Sovereign Wealth Funds in the Gulf: Opportunities and Challenges

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Gawdat Bahgat

From the early 2000s to mid-2008 oil prices witnessed an unprecedented surge, reaching a peak of US$147 per barrel before collapsing by the end of the year and later stabilizing around $80 by early 2010. Most oil exporting countries, particularly the Gulf Co-operation Council (GCC) states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) continue to be heavily dependent on oil revenues as their main source of income. Thus, the rise in oil prices provided crude exporters with massive accumulation of wealth. The relative small size of their economies and the concern about fuelling inflation meant that their ability to absorb these oil revenues domestically was, and still is, limited. Thus, a large proportion of these revenues had to be invested abroad. A number of sovereign wealth funds (SWFs) were founded to initiate and manage these investments. It is important to point out that other fast-growing economies, particularly China and Singapore, have witnessed a similar development, accumulated massive current account surpluses, and created their own SWFs. The focus of this paper is on the oil funds created by the GCC states.

This is not the first time a set of SWFs had been created. A similar wave had occurred in the 1970s following the jump in oil and gas prices. The newly-established funds, however, have substantially expanded the number and size of SWFs. The overall volume of assets under management by SWFs is still relatively small in comparison with total global financial assets. However, these assets are significant relative to hedge funds or private equity (Santiso, 2008, p. 2). Furthermore, their assets are projected to substantially increase over the next few years. Deutsche Bank predicts that SWF holdings will rise from $3.6 trillion in 2008 to $10 trillion by 2015 (Deutsche Bank, 2008, p. 6) and JP Morgan researchers make a similar prediction stating that SWFs’ assets are likely to double from 2009 to 2015 (JP Morgan, 2009, p. 4). In short, one important element in the changing global economy is the increasing prominence of SWFs from a wide range of home countries.

This increasing prominence of SWFs and the emergence of oil exporting countries as major creditors to the world and to industrialized countries in particular have highlighted two fundamental changes in the international financial system. First, the progressive running of large current account surpluses in oil exporting countries had been in parallel to current account deficits built by major industrial countries in Europe and the USA. Indeed, it can be argued that without the contribution of oil funds in bailing out major international financial institutions the
global recession would have been deeper and would have lasted longer. In short, oil exporting
countries have increasingly resumed a prominent role as major creditors. Second, these oil funds
are owned by their home governments and are largely controlled by the state. This framework
is at variance with the traditional private-sector, market-oriented approach, dominant in most
western countries (Truman, 2008, p. 3)

The rapid expansion of petro-dollar investments has fuelled anxiety regarding these new
dynamics in the global financial system. Principally, most countries welcome foreign invest-
ments. However, when the money is owned and controlled by foreign governments, suspicion
arises. Policy-makers in receiving markets are concerned about possible political objectives
behind these SWF investments. Following their capital injections into European and US banks
that suffered big losses from the subprime mortgage crisis, oil funds have attracted heightened
attention from policymakers, national legislatures and the media in the USA and several Eu-
ropean countries. Meanwhile, these capital injections have been welcomed by the International
Monetary Fund (IMF) and others because they have helped to stabilize markets.

This heightened attention and the lack of consensus on the role of SWFs underscore the fact
that the structure, objectives and investment strategies of SWFs in general and those in the Gulf
region in particular are poorly understood. This study seeks to contribute to the growing sys-
tematic academic research of oil funds. In the next section I discuss the different definitions of
the concept and highlight the points of differences and similarities between them. This will be
followed by a close examination of two main funds created and owned by the Gulf states, the
oldest fund (Kuwait Investment Authority) and the wealthiest fund (Abu Dhabi Investment
Authority). In the concluding section I summarize the main findings of the study.

