Political economy of the Gulf sovereign wealth funds:

A case study of Iran, Kuwait, Saudi Arabia and United Arab Emirates

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PhD in Arab and Islamic Studies

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April 2011
Political economy of the
Gulf sovereign wealth funds:

A case study of Iran, Kuwait, Saudi Arabia and United Arab Emirates

submitted by Sara Bazoobandi
to the University of Exeter
as a thesis for the degree of Doctor of Philosophy
in Arab and Islamic Studies
April 2011

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I certify that all material on this thesis which is not my own work has been identified and that no material has previously been submitted and approved a degree by this or any other university.

.................................................................
(Sara Bazoobandi)
Abstract

Using as case studies three GCC commodity-based sovereign wealth funds – Saudi Arabia, Kuwait, and the UAE – and the SWFs of Iran and Norway for comparison, this study examines and analyses their history, governance and structure, and investment strategies, in the context of on-going debates about their transparency.

Most Gulf CSWFs, were established under colonial rule. Now owned by the region’s Arab states they have operated in the global financial system since the 1960s. Since the 1970s and the enormous inflow of oil revenues, the funds have broadened their asset classes and their institutional development. Iran’s SWF, one of the youngest funds in the Gulf, differs from its Arab neighbours in terms of structure and operation, and is less active internationally. Characterised by lack of transparency and corruption, Iran’s sovereign wealth investments and management also lag behind those of its neighbours.

Debate over the transparency of SWFs has highlighted various global practices. Norway’s SWF is reputedly the most transparent in the world; its CSWF provides an operational and structural comparison for the Gulf cases. Recently, organisational measures have been introduced for calculating possible risks from non-commercial investment incentives of SWFs, whose politically-driven investment strategies are viewed as potentially a major threat to the national security of their host countries.

An international working group of 25 countries that sponsor sovereign wealth funds, plus the IMF, has introduced a set of principles and practices for SWF operation, in order to minimise their possible risk of impacting negatively on global financial and political stability. Most western governments are also introducing regulatory codes to identify threats and protect their own strategic economic sectors from certain SWF investments. This study reviews certain incidents that triggered the transparency debate, and scrutinises the reaction of some of the Gulf CSWFs to these recent regulatory codes and strategies.
Acknowledgement

First I wish to express my sincere gratitude to my supervisor, Professor Tim Niblock at the Institute of Arab and Islamic Studies, University of Exeter, for his encouragement, guidance and support throughout my research.

I also would like to thank everyone who facilitated my field research in the City of London and in Oxford, particularly Andrew Rozanov who kindly agreed to participate in several meetings and interviews during the research for this project. During my fieldwork in Dubai and Abu Dhabi I also received much help from the staff at the Gulf Research Centre, and various other financial institutes who wish to remain anonymous. I would particularly like to thank the Chairman of the Gulf Research Centre, Dr Abdul Aziz Al Sager, who kindly accommodated me during my time in Dubai in 2010.

The assistance of Mrs Jo-Anne Baillie and Mrs Lindy Ayubi who sorted out issues of proofreading, and Dr Christian Luber who found time to assist me with the technical formatting of this thesis, is acknowledged with thanks.

I am particularly grateful for the support of the staff and students of the Institute for Arab and Islamic Studies at Exeter. My deep appreciation to all of my friends in Tehran and Exeter, particularly Sharifa Hashem, for their most generous support, and last, but not least I acknowledge my inspirational mother, Dr Soudabeh Chegini. This thesis could not have been completed without the love and encouragement of you all.
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<td>Abu Dhabi Investment Board</td>
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<td>ADGAS</td>
<td>Abu Dhabi Gas Liquefaction Company</td>
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<td>ADIC</td>
<td>Abu Dhabi Investment Council</td>
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<td>ADNOC</td>
<td>Abu Dhabi National Oil Company</td>
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<td>AUM</td>
<td>Assets Under Management</td>
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<td>BBC</td>
<td>British Broadcasting Corporation</td>
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<td>BCCI</td>
<td>Bank of Credit and Commerce International</td>
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<td>Bn</td>
<td>Billion</td>
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<td>CBI</td>
<td>Central Bank of Iran</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>CFIUS</td>
<td>Committee on Foreign Investment in the United States</td>
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<td>CIC</td>
<td>China Investment Corporation</td>
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<td>CNOOC</td>
<td>Chinese National Offshore Oil Company</td>
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<td>CSWF</td>
<td>Commodity-based Sovereign Wealth Fund</td>
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<td>Dh</td>
<td>Dirham</td>
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<td>DIC</td>
<td>Dubai International Capital</td>
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<td>DPG</td>
<td>Dubai Properties Group</td>
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<td>DPW</td>
<td>Dubai Port World</td>
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<td>EDC</td>
<td>Expediency Discernment Council</td>
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<td>EIA</td>
<td>Emirates Investment Authority</td>
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<td>EU</td>
<td>European Union</td>
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<td>EZW</td>
<td>Economic Zones World</td>
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<td>FY</td>
<td>Fiscal Year</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FSC</td>
<td>Federal Supreme Council</td>
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<td>Future Generation Fund</td>
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<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>Government of Singapore Investment Corporation</td>
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<td>GPFG</td>
<td>Global Pension Fund Global</td>
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<td>GPFN</td>
<td>Global Pension Fund Norway</td>
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<td>GRF</td>
<td>General Reserve Fund</td>
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<td>HMKA</td>
<td>Hong Kong Monetary Authority</td>
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<td>ICD</td>
<td>Investment Corporation of Dubai</td>
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<td>IFESA</td>
<td>Iran Foreign Exchange Saving Account</td>
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<td>IFSWF</td>
<td>International Forum of Sovereign Wealth Funds</td>
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<td>IWG</td>
<td>International Working Group of Sovereign Wealth Funds</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>KD</td>
<td>Kuwaiti Dinar</td>
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<td>KFAED</td>
<td>Kuwait Fund for Arab Economic Development</td>
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<td>KFTCIC</td>
<td>Kuwait Foreign Trading, Contracting and Investment Company</td>
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<td>Kuwait Oil Company</td>
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<td>KIO</td>
<td>Kuwait Investment Office</td>
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<td>LIA</td>
<td>Libyan Investment Authority</td>
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<td>MB</td>
<td>Million Barrel</td>
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<td>ME</td>
<td>Middle East</td>
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<td>MENA</td>
<td>Middle East and North Africa</td>
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<td>Mn</td>
<td>Million</td>
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<td>MP</td>
<td>Member of the Parliament</td>
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<tr>
<td>MRC</td>
<td>Majlis Research Centre</td>
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<td>Norges Bank Investment Management</td>
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<td>NDF</td>
<td>National Development Fund</td>
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<td>NIOC</td>
<td>National Iranian Oil Company</td>
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<td>NWF</td>
<td>National Welfare Fund</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OPEC</td>
<td>Organisation of the Petroleum Exporting Countries</td>
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<td>P&amp;O</td>
<td>Peninsular and Oriental Steam Navigation Company</td>
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<td>PIF</td>
<td>Public Investment Fund</td>
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<td>SPC</td>
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<td>Sovereign Wealth Enterprise</td>
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<td>Sovereign Wealth Fund</td>
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<td>TUSRC</td>
<td>Tehran Urban and Suburban Railway Company</td>
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<td>United Arab Emirates</td>
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<td>UK</td>
<td>United Kingdom</td>
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<td>UNCTAD</td>
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1 Introduction and Definition of SWFs

1.1 Introduction

The term Sovereign Wealth Fund (SWF), referring to a state-owned investment fund composed of financial assets including properties, stocks and bonds, was coined in 2005 by Andrew Rozanov, a financial analyst from the City of London. SWFs have recently attracted a large amount of attention in the global financial system, as they have highlighted the role of the governments in the international financial structure.

This controversy was further triggered by the size of the Assets Under Management (AUM) of these funds. In May of 2007, Morgan Stanley published a report on the estimated size of SWFs and predicted that the AUM of the funds could have grown from the estimated 2007 figure of US $2.5 trillion to double that size before 2010, and reach around US $12 trillion by 2015.1

Figure 1-1: Total AUM of global investment funds ($ trillion)

<table>
<thead>
<tr>
<th>Hedge funds</th>
<th>1.6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity</td>
<td>2.6</td>
</tr>
<tr>
<td>SWFs</td>
<td>3.8</td>
</tr>
<tr>
<td>Insurance funds</td>
<td>20</td>
</tr>
<tr>
<td>Mutual funds</td>
<td>23</td>
</tr>
<tr>
<td>Pension funds</td>
<td>29.5</td>
</tr>
</tbody>
</table>


The portfolio of investments of the SWFs was affected by the financial crisis of 2008. Most of these funds recorded significant losses in the value of their assets. However, they emerged quite strong from the crisis. Long-term prospects for SWFs are therefore positive. Deutsche Bank predicted that by 2019 total assets under SWF’s management

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are likely to amount to US $7 trillion, which is more than twice the current volume. In 2010, the SWFs were about 2.5 times bigger than hedge funds and their assets stood about US $1.2 trillion above the AUM of private equity funds (see Figure 1-1). As a result, the SWFs are expected to gain more power in the global financial markets as they have become extremely wealthy institutional investors in less than one decade.

1.2 Definition

Given that SWFs are not the only type of government-owned investment institution, there has been a debate amongst financial analysts, as well as academics, on the definition of the SWFs. To draw a distinct line between SWFs and other types of government-owned pools of assets like pension funds and the central banks’ foreign exchange reserves a number of definitions have been suggested by various sources.

In 2005, Andrew Rozanov defined the SWF funds as:

“...by-products of national budget surpluses, accumulated over years due to favourable macroeconomic, trade and fiscal positions, coupled with long term budget planning and spending restraint. Usually these funds are set up with one or more of the following objectives: insulate the budget and economy from excess volatility in revenues, help monetary authorities sterilise unwanted liquidity, build up savings for future generations, or use the money for economic and social development.”

In 2008, the International Working Group of SWFs, established by the International Monetary Fund (IMF) in cooperation with the fund’s managers to review the operation of the funds and propose a voluntary code for best practice of the SWFs, defined the SWFs to be the:

“... special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets. SWFs have diverse legal, institutional, and governance structures. They are a heterogeneous group, comprising fiscal stabilization funds, savings funds, reserve investment corporations, development funds, and pension reserve funds without explicit pension liabilities”.

Sovereign Wealth Fund Institute, a research institute monitoring the SWFs, defines these funds as:

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4 International Working Group of Sovereign Wealth Funds (2008), *Sovereign Wealth Funds Generally Accepted Principles and Practices (GAPP)*
“(state-owned investment funds) composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets. These assets can include: balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports. Sovereign Wealth Funds can be structured as a fund, pool, or corporation. The definition of sovereign wealth fund exclude, among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals. Some funds also invest indirectly in domestic state-owned enterprises. In addition, they tend to prefer returns over liquidity, thus they have a higher risk tolerance than traditional foreign exchange reserves.”

This study defines the SWFs as institutional investors which are:

1. owned and financed by their respective governments,

2. often, but not always, managed by separate organisations than the central banks,

3. financed from the revenue surpluses (after planned government spending and/or off-budget expenditures are paid from the government commodity or non-commodity export incomes, the surplus is deposited in the SWF’s account),

4. aiming to protect the national economy from income volatility, and/or help monetary system to control inflationary effects of surplus liquidity, and/or accumulate assets for future generations, and/or diversify the government incomes from oil sector, and/or use the surplus incomes to transfer new technologies and expertise to support economic and social development,

5. often, but not always, holding highly diversified portfolio of investments invested in income generating assets spread across the world.

Indeed, the major difference between the commodity and non-commodity SWFs is the source of their assets. Most of the dissimilarities between the two types of funds are driven from their key differentiating characteristic; source of assets. Although, the main focus of this study is to review the commodity-based SWFs, in order to provide a better understanding for commodity-based funds, few key dissimilarities between the commodity-based and non-commodity SWFs are reviewed here.

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Firstly, commodity-based SWFs have a higher risk appetite in comparison with those funds which are sponsored by surplus trade income. This is mainly as a result of their reliance on commodity export revenue. In other word, the commodity-based funds tend to take more risks simply because the source of their assets is oil. Given the global oil demand, the oil exporting countries are fairly certain that their natural reserves can generate significant revenue for the foreseeable future. While the non-commodity funds rely on surplus income from export of goods which may not have an increasing global demand even in short to medium term.

Secondly, the governance and management of the commodity-based funds is more influenced by the political elite in compare with the non-commodity funds. This is indeed as a result of their reliance on oil income and highly politicised international oil sector. Finally, the commodity-based funds tend to have a longer and, to some extent, less cautious approach with their investment horizons. Again, this is as a result of their reliance of their sponsoring sovereign on oil income to finance the commodity-based funds. It is widely assumed that the source of generating surplus revenue in oil-rich countries is more sustainable than in countries with high non-commodity export revenue. Therefore, growing oil prices and high global demand for oil allows the governments of oil-rich countries to apply longer investment strategies for their SWFs.

1.3 Significance of the topic

SWFs have become a subject of concern in the global economy as they hold assets of significant size under their management. Although some of these institutional investors, like Kuwait Investment Authority (KIA), have been operating actively in international financial markets for more than five decades, they have recently become the centre of attention amongst the business leaders and scholars. They recorded a massive growth recently and some have shown high risk appetite in their investment regime. Such growth and investment strategies have put them in a rather controversial position as their power in the global financial market is increasing dramatically.

Figure 1-2: Annual investments by SWFs ($ billions)
As a result of the growth of their assets, SWFs have become extremely active institutional investors over less than one decade. Western financial institutions, which previously provided services to the SWFs as clients for a number of decades, have noticed that the relative weight and importance of these funds to financial firms in the West have increased dramatically since 2003. As Figure 1-2 shows above, the total annual volume of completed investment transactions by SWFs had increased from $8 billion in 2004, to $58 billion in 2008. Therefore the SWFs have been particularly active in accumulating various assets across the world since 2004. Such active investment strategy has highlighted the significant role of the SWFs in the global economy.

There have been two voices in the debate on the role of SWFs in the global economy. One view is that they are cash rich investment vehicles that are able to bring their capital surpluses into the global financial system and help stabilize the international economy, as they have done during the financial crisis of 2008. The opposing view underlines their role in endangering the balance in the global economy where, traditionally, the Western-developed markets have provided sufficient financial resources for the developing countries. Therefore while some view these funds as the desirable outcome of a deeper financial globalization, there has been a growing concern over the size of SWF’s portfolios, which may ultimately destabilize the global financial system.

There are currently about 50 SWFs operating in the world (according to the list provided by Sovereign Wealth Fund Institute). Table 1-1 shows the five largest commodity SWFs of the world. These funds in total hold more than $1.3 trillion which
is about one third of total SWF assets globally. The concentration of wealth in a small number of these funds has given high financial power to the sponsoring governments and they are potentially capable of influencing the global financial system.

Table 1-1: Five largest commodity SWFs of the world

<table>
<thead>
<tr>
<th>Country</th>
<th>Fund Name</th>
<th>Year of Inception</th>
<th>Sources</th>
<th>Objectives</th>
<th>Assets (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UAE</td>
<td>Abu Dhabi Investment Authority</td>
<td>1976</td>
<td>Oil revenue</td>
<td>Saving</td>
<td>627</td>
</tr>
<tr>
<td>Norway</td>
<td>Government Pension Fund-Global</td>
<td>1990</td>
<td>Oil revenue</td>
<td>Saving and stabilization</td>
<td>512</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>Saudi Arabian Monetary Agency</td>
<td>1952</td>
<td>Oil revenue</td>
<td>Saving and stabilization</td>
<td>439.1</td>
</tr>
<tr>
<td>Kuwait</td>
<td>General Reserve Fund/Future Generation Fund</td>
<td>1953/1976</td>
<td>Oil revenue</td>
<td>Saving and stabilization</td>
<td>202.8</td>
</tr>
<tr>
<td>Russia</td>
<td>Oil Stabilisation Fund</td>
<td>2004</td>
<td>Oil revenue</td>
<td>Stabilization</td>
<td>52.9 142.5</td>
</tr>
<tr>
<td></td>
<td>National Welfare Fund</td>
<td>2008</td>
<td></td>
<td>Saving</td>
<td>89.6</td>
</tr>
</tbody>
</table>

Source: Sovereign Wealth Fund Institute (2011)

Moreover, a significant share of the assets under management of these institutions is owned by hydrocarbon producers. International Financial Services London estimated the total assets of SWFs in 2009 to stand around $3.8 trillion. $2.5 trillion of these assets are held by commodity SWFs; while, $1.3 trillion belongs to non-commodity sovereign wealth funds. The size of the AUM of commodity-based sovereign wealth funds (CSWF) has grown significantly since 2008. Deutsche Bank reported 46% of assets held by all sovereign assets, equal to about $1.6 trillion, are owned by the funds of the Middle East amongst which the Gulf countries have the highest share.

The increasing oil prices coupled with the high concentration of oil reserves in the Gulf is likely to boost the assets under management of the commodity-based funds of the Gulf Cooperation Council (GCC) in the foreseeable future. Most of the GCC countries, except Saudi Arabia, have quite small population. The total population of each country is barely more than a couple of million, therefore, the growth of the Gulf funds will increase the concentration of capital to a smaller percentage of the world’s population.

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6 International Financial Services London (2010), *Sovereign Wealth Funds 2010*
Introduction and Definition of SWFs

This leaves the ownership of the largest SWFs in the world to the smallest percentage of global population.

The political system of all the Arab states of the Gulf has a traditional form with weak signs of reform, or democratisation. There has been an overall lack of understanding between the Western countries and the Gulf, which consequently has led to a long lasting sense of mistrust. Therefore the growing size and active investment regime of government investment institutions sponsored by the GCC states has underlined the significance of these organisations in the global financial world.

The investment activities of the CSWFs of the Gulf have created strong links between the region and the economies which host their investments. These links are no longer limited to the developed economies in the West. Due to the expected high investment returns in emerging economies, the investment operations of the government institutions of the Gulf in emerging markets has significantly expanded over the past few years. Such expansion is likely to have significant economic and political outcomes on an international level.

In the light of the growing size and power of the state-owned investment institutions of the GCC, the sponsoring governments of these organisations are playing a stronger role in regional and international levels. The potential political investment motives of these owners of massive pools of capital puts these institutions in a position in which they will be capable of jeopardising the future stability of the global financial markets.

The available literature on the topic tends to generalise various types of the SWFs as a large group of institutional investors, regardless of factors like the source of their funding, the geographic location of their sponsoring countries and maturity of the organisation. For that reason one of the major motives of this research is to narrow the scope of studying the SWFs on a particular geographic region. As the Gulf countries are the most strategically important part of the world for the supply of global energy, understanding the political system, business culture, and structure and governance of the Gulf CSWFs are of high value. In other words, this research was conducted in an effort to highlight the important role of the three Arab oil exporting countries of the Gulf in the future of international finance.
1.4 Research question and methodology

This study focuses on Sovereign Wealth Funds of three oil rich states of the Gulf: Kuwait, Saudi Arabia and United Arab Emirates. The Government Pension Fund-Global of Norway, the largest non-Arab and most transparent CSWF of the world, is also reviewed in this research. The study approaches the topic through an orderly comparison of three GCC Commodity Sovereign Wealth Funds with each other, as well as with Iran’s SWF experience and the Norwegian CSWF on key aspects, including:

- The history of establishment
- Asset size
- The investment strategy
- The governance and structure

Sovereign Wealth Funds of four oil rich states in the Gulf: Kuwait, Saudi Arabia, United Arab Emirates and Iran are reviewed in this project. The Government Pension Fund-Global of Norway, the largest non-Arab and most transparent CSWF of the world, is also reviewed in order to compare the Gulf experience with what has sometimes been seen as ‘best practice’ for management of commodity SWFs.

The issue of transparency of SWFs is reviewed in this study. Various events which led for the call for transparency of Sovereign Wealth Funds by the Western economies, different measures which are taken by various Western governments in order to monitor the activities of the SWFs in their economies, and the reaction of the SWFs to the transparency debate are the core aspects of this issue which are examined in this research.

The study examines the results of application of two different models for management of surplus oil income by the governments based on the economic development theories for natural resource rich countries. One theory argues that the in order to achieve a higher economic development, the oil rich states should keep their surplus commodity income outside of their domestic economy and transfer their wealth to various income generating types of assets. The rationale in this theory is to maintain the security of the sovereign’s wealth with keeping the wealth outside of the national economy as well as,
to generate a stream of income for the future generations who may not be able to have access to oil royalties.

The second theory offers a model in which a significant share of the surplus commodity export revenue is invested in the domestic economy to support the country's production units in various sectors. In this model, the government supports the national non-oil industry, both in public and private sector, to be able to develop and eventually compete globally. In this model, the government aims to protect the domestic economy from volatile oil markets with diversifying the country's income from oil exports and ultimately to generate a stream of income for the future generation who may not have access to oil royalties.

While some countries of the Gulf like Kuwait and the UAE applied the first model in management of their sovereign wealth, others like Iran, and to a lesser extent, Saudi Arabia have chosen the second model. Various economic, social and political factors have contributed in formation of the sovereign wealth management policies of the Gulf countries namely: size of population, the development of domestic non-oil sector, the size of the domestic economy and the political relations with the developed economies. For example, being under heavy political and financial sanctions, Iran has been a unique case for practicing management of the national oil revenue. Therefore, Iran was brought in as a case study in this project in order to provide a different example for SWF management in the region and to highlight the importance of the above mentioned factors in shaping the SWF management policies.

The information was collected through:

1- Documentary search of published datasets

2- A review of existing literature

3- Field trip to the UAE

4- Field work in the City of London, and Oxford

5- Phone interviews with bankers and scholars in the United States
The focus of the field trip in the United Arab Emirates (UAE) was data collection from the following local authorities and the private sector financial investment institutions: Abu Dhabi Investment Authority (ADIA), Mubadala Investment Company, Invest AD, National Bank of Abu Dhabi, Abu Dhabi Investment Council, Istithmar World, Carlyle Group, EFG-Hermes, and Barclays. In addition to the financial institutions in Dubai and Abu Dhabi journalists from leading local newspapers The National and Gulf News and analysts from the Gulf Research Centre were also interviewed.

The field work in London was also conducted to collect data from the following banks: Bank of America Merrill Lynch, State Street, Morgan Stanley, Nomura, and Barclays Capital, as well as research centres including: Eurasia Group and RGE Monitor. Also, a meeting was held with Dr. Yusef Al-Awadi, the former head of Kuwait Investment Authority in London to collect information on Kuwait SWF. This is mainly as a result of difficulties in getting a visa to Kuwait as an Iranian national. The field work in Oxford included attending a number of meetings and interviews with experts of the field from Oxford Analytica and Oxford University.

A series of phone interviews were also conducted to collect information from various experts on the topic from a number of organisations in the United States including: the International Monetary Fund, George Washington University, Georgetown University, American University of Washington and Peterson Institute for International Economics.

About 25 one-to-one interviews were conducted. Most of the contacts were made to arrange the interviews in advance and the interview questions were compiled before the meetings. The questions were centred on three main themes: the investment strategy of the GCC sovereign wealth funds, the issue of transparency, and the size of assets held by these funds. Nevertheless, the extent to which each of the above mentioned three themes was covered varied based on the background of the interviewees and their level of openness in speaking about these organisations.

The interviewees were from five groups: SWF’s current and former portfolio managers, Bank portfolio managers, scholars, consultancies and multilateral organisations. The interviews generally lasted a minimum of one hour and were mostly conducted at the offices of the interviewees or in coffee shops, with the obvious exception of those conducted over the phone.
The interviewing experience led to some interesting observations. Firstly, persistent follow ups were rather crucial in setting up interviews especially in dealing with the local organisations in the UAE, follow up phone calls were essential. Secondly, arranging the meetings in advance, sending the interview questions, and consent forms by email helped in establishing trust and accelerated the process of making an appointment for interviews. Thirdly, for an Iranian national researcher travelling around the GCC countries was quite a challenging task.

Almost all the individuals from the financial sector tend to be overly secretive in answering questions about the topic. The portfolio managers who are employed by the SWFs are more cautious than those who are employed by banks in making comments about these organisations. Both groups however were reluctant to give consent to be referred to by their name in the project’s written output. In contrast, academic researchers and private consultants were willing to openly comment on the topic and to be mentioned by name.

Finally, due to difficulties of collecting information on the government institutions in Iran, the field research for chapter six was carried out remotely. Five phone interviews with private sector business owners in Iran and two interviews with Iranian journalists in the City of London were conducted. In order to safeguard the privacy of the interviewees the information about the individuals is kept confidential. Another source of information for this chapter is Iranian government-owned news agencies, as well as, some Western news agencies including British Broadcasting Corporation (BBC) Persian service and the Guardian. The studies by the Majlis Research Centre (MRC) have also been an important source of information for this chapter. Majlis Research Center is a research institution which plays a supporting role for the Iranian parliament (Islamic Consultative assembly or Majlis). The centre has a leading role for the decision makings and legislative procedures of the parliament. All the reports and studies of the MRC are available through the official website of the centre. The language of interviews and the literature which have been used for this chapter (including press releases by the Iranian news agencies, and the MRC reports and studies) was Farsi.

The MRC was established in 1993 in order to assist the parliament and representatives to ratify the drafts and bills. For about two decades the MRC have been actively conducting research on various topics and it has published more than 10,000 research
papers and publications. According to the Functions Act of MRC, the purpose of establishing this centre is research and case studies to give professionally expert and consultative services to parliament representatives, committees, and the board of its committee chairmen. The MRC governing elements include: the Board of Trustees including the (Majlis) speaker, the Chairman and Members of the Board of Parliament Committees and the head of MRC; the Head of MRC, and the Research Council. The Research council consists a head, 5 individuals among specialists and academic figures among parliament representatives that they are elected by the board of trustees as well as five numbers of efficient researches with higher education(at least associate professor) that they are elected by recommendation of the head and approval of the board of trustees too.  

1.5 The structure of the thesis

Following this introduction, the remainder of this thesis consists of seven chapters. Chapter two aims to highlight the important characteristics of commodity-based sovereign wealth funds of the Gulf. It discusses the main goals of the commodity-based funds of the Gulf and how are they different from those sponsored by Asian governments. The chapter also evaluates the impact of the recent global financial crisis on the investment strategy of the commodity-based sovereign wealth funds of the Gulf.

Chapters 3-5 trace the institutional development and structure of the GCC funds by examining them in three main aspects: history of establishment, governance and structure of management, and investment strategy. There has not been information available on all these aspects in all three cases. The following are the elements discussed throughout the thesis:

1. History of establishment: this element aims to offer a historical introduction on how the organisations were formed and the extent to which the early years of operation of the institution has made an impact on the current strategy and structure of the organisation.

2. Governance and structure of management: the objective of this element is to provide an understanding on the role of the political elite on governance of the sovereign wealth investment institutions of the country and the extent of ruling

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family influence on the overall performance of the organisations. In this respect the examples of failed management experience and financial scandals related to each of the organisations is reviewed.

3. Asset management: Each of the Gulf commodity-based sovereign wealth fund have applied a unique investment strategy of their own, which has developed over the time. Each institutions investment strategy and their investment risk regime are explored.

Chapter Three deals with the oldest commodity-based sovereign wealth fund of the Gulf: Kuwait Investment Authority. The British government played an important in the formation of Kuwait Investment Board and the transition of power from the board to Kuwait Investment Office which for many years was the country’s sovereign wealth fund. The British government had also played a significant role in application of investment strategy in the early years of operation of Kuwait sovereign wealth fund. This chapter elaborates those historical links between the two countries and the way in which they formed the structure of the Kuwaiti sovereign wealth investment institution. This chapter also elaborate the governance, structure, and investment strategy of the Kuwait Investment Authority which is the government organisation that has been managing the country’s sovereign wealth since the 1908s. The impact of Iraqi invasion of Kuwait and the scandal of misconduct of the Kuwaiti assets in Spain is also reviewed in this chapter.

Chapter Four traces the structure and investment strategy of Saudi Arabian Monetary Agency (SAMA) the central bank of Saudi Arabia which has also been in charge of management of the country’s sovereign wealth. The historical political and economic links between Saudi Arabia and the United States have had a significant impact on the formation of overall structure and strategy of SAMA’s management of the country’s sovereign wealth. Saudi investments have been mainly focused in the US government and the portfolio of SAMA foreign assets in heavily invested in US dollars. The emergence of SAMA’s assets has been influenced by various regional events including the Gulf Wars. The size of the Saudi population and the nature of economic environment in Saudi Arabia have had a significant impact on the institutional development and investment strategy of SAMA’s foreign assets which is examined in the chapter.
Chapter Five covers various sovereign wealth investment institutions of Abu Dhabi and Dubai. The chapter reviews the main elements of these investment institutions including: history, governance, and investment strategy. A greater emphasis is put on reviewing the commodity-based sovereign wealth funds of Abu Dhabi due to the significant size of their assets and the important role of Abu Dhabi in the federal system of the United Arab Emirates. Dubai state-owned institutional investors which have been financed by foreign borrowing have given a unique character to these institutions. The experience of the recent financial crisis has also made a different impact on the government-owned investment vehicles of Dubai which will be reviewed in this chapter.

Chapter Six reviews Iran’s sovereign wealth management experience. The chapter reviews various aspects of the fund including: the history of creation, governance, and investment strategy of Iran Foreign Exchange Saving Account (IFESA). The Iranian experience of managing the country’s sovereign wealth is a unique case as it is different than those of the Arab countries in the Gulf region. The issue of sovereign wealth management has been a matter of controversy amongst the Iranian political elite since 2005. President Mahmoud Ahmadinejad has been criticised by various politicians and the Iranian media for his government’s oil revenue management policies. This chapter will study some of the controversial cases in which the government’s sovereign wealth management strategy has been widely criticised.

Chapter Seven explores the Norwegian commodity-based sovereign wealth fund with focusing on the same elements as the previous chapters. The aim of this chapter is to compare the experience of the Gulf commodity-based sovereign wealth funds with that of Norway. Norway has been the most transparent commodity-based fund of the world. The fund has clear processed and procedures for accumulation and investment of the sovereign wealth. Studying the Norwegian experience provides a clear road map for the transparent institutional development of its counterparts in the Gulf region. This chapter is to highlight the gap between the experience of Government Pension Fund Global of Norway and the commodity-based funds of the Gulf region.

Chapter Eight reviews the debate over transparency of sovereign wealth funds. This chapter aims to elaborate what lack of transparency means for the Gulf commodity-based funds. The formation of International Working Group of Sovereign Wealth Funds and creation of the voluntary code of conduct for practice of sovereign wealth funds
(Santiago Principles) has changed the expectations of the government of the host countries from the funds. Now it is the sovereign wealth funds’ responsibility to adapt to the new expectations. This chapter reviews the response of the Gulf funds to the debate over transparency in the context of the Santiago Principles.

The final chapter concludes the study by re-examining the Gulf commodity-based sovereign wealth funds with the reference of transparency debate. The chapter aims to answer the question: “do the sovereign wealth of the Gulf operate transparently enough to satisfy the expectations of the Western host sovereigns?” If not, “what are the reasons?” This concluding chapter also raises several questions such as how the recent financial crisis has undermined the transparency debate in capital hungry Western economies, and whether it would be possible to regulate the investments of sovereign wealth funds without increasing the chances of protectionism.

1.6 Differentiating SWFs from other types of government-owned assets

As it is noted above, one of the core elements of the debate over the SWFs was the definition of these funds. To draw a distinct line between SWFs and other types of government assets (i.e.: foreign exchange reserve funds and public pension funds), it is best to briefly review all the three types of state-owned assets.

1.6.1 Foreign exchange reserves

Foreign Exchange Reserves are public investment funds held and managed by central banks, and financed by the government from fiscal surpluses for economic stabilization purposes. The major purposes of these funds are to maintain currency value, inflation and overall national financial stability for any times of possible economic uncertainties. Traditionally countries with sizeable natural resources (where a major share of the government budget is financed from their commodity income,) establish such funds in order to secure their national economy against the volatility of commodity markets.

Since the Asian financial crisis of the late 90s most of the export-led growing emerging market economies have implemented a mixed exchange rate policy in combination with

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massive reserve collecting to maintain their domestic monetary stability.\textsuperscript{9} As most of the major international financial crises since 1994 (Mexico in 1994, South Asia in 1997, Russia and Brazil in 1998, Argentina and Turkey in 2000) have happened in countries with a fixed or pegged exchange rate regime it has been widely accepted that countries without pegged rates were not as severely affected at the time of the crisis as those with fixed exchange rates. Therefore combined policies are applied in most of the emerging markets to shelter their domestic economies from the causes of potential global financial crises in the future. China brightly exhibits this policy combination by gradually allowing more financial integration and perhaps more exchange rate flexibility in the near future, whilst accumulating massive amounts of foreign reserve.\textsuperscript{10} Today, many of the above mentioned countries hold massive pools of foreign exchange reserves.

Commodity exporting economies have also had, more or less, the same pattern in place in order to maintain their economic growth at the time of oil shocks. Surplus revenues of those countries are primarily held in liquid assets like short term securities and foreign bank deposits which can be easily transferred to their country of origin at the time of any crisis. The foreign exchange reserves are held to support the national currency and to provide a source of financial assistance at the time of any imbalance in the commodity export incomes.

The size of these assets varies in each case. There has been ways in which any given country can calculate a minimum asset holding in the foreign exchange reserves in order to adequately insure against possible shocks.\textsuperscript{11} One view is for each country to save sufficient foreign reserves to cover three months worth of the country’s import revenue.\textsuperscript{12} This is also their major dissimilarity with SWFs. This is indeed what differentiates foreign exchange reserves from sovereign wealth funds. Foreign exchange reserves are not wealth; they are massive sources of liquidity which are kept by the government to be transferred over a short period to protect the domestic economy from

potential financial shocks.\textsuperscript{13} China, Japan, Taiwan and Russia hold the biggest reserves of the kind.\textsuperscript{14}

\subsection*{1.6.2 Public pension funds}

Public pension funds are the government-owned funds which are kept to alleviate the effects of a demographic disequilibrium on the social security balance. These funds are traditionally created either through an explicit fund being allocated by the government into a separate state-owned account to fulfil the purpose, or as the result of excess contributions from people of a particular age group in government saving during a demographic transition.\textsuperscript{15}

Over the last 50 years, many countries in the world, mainly in Asia, have experienced sliding fertility rates and growing life expectancies. The number of people over 65 in Asia by 2050 will be over 500 million.\textsuperscript{16} Japan has become the world’s fastest aging nation, due to low fertility rates and small share of immigration. China is perhaps the next country in the region to face such issues as the ‘one child’ policy during the past 20 years has remarkably reduced birth rates in the country.\textsuperscript{17} Public pension funds, therefore, are the main state-owned investment institutions which are created specifically to control the negative impacts of the demographic disequilibrium.

In contrast with foreign exchange reserves, pension funds are not constrained by a need for immediate liquidity. Therefore, due to their long-term liabilities, they traditionally have been allocated in domestic currency assets and often in foreign government bonds. These reserves, as opposed to foreign exchange funds, are indeed national wealth – like the SWFs. However, they have a certain liability and are managed in the interest of the pensioners while, the SWFs are more designed to serve the future generations.

These types of government assets are often financed by individual pension contributions, rather than other methods of states fund collections like taxes or privatization proceeds. Therefore, the accumulated wealth in pension funds is owned by

\textsuperscript{13} Personal communication with Andrew Rozanov, London, January 2010
\textsuperscript{17} Olivia S. Mitchell, John Piggot, Cagri Kumru, op.cit
current and/or future retirees and is not viewed as SWFs. The Japanese public pension fund, with over 900 billion US$, is the world’s biggest pension fund. The California Public Employees’ Retirement System and Korea’s National Pension fund are other examples of public pension funds.\(^\text{18}\)

### 1.6.3 Sovereign wealth funds (SWFs)

The third category of government-owned institutional investors is SWF. Sovereign Wealth Funds’ assets are usually held outside of the country of their origin. They are managed separately from other types of public investment funds. The SWFs may be held to serve different purposes, such as a balance of payment stabilisation, saving for future generations and transfer of technology and know-how for development and diversification of domestic economy. SWFs usually do not have specific balance sheet liabilities compared with other government investment institutions; therefore, they can afford to take higher investment risks and have long investment horizons.

Although the SWFs are often managed by specifically established government bodies, they function in cooperation with other governmental financial institutions in order to serve the mentioned monetary and financial purposes.\(^\text{19}\) Figure 1-3 summarises a list of the major state-owned financial organisations directly managed by the government. As shown in the chart, the SWFs are one of the investment arms of the government operating in harmony with the others. As visually demonstrated in the chart, SWFs are positioned, more or less, on the same level as central banks; though, in many cases (particularly in Asia) the history of the establishment of the SWFs only goes a few years back, while the central banks have been the main institutions in charge of the management of the national reserves for decades.

Table 1-2 reviews the fundamental differences between SWF asset management and central bank asset management. The SWFs financial role is becoming more financially powerful government agents of the global financial system, in compare with the central banks. This is mainly due to the profit maximisation investment strategy of these funds,

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\(^{18}\) David Bloom, David Canning, Rick Mansfield, Michael Moore, op.cit  
\(^{19}\) Steffen Kern, (2008.a), op.cit
in contrast with the conservative investment portfolio of the central bank’s foreign exchange reserves.

Table 1-2: Wealth vs. Liquidity

<table>
<thead>
<tr>
<th>Type of assets</th>
<th>Management</th>
<th>Investment strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liquidity</strong></td>
<td>Central banks</td>
<td>Safety/ quick transfer when needed/ accessibility</td>
</tr>
<tr>
<td><strong>Wealth</strong></td>
<td>SWFs</td>
<td>High risk-adjusted return maximisation</td>
</tr>
</tbody>
</table>

Source: Interview with Andrew Rozanov

1.7 Commodity-based sovereign wealth funds (CSWFs)

Based on the source of their finance, the SWFs fall into two categories: commodity-based and non-commodity SWFs. The primary dissimilarity between the two types of funds is the source of their financing. Commodity-based funds are funded by excess revenue from the export of natural resources. Non-commodity SWFs are, however, usually funded by governments’ surplus income from export of non-commodities. Both groups of SWFs are established to serve similar monetary purposes (stabilisation of fiscal revenue, inter-generation saving, and balance of payment sterilisation). The CSWFs can be used by the governments as a defence tool to protect the domestic...
consumption against the oil price fluctuation for the current generation - while saving the nation’s wealth for future generations.

CSWFs are often recognised as the key elements of the governments’ defence mechanisms against the price risks during the time of an unpredicted sharp price decline. The oil exporting countries tend to self-insure their economies against volatile prices by either diversifying their export structure or accumulating fiscal assets. The accumulation of assets has evidently become the favourable solution by most of the oil exporting governments, since diversifying the export structure needs long-term structural reforms and access to research and development and technology.

Another purpose for the establishment of CSWFs is their inter-generation saving role. These institutions are primarily the government’s effort to save the prosperity of natural endowments for future generations. Reducing the production and keeping the resources in the ground might not be a useful method of saving the wealth for the next generation, simply because they might lose their value over the time. Therefore, creation of the CSWF as a mediator to transform the natural assets in the ground to other types of assets for future generations is the best way to maintain a nation’s current wealth for future generations.

Some of the CSWFs which have been originally established merely for stabilisation purposes, have over time transformed into dual purpose funds to also serve as inter-generation saving accounts. Such a transformation has affected the initial investment strategy of the funds and shifted their portfolio composition towards highly diversified and long term assets classes. 21 out of 31 oil rich countries have established CSWFs, 16 of which were launched after 1995. Today, there are ten CSWFs around the globe with stabilisation as their central policy; the rest have combined objectives of savings and stabilisation.20 (Table 1.1) Stabilisation SWFs are very similar to traditional foreign exchange reserves due to their similar liabilities; therefore it is not a coincidence that they are often managed by central banks (like Saudi Arabian CSWF).

The size of the assets of the CSWFs relies heavily on the price of commodities. Their Under Management Assets have never officially been announced by the sponsoring governments; hence all the estimates have been made based on speculation and guess

work. Having said that, it is broadly accepted that the AUM of SWFs (including both commodity and non-commodity funds) are still significantly smaller than those of other types of public investment funds (Figure 1-4).

Figure 1-4: The size of global assets ($ trillion)

![Graph showing the size of global assets](image)

Source: Steffen Kern (2007)

The investment pattern and saving requirement of CSWFs has never been the subject of public disclosure. However, due to a lack of a specified balance sheet liability they are, by and large, known to apply longer investment horizons in comparison with other government investment institutions. Regardless of the source of their funding, most of the SWFs hold a long-term, globally diversified portfolio of assets with high risk appetite in exchange for higher expected returns. The governance and structure and the relationship between the funds and other government bodies are also not quite clear in most cases. However, due to high control of the governments in these organisations, they are likely to inherit their main characteristics from the governments of their countries of origin.
2 The Gulf Commodity-based SWFs

2.1 Introduction

Based on the source of their funding, the SWFs are divided into two sub-groups: commodity-based SWFs, (those which are financed from commodity-export surplus like the Gulf sovereign wealth funds,) and non-commodity SWFs which are financed from a government’s surplus revenues of non-oil exporting countries like the Asian SWFs. The different source of funding of commodity-based and non-commodity SWFs creates a number of other dissimilarities between the two groups:

- The CSWFs are financed by hydrocarbon exports, therefore, constitute net financial savings. In contrast, the non-commodity sovereign wealth funds are by-products of controlled exchange rate policies and financed from excess monetary reserves.

- The growth of assets on CSWFs is directly related to the price of oil; while, increase of assets of non-commodity SWFs is directly linked with the increase of local currency debt.\(^\text{21}\)

- Assets under management of non-commodity SWFs do not represent net national savings. CSWFs, on the other hand, represent net government savings.

- Non-commodity SWFs hold a less diversified portfolio of investments in comparison with CSWFs.

- Non-commodity SWFs invest a significant share of their portfolios in commodities while the commodity-based SWFs do not, although the CSWFs of the Gulf countries have recently shown interest in investment in commodities other than oil and gas and included agribusiness investments in their portfolio.

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\(^{21}\) Rozanov, Andrew (2009), ‘Investing Russia’s Oil Wealth: Sharing the GCC Experience’, in Russian & CIS Relations with the Gulf Region, Current Trend in Political and Economic Dynamics, Dubai: Gulf Research Centre
The CSWFs of the Gulf resource-rich countries have recently come into the centre of the Sovereign Wealth Funds debate. In addition to their source of wealth, the CSWFs of the Gulf region share a key characteristic which is the purpose of their establishment. All of these funds have been established by their sponsoring governments to serve one or all of the following fiscal purposes:

1. to provide an opportunity to raise the rate of return on government’s foreign exchange holdings,
2. to insulate the government budget and the domestic economy against volatile commodity prices, and
3. to convert exhaustive natural resources into a diversified portfolio of assets for the future generations.²²

Another key attribute which almost all the CSWFs of the Gulf have in common is the lack of transparency of information. The Gulf CSWFs are ranked as some of the most extremely secretive state-owned investment institutions of the world.²³ Various research organisations have created a transparency index (if transparency index is a title of a specific thing it needs capitals) to measure the level of transparency of these funds. The latest index that was published by the Sovereign Wealth Fund Institute, available on the institute’s website, ranks the transparency index (Max. 10 and Min. 1) of the Gulf CSWFs: Iran (1), Saudi Arabian Monetary Agency (2), Abu Dhabi Investment Authority (3), and Kuwait Investment Authority (6).²⁴

2.2 Size and growth of assets of commodity-based SWFs of the Gulf

Being the most naturally well-endowed region in the world, the Gulf countries managed to accumulate a significant amount of capital from oil export revenues, particularly between 2004 and 2008. There is no exact number for the size of these assets. Nearly all the speculative works tend to form their calculation by a formula which is based on the

²⁴ Sovereign Wealth Fund Institute, op.cit
price of oil, and the crude productions over a specific period of time in addition to 20%-25% of investment returns on existing assets from the previous period. Therefore, the volatility of global markets has led to various numbers for Under Management Assets of these funds. In most cases, the gap between different estimates is huge, particularly between 2007 and 2008, when the oil prices reached a historically high record. Some analysts have counted various channels of the evaporation of wealth between its production point, when the wet crude is sold, and its savings point, when the cash is deposited into the SWF account. Various calculation methods have estimated different numbers for total AUM of these funds, but have united conclusions: the wealth has increased, so have the oil prices. The price of crude oil rose from $23 per barrel in 2002 to over $145 per barrel in July 2008. This has had a knock-on effect on the accumulation of wealth by the oil producing countries.

Table 2-1: Selected government owned pools of assets ($ billions)

<table>
<thead>
<tr>
<th></th>
<th>Dec-07</th>
<th>Jun-08</th>
<th>Dec-08</th>
<th>Jun-09</th>
<th>Dec-09</th>
<th>Mar-10</th>
<th>Jun-10</th>
<th>Sep-10</th>
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<tbody>
<tr>
<td>Gulf CSWFs</td>
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<tr>
<td>SAMA</td>
<td>335</td>
<td>414</td>
<td>475</td>
<td>423</td>
<td>444</td>
<td>455</td>
<td>459</td>
<td>463</td>
</tr>
<tr>
<td>ADIA</td>
<td>453</td>
<td>476</td>
<td>338</td>
<td>359</td>
<td>429</td>
<td>437</td>
<td>400</td>
<td>423</td>
</tr>
<tr>
<td>KIA</td>
<td>259</td>
<td>286</td>
<td>226</td>
<td>234</td>
<td>273</td>
<td>278</td>
<td>258</td>
<td>272</td>
</tr>
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<td>GCC Central Banks</td>
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<td>101</td>
<td>73</td>
<td>72</td>
<td>76</td>
<td>75</td>
<td>77</td>
<td>80</td>
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<tr>
<td>Non-GCC large CSWFS</td>
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<tr>
<td>GPFG</td>
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<td>391</td>
<td>323</td>
<td>367</td>
<td>454</td>
<td>462</td>
<td>430</td>
<td>458</td>
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<td>Kazakhstan Stabilisation Fund</td>
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<td>24</td>
<td>24</td>
<td>23</td>
<td>27</td>
<td>28</td>
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<tr>
<td>LIA</td>
<td>40</td>
<td>45</td>
<td>50</td>
<td>52</td>
<td>62</td>
<td>64</td>
<td>68</td>
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<tr>
<td>Chile Stabilisation Fund</td>
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<td>19</td>
<td>20</td>
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<td>11.28</td>
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<td>11.1</td>
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<td>Russia Reserve Fund</td>
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<td>137</td>
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<td>60.52</td>
<td>52.9</td>
<td>39.32</td>
<td>39</td>
</tr>
<tr>
<td>Russia Wealth Fund</td>
<td>33</td>
<td>88</td>
<td>90</td>
<td>91.56</td>
<td>89.58</td>
<td>85.47</td>
<td>85.47</td>
<td>85.47</td>
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<tr>
<td>Non-commodity SWFs</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Asia (China, Korea, Singapore)</td>
<td>418</td>
<td>432</td>
<td>336</td>
<td>372</td>
<td>445</td>
<td>456</td>
<td>432</td>
<td>444</td>
</tr>
</tbody>
</table>

Source: Roubini Global Economics (2010)
One of the early studies estimating SWF assets was conducted by Morgan Stanley in May 2007, when the company published its report “How Big Could SWFs be by 2015?” The report estimated that in 2007 SWFs held about $2.5 trillion in their account. The study did not divide the assets of commodity-based funds and the other SWFs. However, if one assumed that roughly 50% of the total AUM of global SWFs is managed by the CSWFs, given the assets held by CSWFs of Russia and Norway were included in Morgan Stanley estimated figure, between 30% and 40% of the world SWFs assets (between $75 billion and $1 trillion) were controlled by the CSWFs of the Gulf in 2007.

In early 2008, a study by Deutsche Bank demonstrated that SWFs’ total assets were as high as $3.6 trillion (including the commodity-based funds and the others). Based on that estimate, the AUM of the SWFs stood $1.5 trillion above the total assets managed by hedge funds worldwide and accounted for about 5% of the total assets of the global banking sector. CSWFs controlled 46% of the total SWFs’ assets which is about $1.65 trillion.

At the end of 2008, McKinsey reported that the petrodollar accounted for $5 trillion in foreign financial assets. McKinsey’s estimate included the six GCC states, as well as other oil producers of the Middle East and North Africa, Norway, Russia, Venezuela, and Indonesia. The investors in the report have not been limited to the SWFs. The assets held by central banks have also been included in the study. Given the high oil production of the Gulf countries, if one assumes 40% of the total petrodollars calculated by McKinsey were owned by the CSWFs of the Gulf region, the assets under management of these funds would be about $2 trillion.

In the same year (2008), Jean Francois Seznec of Georgetown University, and a former banker, came up with a different number for total AUM of the Gulf funds. Seznec suggested that the evaporation of the wealth in the GCC countries (the government budget expenditure in the public sector, ruling family allowances, or defence expenditure), is as high as 71% of the total revenue in some GCC countries like the
UAE and Saudi Arabia. Consequently, he argues the total assets held by the CSWFs sponsored by those countries are considerably less than previous estimates.

Today, seven out of the ten largest SWFs in the world are commodity funds and hold around 85% of the total SWFs’ assets (see Figure 2-1). Four of the top ten SWFs in the world are owned by Gulf countries. The sovereign wealth assets of Saudi Arabia, Abu Dhabi, Kuwait, and Qatar account for 50% of the world’s total commodity funds.

Figure 2-1: The largest SWFs of the world ($ billion)

Source: Veronique Ormezzano (2010)

2.2.1 **The impact of financial crisis on the GCC funds**

The fast growth of the size of the commodity-based SWFs of the Gulf region was a result of two factors: record prices of oil and investment earnings. Both factors of growth of CSWFs of the Gulf were negatively affected during the recent global financial crisis. Fluctuations of oil prices have had a sharp and direct impact on the size of the assets of these funds. An estimate by Brad Setser and Rachel Ziemba suggests at the current oil production level, if the price of oil was $50 a barrel on average, the Gulf countries would need to spend total investment returns of their Sovereign Wealth Funds as well as their surplus oil export income to finance their current levels of imports.

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However, at $75 a barrel, they would have roughly $140 billion to add to the foreign assets of their central banks and Sovereign Wealth Funds. Therefore, the Gulf economies would need to transfer a substantial amount of their foreign reserves at any price below $75 per barrel.\(^\text{32}\) Although the price of oil never dropped below $50 a barrel, the portfolio of the Gulf Sovereign Wealth Funds was heavily affected by the decline of oil price.

The second factor of growth of assets of these funds is the portfolio investment returns. The Gulf CSWFs, like other institutional investors, struggled with issues like revenue erosion and decline of portfolio book values as a result of the crisis. There are various estimates for the total losses in book values of the AUM of these funds. However, various sources reported that the funds have emerged strongly from the crisis, despite the significant losses which they made during 2008. Steffen Kern of Deutsche Bank reported that the large SWFs (including commodity and non-commodity funds) recovered from $3 trillion in early 2009 to $3.7 trillion by the end of the year.\(^\text{33}\) Veronique Ormezzano, the Global Head of Coverage for Sovereigns, Supranationals and Central Banks at BNP Paribas, came up with a different estimate. According to Ormezzano’s report, SWFs (including commodity and non-commodity funds) grew from $2.02 trillion in 2007, to $3.05 trillion in 2008, to $3.22 trillion and $3.59 trillion respectively in 2009 and 2010.\(^\text{34}\)

Another impact of the crisis on the Gulf CSWFs was the need for providing financial support in their country of origin. Supporting the domestic economy at the time of potential financial difficulties has been one of the mandates of most of the Commodity Sovereign Wealth Funds of the Gulf region. The economic hardship of 2008 prompted the Gulf CSWFs to provide capital to bail out the domestic financial institutions. The exact amount of capital which was transferred from the CSWFs to the domestic economies by sponsoring governments in all the countries of the Gulf is not clear. In one case in October 2008, KIA was given permission to invest an extra $3.73 billion in the Kuwaiti stock market.\(^\text{35}\) In the same month, KIA was speculated to have transferred $15 billion from its investments abroad to inject liquidity in the local markets.\(^\text{36}\)

\(^{32}\) Setser, Brad and Rachel Ziemba (2009), GCC Sovereign Funds Reversal of Fortune, Council on Foreign Relations
\(^{33}\) Kern, Steffen (2010), The role of SWFs – Towards a new equilibrium, Presentation at Edinburg SWF Dialogue
\(^{34}\) Veronique Ormezzano, op.cit
\(^{35}\) Kuwaiti Times (2009), Kuwait finance chiefs meet to staunch losses, 13 October 2009
\(^{36}\) Reuters (2008), Kuwait’s KIA could inject $15Bn in bourse, 9 October 2008
The transfer of foreign assets to the local economies was not only a supporting mechanism for the local businesses, but also a response to the public anxiety about the management of the national assets by the government. With global financial system in meltdown, public opinion in the Gulf has been asking questions about the impact of the turmoil on the vast investment portfolios of governments. The public pressure in Kuwait was perhaps at its highest level amongst the neighbouring countries and as such Bader al-Saad, the chairman of the KIA, appeared on al-Arabiya TV channel to explain that the KIA is not in the business of bailing out falling Western banks; instead the disasters in the US economy and some European countries created enormous investment opportunities for the KIA and the authority at some point will be investing again in those institutions.37

All in all, there are various estimates for the total losses which were made by the Gulf Sovereign Wealth Funds. The findings of this study, based on various interviews with London-based bankers and consultants, show a total loss of between 25% and 30% by the funds as a result of the crisis. This is as a result of a combination of the following three factors: oil price decline, investment losses, and the withdrawal of funds to support the economies of their countries of origin.

2.3 Investment strategy of the Gulf CSWFs

The asset allocation strategy of the Gulf funds has been a matter of controversy due to the lack of transparency of operation. Each of the Gulf commodity CSWFs have been practicing their unique investment strategy over the years of operation. However, the recent world financial turmoil which damaged the portfolio of investment of all of these funds caused relatively similar changes in investment strategy of these funds. Those similarities will be reviewed in this study through a comparison between various aspects of investment strategy of the Gulf CSWFs before and after the crisis.

Despite the visible impact of the global financial crisis on the Gulf CSWFs, some of the investment characteristics of these funds have remained unchanged. The main attribute of the Gulf CSWFs which has remained unchanged is their investment horizons. Due to the lack of balance sheet liabilities for these funds, similar to other sovereign wealth investment vehicles, the GCC commodity-based funds have a much longer investment

37 Financial Times (2008), Sovereign wealth funds do not have all the answers, 29 September 2008
horizon than most of the public and private portfolio investors. In other words, the Gulf CSWFs can afford to be rather patient investors in the volatile markets, simply because they do not have clearly defined liabilities, as opposed to other types of investment institutions like hedge funds and pension funds. There has been a debate on the positive or negative effects of such a long investment horizon on the markets. On one hand, the long investment horizon of these funds can minimise the risk of destabilising the markets which can be created by a quick shift in their investments. On the other hand, the absence of balance sheet liabilities gives these funds the freedom to be able to afford to turn their backs to the markets when they are most needed. The Gulf CSWFs have remained long-term investors since prior to the crisis and this trend is not likely to change in the near future.

Another aspect of investment patterns of these funds which has remained unchanged after the crisis is their potential for having politically-driven investments goals. There has been an intense debate over the non-commercial investment incentive of the SWFs with the Arab investors being in the centre of the debate. The debate is formed based on the lack transparency of the operation of the foreign investors. The core of the argument originated from the US policy makers who strongly argued for the United States’ right for demanding higher transparency by foreign investors, Gulf CSWFs included. Such demand was used as a defence mechanism to protect the US domestic economy against the potential threat of the politically-driven investment strategy of the foreign investors. However, as far as the investment strategy of the GCC SWFs is concerned, none of the Gulf sovereign investors has been proven to have non-commercial investment motives before or after the financial crisis.

As noted above, the market power and the potential signalling impact of these funds are undoubtedly huge; nonetheless, there has not been any solid evidence found to support the Western transparency argument. A London-based investment banker explained the role of these funds as:

“... certainly strong enough to influence the global balance of economic and political power should they decide to - providing they maintain ownership in strategic sectors. However, they have not done anything yet which gives a signal for such intention”. 38

Most of the analysts who have been interviewed throughout the field research for this project strongly believed that the costs of any non-commercial leverage would be

38 Author’s interview, London, 18/12/09
enormous for the sponsoring governments of these funds; therefore, they are unlikely to apply any strategic influence in their host economies before or after the financial crisis.

### 2.3.1 The Gulf CSWFs’ investments in high-profile assets

One of the key attributes of the GCC sovereign wealth investment strategy before the crisis was the increase of their interest in prestigious and iconic acquisitions. The Chrysler Building and Ferrari deals by Abu Dhabi CSWFs are good examples of this kind. The interviewees of this study had expressed different views on the reasons for high interest of these funds in such flashy investments prior to the crisis. One argument is that, even though, most of the Gulf sovereign investment institutes have been actively operating in the global financial system for many decades, with the recent growth of their assets, a key strategy for them was to advertise their brand name and bring their financial power to the attention of the Western world by such investments.

