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POLICY OUTLOOK

Gulf Arab SWFs—Managing Wealth in Turbulent Times

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Summary

The global financial crisis has caused tremendous volatilities in the financial markets and several analyses by financial institutions suggest that Gulf Arab and other SWFs have been hit hard. The value of their investments has decreased significantly. Accordingly, growth projections have been substantially corrected downward, reflecting current paper losses and, more importantly, more realistic incomes from commodity exports, the main source of funding for Gulf Arab SWFs.

The political environment that SWFs operate in has become further fragmented and more complex. Today, SWFs are exposed to three different political arenas: (1) the arena of international public policy making, (2) the national political arenas of recipient economies, (3) their own domestic political arenas.

We had suggested in a previous Carnegie Paper, *When Money Talks: Arab Sovereign Wealth Funds in the Global Public Policy Discourse,* that the international community was "too early" and "too loud" in dismissing the productive role that SWFs could play in stabilizing the international financial system. The result was a heightened level of perceived political risk that might have prevented SWFs from playing that role and helping to curb the global financial crisis.

The international community, including both recipient and investing economies, should not be "too quiet" or "too late" in arguing for and establishing the frameworks and institutions needed to further integrate SWFs into the global financial architecture.

Sovereign Wealth Funds Hit by the Financial Crisis

Like other market participants, SWFs worldwide have been affected by the global financial crisis, with considerable consequences for their investment policies and their further integration into the global financial architecture.

Morgan Stanley estimates that the value of the world's SWFs might have incurred losses between $500 billion and $700 billion in 2008, bringing the SWFs' current total assets under management down from $3 trillion to between $2.3 trillion and $2.5 trillion within twelve months.[1]

Long-term growth projections have also been revised downward. Morgan Stanley now estimates that the value of the world's SWFs assets will reach $9.7 trillion in 2015, instead of $12 trillion as projected in early summer 2007. Merrill Lynch predicts that SWF assets will grow to between $5 trillion and $8.5 trillion by 2012.[2] Deutsche Bank Research anticipates that SWFs will grow by 15 percent per year, bringing the industry to approximately $5 trillion of asset value by 2010, and $10 trillion by 2015.[3]

The performance of Gulf Arab SWFs has not been shielded from this trend. Estimates from the Council of Foreign Relations suggest that the Gulf's external portfolio fell from about $1.3 trillion in 2007 to $1.2 trillion in 2008. The value of the foreign assets of the governments of Kuwait, Qatar, and the United Arab Emirates, according to the CFR, fell from around $1 trillion at the end of 2007 to about $700 billion at the end of 2008. The Abu Dhabi Investment Authority and Council, assumed to have managed around $450 billion in assets by December 2007, may have lost up to $140 billion by the end of 2008. The value of the assets of the Kuwait Investment Authority fell from $262 billion to $228 billion and those of the Qatar Investment Authority from $65 billion to $58 billion in the same period. Only Saudi Arabia bucked the trend: given its fairly conservative investment behavior, the Saudi Arabian Monetary Agency (SAMA) saw the value of its foreign assets and those that it manages for other government institutions rise from $385 billion by the end of 2007 to $501 billion toward the end of 2008. In all cases, negative capital gains were outbalanced by considerable net inflows, given the average price of crude oil at $100 in 2008.[4]

Although these figures presented by leading financial institutions appear to be based on solid assumption and research, they are still not based on verifiable information provided by SWFs themselves. The continued uncertainty about the global distribution of wealth, and the share that SWFs in the Arab world and elsewhere command, without any doubt has increased the levels of inefficiencies in addressing the global financial and economic crisis.

SWFs Are Becoming More Strategic Investors

The uncertainties in global financial markets have had serious repercussions for Gulf Arab SWF investment behavior. According to the Monitor Group, the publicly-reported investment activity of SWFs already in the third quarter of 2008 has fundamentally refocused. SWFs shied away from investments in the global financial sector and resisted OECD investments in general.[5] A brief assessment of the publicly available data for the fourth quarter of 2008 confirms this trend, with some reservations.

In *When Money Talks*, we had suggested that Gulf Arab SWFs are driven by a range of motives. They could either focus on maximizing risk adjusted returns or engage in strategic investments to diversify national economies and make them more competitive. We argued that SWFs could use their assets to build new strategic alliances and networks with international partners that benefit their overall national economic development objectives.

The fourth quarter of 2008 saw the governments controlling SWFs leaning towards the latter investment approach, using their financial surplus to make smaller scale acquisitions, including in OECD economies, that support their national economic development objectives. In doing so, smaller investment entities that conceptually reside on the border between SWFs and national development companies have been active.

