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THE RISE OF ASIAN SOVEREIGN WEALTH FUNDS

BY: NICHOLAS BORST

Spurred by the region's rapid economic development, sovereign wealth funds in Asia have increased in both size and number over the past decade. These funds have become large and active participants in global financial markets and they frequently make high-profile foreign investments. Given their size and close links to governments, sovereign wealth fund investments often attract media attention and are scrutinized for political motivations. The perception that many Asian sovereign wealth funds are not transparent in their activities and investments has also raised concerns. This *Asia Focus* provides an overview of sovereign wealth funds, evaluates the structure and activities of major funds in Asia, and compares the transparency of Asian funds relative to international best practices.

Overview of Sovereign Wealth Funds

Definitions of sovereign wealth funds vary greatly, making comparative research difficult. The U.S. Department of Treasury adopts a relatively narrow definition that sovereign wealth funds are government investment vehicles that are funded by foreign exchange assets and which are managed separately from the official reserves of the monetary authority.[1] The Federal Reserve System adopts a broader definition that sovereign wealth funds are investment funds that are owned by a national or state government.[2]

In 2008, the International Working Group of Sovereign Wealth Funds (IWG-SWF)[3] defined sovereign wealth funds as special purpose investment funds or arrangements that are owned by the general government. It further stated that sovereign wealth funds are created for macroeconomic purposes; hold, manage, or administer assets to achieve financial objectives; and employ a set of investment strategies that include investing in foreign financial assets.

This *Asia Focus* follows the IWG-SWF definition and employs an analytical framework proposed by the International Monetary Fund (IMF) that classifies sovereign wealth funds by investment purpose. Sovereign wealth funds can be divided into five general categories by investment purposes: stabilization funds, savings funds, development funds, pension reserve funds, and reserve investment corporations.[4] Table 1 provides a brief description of the various types of sovereign wealth funds using the IMF methodology.

In addition to investment purpose, sovereign wealth funds also vary significantly by source of funding. Sovereign wealth funds are commonly financed by balance of payments surpluses, funds accumulated by central banks during foreign currency operations, the proceeds of privatizations of state-owned enterprises, fiscal surpluses, and receipts from commodity exports.[5]

Many of the world's largest sovereign wealth funds are funded by the proceeds from natural resources. These funds are created to preserve the proceeds from the sale of non-renewable resources, such as oil, for future generations. Sovereign wealth funds in Norway and in the Middle East are examples of this type of fund.

Asian sovereign wealth funds differ in that they are primarily funded out of government revenues, foreign exchange reserves, or the contributions of retirees. This direct relationship to national and personal finances can produce different expectations regarding the operation and performance of these funds. For example, sovereign wealth funds in Singapore and China have faced public scrutiny in the past over investment losses or market underperformance. In contrast, funds financed by natural resources, such as Middle Eastern oil funds, lack an explicit liability for their funds and therefore are subject to less public scrutiny.[6]

Table 1 - Types of Sovereign Wealth Funds

Type	Description
Stabilization Funds	Use funds to insulate the budget and economy from commodity prices shocks
Savings Funds	Save wealth for future generations by investing national savings.
Development Funds	Allocate investments into government policy priority areas
Pension Reserve Funds	Invest funds to meet expected outflows for retiree benefits
Reserve Investment Corporations	Invest official foreign reserves into higher-yielding assets

Source: IMF

Major Asian Sovereign Wealth Funds

Asia is a major player in the universe of sovereign wealth funds. As a region, Asia accounts for nearly 40 percent of the more than $7 trillion in total sovereign wealth fund assets and a disproportionate number of the largest funds.[7] Table 2 shows a list of the most prominent sovereign wealth funds in Asia, fund types according to the IMF categorization mentioned above, sources of funding, and assets under management as of 2013.

Pension reserve funds account for a large share of Asian sovereign wealth fund assets. In fact, the largest sovereign wealth fund in the world is the Japanese Government Pension Investment Fund. Faced with rapidly aging societies, a number of Asian governments have created pension sovereign wealth funds to bolster resources available to existing pension reserve funds.

