

ECONOMIC RECESSION
BITTER PILL TO SWALLOW



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**How micro-finance can fulfil
social responsibility Islamically**

Here comes the SUN

Sovereign wealth funds (SWFs) have a sunny disposition in today's stricken markets. Yet they are a target of suspicion and accused of having hidden agendas. **Alberto Brugnoli** takes an in-depth look at their structures



IN 1976, IN A WORLD MUCH LESS OPEN, LAFICO THE Libyan government's bank and precursor of the Libyan SWF, became a shareholder of Fiat, at that time in dire straits. Regeb Misellati and Abdullah Saudi were given two seats on the executive board and proved friendly and competent administrators. Ten years after, Fiat was again flourishing—the strategic vision of Giovanni Agnelli was vindicated and Libya cashed in an extraordinary gain

SWFs are not a new phenomenon in the financial world, nor a new category of investment, as many of the established funds have been around for several decades, some since the 1950s. The new phenomenon is the SWFs' growing prominence fuelled

by their sheer size, by some high-profile attempts to purchase large stakes in Western companies and by their providential help to recapitalise some of the world's leading financial institutions, thus shifting the burden to keep them off the taxpayers' shoulders.

Almost overnight SWFs have become all the rage, to the point that Italy is proposing to turn the mammoth European Investment Bank (EIB) into a sovereign investment fund for the 27-nation bloc, whereas France, with the usual touch of Gallic chauvinism, wants its own. Brazil, Japan, India, Taiwan and Thailand plan to launch their SWFs, whereas Saudi Arabia is considering plans to merge its various funds into one super fund.

Officials, on the other hand, seem to have lost any sense of direction. While Gordon Brown welcomes the positive role that SWFs play in the UK and the US, deputy treasury secretary Robert Kimmitt flies to the Middle East and calls on GCC countries to continue investing in the US. American regulators keep launching investigations into SWF investments while memories of the P&O saga are still hurting the feelings of many Emiratis. Italy's centre-right government opposes SWFs buying more than 5% of individual Italian companies.

SWFs are caught in the middle: they get an unfavourable media coverage but are the favoured topic of economic and geo-strategic forums worldwide while financial institutions are courting them as they play the white knight role. This over exposure has created a great deal of apprehension about SWFs' purposes, structures and investment strategies and has raised issues about their potential impact on financial markets, corporate governance and national security. The unease about their ultimate intentions has spread through governments and Western public opinions alike.

To add to the confusion, while SWFs are used like an homogeneous term, they conceal a reality extremely diversified and fragmented. SWFs can be defined as large pools of capital controlled and owned by governments and invested through special asset management vehicles in a wide range of mostly foreign assets for long-term purposes.

A broader definition includes funds held by other sovereign investment vehicles such as state-owned enterprises, development funds and pension reserve funds. An even broader definition takes into account official foreign exchange reserves not held in other sovereign investment vehicles.

These flexible definitions, which allow for double counting and statistical errors, leave a degree of incertitude about the current size of sovereign investment vehicles. This incertitude is compounded by the limited disclosure of some SWFs. The \$3.3 trillion that falls under the SWF tag are managed by almost 60 SWFs, although, it must be noted that these assets are highly concentrated, as the top 10 funds account for about 80%, and the largest one, ADIA of Abu Dhabi, accounts for about 20–25%. From the regional perspective, the Middle East accounts for 45%, Asia for 28%, Europe for 18% with the balance is evenly spread among Australia, Africa and the Americas.

Macro drivers

The rise in SWFs, which have more than doubled in size in the last seven years, has much to do with the macro drivers behind the surge in foreign reserves, in particular, the large current account imbalances between the US and the surplus economies in Asia and the oil-exporting countries. Although significant, this number pales when compared with the conventional fund management assets, as they represent only 4% of pension, insurance and mutual funds. Should global financial assets be taken into consideration, this percentage drops even further, to less than 2%.