Sovereign wealth fund – definition

Sovereign wealth funds have been around for more than half a century. The proliferation of
SWFs since the early 2000s, however, has stimulated academic and political curiosity to define
what SWFs are and how to distinguish them from other investment vehicles. Analysts at the IMF
have provided a number of similar definitions. Davis, Ossowski, Daniel, and Barnett define a
SWF as a mechanism designed to reduce the impact of volatile revenue on the government and
the economy. Its objectives may also include supporting fiscal discipline and providing greater
transparency in the spending of revenue (Davis, Ossowski, Daniel, and Barnett, 2001, p. 8). Allen
and Caruana see SWFs as government-owned funds, set up for a variety of macroeconomic
purposes. They are commonly funded by the transfer of foreign exchange assets that are invested
long term, overseas. They allow for a greater portfolio diversification and focus on return than
traditionally is the case for central-bank-managed reserve assets (Allen and Caruana, 2008, p. 4).
Sun and Hesse state that SWFs are special-purpose investment funds owned by the general
government. They are often established out of balance of payments surpluses, official foreign
currency operations, proceeds of privatization, fiscal surpluses, or receipts resulting from com-
modity exports (Sun and Hesse, 2009, p. 4). Finally, Das, Lu, Mulder, and Sy argue that SWFs
hold, manage, or administer financial assets to achieve financial objectives, and employ a set of
investment strategies which include investing in foreign financial assets (Das, Lu, Mulder, and Sy,
2009, p. 5).

The US government’s definition focuses on the degree of risk-tolerance: SWF managers
typically have a higher risk tolerance and higher expected return than traditional official reserve
managers (U.S. Department of Treasury, 2007, p. 1). The European Commission’s definition
concentrates on the source of funding – the distinguishing feature of SWFs from other invest-
ment vehicles is that they are state-funded (European Commission, 2008, p. 4). The Monitor
Group, a financial consulting firm, identifies five qualifying characters: owned directly by a sovereign government; managed independently of other state financial institutions; does not have predominant explicit pension obligations; invests in diverse asset classes in search of commercial return; and has made a significant proportion of its publicly-reported investments internationally (Barbary and Chin, 2009, p. 17).

These definitions suggest a number of common characters of SWFs. First, the underlying characteristic of SWFs that distinguishes them from other investment vehicles is that they involve a dramatic increase in the role of governments in the ownership and management of international assets. Second, SWFs are commonly established out of balance of payment surpluses. In the case of oil exporting countries, high oil prices for a prolonged period of time provide such surpluses. Third, there is a general preference to place SWFs’ assets abroad, mainly to allay fears about appreciation of the domestic currency (Ter-Minassian, 2007, p. 15). Fourth, SWFs holdings do not include foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes; operations of state-owned enterprises in the traditional sense; government-employee pension funds; or assets managed for the benefit of individuals.

Fifth, typically, SWFs have a diversified investment strategy, with a higher level of risk accepted in search of higher returns. Sixth, the various objectives of SWFs imply different investment horizons and risk/return trade-offs, which lead to different approaches in managing these funds. SWFs usually pursue multiple objectives. Seventh, generally SWFs can be divided into two categories based on the source of their assets. Commodity funds receive most of their holdings from exporting one or a few commodities that are largely owned by the government (for example, oil funds). Non-commodity SWFs are usually established through transfers of assets from official foreign exchange reserves (some Asian SWFs such as those of China and Singapore). The goal of such transfers is to pursue higher returns. Eighth, two broad types of SWFs can be identified based on their main objectives: (a) stabilization funds, where the primary objective is to insulate the economy against commodity price swings; and (b) savings funds for future generations, which aim to share wealth with upcoming generations.

To sum up, SWFs are a heterogeneous group. They take many forms, pursue different strategies, and establish a variety of legal, institutional and governance structures.

**Investment portfolios**

SWFs from the Gulf region employ a wide range of investment strategies that seek to strike a balance between safe assets and high returns. Given these broad objectives, Gulf SWFs have allocated their holdings in a variety of investment vehicles including conservative (relatively safe with low returns) ones such as debt and equity securities to riskier investments with potential for higher returns such as private equity, real estate, and hedge funds. By their nature, SWFs are expected to invest in more diversified portfolios and riskier assets than traditional reserve holdings.