Another point of view argued that the main motive for the rising number of acquisitions of iconic assets by these funds prior to the financial crisis was a significant lack of understanding of the markets and financial expertise. The following quote is from one of the interviewees in the City of London:

“Before the crisis they (the Gulf CSWFs) were suffering from lack of expertise, lack of proper and professional investment strategy. Even the older funds and the most sophisticated ones, made investment mistakes and took unnecessary risks and irrational investment decisions; therefore, they have made significant losses.”

All in all, a combination of factors has led the Gulf CSWFs to engage in some iconic investments which have not been necessarily profit making but rather ostentatious. The interest of these funds in investing in high-profile assets has declined after the crisis. Such decline has been mainly a result of the losses which the funds made in some of those investments across the sectors.

### 2.3.2 Growth of the GCC funds in emerging markets post-crisis

For many decades the Gulf governments have been investing their surplus petro-dollars in various asset classes in the developed economies, particularly the US. Between early 2007 and the third quarter of 2008 investments in the distressed Western financial industry were the dominant investment theme of the Gulf CSWFs. The investment
flows of these funds during this period were strongly biased towards American financial institutions to support the Wall-Street collapsing banks. As a result of lower economic growth in Western markets however, this trend has started to change prior to the crisis and it has been accelerated since then. As Figure 2-2 shows below, recently, the Gulf CSWFs have shown more interest in investments in intraregional and European investments than those in the US.

Instead, outflow of investment from the GCC towards the emerging markets started prior to 2008 and it is growing fairly quickly since then. The higher expected returns in the emerging markets have been the main incentive for investments in emerging markets. A banker from the City of London who was interviewed for this study said:

“Today, when an investment bank approaches the Arab CSWFs to offer them financial products in Europe or the US, they are not shy to refuse to buy them; instead, they express huge interest in the Asian markets.”

This shift of investment interest from the Western markets to the emerging economies is not limited to Asia. According to a financial product provider to the GCC funds in London:

“most of the emerging markets which are growing faster than the US or EU economies are now popular in the Gulf. Latin America is becoming increasingly attractive to the Arab investors. For example: Brazil has particularly become a major interest for Abu Dhabi investments after a visit which Sheikh Ahmed bin Zayed has recently paid to the country”.

Figure 2-2: Geographic investment targets of SWFs

In addition to the lower investment return of the Western markets, the Gulf governments have been under a significant amount of pressure from the West to clarify their investment motives. This pressure has also had a negative impact on the

39 Author’s interview, London, 27/01/10
40 Ibid
investments of the Gulf funds in those markets. In May 2010, the governor of the UAE central bank, Sultan Bin Nasser Al Suwaidi explained the possible future reaction of the Gulf CSWFs to the Western pressure on the Gulf government-owned investment institutions to reassure the recipient countries of their purely commercial investment goals:

“Another reason that makes me think that SWFs from our region might change the flow of their direct investments is that once we see the proposed regulations re sovereign wealth funds in the industrialized advanced economies start being implemented, more questions will be asked and more forms will become necessary to fill and more disclosure and transparency will be demanded. This behaviour will signal that there is no strong need for foreign capital in the West, and that the political mood has changed. Therefore, we might see gradual tightening of the scrutiny on capital flows from SWF countries at one stage, especially funds that are destined for direct investment in certain companies. Faced with all this nonsense, SWFs will certainly come to the conclusion that it is time to change strategy. This could make SWFs avoid direct investment in certain companies, or even avoid direct investment in all companies, and become more of passive investment vehicles in the West. As SWFs have large sums to invest, this might make them a direct part of their investments to existing or newly created companies in the region. This situation, if it happens soon, will lead to creating a new regional development cycle.”

2.3.3 The Gulf CSWFs’ investment risk appetite

Due to market uncertainties, the risk appetite of the Gulf Sovereign Wealth Funds has decreased immediately after the crisis. The funds have become more cautious in their investments across the sectors as a result of the large losses which they made during the crisis. They have already put various protection measures over their portfolio against riskier investment in the aftermath of the crisis. A banker from London who was interviewed for this project pointed out that there has been a rising interest amongst the Gulf SWFs for co-investment with other investment institutions as a cautious measure to avoid future losses. He explained;

“Now their (GCC commodity-based SWFs) bottom-line for entering in any new deal is alignment of interest in the form of co-investment. They have a different reaction to the banks and the external asset management companies who approach them with various financial products after the crisis”.

Nevertheless, the funds still have relatively high risk tolerance in comparison with their investment strategy a few decades ago, despite such protection measures.

The Gulf Commodity-based SWFs (with an exception of Saudi Arabian Monetary Agency) have been diversifying their portfolio of assets from low-return government bonds to higher-risk/higher-return investments, like corporate bonds and the equity markets. The main driving factor for the investments of the GCC funds in high risk assets is higher expected returns. As I have stated the exception is Saudi Arabian Monetary Agency which has remained a faithful investor in US Treasury bonds, other CSWFs of the Gulf invest over 50 percent of their assets in equities and alternative investments. SAMA however, holds 80 percent of its portfolio in US Treasury bonds. Due to its being highly conservative SAMA has neither generated as much investment return as the other GCC funds over the past decade, nor it has lost as much on the value of its assets after the recent financial crisis as the other Gulf funds (see Table 2-2).

The findings of this study suggest that, after the crisis, the Gulf funds had a temporary setback in their investments. This was as a result of the sizeable losses which they made on their portfolios. However, in the long-term, they are expected to maintain a high risk tolerance in comparison with other portfolio managers.

Table 2-2: Estimated 2008 gains and losses of selected SWFs (US $ billion)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>ADIA</td>
<td>453</td>
<td>328</td>
<td>-183</td>
<td>59</td>
<td>-40%</td>
</tr>
<tr>
<td>KIA</td>
<td>262</td>
<td>228</td>
<td>-94</td>
<td>57</td>
<td>-36%</td>
</tr>
<tr>
<td>SAMA+ assets under management of other government institutions</td>
<td>358</td>
<td>501</td>
<td>-46</td>
<td>162</td>
<td>-12%</td>
</tr>
<tr>
<td>Norwegian Government Pension Fund-Global</td>
<td>371</td>
<td>325</td>
<td>-111</td>
<td>64</td>
<td>-30%</td>
</tr>
</tbody>
</table>

Source: Brad Setser and Rachel Ziemba (2008)

2.3.4 The Gulf CSWFs’ passive investments

The Gulf Sovereign Wealth Funds often hold passive and/or indirect investments in the Western companies in which they hold major stakes. Most of these funds heavily rely on using external asset management companies rather than managing their assets

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42 Interview with Andrew Rozanov, London January 2010
43 Brad Setser and Rachel Ziemba, op.cit
directly. Moreover, in most cases their shares are held below the level that gives them a voting right in the companies in which they invest, therefore they are typically known to be silent investors who do not take part in the management of those companies. This is mainly due to the following reasons:

- To prove that their investment goals are being purely commercial and they are not strategically seeking to intervene in management of the Western companies/banks.

- To avoid management responsibility in the companies in which they invest; as having seats on corporate board’s would bring to them additional responsibility in management affairs of respective businesses.

- To avoid public announcement of their acquisitions by keeping their share below a certain threshold.

Since the crisis, there has been some pressure on the GCC sovereign investors to take part in management of the companies in which they are stake holders. In practice, the funds would have always been able to influence key decisions of those companies unofficially. Therefore, the recipient companies argue that it would be in the best interest of other shareholders, as well as the company, if the funds practice their voting rights and take responsibility for their decisions. Such practice will help keep all the company operations/activities on-record and ensure they are handled in a more transparent manner.44

2.3.5 *Gulf Sovereign Wealth Funds’ investment interest in the financial sector*

The Gulf CSWFs bought sizeable shares of American banks in the aftermath of the credit crunch. Abu Dhabi’s acquisition of 4.9% shares of Citigroup, Kuwait’s 5.7% purchase of shares in Merrill Lynch and Qatar’s substantial 8.9% shares in Barclays and 20.4% acquisition of the London Stock Exchange are the best examples of this kind. The main driving factors for such investments were the following:

- **Availability of funds**: the Gulf funds had sufficient funding for a number of years which provided them with substantial buying power.

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44 Interview with Andrew Rozanov, London April 2009
- **Attractiveness of the financial sector**: until recently, the financial sector had been an attractive investment target, with high returns on equity for banks.

- **Low share prices**: the financial turmoil has caused a share price decline in most banks and other financial resources since mid-2007. At the peak of the crisis, the market value of most major banks has fallen to between 60% and 20%.

- **Strategic opportunities**: holding shares of well-reputed financial institutions was seen by the GCC investors as offering strategic benefits over time, in order to provide the ground for closer business ties with their domestic banking and industrial sectors.

- **Reputational benefits**: the engagement in the US and the European financial sectors has had a perceivable reputation gain for the Gulf CSWFs. They have experienced a more welcoming reception in the US and Europe and their helpful role was understood by Western policymakers and the wider public, as opposed to the previous dialogue which recognised them as threats to the national security.\(^{45}\)

A number of factors including the huge losses made in the Western financial institutions and the change of priorities of the GCC funds towards their domestic economies shows that their interest in the Western financial sector passed its peak and has been decreasing since then (see Figure 2-3).

**Figure 2-3: Share of completed investment transactions by SWF in 2009 (mn $)**

\[\text{Source: Deutsche Bank (2010)}\]

\(^{45}\) Steffen Kern (2008.a), op.cit
2.3.6  *De-dollarization of the Gulf CSWFs’ portfolio of investments*

Another post-crisis behaviour of the GCC Sovereign Wealth Funds has been their gradual diversification from the US dollar. For the past few decades, the Gulf surplus oil-income has been mainly invested in dollars. Arab investors have started to diversify their portfolio of investment towards other currencies prior to 2008. The financial crisis highlighted the importance of substituting dollar with other currencies in the portfolio of investments of the GCC sovereign wealth investors.

There is however, the exception of Saudi Arabia where up to 75%-85% of the SWF assets are held in US dollars. Estimates show that in 2008, about 40% of the Gulf CSWFs' assets were invested in dollar-denominated assets and 25% in yen; while 60% and 2% of their central bank foreign reserves were held respectively in dollars and yen.\(^{46}\) There is one view on the shift of Gulf interest from the dollar which believes that such shift is one of the outcomes of American foreign policy in the Middle East, particularly after September 11\(^{th}\) 2001. However, the second view is that the role of the credit crunch in Western financial markets and its impact on the Gulf monetary policy is the main trigger of such shift of currency for investments by the funds. Most of the interviewees of this study strongly believed that such a shift is not a reaction by the GCC to US foreign policy in the Middle East. Instead it is a risk diversification mechanism by these countries to protect the value of their assets.

The key reason for the GCC decline of interest in holding their financial resources in dollars is the decreasing value of the dollar in the money markets which led to a debate over introduction of a possible multiple currency system should the dollar collapse. Creditor nations have strong interest in the stability of the dollar and they are defending the dollar to prevent their appreciation of their own currencies. However, it is likely for many economies in the world to lose interest in a stable dollar.\(^{47}\) China and Russia have already proposed an alternative international reserve currency as a replacement to the dollar with a currency basket in the form of the Special Drawing Rights of the IMF. Russia also suggested that gold should be a part of this currency basket. However, in the

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\(^{46}\) *Economist, (2008), No. 8596, Vol. 387*

\(^{47}\) *Luciani, Giacomo (2010), The Way Forward for Reserve Currencies, Presentation at Jeddah Economic Forum*
absence of a competitor for dollar in the international financial system, it is likely to remain the major trade and reserve currency.\textsuperscript{48}

A combination of factors has indeed affected the world’s perception of the dollar and the Gulf CSWFs’ have also shown interest in non-dollarized investments more than at any other given time since they were established. The global economy however faces serious challenges in finding a substitute for dollar, therefore the process of de-dollarization is not going to be quick for the Gulf sovereign wealth investors and drastic changes are unlikely to take place in the foreseeable future.

\section*{2.4 The role of the Gulf CSWFs in the global financial system}

The substantial growth of assets and integration of the Gulf CSWFs into the global financial system have made these investment institutions extremely important players of the world economy. One view of these funds considers their role in the international financial system to be the bringing of the capital surpluses of their sponsoring economies into the global financial system and to further stabilise the global economy. This view has become stronger particularly after the recent financial crisis when the funds’ contribution in buying distressed Western financial assets was seen as their attempt to support stabilisation of the global financial system. The opposing view, however, emphasises the role of these funds in endangering the world economic balance. The recent accumulations of sovereign wealth by the developing economies in which the financial resources have been traditionally scarce, and the flow of wealth from these economies to the Western world, have been considered the supporting evidence of the second view as the signs of de-stabilising impact of these funds on the balance of global financial power.

In other words, these institutions undermined the neo-classic economic theories in which the developed economies are the core of the global financial network which provide the periphery with financial resources. This order has been evidently reversed (see Table 2-3). Between December 2001 and September 2009, global reserves almost quadrupled, from US$2.1 trillion to US$7.9 trillion. A large share of the increase is concentrated in the developing world which accounted for more than 81 percent of global reserve accumulation during this period, and their reserves approached US$4.9

\textsuperscript{48} Woertz, Eckart (2010), \textit{Challenges of Financial Sector Regulation After the Global Financial Crisis}, Presentation at Jeddah Economic Forum
The Gulf Commodity-based SWFs

trillion in September 2009. The Gulf economies have been extremely active in generating surplus capital as a result of increase of commodity prices and investing the surplus financial reserves across the world. In 2009, 87% of foreign direct investment (FDI) outflow of West Asia region had been generated by the GCC economies.

Another concern over the growing financial power of the Gulf CSWFs in related to their potential non-commercial investment interests. There has been a rising anxiety that the funds could be used to de-stabilise the global economy with strategic leverage. Given the growing size of the AUM of these funds and the ownership of their sponsoring governments, they may well be motivated by nationalistic considerations rather than purely by wealth maximisation.

Such anxiety over the possibility of investment institutions with large asset holding using their market power strategically, thus leading to a great financial instability, is not new. Strategic usage of financial assets has happened in the private hedge funds in coordinating speculative attacks on the British pound and other currencies participating in the European exchange rate system in the early 1990s. There has not been, however, any supporting evidence to prove the GCC funds’ intention for application of strategic asset allocation policies so far.

Table 2-3: FDI outflows by region (2007-2009)

<table>
<thead>
<tr>
<th>Region</th>
<th>FDI outflow ($ billions)</th>
<th>FDI outflow (% share in world FDI outflows)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2007</td>
<td>2008</td>
</tr>
<tr>
<td>World</td>
<td>2,268</td>
<td>1,929</td>
</tr>
<tr>
<td>Developed economies</td>
<td>1,924</td>
<td>1,572</td>
</tr>
<tr>
<td>Developing economies</td>
<td>292</td>
<td>296</td>
</tr>
<tr>
<td>West Asia</td>
<td>47</td>
<td>38</td>
</tr>
<tr>
<td>South, East, and South-East Asia</td>
<td>52</td>
<td>61</td>
</tr>
</tbody>
</table>


Another impact of the growing financial power of these funds is the increasing role of the public sector in the global financial system. The shift of wealth from private to government sector highlights the inevitable changes that the global financial system will face in the near future. While there is one view that the funds are commercial actors,

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49 Griffith-Jones Stephany and Jose Antonio Ocampo (2010), Sovereign Wealth Funds a Developing Country Perspective, Foundation for European Progressive Studies
50 UNCTAD (2010), World Investment Report
pursuing commercial objectives, another view carries a huge anxiety over the potential ulterior motives in their investment strategies as the Gulf sovereign wealth investment institutions are likely to inherit the commercial and strategic aims of their sponsoring government.

The CSWFs of the Gulf have also made huge impacts on their domestic economies. In addition to their return maximisation mission, the funds have also acted as facilitators for transferring expertise to their sponsoring countries. The interest of Gulf CSWFs in the banking sector coinciding with the booming financial sector in the region is a good example of their role in facilitating the transfer of expertise to particular sectors of their domestic economies. The GCC sovereign wealth investments abroad often intend to increase their market share and to gain expertise which can be transferred to their countries of origin. For example, Abu Dhabi CSWF investment in General Electric includes arrangements for General Electric renewable energy technology to be transferred to Masdar Energy City which a project by one of Abu Dhabi’s CSWF, Mubadala Development Company.\(^{51}\) Also, a $2.7 billion Daimler transaction which was completed in March, 2009, gave Aabar Investments, an affiliated investment company of Mubadala, a 9.1% stake in Daimler and involves a joint venture for electric automobiles and a training centre in Abu Dhabi for its engineers.\(^{52}\)

### 2.5 Conclusion

The Gulf CSWFs have had various impacts on global financial system. The major effects of the operation of these funds in the global economy are as follows:

1. Historically, the flow of capital in the global financial system has been from the developed economies with massive capital surplus to the developing economies which suffered from capital shortage. The Gulf CSWFs has changed this trend and became some of the world’s largest net suppliers of financial resources. Therefore, the flow of assets between the developed and developing economies has been reversed and the current movement of capital is likely to be sustainable one.

\(^{51}\) Reuters (2008), *Mideast Sovereign Funds Seek Reciprocal Investment*, 8 September 2008

2. In today’s global financial system, the Gulf commodity-based sovereign wealth funds are strong competitors for the institutional investors from developed economies. Given the assets of these funds are owned by their sponsoring governments, their financial power in the international economy undermines the neo-liberal economic theory in which the private sector is the main economic axis. With the current oil price fuelled by the global energy consumption this new system is likely to continue in the foreseeable future.

3. For many decades, the surplus oil incomes of the Gulf were invested in dollar-denominated assets and securities, particularly in US Treasury Bills. This trend has started to change due to various reasons. Further moves towards a new currency or perhaps a basket of currencies are expected in a relatively slow manner. Such move towards an alternative currency for the Gulf sovereign wealth investments is likely to weaken the dollar in the global currency markets.

4. Any non-commercial investment incentives of the Gulf CSWFs have not been proven so far. The sponsoring governments of the funds have repeatedly expressed their intentions for responsible investments to support the global financial stability. However, the issue of their potential threat on the national security of recipient economies has been constantly raised by Western policymakers. This has increased the risk for application of protectionist economic policies in the Western countries in order to protect the strategical economic sectors. Such policies are likely to disrupt the free flow of capital in the global financial network.
3 Kuwait Sovereign Wealth Fund Management

“Natural resources and all revenues therefrom are the property of the State. It shall ensure their preservation and proper exploitation, due regard being given to the requirements of State Security and the national economy”. (Article 21, Kuwaiti Constitution)

“The national economy shall be based on social justice. It is founded on fair cooperation between public and private activities. Its aim shall be economic development, increase of productivity, improvement of the standard of living and achievement of prosperity for citizens, all within the limits of law”. (Article 20, Kuwaiti Constitution)

3.1 Introduction

The Kuwait Investment Authority is the sole sovereign wealth manager of the state of Kuwait. The authority was established in 1982 after the National Assembly passed Law No. 47. The KIA is currently the parent organization of the Kuwait Investment Office, which was initially established as the Kuwait Investment Board. The latter was founded before the country’s independence in 1953. The KIA invests in various asset classes in international markets and all of its operations are managed from the main office located in Kuwait City and its office in London.

Kuwait’s government was the first in the world to establish a commodity-based SWF to protect the country’s oil dominant economy against the risk of potential oil shocks, as well as to preserve the national wealth for future generations. Like other Gulf states, Kuwait’s economy is highly reliant on oil incomes. Oil revenues form the major share of Kuwait’s total export earnings and act as the main motor behind the country’s growth. Moreover, the country’s manufacturing sector is dominated by petroleum downstream industries like refineries and petrochemical production lines.53 It is

53 Economist Intelligence Unit (2010), *Kuwait Country Profile*
therefore not surprising that saving revenues from its only source of wealth accumulation has been one of the priorities of the government of Kuwait for more than five decades.

Figure 3-1: Kuwait Gross National Product by sectors

![Pie chart showing Kuwait GDP by sector](chart.png)


As noted above, inter-generational saving and preventing instability from oil price volatility were the major goals of the Kuwait government in establishing a sovereign wealth fund. That being said, diversification from the oil sector has also been a key part of the future economic plans of the government, as has been the case for most of the Arab oil exporters. Kuwait’s economy may well be far away from diversifying from oil, but the fear of running out of oil has motivated the state to take measures for transferring oil revenues into various types of assets across the sector, the most significant of which has been the creation of a sovereign wealth fund, through which the economic capacity in other sectors, such as real estate and finance, can be developed, both inside the country and internationally.

In addition, assets under the management of the KIA have on some occasions been mobilised to maintain the country’s current economic stability and national sovereignty. The two major occasions when the government chose to redirect some of the sovereign wealth assets to the domestic economy were to support the country’s stock market after the financial crisis of *Souk el Manakh* in 1982, and to cover the costs of liberation operations in 1991 after the Iraqi invasion, followed by reconstruction costs from the war devastation.
During the 1990 Iraqi invasion, more than 700 oil wells were set on fire. This resulted in an interruption in revenue generation for the next three years. During that period, the country’s SWF spent more than US $80 billion on Kuwait’s liberation and subsequent reconstruction efforts. Thus, one key role of Kuwaiti SWF has been to invest the country’s oil income in order to create an alternative source of income for “rainy days”.

The Kuwait Investment Authority took over the responsibility of managing the assets of Kuwait from the Ministry of Finance. Today, the KIA manages two main government funds: the General Reserve Fund (GRF) and the Future Generations Fund (FGF). It may also manage any other funds entrusted to it by the Minister of Finance. The major share of the wealth is allocated funds in the GRF and FGF.

The GRF is the main treasury for the government and receives all revenues (including all oil revenues) from which all state budgetary expenditures are paid. All transfers from GRF must be sanctioned by law. Furthermore, the GRF holds all government possessions, including Kuwait’s participation in public enterprises such as the Kuwait Fund for Arab Economic Development and Kuwait Petroleum Corporation, and the country’s participation in multilateral and international organizations such as the World Bank, IMF and Arab Fund.

The FGF was created in 1976 through the transfer of 50% of assets under management of the GRF at that time. Since then 10% of all state revenues are transferred to the FGF every year and the entire fund’s investment income is also reinvested. No assets can be withdrawn from the FGF unless sanctioned by law. The FGF is composed of investments outside Kuwait in various asset classes based on strategic asset allocation. Some of the assets of the FGF account are invested by the KIA in sovereign wealth enterprises (SWE) and are directly under the KIA’s control. Below is a summary of main Kuwaiti SWEs.
Table 3-1: Kuwait sovereign wealth enterprises

<table>
<thead>
<tr>
<th>Name of SWE</th>
<th>Establishment</th>
<th>AUM (US$ million)</th>
<th>Investment focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Technology Enterprises Company of Kuwait</td>
<td>2002</td>
<td>311</td>
<td>Transfer new technology in various sectors</td>
</tr>
<tr>
<td>St Martins Property (acquired by KIA in 1974)</td>
<td>1924</td>
<td>3,000</td>
<td>Real estate</td>
</tr>
<tr>
<td>Kuwait Real Estate Investment Consortium</td>
<td>1994</td>
<td>88.3</td>
<td>Real estate</td>
</tr>
<tr>
<td>Kuwait China Investment Company</td>
<td>2005</td>
<td>280</td>
<td>Investment in various sectors across Asia</td>
</tr>
</tbody>
</table>

Source: Sovereign Wealth Fund Institute (2010)

The assets under management of the authority are owned by the state of Kuwait; the KIA is only an asset manager which does not own any of its entrusted assets. The authority’s mission, as stated in 2008 by the managing director of the KIA, Mr Bader Al Sa’ad, is:

“...to achieve a long term investment return on the financial reserves entrusted by the State of Kuwait to the Kuwait Investment Authority by providing an alternative to oil reserves, which would enable Kuwait’s future generations to face the uncertainties ahead with greater confidence”.  

Mr Al-Sa’ad defined the KIA’s objectives in his keynote speech at the First Luxembourg Foreign Trade Conference on 9 April 2008 as:

1. KIA aims to achieve a rate of return on its investment that, on a three-year rolling average, exceeds composite benchmark by designing and maintaining an uncorrelated asset allocation, consistent with the return and risk objectives that are mandated.

2. KIA will endeavour to be a world class investment management organization committed to continuous improvement in the way it conducts business.

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54 Al Sa’ad, Bader (2009), Overview on the Kuwait Investment Authority and Issues Related to Sovereign Wealth Funds, keynote speech at the First Luxembourg Foreign Trade Conference, 9 April 2009: http://www.kia.gov.kw/En/About_KIA/Overview_of_KIA/Pages/default.aspx, accessed on 10 October 2010
3. KIA is committed to the excellence of the private sector in Kuwait while ensuring that it does not compete with or substitute it in any field.

Law No. 47, based on which the authority was established, put legal restriction on any form of disclosure of information about KIA operations. According to article No. 8 and 9 of this law:

“The Authority shall have the body of personnel, in which the employees are appointed in accordance with the regulations adopted by the Board of Directors, but without prejudice to the provisions of Articles 5 and 38 of Decree Law No. 15 of 1979 Concerning Civil Service. The members of the Board of Directors, the employees of the Authority or any of those participating in any form in its activities, may not disclose data or information about their work or the position of the invested assets, without a written permission from the Chairman of the Board of Directors, and this prohibition remains in force even after cessation of the relation of the person with the business of the Authority.(Article 8) Without prejudice to any heavier punishment whoever divulges any of the secrets of the work of the Authority or data or information of which he became aware, by virtue of his work at the Authority, shall be punished with imprisonment for a period not exceeding three years.(Article 9)”

There was no official announcement of the total assets which are held by the KIA until July 2007, when the authority revealed that its total holdings amounted to $213 billion: $174 billion in the FGF and $39 billion in the GRF. In June 2008 Thomson Reuters reported a 14.4 percent rise in the assets of the KIA, bringing its total assets under management (AUM) to $264.4 billion. Apart from the indication given in the 2007 KIA announcement, most of the estimates of the KIA’s total AUM have been based on speculation and guesswork. The latest figures by the SWF Institute estimate the KIA’s total AUM to be about $202.8 billion.

All in all, the KIA has developed into a sophisticated investor which holds highly diversified risks across asset classes, industries, and geographic zones. The role of the KIA on the domestic economic development of Kuwait has been significant. At various times it has utilised its resources to support the national market, as well as playing a positive role within the global financial system.

This chapter will follow the historical development of Kuwait’s SWF. It will first start with the initial phases in the creation of the fund before the independence and early post-independence years, between the 1950s and 1970s. Then it will move to an in-

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56 Thomson Reuters, Kuwait’s KIA assets up 14.4 pct at $264.4 bn, 20 June 2008
57 http://www.swfinstitute.org/swfs/kuwait-investment-authority/, accessed on 10 October 2010
depth review of the structure and investment strategy of the Kuwait Investment Authority in recent times.

3.2 History of Kuwait’s SWF 1950s-1990s

The Kuwait Investment Board (KIB) was Kuwait’s first attempt to establish a fund for saving oil income. The board was initially established by the British in 1953. It consisted of five British bankers, chaired by the director of the Middle East Department at the Bank of England. As the first oil shipment was exported from Kuwait in 1946, the emergence of Kuwait’s modern economy started to become closely linked with oil income. Therefore, in order to minimise the risks associated with the country’s reliance on a single non-renewable resource, as well as to efficiently manage the country’s growing sovereign wealth, KIB was established.

As Table 3-2 below shows, Kuwaiti oil production was increasing gradually until 1973, while the annual increase in government income was subject to noticeable fluctuations. Except for factors relating to new discoveries, the primary cause of these fluctuations was external. Hence, the economy was extremely vulnerable to factors beyond its control, related to the international oil market and the policies of the major oil companies, which maintained a substantial degree of influence. Therefore, a financial body, i.e. the KIB, was needed to create and maintain a saving system for the country’s oil revenue, in order to safeguard Kuwait’s newly emerging economy against those external factors.

Table 3-2: Kuwait oil production and government revenues 1946-1977

<table>
<thead>
<tr>
<th>Year</th>
<th>Crude oil production</th>
<th>Government oil revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Million (US $)</td>
<td>Annual increase (%)</td>
</tr>
<tr>
<td>1946</td>
<td>5.9</td>
<td>-</td>
</tr>
<tr>
<td>1947</td>
<td>16.2</td>
<td>174.0</td>
</tr>
<tr>
<td>1948</td>
<td>46.5</td>
<td>187.0</td>
</tr>
<tr>
<td>1949</td>
<td>89.9</td>
<td>98.0</td>
</tr>
<tr>
<td>1950</td>
<td>125.7</td>
<td>39.0</td>
</tr>
<tr>
<td>1951</td>
<td>204.9</td>
<td>63.0</td>
</tr>
<tr>
<td>1952</td>
<td>273.4</td>
<td>33.0</td>
</tr>
<tr>
<td>1953</td>
<td>314.6</td>
<td>15.0</td>
</tr>
<tr>
<td>Year</td>
<td>Income Inflow</td>
<td>Population Growth</td>
</tr>
<tr>
<td>------</td>
<td>---------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>1954</td>
<td>349.7</td>
<td>11.0</td>
</tr>
<tr>
<td>1955</td>
<td>402.7</td>
<td>15.0</td>
</tr>
<tr>
<td>1956</td>
<td>405.5</td>
<td>0.6</td>
</tr>
<tr>
<td>1957</td>
<td>424.8</td>
<td>4.7</td>
</tr>
<tr>
<td>1958</td>
<td>522.4</td>
<td>23.0</td>
</tr>
<tr>
<td>1959</td>
<td>525.9</td>
<td>0.6</td>
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<tr>
<td>1960</td>
<td>619.1</td>
<td>17.7</td>
</tr>
<tr>
<td>1961</td>
<td>633.3</td>
<td>2.2</td>
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<tr>
<td>1962</td>
<td>714.6</td>
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<td>1963</td>
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<td>907.2</td>
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<td>1967</td>
<td>912.4</td>
<td>0.6</td>
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<td>1968</td>
<td>956.6</td>
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<td>1969</td>
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<td>1970</td>
<td>1090.6</td>
<td>7.8</td>
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<tr>
<td>1971</td>
<td>1116.4</td>
<td>2.4</td>
</tr>
<tr>
<td>1972</td>
<td>1201.6</td>
<td>7.6</td>
</tr>
<tr>
<td>1973</td>
<td>1102.5</td>
<td>-0.8</td>
</tr>
<tr>
<td>1974</td>
<td>929.3</td>
<td>-15.7</td>
</tr>
<tr>
<td>1975</td>
<td>760.7</td>
<td>-18.2</td>
</tr>
<tr>
<td>1976</td>
<td>785.2</td>
<td>3.2</td>
</tr>
<tr>
<td>1977</td>
<td>718.0</td>
<td>-8.5</td>
</tr>
</tbody>
</table>

Source: M.W.Khouja and P.G. Sadler (1979)

The significant growth of income inflow between 1947 (US$ 0.76 m) and 1953 (US$ 169 m) was another factor for the establishment of the KIB. As shown in the table, the increase in government oil revenues in the 1950s was the engine behind the expansion of Kuwait’s economy. There are no reliable estimates of GDP before 1961/2. However, the pace and level of growth was evident in the rapid increase of imports, population and government spending. Imports expanded swiftly to reach a per capita level of over US$280 by 1952. The value of total imports more than quadrupled and reached as high
as 780$ million by 1960.\textsuperscript{58} All in all, a systematic approach, initially started with the KIB, was needed to manage the income.

Kuwait’s early oil payments were all in sterling and London has been historically the heart of most operations of Kuwait’s SWF. In the immediate years after the Second World War, the Kuwait Oil Company (KOC) was the sole local company controlling the extraction and export of the country’s crude oil. In addition, the KOC had two foreign partners: Gulf Oil and BP. Both companies paid their contributions to the government of Kuwait through an account in London. BP paid directly in sterling, Gulf in dollars which were then converted into sterling.

The oil prices in all Kuwaiti contracts were fixed in sterling and the incomes were paid quarterly into the British Bank of the Middle East in London. These payments were the main revenue of the state budget and the funds in London were transferred to the account of the government at the local branch of the British Bank of the Middle East in Kuwait. The government normally limited its expenditure to the budgeted receipts and usually calculated to leave a small surplus, transferred annually to a reserve account, also held in London.

In addition to the fact that sterling was the currency of almost all Kuwait’s oil deals, the choice of currency was influenced by the British government which sought to maintain the value of sterling – a key aim of the government. Moreover, Kuwait’s relationships in trade were strongly oriented toward Britain. In 1958, Kuwait’s imports from Britain, which consisted mainly of consumer goods, were valued at £57 million. This cost of aggregate import to the country was equal to about half of Kuwait’s oil revenue at the time.\textsuperscript{59}

With most of the country’s revenue being held in London accounts, sterling was clearly the best choice of currency. Also, under an agreement with Britain during the 1940s, Kuwaiti government investments in Britain were exempt from British taxation. Finally, as Kuwait maintained strong political links with Britain under the Protectorate Agreement, holding the sovereign reserves in sterling and the handling of the accounts in London made good sense.

\textsuperscript{58} Khouja, M.W. and P.G. Sadler (1979), \textit{The economy of Kuwait, Development and Role in International Finance}, London: McMillan Press

\textsuperscript{59} Shamma, Samir (1959), ‘The Oil of Kuwait Present and Future’ in \textit{Middle East Oil Monographs: No.1}, Beirut: Middle East Research and Publishing Centre
By the mid 1950s, the concern over a potential shift from sterling by the oil-rich states of the Gulf was raised. It was clear to the British government that if either the existing governments, or possible new hostile regimes, decided to diversify the accumulated wealth, sterling would suffer severely. By 1959 it was estimated that the total assets of the Gulf oil exporters were equivalent to over a quarter of Britain’s gold and foreign exchange holdings.\(^{60}\) Any movement by Kuwait, therefore, to weaken the link with sterling would be likely to affect confidence in sterling as an international currency. The anxiety was calmed in 1960 when Sheikh Jabir, president of the finance department of Kuwait at the time, reassured the British authorities that the government of Kuwait had no intention of changing its basic policy of investing Kuwait’s surpluses in London.\(^{61}\)

After independence in 1961, the Kuwaiti authorities tried to become more economically independent of Britain. On the one hand they had promised the British authorities that they would continue backing sterling, but on the other hand their aspiration and desire for more independence in managing the country’s assets was evident. In 1961, a separate investment committee was established in the Kuwait department of finance, aiming to break the sole responsibility of the KIB for the management of Kuwait’s surplus capital.

In 1962, the Kuwait Fund for Arab Economic Development (KFAED) was founded by the state of Kuwait. The KFAED would allow Kuwaiti authorities to put some of the country’s surplus income into an account other than that of the British-run Kuwait Investment Board, which would be managed independently. By doing so, the Kuwaitis were asserting more liberty in controlling the country’s assets. At this stage Britain was prepared to accept the new developments so long as Kuwait’s balances held in London were maintained.\(^{62}\) The foreign office supported Kuwait’s proposal for adding a Kuwaiti member to the KIB; however, this was rejected by the chairman of the KIB at time, H.T.Kemp. In protest against this decision, 40% sterling backing the Kuwaiti dinar was withdrawn from the assets of the KIB by the Kuwaiti authorities.\(^{63}\)

In 1965, the Kuwait Investment Office (KIO) was established in London with a total number of 11 Kuwaiti staff to replace the KIB. The main aim of this move was to give more management and decision-making power to the Kuwaiti authorities. As was noted

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\(^{61}\) Letter from Richmond to Walmsley, No. 1117/60, 26 April, 1960, T 236/6314


above, Kuwaiti oil income has been saved in London-based banks and in sterling between 1947 and 1965, when the KIO was established. The choice of location for the office was influenced by the historical links between Kuwait and London.

In 1967 there was a major devaluation of sterling, by 16%, which had a big effect on Kuwait’s foreign assets. This immediately motivated Kuwait to reconsider the relationships with London and re-evaluate its foreign portfolio investment policy. It was clear that sterling would not remain a major reserve currency for much longer and negotiations were carried out with British authorities to make sure that compensation would be paid on Kuwaiti investments anytime that the value of sterling fell below $2.40 to the pound.64

In the 1970s, Kuwait’s oil revenue, as well as the foreign assets’ investment income was growing dramatically. As table 3.3 demonstrates below, investment income between 1971 and 1977 was growing by about 60% per year. The significant increase in investment income of the late 1970s was a warning signal to the Kuwaiti authorities to pay more attention to their investment strategy. It was clear at the time that the actual receipt of investment income itself was bound to become more important even if receipts from oil remained unchanged. This motivated the government to expand its investments in various asset classes across the globe. The most favourable destination to redirect the Kuwaiti sovereign wealth in the 1970s was New York. This inevitably shrunk the sterling holdings in London.

Table 3-3: Growth of Kuwait’s government income during the 1970s (million KD)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net balance of current account transactions</td>
<td>420.8</td>
<td>448.8</td>
<td>979.8</td>
<td>2137.4</td>
<td>1939.0</td>
<td>2140.0</td>
<td>1794.0</td>
</tr>
<tr>
<td>Oil receipts</td>
<td>527.9</td>
<td>548.5</td>
<td>1084.6</td>
<td>2369.3</td>
<td>2289.0</td>
<td>2615.0</td>
<td>2587.0</td>
</tr>
<tr>
<td>Investment income</td>
<td>108.7</td>
<td>125.5</td>
<td>141.4</td>
<td>202.6</td>
<td>334.0</td>
<td>441.0</td>
<td>429.9</td>
</tr>
</tbody>
</table>

Source: M.W.Khouja and P.G. Sadler (1979)

With the fast and striking growth of Kuwait’s sovereign assets, saving the current oil windfall for future generations became an easier strategy for Kuwaiti authorities to follow. To serve this purpose the Reserve Fund for Future Generations (FGF) was established in August 1976. The mandate of the FGF was to save some of the country’s

64 M. W. Khouja and P.G. Sadler, op.cit
assets for future generations; the fund was set up to include assets with long investment horizons to secure investment income in the future. As has been discussed above, the Kuwaiti government was pursuing diversification policies to spread the country’s portfolio of investments in various sectors across the global markets. With the creation of the FGF, in addition to geographic and sector diversification, long-term investments were also included in the Kuwait’s government investment portfolio.

The FGF was given KD 632.7 million from the GRF which was 50% of the assets under management of the GRF at that time. It was also to receive 10% of the state revenue annually plus all profits earned on GRF holdings. The FGF commenced with a fund of KD 850 million. It was handled by the KIO – and later by the KIA - in the same way as the GRF. The FGF’s capital and proceeds are designated for the future and are declared inviolate.

The FGF is obliged to reinvest all of its investment profits every year, which has facilitated the growth of its under management assets. All the assets of the FGF have been kept outside of the country and none of its assets can be withdrawn from the fund unless sanctioned by law. Transfer of assets to the FGF is independent from the budget or oil market. 10% of the country’s oil income at any given price of oil for that fiscal year, as well as all the investment returns of that year, must be transferred to the FGF’s account. The government investment policy for the FGF played a key role in boosting the fund’s asset accumulation. By the early 1980s, Kuwait’s foreign investments were generating more income for the country than the direct sale of oil.

The second oil price shock following the Iranian revolution caused dramatic growth in Kuwait’s financial reserves. The total foreign reserves of the country were estimated to have quadrupled between 1979 and 1982. With the increasing amount of oil revenue and investment return, the Kuwaiti government felt the need for a larger and more sophisticated management body. This led to the establishment of the Kuwait Investment Authority in 1982. The KIO, which has been a major player in management of Kuwaiti sovereign assets since the establishment the country’s SWF and had enjoyed extensive prestige and autonomy because of its age and track record was brought under the overarching responsibility and direction of the KIA.

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65 M.W. Khouja and P.G. Sadler, op.cit
66 [http://www.kia.gov.kw/En/About_KIA/Overview_of_Funds/Pages/default.aspx](http://www.kia.gov.kw/En/About_KIA/Overview_of_Funds/Pages/default.aspx), accessed on 12 October 2010
67 Economist Intelligence Unit (2001), *Kuwait in the 1990s, a society in siege*, special report no. 2035
In accordance with Law 47 of 1982 the KIA was established as an independent legal unit that operated under the umbrella of the Ministry of Finance. On behalf of the state of Kuwait, the KIA was given responsibility to develop and manage full operations of the GRF and FGF. The main purpose of the establishment of the KIA was to improve the quality of investment operations and decisions. Over time it also took over the Ministry of Finance’s role in managing and developing the financial reserves. The KIA remained the parent organization of the Kuwait Investment Office. The KIA issued various guidelines for the KIO activities as an investment manager, including an instruction to ensure that employees of the KIO are rotated occasionally with Kuwait-based personnel.

The KIA has been successful in the management of Kuwaiti sovereign assets to the extent that in 1987, Kuwait’s foreign investments produced $6.3 billion, compared to $5.4 billion from oil. In 1990, the total AUM of Kuwait SWF was estimated at over $100 billion, two-thirds of which were believed to be held in FGF. \(^{68}\)

3.3 The impact of the Iraqi invasion on Kuwait’s sovereign reserves

The role of Kuwait’s sovereign wealth fund during and after the invasion of the country was significant. Being the main Kuwaiti financial institution abroad, the KIO played a key role in managing foreign assets during the invasion, including providing funds for exiled Kuwaitis, funding the foreign military operation for liberation, and most importantly funding the reconstruction projects subsequent to liberation. The following paragraphs will review the rise of Kuwait’s national assets before the invasion, as well as the post-invasion exhaustion of the reserves.

The total revenues of the government had significant fluctuations between the early 1980s and early 1990s. The decline of the oil price in 1986/1987 had drastically decreased the government revenues. As a result, the government started to pursue rather conservative fiscal policies which restrained budgetary expenditure and assisted the KIA to continue raising its holdings of sovereign assets. Reflecting the country’s large foreign assets, investment income amounted to 86% of oil export receipts in the year prior to the Iraqi invasion (1989). In the same year, Kuwait experienced a significant

\(^{68}\) Financial Times (1990), 13 March 1990
budget surplus of about 30% of GDP that was double the annual average of the previous three years. As it is shown in the Table 3-4 below, Kuwait’s total revenue for the year of the invasion (1990) was at its highest level in a decade (1982-1992).

Table 3-4: Kuwait public revenues and expenditure 1982-83 (million KD)

<table>
<thead>
<tr>
<th>Period</th>
<th>Oil revenues</th>
<th>Other receipts</th>
<th>Total revenues</th>
<th>Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982/83</td>
<td>2334.6</td>
<td>267.4</td>
<td>2602.0</td>
<td>3248.3</td>
</tr>
<tr>
<td>1983/84</td>
<td>2923.4</td>
<td>251.9</td>
<td>3175.4</td>
<td>3023.9</td>
</tr>
<tr>
<td>1984/85</td>
<td>2493.7</td>
<td>250.9</td>
<td>2744.7</td>
<td>3205.0</td>
</tr>
<tr>
<td>1985/86</td>
<td>2094.7</td>
<td>250.4</td>
<td>2345.1</td>
<td>3105.9</td>
</tr>
<tr>
<td>1986/87</td>
<td>1483.9</td>
<td>247.0</td>
<td>1730.9</td>
<td>2860.1</td>
</tr>
<tr>
<td>1987/88</td>
<td>1991.4</td>
<td>260.3</td>
<td>2251.7</td>
<td>2806.0</td>
</tr>
<tr>
<td>1988/89</td>
<td>2035.1</td>
<td>332.7</td>
<td>2367.8</td>
<td>2998.6</td>
</tr>
<tr>
<td>1989/90</td>
<td>2935.7</td>
<td>298.9</td>
<td>3234.6</td>
<td>3095.7</td>
</tr>
<tr>
<td>Continued</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990/91</td>
<td>2109.0</td>
<td>296.0</td>
<td>2405.0</td>
<td>3634.0</td>
</tr>
<tr>
<td>1991/92</td>
<td>700.1</td>
<td>169.9</td>
<td>870.0</td>
<td>6219.0</td>
</tr>
<tr>
<td>1992/93</td>
<td>2000.3</td>
<td>217.7</td>
<td>2218.0</td>
<td>4000.0</td>
</tr>
</tbody>
</table>

Source: Kuwait Central Bank Annual Report 1993

The country’s assets were depleted by the cost of the liberation operation and reconstruction. The factors of foreign assets disturbance in the aftermath of the invasion were the following:

- Sharp fall in oil output and export,
- An erosion of investment income due to the significant drawdown in foreign assets,
- Large payments associated with Desert Shield and Desert Storm operations,
- The costs of restoring the country’s infrastructure after liberation,
- Higher government payments on account of wages, salaries and transfers.

The Iraqi invasion in August 1990 interrupted regular budgetary activities as the inflow of oil sales was stopped. The invasion and subsequent occupation of Kuwait caused

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serious destruction of physical assets and of administrative and social services, as well as the temporary exile of a large part of the population. It imposed widespread physical damage and led to large budgetary and balance of payments deficits, domestic financial market disturbance, disrupted foreign trade, and paralysis in the labour market. Over 60% of the existing oil wells were set on fire. Estimates of the total damage to oil facilities were in excess of 10$ billion. The economy underwent a considerable fall in investment income - from 27% of GDP in 1989/90 to less than 8% of GDP in 1994/95 - as a result of the drawdown of the sovereign foreign assets in the aftermath of the occupation. Total revenue fell by 66% in 1990/91, while expenditure rose by 126%. More than 80% of total expenses during 1990/91 were accounted for by large official transfers abroad for payments to foreign governments for Desert Shield and Desert Storm operations. Kuwait contributed $21.6 billion to the military operations of liberation, then (by the end of 1994) signed arms purchase agreements worth $5-6 billion. Moreover, the country’s income from oil exports was interrupted during the occupation and the next year, because of the devastation of oil production capacity as a result of 742 of the 1080 Kuwaiti oil wells being set on fire by the Iraqis. A deficit of about 120% of GDP was recorded, which was financed by drawing on official foreign assets.

All oil well fires had to be extinguished and all existing wellheads had to be either repaired or re-drilled. In 1994, the refinery capacity returned to levels achieved prior to the occupation. By 1995, oil production capacity was above pre-invasion levels and exports reached 2 million barrels a day. The regaining of the oil export level was reflected in surpluses on the external current account and GDP growth, which allowed the authorities to start repaying a bank syndicated loan of $5.5 billion, contracted after liberation.

The costs of the seven months of Iraqi occupation and expulsion came to $49 billion. With reconstruction, total costs came to $66.7 billion by the end of the fiscal year 1994-95. A quarter of this amount represents the cost of debt forgiveness. The post-liberation spending left Kuwait with just 40 percent of its pre-invasion foreign reserves. Kuwait's

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70 Hussein, Tahir (1995), *Kuwait Oil Fires: Regional Environmental Perspectives*. Oxford: BPC Wheatons
72 Economist Intelligence Unit (1998), *Kuwait Country Profile*
74 Economist Intelligence Unit (1998), op.cit
foreign reserves fell from over their $100 billion pre-invasion estimated level to $46.7 billion. In addition, $5 billion was lost in a series of investments in Spain.\(^7\) By 1997, strong performance in world equity markets was estimated to have boosted the FGF and the GRF to around $50bn.\(^6\) There is no reliable reference to clarify whether the transactions which were made to cover the reconstruction costs were from the GRF or the FGF. However, due to the considerable share of FGF in total SWF’s assets (two-thirds), the author expects that despite the general restrictions for withdrawals from the FGF, under the circumstances, transactions were made from both accounts.

### 3.4 Governance and structure of the KIA

The KIA is governed by a Board of Directors, which is chaired by the Minister of Finance. Other seats are allocated to the Energy Minister, the Governor of the Central Bank, the undersecretary of the Ministry of Finance, and five other nationals from the private sector, three of which should not hold any other public office. The members of the board are appointed by an Amiri Decree for a four-year term. The board members may be re-appointed, provided that at least three of them do not hold any public office. The board then forms an executive committee of five board members, at least three of whom are private sector appointees. The board appoints a chairman for the executive committee from one of the private sector representatives.\(^7\) The chairman of the executive committee is also the managing director of the KIA. The primary role of the executive committee is to assist the board of directors in setting strategic goals and objectives of KIA. The current members of the executive committee are:

- Bader Muhammad Al-Sa’ad (Managing Director)
- Abdullatif Youif Al-Hamad
- Abdulla Sa’ad Al-Hamidhi
- Hilal Mishari Al-Mutairi
- Abdulmuhsin Mudaaj Al Mudaaj

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\(^7\) Yousef H. Al-Ebraheem, op.cit
\(^7\) [www.kia.gov.kw](http://www.kia.gov.kw), accessed on 12 May 2009
Table 3-5: Managing Directors of KIA, 1982 – 2008

<table>
<thead>
<tr>
<th>Name</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr. Fahad Mohammad Al-Rashed</td>
<td>1982</td>
</tr>
<tr>
<td>Abdulla Ahmad Al-Qabandi</td>
<td>1991</td>
</tr>
<tr>
<td>Ali Abdulrahman Al-Rashid Al-Bader</td>
<td>1993</td>
</tr>
<tr>
<td>Abdulmohsen Yousif Al-Hunif</td>
<td>1999</td>
</tr>
<tr>
<td>Saleh Mubarak Al-Falah</td>
<td>2000</td>
</tr>
<tr>
<td>Bader Mohammad Al-Sa’ad</td>
<td>2003</td>
</tr>
</tbody>
</table>

Source: [www.kia.gov.kw](http://www.kia.gov.kw)

The chairman of the board is officially responsible for communications between the KIA and the government. He submits the annual draft budget of the authority to the council of ministers together with a detailed report on the activities and the position of the invested assets. In addition to this, the chairman of the board is responsible for delivering frequent reports evaluating of the authority’s performance, in accordance with the government policies for long-term development of Kuwait.

Table 3-6: Chairmen of KIA (1982 – 2008)

<table>
<thead>
<tr>
<th>Name</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abdullatif Yousif al-Hamad</td>
<td>1982</td>
</tr>
<tr>
<td>Sheikh Ali Al-Khalifa Al-Athbi Al-Sabah</td>
<td>1983</td>
</tr>
<tr>
<td>Jassem Mohammad Al-Khorafi</td>
<td>1985</td>
</tr>
<tr>
<td>Sheikh Ali Al-Khalifa Al-Athbi Al-Sabah</td>
<td>1990</td>
</tr>
<tr>
<td>Nasser Abdullah Al-Roudhan</td>
<td>1991</td>
</tr>
<tr>
<td>Sheikh Dr. Ali Salem Al-Ali Al-Sabah</td>
<td>1998</td>
</tr>
<tr>
<td>Sheikh Dr. Ahmed Abdulla Al-Ahmed Al-Sabah</td>
<td>1999</td>
</tr>
<tr>
<td>Dr. Yousif Hamad Al-Ibrahim</td>
<td>2000</td>
</tr>
<tr>
<td>Sheikh Dr. Mohammed Sabah Al-Salem Al-Sabah</td>
<td>2003</td>
</tr>
<tr>
<td>Mahmoud Abdul-Khaliq Al-Nouri</td>
<td>2003</td>
</tr>
<tr>
<td>Bader Meshari Al-Humaidhi</td>
<td>2005</td>
</tr>
<tr>
<td>Mustafa Jassim Al-Shimali</td>
<td>2007</td>
</tr>
</tbody>
</table>

Source: [www.kia.gov.kw](http://www.kia.gov.kw)

The board of directors is responsible for the affairs of KIA and has all powers necessary for attaining its objectives, which are mainly dealing with issues like the formulation of the general policy of the authority and supervision of its accomplishments, preparation and follow-up of investment programs, adoption and administration of financial and managerial policies necessary to the authority, transactions of assets and investments,
and approval of the KIA’s draft budget, along with the annual account reports, before submission to the relevant authorities.

The current ex-officio members of the Board of Directors are:

- Minister of Finance (Chairman of the Board), Mustafa Jassim Al-Shimali,
- Minister of Energy, Sheikh Ahmad Abdullah Al-Hamad Al-Sabah,
- Governor of the Central Bank of Kuwait, Sheikh Salem Abdulaziz Al-Sabah,
- Undersecretary, Ministry of Finance, Khalifa Musaad Hamada.

Currently, two ex-officio members of the board of the total nine members are from the royal family. It is not far from reality to assume that there has been a link between the reduced involvements of the ruling family in managing the country’s SWF, and the financial scandal of the KIO in the early 1990s. After the liberalisation of the Kuwait in 1991 there was a huge emphasis put on the management of the fund to be independent from the royal family. The scandal of the 1990s (covered below) has convinced the Kuwaiti legislative system that there needs to be a distinct line drawn between the national wealth and individual assets held by the members of the ruling family. Moreover, it was only after the financial crisis of the 1990s that the need for a well-defined auditing procedure to oversee the operation of the country’s sovereign wealth fund was felt.

3.5 The Torras Company Scandal: a case study in managerial weakness

Starting in the mid-1980s, Kuwait invested almost US $5 billion in Spain. It is not clear what happened but the country lost all of its assets there. The KIO bought a high number of Spanish industrial companies over a short period of time. At their peak, Kuwait's Spanish firms, ranging from chemicals to food to real estate, had assets worth US $7 billion. By 1992, Kuwait's empire in Spain was ruined and either heavily in debt or insolvent. The news raised an enormous level of anger amongst the Kuwaiti public. The debate over the incident consequently led into some legal actions to

78 Waldman, Peter and Carla Vitzthum (1992), Mystery of the Missing US$5B: Kuwait says it's a victim while Spain points to evidence of KIO misconduct, Financial Post, 27 November 1992
minimize the role of ruling family in the management of Kuwait’s sovereign wealth assets.

Three former officials of the fund, including two members of the Al-Sabah family, were investigated. The problems over the missing money hurt the credibility of state of Kuwait while the country was already suffering severe economic problems as a result of the Iraqi invasion of 1990, which had significantly exhausted the sovereign wealth assets. The public fury was provoked further by newspaper reports. The fraud was referred to as: "the worst exploitation and mismanagement of public funds and a betrayal of national trust." 79

The major share of the investments was concentrated in one conglomerate; Grupo Torras. Javier de la Rosa, a famous Catalan financier without a good track record, built the KIO's Spanish empire and served as vice-chairman of Torras. De la Rosa was the director general of Banco Garriga Nogues at the age of 26. The bank had lost more than $1 billion in 1985.80 Although De la Rosa left the bank before this, there were still rumours that he was linked to the fraud; therefore, his appointment by the KIO was referred to as a mistake.

De la Rosa was in the heart of the KIO’s operations in Spain. Using KIO money, he quickly penetrated in prime real estate and old industrial companies in various fields, such as chemicals, food-processing and paper, putting the companies together under the umbrella of Grupo Torras. At the time of his separation from Torras, he owned 80% of a private holding company, Quail Espana, where he had channelled some of the profits from Kuwaiti-related dealings into investments such as an amusement park near Barcelona, a small advertising agency and an investment fund that aims to acquire stakes in undercapitalized family businesses in basic fields like textiles and foodstuffs. He was also a leading investor in Spain's version of media mania, with a 25% stake in one of the country's first three private TV networks, Tele 5.81

Del la Rosa worked with the Kuwaiti officials of the KIO for about six years. His close association with the Kuwaitis began in 1984, when he offered a highly profitable deal, buying a small Catalan paper mill called Inpacsa, to the KIO. From then on, the KIO's policy in Spain changed from being a cautious and secretive investor to an aggressive

80 Peter Waldman and Carlta Vitzthum, op.cit
empire-builder. De la Rosa, advised Kuwaiti authorities based on the idea that the growing Spanish economy was about to boom and the KIO managers liked his proposals. Shortly after the first KIO deal in Spain, Grupo Torras was formed out of a troubled Catalan company, Torras Hostench. In seven years, the KIO grew into Spain’s largest industrial investor. De la Rosa told the Independent that he took 3 or 4 per cent commission on anything the KIO acquired.\(^82\)

Torras was Spain’s largest industrial conglomerate, with nearly $7 billion in group revenues and $600 million in cash flow in 1990. It is estimated that the group’s value was at least $2 billion, and maybe a good bit more. At $2 billion, the investors (KIO, 77%; de la Rosa and associates, 23%) had more than tripled their money.\(^83\) By 1992, Grupo Torras owed more than $1.8 billion to Spanish banks, $200 million to Credit Suisse and $200 million to Bank of America. The KIO repaid the debts. 25,000 jobs were put in danger in the aftermath of the collapse of Torras.\(^84\)

To avoid being identified as an investor, the KIO bought shares in Spanish companies indirectly through offshore accounts and sold them to Torras and banked the profit once the prices of the shares had increased. Torras became the eventual owner of the shares at rather high prices, which it borrowed money from various banks to pay. The strategy was planned to keep Torras at a low profit level, to pay lower taxes, while the KIO benefited from the share deals. This strategy, however, pushed Torras deeply into debt and made the company extremely vulnerable to any downturn in the market. From about 1989, investors started to lose trust in Torras.

