TESTIMONY

Sovereign Wealth Funds:

Implications For U.S. Financial Institutions

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It is an honor to appear today before this distinguished Congressional Commission to evaluate the growing importance of sovereign wealth funds (SWFs), especially those in China, on the U.S. financial services industry. As Treasury Deputy Secretary Kimmet has recently said, "It is hard to escape the conclusion that the ongoing increase in SWF cross-border investment represents a potential structural shift in the global economy. It is incumbent on economic policymakers in all countries to consider fully the implications of this shift and how to respond."[1] This hearing is a critical step to ensuring that Congress and other policy-makers anticipate the challenges posed by sovereign investors and take steps not only to preserve our open market, but also to protect vital interests.

In sharp contrast to many other nations, the United States has had a virtually exclusive focus on private markets since its inception, generally avoiding forays into public ownership of critical institutions. Because the U.S. economy is fundamentally premised on private – not government – ownership, our regulatory system does not take account of very different motivations that may govern non-private investors. Great care thus needs to be taken well in advance of any significant entry into our markets by state-owned or controlled institutions. As former Treasury Secretary Summers has said, "Governments are very different from other economic actors. Their investments should be governed by rules designed with that reality very clearly in mind."[2]

This is particularly true of financial institutions. Financial firms are backed by express and implicit taxpayer guarantees (e.g., deposit insurance, access to the Federal Reserve discount window) and are critical to a functioning U.S. payment system, capital market and economy as a whole. Financial institutions also handle other people's money – funds provided to them in trust by depositors, investors and retirees, taking on a safekeeping or even fiduciary responsibility that may not be compatible with foreign-government objectives. Finally, financial institutions – most notably private-equity firms – invest in other firms and, thereby, gain inside knowledge about their operations, intellectual property and objectives. All of this makes it vital that SWF and similar state activities in the U.S. financial system be conducted in a transparent fashion with clear regulatory authority built in advance to prevent conflicts of interest, insider transactions or – most troubling – activities designed to foster home-country political or military objectives.

In this statement, I would like to emphasize the following conclusions:

- Issues raised by recent high-profile activities by entities owned or controlled by the Chinese government do not raise concerns separate from those posed by other sovereign participants in the U.S. financial market. As a result, no separate action related to them is appropriate or required. However, additional U.S. and international actions are required to anticipate potentially serious problems resulting from sovereign investment, as detailed below. Chinese- entities should be fully within the scope of these standards.

[1] "Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy" by Robert M. Kimmitt, *Foreign Affairs*, January/February 2008.
[2] "Funds that Shake Capitalist Logic" by Larry Summers, *Financial Times*, July 29, 2007.

- State-owned business enterprises should be viewed as a class, with appropriate governance focused not only on SWFs, but also on any other state-owned enterprises that, by virtue of stakes taken in private business, can exert non-economic influence in private markets outside their home borders. In addition, some major corporations (e.g., PetroChina) are nominally private, but are in fact state-controlled and their activities thus must be governed as such. One need look no further than Gazprom's recent acquisitions of European energy pipelines to recognize these potential risks.

- The sharp spike in state-controlled positions in U.S. financial institutions warrants immediate attention from policy-makers and establishment of a clear supervisory framework. As detailed in the table at the close of this testimony, we calculate that sovereign enterprises have invested $44.3 billion since 2006 in U.S. banks, brokers and other financial firms. While a small percentage relative to the trillions in financial-industry market capitalization, several of these stakes (e.g., Blackstone, Merrill Lynch, Morgan Stanley) make the government stake-holder among the firm's largest investors. Even though all of these investments have been carefully structured to meet "passivity" requirements, they are nevertheless so large as to permit significant influence over firm operations. As a result, additional safeguards for these investments are required even if they are structured as passive ones.

- Appropriate additional safeguards for sovereign investments in U.S. financial institutions include requiring that all equity positions in U.S. financial-services firms be conducted through third-party asset managers. Indeed, it would be best if all SWF and similar investments were executed through asset managers (including through broadly-held mutual funds or exchange-traded funds), as this would ensure sole focus on economic objectives and reduce systemic risk. Recent SWF assertions, including those from Chinese officials, that all their investments are solely economic are contradicted by other statements. Controls must and should be instituted in advance to prevent conflicts of interest, insider trading or other potential abuses and to limit market risk.