SWFs are traditionally distinguished by their funding sources and their purposes. In terms of funding, two sources stand out. The first is commodities—primarily oil and gas exports—and

these are based on revenues generated either directly through state-owned companies or commodity taxes. Commodity revenues are viewed as “real wealth”, as they typically have no corresponding liability on the government's balance sheet. It is estimated that around \$2.4 trillion of the \$4.1 trillion in oil exporters' foreign investment was, at the end of 2007, held by governments (the remainder being held by ultra high net-worth individuals). Of these funds, around \$1.9 trillion were invested through SWFs and the balance held as central banks' reserve assets. The increase of these funds in the coming years will largely depend on the future price of oil, and their biggest source may be those countries with the largest oil reserves, such as Saudi Arabia, Canada and Iran

Non-commodities

The second source is non-commodities, based on transfers from government budget surpluses, fiscal surpluses, pension reserves and privatisation revenue of assets. Non-commodity sources include foreign exchange reserves that exceed the portion deemed necessary for the conduct of foreign exchange policy and precautionary reasons.

Non-commodity funds have been steadily growing and are capturing an increasing share of global SWFs: the 13% share

or \$169m in 1997 moved to 36% or \$1.2 trillion in 2007 and may increase to 50% by 2015. This process has been fuelled by the rapid growth of official foreign exchange reserves put in SWFs by Asian countries (above all, China and Japan). Asian official foreign exchange reserves topped 58% of the total of \$6.5 trillion recorded at the end of 2007, of which 18% or \$1.2 trillion was invested in SWFs. The classification of SWFs, based on their purpose, are usually

broken down into four types of funds.

Revenue stabilisation funds: designed to cushion the impact of volatile commodity revenues on the government's fiscal balance and the overall economy. These funds are built up in times of favourable commodity prices and drawn upon in cases of low commodity prices or a shortage of reserves.

Future generation funds: these are meant to invest revenues or wealth over longer periods for future needs. They aim to spread the commodity wealth over several generations rather than fueling a domestic investment and consumption bubble.

Holding funds: these manage the governments' direct investments in companies either domestic state-owned enterprises and private companies as well as private companies abroad.

Generic sovereign wealth funds: these cover one or several of the previous three purposes but whose size tends to be so large that the main objective becomes optimising the overall risk-return profile of the existing wealth.

Other differences among SWFs apply to:

- **Ownership and governance**—while all SWFs belong to the public sector, some are directly owned by the government and others are statutory entities. All have a board, but some are entirely government-controlled, while others have mixed representations from the government and private experts. A few are only answerable to the legislature

SWFs are the favoured topic of economic and geo-strategic forums; financial institutions court them as white
Alberto Brugnoli



- **Disclosure:** standards vary enormously but disclosure is becoming more accepted as best practice and some notoriously secretive funds have started to reveal information about their size, performance and basic asset allocation. Progress, though, is slow, as SWFs are resisting the IMF attempt to draft a code of conduct on the irrefutable argument that it is hypocritical of the West to demand regulations when the failure to regulate European and American banks and hedge funds has led to a global economic crisis. The voluntary Santiago principles were issued last October with the aim to establish a plain level field for the SWFs in the recipient countries: they cover the legal framework of the SWFs, their objectives and co-ordination with macroeconomic policies, the institutional framework and governance structure, and the investment and risk management framework.

Almost at the same time, the OECD (Organisation for Economic Co-operation and Development), mandated by the G-7 finance ministers and spearheaded by the US, has issued its own "declaration on sovereign wealth funds and recipient country policies". These guidelines provide recommendations for recipient countries that help to make these policies effective in protecting their national security and to ensure they are not used as disguised protectionism. To summarise, it is fair to say that some basic best practices concerning governance, transparency and accountability have emerged organically among the SWFs.

- **Institutional structure**—the main difference applies to SWFs that act as separate entities with their own balance sheet (ADIA, Temasek) and those that act as an agent for one or several public-sector entities. In some cases, the central bank acts as the agent that manages the assets of the SWF (SAMA)

- **Asset allocation** that depends partly on the purpose of the SWF. Revenue stabilisation funds tend to invest in liquid and less-risky instruments, while future generation funds tend to invest in higher-yielding asset classes. In general, they have considerable freedom, are usually not constrained to certain asset classes and are well diversified. By contrast, the central banks concentrate highly on the much smaller government bond market.

