

Shadow Financial Regulatory Committees of Asia and Japan

**Joint Statement
Tokyo, July 7, 2008**

Making Sovereign Wealth Funds Mutually Beneficial

Summary

Many surplus countries are setting up Sovereign Wealth Funds. Their increase in number and size, and their move into equity investments have provoked fears, not only in developing countries but also in Western countries. The solution currently proposed by the IMF is to commit the Sovereign Wealth Funds to a code of best practice. This would not address the fundamental problem: distrust of foreign powers in commercial decisions. However, the fears could be alleviated if sovereign investment were channeled via a number of competing "Mutual Wealth Funds", each with diverse sovereign investors. Such collective investment vehicles would insulate sovereign investment from the control of any particular country.

1. Foreign exchange reserves in surplus countries now far exceed what they require for import cover and exchange rate stabilization. The low returns on US Treasury securities and fear of US dollar depreciation have led to a search for investments with higher returns. For this purpose, many countries have established Sovereign Wealth Funds (SWFs). Since global imbalances are likely to grow for the foreseeable future, SWFs are likely to become even more prominent.

2. The increasing number and size of SWFs and their shift to equity investment have created tensions. Western democracies welcome foreign investment in their bonds, and investment in their companies by private foreign companies and by state-linked entities controlled by democratic governments. But suspicion and fear have greeted investment in Western companies by entities controlled by states such as China, Russia, and the Gulf Petro-powers — which run the largest surpluses.

3. Concerns about SWFs include:

- a) Manipulation of corporate policies to advance the sovereign investor's geopolitical agenda
- b) Foreign control of strategic assets
- c) SWF extraction of commercial secrets
- d) SWF abuse of market power
- e) Meddling by inefficient state bureaucracies

4. The only proposals to address such concerns that countries are likely to accept consist of requiring SWFs to commit to a code of best practice. An example is the recent agreement between the US Treasury, Singapore and Abu Dhabi, which is likely to form the basis for the code that the IMF is scheduled to deliver in October 2008. However, even if an SWF is committed to such a code, it is unlikely to alleviate the concerns, since politicians in recipient countries could always detect a geopolitical agenda in any large commercial decision. The basic problem is a fundamental distrust in any entity controlled by a foreign power. This distrust is likely to be extended to the foreign power's commitment to the code of conduct.

5. Then, what is a credible mechanism by which an SWF can commit to a code of conduct? We propose that SWFs invest a portion of their funds through a "Mutual Wealth Fund" or "MWF" whose ownership and governance structure would make it credible so that all its investors would operate purely on the basis of commercial principles. The MWFs would have:

- A charter that commits them to transparency and good corporate governance, for

example, the code of conduct to be proposed by the international working group led by the IMF

- Professional managers supervised by a board that represents SWF shareholders
- A limit on the percentage of shares held by the SWF of any individual country, or group of countries with similar economic and political interests, such as oil exporters

An MWF with these features would have heterogeneous ownership and would set investment policies collectively, but would leave them to be implemented by independent professional managers. This would prevent any single country or group of similar countries from controlling managerial decisions to suit itself. This should alleviate the concerns listed in paragraph (3). Further reassurance would be provided if each country allocated its surplus across several MWFs led by independent managers. The MWFs would have to compete for SWF investment on the basis of investment performance; they would have to compete for investment opportunities on the basis of their transparency and record of political independence.

6. An MWF could be launched at the initiative of a reputable investment management company, a group of surplus countries, or by a neutral country with no SWF, such as Japan. MWFs would differ from existing mutual funds by investing for the long-term, rather than competing on the basis of relative quarterly performance to attract and retain retail investors. MWFs would differ from the current outsourcing of sovereign asset management to investment companies by (i) sourcing funds from a variety of countries and pursuing only long-term objectives that are collectively agreed and (ii) committing to transparency and good global citizenship.

7. MWFs may provide attractive vehicles for countries with large surpluses that seek to recycle them for high long-term returns without controversy, as well as for countries with smaller surpluses that lack the experience and institutional infrastructure for sovereign investment. The credibility of an MWF would be enhanced by participation from SWFs of neutral “global citizens” like Norway and New Zealand.

8. Rising energy prices and global imbalances require economic cooperation between surplus and deficit countries, but the growing prominence of SWFs has created political tensions between them. The MWF proposed here would provide a useful vehicle for cooperation, as they would operate on sound economic principles, yet diffuse political tensions.