

# Sovereign Wealth Funds – An Overview And Indian Perspective

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## INTRODUCTION

The emergence of Sovereign Wealth Funds (SWFs) has been one of the most prominent developments in international finance in the recent years. Although these funds were present in the market since the beginning of 1950s but they have acquired significant attention now- a- days because of the growth in terms of their size and unexpected capital infusion by them during subprime crisis. Because of the unique features of SWFs, they have become the hot topic of debate among international financial thinkers and policy makers. The explosive growth of SWFs, together with the increase in resources available to other government-linked investors such as central banks, public pension funds, and state-owned enterprises in recent years, has spurred intense discussions about the implications for the international financial system (Cognato et.al, 2008). Most of the people think that the SWFs are the next big financial entities, after Hedge Funds and Foreign Institutional Investors (FIIs) that have to play an important role to shape global financial architecture in near future. Large accumulation of foreign exchange reserves in developing countries is the prime driving force behind the growth of SWFs. Most of the developing or emerging economies have experienced boom in capital inflows because of export of trading goods, services or portfolio investments by FIIs. The falling assets return and stagnant growth rate in developed countries have been the chief reasons for the movement of large capital resources to most of the emerging countries.

## CONCEPT OF SOVEREIGN WEALTH FUNDS

The SWFs may be defined in different ways, as these funds can be backed by different purposes of the government. But all the SWFs enjoyed one common feature i.e. they were controlled by a country's sovereign political entity. Sovereign wealth funds or state investment funds are financial vehicles owned by states which hold, manage or administer public funds and invest them in a wider range of assets of various kinds (Kern, 2007). U.S. treasury defined SWFs as government investment funds, funded by foreign currency reserves but managed separately from official currency reserves. Basically, these are pools of money that government invests for profit. The October 2007 report of Morgan Stanley titled, "The Definition of a Sovereign Wealth Fund," states that there is no universal definition of SWFs, but these are investment vehicles of government and essentially possess the following five characteristics: i. Sovereign ii. High foreign currency exposure iii. No explicit liabilities iv. High risk tolerance v. Long investment horizon.

Governments having low level of international debts, having huge budgetary surplus and official reserves at central banks generally float SWFs. One of the distinct feature of SWFs, that make these funds different from other form of foreign institutional investors is that these are the pools of community money which are held by governments only for the purpose of investment and no direct or indirect liabilities are attached to them. IMF (Allen et. al, 2008) gives the following types of SWFs based upon the purpose for which these are floated by the government.

- i. Stabilization funds:* To insulate economy from commodities price shocks (energy and food).
- ii. Savings funds:* To convert the conventional portfolio assets into a more diversified portfolio of assets for future generations.
- iii. Development funds:* To fund socio-economic projects and promote industry that is required to raise the country's output rate.
- iv. Contingent pension reserve funds:* To provide for contingent unspecified pension liabilities on government's balance sheet.

## GROWTH OF SOVEREIGN WEALTH FUNDS

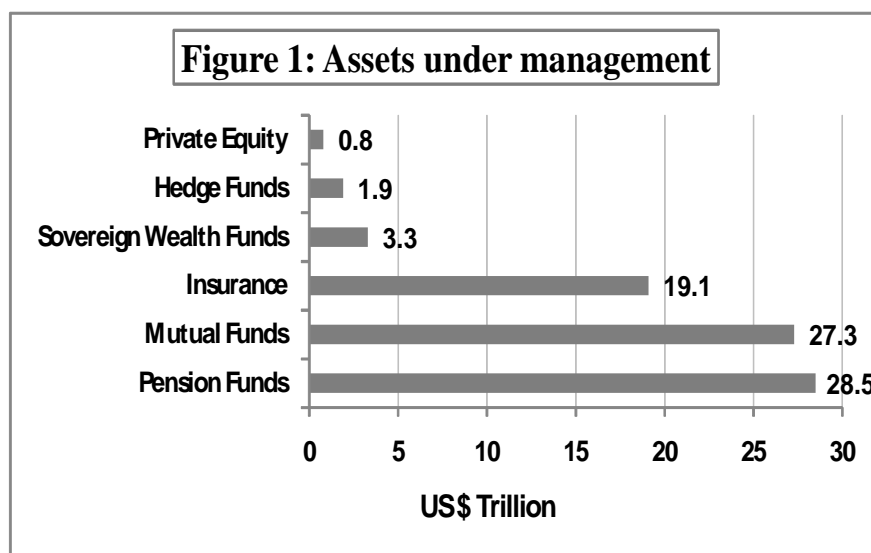
SWF is not a recent phenomenon, as Kuwait Investment Board was the first SWF, floated by Kuwait Investment Authority in 1953. The sole purpose of this Kuwait based SWF was to reduce the reliance of Kuwait on its oil