Largest share

The largest share of SWF assets are invested in public securities (bonds and stocks), but the share of alternatives (private equity, property, hedge funds and commodities) is rising, with some SWFs having large exposures, especially private equity. Of total SWF assets, 35–40% are in fixed income, 50–55% are in public equity, and 8–10% are in alternatives—the largest growth area and where the greatest asset allocation impact will occur, as this is the stated intention of most SWFs.

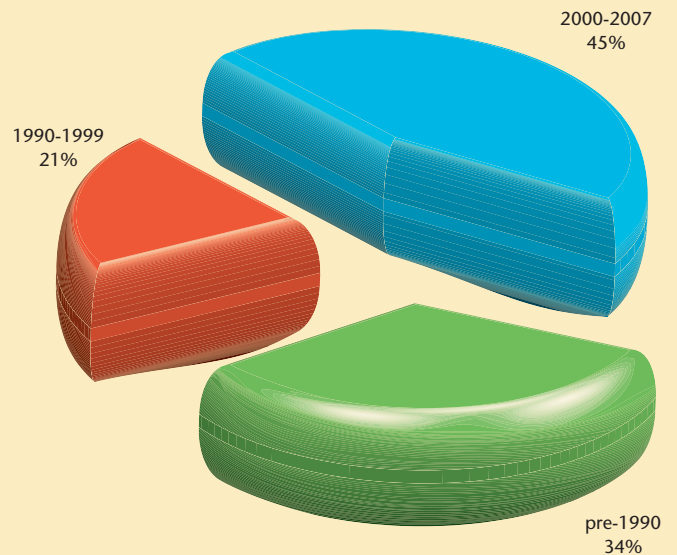
Commodity SWFs show a preference for equity and alternative investments, whereas non-commodity SWFs have been an important source of liquidity on global capital markets and tend to invest in US assets, particularly US government bonds. SWFs have become more active in primary and M&A transactions and this trend is likely to continue. Political issues aside, this is not bad news, because SWFs are likely to be stable providers of long-term funding. Most SWF assets are invested in foreign markets, with around four-fifths of oil-exporting countries' funds invested in overseas assets—the US is the destination for more than half of the investments in 2002–2006. For non-commodity SWFs, the US dollar accounted for nearly two-thirds of the total. There are also some notable exceptions of funds that invest in the domestic market (Temasek, Khazanah).

- **Currency allocation**—SWFs can choose their own currency,

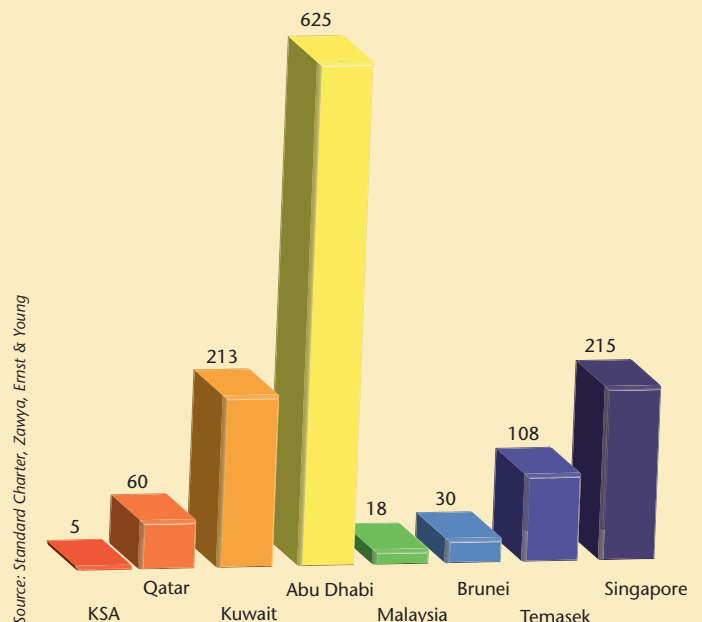
SWFs and official foreign exchange reserves

All countries have foreign exchange reserves. When a country, by running a current account surplus, accumulates more reserves than it needs for immediate needs, it can create a SWF to manage those resources. Key issues in determining whether SWF assets can be considered as official reserve assets include their liquidity and marketability and whether there is some legal or administrative guidance that would preclude the assets from being readily available to the monetary authorities to meet a balance of payments needed.