Abu Dhabi continues to advance its national diversification strategy by engaging in the natural resources exploration and extraction industry outside the Emirate and consolidating its position in the petrochemical industry. The International Petroleum Investment Company (IPIC) purchased a 17.6 percent stake for just over $1 billion in Oil Search Ltd., which operates all of the oil and gas producing fields in Papua New Guinea.[6] It bought a 70 percent stake in Ferrostaal, which designs oil and petrochemical plants for MAN, the German truck manufacturer, and has the option to acquire the remaining 30 percent by 2010.[7] It also invested $1.63 billion for a 71 percent stake in Aabar Investments Co., an energy investment company.[8]

Through the Mubadala Development Company, Abu Dhabi also strengthened its positions in the global aviation, aerospace, and technology industries. Mubadala partnered with Finmeccanica, the Italian aerospace company, to manufacture aerospace composite components for civil aircraft. Already in summer, Mubadala partnered with the European Aeronautic Defence and Space Company, EADS, to build a new aerostructure composites plant. Mubadala also solidified its joint venture plans with General Electric, becoming one of its top ten shareholders.

Mubadala was also set to substantially increase its stakes in Advanced Micro Devices Inc., which will also provide the basis for a semiconductor manufacturing joint venture. It also signed agreements with Veolia Water to create a joint venture that will focus on water production and waste water collection and treatment in the Middle East and North Africa.

Qatar has moved forward with its plans to become an important financial center in the region and beyond; its recent investments might be helpful in this regard. The Qatar Investment Authority (QIA) raised its stakes in the Swiss Bank Credit Suisse to just below 10 percent.[9] QIA also raised its stakes in Barclays to 12.7 percent after going through a rather painful capital raising process. Challenger Universal Ltd., an investment vehicle owned by the state of Qatar, will hold a 2.8 percent stake.[10] During a visit of Prime Minister Gordon Brown, QIA also agreed to set up the Qatar–UK Clean Technology Investment Fund to invest $400 million in clean energy businesses.

These examples illustrate that Gulf Arab sovereign investors are seeking strategic stakes in assets that could help them further their national economic development and diversification objectives.

Politics Matters

Throughout 2008, SWF investments were the subject of considerable political debate. Of particular concern were their function and integration into the global economic system and the threats that they could pose to the economic competitiveness and national security interests of recipient economies. These debates played out in three different arenas: (1) in the international arena mostly structured by the efforts of the IWG and the OECD, (2) within the national political processes of recipient economies, and (3) increasingly within investing economies.

The International Arena

As the most inclusive international policy initiative launched by recipient economies, the OECD sought to develop a more coordinated policy approach of OECD member states vis-à-vis SWFs, aiming to strengthen their commitment to open international investment policies. The OECD completed its work with the adoption of an OECD Guidance on October 8, which was presented three days later to the International Monetary and Financial Committee in Washington.[11]

The OECD Guidance has three parts: The “OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies” of June 2008 provides political support for the OECD Guidance and increases its weight as a source of international investment law. Among other points, it recognizes that if SWF investments were motivated by political rather than commercial objectives and could be a source of concern, especially in the context of preserving national security. The second part, the OECD General Investment Policy Principles, reaffirms the relevance of OECD investment principles (adopted in 1961) such as nondiscrimination, transparency, liberalization, “standstill,” and unilateral liberalization for SWFs. And finally, the “OECD Guidelines for Recipient Country Investment Policies Relating to National Security” provides for the right of governments to safeguard essential security interests. It states that "[R]estrictive measures should be used, if at all, as a last resort when other policies … cannot be used to eliminate security-related concerns."[12]

Moving forward, the OECD will use a "peer review" process to promote adherence to these standards. As for investing economies operating SWFs, the work of the IWG has become the focal point for organizing collective action.

At the IMFC meeting in Washington in October, the IWG published a voluntary code of conduct, the "Generally Accepted Principles and Practices" (GAAP), also known as the "Santiago Principles," named after the venue of the third and final working meeting of the IWG.[13]

The Santiago Principles consist of three parts[14]: (1) the legal framework of SWFs, their objectives, and coordination with macroeconomic policies; (2) institutional framework and governance structure of SWFs; and (3) an investment and risk management framework.

