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Are Sovereign Wealth Funds a Threat to the U.S. Banking System?

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A great deal of attention has focused recently on investments by “sovereign wealth funds” (“SWFs”) in the United States, particularly in banks and investment firms. SWF transactions regularly make headlines, at least in the business pages, and Congress has held three hearings on the subject in the last four months alone.²

What is all the fuss about? These investors have poured tens of billions of dollars into some of the biggest and most prestigious U.S. financial institutions, which sorely needed the cash infusions. This would seem clearly to be a very good thing. Nevertheless, it is apparent that SWF involvement in the U.S. economy evokes concern as well as relief among American policy-makers, business people and academics. In this article, I will try to provide an overview of SWFs and the issues that their recent investments have raised, focusing on investments in U.S. banking organizations.

Some Facts and Figures

Ted Truman, a Senior Fellow at the Peterson Institute for International Economics (and a former Director of the Division of International Finance at the Federal Reserve Board), describes SWFs as “separate pools of international assets owned and managed by governments to achieve a variety of economic and financial objectives.”³ They are not a

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² On March 5, the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the House Financial Services Committee conducted a joint hearing on Foreign Government Investment in the U.S. Economy and Financial Sector. Less than a month before, on February 13th, the U.S. Congress Joint Economic Committee held a hearing entitled “Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?” On November 14, last year, the Senate Banking Committee had held a hearing to consider Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications?

³ Testimony of Edwin M. Truman, Senior Fellow, Peterson Institute for International Economics, before the Senate Committee on Banking, Housing and Urban Affairs, November 14, 2007 (the “Truman Senate Testimony”). See also Testimony of Treasury Under Secretary for International Affairs David H. McCormick before the House Committee on Financial Services, March 5, 2008.

new phenomenon. The earliest ones are more than 40 years old, like the Revenue Equalization Reserve Fund established in 1956 by the Pacific island nation of Kiribati to manage revenues from phosphate deposits, or the Kuwait Investment Authority, established in 1960, and currently one of the world's largest.⁴ The largest SWFs generally derive their revenues from commodity sales (like Kiribati and Kuwait, and many others) or trade surpluses (China). They can serve a variety of government objectives, such as diversifying revenues to avoid excessive reliance on a nonrenewable commodity export; setting aside reserves against the day when that crucial commodity has become depleted; or managing the potentially disruptive impact on domestic financial markets of large trade surpluses.

The new attention to SWFs is attributable, at least in part, to their rapid growth both in number and size in recent years, as well as the expectation that this growth will continue unabated for the foreseeable future. According to testimony of Treasury Under Secretary David McCormick in a March 5 Congressional hearing,⁵ there are now almost 40 SWFs, twenty of which have been created since 2000, with more than ten established since 2005. The funds' total assets, estimated to range between \$2 trillion to \$3 trillion, are at least four times greater than in 2000. While their current size amounts to less than two percent of the \$190 trillion stock of global financial assets, and is a small fraction of the \$62 trillion managed by private institutional investors, it exceeds the total assets currently managed by hedge funds and private equity funds. SWF assets, moreover, are projected to continue increasing rapidly, with some expecting them to reach \$10-15 trillion by 2015.⁶

Countries with SWFs range from Azerbaijan (\$2 billion in its State Oil Fund) to Abu Dhabi (\$500-875 billion), and include close U.S. allies with democratic governments, such as Australia and Canada, as well as nations with which we have somewhat more guarded and wary relationships, such as Russia and China. The largest seven, in descending order of size, are those of Abu Dhabi; Singapore (two funds,

⁴ See Truman Senate Testimony. According to another commentator, the Kuwait Investment Authority was launched in 1953. See *State Capitalism: The Rise of Sovereign Wealth Funds*, November 13th, 2007, a paper written by Gerard Lyons, Chief Economist and Head of Global Research at Standard Chartered Bank. Singapore SWF Temasek Holdings owns a 13% equity stake in Standard Chartered.

⁵ See note 3, above.

⁶ The data cited in this paragraph, all drawn from Under Secretary McCormick's testimony, are generally consistent with estimates of other commentators.

totalling \$208-438 billion); Norway (\$329 billion); Kuwait (\$213 billion); China (\$200 billion) and Russia (\$148 billion).⁷ Together, these seven account for well over two-thirds of total SWF assets.