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resources. An increase in official foreign exchange reserves in some developing Asian countries and rising revenue surplus from oil exports has boosted the number and the size of assets under management of SWFs. In fact, assets under management of SWFs have been rising year by year. The size of assets under the control of Sovereign Wealth Funds (SWFs) has grown from \$500 billion in 1995 to about \$3.3 trillion in 2007, and is expected to quadruple by 2015 (Kotter et.al, 2008). Figure 1 clearly shows that SWFs are managing larger assets than the global hedge fund industry; however smaller than conventional fund managers like insurance companies, mutual funds and pension funds (International Financial Services, London, December 2007).



*Source: Estimated by International Financial Services, London, December 2007.*

Developing countries are looking for the opportunities to float their own SWFs to enhance the return on their assets as most of the developing economies have witnessed handsome growth in foreign exchange reserves and trade surplus in beginning of the present century. If the growth pace of economies continues like the present, then SWFs are expected to rule the global financial markets in the coming years.

As per one estimate by Sovereign Wealth Fund Institute Inc, there are around 45 established SWFs worldwide so far. The recent increase in the number of countries floated SWFs is remarkable as about 25 SWFs have floated in or after year 2000. Table 1 depicts some important information about the SWFs, arranged according to their size. Abu Dhabi Investment Authority is widely believed to be the largest sovereign wealth fund, with assets worth \$ 875 billion under its management. It was established in 1976 with an aim to diversify Abu Dhabi's foreign currency reserves earned by exporting oil into diversified asset classes. Government Pension Fund Global (Norway), SAMA Foreign Holdings (Saudi Arabia), Government of Singapore Investment Corporation (Singapore) and SAFE Investment Co, China are the other most active SWFs having large funds for investment.

Figure 2 shows that the top ten SWFs hold almost 82% of the total assets under management of all SWFs floated so far. It can be seen from table 1 that oil export surplus is the prime source of funding for SWFs. Majority of SWFs have been funded by the proceeds from the sale of the natural resources like oil and gas. Kuwait, Qatar, the United Arab Emirates, Saudi Arabia, Russia, Venezuela are the oil-exporting countries using SWFs as investment vehicle. Similarly, countries like Chile, Botswana and Kiribati operate SWFs by creating surplus from the export of natural resources in the form of copper, diamonds or minerals. It can be observed here that the main countries that have floated SWFs are resourceful countries which currently gained from high oil and commodity prices. Figure 3 shows that majority of the SWFs are funded by Oil and Gas related revenues which comes to around 62%.

The United Kingdom, especially London has developed as an important centre in the SWFs industry, as a large number of these funds managed their international financial operations from here. In fact, the oldest SWF, the Kuwait Investment established its first office in London in February 1953. A large number of SWFs e.g. the Kuwait Investment Office, Brunei Investment Authority, Abu Dhabi Investment Authority and Temasek/General Investment Corporation of Singapore have set up local representative offices in London. Other SWF such as the China Investment Corp. are planning to set up their offices in London. The UK government in association with other advanced

countries, the Organization for Economic Co-operation and Development (OECD) and International Monetary Fund (IMF) is working to set up a voluntary code of conduct for SWFs for regulations of these funds.