- Sovereign stakes in a financial institution above five percent not executed by a third-party asset manager should create a presumption of control. Such investments could thus be considered by the Committee on Foreign Investment in the United States (CFIUS) if CFIUS deemed the takeover target part of the U.S. critical infrastructure. However, financial-institution acquisitions raise unique issues. Thus, all financial investments above a potential control threshold should be subject to prior approval by the appropriate functional regulator (e.g., Federal Reserve, SEC, state insurance commissioner). The Federal Reserve has frequently expressed to Congress its deep concerns about commercial ownership of insured depositories.[3] These

[3] Testimony by Scott G. Alvarez, General Counsel, Federal Reserve Board on Industrial Loan Companies before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 4, 2007.

> fears apply with far more force to ownership stakes by sovereign entities and demonstrate the urgent need for prior approval and careful, transparent governance.

At the same time we take care to insulate financial-services firms from sovereign risk, we must similarly be very scrupulous about ensuring an open market. This is no idle concern, as some of the proposals related to SWFs would not only be protectionist, but also actually endanger U.S. financial stability. Some of the SWF investments cited above in financial institutions came in the nick of time, with several very large – and, thus, systemically significant – firms in urgent need of the funds they found abroad. Even if the U.S. wanted to eschew sovereign investments, our current-account deficit puts us in no position to do so. The Swiss National Bank has recently estimated that the United States accounts for sixty percent of the world's aggregate current account surpluses.[4] Barring sovereign investments would simply cut off our collective nose to spite our face – it would deprive us of urgently-needed resources that, for a wide variety of reasons, we send abroad.

A Unified Policy For All Government-Related Investment

Definitions differ about which firms should or should not be considered in the policy review of sovereign investment, with some suggesting this should simply be limited to SWFs and others urging that other entities (e.g., commodity-focused stabilization funds or even central reserves) be brought under scrutiny as well. This debate arises because nations follow very different practices investing their surpluses. A recent paper by Ted Truman at the Peterson Institute for International Economics[5] provides a careful differentiation of different types of sovereign ventures, as well as an overview of their current scope and size. As the paper notes, some entities – e.g., the Saudi Arabian Monetary Authority – are considered reserve funds, but in fact have very significant holdings of foreign investments (estimated as at least $235 billion for this entity). As Mr. Truman notes, countries generally provide information on their reserve holdings, but it is often incomplete, especially with regard to holdings of foreign securities. As a result, he recommends – as this testimony also supports – policy that focuses on all foreign government investments in private-sector firms, regardless of the nominal nature of the government-controlled enterprise engaging in the investment activity.

Definitional difficulties complicate a sound assessment of the size of SWFs, reinforcing the recommendation of a policy focused on all foreign investment by government-controlled entities. Looking only at the ventures now considered SWFs controlled by China shows firms of considerable size and scope (currently estimated at $66 billion). However, as the Truman paper cited above rightly notes, China has vast reserves in

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[4] Speech by Philipp Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank, at the International Center for Monetary and Banking Studies, Geneva, December 18, 2007.

[5] "Sovereign Wealth Funds: The Need for Greater Transparency and Accountability" by Edwin M. Truman, senior fellow at the Peterson Institute for International Economics, August 6, 2007.

addition to those now housed in its SWFs, permitting it at any point either to invest these reserves directly or to swell SWF balances. Thus, U.S. policy with regard to China's SWFs – like all others – should be based neither on size nor on the definition of how an institution may be defined. Fundamentally, any sovereign investment in a private venture is problematic if that investment is of a size and structure to permit controlling influence.

What are the risks? A recent paper by the Federal Reserve Bank of San Francisco[6] summarizes them as follows:

- the possibility that "strategic leverage " could be used to promote narrow, nationalistic objectives;
- use of resources to support "national-champion" firms at the expense of others;
- use of acquisitions to obtain strategic information; or
- acquisition or control of critical infrastructure (e.g., finance, telecommunications, etc).

