 in the wake of widespread fears across the western world that investments by sovereign wealth funds (SWFs) are largely influenced by strategic and political objectives rather than commercial interests. These fears sparked a heated debate within the western world about the extent to which SWFs should be allowed to invest in domestic markets.

At the initiative of G-7, the IMF was asked to develop a set of voluntary principles for the SWFs. The IMF, in turn, established the IWG with sovereign funds and recipient countries to carry forward the task.

Though SWFs have been around for decades, it is only recently that they have attracted much attention. With an estimated $3 trillion in assets, they are investment funds owned and managed directly or indirectly by governments. They may be funded by foreign exchange reserves, commodity exports, the proceeds of privatisations and fiscal surpluses. The SWFs manage foreign exchange assets separately from official reserves. They are set up to diversify and improve the return on foreign exchange reserves or commodity revenue, besides protecting the domestic economy from fluctuations in international commodity prices.

The GAPP contains 24 principles covering a wide range of issues from legal framework to governance structure to investment policies and risk management of SWFs. Since the principles are voluntary in nature, their actual implementation would be dependent on member-countries. The IWG has also proposed to establish a formation committee that would explore the creation of a permanent international body on SWFs.

One major issue which cut across every principle of GAPP is transparency and public disclosure. True, some SWFs (particularly from the Middle East) are opaque and reveal little information. But there are some SWFs (such as Norway's Government Pension Fund), which are very transparent. There are very few non-SWFs and institutional investors that can match up to the high standards of transparency, governance and accountability of the Norwegian SWF.

The varying degree of transparency among the sovereign wealth funds have to be viewed in their specific national context. It is hardly surprising that opaque governments tend to operate opaque SWFs. It is not that all other investment funds and financial institutional (barring SWFs) are more transparent in these countries. Though both Saudi Arabia and Norway operate SWFs, their transparency, governance and accountability standards are hugely different due to their distinct historical, cultural, political, legal and institutional contexts. In some Middle East countries, even basic national statistics are not made public.

Increasingly, SWFs are becoming more transparent and accountable. Many of them are conducting external audits, hiring external managers and regularly publishing financial information. However, improvements in the transparency and governance will come gradually and organically. One should not expect all SWFs to adopt higher standards of transparency and governance overnight.

The demand for increased transparency of SWFs by western countries lacks credibility in the light of poor levels of transparency and governance standards of big private investors. Singling out SWFs for their opaqueness but overlooking similar (or even greater) levels of secrecy and unaccountability enjoyed by hedge funds, private equity funds and investment banks exposes the double-standards the western policymakers. In principle, all financial institutions (public or private) should be transparent. Why single out sovereign wealth funds?

The second issue underlying the GAPP pertains to the threat to market instability. Till date, not a single incident of sovereign funds destabilising financial markets has come into public notice. On the contrary, a number of factors suggest that SWFs could exert a stabilising influence on global financial markets. First, unlike hedge funds, SWFs do not use excessive leverage to amplify market positions and returns.

Second, SWFs are typically patient investors with long-term investment horizons. The shifts in their currency or asset portfolios happen gradually over a longer period. Third, the funding source of SWFs is fairly stable which makes them less sensitive to market volatility. Fourth, unlike hedge funds and mutual funds, SWFs are not prone to sudden withdrawals by investors, which could force them to liquidate their positions quickly. Fifth, given their stable funding source, SWFs could go against market trends as witnessed during the ongoing credit crisis. By injecting billions of dollars into ailing western banks, the SWFs acted as counter-cyclical investors.

Sixth, the SWFs contribute to the economic stability in their home countries by acting as a buffer against volatile commodity prices and mitigating 'Dutch disease' effects. The third major component of GAPP addresses non-commercial objectives of SWFs. Though Principle 19 falls short of an explicit pledge not to invest for non-commercial purposes, it calls upon funds to publicly disclose investment decisions 'subject to other than economic and financial considerations.'

So far there is not a single instance of mischievous behaviour by SWFs. The overwhelming majority of sovereign funds are passive investors. In cases where SWFs undertake direct investments, they do not seek controlling interests. Even the large-scale direct investments made by SWFs in the US and European banks during 2007-08 are minor in ownership with no special rights or board representation. Additionally, host countries have adequate legal instruments to block any foreign investments that may potentially threaten national security.

Will the GAPP succeed in removing fears in the recipient countries? It is too early to judge. Nevertheless, the rise of SWFs not only reflects the global imbalances, more importantly, it represents a structural shift in the international financial system with the comparative decline of west and the growing financial clout of developing world.

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