The older Gulf SWFs such as the Kuwait Investment Authority (KIA), Abu Dhabi Investment Authority (ADIA), and Oman’s State General Reserve Fund tend to be cautious, discreet, and conservative investors. Meanwhile, the “younger” funds (those founded since the early 2000s) tend to be more aggressive investors, reflecting the financial confidence of high oil prices in most of the decade. Many of them have pursued attractive opportunities in all sectors all over the world. Some of these newly-created funds borrowed to invest in high-profile assets, instead of relying on their own capital accumulations. The collapse of oil prices in mid-2008 and the end of the era of cheap and easy credit have underscored the shortfalls of such a strategy.
The investment portfolios of the Gulf SWFs are not different from their counterparts in other countries. According to researchers at the Organization for Economic Cooperation and Development (OECD) SWFs invest on average 38% in the financial sector, 14% in the communication and transportation sectors and 6% in the energy sector. Other sectors, with allocations below 5% each, are consumer durables and non-durables, utilities, and technology services (Avendano and Santiso, 2009, p. 20). Other analysts (Bortolotti, Fotak, Megginson, and Miracky, 2009, p. 18) give similar trends. From 1986 to 2008, 30.9% of all SWF investments’ deals by number and 54.6% of the value of all acquisitions were in the financial sector. Other targets were real estate (11.9% of deals, 15.3% of value), information technology (7.5% of deals, 7.7% of value), industrials (9.1% of deals and 5.3% of value), and infrastructure (11.9% of deals, and 15.3% of value).

Investments by Gulf SWFs have established similar portfolios, with even more concentration on the financial and energy sectors. Other sectors include real estate, industrial, aerospace, healthcare, and transportation. A close examination of the Gulf SWFs’ portfolios shows that they have disproportionately favoured financial companies, particularly since the early 2000s. At least two factors had contributed to this concentration. First, large banks continued to be regarded as having substantial growth and profitability potential in the medium and long terms. Second, investing in the US and European financial institutions has improved SWFs’ image. Shortly before the eruption of the sub-prime crisis and broad economic recession, many American and European policymakers and media outlets were suspicious of SWFs’ motives and goals. Following their investments in the financial institutions (at a time when some banks were facing serious problems regarding their capitalization) SWFs have experienced a more benign reception and an appreciation of the helpful role they played in a critical phase of market developments (Deutsche Bank, 2008, p. 10).

Another large and growing target of SWF investments is the nascent market for Islamic finance, or investment products that comply with the Islamic law (Sharia). From profit-sharing accounts and crude products, Islamic finance spans derivatives, bonds, fund management, credit cards, and car loans, all of which often use complex structures to circumvent the Islamic ban on interest.

Sharia forbids interest, on the grounds that money alone should not create profit. Thus, the challenge is how to replace conventional financial practices (deemed to be usury-based) with Islamic alternatives (a profit-and-loss sharing partnership).

In recent history, an attempt to reconcile Sharia and modern financial practices was made by the Ottomans in the late 19th century when they introduced western-style banking to the Islamic world to finance their expenditures. While some (fakaha) jurists approved it, others considered them in violation of Islamic prohibition of riba (usury). This lack of consensus lasted through the European colonial period. With the rise of Islamic revival in the 20th century, many Muslim intellectuals have sought to reform Islamic economic systems to adapt to the fast-developing international regimes and norms.

The rise of Islamic finance in the second half of the 20th century coincided with the two oil shocks (1973–74 and 1979–80), which created an immense amount of wealth. Since then there has been a rapid growth in Islamic financial institutions and diversification of available products that comply with Sharia. The goal is to appeal to a growing rich population, particularly in the Gulf region. Some of the earliest Islamic banks of the modern era include Dubai Islamic Bank, Faisal Islamic Bank, Al-Baraka Groups, Kuwait Finance House, and Bahrain’s First Islamic Investment Bank, among others (El-Gamal, 2006, p. 9).

To sum up, SWF portfolios typically involve more diversified asset allocations than traditional reserves holdings, with considerable stakes in equities and a wide geographical dispersion.
Historically, Gulf SWF favoured investments in Western markets. Traditionally European and American capital markets offer the widest selection of investments and a high level of liquidity and are thus able to absorb the large volumes institutional investors typically seek to allocate. Within the OECD, most SWF investments have gone to just two countries, the USA and the United Kingdom. Gulf SWFs make more cross-border investments in US-headquartered companies than in any other country. These heavy Gulf investments in the USA simultaneously reflect and cement the strategic relations between the two sides.

Meanwhile, SWF investments in the United Kingdom have their roots in the establishment of the Kuwait Investment Office in London in the early 1950s. Since then the ups and downs of the British economy have not deterred Gulf SWF investments from coming to London. These strong financial ties are driven by two fundamental dynamics. First, long-standing political and economic relations have served as the glue in strengthening the partnership between Britain and the Gulf states. Second, London enjoys special characteristics which make it a leading global financial services hub, attracting businesses and traders not only from the Gulf region, but from all over the world. These include a legacy of internationalism, tradition of economic opening and stability, and broad and liquid market.