With regard to financial institutions, some have argued[7] that SWFs will in fact have a stabilizing influence because funds will not be infused or withdrawn in a sudden way that could disrupt the market. However, large private investors have sometimes used their market impact to affect currency values in their favor – a move with not only market impact, but also potential national-security implications. Further, the vulnerability of global financial markets to actions by even one major player is clearly evidenced in recent problems in the subprime-mortgage and monoline-bond insurer arenas. SWFs and other sovereign investors have clearly grown to the size at which one or more of them could have at least as much impact on financial markets by any sudden actions resulting either from changed market sentiment or, far more troubling, altered national-policy objectives.

Financial-Industry Considerations

Currently, any controlling sovereign stake in a U.S. financial institution could come under CFIUS review if the transaction were deemed to affect critical infrastructure. However, that review now includes a flawed definition of control and does not differentiate between financial-services firms and all others subject to this review, even though financial institutions play unique roles in the U.S. market and have an array of implicit and explicit guarantees. Review of sovereign financial investments should follow broader U.S. policy and thus bring these acquisitions under additional, advance supervisory scrutiny to protect interests specific to financial markets.

In return for federal protections, U.S. financial-services firms come under numerous regulations. These are based on what has come to be called a "three-pillar" approach following international consensus within the Basel Committee on Banking Supervision,

[6] "Sovereign Wealth Funds: Stumbling Blocks or Stepping Stones to Financial Globalization?" Federal Reserve Bank of San Francisco, December 14, 2007.
[7] Kimmet op. cit.

the International Organization of Securities Commissions and similar organizations. These pillars are:

- regulatory capital;
- supervision; and
- market discipline.

In my view, none of these pillars applies to sovereign investments, with those related to supervision and market discipline especially problematic. As SEC Chairman Cox recently noted,[8] sovereign entities can be subject to significant internal conflicts of interest or even corruption and most are not governed by any form of third-party supervision that would limit this risk. For example, in China, SWFs are not under the supervision or control of any supervisor, nor does any such entity have the power to constrain, alter or limit SWF activity.

Compounding the problem of home-country supervision is the fact that the ability of U.S. supervisors to govern SWFs is most unclear. To be sure, sovereign entities engaging in U.S. commercial activity are subject to the jurisdiction of the U.S. courts, as has been demonstrated in an array of cases.[9] Chairman Cox concedes this point in the remarks noted above, but goes on to say that he wonders if a foreign supervisor would in fact be able to sanction an erring sovereign investor, noting that, "[I]f the same government from whom we sought assistance were also the controlling person behind the entity under investigation, a considerable conflict of interest would arise."

This is no academic matter. Such conflicts have already occurred, with the scope of the problem evidenced by the fact that, in the most public recent case, the foreign entity was not even a sovereign investor per se, but rather a very wealthy individual close to the interests of his home government. In 1991, a then-state owned bank (Crédit Lyonnais) used a front person – a major French investor with close ties to his home-country president – to acquire Executive Life, a troubled California insurance firm. When this transaction came to light several years ago, U.S. regulators sought to sanction Credit Lyonnais and the French investor, but press reports indicated they were blocked for several years in doing so by virtue of direct and indirect French government intervention.[10] It took several years before the Federal Reserve and Department of Justice were thus able to finalize a major settlement with the parties involved. Were these parties either direct government entities and/or affiliated with a government disinclined to honor U.S. law enforcement, the ability of the United States ever to finalize these judgments would be, at best, unclear.

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[8] Speech by SEC Chairman Christopher Cox, "The Rise of Sovereign Business", Gauer Distinguished Lecture in Law and Policy at the American Enterprise Institute Legal Center for the Public Interest, December 5, 2007.
[9] See *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992), *I.T. Consultants v. Pakistan*, 551 F.3d 1184 (D.C. Cir. 2003), interpreting the Foreign Sovereign Immunities Act (FSIA) 28 U.S.C. 1604, 1605(a)(2).
[10] "Decision Nears for Credit Lyonnais in Executive Life Case" by Charles E. Boyle, *Insurance Journal*, February 25, 2002.