By 1992, the KIO faced the need to inject cash in its Spanish holding companies every month, at a rate of $200m a year, with no income, as it was used only to pay the interest on bank loans and to pay the expenses of the running the companies. The Grupo Torras was under suspicion. The government of Spain demanded explanations and the investigation began. Kuwait's Crown Prince and Prime Minister, Saad Abdallah al-Sabah, announced that KPMG, an auditing firm in charge of auditing some of the under management funds of the KIA, started to investigate the KIO’s Spanish investments.

\(^{82}\) Webster Justin (1993), *Kio's Spanish inquisition: The growing scandal of Kuwait's massive losses in Spain is exposing the dirty linen of one of the world’s most secretive investment agencies and ringing government alarm bells*, Independent, 10 January 1993

\(^{83}\) John Marcom, op.cit

\(^{84}\) Peter Waldman and Carla Vitzthum, op.cit
Losses for 1991 were reported to be around $513m. After further investigation, the figures reached $2bn.\(^{\text{85}}\)

There were different views on the Torras scandal. As far as the Spanish government was concerned, a lack of sufficient supervision and control by the government of Kuwait before the invasion, as well as the total collapse of the state upon invasion, which led many Kuwaiti officials to believe that Kuwait might never be independent again, were the main catalysts of the failure of Kuwait’s investments in Spain. It was even rumoured that about $2 bn of the $5 bn loss in Spain was transferred to some Kuwaiti exiled royal family members during the invasion.\(^{\text{86}}\) A Spanish official from the Finance Ministry was quoted by the New York Times in 1993:

"The extraordinary thing in all this is the absence of controls; a dozen Kuwaitis were managing over $70 billion in London with virtually no control. In the end, the people of Kuwait were robbed. In Spain, their money was used chiefly to produce commissions and profits for a few insiders." \(^{\text{87}}\)

Kuwaiti officials blamed mismanagement, poor financial advice and weak government regulation in Spain, and insisted Kuwait was a victim. The KIO’s former managers said they were the victims of a bad Spanish economy, which coincided with the impact of the Gulf War. As noted above, because of the occupation of the country, the KIO’s holdings became the national treasury-in-exile, responsible for both financing the government and drumming up international support for the war. Some of the money which evaporated in Spain was claimed to be spent on buying political support around the world for Kuwait.

De la Rosa’s claim however, was different to those of the Spanish and Kuwaiti governments. He alleged he was the victim of a political power struggle inside Kuwait. He believed that the Kuwaiti opposition had become stronger as a result of the parliamentary election in 1992 and that they were determined to attack the Kuwaiti royal family by linking Sheikh Fahad and Sheikh Ali Khalifa, two first cousins of the Emir, to the Spanish economic disaster. He repeatedly insisted that his personal profit was earned legitimately and that he had acted according to the instructions from the KIO and had done nothing illegal. In an interview with the Independent in 1993 he said:

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\(^{\text{85}}\) Economist (1992), Vol. 324 No. 7777

\(^{\text{86}}\) Murphy, Kim (1993), $5-Billion Loss Riles Even Oil-Rich Kuwaitis. Scandal: Parliament's probe of public funds poses the most serious challenge ever to the ruling family's power, Los Angeles Times, 10 February 1993

“I am aware of the transfer of about $300 million that was made from the Torras in order to make political payments to gain support for the war effort, but again, I was merely acting on instructions from London.” 88

Three attempts were made by lawyers hired by Kuwaiti officials to bring criminal charges against Del la Rosa. All the suits have been rejected by a Barcelona judge and one appeal was made.

As a result of the scandal, the KIO lost its credibility and nationally trust in the ruling authorities was lower than ever. The political and social environment was intense; Kuwait was devastated after the invasion, and the country was in need for money to finance the reconstruction projects. In order to limit the public controversy, the government banned local newspapers from daily coverage of the scandal. 89 Ali Rashid Al-Bader took over from Sheik Fahad as chairman of the KIO in February 1992.

The new management began a serious attempt to track the Spanish investments. 90 The parliamentary Finance Committee was trying to find firm answers even to the question of who really controlled the KIO. In general, the office was not controlled by the national audit office, or by the minister of finance. The Kuwaiti legislature therefore, had to set up a watchdog system over the management of public funds, which until then had been highly controlled by Al-Sabah and businessmen allied with the ruling family.

Three former officials of the fund were investigated in relation with the scandal:

1- Sheikh Fahad, a member of the Kuwaiti royal family of Al-Sabah – a cousin of the Emir - who was chairman of the KIO from July 1984 until 8th April 1992. Sheikh Fahad worked in the Ministry of Finance until 1964 when he joined the KIO as an administrative manager. He became the general manager for the first time in 1967.

2- Mr Fouad Jaffar, was deputy chairman and general manager of the KIO from 1st July 1984 until 21st April 1990. During the Iraqi occupation of Kuwait, which began on 4th August 1990, Mr Jaffar returned to the offices of the KIO to assist on a voluntary part-time basis, which he described to the Royal Court of Justice in London as advisory rather than executive.

88 Webster Justin (1993), Kio's Spanish inquisition: The growing scandal of Kuwait's massive losses in Spain is exposing the dirty linen of one of the world's most secretive investment agencies and ringing government alarm bells, Independent, 10 January 1993
89 Roger Cohen, op.cit
90 Kim Murphy, op.cit
3- Sheikh Khaled, a younger member of the Al-Sabah family. He was born in 1955, studied a degree in economics and international relations at Warwick University and a master’s degree in London. Upon his graduation he devoted himself full-time to training and then working with the KIO. From 1983/4 he was an analyst at the Office for the Japanese department. In 1987 he was promoted to assistant general manager, reporting to Mr. Jaffar. In December 1989 he became Deputy General Manager. 91

Kuwait's Finance Minister, Nasser Al-Rodhan, issued instructions to seize properties of all three suspects of the case. The most serious irregularities were reported to be found in Spain. The matter was the subject of an intense investigation by the public prosecutor in Kuwait, to find out how much of this had been stolen and how much lost because of neglectful management.

At the top of the pyramid of the KIO was Ali Al-Khalifa Al-Sabah, the former oil minister, and finance minister during Kuwait's occupation. Ali Al-Khalifa and his team had been working for the KIO for more than 20 years. They governed and operated the KIO as a self-governed organisation dedicated to generating revenue without being held back by the bureaucratic restrictions of most of the government-owned Kuwaiti investment institutions. Sheikh Al-Khalifa was forced to leave the government after the liberation in 1991. Shortly after liberation, Al-Kahlifa was replaced by Nasser Abdullah Al-Rodhan, who had been a critic of the KIO’s operation for a long time.

As it is shown in Table 3.4 the oil income in the eve of Iraqi invasion was at the highest levels in a decade, which added to the investment returns of equal or even higher than the total oil revenue. However, after the invasion, Kuwait was suffering severe economic problems. The country had moved from being a foreign-aid donor until 1990, to being a net borrower in the aftermath of the invasion. Bailing out banks, forgiving electric and telephone bills, and distributing several thousand dollars to each Kuwaiti family as compensation for their losses during the invasion, added to the losses caused by mismanagement of the assets during the years prior to the invasion, depleted the foreign resources in the early 1990s.

91 Economist (1993), Vol. 327 No.7811
The collapse of the *Grupo Torras* and its political outcomes in Kuwait damaged the reputation of the government inside and outside the country. Kuwaiti critics called the Spanish investments a 'disgrace in the history of Kuwait', which had damaged the country’s financial reputation abroad. The KIO issued a writ in the Spanish high court against Sheikh Fahad, Fouad Jaffar, de la Rosa – the head of *Torras* - and four other Spaniards who worked for the KIO; it accused them of producing losses of over $870m, falsifying commercial and public documents, fraud, price manipulation and tax evasion. Moreover, a Kuwaiti parliamentary commission called for legal action against all KIO employees in Britain in the same year.\(^92\)

Kuwait's Parliament, demanded details about the investment scandals and salaries which were paid to a number of public officials. This was the first and most serious challenge ever to the power of the ruling family in Kuwait. A new investment law was passed by the assembly in 1993 which required immediate reporting of all public investments, even those companies in which the government has 25\% interest. The new law also imposed penalties of up to life imprisonment for anyone who misused public money. Kuwaiti law-enforcement officials were pushing the government to arrest individual Kuwaitis who were directly linked with the scandals.\(^93\)

Ismail Shatti, head of the parliamentary Finance Committee, which was investigating the fiscal scandal, was quoted as saying:

"We have lost $5 billion. This was because of mismanagement. It has disappeared, because the shares have become zero. But right now, we can't say there is crime in the investment there, at least not all of it. We can talk about half a billion dollars... Where has this half-billion gone? Is it stolen, or simply disappeared? We believe all of this mismanagement was an introduction, let's say, to steal money in a very clever way. But to prove that--this is the most difficult job."\(^94\)

London's Commercial Court found Sheikh Fahad guilty of participating in a conspiracy to spirit funds out of the KIO's Spanish subsidiary, *Grupo Torras*; and the Sheikh was found liable for damages of almost $500m. Sheikh Fahad allegedly said:

"This case is part of a witch-hunt by people who do not have Kuwait's best interests at heart. This case is about international politics. I am proud of what I did and the part I played in the liberation of Kuwait."

\(^92\) Kim Murphy, op.cit
\(^93\) Roger Cohen, op.cit
\(^94\) Kim Murphy, op.cit
In his defence Sheikh Fahad's told the court that the money in question was given to countries and leaders, including Serbia's Slobodan Milosevic, in exchange for their support of Kuwait after Iraq's invasion. Fouad Jaffar, the former managing director of the KIO in London, was also found guilty of dishonestly receiving money. He did not appeal against the decision.95

The fraud was not limited to Kuwait's investments in Spain. In Paris also, a Kuwaiti financial institution, the Kuwaiti French Bank, was closed while an investigation was made into money missing from its assets. Kuwaiti bankers claimed that an investment fund in Switzerland was fraudulently managed. Adnan Abdelqader Al-Mussalem, an economist at a financial newsletter called Al Shall, told The New York Times in 1993:

"In Spain the picture is clear; we are talking about $5 billion in publicly owned funds that must be accounted for. But the losses, fraud and misappropriation of funds are much bigger than Spain. There has been a massive abuse of public money in the past."

The KIO scandal, like the fiasco at the Bank of Credit & Commerce International which will be discussed in more detail in Chapter Five, involved a few people operating in utmost secrecy and with almost unlimited access to petro-dollars in vast amounts. Officials in Kuwait failed to act for a long time after initial suspicions were raised about the KIO's operations, particularly in Spain. In 1986, the KIO's executive committee, led by the emir's financial adviser, Khalid Su'ud, had flown to London in an attempt to impose pressure on the KIO and increase government control. But the KIO managers, who were adapted to making multimillion-dollar decisions on the spot, resisted the suggested measures. They shut down access to their offices and computers so that only a few KIO executives could see their trading results. This was mainly due to the strong support of the KIO functioning system by two cousins in the royal family, Fahd al Mohammed Al-Sabah and Ali Al-Khalifa. The only power above the two men was apparently held by the emir. He never imposed his supremacy, perhaps because of the sensitivity of his relation with Sheikh Fahad and Ali Al-Khalifa. Relations between the emir's side of the royal family and Khalifa's side were already tense because of a dispute going back two generations, when Khalifa's grandfather was killed in a purge by the emir's grandfather.96

96 John Marcom, op.cit
The experience of the KIO is Spain had become a key point in the history of the KIA. One can divide the factors which contributed in the creation of the KIO crisis in Spain: internal factors which were rooted in the management traditions and governance pattern of the KIA, and external factors which were imposed by the war and invasion coupled with the economic crisis of Spain at the time. A combination of the three factors led the KIA into making the biggest loss of its history and indeed had major impacts on the structure of the organisation.

Before the crisis in Spain the decision making at the KIO was individual based and monopolised by a few individual from the ruling family. This trend has however, gradually changed. Since 2003, neither the chairman nor the director of the KIA has been appointed from the members of the ruling family. In comparison with the procedures and operation strategies before the KIO scandal in Spain, individual decision making is now subject to tighter restriction than before. The dispute within the ruling family, if not solved fully, is less likely to have direct effects on the KIA’s operations, as result of reduced direct engagement by members of the royal family with the authority in executive levels.

Moreover, since the scandal, the parliament of Kuwait has taken a rather proactive role in supervising the KIA. The authority has been obliged to frequently report to the parliament. Some analysts however, argued that the Finance Committee of the Parliament which is in charge of overseeing the KIA’s affairs is relying on the KIA to “police itself and report what it finds”. Given that the KIA does not share information it is hard for both the parliament and the public to have a clear picture of the KIA operations. Nevertheless, since the government did not have a clear procedure to oversee the KIA operations before the KIO crisis in Spain, a parliamentary intervention to control the KIA affairs is a significant step by the parliament.

In addition to the management and governance issues, the Iraqi invasion had played a crucial role in the KIO crisis in Spain. The Kuwaiti authorities have never confirmed that the government in exile had made several payments to some foreign governments to drum up international support for Kuwait at the time of the invasion. Nonetheless, it was frequently mentioned during the crisis that such payments were made from the KIO’s account. Therefore, it is likely that the un-official costs of the liberation operation had been also added to the losses made in Spain. In addition, the absence of the central

government and lack of hope for liberation has been frequently mentioned factors which played an important role in the mismanagement of the assets at the executive level of the KIO.

Finally, the internal politics and financial situation in Spain had also played strong roles in the creation of the KIO crisis. The government of Kuwait has been actively present in European markets for many decades; the business and economic environment in Spain had been perhaps the most hospitable one for financial scams. The Spanish regulations and partnership with someone like Del la Rosa, with a reputation and track record for financial fraud, allowed the KIO management to act with minimum supervision.

Years after the Spanish scandal of the KIO, the government of Kuwait has managed to recover its reputation within the global financial system. Today, the KIA has the highest score on the transparency index amongst its counterparts from the Gulf countries. Another experience of any financial scandal in the scale of the 1990s KIO experience in Spain is less likely to be repeated under the current organisational structure and current global circumstances. In addition to the low probability of another invasion, the KIA benefits from the technical competence which it gained through more than fifty years of experience. This puts the KIA in a desirable risk management position. Therefore, the chances of the KIA’s heavy and direct investments in economies with higher risk are rather small in comparison with what was the case in the 1980-90s. Moreover, the lower engagement of the ruling family has assisted the KIA to gain more independence from the Kuwaiti political elite, with potential self-serving investment goals to pursue.

### 3.6 Investment strategy of the KIA

Safety, income and capital appreciation were the three main pillars of the Kuwaiti investment strategy since early on in the establishment of the country’s SWF. To address the safety of investments, the KIA has rules, procedures and code of conduct designed to minimize any risk factors, through the development of appropriate benchmarks, and responsible investment. The next pillar of the KIA investment strategy is to achieve a targeted rate of return on the investments. The income target is monitored on a three-year rolling average, by designing and maintaining sound asset allocation across various sectors. Finally, protection of assets is another mission of the KIA. The investment strategies are therefore consistent with the return and risk objectives of the authority to maintain the value of allocated funds.
The Strategy and Planning Department (SPD) which is one of the departments within the office of the managing director of the KIA, is the key planner of the authority’s investment strategy. The SPD is responsible for setting the KIA’s long term strategy over a five year horizon with a review every three years, coordinating the development of the KIA’s business plan between various departments, forecasting the FGF and GRF cash flows on a monthly basis, and conducting macroeconomic analysis to assist the GRF and FGF investment committees. There is no information available about the structure of the SPD and what the relation is between the SPD and the rest of the KIA. However, being a part of the office of the managing director the SPD is expected to be closely involved in the day to day operations of the KIA.

Table 3-7: Equity Department’s, mandates and their relative indices

<table>
<thead>
<tr>
<th>Region</th>
<th>Mandate</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA/Canada</td>
<td>American and Canadian Large Cap</td>
</tr>
<tr>
<td>Europe</td>
<td>Pan European Equity Mandates</td>
</tr>
<tr>
<td></td>
<td>European Small and Mid Cap Mandates</td>
</tr>
<tr>
<td>Asia</td>
<td>Japanese Equities</td>
</tr>
<tr>
<td></td>
<td>Pacific Equities</td>
</tr>
<tr>
<td>Emerging Market</td>
<td>Emerging Market Equity</td>
</tr>
</tbody>
</table>

Source: www.kia.gov.kw

Until the mid-1970s the KIO’s assets were concentrated solely in Britain. After this time, however, the KIO entered the American market for the first time. The top 75 most reliable companies of NYSE were the main recipients of the investments in the US. The KIO was still operating in London directly, dealing with the investments in the UK, while in the US, investment were handled via agents. Soon it was clear that if the strategy was to be continued, Kuwait was on the way of becoming a large holder in all the 75 companies. The Kuwaiti government was no longer a marginal operator. Moreover, it was obvious that if the investments remained restricted to the same group of companies, each year’s purchases would have a significant effect on ownership and market prices. Any sudden reaction against foreign ownership within major companies would unfavourably affect not only the safety of the investments but also the KIO’s ability to invest in different markets. Therefore, a new strategy was needed since the Kuwaiti authorities wished to retain a low profile in their deals.  

98 M. W. Khouja and P.G. Sadler, op.cit
As a result, the KIO started to create new portfolios, or develop its existing ones, in other countries. Equity portfolios outside America and Britain (Germany, Switzerland, France, Belgium, Holland and Japan) were created and handled by local banks. As well as penetration into new markets geographically, Kuwaiti investments within American equity market started to spill outside of the 75 companies into more speculative enterprises. Because some significant purchases required disclosure, moving to companies other than the usual list of the 75 companies helped the KIO to maintain as much secrecy as possible for as long as it was convenient.

By 1974, Kuwait’s investment strategy which was previously heavily concentrated on long-term investment took a different direction and evolved along new lines. By the mid-1970s, the allocation of reserves was roughly 60% equities, industry and real estate, and 40% in bonds and first class medium and long-term securities of over seven year’s maturity. The investments in equities were used as a cover against inflation, while the bonds and securities were to provide a turnover of liquid capital.

The operation of the domestic financial sector in Kuwait was rather limited in the 1960s and 1970s. As a result of underdevelopment of the financial sector, Kuwait’s economy did not provide the government owned investment vehicles with channels for major local operations at the peak of Kuwait’s engagement with the global financial system. Therefore, as Kuwait was becoming a more important player in the international financial system, the government started to actively engage in the establishment of a number of financial institutions inside the country. Those institutions were established jointly by the government and the private sector in Kuwait, holding a dual responsibility of managing investments globally as well as promoting local development.

The two major institutions of this type are Kuwait Investment Company (KIC), established in 1962, and Kuwait Foreign Trading, Contracting and Investment Company (KFTCIC) which was founded in 1964. The KIC was created with 50% government ownership and the KFTCIC with 80% government contribution. The KIC and KFTCIC have played an important role in creating a foundation for the development of Kuwait’s financial sector.

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99 M.W. Khouja and P.G. Sadler, op.cit
At the same time Kuwait joined in the creation of a number of joint banking ventures in Europe and other places. The most notable initial incidents of Kuwaiti government investment in the financial sector overseas took place when in the early 1970s, when the country joined in the creation of the *Banque Arabe et Internationale d’Investment* and *Union de Banque Arabe Francaise*.  

Kuwait’s interest in investment in international financial institutions was not limited to the 1960s and ‘70s. Prior to the peak of the recent global financial crisis, along with the other SWFs of the Gulf, the KIA showed particular interest in investment in the financial sector. A $720 million investment in the Industrial and Commercial Bank of China in 2006 made the KIA the largest investor in the bank; a $3 billion purchase of Citigroup’s shares, and a $2 billion investment in Merrill Lynch, which took place during the second half of 2007 and first half of 2008 are the most recent acquisitions of the KIA in the financial sector.

Another sector in which the KIA has been an active investor, is the real estate market. As noted above, by the 1970s, new sectors within various geographic locations were added into the investment universe of the KIO. In 1974, for the first time, and through the Kuwait Investment Company (KIC), Kuwait entered the real estate market. The early purchases in real estate market were Kiawah Island, a major holiday resort on the east coast of America, and St Martins Properties in London, a group with wide interests, but at that time in urgent need of liquidity.

Throughout five decades of active operation as a global investment institution, on various occasions, the KIA has been a patient and quiet shareholder in its holdings around the world. This has been illustrated by the way in which the authority has managed its holdings in Daimler and BP. The KIA has been a shareholder in Daimler since 1969. Daimler-Benz acquired Chrysler in 1998. In 2007, DaimlerChrysler confirmed a deal to sell its loss-making American unit to Cerberus, a US private equity firm, in a move that will cost it €500 million to end an unsuccessful 10-year trans-Atlantic merger. After Chrysler was sold off, there were valid reasons for KIA to divest from DaimlerChrysler, which would have had negative consequences on the already suffering American car production industry. The KIA decided to instead keep

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101 M.W. Khouja. and P.G. Sadler, op.cit
its stake. Some analysts referred to this decision as evidence of the KIA’s responsible investment strategy helping to maintain the balance of the global economy.

Another historical and strategic investment of the KIA which the Kuwait authorities frequently referred to as a sign of their patience and responsibility in the global financial system is Kuwaiti investment in BP. In 1986 the KIO set out to acquire almost 21.6% of the shares in BP. This plan would absorb more than 7% of Kuwait’s overseas investments at the time.¹⁰³ The deal prompted fear in London that it would put Kuwait in a position to be capable of exercising its influence as a shareholder over BP. The British Monopolies and Mergers Commission ordered Kuwait to sell more than half of its holdings in the company. In January 1989, BP announced it would buy 11.7% of its shares back from Kuwait reducing Kuwait’s share to 9.9%.¹⁰⁴

In 1997, the KIA again built up a near 22% holding, after the sale of a tranche of BP shares by the British government on the day of the "Black Monday" stock market collapse. The KIA purchased the BP shares when few other investors were willing to buy, in good faith and to help the British economy to stabilise. Less than a year later, the purchase was referred to Britain's competition authorities, which ordered Kuwait to reduce its stake to less than 10% within 12 months.¹⁰⁵

Towards the end of the 1980s, the KIA started for the first time to engage in investments in emerging markets. Those markets were not the traditional area of expertise for the KIO. The investments were made directly and the recipient countries of those investments included Brazil and Taiwan.¹⁰⁶ Before the late 1980s, a considerable share of the authority’s assets was invested in developed Western economies. The investments had been mainly in medium or long term ventures and scattered around 45 different countries, a high number of which are in the OECD – mainly UK, US, France and Germany. In 1985, it was reported that the lion’s share of GRF assets were invested locally (60%), 31% in Arab countries, 5% in other foreign countries and 4% with international financial organisations like the IMF. In the same year however, the authority was reported to be applying a different strategy for the management of FGF.

¹⁰³ Middle East Economic Digest (1989), 16 January 1989
¹⁰⁵ Macalister, Terry, Kuwait Investment Office in talks to raise BP stake, The Guardian, 4 July 2010
¹⁰⁶ Economist Intelligence Unit (2001), Kuwait in the 1990s, a society in siege, special report no. 2035
The major share of assets (75%) were invested in non-Arab foreign countries, 23% invested locally, the rest in Arab countries.\textsuperscript{107}

Over time, the KIA has paid more attention to investment in the emerging markets of Asia. It has contributed to the establishment of several companies in the last few years, primarily to develop Kuwait’s investments. One of the major eastward steps of the KIA was establishing the Kuwait China Investment Company (KCIC) in 2005.\textsuperscript{108} The KCIC is particularly focusing on investments in emerging Asian markets. In addition, an announcement was made in summer 2008 that the KIA is considering allocating up to $50 billion, or 20 percent of its assets, in Japan. This plan was introduced as part of the authority’s efforts to rebalance its portfolio\textsuperscript{109}.

Another main investment project of the KIA was signing more than $27 billion of investment agreements with nine Asian countries, including Brunei and the Philippines, in August 2008. The KIA agreements with these nine countries include investments in oil, health and foreign affairs sectors. Kuwaiti Finance Minister, Mustafa Shamali, commented on KIA-Asian economies agreements in the local newspapers in Kuwait stating: "the value of the accords and economic and commercial protocols are more than $27 billion, with $3 billion to $4 billion of investments and possible commercial partnerships with each country." He also noted that Kuwait would "cooperate with South Korea, Thailand and the Philippines, in the health sector."\textsuperscript{110} The KIA’s investments in Asia would take place through the KIA directly, or its investment affiliates.

3.7 Conclusion

The KIA has been the sole institution in charge of management of the Kuwait’s sovereign wealth fund (both FGF and GRF). It has diversified the country’s sovereign wealth across the markets in various asset classes and geographic locations. The investment strategy of the fund is designed to include equities and fixed income in the portfolio of investments of the KIA from North America to emerging economies in Asia with more focus in equities (60% of the portfolio) in comparison with fixed income

\textsuperscript{107} ibid
\textsuperscript{108} \textsuperscript{http://www.kuwaitchina.com/}, accessed on 10 October 2010
\textsuperscript{109} Behrendt Sven (2008), \textit{When Money Talks: Arab Sovereign Wealth Funds in the Global Public Policy Discourse} Carnegie Papers
\textsuperscript{110} Thomson Reuters (2008), \textit{Kuwait signed $27 bn of deals in Asian tour-paper}, 17 August 2008
(40% of the portfolio). The investment interest of the KIA in the emerging markets, particularly those in Asia, is on the increase in comparison with figures from previous decades.

The KIA is the only Gulf commodity-based sovereign wealth to have a clear saving policy. 10% of the country’s oil income at any given price of oil for each fiscal year, as well as the investment returns should be transferred every year to FGF’s account.

The governance and management structure of Kuwait sovereign wealth fund has developed over more than five decades of operation. In comparison with other GCC commodity-based sovereign wealth funds, KIA has a clearer relation with the political elite and this is due to parliamentary system in the country. The experience of Kuwait Investment Office in Spain in the 1990s has assisted the government to create a stronger supervisory system which gives the parliament more right to oversee the KIA’s activities.

Like other commodity-based sovereign wealth funds of the Gulf, the KIA has been a rather passive investment institution in terms of its assets and has avoided practicing its ownership rights. The experience of BP has shown that the KIA’s key aim for such passive practice of investment management is mainly to avoid political backlash with the sovereign host of the economies in which the KIA invests.
4 Saudi Arabia’s Sovereign Wealth Funds

4.1 Introduction

Saudi Arabia with proven reserves of 264.1 billion barrels at the end of 2008\textsuperscript{111} is the regions’ most resource rich country. The country has been reported to be ranked as the owner of the second largest government assets in the GCC after Abu Dhabi (although, depending on the source, some analysts estimate that Saudi foreign reserves are bigger than those of Abu Dhabi). Saudi Arabia is the leading oil producer amongst the OPEC countries with an average daily production of 8.291 million b/d in 2010. Total oil exports from Saudi Arabia in 2010 were US$ 203.1 billion out of total exports amounting US$ 246.1 billion. The oil sector is managed solely by the government. Given the trends in Saudi oil output, and the underdevelopment of non-oil sectors, oil export is the major source of government income and has played a key role in determining the growth of the economy.

The Saudi government has been applying oil income saving policies for many decades. The wealth accumulation has progressed gradually since 1962, as a result of oil production increase. The country’s foreign exchange reserves increased significantly between the early 1970s and 1982 due to the oil price booms, and investment returns. During the first oil boom in the 1970s, a large portion of oil revenue was invested in development of the country’s infrastructure, which was aimed at giving Saudi Arabia a key competitive advantage within the region.

The size of Saudi Arabia’s foreign assets has always been closely linked with crude prices. However, other factors like the costs of the Gulf Wars, defence expenditure, and government withdrawals in order to finance foreign debts have affected the size of the Kingdom’s foreign reserves during various periods of time. The Saudi government's long-term plans focus on reducing the country's dependence on oil incomes. Table 4-1 presents the main indicators of the Saudi economy. As is shown in the table, oil exports between 2006 and 2010 totalled an average of $208.3 billion and in 2008 it reached

\textsuperscript{111} www.iea.org, accessed on 2 November 2010
$281 billion which was the highest level from the previous five years. This is due to the record oil prices of 2008. In 2009, there was a sharp decline in the oil markets which led to a significant decline in oil revenues; however, the export income is gradually catching up and is expected to grow over the next few years.

Table 4-1: Saudi Arabia’s main economic indicators

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011 (estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (US $ bn)</td>
<td>356.6</td>
<td>384.9</td>
<td>476.3</td>
<td>375.8</td>
<td>451</td>
<td>486.5</td>
</tr>
<tr>
<td>Private consumption (US $ bn)</td>
<td>94.8</td>
<td>112.4</td>
<td>132.5</td>
<td>143.3</td>
<td>156.8</td>
<td>173</td>
</tr>
<tr>
<td>Government consumption (US $ bn)</td>
<td>83.1</td>
<td>85.9</td>
<td>92</td>
<td>92.9</td>
<td>103.4</td>
<td>114.3</td>
</tr>
<tr>
<td>Gross fixed investment (US $ bn)</td>
<td>66.8</td>
<td>82.6</td>
<td>105.6</td>
<td>98.2</td>
<td>109.3</td>
<td>122.3</td>
</tr>
<tr>
<td>Exports of goods &amp; services (US $ bn)</td>
<td>225.5</td>
<td>249.3</td>
<td>322.9</td>
<td>202</td>
<td>246.1</td>
<td>261.3</td>
</tr>
<tr>
<td>Imports of goods &amp; services (US $ bn)</td>
<td>113.5</td>
<td>145.3</td>
<td>176.7</td>
<td>160.6</td>
<td>170.3</td>
<td>190.2</td>
</tr>
<tr>
<td>Oil production ('000 b/d)</td>
<td>9,222</td>
<td>8,760</td>
<td>9,158</td>
<td>8,196</td>
<td>8,291</td>
<td>8,508</td>
</tr>
<tr>
<td>Oil exports (US$ bn)</td>
<td>188.9</td>
<td>205.5</td>
<td>281</td>
<td>163.1</td>
<td>203.1</td>
<td>214.6</td>
</tr>
</tbody>
</table>

Source: EIU (2010)

The Saudi Arabian Monetary Agency has been the main government body for the management of Saudi sovereign wealth since it was established in 1952. Saudi sovereign wealth fund has been directly managed by the central bank. This practice of managing sovereign wealth is not the same as other Gulf countries like Kuwait where the SWF is managed by a government organisation other than the central bank like KIA. Being the central bank of Saudi Arabia, in addition to management of the country’s sovereign wealth fund, SAMA has various responsibilities including:

- Regulating the country’s banking system. This includes: the supervision of commercial banks, and maintaining the soundness of the financial system.

- Monetary stabilisation responsibilities. This includes: issuing national currency, acting as a banker to the government, monetary policy making, maintaining the value of riyal, holding monetary reserves, assisting the ministry of finance with the annual budgets.
As SAMA is the central bank of Saudi Arabia and holds other responsibilities, in practice it is not specified as a SWF like its GCC counterparts. This has raised a question on whether SAMA is technically a sovereign wealth fund. In contrast with other GCC oil exporters, the indebted Saudi government had very little opportunity to accumulate sovereign wealth over the past few decades. This is why some scholars like Christin Smith Diwan do not consider SAMA as a SWF. Diwan argues that “... there can be no sovereign wealth fund without sovereign wealth, and Saudi Arabia spent much of the past decade in a debtor’s position”. SAMA is deemed as a commodity-based sovereign wealth fund for the following reasons:

1. The major source of wealth for SAMA is commodity export income.
2. The purpose of wealth accumulation by SAMA is stabilisation of Saudi economy against volatile oil markets.  

SAMA’s dissimilarities with other Gulf sovereign wealth funds lie in characteristics which differentiate Saudi Arabia from other GCC oil-rich states. While Saudi Arabia is the major oil exporter of the region, it has the largest land area and biggest population amongst the Gulf countries. Therefore, the government expenditure and domestic investments have consumed a large proportion of the country’s oil revenue since the establishment of SAMA.

In addition to the high government expenditure in the domestic economy which exhausted the oil revenues, Saudi Arabia had experienced severe financial hardship in the aftermath of the first Gulf War. A significantly large share of the country’s oil export income was spent on financing the country’s massive debt which at some point stood as high as 100% of GDP and was accumulated as a result of the high cost of the war. A 9% debt reduction in 2004 was achieved as a result of the government’s effort to finance the sovereign debt. In 2005, another impressive phase of the Saudi debt reduction campaign was fulfilled by financing 29% of the government debt.

Commodity-based SWFs often hold an element of inter-generation saving which is not justified in the case of SAMA. This is why the Saudi government has recently launched new government investment organisation, Sanibel el-Saudi (SES), which it has been

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112 Smith Diwan, Christin (2009), ‘Sovereign Dilemmas: Saudi Arabia and Sovereign Wealth Funds’ in Geopolitics, Volume 14, Issue 2
113 Ibid.
114 Ziemba, Rachel (2008), Petrodollars: How to spend it, RGE Monitor
speculated will incorporate this element. The initiative is yet to be developed and there is very little information available about the structure and the purpose for establishing the organisation. Table 4-2 below shows a summary of Saudi sovereign wealth investment institutions.

Table 4-2: Saudi Arabia SWFs

<table>
<thead>
<tr>
<th>Name of the entity</th>
<th>Establishment</th>
<th>AUM (US $ billions)</th>
<th>Investment focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAMA</td>
<td>1952</td>
<td>433</td>
<td>Gold, foreign bank reserves, securities</td>
</tr>
<tr>
<td>Sanabil el-Saudi</td>
<td>2009</td>
<td>5.33</td>
<td>Commodities, treasury, real estate, equities, foreign currencies</td>
</tr>
</tbody>
</table>

Source: Sovereign Wealth Fund Institute

4.2 The history of the establishment of SAMA

In 1948 George Eddy who at the time was working in the Office of International Finance of the US Treasury Department, and Raymond F. Mikesell, from US State Department, travelled to Saudi Arabia to study a possible currency reform in the country. The market fluctuation in the gold and silver market made it almost impossible to maintain the stability of Saudi currency. By 1951, the Saudi government signed a technical assistance agreement with the United States to reform the monetary and fiscal system.\(^{115}\)

Upon this agreement a financial mission, under management of Arthur Young, was sent to Saudi Arabia to help the government reform the budgetary and administrative system of the Ministry of Finance. The most important recommendation of Young’s mission was the creation of a central bank. Arthur Young convinced the king that it was crucial for the state to have some monetary and banking regulation and he drew up a plan for what became the Saudi Arabian Monetary Agency.\(^{116}\) SAMA was then established under royal decree No. 30/4/1/1046 which was issued on 20/4/1952 by King Abdulaziz. On 05/08/1952 George A. Blowers, a U.S. citizen, was appointed by the king as the first

\(^{115}\) Long, David E. and Sebastian Maisel (2010), *the Kingdom of Saudi Arabia*, Gainsville: University Press of Florida

governor of SAMA, the first board of directors of SAMA was formed and it began practicing its business on 04/10/1952.\textsuperscript{117}

The term monetary ‘agency’ was chosen to avoid using words like ‘bank’ or ‘financial institution’, these would bring to mind financial activities like charging or paying interest which are forbidden in Islamic banking. Charging and paying interest were specifically forbidden in the SAMA charter for that reason.\textsuperscript{118} One of the main aims of SAMA was to help the ministry of finance in centralising the receipts and expenditures of the government in accordance with the authorised budget and in controlling payments so that, all branches of the government would follow the same rules.\textsuperscript{119}

As mentioned above, SAMA was primarily in charge of pursuing policies which could moderate the value of riyal. Over the past decades the responsibilities of SAMA have increased and today it plays most of the roles of a central bank. These activities cover six main categories:

- Issuing the national currency
- Acting as a banker to the government
- Supervising commercial banks
- Managing the country’s foreign exchange reserves
- Conducting monetary policy
- Promoting the growth and soundness of the Saudi financial system

Although, technically management of the country’s sovereign wealth is one of the activities of SAMA, the government of Saudi Arabia has never officially referred to SAMA as the country’s sovereign wealth fund.

**4.3 The emergence of Saudi Arabia’s sovereign assets**

1948 was the year in which the oil sales began. This caused a significant increase in government revenues (see Table 4-3). By 1953 annual revenue was nearly five times more than half a decade before (1948) surpassing US $100 million. Such considerable

\textsuperscript{117} www.sama.gov.sa , accessed on 2 November 2010

\textsuperscript{118} David E. Long and Sebastian Maisel, op.cit

growth of government income, mainly as a result of oil exports, highlighted the demand inside SAMA to develop capabilities to manage the government revenues. By the end of the 1950s the state incomes stood at US $333.7 million.\textsuperscript{120} In the late 1950s, foreign reserves were depleted and imports had to be restrained. These events caused a trend for maintaining high levels of foreign exchange and short-term assets to protect the economy against price shocks and decline in the oil market.\textsuperscript{121}

Table 4-3: Saudi Arabia government revenue (1902-47)

<table>
<thead>
<tr>
<th>Year</th>
<th>Approximate annual revenue of the government</th>
</tr>
</thead>
<tbody>
<tr>
<td>1902-12</td>
<td>£50,000</td>
</tr>
<tr>
<td>1913-25</td>
<td>£100,000</td>
</tr>
<tr>
<td>1926-37</td>
<td>£4.5 million</td>
</tr>
<tr>
<td>1938-46</td>
<td>£5.6 million</td>
</tr>
<tr>
<td>1947-8</td>
<td>£21.5 million</td>
</tr>
</tbody>
</table>

Source: Tim Niblock (1982)

With the accession of Faisal to the throne in 1964 the modern development of Saudi economy began.\textsuperscript{122} When King Faisal assumed the power, he applied more careful economic policies which assisted Saudi Arabia to emerge as a financial giant in the 1970s. The oil price boom of the 1970s elevated the country’s oil revenue higher than its level in the previous decade. The price of oil rocketed in October 1973 which coincided with the high rate of export by Saudi Arabia. In 1974, the government revenue grew 338\% in comparison with the previous year (see Table 4.4). Saudi crude export revenues rose from US $1.150 billion in 1970 to US $29 billion in 1975. By the late 1970s, the country’s oil income formed up to 40\% of total oil revenues for all of the Gulf countries\textsuperscript{123} (see Figure 4-1).


\textsuperscript{121} Wells, Donald A. (1974), Saudi Arabian Revenues and Expenditures, the Potential for Foreign Exchange Savings, Maryland: Johns Hopkins University Press


\textsuperscript{123} J. S. Birks and C.A. Sinclair, op.cit
As a result of oil revenue increase, public and private sector overseas portfolio investments rose rapidly from US $785 million in 1969 to US $49,589 million in 1976. The income on this accounts also, increased during this period from US $59 million to US $3,800 million (see Table 4-4). By the beginning of the 1980s Saudi foreign assets were about US $132,920 million and income derived from them was US $10,074 million.\textsuperscript{124}

Table 4-4: Saudi overseas investments and income 1969-1976 (US $ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Value of foreign assets</th>
<th>Income earned from foreign assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969</td>
<td>785</td>
<td>59</td>
</tr>
<tr>
<td>1970</td>
<td>893</td>
<td>71</td>
</tr>
<tr>
<td>1971</td>
<td>1,543</td>
<td>79</td>
</tr>
<tr>
<td>1972</td>
<td>2,869</td>
<td>113</td>
</tr>
<tr>
<td>1973</td>
<td>4,786</td>
<td>200</td>
</tr>
<tr>
<td>1974</td>
<td>19,918</td>
<td>1,175</td>
</tr>
<tr>
<td>1975</td>
<td>38,704</td>
<td>2,389</td>
</tr>
<tr>
<td>1976</td>
<td>49,589</td>
<td>3,800</td>
</tr>
</tbody>
</table>

Saudi oil revenue continued to grow throughout the 1970s until the mid-1980s. The price of oil increased from US $3 per barrel in 1972, to US $35 per barrel in 1980. Saudi oil revenue respectively had risen from US $3.1 billion in 1972 to US $102 billion in 1980. However, various events changed this trend and by 1986, the price of oil fell to under US $10 per barrel. This was due to a non-OPEC production increase.

\textsuperscript{124} McLachlan, Keith and Narsi Ghorban (1978), \textit{Economic Development of the Middle East Oil Exporting States}, EIU Special Report No 54
coupled with the increase in Iran and Iraq’s export in response to their financial demands driven by the cost of the war. A 61.4% decline in global oil prices between 1980 and 1986, led to a sharp decline in Saudi oil revenue from US $113.2 billion in 1981 to US $42.3 billion in 1985 to US $20 billion in 1986.125

Table 4-5: Annual rates of change in revenues, 1970-80

<table>
<thead>
<tr>
<th>Year</th>
<th>Change compared with the year before (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>50</td>
</tr>
<tr>
<td>1972</td>
<td>42</td>
</tr>
<tr>
<td>1973</td>
<td>75</td>
</tr>
<tr>
<td>1974</td>
<td>388</td>
</tr>
<tr>
<td>1975</td>
<td>11</td>
</tr>
<tr>
<td>1976</td>
<td>10</td>
</tr>
<tr>
<td>1977</td>
<td>9</td>
</tr>
<tr>
<td>1978</td>
<td>9</td>
</tr>
<tr>
<td>1979</td>
<td>8</td>
</tr>
<tr>
<td>1980</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: Donald A. Wells (1974)

The oil price decline of the mid 1980s and high government expenditure led the country into a massive budget deficit which was financed by foreign borrowing. The government expenditure expanded from just above US $ 1 billion in 1970 to US $33 billion in 1980 (see Table 4-6). The growth of government expenditure continued through the 1980s while the oil revenue shrunk as a result of above mentioned factors. The costs of development plans and the war operation in the early 1990s had pushed Saudi Arabia to the edge of bankruptcy in the late 1990s. Saudi government borrowed emergency loans to finance its debt.

In the light of high oil incomes, several development plans for the modernisation of the Saudi economy have been introduced by the government calling for high expenditure in infrastructure and development projects. The first development plan started in the 1970s. During the first two development plans, the government paid particular attention to seaports, increase of electrical power capacity, and roads. The third economic plan

125 Foley, Sean (2010), *The Arab Gulf States, Beyond Oil and Islam*, London: Lynne Rienner
(1980-1985) focused on increasing spending for education, social services, and health care. The fourth development plan (1985-1990) was to enhance the role of private sector and joint ventures with the public sector. The fifth plan which was inspired by the Iraqi invasion of Kuwait, emphasised improvement of the national defence. The sixth plan anticipated economic growth at 3.6% each year, while the seventh plan (2000-2007) continued to promote development of the private sector and diversification from oil.\textsuperscript{126} The government pledges to education, social welfare and other projects which were introduced by the five year economic development plans led to the high government budget deficit from 1983 to 1999.

Table 4-6: Saudi government revenues and expenditures, 1964-1980 (US $ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenues</th>
<th>Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964</td>
<td>590.2</td>
<td>533.7</td>
</tr>
<tr>
<td>1965</td>
<td>684.9</td>
<td>753.1</td>
</tr>
<tr>
<td>1966</td>
<td>872.9</td>
<td>961.1</td>
</tr>
<tr>
<td>1967</td>
<td>1,116.7</td>
<td>1,015.5</td>
</tr>
<tr>
<td>1968</td>
<td>1,097.1</td>
<td>1,054.3</td>
</tr>
<tr>
<td>1969</td>
<td>1,230.0</td>
<td>1,097.7</td>
</tr>
<tr>
<td>1970</td>
<td>1,385.8</td>
<td>1,203.8</td>
</tr>
<tr>
<td>1971</td>
<td>2,072.5</td>
<td>1,279.1</td>
</tr>
<tr>
<td>1972</td>
<td>2,933.6</td>
<td>2,132.2</td>
</tr>
<tr>
<td>1973</td>
<td>5,000</td>
<td>4,000</td>
</tr>
<tr>
<td>1974</td>
<td>24,400</td>
<td>6,000</td>
</tr>
<tr>
<td>1975</td>
<td>27,200</td>
<td>9,000</td>
</tr>
<tr>
<td>1976</td>
<td>29,900</td>
<td>11,700</td>
</tr>
<tr>
<td>1977</td>
<td>32,600</td>
<td>15,200</td>
</tr>
<tr>
<td>1978</td>
<td>35,400</td>
<td>19,800</td>
</tr>
<tr>
<td>1979</td>
<td>38,100</td>
<td>25,700</td>
</tr>
<tr>
<td>1980</td>
<td>40,900</td>
<td>33,400</td>
</tr>
</tbody>
</table>

Source: SAMA Annual Report (1982), and Donald Wells (1974)

During the 1990s, the oil sector had contributed to the Saudi economy on average up to 35% of the nominal GDP, which formed 75% of government revenue and 85% of

\textsuperscript{126} Sorenson, David S. (2008), \textit{An Introduction to the Modern Middle East}, Colorado: Westview Press
export receipts. In 1993, a combination of oil price and investment income decline pushed the government deficit to 10.6% of GDP.\textsuperscript{127} In an effort to increase the government income, Saudi Arabia proposed an increase in the overall OPEC production quota and individual country quota allocations. The Saudi proposal was accepted by OPEC by 1997. OPEC’s overall production ceiling has been raised to 27.5m barrels/day, from 25.03m b/d, and the new quota took effect on the 1\textsuperscript{st} of January 1998 for six months. Saudi Arabia’s quota therefore, increased by 9.5% (from 8 to 8.76m b/d).\textsuperscript{128} The oil production increase assisted the Saudi government in recovering from its extended period of economic hardship.

Fluctuations in Saudi Arabia's foreign assets have generally reflected changes in oil revenue. Foreign assets reached a high level during early 1980s (US$131.3bn in 1981, US$137.9bn in 1982 and US$136.2bn in 1983). Following these remarkable years, the level of foreign assets declined with decrease of oil revenue. By contrast, following the costs and falling oil earnings caused by the 1991 Gulf war, foreign assets fell to US$6.1bn in 1991, and reached US$8.8bn by 1995. A 17% increase in export revenue in 1995, however, led to foreign assets rising to US$14.7bn in 1996. In 1998 a significant share of foreign assets were withdrawn to finance the current account deficit. Oil revenues had strongly recovered by 2000 and foreign assets reached US$49bn that year before dropping to US$42bn in 2002 as oil revenues again fell, then increasing to US$59.8bn by the end of 2003 as oil export revenues rose by an estimated 30%. The gross foreign assets of SAMA fell from US$72.6bn in 1997 to US$54.5bn in 1999, before recovering to US$62.3bn by the end of 2000 and then rising again to US$72.8bn by the end of 2003.\textsuperscript{129}

The recovery in oil prices during 1999 and 2000 helped rebuild SAMA's net foreign asset position. Table 4-7 shows SAMA’s assets since 2005. As it is illustrated in the table, there has been a sharp increase in figures for all the asset classes illustrated in the table below between 2005 and 2008 which reflects the record oil prices during that period coupled with government expenditure cuts and liberalisation policies. As a result, after a long period of current account deficit, a surplus of US $134 billion was reported

\textsuperscript{127} Economist Intelligence Unit (2001), \textit{Saudi Arabia Country forecast}
\textsuperscript{128} Economist Intelligence Unit (1998), \textit{Saudi Arabia Country forecast}
\textsuperscript{129} Economist Intelligence Unit (2004), \textit{Saudi Arabia Country Factsheet}
in 2008 which was due to an increase of 41.4% in export income for goods and services (36.9% in oil sector and 16.5% in non-oil).130

Table 4-7: SAMA's financial position (US $ millions)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>Average (2005 to 2010)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency cover (gold)</td>
<td>89751</td>
<td>94319</td>
<td>106054</td>
<td>121066</td>
<td>123127</td>
<td>123638</td>
<td>109659</td>
</tr>
<tr>
<td>% from total</td>
<td>0.14</td>
<td>0.11</td>
<td>0.09</td>
<td>0.07</td>
<td>0.08</td>
<td>0.08</td>
<td>0.09</td>
</tr>
<tr>
<td>Cash in vault</td>
<td>18262</td>
<td>12777</td>
<td>23842</td>
<td>27053</td>
<td>23876</td>
<td>22550</td>
<td>21393</td>
</tr>
<tr>
<td>% from total</td>
<td>0.03</td>
<td>0.01</td>
<td>0.02</td>
<td>0.02</td>
<td>0.02</td>
<td>0.01</td>
<td>0.02</td>
</tr>
<tr>
<td>Deposits with banks abroad</td>
<td>113954</td>
<td>123346</td>
<td>246792</td>
<td>379487</td>
<td>335673</td>
<td>318796</td>
<td>253008</td>
</tr>
<tr>
<td>% from total</td>
<td>0.18</td>
<td>0.14</td>
<td>0.21</td>
<td>0.22</td>
<td>0.21</td>
<td>0.20</td>
<td>0.19</td>
</tr>
<tr>
<td>Investments in foreign securities</td>
<td>369973</td>
<td>625667</td>
<td>790559</td>
<td>1154247</td>
<td>1071542</td>
<td>1126127</td>
<td>856353</td>
</tr>
<tr>
<td>% from total</td>
<td>0.60</td>
<td>0.71</td>
<td>0.66</td>
<td>0.68</td>
<td>0.68</td>
<td>0.70</td>
<td>0.67</td>
</tr>
<tr>
<td>Other assets</td>
<td>27464</td>
<td>28215</td>
<td>29569</td>
<td>28142</td>
<td>16435</td>
<td>19589</td>
<td>24902</td>
</tr>
<tr>
<td>% from total</td>
<td>0.04</td>
<td>0.03</td>
<td>0.02</td>
<td>0.02</td>
<td>0.01</td>
<td>0.01</td>
<td>0.02</td>
</tr>
<tr>
<td>Total</td>
<td>619404</td>
<td>884324</td>
<td>1196816</td>
<td>1709995</td>
<td>1570653</td>
<td>1610700</td>
<td>1265315</td>
</tr>
</tbody>
</table>

Source: Saudi Arabian Monetary Agency (2010)

On the other hand, there was a decline in SAMA’s total assets between 2008 and 2010 which was a result of the recent global financial crisis. SAMA’s foreign holdings were estimated to stand above $300billion in 2008.131 SAMA’s portfolio has been extremely overweight in foreign securities as such on average 67% of the total assets during this period were invested in securities. This has been one of the main reasons that, after the crisis, SAMA has reported smaller losses on its portfolio in comparison with other GCC sovereign wealth funds which were speculated to have lost about 20%-30% of their assets. The contribution of the oil sector to GDP has remained high in the Saudi economy and the latest figures by SAMA shows a contribution of 48.1 percent during 2009. The high oil prices, contribution of the oil sector, and government expenditure reduction, have assisted the Saudi government in continuing to reduce the public debts.

130 Sven Behrendt, op.cit
131 Ibid
SAMA’s official figures show that the public debt dropped to Rls 225 billion by the end of 2009 from Rls 237 billion in the preceding year.\textsuperscript{132} The Sovereign Wealth Fund Institute reported SAMA’s total foreign assets as high as $439.1 billion in 2010.\textsuperscript{133}

### 4.4 Investment strategy of SAMA

Reliance on depleting oil reserves as the main source of government income has been a major obstacle in oil dependent economies. To resolve this issue, the governments of oil rich countries have been trying to reduce their economic dependence. There have been two main economic models that can be followed by those countries to tackle the issue; the first approach is transforming the surplus income into various types of assets to generate investment income to cover the expenditure when the oil runs out. The second is to invest the surplus oil income in the domestic economy to support the development of non-oil economic sectors, in order to sustain the government income after the oil is finished. Both approaches attempt in one way or another to secure the welfare of the future generations. Most of the Gulf economies have chosen the first approach for various reasons. In most cases, the domestic economy had very little capacity to absorb the surplus oil revenues and distribution of cash amongst the citizen would in the long run have inflationary effects. In the case of Saudi Arabia, however, the policies have been chosen in a different direction when compared with other GCC oil-rich states.

One of the key differences between the Saudi economy and other GCC countries is high government expenditure. Various factors have contributed to such high expenditure. Firstly, Saudi Arabia has the largest population amongst the GCC countries by a fairly high margin which has given a different characteristic to the Saudi economy. The relationship between the state and the nation in Saudi Arabia has been highly influenced by oil income. The government has used different channels, like granting contracts for development projects, and public or individual subsidies, to distribute wealth amongst Saudi citizens\textsuperscript{134} to maintain a good relationship with the public. Secondly, the defence expenditure in Saudi Arabia has been significantly higher than its GCC neighbouring countries. Finally, even though, Saudi Arabia has suffered from various economic bottlenecks which had lowered the country’s absorptive capacity for many years, like underdevelopment of the infrastructures and lack of administration competence, the cost

\textsuperscript{132} SAMA (2010), SAMA 46\textsuperscript{th} Annual Report
\textsuperscript{133} [http://www.swfinstitute.org/swfs/sama-foreign-holdings/](http://www.swfinstitute.org/swfs/sama-foreign-holdings/), accessed on 21 January 2010
\textsuperscript{134} David E Long and Sebastian Maisel, op.cit
of government-sponsored local development projects has contributed to the increase of the government expenditure.\textsuperscript{135}

The oil export incomes have been the only source for financing Saudi Arabia’s high government expenditure. This has made the Saudi economy extremely vulnerable to oil price fluctuation. As a result of this, the Saudi government has cushioned some of the oil income abroad to protect the economy against oil price shocks. SAMA, which has been the main government organisation to manage the Saudi state-owned assets abroad, has applied rather conservative investment policies to minimise the investment risks which could disturb the inflow of Saudi government income. Therefore, most of SAMA’s foreign reserves are held in low-risk, liquid assets with low investment return like bank deposits, certificates of deposit and bonds issued or guaranteed by developed economies, while other GCC governments concentrated on high-risk assets with higher profit such as equity shares and property.

SAMA foreign reserves have been mainly invested in US dollars. The overweight Saudi investment in dollar is indeed a bi-product of the historical economic relationship between Saudi Arabia and the United States. This is similar to the investment strategy of Kuwait’s government assets in the early years of establishment of the KIA which was mainly affected by the country’s economic links with the United Kingdom. The Saudi oil income has been directed towards investment opportunities in the US as a result of various economic links between the two countries. Strong political alliance with the American administration has led to the formation of various factors which created SAMA’s dollar dominated investment pattern;

- **Close co-operation with the US in oil production:** Saudi Aramco (Arabian American Oil Company) has been the major oil producer in Saudi Arabia since the discovery of oil (see Table 4-8). Therefore, such close cooperation in production of oil has diverted Saudi petrodollars towards American markets.

- **The currency of oil trade:** Since the early 1970s, OPEC members decided to invoice oil sales in US dollars. This decision was made as a part of a proposal

\textsuperscript{135} Kaith McLachlan and Narsi Ghorban, op.cit
which was put forward by the Saudi government and was influenced by Saudi-US economic relations.\textsuperscript{136}

- **Saudi-US agreement for purchase of US Treasury Bills:** The Treasury Secretary of the United Stated, William Simon, signed a secret agreement with the Saudis to buy US Treasury bills before they are publicly auctioned. Such an agreement between the two countries was made to invest Saudi wealth in the US budget deficit to support the value of the dollar, to keep the US interest rates low, and to promote American domestic growth and consumption.\textsuperscript{137}

- **A safe investment opportunity to safeguard Saudi sovereign wealth:** Investment of Saudi oil revenues in US Treasury Bills protected Saudi foreign assets from risks of currency conversion and protected the Saudi government portfolio from investment risks.\textsuperscript{138} In addition, the US government has guaranteed anonymity of the GCC governments’ investment in the US Treasury Bonds. The American Treasury refused disclosure of the Gulf countries’ holdings of Treasury Bills on an individual country basis.\textsuperscript{139} Given the strategic situation of Saudi Arabia, both regionally and domestically, such anonymity has served for the best interest of the Saudi government. It has also provided SAMA sustainable low return-low risk investment opportunities which suit the Saudi government’s demand for safe accumulation of assets abroad to stabilise the domestic economy.

Table 4-8: Saudi Oil revenue by company, 1938-73 (US $ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Aramco</th>
<th>Getty Oil</th>
<th>AOC</th>
<th>Other</th>
<th>Total revenue</th>
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<td>1939</td>
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<td>-</td>
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<td>2.0</td>
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<td>1944</td>
<td>2.5</td>
<td>-</td>
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</table>


\textsuperscript{137} Ibid


\textsuperscript{139} Government Accounting Office (GAO), *Are OPEC Financial Holdings A Danger to the US Banker or the Economy?*, GAO, ID 79-45 11 June 1979
Continued

<table>
<thead>
<tr>
<th>Year</th>
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SAMA like some other GCC sovereign wealth funds, i.e. KIA, was established by Western experts. One can find elements of the long-term impact of American advisors to the Saudi government from the early years of SAMA until today. The initial set ups of SAMA were managed by American experts while its counterpart, KIA was founded by British experts. Therefore, SAMA has been directed towards the US economy and to support the dollar, for the same reasons as the KIA’s assets were invested in the UK and
helped to maintain the value of pound for many years. There has been however, no sign of power struggle between the Saudis and the Americans when it was time to transfer SAMA’s management to the local experts. Until today, most of the high managements at SAMA have been educated at American universities.