If these statistics are not enough to command attention, SWFs in the past year have participated in a number of highly publicized transactions in the United States involving eye-popping sums, including:

- China's \$3 billion purchase in May 2007 of a nonvoting stake in the Blackstone Group, amounting to almost 10% of the company's equity;
- the purchase by the Abu Dhabi Investment Authority, in November 2007, of a \$7.5 billion investment in Citigroup, amounting to just under five percent of the voting stock, and edging out Saudi Prince Alwaleed bin Talal as the company's largest single shareholder;
- Merrill Lynch's December 2007 sale of \$4.4 billion in new stock (with an option to purchase \$600,000 more) to Temasek Holdings, an investment company owned by Singapore's Ministry of Finance, concurrently with a sale of \$1.2 billion in voting stock to Davis Selected Advisors, a U.S. private equity fund;
- Morgan Stanley's sale of a \$5 billion stake to China Investment Corporation, also in December 2007;
- Merrill Lynch's agreement in January 2008 to issue \$6.6 billion of mandatory convertible preferred stock to Korea Investment Corporation, Kuwait Investment Authority and Japan's Mizuho Bank.⁸

Although not a SWF transaction, Bain Capital Partners' bid to purchase network equipment maker 3Com Corp, in partnership with a Chinese investor, also drew attention to foreign governments' growing role as investors here. The deal aborted last month

⁷ Estimates of the size of the SWFs vary somewhat. These asset totals are taken from the Truman Senate Testimony, Table 1, except for China, taken from a September 2007 estimate by Morgan Stanley, cited in L. Tesik, Sovereign Wealth Funds, Council on Foreign Relations, January 18, 2008. The total asset figures for Abu Dhabi, Singapore, and Russia are also estimates.

⁸ SWFs have also made substantial investments in other countries' economies, such as the \$9.7 billion investment by the Singapore Investment Corporation in Switzerland's UBS. The concerns such investments provoke are by no means confined to the United States. See, for example, the Statement of G-7 Finance Ministers and Central Bank Governors, issued on October 19, 2007, discussed in note 16 and the accompanying text.

when the transaction failed to obtain national security clearance from the interagency Committee on Foreign Investment in the United States (“CFIUS”).⁹

What Are the Concerns?

One might have expected that the substantial cash infusions in U.S. financial companies like Merrill Lynch, Morgan Stanley and Citigroup would have been greeted with unalloyed gratitude. After all, if any of these companies had failed to secure new capital, the repercussions for the wider U.S. economy could have been very serious. Moreover, it is reassuring to know that some investors, at least, have confidence in these icons of U.S. finance, and now have an even greater stake in the companies’ – and hence our country’s – continuing success and prosperity. These have indeed been the reactions of many market participants and observers, and not solely the shareholders and management of the companies involved. Moreover, even those who worry about the growing role of SWFs in international capital flows readily acknowledge the importance of keeping the United States open to foreign investment, recognizing the value of these investments in our financial institutions at a time of acute stress.

Yet, serious concerns have also been raised. They include a worry that SWFs owned by U.S. rivals will pursue their countries’ military and strategic objectives rather than ordinary business goals.¹⁰ Bain’s bid to acquire 3Com with a Chinese partner failed because of the perceived national security risks involved in the deal. In the House Financial Services Committee hearing on SWFs on March 5, a subcommittee chair fretted that a hostile power, in lieu of a direct military attack, might acquire a U.S. electric utility and then deliver an order to cut off our power.¹¹

In the banking context, the suspicions about foreign investors’ ulterior motives is partly based on the fact that canny U.S. investors are not coming to the rescue of our

⁹ CFIUS, in its current incarnation, is itself a product of recent concerns about foreign investment in the United States. Its powers were enhanced in last year’s Foreign Investment and National Security Act of 2007, enacted after the ill-fated Dubai Ports deal heightened Congress’s concern about foreign acquisitions viewed as raising national security concerns.

¹⁰ Of course, reasonable people (and countries) might disagree as to what constitutes “ordinary” business goals and how they can be distinguished from government objectives thought to be motivated by non-economic concerns. For example, many SWFs have been established to ensure that wealth from nonrenewable resources is conserved for future generations. Such generational wealth transfer might be thought to be both good public policy *and* sound business planning.