Financial-Industry Sovereign Investment: Specific Recommendations

Finally, I would like to turn to the specific suggestions provided at the start of this statement for sovereign investments in financial-services firms. As noted, I believe ongoing efforts with regard to codes of conduct or best practices, such as those now underway at the IMF – are very important efforts and should be moved expeditiously to a meaningful conclusion. The principles many have espoused for these codes (see, for example, the Truman paper and Summers statement) should generally be incorporated, as they are sound high-level principles that would significantly enhance corporate governance and investor protection.

However, as the above discussion of enforcement problems demonstrates, these codes and high-level principles have considerable limitations. There is no clear mechanism with which nations could enforce these codes or even ensure they are being met, despite assurances to that effect from sovereign nations or their SWFs. This is particularly true with regard to codes that state that sovereign funds should bar corruption or conflicts of interest, as corrupt nations will surely sign these codes and then continue with business as usual.

Specific principles – e.g., transparency and accountability – are also vulnerable, and not just because nation-states may happily concur with these principles and then violate them with abandon. The details of these principles will in practice prove very difficult to hammer out, making it hard to establish a set of principles that goes beyond well-meant goals to specifics that would be meaningful for those nations that would genuinely seek to comply with them. As the San Francisco Federal Reserve has noted, "The requirement for stringent transparency tests of SWFs may be unrealistic, due to costly monitoring and collection of information." Transparency sounds fine – indeed, it is fine – in principle, but deciding which disclosures would in fact be useful will prove very difficult, as evidenced by the decade or so it has taken to hash out still-incomplete rules for the disclosures meant to accompany the Basel II risk-based bank capital rules.

So, moving beyond codes of conduct and high-level principles, how should sovereign financial-institution investments in the U.S. be governed? It is, I believe, vital to ensure that sovereign investments are made only for commercial, not national-policy, reasons and that they are of a size and nature that limits macroeconomic or financial-system risk. To be sure, SWF managers have recently sought to reassure global markets as the scope of their operations has grown. Just last week, the head of the largest Chinese SWF came to Washington on just such a mission. However, he told the press that his SWF would not invest in tobacco or in projects that damage the environment. These are laudable goals, to be sure, but they indicate that investments would still have non-commercial motivations that warrant careful scrutiny.[11] Reinforcing this concern is a recent report from an industry analyst that SWFs have a major interest in acquiring asset-management

[11] "China Tries to Reassure U.S. About Its Investing Plans" by Steven R. Weisman, *New York Times*, February 1, 2008.

firms not to profit by their operations, but rather to learn from them.[12] Again, this is laudable, but not comparable to true commercial motivation. Put another way, these investments are meant to foster externalities – an appropriate goal for governments, but not private firms with shareholder, employee and other stakeholder obligations.

As a result, all sovereign investments in U.S. financial-services firms – regardless of charter or their regulatory structure – should be conducted either through third-party asset managers or placed through diversified investment vehicles such as mutual or exchange-traded funds. This is an important general principle for all sovereign investments, but – due to the unique guarantees behind most financial institutions and the systemic importance of even relatively small ones – it is vital that it govern sovereign investments in this sector. As Secretary Summers has noted:

> All of these risks would be greatly mitigated if SWFs invested through intermediary asset managers, as is the case with most institutional pools of capital such as endowments and pension funds. The experience of many endowments and pension funds suggests that this approach is in most cases likely to produce the best risk-adjusted returns.

Should the requirement for third-party asset management not apply, then all sovereign financial investments above a five percent ownership stake should come under advance supervisory review, in addition to the degree to which they come before CFIUS. As noted, financial-services firms have an array of unique characteristics that differentiate them from other commercial ventures. This is, indeed, the premise of U.S. banking law – which seeks to bar commercial ownership of insured depositories – and it is a critical concern of the Federal Reserve Board and FDIC. Although much of the debate is limited to insured depositories, many systemic-risk and fiduciary issues transcend them, as has been made clear by an array of market developments ranging from the FRB-led rescue of Long-Term Capital Management in 1998 to the problems of the monoline bond insurers now driving global equities markets up and down on a daily basis.