**Table 1: Sovereign Wealth Funds by Assets under Management as in August 08**

Country	SWF Name	Assets \$Bn.	Inception	Source of Funding
UAE - Abu Dhabi	Abu Dhabi Investment Authority	\$875	1976	Oil
Norway	Government Pension Fund – Global	\$396.50	1990	Oil
Saudi Arabia	SAMA Foreign Holdings	\$365.20	n/a	Oil
Singapore	Government of Singapore Investment Cor.	\$330	1981	Non-Commodity
China	SAFE Investment Company	\$311.6		Non-Commodity
Kuwait	Kuwait Investment Authority	\$264.40	1953	Oil
China	China Investment Corporation	\$200	2007	Non-Commodity
China - Hong Kong	Hong Kong Monetary Aut Investment Por.	\$173	1998	Non-Commodity
Russia	National Welfare Fund	\$162.5	2008	Oil
Singapore	Temasek Holdings	\$134	1974	Non-Commodity
China	National Social Security Fund	\$74	2000	Non-commodity
Australia	Australian Future Fund	\$64.20	2004	Non-Commodity
Qatar	Qatar Investment Authority	\$60	2003	Oil
Libya	Libyan Investment Authority	\$50	2006	Oil
Algeria	Revenue Regulation Fund	\$47	2000	Oil
US – Alaska	Alaska Permanent Fund	\$39.80	1976	Oil
Kazakhstan	Kazakhstan National Fund	\$38	2000	Oil
Ireland	National Pensions Reserve Fund	\$30.80	2001	Non-Commodity
Brunei	Brunei Investment Agency	\$30	1983	Oil
South Korea	Korea Investment Corporation	\$30	2005	Non-Commodity
Malaysia	Khazanah Nasional	\$25.70	1993	Non-Commodity
Canada	Alberta's Heritage Fund	\$16.60	1976	Oil
US - New Mexico	New Mexico State Investment Office Trt	\$16	1958	Non-Commodity
Chile	Social and Economic Stabilization Fund	\$15.50	1985	Copper
Taiwan	National Stabilisation Fund	\$15	2000	Non-Commodity
New Zealand	New Zealand Superannuation Fund	\$14.70	2003	Non-Commodity
Bahrain	Mumtalakat Holding Company	\$14	2006	Oil
Iran	Oil Stabilisation Fund	\$12.90	1999	Oil
Nigeria	Excess Crude Account	\$11	2004	Oil
Azerbaijan	State Oil Fund	\$10.20	1999	Oil
UAE - Abu Dhabi	Mubadala Development Company	\$10	2002	Oil
Botswana	Pula Fund	\$6.90	1966	Diamonds & Mineral
Saudi Arabia	Public Investment Fund	\$5.30	2008	Oil
China	China-Africa Development Fund	\$5	2007	Non-Commodity
US – Wyoming	Permanent Wyoming Mineral Trust Fund	\$3.90	1974	Minerals
US – Alabama	Alabama Trust Fund	\$3.10	1986	Gas
East Timor	Timor-Leste Petroleum Fund	\$3.00	2005	Oil & Gas
Vietnam	State Capital Investment Corporation	\$2.10	2006	Non-Commodity
Oman	State General Reserve Fund	\$2.00	1980	Oil & Gas
UAE-Ras Alkhamah	RAK Investment Authority	\$1.20	2005	Oil
Venezuela	FIEM	\$0.80	1998	Oil
Trinidad & Tobago	Heritage and Stabilization Fund	\$0.50	2000	Oil
Kiribati	Revenue Equalization Reserve Fund	\$0.40	1956	Phosphates
Mauritania	National Fund for Hydrocarbon Reserves	\$0.30	2006	Oil & Gas
Angola	Reserve Fund for Oil	\$0.20	2007	Oil

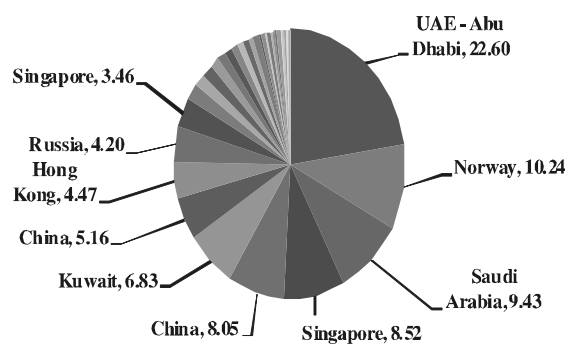
Source: Sovereign Wealth Fund Institute Inc, August 2008 report.

## ROLE OF SWFs DURING SUB- PRIME CRISIS

Global banking industry had faced major losses due to the sub-prime crisis prevailing in USA during 2007. In this context, SWFs have also played a significant role to strengthen international financial stability, by investing multi-billion dollars in some of the largest international investment banks (Table 2). The sovereign funds capital infusion to American banks (such as Citigroup, Morgan Stanley and Merrill Lynch) provides life line to the banks that have lost their huge fortunes in the sub-prime crisis. Collectively, SWFs have invested US \$ 44,938 Million in US banks during the previous financial year. Some of their recent investment activities are listed here.