Despite these strong financial ties to Western markets, Gulf SWF have shown great interest in investing in emerging markets in Asia particularly China, Hong Kong, India, Indonesia, Malaysia, Singapore, Taiwan, and Thailand. The underlying reason for investing in Asian markets is their miraculous economic performance over the last few decades. This astonishing performance means that SWF investments in Asia can earn much higher profit rate than in OECD countries.

Finally, the global economic recession of the late 2000s prompted Gulf SWF to invest a large proportion of their assets in their own home countries and the broad Middle East. Gulf states, like the rest of the world, could not escape the severe economic and financial crisis. They called on their SWFs to help addressing challenges such as low financial liquidity, high unemployment and overall stagnated economic systems. They also sought to play a role in helping overcoming the economic crisis in the broad Middle East. As a leading Bahraini banker put it, “True security comes with the stability of one’s neighbors.” (Kerr, 2008).

Gulf SWFs

The Gulf Co-operation Council (GCC) was established in 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates to enhance their economic and financial integration. Its total population (including expatriates) is estimated at 38m., with a GDP of $1.1 trillion in 2008. The six GCC countries possess 40% of the world’s proven oil reserves and provide 23% of global production. The figures for natural gas are 25% of proven reserves and 24% of global production (British Petroleum, 2010, pp. 6 and 22). Their spare oil production capacity accounts for the bulk of the world’s total. All these figures illustrate the leading role the region plays in global energy markets. On the other hand, despite persistent efforts to diversify their economies and reduce their heavy dependency on hydrocarbon resources, the GCC states are still deeply dependent on oil revenues. Oil accounts for about 50% of the region’s GDP and 80% of fiscal and export revenues (Khamis and Senhadji, 2010, p. 1).

The GCC states are home to some of the largest and oldest SWFs, with estimated assets between $600bn and $1 trillion at the end of 2008 (Friedman and Meakin, 2009, p. 65). The main impetus for the growth of these SWFs comes from high oil prices up to 2008. Thus, through most of the 2000s, the GCC states became the largest source of net global capital flows in the world, rivalling China as a “new financial superpower” (Economist, 2008, p. 2).
Countries such as the GCC states that rely on oil and other non-renewable resources for a substantial share of their revenue face two key problems: the revenue stream is uncertain and volatile, and the supply of the resource is exhaustible. Stated differently, government revenue derived from the exploitation of non-renewable resources differs from other revenue in that it partly represents a depletion of wealth. This suggests that some of this wealth should be saved, both to help stabilize the financial market and for intergenerational equity (Davis, Ossowski, Daniel, and Barnett, 2001, p. 4). These two objectives, stabilization and saving, are further reinforced by the fact that most oil-producing countries cannot absorb the amount of wealth they are generating.

The combination of all these factors was the main drive for the creation and growth of a large number of SWFs in the Gulf region. Indeed, each jump in oil and gas prices has increased the number and size of SWFs in the region. Thus, it is not a coincidence that the majority of Gulf SWFs were founded in the 2000s, when oil prices started their inexorable climb to their peak of July 2008, reflecting the confidence of a Gulf flooded with cash. Little wonder, the region represents the highest concentration of SWF assets worldwide. In 2008 analysts at the Deutsche Bank estimate assets under management by Gulf SWFs at $1.6 trillion, representing 46% of total SWF assets worldwide (Deutsche Bank 2008, p. 4). Other analysts raise the share to 60% (Friedman and Meakin, 2009, p. 6). This disparity is due to the fact that most SWFs in the Gulf and elsewhere do not publish official figures of their assets.

The availability of substantial financial resources proved crucial in both the ability of the Gulf SWFs to play a significant role in overcoming the global financial crisis of late 2000s in their own home countries and in continuing their investments, albeit at much lower levels, in troubled Western banks and corporations. According to one source, the market value of the Gulf’s foreign portfolio fell by an estimated $350bn over the course of 2008 (Setser, 2009, p. 1). Another source estimated that the Gulf SWFs lost on average between 20 and 25% of the value of their known equity portfolios (Barbary and Chin, 2009, p. 4). The IMF estimates that the GCC states’ combined current account surplus fell to $53bn in 2009, after having risen more than tenfold in the previous decade to $362bn in 2008. (IMF, 2010, p. 1). Thus, as the global financial crisis deepened, the demand for oil, and consequently the prices, declined. As a result, the stock and real estate markets plunged and external funding for the financial and corporate sectors tightened. Despite these huge losses, Gulf SWFs have managed to maintain their financial leverage. This relative success is due to the execution of comprehensive economic strategies prior to the global financial crisis. The GCC states grew on average by a robust 5.75% per year between 2005 and 2008 (IMF, 2009, p. 6). They launched huge investment projects to pursue economic diversification and human capital development through investments in oil and gas and infrastructure, as well as in petrochemicals, tourism, financial services, and education. In addition, they saved and invested a significant portion of their oil revenues.