Holding of deposit with foreign banks has been another type of investment which has been favoured by SAMA. The reason for such investments has been indeed to maintain the safety of the government’s foreign assets. The financial institutions which have received these investments have been chosen from amongst the most credible institutions globally. Prior to 1973, a list of 35 banks was authorised by SAMA to receive the authority’s deposit savings. The complete list of these banks was not found throughout this study however, the most probable scenario is that only foreign banks with high credit rating were authorised to receive SAMA’s deposits.

4.4.1 Development of SAMA investment strategy in the 1970s

Until the early 1970s, the Saudi government investment strategy was dominated by safety of assets and the maintainance of economic and political relations with the United States. In 1974 for the first time the Saudi government debated investment opportunities which would offer a higher return. Although, the Saudi government’s portfolio of assets has always been much more conservative in comparison with other Gulf countries, SAMA’s investment practices went through a series of change in the mid-1970s. After the oil boom of the 1970s, with the rapid growth of Saudi government income, SAMA was able to afford investment risks. One of the alterations which were made in SAMA’s investment strategy in the 1970s was amendment of the list of 35 banks authorised to receive SAMA deposits. More European and Asian banks in countries with higher return on bank savings were added to the list of authorised banks of SAMA; therefore, high investment return has become an element in forming SAMA’s investment pattern.

The list of authorised banks by SAMA was further altered in October 1975. Seventeen more banks were added to the list; including Royal Bank of Canada (Canada), Mellon Bank (US), United California Bank (US), Skandinaviska Enkilda Banken (Sweden), Bayerische Vereinsbank (Germany), Westdeutsche Landesbank (Germany), Credit Bank of Brussels (Belgium), Hong Kong Shanghai (China), Sumitomo Bank (Japan), Dai Ichi
Kangyo Bank (Japan), and Bank Kobe (Japan). The addition of these banks shows how geographical diversification of Saudi sovereign wealth assets started in the mid-1970s to increase the investment returns.

In addition to adjustments to the list of authorised financial institutions which received the Saudi government’s deposit holdings, SAMA’s strategy in dealing with foreign banks has faced another change. The maturity of Saudi government deposits with foreign banks were shortened during the 1970s. This had been as a result of the changes in the money markets and not a choice of strategy by SAMA. The banks which received deposits from investors like SAMA, would lend the deposits in the form of loans to their customers. These loans were a key source of income for the banks and helped to pay the interest of the deposit holders. Due to the global economic condition, during the mid-1970s, there was lower demand for borrowing (from the banks). Therefore, the banks which received large blocks of deposits were not able to make profit from lending those deposits to their consumers as much as they did before. This has made the banks reluctant to take large blocks of money for longer terms at the time of low demands for loans as keeping the larger, long-term deposits would have slightly higher costs than the shorter ones. As a result of that, a significant share of assets which were allocated for longer term investments by SAMA in foreign banks were left in cash without available investment opportunities.

Another change in Saudi government investment strategy in the 1970s was using money brokers in London for the first time to invest SAMA’s assets in foreign financial institutions. Until the mid-1970s, all the deposits in foreign banks were handled by SAMA staff inside Saudi Arabia. The use of money brokers had been avoided by the head of SAMA at the time, Anwar Ali. He strongly believed as a matter of principle that, central banks should not use money brokers, although, the use of the brokers was initially considered by Anwar Ali shortly before his death in November 1974, and it was approved soon after the succession of the new governor: Abdel-Aziz Quraishi. The London-based brokers, like the SAMA staff in Saudi Arabia, were restricted to work only with banks on the list of approved institutes by SAMA (some of which were mentioned above).

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140 Field, Michael (1976) ‘The Oil Surplus’ in *Financial Times Survey*
141 Ibid
142 Economist, 5 May 1973
In addition to changes in SAMA’s bank deposit holding strategy, in 1970s, the Saudi government for the first time was interested and financially capable of investing in the equity market. Between mid 1970s and mid 1980s, the international demand for capital in petroleum industry was considerably high ($565 billion globally).\(^{143}\) This attracted the Saudi government’s attention to investments in foreign petroleum companies. Ahmad Zaki Yamani, the Saudi Minister of Petroleum at the time, expressed the government’s interest in investments in foreign oil companies and in the importing countries’ downstream oil operations. All SAMA equity investments have always been kept less than the voting threshold of the companies in which the investment is held at all time. Saudi government investment in equity markets has not remained limited to the petroleum sector. In 1973, the government established a new committee which was headed by late King Fahad Al-Saud, who was the Minister of Interior at that time in King Faisal’s cabinet. The purpose of the establishment of the committee was to review the government investment policies and to recommend new investment opportunities.\(^{144}\)

**4.4.2 SAMA investment pattern adjustment during 1980s and 1990s**

The key element of adjustment in Saudi government investment strategy in the 1980s was the reduction of the share of dollar-dominated assets in SAMA portfolio of investments. In 1982, SAMA’s total foreign investment in the dollar was reduced to 60% while 40% was invested in the deutsche mark and yen.\(^{145}\) Such currency diversification was a reaction by the Saudi government to the global political environment. In 1980, when the US government froze Iran’s foreign assets in America, Saudi Arabia became concerned about the potential danger of overweight investments in US markets at the time of a political crisis with the US government. As a result of this the Saudi government reviewed the country’s investment approach to gradually reduce Saudi holdings in the US.\(^{146}\) The reason for such reduction in the size of Saudi assets in the United States was not officially announced by government.

The 1990s was perhaps one of the most difficult decades for the Saudi economy. There has not been any particular change of investment strategy in SAMA during this period. As was discussed earlier, the Saudi government had to use the financial reserves which

\(^{143}\) Chase Manhattan Bank (1971), *Capital Investments of the World Petroleum Industry*

\(^{144}\) Donald A. Wells, op.cit


\(^{146}\) Phone interview with Hussein Askari, February 2010
were accumulated during the oil boom of the early 1980s to finance huge domestic expenditures and the costs of the first Gulf War. By mid-1992 official external assets were reported to stand at the minimum level which was needed for ensuring the confidence in Saudi currency. The government was forced to borrow heavily in the international market. Despite the high demand for capital in the global markets during this period, there was no sign of moving towards high-income generating investment by SAMA to cover the government deficits. The reliance of the government on oil income was higher than the previous decade. In the 1990s, oil revenues accounted for around 90% of GDP which has increased from 75% during the 1980s.147

4.4.3 The impact of the financial crisis of 2008 on SAMA investment strategy

Unlike other GCC funds SAMA investment pattern has not been highly affected by the recent global financial crisis. Despite the fluctuation of size of SAMA’s dollar-dominated investments, Saudi government has maintained strong support for dollar at all times. In 2008, SAMA was reported to hold about 85% of Saudi’s foreign exchange reserves in dollar-denominated fixed-income securities.148 After the financial crisis of 2008, most of the global investment institutions, including the Gulf commodity-SWFs, were reported to shift the investments from the US markets into European and emerging markets. SAMA however, has not made any visible shift of investments strategy towards the emerging markets. In an interview with the CNN in January 2010 Mohammad Al-Jasser, the governor of SAMA, explained the rationale for the Saudi government investment’s policy in response to the speculations on the Gulf oil-rich state’s investment currency diversification from the dollar:

“The dollar-peg has served our interest very well since 1986 and there is no emotional attachment. It’s basically self interest. And, that is based on the objective analysis of our balance sheets. 100% of our exports are denominated in dollar, and this is because of international markets; it is not by our choice, and about 70% of our imports are denominated in dollars. In the past and in the present, and probably for the foreseeable future, the peg to dollar has served our

148 England, Andrew (2008), Saudis to launch $5.3 billion sovereign fund, Financial Times, 29 April 2008
Saudi Arabia’s Sovereign Wealth Funds

SAMA’s economy very well. But, never say never. If our economy diversifies much greater, then probably there will be reconsideration for this system.”

SAMA’s heavily dollarized portfolio has served the agency quite well during the recent financial crisis. As opposed to the other Gulf CSWFs, SAMA has not engaged in investments in risky assets/markets. Therefore, while most of the Gulf CSWFs have made huge losses as a result of the global financial crisis, SAMA’s heavy investments in US Treasury Bonds kept their value.

4.4.4 SAMA investment strategy

SAMA’s portfolio of investment includes many assets riskier than a classic central bank portfolio like equity, corporate bonds and alternative funds. The key investment goal for SAMA has been to protect the domestic economy against oil price shocks; hence, SAMA’s assets have been kept in a highly liquid and accessible portfolio of investment. Short-term investments like bank deposits and government bonds of industrial countries, particularly US Treasury Bills, have formed a large part of SAMA’s portfolio. McKinsey & Company estimated that 20% of SAMA’s foreign assets are held in cash; 55%-60% of the assets are in fixed-income assets, and 20%-25% in equity.

High exposure of fixed-income and relatively underweight equity investment make SAMA a conservative investor in comparison with other Gulf SWFs.

All in all, SAMA has always been, and is likely to continue being, a relatively conservative investor in compare with other Gulf CSWFs. As Hamad Al-Sayari, the former governor of SAMA described the authority’s investment strategy, SAMA holds some equity investments, but it does not engage with direct investments, real estate or, exotic financial products. Although, SAMA holds riskier assets than a typical central bank, its portfolio is more similar to classic central bank reserve portfolios than the usual diversified long-term sovereign wealth fund investors. Based on the definition of different types of SWF which was given in previous chapters, SAMA is a stabilisation fund rather than a wealth maximization or intergeneration saving sovereign wealth management organisation. Therefore, the key focus of SAMA in all of its investment

150 Brad Setser and Rachel Ziemba, op.cit
151 Rachel Rachel (2010), op.cit
152 Sven Behrendt Sven (2008), op.cit
activities at all times, has been maintaining the initial value of the assets with safe investments in assets with low risk-adjusted return.

4.5 Governance and structure

SAMA is governed by a board of directors with five members including the governor and vice governor. The governor and vice governor are appointed by a royal decree for terms of four years which are extendable. The other three members of the board are appointed from the private sector. These members are also appointed by a royal decree and for a period of five years. The Minister of Finance and the Council of Ministers advise the king with recommendations for appointment of all members of the board of directors of SAMA. The current members of SAMA’s board of directors include:

1. Dr. Muhammad Al-Jasser, Chairman of the board and the governor,

2. Dr. Abdulrahman Abdullah Al-Hamidy, Vice Chairman

3. Dr. Abdulrahman A. Alkalaf, Deputy Governor for Technical Affairs

4. Ibrahim Abdullah Al-Nassar, Deputy Governor for Administration and Finance

5. Abdulaziz Bin Zaid Al-Quraishi

6. Muhammad Obaid Bin Sa’eed Bin Zagar

7. Abdulaziz Bin Muhammad Al-Athel
Figure 4-2: SAMA organisation chart

Over decades of operation, SAMA has proven a high level of institutional stability in senior management levels. All of the top management figures at SAMA had served for long terms of office. The previous governor of the authority, Hamad Saud Al-Sayari, was the longest serving head of central bank in the Gulf and stayed in his position for 26 years (from 1983 to 2009). Upon Al-Sayari’s retirement from SAMA, he was replaced by SAMA’s vice governor, Muhammad Al-Jasser on the 14th of February 2009. Prior to joining SAMA in 1995 as the vice governor, Al-Jasser held a number of government positions including: Acting Deputy Minister of Finance for Budget and Organisation in the Saudi Ministry of Finance and Executive Director for Saudi Arabia at the International Monetary Fund. He was also awarded the King Abdulaziz Medal of the First Order.

Although the change of Al-Sayari happened through a government reshuffle by King Abdullah who changed 13 government officials, including: replacing the head of the religious police and appointing first-ever woman deputy minister of Saudi Arabia, his appointment is not expected to translate into drastic change of strategy at SAMA. Some analysts speculated King Abdullah’s decision for introducing new leadership at SAMA...
was a sign of the kingdom’s effort to adjust with the challenges in the years ahead with possible lower oil prices and recovery from the global economic crisis.\textsuperscript{154}

The overall response to the appointment of a new head of SAMA in 2009 was positive. A chief economist at \textit{Banque Saudi Fransi}, John Sfakianakis, commented on Al-Jasser’s appointment as being “an excellent choice to run the most important central bank in the region and one of the most important in the G-20”.\textsuperscript{155} Based on SAMA’s history of organisational structure, however, it was extremely unlikely that the Saudi government would have brought a new figure from outside of SAMA to this position. Moreover, having served many years as the vice governor, it is not likely that Al-Jasser will initiate drastic measures for change at SAMA. Instead, it is expected that his strategies as the governor will be a rather smooth continuation of SAMA’s policies during his time as the vice governor.

Table 4-9: SAMA governors since its establishment

<table>
<thead>
<tr>
<th>Name</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>George Bowlers</td>
<td>1952</td>
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<td>Ralph Standish</td>
<td>1954</td>
</tr>
<tr>
<td>Anwar Ali</td>
<td>1958</td>
</tr>
<tr>
<td>Abdulaziz Al-Quraishi</td>
<td>1974</td>
</tr>
<tr>
<td>Hamad Al-Sayari</td>
<td>1983</td>
</tr>
<tr>
<td>Modammad Al-Jasser</td>
<td>2009</td>
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Source: \texttt{www.sama.gov.sa}

\textbf{4.5.1 History of governance at SAMA}

For the first 22 years of its establishment, SAMA was managed by non-Saudi individuals, due to the lack of sufficient expertise. During those years, three foreign governors served SAMA the first two of which were American, and the third was a Pakistani. Thereafter, Saudis have managed what has become one of the most powerful

\textsuperscript{154} \url{http://www.saudi-us-relations.org/}, accessed on 29 April 2010

\textsuperscript{155} Sergie, Mohammed Aly (2009), \textit{Saudi Arabia Replaces Head of Central Bank}, Wall Street Journal, 15 February 2009
central banks of the Gulf. Growing resources of the government were used to build an efficient administration in SAMA.\textsuperscript{156}

The longest serving foreign governor of SAMA, Anwar Ali, took the office from his American predecessor six years after the establishment of SAMA in 1958. He stayed in his position for 16 years until he died in November 1974. Anwar Ali was hired by the Saudi government in October 1957 to design and implement a program of fiscal and monetary reform. Prior to his employment in Saudi Ali was the Director of the Middle East department of the IMF. He graduated from Ismailia University in Lahore in 1934, with an MA in economics. He had served as Undersecretary in the Ministry of Finance in India, Deputy Undersecretary in the Ministry of Finance in Pakistan and director of the National Bank in Pakistan before he took on his post with the IMF.

Along with Anwar Ali, another former IMF Executive Director, Ahmed Zaki Saad, entered Saudi to assist the government with monetary policies. Saad, was born in Egypt, attended the universities of Cairo and Paris and spent nine years on foreign diplomatic assignments prior to his appointment at SAMA. He spent six years as Undersecretary of State in the Ministry of Finance and had served as Governor of the National Bank of Egypt, Executive Director and Governor of the International Monetary Fund and Governor of the International Bank for Reconstruction and Development. Both Anwar Ali and Zaki Saad enjoyed a high level of support from the king.\textsuperscript{157}

As noted above, Ali had a close relation with King Faisal, and his absence left a vacuum on the top management level at SAMA when the Saudi government resources were flourishing as a result of an oil price boom. This vacuum was filled by the establishment of an Investment Committee, which since then remained active within SAMA’s organisation structure, to handle day to day investment operations with minimum interruption until the next Governor assumes the office. To assist the committee SAMA employed a six-man team of bankers from Credit Suisse-White Weld and Barings. These new arrangements were also a sign of the growing scale and complexity of SAMA’s

\textsuperscript{156} Hertog, Steffen (2010), \textit{Princes, Brokers, and Bureaucrats, Oil and the State n Saudi Arabia}, Ithaca: Cornell University Press

operations which replaced an earlier system under which the day to day investment work was done by two or three individuals from Morgan Guaranty.\(^{158}\)

A Royal Decree was issued on 26\(^{th}\) of November 1974 appointing Abdulaziz Al-Quraishi as the Governor of SAMA. He was the first Saudi to occupy this position. By the end of 1974, the headquarters of SAMA was relocated from Jeddah to Riyadh. When Al-Quraishi became the Governor, Khaled Al-Qusaibi was appointed as the Vice Governor. Al-Quraishi received an MBA from the University of Southern California and began his career for the government railroad in Dammam, in 1961. From 1968-1974, he served as President of the Civil Service Bureau in Riyadh. During that time, he also served as Minister of State for the Council of Ministers. From 1974-1983, he was governor of SAMA. Upon his retirement from SAMA in 1983, he moved to the private sector to become managing director of Ali Zaid Al-Quraishi & Brothers Company where he later became CEO.

In addition to his position at the family business, Al-Quraishi is Chairman of the Saudi Industrial Group and the Saudi Chevron Petrochemical Company. He is also a Member of the Gulf Cooperation Council High Consultative Council, which serves as an advisory board for the heads of the GCC. He was a Member of the International Board for Security Pacific Bank in Los Angeles, California from 1984-1991. He was Chairman of the National Company for Co-operative Insurance in Saudi Arabia from 1986-1994 and the Saudi International Bank in London from 1987-1996. From 1997-2000, he was Chairman of Royal & Sun Alliance Insurance (Middle East) Ltd. in Saudi Arabia.\(^{159}\)

In 1980, Al-Quraishi was retired by a royal decree and Hamad Bin Saud Al-Sayari replaced him as the Vice Governor. Three years later, Al-Sayari was appointed by the king as the Governor of SAMA, a post he served for the next 26 years.\(^{160}\) Al-Sayari holds an M.A. (in Economics) from the University of Maryland, USA. Prior to his joining SAMA in 1980 he was the Director General of the Saudi Industrial Development Fund and has also served as the Secretary General of the Public Investment Fund. Al-Sayari led SAMA during a turbulent yet prosperous time for Saudi economy. Over the past two decades Saudi Arabia experienced some of the most critical years in the Gulf’s history most important of which was the First Gulf War. Al-Sayari

\(^{158}\) Micheal Field, op.cit
\(^{159}\) http://www.us-sabc.org/j4a/pages/Index.cfm?pageID=3803 , accessed on 10 January 2011
\(^{160}\) www.sama.gov.sa , accessed on 10 January 2011
had served as the Governor of one of the most important government organisations of the country, during a period when Saudi economy went through dramatic fluctuations as a result of turbulence of the oil market.

His position and track record have brought Al-Sayari a great deal of admiration in the global financial community. He was ranked 17 among 50 of the most influential people in the financial community worldwide by Institutional Investor magazine. Institutional Investor described Al-Sayari as "a rock upon which Saudi Arabia's oil-based economy has been built." In addition to his key position at SAMA, Al-Sayari served at other Saudi government economic organisations, including being a member of the Supreme Economic Council, as well as a board member of the Public Investment Fund. 161

SAMA has managed to sustain a high level of stability at senior management level. Most of the governors of SAMA have served in their posts until the age of retirement. Moreover, since the mid-1970s, when the first Saudi governor of SAMA took charge of the organisation, the Governor’s office has been assumed by the Vice Governor rather than an outsider. Therefore, the transitions have been smooth as the individuals have often been given the chance to grow within the organisation and experience their role in a different level of management.

There has been an overall consistency in SAMA investment policies regardless of the individual Governors’ personal management strategies. SAMA has more or less followed the pattern for central banks according to the IMF frameworks which has been adjusted to serve the best interest of Saudi domestic and international politics also. Close technical and training collaboration with leading Western financial institutions has assisted SAMA to gain a high level of in-house expertise over decades of operation. 162

SAMA has successfully maintained relative independency from the ruling family which is indeed in contrast with other GCC sovereign wealth funds. Members of Al-Saud family have never been appointed to senior management level at SAMA or to seats of the board which is exactly the opposite scenario to KIA and ADIA. This shows that the sense of ownership which other ruling families of the Gulf expressed over the sovereign wealth assets has not been practiced in the same manner in Saudi Arabia. Moreover,

161 http://www.ameinfo.com/182763.html , accessed on 10 January 2011
SAMA has proven an excellent track record in which there has never been a scandal like KIA in Spain. This is evidence of the robust operation system which has created a high level of accountability.

4.5.2 Data collection and procedures at SAMA

Saudi government, unlike the neighbouring state of Kuwait, has never introduced clear saving procedures rules which require the government to save a certain share of the oil income on an annual basis. The oil revenue surplus is allocated to SAMA after the investment decision for current and future development projects are made in the beginning of every fiscal year. There has been no indication by the government that they intend to commit to a regular saving system.

Another area in which SAMA lacks in-place regulation is the use of external asset managing companies. SAMA uses both internal and external expertise in managing its resources. While there is no information on the ratios of internally managed to externally managed assets, external managers are obliged to manage their relative allocated fund under a guideline which is approved by SAMA. Portfolio performance at SAMA is measured by total return both for internal and external asset managers.

In spite of SAMA’s well-formed information gathering and reporting system, finding information on SAMA foreign investments has proven to be challenging during this study. Saudi authorities seem to have been extremely concerned about political issues surrounding high profile government investments and avoided flashy transactions unlike other SWFs of the Gulf which have made financial news headlines from time to time. The size of individual holdings by SAMA has been consciously kept limited to avoid public disclosure. All in all, SAMA has constantly maintained a low profile investment strategy during over five decades of operation and it is likely to follow the same policies for the foreseeable future.

4.6 New Saudi SWF

Saudi government announced the launch of a new government investment vehicle named Sanabil el-Saudi in July 2008. The fund was established in the form of a joint-stock company with the initial fund of US$5.3 billion, and it is fully owned by Public Investment Fund (PIF) of Saudi Arabia. The Saudi authorities have not disclosed
detailed information on the SES’s strategy, the purpose of its establishment or, how it would be different from SAMA in those respects. As far as the public announcements about the SES are concerned the SES is:

- A long-term and risk-taking investor,
- Managed independently from the PIF, with heavy reliance on the use of external advisors in management strategies,
- Significantly smaller than SAMA.

One of the initial public announcements on the SES was made by the governor of SAMA, Muhammad Al-Jasser, in January 2008. He told newswire Bloomberg on the sidelines of the World Economic Forum in Switzerland that the SES will probably invest mainly in equities. He also mentioned that Saudi would enter the SWF market slowly to avoid any backlash in places such as the US and parts of Europe, where there is “too much populist bias against emerging markets sovereign wealth funds” over the transparency and accountability of state-owned funds.\(^{163}\)

In April 2008, the Secretary-General of PIF, Mansour Al-Maiman, shared more information about the SES’s investment strategy. In his interview with the Financial Times in 2008, Al-Maiman introduced the general investment strategy of *Sanabil el Saudi* as being similar to some of the world’s large sovereign wealth funds, like Norway’s Government Pension Fund, and Singapore’s GIC. He described the difference between this fund and its counterparts to be the particular focus on taking into account “the specific requirements of Saudi Arabia” with more typical frameworks for SWFs to optimize risk-adjusted returns and portfolio diversification to a level at which it is acceptable by the Saudi financial authorities. Al-Maiman believed that the SES will help further by enhancing development of the country’s financial services sector, building Saudi nationals’ asset management skills, and boosting Saudi financial sector competitiveness.\(^{164}\)

Therefore, based on Al-Maiman and Al-Jasser’s statements, the new Saudi SWF, unlike SAMA, is expected have a highly diversified portfolio of investments similar to other GCC sovereign wealth funds which is focused on maximising long term. It is expected


that the SES will focus on developed economies in the US and Europe. However, in order to avoid potential resentment from the governments of host economies in the West, the initial size of the SES’s investments will be significantly lower than those made by other GCC sovereign wealth funds. In terms of asset classes, the main difference of the SES is that it is expected to engage more in equity investments as oppose to SAMA’s heavy investments in government bonds and dollar deposits in foreign banks.

There has been a very vague explanation of the governance and management structure of the SES. In April 2009, the Secretary General of the Public Investment Fund announced that the SES will start operating by heavy reliance on its external advisors. There is no information on the external advisors of the SES but there are various reasons for such approach. Ashby Monk, in one of his posts on Oxford SWF Project’s blog, clarified that using external advisors for management of the SES is a fine way for the Saudi government to proceed in the short-term because:

“First, the difficulty of setting up an effective investment vehicle should not be underestimated. The governance and competencies required necessitate outsourcing the investment function, at least in the short term. Second, in this tumultuous market, it is better to have a scapegoat for any initial bad investments (see China Investment Corporation). By outsourcing investments, the SWF could simply replace the investors in case of poor performance, and the new SWF will retain domestic legitimacy. Conversely, if the fund started investing its own money from the outset, bad investments could result in a loss of mandate altogether. Finally, investing internationally may spark some concern on the part of target countries; independent consultants making the investment decisions may alleviate any political concerns of recipient countries.”

As it is mentioned above, the initial size of this fund is relatively moderate in comparison with some of the Gulf sovereign funds, particularly given that Saudi oil revenue far exceeds that of its neighbours. There first reason that the Saudi authorities who have managed a conservative portfolio of SAMA would inevitably need to build up a track record and perhaps gain experience in managing a diversified portfolio of investment abroad before increasing the allocated fund. Moreover, as Al-Jasser mentioned clearly, there is a strong desire in Saudi government to avoid the similar backlash that other SWFs experienced. In addition, Saudi Arabia with the largest

population amongst the GCC states, will carry on having higher absorptive capacity domestically.

The Saudi government may also have concerns about the public reaction to high-profile investments abroad, like those made by other GCC governments, since the country is suffering from high unemployment. In addition to this, Saudi oil revenues show, it would be unlikely for the government to be capable of affording transferring funds to the SES from its surplus oil incomes in years to come. Therefore, to increase assets under management of the SES, transactions will need to be made from other government accounts including SAMA. Given that the major share of Saudi foreign assets are held in US government bonds, to divest large sums of these assets in favour of less liquid investments would have a strong signalling impact on both American and Saudi economies which neither side can afford in the foreseeable future.\(^{167}\)

Saudi government has eventually initiated policies to set up a diversified government investment fund with long-term investment horizon and profit maximisation strategies. The reason for taking such a measure is that the current Saudi financial system is not flexible enough to let a broad-based reallocation of assets by SAMA to increase portfolio diversification and it may limit the ability of Saudi government to act quickly, even if it was desired, to acquire large stakes for example in temporary distressed, but otherwise attractive international assets. Moreover, from a macroeconomic point of view, it is rather vital for the Saudi government to decrease domestic investment in favour of investment opportunities abroad as the Saudi economy has progressively shown signs of overheating and higher inflation for a number of years.\(^{168}\)

Saudi government recovered from a near bankruptcy experience and has been successful in repaying its debts fairly quickly. Also, the crude prices of the past few years have been tremendously high and at the current rate of global consumption, are expected to remain at a relatively high level for decades to come. This has worked in favour of the largest oil producer of the region and more importantly has undermined the demand for keeping highly liquid assets to stabilise the economy at the time of price decline. Therefore, Saudi government is moving forward to invest the sovereign wealth not only to secure the national economy against volatile oil prices, but also, to generate higher incomes.

\(^{167}\) Bahgat, Gawdat (2008), Sovereign wealth funds: dangers and opportunities in International Affairs Vol. 84, No. 4

\(^{168}\) Andrew Rozanov (2009), op.cit
4.7 Conclusion

In addition to its role as the central bank of Saudi Arabia, SAMA has served as the main sovereign wealth management organisation in the country’s financial system. The Saudi government has struggled with massive budget deficits over the last few decades. However, during the previous decades with application of debt reduction policies coupled with the growth of oil price in the global commodity markets, the Saudi government has managed to cushion a large sum of the country’s oil revenue in SAMA foreign reserves account. These assets form the country’s sovereign wealth.

The investment strategy of SAMA has not followed the same pattern as other GCC commodity-based sovereign wealth funds. SAMA does not have a diversified portfolio of investments and the assets under its management are mainly concentrated in low-risk asset classes with lower return. Although SAMA’s portfolio of investments includes equities, corporate bonds, and alternative investments; its risk regime is still rather conservative in comparison with the other GCC fund. The main share of SAMA’s assets is held in US dollars and this mirrors the country’s close political alliance with the US over the past decades. This trend is not likely to change for the foreseeable future due to the following reasons:

1. The conservative investment pattern and risk aversion of SAMA has protected SAMA’s assets from significant loss on the value of its investments during the recent global financial crisis.
2. The Saudi-US political and economic links are likely to remain strong enough for the Saudi government to continue financing the US budget deficit.
3. There is no alternative for US dollar in the financial market and due to the multilateral relationship between the Saudi and American governments, SAMA will continue to apply policies which support the value of dollar in some shape or form.
4. Unlike its counterparts in the Gulf region, SAMA has not gained experience in managing a diversified portfolio of assets. Therefore, it is unlikely that it will engage in risky and unknown investment projects, particularly in the current volatile markets.

Through including its holdings in annual government budget, SAMA has practiced a more transparent governance pattern in comparison with the other GCC commodity-
based funds. However, there is a high level of influence from the Saudi political elite in SAMA at senior management level. Like all other GCC funds, SAMA’s senior managers are directly appointed by the ruling elite. Through having long serving governors SAMA has managed to maintain a high degree of stability in its overall operation policy application. This is also another reason for SAMA to follow its past investment patterns.

The Saudi government has recently launched a small fund: Sanabil el-Saudi. The Saudi authorities have frequently commented on the aim of creating such investment institution to be focused on practicing risky investment strategies on a smaller scale. It is expected that over time the government will increase the assets under management of this fund. The capacity of Sanabil el Saudi is likely to develop, reaching a level that makes it able to compete with other GCC funds in a rather gradual and timely fashion.
5 The United Arab Emirates’ Sovereign Wealth Funds

5.1 Introduction

The second oldest SWF of the Gulf, after the KIA, was established by the government of the richest emirate of the United Arab Emirates, Abu Dhabi. The discovery of oil in the early 1960s made a huge impact on Abu Dhabi’s government income. In the mid-1940s, Abu Dhabi’s revenue was estimated to stand just above $75,500. In 1962, this amount was slightly less than doubled; and by 1967, it was estimated that the sheikhdom’s oil income reached $84 million. In the same year, per capita income reached over $5000, which was the highest in the world.\(^{169}\) The increase in government revenue triggered the demand for the establishment of an institution to manage the surplus incomes. Therefore, the Abu Dhabi Investment Board (ADIB) was established in 1967 to manage the emirate’s increasing excess oil revenue. The ADIB’s headquarters were in London\(^{170}\) and it was a part of the Abu Dhabi Department for Finance.

At the beginning of 1971, the Abu Dhabi Investment Administration was established to manage the surplus revenue of Abu Dhabi parallel to the ADIB, while the management decisions were made slightly independent from the Department of Finance. Abu Dhabi’s oil income increased from $952 million in 1973 to $5278 million in 1974.\(^{171}\) The Board was dissolved in 1974 and Abu Dhabi Investment Administration became the sole manager of Abu Dhabi’s sovereign wealth. The Administration was handling about 15 billion Dirhams by the end of 1976.

In 1976, the Administration’s operations were further developed and its name was changed to Abu Dhabi Investment Authority. As noted above, the purpose of

\(^{169}\) Mann, Clarence (1964), *Abu Dhabi: Birth of an Oil Sheikdom*, Beirut: Khayats


establishment of Abu Dhabi Investment Administration and the ADIA was to separate the operations of the emirate’s SWF from direct supervision of the Ministry of Finance. Moreover, with the significant growth of oil revenues, a larger organisation in which more developed asset management operations could be managed was needed. Since 1976, ADIA has remained the main sovereign wealth fund of the government of Abu Dhabi. However, with the growth of oil revenues since the establishment of the ADIA, a number of other government investment institutions have been established in Abu Dhabi to manage the surplus oil income.

The SWFs of the UAE are not limited to those which are owned by the government of Abu Dhabi. The government of Dubai also has been active in creating of a number of sovereign investment vehicles in the form of SWFs and SWEs to manage the government’s assets. After Abu Dhabi, Dubai is considered to be the second richest emirate within the UAE. Dubai’s natural resources have been rather limited and its oil production had been considerably lower than Abu Dhabi (see Table 5-1). Therefore, the sovereign wealth management institutions of Dubai have not been financed solely by oil surplus incomes, and have heavily relied on leverage. However, due to the important role of Dubai’s economy in the overall economic performance of the UAE, Dubai government investment vehicles will be examined in this chapter.

Table 5-1: Abu Dhabi and Dubai annual oil production, 1962-1984 (MB)

<table>
<thead>
<tr>
<th></th>
<th>Abu Dhabi</th>
<th>Dubai</th>
</tr>
</thead>
<tbody>
<tr>
<td>1962</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>1963</td>
<td>18</td>
<td>-</td>
</tr>
<tr>
<td>1964</td>
<td>69</td>
<td>-</td>
</tr>
<tr>
<td>1965</td>
<td>103</td>
<td>-</td>
</tr>
<tr>
<td>1966</td>
<td>131</td>
<td>-</td>
</tr>
<tr>
<td>1967</td>
<td>139</td>
<td>-</td>
</tr>
<tr>
<td>1968</td>
<td>182</td>
<td>-</td>
</tr>
<tr>
<td>1969</td>
<td>219</td>
<td>4</td>
</tr>
<tr>
<td>1970</td>
<td>253</td>
<td>31</td>
</tr>
<tr>
<td>1971</td>
<td>341</td>
<td>46</td>
</tr>
<tr>
<td>1972</td>
<td>384</td>
<td>56</td>
</tr>
<tr>
<td>1973</td>
<td>476</td>
<td>80</td>
</tr>
<tr>
<td>1974</td>
<td>515</td>
<td>88</td>
</tr>
</tbody>
</table>
In order to give a thorough review of the structure of government investment institutions in Dubai and Abu Dhabi, this chapter will start with a brief study of the government structure of the UAE. The unique political composition of the UAE, consisting of seven federal monarchical emirates, and the government organisations which have been created based on this political structure, has created a special business and governance environment which is visibly reflected in the institutional behaviour of the sovereign investment institutions of the country. Therefore, understanding the nature, culture, and mentality of the ruling bodies within the UAE is taken here as the first step towards providing a better understanding of the country’s SWFs.

In the United Arab Emirates, each emirate exercises authority over all matters that are not within the assigned jurisdiction of the union government. In particular, under the UAE Constitution, the natural resources and wealth in each Emirate is the property of that Emirate. The highest federal authority in the UAE is the Federal Supreme Council (FSC) which comprises the rulers of the seven emirates. The FSC is in charge of all the policy makings and appointments to official government posts, including the president, the prime minister and other ministers, and the judges of the Federal Supreme Court. It also ratifies federal laws which can be amended by the president.172 Abu Dhabi and Dubai hold the highest power within the federal government; as such all the decisions of the FSC must be approved by the emirs of Abu Dhabi and Dubai and at least three of the other five emirates.

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172 http://www.uaecabinet.ae/English/UAEGovernment/Pages/TheSupremeCouncil.aspx, accessed on 15 October 2010

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<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>513</td>
<td>93</td>
</tr>
<tr>
<td>1976</td>
<td>580</td>
<td>115</td>
</tr>
<tr>
<td>1977</td>
<td>603</td>
<td>116</td>
</tr>
<tr>
<td>1978</td>
<td>528</td>
<td>132</td>
</tr>
<tr>
<td>1979</td>
<td>533</td>
<td>129</td>
</tr>
<tr>
<td>1980</td>
<td>504</td>
<td>128</td>
</tr>
<tr>
<td>1981</td>
<td>414</td>
<td>131</td>
</tr>
<tr>
<td>1982</td>
<td>329</td>
<td>129</td>
</tr>
<tr>
<td>1983</td>
<td>311</td>
<td>128</td>
</tr>
<tr>
<td>1984</td>
<td>274</td>
<td>129</td>
</tr>
</tbody>
</table>

Source: Central Bank of the UAE, Statistical Bulletin (1978 and 1985)
Traditionally, the federal president has always been the leader of Abu Dhabi. Sheikh Khalifa was accordingly unanimously elected for a five-year term by the FSC in 2004, soon after he became the new emir of Abu Dhabi. The UAE has officially a full set of institutions for the legislative, executive and judicial branches of government on the federal level. However, in practice, all important decisions are made by the ruling families of the larger emirates, particularly Abu Dhabi.

The decision-making process both on the local and federal levels is therefore neither transparent nor accountable. This will be further elaborated in the context of the sovereign wealth management organizations of Dubai and Abu Dhabi in this chapter. Such decision making procedures leave considerable scope for inefficiency in transparency of information in the UAE government institutions, and have allowed them to avoid disclosure of information both on the national and global level. The operations of the government organisations are hidden from public view and are rarely open to challenge. In the case of the Emirati SWFs also, this has become one of the most fundamental characteristics of those institutions.

As noted above, Abu Dhabi in practice holds the greatest federal power within the UAE, even if officially Abu Dhabi does not hold higher constitutional power. It is the largest emirate, representing 86% of the land area and most of the coastlines of the UAE. Abu Dhabi produces around 90% of the total oil of the UAE, and it has been the major financier of the federal budget (see Table 5-2). The federal budget for 2010 was Dh43.6 billion, of which Abu Dhabi paid close to Dh17bn, Dubai contributed Dh1.2bn and the rest came from revenues earned by federal bodies rather than other emirates. The National (2010), FNC calls for fairer federal finances, 16 June 2010 Therefore, heavy reliance on Abu Dhabi finance assistance has put the emirate in a leading position in respect of federal affairs.

Table 5-2: Abu Dhabi contribution to the federal budget (million UAE Dirham)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution to UAE budget</td>
<td>201</td>
<td>403</td>
<td>794</td>
<td>1,600</td>
<td>4,300</td>
</tr>
<tr>
<td>Total government revenue</td>
<td>2,181</td>
<td>4,212</td>
<td>14,176</td>
<td>15,015</td>
<td>18,400</td>
</tr>
</tbody>
</table>

Source: Abu Dhabi Statistical Bulletin (1976)

The National (2010), FNC calls for fairer federal finances, 16 June 2010
Being the major oil producer of the seven emirates of the AUE and in recognition of its hydrocarbons dominance, Abu Dhabi has played a leading role in the country’s oil policies. The federal Ministry of Energy was substantially demoted in the early 1990s and its power for the most part has been transferred to the Abu Dhabi Supreme Petroleum Council (SPC). The SPC consists of 12 members, six of which are from the ruling family, with the others being from prominent Abu Dhabi business families and politically influential individuals. This shift has now made the position of federal oil minister more of a figurehead than a decision making role.

The second largest emirate of the UAE, Dubai, accommodates around one-third of the population of the UAE, even though it accounts for only 5% of the country's territory. As its oil production has fallen, Dubai has started a transition to an economy based on trade and services. Dubai had been moving towards maintaining a fair level of independence from Abu Dhabi, particularly when it comes to economic policymaking, which in return, has led to acceptance of Abu Dhabi's leadership over political issues like defence and foreign policy which affect the federation as a whole. However, the economic failure of Dubai’s enterprises has changed this equation in favour of Abu Dhabi.

The economic downturn of Dubai coupled with the global financial crisis has not only changed the political balance of the UAE, as it has been discussed above, but also damaged the overall UAE economy. To demonstrate the extent to which the UAE economy has been affected by the recent global financial crisis, some of the economic indicators of the UAE are illustrated in Table 5-3 below. As it is shown the table, in the aftermath of the 2008 financial crisis, there has been a sharp decline in the UAE’s main economic indicators, including government revenue, inward and outward direct investments, government budget balance, and real GDP growth.

Table 5-3: UAE economic indicators

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government revenue</td>
<td>31.2</td>
<td>30.2</td>
<td>33.2</td>
<td>24.6</td>
<td>24.2</td>
</tr>
<tr>
<td>(% of GDP)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General government budget balance</td>
<td>11.3</td>
<td>9.1</td>
<td>14.2</td>
<td>2.6</td>
<td>1.9</td>
</tr>
<tr>
<td>(% of GDP)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### General government debt (% of GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>37.2</td>
</tr>
<tr>
<td>2007</td>
<td>41.2</td>
</tr>
<tr>
<td>2008</td>
<td>39.4</td>
</tr>
<tr>
<td>2009</td>
<td>48.9</td>
</tr>
<tr>
<td>2010</td>
<td>45.1</td>
</tr>
</tbody>
</table>

### Continued

<table>
<thead>
<tr>
<th>Year</th>
<th>Inward direct investment (US$ m)</th>
<th>Outward direct investment (US$ m)</th>
<th>Growth of real GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>12,806</td>
<td>-10,892</td>
<td>13</td>
</tr>
<tr>
<td>2007</td>
<td>14,187</td>
<td>-14,568</td>
<td>6.2</td>
</tr>
<tr>
<td>2008</td>
<td>13,700</td>
<td>-15,800</td>
<td>7.4</td>
</tr>
<tr>
<td>2009</td>
<td>4,003</td>
<td>-2,723</td>
<td>-2.7</td>
</tr>
<tr>
<td>2010</td>
<td>6,200</td>
<td>-3,500</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit (2010)

As is shown in Table 5-3, the government of UAE has reportedly had high budget surpluses between 2006 and 2008. Given the large share of Abu Dhabi’s contribution in the federal budget, the figures demonstrated in the table indeed reflect Abu Dhabi’s growing surplus income during that period. In 2006, the government of Abu Dhabi collected Dh157.1 billion from oil-related businesses; it was more than quadruple the amount which was earned in 2002. As a result of the accelerating income growth, the government launched a new development plan in 2006 which was to boost government spending by nearly 50 per cent from what it was in 2002, and to allocate Dh23 billion to subsidies at home and other emirates within the UAE. Despite the significant increase of government expenditure in 2006, Abu Dhabi was reported to have generated US$27.4 billion surplus. The 2008 global crisis has affected the oil markets. Given the heavy reliance of Abu Dhabi’s economy on oil incomes, as it was shown in Table 5.3, government income has dramatically declined after 2008, and it is yet to catch up with its previous level in the next coming years.

### 5.1.1 Abu Dhabi’s sovereign wealth funds

The government of Abu Dhabi hands the surplus revenues to its investment vehicles to protect the economy from increasing liquidity, which ultimately leads to higher inflation, with a view to generating additional revenue from investment returns, and diversifying the economy from the petroleum sector, which ultimately will maintain the natural wealth for the future generation. Abu Dhabi’s fast flourishing economy, like many other GCC countries, is already suffering from double-digit inflation. Therefore, distribution of wealth amongst the citizens in the form of grants, as it used to be done traditionally, is not a feasible option for the government anymore. Instead, the government uses its SWFs to transfer the emirate’s crude income to other types of financial assets. The government of Abu Dhabi has particularly focused on

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diversification of the economy from the oil sector as one of the core investment strategies for its various sovereign wealth funds. Such a strategy is a unique characteristic of Abu Dhabi SWFs which differentiates them from those of Saudi Arabia and Kuwait, where the major focus is to create more income for current and future generations.

Currently, the emirate of Abu Dhabi controls six major sovereign wealth management institutions. A summary of these institutions is given below in Table 5.4. As is demonstrated in the table, each of these institutions has its own individual investment interest, which varies from private equity and real estate to tourism and petrochemical industry. However, one major characteristic which all of these institutions share is their source of funding. All the government investment vehicles of Abu Dhabi are funded from the emirate’s oil and gas income. Moreover, another major attribute of these organisations is that they all are ultimately seeking a mutual goal, which is to strengthen the emirate’s position in regional and global markets. Finally, these institutions are designed to help diversify Abu Dhabi’s economy from the risks posed by volatile oil markets, as well as to secure and maintain the prosperity of Abu Dhabi for future generations.

ADIA is the oldest institution amongst the six major sovereign wealth management vehicles of Abu Dhabi; while Mubadala is the youngest. Although ADIA and Mubadala have a fundamental difference in the size of their assets, as ADIA is the largest SWF of Abu Dhabi with estimated total under management assets of between US $300 billion and US $800 billion, they share some important characteristics. Both of the organisations have highly diversified portfolios and they have managed to establish their brands as highly prestigious organisation within the global financial world. Moreover, ADIA and Mubadala have been equally opaque and have not shared much about their operations. Both of the institutions are seeking to contribute to the diversification strategy of Abu Dhabi; while ADIA has remained focused on profit maximisation as its major investment policy, Mubadala has been actively engaged in projects which contribute to the social and technological development of Abu Dhabi.

The main focus of this chapter will be on ADIA and Mubadala; the two highly diversified government investment engines of Abu Dhabi. The two organisations have engaged in high profile investments which have often become a matter of scrutiny in the global financial world. Therefore, analysing these two SWFs will answer some of the
questions which have been frequently raised by the financial analysts over the last few years.

Table 5-4: Abu Dhabi main SWFs

<table>
<thead>
<tr>
<th>Name</th>
<th>Description</th>
<th>Sector focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADIA</td>
<td>Largest SWF, invests the Emirate’s surplus revenues mainly into financial assets abroad, providing capital diversification for the economy</td>
<td>Multiple sector asset management</td>
</tr>
<tr>
<td>Mubadala</td>
<td>Primary business development company of Abu Dhabi. Its mandate is to support economic diversification and development of Abu Dhabi</td>
<td>Oil &amp; Gas, Energy &amp; Industry, Real Estate &amp; Hospitality, Infrastructure, Services, Aerospace, Information, Communication &amp; Technology, Healthcare</td>
</tr>
<tr>
<td>Invest AD</td>
<td>Initially part of ADIA, it is now a separate entity, it has a greater focus on investments within the MENA region</td>
<td>Private equity, real estate, infrastructure</td>
</tr>
</tbody>
</table>

Source: Field research

5.1.2 Origins of government income in Abu Dhabi

More than four-fifths of Abu Dhabi’s income comes from oil revenue collected by the Abu Dhabi National Oil Company (ADNOC) and the 14 companies under its umbrella. The company does not publish financial statements, but is estimated to produce about three million barrels of crude every day. Under the terms of concessions that date back to 1978, ADNOC pays US $1 a barrel, regardless of the oil price on the market, to its joint venture partners such as BP, Mitsui, Shell and France’s Total. After paying its own costs, ADNOC then pays an undisclosed percentage of its generated income to two of Abu Dhabi’s largest funds: ADIA and Abu Dhabi Investment Council (ADIC).

UAE lacks a formal saving program and an institutionally protected framework such as the law establishing Kuwait’s Reserve Fund for Future Generations. Therefore, the allocated funds from the surplus oil income to the emirate’s sovereign wealth management institutions may vary each year. The flow of oil and gas revenues in Abu Dhabi is shown in the figure below. Arnold Wayne, in an article which was published

176 [www.adnoc.ae](http://www.adnoc.ae) , accessed on 27 October 2010
178 Shihab M. A. Ghanem, op.cit
by “The National”, a leading local news paper, states that 70% of surplus oil revenue is transferred into ADIA’s account. ADNOC’s costs are known to be significantly lower than its royalty and tax earnings. Therefore, up to 95 per cent of ADNOC’s gross revenue is speculated to be surplus.¹⁷⁹

ADNOC has two affiliate company; Abu Dhabi Gas Liquefaction Company (ADGAS)¹⁸⁰ which is a joint venture between ADNOC, Mitsui, BP, Total, and Abu Dhabi Gas Industries (GASCO), another ADNOC’s joint venture with Shell and Total.¹⁸¹ The two joint ventures of ADNOC pay royalties and tax to the government of Abu Dhabi. The payments from ADGAS and GASCO therefore contribute into the government’s income, in addition to ADNOC’s direct earnings, which are transferred to the government accounts (ADIA and ADIC.

Figure 5-1: Source of funds from the government to ADIA

Source: ADIA Annual Review (2009)

5.2 Introduction to the Abu Dhabi Investment Authority

ADIA is the largest government investment institution of the government of Abu Dhabi, and by many estimates, the largest commodity-based SWF of the world. It was established in 1976 to replace the ADIB, a government entity created in 1967 that was a part of the institution which then became the Abu Dhabi Ministry of Finance. ADIA is wholly owned by and subject to supervision by the government of Abu Dhabi. It has an

¹⁷⁹ Field research and Arnold Wayne, op.cit
¹⁸⁰ www.adgas.com, accessed on 2 November 2010
¹⁸¹ www.gasco.ae, accessed on 2 November 2010
independent legal identity with full capacity to act in fulfilling its statutory mandate and objectives.

There is little known about the history of the establishment of ADIA, particularly pre-1976. The findings of this study are therefore limited to what is available to the public through Abu Dhabi government institutions’ official websites, as well as limited available literature. Table 5.5 demonstrates some of the major developments in the history of ADIA.

Five years after its establishment, ADIA went through some fundamental changes which were introduced by ratification of a law known as Law No.5 of 1981 that provides separation of roles and responsibilities among the ownership, the governing entity, and the management at ADIA. According to the official website of ADIA, the authority's current constitutive document is Law No.5 concerning the re-organization of the ADIA. There is no information on how ADIA’s system was different before the ratification of Law No.5. The authority has been highly secretive about its developments and changes over time; however, the application of Law No.5 seems to have given ADIA a higher level of freedom and independence from the government financial system. ADIA has been closely monitored by the government of Abu Dhabi, however, the funds which are under ADIA’s management seem to be separated from other government accounts.

According to ADIA’s website, as a result of the application of Law No.5:

“ADIA carries out its investment programme independently and without reference to the Government of the Emirate of Abu Dhabi or the Government's other "affiliates" that also invest funds on behalf of the Government of the Emirate of Abu Dhabi.”182

According to this law, ADIA’s objective is;

“to receive funds from the Government of Abu Dhabi allocated for investment, and invest and reinvest those funds in the public interest of the Emirate in such a way so as to make available the necessary financial resources to secure and maintain the future welfare of the Emirate.”183

Therefore, ADIA’s assets are invested and managed separated from other government investment vehicles, and the sole strategy of ADIA is to maximise profit on current and

182 www.adia.ae , accessed 1 November 2010
183 International Working Group of Sovereign Wealth Funds (2008), Sovereign Wealth Funds Generally Accepted Principles and Practices (GAPP)
future investment projects in order to secure an avenue of income for the future generation of Abu Dhabi.

Table 5-5: A summary of ADIA’s development history

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1967</td>
<td>Creation of Financial Investments Board of Abu Dhabi under the Department of Finance. Under the Mandate of UBS, Robert Fleming, Morgan Guarantee Trust, and Indosuez.</td>
</tr>
<tr>
<td>1976</td>
<td>A decision was made by the government to separate ADIA from the government as an independent organisation. The following departments were created within ADIA: Equities and Bonds, Treasury, Finance and Administration, Real Estate, Local and Arab Investments.</td>
</tr>
<tr>
<td>1986</td>
<td>ADIA started investing in alternative strategies</td>
</tr>
<tr>
<td>1987</td>
<td>Equities and Bonds Departments became regional (North America, Europe and Far East)</td>
</tr>
<tr>
<td>1988</td>
<td>Number of employees exceeded 500</td>
</tr>
<tr>
<td>1989</td>
<td>ADIA started investing in private equity</td>
</tr>
<tr>
<td>1993</td>
<td>ADIA started formal asset allocation process with a set of benchmarks and guidelines, number of employees exceeded 1000</td>
</tr>
<tr>
<td>1998</td>
<td>Started investing in inflation-indexed bonds</td>
</tr>
<tr>
<td>2005</td>
<td>Dedicated allocation to small caps within equities, and investment-grade credit within fixed income</td>
</tr>
<tr>
<td>2007</td>
<td>Started investing in infrastructure sector; moved into new headquarters building</td>
</tr>
</tbody>
</table>

Source: [www.adia.ae](http://www.adia.ae)

Separation of ADIA from other government investment institutions has provided ADIA with a strong shield from scrutiny and assisted the authority to avoid public disclosure of information both domestically and internationally.\(^{184}\) In addition to this, the government of Abu Dhabi has failed to introduce a saving framework for its surplus incomes which defines the share of allocated fund to the government investment institutions’ account. Furthermore, there has not been any in-place law or other requirements guaranteeing a portion of the surplus oil revenue to be allocated to ADIA or any other government investment vehicles in Abu Dhabi.

Moreover, the government has failed to set up appropriate regulation for managing the withdrawals from ADIA’s account. Although ADIA’s charter in principle forbids withdrawals from its account, “Abu Dhabi officials acknowledge borrowing from the fund when the money is tight.”\(^{185}\) Neither the government of Abu Dhabi nor the

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\(^{184}\) Shihab M. A. Ghanem, op.cit  
management of ADIA have provided information to the public about ADIA’s investment operations, withdrawal and financing methods.

ADIA has developed immensely over the years of its operation. Starting four decades ago from a significantly smaller organisation (ADIB), Abu Dhabi Investment Authority has developed into the largest government investment institution of the Gulf. ADIA has emerged as a major financial player just as Abu Dhabi is racing to become one of the world's energy, tourism, and cultural centres.

The authority has had a long and prestigious history in the global financial world, which it is likely to maintain in the mid to long run. However, the political controversy over the SWFs which was triggered by the financial crisis of 2008 have put ADIA in a rather defensive position which led into the authority’s contribution towards the establishment of the International Working Group of SWFs (IWG) in partnership with the International Monetary Fund.

In May 2008, ADIA agreed to co-chair the IWG along with the IMF. The working group comprised representatives from 26 countries, and was created to help the home and recipient countries and the international financial markets understand the SWFs’ internal frameworks and governance practices, and to confirm that their investments were made only on an economic and financial basis. The outcome of the IWG’s work was 24 Generally Accepted Principles and Practices (GAPP) for operation of the SWFs, also known as the Santiago Principles.

In its first ever published report in 2009, ADIA announced that the authority had gone through a self-assessment based on GAPP and confirmed ADIA’s compliance with the Santiago Principles. The details of the Santiago Principles will be reviewed in Chapter 7 of this thesis. As far as the ADIA’s full observance of GAPP and transparency of operation is concerned, the authority has yet a long way to go. However, the contribution of the ADIA in forming the IWG has made visible impacts on the way in which ADIA communicates with the outside world.

5.2.1 The size of assets held by ADIA

ADIA has grown into the world’s biggest SWF. As noted above, the fund has been reluctant to disclose information on various aspects of its activities to the public. The authority has avoided any official disclosure of the size of its under management assets.
Therefore, almost all the information which is available to the public about the size of ADIA’s assets is based on speculation and guess work. By the end of the 1990s, assets under management of ADIA were estimated to be between $120 and $150 billion. Analysts speculated in 2007 and 2010 that ADIA’s assets amounted to somewhere from $500 billion to $1000 billion (see Table 5-6). The gap between various estimates for ADIA’s under management assets demonstrated in Table 5-6 proves that due to a lack of official information, the estimates may be overstated. Rachel Ziemba and Brad Setser, in a study which was conducted in 2009, argued that the size of ADIA’s assets had been overstated, sometimes by as much as 100 percent. Ziemba and Setser deemed that ADIA was hard hit by the fall in global equities. Therefore, as many of the same factors that had worked in its favour from 2004 to 2007 (i.e. a high allocation to equities, emerging market, and private equity) worked against it in 2008. They estimate that the external assets of ADIA were likely to be less than $400 billion—and could be as low as $300 billion—in 2009.

Table 5-6: ADIA estimated AUM (2007-2010)

<table>
<thead>
<tr>
<th>Source</th>
<th>Year</th>
<th>Estimate ($ billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reuters</td>
<td>2010</td>
<td>500-700</td>
</tr>
<tr>
<td>SWF Institute</td>
<td>2010</td>
<td>627</td>
</tr>
<tr>
<td>The Times</td>
<td>2009</td>
<td>700</td>
</tr>
<tr>
<td>Gulf News</td>
<td>2008</td>
<td>900</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>2008</td>
<td>675</td>
</tr>
<tr>
<td>NBER</td>
<td>2008</td>
<td>875</td>
</tr>
<tr>
<td>Dresdner Kleinwort</td>
<td>2008</td>
<td>1000</td>
</tr>
<tr>
<td>Citi Group</td>
<td>2007</td>
<td>875</td>
</tr>
</tbody>
</table>


Although, the size of ADIA’s assets is not clearly known, there is no doubt that ADIA is the largest SWF of the Gulf region. One can find two reasons to justify this

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187 Brad Setser Brad and Rachel Ziemba, op.cit
assumption. Firstly, Abu Dhabi’s oil and gas production has never been interrupted by regional wars. This has certainly not been the case for Kuwait and Saudi Arabia.

Secondly, ADIA is not involved with, nor has any visibility on matters relating to, the spending requirements of the government of Abu Dhabi. Although in accordance with Law No.5, at the time of financial difficulties ADIA is obliged to provide the government with the necessary financial resources to secure and maintain the welfare of the emirate, the history of Abu Dhabi economic development proves that there have not been many instances in which any major transfer of assets from ADIA’s account has been needed. This has indeed been the opposite to the case of Kuwait Investment Authority.