Many pension reserve funds started with conservative investment portfolios, mainly composed of government debt. However, mounting benefit liabilities have led to a reassessment of this conservative strategy and these funds are now seeking to increase the rate of return on their assets and diversify their holdings. The recent decision by the Japanese Government Pension Investment Fund to increase its holdings of equities and foreign bonds is an example of this trend.[8]

Reserve investment corporations are the most rapidly growing type of sovereign wealth fund in Asia. Reserve funds in Asia expanded quickly in the past decade due to a large increase in the amount of foreign exchange reserves held by Asian governments. The accumulation of foreign exchange reserves was driven by large current account surpluses and by the response to the 1997-8 Asian Financial Crisis.

During the crisis, several Asian countries depleted their reserves trying to maintain the strength of their currencies. After the crisis had subsided, many Asian countries consciously increased their holdings of foreign exchange reserves to create a buffer in the event of a future crisis. Since 2002, global foreign reserves have increased by an average annual rate of 20 percent.[9] Asia's share of the more than $12 trillion in global reserves was nearly 60 percent in 2013.

A drawback of holding large amounts of foreign exchange reserves is that they are typically invested in low-yielding assets, such as government bonds. Fluctuations in exchange rates can produce "paper losses" on the value of reserves. As a result, many Asian governments have created reserve investment corporations in order to invest foreign exchange reserves into higher-yielding assets, such as equity and corporate bonds. In addition to buying publicly traded securities, several Asian reserve investment corporations have made large sum equity investments into public and private companies.

Table 2 - Selected Asian Sovereign Wealth Funds and Pension Funds

Country	Fund Name	Type	Source of Funds	Asset Size ($ billion)
Japan	Government Pension Investment Fund	Pension Reserve Fund	Pension Contributions	1,205
China	China Investment Corporation	Reserve Investment Corp.	Foreign Exchange Reserves	482
Hong Kong	Exchange Fund	Reserve Investment Corp.	Foreign Exchange Reserves	327
Singapore	Government of Singapore Investment Corporation	Reserve Investment Corp.	Foreign Exchange Reserves	248
China	National Social Security Fund	Pension Reserve Fund	Fiscal Surplus	205
Singapore	Temasek Holdings	Savings Fund	State-owned Holdings	158
Korea	Korea Investment Corporation	Reserve Investment Corp.	Foreign Exchange Reserves	57
Malaysia	Khazanah Nasional Berhad	Development Fund	State-owned Holdings	39
Brunei	Brunei Investment Agency	Savings Fund	Oil and Gas	30
Thailand	Government Pension Fund	Pension Reserve Fund	Pension Contributions	19
Taiwan	National Stabilization Fund	Stabilization Fund	Foreign Exchange Reserves	15
Vietnam	State Capital Investment Corporation	Development Fund	State-Owned Holdings	1

Source: The World Bank, author

Development funds are another major type of sovereign wealth fund in Asia. Vietnam and Malaysia maintain development funds, while Singapore and China have funds that can be considered hybrid development funds. The common trait across these funds is that they seek to manage state-owned enterprises or government shares in private firms. In addition to managing government assets, development funds also utilize their resources to support national policy objectives, such as industry consolidation or resource acquisition.

One of the earliest development funds was Singapore's Temasek, which was created to manage the Singaporean government's ownership stake in a variety of companies. Temasek provided a wall of separation between the government's role as both owner and regulator, making it easier for these companies to attract private investment. This model has subsequently been adopted by Malaysia's Khazanah Nasional Berhad and Vietnam's State Capital Investment Corporation.

Some Asian sovereign wealth funds have evolved in purpose and now blur the lines between fund categories. For example, in the decades after its creation, Temasek has transformed itself beyond its role as a state-owned asset manager and is now more akin to a savings fund. China Investment Corporation (CIC) was created in 2007 to operate primarily as a reserve investment fund. However, a subsequent regulatory reshuffle led to the transfer of Central Huijin, which holds many of the government's shares in state-owned commercial banks, to CIC as a wholly owned subsidiary. As a result, CIC now plays a dual role of reserve fund and development fund, although Central Huijin's management operations are largely autonomous.

Concerns over Asian Sovereign Wealth Funds

The increasing prominence of sovereign wealth funds, Asian funds included, has led to concerns about their role and impact. Anxieties about sovereign wealth funds can be divided into two main categories: domestic concerns about effectiveness and foreign concerns about influence.