This strong economic base has enabled the GCC states to address the severe global financial crisis from a relatively better stance than most other countries. Governments used their strong international reserve positions to maintain high spending and introduce exceptional financial measures. Saudi Arabia adopted a $400bn public investment package (equivalent to 110% of its annual GDP, which was the largest fiscal stimulus package relative to GDP among the G20 nations for 2009–10) to be implemented over five years. The increased spending on social sectors and infrastructure in 2009 cushioned the downturn. Countercyclical fiscal policy in the United Arab Emirates also played a key role in avoiding a major disruption in economic activity. Abu Dhabi’s support of Dubai on the debt crisis has limited contagion to the rest of the economy and the banking system not only in the United Arab Emirates, but in the rest of the Gulf region. In Qatar, the government’s pre-emptive intervention in the banking sector was
equivalent to 6.6% of GDP, mainly in the form of equity injections and asset purchases by the Qatar Investment Authority (QIA). The Kuwaiti authorities’ response to the financial crisis was complicated by prolonged negotiations between the government and the parliament. In early 2010 the parliament approved a four-year $105bn spending package (equivalent to 95% of GDP). The Omani and Bahraini authorities introduced liquidity and prudential measures that helped to mitigate the adverse effects of the crisis, particularly on the banking system (Institute of International Finance, 2010, p. 5).

In short, the GCC authorities’ response to the global financial crisis focused on restoring liquidity by providing capital injections into the banking system, supplemented by deposits from government institutions. To shore up investor confidence, Kuwait, Saudi Arabia, and the United Arab Emirates provided guarantees for deposits at commercial banks and asked SWFs to support domestic asset prices and to provide capital injections for banks. SWF resources in Bahrain, Kuwait, Oman, and Qatar were used to set up funds investing in local equity markets. Furthermore, the KIA and QIA bought domestic bank shares to help boost bank capitalization and confidence. Thus, the experience of late 2000s demonstrates that in the times of financial stress, SWF domestic investments may temporarily deviate from pure profit maximization to support broader macroeconomic and financial stabilization objectives.

The role Gulf SWFs have played in addressing and mitigating the impact of the global financial crisis in their home countries was crucial. On the other hand with regard to foreign markets, on the whole, the Gulf SWFs have weathered the financial storm fairly well, out-performing their Asian counterparts in some cases. Generally, older funds with large and diversified portfolios were somewhat protected from critical damage, while younger funds that pursued aggressive investment strategies fared much worse. For example, after buying stocks in Western banks at the height of the global financial crisis, the KIA sold a large portion of its stakes in Citigroup and the ADIA and the QIA did the same with their portions of the British bank Barclays PLC. The three Gulf SWFs made huge profits in these transactions.

The experience of the last several years has contributed to the formulation of the Gulf SWF response to the criticism and reservations expressed by some Western policymakers and media outlets. Indeed, as their profile has risen in recent years, Gulf SWFs were ill-prepared to counter the negative coverage they received in some European countries and the USA. Officials from the Gulf SWFs have repeatedly argued that their record shows that their investment decisions are driven exclusively by economic and financial interests and that they do not have any political agenda. They rightly challenge politicians in the USA and Europe to name a single Gulf investment that was made for political rather than commercial reasons (Khalaf, 2008).

Gulf investors accept the need for increased scrutiny from recipient countries when the investments have potential national security implication, so long as the process is clear, fair, and timely. In return, they call for a reciprocal responsibility meaning that the entire world community (SWF home and recipient countries) has a shared interest in ensuring that financial markets remain open and that investors (private or government) playing by the rules are not discriminated against, and that the regulatory process remain transparent and predictable (Al-Otaiba, 2008).