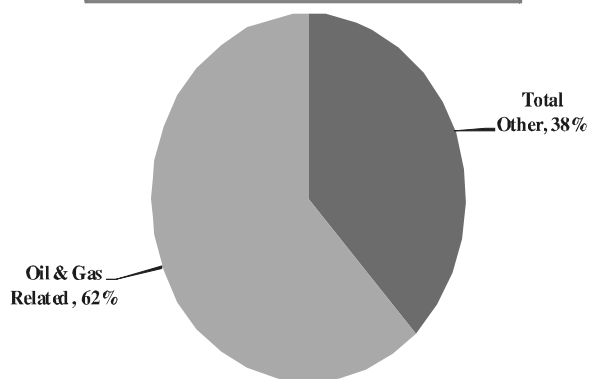
- In May 2007, China's SWF, China Investment Corp purchased a 10% stake of private equity fund Blackstone for \$3 billion and in December 2007, \$5 billion in convertible securities of investment bank Morgan Stanley.
- In November 2007, Abu Dhabi Investment Authority bought \$7.5 billion of mandatory convertible securities from Citigroup which will be converted into the bank's stock in 2010 and 2011 at prices ranging from \$31.83 to \$37.24 a share.

**Figure 2: Share of Top 10 SWFs to total assets of SWFs (figures in %)**



Source: Calculation based on table 1.

**Figure 3: SWFs by Funding Source**



Source: Sovereign Wealth Fund Institute Inc, June 2008 report.

- In December 2007, Singapore based SWF, Temasek Holdings bought \$4.4 billion of Merrill Lynch stock at \$48 a share.

**Table 2: Sovereign Wealth Funds capital infusions in Banks (during March 07-April 08)**

Sovereign Wealth Fund	% Stake	Investment value in US\$ Millions	Company
Abu Dhabi Investment	4.9	7500	Citigroup
Government of Singapore Investment Corp	3.7	6880	Citigroup
Kuwait Investment Authority	1.6	3000	Citigroup
Kuwait Investment Authority	3	2000	Merrill Lynch
Korean Investment Corp	3	2000	Merrill Lynch
Temasek Holdings	9.4	4400	Merrill Lynch
China Investment Corp.	9.9	5000	Morgan Stanley
Temasek Holdings	1.8	2005	Barclays PLC
Qatar Investment Authority	1	603	Credit Suisse
Government of Singapore Investment Corp	9.8	9750	UBS
Saudi Arabian Monetary Agency	2	1800	UBS
<b>Total Cash infusions from Sovereign Wealth Fund</b>		<b>US \$ 44,938 Million</b>	

Source: Sovereign Wealth Fund Institute Inc, April 2008 report.

## SOVEREIGN WEALTH FUND'S INVESTMENT THROUGH FII AND FDI ROUTE IN INDIA

While SWFs have been operated by many countries for years, they have only recently become important players in developing or emerging financial markets including India. India has developed a well structured policy regarding foreign investments. India has been receiving significant foreign capital inflows via Foreign Direct Investment (FDI) and Foreign Institutional Investor (FII) routes since India adopted the policy of liberalization in 1992. FDIs in India are regulated by the guidelines stated by Department of Industrial Policy and Promotion, Foreign Investment Promotion Board and Reserve Bank of India under Foreign Exchange Management Act. Various types of institutional or international funds are eligible under the Securities and Exchange Board of India (FIIs) Regulations, 1995. The eligible foreign entities under this category are Pension Funds, Mutual Funds, Investment Trusts, Insurance &

Reinsurance companies, Banks, University Funds, Endowments (Serving broader Social Objectives), Foundations (Serving broader Social Objectives), Charitable Trusts/Charitable Societies, International or Multilateral Organizations or an agency thereof or a Foreign Government Agency or a Foreign Central Bank, Asset Management Company, Investment manager/Advisor, Institutional Portfolio Manager, Trustees, a Power of Attorney holder proposing to make investments in India on behalf of broad based funds and its proprietary funds. Under FDI route, most industrial sectors are open for foreign investment under the automatic route and the other sectors are required to have prior approval of the Foreign Investment Promotion Board. Presently SWFs can invest in India through both, FDI and FII routes. Recognizing the need of hour and the role SWFs can play to strengthen domestic financial markets; India adopted the policy regarding SWFs by amending Securities and Exchange Board of India (FIIs) Regulations, 1995 w.e.f May 22, 2008. This amendment in SEBI guidelines includes SWFs in the above mentioned category of eligible foreign institutional investors to invest into the Indian capital markets as FIIs. By taking this initiative, India has become pioneer to award the status of FII to SWFs among other developing nations. SWFs registered as FIIs in India are required to provide full information about their organization and operations at the time of registration and afterwards on a continuing basis. A single SWF registered as a FII can invest maximum up to 10 % in a single company. The cap of 10% in a single company does not apply if SWFs are investing through the FDI route. So in other words, India has a dual policy regime regarding SWFs that can come either under the FDI route or the FII route.

