Peterson Perspectives
Interviews on Current Topics

Edited Transcript

Best Practices for Sovereign Wealth Funds

Edwin M. Truman analyzes both the key concerns raised by sovereign wealth funds and the essential measures required to alleviate those concerns.

Sherman Katz: Welcome to Peterson Perspectives. Our perspective today is provided by Ted Truman who has been a senior fellow at the Peterson Institute since 2001. Prior to that, Ted served as assistant secretary of US Treasury for International Affairs in 1999 and 2000. He directed the division of International Finance of the Board of Governors of Federal Reserve System from 1977 to 1998.

He is the author of the Institute Policy Brief published April, 2008, "A Blueprint for Sovereign Wealth Fund Best Practices."

Ted, what are sovereign wealth funds, both the pension and nonpension variety?

Edwin M. Truman: I used sovereign wealth funds as a term describing pools of financial assets that are owned and managed by governments. That includes some international assets. And therefore, I would include, not only sovereign wealth funds as you conventionally think about them, in terms of accumulating foreign exchange reserves but also government pension funds, to the extent that they manage marketable assets. And manage it more than just providing pensioners with their choice of some different money market funds.

Sherman Katz: Is it correct to say that a lot of them come from proceeds from the sale of natural resources?

Edwin M. Truman: Well, they do. They come from excess foreign exchange reserves. They come from proceed sales of natural resources. But I think, conceptually, any government could set up a fund in which it would raise money through taxes or any other method. In fact, some are more financed that way and invested in abroad. So it may be convenient to do it the way that they've done, mostly from excess foreign exchange reserves or from natural resource exports, which they seek to save for a rainy day, but that's not the only reason why I wanted to set up a fund like that.

Sherman Katz: And tell us why we should be concerned about these funds, in your judgment?

Edwin M. Truman: Well, I guess the basic question is how concerned should we be. I think you could think about this question on two levels. One is why are we bothered? We're bothered by sovereign wealth funds for two reasons. One is that they represent a trend in globalization, of wealth transfer from the traditional industrial countries, in general, to developing countries. That makes us feel uncomfortable.

Secondly, a lot of that wealth is being managed by governments, which is not consistent with how we believe the system should work. That in turn leads to some more specific concerns about how the countries are managing their wealth and whether they're doing it wisely or corruptly. That has stability concerns about whether they manage that wealth from a standpoint to try to pursue political or noneconomic objectives or economic objectives that are anti-competitive.

And then on the other side, one worry is about our reacting to the fears or actuality of such behavior by what one can call financial protectionism. So we create barriers to flows of funds which would go against us as well as to the rest of the world.

And then you have somewhat minor issues in terms of the potential for conflicts of interest and country conflicts between governments and finally the role of these funds in financial markets stability.

Sherman Katz: You've looked into the possibility of best practices as a way of reducing or mitigating these concerns. First, what are the best practices? And second, what would it mean if a sovereign wealth fund failed to live up to such best practices?

Edwin M. Truman: Best practices could mean many things to different people. They should cover a broad range of issues, in which the governments and the funds themselves demonstrate to the world—including their own citizens—their accountability for their actions. That involves greater transparency, as well as clarity in terms of how they're set up and what their objectives are and how they are managed.

In the process of having and following these best practices, I think to some degree they would be demystified. Everybody could be somewhat more comfortable about them. Not all concerns will be eliminated, but at least they wouldn't be some mysterious thing out there, an alien force that could adversely effect our economy or the global economy.

Sherman Katz: In your policy brief, you looked at several aspects of these 5 trillion dollars plus worth of these funds to help determine whether they were, shall we say, behaving as you think they should. What were those aspects?

Edwin M. Truman: What I did was to look at things that funds in fact now do. We would not be asking the sovereign wealth funds to do something that isn't currently done. I looked at various issues like how big they are, do they publish annual reports, are they independently audited, is it clear what the government structure is, and so forth.

So we had a list of 33 different elements that we put in four categories, though the categories came after the elements: their structure; how they're set up; how they relate to the financial fiscal system; their governance, how their government and the managers of the fund interact with each other, for example.

Then we looked at a broader set of issues having to do with accountability and transparency more narrowly defined. The last category of issues had to do with how they behave in financial markets, how they use leverage, do they have policies on leverage, do they have policies on derivatives, and so forth.

Sherman Katz: What are some of the major findings that you came to as a result of your examination?

Edwin M. Truman: I think the most interesting finding is that they are not all the same, and they're not in two categories, one where everybody does it and another where there's no one who does these things. Their scores on our scoreboard range from 96 to 9, fairly evenly distributed.

So the point is that these funds were an outgrowth of domestic policy decisions. In general, until very recently, they didn't go around the world and say, "Well, country A has a fund and we're going to set up a fund following the pattern of country A." They did as they were driven by domestic political policy processes.

But now, what they are facing is that they are part of this group, and what you are really looking for is convergence among the sovereign wealth funds on a set of best practices, picking from the practices that each of the funds do use today.

Sherman Katz: If you look at your policy brief, one of the things that becomes clear is that there seems to be some distinction between the behavior of those sovereign wealth funds that contain pension assets and those that do not. Why is that?

Edwin M. Truman: I think there are two points. Certainly, pension funds are set up in a narrower framework, and therefore they are clear. So they do better on their objectives, and they do better on their governance because of the nature of those objectives, which is to fund the pensions.

But they also do somewhat better on everything else. One that we scored is the Chinese pension fund. It scores much more highly on our scoreboard than does the China Investment Corporation, for example.

The interesting thing is, however, that 10 of the 22 funds that score in the top group are nonpension sovereign wealth funds, so many of the nonpension sovereign wealth funds do as well as the pension sovereign wealth funds. That says to me that nonpension sovereign wealth funds can emulate pension sovereign wealth funds in their activities and do, before the rest of them could.