¹¹ This scenario was described by Representative Paul Kanjorski during the March 5 hearing described in note 2, above.

ailing financial firms. Therefore, the reasoning goes, the SWFs which are doing so must be seeking something more than a good return on investment.¹² Even if a SWF is not pursuing military or other strategic objectives, might its government's policy objectives trump the cool calculus of making money and thereby disrupt the smooth and rational functioning of markets driven solely by profit-seeking?

Another concern is that SWFs will gain control or influence over the companies in which they invest and use it for unfair advantage. In the past, critics of foreign government involvement in our banking sector have worried that government-owned banks might benefit from governmental subsidies or pursue lending or other policies designed to favor the business interests of home country companies, providing them with a competitive edge while distorting the credit allocation process.¹³

And, even if SWFs pursue conventional investment objectives in their transactions, the sheer amount of money at their disposal might, it is thought, give them the power to move markets in ways that are disruptive and harmful to private sector participants. Some worry that foreign governments might *stop* investing here, or abruptly pull their money out, which might be even worse than the influence they arguably achieve by continuing to acquire U.S. assets. The prospect that foreign countries, like China, that hold large amounts of U.S. debt, might stop financing our deficits or even dump their current holdings is indeed sobering.¹⁴ However, the problem of an abrupt withdrawal of funds would seem to have limited relevance with respect to equity investments.¹⁵

Fuelling these concerns is the fact that many SWFs are secretive and unaccountable to their own citizens, much less to the countries in which they choose to

¹² See, e.g. Andrew Ross Serkin, "What Money Can Buy: Influence," New York Times, January 22, 2008, quoting Felix Rohatyn: "They are making investments that they probably think are O.K. but not spectacular . . . there has to be a political objective over and above the rate of return."

¹³ See, e.g., Statement of Federal Reserve Governor John LaWare, before the House Committee on Banking, Finance and Urban Affairs, May 8, 1992 (the "LaWare Statement"), noting the existence of such a concern but expressing the view that it was not justified by actual experience. The LaWare Statement is reproduced in 78 Federal Reserve Bulletin 495 (July 1992).

¹⁴ See Foreign Ownership of U.S. Financial Assets: Implications of a Withdrawal, Congressional Research Service Report for Congress, January 14, 2008.

¹⁵ On March 4, the CEO of Dubai's investment agency drew headlines, and may have contributed to a drop in Citigroup's share price, when he commented that the multi-billion dollar equity investments in Citigroup already made by Abu Dhabi, Kuwait and Saudi Prince Alwaleed would not suffice to "rescue" Citigroup.

invest. For example, while Norway's large pension fund is a model of transparency and good governance, disclosing both its holdings and the investment objectives they are intended to achieve, others – like Abu Dhabi's – reveal little about such matters.¹⁶ The lack of transparency gives free rein to the worst fears regarding the motives of SWF investors and has led both supporters and critics of largely unrestricted international capital flows to support adoption of a code of “best practices” to be followed by SWFs. On October 19, 2007, the Finance Ministers and Central Governors of the Group of Seven issued a statement recognizing that their economies “can benefit from openness to SWF investment flows,” while calling for the World Bank, IMF and OECD to work on a code of “best practices of SWFs in such areas as institutional structure, risk management, transparency and accountability.”¹⁷ The OECD and the IMF are expected to issue proposals in March and April, respectively.

Are the Concerns Relevant to Banks?

However justified they may be as a general matter, the worries about SWF investments in the United States seem to have little relevance with respect to the banking sector. Control of a major U.S. bank, even if it could be achieved, would be unlikely to lead to preferential lending or other abuses. For one thing, the regulatory approval process for bank acquisitions – whether by a company, an individual, or a government agency – involves extensive vetting by federal regulators. A SWF seeking a significant stake in a U.S. banking organization would need to obtain approval under the Bank Holding Company Act, the Savings and Loan Holding Company Act or the Change in Bank Control Act.¹⁸ While a sovereign fund might be opaque to outsiders, U.S.

¹⁶ Ted Truman's testimony before the Senate Banking Committee on November 14, 2007, cited in note 2, includes several tables ranking SWFs according to various criteria, including Transparency & Accountability, Structure, and Governance. In Mr. Truman's analysis, the Abu Dhabi Investment Authority and Corporation scored zero points out of a possible total of 12 for Transparency & Accountability. Even Singapore's Temasek Holdings, often cited as a model of transparency, does not prominently disclose on its Web site that it is owned by that country's Ministry of Finance.