Launch of top 40 SWFs by year (%)



Estimated assets of selected SWFs in US\$ (billion)



Source: Standard Charter, Zawya, Ernst & Young

Sovereign investment vehicles other than SWFs

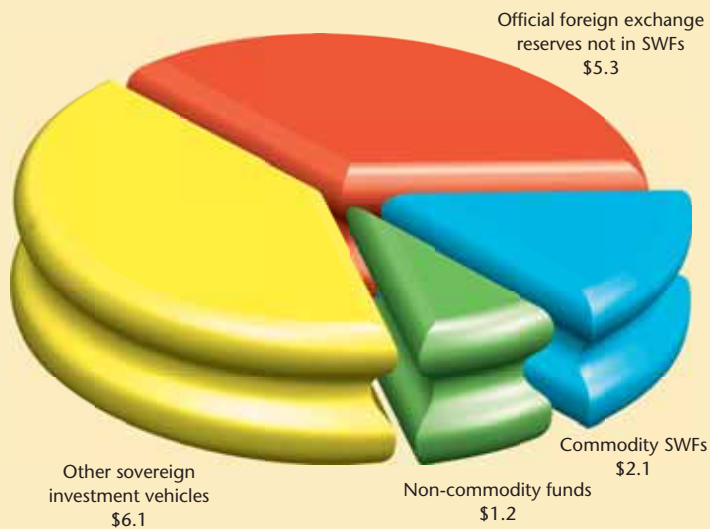
Sovereign and public pension reserve funds—investment vehicles funded with assets set aside to meet the government’s future entitlement obligations to its citizens.

Government investment funds—established to invest official reserves. Often, the assets are still counted as reserves.

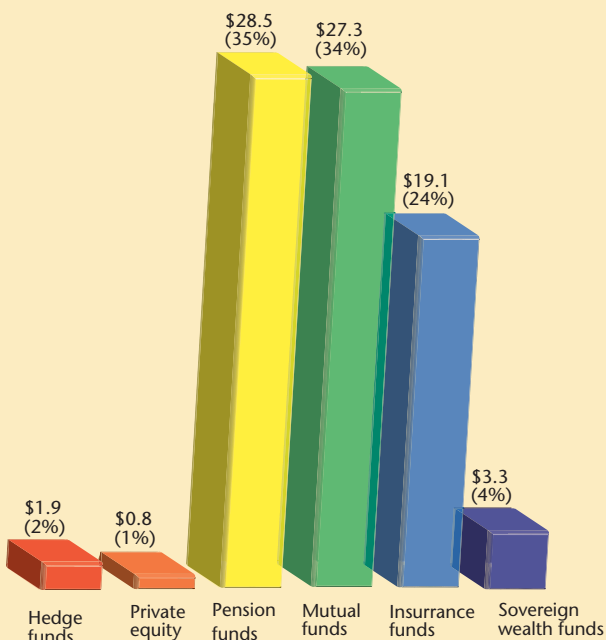
Government development funds—resources allocated for funding priority socio-economic projects, such as infrastructure.

State owned enterprises—companies the state has significant control over, such as manufacturing and financial firms.

Sovereign investment vehicles in 2007 in US\$ (trillion)



Assets under management in 2007 in US\$ (trillion and %)



but many are constrained by their country’s foreign-exchange policy which, in practice, means they are dollar-based.

- **Benchmarks**—some SWFs have overall portfolio benchmarks (index or total return), while others use separate benchmarks for each asset class. Most are based on market indices and some are customised. They tend to be passive benchmark trackers, especially in equity, and few use portable alpha strategies.

- **Investment process**—some funds are run by government or former government officials and members of the ruling families, outsourcing only some operations. Others outsource all front- and back-office operations, focusing entirely on the strategic asset allocation and manager selection. The role of external investment managers has increased in recent years: it is estimated they manage around 45% of SWF assets. This may decline in the coming years as more SWFs increase their investment staff and develop local representation.

On inspection

With this diversity of structure, purpose and ownership, how does this correlate with the popular view that the growth of SWFs is distorting the markets? The common wisdom is they increase the overall demand for risky assets (and therefore drive down their risk premia) and reduce central bank reserves (which should reduce the demand for government bonds and drive up bond yields). Other distortions are feared in the equity markets.