Gulf investors also argue that Western suspicions of their SWFs are grossly inflated. The efforts to regulate SWF investment operations are unjustified given that there are no similar guidelines for private-equity or hedge funds and therefore, it is unfair to single out SWFs. They assert that SWFs tend to be passive rather than active investors. On average, a SWF takes less than 5% of the shares outstanding in a company, not a controlling stake. With such a small share, SWFs can hardly be viewed as possessing control over companies (Avendano and Santiso, 2009 p. 12). Furthermore, the majority of the Gulf SWFs use external managers, partly to fill the skill gap and their relative shortage of indigenous professional financial experts.
Two conclusions can be drawn from this discussion of the Gulf SWFs. First, while the GCC states’ short-term economic outlook is clouded by the global economic slowdown and by the credit crisis in Dubai, the region’s medium-term outlook seems broadly positive. This projection is based on the substantial investments in both economic and human infrastructures. All over the region new cities have been built, economic projects and financial centres have opened, and new schools and universities have been established. In short, it can be argued that the Gulf governments have managed their massive petrodollars in the 2000s better and wiser than they did in the 1970s (following the jump in oil prices). Not surprisingly, analysts at the McKinsey Global Institute conclude that petrodollar investors are “poised for future growth in almost any scenario. Their foreign assets reach nearly $9 trillion by 2013 in our base case, and more than $13 trillion if the economy recovers more quickly” (Roxburgh, Lund, Lippert, White, and Zhao, 2009, p. 12).

Second, it is true that the GCC states have amassed immense financial reserves and accordingly managed to weather the global economic crisis much better than many other regions and their outlook in the medium and long terms looks promising. But, their prosperity is still largely linked to oil prices. The efforts to diversify the region’s economies away from oil and create other sources of national income have achieved a modest success.

**Kuwait Investment Authority and Abu Dhabi Investment Authority**

This broad generalization about the GCC economies and SWFs should not give the wrong impression that they are identical. Gulf SWFs differ in their age, size, and investment strategies. They have also adopted diverse stances on transparency, governance, and other issues. A close examination of the region’s oldest and wealthiest SWFs underscores the similarities and differences between these state-controlled funds.

**Kuwait Investment Authority (KIA):** Kuwait was the first oil producing country to establish a SWF, namely the KIA. Sheikh Abdullah al-Salem al-Sabah, the ruler of Kuwait from 1950–65 decided in 1953 to establish the Kuwait Investment Board (KIB) with the aim of investing the surplus oil revenue in order to provide a fund for the future and reduce reliance on a single finite resource. The Kuwait Investment Office in London (KIO) was set up to pursue these objectives. Preparing for independence from the United Kingdom, the Kuwaiti government established the General Reserve Fund (GRF) in 1960. The GRF is the main treasurer for the government and receives all revenues (including all oil revenues) from which all state budgetary expenditures are paid. It also holds all government assets.

In 1976 Jaber al-Ahmed al-Jaber al-Sabah, Deputy Emir of Kuwait and Crown Prince, issued Law No. 106, under which the Future Generations Fund (FGF) was established. Article 1 stated: “An amount of 10% shall be allocated from the state’s general revenues every year.” Article 2 stated: “A special account shall be opened for creating a reserve that would act as an alternative to oil wealth. An amount of 50% of the available state’s GRF is to be added to this account.” Finally, the law stipulated that the Ministry of Finance shall employ these funds into investments, and the profits accruing from them shall go into this account (KIA 2009A).

Finally, in 1982 Jaber al-Ahmed al-Sabah, Emir of Kuwait issued Law No.47, establishing the Public Investment Authority, now known as the KIA. The law stated that the objective of the KIA is to “undertake the management of the GRF, the monies allocated to the FGF, as well as such other monies that the Minister of Finance may entrust the KIA with its management” (KIA 2008). The KIA’s mission is to achieve a long-term investment return on financial reserves, providing an alternative to oil reserves. In 1986 the KIA’s revenues from investments exceeded revenue from exporting oil.
The degree of transparency of the KIA cannot be understood in isolation of the broader socio-economic and political system in Kuwait. Many Kuwaitis take pride in the fact that in 1962 their country was the first Gulf state to adopt a parliamentary democracy and a constitution. For many years the Kuwaiti press was among the most open in the Gulf region and the broader Middle East. Furthermore, the Kuwaiti General Assembly (parliament) has enjoyed real power in supervising public policy. This parliamentary power was clearly demonstrated in 2006 when a succession crisis erupted and the parliament members voted Sheikh Sa’ad al-Abdullah al-Sabah, the then Emir, out of office on health grounds.