Domestically, concerns about sovereign wealth funds tend to center on their role as custodians of national resources. The fear is that mismanagement of investments by sovereign wealth funds will negatively impact the economic and financial interests of citizens of the home country.[10] As mentioned previously, this concern is especially relevant for Asian sovereign wealth funds as they tend to be funded from fiscal resources rather than natural resource sales.

There are also domestic concerns with respect to the role development funds play as representatives of the government's ownership interest in state-owned enterprises. These funds often face a difficult challenge in improving company performance and dealing with politically connected enterprise managers.

Foreign concerns about sovereign wealth funds revolve around their influence on markets and companies. The size of sovereign wealth funds gives them the power to move financial markets with their investment decisions. As most sovereign wealth funds are guided by long-term investment objectives, this has the potential to be a stabilizing rather than destabilizing influence on markets.[11] However, the ability to contribute to financial volatility through shifts in asset holdings remains a possibility.

Another critique leveled at sovereign wealth funds is that they may pursue national political objectives for their home country, rather than make investments based on economic considerations. These fears are most apparent with respect to sovereign wealth fund equity investments in foreign companies. A large investment in a strategic foreign company could be made for political purposes in order to gain access to resources, technology, or make use of the company's influence in its home country.

Sovereign wealth funds may also be used by political leaders to boost the fortunes of home country "national champion" firms by helping them establish controlling positions in foreign markets. These concerns all have the potential to create backlash in the form of economic protectionism, leading to investment restrictions and the imposition of stronger capital controls.[12]

The height of concerns with respect to Asian sovereign wealth funds appears to have occurred around the time of the global financial crisis. Between 2006 and 2008, Asian sovereign wealth funds made a series of large investments in American and European financial institutions. These investments included:

- In 2006, Temasek purchased a 12 percent stake in Standard Chartered for $4 billion.
- In 2007, Temasek invested $5.9 billion in Merrill Lynch for a 14 percent stake.
- In 2007, the Government of Singapore Investment Corporation (GIC) invested $11 billion Swiss Francs (approximately US$9.7 billion) in UBS for a 7.9 percent share.
- In 2008, GIC purchased a 9 percent stake in Citibank for $6.9 billion.
- In 2007, CIC purchased a 9.9 percent stake in Morgan Stanley for $5.6 billion and a 9.9 percent stake in Blackstone for $3 billion.

At the time, these investments were viewed by the recipients as providing much-needed capital during a difficult period. However, many outside observers worried that Asian sovereign wealth funds, and by extension their governments, would exercise undue influence over the global financial system. During the crisis, concerns shifted to whether Asian sovereign wealth funds would liquidate their holdings in these banks thereby adding to global financial instability.

In hindsight, these fears were largely misplaced. Despite taking significant losses, Asian sovereign wealth funds have acted as long-term investors and have only gradually divested their holdings in foreign financial institutions. This does not mean, however, that Asian sovereign wealth funds have only played a stabilizing impact on global financial markets. In 2012, during the midst of the European debt crisis, CIC announced it would no longer purchase European government bonds.[13] This decision, while justifiable by the fund's investment mandate, contributed to the instability that roiled European markets during that year.

Transparency and Accountability

To help address concerns from critics and defuse threats of economic protectionism abroad, sovereign wealth funds have been active in establishing guidelines and voluntary codes of conduct. The most well-known of these efforts are the Santiago Principles. Created in 2008 through a joint effort between the IWG-SWF and the IMF, the Santiago Principles offers 24 standards for sovereign wealth fund conduct. These standards range from operational guidelines to disclosure and transparency. By adhering to these principles, sovereign wealth funds hope to persuade domestic critics that national assets are well-managed and foreign critics that investment decisions are based upon economic rather than political factors.

Initial participation by Asian countries was limited. Only China, Korea, Singapore, and Timor-Leste took part in the 26 member country discussions.[14] Other Asian economies with sovereign wealth funds, such as Brunei, Malaysia, Taiwan, Mongolia, Vietnam and Pacific Island countries, did not participate at the outset. However, several of these countries have subsequently joined the IWG-SWF's successor group, International Forum of Sovereign Wealth Funds.