The size of the fund’s assets was one of the areas of which there was no mention in the 30 pages of ADIA’s first annual review, after over four decades of activities, which was published on their website in March 2010. As noted above, all the available information about the size of ADIA’s assets is based on speculation and educated guess works. Often there have been enormous gaps between various estimates. All the available estimates have been either:

- based on a simple calculation in which the annual government income is calculated as: income = (production * average annual price) - government costs
- or/and, by following up ADIA’s major acquisitions in each year.

The latter is less reliable as ADIA has maintained a strict investment policy of holding small equity stakes which remain below disclosure requirements. Moreover, ADIA’s heavy reliance on external managers - as much as 80 percent of its assets – makes it more difficult to chase ADIA’s acquisitions.

All in all, with oil about US $100 a barrel, some of the estimates expect Abu Dhabi to at least produce a US $50 billion surplus every year. Given the emirate’s small population, even the most extroverted investment and welfare policies will hardly make any impact on the size of ADIA’s assets. The crude prices have remained below $100 per barrel.

189 http://www.adia.ae/En/pr/Annual_Review_Website2.pdf , accessed on 16 November 2010
However, even at the current rates, Abu Dhabi has also reported income surplus and it is likely to remain the same for the foreseeable future. Despite some estimates, there has been a consensus amongst analysts that ADIA has indeed been the largest commodity-based SWF in the world.

5.2.2 Governance of ADIA

The supreme governing body at ADIA is the board of directors. The board holds absolute control over all ADIA’s affairs and businesses. It is composed of a chairman, managing director, and other board members, all of whom are senior government officials appointed by an emiri decree for duration of three years, subject to renewal.191 The board does not normally get involved in making investment and operational decisions.

The managing director is the chief executive in charge of ADIA’s management affairs and operational decisions. He is responsible for carrying out the strategic policies as well as, legally representing ADIA in its relationships with third parties. The managing director is vested with financial independence and the power to make decisions in respect of investment proposals.

The managing director is assisted by an investment committee which is composed mainly of the heads of the several investment departments. The committee reviews and makes recommendations on investment proposals originated by the investing departments. The investment committee is chaired by the managing director, and it comprises senior executives from across ADIA. A number of other committees provide strategy and guideline advice to the investment committee. The overall performance of the investment committee is managed to allow ADIA to carry out independent investment programmes without reference to the government and/or other government investment vehicles in Abu Dhabi.192

In addition to individuals and committees dealing with the management and investment decision making of ADIA, the authority has an internal audit department to oversee the operations of various departments and report back to the managing directors. The internal audit department evaluates ADIA’s internal control systems to ensure they

191 Zawya (2007), Khalifa reshuffles ADIA’s BoD, 03 Jan 2007
192 http://www.adia.ae/En/Governance/Abudhabi_Government.aspx, accessed on 11 November 2010
adequately safeguard the assets; it also provides an additional layer of security to ensure all transactions are undertaken in accordance with ADIA’s policies and procedures. ADIA’s board of directors also has an audit committee of its own, which appoints two external audit firms to act jointly to audit ADIA’s annual accounts. Both the internal audit department and the external auditors report their findings to the audit committee of the board.\(^{193}\)

Figure 5-2 demonstrates the organization structure of ADIA. As it is shown below, in addition to the investment committee, there are other departments whose roles including supporting the managing director, including: strategy unit, evaluation and follow up, internal audit and legal department. There is very little information available on the details of operations for each of these departments. However, this structure proves that the ADIA indeed benefits from a professionally formed structure.

ADIA has repeatedly alleged that it maintains a high level of independence from the government of Abu Dhabi. However, with more than half of the members of the board of directors being from the Al-Nahyan family, the independence of ADIA from the government of Abu Dhabi does not seem to be effortlessly fulfilled (see Table 5-7). There is no indication of the track record of the board members on ADIA’s official website; but with a basic internet search one comes into the conclusion that most of the members of the board are key political figures in Abu Dhabi.

The current chairman of ADIA’s board of directors is the ruler of the emirate of Abu Dhabi, Sheikh Khalifa bin Zayed Al-Nahyan, who is also the president of the United Arab Emirates. ADIA’s vice chairman, managing director, and three other members of the board are members of the ruling family.

Sheikh Mohammed bin Zayed Al-Nahyan, the crown Prince of Abu Dhabi and Deputy Supreme Commander of the UAE Armed Forces serves as the vice president of ADIA. In addition to his role at ADIA, he has also been the chairman of the Abu Dhabi Executive Council, which is responsible for the development and planning of the emirate of Abu Dhabi and is a member of the SPC. Moreover, he serves as a special advisor to the president of the UAE, Sheikh Khalifa, his older brother. Sheikh Mohammad also serves in other official positions, including the head of Abu Dhabi Council for Economic Development, which is the economic policy advisory council in

\(^{193}\) [http://www.adia.ae/En/pr/Annual_Review_Website2.pdf](http://www.adia.ae/En/pr/Annual_Review_Website2.pdf), accessed on 02 December 2010
Abu Dhabi, the chairmanship of Mubadala Development Company, the head of the UAE Offsets Program Bureau and the head of the Abu Dhabi Education Council.

Figure 5-2: AIDA’s organisation structure chart

![AIDA's organisation structure chart](www.adia.ae)

The next key position at ADIA is the managing director. Between 1998 and March 2010, Sheikh Ahmed bin Zayed al Nahyan, a half-brother of Sheik Khalifa who died in a plane accident in Morocco, was the authority’s managing director. Less than one month after the death of Sheikh Ahmad, another younger half brother of Sheikh Khalifa, Sheikh Hamed bin Zayed, was appointed to be the managing director of ADIA. Prior to his appointment, Sheikh Hamed was the head of Abu Dhabi Crown Prince’s Court and the chairman of the Higher Corporation of Specialized Economy Zones.  

Table 5-7: Members of ADIA’s Board of Directors (as of May 2010)

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### The United Arab Emirates’ Sovereign Wealth Funds

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sheikh Khalifa bin Zayed Al Nahyan</td>
<td>Chairman</td>
</tr>
<tr>
<td>Sheikh Mohammed bin Zayed Al Nahyan</td>
<td>Vice chairman</td>
</tr>
<tr>
<td>Sheikh Hamed bin Zayed Al Nahyan</td>
<td>Managing Director</td>
</tr>
<tr>
<td>Sheikh Mansour bin Zayed Al-Nahyan</td>
<td>Member of the board</td>
</tr>
<tr>
<td>Sheikh Sultan bin Zayed Al Nahyan</td>
<td>Member of the board</td>
</tr>
<tr>
<td>Sheikh Mohammed bin Khalifa bin Zayed Al Nahyan</td>
<td>Member of the board</td>
</tr>
<tr>
<td>Mohammed Habroush Al Suwaidi</td>
<td>Member of the board</td>
</tr>
<tr>
<td>Dr. Jua’an Salim Al-Dhaferi</td>
<td>Member of the board</td>
</tr>
<tr>
<td>Hamad Mohammed Al Hurr Al-Suwaidi</td>
<td>Member of the board</td>
</tr>
<tr>
<td>Khalil Mohammed Sharif Foulathi</td>
<td>Member of the board</td>
</tr>
</tbody>
</table>

Source: ADIA Annual Review (2009)

Another member of the board who is also a younger half brother of Sheikh Khalifa is Sheikh Mansour bin Zayed. He started his political career in 1997 and was first appointed as chairman of the Presidential Office by his father Sheikh Zayed. After the death of his father, he was appointed as first Minister of Presidential Affairs of the United Arab Emirates, which is the merger of the Presidential Office and Presidential Court. He was appointed as Chairman of the Ministerial Council for Services, which is considered a ministerial entity attached to the cabinet. In addition to this, Sheikh Mansour served in various other high profile government capacities including: the chairman of First Gulf Bank, International Petroleum Investment Company, Abu Dhabi Judicial Department, the National Centre for Documentation and Research, Emirates Foundation, Abu Dhabi Food Control Authority and Abu Dhabi Fund for Development, the vice-chairman of the Abu Dhabi Education Council, the member of SPC, the chairman of Khalifa bin Zayed Charity Foundation.

Sheikh Sultan is the second son of Zayed, founder of UAE. Sheikh Sultan started his political career in 1990, and served as Deputy Prime Minister of the UAE until 2009. In addition to that, he has held various other official positions including the President's Representative, the chairman of the Media and Cultural Centre, the Emirate Heritage Club, Zayed Centre for Coordination and Follow-Up, and member of the SPC.
As demonstrated in the table above, a further ADIA board member is also from the Al-Nahyan family is Sheikh Mohammed bin Khalifa al Nahyan, who is the son of the current ruler of Abu Dhabi. Sheikh Mohammed has served in other key government positions and is currently the chairman of the Department of Finance and a member of the Executive Board of Abu Dhabi.

The rest of the members of the board are elected from among the highly influential individuals who are closely linked to Al-Nahyan and have, like the rest of the members, been serving in a number of other high profile positions within the government of Abu Dhabi. Mohammed Habroush Al Suwaidi is a board member of ADIC, SPC, Al-Ahlia Insurance Co, and advisor to the president of the UAE. Jua'an Salim Al-Daherhi, is the president of Abu Dhabi Social Services and Building Department, deputy chairman of the board of National Bank of Abu Dhabi, board member of the SPC, and a member of the Abu Dhabi Executive Council.

Hamad Mohammed Al Hurr Al-Suwaidi, is a board member and director of ADIA, a board member of the Mubadala Development Company, the chairman of the Abu Dhabi National Energy Company (TAQA), under-secretary of the Abu Dhabi Finance Department, chairman of the board at Emirates Power Company, director of the board at Oasis International Leasing, the General Industry Corporation, the Health Care Authority, the National Company for Tourism, member of Abu Dhabi Executive Council, member of the board of Union National Bank, Abu Dhabi Water and Electricity Authority, the GIC Group, and finally a member of the SPC. Khalil Mohammed Sharif Foulathi is the chairman of the Board of the United Arab Emirates Central Bank.

In addition to the official members of the board mentioned above, it was reported that Sheikh Ahmed used to delegate significant authority to Jean-Paul Villain, a French money manager, who directs investment strategy and asset allocation at ADIA. Mr. Villain, the most senior foreign-born executive at the Authority who was ranked as number one among influential expatriates in the region195, joined ADIA in the early 1980s from the French bank Paribas, and has been working for ADIA since, except for a brief period in the mid-1980s. Mr. Villain, who is married to a Syrian-born wife, has reportedly gained high trust in the royal family.

Mr. Villain joined ADIA in 1982 as regional manager for Europe, before being appointed senior fund manager for all financial assets. In 1995 he was promoted to the position of advisor and later senior advisor for investment strategy. He currently is the head of the strategy unit that forms part of the managing director’s office, and is a member of ADIA’s strategy committee, and chair of ADIA’s compensation working group. In addition to his commitments at ADIA, he has also been a board member of the Abu Dhabi Commercial Bank since 2004 and a member of the investment committee of the Abu Dhabi Benefits and Retirement Fund.196

Table 5-8: Members of ADIA’s investment committee (As of May 2010)

<table>
<thead>
<tr>
<th>Name</th>
<th>Position at ADIA</th>
<th>Position on the committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sheikh Hamed bin Zayed Al-Nahyan</td>
<td>Managing director</td>
<td>Chairman</td>
</tr>
<tr>
<td>Dr. Jua’an Salem Al Dhaheri</td>
<td>Board member</td>
<td>Deputy chairman</td>
</tr>
<tr>
<td>Sheikh Mohammed bin Khalifa bin Zayed Al-Nahyan</td>
<td>Board member, executive director for external funds Europe</td>
<td>Member</td>
</tr>
<tr>
<td>Hamad Mohammed Al Hurr Al Suwaidi</td>
<td>Board member</td>
<td>Member</td>
</tr>
<tr>
<td>Khalil Mohammed Sharif Foulathi</td>
<td>Executive director for fixed income and treasury</td>
<td>Member</td>
</tr>
<tr>
<td>Saeed Mubarak Rashed Al-Hajeri</td>
<td>Executive director for emerging markets</td>
<td>Member</td>
</tr>
<tr>
<td>Juma Khamis Mugheer Al-Khalili</td>
<td>Executive director for far East</td>
<td>Member</td>
</tr>
<tr>
<td>Mohammed bin Humooda bin Ali</td>
<td>Executive director for external funds America</td>
<td>Member</td>
</tr>
<tr>
<td>Majed Salem Khalifa Al-Romaithi</td>
<td>Executive director for real estate</td>
<td>Member</td>
</tr>
<tr>
<td>Khalifa Nasser Huwaileel Al-Mansouri</td>
<td>Executive director for accounts</td>
<td>Member</td>
</tr>
<tr>
<td>Hamad Salem Kardous Al-Ameri</td>
<td>Executive director for alternative investments</td>
<td>Member</td>
</tr>
</tbody>
</table>

As noted, ADIA’s investment decisions are closely tied with the managing director who is assisted by an investment committee formed of 11 members. Table 5.8 below illustrates the name and the position of the members of the investment committee. It is not surprising that all the member of the committee come from Abu Dhabi. Like all the board members, the members of investment committee have other key positions at private and/or government organizations, in addition to their position at ADIA.

The largest SWF in the world is managed by the people who are at the top of almost all the key political and economic institutions within the government of Abu Dhabi. As has been discussed above, all of the board members of ADIA are either members of the SPC, or the Al-Nahyan family, or both. It is clear, then, that the oil sector in Abu Dhabi, which is a highly politicised one globally, has direct impacts on ADIA’s course of action. Therefore, it is not far from reality to describe ADIA as a commercial organisation run by top-ranked politicians.

The saving pattern, decision making, investment policy, and withdrawal regulations in ADIA are all vague. This has indeed been inherited by ADIA from the culture of governance in the UAE. One thing which is clear is ADIA is far from being an organisation which operates independent from the government’s policies. However, it has not made any investment decisions which have proved to be driven by non-commercial motives. ADIA officials have frequently emphasised their purely commercial investment decisions; as such, in 2008, Abu Dhabi’s director of international affairs, Yousef Al-Otaiba, wrote an open letter to the US treasury secretary and other Western financial officials, saying: “It is important to be absolutely clear that the Abu Dhabi Government has never and will never use its investment organisations or individual investments as a foreign policy tool.”

Source: ADIA Annual Review (2009)

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Member</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mohamed Darwish Mohamed Al-Khouri</td>
<td>Executive director for internal equities</td>
<td></td>
</tr>
<tr>
<td>Hareb Al-Darmaki</td>
<td>Executive director for private equities</td>
<td></td>
</tr>
</tbody>
</table>

Table 5.8: Members of the Investment Committee

---

197 Thornton, Emily and Stanley Reed (2008), ‘Inside the Abu Dhabi Investment Authority’ in Bloomberg Business Week, 6 June 2008
198 Economist (2008), The rise of state capitalism, 18 Sept 2008
The government of Abu Dhabi is trying to turn Abu Dhabi into a regional hub for energy, finance and culture. Such a transition demands a good track record of the Abu Dhabi’s government institutions, as well as development of various economic sectors. Some of the recent high-profile investments of ADIA in Western financial institutions, and ADIA’s partnership with the IMF in establishing the IWG, are understood to be politically motivated, aiming to bring Abu Dhabi to the attention of global financial market players. ADIA has not taken any measures to leverage its financial power for political purposes and in the foreseeable future; it is unlikely to do so. Nonetheless, the above mentioned strategic decisions of ADIA over the past few years were aiming to help the government build its new identity and credibility at the regional and global level. In other words, even though ADIA’s investment strategy is commercially-driven, it has been actively working in line with major economic and political strategies of the government of Abu Dhabi.

5.2.2.1 The BCCI Scandal and its impacts on ADIA

A major crisis of the early 1990s in the UAE financial system was the scandal of Bank of Credit and Commerce International (BCCI) during which ADIA, a holder of 10% of the BCCI’s shares, is said to have lost hundreds of millions of dollars. Being a major shareholder of the BCCI, ADIA has suffered reputation and financial damage from that experience. In addition to this, as a result of the involvement of influential members of Al-Nahyan family with the bank, who at the same time held high management positions at ADIA, the effect of the BCCI outrage was significant on an individual level. The BCCI was a Luxembourg-registered company that was shut down in 1991 (see table 5.9). The bank’s headquarters were moved from London to Abu Dhabi in 1985. In 1990, Sheikh Zayed Al-Nahyan, who was a founding shareholder in BCCI, had purchased 77% of the BCCI’s shares and planned to restructure the bank’s system. An audit commissioned by the Bank of England alleged major fraud by the BCCI in the same year. The audit triggered the closing of most of the bank’s branches worldwide and had important impacts on the UAE financial sector.

BCCI had a £5.6bn deficit at the time of its closure. It was the largest financial fraud in the world to that date. The government of Abu Dhabi attempted to save the bank by proposing to inject £1.8bn into the bank. It emerged that the BCCI had stolen £1bn from

the personal account of Sheikh Zayed. Due to large operations of the BCCI in London, about 30 local authorities in the UK also lost in total around £82m.\(^{200}\)

The government of Abu Dhabi has always maintained that it was a victim of the BCCI fraud, not the performer. However, due to high government involvement in financial institutions and the low level of transparency of information, the reputation of the country’s banking system suffered from the negative effects of the scandal for some time.

Two key figures involved in the BCCI’s operations were a Pakistani banker named Agha Abedi, one of the founders of the BCCI, and Ghanim Al-Mazroui, a UAE citizen, who served as a financial adviser to Sheikh Zayed for more than 15 years. Al-Mazroui was the secretary general of ADIA at the time and a member of the board of directors of the BCCI. The two men were heavily involved in creating and managing a network of foundations, corporations, and investment vehicles for Abu Dhabi’s ruling family.\(^{201}\)

The BCCI handled the financial arrangements for many of the above mentioned entities, managed a variety of Abu Dhabi’s government portfolio accounts, and provided members of the ruling family with personal services. The bank therefore, maintained a solid relationship with the government and the ruling family in Abu Dhabi. Given the close relation between the BCCI and the government, ADIA had also had close ties, as it has been the main government investment vehicle of Abu Dhabi.\(^{202}\)

The Al-Nahyan family became embroiled in regulatory investigations, although no charges were ever brought against them.\(^{203}\) Twelve executive of the BCCI were sentenced to jail in 1994.\(^{204}\) During the investigations after the BCCI was closed, Al-Mazroui was arrested and held in custody. He was released soon after that and placed as the head of Abu Dhabi’s working group dealing with the BCCI. The appointment of Al-Mazroui with the background of close involvement with the BCCI as the head of the government’s working group for investigating the scandal was not the best choice of individual by the government. Al-Mazroui’s appointment, which was mainly as a result


\(^{202}\) Davidson Christopher M. (2005), The United Arab Emirates: A Study in Survival, Boulder, Colorado: Lynne Rienner Press

\(^{203}\) Thomas Landon, op.cit

\(^{204}\) Hauser, Christine (1994), BCCI men jailed and ordered to pay dollars 9bn by Abu Dhabi court: Former chief executive and founder of collapsed bank sentenced in their absence, Independent, 15 June 1994
of his close relationship with Sheikh Zayed, caused major damage to the reputation of the ruling family and indeed the judiciary system in Abu Dhabi.\textsuperscript{205}

Table 5-9: The key events in the BCCI scandal

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>New York regulators rejected the BCCI’s offer to buy a New York bank</td>
</tr>
<tr>
<td>1978</td>
<td>A US affidavit showing that Bank of America was holding 30% of BCCI’s total shares is critical of BCCI’s lending</td>
</tr>
<tr>
<td>1980</td>
<td>Bank of England rejected BCCI’s request for a full UK banking licence</td>
</tr>
<tr>
<td>1983</td>
<td>International banking supervisory bodies in Basel were concerned about the BCCI and made arrangements for dealing with anomalies in a responsibility sharing agreement</td>
</tr>
<tr>
<td>1985</td>
<td>Treasury fiasco. Auditors failed to uncover the fraud and the Bank of England agreed BCCI’s transfer of its treasury from London to Abu Dhabi</td>
</tr>
<tr>
<td>1986</td>
<td>Ernest and Young wrote to the BCCI to complain about exclusive management power and the weakness of its systems and controls</td>
</tr>
<tr>
<td>1987</td>
<td>Basel supervisors from eight countries created a working group to oversee BCCI</td>
</tr>
<tr>
<td>1988</td>
<td>BCCI was indicted for money laundering in Florida</td>
</tr>
<tr>
<td>1990</td>
<td>Price Waterhouse uncovered false practices and reported them to the Bank of England. Regulators approved a bail-out from Abu Dhabi to save BCCI from collapsing. US and Luxembourg gave BCCI deadlines to move its operations</td>
</tr>
<tr>
<td>1990</td>
<td>Bank of England reported that Palestinian terrorist accounts were held by BCCI</td>
</tr>
<tr>
<td></td>
<td>March</td>
</tr>
<tr>
<td></td>
<td>Bank of England reported $600 million of unrecorded deposits</td>
</tr>
<tr>
<td></td>
<td>January</td>
</tr>
<tr>
<td></td>
<td>BCCI commissioned Price Waterhouse report which led to the shutdown in July</td>
</tr>
<tr>
<td></td>
<td>March 4</td>
</tr>
<tr>
<td></td>
<td>Shutdown</td>
</tr>
</tbody>
</table>


The BCCI experience has been memorable for ADIA and the government of Abu Dhabi. Such experience is not something that the government of Abu Dhabi can easily afford again. The BCCI scandal affected overall strategy and governance of the authority. The most significant impact of the BCCI experience on ADIA is that the authority’s reluctance for sharing information with outsiders has been reinforced. Indeed ADIA has never been a fully transparent organisation; however, the BCCI incident has somehow justified the opaque system of ADIA as a preventative measure.

\textsuperscript{205}Christopher M. Davidson, op.cit
for the time of any potential crisis in order to protect the reputation of the organisation and the ruling family. Moreover, the monopoly of ADIA’s management by a handful of members of the ruling family and their close allies amongst a limited number of non-family members with a long history of working with the government may well be another effect of this BCCI experience on the governance of ADIA. Such policies have been applied in order to avoid assigning high-ranked management positions to any outsiders who may not act as loyally towards ADIA as the members of the ruling family or their closest local allies.

5.2.3 ADIA’s investment strategy

ADIA’s portfolio is formed similarly to European pension funds and American university endowments. ADIA relies on external asset management companies for up to 80% of its assets, and avoids taking large positions in individual companies. Since 2007, ADIA has handed some of its assets to the Abu Dhabi Investment Council which is mandated to invest in domestic and regional projects only. Therefore, domestic investments are no longer included in ADIA’s portfolio. ADIA’s portfolio is biased towards equities – up to maximum 78% of its total AUM.

According to ADIA’s 2009 annual review, the highest share of its portfolio is in stocks of developed markets (up to max 45%), stocks in emerging markets and government bonds (each up to max 20%), cash and credit (each up to max 10%). The lowest allocations have been made into small-cap stocks and infrastructure (each between min 1%-max 5%) (see Table 5-10).

Table 5-10: ADIA’s portfolio* overview by asset class and region

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Share of the portfolio (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks in developed</td>
<td>35-45</td>
</tr>
<tr>
<td>markets</td>
<td></td>
</tr>
<tr>
<td>Stocks in emerging</td>
<td>10-20</td>
</tr>
<tr>
<td>markets</td>
<td></td>
</tr>
<tr>
<td>Small-cap stocks</td>
<td>1-5</td>
</tr>
<tr>
<td>Government bonds</td>
<td>10-20</td>
</tr>
</tbody>
</table>

206 http://fletcher.tufts.edu/swfi/pdfs/UAE_ADIA_05-2010.pdf, accessed on 20 October 2010
207 www.adcouncil.ae, accessed on 20 May 2010
Investments in each of the above mentioned asset classes are managed by specific departments within ADIA. Some of these departments are reviewed below. Cash and credit investment departments have not been included here due to the lack of information. The single source of information in the following part has been ADIA’s official website and the annual review. The exclusion of these two asset classes may well be a result of their comparatively smaller share in ADIA’s portfolio.

- **External and Internal Equities**

The largest share of ADIA’s assets is allocated in stocks in equities both in developed and emerging markets. These allocations are made either directly or through external managers. Approaching and appointing external managers investing in different regions is a responsibility of external equities mandates. Each department is divided further into both actively and passively managed mandates. In total, ADIA operates more than 60 external equity mandates. The activities of all managers are monitored on a daily basis, backed up by regular internal reports on performance, risk and adherence to ADIA’s guidelines.

The internal equities department invests directly rather than through external fund managers. The department was created in early 2008. The department is divided
The United Arab Emirates’ Sovereign Wealth Funds

between active portfolios (7 regional teams), and passive portfolios (2 regional teams: developed and emerging markets).

- **Private Equities**

One of the long-standing departments at ADIA is private equities, which began its operations as early as 1989. The department has four main divisions, focusing on investments in primary funds, secondary and distressed funds and carefully selected co-investments alongside external managers. Its assets are broadly diversified across various geographic regions, industries, investment philosophies, sizes and time-frames. Private equity investments are monitored for their generated returns against a group of peers over a trailing six year period. As well as this, all the private equity investments must be made to outperform in the quoted equity market over 10 years.

- **Real Estate**

The department is divided into regional teams with a primary focus on direct investments in assets with stable cash flows, through joint ventures with experienced local partners or through external managers who are closely directed by ADIA’s in-house team.

- **Alternative Investments**

In order to generate long-term capital appreciation with low correlation to traditional global equity and fixed income markets, this department invests both directly and via external managers in futures markets and hedge funds which trade futures instruments connected to equity indices of currency derivatives, and hard and soft commodities.

- **Fixed Income & Treasury**

To meet ADIA’s liquidity needs and to obtain returns above its respective fixed income benchmarks while keeping an acceptable risk level, the department manages funds both internally and through external managers. In addition to money markets, the department’s investments can be grouped into four broad categories: global government bonds, global inflation-linked bonds, emerging market bonds and global investment-grade credit.
• Infrastructure

This department was created in 2007. As the portfolio overview shows, there is still a relatively cautious approach toward infrastructure investments at ADIA. The aim of investments in this type of assets is to provide a stream of relatively stable returns and cash flows. Its primary strategy is to acquire minority equity stakes alongside proven partners, with an emphasis on developed markets but an ability to look at emerging markets on an opportunistic basis.

In terms of currency allocation and geographic distribution of its assets, ADIA has a relatively heavy focus on developed markets. Also, it does not invest in the UAE nor does it invest in the Gulf region except in instances where such investments constitute part of an index. Up to 70% of the total assets under ADIA’s management are invested in US$ and European currencies. Investments in Asian and emerging market currencies are growing gradually. However, the preferred currencies are still clearly those from the developed world, particularly US$ which can occupy as much as 50% of ADIA’s portfolio currency basket (see Table 5-10).

5.2.3.1 ADIA’s risk framework

Managing risk plays a central role in ADIA’s strategic and day-to-day decision-making. Perhaps in the aftermath the financial crisis of 2008, ADIA, like many other GCC sovereign investment vehicles, has started taking more vigilant actions in terms of risk management and diversification strategies. An Investment Services Department was created in 2009 at ADIA, to bring together a number of existing risks, compliance and performance functions. The department provides various services including centralised administrative support to investment departments, data monitoring and reporting, and ensuring the consistency of business and Information Technology solutions.

ADIA’s risk management responsibility is directly carried by the managing director, with assistance and advice from various committees within the organisation. The risk management system is formed to allow for both pre-trade and post-trade compliance checking and is divided into four main categories:

• Settlement Risk: An operations control function designed to identify operational-risk. Other measures are also taken such as using only approved
brokers and counterparties for trading and breaking up duties across key processing areas.

- **Business Continuity Risk:** This programme includes general awareness and education for staff and all levels of management, as well as the development and regular review of business continuity plans.

- **Reputational Risk:** All of the employees must adhere to the ADIA Code of Ethics and Standards of Professional Conduct, which are designed to help manage potential conflicts of interest and cover several areas, including: pre-approval of personal account trading, disclosure of outside business interests, disclosure of gifts or benefits received. ADIA subjects employees to rigorous selection criteria, including background checks. ADIA’s Code of Ethics and Standards of Professional Conduct is not published on ADIA’s website. However, from the brief mention of the code and the areas which it covers on the website, it seems to be a standard code of practice which is followed in any given international financial institution.

- **Regulatory Risk:** ADIA’s compliance officers, in-house lawyers and key staff work closely with front-office departments to ensure that ADIA responds to changes in market regulations and legal requirements.\(^{208}\)

As has been noted above, the financial crisis has triggered ADIA’s risk management alertness. This may well be as a result of the rather unsuccessful experience of ADIA’s acquisition of Citi Bank. The authority has been the only SWF which made a legal claim on the deal with Citigroup, and has accused Citi of fraud at the time of the deal. Other SWFs which hold shares in Citi reported high returns on their investments. the Kuwait Investment Authority proudly reported 36.7% return on the recent sale of its $4.1 billion shares of Citi. The Government of Singapore Investment Corp. also made a $1.6 billion profit selling about half of its stake in Citi since converting its holdings from preferred shares to ordinary shares.\(^{209}\)

ADIA pursued a lawsuit on the basis of fraud and misinformation; it seems however, unlikely that the Authority will succeed. As a result, the ADIA has been reported to show increasing interest in joint investments, to minimise the risk associated with its

\(^{208}\) [http://www.adia.ae/En/pr/Annual_Review_Website2.pdf](http://www.adia.ae/En/pr/Annual_Review_Website2.pdf), accessed on 20 October 2010

\(^{209}\) Critchlow, Andrew (2009), Adia's Wounded Pride Over Citi, The Wall Street Journal, 18 December 2009
investments. Last year ADIA and Mubadala Development Company agreed to take up joint investment projects with their Singaporean counterpart Temasek Holdings, helping both sides to bring together resources and expertise from all three parties for mutual benefit. Cooperation between the funds is expected to take the form of co-investments based on certain geographical locations and particular industrial sectors.\textsuperscript{210}

\section*{5.3 Invest AD}

Invest AD is one of Abu Dhabi’s small SWFs and it was established upon ratification of an Emiri decree in 1977. The company was established initially under a different brand name: “Abu Dhabi Investment Company”, and was rebranded in 2009. The company gradually developed throughout three decades of actively operating as a government investment company in Abu Dhabi. Invest AD initially operated under the patronage of ADIA. In 2007, however, it started a new mandate to manage third party funds in addition to its existing assets which were entrusted to it by the government of Abu Dhabi. In the same year, the company was removed from the patronage of ADIA and began to operate under the umbrella of Abu Dhabi Investment Council. The company is now owned by ADIC and its vision is aligned with Abu Dhabi 2030 Vision. At the time of its transition in 2009, Invest AD was trusted with all the domestic investments of ADIA, which does not invest locally anymore. In addition to investment within the UAE, Invest AD is actively operating in many countries across the Middle East and North Africa. The company is focusing on three core areas of financial operation: asset management, private equity, and proprietary investments.

The rebranding of the company was an important step in the development of Invest AD and it reflected the evolution of the company’s business model. Invest AD began to offer a new range of services to third-party investors in 2007. Therefore, rebranding was to create a new identity to signal this important change. Nazem Fawwaz Al-Kudsi, the chief executive officer of the company, explained the choice of the new brand name as:

\begin{quote}

“Invest AD” was chosen as our new name because it reflects exactly what the company wants to do – attract investment to great opportunities in the Middle East and Africa. ‘AD’ and the sail-shaped logo symbolise the firm’s Abu Dhabi heritage and its strong connections in the Gulf of Arabia.”\textsuperscript{211}
\end{quote}

\textsuperscript{210} Haider, Haseeb (2006), ADIA to be Replaced by ADIC, Khaleej Times, 23 October 2006

\textsuperscript{211} MacDonald, Craig (2011), 'New name, same focus’ in Global investor ISF, December/January 2011
5.3.1 **Investment strategy of Invest AD**

Under its asset management services, Invest AD offers investors access to securities markets across the Middle East and Emerging Africa through equity funds and discretionary managed accounts, and also provides sub-advisory services to other fund managers. Asset management at Invest AD is operating various funds. Each of these funds has a particular geographic focus for their investment:

1. **UAE Total Return Fund**: this fund is designed to provide the investors access to leading stocks in the UAE.

2. **Emerging Africa Fund**: the fund invests mostly in equities of the countries of Nigeria, Morocco, Egypt, Kenya, Mauritius, Botswana, Ghana, Zambia, Namibia, Tunisia, Algeria, Uganda, Tanzania, as well as equity securities listed on Bourse Régionale des Valeurs Mobilières regional exchange (which includes the equities of companies in Ivory Coast, Benin, Burkina Faso, Guinea Bissau, Mali, Niger, Senegal and Togo). It also invests in other equities, including South Africa, as well as those listed on international stock exchanges.

3. **GCC Focus Fund**: this is a concentrated fund and holds between 20 and 30 stocks. The company’s investment management team has its own “high-conviction” stock picks for the Gulf region.

4. **MENA Dynamic Fund**: the fund analyzes and may invest in equity securities from Saudi Arabia, UAE, Kuwait, Qatar, Oman, Egypt, Jordan, Lebanon and Turkey. The investment managers have full discretion over this fund and may allocate between 100 per cent cash and 100 per cent equity investment. MENA Dynamic Fund is free from a set benchmark but it actively uses cash as part of the investment strategy in order to mitigate downside risk and preserve capital in down-trending markets.

5. **Iraq Opportunity Fund**: the fund channels capital into various areas of the Iraqi economy that will benefit from liberalization, government spending on infrastructure and foreign direct investment. Currently, the banking sector which is forecast to see strong growth as small- and medium-size enterprises seek growth capital, is considered as an opportunity by this fund.
6. **Libya Opportunity Fund**: the fund was established in 2007 and primarily invests in listed companies which it considers as the major players for shaping new growth opportunities in the Libyan economy, such as banking, insurance, manufacturing and telecommunications.

Invest AD’s private equity team is active in portfolio companies to enhance management and governance. It offers access to its regional existing network and new business opportunities. The team is focusing on return generation for all of his investments and it is targeting a gross annual internal rate of return to its investors of over 25 percent. The fund takes control or significant minority positions in companies:

- with primary positions in their respective markets;
- that are established, of good reputation and are either in the middle of late phases of development
- which are active in attractive sectors like fast moving consumer goods, healthcare, logistics, education, and services; and
- are proven to have an opportunity for the private equity team to create value through operational improvements.

The company’s proprietary investments group plays an important role in assisting the development of the funds business by supplying them with what the company refers to as “seed investment”. Proprietary investments are through the company’s own balance sheet in several areas in global markets, including private equity, real estate. The group also manages Invest AD’s treasury and trading operations, including foreign exchange, money markets, fixed income, equities and commodities. To ensure that the clients’ interests are never compromised by Invest AD’s interest, the company has separated operation and decision making teams for its own investments and the third-party asset management businesses.

### 5.3.2 Governance of Invest AD

The company is governed by a board of directors (see Table 5-11 below). Like other government organisations of Abu Dhabi, Invest AD also has few members of families with close links with Al-Nahyan, like Al-Suweidi and Al-Daher. Nazem Fawwaz Al-Kudsi is the chief executive officer of the company and perhaps the key individual in
day to day operations at Invest AD. Al-Kudsi has a prominent investment track record over more than two decades in the Middle East, United States, North Africa and Far East. He has worked in leading roles at the Abu Dhabi Investment Authority. During his time in ADIA, Al-Kudsi was also a member of the Water & Electricity Sector Privatisation Technical Evaluation Group. He played an important role in this position in Abu Dhabi’s early privatisation initiatives. He was also in charge of a number of international investment portfolios at ADIA, including the US technologies portfolio in Silicon Valley and the fund’s portfolio in Japan. In 2005, Al-Kudsi was invited by the National Bank of Abu Dhabi to be group chief investment officer, responsible for all aspects of the business. In 2008, he was asked to take the lead at Invest AD.

Table 5-11: Invest AD board of directors

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Khalifa M. Al-Kindi</td>
<td>Chairman</td>
</tr>
<tr>
<td>Nasser A. Al-Sowaidi</td>
<td>Deputy chairman</td>
</tr>
<tr>
<td>Khalifa S. Al-Suwaidi, Mohamed A. Al-Dhaheri, Khalaf S. Al-Dhaheri, Salem M. Al-Ameri, Hashem F. Al-Kudsi</td>
<td>Board members</td>
</tr>
<tr>
<td>Nasser A. Al-Sowaidi, Khalaf S. Al-Dhaheri, Khalifa S. Al-Suwaidi, Nazem Fawwaz Al-Kudsi, David Beau</td>
<td>Executive committee</td>
</tr>
<tr>
<td>Salem Mohamed Al-Ameri (chairman), Abdirizak Ali Mohamed (member), Clive Gallier (member)</td>
<td>Audit committee</td>
</tr>
</tbody>
</table>

Source: www.investad.ae

5.4 An introduction to Mubadala Development Company

*Mubadala* Development Company is an Abu Dhabi-based business development and investment company, of which the government of Abu Dhabi is the 100% shareholder. The company was established in 2002 by an emiri decree to implement the government’s economic diversification strategy in a commercial and profitable manner. It was mandated to diversify and transform Abu Dhabi’s economy, develop a new generation of business leaders locally and build a prosperous future for the people of Abu Dhabi.

According to Sheikh Mohammad bin Zayed, the chairman of *Mubadala*:

“..the diversification of the Emirate’s economy is an immediate priority of the Government of Abu Dhabi. In delivering against its commercial mandate,
Mubadala contributes significantly to the implementation of that diversification process...through the patient and robust support of its shareholder, Mubadala is able to take a long term perspective when developing projects and deploying capital, both within the UAE and internationally.\(^{212}\)

The word “\textit{Mubadala}” which is the Arabic translation of “exchange” represents the mission of the company well. \textit{Mubadala} was established to invest in foreign companies in exchange for a transfer of their expertise to Abu Dhabi. Involvement in the social development of Abu Dhabi is a core mandate of \textit{Mubadala}’s institutional strategy. Reflecting the mandate, each investment at \textit{Mubadala} is required to demonstrate contributions to the economic and social development of Abu Dhabi.

As of 31\textsuperscript{st} December 2008, the Government’s cumulative contributions (grants, capital and assets) to the company totalled US$10.7 billion. \textit{Mubadala}’s under management assets are invested in a highly diversified portfolio of assets. Table 5.12 below demonstrates further general information on \textit{Mubadala}.

Table 5-12: \textit{Mubadala} Development Company General Information

<table>
<thead>
<tr>
<th>Credit rating</th>
<th>AA2 (Moody’s)/ AA (Fitch)/ AA (S&amp;P)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total employees</td>
<td>Approx. 460</td>
</tr>
<tr>
<td>Total Assets</td>
<td>US$ 14.8 bn</td>
</tr>
<tr>
<td>Total Debt</td>
<td>US$ 3.4 bn</td>
</tr>
<tr>
<td>Total Equity</td>
<td>US$ 8.5 bn</td>
</tr>
</tbody>
</table>

Source: field research

In terms of asset development, the company has achieved significant growth between 2006 and 2008. As Figure 5-3 below shows, over the mentioned period Mubadala’s assets’ compound annual growth has increased up to about $10 billion.

Figure 5-3: Total assets compound annual growth rate (US $bn)

Source: field research

Due to the investment mandate of Mubadala for transferring new technology and know-how to further develop the technology sector in Abu Dhabi, the company has a highly diversified portfolio of assets. Various in-house business development units manage Mubadala’s assets. A list of these units is demonstrated in Table 5.14 below.

Due to the sharp focus of Mubadala on technological advancement and reduction of economic reliance on oil in Abu Dhabi, the company has always been more domestically-focused than other GCC sovereign wealth funds. From 2000 to 2008, 40% of the company’s publicly-reported investments were at home, which is indeed a contrast to some other GCC sovereign wealth funds like ADIA and KIA, whose equivalent this share during the same period was as small as 10%. Prior to 2008, about a third of Mubadala investments were made domestically. However, like many other international investment institutions, Mubadala’s investment strategy has been affected by the recent global financial crisis. Since 2008 the company has gone through a shift of investment strategy towards a more hands-on approach to development and diversification of the national economy.213

On the eve of the financial crisis, Mubadala had chosen a different approach in comparison with other Gulf SWFs. Rather than financing collapsing Western financial institutions, a strategy followed by the KIA and ADIA, the company focused even more on domestic investments, seeking to protect the best interests of the national economy. In the real estate sector for example, prior to the crisis, the company had been involved in geographically mixed projects in emerging markets (65%) and OECD (35%); while, only three investments were made within the UAE. However, after 2008, the company doubled the proportion of transactions made at home from 27 to 55 per cent.

As noted above, the social mandates are a significant element of Mubadala’s investment strategy. Therefore, in order to facilitate the transfer of technology to Abu Dhabi, joint ventures investments have always been preferred at Mubadala, instead of straight equity purchases. There has, however, been further emphasis on joint-venture investments after the financial crisis. This makes Mubadala an active investor which is able to influence how the businesses are managed.214 It can also be seen as a sign of Mubadala’s loyalty to developing both the social and financial capital of the emirate.

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213 Field research
214 Barbary, Victoria and Edward Chin (2009), Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis, Monitor Group
Figure 5-4 demonstrates the number and the value of total deals that *Mubadala* engaged in between 2002 and 2008. As it is mentioned above, *Mubadala*’s portfolio of investments is highly diversified which mainly reflects the government’s will for diversification of the Abu Dhabi economy and the role of *Mubadala* in the overall strategy of the government. As is illustrated in the tables below, 35% of the total number of deals in which the company has engaged since its establishment have been in energy and utilities projects. This underlines *Mubadala*’s crucial role in the development of energy related industries in order to utilise the comparative advantage of the oil rich emirate of Abu Dhabi.

Table 5-13: An overview of *Mubadala* Development Company’s Business Units

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>Strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil &amp; Gas</td>
<td>to leverage technical, commercial and inter-governmental relationships</td>
</tr>
<tr>
<td></td>
<td>to expand regional activities</td>
</tr>
<tr>
<td></td>
<td>to establish <em>Mubadala</em> as a globally competitive oil and gas E&amp;P company</td>
</tr>
<tr>
<td>Energy &amp; Industry</td>
<td>to capitalize Abu Dhabi’s natural resources</td>
</tr>
<tr>
<td></td>
<td>Development of energy-linked infrastructure (including utilities)</td>
</tr>
<tr>
<td></td>
<td>to make investments that focus on basic industries</td>
</tr>
<tr>
<td></td>
<td>to build an export-oriented industrial sector</td>
</tr>
<tr>
<td>Real Estate &amp;</td>
<td>to development residential, commercial and retail real estate</td>
</tr>
<tr>
<td>Hospitality</td>
<td>invest in luxury hospitality sector to increase Abu Dhabi’s appeal as</td>
</tr>
<tr>
<td></td>
<td>travel destination</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>to develop, invest in, own and operate concession-based infrastructure</td>
</tr>
<tr>
<td></td>
<td>(through PPPs), particularly in health and education</td>
</tr>
<tr>
<td>Services</td>
<td>to develop new business ventures in services-based sectors (finance,</td>
</tr>
<tr>
<td></td>
<td>maritime, transportation, defence, and logistic services)</td>
</tr>
<tr>
<td>Aerospace</td>
<td>to establish and develop aviation and aerospace industry in Abu Dhabi</td>
</tr>
<tr>
<td>Information,</td>
<td>to focus on creating an information, communications and technology</td>
</tr>
<tr>
<td>Communications &amp;</td>
<td>cluster and establish a local technology footprint</td>
</tr>
<tr>
<td>Technology</td>
<td></td>
</tr>
<tr>
<td>Healthcare</td>
<td>to enhance the private healthcare infrastructure</td>
</tr>
<tr>
<td>Key Initiatives /</td>
<td>to establish Abu Dhabi as one of the leading global centres for renewable</td>
</tr>
<tr>
<td>Investments</td>
<td>energy, (through minority investments and joint ventures, e.g. with GE)</td>
</tr>
</tbody>
</table>

Source: field research

The next sector which the company has been heavily engaged in, is the real estate sector. 13% of the total number of the projects undertaken by *Mubadala* during the
same period (2002 - 08) has been in the real estate sector. Such investment interest can be seen as evidence to prove the strong ambition of the leaders of Abu Dhabi to further develop the tourism sector to compete with Dubai. Dubai has been the leading emirates for its real estate and tourism industry. Particularly after the financial break down of Dubai which heavily damaged its real estate and tourism sector, Abu Dhabi is racing now to develop into one of the main tourist attractions of the region and to replace Dubai on the federal level.

Figure 5-4: Number of Mubadala deals by sector 2002-2008 (total=60)

Source: field research

5.4.1 Governance of Mubadala

Governance and management of Mubadala is, like other government investment engines of Abu Dhabi, highly dominant by the ruling family. Five of the seven members of Mubadala’s Board of Directors are also members of the Abu Dhabi Executive Council. The Board is chaired by the Crown Prince, who also chairs the Council. The company is developing a portfolio of high profile strategic assets and projects which are closely aligned with the Government’s development strategy. Mubadala is a partner in various world class projects like Dolphin Energy, the proposed GE Joint Venture, Emirates Aluminium and the Masdar initiatives. All in all, the overall highly diversified investment strategy of Mubadala is strongly directed by Abu Dhabi Economic Vision of 2030.

The management team at Mubadala is formed mainly by Western expertise. As a result of this Mubadala has developed into a rather sophisticated investment institution. Various units of the company deal with specific technical issues of the day to day investment and management operations. Figure 5-5 below demonstrates details of the investment decision making procedures at Mubadala. The company has strict decision
making procedures for larger deals. As source Table 5-14 shows, all investments above a threshold of $300m must be approved by the board of directors, which includes the crown prince of Abu Dhabi, Sheikh Mohammad bin Zayed Al-Nahyan (chairman), Mohammed Ahmed Al-Bowardi (vice-chairman), Ahmed Ali Al-Sayegh (member), Hamad Al Hurr Al-Suwaidi (member), Nasser Ahmed Khalifa Al-Sowaidi (member), Mohamed Saif Al-Mazrouei (member), and Khaldoon Khalifa Al-Mubarak (CEO and managing director). Two of the board members of Mubadala are also on the board of ADIA (Sheikh Mohammad bin Zayed Al-Nahyan and Hamad Al Hurr Al-Suwaidi).

In the field research of this study, which was undertaken in 2010, Khaldoon Khalifa Al-Mubarak, the CEO and managing director of Mubadala, was repeatedly referred to as the highest influential individual who makes most of the day to day operational decisions of the company. Like many other high-ranked individuals of the government of Abu Dhabi, Al-Mubarak holds other positions in addition to his role at Mubadala.

He is chairman of the Abu Dhabi Executive Affairs Authority, which provides strategic policy advice to the chairman of the Abu Dhabi Executive Council, of which he is also a member. He is chairman of the Emirates Nuclear Energy Corporation, Abu Dhabi Motorsports Management, the Abu Dhabi Media Zone Authority and Emirates Aluminium (EMAL). He is also deputy chairman of the Urban Planning Council, a member of the Abu Dhabi Council for Economic Development and a board member of First Gulf Bank, Ferrari SpA, and ALDAR Properties. Al-Mubarak holds a degree in Economics and Finance from Tufts University, Boston, USA.215

Table 5-14: Mubadala’s investment approval thresholds

<table>
<thead>
<tr>
<th>Investment Size</th>
<th>Approval Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below US$300 million</td>
<td>Investment Committee</td>
</tr>
<tr>
<td>US$300 million and</td>
<td>Board of Directors</td>
</tr>
<tr>
<td>above</td>
<td></td>
</tr>
</tbody>
</table>

Source: field research

215 http://www.mubadala.ae/about/board_of_directors/, accessed on 12 November 2010
All in all governance and management at *Mubadala* has been highly politicised. This is directly as a result of a strong link between creation of *Mubadala* and Sheikh Mohammed bin Zayed’s offset initiative. Offsets involve a large foreign purchase by a government – the buyer – of which the import price is ‘off-set’ by the seller. Offsets are a reciprocal agreement between foreign firms and the government of Abu Dhabi to perform a compensation practice for large government procurement. Offsets are often associated with arms transfer, thus distinguishing them from the categories above (which tend to embrace commodity or industrial goods).²¹⁶ Such link has made the company a strong tool both to reshape the political economy of Abu Dhabi and to raise Sheikh Mohammed’s influence within Abu Dhabi political elite.

As it is noted above, the role of individual’s influence in the governance of Abu Dhabi’s government investment institutions is stronger in comparison with other Arab SWF case studies of this project. Often the power struggle between various individuals within the political elite has been mirrored in arrangement of senior managers of Abu Dhabi’s

²¹⁶ Nanakorn, Pattarawan (2009), *The Offset Programme as a Development Tool in the UAE*, PhD thesis submitted at Exeter University.
government investment vehicles. A good example of the kind is ADIA’s recent management reshuffle which mirrors the power struggle between Sheikh Mohammed and Sheikh Khalifa. In the new arrangement of ADIA’s senior management, while Shaikh Khalifa remained in final control of ADIA, allies of Sheikh Mohammed, as well as himself, were moved into more influential positions. This has been arguably a strategic move by Sheikh Mohammed to balance his power in ADIA with Sheikh Khalifa’s previously undisputed hold.

5.5 **Emirate Investment Authority**

A new sovereign wealth initiative on the federal level within the UAE was announced in late 2007. The new investment institution is called the Emirates Investment Authority (EIA). The body will be responsible for developing investments on behalf of the UAE government. The initiative could point to a unified investment strategy amongst the seven members of the UAE.

As noted above, according to the federal law of the UAE, each of the seven members of the UAE is entitled to manage their wealth independently. Abu Dhabi, the most well-endowed emirate, has traditionally utilised the surplus oil revenues within the emirate. A small share of Abu Dhabi’s wealth has been distributed amongst other emirates through the form of subsidies, extended loans or grants. Nonetheless, the fairness of such a system has been a matter of scrutiny amongst all the other six emirates, though to a lesser extent in Dubai. Therefore, the federal investment authority may well have been established to tackle such issues.

Establishment of a federal fund has been interpreted as a driver for closer federal cooperation and union among the ruling elites of the seven emirates. According to the EIA’s website, the fund is the sole government body which is responsible for the future stewardship of federal governments’ holdings in more than 30 corporations. Most of the assets under management of the EIA are invested across the GCC; including in *Etisalat*, Du, Gulf International Bank, United Arab Shipping Company, and Gulf Investment Corporation. The objectives of the EIA have been defined to seek high financial returns, and to diversify the government’s asset exposure in the public and private markets internationally.²¹⁷

The governing body of the EIA is a board of directors of eight members, chaired by Sheikh Mansour bin Zayed Al-Nahyan - who also sits on the board of directors of ADIA. The headquarters of the EIA are located within walking distance of ADIA’s iconic building in Abu Dhabi. All in all, despite the distinct lack of revealed information on the newly established federal fund, it is most likely that Abu Dhabi, the major financier of the EIA, would hold the main share of the management.

Table 5-15 presents the EIA senior management team. As it is shown in the Table, the governance of the EIA is monopolised by high-rank individuals from Abu Dhabi and Dubai, and despite the definition of the EIA being to incorporate all the seven members of the UAE, other emirates have not been included in the management team.

There has been very little media coverage and publicity on the EIA. One commentator, Tristan Cooper, a senior sovereign analyst at Moody's Middle East Ltd was quoted as saying:

"The Emirates Investment Authority is certainly an interesting initiative and symbolizes the drive for closer federal coordination and unity among the upper reaches of government...the UAE federal budget is rather small compared with the overall consolidated fiscal position of the country and it tends to be close to balance from year to year...unless significant amounts of extra revenue are injected into the federal budget by individual emirates or assets are transferred from existing funds such as ADIA, it is difficult to see how the EIA will build up substantial amounts of cash for investment over the short to medium term” 218

Table 5-15: EIA’s senior management

<table>
<thead>
<tr>
<th>Name</th>
<th>Position at EIA</th>
<th>Other positions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sheikh Mansour bin Zayed Al-Nahyan</td>
<td>Chairman</td>
<td>Board Member and Director of ADIA/ Chairman of the International Petroleum Investment Company (also manages the Falah Fund)/ Minister of Presidential Affairs for President Sheikh Khalifa bin Zayed Al-Nahyan in the UAE Federal Cabinet/ Chairman of the First Gulf Bank/ Member of the Board of Trustees of the Zayed Charitable Humanitarian Foundation/Chairman of the Emirates Horse Racing Authority</td>
</tr>
<tr>
<td>Mohammad Abdullah Al-Gergawi</td>
<td>Deputy Chairman</td>
<td>Minister of State for Cabinet Affairs</td>
</tr>
</tbody>
</table>

Table 5-16 gives a timeline for the EIA since it was established in 2007. As noted above, there is very limited information available on this organization, particularly since mid-2008. One obvious conclusion is that the EIA is a rather young initiative which has not been followed seriously by the federal government yet.

Table 5-16: Development timeline at the EIA

<table>
<thead>
<tr>
<th>Date</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td>November 13, 2007</td>
<td>Emirates Investment Authority created by Royal decree</td>
</tr>
<tr>
<td>January 9, 2008</td>
<td>Board of Directors appointed</td>
</tr>
<tr>
<td>March 23, 2008</td>
<td>First Board of Directors meeting held</td>
</tr>
<tr>
<td>June 1, 2008</td>
<td>Second Board meeting held and Rashid Mubarak Al-Mansouri appointed as CEO</td>
</tr>
<tr>
<td>July 21, 2008</td>
<td>First investment with a bond sale by First Gulf Bank</td>
</tr>
</tbody>
</table>

Source: www.taighde.com
5.6 An introduction of Dubai’s sovereign wealth investment institutions

The government of Dubai has established various investment institutions. These investment vehicles heavily rely on leverage, and they are not fully financed from commodity income surpluses like the sovereign wealth funds of Abu Dhabi. Therefore, many analysts have argued that they may not fit well into the definition of commodity SWFs. In this study however, Dubai sovereign wealth investment institutions are assumed to be CSWFs for the following reasons:

1. As defined in the previous chapters, the major source of funds for CSWFs is commodity export income. Although the government of Dubai used leverage for financing Dubai SWFs over the past years, the early source of wealth for the government of Dubai, as well as the primary source of funds for these investment vehicles, has been oil revenue. As shown in Table 5-1, oil production in Dubai started in late 1960s. Although, Dubai’s oil production had lagged far behind that of Abu Dhabi, it had significantly increased through 1970s and early 1980s and formed the main source of government’s key income for financing the development projects leading to establishment of the government investment vehicles of Dubai.

2. Based on the definition in this study, the CSWFs, like the KIA, were established to save the country’s wealth for future generations. Dubai’s government investment institutions have also been established to generate revenue for the years to come after the end of oil production.

3. Another aim of some CSWFs, like Mubadala, has been to help the national economy to diversify from the oil sector. Dubai’s state-owned investment institutions have highly diversified investment portfolios. Such investment strategy indeed proves that the government of Dubai has been using these institutions to facilitate the diversification of the economy.

Moreover, as it has been discussed above, the emirate of Abu Dhabi plays an important role in the federal government of the UAE. Dubai is the single competitor with Abu Dhabi in both political and economic contexts. Studying the structure of Dubai government-owned investment bodies in this study is providing a comparison between the different ways in which the national wealth has been managed in Dubai, and what is
practiced by the government of Abu Dhabi. Furthermore, exploring these institutions gives a clearer outlook for the future role of Abu Dhabi SWFs within the UAE, in the region and the global financial system.

Studying Dubai’s sovereign wealth investment engines also underlines the differences between the two emirates in various aspects, such as the visions and mind sets of the rulers, style of management within the local elite, business culture, sector focuses, and macroeconomic climate.

Considering Dubai’s limited oil resources in comparison with its neighbouring emirate, Abu Dhabi, it has managed to attract a significant amount of capital in various projects, which led to a leverage-led growth in the economy. One of the major sources of capital in Dubai was the massive inflow of capital from neighbouring countries, including Iran. Iran’s economic sanctions since the Islamic revolution gave Dubai a unique mediator role between Iran’s massive market and outside world, and made Dubai one of the major trading partners of that country. Moreover, Dubai’s vision for establishing a globally known brand name, which was set long before Abu Dhabi’s economic boom, focused on the development of various sectors of Dubai’s economy, including services, tourism, real estate and banking. Most of these development projects were financed by heavy foreign borrowings. This put Dubai in a unique position to apply a non-commodity based growth model in the region.

Dubai’s government investment institutions comprise several companies with highly diversified portfolios, from real estate to ship repair and marine-related activities. The major Dubai funds are Investment Corporation of Dubai (ICD) and Dubai World. ICD is divided into two major corporations: Borse Dubai (a holding company for Dubai Financial Market and Nasdaq Dubai) and Dubai Holding (with seven major subsidiaries: DIC, Dubai Group, Dubai Property, Sama Dubai, Jumeirah Group, Tecom Investment and Tatweer). Dubai World's holdings include most notably Istithmar, Nakheel, and DP World (international terminal and port manager).