Members of the Board of Directors and the employees of the KIA are banned from disclosing data or information about their work or the position of invested assets, without a written permission from the chairman of the Board of Directors. Meanwhile, the KIA’s activities are reviewed by both external and internal auditors. The Board of Directors appoints an external auditor, who reviews the FGF and GRF as well as the funds managed by the KIA. The KIA has an independent Audit Department that reports to the chairman of the board. In addition, the State Audit Bureau has on-site personnel to monitor KIA’s activities on an ongoing basis. Finally, the KIA makes annual closed-door presentations on the full details of all funds under its management, including its strategic asset allocation, benchmarks and rates of return, to the Council of Ministers and to the National Assembly (KIA 2009B).

Like many other SWFs, the KIA does not disclose information on its assets, rates of return, and allocations of its investments. However, in the last few years some data became available. In 2007 the Kuwaiti finance minister Bader Mishari al-Humaidhi announced that the KIA’s assets had reached $213bn, the largest in the country’s history. Due to the global financial crisis, the KIA, like other SWFs, lost a proportion of its assets.

Investment guidelines prohibit the KIA from investing in the following: a) share ownership in companies whose principal business involves gambling, alcoholic beverages or adult entertainment; b) private placements and venture capitalization; and c) investing in single issuer/issue in excess of 5% of the portfolio at the time of the purchase (KIA, 2009C). Historically, the KIA pursued a conservative investment strategy aimed at preserving capital. Accordingly, the bulk of the KIA’s assets were invested in US Treasury. With a new management since the mid-2000s, the KIA has moved away from safe but low-return bonds and started to invest in alternative assets, such as private equity, real estate, hedge funds and commodities. Like other Gulf SWFs, the KIA has targeted Islamic finance and purchased stakes in Islamic financial institutions and the securities they issued. Other major investments were allocated to Daimler AG, the owner of Mercedes-Benz, and British Petroleum (BP).

In addition to these changes in the KIA portfolio, the fund has sought to diversify its investments across various geographic locations. Owing to historical and strategic strong ties with Europe and the USA, KIA’s holdings in these two markets are significantly high. This geographical allocation has witnessed fundamental changes in recent years. The KIA management has expressed strong interest in investing in emerging markets in Asia. The drive behind this shift is commercial. As Bader al-Sa’ad, managing director of the KIA argued, “Why invest in 2% growth economies when you can invest in 8% growth economies” (Sender 2007).

Finally, at the peak of the global financial crisis many Kuwaitis and the parliament called for the government to spend more of its wealth at home to stabilize the country’s economy. The KIA pumped $418m. into Gulf Bank, Kuwait’s fourth-largest traded lender, after it suffered heavy derivatives-trading losses. The KIA also invested $5.2bn as part of a government fund to stabilize the stock market. Despite this scale back on investments overseas and focus on local economy, the KIA managers have been aware of the fact that the global economic crisis offers some investment opportunities and have sought to take advantage of such “bargains.”
Abu Dhabi Investment Authority (ADIA): The ADIA is one of the wealthiest and oldest SWFs. It was established in 1976 by Sheikh Zayed bin Sultan al-Nahyan, the founder of the United Arab Emirates. The ADIA replaced the Financial Investment Board, created in 1967 as part of the Abu Dhabi Ministry of Finance. ADIA’s current constitutive document is Law No. (5) of 1981, which provides separation of roles and responsibilities among the Abu Dhabi government and the ADIA management. The main objective behind the creation of ADIA is to invest funds on behalf of the government of the Emirate of Abu Dhabi to make available the necessary financial resources and maintain the future welfare of the Emirate (ADIA, 2010A).

The ADIA is not the only SWF in Abu Dhabi and the United Arab Emirates. Since the early 2000s a number of SWFs have been established. The creation of several funds reflects the accumulation of massive wealth due to the rise of oil prices up to July 2008 and the interest in pursuing several financial strategies. Some analysts also suggest that these funds illustrate the influence of various members of the royal family. For example, Sheikh Khalifa bin Zayed al-Nahyan, President of the United Arab Emirates and ruler of Abu Dhabi, is the Chairman of the Board of Directors of the ADIA. Crown Prince Sheikh Mohamed bin Zayed al-Nahyan is the chairman of Mubadala. His full brother Sheikh Mansour bin Zayed al-Nahyan is the chairman of the International Petroleum Investment Company (England and Khalaf, 2009).