Beyond their substance, there are two more fundamental observations about the Santiago Principles to be made:

The process that the IWG has engaged in, culminating in the adoption of the Santiago Principles, is based on an innovative, postmodern approach to global governance and contributes to a growing body of international soft law that provides order to the world of global finance. Whereas traditionally nation states have been the ultimate subjects to international rules and regulations, voluntary codes of conduct such as the Santiago Principles offer an alternative option to global institution building, i.e., a new form of global governance. The constituents of voluntary principles in the most recent past have been non-state actors such as multinational enterprises. It is therefore remarkable that in the case of the Santiago Principles, state entities, i.e., SWFs, commit themselves to voluntary principles.

Second, based on broad participation from Asia, Europe, and the Americas, the Santiago Principles are highly inclusive. This is remarkable since these kind of voluntary arrangements usually feature a constituency that is predominantly recruited from developed economies, undermining their effectiveness given the current dispersion of economic clout. While voluntary principles in other policy areas suffer from a lack of participation from representatives from emerging economies, the Santiago Principles include a broad spectrum of players from established and emerging economies.

Both the policy process that reflects alternative forms of global governance, as well as its inclusive nature, make the IWG's work an innovative example for global public policy making that could resonate beyond the boundaries of the global financial system. Despite the currently lower levels of political exposure, SWFs should move forward with the implementation of the

Santiago Principles in order to prevent any future political backlash, especially when the global economy stabilizes and cross-border investments increase again.

The National Debates in Recipient Economies Calming Down

The public discussions within recipient economies with regard to the economic and security challenges SWFs could pose calmed down considerably by the end of 2008. However, echoing the agitated arguments from spring and summer 2008, individual governments of recipient economies took very different positions on SWFs. European governments very much drove the discussions, whilst the United States was largely preoccupied with its presidential election campaign where SWFs did not prominently feature.

In Europe, the positions of the UK and France represented the two poles with regard to their receptiveness to SWF investment, with the other European economies falling in between.[15]

The UK continued to actively invite investors from the Gulf and elsewhere to invest in its economy, underlined by Prime Minister Gordon Brown's visit to the Gulf region in November and his recognition of their contribution to the efficient allocation of capital.[16] On the contrary, President Nicolas Sarkozy, speaking before the European Parliament in October, suggested that Europeans establish their own SWFs to protect strategic industries from foreign takeover. The German government revised the Foreign Trade Law and proposed a slimmed down version of the Committee on Foreign Investment in the United States (CFIUS) review process. Italy has created a "national interests committee" to vet SWF investments in its economy.

European governments are not only divided about how to best deal with foreign investments but also have to take into account a domestic audience that remains skeptical of foreign investors. This has added to the heightened levels of political complexity that sovereign investors are bound to face in the future.

For example, according to a poll conducted by a German weekly in October, a great majority of Germans support the idea that key industries, such as energy, financial services, aviation, and logistics industries need to be protected by the state against foreign takeover. This sentiment was reflected in the comments of Hartmut Mehdorn, CEO of Deutsche Bahn AG, during a visit to Abu Dhabi in October that although he would like to see Arab sovereign investors participate in the IPO of his company, he was concerned about the political discussions that would inevitably follow.[17]

A second example is the fundraising effort of Barclays, in which QIA and other investors from the Arab world were offered preferential terms for about 30 percent of the stakes in Barclays. Existing shareholders revolted against the plan on the grounds that their shareholdings would be diluted and their influence on the bank reduced. It was only at the last moment that a compromise arrangement ensured the shareholders' agreement to the capital increase.

We suggested in *When Money Talks* that the political exposure of SWFs in recipient economies has been substantially driven by populist concerns, with SWFs being perceived as a threat to national security or economic competitiveness. Responsible political leaders have tried to identify some middle ground, calling for more transparency and accountability. By the end of 2008, due to changing economic fundamentals, formulating consistent policies to better frame recipient economy relations to SWFs appears to have become less urgent. However, should economic fundamentals change and cross-border investment activity pick up again, policy makers in recipient and investing countries might again be faced with the problem of populist sentiment.

National Debates in Investing Economies Flaring Up

We argued in *When Money Talks* that Arab public opinion, the media, and civil society should take a healthy interest in the investment behavior of their countries' SWFs. On the flip side of this proposition, domestic political risk for SWFs is looming. If the public exposure of Gulf Arab SWFs in recipient economies has been somewhat reduced, the pressure from their own constituency has, in some cases, dramatically increased, reminding fund managers of their accountability toward the citizens whose financial future they manage.