So far, all of the recent significant sovereign investment in financial entities have escaped formal advance scrutiny, although several were pre-cleared in an informal fashion with the appropriate agency. This was done because each is carefully structured to meet the specific banking and securities law criteria for "passive investment." However, passivity can sometimes be more a legal fiction than an operational fact, as was made clear in press reports that suggested that the dismissal of Citigroup's former CEO was pressed by a Saudi investor with a large – albeit passive – ownership stake.[13] His pressure may well have been appropriate, but it wasn't passive.

U.S. banking law[14] defines control as an ownership stake above 24.9 percent or when various "indicia of control" are found by the Federal Reserve. The law includes a

[12] "SWFs eye asset managers" by Steve Johnson, *Financial Times*, November 05, 2007.
[13] "Prince Alwaleed: Why Chuck Had To Go" by Andy Serwer and Barney Gimbel, *Fortune*, November 16, 2007.
[14] See 12 U.S.C. 1841(a), 12 C.F.R. 225.2(e).

presumption that control does not exist if ownership stakes are below five percent, although the FRB may still find such control even if nominal ownership positions fall below five percent. This approach – which looks beyond legal formalities – should be applied to all financial-services firms, not just banks to ensure that no sovereign entity takes a position or uses its power to obtain influence disproportionate to its holdings or to advance non-economic objectives.

To accomplish this requirement, Congress would need to instruct the Federal Reserve and other bank regulators to assume that control exists in ownership stakes above five percent by sovereign entities. This could be done through a change in law or just through a resolution. However, a comparable standard would need to be established in law for other financial-services firms, where no such provision of law or prior-approval process exists. This would subject broker-dealers, investment advisers, private-equity firms and insurance companies to an unprecedented level of federal scrutiny, but only with regard to approval of changes of control that involve sovereign entities.

These non-banking firms can play major roles in both the financial system and the economy as a whole and they are often also backed by federal protection. Cases abound – the afore-mentioned rescue of a major hedge fund and the bail-out now being structured for monoline bond insurers to name but two examples. Reflecting these back-stops and broader systemic-risk considerations, the U.S. Treasury is about to propose a new regulatory scheme for the financial-services industry as a whole. This would, if enacted, create the platform from which to establish a unified prior-approval process for sovereign investment in financial institutions, but its completion is years away. Urgent and immediate financial-market concerns warrant short-term action to ensure that any controlling stakes – defined as proposed – thus be carefully reviewed in advance and that all conditions to any such approvals are explicit ones to which persons expressly subject to enforceable U. S. law are bound.

Date	Investor	Target	Amount
21 May `07	China Investment Corp.[15]	Blackstone	$3B
Sep. `07	Bourse Dubai[16]	NASDAQ	$4.2B
30 Sep. `07	Mubadala Development Co.[17]	Carlyle	$1.4B
Oct. `07	Citic[18]	Bear Stearns	$1B
30 Oct. `07	Dubai International Capital[19]	Och-Ziff	$1.3B
27 Nov. `07	Abu Dhabi Investment Authority[20]	Citigroup	$7.5B
19 Dec. `07	China Investment Corp.[21]	Morgan Stanley	$5B
24 Dec. `07	Temasek Holdings[22]	Merrill Lynch	$4.4B
14 Jan. `08	Kuwait & Korea[23]	Merrill Lynch	$4B
14 Jan. `08	Singapore, Kuwait, & others[24]	Citigroup	$12.5B
		Total:	$44.3B

[15] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08.

[16] http://www.iht.com/articles/2007/09/20/business/exchange.php and http://www.nasdaq.com/newsroom/news/newsroomnewsStory.aspx?textpath=pr2007%5CACQPMZ200709200402PRIMZONEFULLFEED127070.htm.

[17] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08.

[18] http://www.bloomberg.com/apps/news?pid=20601087&sid=aINY0sfPcE2Q&refer=home.

[19] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08.

[20] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08.

[21] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08.

[22] http://www.streetinsider.com/13Gs/Temasek+Holding+Shows+9.4%25+Stake+in+Merrill+Lynch+(MER)/3234448.html.

[23] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08.

[24] http://online.wsj.com/public/resources/documents/info-flash07.html?project=foreignSWF08&h=530&w=978&hasAd=1&settings=foreignSWF08 and http://online.wsj.com/article_print/SB120044526135892909.html.