5.6.1 Investment Corporation of Dubai (ICD)

Investment Corporation of Dubai is one of the two major investment institutions of Dubai. It is the overseas investment arm of the government of Dubai, and was formed in 2006. It has been financed by the transfer of the government's portfolio of investments.
from the Department of Finance's Investment Division. The source of ICD’s revenue has been originated to the emirate’s oil income and the estimated size of its assets is about $82 billion. Like most of the government investment funds of the GCC, the major strategy of Dubai SWFs is to reach development plans’ goals and support the diversification of the economy. According to SWF Institute, ICD is rather more transparent than other investment institutions of the emirate like Dubai World. The Corporation is divided into two corporations: Borse Dubai Ltd and Dubai Holdings. Each of these corporations owns a number of subsidiaries.

- **Borse Dubai, Ltd**: the company has $2.2 billion assets under management and was incorporated in 2007. It is the holding company for Dubai Financial Market and NASDAQ Dubai. The company was established to consolidate the government of Dubai’s two stock exchanges as well as current investments in other stock exchanges of the world, in order to expand Dubai’s position as a global capital market hub. Borse Dubai’s main mission is to maintain the synergy between both exchanges inside Dubai and it seeks to improve infrastructure to better serve all stakeholders. Moreover, the company explores opportunities with capital markets across the globe to leverage technology, liquidity, regulation and expertise.

Borse Dubai’s growth mandate is extracted from the 2015 Dubai Strategic Plan which has defined financial services and capital markets as a key focus area to support the development and growth of regional capital markets to the highest international standards. 219 60% of Borse Dubai is owned by the Investment Corporation of Dubai, 20% owned by Dubai Group and 20% owned by Dubai International Financial Centre Investments. 220 The chairman of Borse Dubai is Essa Kazim, who is also managing director and CEO of Dubai Financial Market, as well as holding a number of other positions in various government organisations.

- **Dubai Holding**: There is no reliable estimate data on the actual size of the total assets under management for the Holding, which is believed to be essentially in the private ownership of Sheikh Mohammad bin Rashid, Dubai’s Ruler. 221 However, it is known to be a much larger company than Borse Dubai. Dubai

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219 http://www.borsedubai.com/, accessed on 9 January 2010
220 www.swfinstitute.org, accessed on 15 May 2010
Holding is an active investor in four sectors: property, business parks, hospitality and investments. The Holding’s chairman is Mohammad Al-Gergawi, Minister of Cabinet Affairs of the Federal Government of the United Arab Emirates.\textsuperscript{222} The Holding has seven companies, each of which has a number of subsidiaries, brands and projects:

1. **Jumeirah Group** is a hospitality company and its portfolio includes: Jumeirah Hotels & Resorts, Jumeirah Living (a natural extension to the Jumeirah Hotels & Resorts brand and part of the Jumeirah Group), Jumeirah Restaurants, Sirius (Jumeirah's award-winning recognition and rewards programme which offers members various services from room bookings to spa treatments), the Emirates Academy of Hospitality Management (designed for degree courses in hospitality management), Wild Wadi Waterpark of Dubai, Jumeirah Emirates Towers Offices, and Jumeirah Hospitality (a premier event management company)\textsuperscript{223}

2. **TECOM Investments** is active in buoyant cutting-edge sectors like ICT, Media, Education, Life Sciences and Clean Technology. TECOM Investments manages entities like Dubai Internet City, Dubai Media City, Dubai Knowledge Village, Dubai International Academic City, eHosting DataFort, International Media Production Zone, Dubai Outsource Zone, Dubai Studio City, DuBiotech and Enpark. It also encompasses local and international joint venture interests like Empower, a district cooling service provider established as a joint venture with Dubai Electricity and Water Authority, Emirates International Telecommunications Limited, a joint venture with Dubai Investment Group and SmartCity, a joint venture formed with SAMA Dubai to develop and manage knowledge industry townships worldwide. Emirates International Telecommunications Limited holds stakes in Tunisie Telecom and GO, telecommunication carriers in Tunisia and Malta respectively. SmartCity has already laid the foundations of a global network of knowledge driven clusters through agreements to develop SmartCity Malta and SmartCity Kochi.

\textsuperscript{222} \url{http://dubaiholding.com/}, accessed on 16 May 2010

\textsuperscript{223} \url{http://www.jumeirah.com/en/Jumeirah-Group/About-Jumeirah-Group/Portfolio/}, accessed on 16 May 2010
3. **Dubai Group** is the leading diversified financial services company of Dubai Holding, focusing on banking, investment and insurance. The company was first established in 2000 under the name The Investment Office. In 2004, it was renamed Dubai Investment Group and in January 2007, the company was re-branded as Dubai Group. The group’s headquarters are in Dubai, and it has offices in New York and Istanbul. Dubai Group creates and manages a diverse selection of direct and indirect investments in different parts of the world, including the Middle East & North Africa (MENA) region, the European Union, North America and Asia. Dubai Group has business interests in 14 countries employing 2,000 individuals in 78 branches worldwide. The Executive Chairman of Dubai Group is Soud Ba’alawy. He was previously CEO of Dubai Investment Group and played a key role in its foundation and growth. With more than ten years of experience in banking, he has various other board memberships and affiliations at various financial institutions of Dubai including: *Noor* Islamic Bank, Marfin Popular Bank, *Taib* Bank, Dubai Bank.\(^{224}\)

4. **Dubai Properties Group** (DPG) develops and manages properties, communities and destinations. Through its subsidiaries, DPG also offers end-to-end property related services including sales and leasing via *Salwan*, the real estate broker, property management, facilities management and security services via Dubai Asset Management; and destination management via Dubai Land.

5. **Tatweer** was founded in December 2005 with diverse interests in energy, tourism leisure and entertainment, industry, and healthcare. The companies included under the Tatweer umbrella when formed were: Dubailand - including the *Bawadi* project, Dubai Healthcare City, Dubai Industrial City, Dubai Energy, Dubai Mercantile Exchange, Global Village, *Moutamarat* - a joint venture with Saudi Research and Publishing Company to manage Dubai based conferences and exhibitions.\(^{225}\) In September 2008, Tatweer announced that it would

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restructure its operations into two divisions - *Tatweer* Dubai, and *Tatweer* Investments. *Tatweer* Dubai (CEO Khalid Al-Malik) will focus on UAE operations and incorporate the resulting business divisions and partnerships. *Tatweer* Investments (CEO Ahmad Sharaf) will focus on *Tatweer'*s intellectual property portfolio, and international investments and partnerships. The Executive Chairman of *Tatweer* is Saeed Al-Muntafiq, who is also Director General of Dubai Development and Investment Authority.\(^{226}\) The company website is not currently active, which has made it difficult to assess the current status of the company.

Table 5-17: Dubai Group’s investments

<table>
<thead>
<tr>
<th>Region</th>
<th>Company name</th>
</tr>
</thead>
<tbody>
<tr>
<td>MENA</td>
<td>51% stake in Acacia Bahrain, a $1bn joint venture with Qatar Investment Authority, Dubai Group Sigorta, 51% stake in <em>Al Fajr Re-Takafal</em>(a Kuwaiti shareholding company), <em>Al-Salam</em> Bank, Bank Muscat, Borse Dubai, Commercial International Bank, 100% of Dubai Bank, 100% ownership of <em>Tadawul</em> (a private brokerage company) 25% of EFG- Hermes (a top investment bank in MENA), $320m in Emirates Cement Company, 12% of Global Investment House, <em>Mazaya</em> Saudi, 33.33% of National Bonds UAE, 41% in Oman National Investment Holding Co., TAIB Bank, <em>Tamaweel</em>, 35% of Tunisie Telecom (worth $2.2bn)</td>
</tr>
<tr>
<td>Asia</td>
<td>A joint venture with Adventity BPO India, 40% of ACR Re-Takaful Holding (the world’s largest reinsurance company) , 40% of Bank Islam (the oldest Malaysian Islamic Bank), 18.75% of Bank Islami Pakistan, Bharat Hotels, Bolton Bhd, Chiranjeevi Wind Energy, GDB Investment Limited, 51% KOP Group in Singapore, 10% of Sun Hung Kai Financial, Time Broad Band Television, Vietnam Asset Management</td>
</tr>
<tr>
<td>Europe</td>
<td>16% of Marfin Investment Group, 19% of Marfin Popular Bank in Greece, Markisches Zentrum &amp; Hansecenter Shopping Centre</td>
</tr>
<tr>
<td><strong>Continued</strong></td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>A Massachusetts Portfolio, Jumeirah Essex House Hotel, Chicago City Centre Hotel, the Braintree Portfolio, the Denver Office Portfolio</td>
</tr>
<tr>
<td>Australia</td>
<td>Citigold Corporation Limited</td>
</tr>
</tbody>
</table>

Source: [www.dubaigroup.com](http://www.dubaigroup.com)

6. **Sama Dubai** is the international property arm of Dubai Holding and was created as a company with wider responsibility and mandate than its predecessor (Dubai International Properties). It was announced in the summer of 2009 that *Sama* Dubai would be merged into *Emaar*, along with Dubai Properties and *Tatweer*.\(^\text{227}\)

7. **Dubai International Capital (DIC)** is a Dubai-based international investment company with a primary focus on private equity in the Middle East and Western European regions. It was established in 2004 with the mandate to build an international portfolio of diverse business assets across a broad range of industries. The company currently holds about $13 billion of assets under management and has a long-term view of investment. According to the SWF Institute, DIC is known to be a more transparent investor than its peers.

All in all, there are some similarities and differences between the SWFs of Dubai and Abu Dhabi. The major difference between the SWFs of Dubai and those of Abu Dhabi is in their source of capital. As noted above, the government of Dubai has mainly relied on leverage to finance the sovereign wealth investment institutions, while Abu Dhabi government-owned investment funds are exclusively managing surplus oil incomes. A key similarity between the government-owned investment institutions of Dubai and those of Abu Dhabi lies in their investment strategies. Both emirates own CSWFs with highly diversified, often ambitious portfolios of investments. A key mission for government-owned investment funds of both emirates is to support the economic development and diversification policies of the government.

Another key factor in common between the government investment institutions of Dubai and those of Abu Dhabi is lack of transparency of information. Moreover, the SWFs of Dubai have similar governance and management patterns to Abu Dhabi government investment funds. Almost all the top management and key positions at Dubai SWFs are taken by individuals who have a close personal relationship with the head of the state. However, in contrast with Abu Dhabi government organisations, the number of Al-Maktoum family members who control high management positions or the board of directors in Dubai government-owned investment companies is relatively low.

5.6.2 Dubai World

Dubai World was launched in 2006. The company is a conglomerate with a highly diversified portfolio of investments, which owns various enterprises across sectors including transport, finance and investment, maritime and ship building, and real estate. Dubai World’s investment universe stretches from North America to Asia. The major companies/projects of Dubai World include: Dubai Port World (DP World) and Economic Zones World in transport and logistics, Dubai Maritime City and Drydocks World in dry-docks and Maritime, Istithmar in investment and financial services, Nakheel, and Limitless in real estate development.

- **Dubai Port World** is one of the largest marine terminal operators in the world, with 49 terminals and 12 new developments across 31 countries from Europe to Asia. It was established through the merger of the UAE-based Dubai Ports Authority with Dubai Port International Terminals in September 2005.228

- **Economic Zones World (EZW)** is a developer and operator of economic zones, technology, logistics and industrial parks under the Dubai World Group. EZW’s current portfolio includes Jafza, one of the world’s largest free zones in the UAE; Djibouti Free Zone in Africa; Gazeley, a developer and provider of carbon positive logistics space established in the UK in the 1980s that is active in Europe Asia; TechnoPark, a research driven business and industrial park, and Dubai Auto Zone, an industry specific free zone.229

- **Nakheel** is a real estate company, which is actively engaged in development projects in the residential, retail, commercial and leisure sectors inside the UAE. Nakheel World was established in 2006. The company went through a massive recapitalisation in the aftermath of Dubai’s financial crisis.230

- **Limitless** is also a real estate developer which was established in 2005. It has projects in the UAE, as well as, a number of other countries in the Middle East and Asia, including Hong Kong, Vietnam, Saudi Arabia, Jordan and Russia.231

228 [http://webapps.dpworld.com/portal/page/portal/DP_WORLD_WEBSITE](http://webapps.dpworld.com/portal/page/portal/DP_WORLD_WEBSITE), accessed on 5 March 2011
229 [http://www.ezw.ae/](http://www.ezw.ae/), accessed on 5 March 2011
The United Arab Emirates’ Sovereign Wealth Funds

- **Istithmar World** is a private equity firm which was founded in 2003. It focuses on the consumer, financial services, industrials and real estate sectors. *Istithmar World’s* portfolio is spread across North America, Europe, the Middle East, Asia and Africa. It is headquartered in Dubai, with offices in New York, London, Shanghai and Cape Town. Forms of investment of the company include majority and minority stakes, joint ventures, listed equities and debt securities.\(^{232}\)

- **Drydocks World-Dubai** is a ship repair, vessel conversion, new building, and offshore constructions company. It has branches in Indonesia, Singapore, Scandinavia, and Japan.\(^{233}\)

- **Dubai Maritime City** is a man-made island which will become a multi-purpose maritime centre to create a newly designed environment for the global maritime community.\(^{234}\)

Dubai World has been one of the most indebted and problematic government investment institutions of Dubai, and went through a series of restructurings and refinancings. One of the most important initiatives for restructuring Dubai World was the reshuffle of the senior management team, particularly the company’s chairman. Dubai World was managed since its establishment in 2006 by Sultan Ahmed bin Sulayem, one of Sheikh Mohammed bin Rashid’s, the Ruler of Dubai’s, closest allies. Upon the financial breakdown of the company, Sheikh Mohammed issued a decree on 12th December 2010 restructuring the board of directors of Dubai World, and appointed his brother, Sheikh Ahmed bin Saeed Al-Maktoom, to the chairmanship of the company. Sheikh Ahmad has managed Emirate Airline for many years and proven a prominent track record in Dubai’s government-owned businesses. In addition to these positions he is also the president of Dubai Civil Aviation and chairman of the Higher Committee to oversee Dubai World. The other members of the board are as follows:

- Mohammad Ibrahim Al-Shaibani, Director General of the Dubai Ruler’s Court
- Ahmad Humaid Al-Tayer, Governor of Dubai International Financial Centre
- Abdul Rahman Saleh Al-Saleh, Director General of the Finance Department

• Hamad Mubarak Bu Amim, Director General of the Dubai Chamber of Commerce and Industry

• Sa’adi Abdul Rahim Hassan Al-Rais

• Sun Yong Chang

In addition to appointing the new board member, the decree of the ruler of Dubai on 12th December 2010 states that the board of directors will:

“... study the reports submitted to it on the activities of the Dubai World and its subsidiaries, and their financial positions and will take appropriate action. The jurisdiction of the Board also includes the approval of plans restructuring the company and its subsidiaries and to decide the draft annual budget and final accounts, in addition to the ratification of financing operations and borrowing from financial institutions against financial guarantees to them. The Board will also approve the sale, purchase and leasing of real estates, stocks, bonds, other securities and other property belonging to the institution or its affiliates. The Board will also propose the formation of corporate boards of the subsidiary firms, and the appointment of auditors for the Dubai World and its subsidiaries. The decree stipulated that the Board shall hold its meetings at the invitation of the chairman once at least every two months and whenever the need arises.”

Dubai World has indeed learned from past mistakes. The restructuring of Dubai World’s senior management and the tighter control of the board members on investment activities of the company, defined in Sheikh Mohammad’s decree, proves that company is heading towards becoming a more conservative investor than it was before 2009. A more cautious investment strategy is expected to be applied by Dubai World over upcoming years to recover the extremely damaged reputation of the Dubai government. Moreover, the appointment of Sheikh Ahmed as the chairman of Dubai World is a sign of the ruling family’s strong will to take control of the company in the future, in order to avoid similar circumstances.

5.6.3 The financial crisis and Dubai’s government investment vehicles

The impact of the recent financial crisis on Dubai government-owned business entities has been huge. Given the leverage-led growth of Dubai SWFs, the business model which has been followed by Dubai conglomerates to some extent brings back the memory of what had been practiced by the Korean Chaebols before the financial crisis.

of 1997. In both cases, high levels of foreign borrowing coupled with aggressive investment regimes in extremely diversified portfolios of assets led the economy into a failure. Moreover, Dubai’s government enterprises’ heavy involvement in the domestic real estate market has caused major damage to these organisations, particularly at the peak of the crisis when the expatriate labour that created the real estate bubble in the city of Dubai had to fly out of the country due to the high number of jobs lost. This has caused a sharp decline in demand for housing, leading to a price decrease in Dubai SWFs’ real estate assets locally.

The ongoing global financial crisis has in many ways affected institutional investors around the world. Reviewing the commodity related funds in the previous chapters of this thesis shows that the CSWFs have more or less been forced by the crisis to shift away from risky investments in Western banks and businesses, and to focus more on their domestic economies in order to support local banks and companies, as well as the emerging markets with higher growth prospect. In the case of Dubai, however, most of the state-owned investment engines have been rather active locally since before the crisis. Another major difference in the ways in which Dubai SWFs were affected by the crisis is Dubai’s struggle to refinance these funds. Commodity based SWFs have suffered from losses on both their investments and the oil incomes, as a result of a decline in the price of oil. However, there was constantly an inflow of capital into their accounts from oil export. Given the reliance of Dubai SWFs on leverage, a major struggle for Dubai state-owned businesses after the crisis was to attract foreign investors to refinance their portfolio.

Highly leverage-dependent investments, especially in the real estate sector, have pushed the country towards heavy debts. The government has taken a step in stabilising the business climate through the creation of a financial support fund for state-linked businesses. In order to finance this fund, $10bn was borrowed from the United Arab Emirates Central Bank as part of a broader $20bn bond programme. It was planned to use the borrowed cash to help companies owned or linked to the government to refinance debts and settle the bills, as well as to push the maturity of the debt further, and buy more time.\textsuperscript{236}

\textsuperscript{236} Kerr, Simeon, Andrew England and Robin Wigglesworth (2010), \textit{Emirate’s carefully moulded plan welcomed}, Financial Times, 25 March 2010
The government of Dubai is prompted to provide financial support to the state-owned entities through borrowing, while facilitating reforms to protect the long-term viability of those entities. The establishment of this fund will be an important step towards bringing stability and confidence to the revised business plans of the government, particularly in the real estate sector. In addition to the newly established governmental financial support fund, some state entities have attempted to borrow from foreign institutions. Since the crisis struck, for example, ICD has been able to raise US$ 6 billion from international banks.237

Accumulation of massive debt by Dubai conglomerates has highlighted the urgent need for change in the operation of Dubai SWEs; especially their investment strategy. Some of the state-owned investors have already responded to this need by a shift in asset management and investment strategy in the aftermath of the recent crisis. In September 2008, when the peak of the crisis was felt in equity markets globally, Dubai Group announced that it would focus on traditional asset management services, shying away from distressed financial services firms of North America and Europe, which have been badly hit by the subprime mortgage crisis.238 Further revision of the investment regime is indeed of necessity should Dubai aim for a quicker recovery.

Moreover, the government of Dubai is seeking to streamline its commercial assets to reduce costs in response to the global economic downturn. The restructuring plan has become the core of the new cost efficiency policies of the government. Deep staff cuts have taken place in most of the SWEs, particularly in Dubai Holding.239 There have been some major changes in governance and management of the SWFs and there are more to come in the future. It has been rumoured that Dubai World, a problematic government-owned conglomerate of Dubai, will be moved under ICD’s umbrella. This was later denied by Dubai World. The structuring is aimed at uniting the expansive network of state entities which were the catalysts for Dubai’s debt-driven growth, and reducing costs as a defence mechanism at a time of reduction in the state’s revenues from trade, tourism and finance.

In the aftermath of the crisis, the relationship between Dubai and Abu Dhabi has been significantly affected. There has been a fundamental difference between the experiences of the recent economic crisis in Dubai in comparison with other GCC economies. In this

237 Kerr, Simon (2009), *Dubai asks Rotschild to advise on state fund*, Financial Times, 2 April 2009
239 Kerr, Simon and Roula Khalaf (2009), *Dubai overhaul business empire to cut costs*, Financial Times, 2 April 2009
context, the role of Dubai’s SWFs was significant. Abu Dhabi’s assistance for paying Dubai’s massive debt strengthened the role of Abu Dhabi in the balance of economic power within the UAE. Dubai’s massive debt was not payable either by the oil income or foreign borrowing. Instead, the neighbouring emirate was called upon for a rescue package. The price of the Abu Dhabi-financed debt was dreadfully high to Dubai’s pride, and indeed the political externalities were huge. The iconic 828m Burj Dubai, which was the flag of the growth and success of the emirate, showing off in the sky-line of the city of Dubai, was renamed Burj Khalifa after the ruler of Abu Dhabi, as a sign of appreciation for the generous support of the government of Abu Dhabi in restructuring Dubai’s debt.

All in all, the unique growth model of Dubai has slowed down significantly, and it will indeed take some time before a full recovery is achieved. Dubai SWFs have been the main engines of Dubai’s development and they are likely to remain powerful economic pillars of the emirate in the future. However, some lessons are to be taken from the recent economic downturn. Being the main economic and political competitor to Dubai, Abu Dhabi has in many ways won the power struggle within the UAE after the financial collapse of Dubai government entities. This may well extend the process of recovery in Dubai from the political point of view.

5.6.4 Conclusion

Being the major oil producer of the UAE, Abu Dhabi has become the financial engine of the country. For many decades Abu Dhabi has played a key role in providing the federal government’s budget. The emirate created a number of sovereign wealth investment institutions to manage the surplus oil revenue. The largest sovereign wealth fund of the UAE (and by some estimates the GCC), ADIA has been the front runner of these organisations followed by Mubadala and Investment AD. Each of these investment institutes operate with a particular investment mandate and strategy. ADIA has been actively focusing on global investments; Mubadala has been investing domestically to support technological advancement of the Abu Dhabi; and Invest AD has a broader investment universe which includes some parts of the Middle East and North Africa.

All the sovereign wealth management institutions of Abu Dhabi are managed directly by members of the ruling family and individuals with close links to the ruling family.
This is why the issue of transparency of operation and governance of these organisations has been controversial. The government of Abu Dhabi has become an active collaborator of the international initiative to promote transparency of sovereign wealth funds. As a result of this contribution public disclosure of information by Abu Dhabi funds has improved over the last few years. However, there are still various measures to be taken by these organisations in order to meet internationally accepted criteria of transparency and good governance which was published by the International Working Group of Sovereign Wealth Funds.

The next wealthy emirate of the UAE is Dubai, and here it can be seen that they have applied a different approach than that of Abu Dhabi. Even though the basis of Dubai wealth was oil income, the emirate applied a heavy foreign borrowing strategy in order to promote economic growth and establish Dubai as a successful brand name in the GCC for foreign investment. The global financial crisis had significant impacts on Dubai where some of the major government investment institutions of Dubai made a massive loss. The government of Abu Dhabi stepped in to bail out Dubai sovereign wealth management institutions. The intervention of the government of Abu Dhabi has further strengthened the position of Abu Dhabi in political and financial balance of power within the UAE. Dubai’s experience of sovereign wealth management has not been as successful as its neighbouring emirate. The debate over transparency of operation of Dubai sovereign wealth management organisations and the role of ruling family and their close allies in the emirates financial breakdown has been intense.

Often the governments of the GCC countries have failed to draw a distinct line between the private wealth of the ruling elite and the national wealth. Nevertheless, there is very little difference in managing the private and national wealth regardless of the blury line between the ruling figure’s personal properties and the country’s national wealth. In the case of Dubai for example, Dubai Holding which is known to be owned by Sheikh Mohammed bin Rashid, did not have a particularly different performance at the time of the crisis.240

The UAE federal government has initiated the creation of a federal sovereign wealth fund. This institution is expected to have a long way to develop to the same level as Dubai or Abu Dhabi sovereign wealth funds. The Emirate Investment Authority will likely rely on Abu Dhabi sponsorship and technical financial management assistance.

240 Gulf States Newsletter (2009), Vol. 33, Issue. 860
which is not expected to happen quickly. In the long run, however, if the EIA develops to an active position in local and international level it would be capable to harmonise the UAE financial policies.

The UAE sovereign wealth management organisations have played a significant role in domestic social and economic development of the country. These funds have also highlighted the role of the country in the global financial system. Given the massive crude resources the country is expected to further develop, while the heart of the developments is likely to be Abu Dhabi citing the concentration of natural resources. Moreover, the role of the ruling family in the management of the country’s sovereign wealth is likely to remain strong. The small size of population of UAE the government has contributed in sovereign wealth accumulation and the country is expected to remain a net producer of surplus capital.
6 Iran’s Experience of Sovereign Wealth Management

6.1 Introduction

As the largest country of the Gulf Region with a population of some 75.08 million, Iran has taken a different approach in its oil policies from that of the GCC countries. Its hydrocarbons industry provides over 80% of government revenue. Unlike other countries in the Gulf, the Iranian government is not an active international investor and has invested most of the country’s oil income domestically. Iran’s crude production level in 2010 was estimated to be about 4 million barrel per day. According to Iran’s budget plan as submitted for fiscal year 2011-2012 (the budget runs annually from 20 March), most of the country’s oil revenues are currently being used for government expenditure, which shows an overall increase during the 2011-12 fiscal year, when the allocation for state-owned enterprises will rise by 43.4%.

While Iran’s neighbours in the Gulf have had the opportunity to save a significant share of their oil revenue in various asset classes, Iran has been investing the major share of the country’s oil wealth domestically in order to boost national non-oil production levels in both the public and private sectors. In practice, however, these investments have not been efficient and the non-oil production level has remained low. High government expenditure on food and energy subsidies, and the limited flow of foreign direct investments as a result of the economic sanctions on Iran, have also had a negative impact on the country’s non-oil GDP growth.

Between 1948 and 1979, a large share of the government’s oil income was spent locally on infrastructure and development projects. Following the Islamic revolution, the country then went through eight years of devastating war between 1980 and 1988, and during this period, a major share of oil income was spent on covering the costs of war and subsidies; consequently the development projects were effectively abandoned. In

241 Economist Intelligence Unit (2011), Iran Country Report
242 Ibid
the aftermath of the war most of the economic sanctions that had been imposed on Iran during the war years were lifted; and reconstruction and development projects were re-started. A considerable share of oil income was, therefore, spent financing the government budget deficit that had accumulated during the war, while the rest was allocated to the post-war reconstruction and development projects.

Oil price fluctuations were, however, a key challenge for the government. Reconstruction and development projects were affected by the oil price changes and any price decrease caused delays in the progress of such projects. In order to protect the country from the volatility of the oil markets, the Third Development Plan proposed the establishment of an “Iran Foreign Exchange Saving Account” (IFESA).

The IFESA was created in 1999 at the beginning of Seyed Mohmmad Khatami’s second term as Presidency of Iran. In his keynote speech in the parliament (Majlis), Khatami told the Iranian Members of Parliament (MPs) who were about to give their votes of confidence to his proposed cabinet, that over the past few years he and the Minister of Finance had been “extremely worried about the country’ financial affairs and could not sleep at night as we only had enough wheat reserves for domestic consumption of three days due to lack of sufficient foreign reserves”.

The IFESA, which was established as an oil stabilisation fund, therefore represented, what was historically one of the important steps to have been taken by the Iranian government to manage the country’s oil revenues since the discovery of oil in the country early in the twentieth century.

Compared with its neighbours in the Gulf, Iran had lagged behind in the establishment of an oil stabilisation fund. As noted in previous chapters, some of the largest CSWFs of the Gulf were created three to five decades earlier than Iran’s IFESA. Iran’s oil revenue management policies have, however, been affected by one key factor: the country’s large population. In this respect there have been some similarity to Saudi Arabia which has the largest Arab population of the Gulf. However, the Saudi government has maintained a strong political and financial relationship with the West, particularly the US, while Iran-US relations were effectively ended in the aftermath of the Islamic Revolution. Therefore, Iran started its sovereign wealth management policies not only with decades of delay compared with its Arab counterparts in the Gulf, but with the management policies of its SWF’s heavily influenced by its political relationship with the Western world.

243 Iran Newspaper, 25 August 2001
As noted, Iran’s IFESA has mainly applied an inward-looking investment policy, details of which are discussed later in this chapter, while its operations policy is similar in many respects to the strategy of the CSWFs of the GCC countries. It has sought to protect the Iranian economy against the fluctuations in oil prices (like all the CSWFs of the GCC) and to promote production and growth domestically (similar to some of the CSWFs of the UAE). The key difference between the IFESA and the CSWFs of the Arab countries of the Gulf lies in its international investment activities. IFESA has not been active in the international financial system as its counterparts in the Gulf have been, due mainly to two important factors: the first being Iran’s significant absorptive capacity and large domestic capital demand, and the second, its large population. The latter has contributed directly to high government expenditure mainly on food and energy subsidies.

A new CSWF was due to be created in 2011 to replace the IFESA, and the proposal for establishment of a National Development Fund was submitted to the Majlis in March 2011. It is intended that all the assets of the IFESA will be transferred to the National Development Fund, and that when the Fund is operational, following approval from the Majlis it will become the sole sovereign wealth management organisation in Iran. Details of the Fund’s institutional organisation, governance, asset management and saving policy are reviewed at the end of this chapter.

6.2 The financial relationship between the government and the NIOC

Before the Islamic Revolution. Prior to the revolution in 1979, the National Iranian Oil Company (NIOC) was the main institution responsible for managing the oil sector in Iran on behalf of the government. All offshore and onshore operations were carried out either by the NIOC directly or by other companies contracted by NIOC, and the revenue generated from oil exports was paid to the Company. NIOC was also in charge of managing the financing of the oil sector’s development projects and production facilities. The government was the major shareholder of NIOC and received some of the oil income in the form of shareholder’s interest. Another form of contribution by NIOC to the state’s revenues was by paying tax to the government. In addition to the income from oil exports, the company generated revenue by collecting concession fees and royalties from the foreign companies operating in Iran’s oil sector in Iran. One percent
of all concessions and royalties was saved in NIOC’s account while the rest was paid to the government.  

1979 – 2000. In the aftermath of the revolution, the Revolution Council changed the relationship between the government and NIOC. All foreign companies were forced to leave the country and the concession fees were abolished. All export revenues during this period were paid directly to the government. Therefore, the only source of income for NIOC was income generated from selling refined product in the domestic markets. This caused a major budget deficit for NIOC. To undermine the Company’s massive budget deficit, since 1987 NIOC was permitted to export 200,000 barrel of crude oil per day to cover its expenses (in addition to collecting generated incomes from selling refined products domestically).  

2000 – 2004. After 2000, the Third Development Plan authorised NIOC to receive the revenues generated in the domestic markets from crude oil sales, as well as sales of offshore and refined oil and gas products (domestically), while the government collected the export revenues. Therefore, the main aim of the Third Development Plan was to increase crude production capacity to boost export income for the government. However, increased local automotive production meant that domestic oil consumption and imports of refined products also increased; thus, not only did oil exports not increase but aggregate exports also declined because of the allocation of a large share of the crude production to exchange with refined products from other countries.

2004-2009. The Fourth Development Plan, which began from 2004, redefined the relationship between the government and NIOC. About six percent of land-based oil exports and 11 percent of oil exports transported by sea was allocated to NIOC. In addition, the government was authorised by the Majlis to allocate additional funds to NIOC from the assets held in reserve to cover the company’s budget deficit.

During the past thirty years since the Islamic Revolution, one of the key criticisms of the NIOC made by member of the Majlis concerned the lack of transparency in the Company’s financial operations. Pricing methods and NIOC’s total income have not
been clearly stated in the annual budgets and this has been a matter of controversy between NIOC and the Supreme Audit Court.

### 6.3 Iran Foreign Exchange Saving Account

Unlike the experience of the Second Development Plan, the Government’s oil income increased significantly under the Third Development Plan (2000-2004). Actual oil income increased from five percent above the level that had been estimated by the Third Development Plan in 2000 to 44 percent above the estimated levels of the Plan in 2004 (each programme has an estimated oil income based on the price of oil at the start of that plan). According to the Third Development Plan the government had committed itself to depositing the country’s oil revenue surpluses (i.e., what was earned above the estimated level of the Plan) in the IFESA to meet the following aims:

1. to protect the country against oil shocks;
2. to reduce the government’s reliance on oil incomes;
3. to support and strengthen the private sector’s production and exports

<table>
<thead>
<tr>
<th>Description</th>
<th>US $ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government approved revenue for this period</td>
<td>56,674</td>
</tr>
<tr>
<td>Growth of foreign reserves</td>
<td>12,027</td>
</tr>
<tr>
<td>Withdrawal from foreign exchange account</td>
<td>9,422</td>
</tr>
<tr>
<td>Foreign exchange loans payback</td>
<td>7,638</td>
</tr>
<tr>
<td>Total government foreign exchange expenditure</td>
<td>85,761</td>
</tr>
<tr>
<td>Total oil and gas export income</td>
<td>130,255</td>
</tr>
<tr>
<td>Ratio of foreign exchange reserves to oil and gas export income</td>
<td>65.84 %</td>
</tr>
</tbody>
</table>

Source: Mohammad Hadi Mahdavian (2006) in Farsi

The Fourth Development Plan continued the government’s sovereign wealth management policies and strongly emphasised IFESA’s role in the country’s

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247 Majlis Research Centre (2005), Report no. 8126, January 2005
248 Ibid
development. Article No. 1 of the Fourth Development Plan (2005-2010) defined the functions of the IFESF as follows:

- From 2005 until the end of the Fourth Development Plan, the surplus oil income will be kept in IFESA.

- Accumulated surplus oil revenue from the third development plan and capital from government loans that had been extended to private sector entities from the oil revenue account will be transferred to IFESA.

- Should it face a budget deficit the government is allowed to use the assets of this account only if the oil export incomes drop below the estimated levels of each annual budget. In this case the government can withdraw its assets at the end of every quarter of each fiscal year.

- Using the assets of this account to cover budget deficit generated from non-oil government income is forbidden.

- The government is allowed to invest a maximum of 50% of the assets of this account in production projects from the industrial, mineral, agriculture, transport services (including tourism), and the information technology sector. These investments should only take place in the form of loans that are extended through national and foreign banks after sound reviews and risk analysis by their respective ministries, in order to prove the profitability of the projects.

- A minimum of 10 percent of the assets of this account must be allocated to private projects in the agriculture sector. These assets will be transferred to the Agriculture Bank to be distributed in the form of loans to agricultural projects aimed at promoting agricultural exports.

- Should the government use the assets of the account, all transactions must be clarified in the annual budgets.

- All decisions concerning the operation of this account must be proposed by the Organisation of Budget and Planning, the Central Bank, the Ministry of Finance and approved by the cabinet.249

Table 6-2: Petro dollars in budget, 4th Development Plan (2005-2008)

<table>
<thead>
<tr>
<th>Description</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US $ million</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government approved revenue for this period</td>
<td>15,235</td>
<td>15,597</td>
<td>16,321</td>
<td>17,044</td>
</tr>
<tr>
<td>Growth of foreign reserves</td>
<td>16,617</td>
<td>15,337</td>
<td>23,458</td>
<td>32,540</td>
</tr>
<tr>
<td>Withdrawal from foreign exchange account</td>
<td>7,752</td>
<td>15,929</td>
<td>11,950</td>
<td>17,269</td>
</tr>
<tr>
<td>Total foreign reserves</td>
<td>39,604</td>
<td>46,863</td>
<td>51,729</td>
<td>71,853</td>
</tr>
</tbody>
</table>

249 Majlis Research Centre (2008), Report no. 8861, January 2008
Sources of finance for the account were defined in the Third Development Plan as the following:

1. Budgetary surplus of the third and fourth development plans
2. Loan interests
3. Saving interests from the central bank

The government’s plan was to establish two accounts with the central bank: one to hold riyal incomes and one to save foreign currency incomes. These accounts were aimed at maintaining the balance of the government’s income and at protecting the economy against oil income volatility. In practice, however, only the foreign exchange account (IFESA) was established. The assets of this account had been used solely for extending loans to domestic businesses with very limited recorded savings.

### 6.3.1 Governance of IFESA

The IFESA is managed by a board of trustees comprising the Head of the Organisation for Planning and Budget, the Minister of Finance, the Governor of the Central Bank, and two other ministers who are chosen by the President. The responsibilities of the board include the following:

- To prioritise the projects that will be financed by the account
- To calculate the interest rates for loans that are extended to finance the chosen projects
- To decide the period in which the extended loans should be paid back
- To establish procedures that define the loan pay-back methods
- To design the procedure for contracts between banks and businesses when a loan proposal is approved
- To set the handling fees of the banks
- To set other procedures as necessary on a case by case basis.  

In 2007, the government reshuffled the arrangement of the Board of Trustees of the IFESA. In the new arrangement the board included: the President’s Deputy for

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250 Majlis Research Centre (2006), op.cit
Planning and Strategic Supervision, who replaced the Head of the Organisation for Planning and Budget (the government having dissolved the Organisation for Planning and Budget around the same time that it reshuffled the Board), the Minister of Finance, the Minister of Industry and Mining, the Minister of Employment and Social Affairs, the First Deputy of the President, the Governor of the Central Bank, the Minister of Trade, and the Head of the Organisation for Cultural Heritage. The government’s decision to change the arrangement of the Board was part of a restructuring plan that also included closing the Organisation for Planning and Budget. The Organisation had operated for 60 years and the decision to shut it down was criticised by many political figures in Iran. The government produced no obvious justification for the decision; nevertheless there was no pressure from the Supreme Leader or from the Majlis to reverse it. Many Iranian critics argue that President Ahmadinejad’s decision for dissolving such an important organisation was merely to give the President’s Office more power over the country’s economic affairs and specifically on the government’s budget and expenditures.

In 2008, the cabinet proposed another change in the arrangement of IFESA’s Board of Trustees in order to conduct a “fundamental reform, removal of parallel institutions and procedures which disturbed the government’s economic decision-making process and quicker application of the government’s economic policies.” The cabinet dissolved the board and replaced it with the Government’s Economic Commission. The president is the head of the commission and he appoints its members. The Government Economic Commission is composed of the Minister of Finance and the Governor of the Central Bank, the First Deputy of the President and few other presidential secretaries. The exact list of the member of the commission could not be found on the government’s official portals. The government of President Ahmadinejad has also changed the name of the account to ‘Iran Foreign Exchange Savings Fund’ (IFESF). This new arrangement of IFESA’s Board of Trustees has given the President more control over the management of the assets held by IFESA.

### 6.3.2 Investment strategy of IFESA

IFESA’s investment strategy and spending regime was designed to allow the government unlimited withdrawal facilities from the account when the price of oil fell

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251 BBC Persian, 10 June 2007  
252 BBC Persian, 11 May 2008  
253 ibid
below the levels estimated in the development plans, withdrawals of 50 percent of the total assets were made at any given time in order to extend loans to private sector businesses and production units, and other withdrawals took place subject to parliamentary approval.

In practice the private sector did not benefit from the allocated 50 percent of the IFESA’s total assets. In an interview with Fars News Agency, Bahman Arman, a former member of the Board of Trustees of the IFESA, explained the reason for the private sector’s very poor performance in absorbing the surplus petrodollars:

“We do not have industrial units which are capable of production in international standard level. This is why most of the financed projects by the account were small units. The number of projects which received investments of US $100 million and above was rather low in comparison with those of the public sector. Some of these projects (public sector production units which received investments of US $100 million and above from IFESA) include: Kermanshah Petrochemical (US $ 2604 million), A tile company which is owned by Tamin-e-Ejtemaee Investment Company, a semi-government investment organisation, (Euro 110 million), and a textile company in Ardabil (Euro 100 million). One of the main reasons for limited activity of the account in financing production units in the private sector is inefficiency and bureaucracy in the government-owned banks. This issue could be undermined by changing the current lending procedures and involvement of private banks in handling the lending process of the extended loans from the account.”

Figure 6-1: IFESA’s financed project, public and private sector (US $ billion)

Another reason for the low efficiency of investments in the private sector from IFESA’s assets was the high interest rates on long-term deposit holdings by local banks. Due to their high interest rates, many private sector businesses applied to IFESA for loans, but instead of investing these loans in production units, they kept the capital in long-term

254 Fars News Agency, 16 September 2009
savings accounts at local banks. While the private sector businesses were asked to pay the loans with only a nine percent return, the local banks offered a 23 percent return on five-year deposit holdings. Therefore, the extended loans to the private sector production units were in many cases never invested in projects that generated production and growth. Although low interest rates for loans were initially set to boost private sector borrowing and production, the domestic banks’ high interest rates for long-term holding deposits acted as a counterproductive factor and minimised the efficiency of private sector borrowings. Keeping interest rates high at the local banks was the government’s policy for controlling out-flows of private sector capital and to help the national banks safeguard sufficient private sector holdings. Eventually the government had to decrease the local banks’ interest rates to 14 percent per annum in 2010 and 12.5 percent per annum in 2011.

The next factor that contributed to the low efficiency of the private sector’s borrowing from IFESA was corruption in the key institutions involved in the lending process. Since the eligibility criteria for projects when applying for these loans were broadly defined, in practice every applicant had the right to apply for them. In many cases neither the profitability of the projects nor the credibility and track record of the applicants were examined in a rigorous manner.

Three private sector entrepreneurs who were interviewed for this study recounted similar stories about their experience of the loan extension procedures (see Figure 6-2). One interviewee said: “having personal contacts and “Wasta” – someone with a position in one of the institutions involved in the procedure who can breach the rules or influence the final decision – can change the final decision of any application.” Another interviewee also mentioned how, in many cases, employees of the bank to which the first proposal for a loan was submitted would increase the total amount approved for the loan in exchange for receiving a percentage of the loan in cash from the applicant.

In the Third Development Programme, procedures were designed for lending based on the amount of capital that was invested in each project. Loan proposals for less than US$20 billion were reviewed by the Ministry of Mining and Industry and the banks (as it is shown in the figure below). However, loan requests of more than US $ 20 billion were reviewed by the Board of Trustees and the decision was made directly by

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255 Majlis Research Centre (2004), Report No. 7114, September 2004
256 Fars News Agency, 2 April 2011
the board. The financial operations of transferring the funding to the companies, receiving collaterals and letters of guarantee, and following up the paying back of the loans in the event of a company default were the bank’s responsibility. During Khatami’s administration, the chairman of the Board of Trustees, Dr Bayzeed Mardoukhi, was the key decision maker for loan proposals with a total value of more than US $ 20 billion. After 2005, the government changed the decision making process, including new procedures, as follows:

- Proposals of less than US $ 10 billion were to be reviewed by the Ministry of Mining and Industry
- Proposals between US $ 10 billion and US $ 50 billion were to be reviewed by a group of “experts” (the arrangement of the group is not specified in the documents)
- Proposals over US $ 50 billion were to be reviewed by the experts’ group and the president’s advisors and the board of trustees.

Figure 6-2: Loan application procedure

Source: Majlis Research Centre (2005)
There has been a noticeable concentration of investment in the mineral sector (see Figure 6-3). Cement production companies were the main production units of this sector, which received a large share of allocated investments from the IFESA. US $ 1.07 billion-worth of all the financed projects between 2000 and 2005 were in cement production companies. From the establishment of the IFESA until September 2008, 52 projects were funded by loans over US$ 25 million and US$ 22 million of which were extended to cement production companies. 257 This resulted from a combination of domestic demand among infrastructure projects and demand in neighbouring countries, particularly Iraq and Afghanistan. The concentration on this particular industry was also caused by interest from individual policy makers who had a network of contacts with decision makers in neighbouring countries.

Figure 6-3: A review of projects financed by IFESA until September 2005

The physical proximity to the capital, Tehran, of the projects that received financing, as well as overall government policies on investment in the more politically-stable areas of the country also played an important role in decision making in the investment process. The Sunni minority population, which is concentrated in the Western and Eastern provinces along the borders with Iraq and Pakistan (Ilam, Kurdistan and Balouchestan), have been less favoured by the government. Table 6.3 shows that they received the smallest share of the allocated funds from IFESA (respectively 0.4%, 0.7% and 1%). Tehran received the highest share of these funds (about 18%) followed by its neighbouring provinces Isfahan, Qazvin, Markazi, and Semnan (which received respectively 9.4%, 6.4%, 5.9%, and 4.9%).

257 Majlis Research Centre (2008), Report no. 7607, December 2008
Table 6-3: Number of funded projects in each province (2000-2005)

<table>
<thead>
<tr>
<th>Province</th>
<th>Number of projects</th>
<th>Share of total number of projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ilam</td>
<td>4</td>
<td>0.4</td>
</tr>
<tr>
<td>Kohkilouye va Boyer Ahmad</td>
<td>5</td>
<td>0.5</td>
</tr>
<tr>
<td>Kurdistan</td>
<td>6</td>
<td>0.7</td>
</tr>
<tr>
<td>Chaharmahal Bakhtiari</td>
<td>7</td>
<td>0.8</td>
</tr>
<tr>
<td>Sistan Baloochestan</td>
<td>9</td>
<td>1.0</td>
</tr>
<tr>
<td>Boushehr</td>
<td>10</td>
<td>1.1</td>
</tr>
<tr>
<td>Hormozgan</td>
<td>10</td>
<td>1.1</td>
</tr>
<tr>
<td>Ardabil</td>
<td>11</td>
<td>1.2</td>
</tr>
<tr>
<td>Hamedan</td>
<td>13</td>
<td>1.4</td>
</tr>
<tr>
<td>Golestan</td>
<td>14</td>
<td>1.5</td>
</tr>
<tr>
<td>Kermanshah</td>
<td>20</td>
<td>2.2</td>
</tr>
<tr>
<td>Lorestan</td>
<td>21</td>
<td>2.3</td>
</tr>
<tr>
<td>Qom</td>
<td>23</td>
<td>2.5</td>
</tr>
<tr>
<td>Kerman</td>
<td>25</td>
<td>2.7</td>
</tr>
<tr>
<td>Khuzestan</td>
<td>26</td>
<td>2.9</td>
</tr>
<tr>
<td>Azarabijan Ghrabi</td>
<td>28</td>
<td>3.1</td>
</tr>
<tr>
<td>Gilan</td>
<td>31</td>
<td>3.4</td>
</tr>
<tr>
<td>Fars</td>
<td>33</td>
<td>3.6</td>
</tr>
<tr>
<td>Zanjan</td>
<td>34</td>
<td>3.7</td>
</tr>
<tr>
<td>Mazandaran</td>
<td>38</td>
<td>4.2</td>
</tr>
<tr>
<td>Azarabijan Sharghi</td>
<td>41</td>
<td>4.5</td>
</tr>
<tr>
<td>Yazd</td>
<td>43</td>
<td>4.7</td>
</tr>
<tr>
<td>Semnan</td>
<td>45</td>
<td>4.9</td>
</tr>
<tr>
<td>Khorasan</td>
<td>52</td>
<td>5.7</td>
</tr>
<tr>
<td>Markazi</td>
<td>54</td>
<td>5.9</td>
</tr>
<tr>
<td>Qazvin</td>
<td>58</td>
<td>6.4</td>
</tr>
<tr>
<td>Isfahan</td>
<td>86</td>
<td>9.4</td>
</tr>
<tr>
<td>Tehran</td>
<td>165</td>
<td>18.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>912</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Majlis Research Centre (2006)
The government’s share of the total assets held by IFESA has remained unclear. Assets managed by IFESA were initially planned to be from two major sources: allocated assets from the government (in US dollars), and investment returns from the loans (in riyals). However, high consumer price inflation and foreign exchange rates have had a negative impact on the size of assets held by the IFESA. The consumer price index increased from 100 to 304.3 between 1995 and 2003, while the rate of dollar exchange to the riyal in 1997 was 1 to 366.3; this rate had increased to 1 to 292.12 by 2003. Between 2001 and 2005 the value of the riyal decreased by about 12.5% against the dollar. Private sector businesses received the allocated credits in dollars and paid back their loans in riyals. Due to the constant loss in the value of the riyal against the dollar, the government made massive losses. Not only was the share of the assets allocated for investment in government entities and the government’s limit for spending the resources of the IFESA (in the budget) not clarified but the government organisation responsible for making the deposits into the account also remained unclear.

6.3.3 The size of assets of IFESA

Given that oil revenues during the Third Development Plan were constantly above the Plan’s estimated levels, the government should not have withdrawn from the IFESA account. In fact it spent a large share of the assets of the account on stabilising the domestic foreign exchange markets, and financing agriculture and water projects. Some of the assets were disbursed in the form of government expenditure rather than the usual investments by the IFESA. It is worth mentioning that this trend has continued during the fourth and fifth development plan, and that 80 percent of all the withdrawals from the account were used to cover government-financed projects. The government has not released any reports concerning movement on the account since 2005. The Central Bank of Iran (CBI) reported in 2005 that the total assets held in the IFESA stood at about US$ 25 billion. The Fourth Development Plan, however, allowed the government to withdraw US$ 81.6 billion of assets held in the IFESA.258

258 Majlis Research Centre (2009), Report no. 9913, October 2009
Table 6-4: The government incomes (US $ million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total income</th>
<th>Oil income</th>
<th>Share of oil income in total income (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>104.3</td>
<td>59.5</td>
<td>57</td>
</tr>
<tr>
<td>2001</td>
<td>125.1</td>
<td>72</td>
<td>57.5</td>
</tr>
<tr>
<td>2002</td>
<td>201.1</td>
<td>138.5</td>
<td>68.9</td>
</tr>
<tr>
<td>2003</td>
<td>251.2</td>
<td>171.5</td>
<td>68.3</td>
</tr>
<tr>
<td>2004</td>
<td>481.6</td>
<td>226.6</td>
<td>47</td>
</tr>
<tr>
<td>2005</td>
<td>457.1</td>
<td>335.3</td>
<td>73.4</td>
</tr>
<tr>
<td>2006</td>
<td>995.6</td>
<td>418.1</td>
<td>75.1</td>
</tr>
<tr>
<td>2007</td>
<td>580</td>
<td>370</td>
<td>63.8</td>
</tr>
<tr>
<td>2008</td>
<td>842</td>
<td>503</td>
<td>59.8</td>
</tr>
</tbody>
</table>

Source: Majlis Research Centre (2009)

Since the government has not been transparent, information about its expenditure is lacking. Most of the information which is collected in order to estimate the size of assets held by the IFESA is gleaned from press releases and from newspaper interviews with officials, in the absence of any formal report about the account’s activities. In 2006, 30 percent of the assets of IFESA were transferred to a fund called “Mehr-e-Reza” fund, the aim of which was to empower civil society, encourage capacity building, job creation, and poverty eradication, and support marriage among young Iranians, particularly in poorer areas. In 2007, total government savings to the account amounted to US$ 38 billion; in the same year, the government withdrew about US$ 28 billion from the account, for budgetary purposes (US$ 22.9 billion) and for loans to the private sector (US $ 5 billion). In other words, the government made withdrawals from the assets in the same year in which they were deposited with IFESA.

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259 Aftab News Agency, 15 November 2005
Table 6-5: IFESA’s activities 2000-2007 (US $ million)

<table>
<thead>
<tr>
<th>Description</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflow</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Surplus foreign exchange income</td>
<td>5943.7</td>
<td>1847.8</td>
<td>5596</td>
<td>5400.4</td>
<td>10207.3</td>
<td>12805.9</td>
<td>21174</td>
<td>12322</td>
</tr>
<tr>
<td>Deposit interest</td>
<td>-</td>
<td>312.1</td>
<td>281.7</td>
<td>6246</td>
<td>175.2</td>
<td>216.6</td>
<td>380</td>
<td>149</td>
</tr>
<tr>
<td>Loan pay backs</td>
<td>-</td>
<td>417</td>
<td>33.3</td>
<td>40</td>
<td>196</td>
<td>156</td>
<td>252</td>
<td>158</td>
</tr>
<tr>
<td>Loan interest</td>
<td>-</td>
<td>-</td>
<td>1.7</td>
<td>2.7</td>
<td>5.5</td>
<td>14.6</td>
<td>25</td>
<td>19</td>
</tr>
<tr>
<td><strong>Outflow</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan to private sector</td>
<td>-</td>
<td>158.3</td>
<td>597.8</td>
<td>1075.5</td>
<td>1937.5</td>
<td>2313.3</td>
<td>5512</td>
<td>5202</td>
</tr>
<tr>
<td>Share of loan to private sector in total assets (%)</td>
<td>-</td>
<td>19.4</td>
<td>11.7</td>
<td>19.8</td>
<td>20.6</td>
<td>19.3</td>
<td>23.7</td>
<td>37.2</td>
</tr>
<tr>
<td>Government spending</td>
<td>-</td>
<td>655.7</td>
<td>2100</td>
<td>1947</td>
<td>4732</td>
<td>8051</td>
<td>17761</td>
<td>8785</td>
</tr>
<tr>
<td>Share of government spending in total assets (%)</td>
<td>-</td>
<td>80.6</td>
<td>40.9</td>
<td>35.8</td>
<td>50.2</td>
<td>67.2</td>
<td>76.3</td>
<td>62.8</td>
</tr>
<tr>
<td>Total assets</td>
<td>5943.7</td>
<td>5943.7</td>
<td>7297.9</td>
<td>8082</td>
<td>8443.3</td>
<td>9478</td>
<td>10686</td>
<td>9555</td>
</tr>
</tbody>
</table>

Source: Majlis Research Centre (2009)

In 2008, the Central Bank reported that withdrawals from the account had exceeded deposits. During 2008, Iran’s total crude export income was US$ 67,755 million. Production costs of were paid from the total crude export income; US$ 10,053 was paid as the National Iranian Oil Company’s share of the crude production, US$ 5,585 million was paid as a concession to NIOC, and US$ 8,936 million was paid as the profit on NIOC’s share. In addition to the payments to NIOC, US $3,282 million of total export income was spent on imports of petrol and sidelf for domestic consumption, and US$ 15,792 million was transferred to government revenue accounts for budgetary purposes. In total, out of US $67,775 million total crude export income, US$ 24,106 million was deposited to the IFESA.

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260 Central Bank of Iran (2008), *A review of the country’s changes in 2008*

261 Majlis Research Centre (2009), Report No. 2309543, February 2009
The Central Bank report in 2008 estimate shows that total assets in the account stand at about US$12.8 billion. As noted, the government’s total deposit to IFESA in 2008 was US$ 24.106 million, considerably more than the CBI had reported. The reason for this large gap between the deposits and the holdings of IFESA is that government withdrawals from IFESA often exceeded the deposits made to the account. For example, a report by the Majlis Research Centre published on 18 February 2009 shows that in 2008 US$ 27,813 million was withdrawn from the IFESA for the following items: infrastructure projects (US$13,747 million), foreign exchange liabilities (US$1,028), protecting school building projects against earthquake (US$940 million), investments in oil rich provinces (US$1,045 million), drought compensation projects (US$4,737 million), and energy subsidies (US$6,316 million). Therefore, the assets held in IFESA showed a negative growth in 2008.

In 2009, the total assets held in IFESA were reportedly around US-$ 23.175 billion, which shown 142.5 percent growth compared with the previous year. Reports by the Ministry of Finance and the CBI show that between March and August 2009 government withdrawals from the account were in total about US$ 43 billion, of which US$37 billion was invested in infrastructure and development projects. Due to the increase in oil prices in 2008 and 2009, the government’s oil revenues increased significantly. However, the size of assets held by IFESA did not reflect this trend in the oil markets. The government became more secretive about the size of IFESA’s assets, and throughout 2009 government officials made contradictory statements on the question of the extent of the assets held by the IFESA.

On 9 June 2009, Mahmood Bahmani the Governor of the CBI told Fars News Agency that:

“the size of assets held in the account is in a desirable level, but do not expect me to reveal more information on this issue. We will announce the exact size of the assets soon. Bearing in mind that there is no governments in the world which would announce the exact size of its sovereign wealth assets, in our case particularly we must not answer questions regarding the size of our assets as the enemies will attempt to freeze our assets should they learn about them.”