Intuitively, one would say that SWFs are unlikely to have any significant distorting impact on financial markets because of their tiny weight in world finance. Even if they had to quadruple their assets over the next 10 years, they will remain small compared with the financial universe, accounting for no more than 3–4% of global financial assets. Moreover, while SWFs have the mandate to take more risk and target higher returns than central banks, they remain public-sector institutions and are unlikely to turn into hedge funds or private equity firms that engage in speculative trading and use extensive leverage.

A closer look shows that the \$1.1 trillion to \$1.4 trillion in fixed-income assets held by SWFs represent only about 1.8–2.2% of the global debt market and that the \$1.6 trillion to \$2 trillion in public equity is about 3.2–3.8% of the global equity market. Without foreign investment, the interest rates on 10-year US bonds would have been 90 basis points higher in 2005.

As the total exposure of SWFs to public equity is already large, it is unlikely they will increase their share. Even if they did, the impact will be negligible. Individual funds will probably have more impact on primary and M&A transactions, where SWFs will increasingly function as lead or anchor investor. This activity reached new highs in the last year when a few SWFs invested in more than \$40 billion in some of the world’s largest financial institutions.

However, it would be wrong to view this increased M&A activity as distorting, as SWFs acted more as providers of stable long-term risk capital. As for alternatives, SWFs hold roughly \$270bn–\$340bn, which represent about 7.5% of the total market. Of that, at least half is private equity. Given SWFs’ growing risk appetite and higher return targets, alternatives are likely to experience the largest allocation increase, with SWFs’ share in alternatives likely to double over five years to about 13%. This is where the most effects will be felt.

The rise of SWFs, although significant, is unlikely to have distorting effects on overall markets because of their relative size and wide diversification. On the contrary, one could argue that

SWFs have a stabilising effect, as they are long-term investments with stable funding sources that are unlikely to be withdrawn quickly or used to engage in speculative activities, and use little, if any, leverage. Instead, risk management will be high on their agenda and be reflected in well-diversified portfolios. Combined with their higher return targets, SWFs are likely to be stable providers of long-term risk capital.

So with this in mind, what are the reasons for this call for restrictions and more regulations? The answer lies, I suspect, beyond the scope of economics and has to be found within the current debate about the governance of globalisation and the international financial system. It has to do with the emergence of a new economic order, the extraordinary dispersion of financial power and with the psychological self-reassessment through which the Western world (the "old boys" network) needs to go through. It has to do with the scaling up by the GCC SWFs of their investments in Islamic finance and with the more active role that GCC governments are directly taking in Islamic banks, promoting the development of such financial institutions at home, in the MENA region, Pakistan and now in the EU.

The old power brokers see the SWFs abandoning their traditional passive approach and becoming more active as shareholders. As such they want to exercise their rights. For years, the SWFs have been content to feed on near-cash investments such as US bonds, thus keeping the US economy afloat. But now they are on the move. They are new actors coming to the scene, challenging the status quo of international financial power bases and bringing with them a list of mega deals that expands by the day.

Multipolar

The planet has suddenly become multipolar to the surprise of many. Here are the foreigners coming onto the turf, those very foreigners that have been regarded by the developed world as targets for investment and subsequent exploitation. Are they pursuing political or foreign policy interests? Are they investing to secure control of strategically important businesses or sectors for political rather than commercial reasons? Arguably, this been the role that the West and its corporations has played in their countries since the industrial revolution. Also, SWFs have never participated in any hostile takeover, and the recent large-scale investments in financial institutions have been done with a high degree of transparency.

But to move the argument a step further. What will happen if a major Middle Eastern country decided to follow the example of the Russian Gazprom and list its own oil industry? A listed Saudi Aramco, for example, would easily top the world market capitalisation and give the Saudi SWFs enough financial resources to launch a takeover bid of, say, an Exxon Mobil looking for its technical know-how. What at this point will the free-trade West do?

In search of a new world order, the industrialised countries should remember that the oil economies and their surpluses are the result of strategic choices made when the Seven Sisters were ruling the world and that for the surplus economies in Asia the principal issue is not the SWFs, but their industrial, trade and currency policies that generate these surpluses. The right move is to engage the SWFs and their governments, not villainise them. Addressing these concerns through capital-flow restrictions is likely to fuel protectionist forces and make things worst. ■

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