Sherman Katz: You point out that the IMF has begun a process of looking at best practices. You’re now one of the world's experts on best practices. What are the criteria you suggest for evaluating this successful implementation of the IMF criteria?

Edwin M. Truman: I think one should emphasize that the IMF is facilitating the process by which the sovereign wealth fund countries themselves will, hopefully, come up with a set of best practices. If they fail, it's not because they have a lack of leadership at the IMF; the funds themselves may not agree to do that.

That effort is supposed to reach fruition at the end of the summer or in the fall. The test I would apply would be: whether the list of best practices they come up with is relatively complete, in terms of the ones I put forward; whether all the funds or all the major funds sign up to adhere to those best practices; and then to the extent that having signed up to adhere to those best practices, whether they do what they say they’re going to do—whether they comply with that commitment. Only time will tell.

Sherman Katz: You say in your policy brief that properly drafted best practices should be self-enforcing, and you suggest that politicians, the media, the financial market participants, and the general public should be able to determine the degree of compliance.

As we know, because of rising oil prices, there's a huge accumulation of sovereign wealth funds in the Middle East. Do you maintain that there's enough public participation in government affairs in the Middle East that we can still expect these best practices to be self-enforcing?

Edwin M. Truman: I was thinking more of self-enforcing from a global perspective. You want them to be self-enforcing, so that it’s not just a question of the manager of some sovereign wealth fund telling the United States Treasury what it's doing. So you want the general public—in the United States and in principal in Kuwait, Abu Dhabi, Saudi Arabia, and elsewhere in the Middle East—to be able to understand what's going on.

I understand that the cultures of those countries and other parts of the world do not necessarily apply western standards of accountability. But in terms of their participation in the broader global financial system, the standards that should be applied are our standards of accountability that respect any other large institution, whether it's Harvard University, the Peterson Institute, the United States government, or your favorite local government. Those standards should apply and indeed, you're going to see some considerable convergence over time.

Sherman Katz: We've been talking about the conduct of the countries where these funds have been created. But there's a flip side of this, and that is OECD industrial countries are looking at best practices among those who receive investments from sovereign wealth funds. The question has arisen that our Committee on Foreign Investment (CFIUS) in the United States, which for various purposes screens investment here, might include within its criteria the behavior of compliance of sovereign wealth funds with best practices. Do you think that is a factor that ought to be considered?

Edwin M. Truman: I think it's perfectly reasonable for the CFIUS to take account of such compliance, when considering investments, either by sovereign wealth funds or by sovereign wealth fund countries in the United States.

I might add, parenthetically, that few sovereign wealth funds at this point take controlling interests, no matter what your definition of investment, so that they're not so particularly relevant, even to CFIUS’s procedures. But I think they should take account of that because it basically provides a basis for trust in the country.

So if a government-owned entity in the country, sovereign wealth fund or not, wants to invest in an industry that we consider sensitive, and there's some sort of agreement about the nature of that investment, such as how they're going to manage that investment, one could look to their compliance with sovereign wealth funds best practices as one element to say, "Should we trust this government or this sovereign wealth fund to keep their word?” I think that would be a perfectly reasonable, pragmatic way of proceeding.

Sherman Katz: The very first group of best practices you mentioned had to do with financial structure. I gather that there's a concern that in some cases these sovereign wealth funds might spill over into national budgets, might be used or misused for purposes that we consider should be segregated from sovereign wealth funds.

Edwin M. Truman: There are two issues here. One is that you don’t want this pool of money that has been segregated to be used directly or indirectly as a second budget. One of the reasons for keeping the money offshore is so that you don’t plow it back into the domestic economy right away, which causes inflation and economic and financial instability in the country itself.

The other element of it is just one of outright corruption, if you want to put it that way. These are huge amounts of money, and the scope for corruption is huge. And increased transparency and accountability in this area limits the scope for corruption and the waste of this money.

If Nigeria wastes its sovereign wealth fund, as it already has wasted a previous one it had set up, then it becomes politically unstable. So it is in our interest to make sure these funds are wisely spent in the interest of the country itself.

Sherman Katz: At a time when parts of our economy, such as the financial sector, have been and may continue to be at urgent need of additional capital, and at a time when our federal government relies on the willingness of foreign investors to buy our treasury obligations, what do you say to those who say we do not have the luxury of asking sovereign wealth funds to be transparent, particularly when perhaps in their own countries continued investments in the West may be controversial?

Edwin M. Truman: One needs to have some perspective on all this. We should be open to foreign investment. That is certainly the case. And that's in the interest of the United States, as well as other countries.

One can, however, exaggerate the extent to which sovereign wealth funds have risen to the rescue. They are as much as to 5 trillion dollars, maybe somewhat less, but that money is going to be here to a large degree anyhow. It's just a question of what form it takes.

For example, in the case of investment in US financial institutions, it's not as if that money fell from heaven on to the institutions. The money was either disinvested from other investments that probably were already in the United States, or they were not invested and instead invested in US financial institutions.

It's wonderful, no doubt, for the US financial institutions to add these large blocks of money, but one should understand that other parts of the economy are deprived of that money in the process.

So I think we should be open. But I don’t think we need to pander to these flows of funds. We need to be, the phrase I like to use, reciprocally responsible, in terms of our welcoming of these investments, and the countries with the sovereign wealth funds similarly need to be reciprocally responsible. The world would be safer for sovereign wealth funds.

Sherman Katz: Thanks very much, Ted, for this discussion. I commend to everyone your policy brief with its scorecard. Ted has also testified, frequently, on this subject before Congress.