Similarly, the Head of Tehran’s Local Assembly (Tehran Islamic Shoura), Mahdi Chamran, said:

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262 Ibid
263 Mehr News Agency, 1 December 2009
264 Mehr News, 23 December 2009
265 Fars News Agency, 9 June 2009
“the assets held in the account is over US $ 20 billion which is three times more than the assets in the account when the current government came to the office. Also, the CBI’s asset holdings are currently at a historically high level.”\textsuperscript{266}

Interviewed by Iranian Student News Agency, Gholam Reza Mesbahi Moghadam, a Tehran’s MP and the Head of Economic Commission of Majlis commented:

“the size of assets held in the account is not likely to stand as high as three times more than their size under the previous government. The reason for this is mainly the government’s policy for transferring the assets from the IFESA to the CBI reserves. As a result of such policies, the CBI currently holds about US $ 100 billion which is a historical record”.\textsuperscript{267}

Mesbahi Moghadam was also asked to comment on the rationale for such policy applications, given that high central bank reserves have had a significant inflationary effect on the Iranian economy. He explained that the reason for transferring most of the oil revenues into the CBI’s reserve accounts was mainly due to the government’s plan for spending a large share of the sovereign assets in infrastructure and development projects. According to Mesbahi Moghadam’s comment, only US$ 6 billion of the government’s assets had been invested in such projects under the previous government but these investments had increased to US$ 24 billion-worth of assets under the government of President Ahmadinejad.\textsuperscript{268} A few months later, Hamid Borhani, the Foreign Exchange Deputy of the Central Bank of Iran refused to comment on the size of assets held in the account. He mentioned only that the CBI had put “special arrangements in place in order to by-pass the sanctions and they will continue”.\textsuperscript{269}

On 16 September 2009, Bahman Arman, a former member of the Board of Trustees of the account, criticised the government’s policy for its lack of transparency regarding information about IFESA. He told the Iranian Student News Agency that: “if the legal mechanisms for withdrawals from account were followed we would have had US$ 100 billion in the account”, and added:

“despite the low oil prices in 2002 (US $ 20-US $ 23) the private sector received about US $ 2.5 billion funding. Also, the government used to publish monthly reports of the account’s activities through the Ministry of Mining and Industry. However, the current government has failed to follow the reporting and lending activities of the account despite the growing oil prices”.\textsuperscript{270}

\textsuperscript{266} Iranian Student News Agency, 2 June 2009
\textsuperscript{267} Iranian Student News Agency, 26 May 2009
\textsuperscript{268} Ibid
\textsuperscript{269} Iranian Student News Agency, 21 October 2009
\textsuperscript{270} Fars News Agency, 16 September 2009
The country’s oil production declined in 2010, although the budget proposed by the government for 2010 anticipated production of 4,015,000 barrels per day. However, in practice, production averaged about 3,943,693 barrels per day which was 72,000 less than what had been projected in the budget. Also the predicted oil price in the budget was $60 per barrel, which in fact was lower than the actual price in the market. The government was committed to depositing in IFESA the revenues that were generated beyond the predicted price (thus, if each barrel of oil was sold for $75, the government was committed to depositing $25). However, the government’s deposit to IFESA in that year was zero.271

In the proposed budget for the fiscal year starting in March 2011 (FY 2011-12), the government’s expenditure, including the allocation to state-owned enterprises, is expected to rise to US $524 billion, i.e., up by 46.5 percent from the previous year’s budget. Such rise is the result of increases in current expenditure (up by 48.8 percent) and more development spending (up by 53.2 percent). The budget assumes the oil price will stand at US $80 per barrel. Overall, the general budget, which includes government expenditure plus the costs of development projects for each fiscal year, is up by nearly 40 percent. The allocation for state-owned banks and enterprises also shows an increase in the 2011 budget of 43.4 percent compared with the 2010 budget.272 Therefore, most of the assets allocated to the state-owned enterprises are likely to be transferred from the IFESA. Given the government’s zero deposit in IFESA in 2010, the assets held by the account are expected to show negative growth in FY 2011-12.

The government’s expenditure from oil revenues has increased over the last few years, but the government has remained reluctant to share information about the activities of the IFESA. This has caused controversy between the Majlis and the government, and the issue has been raised in various political debates by critics of the current government. This research has proved that there is a massive gap between the various estimates of the size of assets held by IFESA. All in all, the government is expected to continue spending most of the country’s oil revenue during the years to come. This will leave very little room for saving Iran’s sovereign wealth in the IFESA.

271 Alef News Agency, 17 March 2011
272 Economist Intelligence Unit (2011), op.cit
6.3.3.1 The scandal of Tehran Urban and Suburban Railway Company (TUSRC)

One of the most controversial debates between the government and the Majlis over the size of assets held by IFESA concerned the case of TUSRC. The company is owned by the Tehran Municipality and is in charge of the construction and operation of Tehran’s underground public transport. The company has been managed for 17 years by Mohsen Hashemi, son of the former Iranian President, Akbar Hashemi Rafsanjani. The company was scheduled to receive US$2 billion from the government, to import new trains in order to develop the underground public railway network, and to cover some of the company’s operating costs, so as to be able to provide subsidised services to Tehrani residents.

The project was put on hold when the government refused to make the payments that had been approved two years earlier. An initial plan was made to make the payments from the IFESA but the government later said that the payment was to be made only from the National Development Fund (NDF). The NDF is a new fund created, as announced in the Fifth Development Plan, to replace the IFESA. At the time when this condition was imposed by the government the fund had not even been established, and the government announced therefore that no payment would be made before the fund had been set up and was fully operational.

The government’s refusal to make the payment to the TUSRC became a source of controversy between the government of President Ahmadinejad and the Majlis since it also coincided with a period of intense political conflict between President Mahmoud Ahmadinejad and former President Rafsanjani. In his resignation letter to Mohammad Bagher Ghalibaf, Mayor of Tehran, Mohsen Hashemi, former CEO and the Chairman of the Board of Directors of the TUSRC, clearly stated that the government’s reluctance to provide the promised finances was a personal attack on him because of his father’s political disagreement with the government of President Ahmadinejad.273

Mousa Al-Reza Sarvati, a member of the Budget and Planning Commission of the Majlis, commented on the overdue payments to TUSRC;

“Linking Tehran Metro’s payments to establishment of the National Development Fund is irrelevant. All the oil export income surplus of US $ 65 per barrel should have been transferred to the account. Therefore, the

273 Merh News Agency, 4 March 2011
government’s claim for lack of sufficient funding in the account to make overdue payments of this project is not valid. The government can not refuse obeying the law while it refuses to answer the enquiry of the Majlis on this topic. Even if the government has legitimate reasons for its refusal, it must be discussed in the Majlis and the decision must be made there. Should the government refuse obeying the law, we will invite the ministers who are related to this case for an official enquiry.” 274

The debate over the TUSRC payment became intense. The Majlis discussed holding an official enquiry among ministers who had played a role in the government’s decision in the financial dispute between it and the TUSRC. The names of those who were likely to be invited to such an enquiry were never officially announced; however, Mohammad Hoseini, the Finance Minister, and Hamid Bebhanani, Minister of Transport, were the two cabinet members who would have been called in by the Majlis if the majority of the MPs had voted for an enquiry. According to the constitution, when ministers are invited to such an enquiry they must obtain a vote of confidence from the majority of Majlis members. If, after the enquiry, the majority of members did not vote for that minister, he would lose his ministerial position and the president would need to find a replacement.

There was an intense debate inside the Majlis over the controversy to the TUSRC. On one hand, some MPs criticised the government openly for its lack of cooperation in this particular case with another government body (Tehran Municipality). The political disagreement between the government, the Tehran Municipality, and TUSRC was referred to as clear a case of violation of the law. Moreover, the delay that resulted for the development of Tehran’s underground public transport projects because of the overdue payments to the company was heavily criticised since it directly affected the welfare of Iranian citizens. On the other hand some of the MPs argued that allocation of such funding to one single project that would benefit only the citizens of the capital was unjust.

The Majlis approved the bill for payment to the TUSRC in January 2010. According to the Constitution any bill approved by the Majlis must also be approved by the Council of Guardians. In the Iranian legislative system, although the Council acts like an upper house and does not introduce bills, it is able to block bills that are passed by the Majlis, which is the lower house. In this instance, the Council did not approve the bill regarding the payment to TUSRC. Again, according to the Constitution, when there is disagreement between the Council of Guardians and the Majlis (e.g., the Council does

274 Mehr News Agency, 12 January 2010
not approve a bill which the *Majlis* has approved); the bill will be sent to the Expediency Discernment Council (EDC) for review.

The EDC is a government body in Iran’s political system to which the Supreme Leader has delegated some of his authority. Therefore, in the case of TUSRC, the Expediency Discernment Council was needed to apply its powers to resolve the issue. The former President, Akbar Hashemi Rafsanjani, father of the CEO of TUSRC at the time, is also the Chairman of the Expediency Discernment Council. Therefore, when the EDC gave its vote of approval to the TUSRC’s bill in February 2010 the government remained disinclined to execute the bill and refused to make any payment to TUSRC. Shortly after the EDC had confirmed its approval, the President’s Secretary of Parliamentary Affairs declared that the government was unable to make the payment despite the EDC’s decision, and that the payment would remain on hold until the government had announced the legal procedures for the operation of the National Development Fund.

Various *Majlis* members and government officials were interviewed and asked to comment on the controversy over the TUSRC; these included Mohammad Reza Khabbaz, a Tehran MP and a member of the Economic Commission of Majlis, who told the Mehr News Agency:

“This bill is potentially a good one as it will resolve many problems of the city’s public transport network. However, it has two fundamental negative aspects: firstly, withdrawals from the Iranian Foreign Exchange Saving Account which its assets belong to all the Iranian citizens must be done carefully and since the Council of the Guardians did not approve the payment, the responsibility of the Majlis (in making the best decision) was increased – therefore, the Majlis must pay extra attention to ensure the bill is not violating the equal right of the citizens to the national assets. Secondly, the withdrawal was approved by the Majlis when the members of the Majlis did not have sufficient information on the size of total assets held in the account. The MPs have not had a correct estimate of the available fund in the account (therefore, a wrong decision was likely to be made by them).”

Sattar Hedayat Khah, the spokesman of the Cultural Commission of the Majlis, also commented on the matter of approving payment for the TUSRC, pointing out that:

“the Article No. 9 of the constitution clearly stated that all the Iranians must benefit equally from the national wealth. Therefore, spending this amount (US $ 2 billion) on one project which only the citizens of Tehran will benefit from when there are still many villages in the country where their residents do not have access to clean water would be a clear violation of the constitution.”

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275 Ibid
Mohsen Hashemi, CEO of the Tehran Urban and Suburban Railway Company resigned on 5 March 2011, and former President Rafsanjani, who had served as the chairman of the Assembly of Experts of the Leadership since 2006, withdrew his candidacy for re-election on 8 March 2011. The Assembly of Experts of the Leadership is a government body in the Iranian political system which is charged with the electing and removing of the Supreme Leader and supervising the Supreme Leader’s activities.

The controversy over the TUSRC was just one of the political backlashes amongst members of the Iranian political elite. The government’s decision over paying the TUSRC and its disagreement with the country’s legislative system on the one hand, and the stand taken by the government on the other, has confirmed the politically-oriented investment strategy of the Iranian Government in its management of the country’s sovereign wealth. In contrast to the commodity-based sovereign wealth funds of the GCC members, the Iranian government has not succeeded in protecting the commercial nature of the country’s sovereign wealth investments from politics. The financial debate over the TURSC was transformed into a straightforward political disagreement between the former Iranian President Rafsanjani, who had supported the government’s opposition movement in the aftermath of the Presidential Elections in 2005, and the Ahmadinejad Administration. The TUSRC case was seen as a major turning point for the balance of political power in Iran, while Rafsanjani’s resignation from the Assembly of Experts of the Leadership was interpreted as a major step back for the government’s opposition.

### 6.3.4 National Development Fund (NDF)

The current government of the Islamic Republic of Iran has proposed the establishment of a new sovereign wealth fund. Even though the NDF was established to receive all the assets held by the IFESA, the creation of the fund was not simply a change of name for IFESA, since the governance, operational strategy, and savings policies of the NDF differ from those of the IFESA. The plan for creating the National Development Fund was initially suggested in mid-2010, but because of the delay in submitting the 2011

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277 [http://www.guardian.co.uk/world/2011/mar/08/iran-president-rafsanjani-assembly](http://www.guardian.co.uk/world/2011/mar/08/iran-president-rafsanjani-assembly), accessed on 1 April 2011
annual budget, no further progress was made. However, the government has committed itself to sending its final proposal to the Majlis for approval by the end of April 2011.\textsuperscript{278}

The goals and responsibilities of the fund are similar to those of IFESA, but there has been another major objective added to the National Development Fund that was not included among the goals of the IFESA; this is inter-generation saving. Like the IFESA, the NDF seeks to support private sector businesses that are capable of increasing the country’s production and export levels by extending loans to them. Moreover, the government has committed itself to keeping the Fund’s management structure independent of the political elite. The initial proposals also reveal the government’s plan for managing the National Development Fund directly, as opposed to the IFESA which was managed through the country’s banking network or the Central Bank of Iran (CBI). There are plans to transfer all the assets of the IFESA to the National Development Fund’s account, and the investment returns on the Fund’s assets will be taxed by the Majlis as well as by the government.\textsuperscript{279}

Governance of the National Development Fund is divided between a Board of Trustees, a Board of Managers, and a Supervisory Board. Other government bodies, including the Majlis and the Expediency Discernment Council, have also been given a stronger role in the governance of the NDF, compared with IFESA. The Board of Trustees of the fund includes:

1. The President’s Secretary of Strategic Planning
2. The Governor of the CBI
3. The Minister of Finance
4. A member of Majlis chosen by the Majlis (preferably a member of the Economic Commission of the Majlis)
5. A member of the EDC chosen by the EDC
6. The Head of Chamber of Commerce, Industry and Mining

\textsuperscript{278} Khabar Online News Agency, 8 December 2010
\textsuperscript{279} Ebtekar Newspaper, 21 June 2008
7. The Head of Iran Central Chamber of Cooperatives (which represents the cooperative sector) 280

The Board of Trustees is to be the main element in the governance of the NDF, and its administrative office will be located in the Central Bank. A special inspector will be appointed by the Board of trustees to monitor the activities of the fund constantly. There is no detailed information on the division of responsibilities between the Board of Trustees, the Board of Managers, and the Supervisory Board.

The Board of Managers will include the Governor of the Central Bank of Iran who is the chair of the Board and two experts in finance who will be chosen by the Board of Trustees. There is no information on the role of the Board of Managers. However, since the government’s proposals suggest that two experienced financiers will be on the Board of Managers, it is expected that it will be engaged with the day-to-day operation of the Fund. Finally, the NDF will have a Supervisory Board including three auditor chosen by the Majlis who will be responsible for supervising all the Fund’s activities and presenting annual reports to the Majlis. As noted above, it appears that the Majlis will have a strong role in decision-making and overseeing the National Development Fund.

The NDF will initially receive all the assets held in the IFESA. It is not clear when IFESA’s activities will end, and whether or not both funds might operate actively for some time. On 15 March 2011 the Minister of Job and Social Affairs told the Mehr News Agency that the initial transfer to the NDF would amount to US $30 billion. The findings of this research show that the government has not put forward any detailed procedures for the transfer of assets from IFESA to the National Development Fund; nor is it clear whether the government plans to close down the IFESA and start a new sovereign wealth management institution or whether the NDF will be an improved continuation of IFESA. It appears that the government plans to:

1. Deposit 20 percent of annual oil revenues which will be paid on a monthly basis to the Fund’s account.
2. Increase the savings by five percent annually in order to achieve a savings rate of 40 percent (of total commodity revenues) in the final year of the Fifth Development Plan.
3. Save loan pay-back instalments for the loans which are made to the public and private sectors from the assets held in the Fund.
4. Reinvest all investment returns. 281

280 Majlis Research Centre (2010), Report No. 10260, May 2010
The government’s savings proposals for the NDF appear to be quite ambitious. It was suggested that the government might aim to deposit all the oil and gas export income to the Fund’s account over the next ten years. By the end of the tenth year after the creation of the NDF, the government would then be in a position of full financial independence from oil revenues and would finance its budget from non-oil incomes. Throughout this ten-year period, the government plans to cut the subsidies entirely, and instead transfer all the assets allocated to the subsidies in previous years to the National Development Fund’s account. Moreover, the initial proposals for the Fund aim to deposit the investment and saving returns into the Fund’s account as well. All the returns would be kept in a separate account from the actual assets and the government would not be permitted to withdraw from the assets of that account.

Similarly to IFESA’s investment strategy, the National Development Fund aims to support the private sector, so 30 percent of total assets under management of the Fund would be invested in the private and cooperative sectors in order to increase production and efficiency in the domestic economy. In addition, ten percent of the total assets under management of the Fund would be invested in the oil and gas sector. This will be a new investment area in which the country’s sovereign wealth management institution will operate. Investments in the oil and gas sector were not included in IFESA’s investment mandate. Furthermore, up to 20 percent of the assets held in the Fund will be deposited in local banks to support the domestic financial sector. Support for the domestic financial sector was not included in the IFESA investment mandate. Finally, the government has proposed that it will invest the rest of the NDF’s assets in various financial products in the international markets. \(^{282}\) For the first time since the creation of Iran’s sovereign wealth investment institution, the government has committed to invest up to 40% of the country’s sovereign wealth in international financial market.

The government has also included other areas for investing the Fund’s assets, such as projects that aim to support the poor and young newly-married couples, to maintain the market balance in consumer goods, to provide affordable housing for the under-privileged, and to invest in development projects aimed mainly at strengthening schools against natural hazards (earthquakes).

\(^{281}\) Ibid
\(^{282}\) Ibid
The government’s proposals for the creation of the NDF have also indicated particular procedures that will be put in place in order to maintain the transparent operation of the Fund. It is suggested that the assets managed by the Fund will be kept in a separate account from the Central Bank’s foreign exchange reserves. The Board of Trustees will appoint an external auditing team to conduct regular auditing and update the Board and the Majlis on the operational activities of the Fund. In addition, regular internal auditing will take place (internally every six months, external auditing annually). The Fund will be committed to release regular quarterly reports. There has been no information as to whether or not these reports will be made available to the public or if access will be restricted to the Majlis and the EDC only, but given the government’s policies on public disclosure of information about IFESA’s activities, it seems unlikely that such information will be available to the public.

The government has put forward a much more developed proposal for the structure of the National Development Fund than it did for the IFESA. This is probably due to a combination of factors. The IFESA has been criticised by various groups, mainly the members of the Majlis; therefore, the government has felt the need for a different approach in its sovereign wealth management policies. Moreover, an economic restructuring programme is more in demand in Iran than previously. Iran’s economic performance of over the last few years, in comparison with other oil-rich countries of the region, has not recorded satisfactory results. Therefore, embarking on a new approach to the sovereign wealth management of Iran may well result from the government’s experience in the previous years. The country’s sovereign wealth has been managed with a high level of corruption since the first sovereign wealth management institution was established. Therefore, it is difficult to predict whether the NDF will operate more efficiently and with more transparency in the coming years. Given the overall inefficiency of Iranian government institutions the country’s sovereign wealth management is not expected to develop to the same level as that of the neighbouring countries in the Gulf in the foreseeable future.

6.4 Conclusion

The Iranian government has remained highly dependent on its oil income, and Iran’s sovereign wealth management has been the poorest of its kind in the Gulf. The key issue that has contributed to the poor performance of the country’s sovereign wealth
management institutions is its weak legal and management systems and lack of supervision. The IFESA caused controversy between the government, the Majlis, and the public. There was also a visible lack of consistency in the economic policies applied by the previous as well as the current government. After 2005, monetary decision-making was taken over by the President, who dismissed two central bank governors within a single year. The orders of the Majlis have either been ignored by the government or by-passed following intervention by the Council of Guardians, which has been a strong supporter of the government within the country’s legislative system, while the government has had an unstoppable tendency to increase its expenditures along with its unlimited access to IFESA’s assets.

Moreover, the international economic sanctions forced Iran into severe economic isolation, whereas integration into the global financial system has proved to be in the best interests of the sovereign wealth management policies of other Gulf states. In addition to the external isolation imposed by economic sanctions, Iran has struggled since 2005 with major internal political issues, which have impeded the sound operation of the country’s domestic economic activities. A good example of this is the case of the TUSRC. The creation of a new sovereign wealth fund which seeks to avoid the mistakes of the previous fund represents a huge step for the country. However, with Iran’s internal and external difficulties on the economic as well as the political front, it is unlikely that the NDF will turn out to be the country’s shortcut to catching up with the Gulf’s larger sovereign wealth funds.
7 The Government Pension Fund of Norway

7.1 Introduction

Norway with an oil production of 2.38 million barrel per day is one of the world’s main oil producing countries. The Norwegian economy faces two key issues; an aging population and high dependence on oil production incomes. The petroleum sector generates more than one-half of total export revenue.\textsuperscript{283} Crude and refined oil and gas products form 65\% of the country's total export.\textsuperscript{284} The proportion of the population aged 67 or above will increase in Norway from around 13\% of the population in 2009 to 17\% by 2030. The ratio of population of 67 or above relative to those aged 15-66 is expected to increase from around 20\% to just over 30\% during the same period. As a result, the government of Norway will need to finance a larger volume of services and transfers to the aging population.\textsuperscript{285}

With a relatively old population, and surplus oil income the government bears two major commitments to the Norwegian citizens; high pension obligation and the responsibility of saving the country’s natural wealth for the future generation. As a result of the government commitments in these areas, two government funds were established;

1. **The National Insurance Scheme Fund** was established in 1966 when the National Insurance Act was adopted. The purpose of this fund was to set aside assets in the National Insurance Scheme Fund as reserves for the future which were not to be used for meeting current social security expenditure.

2. **The Government Petroleum Fund** was established in 1990 as a fiscal policy tool to support the long-term management of the country’s petroleum revenues. The first net transfer to the fund took place in 1996.

\textsuperscript{284} Economist Intelligence Unit (2011), *Norway: Country Forecast*, November 2010
The government established the above mentioned funds to serve its future pension liability and to save the oil revenue for the future generations when the resources are finished. The country’s hydrocarbon resources have already started to shrink. Norwegian oil production peaked in 2000; although, natural gas production is still increasing. Norwegians realise that once their gas production peaks they will eventually face declining oil and gas revenues.\(^{286}\) Moreover, with the aging population, regardless of the flow of oil revenue, the pension liabilities of the government are expected to greatly exceed the estimated assets of the entire government pension funds.\(^{287}\) The government will therefore, need to pursue policies for prudent management of Norway’s petroleum wealth. Given the structure of the Norwegian society in which the government is a key player to maintain the social safety of the population, the management of the country’s public wealth is a fundamental social perspective and a priority for the government.

In 2006, the government renamed the National Insurance Scheme Fund and the Government Petroleum Fund to Government Pension Fund-Norway (GPFN) and Government Pension Fund-Global respectively (GPFG). Both funds have been often referred together under one overarching title; Government Pension Fund. The purpose of the Government Pension fund, which includes both GPFG and GPFN has been defined as: “to support government savings to finance the pension expenditure of the National Insurance Scheme and long-term considerations in the spending of government petroleum revenues.”\(^{288}\) In other word, the Government Pension Fund is a combination of National Insurance Scheme and Petroleum Fund and carries on the responsibility of serving the government in the same way as those fund did only with a new title.

The GPFN has been managed by Folketrygsfondet on behalf of the ministry of finance since it was established. Folketrygsfondet is an investment institution which established by the government of Norway in 1967 and has been commissioned to manage the GPFN (previously named as National Insurance Scheme Fund). The GPFG has been managed by the central bank during the first two years of its establishment (between 1996 and 1998). In 1998, Norges Bank Investment Management (NBIM) was set up to be in charge of management of the GPFG on behalf of Norwegian ministry of finance.

\(^{287}\) Economist Intelligence Unit (2011c), op.cit
\(^{288}\) Ministry of Finance (2009), Report No. 20
The funds are managed separately as the National Insurance Scheme and Petroleum Fund with no signs of transactions from one fund to another. Both funds have been active institutional investors since their establishment. The main technical factor which differentiates the GPFN and GPFG is their investment universe. The GPFN investment mandate is to invest in Nordic region only, while the GPFG invests globally.

The GPFG was set up to protect the government’s fiscal policy should oil prices drop or the domestic economy contract. The fund is also considered as a tool to manage the financial challenges of an ageing population and an expected drop in petroleum revenue. The fund is designed to invest in long-term assets, but in a way that made it possible to draw on when required. The change of name of the fund highlights the fund’s role in saving government income to finance expected increase of the future public pension expenditures. Notwithstanding its name, the fund has no formal pension liabilities and there has been no political decision on when the fund may be used to cover future pension costs. The Government Pension Fund has two main objectives:

- to serve as a savings mechanism which aims to distribute petroleum revenues across generations – based on Norwegian welfare mindset, petroleum resources are part of the national wealth which do not only belong the current generation but also to future generations.

- to protect Norwegian economy at the time of fluctuations in oil prices. Although, the country benefits from a rather diversified tax-base, the volatile crude markets could have a negative impact on the competitiveness of Norwegian internationally exposed industries. The Fund is designed to serves as a buffer between current oil incomes and the expenditures.

Therefore, based on the definition of the SWFs by this thesis, the GPFG is the SWF of the government of Norway and it will be reviewed in detail in this chapter.

The GPFG is integrated in the government’s annual budget. The capital inflow of the GPFG includes all government petroleum revenue, net financial transactions related to petroleum activities, net of what is spent to balance the state’s non-oil budget deficit. The full integration of the fund with the state budget proves that net allocations to the fund reflect the total budget surplus. Norwegian fiscal policy is formed based on the

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289 www.nbim.no, accessed on 25 February 2011
The guideline that the structural, non-oil budget deficit shall correspond over time to the real return on the fund’s investments which is estimated to stand about 4 percent of the value of the assets. Therefore, a spending rule was established in 2001 for the GPFG which does not allow more than 4 percent of the fund’s return over time to be spent on the annual national budget. For that reason the market value of the GPFG’s assets have constantly grew over time. This is in contrast with the saving and spending policy of the Gulf CSWFs which their assets have been drained out to cover various government expenditures including the costs imposed by the regional conflicts.\(^\text{291}\)

Figure 7-1: The GPFG’s market value (krone billion)

![The GPFG’s market value (krone billion)](image)

Source: GPFG Report, 3\(^\text{rd}\) quarter of 2010

### 7.2 The GPFG investment strategy

The investment strategy of the GPFG has gradually developed over time since it was established. The fund has been investing in equities in developed economies since 1998. In 2000, emerging markets were also included in the benchmark portfolio for equities. The benchmark portfolio for bonds was expanded in 2002 to include the non-government-guaranteed bonds (i.e. corporate bonds and mortgage-backed bonds). In 2006, the investment universe of the GPFG was further expanded. Ministry of Finance expressed an intention for an expansion of the investment universe to include the small-cap sector in the benchmark portfolio for equities and to increase the equity portion of the benchmark portfolio from 40 per cent to 60 per cent. The parliament, *Storting*, was informed of the ministry’s intention in Report no. 24 (2006–2007) to *Storting*. In 2008, the ministry decided to include property investments in the GPFG’s portfolio and informed the *Storting* of this decision in Report no. 16 (2007–2008). It was also decided...

\(^{291}\) [www.nbim.no](http://www.nbim.no), accessed on 25 February 2011
to expand the benchmark portfolio by including more emerging stock markets and to increase the limit on ownership stakes for equity investments in individual companies from 5% to 10% (see Table 7-1).

Table 7-1: Development of investment strategy for the GPFG

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969</td>
<td>Petroleum discovered in the North Sea (production starts in 1971)</td>
</tr>
<tr>
<td>1990</td>
<td>Parliament passed the Government Petroleum Fund law</td>
</tr>
<tr>
<td>1996</td>
<td>First net transfer to the fund, invested similarly to the Central Bank of Norway’s currency reserves</td>
</tr>
<tr>
<td>1997</td>
<td>Prior to this year, the fund was wholly invested in government bonds; the ministry decides to invest 40 percent of the fund in equities.</td>
</tr>
<tr>
<td>1998</td>
<td>Norges Bank Investment Management (NBIM) was set up on 1 January to manage the fund. NBIM converted about 40 percent of the fund’s bond portfolio into equities within the first half of 1998.</td>
</tr>
<tr>
<td>2000</td>
<td>Five emerging-market countries were added to the equity benchmark</td>
</tr>
<tr>
<td>2002</td>
<td>Non-government bonds (corporate and securitised bonds) added to the fixed income benchmark</td>
</tr>
<tr>
<td>2004</td>
<td>Ethical guidelines were established</td>
</tr>
<tr>
<td>2006</td>
<td>The fund was renamed from Government Petroleum Fund to Government Pension Fund-Global</td>
</tr>
<tr>
<td>2007</td>
<td>The Ministry of Finance decided to increase the fund’s share of equity investments to 60 percent from 40 percent. It also decided to add small-cap companies to the benchmark portfolio.</td>
</tr>
<tr>
<td>2008</td>
<td>The Ministry of Finance included real estate to the fund’s investment universe, with a maximum share of 5 percent of total assets. All emerging markets were included in the reference equity index.</td>
</tr>
<tr>
<td>2009</td>
<td>The fund’s ethical guidelines were evaluated. Its share of equity investments reached 60 percent in June. The fund posted a record return of 25.6 percent.</td>
</tr>
<tr>
<td>2010</td>
<td>The Ministry of Finance gave the fund a mandate to invest as much as 5 percent of its assets in real estate, reducing its share of fixed-income investments correspondingly.</td>
</tr>
</tbody>
</table>

Source: www.nbim.no

The overall aim of the investments in the GPFG is to achieve maximum financial return with moderate risk. Similar to most of the SWF case studies of this project, the GPFG investment strategy is to diversify the fund’s assets in different asset classes. In order to minimise the risk associated with diversified asset classes in which the GPFG invests, various risk calculation measures are in place on the basis of historical events impacts on investment returns under the current asset composition and country allocations. The crisis scenarios include different historical events during the past 100 years of the world
history such as; the oil crisis of 1973-1975, the stock market crash in 1987, Mexican and Asian crisis of the 1990s. Majority of the GPFG investments are in shares of listed companies and fixed income products with high credit rating by various credit agencies like Moody’s Standard & Poor and Fitch (see Figure 7-2).

Figure 7-2: Fixed-income holdings based on credit ratings (% of portfolio)

The GPFG does not have any concrete commitments linked to its assets. This minimises the fund’s short-term liquidity requirement and extends the investment horizon of the GPFG. Like other CSWFs case studies of this research the GPFG is a rather patient investor with a long investment horizon. The fund has a formulated long-term investment strategy in which the shares of investments in various asset classes and geographical regions is decided based on their expected long-term returns and risks.

As was mentioned above, the portfolio of investment of the GPFG is diversified various sectors and geographic locations. The benchmark index for equities of the GPFG comprises almost 7,700 companies across 27 countries and the benchmark index for bonds comprises more than 9,800 bonds across the currencies of 21 countries. Equity investments in basic material and oil and gas sectors earned the highest percentage of return in 2010 (see Table 6.3). Below, there are lists of the fund’s largest equity and
bond holdings in 2010. As it is shown in the table the main share of the GPFG investments are held in European economies.

Figure 7-3: Benchmark portfolio of the GPFG

Table 7-2: The largest holdings of the GPFG (million krone)

<table>
<thead>
<tr>
<th>Company</th>
<th>Country</th>
<th>Holdings</th>
<th>Issue</th>
<th>Country</th>
<th>Holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Dutch Shell</td>
<td>UK</td>
<td>19,914</td>
<td>US government</td>
<td>US</td>
<td>136,622</td>
</tr>
<tr>
<td>HSBC</td>
<td>UK</td>
<td>18,982</td>
<td>UK government</td>
<td>UK</td>
<td>91,768</td>
</tr>
<tr>
<td>Nestle</td>
<td>Switzerland</td>
<td>18,123</td>
<td>Federal Republic of Germany</td>
<td>Germany</td>
<td>65,155</td>
</tr>
<tr>
<td>Vodafone Group</td>
<td>UK</td>
<td>14,781</td>
<td>Japanese government</td>
<td>Japan</td>
<td>51,322</td>
</tr>
<tr>
<td>Novartis AG</td>
<td>Switzerland</td>
<td>13,947</td>
<td>Italian Republic</td>
<td>Italy</td>
<td>51,226</td>
</tr>
<tr>
<td>BP</td>
<td>UK</td>
<td>13,695</td>
<td>French Republic</td>
<td>France</td>
<td>49,158</td>
</tr>
<tr>
<td>Telefonica</td>
<td>Spain</td>
<td>11,667</td>
<td>Kingdom of Spain</td>
<td>Spain</td>
<td>23,207</td>
</tr>
<tr>
<td>Total</td>
<td>France</td>
<td>11,018</td>
<td>European Investment Bank</td>
<td>Supranational</td>
<td>23,163</td>
</tr>
<tr>
<td>BHP Billiton</td>
<td>UK</td>
<td>10,805</td>
<td>Fannie Mae</td>
<td>US</td>
<td>19,806</td>
</tr>
<tr>
<td>GlaxoSmithKline</td>
<td>UK</td>
<td>10,562</td>
<td>Bank of Scotland</td>
<td>UK</td>
<td>18,762</td>
</tr>
</tbody>
</table>


7.2.1 New investment programmes

Since 2008, the GPFG has introduced two new investment programs which contain investments in asset classes which have not been included in the fund’s portfolio before; real estate and infrastructure. Unlike the Gulf funds, GPFG has not been active in real estate markets. The Ministry of Finance asked for Storting’s approval on the plans to invest up to 5 per cent of the GPFG in real estate in 2008. Due to the poor return in global real estate market in 2008, the Ministry has not set a fixed investment plan in real estate for the coming years. The new investment plans will have to be adapted to the market conditions and capacity. Therefore, in the first few years, the investments in real estate will be concentrated in a number of chosen areas. The GPFG will gradually build up a global real estate portfolio over time with a high degree of risk diversification.

As is the case for real estate, the Ministry of Finance gas decided to include investments in infrastructure in the portfolio of investments of the GPFG as an element of risk diversification strategy. The decision was approved by the parliament on the basis of rapid growth of the sector as a result of the large demands for infrastructure investments in emerging economies. Investments in infrastructure by the GPFG will include various assets across the sector such as: water supplies, toll roads, airports and telecommunications. The Stroting suggested that the fund must develop investment competence in all the asset classes including infrastructure in order to maintain a good international representation in all the markets in which other institutional investors are actively investing in.
7.3 The GPFG ethical guidelines

Ethical guidelines were established for the GPFG on 19 November 2004. The guidelines build on recommendations made by a government-appointed committee which presented its report in summer 2003. The committee identified two ethical obligations for the management of the fund:

- “Firstly, the fund should be managed with a view to achieving high return that will enable coming generations to benefit from the country’s petroleum wealth.

- Secondly, the fundamental rights of those affected by companies in which the fund invests should be respected. This ethical basis is promoted through two instruments: exercise of ownership rights and exclusion of companies from the fund’s investment universe.”

7.3.1 The ownership rights by the GPFG

One of the key characteristics which differentiate the investment strategy of the GPFG from that of the other SWFs is exercising the ownership rights. The exercise of the ownership rights by the GPFG is focusing on two key aspects: good corporate governance and environmental and social issues. Each of these two main aspects of the companies’ operations also includes a number of issues;

1. Good corporate governance
   - Equal treatment of shareholders


- Shareholder influence and board accountability
- Well-functioning, legitimate and efficient markets

2. Environmental and social issues
- Children’s rights
- Climate change
- Water management

Unlike the Gulf CSWFs which are often passive investors, in order to protect the financial interests of the GPFGm the fund has been actively practicing its ownership rights actively in the companies in which it invests in. Norges Bank is responsible for exercising the ownership rights of the GPFG through voting at general assembly meetings of the companies in which the GPFG invests. In general, Norges Bank votes in favour of the proposals forwarded by the management of the companies in which it holds a shareholder right unless the board as a whole does not satisfy the bank’s expectations in maintaining sufficient independence from the company’s management or major share owners. In addition, the bank often votes against managerial salary schemes in cases where there is no obvious link between performance and reward.

The bank has also strict guidelines for exercising its ownership rights in various social and environmental issues such as those concerning child labour and carbon emission. Norgest Bank has prepared a document “NBIM Investor Expectations on Children’s Rights”, to explain the expectations of the bank concerning children’s rights to companies in which the GPFG invests. The document is designed for companies that operate in areas or sectors where there is a high risk of children’s rights violation. It has specifically targeted countries like India, Brazil, China and West Africa. Since 2008, Norges Bank has focused on the activities of certain companies in accordance with the national climate change regulations in the USA. The Bank is also part of the Carbon Disclosure Project which is an independent organisation that gathers and publishes information on companies’ emissions of greenhouse gases. Norges Bank also takes part in a petition by 135 funds calling for wealthy nations to reduce their emission of

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294 Ministry of Finance (2009), op.cit
greenhouse gases in accordance by recommendations of the UN Intergovernmental Panel on Climate Change (25–40 per cent by 2020).  

### 7.3.2 Exclusion of companies from GPFG portfolio on investments

Under a number of circumstances the companies may be excluded from the GPFG portfolio. First, the companies which produce weapons that violate fundamental humanitarian principles in their normal use. Second, those that sell weapons or military material to states mentioned in the supplementary guidelines for management of the fund. Third, when investment in a company entails an unacceptable risk of contributing to actions or omissions that must be deemed grossly unethical. So far 32 companies have been excluded from the investment universe of the GPFG. In 2010, three companies were excluded from the GPFG; two Israeli companies and one Malaysian. Israeli companies, Africa Israel Investments Ltd and Danya Cebus Ltd, and the Malaysian company, Samling Global Ltd, were excluded from the GPFGs investment portfolio and the divestment from these companies has been concluded.

- **Africa Israel Investments Ltd** is the parent company of several subsidiaries with interests in property development, infrastructure and energy. The company holds major shares in Danya Cebus which is a construction company that is involved in developing settlements in occupied Palestinian territory. This company was excluded from investment universe of the GPFG on the basis on serious violations of individual rights by the two companies in situations of war and conflict. The GPFG owned shares worth NOK 7.2 million in Africa Israel Investments at year end 2009.

- **Samling Global** is an integrated forest resource and wood products company that produces timber, plywood, veneer and palm oil. The exclusion of this company from GPFG portfolio took place on the basis of extensive and repeated breaches of the licence requirements, regulations and other directives governing the company’s forest operations in Sarawak, Malaysia and Guyana.  

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296 Ministry of Finance press release No. 48/2010, 23 August 2010
The ethical guidelines are constantly reviewed to assess whether the guidelines are satisfying their intended purpose, and maintaining broad political support for the ethical guidelines. As part of the evaluation process, the ministry carries out a number of activities to gather information and views from Norwegian and international stakeholders. One of the ongoing processes in reviewing the ethical guidelines is negative screening of companies from the portfolio on the basis of the companies’ products. A new screening criterion is being planned to cover companies that produce tobacco. However, with respect to excluding other unhealthy or socially unbeneficial services, like alcohol, from the GPFG investment universe, there has not been the same degree of norm development that can provide a similarly clear anchoring nationally or internationally.

### 7.4 Saving regulation of the GPFG

The Governance Pension Fund of Norway has a comprehensible guideline for the government saving policy and transactions of funds. Government Pension Fund Act No. 123 of 21 December 2005 clarifies the gross revenues which are part of the cash flow from petroleum activities;

1. “total tax revenues and royalties deriving from petroleum activities collected pursuant to the Petroleum Taxation Act (no. 35 of 13 June 1975) and the Petroleum Activities Act (no. 72 of 29 November 1996),

2. revenues deriving from tax on CO2 emissions due to petroleum activities on the continental shelf pursuant to Act relating to CO2 tax in the petroleum activity on the continental shelf (no. 72 of 21 December 1990),

3. revenues deriving from tax on NOx emissions due to petroleum activities on the continental shelf,

4. operating income and other revenues deriving from the State’s direct financial interest in petroleum activities,

5. central government revenues from net surplus agreements associated with certain production licences,

6. dividends from Statoil ASA,

7. transfers from the Petroleum Insurance Fund,

8. government revenues deriving from the removal or alternative use of installations on the continental shelf,
9. any government sale of stakes representing the State’s direct financial interest in petroleum activities.”

In addition, the guideline sets a clear procedure for the expenses which should be deducted from the gross revenues:

1. “government’s direct investments in commercial petroleum activities (the State’s direct financial interest),

2. operating costs and other costs directly related to the State’s direct financial interest,

3. government expenses in connection with the Petroleum Insurance Fund,

4. government expenses in connection with the removal or alternative use of installations on the continental shelf,

5. any government purchase of stakes as part of the State’s direct financial interest in petroleum activities.”

The Ministry of Finance transfer the GPFG assets in the form of a Norwegian krone deposit with Norges Bank. The bank shall manage this deposit to achieve the highest possible return through investment decisions which are made independently of the ministry. Norges Bank invests those assets in its own name in a portfolio of financial instruments, real estate and cash deposits denominated in foreign currency. The portfolio’s book return after deduction of the management costs will be added to GPFG’s krone account. The bank outsources some of its operational functions. The capital of the Government Pension Fund may only be used for transfers to the central government budget subject to an approval by the Storting. The Government Pension Fund has no rights or obligations to the private-sector entities or public authorities.

7.5 Governance and management of GPFG

Ministry of Finance is the owner of the GPFG and holds the overall responsibility of the fund. The ministry is in charge of setting strategic asset allocation and ethical guidelines. In addition, the ministry is responsible for monitoring and evaluating operational management and constant reporting to the parliament. All the guidelines for

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298 Ibid
299 Ministry of Finance (2005), Management mandate for the Government Pension Fund Global, 8 November 2010 pursuant to Act no. 123 of 21 December 2005 on the Government Pension Fund
the fund are designed by the ministry of finance subject to Parliamentary approval. The ministry has a separate Council on Ethics, which gives the ministry advice on exclusion and negative filtration of companies based on ethical criteria.

The Central Bank, *Norges* Bank, is the manager of the fund. The bank is responsible for implementation of investment strategy, active management to achieve excess return, risk control and reporting, and exercising the fund’s ownership rights. The bank is also responsible for providing the Ministry of Finance with professional advice on investment strategy. Within the central bank, there is an asset management unit, *Norges* Bank Investment Management (NBIM), which is in charge of day to day management of the GPFG. NBIM was established by the central bank in January 1998 to manage the GPFG and most of *Norges* Bank’s foreign exchange reserves. NBIM has about 290 employees in its five offices in Oslo, London, New York, Shanghai and Singapore.  

NBIM is an incorporated part of *Norges* Bank and it is subject to the same laws and regulations as the bank. NBIM’s investment activities are governed by the Parliament of Norway, the Ministry of Finance and *Norges* Bank. Rules and guidelines for the fund’s management are laid down by executive board of *Norges* Bank and NBIM leader group (headed by the Chief Executive Officer of NBIM). The CEO’s job descriptions are issued by the executive board of *Norges* Bank.  

Figure 7-6: Structure of governance and management of the GPFG

Source: Martin Skancke (2008)

### 7.5.1 The Executive Board of Norges Bank

The board is the responsible body for *Norges* Bank’s operations. It is chaired by the governor of the central bank and has seven members who are all appointed by the King.

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300 [www.nbim.no](http://www.nbim.no), accessed 10 February 2011
301 Ibid
in Council. The board sets all the guidelines and strategic plans for NBIM’s management activities. The board consists of seven members, appointed by the King in Council. They are appointed to full-time positions for a term of six years. Reappointment to the same position may take place for one period of a further six years. There are also five more members to the board who are appointed for four year terms. Every other year, two (alternately three) members retire. These members may be re-appointed for maximum twelve years. Employees also have two representatives who participate in meetings when the board deals with administrative matters.  

Table 7-3: Members of the Executive Board of Norges Bank

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Experience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Øystein Olsen</td>
<td>Chairman</td>
<td>Director general of Statistics Norway, director general of Economic Policy Department at Ministry of Finance, head of the research department, Statistics Norway, Professor II at Norwegian School of Management, deputy director general of Economic Policy Department at Ministry of Finance</td>
</tr>
<tr>
<td>Jan Fredrik Qvigstad</td>
<td>Deputy chairman</td>
<td>director and member of the management team at Norges Bank, executive director of Norges Bank Monetary Policy, Professor II (shared professorship) in economics, Norwegian School of Management, director of studies II in economics at Norwegian School of Management, director of economics department at Norges Bank</td>
</tr>
<tr>
<td>Asbjørn Rodseth</td>
<td>Member (2004 - 2007, Reappointed 2008 - 2011)</td>
<td>Professor of economics of the Faculty of Social Sciences, Oslo University, member of the Royal Commission on Pensions, chair and vice chair of the Banking, Insurance and Securities Commission</td>
</tr>
<tr>
<td>Ida Helliesen</td>
<td>Member (2010 - 2013)</td>
<td>Retired. held several executive positions in Norsk Hydro, including director of finance, board member at AkerSolutions, Skagerak Energi, Statistics Norway, Storebrand Bank, member of the Norwegian Ministry of Finance’s Investment Strategy Council.</td>
</tr>
<tr>
<td>Eirik Wæremess</td>
<td>Member (2010-2013)</td>
<td>Head of Energy Market Analysis in Statoil, work experience from the Norwegian Ministry of Finance, Total E&amp;P Norge and Econ Pöyry</td>
</tr>
</tbody>
</table>

302 www.norges-bank.no, accessed on 10 February 2011
<table>
<thead>
<tr>
<th>Name</th>
<th>Role Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gøril Bjerkan</td>
<td>First alternate (2010 - 2013)</td>
<td>Research fellow at the Department of Private Law, of University of Oslo.</td>
</tr>
<tr>
<td>Egil Matsen</td>
<td>Second alternate (2010 - 2013)</td>
<td>Associate Professor at the Norwegian University of Science and Technology</td>
</tr>
<tr>
<td>Jan Erik Martinsen</td>
<td>Employee representatives (2001 - 2012)</td>
<td>Chief Safety Delegate of Norges Bank, deputy chairman of Norges Bank's Staff Association since</td>
</tr>
<tr>
<td>Petter Nordal</td>
<td>Alternate for Jan Erik Martinsen.</td>
<td></td>
</tr>
<tr>
<td>Jens Olav Sporastøyl</td>
<td>Alternate for the employee representative.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Norges Bank

**Figure 7-7: Organization and governance structure**

![Organization and governance structure diagram](image)

Source: Ministry of Finance, and Norges Bank

### 7.5.2 NBIM Leader Group

The leader group is in charge of management of investment operations of the NBIM and it is consist of seven members. The members are appointed through procedures which are run by the human resources department on the NBIM. In contrast with the Gulf funds where appointment processes are based on individual’s links with the high-ranked
senior political figures that are often from the ruling family, the NBIM appointments take place based on individual’s professional experience in financial sector. Another key difference between the senior management team of NBIM and that of the Gulf CSWFs is appointment of non-Norwegian nationals to high management position at NBIM. This is something which with the exception of early years of SAMA’s operation has never happened in the Arab CSWFs of the Gulf. In this respect, the NBIM leader group is very much similar to any given private investment institution rather than a state-owned investment organisation like those in the Gulf.

- **Chief Executive Officer:** Yngve Slyngstad was appointed in January 2008. He joined *Norges* Bank in 1993 and NBIM in 1998. His first role at NBIM was to establish and manage the equity investment activities. He was the Head of Equities and Chief Investment Officer Equities between 1998 and 2007. Prior to joining NBIM, Slyngstad was Chief Investment Officer of Asian Equities, at Storebrand Asset Management. He also worked as a strategist and portfolio manager at Storebrand.

- **Deputy CEO:** Trond Grande was appointed in February 2011. He joined NBIM in November 2007 as Global Head of Risk Management and later also filled the role of Deputy Chief Operating Officer. In October 2009, he became Chief Risk Officer at NBIM. He previously spent 11 years in senior management positions at Storebrand Asset Management.

- **Chief Investment Officer:** Bengt Enge was selected Chief Investment Officer in October 2009. Enge joined NBIM in 1998. He served in various positions at NBIM including Global Head of External Management. Before joining NBIM, he was a research analyst with Frank Russell Company in London.

- **Chief Treasurer:** Jessica Irschick joined NBIM in October 2009 as Chief Treasurer. Her previous work experience includes positions with various investment institutions like Morgan Stanley, Salomon Brothers, Wells Fargo, Goldman Sachs, and UBS.

- **Chief Strategic Relations Officer:** Dag Dyrdal was selected as Chief Strategic Relations Officer in October 2009 after joining NBIM earlier that year as Global Head of External Relations. He has management experience from research and consulting. He started his career as a financial journalist with Reuters.
- **Chief Operating Officer:** Age Bakker was appointed Chief Operating Officer in October 2009. He joined NBIM earlier that year as Global Head of IT. He has previously held positions within teaching and the investment management industry including 14 years in senior management positions at Storebrand Asset Management.

- **Chief Compliance Officer:** Jan Thomsen joined NBIM as Chief Compliance Officer in February 2010. His previous work experience includes management positions at the international classifier *Det Norske Veritas*, consultant position at Andersen Consulting, and a teaching assistant at the Norwegian University of Science and Technology.

- **Chief Administrative Officer:** Mark Clemens was appointed as Chief Administrative Officer of NBIM in October 2009. He started his career in London at Salomon Brothers and later moved to Citi Group.

Unlike the Gulf CSWFs executive management teams, particularly those from the UAE, individuals from the NBIM leader group team do not hold other government positions. Such arrangement separates the political elite from those who are in charge of making investment decisions for the GPFG. This has indeed been something that the Gulf funds have failed to accomplish. The overlap between the political and financial power in the Gulf countries has the major source of uncertainty about the non-commercial investment incentives of the Gulf CSWFs.

### 7.6 The Government Pension Fund Norway

The second part of Government Pension Fund of Norway is GPFN. The GPFN is managed by *Folketrygdfondet* which manages the fund’s capital in its own name. The GPFG assets are invested in Norway, Denmark, Finland and Sweden. The basic capital of the GPFN originates primarily from surpluses in the national insurance accounts from the introduction of the National Insurance Scheme in 1967 and until the late 1970s. The return on the assets of the GPFN is not transferred to the treasury, but is added to this part of the fund on an ongoing basis. Consequently, there are no transfers between the Fiscal Budget and the GPFN nor are there any transfers of capital between the two parts of the Government Pension Fund.
Folketrygdfondet is a company which is wholly owned by the state of Norway and has been commissioned to manage the Government Pension Fund Norway on behalf of The Norwegian Ministry of Finance. It is a long-term asset manager aiming the best investment returns on the capital within the management limits. Capital can be invested in shares listed on regulated markets in Norway, Denmark, Finland and Sweden, and in fixed income products issued by these countries. The GPFN which constitutes a part of the Government Pension Fund is to support government savings for financing future national insurance pension fund costs. By the end of 2009 total assets amounted to 117 billion Norwegian krones.\(^{303}\) The Folketrygdfondet is governed by a board which is responsible for the management of the fund. The board consists of nine members which are all appointed by the The Norwegian Ministry of Finance for four years. Folketrygdfondet has 45 employees.\(^{304}\)

The share of equity investments of the GPFN is 50-70 percent, whilst the share of fixed income instruments is 30-50 percent of the portfolio. 80-90 percent of all the investments of the fund shall be placed in Norway, whilst 10-20 percent shall be placed in Denmark, Finland and Sweden. The investment limit for Folketrygdfondet is 15 percent of the share capital or the basic capital in any single company in Norway, and up to 5 percent of total equity capital and basic capital in any single company in other countries of the GPFN investment universe.

Folketrygdfondet is responsible for exercising the ownership rights through management of the Government Pension Fund Norway. The guidelines for the exercise of ownership and the ethical principles for investment activities of GPFN is the same as that of the GPFG to help promote long-term wealth creation and good corporate governance. The Ministry stipulates general investment strategies, whilst the board of directors of Folketrygdfondet is responsible for the operational management of the Government Pension Fund Norway.


\(^{304}\) [http://www.ftf.no](http://www.ftf.no), accessed on 2 June 2010
The overall management model of the fund is to maximise transparency of operation. Norwegian sovereign wealth fund has been referred to as one of the most transparent commodity-based fund of the world by various organisations. All the information used in this chapter was collected from the online sources which are made available to the public by the Norwegian government. NBIM, Norgest Bank, Ministry of Finance and Folketrygdfondet publish information on the size of assets under management of both parts of the Government Pension Fund, return, holdings, asset mix, risk management and ethical guidelines. In most of the official documents such public disclosure is emphasised as a key tool in building trust, both domestically and internationally.

Norway has thus been remarkably successful in transparent management of petroleum revenue and transferring the surplus oil export income to other types of assets globally. Given the inter-generation saving aim of the fund, a major concern in various activities of the fund is to safe-guard the wealth for posterity of current and future Norwegians. Therefore, it is considered an important responsibility for the managers of the fund to ensure that a favourable rate of return is produced on the wealth over time which is accompanied by social and environmental sustainability. The Ministry of Finance has contributed to the formation of International Working Group of Sovereign Wealth Funds and has supported the development of the Generally Accepted Practices and
Principles for Sovereign Wealth Funds. The GPFG has met most of the criteria of the 24 principles of GAPP.\(^{305}\)

Part of the success in Norway may be as a result of the inclusion of the fund in the government fiscal balance. All the transfers to the Government Pension Fund are made after the government budget is balanced at the end of each fiscal year. This mechanism has included the transactions of the sovereign wealth fund on government record. This has proven to be a challenge for all the Gulf CSWFs where there are no fiscal records of the assets of the sovereign wealth funds as the assets of those institutions have never been included in the government’s budget. In all the Gulf countries, with an exception of Kuwait, there is no clear saving policy according to which the government’s sovereign wealth saving commitment is designed (see Figure 7-9).

Another factor of success for transparent operation of Norway sovereign wealth fund is clear governance structure and the relationship between the asset management bodies (NBIM and Folketrygdfondet) with Ministry of Finance and the legislature. The decision making process and the role of each of the organisations involved in the process is clearly defined and all the decisions are announced publically. This is in contrast with the Gulf CSWFs where understanding the decision making process and procedures has been rather challenging as the information is not often made available to the public.

Figure 7-9: GPFG mechanism

\[\text{Diagram of GPFG mechanism}\]


\(^{305}\) Ministry of Finance (2009), op.cit
Having an independent senior management team from the government is also another key difference between the Norwegian SWF and those from the Gulf. As is noted above, most of the senior leading team of the Norwegian fund are selected through transparent recruitment processes which are conducted by human resource departments of central bank or NBIM. This is in contrast with the Gulf CSWFs where the leading management positions and the seats of the executive boards are allocated to the members of the ruling family or those with long-term historical link with the ruling elite.

7.8 Conclusion

The Norwegian Sovereign Wealth Fund is the most transparent and well-governed commodity-based SWFs of the world. The fund’s governance and management strategy is extremely different than those of the Gulf region. Norway has enjoyed having a well-developed economy and democratised government institutions for many decades. The development in the Norwegian government institutions has had a direct impact on the advancement of the GPFG. In contrast with the young government institutions of the Gulf which are often managed by the members of the ruling family (or their close local allies), the Storting which is a key organisation has been established in the 1800s. The Norwegian organisation management culture is therefore developed ahead of traditional individual-based management culture of the Gulf CSWFs. The members of the senior management team of the NBIM are not chosen on the basis of individual links with the ruling body of Norway and the ethical guidelines – and other investment regulations - limit the influence of the members of the management team in the overall strategy of the GPFG. This is in contrast with the CSWFs of the Gulf where often extreme shifts of strategy take place as a result of management changes.

Another key difference between the GPFG and the Gulf CSWFs is public disclosure of information. In contrast with the other case studies of this project, in the case of GPFG all the relevant information is accessible via the organisations’ websites. There was no need for the use of sources like news coverage bank reports or academic literature, as the information is made available to the public directly by the Norwegian Government’s organisations. A good example for the difference between the Gulf CSWFs public disclosure of information and the GPFG is the public disclosure of the size of the assets under management of the funds. Estimating the size of assets under management of the
Gulf CSWFs has been one of the major challenges of this research. In some cases, there has been huge gap between various estimates done by analysts from outside of the organisations. In the case of Iranian CSWF the government officials have made contradicting statements about the size of assets managed by the country’s sovereign wealth management institution. The GPFG’s market value is published on the first page of the official website of the NBMI.

All in all, the Norwegian Government has proven to be much more successful in the development of the country’s sovereign wealth. There has been no record for corruption during the years of operation of the GPFG and the Storting has set clear rules for operation of the GPFG and supervision procedures. On the other hand, the governments of the Gulf countries have failed to introduce clear guidelines for various aspects of their operations and often have had financial scandals and loss of assets as a result of mismanagement. Even though there are a mixture of fundamental differences between the Norwegian Government’s structure, management culture and institutions, the Gulf CSWFs can learn from the experience of the GPFG particularly when there is a huge emphasis by the Western host governments on the issue of transparency and good governance of the SWFs.
8 The challenge of practice for SWF

8.1 Introduction

The issue of the transparency of sovereign wealth funds has become one of the current challenges facing the global financial system. The role of these funds in the international economic structure has been highlighted as a result of financial globalisation which has put them in the position of having strong impacts on the international economy. The integration of SWFs into the global financial network has raised the issue of their possible threat to the political and economic stability and market competitiveness of the countries in which they invest. Moreover, critics of SWFs have seen them as promoting a new concept of state capitalism at the expense of global free market principles.