Still the ADIA is the largest SWF in Abu Dhabi and the United Arab Emirates.

ADIA’s Board of Directors comprises a chairman, managing director, who along with other Board members, are appointed by a decree of the Ruler of Abu Dhabi. The Board holds primary responsibility for implementation of ADIA’s strategy. It also oversees ADIA’s financial performance and the activities of management. The Board does not involve itself in ADIA’s investment and operational decisions, for which the managing director is responsible. Several

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<th>Table 26.1 Portfolio Overview by Asset Class</th>
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<tr>
<td>Alternative</td>
</tr>
<tr>
<td>Real Estate</td>
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<tr>
<td>Private Equity</td>
</tr>
<tr>
<td>Infrastructure</td>
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<td>Cash</td>
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<th>Table 26.2 Portfolio Overview by Region</th>
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<tbody>
<tr>
<td>Minimum</td>
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<tr>
<td>North America</td>
</tr>
<tr>
<td>Europe</td>
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<tr>
<td>Developed Asia</td>
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<td>Emerging Asia</td>
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</table>

committees provide assistance to the Board of Directors including Investment, Strategy and Guideline Committees as well as Evaluation and Follow up Department (ADIA 2010B). The ADIA management depends heavily on foreign experts. United Arab Emirates nationals make up around 30% of the total analysts (ADIA 2010 C).

Until the late 1980s, ADIA invested in mostly low-profile, conservative havens like US Treasury securities and government bonds. However, in recent years it has altered its asset allocation substantially and became a more risk-tolerating investor. ADIA has always sought to have a diversified portfolio, both across regions and asset classes, as Tables 26.1 and 26.2 illustrate.

ADIA usually does not invest in the United Arab Emirates or in the Gulf region, except in instances where such investments constitute part of an index. Like other Gulf SWFs, ADIA has recently taken a closer interest in emerging markets, particularly China and India. ADIA has pursued investment opportunities in insurance, financial, infrastructure, and energy sectors.

In March 2010 ADIA published its first annual review, marking the first performance disclosure of any sort since the fund was established in 1976. The review states ADIA’s 20-year and 30-year annualized rate of return to the end of 2009 was 6.5% and 8%, respectively. The fund, however, declined to divulge its total assets. Whatever these assets are, it is likely ADIA, like other SWFs, has suffered significant losses as a result of the global financial crisis.

Conclusion

The global financial crisis in the late 2000s and the constructive role Gulf SWFs have played in the efforts to overcome the challenges and provide liquidity have partly reduced the intensity surrounding SWFs. It is uncertain what direction the controversy might take in coming years. Will sceptics in the USA and Europe accept these government-controlled investment vehicles? Or will they seek more regulations? The experience of the last several years suggests a few lessons. First, the financial muscles and leverage Gulf SWFs might have in coming years will largely depend on the future oil prices and the scale of their domestic spending. The higher the price and less domestic spending, the more assets they have to invest overseas.

Second, while some information on Gulf SWF assets, strategies, management, and governance is available, there is no uniform public disclosure. As the KIA’s and the ADIA’s experiences suggest, a number of SWFs have come to accept the need for transparency and accountability in recent years. This acceptance might be driven by pressure from domestic public opinion or the desire to adhere to Santiago Principles. Still, there is much to be desired. Third, both SWF host and recipient countries share a mutual interest in maintaining an open international investment climate in which all participants have confidence. A sensible management of oil-producing countries’ petroleum wealth in well-functioning financial markets is in everyone’s interest.

Fourth, the record of Gulf SWFs and indeed most SWFs demonstrates that they are generally passive investors with no desire to impact company decisions by actively using their voting rights, purchasing controlling shares, replacing old management, or any other means. Furthermore, there is no evidence that these SWF investments are motivated and driven by political objectives. Like other investors, Gulf SWFs seek to maximize their profit.

Finally, in the last several years there have been many political and academic arguments put forth regarding the potential positive and negative effects of SWFs on global financial markets. Despite the hyper-ventilation surrounding SWFs, a close examination suggests these funds are not threatening to the established financial system. Rather, the evidence suggests that they can be, and have been, a stabilizing force.
References