Many analysts have begun using the Santiago Principles, or modified version of these principles, as a benchmark to "grade" the governance of sovereign wealth funds. One of the more comprehensive rating methodologies is produced by the Peterson Institute for International Economics. The authors regularly assess the transparency and accountability of major sovereign wealth funds and government pension funds according to 33 separate guidelines, 25 of which are from the Santiago Principles.[15]

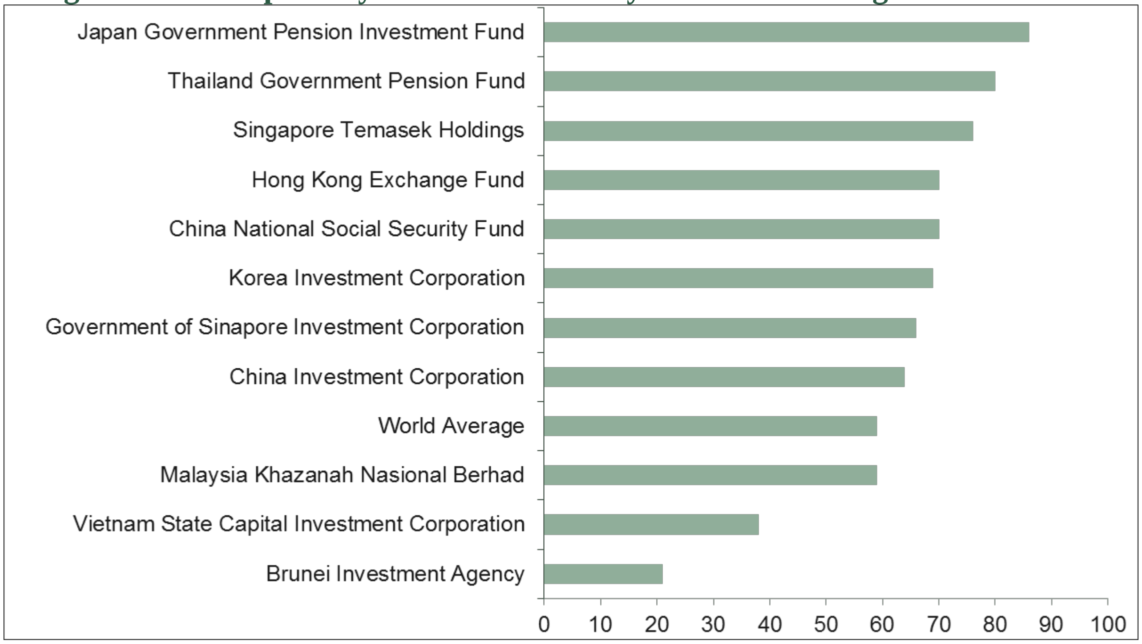
Chart 1 shows the results of this methodology for Asian sovereign wealth funds.[16] Compared to the global average for sovereign wealth funds, Asian funds perform well. Of the eleven funds listed below, eight are above the global average. Only funds in Malaysia, Vietnam, and Brunei are at or below the global average.

Case Study: Financial Disclosure

Although the Santiago Principles are sensible and should be upheld, evaluating their implementation at specific sovereign wealth funds can be problematic. For example, Principle 1 states that the legal framework for a sovereign wealth fund should be sound and support its effective operation and the achievement of its stated objectives. Except in extreme cases, determining whether a legal framework fully meets these conditions is subject to individual interpretation. Sovereign wealth funds, especially those in emerging economies, often operate in legal environments that are evolving and the impact on a fund's operations is difficult to gauge. This makes comparisons of sovereign wealth funds highly subjective and vulnerable to charges of bias.

An alternative approach is to evaluate sovereign wealth funds according to their level of financial disclosure. Providing detailed financial information to the public, subject to verification by an independent auditor, gives useful insight into a fund's performance and activities. This information allows outside observers to identify persistent underperformance, inappropriate investment strategies, and inefficient fund management. Financial disclosure, therefore, is essential for ensuring the transparency and accountability of sovereign wealth funds.