At the end of 2006, the estimated size of global capital markets was $190 trillion.\(^{306}\) During the same year, a modest estimate of financial assets owned or controlled by governments was calculated to be as high as $US15 trillion, or about 8 percent of global financial assets.\(^{307}\) Given the significant share of management assets of SWFs in the global capital markets, they would arguably have had the potential to jeopardise the national economies of their host countries. In addition to their size, the lack of clear information about various aspects of these funds has put more emphasis on their possible impact on the recipient economies.

There has been no uniform public disclosure of the assets, strategies, and governance of SWFs. Institutional arrangements, such as withdrawal and accumulation rules, investment management, and reporting channels have not been publicly disclosed, and accountability of these organisations is often unclear. Furthermore, despite the

\(^{306}\) IMF (2008), Global Financial Stability Report
\(^{307}\) Truman, Edwin (2008), The Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests, Testimony before the Committee on Foreign Affairs, US House of Representatives, Washington DC
importance of SWFs in domestic policy management, it is usually difficult to establish how the funds are integrated into domestic policy frameworks and macroeconomic datasets. For example, in the case of Abu Dhabi, the CSWFs are not integrated in the fiscal structure of the emirate through constitutional rule. Some SWFs are leading the way in disclosure, such as those of Norway. Some Gulf CSWFs have also begun to strengthen their organizational structures and provide more information on their investment policies.

During 2007 and 2008, understanding the role of SWFs in the global financial system became transformed into a political debate. Discussion of the potential risks of sovereign wealth investments was triggered by the forced withdrawal of two deals, both of which had involved acquisition of an American company by a sovereign wealth investor (a Chinese company and an Emirati company) between 2005 and 2006. Advanced economies in the West found themselves at the heart of the argument over identifying the optimum response to the growing strength of SWFs in the world economic network. Their discussions prompted Western countries receiving SWF investments to see if the mechanisms that they had put in place to minimise potential risks to their economies associated with such investments, were in fact sufficient.

Although SWF investment behaviour has resembled that of private and commercial entities, there are concerns that these funds might have non-commercial objectives or might target strategic assets in the host economies. This perception has fuelled resistance to SWF investments, particularly those that are thought to jeopardize national security. Another concern over their investment objectives is that they could possibly gain an unfair advantage in the markets if their financial commitments are assumed to be guaranteed by their sponsoring governments. Finally, with SWF investments being directed towards host countries with lighter fiscal restrictions, there is a perceived need for regulating arbitrage by these funds.

In order to ensure the adequacy of their supervisory mechanisms, the governments of the host countries, with the support of multilateral organisations such as the IMF and the OECD, have begun procedures to design and embrace best practices for these institutions that will enhance their accountability and transparency. Such procedures

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308 Kimmit, Robert (2008), ‘Public Footprints in Private Markets, Sovereign Wealth Funds and the World Economy’ in Foreign Affairs 87:1
aim to increase understanding of how the funds operate in the countries sponsoring them, as well as in the countries in which they invest. In response to these initiatives, the governments sponsoring SWFs have asked for certain measures to be put in place by the host economies, to ensure that the transparency initiatives do not create economic and political barriers to their investments. Given that financial protectionism will disrupt the global financial system that has been built on the fundamentals of economic liberalisation, the developed economies of the west are keen to avoid disengaging from the changes occurring in the global financial system by creating investment barriers between the sovereign wealth investors and their own national economies.

8.2 What does transparency mean for the Gulf CSWF?

Understanding the Gulf CSWFs has proved challenging for the international financial markets. The inadequate information that the SWFs of the GCC have provided to the public on aspects of the fund’s operation has caused huge uncertainty about their impact on the global financial system. As the Figure below indicates the key area of ambiguity of the funds’ activities, about which they have failed to provide information to the public is the structure of the funds’ relationship with other entities within the global community.

Figure 8-1: SWF’s relationship with the surrounding environment

Source: author
The nature of the funds’ relationships with each element of the environment in which they operate plays an important part in forming the role of these institutions in the global financial system. The key areas of connection between the funds and their surrounding environment, which have not been clearly defined, are as follows:

- their relationship with their sponsoring sovereign
- their relationship with their host sovereigns
- their relationship with other market players
- Intra-organisational relationships within a sovereign wealth investment institution.

Providing adequate and accurate data to clarify the position of these institutions in relation to the surrounding environment is indeed expected to be a responsibility of their sponsoring sovereign, i.e., the supreme entity that established the SWFs and has overall management of their operation. There are a number of areas in the relationship between the Gulf CSWFs and other market players which have not yet been clarified. A key aspect of the relationship of these funds with other market players is their relative financial positions. Because of lack of transparency and the limited availability of statistics, there is insufficient data on the funds’ financial status. The funds are not captured in macroeconomic datasets and there are no regular and timely publication of accurate data on the size, sources and uses of their assets, since there is no clarification of asset holdings, the composition of assets and liabilities, or the type and class of the assets. Moreover, there are significant gaps in the statistics. Available financial data on the funds is based on no more than speculation and guesswork mainly produced by other market players, and there are often huge gaps between the data produced by various sources.

ADIA is a good example of this lack of information on source of funds and rules for fund withdrawals. The official website of ADIA is the only reputable source providing details of this aspect of the funds’ activity, but the information is quite vague and does not include any figure. According to ADIA’s website:

“The Government of Abu Dhabi provides funds to ADIA on a periodic basis that are surplus to its budgetary requirements and other funding commitments. ADIA is required to make available to the Government of Abu Dhabi, as needed, the financial resources to secure and maintain the future welfare of the Emirate. In
practice, such withdrawals have occurred infrequently and usually during periods of extreme or prolonged weakness in commodity prices.”

Another area of information that explains the funds’ activities in relation to other market players is the figures that relates to shareholdings of the funds. To avoid obligations of regulatory notification requirements, and/or reporting ownership interest to the invested companies and regulating bodies, acquisitions of shares in publicly-traded companies by these institutions are often kept under certain thresholds (5 percent in the United States, 10 percent in the EU).309

In addition to lack of information about the funds’ relations with other market players, there are some aspects of their operation in which such relations overlap with their dealings with the host sovereign. One of the significant areas of this overlap is the risk that they will violate market integrity. GCC funds, like those of other market players, are potentially capable of insider trading and other forms of market manipulation. However, because of sovereign ownership of the funds, it may be more difficult for the rules of market integrity to be enforced against these institutional investors. The extent to which the Gulf CSWFs operations are committed to maintaining market integrity is not made clear.

Kuwait Investment Authority offers a good example of the lack of information on the funds’ commitment to keep market integrity. Like most of the CSWFs of the GCC, the only open channel for acquiring information about KIA, is the organisation’s own official website. The information published under the heading of “Mission and Principles” of the KIA does not refer directly to this issue. KIA’s rules, procedures and code of conduct are stated “to be respected and honoured by its staff without restricting appropriate flexibility, and aim to set exemplary standards for professional behaviour, prudence”.310 However, its code of conduct is not publically available. The KIA also encourages the staff “to devise appropriate benchmarks, set realistic targets, and be responsible for their performance”. Again, the responsible performance has not been defined clearly by the KIA.

Another area of overlap in the funds’ relationship with the surrounding environment occurs between the organisation’s connection with the sponsoring sovereign and the intra-organisational relationships within the funds, where there is a lack of information

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309 IMF (2009), Sovereign Wealth Funds-A Work Agenda
on the practice of corporate governance. There is a shortage of data that can clarify the relationship between elements of various organisations within the funds, as well as the extent to which the funds are influenced by their sponsoring sovereign. The controlling influence of the sponsoring governments over directors, legal principles related to fiduciary responsibility, and avoidance of conflicts of interest in the funds has been more or less unknown. While it is assumed that the sponsoring sovereign holds unlimited control over the above-mentioned elements of corporate governance of the funds, the absence of good corporate governance practice has been a key question in the debate over non-commercial investment of the funds.

Lack of independent auditing is also an area of overlap, where the Gulf CSWFs have failed to provide a clear definition of their connections with the sponsoring sovereign as well as their intra-organisational relations. Their internal auditing procedures appear vague and there are no external audits of the funds’ financial statements. Internal audit reports are not published, and there are no clear provisions for ensuring the integrity of operations or of any published information. Nor is there a well-defined framework within the legal structure of the sponsoring countries to describe the institutional context in which the operational procedures, objectives, role, scope, and responsibilities of the fund and its subsidiaries are carried out.

The lack of transparent information is likely to slant economic analysis and has the potential to mislead policymakers of sponsoring and host economies of the funds as well as other global market participants. Although some analysts believe that the distribution of information must be coherent and open while disclosures may need to be selective\textsuperscript{311}, the overall findings of this study show that there has been an element of distrust amongst the host sovereigns where hype has prevailed in the absence of coherent information.

On the issue of trust there is an opposing view which believes that these funds have so far done nothing to violate the trust of their host sovereign; therefore, the argument over creating trust while tackling the issue of lack of information is no longer relevant. Instead, the funds must seek ways through which they can gain legitimacy. Ashby Monk, in a paper on “Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy, and Governance”, notes that institutional legitimacy occurs when “organisational

procedures, structures and principles align with the values, norms and expectations of the society in the environment in which the organisation seeks legitimacy.” He points out that for SWFs, “gaining legitimacy is synonymous with gaining access to operate and invest in a given country or market.”

It is rather challenging to draw a line between legitimacy and trust as Monk did in his paper. As discussed above, the principles and procedures of the funds in relation to the other entities in the environment in which they operate are unclear, as are their intra-organisation relations. Therefore, it is difficult to evaluate whether or not those values and structures align with the expectations of the host society. It is true that the overall, political and cultural norms and values of the societies in which these funds originate are known to the societies where they have had difficulties accessing some of the markets; however, the issue of resistance to the operation of the funds in certain specific markets is not limited to those particular aspects. Indeed a counter-example to Monk’s argument is the case of GCC sovereign wealth funds. Historically the sponsoring sovereigns of Gulf CSWFs have been the closest allies of the Western powers in the region, yet they have had difficulties in accessing some of the markets in the West. Therefore, if the issue of lack of information on these funds was raised merely on the basis of their legitimacy of their sponsoring sovereign, the issue should have been discussed in other shapes and forms.

In the case of GCC sovereign wealth funds, a combination of factors has created the non-transparent reputation of these organisations. First, the Gulf governments that historically were built around the monopolised authority of the ruling family (vested in them by the former colonial power of the region), have never felt obliged to act domestically in a transparent manner. Therefore, there has been a strong emphasis amongst the sponsoring sovereigns of the Gulf CSWFs to avoid disclosure of information to the public. The best example is Kuwait, where clauses 8 and 9 of Law No. 47 of 1982 concerning the KIA, clearly prohibit general disclosure to the public of any information related to KIA’s work, while also setting out the penalties for unauthorized disclosure of information to the public.\footnote{Kuwait Investment Authority: \url{http://www.kia.gov.kw/En/About_KIA/Transparency/Pages/default.aspx}, accessed 1 February 2011}
Secondly, in the case of the Gulf funds, there is a huge data deficit. The data collection system in the region is relatively under-developed; therefore, there is a lack of ‘data’ rather than a lack of ‘transparency of data’. In some areas of the funds’ relations with their surrounding environment, there are no clear procedures embedded in the legal system of the sponsoring countries. In other words, the issue of lack of available information to the public results from the lack of a strong legal and institutional framework, rather than having the law and procedures in place but not sharing them with the public.

8.3 How did the debate start?

Debate about the need for greater transparency of SWFs was triggered by two proposed transactions by two foreign companies in the US. The companies themselves were not SWFs, but their major shareholders were sovereign wealth funds. One of the transactions, which was proposed in June 2005, involved the Chinese National Offshore Oil Company (CNOOC), 70 percent of which is owned by the Chinese government. A few weeks later, a second controversial transaction was proposed by Dubai Ports World (DPW) which is a subsidiary of the Dubai SWF, Dubai World.

8.3.1 The CNOOC scandal

On 7 June 2005, the Chinese National Offshore Oil Company made an offer of $18.5 billion to acquire the Union Oil Company of California (Unocal). Unocal is a California-based oil company that was founded in 1890. The next bidder was Chevron Oil Company which offered $16 billion. The offer led to an intense discussion among American politicians, and the debate was also made public by the media.

On 17 June 2005, two Republican representatives from California, Richard W. Pombo and Duncan Hunter, wrote to President Bush expressing their concern about the effect of CNOOC’s bid for Unocal on US jobs, energy production and energy security, and urging scrutiny of the transaction on grounds of national security. On 24 June 2005, the New York Times published a report on the on-going negotiations between Unocal and CNOOC, quoting Michael O’Hanlon, an international military specialist at the

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Brookings Institution: quoted: “It does raise questions about how much of the country we are willing to sell to a Communist country that we might be fighting someday,... I'd be surprised if we really fall on our sword to prevent the sale.”

In August 2005, domestic policy makers, whose fears of losing control over strategic US oil resources were fuelled by Chevron lobbyists in Washington, ultimately forced the CNOOC to withdraw its bid. In response to the US government’s reaction to the bid, CNOOC issued a statement after the withdrawal, saying that such unprecedented political opposition had been “…regrettable and unjustified…This political environment has made it very difficult for us to accurately assess our chance of success, creating a level of uncertainty that presents an unacceptable risk to our ability to secure this transaction.” Shortly after this, Chevron completed its acquisition of Unocal.

8.3.2 The controversy of Dubai Port World

A few months after the CNOOC scandal in August 2005, Dubai Port World (DPW), a foreign corporate, approached another American company, wanting to buy the British ports operator, Peninsular and Oriental Steam Navigation Company (P&O). P&O managed ports in eighteen countries, including six major East Coast ports in the United States; New York, New Jersey, Philadelphia, Baltimore, New Orleans, and Miami. DPW notified the Committee on Foreign Investment in the United States (CFIUS) about its intentions to acquire P&O, and CFIUS duly agreed to DPW’s acquisition of P&O. However, CFIUS’s approval of the deal raised negative reactions amongst US domestic policy makers. Several lawmakers, including Peter King, a Republican Representative of Long Island, who was also chairman of the House Homeland Security Committee, and Senator Charles Schumer, criticized the speed of the approval process, claiming that there had been insufficient scrutiny of the security ramifications of the deal for the US.

The Congress demonstrated American patriotism by opposing the acquisition, and the CFIUS was criticised further for approving the DPW transaction without a full investigation. The United Arab Emirates was referred to as a state supporter of

318 BBC (2006), Rival bows out of P&O bid battle, 10 February 2006
terrorism, and concern was raised over the possibility of the company being infiltrated by terrorists.

On 22 February 2006, President Bush strongly supported the decision to approve the DPW transaction approval and released the following statement:

“The Administration, As Required By Law, Has Reviewed The Transaction To Make Certain That It Does Not In Any Way Jeopardize National Security. Under the process conducted by the Committee on Foreign Investment in the United States (CFIUS), officials carefully reviewed the national security issues raised by the transaction and its effect on our national security. Twelve Federal agencies and the government's counterterrorism experts closely and carefully reviewed the transaction to make certain it posed no threat to national security.”

P&O’s shareholders approved the sale in early March 2006 and DPW voluntarily submitted to a further forty-five days of investigation by the CFIUS. At the same time, the Democrats were pushing for amendments to reform the legislation and to ensure that no UAE-related company would have any control over US port operations. The amendment, sponsored by Schumer, would block not only the Dubai deal, but also any other US port deals with companies wholly owned or controlled by any foreign government that had recognized the Taliban in Afghanistan between 1996 and 2001. DPW finally had to withdraw from the deal; a statement was released by the company’s chief operating officer, Edward H. Bilkey, and read in the Senate by Senator John Warner: “Because of the strong relationship between the United Arab Emirates and the United States and to preserve that relationship, DP World has decided to transfer fully the U.S. operation of P&O Operations North America to a United States entity.”

The CNOOC and DPW episodes ended with the forced withdrawal of both companies, although the reaction of the US administration to the two cases was somehow different. The Chinese government-owned CNOOC did not receive the same support from the White House as DPW. According to Professor Gordon Clark of Oxford University, who was interviewed during the field research of this project, there is, generally speaking:

... less pressure on investments by the rich Arab states from the US government. The reason for this is that the US policy makers

believe that the Chinese would never have grown as high and fast without the American support during the Cold War. The US had tried to split China from the Soviet Union for decades by supporting the Chinese economic liberalisation process. Now, it is time for the Chinese to show their support of the US.

The second point raised by Prof. Clark concerning the rationale for the US-led transparency debate was “the economic nationalism of a group of American domestic policy makers” who saw foreign investments in the US, in any shape or form and regardless of the sponsoring country of those investors, as a potential threat to the national security of the United States.

Finally, both deals were initiated within a few months of the US Congressional midterm elections in November 2006. This coincidence made the Congress rather eager to demonstrate that they would not be out-manoeuvred by President Bush, the CFIUS, or the Chairman of the Joint Chiefs of Staff; also the Democrat and Republican Parties were both seeking recognition for taking a stronger stand on national security issue.\(^{322}\)

### 8.4 Foreign Investments in the US

For several decades foreign investment in the US has been causing anxiety among American politicians, and various measures that have been taken have continued to develop over time. All these measures are concerned with the broadly-defined term, “national security”, and have been dealt with through the following procedures:

- **The Committee on Foreign Investment in the United States (CFIUS):** in 1975, President Gerald Ford signed an Executive Order for the establishment of a committee to review certain investments by foreign investors in the US. At that time there was no explicit concern about direct or indirect control of American businesses by foreign governments. In 2006, there were approximately 10,000 merger transactions in the United States, of which 1,730 involved a foreign party and which only required review by CFIUS. None of these transactions was blocked by CFIUS.\(^{323}\)

- **The Exon-Florio Amendment:** in 1988 an amendment was made to the previous regulation on foreign investments in the US to empower the President to investigate

\(^{322}\) Winfield Bean, Bruce (2009), *Attack of the Sovereign Wealth Funds: Defending the Republic from the Threat of Sovereign Wealth Funds?*, Legal Studies Research Paper Series of Michigan State University College of Law, Research Paper No. 08-01

\(^{323}\) Robert M. Kimmitt, op.cit
foreign investment deals over American businesses which would jeopardise national security.

- **The Byrd Amendment**: in 1993 Senator Robert Byrd raised concerns with CFIUS over the sufficiency of new amendments for protecting American security. As a result of this, Section 721 of the Defence Production Act was altered. The change required the investigation of investments by foreign governments that could affect national security.

- **The Foreign Investment and National Security Act (FINSA)**: in 2007, FINSA was mandated to establish new standards for bringing CFIUS’s investment review procedures under more direct Congressional supervision.

### 8.5 The OECD regulation for foreign investments

As opposed to the US regulations for foreign investments that are concerned specifically with America’s national security, the OECD has been working to develop international rules relating to foreign investment. The principal OECD instruments for regulating international capital movements are:

- **Codes of Liberalization**: including the Code of Liberalization of Capital Movements, and the Code of Liberalization of Current Invisible Operations which promotes non-discriminatory liberalization of capital movements.\(^{324}\)

  **Declaration and Decisions on International Investment and Multinational Enterprises**: these contain an agreement among member countries for co-operation on a wide range of issues related to international investments. Four elements are included: national treatment, guidelines for multinational enterprises, international investment incentives and disincentives, and conflicting requirements.\(^ {325}\)

The issue of protecting national security in the OECD’s member countries has also been considered. Existing investment codes recognize the right of countries to protect their important security interests. The “Freedom of Investment, National Security and ‘Strategic’ Industries” that was reviewed in March 2008, emphasised the need for:

> …further clarification of the content and best practices regarding the implementation of, the three guiding principles, especially regarding ‘accountability’. It will also explore the interaction of

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\(^{324}\) OECD (2008), *Codes of Liberalisation*

\(^{325}\) OECD (2000), *Declaration and Decisions on International Investment and Multinational Enterprises*
investors’ transparency and governance practices (e.g. adequate disclosure) with recipient countries’ efforts to design and implement policies that efficiently address national security concerns while preserving the open investment environment.\textsuperscript{326}

In addition, a separate group at the OECD had been working on the existing OECD guidelines for the Corporate Governance of State-Owned Enterprises and exploring the extent to which these were relevant for the SWFs.\textsuperscript{327}

\section*{8.6 The European Union regulation on foreign investments}

Despite the European Union’s rules on the free movement of capital, the debate about sovereign investments has reached Europe, and in practice most European politicians have promised to keep their economies open to all investors, sovereign or otherwise. They have welcomed SWF investments to link both the oil-producing countries and the emerging markets of Asia more closely with the European Union. Thus Article 56 of the European Commission Treaty prohibits “all restrictions on the movement of capital between Member States and between Member States and third countries”\textsuperscript{328}

The EU legal framework does allow investment reviews to protect national security, but the European Commission does try to prevent member states from blocking acquisitions for protectionist reasons. The European Court of Justice is the judiciary body for dealing with alleged actions by member countries that can limit the free movement of capital. Even so, most of the EU countries have various rules in place to protect the strategic sectors of their economies from investments that have national security implications. Most of these regulations are concerned with foreign investments in defence, media, and infrastructure. In the European Union, legal regimes are very diverse: for example,

\begin{itemize}
  \item The British government, like the US government, can veto almost any deal, though this has never happened in the way that it did in the US.
  \item France has strict controls in its defence and security sectors but none in other industries.
  \item Germany introduced a framework similar to that of the CFIUS in 2008.
\end{itemize}

\textsuperscript{326} OECD (2008), \textit{Freedom of Investment, National Security and ‘Strategic’ Industries}

\textsuperscript{327} OECD (2005), \textit{Guidelines on the Corporate Governance of State-Owned Enterprises}

\textsuperscript{328} \url{http://ec.europa.eu/internal_market/capital/framework/treaty_en.htm}, accessed on 5 February 2011
The Netherlands has no such processes at all.\(^{329}\)

There have been several examples of unfriendly European attitude towards the SWFs. In July 2007, a bid by Barclays for ABN-Amro ended unsuccessfully after the China Development Bank and Singapore’s Temasek had taken a large stake in the UK bank.\(^{330}\)

In the late 1980s the British authorities asked the KIA to reduce its stake in BP from 22 per cent to below 10 per cent. In Germany, when Neptune Orient Lines (controlled by Temasek), attempted to buy Hapag-Lloyd in 2008, workers took to the streets to demonstrate against feared job-losses. The company was then sold to a German consortium.\(^{331}\)

In response to the controversy over state-owned investment institutions entering the EU, a number of proposal have been made. EU Trade Commissioner Peter Mandelson suggested in 2007 that so-called “golden shares”, which in certain circumstances give their owners veto rights, could be used to protect strategic assets in the EU against foreign takeovers,\(^{332}\) while a report on SWFs commissioned in 2008 by the French government suggested that “European regulation on foreign investment should be founded on the principle of reciprocity”.\(^{333}\)

Unlike the US and European economies, Australia and New Zealand have been far more welcoming to SWFs. Asian SWFs and those from oil-exporting economies have substantial investments in these two economies. SWFs of Singapore have more commercial assets in Australia than the Government of Australia.\(^{334}\)

### 8.7 How transparent are the Gulf CSWFs?

The debate over fears of negative influence from the GCC sovereign wealth funds on the host economies has been driven mainly by a lack of understanding of the structure, governance, legal framework, and operational procedures and policies of these institutions. A number of factors have contributed to the rise of uncertainty amongst the host sovereigns; including:

\(^{329}\) Veron, Nicolas (2011), *Europe Needs Consistency in Welcoming Foreign Investors*, Bruegel Research


\(^{331}\) Reuters (2008), “German Hapag-Lloyd workers march against NOL takeover”, 19 August 2008

\(^{332}\) Business Intelligence Middle East (2007), “Mandelson mulls EU golden share against takeovers”, 22 July 2007

\(^{333}\) Barysch, Katinka and Simon Tilford and Philip Whyte (2008), *State, Money and Rules: An EU Policy for Sovereign Investments*, Centre for European Reform.

1. The available information on the investment activities (size of assets, investment strategy, etc..) of the funds is highly limited.

2. Senior management positions in these institutions have been monopolised for decades by members of the ruling families or those closely linked to them, which confirms the strong governmental influence on the operational policies of these institutions.

3. There have been a few financial scandals in the Gulf CSWFs over large-scale corruption in handling the volumes of assets, as in the case of KIA in Spain and BCCI for ADIA.

4. The national laws and regulations for managing these organisations are unclear, and in most cases there are no procedures in place to monitor transactions in and out of the funds’ accounts.

5. Reporting and auditing procedures among the sovereign management institutions in the Gulf region are not disclosed.

6. The role of the CSWFs in domestic policy frameworks is not clear, and the funds’ assets and activities are not included in macroeconomic data sets.

7. Historically, public sectors in the GCC countries have been known to be inefficient, and public administration has remained underdeveloped. The growing financial power of the public sector in the region is a potential threat for wider inefficiencies and corruption that can spread throughout the international financial network.

All in all, there has been a feeling of uncertainty over the funds’ management of their assets in the international markets. There is thought to be a high probability that the sponsoring sovereigns of the Gulf CSWFs are intending to manage their sovereign wealth investments in pursuit of political power objectives. This has raised a number of national security concerns, particularly in the aftermath of the post-2001 terrorist incidents in the West. Furthermore, the GCC countries have failed to draw a distinct line between their political and financial elites. In all these countries, the sovereign wealth investment institutions are managed by either a member of the ruling family who is close in rank to the ruler, or by someone who is not a royal family member but is directly appointed by the monarch.

Finally, the rising financial power of the Gulf’s sponsoring sovereigns puts these countries in a position from which they are capable of promoting state-owned or state-controlled national champions as global champions. Potentially this can lead to political
conflicts and economic distortions between countries. However, the sponsoring governments of the funds seem to be aware of the implications of their actions. As has happened in the past, with Middle Eastern governments like Iran and Libya, if the sponsoring sovereigns take any action at a time of probable political crisis that would indicate their intention of using their assets for political leverage, they will lose their access to Western markets and are likely to receive strong reactions from the recipient end.

8.7.1 Measuring transparency of Gulf CSWFs

Various methods have been designed for measuring the level of transparency of SWFs. The most popular ones are the Truman Scoreboard and Linaburg-Maduell. Both methods introduce an index for the transparency of each fund, and these indexes are calculated from a series of yes/no questions. The sum of the scores for all the answers about each fund represents the index for transparency of that fund.

8.7.1.1 Truman Scoreboard

In 2007, Edwin Truman from Peterson Institute for International Economics created a scoreboard for SWFs. It scored the funds based on systematic, regularly available, public information. The scoreboard covers four basic categories: (1) structure, (2) governance, (3) transparency and accountability, and (4) behaviour. Within each category there is a set of yes/no questions the answer of which score between 1 and 0 (sometimes 0.5 and 0.25). The total number of questions was 25;

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Structure

1. Is the SWF’s objective clearly communicated?

2. Is the source of the SWF’s funding clearly specified?

3. Is the nature of the subsequent use of the principal and earnings in the fund clearly stated?

4. Are these elements of fiscal treatment integrated with the budget?

5. Are the guidelines for fiscal treatment generally followed without frequent adjustment?

6. Is the overall investment strategy clearly communicated?

7. Is the procedure for changing the structure clear?

8. Is the SWF separate from the country’s international reserves?

**Governance**

9. Is the role of the government in setting the investment strategy of the SWF clearly established?

10. Is the role of the manager in executing the investment strategy clearly established?

11. Does the SWF have in place and publicly available guidelines for corporate responsibility that it follows?

12. Does the SWF have ethical guidelines that it follows?

**Transparency and Accountability**

13. Does the SWF provide at least an annual report on its activities and results?

14. Does the SWF provide quarterly reports on its activities?

15. Do regular reports on the investments by the SWF include the size of the fund?

16. Do regular reports on the investments by the SWF include information on the returns it earns?

17. Do regular reports on investments by the SWF include information on the types of investments?

18. Do regular reports on the investments by the SWF include information on the geographic location of investments?

19. Do regular reports on the investments by the SWF include information on the specific investments?

20. Do regular reports on the investments by the SWF include information on the currency composition of investments?

21. Are the holders of investment mandates identified?

22. Is the SWF subjected to a regular audit?

23. Is the audit published?

24. Is the audit independent?
Behaviour

25. Does the SWF indicate the nature and speed of adjustment?"336

In 2009, Truman revised the scoreboard and added eight more elements, so that after adding a number of questions to the previous list of 25 questions and also removing a few, his 2009 scoreboard included 33 questions.

In the elements concerning structure, question 5 on the guidelines for fiscal treatment was removed from the 2007 scoreboard and replaced by a question on whether or not the SWF has a “clear legal framework”. Three questions were also added to those concerning the governance of SWFs;

- Is the role of the governing body of the SWF clearly established?
- Are decisions on specific investments made by the managers?
- Does the SWF have internal ethical guidelines?

Among the elements concerning transparency and accountability, a question about regular reports on the types of investments of the SWFs was deleted and the following questions were added;

- Does the strategy use benchmarks?
- Does the strategy use credit ratings?
- Are the holders of investment mandate identified?

Finally, three further questions were added to question 25 on behaviour;

- Does the SWF have a policy on the use of derivatives?
- Does the SWF have a policy on the use of leverage?
- Does the SWF have an operational risk management policy?337


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Table 8-1: Comparison of sovereign wealth fund scoreboards (2007-2009)

<table>
<thead>
<tr>
<th>Fund’s name</th>
<th>Score 2007</th>
<th>Score 2009</th>
<th>Change in percentage points</th>
<th>Percent change in percentage points</th>
<th>Linaburg-Maduell Transparency Index</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008-09</td>
<td>2007-09</td>
<td>2007-09</td>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Norway</td>
<td>23</td>
<td>97</td>
<td>5</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>KIA</td>
<td>12</td>
<td>63</td>
<td>15</td>
<td>15</td>
<td>31</td>
</tr>
<tr>
<td>Mubadala</td>
<td>3.75</td>
<td>59</td>
<td>45</td>
<td>47</td>
<td>392</td>
</tr>
<tr>
<td>Istithmar</td>
<td>3.5</td>
<td>15</td>
<td>3</td>
<td>2</td>
<td>17</td>
</tr>
<tr>
<td>ADIA</td>
<td>0.5</td>
<td>11</td>
<td>3</td>
<td>7</td>
<td>165</td>
</tr>
<tr>
<td>SAMA</td>
<td>Truman does not calculate an index for SAMA as it does not have an identifiable structure which is independent from the central bank</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Truman (2010), and Sovereign Wealth Institute

8.7.1.2 Linaburg-Maduell Transparency Index

The Linaburg-Maduell Transparency Index was developed in 2007 at the Sovereign Wealth Fund Institute by Carl Linaburg and Michael Maduell, who based their index on ten essential principles for disclosure of information on sovereign wealth funds to the public. The scores for each question depend on the answer (yes is equal to 1 and no is equal to 0), and 1 is the minimum rating a fund can receive. The Sovereign Wealth Fund Institute recommends a minimum rating of 8 for a fund to be recognised as adequately transparent. The process is on-going and the ratings may change as additional information is released. The principles include the following:

1. Fund provides history including reason for creation, origins of wealth, and government ownership structure
2. Fund provides up-to-date independently audited annual reports
3. Fund provides ownership percentage of company holdings, and geographic locations of holdings
4. Fund provides total portfolio market value, returns, and management compensation
5. Fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines
6. Fund provides clear strategies and objectives
7. If applicable, the fund clearly identifies subsidiaries and contact information
8. If applicable, the fund identifies external managers

9. Fund manages its own web site

10. Fund provides main office location address and contact information such as telephone and fax

8.7.1.3 Abu Dhabi improvements for sovereign wealth funds transparency

There has been a significant improvement in the Gulf CSWFs’ score since 2007. As Table 1.1 shows, two of Abu Dhabi’s sovereign investment institutions, ADIA and Mubadala, have recorded an impressive increase in the number of points which they gained in 2009. Mubadala’s points improved from 3.75 in 2007 to 59 in 2009, and ADIA’s score improved between 2007 and 2009 from 0.5 to 11.

The government of Abu Dhabi has actively invested in buying a positive reputation for the emirate’s CSWFs since the purchase by ADIA of 4.9% of Citigroup in 2007. ADIA, like Dubai Port World, was a sovereign wealth fund and Abu Dhabi was a member of the UAE as Dubai was; but the experience of DPW in 2005 was one which the government of Abu Dhabi will never have wished to repeat. The size of the stake in Citigroup purchased by ADIA was below the legal threshold for mandatory disclosure, but it would have been extremely difficult for ADIA to keep the deal confidential in the US financial climate at the time when the deal was closed.

The attitude of American domestic policy makers at the time of the financial difficulties of 2007 was not the same as it had been in 2005. Commenting in 2007 on the ADIA-Citi deal, Senator Schumer, who had actively lobbied against the DPW deal in 2005, remarked that:

It seemed to me that this is good for Citigroup, it’s good for jobs in New York. It bolsters their capital position, allows what is fundamentally a very strong company to weather a difficult time. My worries relate to when there is a very strong security interest as in the ports deal or if they are buying an entity that is

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340 Sidel, Robin (2007), Abu Dhabi to Bolster Citigroup with $7.5 Billion Capital Infusion; Government Investment Arm to Become a Top Holder, with up to a 4.9% Stake, Wall Street Journal, 27 November 2007
not purely an economic one. They have made those assurances and have lived up to them in the past.\footnote{Timmons, Heather and Julia Werdigier, (2007) \textit{For Abu Dhabi and Citi, Credit Crisis Drove Deal}, New York Times, 28 November 2007}

In responding to the welcoming position in the US, ADIA was obliged to take a friendly and transparent approach. In January 2008, ADIA hired a US public relations company: Burson-Marsteller, mainly to help ADIA to form a strategy to deal with the banks and the US Congress. James Lake, a former official in the Department of Commerce under US presidents Ronald Reagan and George W. H. Bush, was Chairman of Burson-Marsteller when the deal between ADIA and Burson-Marsteller was signed, and is believed to have played an important role.\footnote{Kerr, Simon and Roula Khalaf (2008), \textit{Abu Dhabi Fund Hires Media Experts}, Financial Times, 18 January 2008}

Shortly after, in March 2008, the US Treasury coordinated the creation of principles for investments of sovereign wealth funds into the United States. Hamad Al-Hurr Al-Suwaidi, a member of the board, and Hareb Masood Al-Darmaki, an executive director, both from ADIA, worked directly with Secretary Paulson on this initiative.\footnote{Wayne Arnold (2008), \textit{Wealth Funds Draw Profits and Attention}, The National, 13 July 2008} In May 2008, the International Working Group of Sovereign Wealth Funds (IWG) was established. ADIA became a founding member of the IWG and Hamad Al-Hurr Al-Suwaidi became co-chair and undersecretary of the group which in October 2008 published the Sovereign Wealth Funds’ Generally Accepted Principles and Practices (GAPP) which are also known as the Santiago Principles.

\section*{8.8 Generally accepted code of conduct for SWFs}

Debate over the practice of SWFs concluded that the best way forward would be to develop a voluntary code of principles for SWFs which would clarify the investment decisions driven by financial and economic considerations, not political motives, of these institutions.

\subsection*{8.8.1 History of the GAPP}

The creation of a code of conduct for SWFs in November 2007 was initiated at the Roundtable of Sovereign Asset and Reserve Managers, organised by the IMF. The IMF’s roundtable was attended by senior-level delegates from central banks, finance ministers, and sovereign asset managers from 28 countries. It was planned that the IMF,
in identifying sound practices to be followed in the management of SWFs, would take the views of the two sides into consideration. Dominique Strauss-Kahn, the Managing Director of the IMF, emphasized the imperative need for SWFs to function “in ways that are consistent with global financial stability”.

8.8.2 Existing IMF standards of governance and transparency

Before 2008, a range of fund guides produced by the IMF already existed for fiscal, monetary and financial transparency and for reserve management; these include guidelines on fiscal transparency and reserve management.


- The reserve management guidelines stress the significance of the roles, responsibilities, and objectives of the financial agencies responsible for reserve management. They also emphasise strongly an open process for reserve management operations and the public availability of information on foreign exchange reserves, as well as accountability and assurances of integrity by reserve management agencies, which can be achieved by a sound institutional and risk management framework. One of the relevant guides of this kind is the Guidelines for Foreign Exchange Reserve Management.

8.8.3 Santiago Principles

In April 2008, the IWG was established in Washington, at a meeting of 26 IMF member countries with SWFs; these included Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Islamic Republic of Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad

345 IMF (2009), op.cit
and Tobago, the UAE, and the US. In addition to the member countries, the IWG has a number of permanent observers; Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank. The generally accepted principles and practices were created by the IMF according to the following guiding objectives for SWFs:

1. To assist maintenance of global financial stability and free flow of capital;
2. To observe all applicable regulatory and disclosure requirements in their host countries;
3. To have appropriate consideration of the economic and financial risk; and
4. To apply transparent and sound governance which provide adequate operational controls, risk management, and accountability.  

8.8.4 The IWG Development after the creation of the GAPP

The IWG evolved into an informal coordinating and knowledge-sharing initiative and was renamed the International Forum of Sovereign Wealth Funds (IFSWF). The IFSWF held meetings in Kuwait City in April 2009 (IFSWF was established at this meeting), in October 2009 in Baku, May 2010 in Sydney, and was scheduled to meet in April 2011 in Beijing. In the spirit of GAAP, a number of SWFs demonstrated their commitment to the Santiago Principles, having conducted self-assessments to ensure compliance with the Principles. Some, including ADIA and Mubadala, published their first annual reports. The creation of GAPP was a positive development in the international dialogue about SWFs. However, there has been little public assessment of the implementation of these principles by the 26 IWG signatories, and no third-party verification for the performance of GAPP by the SWF members of the IWG.

During the IFSWF meeting in Kuwait, sub-committees were established to work on such issues as: experiences in applying the Santiago Principles to date, investment and risk management practices, the international investment environment, and recipient country relationships. Overall, however, the process appears to be rather slow, and debate on the threat posed by SWFs seems to have peaked. But SWFs will remain

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346 International Working Group of Sovereign Wealth Funds (2008), *Sovereign Wealth Funds Generally Accepted Principles and Practices, ‘Santiago Principle’*
347 International Working Group of Sovereign Wealth Funds (2009), ‘Kuwait Declaration’: Establishment of the International Forum of Sovereign Wealth Funds
348 International Forum of Sovereign Wealth Funds (2009), Sovereign Wealth Funds Issue ‘Baku Statement’ Reaffirming the Need for Maintaining Open Investment Environment
349 International Forum of Sovereign Wealth Funds (2010), Sydney Statement
350 International Working Group of Sovereign Wealth Funds (2009), Working Group Announces Creation of International Forum of Sovereign Wealth Funds
active institutional investors for years to come which will probably push the IFSWF to come up with controlling measures that will increase SWF compliance with the GAPP.

Figure 8-2: GAPP Compliance Index as of March 2010

![GAPP Compliance Index Chart]

Source: Sven Behrendt (2010)

The KIA’s compliance with GAPP lagged behind that of ADIA by 8 percent in 2010, while the Peterson scoreboard showed 12 and 0.5 points respectively for the KIA and ADIA on the initial index for the Gulf CSWFs. The KIA is reported to have been under substantial domestic pressure from parliament about its foreign investments, and has been pressed to play a more active role in stabilising Kuwait’s domestic economy.351 Furthermore, the volume of assets under the KIA’s management is notably smaller than that of ADIA. Thus, compared with ADIA, small numbers of assets along with considerable pressure from the domestic policy makers have made the KIA less active in Western markets. This may make the KIA less motivated about improving its image as a transparent SWF.

8.9 Conclusion

The findings of this chapter show:

1. The key issue behind the transparency debate was to understand whether or not the SWFs were really a threat to the national security of the host countries.

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351 Behrendt, Sven (2010), Sovereign Wealth Funds and the Santiago Principles, Where Do They Stand?, Carnegie Papers No.22
2. The debate over the SWFs’ threat to the stability of host sovereign is a result of the issue of ownership in SWFs. In other word, sovereign wealth funds are owned by sovereigns; therefore, they can use the government’s financial resources to satisfy the interests of the government. This has become a source of mistrust in countries in which the SWFs invest, although the funds have taken no action and shown no intention of proving that such mistrust is rational.

3. To a great extent, the financial crisis that began in 2008 has changed perceptions of SWFs. Funds that were previously seen as threat to the national security of the US became the providers of capital for sinking American financial institutions and even the strongest opposing US domestic politicians in case D&P became the supporters of Arab SWFs’ investments in Wall Street banks in the aftermath of the crisis. Therefore, the financial demand of the host economy is a key factor in forming the host sovereign’s policies towards the SWFs.

4. To undermine the notion of mistrust against the SWFs, a voluntary code of conduct for SWFs (GAPP) was created by the funds to promote transparency, accountability and good governance in these investment institutions.

5. The implementation of GAPP has been weak, and the process appears to have lost some of its earlier momentum. There are no formal authorities to enforce the GAPP.

6. As noted above, the world has undergone major changes since the financial crisis of 2008. Almost all the acquisitions by the SWFs have been approved and welcomed by Western host sovereigns. The changed attitude of the West resulted not from improved transparency in operation of these funds, but from a high demand for capital in the developed economies.

7. In the transparency debate, fears of the SWFs’ non-commercial investment interests raised new concerns in the host economies about the risk of protectionism, now the greatest risk to the global economies. The possibilities of creating unnecessary barriers to the free flow of capital into the global financial system have increased over the last few years. Competitive freedom and
investment efficiency have been threatened by the growing risk of protectionist approaches among the host sovereigns. It is unlikely that the Santiago initiative will help to minimise the threat.

8. It is hard to imagine the SWFs’ compliance with the GAPP principles will prevent cases like CNOOC and the DPW. It is true that the US administration welcomed SWF investments in the US financial sector; nevertheless, the American government’s perception of the country’s strategic sectors is unlikely to have changed. The global financial crisis may have postponed such cases; however, with increasing growth of SWF’s assets it is expected that once the global economy recovers from the recent financial predicament there will be more similar cases.

9. Lack of trust in the SWFs and the debate over transparency has not ended with the introduction of GAPP. Even if compliance with the Santiago Principles becomes compulsory for all the SWFs, the US, and other Western governments in general, are unlikely to permit foreign governments to have ownership of their key industries.
9 Conclusion

Commodity-based SWFs have grown drastically over the last few decades and it is anticipated that their assets will increase still more over the years to come, as a result of commodity price increases. The Gulf region is the origin of some of the world’s largest commodity-based funds, which have gained a significant degree of financial power within the global economy that is expected to continue for the foreseeable future.

One of the core elements of the debate over the SWFs has been the issue of transparency. The Gulf SWFs have been ranked by various institutions as the least transparent SWFs in the world. Global initiatives for promoting transparency of operation and good governance of the SWFs have been taken rather well by some of the GCC funds, mainly by those from Abu Dhabi, and the sponsoring sovereigns of the Arab Gulf SWFs have broadly accepted that, in order to remain active in the financial markets of the developed world, they need to apply more transparent strategies. Hamad Al Hur Al-Suweidi, a key figure in the Department of Finance of the government of Abu Dhabi co-chaired the International Working Group of SWFs (IWG) in 2008, and Bader Mohammad Al-Sa’d, Managing Director of the KIA, has co-chaired the International Forum of SWFs (IFSWF) since the Forum was established by the Working Group, and technically replaced it, in 2009. As a result of such close collaboration, the transparency index of the SWFs, sponsored by the government of Abu Dhabi and to a lesser degree by the KIA, has recorded significant improvement.

While some of the governments of the Gulf have taken active roles in leading the global initiative for transparency of the SWFs (i.e. Kuwait and Abu Dhabi), the government of Saudi Arabia has shown very little interest in contributing to this scheme. Saudi Arabia has remained a permanent observer of the IWG and did not become a member of IFSWF. The main reason why the Saudi government has applied such an approach comes from the fact that the Saudi Arabian Monetary Agency (SAMA) has been the country’s central bank and the government has remained somewhat reluctant to introduce SAMA as an SWF. Though the Agency has been a key organisation in
managing Saudi sovereign wealth, with the creation of the new government-owned investment institution, *Sanabil el-Saudi* (SES), the Saudi government may find it rather difficult to maintain the low profile of its sovereign wealth practices. If the SES becomes an active institutional investor in the global financial markets, the Saudi authorities will inevitably need to comply with the GAPP.

Iran’s SWF has been a member of the IWG and IFSWF. However, given that the investment strategy of IFESA is focused mainly on the domestic economy, there has been almost no pressure on the Iranian government to take a more transparent approach. Due to the prevailing economic sanctions, IFESA has not been an active institutional investor globally; therefore, there has been no need for the Iranian authorities to improve the governance and credibility of IFESA in the West. Nevertheless, the new initiative for the creation of the NDF shows that in the proposal which was submitted to the *Majlis*, the government has taken some of the principles of the GAPP into account. In particular, the principles that concern the independence of the Fund’s management from the political elite, and the principles related to having a clear savings policy, are evidently being taken into account. This shows that despite the significant lack of motivation for transparency and good governance because of Iran’s economic isolation, the government has picked up some lessons both from participating in the global initiative for transparency of the SWFs, and from its poor performance in managing the country’s sovereign wealth in previous years.

The transparency of the Norwegian government’s sovereign wealth management strategy has enabled it to remain in the highest-ranked position amongst the world’s commodity-based sovereign wealth funds. The GPFG has set a great example for the transparency of sovereign wealth management in countries that possess rich natural resources. However, it would be very difficult to predict how long, if ever, it would take the Gulf’s CSWFs to reach the same level of transparency that is practised by the Norwegian government.

The debate over politically-driven investment decisions of the SWFs has been a key element in the transparency debate. The strategy of the GCC funds has been focused on avoiding any investment whose goal can be regarded as a non-commercial one. A good example of such a strategy is the KIA’s investment in BP and its reducing of its share at the request of the British government. In contrast, SAMA has managed a highly-politicised portfolio. Over the past decades, it has heavily financed the US
government’s debt in order to maintain its links with the US government. One important factor in forming the investment strategy of the GCC funds over the decades of their operation, and particularly during their first twenty years, has been the role of the colonial powers. KIA was initially created by the British government and the first governors and founders of SAMA were American bankers from the US Treasury Department. The impact of such collaborations on shaping the investment strategy of SAMA and KIA are visible until today, and it is unlikely that the governments of Kuwait or Saudi Arabia will find it easy to diversify their financial strategies from their political alliance with the former colonial powers that assisted them in creating their sovereignty. After all, there would have been no sovereign wealth fund if there was not a sovereign.

Iran’s sovereign wealth management strategy is also one of the most politicised ones in the Gulf region. The recent experience of the TUSRC shows that decision-making for the country’s SWFs are highly influenced by the government’s political agenda. Although Iran’s strategy for managing its sovereign wealth assets has not caused any particular global controversy, the government would have needed to make fundamental adjustments in the management strategy of the country’s SWF, if it was to invest globally. Finally, Norway is an interesting case of a politicised investment strategy. The GPFG’s investments can also be considered politicised because even if an investment is profitable commercially, the fund may still divest should the ethical guidelines suggest this course of action. Given that the ethical guidelines are based on the Norwegian government’s democratic principles, the GPFG has, in some cases, chosen politics over profitability. Nevertheless, the politicisation of the GPFG’s investment strategy has never been a matter of concern for the host sovereigns, which often share such principles with the Norwegian government.

Another important criticism of the Gulf funds in the transparency debate has been their reluctance to practise their ownership rights. Almost all the GCC commodity-based SWFs have been avoiding heavy involvement in the operation of companies in which they invest by not practising their ownership rights. In this respect, however, Mubadala is a relatively unique case. It is a cash-rich long-term investor which does not divest easily, and has been one of the very few companies in the region that has managed to keep hold of its investments, even during the peak of the financial crisis. Given that Mubadala has a social income generation strategy it is generally an active investor. In
order to facilitate the transfer of technology to Abu Dhabi, most of Mubadala’s managers have seats on the boards of different companies, and are actively involved in their decision makings.

While most of the GCC funds have not taken an active role in the management of the companies in which they invest, Iranian and Norwegian CSWFs have adopted a different approach. The Norwegian GPFG has had clear guidelines for practising its ownership correctly. Indeed, as noted, such a strategy has played a key role in identifying the GPFG as the world’s most transparent CSWF. Moreover, Iran’s IFESA is a different case from the SWFs of the GCC and Norway, since it mainly invests in state-owned businesses; hence the sponsor of the fund, the Iranian government, is also the major stakeholder in companies in which the IFESA invests. In most cases, therefore, the fund has full control over the management of those companies.

Another factor for which the transparency of the GCC funds has been ranked rather low amongst their peers in the global financial markets is their unclear risk management strategies. As a result of their poor investment risk management, the GCC commodity-based SWFs have been reported as being significantly affected by the crisis, and as a result of the collapse of the global financial markets, have lost a considerable share of their assets. However, there have been other factors leading to their loss of assets; namely the decline in crude prices, and the need for transferring their assets to their domestic economies. Nevertheless, their aggressive appetite for risk in most of their direct acquisitions has been a key factor and means that they have been affected more than other commodity-based SWFs, particularly the GPFG. There has also been a certain element of nationalism involved in the decision-making processes of the Arab funds in order to make the region known and to establish their brand names in the global financial system. Good examples of such an investment strategy are the sovereign wealth management institutions of the UAE and, to a lesser extent, the KIA of Kuwait. SAMA has, however, lagged behind the other GCC commodity-based funds in this respect. Investments in high profile and reputable assets have proved nevertheless to be risky and have been significant factors for massive losses by the GCC funds in the aftermath of the crisis. The lessons of the crisis have indeed forced the funds to take a more careful approach in their investment strategies; however, it is rather difficult to judge whether or not they will go back to these reputable if flashy acquisitions with their high investment risks.
There is some speculation that the Iranian sovereign wealth management institution, IFESA, has been also affected by the crisis, although Iran’s case is not like those of the GCC countries, which have lost their assets due to their poor risk management strategies. The loss of IFESA’s assets has not been as a direct result of the collapse of the international markets, simply because, as a result of the international sanctions, the Iranian economy is quite isolated and the IFESA has not have access to global markets. Instead the Iranian government has been allocating a large share of the oil revenue to subsidised food and energy in the domestic markets. Therefore, because of the increases in food and energy prices, the government has been forced to spend a massive amount of the sovereign wealth assets on the subsidies.

When it comes to risk management, the Iranian sovereign wealth management organisation remains far behind all the case studies mentioned in this thesis. IFESA has focused mainly on local investments, and the lending process for local investments is not based on clear risk management, since the country suffers from a high level of corruption, weak investment law, and a strong club division system, particularly in the lending process when the profitability of each project is assessed. A combination of the above mentioned factors often makes it difficult for certain businesses to break into in the system, while the others have easy access to credit for investment projects not efficient at all.

The Gulf commodity-based funds have operated in the global economy for a number of decades, but the debate over the transparency of these funds has only intensified over the last few years. The findings of this study shows that a large number of analysts from academia and the financial sector, both in the West and in the region, believe that the issue of transparency of SWFs has been exaggerated, and that cases like P&O and CNOOC are quite unlikely to happen again. The underlying assumption here is that, realistically speaking, the Western economies (both private and public) are not in a position to be able to decline investments from SWFs. This trend might change once the dust of the post-2008 crisis settles. Nevertheless in order to attract SWF investments, Western economies have to compete with emerging markets hence more emphasis on transparency is going to scare the Gulf countries away from the investing in the developed economies in Europe and the United States.

The main outcome of the global initiative for transparency of SWFs was the establishment of the IWG and the creation of the Santiago Principle. While the Santiago
Principles were a significantly speedy action by the global community and made visible impact on some of the Gulf commodity-based funds, they will not end the controversial debate over the strategic investment of the funds. In other words, even if a SWF applies full compliance of the GAPP, when it initiates procedures to acquire a strategic asset, such as an oil company or a border management company in the developed economies, the deal will most likely be blocked by the authorities because of national security concerns. Therefore, the SWFs’ growing financial power is expected to be concentrated in specific sectors in the Western economies which do not impose national security threats on the host sovereigns, and indeed they are likely to grow in the emerging markets.

The role of expatriates in managing the Arab Gulf funds has been a matter of controversy. While the technical development of these organisations has been materialised mainly as a result of engagement of foreign financial experts, there has been a notion of mistrust amongst the local individuals towards the role of the foreign employees of these organisations. It is clear in the two financial scandals which have been reviewed in this study (KIO in Spain and the BCCI) that when it comes to making wrong decisions, it is often the foreign partner who is to be blamed. In the case of BCCI for example, while Agha Abedi was imprisoned and forced to leave the UAE, Al-Mazroui, who was heavily involved in the BCCI’s activities since the beginning, was released shortly after he was initially arrested for investigation and was appointed as the head of the government’s working group for investigating the scandal. Such mentality towards the expatriates still exists in the region and indeed in the government investment institutions.

The Arab Gulf CSWFs have grown significantly in size and expertise. Each SWF of the case studies in this project has been following a mission heavily aligned with the government economic, social and political policies. SAMA has been financing the US government’s debt in exchange with political and military security provided by the American administration. The KIA has been piling the country’s surplus income outside of Kuwait to provide a secured source of finance in the case of emergency. Abu Dhabi SWFs have been actively working to materialise the government’s ambitions for turning Abu Dhabi into an energy, technology, and education hub in the Gulf. While ADIA has been investing in flashy assets to gain attention in the global financial system and establish itself as the largest SWF of the world, Mubadala has been actively engaging in
projects which can bring technology to Abu Dhabi in exchange with the emirate’s surplus petrodollars. Dubai government investment vehicles have been affected by the burst of the bubble in the emirate; however, the fine job of these institutions in establishing Dubai as an investment and financial centre, as well as a luxury tourist attraction must not be ignored.

Finally, Iran’s SWF practice has provided the government with sufficient rent to distribute amongst the key political powers of the country. President Ahmadinejad’s populist policies and distribution of cash between lower middle class Iranian citizens, both in the cities and rural areas; have assisted him to maintain his power despite the controversies of the election. Moreover, the distribution of the country’s oil revenue since 2005 which has been to support the financial interests of the Revolutionary Guard has created a strong shield for the regime’s power domestically. Therefore, the sovereign wealth funds of the Gulf which have been seeking to secure the interest of their sponsoring sovereign have all done a significant job in fulfilling their roles.
Appendix

Generally Accepted Principles and Practices (GAPP) – Santiago Principles

- **GAPP 1. Principle**
  The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).
  
  - **GAPP 1.1 Sub-principle** The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.
  
  - **GAPP 1.2 Sub-principle** The key features of the SWF’s legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.

- **GAPP 2. Principle**
  The policy purpose of the SWF should be clearly defined and publicly disclosed.

- **GAPP 3. Principle**
  Where the SWF’s activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.

- **GAPP 4. Principle**
  There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF’s general approach to funding, withdrawal, and spending operations.
  
  - **GAPP 4.1 Sub-principle** The source of SWF funding should be publicly disclosed.
GAPP 4.2 Sub-principle The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.

- **GAPP 5. Principle**
The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.

- **GAPP 6. Principle**
The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.

- **GAPP 7. Principle**
The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.

- **GAPP 8. Principle**
The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.

- **GAPP 9. Principle**
The operational management of the SWF should implement the SWF’s strategies in an independent manner and in accordance with clearly defined responsibilities.

- **GAPP 10. Principle**
The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.

- **GAPP 11. Principle**
An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.

- **GAPP 12. Principle**
The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.

- **GAPP 13. Principle**
  Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.

- **GAPP 14. Principle**
  Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.

- **GAPP 15. Principle**
  SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.

- **GAPP 16. Principle**
  The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.

- **GAPP 17. Principle**
  Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

- **GAPP 18. Principle**
  The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.

  - **GAPP 18.1 Sub-principle** The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.

  - **GAPP 18.2 Sub-principle** The investment policy should address the extent to which internal and/or external investment managers are used, the range of
their activities and authority, and the process by which they are selected and their performance monitored.

- **GAPP 18.3 Sub-principle** A description of the investment policy of the SWF should be publicly disclosed.

**GAPP 19. Principle**
The SWF’s investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.

- **GAPP 19.1 Sub-principle** If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.

- **GAPP 19.2 Sub-principle** The management of an SWF’s assets should be consistent with what is generally accepted as sound asset management principles.

**GAPP 20. Principle**
The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.

**GAPP 21. Principle**
SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.

**GAPP 22. Principle**
The SWF should have a framework that identifies, assesses, and manages the risks of its operations.

- **GAPP 22.1 Sub-principle** The risk management framework should include reliable information and timely reporting systems, which should enable the
adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.

- **GAPP 22.2 Sub-principle** The general approach to the SWF’s risk management framework should be publicly disclosed.

- **GAPP 23. Principle**
  The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.

- **GAPP 24. Principle**
  A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

Source: (International Working Group of Sovereign Wealth Funds, 2008).
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