An illustrative example is Kuwait. The high-exposure investments of the KIA in Citigroup and Merrill Lynch not only exposed the fund to the international audience, but also to a domestic one some twelve months later. KIA's investments were not seen as problematic as long as the dramatic increase in the price of oil provided some degree of economic security to the citizens of Kuwait and kept the Kuwait Stock Exchange (KSE) afloat. But it contributed to a political crisis when the price of oil and the KSE lost some 40 percent of its value from early 2008. Local investors forced the KSE to close down by court order. KIA was asked to provide liquidity to local markets in an attempt to reinsure investors, and to invest at least $5.4 billion in Kuwaiti equities in December.[18] Exacerbating the already volatile situation was the decision of the government to step down over charges of alleged government mismanagement.

A second case, involving a Kuwaiti state-owned enterprise rather than a straight-forward SWF, indicates that investments that appear to directly benefit the national diversification strategies of Kuwait's national economy do not necessarily pass without political scrutiny. On December 1, Dow Chemical Company (Dow) and the Petrochemical Industries Company (PIC), signed an agreement to establish K-Dow Petrochemicals as 50:50 joint venture project, set to become a leading global supplier of petrochemicals and plastics. The total enterprise value of the Dow business going into K-Dow was supposed to amount to approximately $17.4 billion. PIC was due to pay around $7.5 billion.

The JV was seen by the leadership of PIC as a useful option to achieve a leading position in petrochemicals and to connect its oil refining business with the production of basic petrochemicals. However, by the end of December, Kuwait decided to pull out of the deal due to uncertainties of the impact of the global financial crisis on the value of the assets of K-Dow and in consequence to political pressure that Kuwaiti parliamentarians exerted on the government. These cases illustrate how carefully investors and recipients have to navigate an increasingly fragmented stakeholder environment that threatens to put higher political risk premiums of cross-border deals.

Conclusion

The past 20 months have witnessed a heated debate about the future role of SWFs in the international financial system. The debate has also been a highly cyclical one. At its peak in summer 2007, commentators suggested that SWFs would shake the logic of capitalism. Today, others ask if we are seeing a "bonfire of SWFs." It appears that the international community has difficulties identifying a middle ground that could provide the basis for a mature discussion about the constructive international role of SWFs, given their mandate and accountability to their own constituents.

It is therefore important that the work of the SWFs toward their orderly integration into the global financial architecture or what is emerging as such is maintained. During this period of huge economic uncertainty it is easy to drop the ball. But once the global economy is bouncing back, SWFs will want to invest and seek global opportunities again.

It would therefore be important to move forward with the implementation of the Santiago Principles in order to ensure that SWFs become widely accepted market participants.

In order to ensure progress, the group of SWFs should engage in setting up a thorough peer review mechanism that would prevent individual members from taking a free ride; allow an educated and politically mature public audience to perform a watchdog function; and foster knowledge transfer amongst its members. Furthermore, the Santiago Principles could be supported by a secretariat that provides process management, monitoring, and verification functions. At a later stage, the secretariat could also serve as a representative body on issues that SWFs collectively might wish to move into the public policy arena.

Should the Santiago Principles suffer from sluggish take-up and slow implementation, association with them might become a detriment to SWFs that are more advanced than others.

There is yet another argument that supports rapid implementation of the Santiago Principles. An ever growing community of experts based in financial services institutions, consulting firms, think tanks, and academic institutions have developed a substantial body of research in an attempt to address an information deficit about SWFs that a broader international audience of policy makers and financial market participants demanded to fill. Absent verifiable information about the asset base of many SWFs, this body of research is largely based on a connect-the-dots approach—bringing disparate fragments of information together. One can assume that these efforts result in an ever more accurate picture of SWFs.

One can also assume that the remaining uncertainties about SWFs have been giving impetus to new regulation and legislation, increasing the political and regulatory risk premium for SWF investments in Europe and the United States.

More transparent SWFs could therefore become a more valuable proposition than in the past. As more knowledge is developed about SWFs, the value of not disclosing essential information is decreasing. Uncertainty with regard to SWFs has increased the political and regulatory risk premium for all sovereign foreign investors. It has also caused inefficiencies in addressing the global financial crisis. It might therefore be in the individual interest of SWFs, as well as in the collective interest of the group of SWFs as emerging global investor class, to shift gears on the issues of transparency and disclosure.

Notes

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[12] Ibid., p. 5.
[13] International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds: Generally Accepted Principles and Practices, "Santiago Principles"*, October 2008.
[14] For an excellent assessment of the Santiago Principles, see Alastair Newton, "Geopolitics: Sovereign Wealth Funds and the 'Santiago principles,'" October 2008, Nomura Global Equity Research.
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[16] "So Many Challenges the Gulf and Britain Must Face Together," Gordon Brown, *National*, November 1, 2008.
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