## **SOVEREIGN WEALTH FUND'S INVESTMENTS FROM INDIA**

The SWFs capital flows may flow in two directions, that is, investments by foreign SWFs into India (India is the host country in this case) and an Indian SWF investing into other countries (India will be the home country). India is one of the few fast growing countries that possesses a huge amount of foreign reserves yet does not have a Sovereign Wealth Fund. Experts supporting the belief since long time that India should float a SWF as it may be a good channel to invest money and generate high returns. The former governor of RBI, Y.V. Reddy initially expressed his intention regarding Indian SWF during a speech in Washington in April 2008. In his speech he told that India's foreign currency reserves, which currently stand as the World's fourth-largest, are inhibited by the Reserve Bank's policy of low risk and liquidity. He further said that 'given the limitations placed on the central bank by its mandate, it will be appropriate to bestow this responsibility on a different sovereign entity'.

India witnessed highest foreign capital inflows and bullish exports because of which India stood among the first ten largest foreign reserve holders in the world (International Financial Services, London). India's foreign exchange reserves stood at \$309.7 billion at the end of March 2008, up \$110.5 billion over end-March 2007, making India the third largest reserve holder among emerging market economies. The surge in reserves causes a difference between the costs of holding the reserves and returns because of falling interest rates world wide. The most of India's reserves are invested in USA Fed securities that made the real rate of return negative between 2% to 3% during the recent 4-5 years. At this negative real yield on investments in US government securities, India's loss on its foreign reserves holdings is anything between \$6 billion and \$9 billion per annum at current reserves level (The Economic Times). In fact, countries with large "excess reserves", i.e. reserves in excess of traditional balance of payments needs may opt for a more return and less liquidity-oriented portfolio allocation of these assets (Beckand et al., 2008). Beckand et al. show India as a resourceful country having the potential to float SWF. There is no concrete policy action towards the floatation of a domestic SWF; rather Indian policy makers are still debating the issue. There are certain liquidity, composition and political concerns attached with the launch of SWF. Hence it is not an easy task to float a SWF and earn additional return, while maintaining the original purpose of holding reserves.

## **CONCLUDING REMARKS**

The difference between other forms of FIIs and SWFs is that the investment horizon of SWFs is comparatively large whereas the other FIIs, especially hedge funds, invested for short terms are speculative in nature. SWFs bring a number of other benefits to recipient countries in terms of market liquidity and stability in financial markets. Still there are certain concerns regarding SWFs because of possible threats to financial stability as SWFs flow some times may be motivated by non-commercial (political) objectives. Lack of transparency in the functioning of SWFs is another area of concern for international finance ministers. Hence it is the need of hour to make a trade-off between the possible benefits and risks associated with the SWFs entry into domestic financial markets. These concerns are being addressed by IMF as it is busy in developing a code of conduct for SWFs to manage official foreign exchange reserves with best market practices.

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hypothesis that AARs occur randomly before the event day for good news portfolio under both – market model with raw and log returns.

To test if there is any significant difference between the number of positive and negative AARs, we calculated sign values. The sign test statistics indicates that the computed value of Z is less than the critical value of  $\pm 1.96$  for all the three portfolios for the entire event window of 61 days. Therefore, we accept the null hypothesis that there is no significant difference between the number of positive and negative AARs.

We used t-test on AARs and CAARs to verify whether AARs and CAARs are close to zero. The t-values on AARs indicate that for less than 9 (14.75%) of days, computed t-values falls in the rejection region and for the remaining days, they are within the acceptance region. This indicates that AARs are close to zero for more than 85% of the days and therefore, no trader could earn abnormal returns by trading on daily basis for more than 85% of the days. The results of t-test on CAARs indicate that CAARs are significant for the majority of the days for all the three portfolios under both – market model with raw and log returns. This indicates that CAARs are greater than zero for majority of the days during the event window and Indian stock market reaction to quarterly earnings information is slow and contradicts semi-strong form of efficient market hypothesis.

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