Figure 1 – Transparency and Accountability of Asian Sovereign Wealth Funds



Source: The Peterson Institute for International Economics

The Santiago Principles do not specifically identify what financial information sovereign wealth funds should disclose. The Norwegian Government Pension Fund Global, referred to as the Oil Fund, is often cited as the most transparent sovereign wealth fund. Using the financial information in the Oil Fund's annual reports as a guide for "best practice," the following categories of financial disclosure can be identified:

> **Assets:** This category refers to whether a firm reveals the total size of its assets, the asset types held in the portfolio, and its exposure to different business sectors.
>
> **Return:** This category refers to whether a sovereign wealth fund releases detailed information on its investment returns. This includes annual returns for the past several years, the fund's long-term return, the performance of major portfolio asset types, and disclosure of management costs and fees.
>
> **Benchmark:** This category refers to whether a sovereign wealth fund uses a benchmark portfolio to track its performance and if the fund discloses its performance relative to the benchmark.
>
> **Currency and Geography:** This category refers to whether a sovereign wealth fund reveals the currency composition and geographical distribution of its investment holdings.
>
> **Independent Audit Disclosure:** This category refers to whether a sovereign wealth fund uses an independent auditor to verify its financial reporting and discloses the auditor's report in its annual report. Government auditors are not considered independent auditors in this context.

Table 3 shows the results of this approach when applied to five large Asian sovereign wealth funds. The table reveals that there is still significant room to improve transparency at most of the large Asian sovereign wealth funds.

Of the Asian funds compared, Singapore's Temasek Holdings offers the greatest amount of financial disclosure and broadly matches Norway's Oil Fund in terms of information provided. The fund that offers the next best level of disclosure is Japan's Government Pension Investment Fund.

Overall, most funds disclose detailed information about their assets and use of a benchmark portfolio to measure results. However, many funds provide only partial disclosure of their returns as well as the currency composition and geographical distribution of their investments.

The use of an independent auditor appears to be an area of particular weakness for Asian funds. While most funds utilize external auditors, they tend to be government-affiliated and therefore possibly less independent. Of the funds that use an independent auditor, some do not disclose the auditor's report.

Table 3 – Financial Disclosure

Country	Name	Assets	Return	Benchmark Portfolio	Currency and Geography	Independent Audit Disclosure
Norway	Government Pension Investment Fund Global	FD	FD	FD	FD	FD
Japan	Government Pension Investment Fund	FD	FD	FD	PD[1]	PD[2]
China	China Investment Corporation	FD	PD[3]	ND	PD[4]	PD[5]
Hong Kong	Exchange Fund	FD	PD[6]	PD[7]	PD[8]	ND
Singapore	Government of Singapore Investment Corporation	PD[9]	PD[10]	FD	PD[11]	PD[12]
Singapore	Temasek Holdings	FD	FD	FD	FD	FD

FD = Full Disclosure | PD = Partial Disclosure | ND = No Disclosure

[1] Does not reveal the currency composition or detailed geographical distribution of investments.
[2] The fund uses an independent auditor but does not disclose an auditor's report.
[3] Provides annual returns but does not reveal returns on major asset categories.
[4] Does not reveal currency composition and provides only limited detail about the geographical distribution of investments.
[5] The fund uses an independent auditor but does not disclose an auditor's report.
[6] Investment returns are available, but management fee information is not.
[7] A benchmark portfolio is used, but comparison of the fund's performance relative to the benchmark is not disclosed.
[8] Information on currency composition is available, but not geographical distribution.
[9] Information on asset structure is available, but total fund value is not.
[10] Information on total return is available, but return on asset types is not.
[11] Geographical distribution of the portfolio is available, but currency composition is not.
[12] Some Companies and holding companies within the fund are independently audited, but the auditor's report is not disclosed.

Conclusion

Asian sovereign wealth funds are already major players in global financial markets. These funds manage enormous investment portfolios and are active international investors in both public securities and private equity. The prominence of Asian sovereign wealth funds is likely to increase as Asian countries continue to accumulate foreign exchange reserves and allocate more resources to retirement funds.

To defuse foreign and domestic concerns, many Asian sovereign wealth funds have embraced the Santiago Principles. These principles establish a number of best practice guidelines for sovereign wealth funds in terms of activities and disclosure. When benchmarked against other sovereign wealth funds, Asian funds appear to be relatively transparent. Nevertheless, there is still room for improvement, especially with respect to financial disclosure. Progress on this front will be essential to ensuring that these funds remain effective custodians of national resources.

Endnotes

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Written by: Nicholas Borst (nicholas.borst@sf.frb.org)

Additional Contacts: Walter Yao (walter.yao@sf.frb.org) and Chris Sigur (christoper.sigur@sf.frb.org)

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