¹⁷ See Statement of G-7 Finance Ministers and Central Bank Governors, October 19, 2007, available on the Web site of the Treasury Department, www.ustreas.gov/press/releases/hp625.htm. The joint action of the G-7 officials reflects that the concerns about SWFs are shared by other industrialized nations that are experiencing similar economic pressures. Unsurprisingly, many of the SWFs question the need for such a code, pointing out that, to date, they have avoided political interference in the countries where they invest, and have good records as corporate citizens. See Steven R. Weisman, “Overseas Funds Resist Calls for a Code of Conduct,” *New York Times*, February 9, 2008.

¹⁸ A SWF organized as a business entity, as many are, would likely be treated as a “company” under the Bank Holding Company Act. A foreign government or government agency would not be so treated, but

regulators would require adequate disclosure of ownership and other material facts as a condition to approval of a bank acquisition. Moreover, the reporting and examination regime that would apply following the acquisition, as well as the restrictions on non-arm's-length transactions under federal banking laws, would provide substantial safeguards against the types of abusive transactions feared by some.

To date, SWF investments in Citigroup and other U.S. financial institutions have been structured to fall below "control" thresholds and have not resulted in board representation, suggesting that these investors are aware of the concerns that larger investments might evoke, as well as, perhaps, that they have little appetite for being regulated as depository institution holding companies. The significant stakes of investors such as Saudi Arabia's Prince Alwaleed and the Abu Dhabi Investment Authority in Citigroup no doubt provide them with influence over the organization, but this is to be expected, consistent with good corporate governance. There is no evidence that this influence has exceeded that which any large shareholder would expect or could legitimately exercise.

In addition, banks are not themselves, and do not generally possess, the types of strategic assets whose control by foreigners raises national security concerns. A foreign country that wishes to acquire control of a U.S. bank or securities firm in order to obtain the secret of its lending and securitization practices is welcome to have them!

Concerns about foreign government involvement in U.S. banking are not new. It seems almost incredible now, but Congress in 1992 considered legislation that would have precluded foreign government-owned banks from engaging in any financial transactions in the United States, whether through a subsidiary or a branch, other than extensions of credit for trade finance.¹⁹ Federal Reserve Governor John LaWare, in testifying against the proposal, provided a detailed account of the abuses that foreign government ownership might entail, including unfair competitive advantage and preferential lending. He reported then that "[m]ost foreign government-owned banks

significant investments by non-company investors would still require approval under the Change in Bank Control Act, and the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act would apply to loans and other dealings between a U.S. bank controlled by a foreign government and other entities controlled by that government. See Testimony of Federal Reserve Board General Counsel Scott G. Alvarez before the House Committee on Financial Services, March 5, 2008.

¹⁹ H.R. 4803, discussed in the LaWare Statement, cited in note 12.

operating in the United States behave in a manner fully consistent with market practices and in compliance with law. Although we recognize that abuses have occurred, such abuses have been limited in number and cannot be attributed to the mere fact of government ownership.”²⁰ Governor LaWare also assured his listeners that the Federal Reserve Board possessed the regulatory tools to deal with the issues presented by the operations of foreign government-owned banks. I believe the Federal Reserve would take the same positions today.

It would appear that wariness about SWFs stems, in part, from understandable uneasiness about our economy’s fragility, as well as, perhaps, the perception that the days of unquestioned American economic primacy and dominance are over. Xenophobia and partisan politics also seem to be playing a part. Much of the Congressional criticism of SWFs has come from Democrats, who evidently view the issue as a stick with which to belabor the Bush Administration, whose fiscal, trade and other economic policies they blame for contributing to the weakness of U.S. financial institutions and the strength of the SWFs that are riding to their rescue. Whether that blame is misplaced is debatable, but the problems of energy dependence, trade imbalances and deficit spending are real enough.

In sum, while the economic trends that have thrust SWFs into new prominence are a legitimate cause for concern, the prospect of more investments by these funds in the U.S. economy generally, or its financial institutions in particular, does not seem especially worrisome. The Peterson Institute’s Ted Truman expressed the point well: “We live in a risky world, but the economic and political risks to the United States from sovereign wealth funds do not make my top 100.”²¹

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Peter Heyward welcomes comments and questions about this article. He can be reached at peheyward@venable.com.

²⁰ See the LaWare Statement.

²¹ Edwin M. Truman, “Do Sovereign Wealth Funds Pose a Risk to the United States?” Remarks at the American Enterprise Institute, February 25, 2008.